BANCO DE ESPAÑA
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Closing remarks

Event on the "Impact of the new law on real estate credit"/PWC

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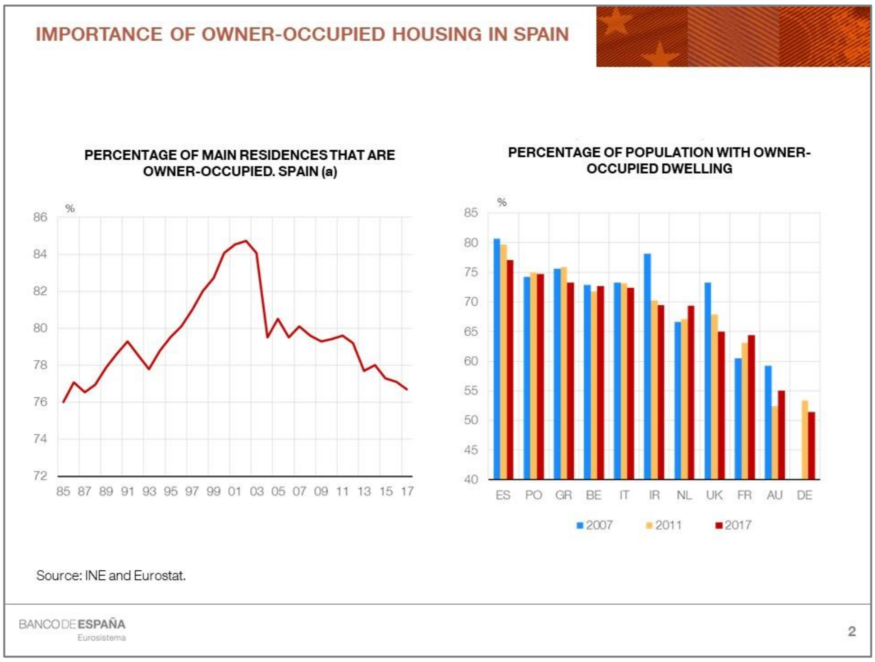
Deputy Governor

Good afternoon,

I would like to thank PWC for kindly inviting me to speak at the close of today's event on the new real estate credit law. I shall try to speak about the most innovative features of the new law from the supervisor's standpoint, not dwelling too long on the details of the legal changes introduced, as I am sure that they have been widely discussed over the course of the morning.

Specifically, I shall focus on the three features of the new law that strike me as particularly important from a supervisory viewpoint: (i) the emphasis given to customer protection, (ii) the need to ensure legal certainty for the mortgage market to function properly and (iii) the growing importance of credit conditions. I shall also refer to the potential short and medium-term consequences of this law for access to owner-occupied housing, and shall conclude with some thoughts on how the new macroprudential tools may shape the way we supervise certain banking businesses, notably real estate lending.

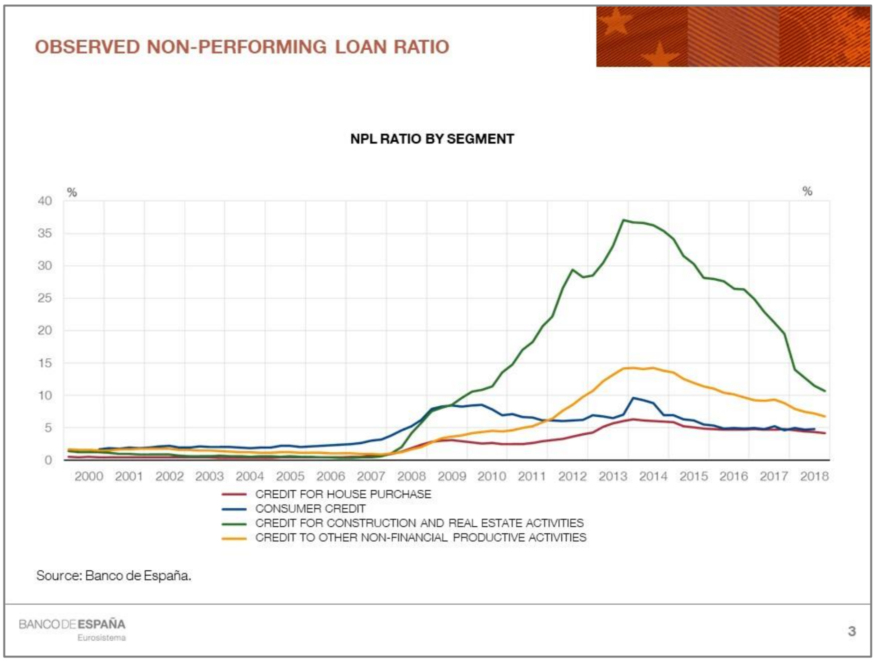
Introduction



As we know only too well, access to home ownership is an issue of great concern to Spanish society. Worldwide, Spain has traditionally been among the countries with the highest owner-occupancy rates. Although this rate has declined from the peak reached in 2002, it is still higher than in other European countries.

Obviously, I am not going to analyse here our cultural preference for home ownership, although I will say that, in my opinion, there are both positive and negative aspects to this. On the positive side, ownership affords households greater stability and financial security for retirement. As a matter of fact, our home often represents the main part of our “savings” when the time comes for us to retire. Evidently, this tendency also has a less positive side. For instance, it is an obstacle to personal and professional mobility at different stages of life and reduces the proportion of savings we hold in the form of financial products.

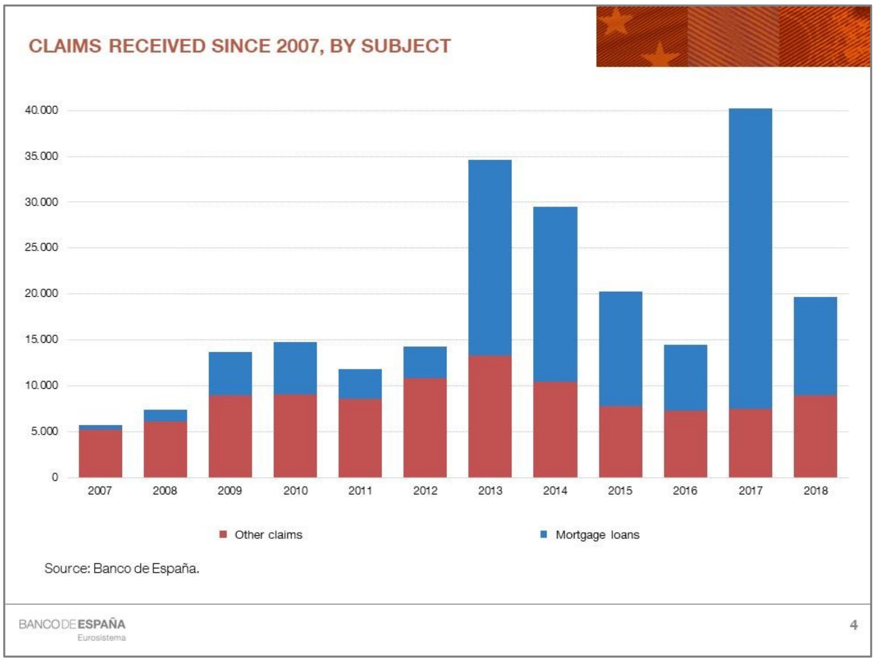
At any rate, buying a home is one of the most important financial decisions in a person’s life and, in many cases, our biggest investment, which normally requires financing and means entering into a long-term payment commitment with a lending institution. As the financial crisis has painfully reminded us, this long-term commitment is a potential source of problems at times of financial instability or job insecurity.



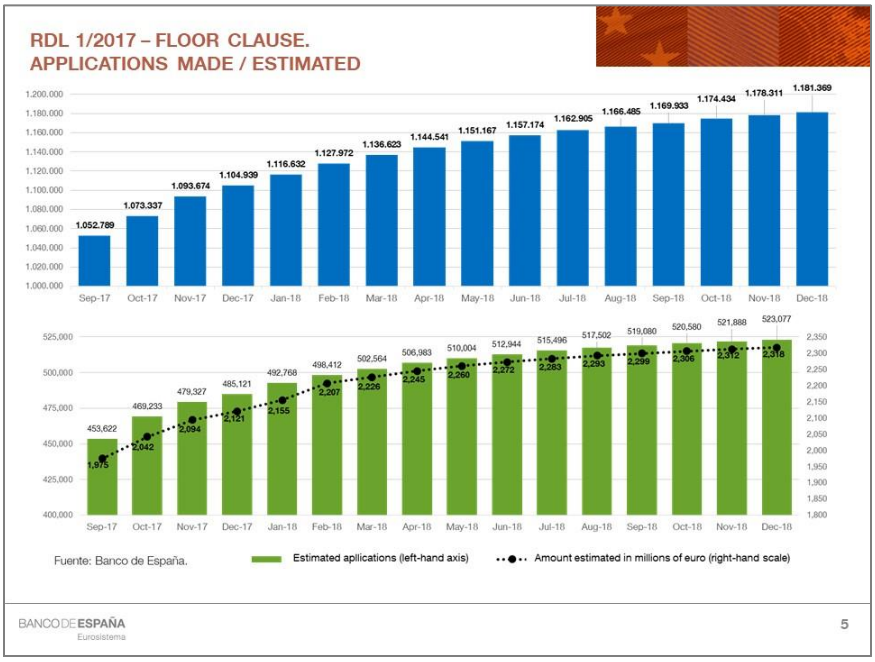
Let me remind you that the mortgage market has historically given millions of individuals access to owner-occupied housing. Also worth mentioning is the fact that mortgage lending fared relatively well during the crisis, with the average default rate of residential mortgages remaining below 6% at all times. In contrast, that observed in the real estate development and construction segment reached levels of more than 36%. Therefore, although it may seem obvious, when we talk about default rates, we are not referring to household mortgages, but primarily to real estate development exposures and to financing for land purchases and other real estate business activities. To use an English expression, we are referring to what is known as “pipeline risk”.

However, despite the relatively favourable behaviour of residential mortgages, the financial crisis has clearly exposed certain weaknesses in the mortgage market which need to be addressed and which have had a painful social impact and financial consequences that still linger on.

We must also recognise that there were highly questionable banking practices before and during the crisis. In many cases, bank managers introduced perverse incentives for mortgage sales, which led to the outcome that is all too familiar.



In recent years, in addition to the dramatic social and economic situation, we have witnessed a period of unprecedented litigiousness and legal uncertainty. Much of this litigiousness has notably centred on the mortgage market, according to the complaints data of the Banco de España.



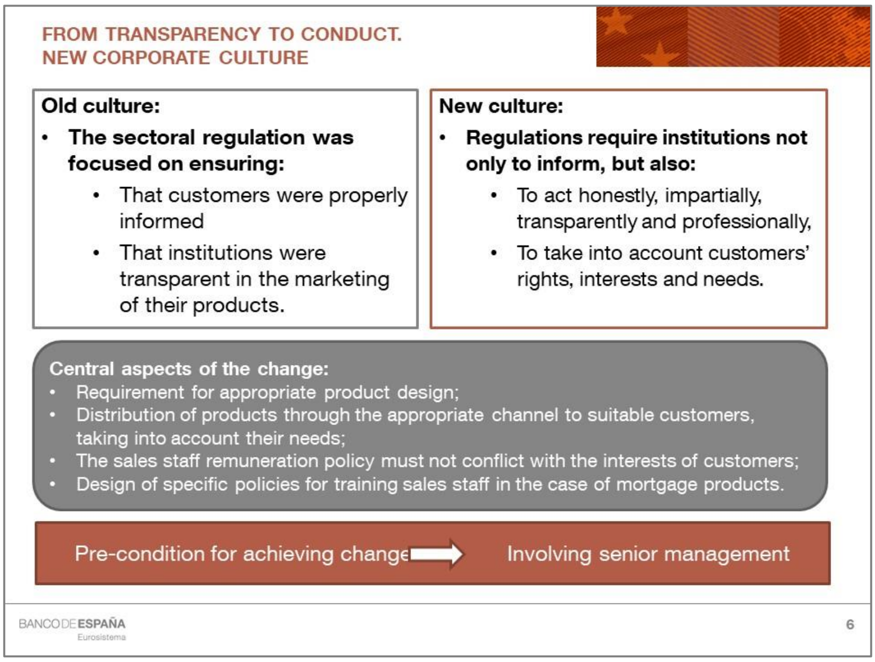
A case in point here are floor clauses. The number of complaints filed through the ad hoc system established by RDL 1/2017 has come to almost 1.2 million, with refunds amounting to more than €2,300 million to date. This high level of litigiousness is also apparent in the courts of justice.

It is worth remembering that litigiousness and the attendant uncertainty is not only very detrimental to banks, but also negative for the customer. Uncertainty means that sometimes it is impossible for the costs and risks of a transaction to be known, which may have the effect of freezing up the market.

Banks can react to legal uncertainty in two ways. First, by limiting or reducing the number of transactions, which ultimately limits access to credit. Second, by increasing the cost of new loans, in order to cover the cost of potential litigation. Of course, if we apply this to the real estate market, the result is that access to housing becomes more difficult, when, paradoxically, this is precisely what has to be protected.

In this context, the Banco de España takes a favourable view of the legal certainty provided by the new real estate law. In our opinion, as well as transposing Directive 2014/17/EU and thus removing the risk of financial penalties, the law introduces measures to safeguard and protect bank customers and restores legal certainty, essential for the proper functioning of the mortgage market.

Customer protection and legal certainty



The law is based on the asymmetrical nature of the contractual relationship between lender and borrower, which is not addressed simply by providing the customer with information and advice. The law requires the dominant party to assume added responsibility, as a professional, in its conduct vis-à-vis the borrower.

In particular, the law regulates the documentation that the borrower must be provided with in advance of the date of signing and specifies the customer's right to advice from the notary. Moreover, it sets limits on the remuneration policy applicable to staff who assess solvency and sell mortgages and, lastly, requires such staff to have a minimum level of knowledge.

I would like to underline that the new law, which protects customers by ensuring that (i) they are fully informed in a timely way by trained staff, (ii) the contractual clauses applied are clear and comprehensible, (iii) the product is genuinely adapted to the customer's needs and (iv) there are no hidden charges, is precisely helping to ensure legal certainty and significantly reducing litigation risks, which, as I mentioned earlier, entail costs which ultimately make loans more expensive for the customer.

I believe that customer protection, far from hindering the business and profitability of banks, is central to a banking business model that is viable and sustainable in the long term. Evidently, in economic terms, the cost of litigation and its very negative impact on the reputation of the entire sector, far exceed any hypothetical profit that individual banks might have obtained through highly dubious practices.

On the other hand, it must be stressed that only through ethical conduct towards their customers can banks recover, in the medium term, their reputation and their customers' trust, an essential asset that takes much effort and time to build up and which, unfortunately, can be lost in no time.

Against this background, it is important to point out that there needs to be a cultural change in the way banks relate to their customers. Banks must integrate customer protection in the risk appetite framework and in the three lines of defence.

Of course, as with all cultural change, to be successfully implemented, it must begin at senior management level. In order to be able to develop and implement this new culture, it is essential for the governing bodies to be committed and actively involved in aspects such as the design and governance of the products sold by banks, as well as in training and changes to incentive mechanisms for sales staff.

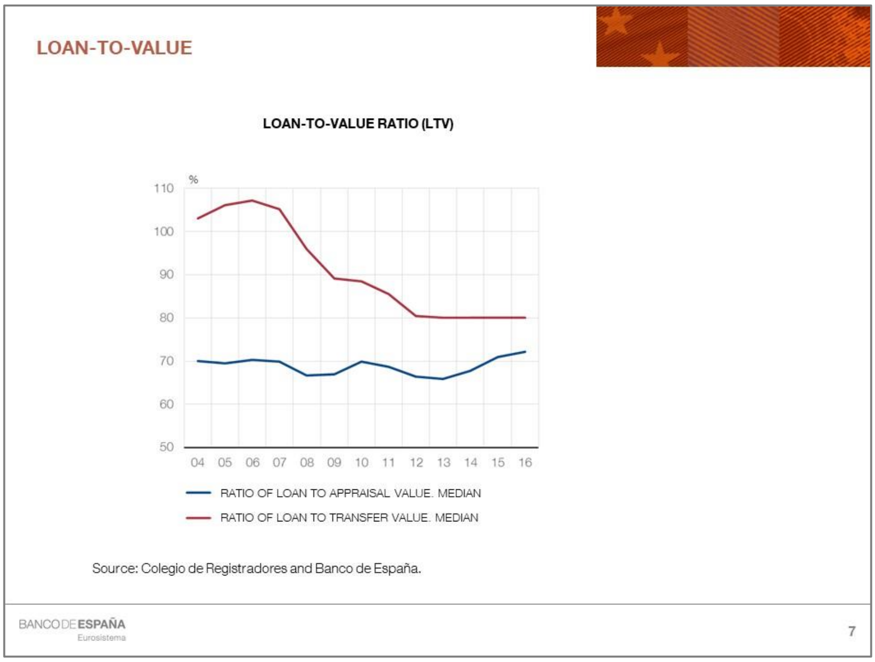
Credit standards: ability to pay vs. value of collateral.

Apart from the strengthening of transparency and protection of customers, I would like to mention an aspect of the law which seems to me especially significant from a supervisory viewpoint. Specifically, the law requires lenders to assess the solvency of potential borrowers, sureties and guarantors in depth before entering into loan agreements. This quires them to evaluate, among other matters, their employment situation, present and future income, assets, available savings, and any other fixed expenditure or commitment they may have already assumed.

Of course, as a supervisor I fully agree with all these requirements, which are absolutely necessary and obvious. However it is somewhat disheartening to have to see them specifically mentioned in legislation. The text of this law shows that on many occasions institutions relaxed their standards and basic principles excessively, in order to carry on lending. That does not say much for us supervisors either, since we did not react sufficiently to the weakness of credit standards.

The crisis has clearly shown that the fundamental consideration when granting a loan is not the value of the collateral, but the borrower's ability to pay. There should be no need to mention that whenever a loan is granted it is necessary to consider the probability that the principal and agreed interest will be paid, not the supposed quality of the collateral.

A property bubble, like the one seen in Spain, can only occur if sufficient financing is available. Hence the responsibility of the banking industry, and by extension the supervisor, to avoid another similar bubble in future. Clearly, if the analysis carried out prior to granting a loan is based excessively on the value of the collateral supplied, there is no effective practical limit to credit growth, at least as long as the value of collateral also continues to rise.



Certainly, if the amount of financing granted is close to the value of the property or, worse still, based on expectations of future growth in the value of the dwelling, the consequences will be even more dire.

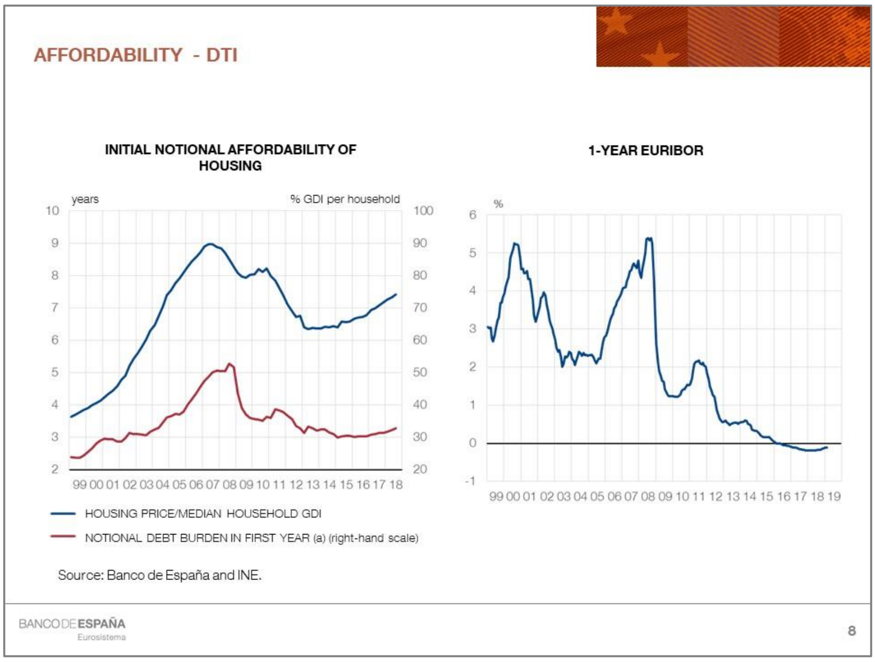
In this respect, we can see in the chart how two ratios that are highly relevant from a supervisory viewpoint have changed since 2004. The blue line represents the median loan as a proportion of the appraisal value (the so-called "loan to value" - LTV), while the red line shows the median loan as a proportion of the transfer price, according to the transfer deed.

The chart shows that the ratio between the median loan amount and the transfer value of the dwelling as stated in the transfer deed was very high and rising during the years leading up to the crisis. After the crisis, the ratio declined gradually, until it stabilised at around 80%. By contrast, the LTV was much more stable over the same period.

The differences between these two ratios reveal two things. First, that the appraisal value was clearly higher than the transfer value before the crisis, the difference between them having subsequently been reduced. Second, that the appraisal value has been more cyclical than the transfer value: it rose more steeply during the upturn and fell to a greater extent during the recession. In my view we can conclude that, to ensure greater stability in the property market, we need rigorous, prudent and, thus, less volatile appraisals.

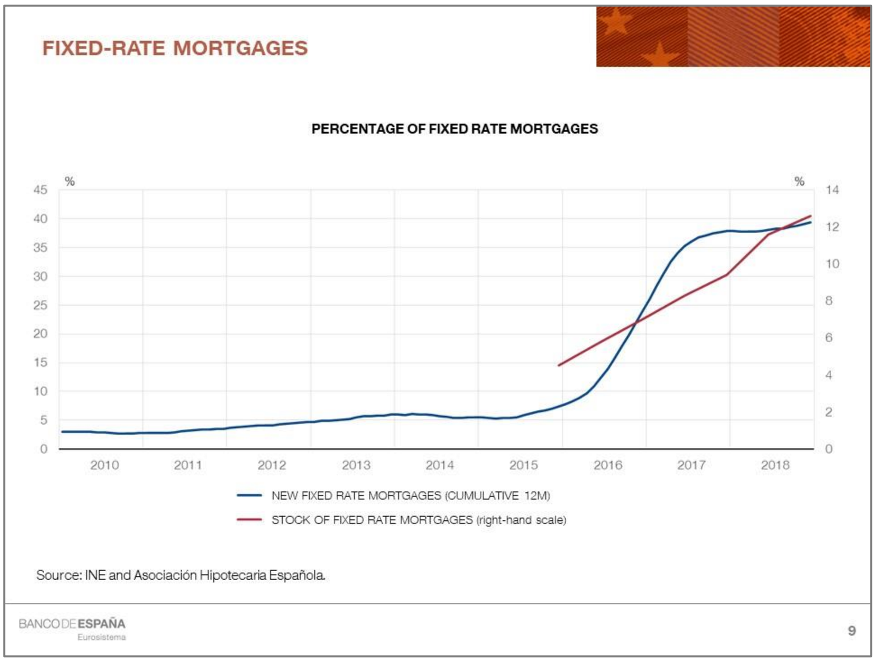
Naturally, the importance of the appraisal value was at its greatest when it justified, to a large extent, the granting of credit. This is another basic and, therefore, essential lesson which is also reflected in the new law, in so far as it requires that the solvency assessment must not be based primarily on the value of the collateral or on the hypothesis that the value of such collateral will increase.

Needless to say, had the debtor's solvency and ability to pay been strictly used as the main consideration when granting credit, as proposed in the new law, this would have helped curb the runaway growth of credit before the crisis.



At this point, it is worth asking where we currently stand in terms of ability to pay. We can see in the left-hand chart that, having peaked in 2007, the ratio between the price of housing and the median household income declined until 2012 and subsequently rose again after 2014.

However, if we consider the red line, which represents the affordability of housing, we see that the instalments payable in the first year are currently slightly above 30% of monthly household income, in contrast to the level of over 50% reached in 2008. Admittedly, we need to treat these affordability data with caution. Since interest rates remain at historic lows, monetary policy normalisation in the medium term will inevitably have an effect on mortgage payments.



We should not forget that, although the proportion of fixed rate mortgages has recently reached 40% of all new transactions, 87% of the existing stock of mortgage loans remain linked to a variable rate, so that our mortgage market continues to be particularly sensitive to rising interest rates.

Consequently, we take a positive view of the facilities to encourage conversion of variable to fixed rate loans introduced by the new law. In any event, it is worth mentioning again that at no point in the crisis did non-performing mortgage loans exceed 6% of the total.

Consequences of the application of the law on access to housing

The crisis has also reminded us again that the worst business to do is to grant a mortgage to a person who, a priori, is unlikely to fulfil their payment obligations. In economic terms this is bad business for the customer concerned, but also for the institution, which will have to deal with an irregular loan and, possibly, following a lengthy and difficult judicial process, assume the cost of having a property on its books, managing it and paying all the attendant costs. Finally, given the painful situations we have lived through recently, there is no need to spend much time discussing the social effects of such business.

Precisely because of the asymmetric positions of the lender and borrower in the contractual relationship, the new law provides that incorrect assessment of solvency will not entitle the lender to terminate, rescind or modify the loan agreement. That is to say, the responsibility for analysing the ability to pay falls entirely on the institution, and not on the customer. The law also protects the debtor who is unable to make payments, by making enforcement of mortgages in the event of default more complicated.

Naturally, all these legal provisions reinforce the idea that extreme caution must be exercised when granting new loans.

At the same time, it is common knowledge that the law has assigned most of the costs associated with granting a mortgage to the institution. Some institutions have even decided to assume the cost of appraisal as well, which is in practice the only one that the law places upon the customer. In addition, the requirements relating to the minimum number of instalments that must be due and payable before it is possible to initiate judicial enforcement proceedings, will delay the recovery of debt outstanding on non-performing loans, which will inevitably increase the costs of the foreclosure process. This will also initially have negative effects on the overall level of non-performing mortgage loans.

Clearly, banks, like any other firm, can only survive if they are profitable. Consequently institutions must be able to measure the costs and risks associated with each new transaction. I would like to stress here that, to guarantee their viability and to be able to adequately remunerate their capital, each individual institution must have an appropriate pricing policy allowing it to cover all the costs and risks associated with each loan, and must establish governance structures and management processes that ensure effective management of such risks.

When assessing solvency and assigning an appropriate price to each new transaction, institutions will have to optimise the use of the information available on their customers. For this purpose they need to have technological solutions enabling such information to be appropriately collected and used efficiently subsequently.

Finally, we must remember that the application of strict standards, as required by the law, will, at least in the short term, limit the access to owner-occupied housing of certain low income groups. I sincerely believe that in the medium and long-term the effect will be more positive, by fostering greater price stability over the business cycle. We should remember that runaway growth of prices is the main factor that ultimately restricts access to owner-occupied housing.

In any event, it is up to public authorities to shape the social measures that aim to guarantee decent homes for the less well off. It should be noted that construction of subsidised housing is currently at low levels, despite the economic recovery. Certain initiatives in our neighbouring countries are of interest, such as the role played by the deposits and consignments fund in France or the state guarantee arrangements in the Netherlands for housing up to a certain value. It is true that banks must not forget to apply strict economic criteria in their business, but it is just as true that a fair and responsible society should not be guided by economic criteria alone.

Use of the new macroprudential tools.

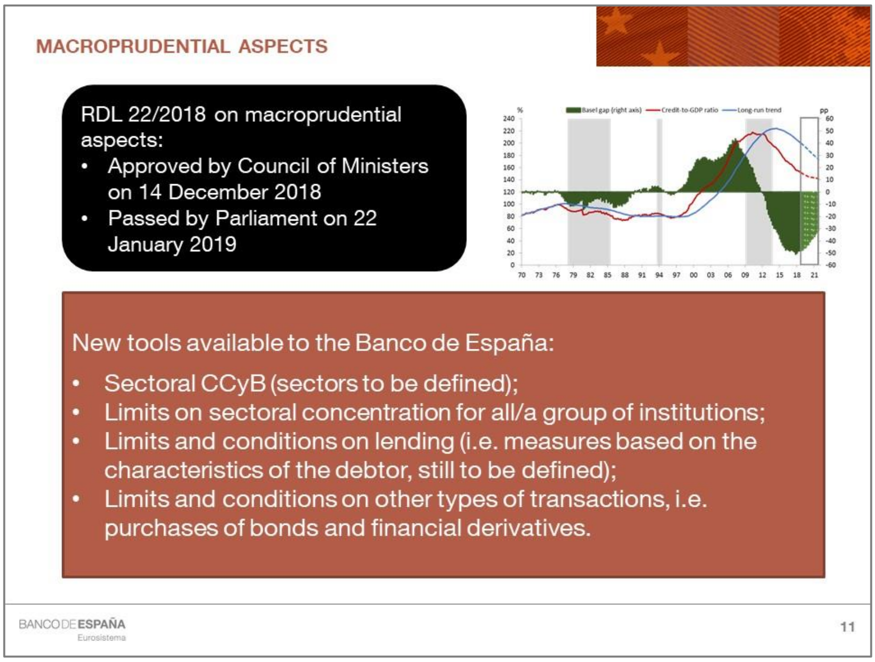
In the last part of my speech I would like to depart a little from the real estate credit law to discuss the new macroprudential tools recently introduced by Royal Decree-Law 22/2018.

As I have already mentioned, the crisis highlighted the insufficiency of microprudential supervision to identify, prevent and mitigate the materialisation of systemic risk. In fact, during the stage when structural imbalances were building up on bank balance sheets, institutions never failed to comply with the solvency requirements.

A significant part of the response to the crisis has been based on regulatory changes to correct the design of the capital framework. However, apart from this traditional micro response, the introduction of the macroprudential viewpoint in supervision has been a notable development. The purpose of this perspective is to contribute to the correction of macrofinancial imbalances and improve control over the credit cycle, which should result in more stable and sustainable economic growth.

A necessary condition to be able to develop this function is the early identification of macroeconomic imbalances and analysis of the interconnections between individual institutions and markets. As we all know, the Banco de España has been performing these tasks of identifying and monitoring financial system vulnerabilities since 2014 and, moreover, has the option of introducing countercyclical capital buffers. Consequently, one might ask what changes have recently been made to Spanish law and why they are relevant.

First, a royal decree setting up a macroprudential authority in Spain was finally approved on 1 March. This needed to be done as Spain was the only EU country, apart from Italy, that had still not established such an authority.



Second, last December saw the publication of RDL 22/2018, which assigned additional powers to the Banco de España, in the form of new tools, such as the sectoral countercyclical capital buffer and limits on credit conditions and sectoral concentration of credit exposure.

What is the difference between these tools and the ones approved in 2014? The first fundamental difference is that instead of a global buffer, we can now make use of much more focused tools.

In this respect, we need to be aware that, although the application of a global capital buffer affects lending, it does so indiscriminately, and in certain circumstances its application may have unintended consequences.

Allow me to give an example. Imagine that the supervisor observes excessive growth in consumer credit and decides to activate the global buffer to limit this growth. It is very likely that institutions will react to this tightening of capital requirements by increasing credit, precisely in those sectors that offer the highest returns, in order to compensate for the increase in their capital costs. Therefore, the activation of this global buffer may mean that consumer credit growth, instead of moderating, increases, largely at the expense of financing to other sectors, in which the supervisor had not observed any problem.

The new legislation, by giving the Banco de España the power to limit the assumption of risk at sectoral level, allows the measures to be restricted to exposures to the specific sector in which the risks are concentrated. As a result, the new tools allow exposures to that sector to be deterred. The application of a global buffer, on the other hand, does not alter the relative incentives across the different lending segments, which may have unintended consequences.

Also, other tools are made available to the regulator that do not impact lending institutions' capital requirements, but rather the characteristics of borrowers and even of loans. Unlike capital tools, which are designed to increase institutions' capacity to absorb shocks, these new tools seek to reduce the vulnerability of borrowers or to limit the appearance of bubbles.

Finally, to be able to cover the financial system as a whole, the legislation gives other sectoral supervisors similar tools. In the design of macroprudential instruments that go beyond banks, Spain has taken the lead in European regulation, although clearly the coordinated application of these tools will be one of the tests that the new macroprudential authority has to pass.

Of course, these tools can never be applied automatically. Their use must be measured and fine-tuned responsibly by the supervisor. In any event, activation of these measures in cyclical upswings is likely to meet with criticism from public opinion, consumers and the institutions themselves. We must not forget that the aim is to restrict credit, with the focus on a particular sector. When applied to the property sector, the measures will curb credit and make it more expensive, hampering access to owner-occupied housing, even if only temporarily.

It will also be necessary to decide when and how to loosen or remove these credit restrictions at low points in the cycle. I am sure that this part will prove to be more popular and easier to sell to public opinion, but it is worth remembering that a buffer can only be released at a low point in the cycle if one has previously been imposed during the boom.

In any event, in the light of recent experience, I believe that we can all agree that the consequences of a failure to act by the supervisor is infinitely worse than the alternative, although the appropriateness and timing of measures to restrict credit will always be controversial.

Conclusions

I would like to finish by reaffirming the Banco de España's positive assessment of the new real estate credit law. We consider that the strict regulation of its provisions, along with the increase in the information available to customers in the pre-contractual stage, will help to reduce legal uncertainty and the current high level of litigiousness in this market. I would also like to point out that implementation of the law involves, in many cases, promoting a cultural change in customer relations, for which purpose the wholehearted support of the entire organisation is needed, starting with the governing bodies and senior management. All these elements should improve the functioning of the mortgage market to the benefit of customers and institutions.

However, it should be noted that the increase in the costs of granting a mortgage borne by lenders, the limits on early repayment fees and the delay in the recovery of past-due amounts will inevitably increase the costs of new loans, which institutions will have to incorporate into their pricing policies for the sake of their viability and to provide an adequate return to capital. At the same time, we take a positive view of the reminder of the strict requirements to evaluate borrowers' solvency. Although this may restrict access to mortgage credit, it will foster greater stability in the mortgage market and an improvement in the quality of institutions' loan portfolios.

Finally, I trust that the new macroprudential tools that the law has recently made available to us will allow us to react and take the appropriate corrective action before excessive imbalances build up in bank balance sheets. The collective memory is fragile, but I trust we will never forget the price of not taking timely resolute action.

Thank you very much.