Structure of the Spanish housing market and sources of finance: an overview

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Summary

In Spain, gross capital investment in construction, particularly that related to residential uses, has made a significant contribution to aggregate economic and financial developments. In nominal terms, in 2004 construction investment represented 16% of GDP and 58% of total gross fixed investment. Around 50% of the investment in the construction sector was related to residential uses.

The involvement of the public sector in the construction sector and, more specifically, in the residential housing segment has been extensive in Spain. Such involvement has taken the form of new regulations, favourable tax treatment of certain operations, direct supply of subsidised housing and subsidies for housing financing. Although over recent years such involvement has diminished, regulations are still impinging on the structure of the housing market.

Over the last decade, residential building activity in Spain has remained strong and relatively stable in comparison with other types of building activity due to a combination of factors. In a context where the ratio of owner-occupied dwellings has been traditionally high (above 80%), regulations and fiscal treatment have boosted housing ownership against rentals. In addition, the declining trend in the level of interest rates and the lengthening maturities of mortgage loans contributed to improving affordability ratios over the 1990s, even against a background of dynamic house prices.

Demand for housing, mainly for principal housing, has remained strong and has supported a significant increase in the growth of house prices in a framework of high land prices but relatively low and stable construction costs. The expansionary credit policies of credit institutions in a context of low interest rates and strong employment growth have made financing of housing demand possible.

Over the last decade, the expansionary behaviour of the residential building market has been financed directly through the banking system, mainly banks and savings banks. The role of specialised institutions has been minor. Regarding housing finance, credit institutions have provided funds not only to households for house purchases but also to constructors and building developers that, in many cases, transfer their mortgage credits to households when house purchases are formalised. In addition, in some cases, financial institutions hold direct stakes in construction firms and building developers, though this channel of involvement is of minor importance except for specific institutions. Competition between institutions has taken place not only through prices but also through the supply of new mortgage products which allow borrowers more flexibility regarding maturities and debt payments and, in some instances, through the holding of credit lines available for uses other than house purchase.

In a context of ample liquidity and favourable housing market prospects, Spanish credit institutions have aimed to increase their market share in the mortgage credit segment. The relatively low level of household indebtedness in the 1990s and the lower risk associated with collateralised credit have been factors supporting this goal. The increasing competition in the Spanish mortgage market has gone hand in hand with an adequate control of credit risk by financial institutions. This control has been based on the development of internal processes in line with guidelines issued by the Bank of Spain and compatible with Basel II principles.

In Spain, mortgage loans have shown an accelerating trend from the 1990s onwards. Most of this financing has been directed to house purchases by households and has taken the form of credit at variable rates (more than 95% of all outstanding contracts) with an average maturity of 15-20 years.

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Traditional liabilities, mainly deposits from the private sector, have been the main source of financing of asset growth. However, over recent years deposit growth has been unable to keep pace with the high growth rates of the mortgage business. External financing and refinancing of mortgage operations through securitisation have helped to fill the gap. Since the late 1990s, the need for funds together with some changes in mortgage market regulations have helped boost the growth of mortgage-backed bonds.

Housing markets are by definition local in nature. However, internationalisation of mortgage financing through securitisation is probably contributing to the creation of financial links between markets. It should be noted that a large portion of Spanish securitised mortgage bonds is in the hands of foreign investors (around 60% according to the latest available information).

Policy-related questions

- How can different mortgage finance structures affect the growth of mortgage financing to households and, in more general terms, the structure of total financing?
- Mortgage securitisation helps diversify risks, but what are the consequences for financial stability, from both an individual country perspective and a global one? What is needed is an analysis of the repercussions for the fragility of different economic sectors and their sensitivity to simultaneous shocks in economic activity, interest rates and the real estate markets.
- How do new mortgage products affect supervision (methods, organisation and coordination of supervisory bodies/agencies) of the financial system on both country and EU levels?
- Has mortgage securitisation intensified international links between housing markets and, therefore, the spillover effects in a stress scenario?
- In the absence of legal impediments, to what extent can an easy refinancing of mortgage credit by financial institutions trigger the use of mortgage credit to finance consumption?

1. Structural issues in the residential housing market and price developments

1.1 General considerations

According to the latest Spanish housing census available (2001), around 69% of the total number of dwellings in Spain are primary homes, 16% secondary housing and 14% remain unoccupied. Moreover, 84.6% of all dwellings used as primary homes are owner-occupied, against 10% which are rented. The predominance of owner-occupied principal dwellings has intensified over the last two decades, partly as a result of the favourable fiscal treatment of this type of tenure and the negative effects of some rental regulations on the supply of rented houses.

Since the 1990s, demographic and economic developments[2] have prompted strong housing demand from first-time buyers. In addition, the increasing demand for secondary homes, from both residents and non-residents, has supported strong activity in the residential segment of the real estate market. These developments have given rise to a strong demand for housing in an environment of low financing costs and lengthening maturities of mortgage loans. In addition, downward adjustments in stock prices in the late 1990s after the equity boom and the greater appreciation of risk regarding

[2] The demographic factors include: the increase in the number of young people over 20, the reduction in the number of inhabitants per home, the increase in the number of single-person households or households with two adults and no children. The economic factors include: the growth of average real disposable income since the 1980s and the declining trend in interest rates over the 1990s. See J Martínez and LL Matea, "The housing market in Spain", *Economic Bulletin*, Bank of Spain, October 2002.

financial investments can explain an increase in housing demand in terms of investment considerations, mainly in a context of strong and persistent growth of house prices.

As can be observed in Graph 1, after a recession period which involved negative growth rates in nominal terms from March 1992 to June 1993, and in real terms from that period to 1996, prices of new dwellings excluding those subsidised have shown an accelerating trend. Growth between December 1994 and December 2004 was 178.1%, maintaining annual growth rates well above 15% from December 2000 onwards. By contrast, over the same period, residential building costs have shown more subdued behaviour (an accumulated growth of 35.5%). The price and availability of land have often been mentioned as explanations for such developments. Notwithstanding, expectations of increasing house prices in the future are among the main factors contributing to current land price developments.[3]

1.2 Public sector involvement in the housing market

In Spain, the housing market has been one of the most affected by public sector intervention. However, over recent years, measures have been taken to diminish the burden of regulations and to avoid interference with the structure of the market. The public sector has mainly been involved through two channels: (i) direct regulations, and (ii) fiscal policy.

The regulations with the most direct impact on the housing market structure have been:

- The Planes de Vivienda (Housing Plans), which comprise policy on subsidised housing and whose objective is to ease the access of low-income segments of the population to housing, fixing maximum prices for subsidised housing. These plans are developed and implemented by local and regional governments.
- The Ley del Suelo (Land Law), which regulates the land regime and use of land, urban planning, and the valuation of different types of land, and defines the administrative procedures involved in the building and promotion of housing.
- The Ley de Arrendamientos Urbanos (LAU, Urban Leasing Law), which has had a decisive impact on the housing tenure regime (ownership or rental) in Spain. This law regulates the different interests of lessors and lessees. It lays down rental provisions such as contract duration, rents and how and when they can be updated, and subrogation possibilities. Until the reform of the existing regime in 1985 (RD 2/1985), further developed by the LAU of 1994, the regulation of rentals had been very restrictive and had favoured lessees. The result was a significant negative effect on the supply of rentals and an incentive to owner-occupied dwellings. From 1994 in particular, measures were taken to change the situation and to promote the rental regime, including the liberalisation of rents and duration of new contracts.

The legislation above and the fiscal treatment of the different tenure regimes have accounted for the current structure of the housing market. Housing ownership has been encouraged through the favourable fiscal treatment of investment in housing and of mortgage borrowing.

Until 1987, investment in principal housing or in secondary residences (in an unlimited number of units) had been personal income tax deductible. In 1988 and 1990, the deduction in respect of the financing of secondary housing was limited to a single dwelling, and in 1991 it was completely abolished. In the case of principal residences, modifications and limits to the fiscal benefit regime were introduced in 1999. Notwithstanding, investment in respect of owner-occupied housing continues to be favourable. Moreover, in the 1999 fiscal reform, the favourable treatment of imputed income to principal dwellings under personal income tax was removed, though it remains in the case of secondary residences. However, in the case of rentals, between 1992 and 1998, rent payments became personal income tax deductible, but the fiscal reform of 1999 eliminated such benefits.

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[3] Land price developments are closely linked to the expected return of the project to be developed on the land and, therefore, to house prices. For different approaches to the analysis of house price determinants in Spain, see, for example: J Ayuso and F Restoy, "House prices and rents: an equilibrium asset pricing approach", *Working Paper* no 0304, Bank of Spain, 2003, and J García-Montalvo, "La vivienda en España: degravaciones, burbujas y otras historias", in *Perspectivas del Sistema Financiero* no 78, 2003.

In conclusion, although legal modifications have been introduced in order to correct those aspects of the regulatory and fiscal regime which encouraged ownership tenure against rentals, the current supply of rented housing has not grown significantly, and new measures are still being implemented to boost it.

In the 1980s, official subsidised housing (viviendas de protección oficial) represented on average around 60% of the total number of housing starts. This percentage subsequently diminished, ranging from 20 to 30% over the 1990s, and has further decreased since then, remaining around 10%. In July 2005, the Housing Plan for the period 2005-08 was approved; among other objectives, it envisages an increase in subsidised housing.

Total public sector housing subsidies comprise not only the building of housing under special price conditions for low-income segments of the population, but also fiscal housing benefits, interest rate subsidies, and any other type of subsidy implemented by the central, local and regional governments. According to some available estimates,[4] total public sector subsidies represented around 2% of GDP in the first half the 1990s, but declined thereafter to close to 1.5% in 1999 (the last date for which data are available). Over the 1990s, according to some available estimates, such significant subsidies represented between 20 and 50% of the final price of housing, depending on the region, the income of the recipients and the year considered.

2. The financing side of the housing market

The banking system is the main provider of financing to the residential housing market through credit granted to households for house purchases and also to constructors and building developers. As might be expected, most mortgage credit granted by Spanish credit institutions is directed to residents. In 2004, only around 2% of total mortgage credit granted by Spanish institutions through their network in Spain went to non-residents. However, at the end of 2004, foreign banks (branches and subsidiaries of foreign institutions) provided 14.4% of total mortgage credit for house purchases granted by banks and around 5.5% of credit to constructors and building developers. Foreign subsidiaries appear to be more active in granting credit for house purchases than credit to constructors and building developers, but, in the case of branches, the opposite is observed.

According to the law regulating the Spanish mortgage market (Ley 2/1981 de regulación del mercado hipotecario), any deposit-taking institution can grant mortgage loans and issue bonds for financing such loans. In addition, specialised mortgage credit institutions, which cannot receive deposits, also exist, but their market share is small in relation to deposit-taking institutions. Granting mortgage credit is a profitable activity for credit institutions given the above-mentioned developments in the demand for housing and the scope opened for cross-selling.

In Spain, on average, loan-to-value ratios (LTV) of outstanding operations stand at 70-80%. According to capital requirement regulations issued by the Bank of Spain, mortgage loans with housing collateral in respect of owner-occupied or rented property have a weight of 50% against that of 100% if the LTV ratio is equal to or lower than 80%. In the cases where LTV ratios are above 80%, Spanish credit institutions often demand complementary guarantees. It should be stressed that in Spain the value of the collateral to be taken into account for a credit to be granted is determined by special valuation firms (tasadoras) which are regulated by the Bank of Spain.

Since the mid-1990s, in a framework of liberalised credit conditions, the credit policies of financial institutions have been very competitive. Competition has taken place through prices and also the issuance of mortgage products with flexible characteristics regarding maturities and interest rate arrangements (fixed or variable rate or a combination of the two over time). More recently, credit institutions have started launching mortgage products which, in some cases, give borrowers mortgage credit lines that, under certain conditions, can be directed to uses other than house purchase.[5] The

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4 See ECB, *Structural factors in the EU housing markets*, 2003.

5 Products which allow borrowers to use mortgage credit to finance operations other than house purchases are being marketed by some credit institutions.

decline in the cost of subrogation and modification of mortgage loans as a consequence of certain regulatory changes introduced in 1994 to liberalise the mortgage market (Ley 2/94 de subrogación y novación de préstamos hipotecarios) helped boost such competition.

Mortgage credit conditions are freely set by credit institutions depending on demand and their own objectives. Only a low percentage of credit for house purchases, around 6.5% in 2003 and 2004, is subject to special privileged conditions regarding interest rates. This type of credit is regulated in the Housing Plans (Planes de Vivienda) mentioned above and is used to finance subsidised housing.

The degree of competition in the Spanish mortgage credit market can be considered relatively high. At the end of 2004, the four largest deposit-taking institutions provided around 36% of mortgage credit and the 11 largest ones approximately 55%.

In Spain, most of the credit to the private sector is at variable interest rates (63.3% at the end of 2004), partly because of the past experience of high inflation and interest rates. In the case of credit for house purchases, this percentage has always been significantly higher; in December 2004, around 90% of new credit for house purchases had interest rates revisable within a year.

Financing to the private non-financial sector has expanded at very high rates over recent years, particularly that to households, and has continued to post high growth rates because of the strength of credit for house purchases, which represents around 35% of total credit to the private sector.

Credit for house purchases is not the only source of financing related to the housing sector. Credit granted to constructors and building developers has also shown a strong pattern of growth over recent years. Annual growth rates of credit to building developers have been above 35% since 2003 (Graph 2). As a result, credit to constructors and building developers has increased in relative importance in total credit to the private sector (more than 18% of total credit in 2004). In many cases, credit granted to building developers is subrogated to house buyers when the purchases are carried out (when the credit is transferred, it is booked as new credit to households for house purchase).

To a large extent, the above-mentioned considerations explain why the growth of financing to the private sector by credit institutions has remained at levels significantly higher than that of the funding from this sector. As a result, interbank financing from abroad has gained ground, issues of debt have increased in importance and, to a certain extent, securitisation of banking assets has been boosted as a means to refinance mortgage credit and to manage not only risk profiles but also liquidity.

In Spain, financial institutions took the first steps in the asset securitisation process in 1981, when the Law of the Mortgage Market (Ley 2/1981 de regulación del mercado hipotecario) enabled them to finance mortgage credit through the issuance of different types of mortgage bonds (cédulas hipotecarias, bonos hipotecarios and participaciones hipotecarias). These securities allowed credit institutions to raise funds and to manage certain risks associated with the mortgage portfolio. Cédulas hipotecarias are backed by a credit institution's whole mortgage portfolio and do not involve a narrowing of balance sheet portfolios because the credit risk of mortgage loans remains with the credit institution. By contrast, participaciones hipotecarias are backed by a specific category of mortgage credit and buyers acquire credit risk while the legal responsibility for the legitimacy of the credit remains with the issuer.

The legal framework for mortgage securitisation was not fully developed until 1992 (Ley sobre el régimen de las sociedades y fondos de inversión inmobiliaria y sobre Fondos de Titulización Hipotecaria), when securitisation through a type of special purpose vehicle was made possible. That law allowed participaciones hipotecarias issued by financial institutions to be transferred to Fondos de Titulización Hipotecaria (FTHs), which transform them into homogeneous standardised bonds (called mortgage-backed bonds) that can be negotiated in organised markets. Mortgage credit backing participaciones hipotecarias must comply with certain conditions: it must be a first mortgage, it must not exceed 80% of the appraised value of the collateral, and the collateral must be under the complete control of the lender.

The maturity of participaciones hipotecarias in a Fondo de Titulizacion Hipotecaria should be equal to that of the associated mortgage credit. In this framework, securitisation does not refer directly to mortgage credit but to the participaciones hipotecarias. FTHs are vehicles completely independent of the financial institutions which originated the mortgage credit. They do not have any legal status and their net assets are zero, though a formal deed is required to set them up. The holders of the mortgage-backed bonds issued by an FTH assume the credit and prepayment risks and are not empowered to take any type of legal action against the originators of participaciones hipotecarias or the mortgage debtor in case of default or prepayment.

In 1998, some new regulatory developments (RD 926/1998) introduced major changes regarding securitisation processes: the creation of Fondos de Titulización de Activos (FTAs, as distinct from Fondos de Titulización Hipotecaria), which can issue bonds against any financing instrument, not only mortgage loans, granted by credit institutions.

The creation of FTAs represents a significant step in the advancement of securitisation in Spain. FTAs are much more flexible than FTHs. They are open funds: assets and liabilities of a specific fund can change. These SPVs allow the securitisation of assets other than mortgage loans and even synthetic securitisation, in which only risks or rights (not assets) are transferred. FTAs allow cédulas hipotecarias issued by banking institutions to be securitised. Some small savings banks can jointly create a single SPV to securitise loans or cédulas whose securitisation by each bank individually would have been impossible because of size.

In addition, the liabilities of FTAs can be made up of bonds or banking loans. In the case of mortgage loans, if the securitisation takes place through an FTA, the loans do not have to comply with the conditions set for loans securitised through FTHs. However, this does not necessarily imply that loans are of sub-prime quality, though the law does offer the possibility of securitising mortgage loans of lower quality. Were lower-quality loans to be securitised, the rating of the bonds issued would reflect that fact if no additional guarantees were provided. Moreover, capital requirements would take this situation into account. Notwithstanding, for the moment, the rating of bonds backed by mortgage loans issued by FTAs does not appear to be worse than that of bonds issued by FTHs.

According to data on new issues of asset-backed securities in 2004, the assets securitised by FTAs (as a percentage of total new issues by FTAs) are: cédulas hipotecarias 39%, mortgage loans 30%, loans to small and medium-sized firms 18%, all others 13% (credit rights with issuance of commercial paper, credit to public sector, consumer loans, other).

Issues of asset-backed securities accelerated from 2000, when non-mortgage assets were first securitised and mortgage loans securitised by FTAs started to grow significantly.

Spanish credit institutions are careful and prudent in granting mortgage loans to households, because, inter alia, capital requirements and provisioning take direct account of the quality of the loans granted. Spanish banks use score models and other internal risk control tools to closely analyse probabilities of default and the severity of the different types of borrowers/operations. The Bank of Spain's supervision unit carefully monitors the standards of credit institutions' lending policies.

In 2003, synthetic securitisation, that is, the transfer of only credit risk with assets remaining in the balance sheet, was legally authorised (Ley 62/2003), though specific rules for its implementation are still to be fully developed.

Securitisation of assets by credit institutions has been very dynamic over recent years, particularly since the above-mentioned regulation changes in 1998. In 2003, approximately 60% of total issues of asset-backed bonds were related to mortgage assets. Since 2000, and in 2003 in particular, the growth of issues of asset-backed bonds has been strong, mainly in the case of mortgage asset bonds through Fondos de Titulización. The volume of issues of mortgage-backed securities from 2000 to 2003 increased by a factor of 5 (by 2.0 and 5.5 in the case of Fondos de Titulización Hipotecaria and Fondos de Titulización de Activos respectively).

The main holders of Spanish asset-backed securities are foreign investors. Among domestic holders, credit institutions, on occasion the originators, acquired the majority of asset-backed bonds (76% in 2003), followed by mutual funds and insurance companies. The investment in asset-backed securities by originators is explained by liquidity considerations insofar as bonds with standardised conditions are more liquid than loans and can be directly exchanged in the market.

The growth of Fondos de Titulización de Activos and Fondos de Titulización Hipotecaria means that part of the mortgage financing granted by credit institutions has been written off from balance sheets. Therefore, when looking at total mortgage financing to the private sector, one should take into account not only direct credit granted by financial institutions but also off-balance sheet mortgage securitisation. As shown in Graph 2, the annual growth of both total mortgage financing and financing for house purchases has remained above 15% since the late 1990s.

One of the consequences of the strong growth of mortgage financing to households has been their increasing level of indebtedness. In December 2004, household indebtedness represented 103% of households' disposable income. At the same time, the ratio of household savings to GDP showed a declining trend during the late 1990s, which has stabilised at low levels over recent years. However, house price inflation has involved a revaluation of real estate wealth held by households, which represented almost five times GDP in 2004. Nonetheless, the debt burden on households has remained relatively stable in terms of their gross disposable income, though with a tendency to increase (around 13.5%, taking into account interest payments and an estimate of amortisation flows). Low interest rates and longer maturities have compensated for the increase in debt payments because of increasing house prices in the 1990s. However, since 2000, the effort (annual payment as a percentage of wage cost) made by an average household to purchase a house has been increasing (see Graph 3). House prices in relation to disposable income per household have steadily increased since 2000, representing four times the disposable income per household in 2004.

3. Some issues related to the management of credit risk by credit institutions and borrower protection

According to the guidelines for adequate internal management of risks issued by the Bank of Spain (in line with the Basel II principles) and to the regulations on capital requirements and provisions on credit risk, Spanish institutions have developed internal processes to monitor and manage risks. Detailed information about these processes and internal models can be found in the annual reports of the credit institutions.

Many credit institutions use scoring techniques to classify their clients or products in relation to their probability of default. These scorings are reviewed periodically (at least annually) to incorporate new information. In addition, and according to the type of product, an estimate of loss-given-default is carried out.

To a large extent, the assessment of credit risk profiles associated with mortgage credit is based on the capacity of borrowers to cope with their debt burden, taking into account past records, level of indebtedness in relation to income, holdings of financial and real assets, etc. Additional factors considered in credit assessment are the specific characteristics of the mortgage products and type of collateral.

Apart from the analysis mentioned, credit institutions set internal limits on total credit exposure by type of client and/or type of credit which are periodically reviewed by internal committees. In this connection, limits on LTV ratios are also internally established.

Most credit for house purchases has a mortgage guarantee, and on average the LTV ratio is around 70-80%. On the occasions when this percentage is higher, institutions usually demand other types of collateral or guarantees. Mortgage collateral has to be appraised by a recognised valuation firm (conditions of the valuation are regulated by the Treasury and the Bank of Spain). In addition, mortgages have to be entered in property registers.

Credit institutions usually require borrowers to take out a house insurance policy to protect the state of the collateral.

Default rates of mortgage credit to households are low (on average, lower than 0.5%) and significantly below those of other types of credit, particularly when the collateral is the principal residence.

As mentioned, financing of housing not only comprises credit for house purchases but also credit to constructors and to building developers. The credit risk inherent in this financing is higher, as shown by the delinquency rates of loans to these sectors, which, in addition, are particularly sensitive to economic cycles. As a consequence, capital requirements and provisions are tighter.

If the debt burden of a credit is unpaid, after a period determined by the Bank of Spain (three months) it must be classified as doubtful (if the unpaid debt represents more than 25% of the total credit, all the exposure, not only past due debt, is classified as doubtful). In case of bankruptcy, if there is a significant deterioration in solvency or if doubtful debt remains unpaid for three years after being classified as doubtful (six years in the case of mortgage credit financing of fully built dwellings and with LTV ratios not higher than 80%), loans are written off against provisions and profit and loss accounts, and the unpaid debt is accounted for in an off-balance sheet account. This process is independent of any negotiation or legal prosecution with a view to recovering debt.

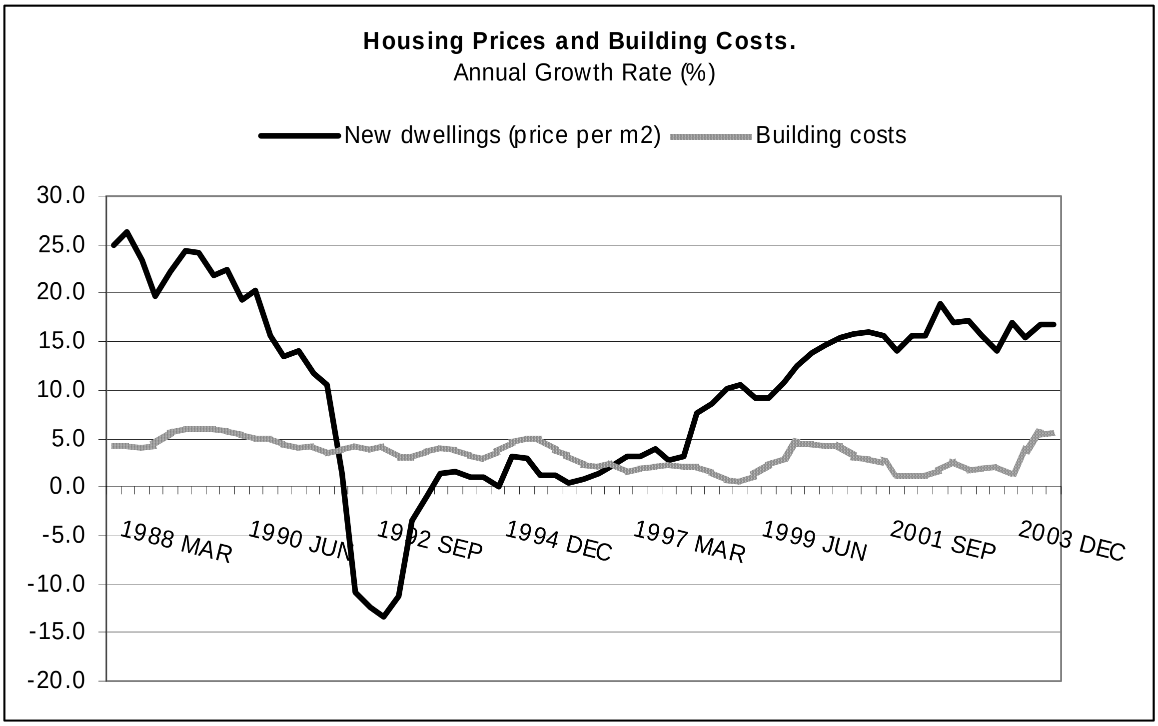
In the case of unpaid debt, borrowers have to pay some penalty interest and fees for claims for unpaid debt. Credit institutions cannot execute guarantees directly; they must follow a legal procedure and present a legal claim to the courts.

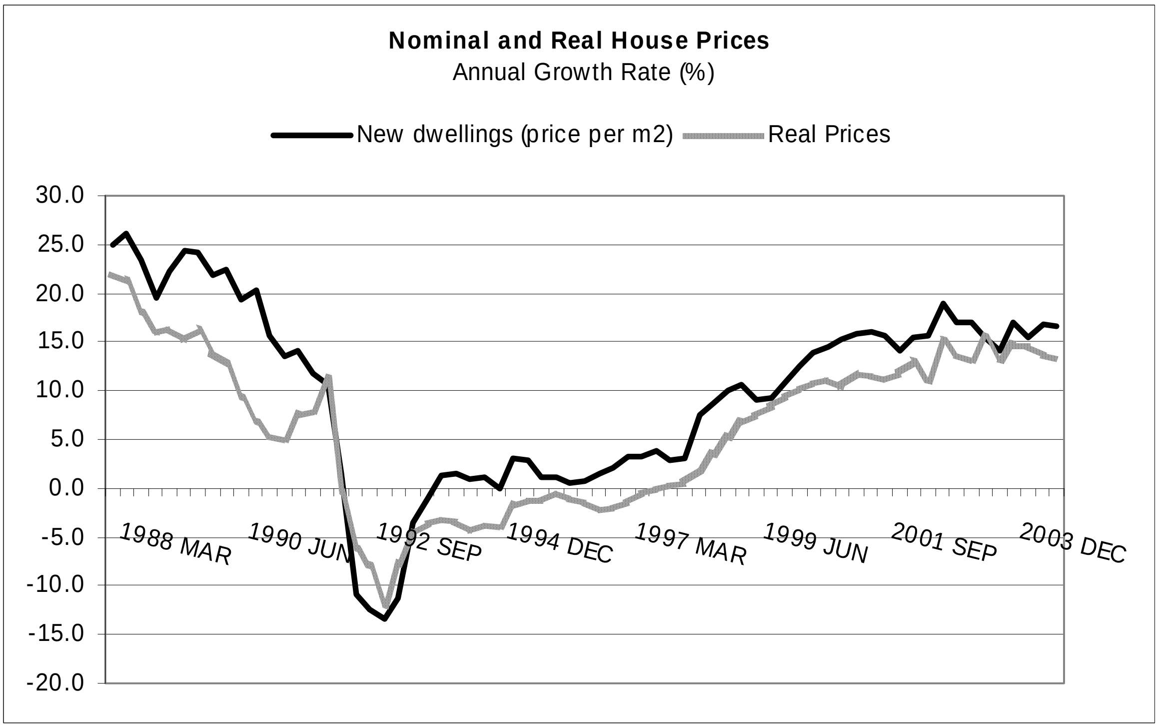
Regarding the rights of mortgage borrowers, the conditions of mortgage loans have to be specified in a deed to be entered in a property register. Among such conditions, the interest rate arrangements of the contract must be included, and in the case of flexible rates, the reference rate too. A set of official reference rates is defined by the Bank of Spain, but any other reference can be chosen as long as it is external to the lender institution. Borrowers can freely move any existing mortgage to any lender other than the originator. Since 1994, maximum fees have been set by legislation (Ley 2/1994) to facilitate these movements. The interest rate arrangements or the maturity of a mortgage loan can also be modified.

The Bank of Spain has issued detailed regulations on due transparency in banking operations.

Graph 1

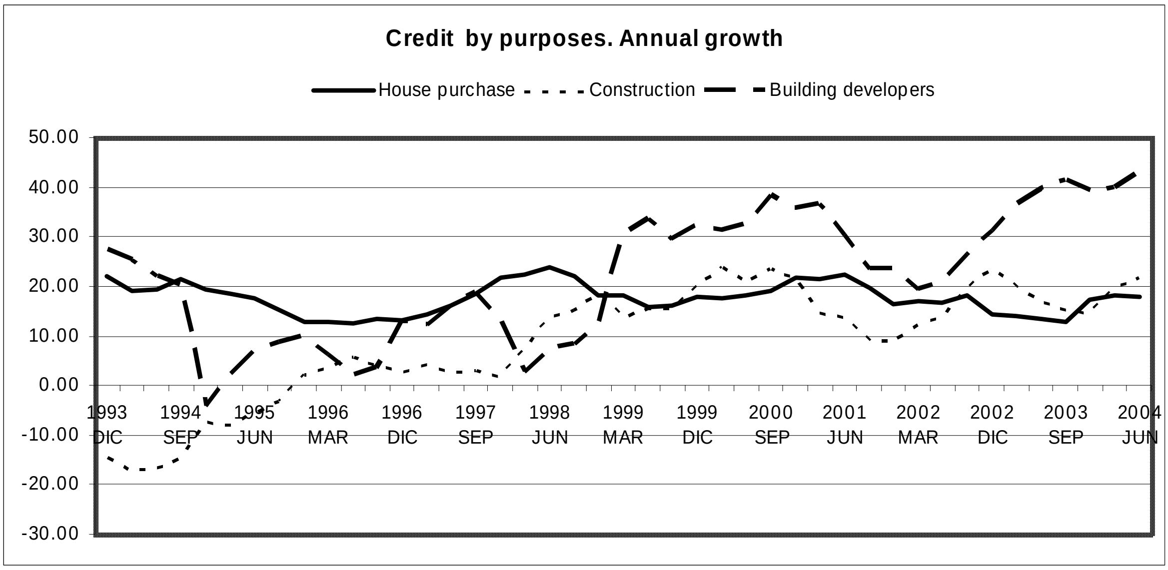
House price developments

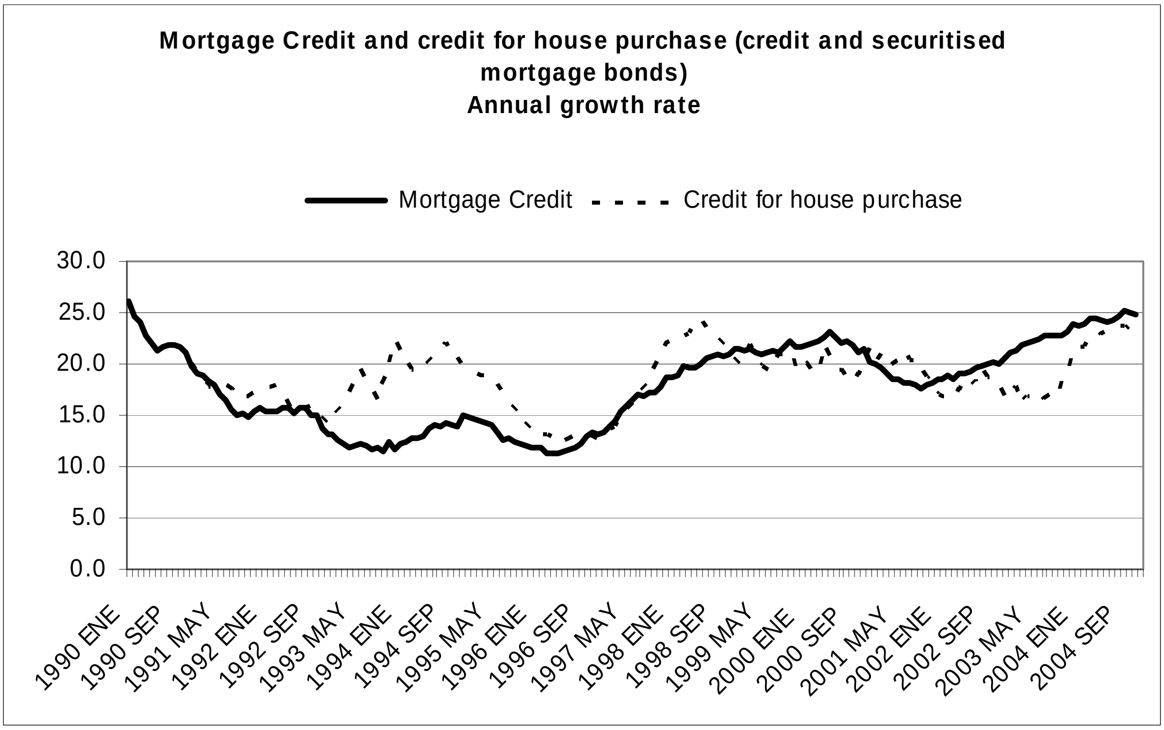




Graph 2

Credit related to the housing/mortgage market





Graph 3

Housing affordability and interest rates