The Spanish housing market: Is the adjustment over?

José García Montalvo[1]

The recent evolution of house price indices, transactions activity, and trends in the Spanish property market all point to cautious optimism over a recovery in the sector. House prices remain overvalued, but continue falling.

The housing market adjustment following the bursting of the property bubble in Spain has represented a key challenge for the economy. During several years, the adjustment has largely been made through quantities rather than prices. Nevertheless, the recent evolution of house price indices shows that they are finally adjusting fast and remain on a declining path. In addition, large operations in the Spanish real estate market have helped to increase the confidence of international investors. Some key trends have also emerged in the property market, such as the presence of banks as key players in the sector, the increase in cash purchases versus reliance on external financing, and the larger role of foreign investors and foreign funds. Recent transactions by banks and Spain's so-called bad bank the SAREB have also been promising. Despite these developments, the stock of new houses remains largely unchanged and banks continue to accumulate repossessed properties on their balance sheets. Ratios show that the Spanish property market remains overvalued, but that progress on the adjustment process is on going.

Introduction

The Spanish housing market has been one of the best examples of a large housing bubble bursting after the beginning of the financial crisis in 2008. The specific characteristics of the Spanish real estate market have produced an evolution of the main indicators of the housing sector quite different from other countries with similar bubbles. While in some countries, like in the US, the real estate sector seems to already be recovering, questions remain over the extent of the recovery in other countries, such as the case of Spain. In this context, this article examines whether or not the Spanish housing market has completed its adjustment. To analyze this question, we describe the current situation of the Spanish housing market and its future perspectives.

The main characteristic of the Spanish market is its inefficient adjustment process. Unlike efficient markets, Spanish markets usually adjust via quantities instead of via prices. An extreme example of this can be observed in the case of

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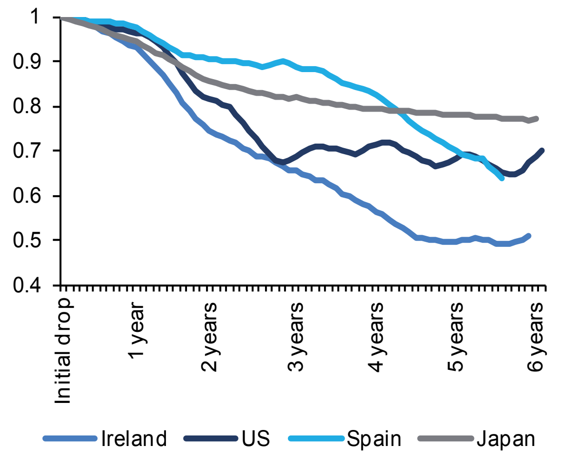
Exhibit 1

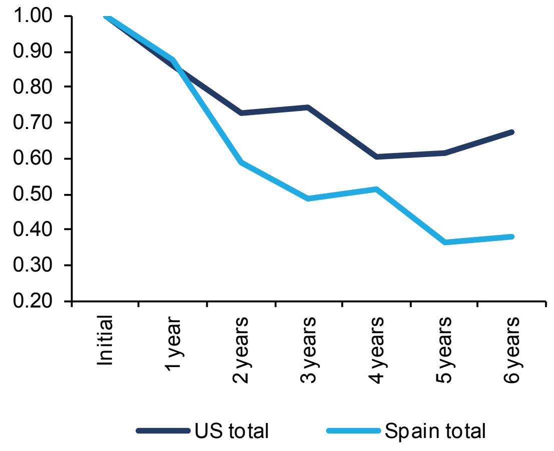
Evolution of housing prices in several countries after the busting of a bubble



Sources: US: Case-Shiller 20 cities composite index. Spain: INE. Ireland: National Residential Property Price index. Japan: Nationwide residential urban land price (Japan Real Estate Institute); and author's calculations.

Exhibit 2

Evolution of housing sales since the beginning of the crisis



Sources: NAR, Census Bureau, Ministerio de Fomento and author's calculations.

the Spanish labor market. While unemployment was growing by the millions, real wages were increasing until very recently. The Spanish housing market is another example of this type of adjustment. Exhibit 1 shows the adjustment of house prices since the beginning of the crisis in four representative countries: Spain, Japan, the US and Ireland[2]. The exhibit shows that the drop in house prices after 3 years of crisis in the sector was around 30% in Ireland and in the US. In Spain, the corresponding figure was around 10%[3]. Even in the Japanese case, where the bursting of the housing bubble started in 1991, the price adjustment was initially faster than in the Spanish case, although it decelerated soon after the second year into the crisis and it has continued until today.

Obviously, the immediate result of the failure to adjust prices at the proper speed has been plummeting home sales . Exhibit 2 shows that after three years of crisis, sales of US homes went down by 25%,while in Spain they dropped by 50%. This fact translates into a large drop in new residential construction. In the Spanish case, the drop from the peak has been 92%.

Recent evolution

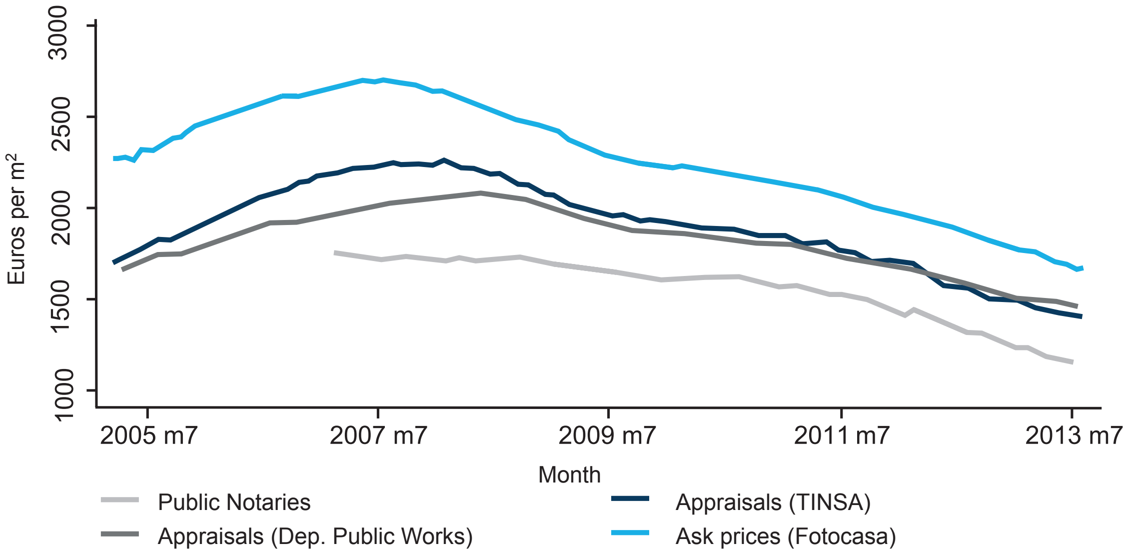
In any case, the analysis of the evolution of house prices in Spain is complicated because of the multiplicity of indicators and the fact that none of them is, strictly speaking, the market price. It is possible to make some inferences about the process of adjustment of the Spanish residential market by comparing the evolution of different price indicators. Exhibit 3 shows the level of four indices: the ask price on existing houses

[2] The initial drop happens in different periods in each country. In Japan it occurs in January 1991. In the US, in July of 2006. In Ireland, in December of 2006. In Spain, in September of 2007.

[3] The message of the exhibit is identical if we work with deflated home prices. There is a large divergence during many years in the speed of adjustment of house prices between Spain and other countries that suffered large housing bubbles.

Exhibit 3

Evolution of alternative indicators of house prices in Spain



Sources: Centro de Información Estadística del Notariado, Ministerio de Fomento, TINSA, Fotocasa and author's calculations.

compiled by Fotocasa; the official house price maintained by the Department of Public Works (Ministerio de Fomento, formerly Ministerio de Vivienda), based on an aggregation of appraisal values from many companies; the house prices compiled by the Spanish Official Association of Notaries[4]; and the IMIE Spanish housing market index, which is produced by TINSA, one of the largest appraisal companies in Spain[5]. It is reasonable to expect ask prices to be above appraisal values and prices recorded by notaries. The difference between appraisal values and prices as compiled by notaries is due to the inertia of the bias towards over-appraisals during the housing bubble and the undeclared cash that is involved in many house purchases. Montalvo and Raya (2012)[6] estimate an 8% average divergence between the declared price and the actual price paid. We argue in the following pages that the increase in the proportion of buyers who do not use external financing makes indices based on appraisals less relevant.

There are some other price indices. Table 1 covers all the relevant indicators of house prices.

The change in house prices since the peak is around 35% and this figure is very similar for the majority of price indicators.

Besides the ones describe above, there is the price compiled by the Sociedad de Tasación

[4] There is another official price index produced by the Spanish Statistical Office but being an index, it does not allow for calculation of original levels. In principle, the index of the notaries should have a similar level since most sales are first notarized and, afterwards, registered in the official Property Registry.

[5] Notice that the methodology to construct these indicators is diverse and their geographical coverage may not be identical.

[6] "What is the right price of Spanish residential real estate?," 1 (3), *Spanish Economic and Financial Outlook,* September 2012, 22-29.

Table 1

House price change since the peak

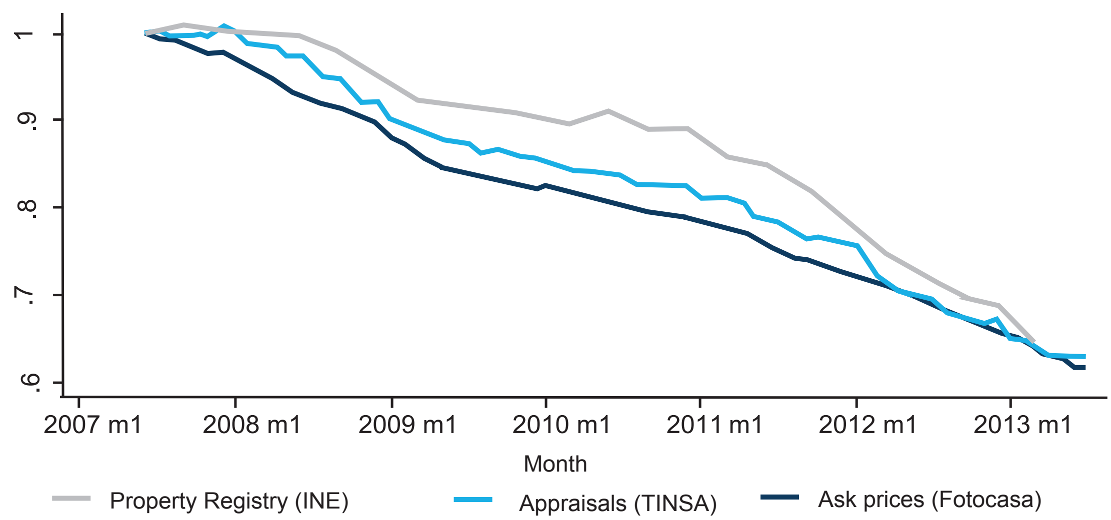
	Peak	Last observation	Change since peak
Ministerio - Appraisals	March-08	June-13	-29.5%
INE-Registry prices	September-07	June-13	-36.7%
Fotocasa-Ask prices (existing houses)	June-07	June-13	-33.6%
Official Association of Notaries	July-07	June-13	-34.9%
SOCTAS- New houses	Decembre-07	June-13	-27.6%
IMIE- Appraisals	Decembre-07	August-13	-38.6%

Source: Several sources, as detailed in table, and author's calculations.

(SOCTAS) referred to new residential construction, and the index of the Spanish Statistical Office (INE) that comes from the data of the property registries. Table 1 indicates that the change in price since the peak is around 35%, and this figure is very similar for all the indicators with the exception of the SOCTAS, probably because it refers only to new construction. The timing of the change in prices is as interesting as its current accumulated loss. Exhibit 4 shows that house prices have been converging across the different indicators during the first years after the beginning of the crisis. Ask prices initially were going down faster than appraisal values and appraisal prices faster than the prices compiled by the INE. Appraisal values have adjusted downward very quickly

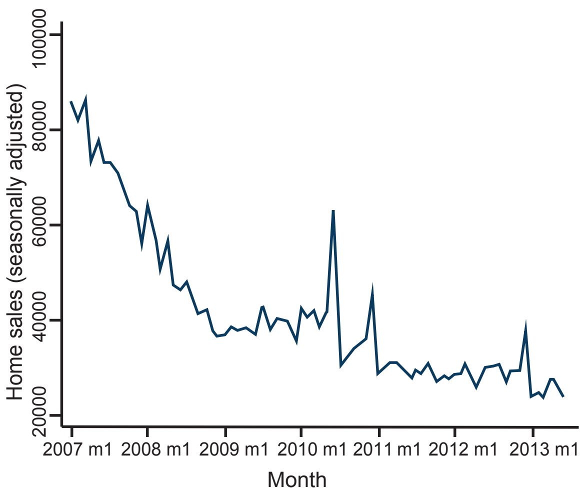
Exhibit 4

Evolution of prices since the beginning of the housing crisis



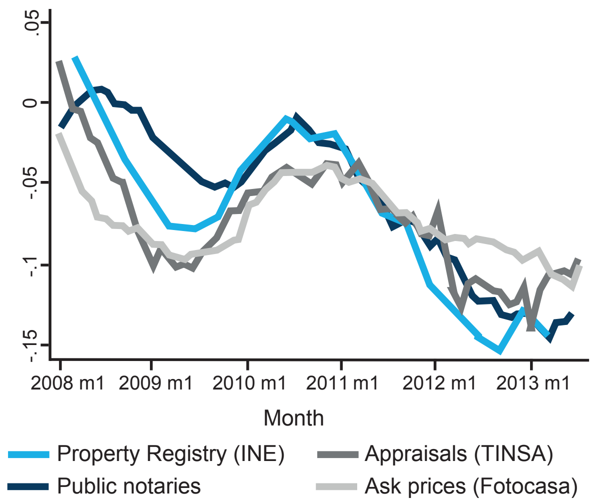
Sources: Bank of Spain, TINSA and author's own calculations.

Exhibit 5
Housing sales seasonally adjusted



Source: Centro de Información Estadística del Notariado.

Exhibit 6
Prices changes of alternative indicators



Sources: INE, TINSA, Official Association of Notaries, Fotocasa and author's calculations.

after 2012, basically because of the impact of the government's financial reform decrees known as Guindos I and II that increased provisions on real estate credits and repossessed real estate kept on banks' balance sheets. However, in recent months, appraisals and ask prices have slowed their decline while the prices of INE have accelerated their downward adjustment.

The evolution of home sales shows a downward trend with spikes explained by frequent changes in tax conditions on home buying since the beginning of the crisis. Exhibit 5 show the evolution of seasonally adjusted sales calculated from the data of the Spanish Official Association of Notaries[7]. Despite being seasonally adjusted, the data of Exhibit 5 show three clear peaks. In June 2010 there was a peak before the increase in the value added tax and the transaction tax. The latter one affected only some regions (the most significant Catalonia, Andalucia and Extremadura). In December of 2010 there is another peak to take advantage of the last period of general deduction for interest and capital of mortgages for the acquisition of a house. After that date, only individuals earning less than 24,107 euros could itemize tax deductions for buying a home. In January of 2012 the newly elected government introduced again a general tax deduction on house buying that was, finally, eliminated in December of 2012. That is the last peak in Exhibit 5. During 2010, there was a stabilization of sales and a slow down in price adjustment (Exhibit 6) due basically to the expectation of the end of the general fiscal incentives for home buying.

Current situation

The current situation is characterized by several distinctive facts. First, the banking sector has become a critical player in the housing market and, generally speaking, in the real estate market.

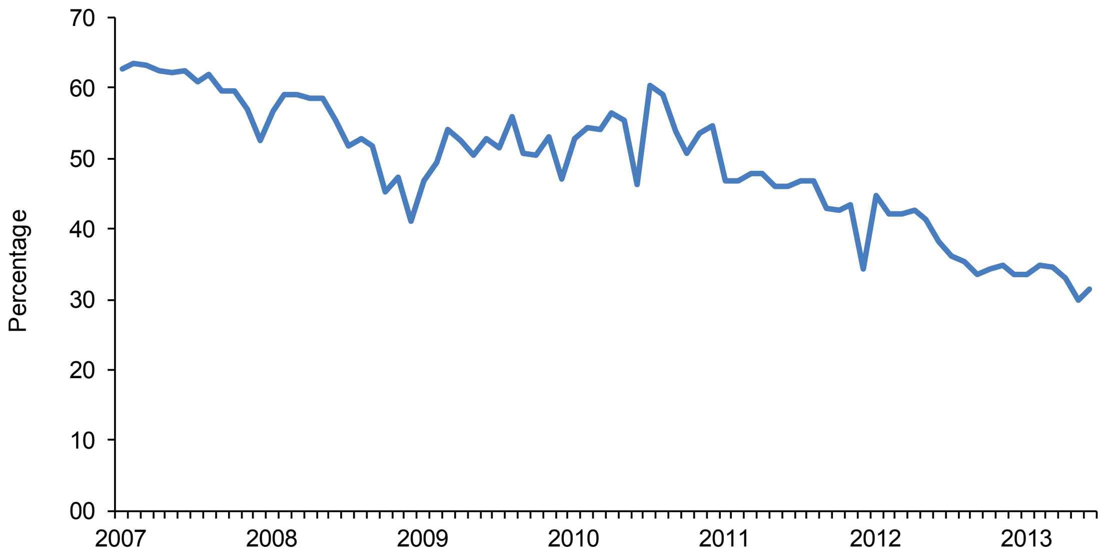
[7] The data of the Property Registries offered by the Department of Public Works is not appropriate to analyze this question since registration may take up to three months which distorts the temporal pattern of actual sales.

During the first semester of 2013, the five largest private banks (La Caixa, BBVA, Santander, Sabadell and Popular) plus Spain's so-called bad bank, SAREB, have sold around 35,000 properties. SAREB represents 5% of the sales of that group of financial institutions. These properties account for 25.5% of all the transactions in urban properties (houses and other properties attached to them) during the first semester as reported by the Spanish Official Association of Notaries. This proportion should be considered just a possible approximation since the banks do not disclose separately some urban properties (houses, apartments, garages and box rooms) from land and commercial properties. If we consider the total number of transactions of urban properties then the proportion is 20.2%. It is interesting to notice that we can conclude, based on partial information, that banks are getting profits out of these sales since the prices at which they are closing operation are, on average, above the net accounting value. The reason is that the bank provisions for nonperforming loans and repossessed properties forced by the so called Guindos I and II decrees of 2012 reduced very much the net accounting value. The rush to sell their properties taking advantage of this situation will lead to the end of these profits.

Secondly, the proportion of home buyers who pay cash has increased drastically[8]. Several reasons explain this trend. First, the sharp reduction in the price of the properties allows buyers with some savings to pay without the need to get a mortgage. Second, banks have adjusted their risk parameters and have decided to reduce their exposure to the housing sector. Therefore, it is more difficult to get a mortgage. In additional, conditional on approval, the spread with respect to the reference interest rate (Euribor) has multiplied from 4 to 6 during the last year and a half. Finally, the return on alternative investments, and in particular deposits, has gone down quite significantly. Using data of Tecnocasa, an intermediary in the residential housing market,

Exhibit 7

Proportion of house sales financed with a mortgage



Source: Official Association of Notaries.

[8] This trend makes the price indices based on appraisals less relevant since many sales would not require an appraisal.

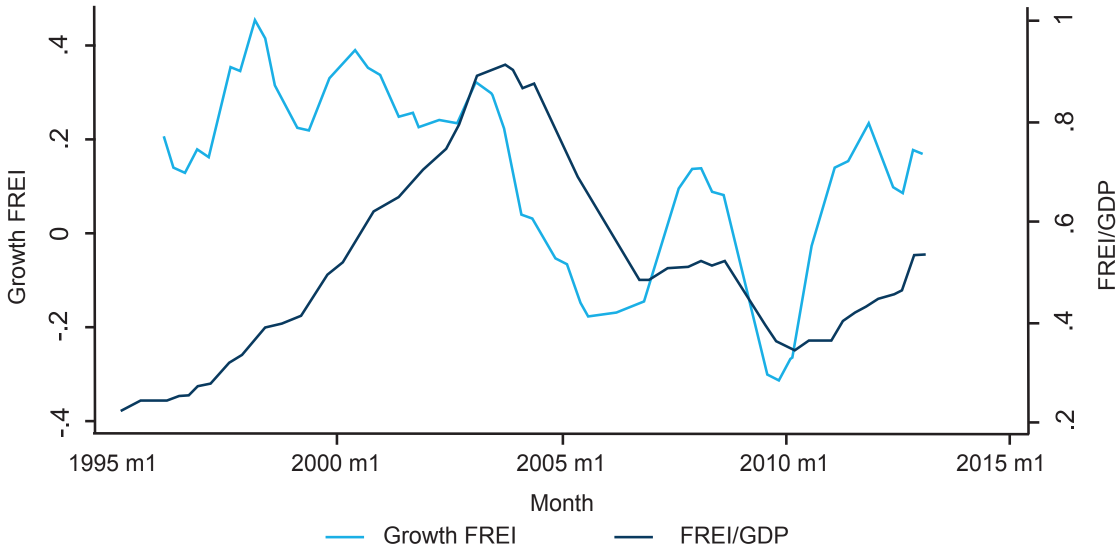
we estimated that during the first quarter of 2013 the proportion of houses bought without external finance was around 55%, and reached 60% in Barcelona. The Spanish Official Association of Notaries has estimated that close to 70% of all the transactions take place without a mortgage (see Exhibit 7). They calculate this figure dividing the number of new mortgages for buying houses by the sale of houses in urban buildings. Banco de Sabadell claims that 70% of their sales during the first semester of 2013 did not involve a mortgage.

The trend towards all-cash deals is associated with the return of investors to the market. Using the data of Tecnocasa, we estimate that 25% of the buyers during the third quarter of 2013 were investors, mostly buying houses of less than 100,000 euros. We should notice that the recovery of the US market started also with a rush of investors buying cheap properties ($70,000-$100,000) to convert them to rentals. This process was accompanied by a sizeable increase in the percentage of all-cash sales. For instance, during the first quarter of 2013, 65% of homes in Miami were sold in all-cash deals compared with 16% in 2007. The national proportion for all-cash purchases in the US shows a large increase in recent years, although there is some controversy on the level: the National Association of Realtors (NAR) sets the most recent proportion at 31% while Goldman Sachs says it reaches 57% and Realty Trac estimates 40%. The NAR also estimates that 70% of all Miami investors paid cash.

Thirdly, foreign buyers are coming back to the Spanish real estate sector. Exhibit 8 shows that foreign investment in the Spanish real estate sector is growing at 16%. In the past the behavior of foreign investors tended to anticipate changes in the evolution of the sector. Foreign investment went down at the beginning of 2005 in anticipation of the bursting of the bubble. However, the proportion of foreign real estate investment over GDP is still far from the pre-bursting levels, although it has grown since the minimum of 2010. Another measure of the growing importance of foreigners in the Spanish real estate market is the proportion of foreigners buying real estate as reported by the

Exhibit 8

Foreign investment in the Spanish real estate market



Sources: Bank of Spain. FREI: Foreign Real Estate Investment.

Registry. During the first quarter of 2013, foreign buyers represented 17.5% of the transactions, while in 2012, they accounted for around 12% and one year before they represented around 10%. Of those foreigners, 91.4% had their residence in Spain.

A final indication is the interest of foreign funds, especially during the last months, for buying real estate properties in Spain. During the first semester of 2013 the sales of non-residential real estate reached almost 900 million euros (DTZ Consulting), although the first quarter was not especially positive. In clear contrast with the situation in 2012[9], when many large operations had Spanish buyers like Amancio Ortega[10], international funds are betting on Spanish real estate properties. Table 2 compiles some relevant real estate deals and a few pending operation during 2013. It also shows that the activity of international investors has accelerated during July and August. There was a consensus among international real estate investment fund managers that prior to entry into the Spanish property market, it was first necessary to see a few large operations and, specifically, from the SAREB. Recent SAREB operations BULL and BERMUDAS have helped to improve sentiment towards investment in Spanish real estate (See Table 2).

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It is certainly true that some of these operations were not simple transactions of packages of real estate properties for cash. For instance, when a real estate subsidiary of a nationalized bank is sold, the operation does not entail the transfer of any property but the right to manage the contracts of SAREB and get (part of) the fees and commissions for selling properties. Project BULL is not a simple operation either. US private equity fund HIG (51%) and SAREB (49%) will share a Bank Asset Trust, or FAB (Fondo de Activos Bancarios) in its Spanish initials. The model is vendor financed, which means that SAREB will finance part of the price paid by Bayside Capital, an HIG Capital affiliate. Banco de Sabadell has sold a securitization vehicle that has 953 houses of former savings bank CAM as underlying assets. Solvia, the real estate company of Banco de Sabadell, will still be in charge of finding buyers for them and will get fees for maintenance and commissions for sales.

Many experts have argued that the participation of SAREB in the real estate market would imply a very strong downward pressure on housing prices. This is not likely to be the case. Opposite to what we hear frequently, SAREB is mostly a depositary for real estate credits. Properties (land and buildings in construction and finished) account for only 11.3 billion of total assets of 50.7 billion. The total number of finished units for sale represents a little more than 10% of the total stock of new construction on sale[11]. The large acceleration in the adjustment of house prices happened after the Decrees for new provisions Guindos I and II that eliminated partly the incentives of banks to

[9] Investment in real estate by international investors is very sensitive to Spanish macroeconomic conditions. Most of the investment (42%) in 2012 took place during the fourth quarter after comments by Mario Draghi on doing whatever was necessary to keep the Euro area safe. In 2012, foreign investors accounted for 46% of the investment.

[10] Founding chairman of the Inditex fashion group. In early 2013, he was ranked as the third richest person in the world by Forbes with a net worth of USD $57 billion.

[11] Notice that the units of SAREB include new constructions and existing homes.

Table 2

Some relevant real estate operations during 2013

Month	Asset	Seller	Price (millions)	Investor
February	Fontanella 6-8 (Barcelona)	Generalitat Catalunya	25	Avignon Capital
April	Castellana 18 (Madrid)	Deutsche Bank	42	Ram Bhavnani
April	Apt building	Ayuntamiento de Madrid	42.5	Rilafe
May	Ronda Sant Pere 5	Casacuberta Inmuebles	19	Deka inmobilien
June	Former headquarters of Altae	Bankia	9	Norman Foster
June	Hotel Vela (Starwood)	FCC,Comsa-Ente, OHL y BCN Godia	200	Qatar Fund Diar
June	Public buildings (13)	Generalitat Catalunya	172	AXA Real Estate
June	Caspe 6 (Barcelona)	Longshore (Drago Capital)		International investor
July	VPO Madrid (IVIMA): 1860 houses in rent control	Comunidad de Madrid	128.5	Blackstone (management Magic Real Estate)
July	@Mar Building	AXA Real Estate	17	Autonomy
July	Los Alcores, Mirador de Cuenca and Almazora	Morgan Stanely y Grupo Lar	30	Incus Capital Advisors
July	Serrano 60	La Caixa	42.5	Meyer Bergman
July	Corte Inglés building (Plaza Catalunya)	El Corte Inglés	100	IBA Capital Partners
July	1000 houses	BBVA	Aprox. 100	Baupost Group
August	Operation BULL: 939 houses and 750 others (parkings, etc.) plus	SAREB	100	HIG Capital (management by Monthisa)
August	Operation BERMUDAS	SAREB	245	Burlington Loan Management Limited
August	VPO Madrid (IVIMA): 2932 houses	Comunidad de Madrid	201.2	Goldman Sachs (management by Azora)
August	Parque Principado	SONAE y CBRE Global Investors	145	Intu Properties
August	CXI Inmobiliaria	Catalunya Banc	40	Kennedy Wilson y Värde Partners
August	953 real estate properties in a vehicle	Banco Sabadell		
September	Bankia Habitat	Bankia	40-90?	Cerberus Capital Management
September	Servihabitat Gestión In (51%)	La Caixa	185	Texas Pacific Group
September	Serrano 83	DAFOR	14.6	Crescendo

Note: Transaction prices are based on publicly available information.

Operation	Seller	Description
Operation HARVEST	SAREB	22 real estate pieces (land), 5700 ha
Operation RUNNER	SAREB	35% park Corredor (Torrejón de Ardoz)
Operation BLUE	SAREB	Package of resorts
Operation TEIDE	SAREB	Buildings finished and in construction
Operation CORONA	SAREB	Office space rented in Madrid
Public buildings	Spanish Government	15,135 public buildings, residential and commercial properties

Source: Author's elaboration.

keep unrealistic appraisals for their repossessed real estate properties.

Despite the above referenced trends in the Spanish housing market, there are still two important questions to address. The first one is the evolution of the stock of new houses for sale. Some calculations estimate the number at 811,000 houses at the end of the first semester of 2012[12]. The number has been around 800,000 since the end of 2010, which means that the market is still not able to absorb the new constructions, even though they are much fewer than before. The second question is the issue of the total amount of repossessed properties on the balance sheets of the large banks that did not transfer most of their real estate assets to SAREB. We already mentioned that the largest private banks are selling their repossessed properties much faster than in the past. Despite this fact, they are accumulating real estate properties, which means that the speed of entrance of new properties on their balance sheets is still faster than their ability to sell them. Table 3 shows that the five largest banks accumulated around 62 billion euros (Gross accounting value) and they have increased their holdings by 7% during the first semester of 2013. Around 72% of those assets come from

Table 3

Repossessed properties by the largest Spanish private banks

	End of 2012		End of June 2013		June 2013	Dec12-June 2013	June 2013
	NAV	Coverage	NAV	Coverage	GAV 2013	Increase NAV	Coverage
From developers and construction firms							
Santander	2,906	3,650	3,125	3,917	7,042	7.54%	55.62%
Popular	3,772	3,613	4,158	3,845	8,003	10.23%	48.04%
BBVA	4,001	4,893	3,876	4,987	8,863	-3.12%	56.27%
Sabadell	4,037	3,217	4,473	4,110	8,583	10.80%	47.89%
Grupo “La Caixa”	5,417	5,531	6,071	6,708	12,779	12.07%	52.49%
From households							
Santander	707	454	728	446	1,174	2.97%	37.99%
Popular	665	351	732	379	1,111	10.08%	34.11%
BBVA	1,492	1,020	1,766	1,142	2,908	18.36%	39.27%
Sabadell	2,397	1,197	2,073	1,014	3,087	-13.52%	32.85%
Grupo “La Caixa”	1,458	946	1,599	1,240	2,839	9.67%	43.68%
Total							
Santander	4,323	4,913	4,562	5,213	9,775	5.53%	53.33%
Popular	5,402	5,191	5,998	5,508	11,506	11.03%	47.87%
BBVA	5,873	6,103	6,081	6,489	12,570	3.54%	51.62%
Sabadell	6,712	4,735	6,643	5,463	12,106	-1.03%	45.13%
Grupo “La Caixa”	7,174	6,720	8,065	8,329	16,394	12.42%	50.81%
TOTAL	29,484	27,662	31,528	31,002	62,530	6.93%	49.58%

Note: NAV stand for Net Accounting Value. The Gross Accounting Value is abbreviated as GAV. Total includes others plus capital instruments and financing of companies holding repossessed real estate.

Source: Financial information of banks (1st semester) and author's calculations.

[12] CatalunyaCaixa (2013), *Informe sobre el sector inmobiliario residencial en España.*

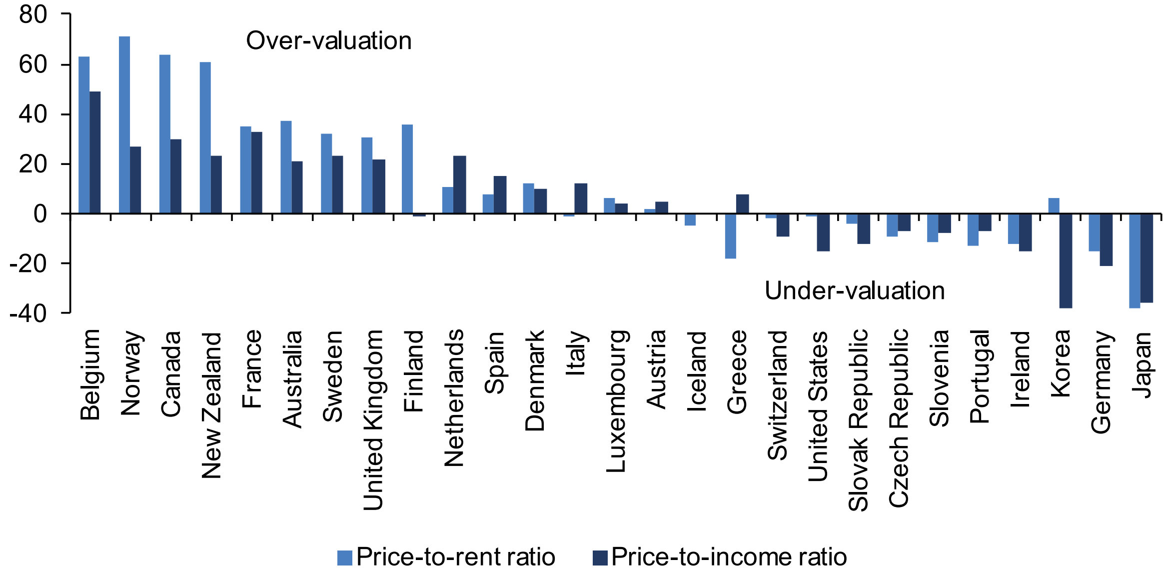
developers and construction firms, and 57% is land. The repossessions from retail mortgages account for 18% of the total. The increase in the delinquency rate of retail mortgages can lead to an acceleration of future repossessions. The net accounting value adds up to 31 billion euros for the five largest banks and it reaches 39 billion euros for all the banks.

The future ahead

By now it is generally accepted that two ratios are better suited to analyze the situation of the housing market than prices[13]. The first indicator is the price-to-rent ratio, which basically calculates the return of the rental market. This ratio is relevant for investors (especially today since the future of the Spanish housing market goes through the rental market) and for the demand for housing services (to decide between buying and renting). The second indicator is the price over income, which is the most relevant indicator for local demand. Exhibit 9 shows the OECD estimation of both indicators with respect to the long term average for a large sample of countries. In the United States, house prices have no undershot and they are rising. In fact the Case-Shiller's 20-cities composite index has grown at an annual rate of 12.1% in the year ending in June of 2013, although it is slowing down. Housing prices seem to be also undervalued in Ireland and they are stabilizing. Spain belongs to the group of countries in which there is overvaluation but house prices are still falling. The OECD price-income index shows an overvaluation of 15% while the price-rent ratio sets the overvaluation at 8%[14]. However, these indices are sensitive the determination of the period to calculate the long run average and the definition of the variables. If we use household disposable income as a

Exhibit 9

Price to rent ratio and price to income ratio: International comparisons



Source: OECD.

[13] Unfortunately, the European Union decided recently to include just the house price index in the macroeconomic excessive imbalances procedure, instead of these two indicators.

[14] *The Economist* uses a different reference period and finds the current overvaluation of Spanish residential properties to be 12.9% using the price to income ratio and 11.1% using the price to rent index.

denominator of the second ratio and take the average over the period prior to 2001 then the overvaluation following the price-rent index will be still 29%. Notice that house prices are going down but disposable income is also going down which reduces the speed of adjustment of the ratio for a given drop in house prices. The price-rent ratio is still further away from the long run average since the return to rent is around 4.53% while the long run average is around 6%. In any case this second indicator is less reliable in the Spanish case because the 2006 survey of the rental market, used to set the reference rent, is not very credible.

In addition, VAR models are predicting a drop of prices of 9% by the end of 2013[15]. Finally, existing house prices are quite sensitive to changes in the sentiment of the market. When the market improves and prices recover, or go down more slowly, the growth rate of prices of existing homes is faster than that of new constructions. The opposite is true when the market deteriorate. There is no indication in the relative evolution of prices of existing versus new houses that leads us to expect a change in the trend of price declines. In summary, real estate prices and, in particular, residential property, are expected to continue dropping fast for a while. This may not be a bad trend if it continues attracting foreign investors, as it helps to improve the affordability of housing for Spanish families, and it stimulates the rental market.

[15] García-Montalvo (2013), *Predicción de los precios de los activos inmobiliarios en el segmento residencial,* mimeo.