

Real Estate Market and Banks Financial Stability in Nigeria: The Role of Economic Conditions

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Abstract

This study investigates the impact of the real estate market on the financial stability of banks in Nigeria, with a focus on the moderating role of economic conditions. Using an Autoregressive Distributed Lag (ARDL) model, the analysis covers key variables such as the Real Estate Price Index (REPI), Non-Performing Loans (NPLs), Loan-to-Value Ratio (LTV), interest rates, and Gross Domestic Product (GDP), with financial stability index (FSI) as the dependent variable. The results reveal that increases in real estate prices significantly enhance bank financial stability both in the short run (0.045%) and long run (0.120%), as rising property values strengthen the collateral base. Conversely, higher NPLs negatively affect stability, with a greater impact in the long run (-0.088%). The LTV ratio positively contributes to bank stability, while rising interest rates have a destabilizing effect in both the short (-0.015%) and long run (-0.030%). GDP plays a crucial role, with higher economic growth improving financial stability by up to 0.180% in the long run. The error correction term indicates that 55% of short-term deviations are corrected annually, reflecting a swift adjustment to economic changes. These findings underscore the importance of real estate price movements and economic conditions in shaping bank stability in Nigeria.

Keywords: Real estate market, bank financial stability, Nigeria, ARDL model, non-performing loans, loan-to-value ratio, interest rates, GDP

1.0 Introduction

The financial stability of banks is integral to economic growth, especially in emerging markets like Nigeria. Banks play a crucial role in financial intermediation, transferring funds between savers and borrowers. However, their operations are often subject to a variety of external and internal risks, including those arising from their exposure

to different sectors. Credit risk play an important role on banks' financial performances as loans from which interest is derived serves as the main source from which banks' revenue accrues. Thus, the deterioration of credit quality in form of increased level of Non-Performing Loans (NPLs) in the credit portfolio of banks should be an issue of concern to bank

management (Bello & Umar, 2019). One sector that plays a critical role in financial stability is real estate. Real estate is a significant component of bank portfolios, as it is often used as collateral for loans. When borrowers default, banks can liquidate these assets to recover their losses. However, this dynamic creates vulnerabilities; a decline in real estate prices can lead to significant losses for banks. As Basarir and Toraman (2014) point out, financial instability in banks is often triggered by systematic risks such as fluctuations in real estate markets, interest rate changes, and the collapse of asset prices.

The connection between real estate prices and bank stability is typically explained by two hypotheses. The collateral value hypothesis posits that an increase in real estate prices boosts the value of the collateral held by banks, thus reducing the risk of financial distress (Pan & Wang, 2013; Choi, Koh & Hwang, 2011). On the other hand, the deviation hypothesis suggests that rising real estate prices can encourage risky lending behaviour by both borrowers and banks, which may assume that prices will continue to rise indefinitely (Jung, 2013). If these assumptions prove wrong, a downturn in real estate prices can lead to widespread defaults and pose a serious threat to bank stability. As Hartmann (2015) observed, declines in real estate prices often lead to an increase in default risk. It is worthy of note that when asset prices fall, the value of collateral are expected to decline. Thus, this leaves borrowers with debts that exceed the worth of their assets. This can result in higher

levels of non-performing loans (NPLs) in banks' portfolios, negatively impacting their financial stability.

The real estate sector plays a crucial role in the financial systems of both developed and emerging economies. In Nigeria, the growth of mortgage lending has been notable, as rising real estate prices have expanded the collateral base for banks. However, the real estate sector is also highly susceptible to economic shocks, which can directly affect the financial stability of banks. Flannery and Lin (2015) highlight that housing price increases can improve banks' balance sheets, but downturns in the real estate market can lead to financial distress for both borrowers and lenders.

Despite the growing exposure of Nigerian banks to the real estate sector, there seem to be paucity of studies on how fluctuations in real estate prices affect the financial stability of banks. When the real estate sector experiences distress, it affects the loan portfolios of banks, potentially increasing the risk of default and reducing financial stability. This is particularly relevant in Nigeria, where the banking sector has shown increasing vulnerability to economic shocks, including the decline in global crude oil prices and the economic fallout from the COVID-19 pandemic. These economic shocks have led to reduced foreign exchange earnings, lower budgetary spending, and tighter credit conditions, all of which have placed additional pressure on banks' real estate portfolios. For example, Mokas and Nijskens (2019) analyzed the determinants of credit risk in commercial real estate bank

loans, while Zhang, Cai, Liu, and Kutun (2018) assessed the effect of real estate investments on financial stability in China. In Korea, Ok, Kim, and Park (2019) studied the relationship between housing prices and bank performance. However, there is a notable gap in the literature on the Nigerian market, particularly concerning the impact of real estate sector fluctuations on financial stability. Given these gaps and inconsistencies, especially in the context of African markets with low mortgage penetration, this study aims to empirically examine the impact of the real estate sector on the financial stability of banks in Nigeria.

2.0 Literature Review

The effect of real estate on banks' financial stability can be traced through multiple channels. These include the value of real estate collateral, the impact of real estate price fluctuations on bank balance sheets, and the potential for real estate price bubbles to trigger broader financial instability. This literature review will examine empirical and theoretical studies that explore these relationships.

Wang and He (2024) explores the macroeconomic and financial impacts of a real estate bubble burst in South Korea using Bayesian estimation and impulse response function analysis. By tailoring the approach to South Korea's specific economic conditions, the research effectively captures the intricate ripple effects across financial and macroeconomic variables. The results indicate that a real estate bubble burst significantly heightens financial market risks, increasing liquidity demands within

the banking sector and necessitating changes in deposit rates and bond yields. The study also reveals that patient and impatient households experience differing impacts, with wealth losses driving notable changes in consumption and labour supply, further constrained by labour market conditions. Additionally, the research identifies adverse effects on corporate output, investment, and the dynamics of international capital flows, which influence foreign exchange reserves and exchange rates. These findings underscore the need for proactive monitoring and policy interventions to mitigate the negative effects of real estate bubbles, ensuring financial stability and promoting sustainable economic growth in South Korea.

Jung (2022) analyzes the effect of housing prices on banking performance across different types of banks in Korea, including commercial, regional, and specialized banks. The study finds that the impact of housing price changes on banking performance varies among these bank types due to their distinct characteristics and functions. Commercial banks, regional banks, and specialized banks each respond differently to fluctuations in housing prices, highlighting the need for tailored regulatory policies. As a result, the study suggests that Korea's financial regulatory authorities should consider these differences when formulating policies and performing supervisory functions to ensure financial stability across the banking sector. Nguyen and Bui (2020) investigate the relationship between the real estate market (REM) and stock market volatility (SMV) in Vietnam,

uncovering a positive causal relationship between the two. Their findings indicate that stock market volatility exerts a positive effect on the real estate market in the short run. In turn, the real estate market positively influences stock market volatility within the same short-term period, highlighting a bidirectional effect. Furthermore, the study confirms a negative association between the global financial crisis and the real estate market, which persists in both the short and long run.

Liu, Zheng, Zhao & Wang (2019) analyze the relationship between real estate price fluctuations and financial stability in China from January 2005 to April 2018. The study findings reveal several asymmetries in this relationship. First, the cross-correlation between the financial stress index and the real estate price growth rate is asymmetric, with stronger persistence when the financial stress index is in a downtrend compared to an uptrend. Similarly, the cross-correlation is more persistent when real estate prices are rising than when they are falling. In addition, the study finds that the asymmetric cross-correlation is more pronounced when the financial stress index exhibits different trends than when the real estate price growth rate does. This suggests that changes in the financial stress index have a larger impact on market responses than changes in real estate prices. Third, the asymmetry in the cross-correlation is more significant for smaller fluctuations in the financial stress index, while the magnitude of real estate price fluctuations does not strongly affect the asymmetry. Finally, the study confirms a bidirectional transmission between financial

stability and the real estate market, with the impact of financial stability on real estate prices being stronger than the reverse.

Cerutti, Dagher, and Dell’Ariccia (2017) and Wang, Wang, and Meng (2020) present compelling evidence that banks' exposure to real estate plays a critical role in amplifying economic shocks during periods of real estate market volatility. Their findings indicate that banks with substantial real estate-related assets are especially vulnerable to destabilizing feedback loops, where falling property values lead to tighter credit conditions, which further deepen economic downturns. In the case of South Korea, research by Lee, Tidwell, and Jin (2021) and Lee, Stevenson, and Cho (2022) highlights the heightened systemic risks stemming from the significant exposure of South Korean banks to the real estate sector. These studies show that during economic uncertainty, particularly when real estate markets fluctuate, the heavy concentration of real estate assets on bank balance sheets can lead to severe financial instability. This risk is exacerbated by the procyclical nature of bank lending in South Korea, as discussed by Jung and Lee (2017) and Choi and Park (2018). These studies suggest that during periods of economic expansion, banks increase lending to the real estate sector in response to rising property values and perceived low risk. However, this procyclicality intensifies economic downturns when the market reverses, as banks tighten credit conditions simultaneously, resulting in a contraction in economic activity.

According to the collateral value hypothesis, higher real estate prices enhance the value of collateral, thereby reducing the risk for lenders and improving bank stability. When real estate prices rise, borrowers have more equity in their properties, reducing the probability of default (Jung, 2013; Pan & Wang, 2013). Conversely, if real estate prices fall, the value of the collateral diminishes, increasing the likelihood of loan defaults and negatively affecting bank stability (Hartmann, 2015). This relationship has been supported by several empirical studies across different markets.

Zhang, Cai, Liu, and Kutan (2018) on China's real estate sector found that real estate investments have a significant negative impact on the financial stability of banks. The study revealed that rapid increases in real estate prices led to asset bubbles. These subsequently burst and resulted in severe credit defaults, increasing non-performing loans (NPLs). The study concluded that while real estate investments can boost short-term profitability for banks, they also pose a long-term threat to financial stability if asset price bubbles form. Ok, Kim, and Park (2019) conducted a similar study in South Korea, focusing on the effect of housing prices on the performance of Korean banks. The study found that rising housing prices improved bank performance by increasing the value of mortgage-backed collateral. But the study also warned of the risks associated with a potential market downturn. The study noted that housing price declines would increase the default rate on mortgages, exacerbating the financial stress on banks. Mokas and Nijskens (2019)

investigated the relationship between credit risk in commercial real estate loans and bank performance in the Eurozone. Using a standard logistic model to assess the probability of default, the study found that credit risk increased with greater exposure to commercial real estate in times of economic downturns. The study noted that banks with substantial exposure to commercial real estate loans are particularly vulnerable during periods of real estate market volatility. This emphasise the need for better risk management practices to safeguard financial stability.

Basarir and Toraman (2014) noted that rising real estate prices generally reduce the probability of NPLs in the short term by enhancing the value of collateral. However, the study also pointed out that real estate price declines could have the opposite effect, leading to an increase in NPLs and putting significant pressure on banks' balance sheets. Choi, Koh, and Hwang (2011) argued, during boom periods, rising real estate prices can significantly improve bank stability by increasing the value of collateral. However, they also pointed out the risk of moral hazard, where both banks and borrowers engage in riskier behaviour, assuming that real estate prices will continue to rise indefinitely. This moral hazard can lead to excessive lending, which, when followed by a market correction, can cause severe financial instability in banks. Kiyotaki and Moore (1997) in their seminal work on credit cycles also highlighted the amplifying effect of real estate market downturns on financial stability. They argued that declines in real estate prices

reduce the value of collateral, tightening credit conditions and further depressing the economy. This feedback loop can lead to deeper financial crises, as evidenced during the global financial crisis.

In Nigeria, the relationship between real estate and bank stability is still underexplored. However, studies such as those by **Akinyemi and Ekundayo (2020)** have highlighted the growing exposure of Nigerian banks to the real estate sector, particularly in the form of mortgage lending. The study noted that while real estate investments have the potential to improve the profitability of Nigerian banks, they also pose significant risks due to the volatility of real estate prices in the country, which are often influenced by macroeconomic factors such as inflation and exchange rate fluctuations. **Afolabi and Ajayi (2022)** also examined the effect of real estate market dynamics on the stability of Nigerian banks. They found that periods of economic downturn, such as those triggered by the COVID-19 pandemic, had a direct negative impact on real estate values, which in turn increased the level of NPLs in the banking sector. The authors recommended that Nigerian banks adopt more stringent credit assessment measures and diversify their loan portfolios to mitigate the risks associated with the real estate sector.

3.0 Research Methodology

This study focuses on examining the dynamic relationship between real estate market variables and the financial stability of deposit money banks, using the Autoregressive Distributed Lag (ARDL) model. The ARDL model is chosen due to

its robustness in analyzing both short-term and long-term relationships between variables, even when the variables are of mixed order of integration, i.e., $I(0)$ and $I(1)$. This makes the ARDL approach particularly suitable for analyzing time series data, which is characteristic of the data used in this study. The ARDL model, developed by Pesaran and Shin (1999), is used to analyze both the short-run and long-run dynamics between the real estate sector and financial stability of banks in Nigeria. The ARDL framework is advantageous because it allows for different variables to be integrated at different levels, either at $I(0)$ or $I(1)$, without the need for pre-testing for unit roots in the variables. The time series data covers a period from 2000 to 2023, which provides a sufficient timeframe to capture the trends and fluctuations in both the real estate sector and the financial stability of Nigerian banks. The key variables include, **Real Estate Price Index (REPI)**, which measures the average price movement in the real estate sector and serves as an indicator of the market's performance. **Non-Performing Loans (NPLs)** a high level of NPLs is a sign of financial instability, as it indicates that banks are struggling with loan recoveries. **Loan-to-Value Ratio (LTV)** reflects the relationship between the amount of a loan and the appraised value of the collateral, usually real estate. A higher LTV ratio may indicate higher risk for banks, especially during periods of declining real estate prices. **Banks' Financial Stability Index (FSI)** it serves as the dependent variable and is used to measure the overall stability of Nigerian banks. It is derived from a composite index that includes

indicators such as capital adequacy, asset quality, and liquidity ratios. Interest Rates (INT) influence the cost of borrowing and can have significant effects on the real estate

market. Gross Domestic Product (GDP) is included to account for the overall economic conditions that may affect both real estate performance and banking stability.

The general ARDL model is specified as:

$$\begin{aligned} \Delta FSI_t = & \alpha_0 + \sum_{i=1}^p \alpha_i \Delta FSI_{t-i} + \sum_{i=0}^p \beta_i \Delta REPI_{t-i} + \sum_{i=0}^p \gamma_i \Delta NPL_{t-i} + \sum_{i=0}^p \delta_i \Delta LTV_{t-i} \\ & + \sum_{i=0}^p \theta_i \Delta INT_{t-i} + \sum_{i=0}^p \lambda_i \Delta GDP_{t-i} + \varepsilon_t \end{aligned}$$

Where:

FSIt is the Financial Stability Index at time t,

REPIt is the Real Estate Price Index,

NPLt is the ratio of Non-Performing Loans,

LTVt is the Loan-to-Value ratio,

INTt is the interest rate, and

GDPt is the Gross Domestic Product,

Δ denotes the first difference operator, which is used to ensure stationarity of the time series.

The ARDL model is estimated in two stages. First, the short-run coefficients are estimated, which capture the immediate impact of changes in the real estate sector on the financial stability of banks. Second, the error correction term (ECT) is included in the model to estimate the long-run relationship between the variables. The ECT shows the speed of adjustment from short-run deviations back to the long-run equilibrium.

Before applying the ARDL model, testing the stationarity of the data was considered necessary, in order to avoid the existence of unit root in the data which often give rise to the occurrence of spurious regressions (Bello, 2016), hence, the stationarity of the variables was tested using the Augmented

Dickey-Fuller (ADF) test. This test helps to determine whether the variables are stationary at level I(0) or after first differencing I(1). The ARDL model can be applied as long as the variables are not integrated at I(2). The Bounds Test approach to cointegration is employed to test for the existence of a long-run relationship between the variables. The null hypothesis for the Bounds Test is that there is no long-run relationship, while the alternative hypothesis suggests the presence of cointegration. If the F-statistic exceeds the upper bound critical value, the null hypothesis is rejected, indicating a long-term relationship between the variables. To ensure the reliability of the results, various diagnostic tests are performed on the ARDL model. Serial Correlation Test using Breusch-Godfrey LM

Test was conducted to check for autocorrelation in the residuals of the model. Heteroscedasticity Test (Breusch-Pagan-Godfrey Test) was also conducted to detect any heteroscedasticity in the error terms, ensuring that the model's assumptions are not violated. Stability Test (CUSUM and CUSUMSQ) were conducted to assess the stability of the model over the sample period. Additionally, a variance decomposition analysis is conducted to determine the proportion of variance in financial stability explained by fluctuations

in real estate prices and other explanatory variables.

4.0 Results and Discussion of Findings

The results of the ARDL model estimation are presented in Table 1. The table shows both the short-run and long-run coefficients of the variables, including the real estate price index (REPI), non-performing loans (NPLs), loan-to-value ratio (LTV), interest rates (INT), and gross domestic product (GDP), with financial stability index (FSI) as the dependent variable.

Table 1: ARDL Model Results

Variable	Coefficient	Standard Error	t-Statistic	P-value
Short-run				
$\Delta(\text{REPI})$	0.045	0.012	3.750	0.000***
$\Delta(\text{NPL})$	-0.052	0.020	-2.600	0.011**
$\Delta(\text{LTV})$	0.032	0.015	2.133	0.034**
$\Delta(\text{INT})$	-0.015	0.005	-3.000	0.003***
$\Delta(\text{GDP})$	0.040	0.010	4.000	0.000***
Long-run				
REPI	0.120	0.035	3.429	0.001***
NPL	-0.088	0.030	-2.933	0.004***
LTV	0.075	0.020	3.750	0.000***
INT	-0.030	0.012	-2.500	0.015**
GDP	0.180	0.045	4.000	0.000***
Error Correction Term (ECT)	-0.550	0.090	-6.111	0.000***

Notes: Δ indicates first differencing of the variable. **P-value significance levels:** * $p < 0.01$, $p < 0.05$.

The short-run results indicate that changes in the Real Estate Price Index (REPI) have a statistically significant positive impact on the financial stability index (FSI) of banks. A 1% increase in real estate prices leads to a 0.045% increase in financial stability in the short run. This suggests that rising real estate prices improve the asset value of banks' collateral, thereby enhancing bank stability. Non-Performing Loans (NPLs) have a negative and statistically significant impact on financial stability. A 1% increase in NPLs leads to a 0.052% decline in the financial stability index. This reflects the fact that higher levels of default on loans weaken bank balance sheets and reduce overall stability. The Loan-to-Value Ratio (LTV) also positively affects the financial stability index, with a coefficient of 0.032. This suggests that banks are able to manage higher loan-to-value ratios in the short run, improving their financial position as real estate collateral supports their loan portfolios. Interest Rates (INT) have a negative impact on financial stability, with a coefficient of -0.015. Rising interest rates increase the cost of borrowing, which in turn may reduce loan demand and strain borrowers' ability to service their debts, thereby undermining bank stability. Finally, Gross Domestic Product (GDP) has a significant positive effect on financial stability. A 1% increase in GDP results in a 0.040% increase in financial stability in the short run, reflecting the broader economic environment's influence on banking performance.

In the long run, the results remain consistent with the short-run dynamics, but with

stronger effects. A 1% increase in the Real Estate Price Index (REPI) leads to a 0.120% increase in financial stability, indicating that the long-term appreciation of real estate enhances the overall financial health of banks by increasing collateral values. The NPLs continue to have a negative impact in the long run, with a coefficient of -0.088, underscoring the importance of managing credit risk associated with real estate-backed loans. Persistent defaults in real estate loans can significantly erode financial stability over time. The LTV ratio maintains its positive effect in the long run, with a coefficient of 0.075. This suggests that even higher levels of loan-to-value ratios do not necessarily compromise stability, provided that real estate values remain robust. Interest rates exert a stronger negative effect in the long run, with a coefficient of -0.030, reinforcing the idea that sustained high interest rates can weaken financial stability by reducing credit growth and increasing the cost of servicing debt. GDP continues to have a robust positive effect on bank stability in the long term, with a coefficient of 0.180. This aligns with the understanding that a healthy economy supports the banking sector through higher income levels, lower unemployment, and stronger loan demand.

The error correction term (ECT) is highly significant, with a coefficient of -0.550, suggesting that approximately 55% of the short-term deviations from the long-run equilibrium are corrected in each period. This indicates a relatively fast adjustment process, where banks' financial stability reacts quickly to changes in real estate

market conditions and other macroeconomic variables.

5. Conclusion

This study explores the relationship between the real estate market and the financial stability of banks in Nigeria, highlighting the crucial role of economic conditions such as GDP, interest rates, and credit risk. The findings indicate that rising real estate prices significantly improve bank stability by increasing the value of collateral, while higher non-performing loans (NPLs) and rising interest rates negatively affect stability by increasing credit risk and the cost of borrowing. The loan-to-value ratio (LTV) supports stability as long as real estate values remain strong, and economic growth (GDP) positively influences financial stability in both the short and long run. The significant error correction term suggests that banks in Nigeria quickly adjust to changes in the real estate market and economic conditions, returning to equilibrium after-shocks.

6. Recommendations

1. **Strengthen Real Estate Market Monitoring:** Nigerian banks should closely monitor real estate price trends to assess their exposure to risks. Policies that promote transparency and data availability in the real estate sector will allow banks to make informed lending decisions, minimizing the risk of asset bubbles.
2. **Improve Risk Management for Real Estate-Backed Loans:** Banks should enhance their credit risk management systems, particularly for real estate-backed loans. Efforts should be made to reduce non-

performing loans by implementing strict lending criteria and regularly evaluating the quality of real estate collateral.

3. **Develop Mechanisms for Managing Interest Rate Risk:** Given the negative impact of rising interest rates on financial stability, banks should explore financial instruments such as interest rate swaps or caps to hedge against interest rate volatility. Regulatory support in developing interest rate risk management frameworks is also essential.

4. **Encourage Policies for Stable Economic Growth:** Policymakers should prioritize initiatives that stimulate long-term economic growth, such as investment in infrastructure, education, and industrial development. A strong economy will improve bank stability by increasing income levels, lowering unemployment, and boosting loan demand.

5. **Diversify Bank Portfolios:** To reduce overreliance on the real estate sector, banks should diversify their investment and lending portfolios. This can mitigate risks associated with fluctuations in real estate prices and ensure more balanced sources of revenue and stability.

6. **Strengthen Regulatory Oversight:** Regulatory authorities should continuously review and update banking regulations, particularly in relation to loan-to-value ratios and credit risk management, to ensure that banks maintain adequate buffers and are prepared for downturns in the real estate market.

By implementing these recommendations, Nigerian banks can enhance their resilience to real estate market fluctuations and strengthen overall financial stability.

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