Developments in the Spanish mortgage market

By Gustavo Levenfeld and Eduardo Sánchez

THE Regulation of the Mortgage Market Act, which represented a milestone in the development of this type of lending in Spain, was passed by the Spanish Parliament in 1981. Previously, the Banco Hipotecario de España, a government banking institution, had enjoyed a monopoly of the issue of Cédulas Hipotecarias (mortgage bonds), having been granted the privilege at the time of its foundation in 1872.

The Act ended this monopoly and made it possible for virtually all financial institutions offering mortgage loans to refinance them in this way. But it went further, and created a new type of institution specialising in mortgage finance and, through the new regulations applicable to the loans to be used as backing or collateral for mortgage securities, modernised the whole system of mortgage lending regarding term, loan/value ratio, interest rates, etc. It really amounted to a complete update of mortgage finance in Spain.

The Act relates to mortgages on a wide range of land and property, but, bearing in mind that rather more than 75% of mortgages, by value, are on residential property, when we talk about mortgage lending in Spain, essentially we are talking about housing finance.

Housing finance in the 1960s and 1970s

In the 1960s and 1970s, a period when Spain was undergoing intensive development, nearly six million homes were built. The rapid process of industrialisation, as always, resulted in a massive redistribution of the country's population; in 1950, 23.7% of the total population was living in centres of over 100,000 inhabitants. Twenty years later this percentage had risen to 41.8%. Obviously, a huge demand for housing was to be expected.

Some 60% of these homes were "protected" housing, ie direct or indirect government aid was available for their construction and purchase, while the other 40% were "open market." In both cases, the vast majority were sold, following a trend begun in the post-war years, and this resulted in Spain having the highest percentage of owner-occupiers in Europe. (*See Table 1*).

TABLE 1
RATE OF OWNER-OCCUPATION IN EUROPE
(as a percentage of the total number of main residences)
Changes over the period 1950-1980

	1950	1960	1970	1980
Federal Republic of Germany	—	35.1	35.9	40.0 (1982)
Belgium	38.9	49.7	54.8	61.0 (1981)
France	35.5	41.6	44.7	51.0 (1983)
Netherlands	29.3	—	35.4	44.0 (1983)
United Kingdom	—	41.0	49.2	60.0 (1983)
Italy	40.0	45.0	50.3	60.0 (1983)
Spain	49.5	50.6	64.0	69.0 (1982)

Source: United Nations 1982
1982 report by ANAH [French Agency for the Improvement of Housing]

During this period there was extensive government intervention in housing finance, for in addition to the direct state aid available for "protected" housing, the financial system and, more especially, the cajas de ahorro (savings banks) — who were the main providers of home loans during the period — were obliged to observe "compulsory investment ratios," under which the financial institutions were required to lend on special terms to certain sectors, among which house-building figured prominently.

The finance available for "open market" housing was inadequate. Mortgages were only offered for up to 50% of the price of the property and were not easy to obtain; in any event, they were only medium-term loans, of between eight and 10 years. Frequently it was the developer himself who financed the sale, or at least a major part of it, by offering short- to medium-term credit (three to five years). In the case of re-sales, the vendor had to accept payment in instalments, thereby running the risk of non-payment.

By the early 1970s, it was already clear that the financial system was in need of liberalisation, and 1977 saw the introduction of a staged reduction in the compulsory investment ratios of the banks and, more especially, the cajas de ahorro — for which they were highest — and this process culminated in 1985 in the virtual abolition of these ratios.

At the same time there was a perceived need to establish methods by which the financial institutions would be able to obtain long-term, or at least medium-term, refinancing of their loans. The banks and cajas de ahorro were basically obtaining their funds from sight and term deposits, rarely exceeding three years.

At this time, home loans were arranged mainly by the developer, with the buyer taking over the loan on completion of the purchase. The cajas de ahorro accounted for just over 75% of outstanding home loans, the private banks for about 15% and the state banking sector — including the Banco Hipotecaria de España — for just under 10%.

The Mortgage Market Act

Aims and objects

The main object of the Mortgage Market Act was to create instruments — mortgage-backed securities — by which the financial institutions could obtain adequate refinancing of their mortgage lending operations, to enable them to avoid fluctuations in the availability of funds. To this end, it specifies the essential features of these instruments, stipulates which institutions may make use of them (creating, in addition, a type of institution new to Spain, namely companies specialising in mortgage finance) and, lastly, it establishes a framework to ensure the liquidity of the new securities.

The aim of the new market is to encourage the long-term financing, through the use of mortgage loans, of those investments which call for it, among which one of the most important is the home.

The Spanish mortgage market therefore has a broad spectrum of aims, even though they do include the hope that housing will be one of the sectors to benefit most. The breadth of its aims, when combined with the purpose underlying the arrangements for the new securities, in practice operates against any policy of encouraging a particular sector.

The institutions involved

The Act allows the issue of securities by the following institutions, grouped according to the nature of the securities they may issue:

- "Cédulas," "bonos" and "participaciones":
  - — The state banking sector
  - — The Cajas de Ahorro
  - — Mortgage finance companies.
- "Bonos" and "participaciones":
  - — The private banks
  - — Finance companies and co-operative savings banks.

The second group have been virtually inactive in the mortgage market since they are not allowed to issue "cédulas."

Mortgage finance companies represent an attempt to create an institution specialising in mortgage lending, on the lines of the German private mortgage banks. Their lending operations are restricted to the offer of eligible loans on the mortgage market, while they may raise funds by issuing mortgage-backed securities, by taking long-term deposits — originally for a minimum of three years, later reduced to 18 months — and by operating regular savings schemes. They may, in addition, engage in operations which are related or accessory to the above.

In practice, the mortgage finance companies came into being as subsidiaries of the commercial banks — which are not allowed to issue cédulas hipotecarias, the mortgage-backed security offering the most advantages — and more recently they have been set up by certain property companies and have also been used by foreign banking institutions (such as the Abbey National Building Society) as a means of securing a foothold in the market.

Lending operations

The lending operations covered by the Act, in the context of the mortgage market, involve the provision of mortgages, which must comply with a number of requirements if they are to be regarded as "eligible," to use the term adopted in French and English-speaking countries, by the market. There are two aspects of these requirements: the loans must be in line with the aims of the Act — ie, they must be loans for fixed investments requiring long-term finance — and they must have a high degree of security, since they represent the collateral for the securities to be issued.

This means that they must be first mortgages, no prior charge or encumbrance being permitted. The property must be real property, excluding any buildings erected without the necessary planning permission, or under government licence, or where rights of usufruct, building rights, etc, exist, which would mean that the lender would not have absolute rights in the mortgage property.

The property must be insured against damage for not less than its assessed valuation. The Act devotes special attention to the valuation process, laying down rules as to who may carry it out and, in a subsequent Order, establishing strict procedures to be followed.

Lastly, the Act allows a very generous proportion of the assessed value of the property to be borrowed: up to 70% in all cases, but as high as 80% in the case of residential properties. Although this level of borrowing against the value of the property is, in the case of home loans, quite common in other European countries — except Germany, where it is strictly limited to 60% — it is much lower in the case of mortgages on other types of property. It is Switzerland which has the most complex legislation, distinguishing as many as 11 categories of mortgageable properties, with a different ratio for each, but which is invariable well below 70%, except in the case of rural properties.

Borrowing operations

The borrowing operations which are specifically provided for in the Act

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are of three types, involving the issue of "cédulas hipotecarias," "bonos hipotecarios" or "participaciones hipotecarias."

The "cédula hipotecaria" is exactly the same instrument as was formerly allowed only to be issued by the Banco Hipotecario de España but which, since the Act, has become the mainstay of the mortgage market. The "cédula" is similar in nature to the French "obligation foncière," or to the German "Pfandbriefen"; it consists of a security, which is normally a bearer security, backed by the undivided pool of mortgage loans granted, or which may in future be granted, by the issuer, up to the maturity of the security.

Loans earmarked as backing for "bonos" or "participaciones" are excluded. The holder of the security acquires a preferential right over any other creditors of the issuer, in respect of the portfolio of mortgages. It is therefore a maximum security investment. Neither issue nor transfer require the services of a notary public.

"Bonos hipotecarios" are securities guaranteed by a group of loans which are specified in the issue document. The possible usefulness of these securities, whose backing by carefully selected loans might have earned them a special status, is seriously impaired by the complexity of the issue procedure and the attendant high costs; the instrument of issue must be a notarised document, it must be entered in the form of a marginal note in the Land Registry against the entries for the mortgaged properties, the holders of the bonds must form a syndicate, the terms and interest rates of the bonds must be adjusted to those of the mortgages, etc. All of this has meant that the issue of "bonos" has been no more than token.

The "participación hipotecaria" is an instrument by which the issuer may assign to a third party all or part of one or more mortgages, while retaining the title. If the "participación" is not insured by the issuer, the risk is also assigned and it then amounts to a complete assignment, but this is not the case if the "participación" is insured by the issuer.

The "participación hipotecaria" may be either limited or unlimited. In the latter case, it may be held by anyone, but it must then take the form of a notarised instrument and must be recorded in the Register — complications similar to those of "bonos hipotecarios."

If it is limited, it may only be issued to an institutional investor. In this case the issue is extremely straightforward, as it does not involve using a notary public, and it serves to bring more funds into the system if the holder is an institutional saver. If the holder is a finance company, the operation merely involves a transfer within the financial system, without generating a net inflow of funds. In this last case, the "participación" is simply a means of increasing liquidity.

Initially, the Act created extremely favourable conditions for mortgage securities, to give them an advantage over other market securities. Among them are the fact that the funds raised by this method did not have to be counted as external funds for the purposes of cash ratios; investors were entitled to tax relief; no duty of any kind was payable on their issue, transfer, repayment or redemption, etc. On the other hand, the issue was subject to certain conditions, such as compliance with the rules, already referred to, for mortgages to be accepted as eligible, limitation of the securities in issue at any time to 90% of the value of the "eligible" mortgages outstanding, and the requirement for the funds raised through the issue of these securities to be reinvested in "eligible" loans.

Secondary market

The Act creates the necessary framework for the development of a secondary market, to provide liquidity for securities for which a long term is desirable.

To this end, mortgage-backed securities are made freely transferable, without recourse to a notary public or the need to inform the borrower. Furthermore, three ways of ensuring liquidity are made available, namely the private secondary market, the official stock markets and the "regulatory funds."

The private secondary market is made possible by enabling issuers to buy, sell or pledge their own securities, with the institution able to retain in its own portfolio, for an unlimited period, up to 5% of the total volume issued (the limit was originally 10%).

An exceptional arrangement has been introduced for stock exchange quotation: mortgage-backed securities are automatically admitted on a provisional basis, and the issuer has one year in which to comply with the requirements for full admission.

Lastly, the "regulatory funds" are collective institutions in which all issuers may participate, their object being to ensure the necessary degree of liquidity and to steady the movement of quoted prices, to which end they engage in the buying and selling of the securities. As a further stimulant to these funds, there are proposals for the creation of a public fund, the management, administration and representation of which would be undertaken by a managing company set up by the Banco Hipotecario.

The liquidity of the secondary market is guaranteed in these three ways. However, the possibilities offered by the first — the private market — make it likely that it will be sufficient on its own, the other two being relegated to a marginal use by institutions which do not have the means or the will to organise a market in their own securities.

The result is that three sub-markets have grown up, by far the most favoured — the private market — being the least transparent, as well as being very much centred on the issuer, which is the complete opposite of the breadth, transparency and continuity which are desirable for an efficient market in mortgage-backed securities.

Mortgage market activities

The creation and the first years of operation of the mortgage market have taken place against a background of rapid change in Spain's financial markets generally.

These changes involve a process of securitisation of the money markets and a massive shift away from the use of intermediaries by non-financial concerns wishing to raise money and, consequently, an increasing interest on the part of the commercial banks in lending for the purchase of durable goods — including housing — and, lastly, increasing recourse by the government to the money and capital markets to finance the public deficit.

This was the background against which mortgage-backed securities were first issued, in 1982. As was to be expected, in view of the simplicity of the issue procedures, the "cédula" immediately became the mortgage-backed security *par excellence*, for 97% of the funds obtained by the issue of securities have been raised by this method. Redemption periods vary from three to 10 years, although the most commonly used is three years (minimum period for which an asset must be held, by law, before the holder can obtain tax relief). The most common unit value is between 50,000 and 100,000 pesetas.

The "cajas de ahorro" are the main issuers of mortgage-backed securities, although the total in issue at the end of 1986 barely represented 6-7% of their total external funds. For these institutions, the "cédula hipotecaria" is to a large extent replacing deposits for longer than two years.

The mortgage finance companies are the second most important group in terms of the size of their issues, with mortgage-backed securities accounting for 40% of their external funds. Lastly, the Banco Hipotecario de España maintains an issued volume of mortgage-backed securities of the order of 12% of its funds.

From 1982 to 1986, mortgage-backed securities enjoyed all the advantages previously referred to over other securities, but these were gradually reduced. In 1986 the right of investors to deduct 15% of the amount subscribed for mortgage-backed securities from their tax was abolished.

As long as the advantages continued, issues could be effected and placed at relatively low nominal rates so that rates for the mortgage financed by them could also be kept down. In 1987, all the tax and other advantages originally enjoyed by mortgage-backed securities were completely abolished, with the result that the rates had to rise to make them competitive in the market, essentially with public issues (*see Table 2*). Institutions like the "cajas de ahorro", which are able to raise funds by taking short-term deposits, preferred to cut back on their inflow from the issue of mortgage-backed securities.

1987 saw a decline in the net issue of mortgage-backed securities by all the institutions involved (*see Table 3*). The market could be said to be

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TABLE 2
AVERAGE NOMINAL INTEREST RATES
Percentages

	1982	1983	1984	1985	1986	1987
Tax-deductible Government Stock	12.6	13.8	13.5	11.7	9.7	—
Non tax-deductible Government Stock	16.0	15.9	15.5	13.2	9.8	11.4
Private sector debentures	14.1	13.9	14.7	13.0	11.2	11.7
Bank bonds	13.0	13.1	12.8	10.8	9.3	8.8
Cédulas hipotecarias	12.2	12.2	12.3	10.7	9.1	9.8
Cajas de Ahorro	12.1	12.1	12.1	10.7	9.3	9.5
Banco Hipotecario de España	12.0	12.5	13.0	12.0	9.8	11.0
Mortgage finance companies	13.0	12.7	12.6	10.4	8.4	9.0
Bank deposits – 1-2 years	12.9	12.7	12.5	10.8	9.3	9.8
"Caja deposits" — 1-2 years	11.1	11.1	11.6	10.6	9.3	9.5
Treasury bills ["pagarés"][1]	15.6	15.5	14.3	11.8	8.5	7.9

[1] 1 year and 18 months
Source: Banco de España and Banco Hipotecario de España

TABLE 3
ISSUES OF MORTGAGE-BACKED SECURITIES IN CIRCULATION
Amounts outstanding at end of period. Face value
Billions of pesetas

	1982	1983	1984	1985	1986	1987
1. CEDULAS HIPOTECARIAS	80.7	208.8	377.5	520.1	700.7	655.0
Cajas de Ahorro	73.7	186.1	314.8	429.9	558.5	490.5
Government issues (B.H.E.)	2.0	4.8	18.4	28.4	59.9	85.0
Mortgage finance companies	5.0	17.9	44.3	61.8	82.3	79.5
2. BONOS HIPOTECARIOS	—	—	0.6	2.7	5.0	5.0
Cajas de Ahorro	—	—	0.6	2.7	5.0	5.0
3. PARTICIPACIONES HIPOTECARIAS	3.5	5.4	21.1	21.5	20.2	3.5
Cajas de Ahorro	0.3	1.4	2.3	2.3	1.4	0.2
Private banks	3.2	4.0	7.7	7.4	5.5	2.1
Government issues (B.H.E.)	—	—	11.1	11.1	12.5	1.0
Mortgage finance companies	—	—	—	0.7	0.8	0.2
4. ALL MORTGAGE-BACKED SECURITIES (1 to 3)	84.2	214.2	399.2	544.3	725.9	658.5

Source: Banco de España. Financial Policy Directorate-General, Banco Hipotecario de España pausing in anticipation of a reform of the mortgage market itself and of the forthcoming arrival on the scene of the pension funds, which should, by their nature, become major investors in mortgage-backed securities.

Table 4 illustrates the structure of the securities market in Spain, by percentages, covering the capital and money markets. Mortgage-backed securities have been included in the figures for the money market rather than the capital market because they have really been traded, thanks to their liquidity, as short-term securities.

Effects of the mortgage market on housing finance

In the second half of the 1970s the after-effects of the oil crisis were felt severely by the building sector in general and house-building in particular. The rate of 350,000 house starts a year, which was usual during the first half of the 1970s, fell to around 200-250,000 at the end of the decade and in the early 1980s.

To sustain even this rate required firm intervention by the government, beginning in 1978 with the plans for "officially protected housing". Under these plans, house-builders could obtain loans, which were later taken over by the purchasers, at privileged interest rates — some 2.5-3 percentage points below market rates — provided the homes had a habitable area not exceeding 90 squares metres — equivalent to a built area of 110 square metres — and complied with special standards of design and quality.

The amount of the mortgage, which was then taken over by the purchaser, was between 65 and 80% of the purchase price, with a repayment period of 12-13 years, plus a two-year period of grace. In addition, if the purchaser could show that his income was below a certain level, he qualified for grants and a subsidised rate of interest which could be as much as 5-6% below market rates.

Thanks to these plans, it was possible to hold the rate of construction at just over 200,000 new homes a year, of which 60% were "officially protected housing".

TABLE 4
STOCK MARKET
Breakdown of Net Issues (%)

	1982	1983	1984	1985	1986	1987[1]
CAPITAL MARKET	56.0	22.9	23.2	40.7	66.7	61.0
VARIABLE INTEREST SECURITIES[2]	19.2	12.7	9.8	17.0	15.8	13.2
FIXED INTEREST SECURITIES:	36.8	10.2	13.4	23.7	50.9	47.8
— Public Authorities	28.4	6.6	3.4	12.0	43.4	47.5
— Financial Institutions[3]	1.5	0.0	1.9	4.2	2.0	0.7
— Non-financial concerns	6.9	3.6	8.1	7.5	5.5	−0.4
MONEY MARKETS	44.0	77.1	76.8	59.3	33.3	39.0
FIXED INTEREST MONETARY SECURITIES:	17.8	12.6	7.2	9.2	9.3	−1.3
— Bank bonds[4]	9.2	5.4	2.3	4.1	5.3	−2.8
— Mortgage-backed securities	8.6	7.2	4.9	5.1	4.0	1.5
SHORT-TERM MONEY MARKET SECURITIES:	26.2	64.5	69.6	50.1	24.0	40.3
— Treasury bills and notes [pagarés and letras]	8.6	66.4	62.9	50.4	19.0	41.8
— Commercial bills and notes	17.6	−1.9	6.7	0.1	5.0	−1.5
STOCK MARKET TOTAL	100.0	100.0	100.0	100.0	100.0	100.0
PRIVATE SECTOR[5]	63.0	27.0	33.7	37.6	37.6	10.7
NON-FINANCIAL PUBLIC SECTOR	37.0	73.0	66.3	62.4	62.4	89.3
N.B. Mortgage-backed securities as a percentage:						
— of total private sector securities	13.6	26.7	14.5	13.6	10.6	14.0
— of private sector fixed interest and money market securities	19.6	50.3	20.5	24.7	18.3	—

[1]Provisional [1987]
[2]Issues and shares contributing to investment funds
[3]Government (Crédito Oficial) and subsidiary bonds
[4]Private bank and Savings bank bonds
[5]Include Government credit agencies
Source: Banco de España and B.H.E.

Mortgages at the subsidised rate — known as the "agreed" rate because it was fixed by negotiation between the financial institutions and the government — were provided to the tune of 60% by the "cajas de ahorro", 30% by the Banco Hipotecario de España and the remainder by the private banking sector. Where special assistance was given to individuals — in the form of subsidised interest rates — it came out of general state Budget provisions.

The funds offered by the financial institutions, and specifically by the "cajas de ahorro", after 1982, were raised by the issue of mortgage-backed securities. In the case of the Banco Hipotecario de España, its funds were partly derived from Treasury grants and partly from the issue of mortgage-backed securities.

It can safely be said that, over the period 1982-86, the "cajas de ahorro" covered the funding of their new home loans by the issue of mortgage-backed securities. In 1987, since the abolition of the tax advantages for investors, net issuers of mortgage-backed securities have been in decline.

In 1986, the Spanish economy began to pick up and by 1987 this recovery was already feeding through to the housing sector. The number of "open market" housing starts is higher than the figure for "protected" housing, although the overall total still remains at just over 200,000 homes per annum. This is indicative of the changing pattern, with a greater demand for larger, better located — and certainly more expensive — homes than are provided under the government "protected housing" scheme.

In addition, the total number of units built, which is markedly lower than in the 1970s, seems to confirm that there is no longer a housing shortage. As elsewhere in Europe, much more attention is being paid to the restoration of existing buildings.

The recovery in the housing sector is, of course, a consequence of the general improvement in the economy, but, to a large extent, it has also been directly affected by the marked improvement in the terms for home loans: the amount which can be borrowed has been increased to around 70-80% of the purchase price of the property; the loan periods have been extended to 15-20 years; rates of interest have come down; and variable rates were introduced without public opposition, because further falls in interest rates were anticipated. All this is largely due to the new mortgage market regulations, in so far as they relate to lending operations.

Since 1985, there have been signs of changes in the structure of housing finance. In the first place, as illustrated in *Table 6*, the share of overall private sector borrowing represented by home loans has been rising steadily, and is now a major item. The private banks are beginning to show an interest in home loans and are rapidly increasing their share of the market, to the point where it has already reached 19.6% of total lending for home purchase (*see Table 5*). Mortgage-backed securities, which were conceived as a medium-term method of refinancing (five years of more), are being issued with a three-year maturity and are being intensively traded in private secondary markets, so that in practice they are coming to be treated as short-term securities.

The abolition of the tax advantages at the end of 1986 led to a fall in the number of issues in 1987, resulting in a lower net volume. the refinancing of home loans is, at the present moment, based on short-term funding, since, with interest rates expected to come down further, the institutions are not interested in long-term issues at short-term rates and investors will not accept variable rate instruments.

Something similar is happening in other European countries. We are witnessing a period of readjustment, looking to the year 1992 when the Community Directive comes into force, and there are bound to be far-reaching changes before then. ■

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TABLE 6
HOME LOANS AS A PERCENTAGE OF TOTAL PRIVATE SECTOR LENDING
(Loans outstanding)

	Private Banks	Cajas de Ahorro	State Banks	Total
1982	n.a.	43.5	38.4	n.a.
1983	3.7	41.0	37.3	15.5
1984	4.0	41.8	40.6	17.2
1985	4.3	41.5	42.8	17.8
1986	5.0	40.5	44.8	18.7
1987(*)	5.3	37.5	45.2	19.0

(*)Figures as at 30.09.87 *Source:* Prepared by the B.H.E.

TABLE 5
GROWTH OF OUTSTANDING HOME LOANS(*)
(Billions of pesetas)

	(1) PRIVATE BANKS			(2) CAJAS DE AHORRO(**)			(3) STATE BANKS (***)	
Year	Homes purchased	Properties built	Total	Homes purchased	Properties built	Total	Total	Total (1) + (2) + (3)
1982	n.a.	n.a.	n.a.	860.2	409.0	1,269.2	433.8	n.a.
1983	50.7	332.4	383.1	1,042.0	421.6	1,463.6	556.6	2,403.3
1984	81.1	316.3	397.4	1,192.0	369.4	1,561.4	698.3	2,657.1
1985	112.8	343.2	456.0	1,296.0	389.6	1,685.6	822.9	2,964.5
1986	183.9	392.6	576.5	1,537.0	376.7	1,913.7	937.9	3,428.1
1987	330.8	437.4	768.2	1,660.5	452.6	2,113.1	1,027.9	3,909.2

(*)Homes purchased and properties built
(**)Including Post Office
(***)Figures provided by the B.H.E.
Source: Banco de España