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Spain's Bad Bank Seen as Too Big to Work: Mortgages

By Sharon Smyth - Oct 25, 2012

Spain's bad bank will struggle to sell the 90 billion euros ($117 billion) of toxic property assets it takes from other lenders because of its size and inability to help buyers finance purchases.

"When managing tens of thousands of assets scattered across the whole of Spain, big is not beautiful, it's sheer chaos," said Mikel Echavarren, chairman of Irea, a Madrid-based financial adviser. A large, "clumsy" bad bank will be at a "tremendous" disadvantage and will generate losses that Spaniards will have to pay for.

The country has until the end of next month to establish the institution, a condition for receiving 100 billion euros of external aid for the financial system it requested in June. Premier Mariano Rajoy's government seeks to purge about 180 billion euros of bad assets that the Bank of Spain says are on the balance sheets of lenders. The government has said the bank will be profitable and won't cost taxpayers.

The bad bank will not take deposits and so won't be able to provide financing to potential buyers of its assets, Antonio Carrascosa, director general of the state run FROB bank-rescue fund, said in an Oct. 18 interview at a Barcelona conference.

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The aim is to place soured real estate loans and other assets in the vehicle for as long as 15 years in the hope that, once cleansed of bad property bets, banks can resume lending and reactivate an economy mired in its second recession since 2009. The bad bank will have to compete with healthier lenders that have set up units to sell their own problem assets and can provide credit, known as vendor financing, to potential buyers.

Financing Agreements

"It won't be a bank and the only way it may be able to achieve sales with attractive mortgages is by reaching financing agreements with other banks, which will be competing to deleverage their own real estate," said Fernando Acuna Ruiz, managing partner of Taurus Iberica Asset Management in Madrid.

Acuna, whose company oversees 60,000 foreclosed properties on behalf of 25 banks, said that while the structuring will be in place by December, it will be "mammoth," with tens of thousands of assets and loans to service and transfer onto its books. "Integrated management won't be up and running for 12 to 24 months after," he said.

Known by its Spanish acronym SAREB, it will have as much as 90 billion euros of assets based on their transfer price, initially comprising land, developer loans and residential units that went bad after Spain's decade-long real estate boom turned to bust, an Economy Ministry official who spoke on condition of anonymity told reporters on Oct. 17.

Transfer Valuations

The Bank of Spain has yet to fix transfer valuations for the assets based on the stress tests of Spanish lenders carried out by management consultants Oliver Wyman and published on Sept. 28. The 90 billion-euro number is based on transfer prices, so the original value of the assets is likely to be higher.

In comparison, Ireland's National Asset Management Agency, set up in 2009, spent 32 billion euros on mortgages with a face value of 74 billion euros to cleanse its banking system.

Lenders that take state aid will have to transfer to the bad bank foreclosed property of more than 100,000 euros, real estate and builder loans of more than 250,000 euros and controlling stakes in property firms, according to the Economy Ministry official. A decree to regulate the entity should be passed on Nov. 16. It may be amplified in the future to include loans to consumers, small- and medium-sized enterprises and retail mortgages.

'Consume Capital'

"It will need a legion of lawyers, notaries and debt servicers to ensure properties and loans have no legal issues and change title documents," Echavarren said by telephone. "By the time they find out what and where the assets are, they won't have any idea of what they have and what to do with it for at least a year."

The vehicle won't have the resources to manage assets, which are like "livestock that consume capital," he said. Holding the assets cost money in taxes, maintenance and security and will generate losses for Spaniards.

Spain is considering giving tax breaks to the bad bank, two people familiar with the matter said. They asked not to be named because the information isn't public.

A lack of financing options will also hamper the bank, Echavarren said. "A bad bank can try to compete by slashing prices but as a buyer if you can't get a loan, and the bad bank won't be able to provide them, you can't buy full stop."

The FROB, which will be a shareholder in the bad bank, is searching for investors to take at least 51 percent of the vehicle, an onerous task, according to analysts including Krista Davies at Fitch Ratings.

Skeptical Investors

"Equity investors in the private sector are likely to be skeptical of the benefits to be drawn from investing in a wind- down vehicle," Davies wrote in an Oct. 22 report. "As SAREB purchases will take place during a period of uncertainty around economic development in Spain, there is likely to be only a small number of potential private investors in SAREB."

Jaime Guardiola, chief executive officer of Banco Sabadell SA, told reporters today in Madrid that more details about the bad bank are needed before it can decide on a possible role for the vehicle. Banco Santander SA (SAN) Chief Executive Officer Alfredo Saenz said he has concerns over the transfer price of assets, though they are based on incomplete information.

Concerns about Spain's creditworthiness have grown since the government, which is struggling to trim a 2011 deficit that was more than three times the EU limit, requested as much as 100 billion euros in European Union aid in June to shore up its lenders and its economy contracted for a fifth quarter.

Ratings Reviews

On Oct. 17 Spain avoided joining euro-region peers Cyprus, Portugal, Ireland and Greece as being rated below investment grade by Moody's Investors Service as it concluded a review for a possible further downgrade of Spain initiated in June. Standard & Poor's lowered Spain's ratings to BBB- on Oct.10.

According to Carrascosa, the bad bank "cannot make losses in the short, mid or long term." As well as reaching accords with banks participating in the vehicle, the bad bank will need to reach agreements with other "healthy" financial institutions to arrange vendor financing, he said.

It also hasn't ruled out selling homes individually.

"We can't set up offices all over Spain because it's too big so we'll try to sell packages of assets to institutional investors and not individual apartments," he said. "If we have to set up agreements with real estate agents, we could do it. Flexibility and profitability are the two key words."

Santander's Success

The bad bank's limitations stand in contrast to Santander, Spain's largest lender. The company advertises homes on its Altamira real estate website for as little as 40,000 euros in Madrid and apartments complete with swimming pool and garage on the coast of Moncofar in Valencia for 65,100 euros. The lender offers 40 year mortgages with loan to values of as much as 100 percent.

The strategy is paying off. Proceeds from sales of homes on its balance sheet reached 1.3 billion euros in the second quarter -- almost as much as the total for the whole of 2011, according to Saenz who said on July 26 that sales are taking place at discounts of as much as 45 percent. Santander has reduced its exposure to Spanish real estate to 26.5 billion euros from 42.5 billion euros in 2008, the bank said today in a results presentation.

Banco Bilbao Vizcaya Argentaria SA (BBVA), Spain's second-largest lender, last year created BBVA Real Estate to handle its 30 billion euros of property assets.

'Market Prices'

"Our policy is to sell at market prices with 100 percent financing," Ignacio San Martin, head of research at BBVA Real Estate, said on Oct. 19. The bank is selling more houses than last year, though said that for large institutional investors, the bank prefers buyers to provide their own financing. "That way we don't hold the loan on our books or have to provision them."

Sabadell, a Catalan lender, sold 708 million euros of properties via its Solvia real estate unit in the first nine months of the year, up from 433 million a year earlier. The company is aiming for sales of 1.19 billion euros this year, according to an earnings presentation by the lender today.

The strategy works well for healthy banks, according to Fernando Rodriguez de Acuna Martinez, a partner at Acuna & Asociados, a real estate consulting firm in Madrid. If nationalized banks that transfer assets to the bad bank were forced to provide vendor financing for sales, it would perpetuate the subprime lending that initially got them into trouble.

"As a nationalized bank, you'd be looking at an asset that came to you via way of default, so do you really want to be forced to finance its sale again to get it out of the bad bank?" he said during a telephone interview.

Acuna said the best discounts are on the worst assets, where demand comes only from people with a low credit rating.

"So they are subprime or less than subprime borrowers and if you give them credit, you are assuming bad risk again. It's a vicious circle as you are financing the very assets and debtors that got you in trouble in the first place."

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