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08.11.2022

The mortgage appraisal system in Spain

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Conference: “The mortgage market, 40 years on: trends and challenges”

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* English translation from the original in Spanish

First, I would like to thank the organisers for inviting me to speak at the close of this conference, celebrating the 40th anniversary (actually, the 41st) of the publication of Law 2/1981 of 25 March 1981 on the regulation of the mortgage market. This law, the first of many that were passed that decade to modernise the Spanish financial system, remained in force, albeit with amendments, until it was repealed by Royal Decree-Law 24/2021, transposing Directive 2019/2162 on covered bonds.

Spain has a deeply rooted culture of home ownership which sets us apart from other European countries, where rented housing is the norm. The mortgage market has given many Spaniards the chance to own their own home. Investing in housing represents a large proportion of household savings and contributes to maintaining quality of life when the time comes for us to retire.

The Spanish mortgage market was built on three main pillars: i) mortgage collateral (in addition to personal guarantees) whose foreclosure was for a long time subject to exceptionally summary procedures; ii) a real estate appraisal system, supervised by the Banco de España; and iii) specific instruments to help credit institutions raise funds on the markets and thus maintain the pace of lending. The Spanish mortgage market's most distinctive feature is its supervised appraisal system, to which I will return later.

The creation of mortgage-backed securities enabled credit institutions to obtain the funds they needed to start offering mortgages. We should bear in mind that in the 1970s mortgages were almost exclusively issued by savings banks and that to obtain financing to buy a home, individuals normally signed a bill of exchange to the property developer, which was then discounted by the bank.

Since then, the real estate market has seen continuous growth, curbed only by three financial crises: those of the late 1970s, the early 1990s and 2008-2014, the deepest crisis of all. Indeed, the ease with which wholesale funding could be accessed and channelled to the real estate sector, along with a mistaken perception of risks and the absence of macroprudential tools to reduce imbalances at the time, were among the factors which, among others, contributed to the outbreak of the global financial crisis of 2007-2008. In Spain, this led to a real estate crisis between 2008 to 2014, during which prices and transactions contracted sharply, as did mortgage lending.

This crisis was followed by a gradual recovery which, in the case of lending, stalled temporarily during the COVID-19 pandemic lockdown. Once the worst of the pandemic was over, real estate activity surged again and prices accelerated. This trend has continued through to early 2022.

IN RECENT YEARS, REAL ESTATE ACTIVITY HAS REMAINED EXPANSIONARY

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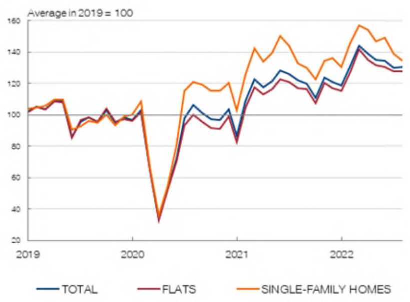
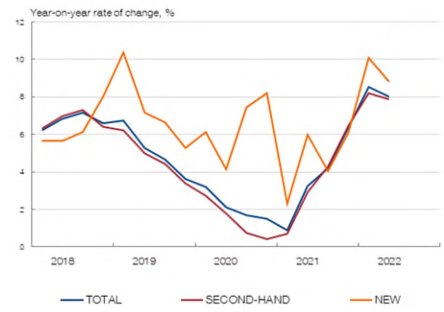
- According to the latest information, there are signs of a slowdown in transactions and prices, against a backdrop of deterioration in the economic outlook and tightening financing conditions.

NOTARIAL HOUSE PURCHASES (a)



HOUSE PRICES



Sources: Banco de España, Centro de Información Estadística del Notariado, INE.
a. Seasonally and calendar adjusted series. Latest observation: August 2022.

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On notarial information, between January and August 2022, house purchases were slightly more than 30% above those recorded in the same period in 2019 and had reached the highest values since 2007. This buoyancy was underpinned by the materialisation of demand pent up during the pandemic (first in Spain and more recently, foreign demand), the changing needs of households as a result of the health crisis, and highly favourable financial conditions.

The strong rebound in housing demand in recent years, along with the loss of momentum in supply, has translated into a sharp rise in prices, with a year-on-year growth rate of 8% in 2022 Q2, according to INE data.

RECENT QUARTERS HAVE SEEN NOTABLY ROBUST MORTGAGE ACTIVTY

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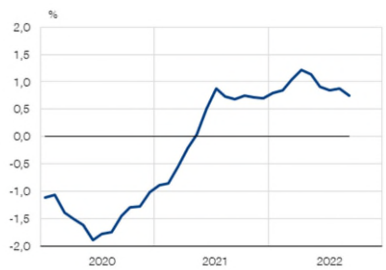
- The outstanding balance of housing loans has seen a return to growth since 2021, following over a decade of decline.

NEW LENDING FOR HOUSE PURCHASE (a)
3-month cumulative seasonally-adjusted flows

LOANS FOR HOUSE PURCHASE (a)
Year-on-year change



Source: Banco de España. Latest observation: September 2022.
a. Bank financing series include financing granted by credit institutions and by specialised lending institutions.

In line with developments in residential property purchases, new lending for house purchase has also proven highly robust in recent quarters, posting the highest levels since 2010 between January and September 2022. The greater volume of new loans meant that, in May 2021, the outstanding balance of such loans ceased to contract in year-on-year terms after more than a decade of decline. Despite their buoyancy, the outstanding stock of mortgage loans grew by just 0.8% in September, compared with the same period a year earlier, given the still sizeable volume of repayments.

In 2021, Spanish households' outstanding stock of loans for house purchase accounted for 41% of GDP, somewhat below the euro area average (45%). This figure is also lower than that of other large countries such as Germany or France (49%, in both cases), and far below that of other economies such as the Netherlands (92%). However, this ratio is far higher in Spain than in Italy, where it stands at 23%.[1] In any event, it should be noted that the pick-up in activity and prices in recent years has been uneven depending on the type of property and geographical location. Demand has recovered more strongly in coastal areas and large cities, which is also reflected in higher price increases in those areas.

Nevertheless, the latest information shows signs of diminished dynamism in real estate activity and a slowdown in prices. Both appear to be due to the waning of the expansionary factors associated with the pandemic that I have mentioned earlier, and to the new adverse macro-financial setting, in which monetary policy normalisation has raised interest rates, households' real income has fallen owing to persistently high inflation and their confidence and economic outlook have been eroded.

If these adverse factors continue to affect housing demand or are exacerbated, the loss of momentum in real estate activity and prices are likely to become protracted or more pronounced.

On the regulatory front, one notable aspect at a global level in recent years has been the creation of new macroprudential instruments that can be deployed in the face of mounting systemic risks. In Spain, Royal Decree 102/2019 of 14 December 2019 created the Spanish macroprudential authority (AMCESFI), which is tasked with coordinating the systemic risk oversight carried out by the different sectoral supervisors. Also, Royal Decree-Law 22/2018 equipped the Banco de España with various macroprudential tools; in particular, the counter-cyclical capital buffer, the limits on sectoral concentration and the restrictions placed on certain loan conditions (LTV and LTI ratios). None of these instruments have yet been deployed, since the Banco de España has not identified any signs of a build-up of systemic financial imbalances.

Indeed, when compared with our fellow European countries, housing prices have grown at a slower pace in recent years, without any signs of significant real estate market imbalances in terms of price or volume. Thus, while the valuation indicators show that, on average, prices are above the long-term equilibrium levels, the gap between the two is narrow.

Meanwhile, household borrowing is moderate and lending standards have not been relaxed in recent years.

[1] https://hypo.org/app/uploads/sites/2/2022/09/HYPOSTAT-2022-FOR-DISTRIBUTION.pdf 8. Total Outstanding Residential Loans to GDP Ratio %.

The Spanish appraisal system

Given the close relationship between the real estate and financial sectors, property valuation is a key factor for financial stability. Or, to put it another way: the quality of appraisals has a direct bearing on banking risk. Moreover, boom and bust cycles in real estate markets have been a major factor in systemic financial crises. With this in mind, they should be at the forefront of macroprudential policy.

Appraisal value plays a pivotal role in determining two things: the amount of the loan granted to a household, and the capital reserves the financial institution offering the loan needs to cover any unexpected losses. Thus, to ensure that appraisal values are independent and as objective as possible, regard should be had, among other factors, to the design of a legal framework and suitable methodological criteria.

Given that appraiser independence can be undermined by a range of issues, various approaches have been taken at international level. Regulation has been used to make valuation processes more objective, thereby reinforcing such independence. Supervision systems have also been set in place to discourage actions that might damage the credibility of valuations and, where applicable, to monitor the appraisal market so as to remedy any inappropriate conduct.

Broadly speaking, there are four ways of making the system more reliable:

a) Valuation standards and methodologies, to ensure that valuations are based on criteria that are as standard as possible.
b) An appraiser certification process, to ensure that appraisals are conducted by people with the necessary expertise.
c) A standard report model, to ensure that reports contain the minimum information necessary and that the conclusions set out are easy to understand.
d) An appraisal supervision and oversight body that seeks to ensure high-quality valuations that meet these requirements.

The Spanish model for valuing properties for the purpose of arranging mortgages is a model that was first regulated with the enactment of Law 2/1981, which is based on detailed methodology and a standardised report model and which opted for a corporate model, in order to strengthen oversight of appraisals.

Up until 2013, appraisal companies could be controlled by credit institutions. That year, to address the potential conflict of interest between appraisers and credit institutions, major changes were made to the regulations governing appraisal activities, making them more independent.

Nonetheless, there are still some aspects of the valuation rules and regulations (as set out in Ministerial Order ECO 805/2003) that have yet to be improved, such as the regulation of automated valuation models (AVMs) and the rules for estimating mortgage lending value (which, unlike market value, is considered sustainable over time).

At international level, supervision of mortgage appraisers for prudential banking regulation purposes is far from commonplace. Many countries simply have mechanisms for sectoral self-regulation, carried out by professional bodies or associations. However, supervision has an important role to play in safeguarding the independence and objectivity of real estate valuations.

In the course of the Banco de España's periodic reviews of appraisal companies, we have seen how important it is to have in place robust internal controls. In our view, in general, efforts should be made to further strengthen such controls.

Before finishing, I'd like to touch briefly on the challenges still facing the real estate and mortgage market.

Improving the financial literacy of the general public. People must be equipped with enough knowledge to face what is likely to be the biggest investment they'll ever make, and one that, in one way or another, may shape their future.

Improving the statistical information on the real estate market.

Regenerating the housing stock. Given that the lifespan of a property can be very long, not all of the demand need be met with new housing. Spain is home to over 26 million residential properties, a significant number of which are in need of refurbishment in terms of both functionality and efficiency.

Which leads us to another need that has been exacerbated by the war in Ukraine, the **need to make housing more energy efficient**. While proposals to incorporate ESG-related factors into lending have been around for some time now, the need to save on energy is now more pressing than ever.

Financial products must be developed to enable borrowers to tap the savings realised in housing in an efficient and transparent manner. Past attempts to roll out new products such as the equity release mortgage met with little success; whether due to marketing errors or because they coincided with the onset of the 2008 financial crisis.

To sum up: today, we can safely say that the Spanish mortgage market is well positioned, with a regulatory framework that safeguards its vibrancy and soundness. As far as the real estate market is concerned, the warning signals discernible in other European countries have not yet been seen in Spain. Despite buoyant activity in recent times, no general imbalances that might concern us have yet been detected. Moreover, mortgage lending standards do not appear to have been relaxed, which leaves us in a sounder position in the face of potential deterioration in the macro variables. In this regard, experience has taught us to keep a close eye on developments in this sector.