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How do information advantages and regulation influence banks' real estate activities in other European countries?

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A substantial share of bank loans of euro area banks is secured with real estate. In a new study, we examine whether, in the low interest rate environment, banks invested more in foreign real estate-backed lending. Our results suggest that regulatory differences between the bank's home country and possible destination countries matter for banks' search for yield.

Financial crises are often not detached from problems in real estate markets. One reason for this is that a substantial part of bank loans are secured with real estate (Chart 1). Selected studies focus on developments in the domestic real estate market and potential risks to banks' stability. However, little evidence exists on the determinants of banks' real estate activities in other European countries and their implications for the stability of banks. Our paper explores two questions. First, we examine whether, in the low interest rate environment, banks invested more in foreign real estate backed lending (Schmidt and Tonzer (2024)). Second, we analyse how banks' foreign real estate backed lending affects bank risk.

Problem statement

In a first step, we investigate the extent to which local (borrower-country) information advantages are relevant for banks in the euro area in search for yield from granting foreign real estate loans. Particularly in the low interest rate environment, banks might have leveraged information and specialisation advantages abroad to strengthen their profitability by investing there. In a second step, we examine whether banks disclose potential losses if they were more active in a foreign real estate market offering a higher interest margin compared with their home country.

Procedure and findings

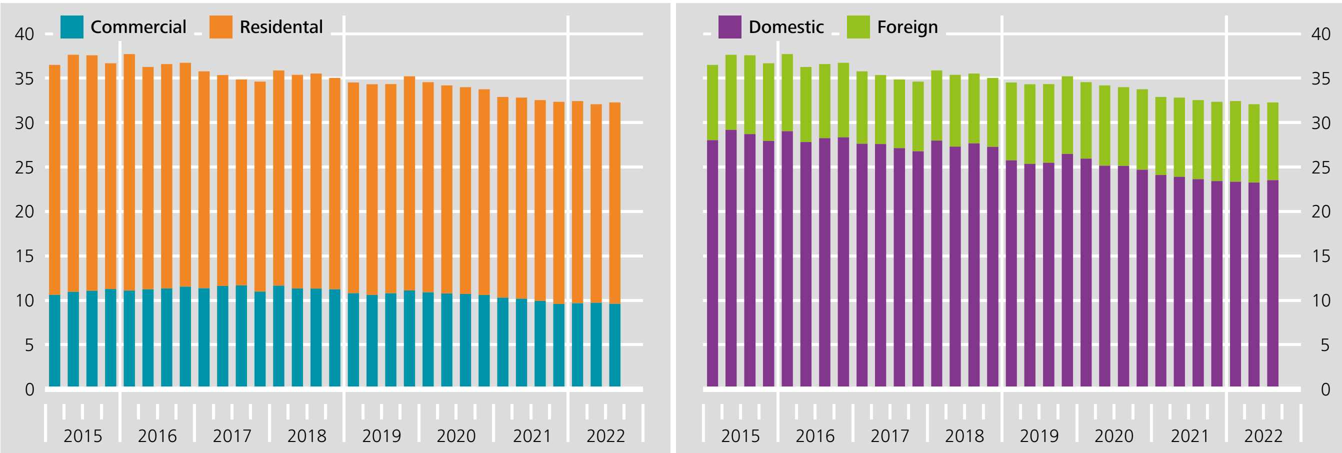
Based on a sample of the largest banks resident in one of the euro area countries between 2015 and 2022, we exploit information on business activities at the country level. In particular, we know the volume of real estate backed loans that each bank granted in every euro area country. Using this bilateral data structure, we find that banks that have stronger links to the destination country expand their lending activities in the respective real estate market if the foreign market offers higher lending rates compared to the home country. The result is especially present if there are no (real estate-specific) macroprudential measures observed for the home and destination countries, or if there is a misalignment in macroprudential policies across the home and destination countries.

Macroprudential measures are taken at the discretion of the competent national supervisory authorities. The aim of those

Relevance of real estate backed loans

Chart 1

Percentage share of loans



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measures is to avoid systemic risks in the home country, for example in the real estate market. This can be achieved, for example, by increasing the capital risk weights applied to the loans concerned, making it "more expensive" for banks to grant loans in the respective segment.

Our results show that, for loans secured by commercial real estate, banks show greater lending sensitivity to interest rate spreads, especially in the case of a non-existence of real estate related macroprudential policies or implementation differences across countries. For exposures secured by residential real estate, it is mostly a tighter regulatory stance at home compared to abroad that generates a positive and significant lending response to the interest rate spread.

Higher interest margins may be associated with greater risk. We therefore analyse whether banks that have invested more in foreign real estate markets with higher interest margins have higher risk metrics. Our results show that better capitalised banks notably have higher forbearance ratios, meaning that they grant more borrowers (temporary) relief in the repayment of the loan owing to doubts about their creditworthiness. By contrast, potential loss disclosures generally decline for weakly capitalised banks that are more exposed to countries in which lending rates for real estate loans are higher. The finding that capitalisation is a factor in loss disclosure is consistent with existing research findings (Behn and Couaillier (2023)). During the pandemic, it was above all weakly capitalised banks that saw an increase in the foreign share of underperforming real estate loans in banks' portfolios.

Conclusion

Our findings help understand recent dynamics of banks' foreign real estate backed loans and the effectiveness of macroprudential regulation. Overall, our results suggest that regulatory differences between the bank's home country and possible destination countries matter for banks' search for yield. If banks engage in regulatory arbitrage and consequently invest in the individual euro area countries, this can benefit diversification aspects, reduce home bias and contribute to financial integration in the euro area. Banks' response to differences in regulation is to be welcomed in this case, because it means that they are still in a position to cover a certain range of loans without having to invest in markets subject to systemic risk. This finding only holds, however, if supervisory authorities in the home and destination countries apply the same regulatory standards when assessing systemic risks. Consistent with this line of thinking, our analysis supports the efforts of the European Systemic Risk Board (ESRB) to ensure the harmonisation of macroprudential policies across euro area countries.

References

Behn, Markus and Couaillier, Cyril (2023). Same same but different: credit risk provisioning under IFRS 9 ECB Working Paper Series, No 2841. European Central Bank.

Schmidt, Kirsten, Tonzer, Lena (2024). „Banks' Foreign Homes". Discussion Paper No 46/2024. Deutsche Bundesbank.

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News from the Research Centre

Publications

"Banks of a Feather: The Informational Advantage of Being Alike" by Peter Bednarek (Deutsche Bundesbank), Valeriya Dinger (University Osnabrück), Alison Schultz (University Mannheim) and Natalja von Westernhagen (Deutsche Bundesbank) will be published in the *Journal of Money, Credit and Banking.*

"Are risky banks disciplined by large corporate depositors?" von Björn Imbierowicz (Deutsche Bundesbank), Anthony Saunders (NYU Stern), Sascha Steffen (Frankfurt School of Finance and Management) will be published in the *Journal of Money, Credit and Banking*.

Events

24. – 25. April 2025
"Spring Conference on Expectations of Households and Firms", Eltville