The Spanish mortgage debt market: Key features and considerations for regulatory reforms

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The Spanish mortgage debt market is generating heated debate. Deteriorating macroeconomic conditions may further increase mortgage defaults. Rising foreclosure rates are escalating social tensions. In response, the Government plans to reform existing mortgage regulation through introduction of a series of measures to improve protection of debtors without significantly altering the mortgage market.

Spanish households are facing a substantial deleveraging challenge. Even if the average mortgage loan has declined from 150,647 euros in 2009 to 112,875 euros in 2012, residential mortgage debt still represents around 64% of Spanish GDP. Additionally, Spain is the fourth largest mortgage market in Europe. Taking mortgage-backed securities and covered bonds together, it is the second largest country in the EU (only after the United Kingdom) in terms of securitized mortgage debt, with an outstanding volume of 683 billion euros. Although macroeconomic conditions have not been favorable, the quality of the mortgage portfolio of Spanish banks has not deteriorated significantly. The non-performing ratio of these loans (NPL) was 3.49% in 2012Q3. Despite this relatively low level of NPLs, foreclosures have been increasing. Recently, they have been particularly on the rise, such that foreclosures and evictions have caused significant social debate surrounding mortgage regulation in Spain. The Government is supportive of several measures currently under Parliamentary debate designed to alleviate pressures on mortgage debtors; however, opposed to the proposal to reform retroactively dation in payment. In our view, implementing retroactive non recourse mortgages would be more harmful than beneficial for the Spanish economy, thus, providing support to the Government's position.

The mortgage debt market debate in Spain: A snapshot

There is a widespread debate in Spain on mortgage debt from, at least, four different perspectives:

i) Mortgages represent the main source of households' debt in Spain and the size of that debt has increased substantially in the years prior to the crisis. As a result, mortgages have become the main challenge for the necessary deleveraging effort that households have to make over the next years.

ii) The importance of mortgages goes beyond the contractual relationship between borrowers and lenders, as many mortgages have been securitized and sold in international markets

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mainly as covered bonds or mortgage-backed securities (MBS). The size of such securitization is currently around 683 billion euros.

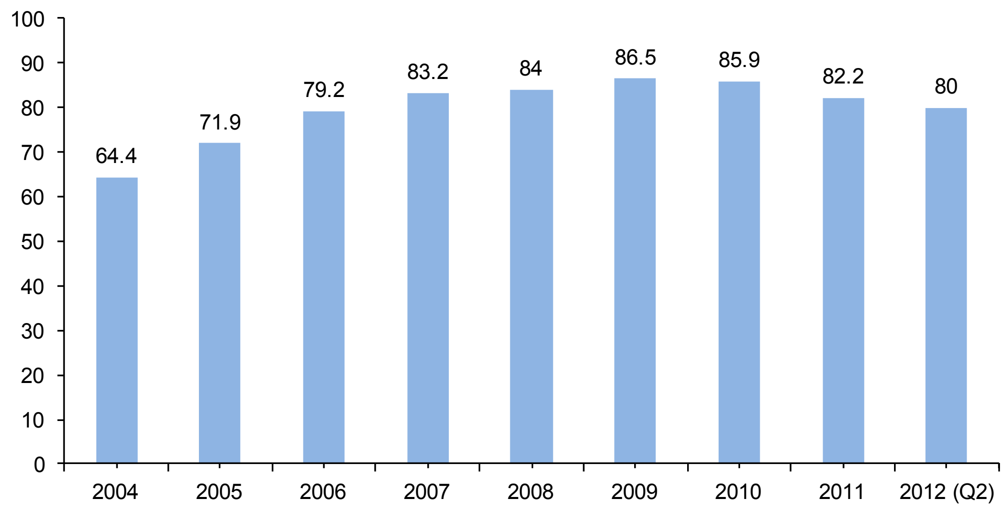
iii) Spain is undergoing a process of bank restructuring and recapitalization and the deterioration of loan portfolios up to date has been mainly attributed to loans to developers and construction. However, mortgage loan defaults have remained much lower. In any event, there is still a risk that non-performing mortgages may increase if macroeconomic conditions do not improve considerably.

iv) Even if mortgage default rates have stayed relatively low, there are increasing difficulties for households to face mortgage payments and this is clearly shown in the growing number of foreclosures in Spain. Between 2007 and 2012Q3, there have been 416,975 foreclosures. As regards mortgages, the way this social problem can be addressed is probably the main current controversial issue in Spain.

Some figures illustrate the size and importance of mortgages both for the Spanish economy and, in particular, for households. Exhibit 1 depicts what the Financial Accounts provided by the Bank of Spain call the "debt of Spanish households in the form of loans and securities other than shares" as a percentage of GDP. This indicator is a good proxy for the deleveraging effort that Spanish families will have to make. This debt ratio was 64.4% in 2004 and rapidly increased to 86.5% in 2009. From 2010 onwards, a deleveraging effort can be observed with the debt to GDP ratio falling to 80% in 2012. This means a 6.5% percentage point fall from peak.

As shown in Exhibit 2, the outstanding mortgage market debt increased from 415 billion euros

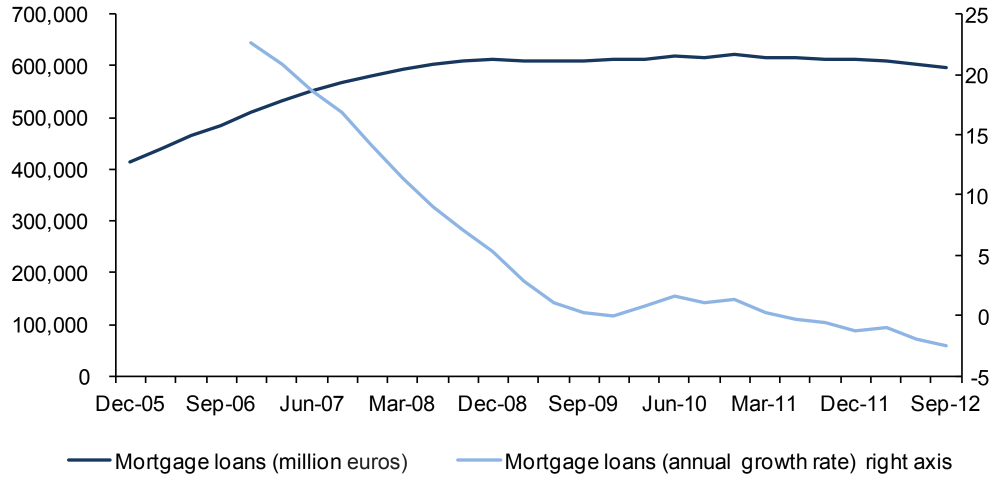
Exhibit 1
Debt of Spanish households in the form of loans and securities other than shares (% of GDP)



Source: Bank of Spain and own elaboration.

Exhibit 2

Mortgage loans (outstanding amounts and annual change) (2005Q4-2012Q3)



Source: Bank of Spain and own elaboration.

in 2005Q4 to 618 billion euros in 2010Q2. Subsequently, the volume of loans has decreased to 597 billion euros in 2012Q3. The annual growth rate of mortgages peaked at 22.6% in 2006Q4, and then fell progressively. It was 1.4% in 2005Q4. From 2006 onwards it turned negative. In 2012Q3 mortgages fell by 2.5% year-on-year.

How important is mortgage debt for Spanish households compared to other countries? The statistics of the European Mortgage Market Federation provide an idea. The latest available comparative data, as of 2010 (see Table 1) show that Spain is one of the largest mortgage markets in the world in absolute terms. Total outstanding

Table 1

Total mortgage debt outstanding. International comparison (2010)

	Outstanding amount (millions of euros)	Residential mortgage debt to GDP (%)
United States	8,383,789	76.5
United Kingdom	1,442,685	85.0
Germany	1,152,195	46.5
France	796,600	41.2
Spain	680,208	64.0
Netherlands	629,153	107.5
Italy	352,012	22.7
Sweden	283,666	81.8
Denmark	237,313	101.4

Source: European Mortgage Federation and own elaboration.

Table 2

Annual change in mortgage contracts in Spain (2009-2012)

	Number of contracts	Value of the new mortgages	Average amount
2009	-15.6	-27.5	-14.1
2010	-11.2	-18	-7.6
2011	-32.2	-36.4	-6.2
2012	-29.5	-33.4	-5.6
Memo:			
Average mortgage value in 2009 (euros)			150,647
Average mortgage value in 2012 (euros)			112,875

Source: National Statistics Office (INE).

mortgage debt held by residents as a percentage of GDP is 64% in Spain. This seems relatively high compared to other countries, such as Italy (22.7%), France (41.2%) and Germany (46.5%) but it is lower than the case of the United States (76.5%), the United Kingdom (85%) or the Netherlands (107.5%).

Examining the most recent data, the number of new mortgage contracts has been continuously falling since 2009. In that year, the mortgages signed decreased by 15.6% and in 2012 the fall was 29.5%. The value of the mortgages subscribed has declined even more rapidly, from -27.5% in 2009 to -33.4% in 2012. As a consequence, the average amount of mortgages in Spain has decreased from 150,647 euros in 2009 to 112,875 euros in 2012.

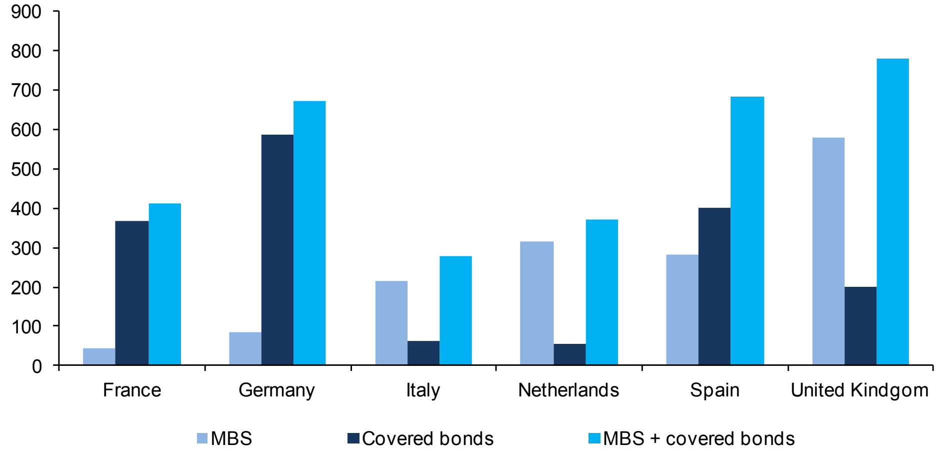
The securitized mortgage debt market: The relevance of Spain

Securitization is an essential feature of most mortgage markets in the world, with Spain being a prominent example. Current debates on the status and future evolution of Spanish financial stability are a key reference for mortgage markets. There are two main types of mortgage securities being issued in Europe: mortgage-backed securities (MBS) and covered bonds. MBS are debt obligations that represent claims to the cash flows from pools of mortgage loans, most commonly on residential property. Mortgage loans are purchased from banks, mortgage companies, and other originators and then assembled into pools by a specialized entity. The entity then issues securities that represent claims on the principal and interest payments made by borrowers on the loans in the pool. Covered bonds are similar to MBS but bondholders have a claim (full recourse) against the cover pool of financial assets in priority to the unsecured creditors of the issuer. Importantly, the issuer has the ongoing obligation to maintain sufficient assets in the cover pool to satisfy the claims of covered bondholders at all times.

As shown in Exhibit 3, Spain represents the second largest mortgage securitization market in Europe, following the United Kingdom. According to the Association of Financial Markets in Europe (AFME) and the European Covered Bond Council, Spain and the UK are large issuers of both MBS and covered bonds, which is not the case of most of the rest of the EU countries where either covered bonds (i.e., Germany) or MBS (i.e., Italy) dominate. There are many reasons for such differences, which mainly respond to legal and institutional features.

Exhibit 3

Mortgage-backed securities and covered bonds in Europe. Total outstanding (billions of euros) (2011)



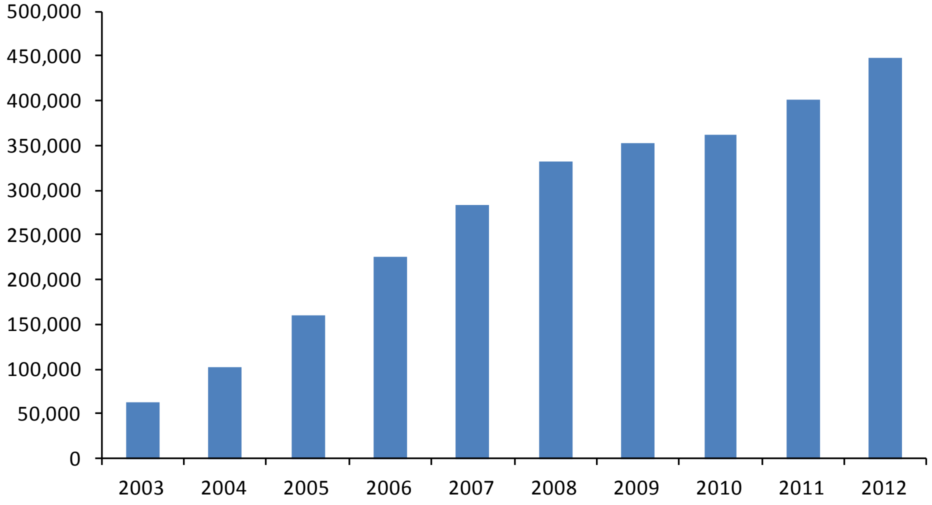
Sources: AFME, European Covered Bond Council and own elaboration.

Total covered bonds and MBS outstanding in the UK in 2011 were 777 billion euros and Spain follows with 683 billion euros. The third country in this ranking is Germany with 671 billion euros, while the volume in France is 410 billion euros.

In the case of Spain, the most important mortgage-securitized assets are covered bonds. The outstanding value of these instruments has increased from 62 billion euros in 2003 to 410 billion euros in 2012 (Exhibit 4).

Exhibit 4

Covered bonds in Spain (outstanding amount, millions of euros)



Source: AIAF and own elaboration.

These figures suggest that a great deal of the growth in lending during the years prior to the crisis was funded through securitization. As these securities have been sold widely throughout Europe and elsewhere, it seems clear that any features affecting the evolution of mortgages –from their default rates to any change in the mortgage regulation in Spain– are of key importance for international investors.

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The quality of mortgages

Given the relevance of Spanish mortgages both domestically and internationally, it seems worthwhile to look at the evolution of the non-performing mortgage loans (NPL) ratio. This is shown in Exhibit 5. In particular, the NPL ratio has increased from 0.37% in 2005Q4 to 3.49% in 2012Q3. Even if the increase is significant, the NPL ratio seems low compared to the 10.4% NPL of the entire loan portfolio in a country with a 26% unemployment rate.

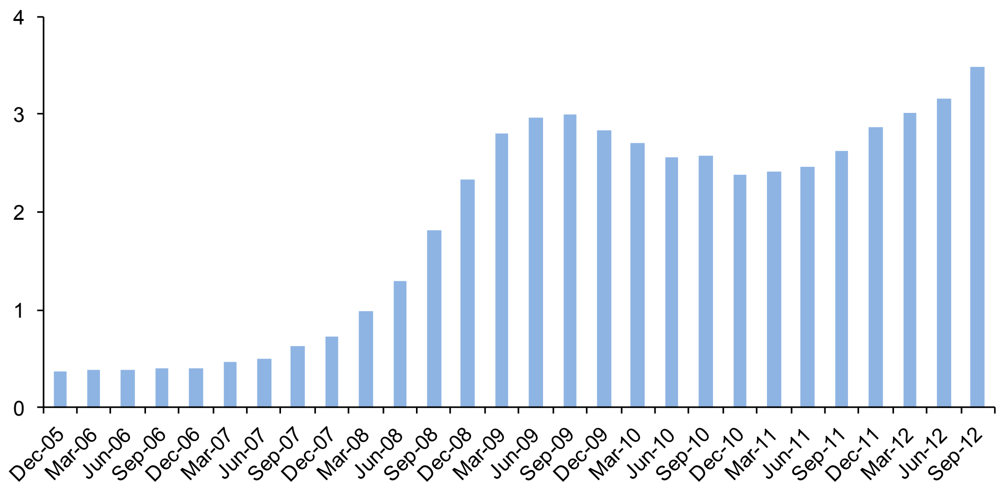
However, as the European Commission has shown in their March 2013 report entitled *Second Review of the Programme on the Financial Assistance for the Recapitalization of Financial Institutions in Spain* there are various factors that may explain such relatively low NPL ratios for mortgages in Spain:

i) Relatively low loan-to-value (LTV) ratios, which on average are estimated around 62%.

ii) A relatively low level of unemployment amongst residential loan holders. In particular, the EC claims, “while unemployment in Spain has exceeded 26%, according to recent data, only 7% to 9% of total outstanding mortgages were signed by people currently unemployed”.

Exhibit 5

Non-performing mortgage loans (% total mortgage loans)



Source: Bank of Spain and own elaboration.

iii) The low and recently reduced interest rate levels. The Euribor 12-month rate decreased by 70% during 2012. As a result, mortgage interest rates have significantly decreased. The EC points out that "on average, Spanish households today pay around 40% less on a monthly mortgage payment as compared to the end of 2008".

As the EC points out, misclassifications of credits in the retail portfolio (including mortgages) have been found to be almost negligible (less than 0.1%) while they were higher in the SME portfolios. It is worth noting that most Spanish banks have also maintained active renegotiations of mortgages to make the fulfillment of payments as easy as possible for borrowers.

In any event, even if these default-attenuating factors are important, they highlight the fact that macroeconomic risk may have a considerable potential impact in increasing mortgage defaults. In particular, persistent unemployment rates or future increases in interest rates could trigger increased non-performing mortgage loan ratios.

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Mortgages and foreclosures: Contrasting social perceptions with financial sector reality

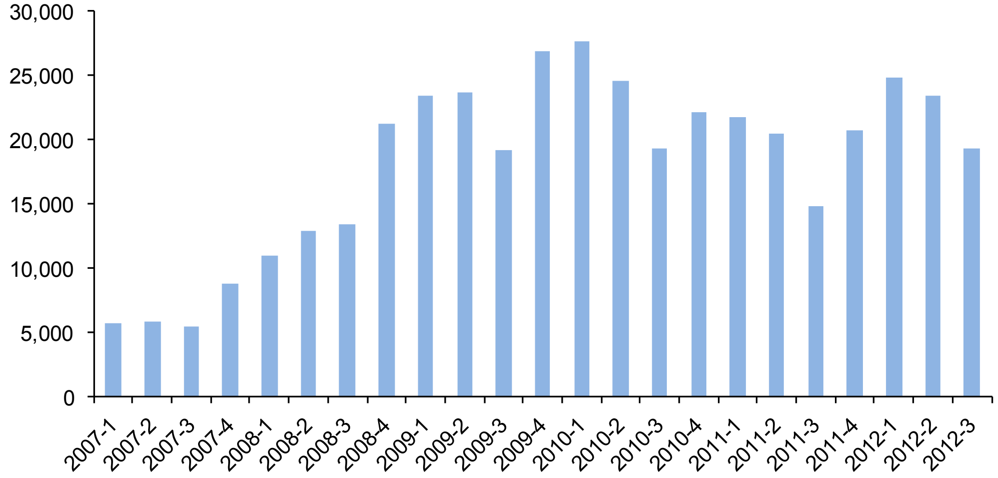
Even if non-performing mortgage loan rates have been kept at relatively low levels, many Spanish families are facing the drama of foreclosures and evictions. This represents possibly the most controversial social issue concerning mortgages in Spain now.

Exhibit 6 shows the evolution of foreclosures in Spain from 2007 to 2012. In this period, there have been 416,975 foreclosures. It is worth noting that this foreclosure statistic refers to the number of court rulings, and not necessarily the number of actual foreclosures that have taken place. Moreover, the statistics in the exhibit take into account foreclosures as a whole for a wide range of properties, such as second residences, businesses, and garage spaces, in addition to primary residences. Their growth has been particularly intense in 2009, in 2011 and in 2012. Foreclosures have become a matter of tremendous social discontent in Spain. Recently, an association of citizens called *Plataforma de Afectados por la Hipoteca, PAH* (Platform of People Affected by Mortgages) has come up with some proposals to change Spanish mortgage laws. The proposals of *PAH* have obtained around 1.5 million signatures in support. Importantly, the *PAH* proposals will now be discussed at the Spanish Parliament.

Perhaps the most important of the *PAH* proposals is for a universal and retroactive dation in payment. However, given the structure of the mortgage market in Spain, such a proposal would have harmful consequences for the economy as it would reduce the collateral value of the mortgage securitized assets and would set the wrong incentives for mortgage borrowers. As it has been shown in the previous sections, the reality of mortgages in Spain –as in many other countries– goes beyond a contractual relationship between lenders and borrowers as it also involves a substantial amount of securitized assets whose collateral would be affected by a retroactive change in recourse conditions. The Government is supportive of several measures currently under Parliamentary debate designed to alleviate pressures on mortgage debtors; however, opposed to the proposal to reform retroactively dation in payment. In our view, implementing retroactive non recourse mortgages would be more damaging

Exhibit 6

Foreclosures in Spain (2007Q1-2012Q3)



Source: General Council of Judicial Power and own elaboration.

than beneficial for the Spanish economy, thus, providing support to the Government's position.

Some of the other relief measures under consideration include: limitations on late-interest payments and making evictions[3] and house auction processes more favorable to mortgage holders underwater[4]. Even a moratorium on evictions has been approved for the most vulnerable cases. There are also interesting proposals involving the establishment of a personal and family bankruptcy law. These seem far more prudent ways to proceed to alleviate the foreclosures problem.

General assessment

The financial crisis started with subprime mortgage loans in the US and now it seems that mortgages again play a key role in the resolution of the banking crisis in Spain. Given the current conditions of the mortgage market, the real remaining test for the Spanish banking sector is how defaults from mortgages (and corporate loans) can be managed if the macroeconomic scenario does not improve. Given the set of actual and contingent restructuring and recapitalization mechanisms available for Spain (including an EU bailout fund backstop), the problem looks challenging but manageable.

Overall, mortgages are a key element of the deleveraging of the Spanish economy, which is probably the most important challenge for the country and will require years of adjustment. The figures shown in this note suggest that such a deleveraging process is ongoing, but will still take several years to complete.

Finally, even if mortgage loan delinquencies have been kept relatively low, we have also shown that foreclosures and evictions are becoming a substantially controversial social issue in Spain.

Due to their proposed negative impact on the

[3] The European Court of Justice has issued a sentence that allows for a debtor to plea abuse in the process of foreclosure, but whose legal jurisdiction remains to be determined. The ruling may affect the reform (Royal Decree-Law 27/2012) for protection of mortgage debtors, which is currently being discussed at Parliament; however, we estimate the impact of the sentence will be moderate under correct implementation.

[4] Underwater refers to a situation where the current outstanding debt exceeds the housing price.

Spanish economy, proposals for a retroactive change to move to a non recourse mortgage framework have been rejected by the Government. While the final law is still subject to Parliamentary debate, we believe the outcome will be regulatory reform better suited to the size, structure, and reputational features surrounding the Spanish mortgage debt market.