The Spanish banking system: The process of cleaning up property assets

José García Montalvo[1]

The recovery of the Spanish economy in 2015 allowed the financial sector to significantly reduce its volume of troubled assets. However, progress was primarily concentrated in a decrease in doubtful loans, as banks continued to accumulate foreclosed assets on their balance sheets.

Various property market indicators point to a recovery in 2015, although below pre-crisis levels – in line with the correction of the sector´s imbalances. As in the case of the Spanish economy´s overall recovery, the property sector's future remains highly sensitive to global and domestic conditions. Despite current macroeconomic uncertainty, today's interest rate environment may positively impact housing for investment purposes, as current yields represent a profitable alternative to negative returns. As regards banks, there has been a significant drop in exposure to different segments of the property sector relative to pre-crisis levels, but the reduction needs to factor into account the transfer of assets to SAREB. Troubled assets have also been reduced, but this has been due to the fall of NPLs, whereas progress on reducing foreclosed assets has been going very slowly, with the net effect being an accumulation on financial institutions' balance sheets. Finally, latest data reveal a significant reduction in SAREB's portfolio of financial assets; however, the value of its real-estate assets has remained largely unchanged since the initial transfer.

The property market crash and financial crisis affecting the Spanish economy revealed the problems stemming from the Spanish financial system's overexposure to property risk. It is therefore logical that both the speed and the nature of the clean-up process in the financial sector will be very much shaped by trends in the property sector and entities' ability to reduce their exposures. This article reviews recent trends in the Spanish financial sector's property exposures and balance sheet clean-up, and the process of liquidation of property exposures through SAREB.

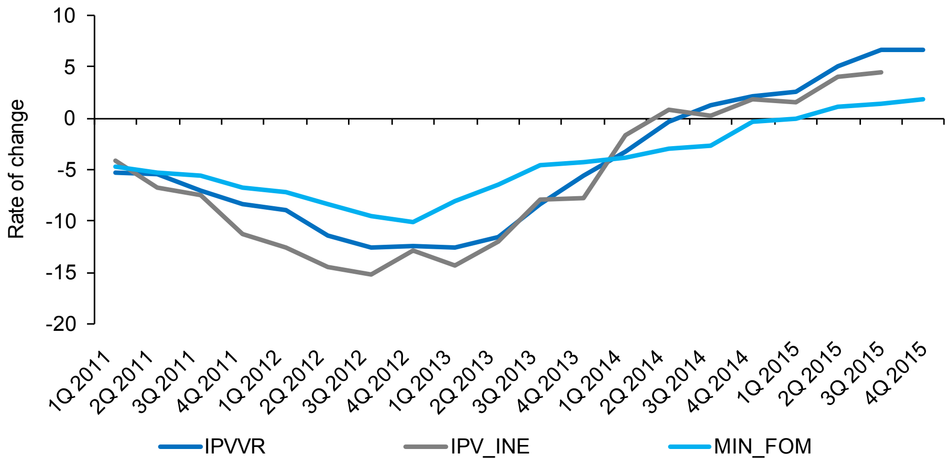
Recent trends in the property sector and lending

The recovery of the property sector is crucial to the financial sector's ability to clean up its balance sheet and the speed of this process. The property sector's figures in 2015 are relatively optimistic, at least when compared to the poor indicators in previous years. Exhibit 1 shows the recent trend in housing prices. Based on the repeat sales indicator, property register statistics situate price growth at 6.6%.

[1] Professor of Economics and ICREA-Academia Fellow, Pompeu Fabra University.

Exhibit 1

Recent upward trend in housing prices
(Percentage)



Sources: Ministerio de Fomento, INE, Registradores de la Propiedad and author's calculations.

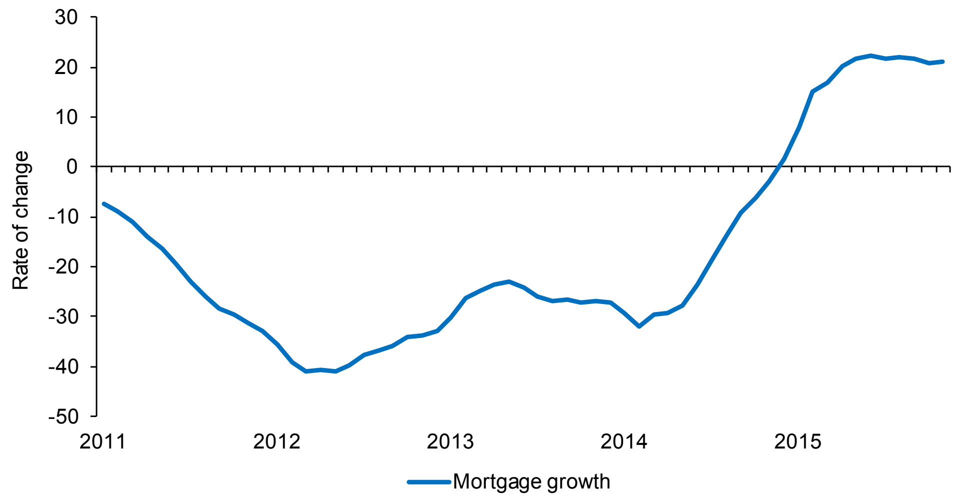
National Statistics Institute data show slower progress, although the rate is also significant. Data from the Ministry of Public Works and Transport report an increase of 1.8%, rising to an average of 1,490 euros per square metre. The characteristics of the appraisal prices used by the Ministry of Public Works and Transport for its statistics give less volatile results, as can be seen in Exhibit 1. Appraisal prices dropped more slowly during the decline in prices, which lasted until 2014, and are going up more slowly than property register prices now that property values are rising.

For their part, property registry statistics (Registradores de España, 2016) show that transactions grew by 11.2% in 2015, while new lending to households for home purchases grew by 22.4% in the period to November 2015, while the number of new housing permits rose by the 35.1%. As can be seen, many sector indicators are growing at two-digit rates, although this is a reflection of a property sector returning to a degree of normality after several years of very low activity. Housing transactions still represent just 45% of the 2007 total. New housing starts came to just 7% of the permits issued during the boom. It is true that the number of workers in the construction sector has grown 12% since the minimum of the first quarter of 2014 until the fourth quarter of 2015, but construction and real estate services had shed 1.7 million jobs since the start of the crisis.

Prices certainly rose significantly in 2015, but property registry prices remain 29% down from the highs reached during the bubble. As Exhibit 2 shows, new mortgages on residential property are growing rapidly, although this is from a low baseline given the small number of mortgages granted in the preceding years. In January of 2016, the growth of new mortgages has gone down to 10.6% from more than 20% at the end of 2015. In view of the double-digit growth of some property-market figures, there has been talk of the possibility of a new bubble forming. However, this is not supported by solid empirical evidence. It could be argued that the battle for the mortgage business is driving rapid growth in new lending, which could push up house prices, as happened during the bubble. However, there are no solid grounds for supporting this hypothesis at this stage. While it is true that there has been intense competition in terms of spreads on mortgages, there has been

Exhibit 2

Mortgages on residential property
(Percentage)



Source: INE and authors' calculations.

no relaxation of the requirements for borrowers' ability to pay when granting loans. Relaxing income requirements and over-appraisals were what caused problems in the past. In fact, to judge from the trend in the Ministry of Public Works and Transport prices shown in Exhibit 1, the over-valuation of the past has given way to under-valuation today.

In view of the double-digit growth of some property-market figures, there has been talk of the possibility of a new bubble forming. However, there are no solid grounds for supporting this hypothesis at this stage.

In any event, like the rest of the economy, the sector's future is highly sensitive to both the global economic conditions and domestic political difficulties in Spain. International geopolitical issues (Syria, Yemen, Ukraine, North Africa, etc.), upheavals in the EU (Brexit and the refugee crisis), the difficulty of forming a government in Spain, the fall in stock exchanges, or the loss of confidence in China's ability to keep driving the world economy, have all had an impact on Spanish consumers' confidence. The data from the start of the year show a big drop in confidence, driven more by future expectations than the current situation. This loss of confidence will most likely impact general consumption and housing demand. However, for the time being, the economy is still being driven by the momentum from 2015.

Although demand for housing as a durable consumption good may be adversely affected by negative macroeconomic factors, the opposite is true of its performance as an investment. In recent months, assets of all classes have been yielding negative returns. This has been true of equity funds, commodity funds, short-term debt, long-term debt, high-risk corporate debt, and even money-market funds. The only asset class that has yielded positive returns has been housing. Rental yields in Spain's largest cities (Madrid and Barcelona) are around 6.5% and 7%, with capital gains in the past year of 6.6%. This makes investing in housing an attractive option for many small investors and for some large investment funds. Faced with interest of just 0.2% when their deposits mature, it is not uncommon for customers

The effect of buying as an investment, basically in response to extremely low interest rates narrowing the range of profitable investment alternatives, could act as a counterweight to falling demand for housing bought for the purpose of somewhere to live.

to decide to invest the money in property bought in cash at today's reduced prices. As many as 65% of property purchases have come to be paid in cash in 2014. There was a drop in 2015 as lending for home purchases picked up, although over the last few months, the trend in the number of cash transactions has again tended to be upward. The effect of buying as an investment, basically in response to extremely low interest rates narrowing the range of profitable investment alternatives, could act as a counterweight to falling demand for housing bought for the purpose of somewhere to live.

Meanwhile, the outlook for housing supply is optimistic. Many financial institutions and real-estate platforms have begun to develop highly provisioned foreclosed building land in prime locations. The relationship between banks and developers has also changed. Given the huge problems in the past and the lack of professionalism among some property developers, banks have returned to the standards of the past: before financing a development they require the developer to own the land and to have made a substantial number of sales plans. On this point, word in the sector that some banks have part-financed land purchases could be a cause for concern, as it would represent a return to practices that caused so many problems in the past, when developers did not risk any money of their own but relied entirely on bank loans to pay for both the land and construction work. However, these practices do not seem to be widespread in the financial sector at present.

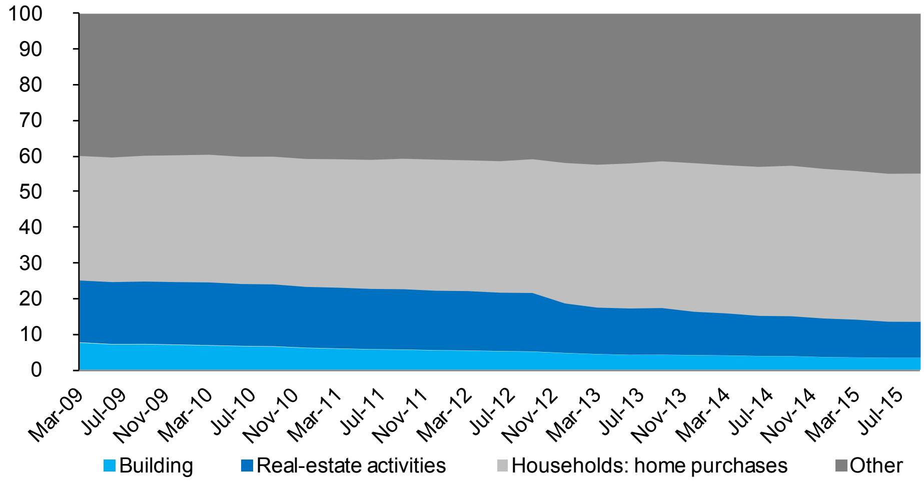
The last question concerns the accessibility of housing. Taking the traditional indicator (mortgage payments as a share of household income) as a guide, the current situation is optimal in terms of low interest rates and the big drop in housing prices in recent years. However, this indicator is not a good measure of a household's effort to buy a home. A better indicator, the ratio of house prices to households' disposable income, remains high by historical and comparative standards (6.3 years of total income to buy an average home), because, although prices have dropped considerably, households' disposable incomes have also fallen in recent years, preventing the indicator from returning to normality (around 4 or 4.5 years). Future adjustment could basically come from increased household incomes, provided the economy does not suffer the negative impact of the current conditions. Prices will also have to slow their rise from the past year's rate, as household incomes seem unlikely to be able to keep pace even if the economy does not lose its momentum.

The banks' property exposure

In the years prior to the property crisis, the Spanish financial sector rapidly increased its exposure to various segments of the property business. In early 2009, the combined exposure to the building industry, the real-estate sector, and lending for home purchases totalled 1.12 trillion euros, or approximately 60% of all lending. Exhibit 3 shows how these three components evolved as a percentage of total credit. A significant drop was observed in the share of lending to the building industry and the real-estate sector, approximately halving from almost 25% of the total to 13.4%. Exhibit 4 shows lending to the building industry and the real-estate sector as a share of total lending for productive activities. It is worth noting

Exhibit 3

Distribution of credit by purpose
(Percentage)



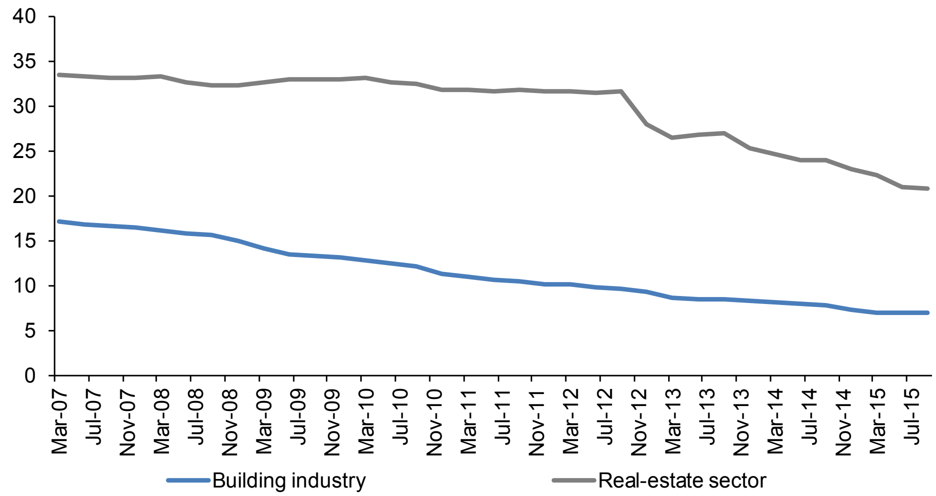
Source: Bank of Spain and author's calculations.

that, as Exhibit 4 clearly shows, part of this drop is due to the transfer of building industry and real-estate sector loans to SAREB in December 2012 and the first quarter of 2013.[2]

Part of this drop in the share of credit to productive activities relating to the real-estate sector was made up for by the increase in lending to households for home purchases and refurbishment. Their share

Exhibit 4

Credit exposure to the building industry and real-estate sector
(Percentage)



Source: INE and authors' calculations.

[2] Entities in Groups 1 and 2 transferred financial assets for a total value of 39,438 million euros.

of the total went from 35% in January 2009 to 41.6% in September 2015. Obviously, this increase in the share of lending to households for home purchases was accompanied by a contraction in this credit category. However, this was much smaller than the reduction taking place in lending to productive activities in the property sector or in credit in general. Indeed, total lending for housing purchases continued to fall by around 4% at the end of 2015, despite the fact that lending for new home purchases by households rose by over 20%.[3] Despite this significant growth, new home loans account for just under 3% of total lending for house purchases, compared with a figure of 31% in 2005. This ratio reveals how low the level of new credit for housing purchases remains in comparison with the situation in the mid-2000s.

Building loans contracted by 14.9% between September 2014 and September 2015, a rate close to that one year earlier (15.1%). The decline in lending to the real-estate sector was similar (13%), although the pace of the reduction was significantly slower than a year earlier (20%).

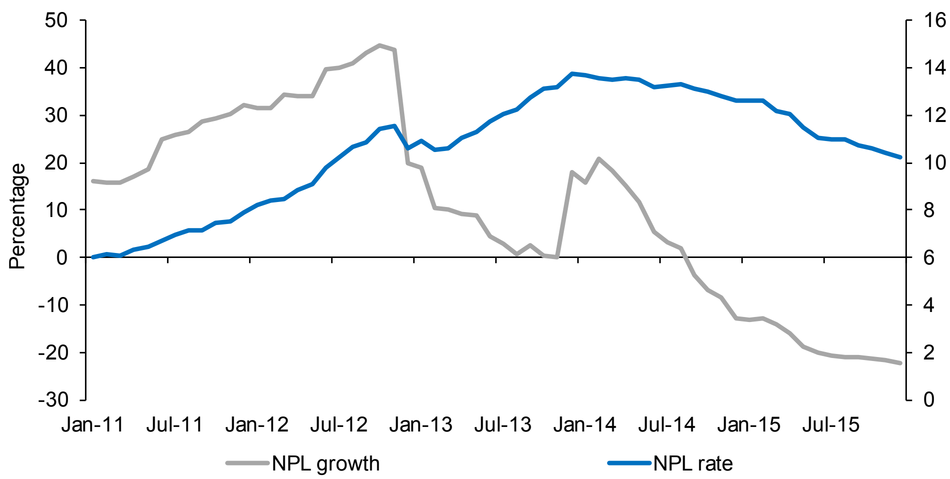
Overall, credit for construction, real-estate activities and housing purchases fell from 1.1 trillion euros in January 2009 to 0.74 trillion in September 2015.

Trends in the NPL rate

The rising non-performing loan rate has been one of the biggest problems the Spanish financial system has faced since the outbreak of the crisis. According to the EC (2016), the NPL rate remains high, but has fallen significantly since 2013. The trend in the NPL rate has passed through several phases. From the onset of the crisis up until end-2012, there was a progressive rise, which was interrupted by the transfer to SAREB in December 2012 and March 2013 of a large share of past-due loans related to the property sector from entities in Groups 1 and 2. The rapid increase up until late 2013 was the result of a reclassification of a large portion of restructured loans as doubtful. In 2015, there was a continuation of the downward trend in the NPL rate that began in 2014. In December 2015, deposit-taking institutions' NPL rate dropped to 10.12%, its lowest level since July 2012 (Exhibit 5).

Exhibit 5

Trend in NPL rate and rate of change
(Percentage)



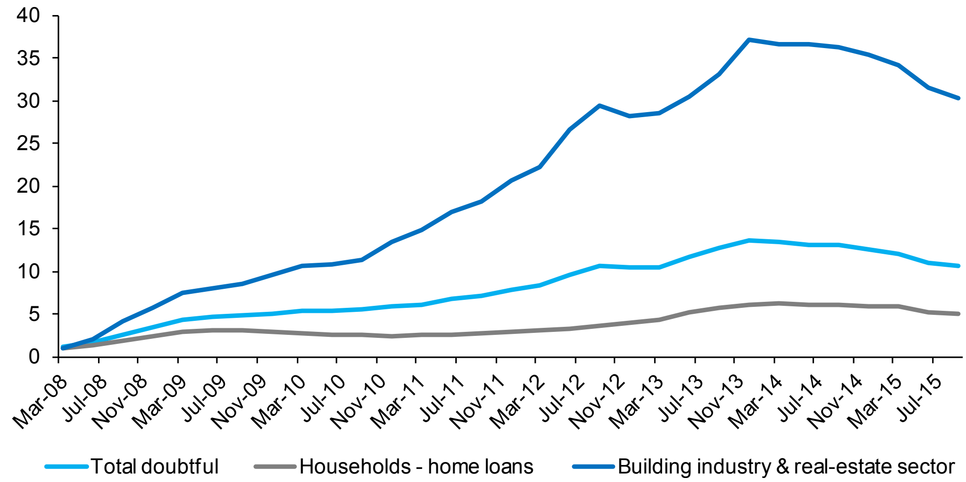
Source: INE and authors' calculations.

[3] Only the stock of households' consumer credit is growing.

Exhibit 6

Non-performing loan rate

(Percentage)



Source: INE and authors' calculations.

There was a year-on-year reduction of 38,276 million euros in doubtful loans. The NPL rate dropped 3.48 percentage points, down from its peak in December 2013 at 13.6%. The volume of doubtful loans dropped below 130 billion euros for the first time since November 2011. The NPL rate was falling at 22.4% by the end-2015.

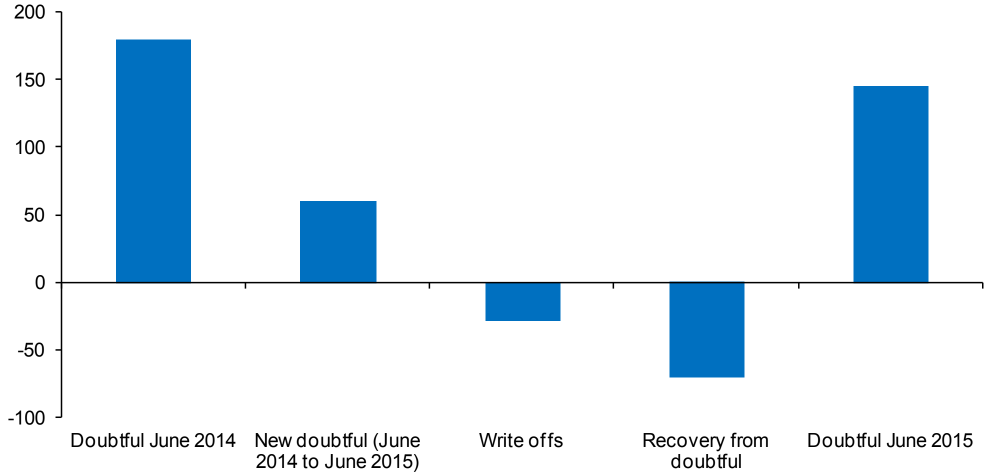
Nevertheless, significant differences persist in the NPL rate broken down by purpose of loan (Exhibit 6). Lending to the building industry and real-estate sector continue to present the highest NPL rates and, although they have fallen from their peak of 37% in December 2013, they remain high, at 30%. The NPL rate of households on loans for home purchases or refurbishments has dropped to 5%.

The analysis of the trend in doubtful assets can be deepened by analysing the difference in the volume of doubtful assets at two distinct points in time. Only recently has disaggregated information on flows of loans being classed as NPLs been available, however. Exhibit 7 shows the breakdown in the change in doubtful assets between June 2014 and June 2015. In June 2014, a total of 180 billion euros had accumulated and the following year a further 60 billion euros were classed as non-performing. The writing off of 27 billion euros of bad debt and the recovery of loans worth 69 billion euros (removed from the NPL category) reduced total NPLs to a total of 145 billion in June 2015. Thus, over the period considered, recoveries of doubtful loans exceeded loans newly classified as doubtful, which, in conjunction with the write-off of doubtful loans considered unlikely to be recovered, substantially reduced the NPL balance.

The strength of the various sectors' contribution to reducing the NPL rate has changed over time. Exhibit 8 shows that the lion's share of the drop in the NPL rate between December 2013 and September 2014 (8.4 percentage points) was due to the lower NPL rate on loans for productive activities (almost 80%) - households made a smaller contribution (just 8.6%). The fact that 75% of defaults are concentrated in lending for productive activities undoubtedly explains a significant part of this breakdown. The reduction in the NPL rate between September 2014

Exhibit 7

Breakdown of changes to doubtful loans
(Percentage)



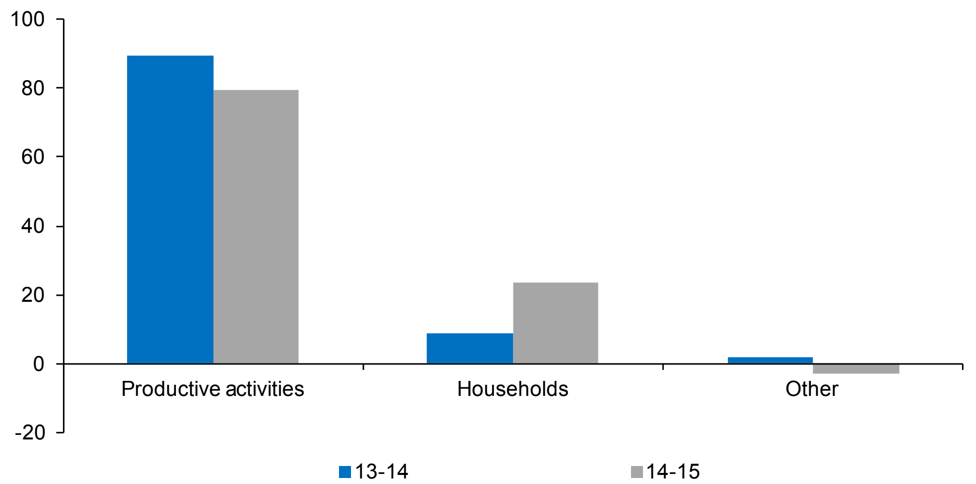
Source: Bank of Spain.

and September 2015 was much bigger (20.8 percentage points) and households accounted for almost 25% of the drop.

Disaggregating the sectors and purposes further to zoom in on lending directly related to the property sector we find, as Exhibit 9 shows, that almost all of the reduction in the NPL rate between December 2013 and September 2014 was due to lending to the building industry and real-estate sector (94%), while the contribution of lending to households for home purchases and refurbishments was just 5%.

Exhibit 8

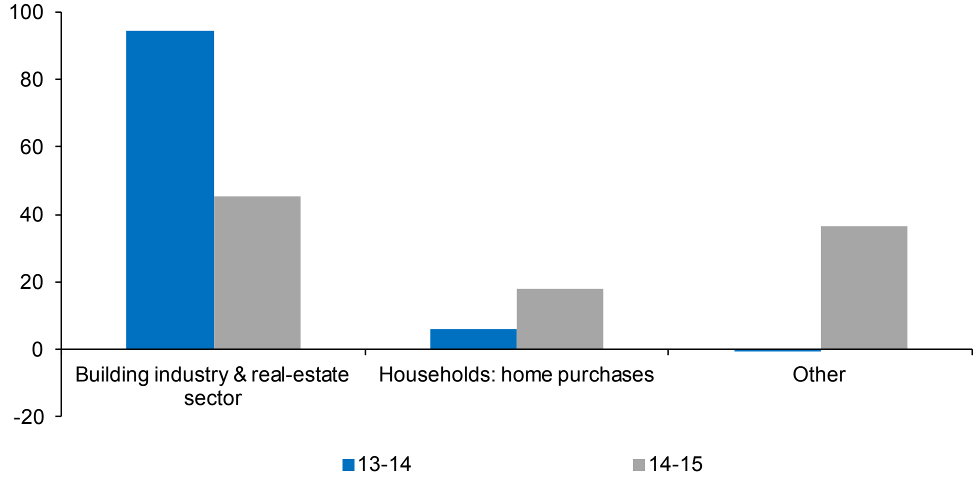
Contribution to drop in NPL rate
(Percentage)



Source: Bank of Spain and author's calculations.

Exhibit 9

Contribution to drop in NPL rate
(Percentage)



Source: Bank of Spain and author's calculations.

A major part of the significant contribution to the reduction in the NPL rate in the building industry and real-estate sector stems from the way the financial crisis had a more rapid impact on these sectors and the writing off of a significant portion of doubtful loans. Between September 2014 and September 2015 the contribution of firms in the building industry and property services to the reduction in the NPL rate fell to 45%, with the lower NPL rate among households on home loans significantly increasing its share (18%).

The Bank of Spain (2015) has analysed the trend in doubtful loans broken down by company size. The data show that large companies have significantly lower NPL rates than SMEs (14% compared to 23.4%). Indeed, the NPL rate is inversely proportional to company size, reaching 27% among micro-enterprises. The recent fall in the NPL rate was more pronounced among large companies (22%) than SMEs (14.3%).

The NPL rate among businesses in the building industry and real-estate sector is above average, and there is also a significant difference between large companies (24.8%) and SMEs (35.1%). In the case of these sectors, however, the negative correlation between the NPL rate and size is not always so clear cut: in June 2015, small businesses had a higher rate than micro-enterprises, basically due to the large drop in the NPL rate among micro-enterprises since June 2014. As in the case of non-financial corporations as a whole, the drop in the NPL rate is bigger among large companies than SMEs.

Trends in foreclosures and refinancing

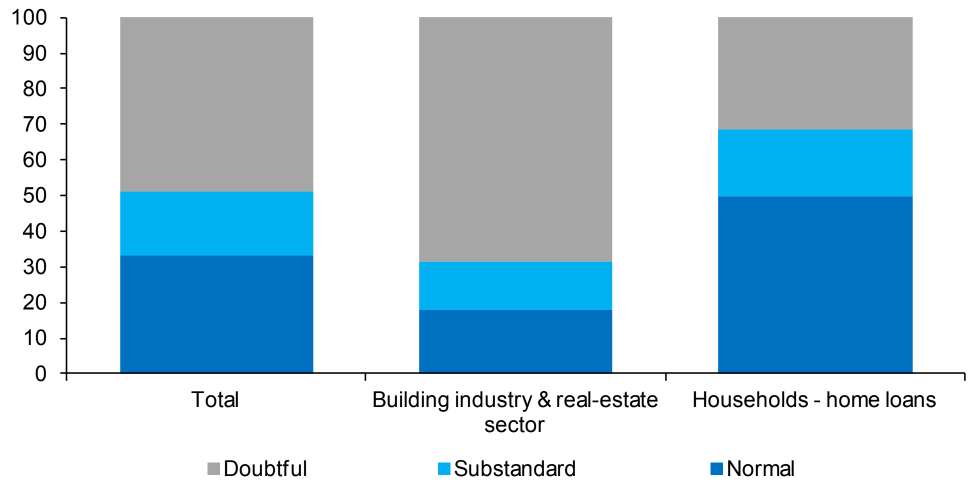
A major part of the Spanish financial sector's non-performing assets are the result of foreclosures or settlement of debts. These represent around 38% of the Spanish financial system's troubled assets in its business in Spain. In this regard, the improvement is not as clear as in the cases of the NPL rate. The volume of foreclosed assets on Spanish financial institutions' balance sheets from business in Spain has stabilised at around 80 billion euros since December 2012 when, following the transfer to SAREB, it dropped from around 100 billion euros. The reduction in foreclosed assets since December 2014 has been proceeding very slowly, which shows that the sale of property assets from financial institutions' portfolios has been offset by the rising number of foreclosed assets coming onto their balance sheets. Land makes up the largest share of these foreclosed assets, accounting for 35.3% of the total, followed by completed buildings (24.9%) and repossessed homes (21.5%). These proportions have remained fairly stable over time.

The preview of the major Spanish banks' results at the end of 2015 show no signs of any significant reduction in foreclosed assets. Indeed, several financial institutions show an increase in the number of foreclosed properties, particularly in the segment of real-estate assets from the financing of households for home purchases. This suggests that, despite a slight increase in the sale of properties by most financial institutions, the net effect was a continuing accumulation of properties in 2015. Another trend in the sale of properties by financial institutions, coinciding with the recovery in property prices, is the reduction of discounts. For example, according to Banco Sabadell, discounts on the sale of its properties dropped from 51% in 2014 to 44% in 2015. For its part, Banco Popular, which saw an increase in the number of foreclosed assets on its books in 2015, reports that online prices have risen by 5% and the capital gain on property sales has gone from -1.8% in the first quarter of 2015 to 2% in the final quarter (with the retail price rising by 2.7%). BBVA indicates that although there has been a reduction in sales of property assets of 9% in 2015, profitability has increased.

The most recent uniform data on refinanced and restructured assets (June 2015) show the volume to stand at 211 billion euros.[4] There has been barely any improvement with respect to the previous six months, with 49% of these assets being classed as doubtful. 33% of the total refinanced and restructured assets were classed as normal (Exhibit 10).

Exhibit 10

Refinanced and restructured transactions: Classification
(Percentage)



Source: Bank of Spain and author's calculations.

[4] García Montalvo (2015) describes how refinanced and restructured assets have evolved over time.

64% of refinanced transactions concern loans to businesses, while the remaining 36% are loans to households. The breakdown of the refinanced transactions also differs depending on the sector of productive activity and the purpose of lending to households. Among the latter, mortgages for home purchases represent 26% of the total, and approximately 50% of them are classed as normal, while just 30% are classed as doubtful. The situation for construction and property companies is very different, representing approximately 50% of refinanced transactions to companies, and almost 70% of their refinanced transactions are classed as doubtful.

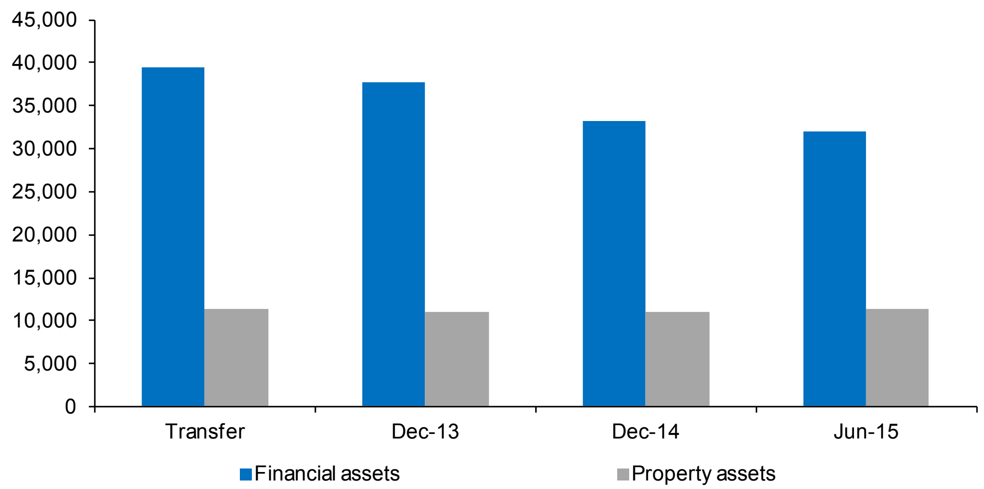
Property risk in SAREB

The transfer of troubled assets to SAREB temporarily reduced the accumulation of these assets on the books of entities formally classed as credit institutions. Nevertheless, bearing in mind the origin of the property risk and the fact that many financial institutions have an equity interest in SAREB, it is also worth looking at how it has progressed when considering the property risk facing the economy as a whole. What is more, SAREB is a major player in the market for troubled assets (real estate lending and properties) and, as such, its decisions and strategies are relevant to other financial sector agents. The most recent data available reveal a significant reduction in SAREB's portfolio of financial assets.[5] However, as discussed above, the value of its real-estate assets has remained largely unchanged since the initial transfer of assets. Some of the reduction in financial assets has been due to loans being turned into property assets as a result of foreclosures.

The most recent data available reveal a significant reduction in SAREB's portfolio of financial assets. However, the value of its real-estate assets has remained largely unchanged since the initial transfer of assets.

Exhibit 11

Changes in SAREB's assets



Source: SAREB's (2015) financial report.

[5] García Montalvo (2015) describes the main operations.

Concluding remarks

The reduction in private sector debt in the economy continued in 2015. In particular, lending to the building industry was reduced by 15%, while lending for real-estate activities dropped by 13%. The improvement in the Spanish economy in 2015 allowed the financial sector to significantly reduce the volume of troubled assets. In December 2014, troubled assets (doubtful loans and foreclosed real-estate assets) came to almost 250 billion euros. Non-performing assets were projected to drop below 211 billion euros at the end of 2015. However, the 39 billion euro reduction in troubled assets was concentrated solely in doubtful financial assets. The non-performing loan rate and volume of doubtful loans were falling at a rate of 22.4% at the end of 2015. The most recent data available show that recoveries of doubtful loans are outpacing new non-performing loans, which together with write-offs, explains the substantial drop in the NPL rate.

By contrast, it is foreseeable –based on the 2015 results presented by the major banks– that foreclosed real-estate assets remained stable at the same level as in the preceding half-year periods. Although many financial institutions have pointed to an improvement in the sale of foreclosed assets, properties continue to accumulate on credit institutions' balance sheets, although the prices they are obtaining for them improved over the course of 2015.

References

Bank of Spain (2015), *Financial Stability Report*, 11/2015.

European Commission (2016), Evaluation of the Financial Sector Assistance Programme, *Institutional Paper* 019.

García Montalvo, J. (2015), "Cleaning up the Spanish financial sector's real estate risk exposure: situation and outlook," *Spanish Economic and Financial Outlook*, 5(4): 29-46.

Registradores de España (2016), *Estadística registral inmobiliaria*, 4º trimestre de 2015.

SAREB (2015), *Informe de Actividad: primer semestre de 2015.*