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Islamic Financial Institutions and Real Estate Cycle: A Review

Siti Latipah Harun*[1], Norazlina Abd Wahab[1], Rosylin Mohd Yusof[2]

[1] *Islamic Business School, Universiti Utara Malaysia*
[2] *UUM Kuala Lumpur, Universiti Utara Malaysia*

Abstract: The role of Islamic financial instuitions is essential in providing Islamic financing specifically to investors and stakeholders to invest in real estate. Therefore, understanding the link of the real estate cycle to the financial institutions is crucial. This is because the real estate cycle is one of the critical elements that will affect financing decisions and strategies of the banking sectors. Hence, this paper employed meta-analysis which aims (1) to systematically review survey the growing literature on real estate cycle and its links to the financial institutions; (2) to highlight possible cross-country trend analysis financial strategy among investors in dealing in with the real estate cycle. The results of the study suggest that during the peak cycle or period of crisis, most investors are risk-averse and increase the risk to the financing of real estate as well. This real estate cycle that occurs almost every 10 years in conventional real estate sectors also give some consequences to the Islamic financial institutions. This paper suggests to investors to understand the real estate cycle and its impact on Islamic financial institutions.

Keywords: Islamic financial institutions, real estate cycle, literature review

JEL Classification: G20, L85
Paper Type: Literature Review

* Corresponding author: E-mail: sitilatipah@uum.edu.my, Phone: +60169694080, Fax: +6049284000

1. INTRODUCTION

Real estate is one of the most diversified portfolios to be invested in since this market is less risky as compared to other assets. The detail discussion on real estate is more diversified than the other assets detail discussed by Eichholtz (1996). Many studies including Zhu (2003) find that commercial real estate cycle (proxy with real estate price) is affecting bank lending. He finds real estate prices is depending on the borrowers' credit risks. This happened because of the commercial real estate acts as collateral in the commercial property financing.

Review of literature on financial sustainability concludes that policymakers and financial regulators should ensure the Islamic financial institutions is operate under the guidance of *shariah* (Aliyu, Hassan, Yusof, & Naiimi, 2016). The following sections detail out the overview of the real estate cycle followed by a review of the literature on real estate cycle and its link to the financing. At the end of this paper, we suggest a few roles of central banks and policymakers to overcoming the impact of the real estate cycle in the future.

2. OVERVIEW OF REAL ESTATE CYCLE

Real estate cycle is a vital cycle to be recognised especially for investors, developers and financial providers. Lee (2011) states that real estate cycle may work for every 10-year cycle and Mueller (2018) shows the 30 years of each cycle completed from periods 1968 to 1997 whereby real estate cycle involves four stages of the cycle as follows:

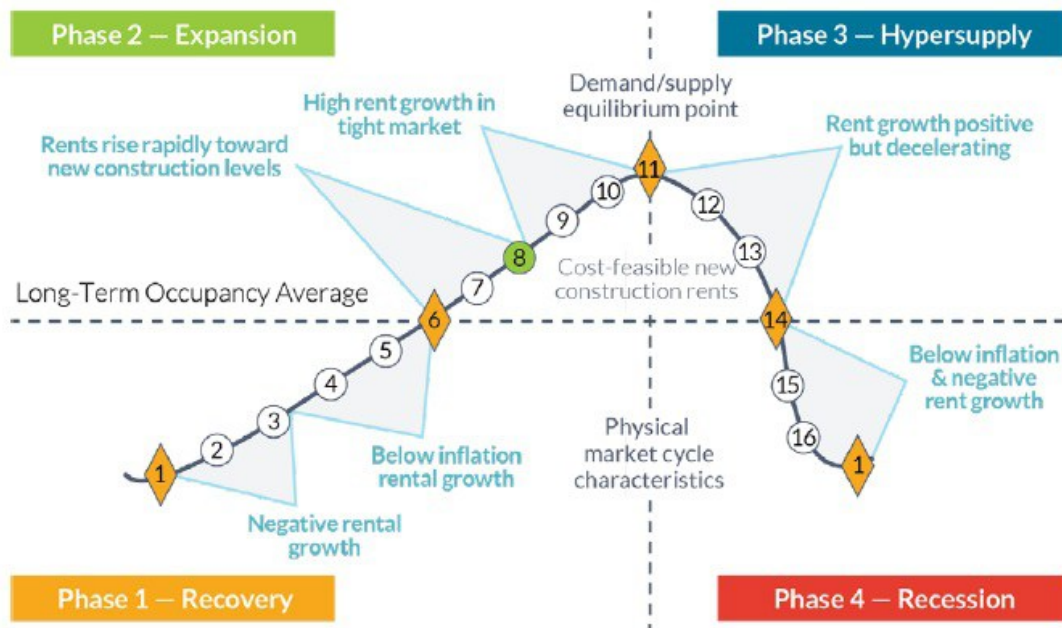

Figure 1. Real Estate Cycle
Source: Extracted from Mueller (2018)

Figure 1 shows four stages involve in real estate cycle which move in a cyclical order. Phase 1 was the Recovery phase. This phase was the period where the oversupply of commercial property from the previous period remain unchanged. Commercial property experiencing low rental growth because of slow demand in commercial property. For

instance, Kuala Lumpur office market after the 1997 crisis take three to five years in recovery phase (Hussein, 2011). Phase 2 was the Expansion phase whereby the property price upswing whereby property values rise, leasing activities as well as GDP were rise. The peak point during expansion phase occur when supply and demand of commercial property space in equilibrium. This then increases the borrower's demand for commercial property financing. Banks are more willing to lend to borrowers because of the expectation of higher profits.

Moving on to hypersupply phase 3, The equilibrium between supply and demand in the expansion wave leads to oversupply (imbalance demand and supply). Oversupply of space can be caused by overbuilding. This might happen due to shift in economy. Hypersupply is marked by rising vacancies. Rent growth may remain positive, but at declining levels. In banks, capital rising, and low cap rates. At this phase, the real estate price also raise unexpectedly and then leads to declining in real estate financing. Then at stage four was the period of crisis. At this moment, entity downsizing, the decline in real estate values, declining rents and high vacancy rates, low development and government intervention needed. Based on the real estate cycle, some of the scholars state the real estate cycle could be predicted (See Lee, 2011; Mueller, 2018). However, Olszewski (2012) states that lessons from the Global Financial Crisis were real estate cycle could not be predicted because real estate price was depending on the changes in macroeconomics and local factors (local economic conditions,) as well as the behaviour of investors.

3. FINANCIAL INSTITUTIONS AND REAL ESTATE CYCLE LINKAGE

Some studies argue that the property boom in the real estate cycle contributes to underperformed of financial institutions. An example, Olszewski (2012) finds that deregulation and interest rates volatility leads to real estate price booms. These situations will, later on, put the banking sectors and the economy more at risk. In other words, the rise in real estate price will give an impact to the banking system and demand shock[1]. As Keeton (1999) finds that an increase in loan growth will lead to higher loan losses. This loan is determined by the shift in the supply of bank credit. Evidence from the Global Financial crisis, many banks collapsed due to the facts of property boom. For instance collapse of the Norwegian banking institutions is due to asset price bubbles in 1860 and followed by the banking crisis in 1864 (Gerdrup, 2003)

However, some studies argue that lenders' behaviour tends to effects the real estate cycle. For instance, Pavlov and Wachter (2011) studied on subprime lending and real estate price. They found that aggressive supply of financing leads to increases the real estate boom. In addition, their results conclude that regions that receive a high concentration of aggressive financing instruments experience larger asset price increases and subsequent declines than areas with a low concentration of such instruments.

Also, Gerdrup (2003) compares three major banking crises in Norway (1899-1905, 1920-28 and 1988-92). He employed financial and macroeconomic data spanning more than 130 years. He finds that financial sector development appears to be closely linked to booms and busts in economic activity during these years. The boom periods that preceded each of the three crises all have some common features: they were characterised by significant bank expansion, considerable asset price inflation and increased indebtedness. Nonetheless, the commercial banks were severely affected in each subsequent bust. Possible explanations are provided, but this puzzle calls for more research. Altogether, a

[1] A demand shock is a sudden surprise event that temporarily increases or decreases demand in this case, real estate A positive demand shock increases demand, while a negative demand shock decreases demand. Both a positive demand shock and a negative demand shock have an effect on the prices of real estate.

strong causal link between financial fragility and banking crises is suggested. The crises occurred in different institutional environments and monetary policy regimes, and the role of these is explored, and policy lessons are drawn. In particular, the close link between monetary and financial stability is highlighted.

Pavlov and Wachter (2006a) and Pavlov and Wachter (2006b) investigate the "underpriced[2]" lending and real estate market. Similarly, they found that financing and real estate cycle are interrelated. Pavlov and Wachter (2006a) use three different datasets for 18 countries and property types and Pavlov and Wachter (2006b) highlight the case in non-recourse financing (financing was involving with collateral of the property). They find that, following a negative demand shock, the "underpricing" economies experience extreme real estate market crashes than economies in which the financing is correctly priced. Furthermore, they find that only one of the countries in their sample continues to show the underpricing symptom following a real estate market crash. This indicates that real estate market crashes have a cleansing effect and eliminate underpricing at least for some time. This makes investing in real estate markets safer following a negative demand shock.

In their previous research, Pavlov and Wachter (2004) find that financier's incentives to give financing at a lower price in the event of a highly competitive market. Pavlov and Wachter (2004) demonstrate that in a bank competition causes the mispricing of real estate are inevitable. The underpricing also leads to excess financing in the bank. As an example is a sudden collapse in United States banks (Hubbard & Mayer, 2009). Davis and Zhu (2011) find strong relations of bank's credit to commercial property in the countries that experienced crises.

Sirtaine and Skamnelos (2007) studies on credit growth in emerging Europe. They adopt a holistic approach in reviewing the rapid credit growth experienced in the region, examining macroeconomic, financial sector, corporate sector, and asset market consequences and possible vulnerabilities. They conclude that since 2000, abundant liquidity has fed an upsurge in financial activity translating into a rapid rise in bank credit, surging stock markets and a booming real estate sector.

Hendershott, (2000) investigates the real estate price bubbles. He points out that the Sydney office market is an example of asset price bubbles in the late 1980s. Real estate price bubbles occur due to the egoistic developers and profligate lenders. This is because the developers do construct the building during a period of high real estate values and vice versa. They found evidence that during real estate cycle peak, the higher the vacancies and oversupply of real estate occurred.

Some argue that real estate cycle and financial institutions move together — for example, a study by Bean (2003) which finds the association between asset prices, financial imbalances and monetary policy. He finds that financial imbalances, asset price misalignments and instability is a significant problem for monetary policymakers. Borio and Lowe (2004) define "financial imbalances" is the event of rapid credit growth occurring unusually sustained and large increases in real estate prices.

On the other hands, Bean (2003) states asset price misalignment as the large asset price movement in the real estate market. He added that achieving price stability is no guarantee that financial instability can be avoided. Firstly, he suggests that the role of monetary policy in detecting the rapid credit expansion and asset price increases are symptomatic of the development of underlying imbalances that are susceptible to future correction, rather than merely reflecting sustainable movements in the underlying economic fundamentals. Borio and Lowe (2004) use empirical proxies for financial imbalances consists of useful information about subsequent banking crises, output and

[2] Underpriced means lenders give financing at lower price, lower than their competitors.

inflation beyond traditional two-year policy horizons. They also investigate the response of central banks to financial imbalances.

Borio and Lowe (2004) find evidence that central banks generally either have not responded to imbalances systematically or, to the extent that they have, have done so asymmetrically, loosening policy further than normal in the face of their unwinding but not tightening it beyond normal as they build up. Therefore, the important of understanding imbalances unwind and their associated costs would facilitate the design of appropriate policies, on both the monetary and regulatory front (Bean, 2003; Borio & Lowe, 2004). Example of impact of high credit growth leads to a soft landing as experienced by Portugal in the early 2000s, and a hard landing as experienced by Asia in 1997 (Sirtaine & Skamnelos, 2007).

4. INVESTORS PERCEPTION LEADS TO FINANCIAL CRISIS

Investors role in enhancing the financial institutions are inevitable because, without a player, no game can be played. Gorton (1988) analyses the competing theories explaining banking panics are tested. Banking panics is the event where the borrowers nor depositors with risk averse tend to withdraw their money from the bank as soon as they perceived that recession would occur at a particular time. He finds that banking panics during the U.S. national banking era (1865-1914) were caused by the perceived risk of the banking system based on the arrival of new information. Panics were triggered by a leading indicator of recession. As in the case of US, he finds that banking panics caused by investors perception towards risks. Their findings are contradicting with the theory saying that panics in banking is a random event. Later research by Hendershott (2000) finds a low understanding of the real estate cycle among investors also leads to financial vulnerability.

The following table summarising the main finding on financial institution links to the real estate cycle.

Table 1. Summary of the main finding on financial institutions links to the real estate cycle

Authors	Main findings
Hendershott (2000)	They found evidence that during real estate cycle peak, the higher the vacancies and oversupply of real estate occurred. The low understanding of the property market among investors also among the contributing factors. Sydney office market is an example of asset price bubbles in the late 1980s.
Bean (2003)	Achieving price stability is no guarantee that financial instability can be avoided. The role of central bank and policymakers may reduce the risk of financial imbalance or misalignment of real estate price.
Gerdrup (2003)	Financial sector development appears to be closely linked to booms and busts in economic activity in late 1890 to early 1990s — the boom periods after the three crises caused by significant bank expansion, considerable real estate price inflation and increased indebtedness.
Borio and Lowe (2004)	They find evidence that central banks generally not responded to financial imbalances (real estate price boom and accumulated debt) systematically. In addition, they have loosening policy but not tightening it beyond normal as they build up.
Pavlov and Wachter (2006a)	Following a negative demand shock, the “underpricing” economies experience far deeper real estate market crashes than economies in which the put option is correctly priced. Furthermore, only one of the countries in their sample continues to exhibit the underpricing symptom following a real estate market crash. This indicates that real estate market crashes have a cleansing effect and eliminate underpricing at least for a period of time.

Authors	Main findings
Pavlov and Wachter (2006b)	The longer the underlying real estate cycle, the greater the value of the put option and the elasticity of demand for bank financing, the greater the probability that the market will enter into an equilibrium in which all banks are facing underprice risk.
Sirtaine and Skamnelos (2007)	Despite growth in the economy of UK, the financial imbalances (accumulated debt) and real estate bubbles are inevitable.
Hubbard and Mayer (2009)	In some cases, When the real estate cycle leads the market, the interest rate declines. Hence the financing is vulnerable. On the other hands, there also a case whereby the real estate boom led to a rise in the interest rate. This evidence from the 2006 and 2007 crisis.
Pavlov and Wachter (2009)	availability of aggressive mortgage lending instruments magnifies the real estate cycle and the effects of fundamental demand shocks.
Pavlov and Wachter (2011)	They find that area that highly accessible to the lending instruments experience larger real estate price increases. On the other hands, real estate price declines at the areas with a low concentration of such instruments. This indicates significant controls on the lending instrument.
Davis and Zhu (2011)	They find strong links of bank's credit to commercial property in the countries that experienced crises.

5. ISLAMIC BANKING AND REAL ESTATE CYCLE

To our knowledge, there is a lack of studies on Islamic banks relation to the real estate cycle. This may due to Islamic financing always adhered to Islamic conducts. Islam always takes into consideration the property cycle throughout the acquisition, management, and transmission (Sait & Lim, 2006).

Then, Kayed and Hassan (2007) study the crisis and Islamic finance. They found evidence that on conventional sides, the global financial crisis (GFC) was occurred due to extraordinary high liquidity, reckless lending practices, and the rapid pace of financial engineering making the complex financial instrument to transfer the risk. In contrast, most of the Islamic financial institutions did not face those problems due to factors that contribute to the financial crisis are strictly forbidden under the *Shariah* guidelines. Shariah guidelines applied by Islamic financial institutions are avoidance of *riba* in any form, circulation of wealth or money as the currency is based on the real growth in the economy. Lastly, all activities in Islamic financial institutions are free from *riba(interest), gharar (uncertainty)*, and *maysir (speculation)*. Muslims always reminded to invest only in permitted (*halal*) and leaving the forbidden (haram).

Rahman (2010) analyses the impact of financing structure on Islamic banks' insolvency risk exposure. He finds that an increase in real estate financing decreases insolvency risk. However, an increasing concentration of financing structure increases insolvency risk. He discovers that increasing the stability of the financing structure reduces risk in the short term, but not in the medium term. Interestingly, his findings show that the level of insolvency risk exposure during the 1997 Asian financial crisis was lower than it was for the overall period, whereas it is higher than the overall average in the ongoing global economic crisis. Thus, regulatory bodies, policymakers, and market players in the Islamic banking industry should take appropriate action to manage the insolvency risk of Islamic banks.

6. CONCLUSION

This paper used content analysis and found that the majority of the scholars conclude that the financial institutions associated or significantly affecting the real estate cycle, excess financing leads to the property boom in the real estate cycle. During the peak cycle or period of crisis, most investors are risk-averse and increase the risk to the financing of real estate as well. This real estate cycle occurs almost every 10 to 30-year period to complete each cycle. Based on the financial fragility approach, asset prices boom is closely linked to the boom in the financial sector and economic activity (Gerdrup, 2003). We also found that literature shows that the excess lending by financial institutions severely leads to the financial crisis and boom in real estate price. However, Islamic financial institutions are not affected by the financial crisis even stable during that phase due to the Islamic principles applied.

Therefore, to mitigate from those sudden increase in real estate price and to avoid from fluctuate in interest rate due to asset price bubbles, we suggesting that the authorities should consider to enhance the role of financial institutions either Islamic nor conventional in providing a stable rate and always ensuring the conduct of Islamic financial system following the Shariah guidelines. For instances, a few studies on Islamic financing suggest Islamic commercial real estate financing to use Sukuk (Parsa & Muwlazadeh, 2013); rental rate as the pricing of Islamic home financing (Yusof, Kassim, Majid, & Hamid, 2011).

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