

## Vienna & Walzer- Real Estate and Banking - By Jerry Cedicci & Robin Trehan

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The real estate market has long been considered one of the key factors that affect the stability of the banking industry, most especially during a general economic crisis. In the 1980s and into the early 1990s, many banks failed due to the sharp fall of commodity prices, the entry of new banks, restrictions against interstate branching of banks, and steep increases in commercial real estate lending because of tax incentives and increased competition.

These all conspired to increase the exposure of banks in residential real estate lending, many borrowers failing to fulfill their obligations on their mortgages as the economy spiraled downward. In this period, about 9% of banks closed or required financial succor from the FDIC.

Some analysts believe there were really too many banks during this period, undermining profitability in lending as competition drove banks to underprice and take on more risk than was wise. The drastic decline in the number of banks through bank failure or through mergers and acquisitions helped to rectify such risky behavior. In choosing banking companies for investment, one of the characteristics that affect decision-making is the level of prudence in mortgaging behavior, transparent in hedging real estate mortgage market risks as well as the percentage of non-performing assets. This clearly illustrates how real estate lending policies have a significant impact on a bank's perceived stability, and would also indicate that growth in the real estate industry would have a direct effect on the banking industry as well.

In a study of 'de novo' banks, or new bank activity between 1995 and 2003, it was found that the greatest numbers of start up banks were in Florida, Georgia, Illinois, California, and Texas. It was also found that the financial fragility and susceptibility to failure of these new banks were largely attributable to fluctuations in real estate mainly because new banks are typically established in areas of greater economic activity, which translates to higher risk in terms of real estate loans. Moreover, newer banks tend to adopt risky lending strategies more than established banks in efforts to turn a profit amidst fierce competition for low-risk loans.

Aside from straightforward mortgages, the state of the real estate industry also has an effect on the activity of private equity funding. Because these types of financing are often expect solid returns over the long-term, an unstable real estate market is unlikely to attract positive attention from private equity groups.

It is interesting to note, however, that hedge funds has been actively used in the real estate market. Because real estate is typically a long-term investment and hedge funds are normally a quick in-and-out investment strategy, many analysts believe this is a positive indicator of the future of the real estate market.

Despite these observations, however, it is undeniable that the real estate market is subject to cyclic trends. Even established banking institutions are not proof against real estate booms and busts as evidenced by those that occurred several times in the history of the US, emphasizing the correlation between real estate and bank activity, which in turn reveals the economic health of a particular country, whether developed or with an emerging economy. As recently as 2006, delinquencies in the mortgage market began a domino effect on banks and hedge funds as interest rates rose and housing prices dropped and borrowers defaulted as the value of their property became less than their mortgage. In other words, history shows clearly that the financial aspects of real estate have a significant effect on bank performance and subsequently on overall economic health of the country. In terms of financial strategies, those who can afford to hold on to their investments during the low point of the cycle will most likely reap the expected profits.

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