2015

The role of the banking system, the private investors and the government in the rise and fall of the Cyprus property market

Raftis, George

Real Estate Valuation and Development, School of Architecture, Land and Environmental Sciences, Neapolis University Pafos

«The role of the banking system, the private investors and the government in the rise and fall of the Cyprus property market »

BSc Real Estate Valuation and Development-
George Raftis

«No human agency has achieved so much economic destruction in such a short period of time without the use of weapons »

Pawel Morski about Cyprus

Chapter 1

Introduction

The property market in Cyprus is of enormous importance to the economy as it plays an important role in the wealth of households and portfolio investors alike (Boydell and Clayton, 1993).

During the last decade in Cyprus, due to various socio-economic changes (such as the liberalization of the financial markets, low interest rates, increase in stock market returns, increase of the purchasing power of sterling against the euro and the accession of Cyprus to the European Union and the Eurozone), property values witnessed phenomenal growth particularly during the period between 2002 and 2008.

Property is the bulk of a household's wealth as the value of their property assets has a significant effect on the propensity for consumption and savings. So any changes in real estate prices will have an impact on the behaviour of the household.

The importance of the housing sector is not confined within the narrow limits of family and household since it is connected with the creation of positive externalities related to economic development, public health and social environment (Warnock, VC & Warnock, FE, 2008; Montgomery, MR, & Hewett, PC, 2003, Atterhog, M., 2005).

For participants in the financial system and the property market, the level and uncertainty of future property prices play a decisive role.

Particularly on the part of financial institutions, housing is the most common form of loan guarantees for households therefor housing loans constitutes a large portion of banks' assets. During the last decade mortgage lending has experienced unprecedented growth. While in the past buying a house was funded primarily through household savings, today the majority of transactions is financed by banks. Therefore, property prices significantly affect the balance sheets of banks. The recent crisis illustrates that changes in value can have dramatic effects on financial institutions and consequently economies.

For the public sector, fees and taxes are large contributors to the economy. In Cyprus, the revenue from the real estate transactions in 2007, at the peak of the market, amounted to 465 million euros, representing 22% of the total government revenue. Furthermore, according to Schulz and Werwatz, (2004) the Government and monetary authorities are interested in the property prices in an effort to regulate the market in order to work competitively and to maintain monetary stability.

Determining factors for property values are characteristics such as type, size and location. But these characteristics usually change in the long run and are not responsible for changes in property values from one year to another. For these short changes macroeconomic indicators must be responsible. The importance of these is perceived by government policies resulting in every political agenda to include actions related to property taxes, property development, mortgage loans the construction sector, labour market, etc.

Cyprus' land development sector and particularly housing are contributors of a considerable proportion of economic activity and GDP. They are connected with a large number of other goods, services and jobs while in addition housing sector is for Cypriots not only a necessity but also a form of investment and savings (C Hardouvelis 2009). In the case of Cyprus main macro-economic factors such as employment and the financial system had adapted for so many years in the above peculiarity of the Cypriot reality so that the current economic crisis has turned into a form of chain reaction for the main productive sectors of the country.

Research Aims and Objectives

The main objective of this dissertation is to examine the distraction of the property market in Cyprus which was well performing for many years leading to the outburst of the global recession.

Cyprus and the euro area as a whole have come across difficult challenges due to the global financial crisis that erupted in 2007 in the USA and gradually became a debt crisis. Today the euro area is plagued by large fiscal imbalances, high increase in unemployment, anaemic growth and other social problems. It is very important to investigate both the state of the property market and the state of the economy in general as the two are interconnected and influence one another. The state of the economy influences the property market through various macroeconomic factors such as unemployment, inflation, economic output, savings and investment which all affect the demand for housing. Through the analysis of the recent crisis, important questions arise relating to processes and institutions, which sometimes need to adapt and other times be formed from the beginning. As each crisis is unique, investigating the causes and the consequences that followed is not intended to create a "guide" to avoid future crisis, but rather to provide a deeper understanding of the channels through which an initially small crisis was channelled throughout the economy and society.

In order to achieve the main objective, a following of questions have been generated as seen below:

- What was the role played by the banking system and private investors in the rise and fall of the property market and the Economy?
- What was the contribution of the government of Cyprus and European Union’s decisions and their impact on the real estate market and the economy?

The target audience for this research is property professionals, the banking sector, real estate investors and the government of Cyprus. It aims to provide a better understanding of the under-researched crisis in Cyprus and what are the lessons to be learned moving forward.

Research methods

The objectives of this research will be examined via a qualitative research through interviews with professionals operating in the island's property market. In order to conduct the research, data has been gathered through the use of semi-structured interviews. This approach was selected in order to engage in a more fluid form of interview and allow the participants to express their thoughts and opinions in greater depth. A total of 26 questions were prepared in order to get a broad idea regarding the research questions. The questions were also designed to allow for in-depth analysis of the thoughts and opinions of the interviewees. The data was analysed by looking at patterns as to the reasons and channels through which the property market in Cyprus was hit by the global crisis.

Aspects of research

The dissertation is split into five sections. Following the introduction, Chapter two will examine the literature looking into economic cycles the phenomenon of the property bubbles, the recent economic crisis. In addition, a review of the literature related to behavioural investment and macroeconomic factors affecting the property market will be looked at. All of these topics are of interest to the housing market as they influence its performance within the economy.

Chapter 3 will provide an overview of the methodology used to gather information and analyse data. It will also describe the research process showing the procedures followed.

Chapter 4 will provide the analysis of the findings having the research objectives in mind while examining any new avenues requiring further research.

Chapter 5 will draw a conclusion based on the findings of the previous chapters and finalize the arguments.

Chapter 2

Literature Review

The Global Economic Recession

The current economic downturn is the result of a mix of serious weaknesses and global macroeconomic imbalances in the western economic models and the United States of America (McKibben, 2007; Cooper, 2008).

The low real interest rates led to a striking increase in high risk loans. The aggressive lending policies combined with the explosive growth of the leverage of households contributed to the increase in property prices. At the same time the value of the collateral and therefore the bankruptcy risk of a household did not seem to contain the expected losses for banks.

As expected, the continuous and substantial increase in the price of housing fed speculation in real estate investment. The general euphoric climate led to the issuance of more loans, therefore investment in housing increased.

In order to entice more and more investors, banks invented the Adjustable Rate Mortgages (ARM). With these loans, the borrower bears the entire burden of any change to the actual debt during the start of repayment (especially in periods of high and volatile inflation). The fact that borrowers preferred loans instead of the Fixed Rate Mortgages (FRMs), is a paradox for economic theory, since borrowers should have preferred FRM, which transferred the interest rate risk to the lenders, rather than borrowing at a variable rate (Leece, 2004).

The effect of the widespread use of ARMs, is shown in the research of Jones et al(1995) for the USA and Leece (2001) for the United Kingdom, highlighting the excessive optimism of borrowers, which leads them to prefer, ceteris paribus, the more short term ARMs on particular interest rate levels (Leece, 2004).

ARM rates were for a period of time below the market and when after this period there had to be a higher rate payments, a refinancing of the mortgage would be done

(Lee and Pace, 2006), as the value of the property would have been significantly higher. In this way, both the buyer and the provider of the loan would enjoy profits.

The practice of securitization was a way of converting loans into tradable assets and at the same time a way for the banks to convey their demands off balance, exempted from the obligation to comply with additional provisions to cover credit risk. Thereafter worked with credit rating companies (Moody's, S & P, Fitch) to rate loans and result of high scores was the demand from investors small amount of guarantees to cover risks assumed and therefore there is great demand particular class of securities.

As a result of inflation, the '06 rates began to raise, monetary policy tightened and the market reached saturation. At that point it became apparent that there was a property bubble in the USA's real estate market. Real estate prices started to fall in mid '06 and stabilized in April '09.

The fall in prices of that period resulted in late payments on loans which had multiple effects on the financial system. Many borrowers had entered during the phase of higher repayments and low interest rates which were no longer able to be serviced or replaced by cheaper loans. Borrowers began to realize that the value of the house they had bought fell below the value of their loan resulting in them handing it over to the bank. Since then more and more households went bankrupt and at the same time more and more homes entered the real estate market causing lower prices dragging down the loan guarantees.

The collapse in the real estate market caused defaults on obligations in the USA's subordinated mortgage market. In June '07 two Hedge Funds of the fifth largest investment bank in the United States, Bear Stearns, collapsed so Bear Stearns provided $ 3.2 billion in loans to keep them alive. The damage had already been done though and the following month the funds had lost more than 90% of their value. This was just the tip of the iceberg that had already been created.

The collapse of Bear Stearns revealed the combination of two events which precede the financial crisis, the credit expansion which increases the leverage of financial institutions and the bubble in the capital market for a financial asset involving unusually high prices as it happened in the housing market (Acharya et al, 2009-Carmassi et al, 2009).

In August '07, French bank BNP Paribas temporarily suspended the impunity of three structured investment vehicles (SIVs0). This affected the investor confidence for the reason that the perception of the bank's portfolio was that there were financial instruments of dubious quality and subordinated debt. The announcement froze the market and brought the crisis to the next level.

The pinnacle point was the bankruptcy of the fourth largest investment bank in the USA that of the Lehman Brothers. The government of the United States, when some of the banks were rescued , considered appropriate mainly with ideological criteria that would not be a problem to let Lehman Brothers collapse, as an example of discipline and responsibility to shareholders and creditors. The fourth in size bank of the United States had $ 600 billion liabilities in capital to thousands of investors worldwide, participated as a member in 30 international payment systems, settlement and custody of securities and had concluded 900,000 derivative contracts with third parties, worth three trillion dollars, mainly with international banks and institutional investors. As a result, the bankruptcy immediately created global chaos; with investors speculating which will be the next bank to collapse. This insecurity spread the crisis in financial markets worldwide in lightning speed.

These in result led the investors to reassess their investments, while they realized that they did not understand the nature and extent of the risks, leading to swift price decline of the subprime market.

The problem for banks inflated when empty dwellings held by banks began to lose value even further, even sections of the securitization which were considered relatively safe were making losses. The banks in their effort to keep stable the relation equity / assets, as required by the supervisory authorities, they begun selling the assets at extremely low prices. The suffocation in the interbank money market, led to the crisis of confidence between financial institutions and limiting the possibility of refinancing the banks, had as a result the situation to start affecting the real economy negatively making it impossible for entrepreneurs and individuals to borrow.

Private Investors in Cyprus - Behavioural finance and the role of Investors

Behavioural economics draws data from other social sciences, particularly sociology, psychology and anthropology for understanding the behaviour of individuals in the financial markets. It emphasizes on the decision making of people who are not always the result of a rational process, but rather directed by emotional factors and psychological limitations. The psychological limitations, also known as biases, affect how people gather information and use them to take decisions in general in their lives and also in investing. The investments decisions of people which are influenced by psychological biases are most often wrong because they are not the result of a logical thinking but rather contain elements of fear, emotional confusion and greed leading to undesired results. (Alexakis and Ksanthakis 2008)

Thus, when prices rise, they rush to acquire assets, considering that in the future it will be more difficult to acquire or that the annuity they will receive from an investment will be significant. Conversely, when prices fall, they rush to sell their property in order to minimize the losses. Analogously this is how the real estate market works thus intensifying the overall characteristics of the property cycles. Thus, demand and property prices increase during periods of economic prosperity and upward movement of the cycle. During the upwards movement of the property cycle, the time of onset and intensity of the above phenomenon compounded by the slow production of new buildings an interval of about two years is needed from the time of manifest demand and for it to be satisfied. Therefore supply falls short of demand for some time, with obvious impact on prices. The opposite happens in times of a downturn on the cycle. Regarding the number of real estate transactions and their price. Renard (1993) emphasizes that they grow swiftly in periods of market expansion (effet de levier), while in periods of shrinkage they slowly decrease, because owners refuse to accept the reduced value of their property and sell at a lower price than the maximum they had achieved at the pinnacle of the market (effet de cliquet).

According to behavioural economic approaches, most investors do act like the crowd, obeying herd instincts causing an overheat of the markets and bubble as a result (Shiller, 1995). The phenomenon of herd mentality and behaviour initially attracted the interest of psychology and then economics.

An approach to the phenomenon of "herd behaviour" is needed to analyse its causes and effects as much as in micro as in macro-scale. The contingency for this was the mitigation of the neoclassical idea of The Efficient Market Hypothesis, the rationality of people and the Homo Economicus, who dominate most economic approaches, while some social psychologists do not recognize irrationality in the behaviour of the crowd, such as Turner and Killian (1957). The latter even consider that mimicry as a concept of psychology - should be placed primarily in a sociological approach (Borch, 2006).

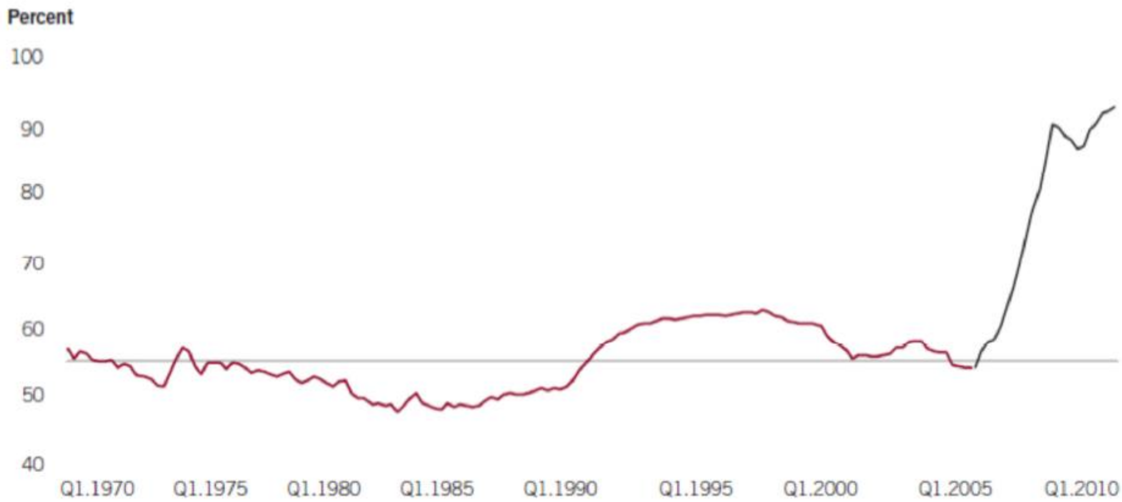
Finally, the concept of “bounded rationality” should be mentioned as introduced by the economist Herbert Simon in the early 1950 (Simon, 1986). This concept is now acceptable by psychologists and furthers the understanding between psychology and economics. According to the concept, factors inherent in human nature, and the broader institutional environment lead people astray from the best possible economic decisions.

Real Estate and the Banking Sector

In 2008, the volume of mortgage loans in the EU's 27 member states reached 49.8% of the total GDP (EMF, 2009). These percentage shows that the role of this kind of debt is very crucial for the housing market, banking sector and the economy generally. Any reduction in property prices may result in reduction of bank capital, limiting bank lending and thus reducing investment in housing (Case EK et al, 2000).

This relation is confirmed also by Adams & Fuss (2010) who further argue that the increase in house prices in turn leads to increases of bank lending which become more pronounced as the Loan to Value (LTV) ratio becomes higher. Figure 1 shows the development of the LTV ratio for the United States between 1970 and third quarter of 2011 It shows the very large increase in the index for the period between 2005-2010.

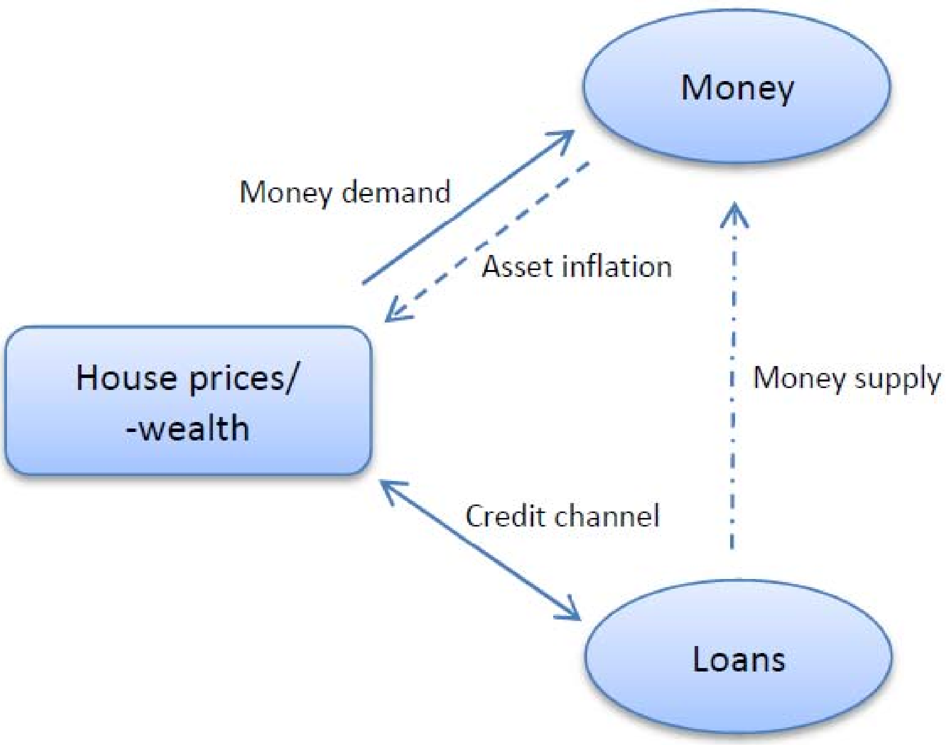
Figure 1: LTV ratio in the USA (Feroli M. et al, 2012)



Tsatsaronis K. & Zhu H., (2004) used a Vector Auto-regression (VAR) model to depict that the relationship between house prices and bank lending is influenced largely by the banking practices regarding collateral. So when leverage is large (large LTV) a strengthening of this relationship is observed. In contrast when the LTV is low the relationship becomes weaker. Essentially when banks' requirements in collaterals loosen and the mortgage market gets deregulated, the demand for housing increases causing property prices to increase (short term supply in housing is relatively inelastic). Rising prices lead to a rise in the value of mortgages and improves the creditworthiness of borrowers making them able to borrow more. This situation where the volume of loans increases rapidly with the increase in price is a strong indicator of potential future bubbles and economic crisis (Borio, C. and P. Lowe, 2002).

This correlation is schematically shown in Figure 2 below. Money is connected with the housing market through the channels of money demand and inflationary trends of assets while the funding channel works in both directions with the increase of prices and loans interacting with each other.

Figure 2: Money, Loans and Housing (Greiber, C. & Setzer, R., 2007)



Therefore the connection between house prices and loans operate in both directions (Igan D. et al, 2011) with a mechanism known as financial accelerator (Ben Bernanke et al, 1998)

Igan D. Et al (2011) conclude that In the long run real estate prices drive and affect both the lending for housing and the real economy (data from 18 advanced countries). Finally Iacoviello & Pavan (2011) confirm recent empirical evidence by concluding that under high leverage the housing market is more responsive and more vulnerable to negative shocks than positive ones.

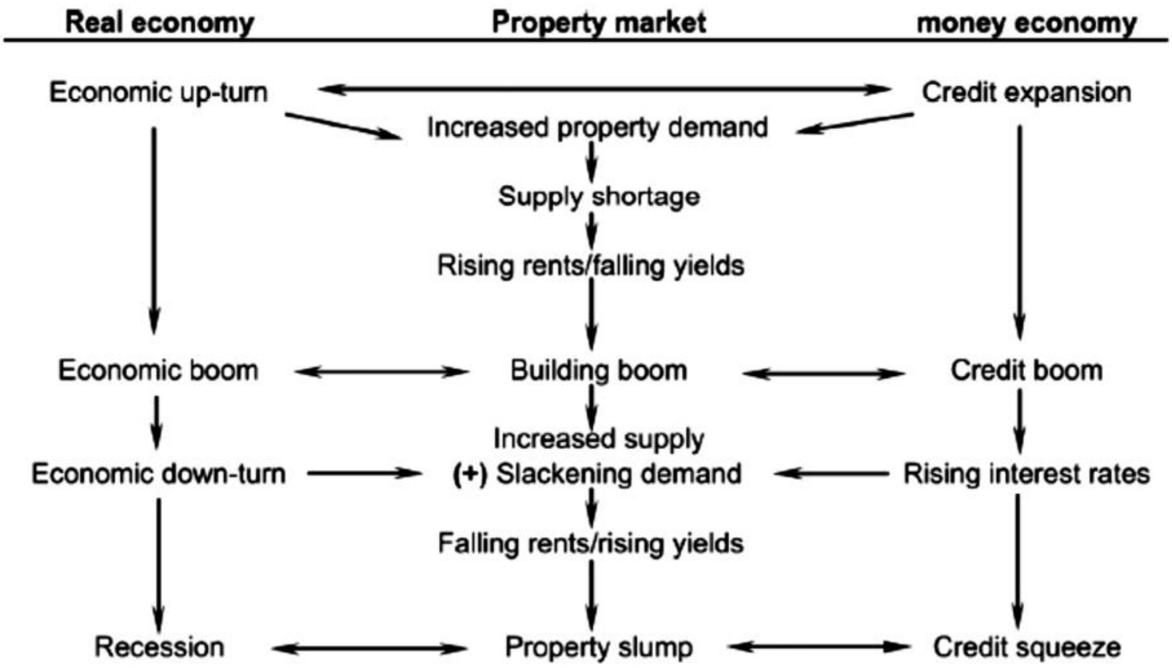
Generally, the description and analysis of the above mechanisms has been the subject for literature for many years and the researchers conclude to the fact that house prices affect the field of finance and the same occurs also in the opposite direction with increased force.

Economic Cycles

Business cycles are fluctuations in economic activity of countries which have organized their production operation through businesses activity (Burns & Mitchell, 1946). Each cycle is repetitive, but not periodic, and comprises bulges which occur almost simultaneously in many economic activities, followed by recessions and depressions, and then lead to recovery by entering the development phase of the next cycle. The cycles in the property market are defined by recurrent fluctuation around a steady state incurred due to instability introduced by a strong economic change (shock) (Wheaton, 1999).

The way in which the construction cycle works is very interesting and can be seen through the model of Barras (1994) which is schematically shown in Figure 3. In the initial phase there is an increase in economic activity and relative shortage in supply of housing after a period of low growth in the previous cycle. The limited supply and improving demand result in increase in house prices and accelerates construction activity. Where the enhancing of construction activity is accompanied by an increase in funding, a financial bubble might occur which leads to a second wave of speculative development activity. Considering the time lag involved in the construction of new buildings, the demand and supply is not immediately affected, resulting in prices to continue to rise. When a large volume of new projects is released into the market, the first signs of a pending recession appear due to falling business activity, limitations in the supply of money and rising interest rates. When the supply overcomes the demand, it results in rents along with house prices to fall while the housing stock increases. The economy then goes into a recession, prices decline further, firms are unable to meet their debt obligations and many are driven into bankruptcy while the property market is characterized by a large stock increase of unsold properties and low prices.

Figure 3: Operation cycle of building construction (Barras, 1994)



From the figure above we see a clear relationship developing between the real economy, real estate market and bank lending. Several researchers have studied the relationship among the cycles in these markets. Leung (2004) through a literature overview presented his views along with research results around the quantitative and qualitative dimension of the relationship between business and housing cycles. Their findings suggest that both in empirical and theoretical level, the two markets are interrelated and go hand in hand. Davis, M. a. & Heathcote, J., (2003) studied cycles for housing and business activity through their respective investment and confirmed the conclusions of previous researches showing that business investment and housing move together while the degree of volatility of housing investment is twice more volatile than the one of business. Alvarez et al (2010a, b) monitored comparatively the market cycles for housing of four European countries (Germany, Italy, France and Spain) and discovered that although the GDP cycle for these countries was synchronised that was not the case for the housing market cycles, where due to cultural differences and specific characteristics of countries, movements differ. Focusing on the Spanish market they found that between the housing and the business investment there is a lead - lag connection. Finally Bracke (2011) studied housing cycles of 19 OECD countries with data over the past 40 years focusing on their time duration. The overall analysis showed that the upstream portion of the cycles, on average, is larger than the downstream portions. These intense periods of housing activity are characterized by rapid price increases, high transaction volumes, and strong construction while the succeeding inactive periods are characterized by low levels of trade and slow price adjustment. Generally an overheated economy with an unusually large, in duration and size, increase in GDP is very likely to face falling prices in the housing market.

Macroeconomic approach Values

Baffoe-Bonnie (1998) showed that a sudden increase in the money supply lowers interest rates and hence the cost of using property. Studies were carried out to examine the impact of macroeconomic variables on house prices which normally arise from changes in supply and demand for housing. This leads to an increase in demand and prices for residential units.

In addition to the money supply, other economic variables which affect house prices is employment / unemployment, the level of interest rates, gross domestic product (GDP) and inflation as supported by Smith and Tesarek (1991) and Sternlieb and Hughes (1997). Hartzel et al (1993) emphasize that employment plays an important role in the decision of investors. Furthermore, Giussani et al (1992) found that GDP has a significant positive effect on house prices. Regarding the impact of inflation in the housing sector, several studies conclude that the increase in inflation reduces the demand for real estate (Kearl, 1979; Hendershott, 1980; Poterba, 1992). Specifically, Feldstein (1992) argues that inflation reduces the incentive to invest in real estate, therefore reducing the demand for housing. Kearl (1979) argues that inflation leads to lower demand for housing, due to an increase in nominal payment for mortgages.

Economic activity affects the housing market in two ways: a) the income effect and b) the inflation.

Under the income effect, economic growth improves household income, so households who rent decide to buy in order to meet their housing needs. It should be noted that economic activity strengthens the housing market only if the growth does not cause additional inflationary pressures. It is known that if growth results in inflation, the borrowing costs will rise and the financing of the market will fall, causing prices to decline, this is the result of inflation.

Consequently, whether the improvement in economic activity encourages purchasing interest in the housing market or not depends on which of the two effects will prevail. If the income effect prevails, the demand for housing increases by an improvement in economic activity. However, when the inflation overrides, demand for housing will decline causing house prices to fall as a result.

The mortgage interest rate is an important variable that affects the housing demand, as shown by the studies of Muellbauer (1992), Muellbauer and Murphy (1997) and Maclennan et al (1998). The increase in interest rates increases the cost of money and prevents people from borrowing, causing the demand and the prices to fall.

For the real estate market in Cyprus a limited number of researches have been made . The study of Platis and Orfanides (2005) focuses on macroeconomic factors suggesting that factors such as consumer's income, cost and terms of financing, construction costs, land values, the behaviour of the market; supply and demand and cultural characteristics play a significant role in the activity of the housing market. However, the study is descriptive, not based on statistical and econometric data.

Chapter 3

Methodology final

Research Aims, Objectives and Questions

This dissertation has the main objective of examining the destruction caused in the property market of Cyprus, which was well performing for many years leading to the outburst of the global recession. The country's economy and property market have been performing very well for the past 30 years. Following the Turkish invasion in 1974, the economy of the island restarted and had a growth rate averaging above 10% while having a low unemployment and inflation rate. In 2001 Cyprus was rated by the IMF to an advanced economy from its previous developing country status. In the years leading up to 2008 the country experienced an exponential rise in property values especially in the period between 2006 to 2008 only to drop sharply thereafter.

In order to achieve the main objective, a followed of questions have been generated as seen below:

- What was the role played by the banking system and private investors in the rise and fall of the property market and the Economy?

- What was the contribution of the government of Cyprus and European Union's decisions and their impact of the real estate market and the Economy?

Theoretical methodological approach to research

The method to be adopted for the conduct of an investigation depends on how appropriate it is for the subject under study (Strauss & Corbin, 1998, p. 29). For this dissertation, the interview was chosen as a suitable research tool, because this method is appropriate for a qualitative analysis. Central position of qualitative research is to understand the subjective world of human experience. Furthermore, this approach addresses the social reality as a result of the action of individuals (Cohen & Manion, 1994, p. 63).

The behaviour exhibited by people, therefore, is one that illustrates the social reality (Kyriazis, 2004, p. 18). Supporters of this approach believe that in order for the researcher to understand the values and behaviour of individuals, they must choose appropriate research tools which are quite sensitive and will be able to better grasp the subject of research (Creswell, 1998, p. 124). The desire to examine and interpret the opinion of property professionals, led to the selection of qualitative analysis as a method of approach. In particular, interviews were chosen as the most suitable research tool.

The interview is a form of conversation, which is structured and organized by the investigator in the form of questions and answers (Mishler, 1996, p. 11). The interview is defined as the discussion of two people, starting from the interviewer, with the specific purpose of obtaining research-related information, and focuses on content specified by research objectives with systematic description, prediction or interpretation (Cohen & Manion, 1994, p. 374). It is a methodological tool that allows the exploration of feelings and thoughts of the participants from their own perspective (Rubin & Rubin, 1995, p. 1). Also the interviewer can investigate the behaviour of the subject in relation to the object of research, but also to understand how the participant interprets a situation (Burton, 2000, p. 197). According to Cohen & Manion (1994), interview compared to other methods of data collection allows greater depth. Furthermore, according to Silverman (1997) during the interview, both the interviewer and the interviewee are acting subjects, i.e. both involved in shaping the research results.

A quantitative research was considered but due to the reason that the data of property market in Cyprus is insufficient and unreliable, the quantitative research was declined.

Chosen Data Collection Method

The type of interview that was chosen for this research is the semi-structured interview model. It is characterized by the fact that before conducting the interview, the researcher prepares questions in order to make sure that all aspects of the research will be covered (Patton, 1990, p. 280). The semi-structured interview allows, the researcher the freedom to introduce questions during the interview that will lead to the investigation of the research questions (Ellen, 1990, p. 230). Thus, given the ability to see beyond the structured questions already prepared prior to the interview.

From all the types of interviews that exist, individual interview was chosen as the most appropriate one to explore the subject of the investigation. The individual interview allows the researcher the opportunity to exam in depth the personal view of the interviewee (Burton, 2000, p. 199).

The type of questions that were selected during the organizing of the interviews, were the open type instead of the closed ones. This kind of questions provides the interviewee the opportunity to elaborate, periphrastically and on their own terms (Patton, 1990, p. 295).

The advantages of open-ended questions with respect to the closed questions are that they give the opportunity to the interviewee to express more freely and do not feel directed by the interviewer (Burton, 2000, p. 199). They are also flexible, encouraging cooperation between the researcher and the respondent which result in unexpected answers which may indicate relationships and assumptions that were not considered until that moment (Cohen & Manion, 1994, p. 381).

Certainly, in the interview lays the validity and reliability of the research. The validity concerns the degree of achievement of the purpose for which the interview was created. The researcher should design the form of questions in such a way that there is cohesion between questions and research questions. Thereby will ensure the validity during structural configuration of the interview.

Reliability is interconnected to the stability of the results of the interview in repeated measurements of research. The researcher's familiarity with the interviewee, the anxiety levels of the interviewee and overall conditions under which the interview is conducted can affect the results of the investigation, all of the above factors were taken into consideration.

Participants

For the interview selected individuals' professionals working within the Property market of Cyprus. They have professional background ranging from Property valuers, Real Estate agents, Property analysts and Property developers. This selection of participants is considered to be appropriate for the purpose of this study. For the objectivity of this research study we depend on their professional knowledge and inner understanding of the property market of Cyprus, they provided the researcher with reliable data which in turn was examined and analysed to reach the best possible conclusions.

Participant Recruitment

The participants were randomly selected through business websites and yellow pages entries of companies active currently in the market. Emails were sent to these companies asking whether any individuals within their organisation were willing to participate in this research. This strategy was used in order to generate random sample of responses and preserve data integrity.

30 companies were chosen for the interviews and a total of 7 companies accepted to participate in this research while the rest 24 companies did not respond. The ideal number of participants was up to 12 but for the reason that most of the companies have shown no interest nor replied, so the sample size was created with the 7 willing companies.

Interview details and analysis

The interviews were recorded using a Dictaphone. The participants were asked to elaborate on their answers in order to provide as much information as possible. Following the interviews which lasted from 25 minutes up to 30 minutes, the data was transcript and the a unique identifier was assigned to each participant to preserve anonymity.

Finally the transcripts were then analysed by breaking down the key components of the response and categorizing them based on the subject they were referring trying to identify patterns in the responses.

Chapter 4

Data Analysis

Reasons for the Property Boom

The property market in Cyprus from 1990 onwards was experiencing a stable increase in real estate prices circa 10% annually, in alignment with inflation and economic growth of previous years. From 1998 to 2000, a mild downturn and the prices became stagnated in the property market due to a boom in the stock exchange. During the stock market's golden years, investors started disposing of properties in order to invest in stocks, which resulted in large increase in supply and lowered demand for property. The herd behaviour of investors is evident here as the irrational investment decisions where fuelled by speculations, rumours and greed. When the stock market bubble burst, the majority of investors experienced heavy losses and many saw their savings of a life time disappear overnight.

Participant 2 suggested that following the crash of the stock market, those who managed to withdraw early, turned to real estate for investment. This boosted the property market and 2001 onwards, prices returned to normal levels of growth. The high returns on investment in real estate at that period of time, led to attracting more investors to start investing in real estate again, with the hope it will help make up for the losses from the stock exchange.

Participant 1 stated:

“Unfortunately, we saw the same mistakes repeated as many investors got carried away by myths. The biggest myth is that there is no way to lose by investing in land. This argument was based primarily on recent experience with real estate prices, since everyone knew someone who made money by investing in the property market. The common notion was that property prices do not fall. The fact that something had not happened by that time did not mean it would not happen in the future.

“For some reason Cyprus is different from the rest of the world”

But of course this is not the case. The participant begun explaining the example of the Economist magazine claiming that during 2003, there was a possible bubble in Spain, Britain, Holland and Australia as the housing market was experiencing average annual increases of 8-12%. The fact that the increase in Cyprus was even greater should have troubled investors.

Nobody seemed to expect the developments in the economy, as those analysts who dared to make their own statements warning for a property "bubble", were characterized as seers of bad.

All participants agree on the fact that during the period between 2001 to 2008 the real estate market returned to growth due to factors such as: Cyprus was preparing to join the European Union and later the Eurozone, interest rates were relatively low in order to converge with European standards, foreign investors (mainly British) turned to Cyprus for investment in property, competition between banks for attractive mortgage loans. The fore mentioned along with the sluggish stock market and the ever increasing foreign and domestic demand for property pushed prices upward.

The real booming of the market started in 2006 and begun to deflate during Q4 of 2008. During the boom period of the construction industry the coastal touristic areas experienced an unprecedented growth, through the escalation of building developments, particularly targeting foreign investors and Cypriot buyers alike. From Q1 of 2006 to Q3 of 2008 prices (houses and apartments) on the island, rose by 53.7% according to data by the Central Bank of Cyprus. According to the report, the biggest rise in house prices in the period Q1 of 2006 to Q3 of 2008 was recorded in Famagusta, where there was an increase of 88.1% (CBC, 2010).

During the boom period, as participant 3 explains,

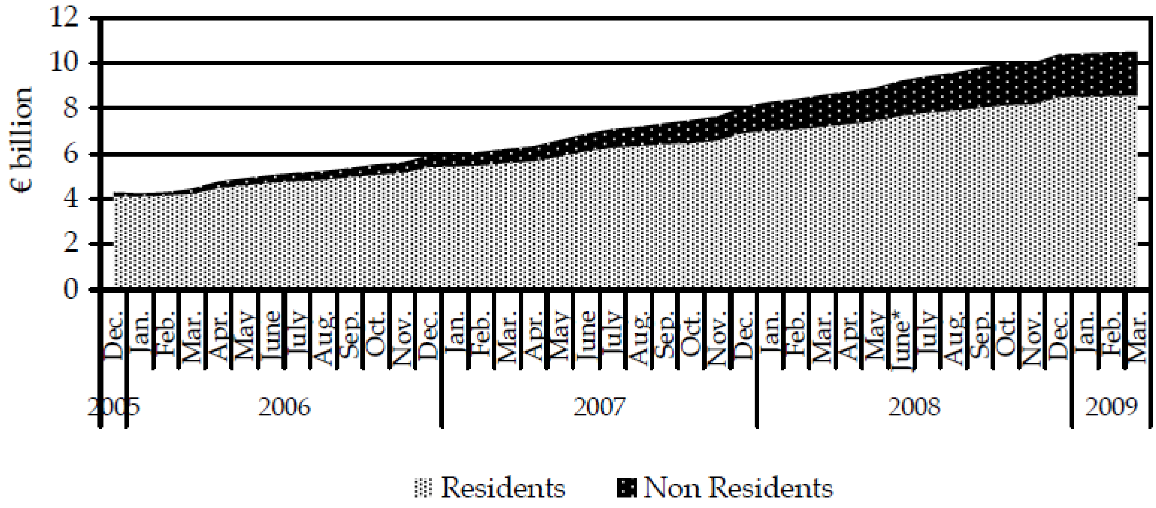
"Investors were willing to purchase anything on offer."

Real estate professionals and investors were reassuring each other citing various reasons for the increase in demand and property prices. However the main question should have been whether the increase in the demand is permanent or temporary. Many of the reasons for the increase such as low interest rates were temporary. Other reasons may have been more 'permanent' but only applied to some property types. For example, the increase in divorced couples and students and the inclination of the young to seek their own housing increased the demand for small apartments in large cities, but that did not mean that concurrently increased the demand for land in suburban areas.

For all the above reasons, Cyprus was experiencing a credit boom, according to participant 1, with bank lending rising by 20% per annum during 2006-2008. This gave rise to deficit from 5% of GDP in 2004 to 7% in 2007.

A striking aspect of the fast expansion in bank housing loans was the marked increase of lending to non-residents, whose share of bank housing loans increased from 3.2% of the total bank housing loans in January 2006 to 18.6% in March 2009 Figure 1, demonstrates this rise.

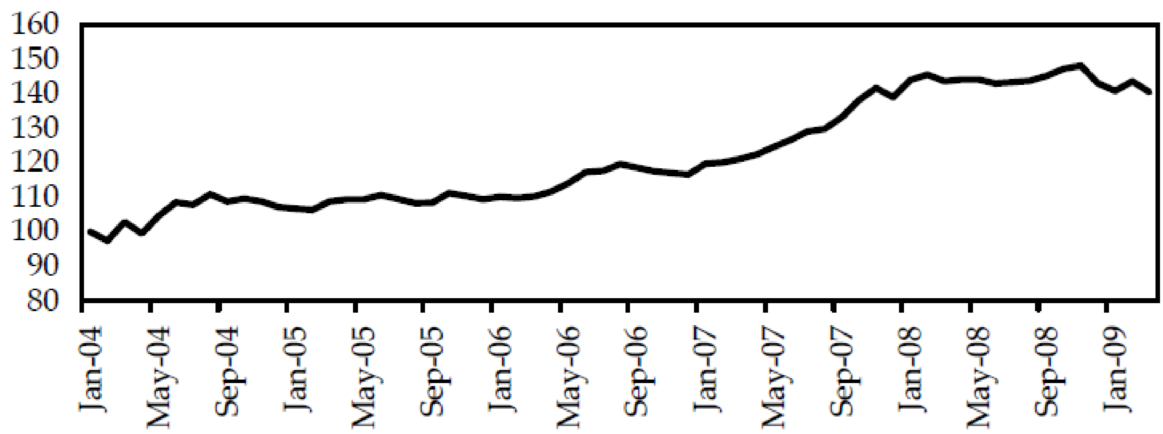
Figure 1: Composition of housing loans (2005-2009)



Source: Central Bank of Cyprus

House prices increased by almost 55% from early 2004 to the end of 2008 as seen in Figure 2 below:

Figure 2: MAP Platis property price index (2004-2009)



Source: S. Platis Economic Research.

The banks following the introduction of the euro on the 1st of January 2008, started to receive increasing deposits from non-residents within the Eurozone due to the high deposit interest rates of circa 4%. Until that period of time, these deposits were considered as foreign currency and where subject to high liquidity requirements set by the Central Bank of Cyprus. Following the introduction of the euro, these deposits were classified as local currency and were subject to a 25% liquidity requirement which was much lower than the 45% of that of foreign currency. The further lowering of the Euro liquidity requirement down to 20% in July 2008 boosted the credit expansion of banks further incentivized an escalation of credit to property developers, households and investors, that further expanded the property bubble.

The most important source of financing for the housing market are the mortgages, the cost of financing and the conditions for granting mortgage loans play an important role in forming the demand and prices of housing.

Over the past two decades, as participant 4 mentioned, the evaluation of loans has gradually changed in a way that explains, in part, the current state of the economy. 10-15 years ago many of the loans were approved based on "name lending". That is, depending on who you were (your 'reputation', business credit, family name) the appropriate loan was given. This way of assessing loans is a wrong practise of risk management primarily because it does not represent an informed decision. There is no background check of the client, does not justify the purpose of the loan, does not evaluate the guarantee (property assets), there is no monitoring of the ability to repay, and there is no connection between risk and pricing. All this was based on the belief and on the faith that the borrower will never go bankrupt.

Banks in Cyprus have underestimated credit risks embedded in loans secured by real estate during the upward movement of the market. This happened due to various reasons, such as the absence of sophisticated systems of risk assessment, the lack of reliable data and information, but most importantly for the reason that the increase in property prices and the false sense of security gave the banks motivation for further credit expansion.

Participant 5 points out that:

“In Cyprus, fluctuations in property values have significant effects on the financial stability of the country as most lending criteria applied by local banks are often 'circular' and can amplify fluctuations in the property prices.”

Participant 1 noted that data reported by the Audit Office for Tax Evasion, based on a sample from the Land Registry were mortgages applications were completed after being granted. The tactics followed by the banks prior to the realization of the bubble, were characterized as irresponsible and unacceptable to say the least. The banks irresponsibly where giving out large sums as loans to borrowers who were unable to repay. They found that many of the borrowers either did not file tax returns or declared low incomes and therefore the question arises how they were going to repay these loans. Noteworthy is a case in which a borrower a receiver of public benefits for one year and the following two years had not submitted a tax return and was granted a loan of approximately half a million.

More recently and throughout the housing bubble, almost all the loans were given based on "asset lending" depending on the value of the guarantee given, the appropriate loan was then given. This led to a vicious circle where, as the prices went up, it became possible to borrow even more. The funds from these loans were usually used to buy more real estate, moving prices upwards and allowing banks to increase lending because the properties in their books had increased in value. As demonstrated, this way of borrowing had failed. As participant 2 explains, It is not important whether the property value is equal to or greater than the loan, since the purpose of the financial institution should be the repayment of the loan and not simply the seizure of the collateral in the case that the borrower cannot repay the loan amount, the downturn of prices will result in loses for the bank.

International experience shows that real estate prices are characterized by considerable variations which may coincide with the economic cycle. Under certain circumstances in fact, these variations can be strengthened and made more potent by the credit policy implemented by the financial institutions, i.e. when the policy has been cyclical. In any case, monitoring the development of real estate prices should be of interest to the monetary and supervisory authorities as the recent experience of the domestic financial crisis highlights that a steep fall may have significant impact on the banking sector and the real economy in result.

There is no doubt that the Cyprus Property Bubble was home-made and the economic downturn in Europe acted as the catalyst that flicked the “domino phenomenon” that was already lined up to fail. The misconception of banks and the irrational behaviour by investors were the main factors in maintaining the upward trend in prices and the negative consequent increase in the credit risk of domestic banks. The situation in Cyprus largely has a similar appearance and qualities in common with the subprime mortgage market in the USA that led to the collapse of major institutions and its consequences to the economy as analysed in the literature.

Unfortunately, the financial crisis and the toxic financial products of the United States expanded to Europe without leaving Cyprus unaffected. Slowly but steadily and then suddenly, the construction sector and real estate market were powerfully affected, more than any other sector, when the crisis hit the economy. Suddenly, when most did not expect it and thoughtlessly invested in real estate at over inflated prices, the "bubble" deflated and burst. It took along Cypriot households, foreign investors, land developers and entrepreneurs who were building thoughtlessly through loans from the financial sector who now find themselves exposed to more and more non-performing loans.

As seen in Figure 3 below, the property market saw a decline towards the end of 2008 only to stabilize throughout 2009. From 2010 the market started decreasing significantly, which is represented in lower property prices compared with previous years, the lack of liquidity in the market and the feeble construction activity.

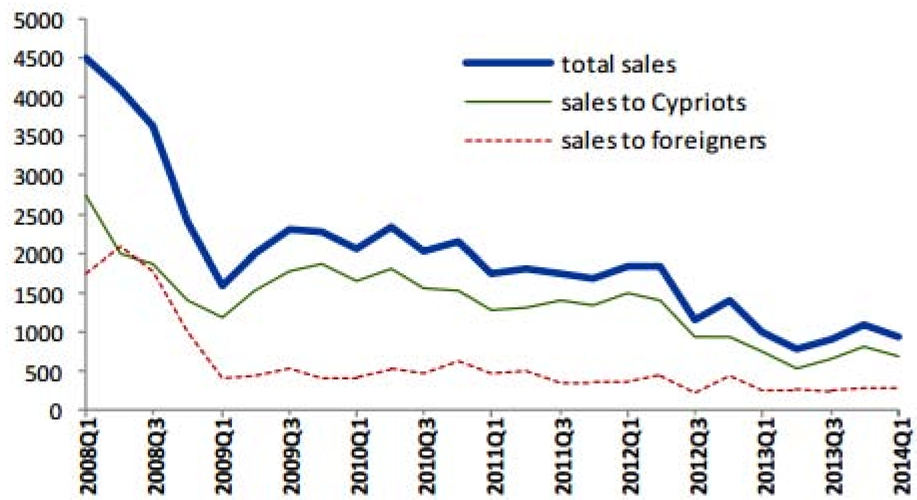
The biggest decline was recorded in the prices of apartments. The reason being that during the booming of the market, the apartments were promoted for sale to foreign investors and local middle- class buyers. With the departure of foreigners from Cyprus, especially the British after the diffusion of the crisis in the USA and its deterioration in Europe, a rapid excess stock of apartments was created.

Figure 3: House and Apartment Price Indices (2010 Q1= 100)

Source: Central Bank of Cyprus

Then with the reduced or missing liquidity, reduced demand and worsening state of the economy and the rise of the cost of money, borrowing for housing was made undesirable. The interest rates for housing purposes increased and the criteria for granting loans made stringer, resulting in a decrease in transactions as seen in Figure 4 below:

Figure 4: Number of sale contracts



Source: Central Bank of Cyprus

The role of the Government

During the boom period the government was earning huge amounts in revenues from the property sector. Property Taxes, Transfer taxes, Stamp Duties, Local Authority Taxes, VAT, Corporation Tax as well as Income Tax from people employed by the frenzy and the multiplier effect in the economy. The success of the Cyprus property sector was in everyone's benefit and to pull the plug on it was not considered an option.

According to participant 3,

"Noteworthy is the debt dynamics during the accession to the Euro zone: a acute increase in debt of financial institutions and households compel the reduction of public debt, thus satisfying the Maastricht criteria for joining the euro area. This was the result of increase in government revenue due to the housing bubble. When joining the EU the country had a slight reduction in public expenditure stabilized around 42% of GDP and a significant increase of revenue by 5 p. p"

But since revenue increases were not a permanent situation, so neither the state of public finances would be sustainable. The situation deteriorated rapidly after 2008.

The two most important tools the government processes in dealing with an economic crisis is the monetary and fiscal policy. The economic policy is applied by the Central Bank through its interventions in the banking sector, and the second by the central government through spending and taxation. Participant 2 notes that domestic and international actors warned that the success of tackling the effects of a crisis in Cyprus laid in the careful adoption of monetary and fiscal policy. Since the accession to the Eurozone, monetary policy is governed by the ECB leaving the government of Cyprus to deal with spending and a close monitoring of the deficit.

All participants agree on the fact that the outcomes of the crisis largely lay with the previous Cypriot government on their policies that they adapted to handle the upcoming economic crisis. As participants 3 and 5 noted, during the election campaign in 2008, President Christofias promised to conduct an expansionary fiscal policy through social benefits, amounting to three billion euros during his five year term, the equivalent to 33.5 % of the country's GDP. After his election the new president criticized the outgoing government for unbelievable lack of "generosity" to social benefits in terms of economic policy and rejected the fact that there was a need to restrain spending in view of the coming financial crisis. He also promised not to impose new taxes to offset the benefits. The election bid, as announced, definitely exceeded the capabilities of the economy.

However, as early as April 2008, analysts warned that the small and open economy of Cyprus made it particularly vulnerable to the global economic crisis and called for rational and conservative government spending and a close monitoring of the budget deficit. They also warned that the implementation of the pre-election agenda could undermine the foundations of the economy. Moody's warned in its report, noting that any deviation from the financial indicators will lead to lower credit ratings of the Republic. Similarly, the European Commission in its evaluation of the Stability Programme of Cyprus for the years 2007-2011 indicated strongly that the Cypriot government should try to hold government debt, particularly by reforming the pension system and advancing reforms in the health sector. (Ioannou and Aimilianidis, 2013)

None of the above though was taken into consideration by the then president. As Participant 3 stated,

"Undoubtedly we did not seem to understand the real situation. Instead of intensifying our efforts to exploit the new environment - activating the Cypriot entrepreneurship that built the Republic in the 1960 and revived the deteriorating economy after the Turkish invasion of 1974 - Instead we Increased our salaries, we took bonuses and left for shopping. Rather than increasing savings and investment, we increased public benefits. These bring only temporary benefits in a society -and temporary gain in those political forces that support them. "

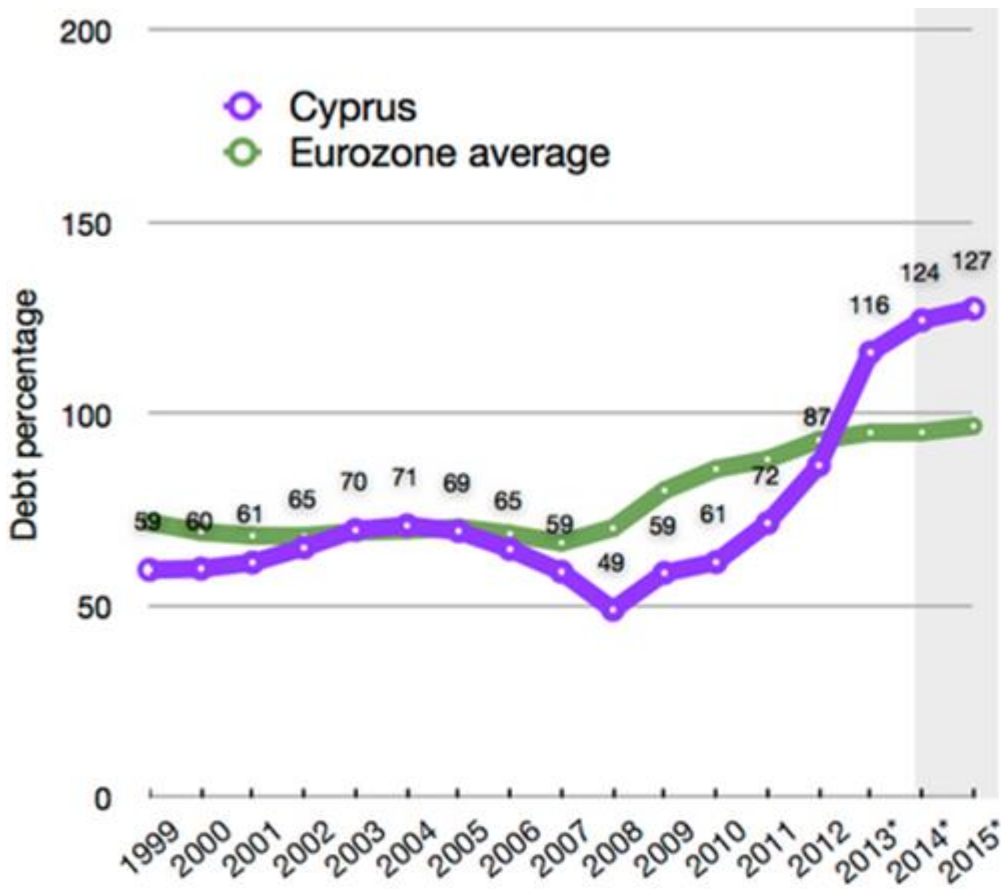
Until the dramatic escalation of the crisis, the government expressed its confidence that the Cypriot economy will not be affected by the global recession because it had a strong, modern and efficient banking system, which could not be spoiled.

According to participant 4,

“The lack of realism at the time did not help to manage the problem but posed risks of complete economic collapse. Similar situation that happened in Iceland were the banking system collapsed and consequently the entire economy. In that case though, the government had been dissolved and the prime minister tried for negligence.”

Figure 5 shows the level of debt rising from 50% that stood during 2008 up to 124% of GDP by the end of 2013.

Figure 5: Cyprus Debt Compared to Eurozone Average



Source: Eurostat

The big issue which was not grasped by the government was the Cypriot banks' holdings of Greek government bonds to an extent disproportionate to the size of the Cypriot economy, worth around 6 billion euros. It is worth mentioning that the purchase of Greek bonds by the Cypriot banks was made during the period 2009-2010 a period when Greece was in deep recession and the signing of a memorandum was imminent. At the end of 2010, the exposure of the Cyprus' banking system in Greek bonds and Greek economy exceeded 2.5 times the GDP. The expansion to Greece in relation to the overall activities were extremely disproportionate as a large percentage of loans the two largest Cypriot banks held, were allocated to Greek businesses , organizations and households.

The European Council on the 21st of July 2011 decided to implement the PSI on Greek debt. The "haircut" was decided to be in the region of 21 % imposed on holdings of Greek debt. This "haircut" was believed to be weathered by Cypriot banks as they had existing capital buffers. On the 26th October 2011 the Council decided to abandon the previous agreement and force a 50 % "haircut" instead which eventually translated to about 80% in market value according to participants 3 and 5.

This decision regarding the Greek PSI and the associated recapitalization exercise, created a huge capital charge for the two largest banks. The loss of capital was about 25% of the country's GDP.

The interdependence between public finances and financial needs of Eurozone banks has been described as Siamese twins in recent studies of the Basel Bank and the International Monetary Fund. Cyprus is an example of this phenomenon and rating agencies warned of the danger of interdependence when they started the continuous downgrades towards the end of 2011 (BIS, 2011). Fitch and Moody's were clear when warnings about upcoming problems and what was causing them. These were the deterioration of structural fiscal metrics, competitiveness and the exposure of the banking sector to macroeconomic stress in Greece. (Moody's, 2011)

The great crisis of the Cyprus economy commenced by the activation of a vicious cycle of interdependence-between banking system and public finances. Public finances where not exclusively responsible as in the case of Greece, and neither was entirely a banking crisis as in the cases of Iceland or Ireland. According to Mody and Sandri (2011) when the debt crisis is combined with a banking crisis the problem gets more difficult to handle. If a debt problem generates a banking crisis then a vicious circle starts as the credit crunch intensifies the debt problem which created the credit crunch .

As participant 3 explains, banks of countries with over ten times the budget of Cyprus such as Germany and France where holding €22 and €15 billion worth of Greek bonds respectively.

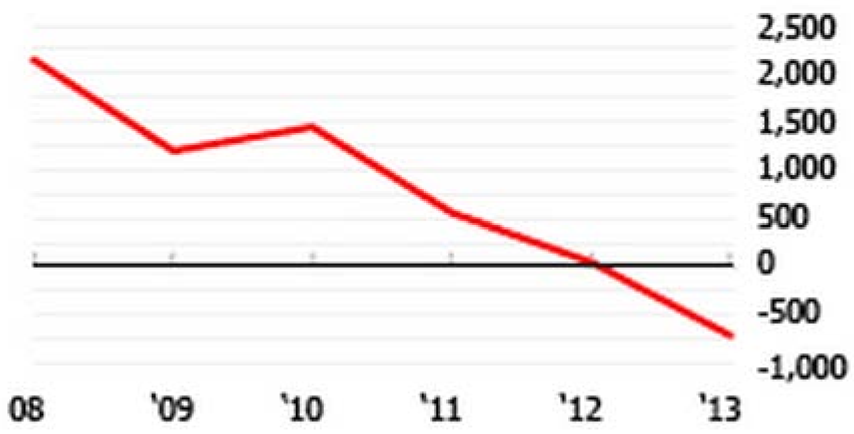
Participant 4 notes that a significant share of the responsibility for this matter lies with the European Central Bank (ECB) which allowed the commercial banks of the euro area to collect bad government bonds on such a large scale and extent.

The "haircut" of Greek government bonds smashed the value of the shares of the two largest banks in Cyprus and made it impossible for recapitalization. The Cypriot government accused banks that if they had not done such heavy investments in Greek bonds and the Greek market, then there would be no great exposure to Greek economy and the impact of the PSI would be smaller. This approach however completely ignores the fact that the Cypriot government left the economy and the banking system unprotected. Undeniably, the decision for the "haircut" on Greek government bonds was taken with the consent of the government without setting any conditions forward.

As a consequence of the Greek bond 'haircut' the cost of borrowing increased as the banks were trying to recover losses. Further reductions in lending and stricter criteria were introduced for future borrowers. According to the December 2013 Economic Bulletin of the CBC, bank lending criteria are currently at their tightest level since the fourth quarter of 2008 (CBC, 2013). The reduction in loans reduced growth in the economy and led to a significant increase in financial pressure on households. A knock-on effect of increase in non-performing loans followed which increased further the pressure on property prices, financial institutions and the Island's economy in general. (Ioannou and Aimilianidis 2013)

Changes in the supply of housing loans can be seen in Figure 6 below:

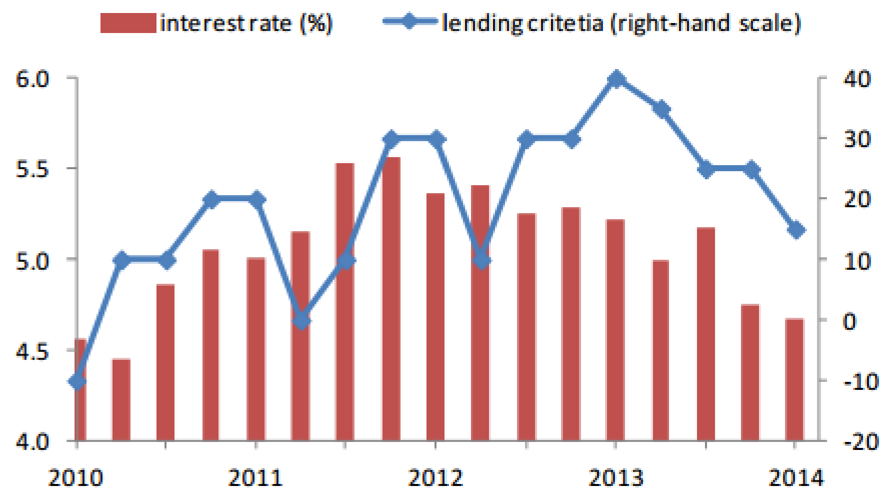
Figure 6: Housing Loans



Source: Central Bank of Cyprus

The average interest rates seen in Figure 7 as well as the tightening of loans have hindered potential investors from entering the market, both domestic and foreign. According to participant 4, the reasons for the high interest rates include the lack of liquidity faced by the majority of the credit institutions, the higher risks resulting from the increase in non-performing loans and the high depository interest rates.

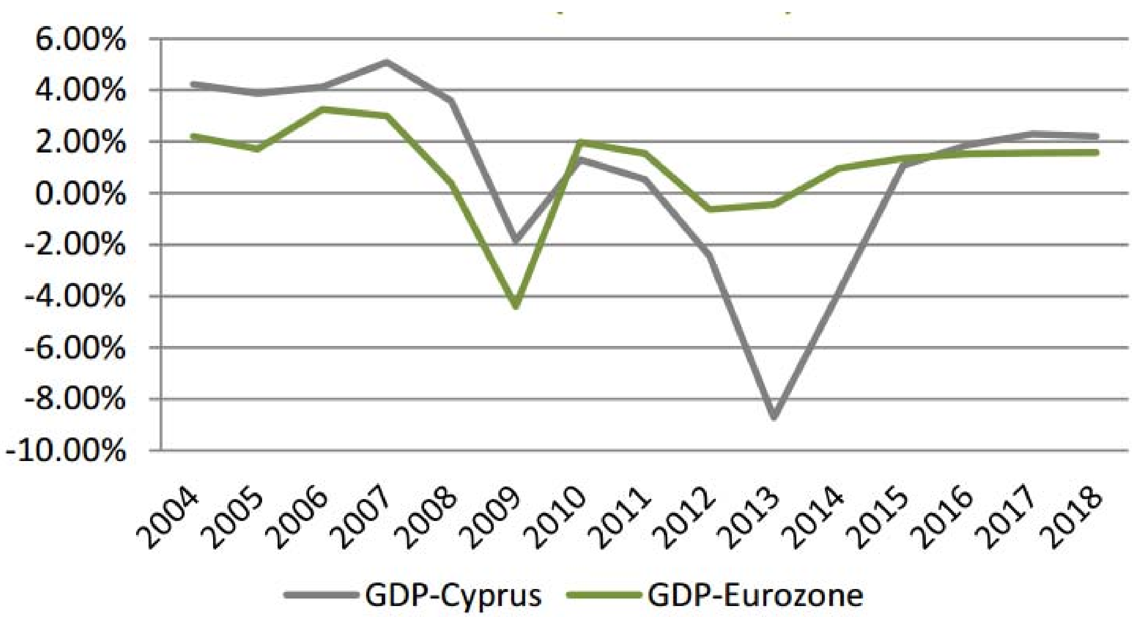
Figure 7: Interest rate and Lending Criteria for Housing Loans



Source: Central Bank of Cyprus

According to participant 5, in April 2012 the Cypriot Minister of Finance suggested that the government should adopt and implement substantial unification measures to avoid being forced to enter the support mechanism. During a meeting with the ECB later in the same month he committed to present results before the end of May. On the 1st June 2012 the president rejected the minister's suggestions for a significant reinforcement plan and as a result Cyprus lost its investment-grade rating. The president then decided to avoid finalizing any agreement with the Troika (Euro-group, IMF and the ECB) in an effort to push adjustments beyond the February 2013 elections. The continued delay damaged the economy further as corrective measures where postponed ensuring the problem would get bigger. Meanwhile the Cypriot government continued to attack the banks as a platform for the forthcoming elections. The results from this inertia can also be seen in the outlay of the GDP shown in Figure 8 below.

Figure 8: Cyprus and EU average Gross Domestic Product (2004-2018)



Source: IMF

On the16th March 2013 the Eurogroup decided to impose "haircut" on all deposits, insured and uninsured, in all banks regardless of capitalization, to raise resources. This proposal opposed the fundamental principles of any known framework. For example, bank bond holders were fully protected, only depositors were targeted. The deposit "haircut" proposal was rejected by parliament in Cyprus and so on March 25 the Eurogroup changed the program to protect insured depositors. The agreement between the Troika and the new government was finally reached, which was elected in February, for a €10 billion bailout to the sovereign and a €5.8billion bail-in for Cyprus banks. This agreement was the first of its kind for the Eurozone as the recapitalization of banks was going to be done through deposits opposing principles and ensuring lasting damage to the banking system.

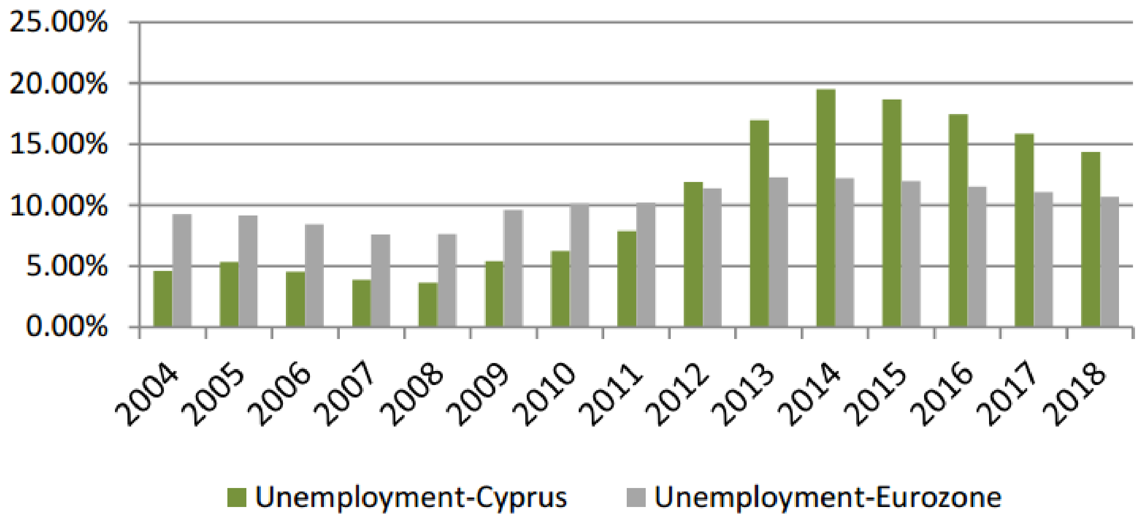
Under the new deal Cyprus second-largest bank, Laiki, dissolved and split into "Good Bank" and "Bad Bank". The secured deposits (under 100,000 euros) were transferred to the larger Bank of Cyprus (BOC) to create the "Good Bank". Depositors in the BOC lost 47.5% of uninsured savings and are to be compensated with equity in the bank. They basically unwillingly transformed from depositors to investors in a bank which no logical human being would consider investing under the current conditions. Following the implementation of the agreement, the banking sector size changed from over 700% to 350% of GDP within a few weeks. This had a significant impact on the financial services sector of the economy (9% of the country‘s GDP) but also on other professional services that were supportive of the banking sector that accounts for 20% of GDP according to participants 4 and 7. Liquidity, unemployment and uncertainty for the future, became the triptych, hindering any type of business development on the island. The Real Estate market could not be an exception due to its heavy dependence on the financial sector and the economy in general.

According to participants 2,4 and 7 , information published by both the Land Registry and the Cyprus statistics, the Real Estate market was suspended. Purchases and sales from Cypriots are from minimal to none, while the situation seemed to be saved by the few transactions carried out by foreigners, mainly Chinese and Middle East investors. Transactions fell circa 35% from the previous year's already low levels. The decrease in sales was mainly due to the local market, since external demand showed no change. Sales to locals fell by circa 60%.

Participant 5 stated that "Purchases by locals, are almost non-existent. There are occasionally some foreigners mostly Chinese and Arabs who buy residential properties over € 300 thousand for securing visas ".

The reduction in local demand could be partly explained by the rise of unemployment as according to data from Cyprus Statistics, in August 2013, the number of registered unemployed stood at 48,451 compared to 33, 866 in the same month of 2012. Data adjusted for seasonal variations, show that the number of registered unemployed in August 2013 increased to 51,275 compared to 37,901 in 2012 (CyStat 2013). Unemployment is one of Cyprus' biggest problems with a rate of almost 20% in 2014 as seen in Figure 9 and with young people (under 30 years) in some areas reaching 45-50%.

Figure 9: Cyprus and EU Average Unemployment (2004-2018)



Source: CySTAT

Cyprus now carries the deterioration of the vicious cycle of austerity, recession and assistance repayment resulting in unemployment increase at an alarming rate. The adverse developments in the labour market, marks the transformation of the social problem of unemployment. The negative trend means limited saturation of the stock of unemployment / unemployed will accumulate due to the prolonged recession in 2013-2015, necessitating many years to reduce. These people are cut off from the property market and the sharp fall in prices and decrease in the value of mortgaged property, further increases credit risk and capital requirements of banks, causing a significant reduction of credit (zero extension), a reduction in demand for real estate, commercial investment, etc. Thus strengthens the downward trend of property prices and value.

According to participants 4 and 6, given the quality of the loan portfolios of banks which are mainly secured by property, the CBC and the banks themselves should have a clear picture of the consequences of the reduction in property prices in their portfolios and their recapitalize but at the same time the stability of the financial system in order to adjust their policy. To achieve this, data needs to be collected on all properties held by the banks, and

analyse them through statistical models and mapping tools in order to calculate the geographic concentration of properties / mortgages and assess risk of disposal / liquidation of certain properties in specific areas, etc.
The question is whether both the authorities and the banks will move to modernize the evaluation and monitoring of mortgages / real estate to better manage their portfolio.
Gradually, financial institutions adopt another way of assessing loans, which is the "cash-flow lending". By this method, loans are a multiple of the expected cash flows that a person or company is expected to have in the future. With this method there is a direct link between the amounts of the loan with the borrower's repayment ability putting the value of the collateral at a secondary fate. This can be obtained indirectly through the 'credit scoring', which is a technique used to estimate the probability that a customer will meet its financial obligations. This technique helps financial institutions to make decisions about opening accounts and granting credit by using statistical methods to measure the probability that a customer applying for credit will be of acceptable credit risk.

The Role of Property Professionals

It was evident that during the upwards trend of the market property professionals such as estate agents, developers and valuers pursued profits without looking the wider picture and as participants 5 and 7 explain, they would not have done their job otherwise. Sales Agents and Developers were doing what they were supposed to do and that is to bring more properties into the market in order to satisfy the demand. This had a negative effect though when the demand was reduced, mainly from overseas investors, back in 2008.
Participant 7 points out that the government and the banks should have monitored the situation more closely and carefully control the situation to avoid this saturation. Both the banks and the governments had interest to do so, for the reason that the banks on one hand where greatly exposed to property and the government was exposed to the banking sector due to its size. Rather the banks continued with the same attitude causing the market

well beyond saturation. As all participants noted, some developers where receiving loans to build even during 2012 when the market was on a downturn.The Government on the other hand did nothing to intervene until it was too late.

As explained by participants 3, 4 and 7, during the booming of the market there were plenty unlicensed estate agents approaching unsuspected byers and offering them bad advice. As they explain this had a negative effect on the profession as in many cases the purchaser ended up paying over the odds or even lost their money due to unreliable practises. This had as a result a number of investors to lose faith in the market as news of these cases where circulated on the internet by those who were victims of these practices.

All participants agree on the fact that property fraud in Cyprus has also been a major problem during that period of time, not only for investors but also for banks, developers, and the government. Many investors ended up losing their money when a developer went bankrupt even if they had paid in full. This is due to the fact that a common practice was for the developer to keep the Title Deeds without informing the buyers that the title will be withheld for an unspecified time or that they have mortgaged the land on which the property is built on. The bank holding the title deed as collateral had the right to foreclose in case of non-payments but as the foreclosure would take up to 12 years to go through, banks pretended and extended, until the developer went bankrupt.

In some cases double selling fraud was detected, as participant 6 explained, where the developer would sell a property to a buyer without lodging the contract with the Land Registry and then sell it again to another buyer without reimbursing the first.

These are just a few examples of how some “professionals” managed to harm the reputation of the sector repelling from the market potential new investors.

Valuers also played a role in the turmoil that was created as they were sometimes influenced by the customer in a way that they should not have. As participant 6 noted, the market value is quite simply the price at which a buyer is willing to purchase the property and the seller willing to sell. Here is where the problems begun. For example the buyer would reject to pay over € 100,000 and the seller would reject to sell under €120,000. Normally the valuer should ignore them both and proceed to the assessment of the property regardless. Instead some valuers wrongly would end up valuing the property somewhere in between in order to satisfy both sides.

Participant 6 wanted to explain that in other cases, especially more recently, the seller or the borrower pushed the appraiser saying how much the property cost to them. Usually including a long list composed of how much they bought the land, the time they spend dealing with the issues of securing various licenses, construction costs etc. But value and cost does not always go together. If someone built a luxury mansion on the top of a mountain, this does not mean that someone else is willing to buy it for what it costed. Especially for homes that are special design or character, there tends to be a significant difference between cost and value since the building reflects the taste of the particular owner and not necessarily that of the buyer's.

Regarding the future of valuers in the market, participants 3, 6, and 7 seem to agree that the "golden age" of valuations and valuers has probably finished or is in the twilight, as the volume of estimates necessary in order to provide loans in the past 10 years will not be repeated. Valuers in this 'new age' must give more emphasis on the content of disposal of the property (liquidity of the collateral in case of sale) investigate deeper into the legal and planning aspects of the collateral and for properties which are rented to carry assessments of tenants and the rents they pay. As participant 7 noted, the valuer should be developed into a financial analysts and should have a wider range of knowledge, giving more emphasis to information for risk management of the client rather than the simple assessment of the value of a property. Participant 7 went on to suggest that until this change happens, the valuers will not reach the needs of the financial institution, creating tension between them. The transformation will occur only when the customer is willing to pay the appraiser what ought to devote the necessary time to carry out the necessary checks and make a more thorough analysis of the data.

Chapter 5

Conclusion

Since Cyprus joined the European Union in 2004 and the Euro-zone subsequently in 2008, has brought significant changes and opportunities for the country as a whole, although some risks were hidden in amidst. The safety provided by the EU and the common currency has attracted huge amounts in Cyprus, amounts that the country was not able to manage properly.

The Real Estate sector of Cyprus has always been one of the ageless muscles of the island's economy, with a major contribution to the GDP and creation of new jobs. The sector went on adventures, mainly due to external factors, long before the effects of the crisis were reflected on the whole economy. The tipping point was the collapse of an American Bank, Lehman Brothers in the September of 2008 and the knock-on antagonistic developments that took place mainly in Europe, greatly reduced the interest of traditional foreign investors such as the British.

The current crisis of the Real Estate market of Cyprus is mainly due to the current financial crisis of the country and the impact on the ability to be able to finance companies and investors that are active in the sector. There is a nationwide decline on building activities, rise of unemployment and high rate of temporary suspension in production reveal the deep recession in which the Real Estate market found itself. The current situation of the entire Cypriot economy is that being in recession it resulted in multiple negative effects on the entirety of the economic sectors. The impact of this financial crisis on the domestic financial system (lack of liquidity) has in a sense forced the commercial banks to be more reluctant and cautious in granting housing loans in general. This tightening of the banks on the new mortgages coupled with the fiscal period of consolidation and deleveraging of the economy (Kouretas and Vlamis, 2010) has inevitably limited the available funds to prospective buyers. There is a lack of buying interest on the part of households and significant reduction in demand of new apartments for the reason that there is a level of uncertainty in continuation of employment as well as the integrity of their future income.

To demonstrate an integral account of what occurred, it is necessary to observe the evolution of the crisis in three distinct phases:

<u>The condition of the Cypriot economy up until 2008 when the international economic crisis was spread:</u> During this period an enormous debt was accumulated over households, businesses and public debt. The economy lost its competitive edge and demonstrated significant imbalances that were concealed by the oversized banking sector. These dreadful economic conditions made Cyprus even more prone to the global crisis. The banks were granting loans with awful criteria, as money were flowing in from foreign deposits, while the non-performing loans were increasing every year and no one even seemed worried over the situation not even the supervisory authority, since the collaterals were covering the loan balance. The issue was that those collaterals had an over inflated price that was caused by the “property bubble”. Valuers, developers and real estate agents would not admit that this was the case as they did not want to bear any responsibility over the situation. Furthermore the actions of some professionals of the sector had caused a decrease in the trust of foreign investors, which had a negative impact in foreign markets. Crucial role played the utter failure of the Government and the regulatory authorities to diagnose and prevent the major problems in the banking sector. One of the major problems of the Cypriot banks was the uncontrolled lending, which was supplied for years and was exceeding the needs and strength of the Cyprus economy. During the period of 2006-2008 the amount of loans was increased by more than 25% annually, while the absorptive capacity of the economy that was based on the growth rate did not justify an increase over 10%. These lending rates continued for some years which led to the creation of unjustified high real estate prices and subsequently an increase of non-performing loans. When it was confirmed that the property prices did not correspond to the real market, the banks were already heavily exposed and the deterioration of the loan portfolios led to an increase in the provision for loan impairments.

Post 2011 period: On 4th of October 2010, the Khaleej Times newspaper of the United Arab Emirates issued a special tribute for Cyprus titled “Celebrating 50 years of resistance and development”. The then president of the Republic of Cyprus, Demetris Christofias, took pride on this occasion and made a statement: “The Island is recognised as having a certain economic environment that offers confidence and security.” In six months the country would conceive one of the most complex financial crisis of the Eurozone (Zenios S., 2013). Cyprus was excluded from international financial markets and the banks suffered the enormous amount for the size of the economy of € 4.6 billion from the impairment of Greek government bonds that followed the decision of the Euro-group. The deterioration of public finances and the negative impact on banking sector by the impairment of Greek government bonds triggered a vicious circle of interdependence between bank and public finances. Without the adoption of measures, Cyprus was driven by mathematical accuracy in the exclusion from financial markets and only the timing of exclusion was not predefined. This period is characterized by bad judgment leading to the accumulation of larger problems. The decision of the Greek debt “haircut” raised the banking system in unprecedented risks and challenges resulting in a drastic reduction of demand for housing not only for the reason that funding was limited to a minimum, but also because uncertainty and negative psychology was created.

Up until the period of March 2013 when Cyprus managed to secure assistance by the international organizations that assigned significant sovereign rights to lenders: Negligence, unprofessionalism, timidity, laxity and political tactics of expediency led to the first big issue of the €4.6 billion that equalled 25% of the country’s GDP. The Cypriot economy started to face a huge intractable problem needing €17 billion (almost 100% of the GDP) in order to avoid default, and the implementation of unprecedented solutions became inevitable. This is period is characterized by further mismanagement that caused the final collapse.

The period post 2013: The climax of the new Cypriot tragedy was written in March 2013 following the decisions of the Euro-group regarding the bail in. The country enters the era of the Memorandum and supervision by the international lenders. Cyprus was converted into a guinea pig for unprecedented debt crisis management methods and became an example to be avoided by the international media. This is the biggest crisis that the Cypriot economy has faced since the proclamation of the Republic and by economic criteria, of similar magnitude as the Turkish invasion that took place in 1974. The March 15, 2013 decision marked a new painful blow for the Cypriot economy and the real estate industry, which already was counting the wounds and losses of the previous years. But more importantly it marked the end of an era characterized by uncontrolled growth and large oversized borrowing and unsustainable debt. Today the market is characterized by the reduction of funding resources, the many non-performing mortgage loans, high interest rates, the sharp drop in real estate prices and lack of a strategy for tackling the problems. All participants in the interviews agree that a correction was needed; however, it was done in a manner that caused the industry to confront the already existent challenges that exceeded its capabilities. At the same time, investors are more reluctant than ever to invest.

We saw that the rapid growth and economic liberalization of loans and cash created severe imbalances in the financial environment. It is therefore clear, that period before a crisis is created there is a financial bloom that prevails. It should be noted that always on the altar of economic growth there are losses, which the Governments should mitigate through proper and stricter regulatory framework. The loose monetary policy was essential; however, it lasted for a long period of time and was excessive, while the lack of supervision led the banks in a dangerous high leverage and low capital adequacy situation. The "golden mean" of course between full deregulation of the financial system and state intervention is difficult to be found but should always strive for balance and an in-depth examination of the possible consequences.

The true causes of the crisis largely lay on the inability of the Cypriot government to comprehend the mechanisms of the global economic system and the ideological denial to deal with the structures of the international markets. As demonstrated above, the non-pragmatic belief that the Cypriot economy would not be affected by the global crisis left the economy unprepared to handle the crisis. As well as the failure to prevent the major problems of the banking sector, the “haircut” on the Greek bonds and the cost of delaying action resulted in economic collapse and the bail-in. The excessive delay of the Government to carry out effective negotiations with Troika and the continuing decline of reliability of the Cypriot banks aggravated the problem even further and fatally damaged the credibility of Cyprus as a safe international financial centre.

The property market has suffered since the credit crunch back in 2008 were supply overtook demand. The credit crunch has transformed into a debt crisis for the Country elongating and enhanced the problems within the market. Currently it is evident that measures should have been taken without delay to circumvent the present state of the economy and property market by extension.

References

Adams, Z. & Fuss, R. (2010), "Macroeconomic determinants of international housing markets ". Journal of Housing Economics, 19 (1), pp.38-50.

Alexakis C. and Ksanthakis E., (2008) Behavioral Finance - Introductory Elements (Greek), Athens: Stamoulis

Alvarez, L.J. & Cabrero, A., (2010a) "Does Housing Really Lead the Business Cycle?"SSRy-Electronic-Journal.-Available-at: http://www.ssrn.com/abstract=1646 845.

Acharya, V., L. Pedersen, T. Philippon, and M. Richardson (2009). Regulating Systemic Risk. In Restoring Financial Stability: How to Repair a Failed System. New York University, Wiley & Sons

Bank of International Settlements (BIS) (2011), The Impact of Sovereign Credit Risk on Bank Funding Conditions, [Online] [Accessed 07/08/2014] http://www.bis.org/publ/cgfs43.pdf

Barras Richard (1994), "Property and the economic cycle: Building cycles revisited", Journal of Property Research, 11: 3, 183-197

Baffoe-Bonnie, J. (1998). "The dynamic impact of macroeconomic aggregate on housing prices and stock of houses: A national and regional analysis." Journal of Real Estate Finance and Economics 17: 179-197

Bernanke Ben & Mark Gertler & Simon Gilchrist, (1998), "The Financial Accelerator in a Quantitative Business Cycle Framework, "NBER Working Papers 6455, National Bureau of Economic Research, Inc.

Burns, A.F. and Mitchell, W.C. (1946), "Measuring Business Cycles", National Bureau of Economic Research, New York, NY.

Borio, C. and P. Lowe (2002), "Asset prices, financial and monetary stability: Exploring the nexus ", BIS Working Papers, No. 114.

Borch, C. (2006) 'The exclusion of the Crowd. The Destiny of a Sociological Figure of the Irrational', European Journal of Social Theory, 9(1), pp. 83-102.

Boydell, S. and P. D. Clayton (1993). "Property as an Investment Medium - Its role in the institutional portfolio." A Financial Times Management Report: 144.

Bracke, P. (2011) "How Long Do Housing Cycles Last? A Duration Analysis for 19 OECD Countries ", IMF Working Paper WP / 11/231

Burton D, (2000) Research training for social scientists, Sage Publications, UK

Cooper, G. (2008) "*The Origin of Financial Crises: Central Banks, Credit Bubbles, and the Efficient Market Fallacy*" Vintage.

Creswell JW, (1998) Qualitative inquiry and research design, choosing among five traditions, Sage Publications, UK,

Cohen, L. and Manion, L., (1994) Educational Research Methodology (Greek), Routledge, Athens.

Central Bank of Cyprus (CBC) (2013) Economic Bulletin December 2013 [Online][Accessed08/08/2014]http://www.centralbank.gov.cy/nqcontent.cfm?a_id= 9839&lang=en

CyStat (2013) *Latest Figures: Registered Unemployed, Dec 2013* [Online] [Accessed08/08/2014]http://www.mof.gov.cy/mof/cystat/statistics.nsf/All/76D9C2C919FB52D7C2257BF3002CF085?OpenDocument&sub=2&sel=1&e=&print

Davis, M. a. & Heathcote, J. (2003). "Housing and the Business Cycle", SSRy Electronic Journal. Available at: http://www.ssrn.com/abstract=528102

EMF (2009), "A review of Europe's Mortgage and Housing Markets", Hypostat 2008 [online] [Accessed 09/08/2014] http: //www.law. berkeley.edu/files/bclbe/Hypostat_2009__europe_s_mortgage_and_housing_markets.pdf

Ellen R. F (1990), Ethnographic research, Academic Press

Feldstein, M. S. (1992), Comment on James M. Poterba's paper, Tax Reform and the Housing Market in the late 1980s, Real Estate and Credit Crunch, Federal Reserve Bank of Boston Conference Series, p 252-257

Feroli, M.E., Harris, E.S. & West, K.D., (2012) *"Housing, Monetary Policy, and the Recovery"* University of Chicago Booth School of Business,

Greiber, C. and Setzer, R. (2007), *"Money and housing – evidence for the euro area and the US"*, Deutsche Bundesbank, Discussion Paper Series 1: Economic Studies, No 12/2007

Giussani, B., M. Hsia, and S. Tsolocas (1992). "A Comparative Analysis of the Major Determinants of Office Rental values in Europe." Journal of Property Valuation and Investment 11: 157-173.

Hardouvelis Gikas (2009), "The importance of the housing market in the economy," (Greek) Property Markets: Developments and Prospects, Speeches Conference 29/4/2009, NBER Working Paper No. w15998

Hilbers, P., Hoffmaister, AW, Banerji, A., & Shi, H. (2008.), "House Price Developments in Europe: A Comparison ", IMF Working Papers 08/211, International Monetary Fund

Hartzell, D., Eichholtz, P. and Selender, A. (1993). "Economic diversification in European real estate portfolios." Journal of Property Research 10: 5-25.

Hendershott, P. (1980). "Real user costs and the demand for single-family housing." Brookings Papers on Economic Activity 2: 401-444.

Iacoviello, Matteo M. and Pavan, Marina (2011), "Housing and Debt Over the Life Cycle and Over the Business Cycle ", FRB International Finance Discussion Paper No. 1032

Igan, D. et al., (2011), "Housing, credit, and real activity cycles: Characteristics and co-movement ", Journal of Housing Economics, 20 (3), pp.210-231

Ioannou C. and Aimilianidis A. (2013) How and Why Cyprus entered the Crisis. Foreign Affairs the Hellenic Edition

Kearl J. R. (1979), "Inflation, Mortgages and Housing", Journal of Political Economy, vol. 87, p 1115-1138

Kearl, J. H. (1979). "Inflation, mortgages, and housing." Journal of Political Economy 87: 1-29.

Kouretas, G. P. and Vlamis. P. (2010)."The Greek crisis Causes and Implications" p.p. 392-400

Kyriazis, P., (2004) sociological survey. Critical review of the methods and techniques (Greek), Greek Letters: Athens

Leung, C. (2004), *"Macroeconomics and housing: a review of the literature"*, Journal of Housing Economics, 13(4), pp.249–267.

Leece D. (2004) Economics of the Mortgage Market: Perspectives on Household Decision Making, Wiley-Blackwell.

Leece, D. 2001. Regressive Interest Rate Expectations and Mortgage Instrument Choice in the United Kingdom Housing Market, Real Estate Economics

Lee, M.-L. And R.K. Pace (2006) Local Housing Prices and Mortgage Refinancing in US Cities. Property Management

Maclennan, D. and J. a. S. Muellbauer, M. (1998). "Asymmetries in housing and financial market institutions and EMU." Oxford Review of Economic Policy 14: 54-80.

Mckibben, B. (2007)”*Deep Economy*” 1sst ed. Henry Holt

Mody, A., and Sandri D., (2011*) The Eurozone Crisis: How Banks and Sovereigns Came to be Joined at the Hip*, Washington, DC: International Monetary Fund

Mishler EG (1996), Interview survey (Greek), Greek Letters, Athens

Moody’s (2011) Moody's downgrades Cyprus to Baa1 from A2, negative outlook-[Online]-[Accessed:08/08/2014]-
https://www.moodys.com/research/Moodys-downgrades-Cyprus-to-Baa1-from-A2-negative-outlook?docid=PR_223439

Muellbauer, J. (1992). "Anglo-German differences in housing market dynamics: The role of institutions and macroeconomic policy." European Economic Review, Papers and Proceedings 36: 539-548.

Muellbauer, J. and A. Murphy (1997). "Booms and busts in the UK housing market." The Economic Journal 107: 1701-1727.

Poterba, J. M., (1992). “Taxation and Housing: Old Questions, New Answers.” American Economic Review 82(2): 237-242.

Platis, S. and S. Orphanides (2005). "Factors that shape house prices in Cyprus (in Greek)." Monograph, BuySell Cyprus Real Estate.

Patton, Q. (1990), M. Qualitative Evaluation and research method. Sage Publications: Newbury Park, CA,

Renard V. (1993) 'Bulles spéculatives, prix immobiliers, prix fonciers', in J.-J. Granelle and T. Vilmin (et seq.) L'articulation du foncier et de l'immobilier, Paris: ADEF

Rubin HJ, Rubin S., (1995) Qualitative interviewing, The art of hearing data, Sage Publications, USA

Smith, B. A. and W. P. Tesarek (1991). "House prices and regional real estate cycles: market adjustment in Houston." Journal of the American Real Estate and Urban Economics Association 19: 346-416.

Sternlieb, G. and J. W. Hughes (1997). "Regional market variations: The northeast versus south." Journal of the American Real Estate and Urban Economics Association 19: 396-416.

Schulz, T. and A. Werwatz (2004). "A state space model for Berlin house prices: Estimation and economic interpretation." Journal of Real Estate Finance and Economics (28): 37-57.

Shiller R. (1995) 'Conversation, Information, and Herd Behaviour', Cowles Foundation Paper 909.

Simon H. (1986) 'Rationality in Psychology and Economics', The Journal of Business 59, The Behavioral Foundations of Economic Theory, pp. S209-S224.

Silverman D. (1997), Qualitative research - Theory, Method and Practice, Sage Publications, UK

Strauss A., Corbin J. (1998), Basics of qualitative research, Techniques and procedures for developing grounded theory, Sage Publications, USA.

Tsatsaronis, K. and Zhu, H. (2004), "What Drives Housing Price Dynamics: Cross-Country Evidence ", BIS Quarterly Review, [Online] [Accessed 10/08/2014] http://ssrn.com/abstract=1968425

Turner H. and Killian M. (1957) Collective Behaviour. Englewood Cliffs, NJ: Prentice Hall.

Wheaton, W.C. (1999), "Real estate 'cycles': some fundamentals", Real Estate Economics, Vol. 27, pp. 109-30.

Warnock, V.C. & Warnock, F.E. (2008), *"Markets and housing finance"*, Journal of Housing Economics, 17(3), pp.239–251

Zenios S., (2013) H Destruction of Cyprus Economy: the lack of good sense to the defective management [Online]-[Accessed:06/08/2014] http://zenios.files.wordpress.com/2013/10/h-cebacf81ceafcf83ceb7-cf84ceb7cf82-cebacf85cf80cf81ceb9ceb1cebaceaecf82-cebfceb9cebacebfcebdc ebfcebcceafceb1cf82_cf87cf89cf81ceafcf821.pdf

Questionnaire

1) How did the investors behave after the stock market crash in 2001?

2) What did attract the investors to begin re-investing majorly in the property market?

3) Were there any signs that investing in property market was a reliable choice compared to the situation of foreign property markets?

4) How was the property market affected by the then upcoming EU membership?

5) Which reasons caused the increase in property demand?

6) How do you explain the upsurge in the amount of bank loans granted?

7) What is the relationship between the property values and the economic stability of the country?

8) What measures could the Government have taken to manage the economic crisis?

9) What is your opinion on the way the Cypriot government managed the economic crisis, was it sufficient?

10) What is the position of financial analysts on the crisis of 2008?

11) What are your comments on the economic situation of citizens after the invasion of 1974 up until 2008?

12) What is your opinion on the effect of the “haircut” of the Greek bonds on the economy of the country? Was the situation handled properly?

13) What caused the decrease of domestic and foreign investments after 2008?

14) How was the Banking sector affected by the presidential elections of 2013?

15) What changes were made on the Banking system after the Government – Troika agreements?

16) What role did the Property professionals play in the market in these last years?

17) How the Government should have managed the Banking system in order to achieve more preferable results?

18) Explain the situation with domestic and foreign property buyers acquiring the Title deeds of the properties they had purchased, was it secured ?

19) Which practise did the Property valuers follow at the time, and what effects did it have?

20) What is the relationship between value and cost and how it translates in valuations?

21) Explain if whether the Property valuers methods and practise needs to update to reflect this new economic age of the country?