Recent Mortgage Market Development in Spain

by Baralides Alberdi

INTRODUCTION

The reform of the financing system in Spain started in the mid–1970s but was not completed until the mid–1980s, giving rise to a fully deregulated system which resulted in a rush into mortgage financing by commercial banks. Until then mortgage finance had been the responsibility of Banco Hipotecario, a public bank, and the savings banks system, the latter being subject to high quotas of obligatory investment.

Currently, mortgage finance is satisfactorily served by the financing institutions without any credit restriction. Banks and savings banks compete hard to attract borrowers. All the public banks have been merged to form Argentaria, which has privatized 75% of its shares and now acts in the market on the same basis as other financial institutions.

The purpose of this article is to give a general and descriptive overview of the Spanish mortgage market during the last three years. The first section describes the structure and the evaluation of the market, the institutions that participate in it, the share among final users and the concentration of the market. The second section describes the characteristics of mortgage loans. The third section analyses the mortgage market funding. The final section looks at the evaluation of mortgage interest rates and credit risk.

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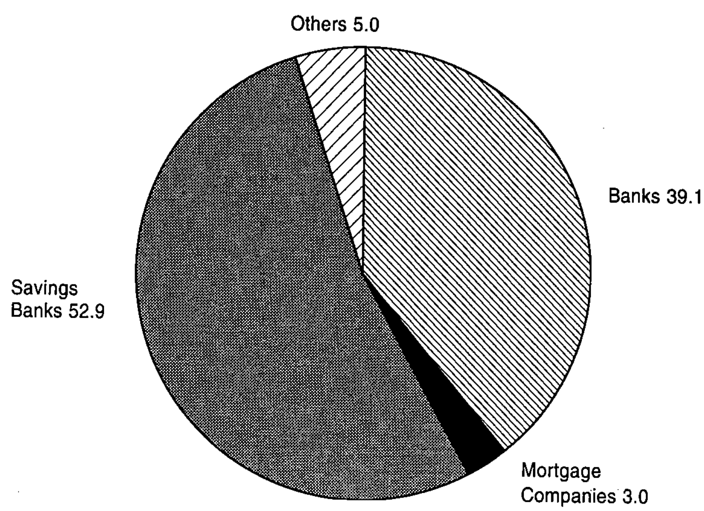
MORTGAGE MARKET

Structure

The total of mortgage loans outstanding in Spain at the end of September 1996 was shared between savings banks with 52.9% of the market and commercial banks with 39.1%. The rest was held by credit cooperatives (5%) and mortgage companies-SCH (3%). (See Figure 1.)

The structure has changed little in the last few years. Savings banks have increased slightly from 49.3% share at the end of 1992 while commercial banks have decreased from 41.4%. Cooperatives have increased from 3.5% while SCH have decreased from 5.8%.

Figure 1. Percentage Share of Mortgages, September 1996



Source: Bank of Spain

Evolution

At the end of September 1996, mortgages amounted to Pta. 19.8 trillion, representing an increase of 12.5%.[1] The net mortgage flow in the previous 12 months amounted to Pta. 2.2 trillion, and it is estimated that the gross volume of mortgages will amount to Pta. 4.2 trillion in the same period.[2] Table 1 and Figure 2 show the evolution of these figures during the last three years. Growth of totals outstanding has always remained over 10%. Nevertheless, 1994 shows a special rise which coincides with a big fall in interest rates and the approval of the subrogation law (explained later). The weaker growth in the 1995 total outstanding corresponds with an increase in interest rates.

Both net and gross mortgage credit experienced a decrease in 1995 due to the high levels of activity reached during 1994. During 1994 the volume of new mortgages increased dramatically due to the high volume of prepayments of mortgages with high interest rates and the origination of new mortgages at much lower interest rates.[3] A recovery started in 1996 together with a new drop in interest rates.

Mortgage debt has increased five-fold since 1986, rising from 12.5% of GDP in 1986 to 27.7% in 1996. The number of new mortgages is estimated to amount to nearly half a million a year, of which more than 80% correspond to mortgage loans against residential property. The number of mortgage loans increased strongly in 1994, decreased in 1995 and remained steady in 1996. According to data from the census, the number of main households with mortgages in due payments amounted to 1.8 million, which represents 15.6% of the total main residences. An additional half million secondary houses are also mortgaged.

Figure 2 shows also the change in total loans to residents (companies and families) during the last three years. As seen from the chart, most of the increases in total lending to residents were due to the big increases in the mortgage market from the middle of 1993 to the end of 1994, mortgages being the most active sector in total finance.

According to the latest figures, the growth rate for total outstanding mortgages (12.5%) surpassed the 7.2% growth rate of lending to residents (by 5.3 percentage points). Differences were greater, however, at the end of 1993 and the beginning of 1994 (over 10 percentage points). (See Figure 2.)

As a result, the weight of mortgages in total domestic lending to residents has increased during the last 10 years, representing now 41.5% as against 35.5% at the end of 1993. The weight of mortgages in total domestic lending to residents represents near 60% of their total domestic lending to savings banks, while it represents only 30% for commercial banks. This shows the

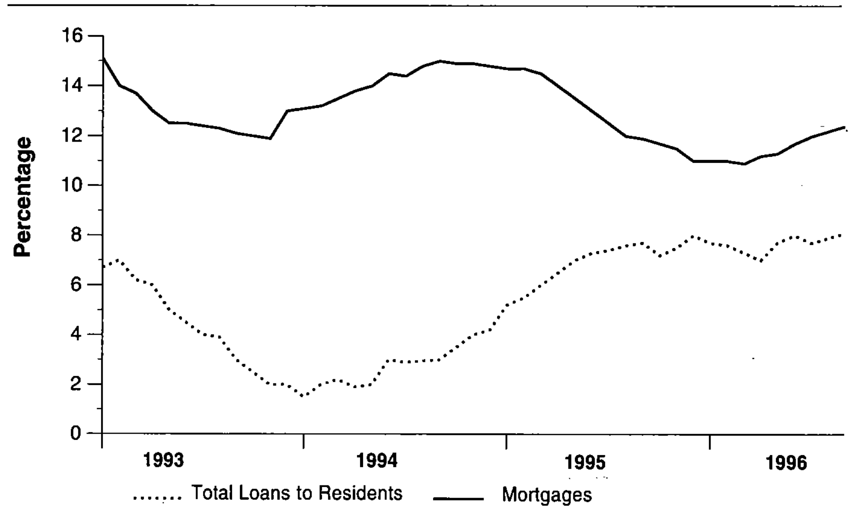
Table 1. Mortgages in Billions Pta. and Changes in Percentage

	*1996**	*1993*	*1994*	*1995*	*1996***
Total Outstanding	20,345	12.9	14.5	11.22	12.7
Net Mortgages	2,293	2.1	27.6	-11.6	26.0
Gross Mortgages	4,521	32.1	18.9	- 7.1	2.1

*Estimates by Argentaria
**Figures refer to all mortgages, residential and commercial.

Source: Bank of Spain and Argentaria

Figure 2. Loans to Residents (Changes in Total Loans and Mortgages)



Source: Bank of Spain

specialization of savings banks in the mortgage market.[4]

By type of institution, the highest growth—on the basis of the data available up until September 1996—was achieved by credit cooperatives, although their portion of the total is only 5%. The growth rate of savings banks has slowed slightly from the 20% rate of 1993. Mortgage credit by commercial banks has grown by around 12% since the middle of 1994. At the present time, banks and savings banks have converged to the same level of growth. (See Figure 3.)

Final Use

Financing home buying for individuals represents around 70% of the total outstanding mortgage market, while construction accounts for 20% and real estate development 10%.

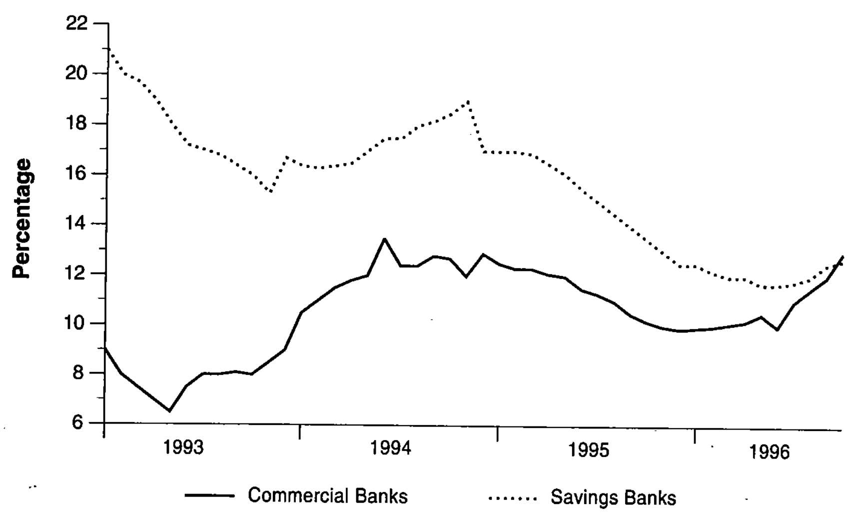
Financing home buying for individuals is the mortgage segment which has undergone the strongest growth in the past 10 years. In 1986 the balance of lending for this purpose represented 7.9% of the GDP. By 1990 it had risen to 10.4%, reaching 18.1% at the end of 1995 and estimated at 19.1% for the end of 1996. In the last decade this ratio has gradually approached that of other European countries, indicating the degree of maturity of the Spanish mortgage market.

The other two components of mortgage financing, construction and real estate development, have performed better during the last year after a decline until the middle of 1995. (See Figure 4.)

Concentration of the Spanish Mortgage Market

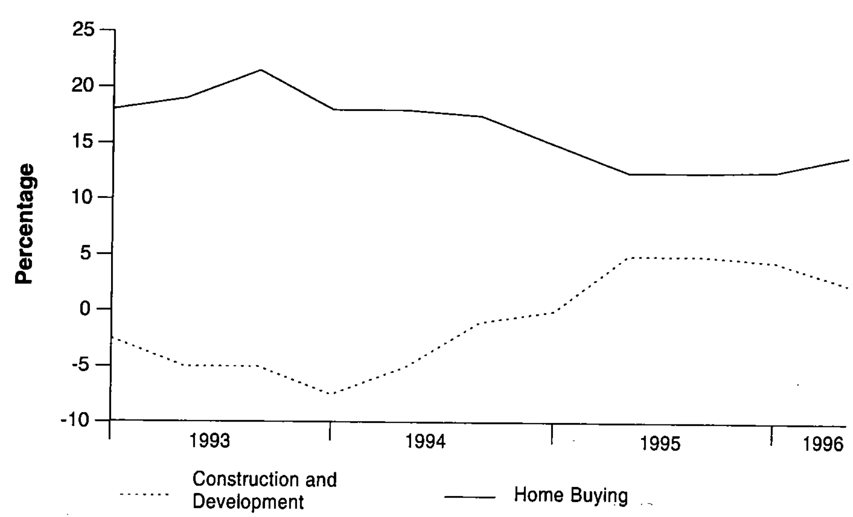
There is considerable concentration of the mortgage market in Spain. At the end of 1995 the portfolios of the six main mortgage lenders accounted for 47.5% of the total mortgage market, and the two biggest accounted for 23.7% of the market. (See Table 2.)

Figure 3. Changes in Share of Mortgages for Commercial and Savings Banks



Source: Bank of Spain

Figure 4. Annual Changes in Lending to the Real Estate Sector



Source: Bank of Spain

Table 2. Principal Mortgage Lenders in the Market, Year-end 1995 (Value in Pta. billions)

	Outstanding Mortgage Loans	*Market Share (%)*
1. Caixa	2,172	12.0
2. Argentaria	2,104	11.7
3. Caja Madrid	1,368	7.6
4. Banco Central Hispano	1,143	6.3
5. Banco Bilbao Vizcaya	1,079	6.0
6. Caja Cataluña	703	3.9

Source: Annual reports of the institutions

Subsidized Housing Financing

Even if the financing system is a fully deregulated market, the state continues to play a role in housing finance through a system of subsidized housing finance which has changed only slightly since the middle of the '80s.

This system consists of granting loans to developers at rates slightly below market (the official agreed rates) with additional interest subsidies and allowances for house buyers fulfilling special socioeconomic conditions. The government makes periodic agreements with commercial banks and savings banks to provide a certain amount of money to finance the construction of new houses and low-interest loans for house buyers, who have to meet certain requirements to qualify to receive the subsidies. In its annual budget the government allocates a sum of money for interest rates subsidies. This is paid directly to the financial institutions once the government is satisfied that all the conditions have been fulfilled. This policy minimizes distortions in the free functioning of the market.[5] Table 3 shows the weight of the subsidized housing finance system.

Until 1992 half of the subsidized housing finance total outstanding was held by Banco Hipotecario and the rest mainly by the saving banks. Since the '90s, most financial institutions have competed to participate in subsidized housing finance, and the share among financial institutions has changed slightly. At the end of September 1996, savings banks held 61.7% of the total; Banco Hipotecario 29.9%; and the balance, 8.4%, was held by the remaining banks. Financial institutions are eager to participate in this scheme because it gives them the possibility of other business with the developers in the non-subsidized sector. Also, as can be seen in Figure 5, in recent years it has not been very costly for financial institutions, as differences in interest rates have not been very important. Official agreed rates have even at times been above market rates, due to administrative delays in fixing them. Finally, default rates appear to be smaller in this housing sector than in other areas of lending.

CHARACTERISTICS OF MORTGAGE LOANS

The prevalent mortgage instrument available in Spain today is a relatively high (around 80%) loan-to-value (LTV) annuity loan with constant payments during the life of the loan. The share of interest installment amount will fall while the installment of the principal will rise during the life of the loan. Mortgage loans are provided mostly at variable interest rates (80%) as well as some at fixed rates. Fixed-rate mortgage loans are provided for 10- to 15-year terms. Variable-rate-loans are offered for up to 20 to 25 years. The average loan life, however, reflecting prepayments, remains around eight years. The rate for variable-rate-loans is indexed and modified annually. Indexation is based on one of the five indices published monthly by the Bank of Spain.

- The rate of the average mortgage loan granted by banks.
- The rate of the average mortgage loan granted by savings banks.
- The average six-month moving average rate negotiated in the secondary market for public debt between two and five years.
- MIBOR (Madrid Interbank Offer Rate) at one year.
- The asset interest rate of savings banks.

The most frequent benchmark index used during the last two years has been MIBOR plus 1.25 and 2.0 percentage points. Maximum payment-to-income ratios are around 30% to 40% depending on the volume of the income (the higher the larger). Prepayment is allowed but subject to a 1%

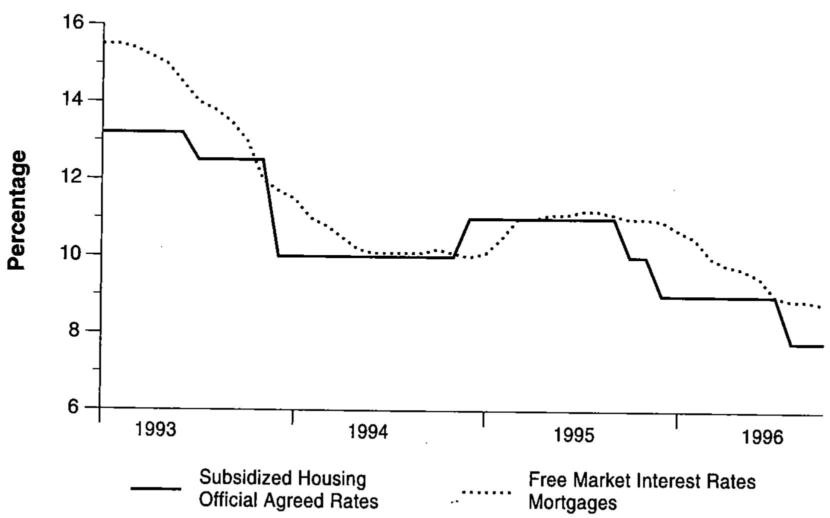
Table 3. Total Home Buying Debt Outstanding (pta. in billions)

	1993	*1994*	*1995*	*1996**
Subsidized**	2,386	2,555	2,940	3,347
Total	9,383	11,186	12,645	14,436
% Subsidized	25.4	22.8	23.3	23.2

* Argentaria estimates
** Subsidized figures refer to both developers and homebuyers.

Source: Bank of Spain and Argentaria

Figure 5. Interest Rates, 1993–1996



Source: Bank of Spain and Public Work Ministry

penalty for variable rates and 2.5% for fixed-rate loans.

Lenders in Spain typically charge origination fees of 1% to 2%. In addition, nominal fees for appraisals, together with solicitor's fees, mortgage registration, taxes and other miscellaneous costs represent another 2.5%. The total costs of taking out a mortgage, therefore, amount to between 3.5% and 4.5%. Fire insurance is required for all mortgages, and life insurance is increasingly used.

There is tax relief for interest rates paid annually on repayments of loans for house purchase. This can be deducted from the base taxable income, as an expense, up to a maximum of Ptas. 800,000. House buyers can also deduct 15% of the purchase investment from their tax bill annually, with the limitation that the sum to which the 15% applies does not exceed 30% of the base taxable amount. The average loan size for housing reaches up to 10 million pesetas.

MORTGAGE MARKET FUNDING

In Spain banks and savings banks are basically funded through retail deposits and the interbank money market in a proportion of ²/₃ and ¹/₃, respectively. These institutions also fund themselves through the issuance of mortgage bonds. The annual gross volume of mortgages is estimated to amount to Pta. 4.5 trillion during 1996, while the gross volume of new issues of mortgage bonds is estimated to amount to Pta. 300 billion (7.5% of mortgages). The importance of this way of funding, therefore, is very small; and a systematic reduction has taken place slowly but surely since 1986, when fiscal advantages of these securities disappeared. (In 1986, mortgage bonds represented 16% of the total mortgages outstanding.)

At the end of September 1996 the total volume of mortgage bonds in circulation amounted to Pta. 1.08 trillion, representing 5.5% of the total mortgages outstanding and 5.6% of the total medium- and long-term negotiable fixed-rate mortgages. Sixty-one percent of bonds outstanding are issues of the saving banks and 39% come from commercial banks, of which nearly all are held by the Banco Hipotecario, which had until 1981 a monopoly on the issuing of mortgage bonds. The mortgage bond market is now shared basically between Banco Hipotecario and the savings banks, which have been allowed to issue mortgage bonds since 1981.

Since 1991 all financial institutions have been allowed to issue mortgage bonds. For savings banks this is one of the cheapest ways of raising money, as mortgage bond interest rates are in fact at the same level as those of short- and medium-term deposits. This is due to the large branch networks savings banks have that allow them to sell this kind of security to unsophisticated retail customers.

This is not the case for Banco Hipotecario which, with a very limited retail network, has to pay interest rates higher than those of the public debt for their mortgage bond issues. Yields for investors (basically those of savings banks) are not very much more than for governments, reflecting the fact that they are very simple securities issued by publicly supported institutions. The normal term is three years. The typical issuance cost for mortgage bonds is up to 30 basis points. The spread of mortgage bonds issued by Banco Hipotecario to comparable maturity government bonds is variable. They are higher when government bond issuance volume is high and very small in other circumstances.

Securitization

Securitization was introduced in Spain on July 7, 1992. The first mortgage-backed security (MBS) was issued in July 1993. Since then 13 issues have taken place for a total amount of Pta. 234 billion, of which 37 billion was issued in 1993, 85 in 1994, 109 in 1995 and only 3 billion in 1996. Hipotebansa, part of the Santander group, is the largest Spanish issuer of MBS to date, with 58% of the total issues. The total volume of MBS in circulation at the end of September 1996 amounted to Pta. 198.4 billion, representing only 1% of the total mortgages outstanding.

Most of the issues offered interest rates calculated using MIBOR at three-to-six months plus between .3 and .5 points.

The MBS market has not been a very active market. Many institutions have made at least one issue to see how the process worked, but they have not repeated the experience. Spanish financial institutions have, in general, an excess of liquidity (especially savings banks) and an excess of capital. In addition, there is a disincentive for mortgage securitization due to the 50% risk weighting for MBS in the solvency ratio. With this treatment and the current condition of Spanish financial institutions, there is no great incentive to use this instrument for raising funds.

Secondary Mortgage Market

The secondary mortgage market for mortgage bonds is relatively small, but the bonds have a high level of liquidity. They are traded through the AIAF (Financial Fixed Assets Brokers Association), and they are easy to buy and sell at relatively low cost. During 1996 the total mortgage bonds traded through the secondary market amounted to Pta. 200 billion, 70% of the new issues made during the same period.

The activity in the MBS secondary market is made through the same association but its activity is practically nil. In Spain there has not been a development of an MBS secondary mortgage market nor specialization of mortgage functions. All the institutions that participate in the mortgage market in Spain are responsible for the origination, servicing and investment functions. Spain does not have, as in the USA, mortgage loan servicing performed by an institution other than the originator or investor.

Interest Rates

Mortgage interest rates are at the lowest level in recent history in Spain. Mortgage rates started falling in the middle of 1993, experiencing the sharpest reduction ever seen. They reversed this trend by rising after the summer of 1994 and until the middle of 1995. Since then rates have been going down. This new downturn has put the levels of interest rates at record lows.

After the big decrease that took place in 1993 a new law was approved to reduce the cost of refinancing a mortgage loan and to allow the borrower to move the mortgage to another financial institution without the approval of the present lender. Law 2/1994, "the subrogation law," has been one of the most important legal developments in the last three years. According to this law, the subrogation of the lender must be accompanied by a "binding offer" presented to the original lender.

Law 1/1994 states that the commission charged for the cancellation of mortgages at variable interest rates may not exceed 1% of the outstanding principal. Law 2/1994 encourages agreements between the lender and the borrower to improve interest rate conditions or to change the term of the loan. The theory is that costs will be lower when the borrower renegotiates at the same institution. Under this law it is easier and cheaper to change the mortgage conditions when this only involves an improvement in interest rates. The reduction in costs contemplated in the law includes exemption from the Stamp Tax and the reduction in registration and notary fees. The registration and notary fees were reduced to approximately 20 basis points of the total loan from the approximately 100 basis points before the law. As a result of this law, interest rates on existing loans have been reduced to nearly the same level as new loans.

Another recent related development has been the agreement signed between the government and the financial institutions at the end of October 1996 fixing a maximum penalty for prepayment of fixed-rate mortgage loans at 2.5% of the outstanding balance. This will affect only mortgage loans below Pta. 40 millions, and only for fixed-interest-rate mortgages to be converted into variable rate mortgages. The agreement also affects the notary and registration fees that will suffer a 50% reduction over the reduction already stated in Law 4/1994.

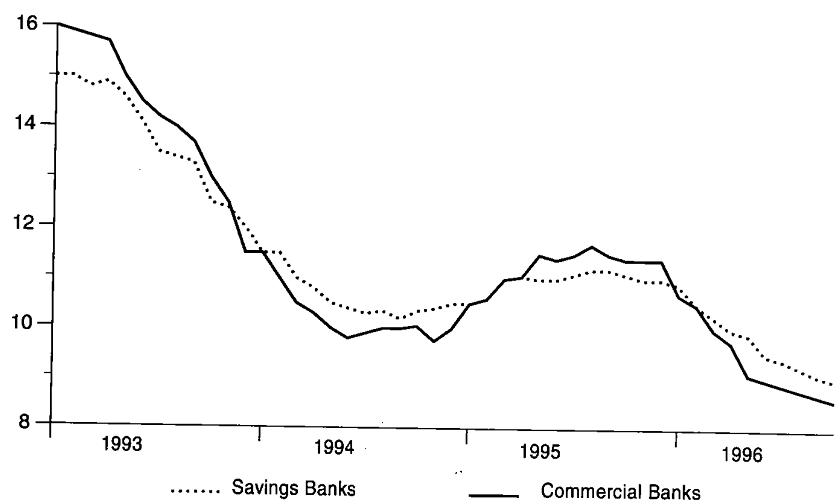
Figure 6 shows the evolution of mortgage interest rates for banks and savings banks. Mortgage interest rates shown in Figure 6 are annual effective and include all the costs charged by the lender for its benefit. In real terms, Spanish interest rates have shown a strong tendency, since the middle of 1993, to fall to the same levels as Spain's closest EU partners and even below in some cases.

Default Rates

Default rates, shown in Figure 7, apply to mortgages for housing, offices and commercial premises, which are completely finished and may be used for any purpose.[6] They do not include operating real estate assets or other kinds of mortgages. Thus the mortgages in arrears represent only the total mortgage balance outstanding of these kinds of mort-gages which represent around 80% of the total. The percentage of loans 90 days or more in default actually going to foreclosure is very low. It is estimated to be far below 1%, but official data are not available.

The legal protection of collateralized lending in Spain is not strong. Foreclosure and sale of property in situations where the owners contest is long and complex (approximately three years), and it is also costly (between 5% and 15% of the price obtained, inversely proportional to the amount of the house price). Unfortunately official data on foreclosures and sales procedures in Spain are not available.

Figure 6. Mortgage Interest Rates, 1993–1996



Source: Bank of Spain

Figure 7. Total Mortgage Default

Source: Bank of Spain

SUMMARY

The mortgage market in Spain has been the most active sector in total finance during the last three years, with savings banks being the lending institutions controlling more than 50% of the total market. Financing home buying for individuals has been the mortgage segment with the strongest growth during the analysed period. There is a certain concentration of the mortgage market with the six main mortgage lenders accounting for nearly 50% of the total market. Interest rates decreased sharply since the middle of 1993, reaching levels at record lows at the end of 1996. Intermediation margins have been reduced sharply. Mortgage default rates have trended downwards since the beginning of 1994.

Although the Spanish mortgage market performed very well during the last three years, there are still some structural problems to be resolved. One of the most important pending problems of the mortgage market in Spain is the funding side of the business, where a mismatch in terms between assets and liabilities remains, causing liquidity and interest rate risk. Another problem is the cumbersome administrative burden that reduces competition and increases transaction costs.

Future prospects for the development of the Spanish mortgage market are positive, as interest rates are falling and competition is increasing. The liberalization of services by the government, although being done slowly, will lead to a simplification of administrative processes that will reduce the costs for the mortgage market. As the market develops, the mismatch between the terms for funding and lending is likely to be progressively improved.

NOTES

[1] Inflation rates in Spain were 4.6% in 1993, 4% in 1994, 4.7% in 1995 and 3.6% in 1996. [Editor's note: The exchange rate as of February 1997 is approximately Pta.. 143/$].

[2] Net mortgage credit is defined as the difference between total outstandings of two consecutive years. Gross mortgage credit is the net mortgage credit plus an estimated percentage of amortization of the total outstanding at the end of the preceding year.

[3] Statistical data in Spain do not separate data between loans originated from prepayments and new originations.

[4] There is an on-going controversy in Spain about the nature of the savings banks. They are non-profit foundations that cannot distribute profits to their shareholders. Their profits go to social works and to increase their capital. Their boards of directors are comprised of savers (44%), municipalities (40%), creators (11%) and employees (5%). The board determines the use of the profits, which has over the years created political controversy due to the large portion of board seats held by municipal governments.

[5] Only loans for low-cost housing (up to a maximum house price and income of the borrower) are included in the subsidized housing finance. "Official agreed rates" are determined by the Ministry of Public Works in agreement with the Ministry of Finance, the latter always trying to raise them as near to the market rates as possible against the will both of the developers and the Ministry of Public Works. Rates on subsidized loans are fixed for a period of three years (down from five previously). These rates are applicable both to developers and to financial institutions. In addition to subsidies of interest rates some allowances (up-front grants for downpayment) are paid to the buyers who meet certain socio-economic requirements.

[6] Default data do not separate housing and non-housing loans. You have the specification of what is included and what is not in the text. Data came from the weighting as regards the constitution of provisions for insolvency and it is the same for all these types of loans.