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Exposure of the Spanish financial system to the construction and property development sector: myths and realities

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The environment in which the Spanish financial system is now operating is unquestionably the most difficult and demanding in recent decades. In addition to an unusually severe crisis of the real economy, there is a difficult situation in the international financial markets, higher risk premia than in the past (particularly for the world banking sector) and, in the Spanish case, a need to digest the excesses resulting from a pronounced real estate cycle. For this reason, and perhaps because this real estate component is specific to Spain, it comes as no surprise that the management of real estate risk, and particularly that associated with property development companies, should attract the interest of markets, analysts and the media. And, indeed, the success of deposit institutions in getting through this difficult period depends directly on the appropriate past, present and future management of that exposure to the real estate sector.

But, as often occurs in complex situations, the debate about that difficult digestion of real estate excesses has given rise to inaccuracies, overstatement and, to put it plainly, declarations in defence of vested interests which are in some cases legitimate, but often particular. To overcome this, it is essential to be clear and transparent about the situation of the Spanish financial system. Otherwise, we run the risk that the public will perceive the situation as being worse than it actually is. And that obligation of transparency falls, first and foremost, on individual institutions, which must explain to the market how they are dealing with those risks.

EXPOSURE TO THE CONSTRUCTION AND PROPERTY DEVELOPMENT SECTOR

The exposure of the Spanish financial system (banks, savings banks and credit cooperatives) to the domestic construction and property development sector amounts to €445 billion as at December 2009. This information is published regularly in the Banco de España's *Boletín Estadístico*. Although unquestionably a high exposure in absolute terms, this figure in itself does not have a clear meaning. It represents 12% of the consolidated balance sheet of Spanish deposit institutions. If measured in terms of the credit granted to households and firms in Spain, that weight is nearly 25%. In any event, it is a significant volume of lending, particularly in view of the difficulties besetting the sector.

It is advisable to analyse the construction and property development sectors as a whole, because the boundaries between them are diffuse and reclassifications between the two sectors are not infrequent. It should be taken into account that exposure to these sectors does not consist solely of exposure to construction and property development activity: there are firms in this area with highly diversified activities in sectors including energy, infrastructure and oil.

The first and most basic mistake is to draw an equivalence between exposures to the sector and losses for the financial system. For an exposure to become a loss there must first be a default (the probability of default referred to in Basel II) and, second, a loss given default (LGD, also defined in Basel II), which depends on the collateral and on its effectiveness and value.

The doubtful assets ratio in the construction and property development sector stood at 9.6% in December 2009. Given that both the economy and this sector are still in a difficult position, it is highly likely that this ratio will increase, although it is hard (or nigh impossible) to predict by how much. That said, it is evident that a doubtful assets ratio of 100% and a loss given default also of

100% (i.e. the value of collateral is zero), which is what would be required for the loss to equal the exposure to the related customer, is an unrealistic scenario.

Collateral and its effectiveness and value are vital in this banking segment. And it should not be overlooked that, despite the difficulty in valuing real estate collateral in such an uncertain environment, from the standpoint of managing non-performing and doubtful assets and their impact on the income statement, it is better to have this kind of collateral because it is very effective. Indeed, the mortgage underlying the loan transaction ensures repossession of the pledged asset, and its real estate nature rules out concealment of collateral and, to a large extent, any loss of value through obsolescence. Furthermore, it is obvious that, despite this uncertainty about the value of collateral, it cannot be said that its value is zero.

It is evident that the value of collateral must be treated prudently by institutions and the supervisor. The value of collateral is not the same as its short-term disposal value, and, moreover, not all collateral requires the same length of time before it is ready for disposal (completed housing in the centre of a large city is quite different from development land). Therefore, in calculating the loss due to the credit impairment, a prudent practice is to not recognise in full the value of the collateral and to reduce its valuation. Observation of transactions in a market with very little activity seems to indicate that disposal values between 20% and 50% below the book value allow most collateral to be rapidly sold. It should be noted that, in Spain, book value is set by management on the basis of independent appraisal and may be analysed by the supervisor. In any event, it should be mentioned that collateral is extremely varied, so any results should be extrapolated with great prudence.

In situations of increasingly troubled loans, the supervisor has tools that enable it to track the performance of credit portfolios, including, in particular, the possibility of classifying loans as substandard. Substandard loans are those that, although current (i.e. payments continue to be made) and free from other objective difficulties (such as insolvency proceedings), do however present weaknesses that may degenerate into default and loss. Moreover, once a loan is classified as substandard, provisions must be made. Whether or not a substandard loan becomes a doubtful loan depends on whether or not the financial situation of the firm deteriorates and whether or not there are any notable defaults. At the close of 2009, substandard loans made up 14% of the exposure to the construction and property development sector, and the related provisions stood at 13%.

Asset foreclosures, dation in payment and acquisitions are other ways of dealing with problem loans. Indeed, the most effective way to handle a defaulted loan that is unrecoverable from a customer may be to repossess the related collateral. It should be underlined that these are the tools for appropriate risk management. Clearly, if the assets pledged as collateral are not properly valued (or, to be more specific, if the valuation is not sufficiently prudent), this should be reflected in the accounting records. Accordingly, institutions have made provisions for these assets, for approximately 22% of their book value.

Refinancing is another practice that it is usually mentioned as one to conceal troubled loans. However, for customers facing temporal liquidity problems but whose ability to pay in the medium term is not affected, refinancing (for example, by extending repayment periods) is a correct, and habitual, banking practice, both here in Spain and in other countries. Naturally, refinancing for customers who are unable to meet their payment obligations represents an inadmissible delay in recognition of problem loans. For this reason, the supervisor monitors these practices closely (especially, although not exclusively, in the case of wholesale customers) and, if it detects any inappropriate practice, or if there is any subsequent deterioration in the customer's ability to pay, the loans are reclassified as doubtful or substandard (with the consequent recording of provisions). Indeed the bulk of loans classified as substandard are a result of refinancing processes.

Taking the doubtful and substandard loans of the construction and property development sectors, and adding in all the foreclosures (including retail mortgage foreclosures), dation in payment and acquisitions, the coverage by specific provisions stands at approximately 25% for this set of exposures. Including general provisions as at December 2009, the coverage would be 35%. It is very likely that the strains in the construction and development sectors will continue through 2010, and that institutions will be required to make further efforts. But the percentages of coverage mentioned show that this will not mean starting from scratch, as risk coverage has been rigorous, ensuring that, overall, institutions would be able to dispose of their troubled construction and property development portfolios for 65% of the book value of the related collateral, recording no loss on their income statements.

In 2010, the strains in the construction and property development sectors will continue, and institutions will have to make an extra effort in the areas of retained earnings, write-downs and capitalisation.

CONCEALMENT OF LOSSES OR UNCERTAINTY IN VALUATION?

Another idea that has spread in connection with the exposure to the sector is that latent losses in construction and property development loan portfolios are being concealed by institutions, with the more or less explicit acquiescence of the Banco de España. Demands have been made for the extent of these losses to be disclosed, and for the Banco de España to refrain from tolerating institutions' delay in recognising the real situation. These claims generally reflect ignorance of the relationship between the supervisor and those it supervises. In effect, this is not a freely negotiated relationship, but one based on specific rules that are legally binding on both parties, such as those relating to provisions contained in Annex IX of the Accounting Circular.

Clearly, valuing real estate collateral is tremendously difficult in the present environment. First, because it is so varied (second-hand housing, new housing, housing under construction, whether for main residences or second homes, urban land, development land, etc.). And second, because there is no deep, active market to establish benchmark prices, especially in the present circumstances of economic and financial contraction. In this respect, fire-sale prices do not provide a valid benchmark for accounting purposes, since they do not even do so for financial instruments in markets where liquidity is tight. At the other extreme, valuing collateral for prudential purposes cannot signify an unlimited time period for its disposal. In short, institutions must treat the value of collateral prudently, based on its specific characteristics and its potential sale within a reasonable period of time.

In any case, the overall outcome, based on prudent valuations, seems to indicate that risk coverage is sufficient, for the time being, as is reflected in the figures mentioned earlier. In addition, the Banco de España’s accounting regulations on provisions, based on schedules and increasingly demanding provisioning requirements, ensure the complete coverage of losses over time.

It is striking that practices of concealment are sometimes referred to in relation to the Banco de España's accounting regulations on provisions, since provisioning obligations are set on the basis of objective features, such as length of time past-due, loan characteristics or the passage of time, and are available not only to institutions but to anyone who reads Annex IX of the Banco de España Circular. This does not seem to be the case in other financial systems, where determining the provision depends on bank managers' judgement, globally endorsed by the auditor, without there being any objective public regulation to set minimum provisioning requirements. In short, the Banco de España's accountancy powers have been an element of strength in comparison with other financial systems. They have prevented the creation of off-balance sheet special investment vehicles (or SIVs), permitted the recording of general provisions before the crisis and provided an intensive supervision model based on clear, public rules setting minimum requirements.

That success does not preclude this scale-based system of provisions from being subject to debate, and the time which has elapsed since its approval in 2004 perhaps warrants its revision. However, if this system can be criticised, it is precisely because it is in the public domain, something unique among the financial systems of developed countries.

HETEROGENEITY

The main feature of the problem loans associated with the construction and development sector is the variety of collateral for them. If, to this array of housing in use, new or completed, housing under construction, urban land, development land, rural land, industrial premises, etc., we add another variable, namely location, then far from having one single real estate asset with well defined characteristics, there will be a wide spectrum of assets with different characteristics in terms of valuation, market-readiness and realisable value.

This variety derives not only from the real estate risk characteristics but also from the position of individual institutions in relation to this risk. Thus, for example, among the major institutions (which account for 94% of total lending to the sector), the share of exposure to the construction and property development sector (measured as a percentage of credit to the resident private sector) ranges from 6% to 50%.

The doubtful assets ratio of the construction and property development sector for the same institutions also varies greatly, ranging from 2.3% to 28%. Also, to further complicate the analysis, there is no simple relationship between exposure to the sector and the volume of doubtful assets. There are institutions with a share of exposure to the sector of approximately 25% and doubtful asset ratios ranging from 23% to less than 5%.

In short, not all the institutions have followed the same business growth strategy in the last decade and, among those which have followed the same strategy, not all of them have shown the same ability in selecting the best risks.

Faced with this variety, analytical simplifications are not appropriate since they will lead to error. However, it would be desirable for institutions to strive for greater transparency by explaining to the markets their exposure, their default problems and their strategy for recovering bad loans.

TRANSPARENCY

I will conclude by briefly mentioning transparency. The Banco de España has been a pioneer in the publication of Financial Stability Reports which analyse in detail deposit institutions' exposure and their position in terms of profitability (profits, it should not be forgotten, are the first line of defence against risks) and solvency (the second line of defence). The *Boletín Estadístico* publishes, on a quarterly basis, banks', savings banks' and credit cooperatives' exposure to the construction and development sector and each sector's volume of doubtful assets. Annex IX of Accounting Circular 4/2004 sets out provisioning obligations with specific percentages based on a precise time scale. Furthermore, when there is a clarification of the rule which may have a material impact, it is also published.

Can further progress be made in transparency? Yes, there is no doubt that more can be done, but in the other developed economies better practices in this area are hard to find.

What does seem essential is a greater effort by institutions in explaining their strengths, weaknesses, risks and how these risks are mitigated and managed. This is because, in the absence of information, the market may perceive the situation to be worse than it really is. Therefore, it is not a question of transparency for the sake of plain good-heartedness or generosity, but rather it is in the institutions' own interest.

CONCLUSION

The combination of a deep crisis and a rapid correction of the excesses of the recent real estate cycle are setting the priorities for deposit institutions' risk management and will continue to do so over the next few years. The Banco de España is aware of this and is exercising its oversight functions in an extraordinarily complex setting due to the wide variety of collateral underlying the overall exposure to the construction and development sector. All of us, both supervisor and institutions, must make greater efforts to explain our priorities, our strategies and our uncertainties to the market. Thank you very much.