

BBVA



adelante.

Real Estate Watch Spain

Economic Research Department
December 2007



Following the demand slowdown,
supply also adjusts.
Global uncertainties,
a test for economic supports.

Index

Closing date: December 19th 2007

In summary	1
Supply is falling into line with demand	3
Box 1: "Building and real estate sector adjustments in other developed economies"	7
Box 2: "The US real estate sector: A very different performance between the residential and non residential segments"	9
Economic supports limit the scope of the adjustment	12
Box 3: "Revised growth forecasts for Spanish economy in 2008"	16
Uncertainties in the global financial market	18
Box 4: "Investment in housing and mortgage loans"	21
Challenges facing the Spanish mortgage market in the new regulatory context	23
Box 5: "The mortgage reform"	27

The following have contributed to this publication:

Julián Cubero	34 91 537 36 72	jcubero@grupobbva.com
Cristina Fernández	34 91 537 73 20	cristina.fvidaurreta@grupobbva.com
Juan Ramón García	34 91 374 43 39	juanramon.gl@grupobbva.com
Vicente Lloret	34 91 374 03 50	vicentejose.lloret@grupobbva.com
Daniel Navia	34 91 537 83 51	daniel.navia@grupobbva.com
Virginia Pou	34 91 537 77 23	virginia.pou@grupobbva.com
Tomás Riestra	34 91 537 35 88	riestra.giner@grupobbva.com
Jorge Rodríguez-Vález	34 91 537 48 90	jorge.rv@grupobbva.com
Ana Rubio	34 91 374 33 42	arubiog@grupobbva.com

Editorial committee:

Francisco Balcells, Jon Bilbao, Carlos Deprit, José Luis Escrivá, Rafael de Vicente, Ignacio San Martín

Available on the website:

<http://serviciodeestudios.bbva.com>

In summary

Supply is falling into line with demand

The current adjustment of the Spanish real estate market is not the first, nor will it be the last. It began when demand for housing slowed nearly two years ago and coincided with the beginning of the cycle of interest rate hikes. As this process has intensified, residential demand has progressively weakened with housing activity typically taking time to follow suit, although the reaction was more intense. Therefore, in September, once the effects of the technical building code had been corrected, housing permits granted registered an annual decline of 30%, one of the highest ever. With regard to demand, the number of housing transactions fell 16% yoy in 3Q07 while prices continued to slow in an orderly and gradual manner thanks to supply and demand falling into line.

These trends are set to continue in the coming quarters: effective demand for housing should ease despite support from the forecast decline in mortgage interest rates. Also, with regard to the other variables which determine housing market affordability, the available income trend will be weaker and the factor for rising house prices will contribute less negatively to the deterioration of the indicator. The performance of demand should lead to further falls in residential housing supply.

Given all this, in 2008 investment in housing is expected to fall 3.5% with permits granted for 500,000 homes, some 175,000 fewer than in 2007. Investment in housing is estimated to have risen 3% in 2007, suggesting the adjustment in Spain is not particularly harsh when compared to other developed countries. Therefore, as this report illustrates, in those countries where more block housing is built than single family homes, such as in Spain, fluctuations in housing expenditure tend to be lower than in those countries (US, Ireland) where single family homes predominate. Likewise, inertia plays a more important role in the changes in those countries where block housing is more popular.

Economic supports limit the scope of the adjustment

Even though the current adjustment should continue to gather pace there will be more supports than in the past, giving a more gradual pace. Investment and housing prices have been slowing for the past four and three years, respectively, and real growth levels are currently positive. During the previous sector adjustment at the beginning of the 1990s, it only took four quarters from the time the growth peaked in both variables for real falls both in prices and investment to materialise.

The comparatively better performance of the rest of the economy will be the main support in the current real estate adjustment, unlike at the beginning of the 1990s. The Spanish economy is not driven solely by the housing market and, despite lower growth, it should be able to continue creating jobs and therefore offset the job destruction resulting from the downsizing of the residential sector. A more efficient job market (in terms of inter-sector mobility and workers' socio-demographic profile) will act as a support in this slowdown, which our forecasts for 2007-08 suggest will not be especially severe.

The Spanish economy is forecast to grow at a rate of 2.6% in 2008, down 1.2 pp on the rate of 3.8% forecast for 2007. The estimate for 2008 is 0.2pp lower than our estimate in September. There are two factors behind this change. The first is the worsening global forecasts against a backdrop of uncertainty with rising oil prices and a stronger euro. Also, current forecasts include the most recent national

economic figures for the third quarter, released four weeks ago, which reflect a scenario in which the adjustment in household expenditure on consumption and investment in housing is proving to be more extensive than expected.

In addition to a strong labour market, which is key to maintain household income, families currently enjoy a healthy wealth situation and have very low financial debt over assets. They are therefore able to enjoy some room of manoeuvring in an unfavourable income scenario.

Furthermore, in an scenario of lower demand for housing, the construction sector (activity and employment) has the support of higher public investment. Also, if needed, Spain's public finances would enable it to adopt counter-cyclical policies.

Uncertainties in the global financial market

The financial markets have changed since the summer and are now characterised by their lower liquidity and the decline in consumer confidence. Against this backdrop of greater uncertainty, banks have become more careful in their management of liquidity which has led to tension in the interbank markets. This tension should correct although there are still concerns about the possible effect on credit and real activity.

With these uncertainties in the financial area, the Spanish market is not exempt from the possible impact of an extension of the current liquidity crisis although the fundamentals of wholesale financing in the mortgage market remain strong. The Spanish mortgage market obtains financing mainly via customer deposits but in recent years there has been a significant diversification in its funding base through the issue of securitisation funds and covered bonds. These instruments will remain attractive to investors in a context of financial uncertainty. The collateral for covered bonds is the issuer itself, which provides an advantage over other funding sources given the solvency and profitability of the Spanish financial system.

There is also unlikely to be a significant deterioration in the quality of the collateral used by securitisation funds, the mortgage loans granted by the Spanish system. These funds are built on the lowest-risk loans in the portfolio, which have been managed on strict criteria.

Supply is falling into line with demand

The most recent figures for the real estate sector show that the adjustment in housing demand which began nearly two years ago is intensifying. As usual, housing activity has taken time to react to this slowdown although its reaction has been stronger. Against this backdrop, prices are falling very gradually.

These trends are set to continue in the coming quarters: effective demand for housing will continue to ease despite the support from the forecast decline in mortgage interest rates, as this decline will not be enough to reverse the past two years' increases. Also, the income trend will be weaker and conditions for granting loans are set to become tougher at least for some demand tranches, until the liquidity crisis caused by the global financial turmoil last summer is resolved. The demand trend will lead to further falls in residential activity. However, there are supports both for housing demand and construction activity which should limit the scope of the current adjustment.

Demand sets the pace: general demand for housing is falling sharply with existing homes suffering the most, an indication of the current tone of the market.

Housing demand fell more sharply during the third quarter of 2007 and this trend is set to continue if we consider that it is taking longer to sell properties and the leading developers are forecasting significant falls in the number of pre-contract sales.

Based on figures released by Property Registrars, demand in FY07 fell 12% yoy and 16% in 3Q07. These figures are 10% and 20% respectively for the existing homes market which is more sensitive to market trends.

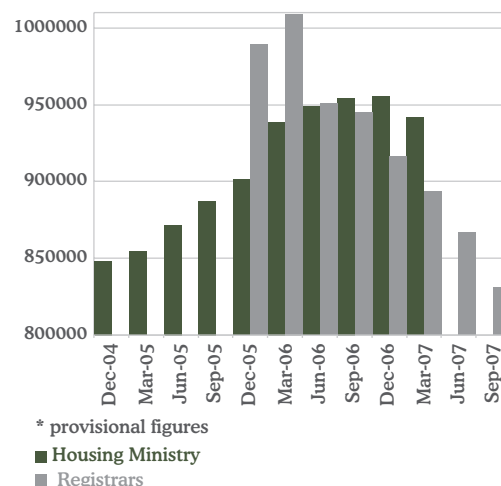
Demand is adjusting across the board. Looking at Autonomous Regions of Spain, only Navarre has seen a positive trend in the number of transactions in the first nine months of 2007. Nevertheless, declines vary greatly with the country's main real estate markets (Aragon, Catalonia, Madrid and Valencia) recording the largest falls. Along these lines, the slowdown in existing home sales in 3Q07 was more pronounced in Catalonia and the Balearic Islands at over 30%, followed by the Basque Country, Aragon, Valencia and Murcia with drops of over 20%.

The housing affordability of Spanish families is the key to curbing demand: the deterioration of the former, which has been more rapid since the beginning of 2007 due to interest rate hikes, has steepened the decline of the latter.

A rise in the mortgage market's benchmark interest rate, the 12M Euribor, from 2% in mid-2005 to close to 4.8% at present, has caused the affordability ratio for Spanish families to drop sharply.

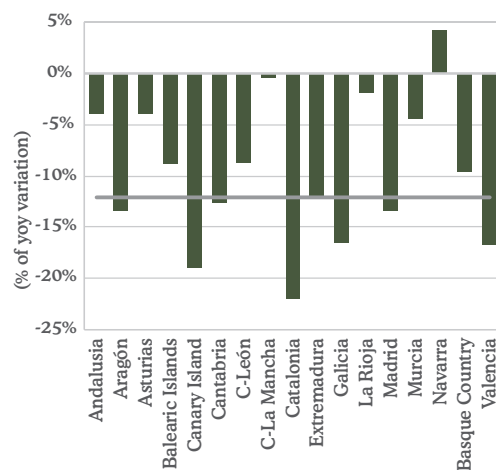
Even though the ECB has stopped raising interest rates and may even cut rates by 25bp in 1H08, the current financial uncertainty has kept inter-bank rate spreads at record highs. This saw interest rates for new mortgages pushed up to 5.6% in October, a figure not seen for the past six years. All this has taken place without the spread between the Euribor rate and the rate eventually paid widening.

Chart 1.
Housing sales
(cumulative 12 months)



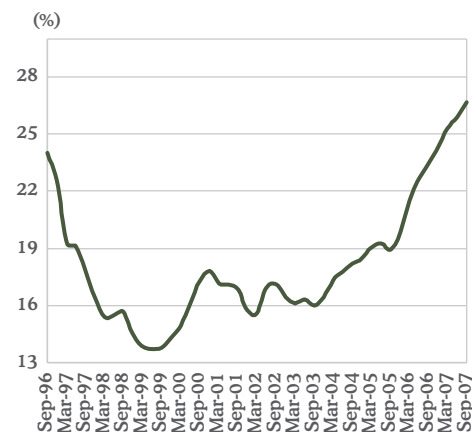
Source: Ministry of Housing and Registrars

Chart 2.
Trend in number of housing sales to September



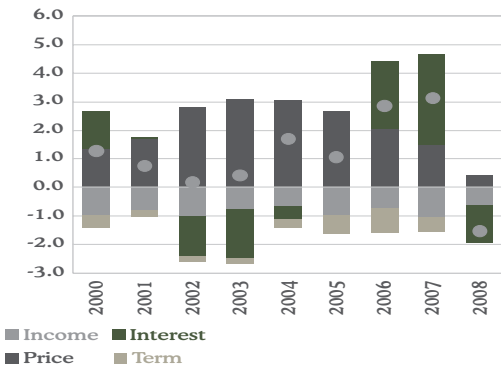
Source: Registrars

Chart 3.
Housing Affordability in Spain
Mortgage repayment as a % of weighted earnings
(tax exemption inc.)



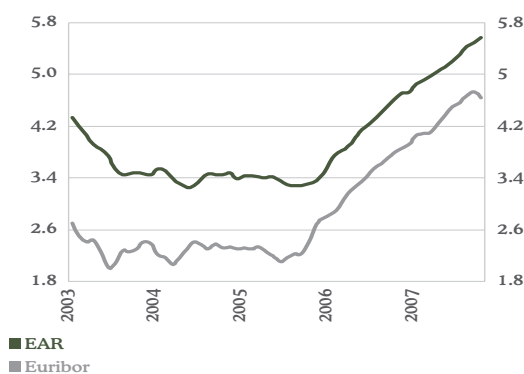
Source: BBVA

Chart 4.
Contributions to changes in housing affordability



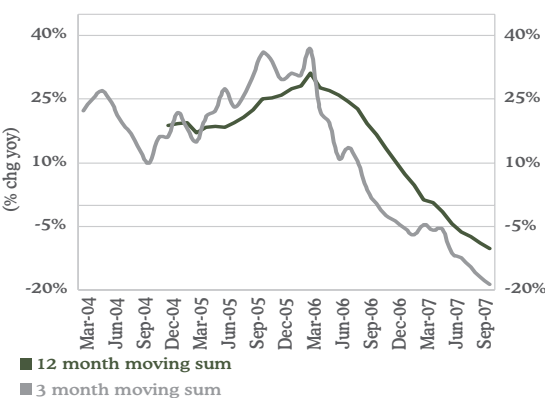
Source: BBVA

Chart 5.
APRC of new mortgage applications and 12M Euribor



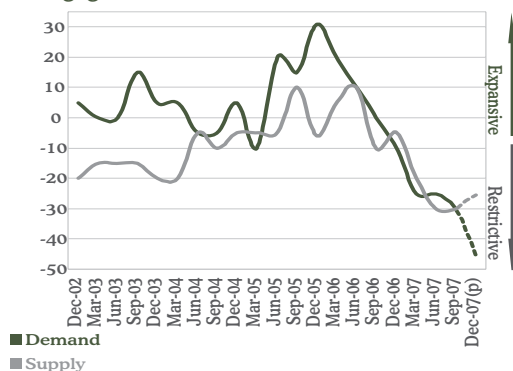
Source: Bank of Spain

Chart 6.
New business mortgage loans



Source: Bank of Spain

Chart 7.
Bank lending survey
Mortgages



Source: Bank of Spain

Therefore, housing affordability indicators have fallen by over 3pp in the past year and the average acquisition of a home represents 27% of average household income. In the past year alone, affordability has dropped a quarter of the accumulated fall from 2Q99 lows.

Breaking down the components of the affordability indicator we can see that, in line with the previous year's trend, the weighting of interest rates as a key factor playing against housing prices has risen. Rising rates have also offset the positive contribution of longer mortgage repayment periods. According to figures from the college of property registrars, the average length of mortgages taken out in 3Q07 was 28.3 years, 12 months more than in the same period the previous year while in 2006 mortgages were extended by 23 months.

The fall in residential demand leads to falls in new financing operations.

Growth in the credit balance for housing acquisitions continued to ease throughout 2007 to 16% in September, the lowest since the housing boom began in mid-1997. The slowdown has intensified in the past year with growth in September nearly 9pp lower than the high reached in mid-2005. This slowdown was due to the decrease in new loans in credit entities' portfolios rather than an increase in amortisation. In fact, new mortgage applications have been falling increasingly sharply over the past year. In October, new operations on this type of loan were, on a 3 monthly average, 19% lower than in the same period the previous year.

However, mortgage lending has not only slowed due to lower pressure from the demand side, financial conditions for supply have also tightened according to the Bank of Spain's survey of bank loans. This restriction is also increasingly seen as more stringent guarantees and a lower loan-value ratio of transactions. For the time being there has been no tightening of spreads offered by banks due to the huge competition in this kind of financing, largely for lower risk transactions.

Activity, which has lagged demand, is now showing clear signs of correction in much of Spain

In 2006 the frenetic pace in the real estate sector amid signs of a slowdown in housing demand did not cease to surprise. The number of transactions fell while housing starts reached record highs. Therefore, given the intensity of the drop in demand mentioned above, it was hoped there would be a slowdown in the number of houses built in order to avoid a glut of homes for sale which would affect the market trend.

In this regard, the latest permits figures show a clear correction in the number of projects started in practically the whole of Spain. Permits granted to 30 September had fallen 22%. However, we must note that the figures are affected by the introduction of the technical building code. If we were to exclude this effect (both in September and March) the fall in number of permits granted in the period would have been approximately 13%.

As we mention above, the number of permits granted for new construction projects has fallen throughout Spain except for in Badajoz, Vizcaya, Teruel and Lugo. The number of permits in the country's main cities has dropped more than the average, with 3Q07 figures for Madrid and Barcelona at their lowest level for the past ten years.

The most gradual slowdown in house prices in history continues

The average price for a home in Spain in the third quarter was 2,061 euros per square meter, 5.3% more than in the same period the year before, which was almost four percentage points below the figure seen at year-end 2006. This signalled the fifteenth consecutive quarter of falling prices.

Despite the increased momentum of the property downturn both on the demand and the supply side, prices have maintained the same slowdown trend as before. As can be seen in the chart below, September's figure came as no surprise¹.

The slowdown remains widespread. With the exception of western Cantabria, the Canary Islands and Murcia region, all the other autonomous communities registered price slowdowns with regard to the same period in the previous year. As the chart shows, a stronger reduction in the contribution from the largest Autonomous Regions can be observed (Andalusia, Catalonia, Madrid and Valencia) compared to other regions, which explains the effect on prices.

In 2008, the adjustment in demand and housing activity should increase, and the gradual slowdown in prices should continue.

As explained below, a high degree of uncertainty currently exists as a result of the financial turmoil which is affecting the inter-bank and credit markets. The intensity and length of this period of turmoil will depend on the final extent of the impact on the real economy worldwide. Furthermore, the real estate market is more sensitive to financial market performance due to the importance of financing both for property development and household demand. However, provided no other shock of an exogenous nature occurs, the adjustment in the property market is expected to continue throughout 2008 in an orderly manner, and should affect market volumes more than prices as it has done so far.

Even though Spanish economic growth is slowing², job creation is forecast to continue, which will provide support for the economy during the current downturn in demand.

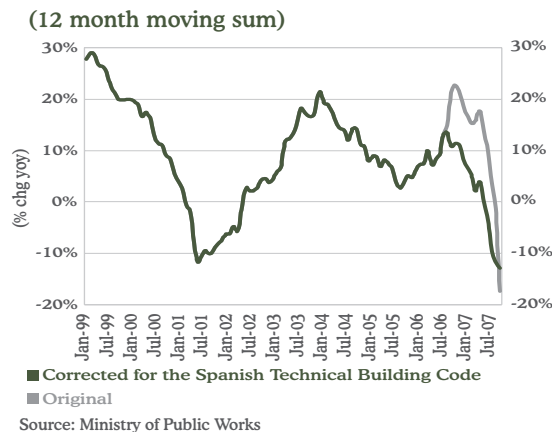
Furthermore, given the sharp appreciation of the euro and the consequent increased risk for European growth, and that inflationary pressure is not rising and should ease, the ECB is likely to cut official interest rates in the first half of 2008. This should start to feed through to the Euribor in 2008. Against this backdrop, and given that house prices will undergo a further slowdown, affordability ratios should improve during the year. Nonetheless, there are various factors which are not included in the affordability ratio and which could squeeze demand.

As mentioned above, in reaction to the change in the property cycle, credit institutions are asking for more guarantees when they grant a mortgage, which is making it more difficult for first-time buyers to enter the market. This could trigger a change in the trend in demand, despite the fact that significant support factors exist which should prevent the pace of the adjustment increasing.

¹ It is important to bear in mind the seasonality of the series when analysing qoq growth in prices (0.3%) as September is usually weaker than other quarters. However, this does not mean that prices will not continue their slowdown trend.

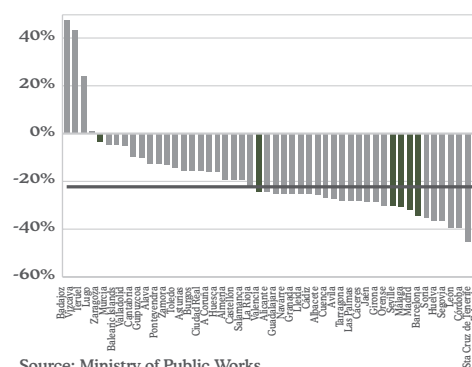
² See table: "Revised growth forecasts for the Spanish economy in 2008".

Chart 8. Housing permits (12 month moving sum)



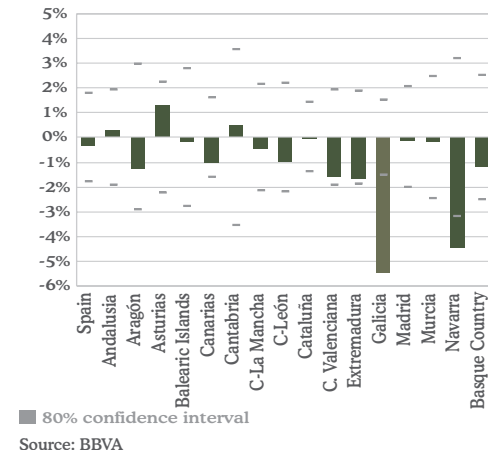
Source: Ministry of Public Works

Chart 9. Permits Jan-Sept 2007 vs. 2006



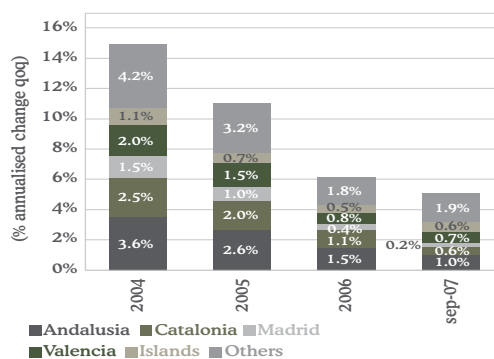
Source: Ministry of Public Works

Chart 10. Error in forecasting housing prices in 3Q07



Source: BBVA

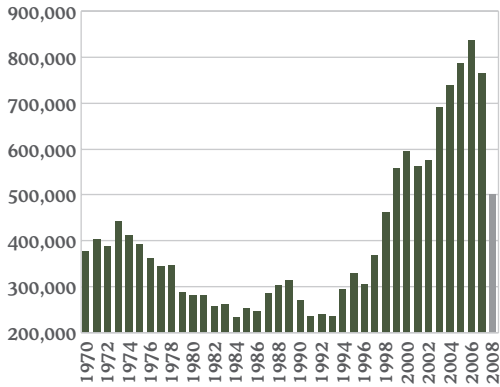
Chart 11. Breakdown of housing price trend



Source: BBVA

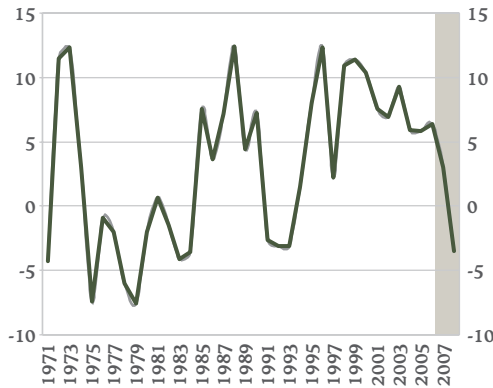
Chart 12.
Housing permits

(Corrected for the Spanish technical building code)



Source: BBVA

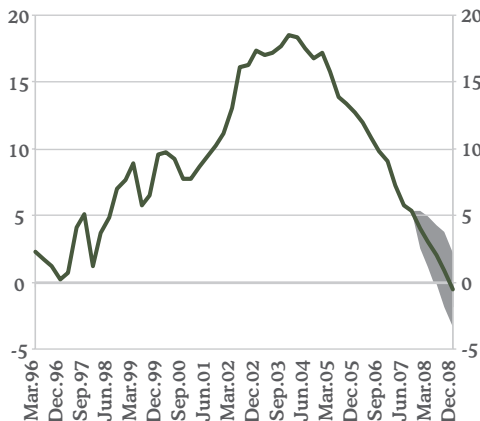
Chart 13.
Housing investment



Source: BBVA

Chart 14.
Spain: housing prices

(% chg yoy)



Source: BBVA

Building activity will adjust further to a level which is more in line with long-term market growth. 2007 is expected to close with 675,000 new building permits (without correcting for the effects of the Spanish Technical Building Code) and the forecast for 2008 is 500,000. This is the sharpest adjustment in activity seen in recent years. However, to gauge the impact of the adjustment, it is important to take execution times into account.

As the accompanying box shows³, given the large proportion of block construction in Spain, the impact of a drop in housing feeds through to the economy and affects employment figures more intensely with a 1-2 year time lag (as building projects take 24 months on average to complete). This is a very different scenario to that of the US or Ireland, where single family homes account for most of residential construction and the impact of a slump in activity has an immediate knock-on effect.

Due to this higher inertia, job destruction in the building sector is not expected to exceed 90,000 in 2008 (around 3%). Meanwhile, residential investment will gradually absorb the adjustment in housing starts. Estimates are for 2007 to close with a 3% increase and a 3.5% fall in 2008, which would imply a direct negative contribution to economic growth of 0.3 points in 2008.

With regard to prices, the current slowdown is expected to continue, with 5.5% average growth in 2007 and 1.4% forecast for 2008.

³ See table: "Building and real estate sector adjustments in other developed economies".

Building and real estate sector adjustments in other developed economies

Regardless of the specific reasons behind the adjustments in housing prices currently being seen in many neighbouring countries, the original cause is always the same: the imbalance between supply and demand. The absence of a housing demand indicator with a sufficiently long time horizon and applicable to all countries makes a comparative analysis of the current correction (and previous ones) a difficult task.

However, there are comparable variables for supply and activity (number of housing starts made during a specific period, on the supply side, and investment in housing on the expense side¹) which allow analysts to identify similarities and differences between countries. Therefore, in this section we analyse the relationship between changes in housing supply and activity occurring over the past few decades and compare these with the current episode.

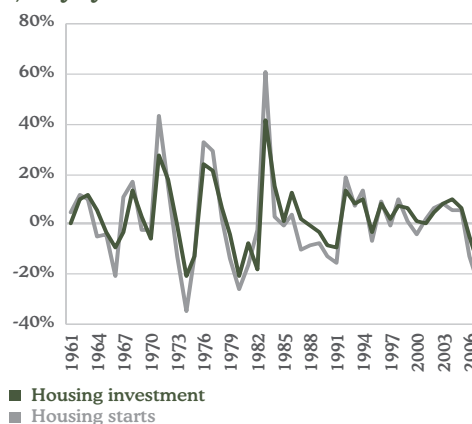
When we look at both series together, we observe that first, fluctuations in supply have been significantly sharper than fluctuations in activity in all countries in our sample. This is due, among other factors, to the longer duration of growth in housing starts, which triggers sharper adjustments when fluctuations in residential investment occur.

Second, an analysis of the correlation between the two factors allows us to differentiate between two groups of countries: those where there is a strong contemporary relationship (US, Canada, Australia, New Zealand, UK, Ireland and Japan) and those where the contemporary relationship is not so strong and fluctuations in supply have preceded fluctuations in activity by at least one year during previous adjustment episodes (Spain, France, Germany, Denmark and Holland). One of the main reasons for this divergence between countries is the **different breakdown of housing units completed**: In the first group of countries, single family homes are significantly more common than housing blocks, which reduces the average building time. This means that any change in the number of housing starts is transferred directly to investment, and hence the economy as a whole². In the second group of countries, the portion of housing blocks in total housing units completed is higher, lengthening the average building time, and therefore delaying the impact of a decline in housing starts on residential investment (Charts 3 and 4).

¹ Accounting rules stipulate that new housing supply is booked to households, regardless of whether or not the effective acquisition has been made. Therefore, expenses relating to residential investment are a variable reflecting activity rather than demand. An authentic indicator of demand is the number of transactions carried out, but in Spain data is only available from 2004.

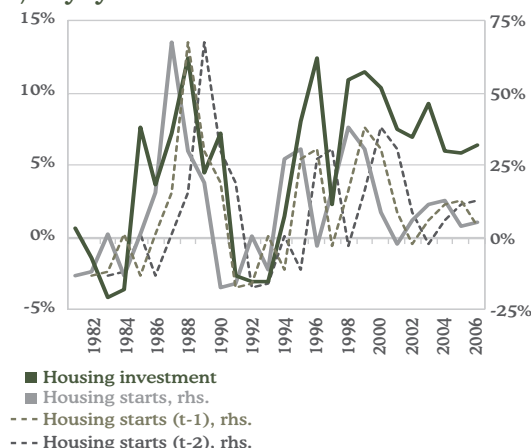
² See the June 2007 edition of "Real Estate Watch" magazine for a review of the impact of the real estate market adjustments on GDP growth in several developed countries.

Chart 1.
US. Housing investment and housing starts, % yoy



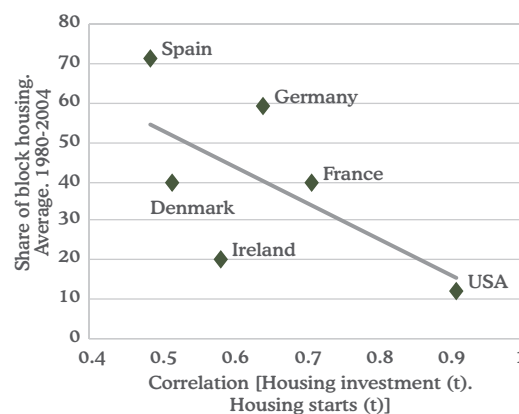
Source: AMECO, Datastream and BBVA

Chart 2.
Spain. Housing investment and housing starts, % yoy



Source: AMECO, Datastream and BBVA

Chart 3.
Share of block housing and contemporary correlation between increases in housing investment and the number of housing starts

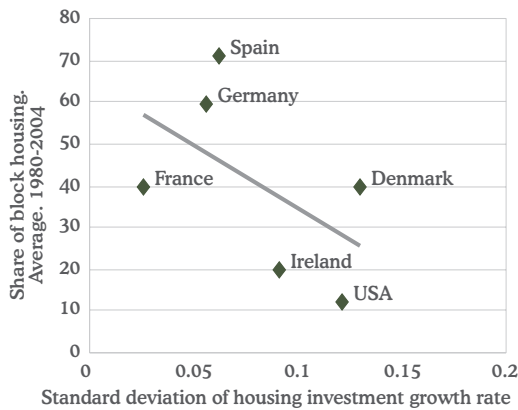


Source: Datastream, AMECO, Housing Statistics in the EU, 2005-2006, and BBVA.

Thirdly, it can be observed that volatility in housing investment is higher in countries where the contemporary correlation between supply and investment is higher. Once again this is due to the lower weight of housing blocks in Anglo-Saxon markets, which triggers a sharper adjustment in residential investment when the number of housing starts declines (Chart 5).

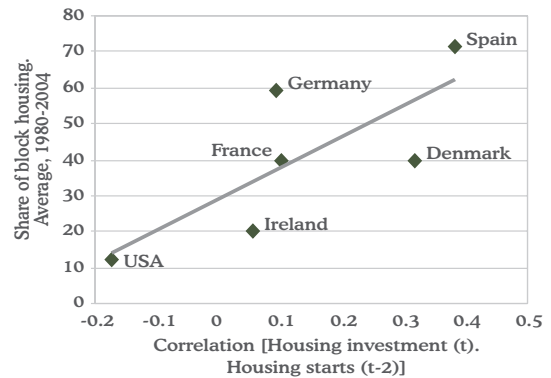
In summary, results show that in those countries where housing block constructions are more popular, investment in housing is more inertial and less volatile, and therefore, in comparison with countries where single family homes are more dominant, the scope of the contemporary impact of a decline in the number of housing starts is relatively smaller.

Chart 4.
Share of block housing and standard deviation of housing investment growth rate



Source: Datastream, AMECO, Housing Statistics in the EU, 2005-2006 and BBVA

Chart 5.
Share of block housing and contemporary correlation between increases in housing investment in year t and the number of housing starts in year t-2



Source: Datastream, AMECO, Housing Statistics in the EU, 2005-2006 and BBVA

Table 1. Recent housing investment and housing starts trends in several developed countries

Correlation [Housing investment (t), Housing starts (t - j)]		
Germany	j = 0: 0,64 j = 1: 0,45 j = 2: 0,10	In 1994, the housing starts growth rate was above 38%, the highest figure since the 1960s. Also, the variation in residential investment was 12%, the highest growth in supply seen since the mid-1970s. From that point on, both variables have adjusted sharply. During the past decade, the number of housing starts has dropped by more than 35%, while investment has fallen 15% in real terms.
US	j = 0: 0,92 j = 1: 0,45 j = 2: -0,17	The contemporary correlation between growth in housing starts and the rise in gross investment is the highest of all the countries in our analysis (0.92). With regard to activity, the current slowdown started, albeit hesitantly, in 2004. One year later supply followed suit. Both variables have shown a negative variation ¹ (Chart 1) since 2006.
Denmark	j = 0: 0,52 j = 1: 0,54 j = 2: 0,32	Figures do not reflect a clear time relationship between supply and activity: During some periods the two variables move in parallel, while at other times supply outstrips activity (and vice versa). 1997 saw the start of a slowdown in housing starts which lasted into the following years and figures did not hit positive ground again until 2001. From then on, volatility has been the dominant note. The slowdown in investment commenced a year earlier, in 1996, but a consistent growth trend did not materialise until 2002.
Spain	j = 0: 0,49 j = 1: 0,74 j = 2: 0,38	The correlation between the increase in gross residential investment in a period and the change in the number of housing starts made during the previous period is significantly higher than the contemporary one. Even the correlation with supply two periods earlier is positive and significant. This is because investment is more inertial: i) it continues to increase when the supply growth rate has started to fall and ii) it picks up after supply does (Chart 2).
France	j = 0: 0,71 j = 1: 0,82 j = 2: 0,10	After hitting a growth rate of 14% in 2004, growth in housing starts began to slow in 2005, followed a year later than investment. In contrast to the other countries analysed, the adjustment in France did not hit negative ground. In fact, as occurred in the previous adjustment, supply is expected to recover in 2007.
Ireland	j = 0: 0,58 j = 1: 0,24 j = 2: 0,06	Although the supply and activity correlation was contemporary until the mid-1990s, since 1998 residential housing investment started to move ahead of activity, due mainly to the greater inertia of this variable. Therefore, growth in the number of housing starts started to fall in 2005, a year after the decline in investment.

¹ See Box 2 for a detailed revision of the real estate adjustment process in the US.

The US real estate sector: A very different performance between the residential and non residential segments

The residential sector: falling sales, prices and activity

Housing sales are dropping significantly in a context of across-the-board price adjustments. New housing development is heading towards historic lows.

Overall, residential investment in the US has been procyclical, expanding when the economy grows and contracting and more volatile during episodes of recession. However, the last period of real estate market expansion (1992-2006) was largely unaffected by the economic slowdown that commenced at the start of the current decade, by far the longest slowdown since the middle of the last century. During this period, residential investment grew 135% in real terms. However, in 3Q07 a correction of 23.5% vs. the peak hit in the last quarter of 2005 was observed - a correction which was believed to have further to run. In 2008, we expect to see additional adjustments in residential investment, so that in the current scenario of credit restrictions, the drop in residential investment could be as much as 40% from peak, the second largest adjustment seen in the last 40 years.

Table 1.

Period	GDP		Residential investment	
	Average	Deviation	Average	Deviation
2Q1947-4Q1969	4.0%	4.9%	6.1%	24.5%
1Q1970-4Q1984	3.2%	4.8%	6.4%	27.7%
1Q1985-3Q2007	3.0%	2.0%	2.1%	10.4%

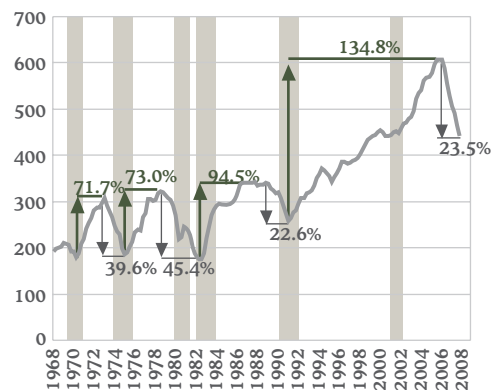
Source: BEA y BBVA USA

According to the Federal Reserve's latest survey of credit conditions published in October 2007, financial institutions are implementing stricter conditions for granting mortgage loans for both subprime and prime customers. These more stringent mortgage financing conditions are having a negative impact on both residential demand and the development of new housing. Given the current default problems and the growing number of delinquencies, in 2008 we expect mortgage lending to continue to decelerate.

The decline in new housing developments from the peak reached in the first quarter of 2006 to the third quarter of 2007 was 43.3%. Our forecasts suggest that the development should continue to decline in 2008 by just over a million new housing units a year, which would mean

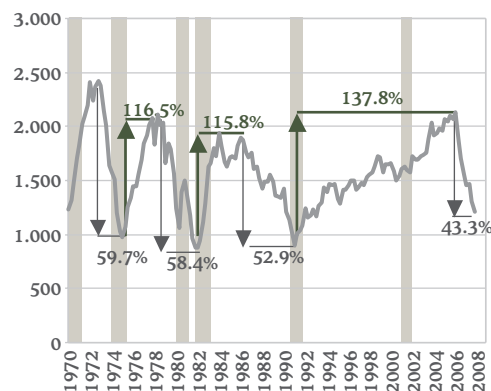
a 53% fall in housing starts from the figure of 2.2 million hit in 2005. Note that at the low points of previous cycles, development fell to slightly less than a million housing starts a year.

Chart 1.
Private residential investment
SA, Thousand million dollars, 2000



Source: BEA and BBVA USA

Chart 2.
Housing starts
Thousands (12 months cumulative)

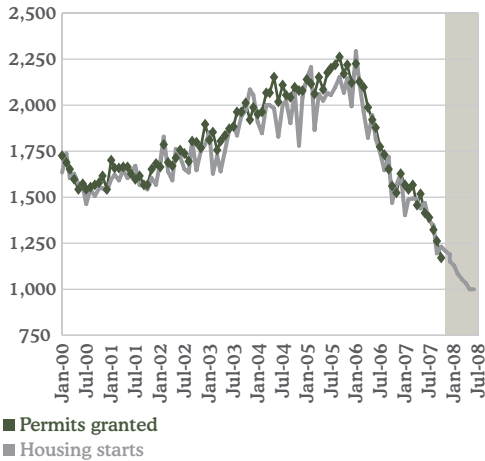


Source: BEA and BBVA USA

The number of building permits granted, an early indicator of sector activity, has also shown a clear downwards trend since the end of 2005. The accumulated number of projects approved in the 12 months to October 2007 was 25% lower than the figure seen a year earlier, with 1.17 million housing projects approved. The trend marked by this indicator is projecting a sharper decline in housing starts in the next few months. The increasing number of homes available for sale on the market is a clear obstacle

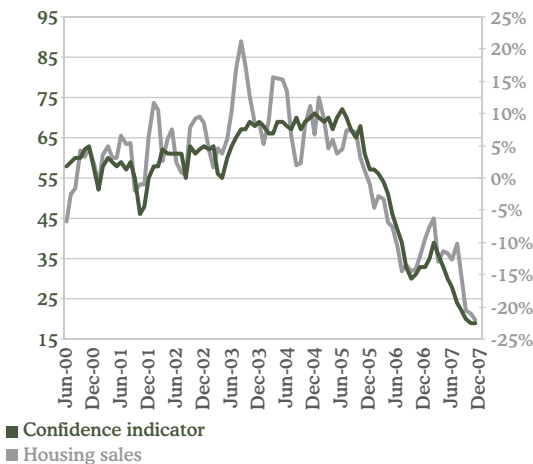
for the development of new homes: in October 2007, 4.32 million homes were on sale, of which 3.80 million were existing homes and 0.52 million were new. At the current pace of sales, the supply of available housing accounts for 10.5 months of existing home sales and 8.5 months of new home sales.

Chart 3.
Housing starts and permits granted
 Thousands (12 months cumulative)



Source: Census and BBVA USA

Chart 4.
Confidence Indicator and Housing Sales
 NAHB index and yoy chg

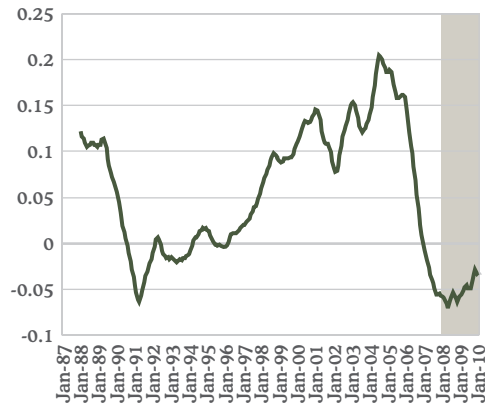


Source: NAHB and Census

The accumulated house sales figure in the last 12 months to October 2007 was 5.1 million units, 21.7% lower than the previous year. Our forecasts suggest that in 2007 an average of 5.7 million housing units will have been sold, 15% less than in 2006. In 2008, we expect this figure to drop to 4.6 million units, a decline of 20% vs. the average for 2007. The National Association of Home Builders (NAHB) confidence index, an early

sales indicator, is at historic lows, suggesting that this weakness is a cause for concern. Also, other NAHB market indicators, such as present and future sales figures, are at lows, indicating that the drop in sales is likely to continue over the next few months.

Chart 5.
Housing prices. 10 City index
 % chg yoy



Source: S&P and BBVA USA

Chart 6.
Non residential real estate investment
 Total return (%)



Source: National Council Real Estate Investors Fiduciaries

The oversupply caused housing prices to decline during 2007. Therefore, in the third quarter of the year, Standard&Poors price indices reflected a decrease of 4.5% in the country as a whole, 4.9% in the 20 biggest metropolitan areas and 5.5% in the 10 largest cities: the bigger the city, the larger the fall in residential housing prices. Other price indices, such as that compiled by the OFHEO (Office of Federal Housing Enterprise Oversight), the NAR (National Association of Realtors) or the census also reflect a drop in housing prices in 2007.

In summary, stricter mortgage lending conditions, coupled with lower housing demand and increased supply should mean that prices continue to fall in 2008. Our forecasts suggest an average drop of 6.5% for the major cities as a whole for year-end 2008.

Table 2. Housing price indices.

Forecasts

% chg yoy

	2007	2008
Chicago	-2.3%	-3.4%
L. Angeles	-6.8%	-6.0%
Miami	-12.4%	-10.7%
N. York	-5.4%	-6.6%
S. Francisco	-3.4%	-8.0%
Washington	-6.4%	-6.3%

Source: BBVA USA

The non-residential sector: small signs of exhaustion

In general terms, the non-residential real estate sector has not yet embarked on a process of adjustment. However, the first signs of exhaustion are appearing in the commercial segment.

Returns in the non-residential segment are at their highest for the last twenty years. Although lower than late-2005 levels, the return on non-residential investments, measured as the rental yield plus price rises was 17.3% in September 2007, more than double the average return seen in the last 20 years (8.6%). The current economic slowdown is resulting in lower demand for commercial spaces, office buildings and industrial warehouses, suggesting that rental prices will start to decelerate and there will be little incentive to create new supply on a medium-term horizon. Therefore, a sharp adjustment in the non-residential segment is not expected.

Employment trends in the last few years are buoying the development of the market for office buildings (where total yields are over 20%), and industrial warehouses (where yields are more moderate at c.17%, although in the proximity of historic highs). However, in the commercial segment clear signs of slowdown have been observed since mid-2005, and yields have fallen to 12.9% in September 2007, 12 points below the figures seen two years ago. This is the result of a large increase in the supply of commercial space and the fall in household consumption.

The market as a whole is faring well. However, there are huge differences at local level. For instance, in some metropolitan areas there is already a oversupply for non-residential products, rentals are stagnating and unoccupied space is on the rise. In these areas, the current economic slowdown should significantly affect yields, and could trigger price adjustments in some segments.

Chart 7.
Investment in offices

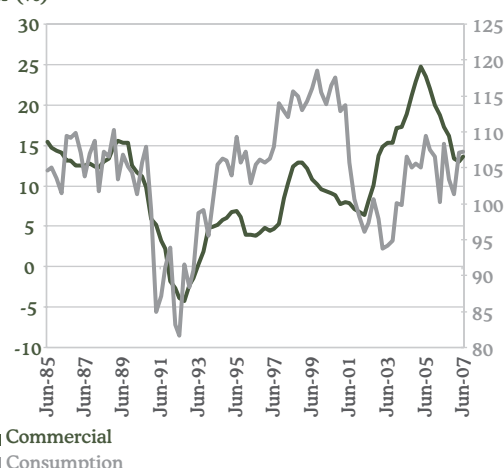
Return (%)



Source: NCREIF

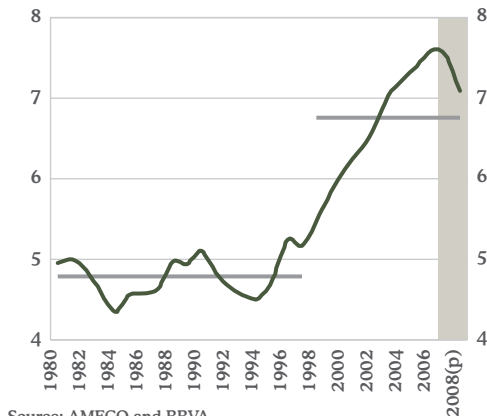
Chart 8.
Investment in commercial real estate

Return (%)



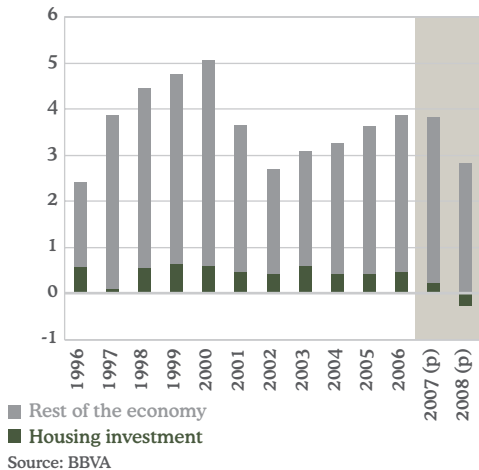
Source: NCREIF

Chart 1.
Housing investment
(% of GDP)



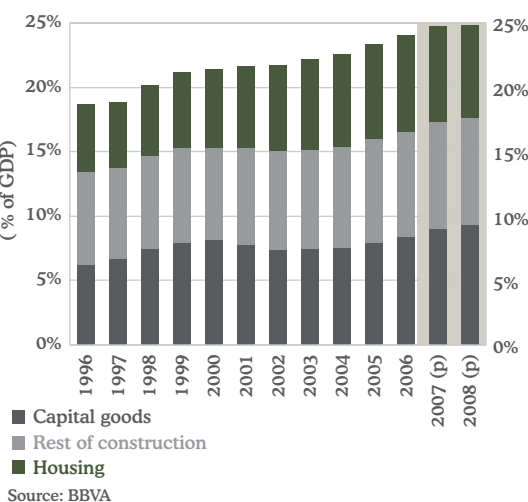
Source: AMECO and BBVA

Chart 2.
GDP growth and direct contribution of
housing investment



Source: BBVA

Chart 3.
Gross fixed capital formation



Source: BBVA

Economic supports limit the scope of the adjustment

Even though the adjustment currently affecting the real estate sector is likely to become sharper, there are still more economic supports than during previous similar episodes, which will limit the impact on the rest of the economy. In fact, the comparatively better performance of the rest of the economy will provide the main support in the current adjustment. The Spanish economy is not solely reliant on housing and jobs should still be created, albeit at a slower pace.

Furthermore, the robust fiscal health of the Spanish economy should lead to greater investment in infrastructure and, if necessary, offer scope for the implementation of counter-cyclical policies. The buoyancy of the non-residential segment should give some support to activity.

Lastly, net household wealth remains sound, even more so in a context of falling interest rates which will relieve the financial burden.

The economic model is based on more than just housing

The first stage of the real estate sector correction (which ended in the first half of 2007 and was markedly smooth) ran parallel with a period of stronger economic growth. However, the intensification of this adjustment process (which started at the tail end of 2007) will coincide with a slowdown in the Spanish economy which should become more apparent as the year progresses. This introduces an element of uncertainty, given the possibility that the adjustment in the construction sector may have an impact on the rest of the economy at a time when it is more vulnerable, and that the slowdown forecast for the economy as a whole could negatively impact activity and demand in the real estate sector. However, the Spanish economy's positive performance in these last few years brings to light certain differences in the current episode, which are likely to limit the scope of the real estate sector's adjustment and soften its impact on the rest of the economy.

The projected performance of the rest of the economy will be the housing sector's main support. A clear decoupling is expected between the performance of the real estate sector and that of the economy as a whole, in contrast to previous episodes. The Spanish economy is embarking on a slowdown although this should be much less bumpy than the landing forecast for residential investment. The fact that other sectors are gradually correcting their recent growth will be the real estate sector's best support.

Even though construction in general, and housing in particular, have contributed enormously to the economic expansion seen in Spain in the last few years, the Spanish growth model is not as dependent on housing as it is sometimes said to be (see chart below). The housing component has gained weight in total GDP

in recent years (rising from 5.2% in 1996 to 7.5% in 2007). However, 0.5pp of GDP growth in the same period (3.7%) was investment in housing, i.e. 14%. Therefore, although this figure is certainly respectable, it is not sufficient to set the pace of the whole economic cycle. The same can be said of the weight of housing in total investment in the economy. Over the last few years, gross fixed capital formation has increased as a percentage of Spanish GDP to 25% from 20% in 1998. But, despite the expansion of the real estate sector and compared to historic averages recorded since 1970, investment in capital goods has increased further, rising 2.6% vs. its historic average, clearly above the 1.7 point increase in the housing investment deviation.

In sum, all of the above demonstrates that the housing segment is not the sole driver of the Spanish economy, and that the structural reforms carried out during the expansion phase of the current cycle have made markets more flexible and make it viable to redirect production resources towards other sectors. The outlook for the other sectors of the economy is relatively brighter. Market services, which account for more than half of the economy's GVA, are still buoyant with growth unaffected, as evidenced by National Accounts for the third quarter. Forecasts suggest a soft landing for industry, and production may pick up again from mid-2008, if external demand, particularly in Europe, recovers.

As a summary, growth forecasts for the Spanish economy (2.6% in 2008) reflect a decline from the 3.8% estimated for 2007 (see "Revised growth outlook for the Spanish economy - 2008"). In this scenario, housing will detract 0.3 percentage points of GDP growth. But even so, growth is still 0.8 pp higher than our forecast for the eurozone.

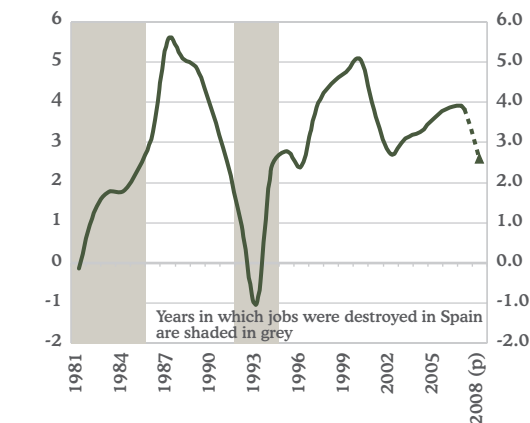
Job creation, a key support in the adjustment

In this projected framework of growth, Spain's ability to create jobs is key to preventing a sharp and unruly adjustment in the real estate sector and limiting its impact on the rest of the economy. Therefore, our forecasts suggest that the Spanish economy will continue to create jobs although the pace of job creation will moderate, as recently-released employment indicators are starting to reflect. Effectively, growth of 2.6% forecast for 2008 is slightly below potential and, as the chart below shows, clearly above the rates below which the economy registers a drop in employment.

The most recent "Spain Watch" report published in October¹ showed the main results of an in-depth survey carried out by BBVA, in which the impact of a slowdown like the present would have on labour movements has been simulated. Inter-sector mobility and improvements in the population's socio-economic profile suggest that the impact on employment will be limited. Results demonstrate that during episodes of slowdown (moderate from a historical perspective) the probability of a worker losing his/her job is significantly lower than the probability of changing sector, and this applies for all sectors of the economy, including construction.

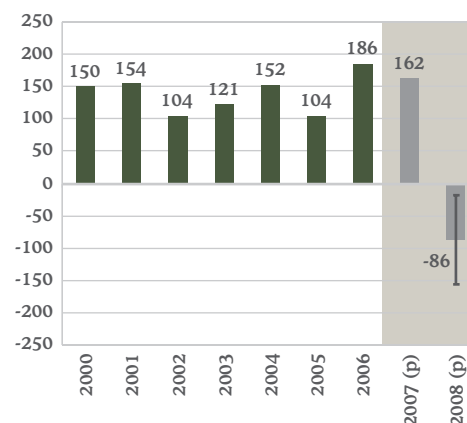
¹ Available in <http://serviciodeestudios.bbva.com>

Chart 4.
Spain. Economic growth and job destruction



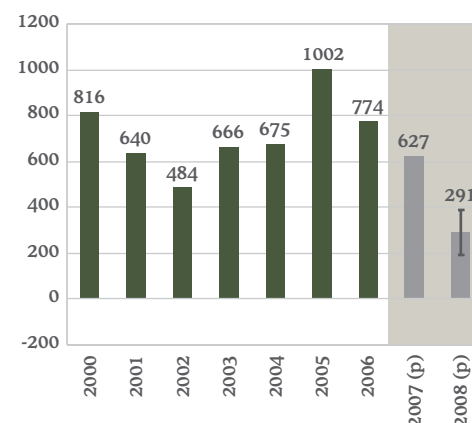
■ Growth
Source: INE and BBVA

Chart 5.
Construction: Net job creation (thousands)



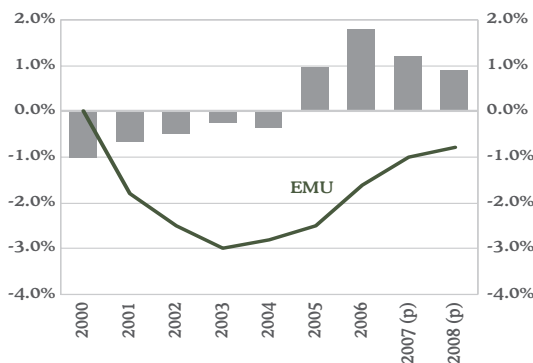
Source: INE and BBVA

Chart 6.
Spain. Total net job creation (thousands)



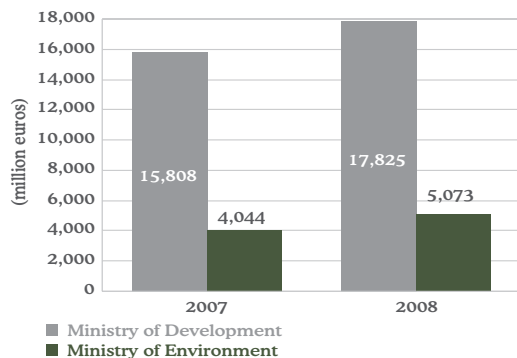
Source: BBVA

Chart 7.
Public deficit (-) / surplus (+)
(as % of GDP)



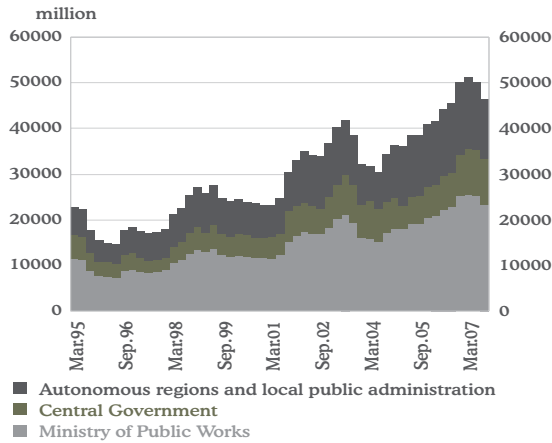
Source: AMECO and BBVA

Chart 8.
Budgeted investment



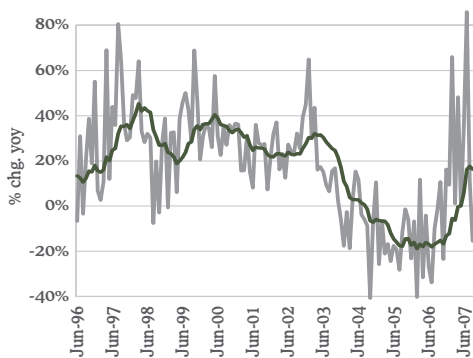
Source: Seopan

Chart 9.
Public tenders. 12 month moving sum



Source: Development Ministry

Chart 10.
Foreign investment in real estate



12 month moving sum
Source: Bank of Spain

However, it is fair to assume that the construction sector will lose more than 80,000 net jobs in 2008. This figure is so moderate (compared to the scale of adjustment in sector activity) because not all gross job destruction in the construction sector will lead to unemployment - a portion will be absorbed by other sectors. Therefore, an overall increase (measured by the labour force survey) of 291,000 jobs is expected, slightly less than half the figure forecast for 2007.

In short, job creation, which has always been one of the drivers of real estate sector performance, will continue to act as a support for activity, because employment trends ensure the continued growth of household wealth and support residential purchasing decisions.

Public investment, a valuable aid

The role of the public administrations in offsetting the cool down in residential investment is also significant. The Spanish public sector currently has the capacity to implement counter-cyclical fiscal policies if necessary. The deficit reduction of public accounts carried out over the last few years has had notable results, leading to a clear fiscal surplus, even taking into account the cyclical slowdown expected for the next few years. Healthy public accounts mean Spain will be able to face the upcoming economic slowdown with considerable room for manoeuvre on fiscal policy. Some of these hypothetical counter-cyclical public spending measures may relate to civil engineering works and social housing, offsetting the performance of the housing segment in the construction sector as a whole.

In fact, an increase in investment in both infrastructure and social housing is expected next year. As we can see from the chart below, there has been a slowdown in public tenders in the third quarter of the year, due probably to the political cycle. However, this effect should wear off due to transfers to public authorities and planned investment for 2008, leading us to forecast a buoyant civil works segment next year. The investment budgeted by the Ministry of Development and the Ministry of the Environment has increased by 15% vs. 2007.

Even though there has been a drop in the number of building permits granted for non-residential work, this segment should perform better than residential housing in 2008. However, the economic slowdown should lead to a more moderate performance by the non-residential sector, while the low office vacancy rates in the major Spanish cities suggest a very soft landing. The recovery of foreign investment in real estate observed during the year can largely be attributed to investment in this segment. According to data on housing sales provided by the Ministry of Housing, purchases by foreigners fell 44% in the first quarter of the year while monthly foreign investment flows have grown at an average pace of 30%. Even so, the figure for September reflects a change in the trend seen in previous months. Therefore, the next few months' data will allow us to assess the impact of financial turmoil on cross-border investment in the Spanish real estate sector.

Household wealth remains strong despite the increased financial burden

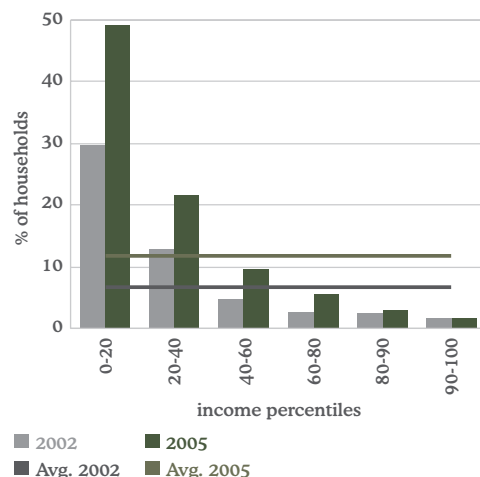
Spanish household debt-to-income reached 130% in the third quarter of 2007. This is comparable with levels seen in more financially-developed nations although the increase has been sharper. The rise in interest rates has triggered a significant increase in households' financial burden, causing it to grow from 12% of available income in 2003 to over 16% in 2007, mainly due to higher interest payments (these have practically doubled in the last few years).

Also, the latest Household Financial Survey published by the Bank of Spain shows that the breakdown and evolution of the financial burden for households is not the same in all income brackets, and the increase has been relatively higher among the lower income segments. In 2005, 12% of indebted households had a financial burden of over 40% vs. 7% in 2002. This was particularly evident in the lower income brackets where the financial burden of practically half the indebted households was higher than this.

However, as we explain in the next chapter, despite this increase in the financial burden seen over the last few years there has been no significant increase in default levels, suggesting that households have been able to absorb the rise in interest rates. Also, the forecast rate cuts will relieve the financial burden borne by households.

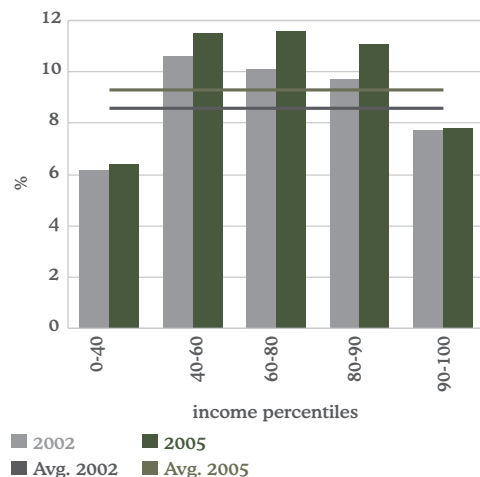
We also highlight the increase in household wealth (up 68% between 2002 and 2005). Comparing debt with household wealth we can see that the latter is very sound. From an international standpoint, only Italy is comparable with Spain, and the lower income brackets appear to be in a better position than the middle income brackets. This is because more of the debt taken out in Spain is used to acquire real estate and homeowners (81% of the total) have benefited from the housing price increases registered over the last ten years.

Chart 11.
Household financial survey: % of households with an available income ratio of over 40%



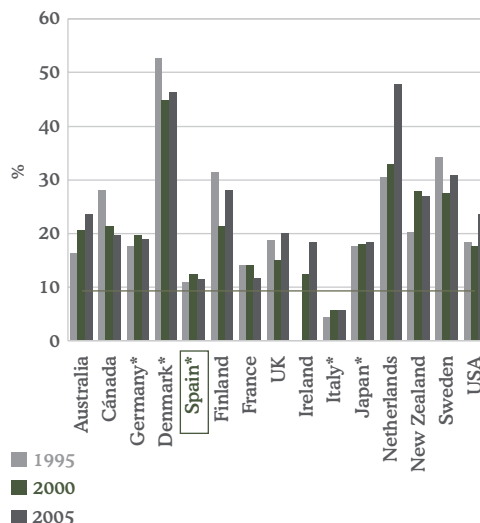
Source: Bank of Spain

Chart 12.
Household financial survey: Debt as a % of total wealth



Source: Bank of Spain

Chart 13.
Household debt over wealth
(Financial debt as % of net wealth)



* last figure 2004
Source: OECD

Revised growth forecasts for Spanish economy in 2008

The Spanish economy is forecast to grow at a rate of 2.6% in 2008, down 1.2 pp on the growth forecast of 3.8% for 2007, which is about to end. The current growth forecast for 2008 is 0.2pp lower than our September estimate. Two factors lie behind this revision. Firstly, the worsening global outlook, against a backdrop of uncertainty triggered by the problems plaguing the credit markets since the summer. Also, current forecasts include the most recent national economic figures for the third quarter, released four weeks ago, which reflect a scenario in which the adjustment in household consumer spending and investment in housing is proving to sharper than expected.

Table 1. Economic growth forecasts
(yoy rate)

	2003	2004	2005	2006	Forecast at Dec-07		Previous forecast	
					2007	2008	2007	2008
US (%/a PIB)	2.5	3.6	3.1	2.9	2.1	1.7	1.9	2.2
EU (%/a PIB)	0.8	1.8	1.6	2.9	2.6	1.8	2.7	2.0
Oil (\$)	28.8	38.2	54.7	65.6	71.9	67.7	57.48	55.5
Exchange rate €	1.13	1.24	1.24	1.26	1.37	1.44	1.35	1.39

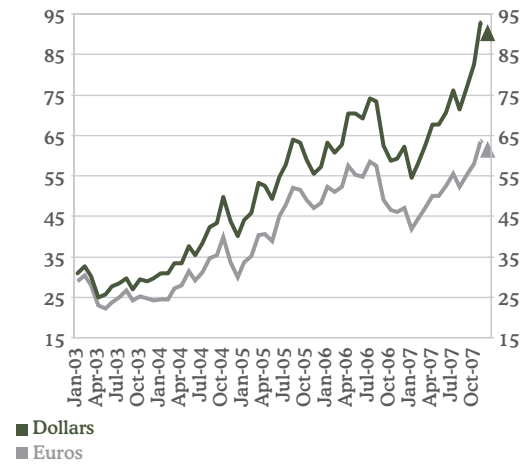
Source: SEE BBVA

Global growth forecasts have been revised since the last edition of BBVA's Real Estate Watch report in June 2007 as a consequence of three simultaneous shocks. Firstly, the financial turmoil which developed over the summer is proving more intense and persistent than expected despite the measures taken by central banks. In fact, and despite the market's partial return to normality in October, tensions have intensified recently. Consequently, the probability has increased that what was initially regarded as a liquidity crisis (shortage of commercial paper, increase in corporate spreads...) could become a credit crisis (restricted access of private agents to financing) which will impact the real economy, especially in the US. The second shock is the performance of the oil market. Oil prices are systematically breaking record highs, with an average price of USD 92.7 in November, an increase of 70% since January. The final shock is the sharp appreciation of the euro (12.8% year-to-date), linked to growing uncertainty over the adjustment of the US economy.

The initial repercussions of these three shocks are already being felt. Firstly, we have seen a sharp increase in inflation since October as a result of inflationary pressure on food and energy prices worldwide. In the EU, inflation rose from 1.7% in August

Chart 1.

Oil: Brent bbl price



Note: December, average of available data
Source: Datastream and SEE BBVA

to 3.1% in November, a period of just three months. In Spain inflation rose from 2.2% to 4.1% in the same period. Secondly, we would highlight the negligible impact of the appreciation of the euro to date on exports, both in Spain and Europe. Nonetheless, the impact of the ongoing appreciation of the euro on growth is negative. Thirdly, confidence is waning, more sharply among consumers than in manufacturing. Moreover, at the global level, tensions on the interbank markets have begun to affect wholesale corporate financing. Information gleaned from surveys on bank loan conditions, both in Spain and the EU, shows tighter conditions for financing for businesses.

As a consequence of all the above factors, the overall outlook for the Spanish economy is less dynamic, since global growth prospects have also worsened, above all in the US and the EU, while emerging markets remain relatively immune to the impact of this financial turmoil.

This less dynamic global backdrop, and with a bearish risk balance trend depending on the eventual outcome of the current liquidity crisis, has been factored into national economic figures for the third quarter, which confirmed forecasts with 3.8% yoy GDP growth, just 0.20 points less than in the second quarter. Nonetheless, in the breakdown of components some factors appear to point to a sharper slowdown of the Spanish economy beyond previous estimates.

The adjustment in household spending (both on consumption and housing) is occurring earlier and is more intense than forecast. Also, the positive surprise in the third quarter (investment and exports) was provided by components where growth can be expected

to slow in the near future. Against a backdrop of increased uncertainty, slowing domestic demand, a slowdown in the European economy and liquidity tensions at least in the coming months, investment in capital goods is likely to correct from the fourth quarter of 2007 in line with the cyclical slowdown in domestic and foreign demand. The rally in exports also seems to have peaked, with forecast growth of 1.8% for the EU in 2008 (0.8pp less than the forecast for 2007), and a very strong euro vs. the dollar until well into 2008.

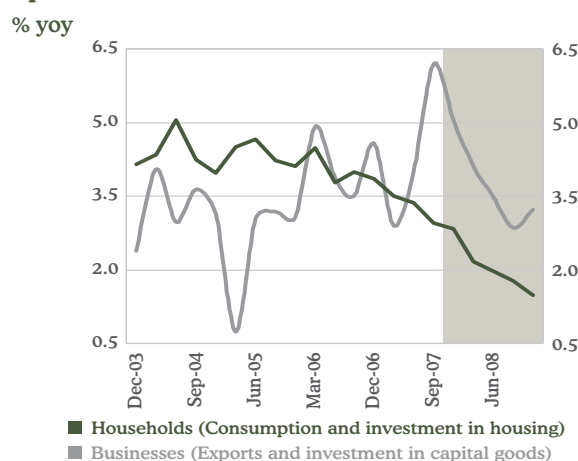
To sum up, the current economic environment is more uncertain for the Spanish economy. Even so, the impact on growth is relatively limited given its supports. In particular, its capacity to continue to create jobs (ensuring the dynamism of household income), household wealth, a robust financial system and healthy public accounts, as well as a diversified corporate sector in terms of both composition and geography.

Chart 2.
EU: Consumer confidence



Source: European Commission

Chart 3.
Spain: Growth: households vs. businesses



Source: BBVA

Table 2. Spain, GDP components

yoy rate	2004	2005	2006	2007 (e.)	2008 (p.)	Revision (pp)
Government consumption	4.2	4.2	3.7	3.2	2.5	-0.3
Household consumption	6.3	5.5	4.8	5.5	5.1	0.0
GFCF	5.1	6.9	6.8	5.9	1.7	-1.2
Capital goods	4.6	8.1	8.2	8.7	4.0	0.1
Construction	5.4	6.1	6.0	4.0	-0.3	-2.2
Housing	5.9	5.9	6.4	3.0	-3.5	-3.5
Rest	5.0	6.3	5.5	5.1	2.5	-1.2
Chg in inventories (*)	0.0	-0.1	0.1	0.0	0.0	0.0
Domestic demand (*)	4.9	5.3	5.1	4.7	3.0	-0.5
Exports	4.2	2.6	5.1	5.7	4.2	0.2
Imports	9.6	7.7	8.3	7.0	4.3	-0.6
External balance (*)	-1.7	-1.6	-1.2	-0.8	-0.5	0.3
GDP at mkt prices	3.3	3.6	3.9	3.8	2.6	-0.2
Pro-memory						
Inflation		3.4	3.5	2.8	2.9	0.2
Total employment	2.7	3.2	3.2	2.9	1.3	-0.2
Of which, construction	5.7	7.0	5.4	5.9	-3.0	-2.9

(*) contribution to growth

Source: INE and BBVA forecasts

Chart 1.
Price of securitized subprime mortgages.
Daily and Avg. Jan-Jul

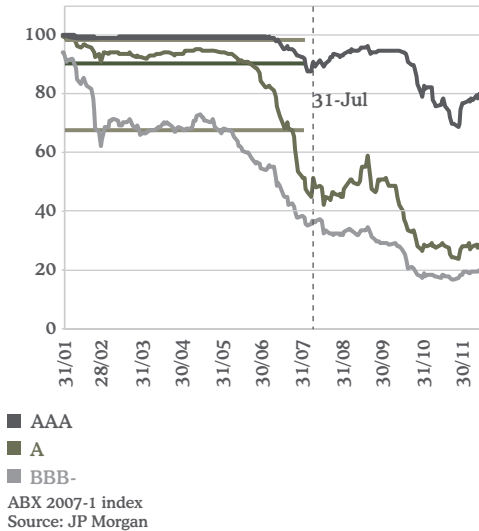


Chart 2.
US: Commercial paper volume
Total chg (\$mn) since 8 August

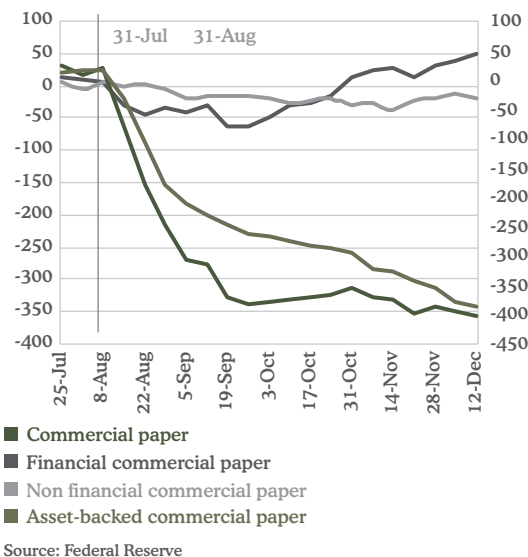


Chart 3.
US: Libor curve



Uncertainties in the global financial market

Since last summer a change has been underway in the financial markets, driven by a reduction in liquidity and a decline in consumer confidence. The spread of the sub-prime crisis has triggered a re-evaluation of the risk in structured products and a decline in demand for these from traditionally more conservative investors. Against this backdrop of greater uncertainty, liquidity tensions have persisted and intensified despite the action taken by central banks.

The Spanish mortgage market is not insulated from the situation on the global markets and, in fact, the ongoing financial turmoil has become the main factor of uncertainty for the sector in the coming year. Nonetheless, the foundations of the key mortgage loan financing mechanisms via wholesale markets remain strong.

The international financial situation is entering a period of uncertainty, characterised by lower liquidity and greater risk aversion.

Last summer marked a turning point in the international financial situation. If previous years were characterised by an abundance of liquidity and low risk premia in recent months the financial context has shown the opposite features: the disappearance of liquidity in major markets and the extremely cautious approach adopted by financial agents, who have become significantly more risk-averse.

The origins of the current difficulties lie in the exceptional conditions that prevailed in the previous period. Central banks maintained relatively lax monetary policies over a lengthy period of time, whilst long-term interest rates stayed at historic low levels. This encouraged investors to seek profits from alternative investments and boosted demand for innovative financial products from more conservative or less sophisticated institutions that had previously focused solely on traditional products. Insurance companies, money market funds and public institutions (including, for example, town halls and the US state funds) acquired substantial amounts of these products, guided by the favourable assessments of credit ratings agencies, which failed to completely outline the implicit risks. The ease with which mortgage origination companies in the US could securitize their loans and sell them to investors with an insufficient understanding of their terms resulted in a relaxation of the criteria usually employed in granting mortgage loans, such as the verification of documentation or the limitation of loan to value ratios. It also facilitated the growth of mortgage instruments that reduce the financial burden in the initial years of the loan; thereafter, however, this burden increases substantially, with the debtor frequently unable to meet payments.

This stage came to an end when, at the end of 2006, subprime mortgage default rates began to rise in the US. Faced with evidence that these defaults would cause substantial losses, the credit rating agencies raised their estimate of the risk of subprime securitisations shortly before the summer of 2007, triggering the decline in value not just of these assets (see chart 1), but also of the structured products deriving from them (e.g. CDOs). This process (which is still ongoing) entailed a reassessment of risk by investors, who became far more cautious.

The impact, especially in the US, was felt from the initial stages of the crisis in the commercial paper market, an important avenue of financing for the global economy. In particular, investors began to shun ABCPs, causing the outstanding balance of these to fall by more than 30% (approximately USD400bn) (see Chart 2). Other important forms of financing for the banking sector, such as covered bonds, were also affected by investors' reluctance to acquire mortgage exposure in the current setting.

Banks, for their part, face a reduction in available liquidity. The money markets have been under intense pressure since the start of August. Interest rates in the inter-bank market offer premiums over official overnight rates that are much higher than before the crisis; these cannot be justified by monetary policy expectations (see Charts 3 and 4). The persistence of this situation is worrying as the interbank markets play a pivotal role in the correct functioning of other financial markets and their interest rates are the benchmark for other financial instruments, including mortgages.

In addition to liquidity pressures there are also the uncertainties already mentioned in relation to the possible impact on different banking systems of the losses associated with the real estate crisis in the US. Since the second quarter of 2007, the international banks exposed to the US subprime market have been obliged to write down the valuation of their structured assets (around USD75bn so far). Moreover, the increase in default rates has caused a corresponding surge in US banks' loan provisions, and even government-sponsored companies (Freddie Mac and Fannie Mae) have reported substantial losses. From the outset, fears that some banks' solvency could be compromised caused a sharp rise in the cost of debt issued by financial institutions (see Chart 5). Although the impact is significant, banks' endeavours to improve their capital base in recent years should permit them to weather the storm.

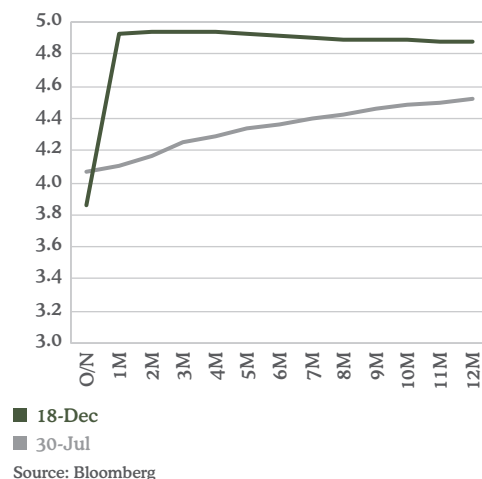
In the most likely scenario liquidity tensions will be temporary and will not have a major impact on activity. Although the level of uncertainty remains high, the fundamentals of wholesale financing of the mortgage market remain sound.

In the future, the combination of liquidity and capital pressures could trigger a slowdown in credit in the global markets. The most recent bank surveys already indicate tighter lending criteria (see chart 6). In the most likely scenario, liquidity tensions would prove short-lived and their impact on real activity limited. The financial situation would normalise as financial institutions raise capital and central banks step up actions to provide the markets with sufficient liquidity. Nonetheless, the financial outlook is highly uncertain as the credit shock could become tighter if these two conditions are not met, with an even more pronounced impact on activity.

In this context of uncertainty in the global financial market, Spain is not immune from the potential impact of an extension of the current lending crisis, though the fundamentals of wholesale financing on the Spanish mortgage market remain solid.

The Spanish mortgage market is mainly financed by customer deposits but in recent years there has been a significant diversification in its funding base through the issue of securitization funds and covered bonds. The particular

Chart 4.
EU: Euribor curve



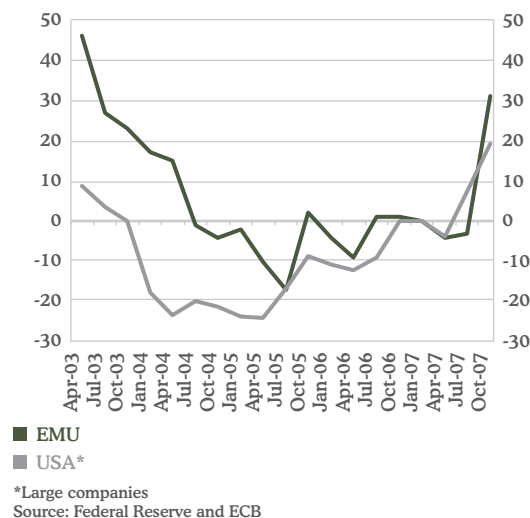
Source: Bloomberg

Chart 5.
Credit spread of AA rated banks: US and Europe



Source: Bloomberg

Chart 6.
Banking credit standards (% net of banks imposing restrictions on corporate loans)



*Large companies
Source: Federal Reserve and ECB

Table 1. Banking sector ratios 1H07

	ROE	Efficiency	Solvency
Spain	21.4	44.7	11.8
EU	20.19	58.4	11.2

Source: Bank of Spain and ECB

Chart 7. Mortgage loan delinquency rate

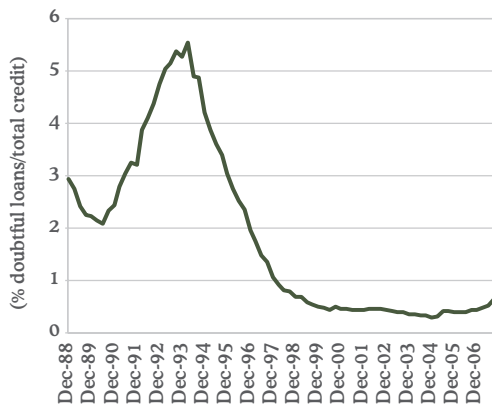
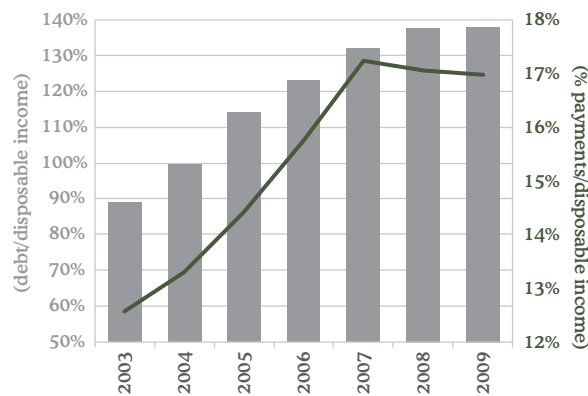


Chart 8. Financial burden and debt (Debt/ Disposable Income)



characteristics of these instruments mean they will remain attractive to investors in a context of financial uncertainty.

The collateral for covered bonds is the issuer itself, which provides an advantage over other types of financial asset given the solvency and profitability of the Spanish financial system. It should also be remembered that, according to the survey carried out by the Bank of Spain, the direct or indirect exposure of Spanish financial institutions to the subprime crisis is very low (just 0.03% of total banking system assets).

A significant deterioration in the quality of the collateral used by securitisation funds, i.e. the mortgage loans granted by Spanish banks is unlikely. These funds are formed from the lowest-risk loans in the portfolio, which have also been granted based on comparatively strict criteria. The likelihood of default on a securitised portfolio is very low and this will probably remain the case since the following risk factors will remain low: macroeconomic, financial and real estate. The first is linked to a process of job destruction which does not seem likely given the outlook for the Spanish economy. In a context of net job creation a significant rise in default rates is unlikely. This variable, as the chart shows, has in fact barely worsened despite high financial charges and rising interest rates. Therefore, given the projected falls in the 12M Euribor rate during 2008 from current levels (around 4.8%), it is likely that the financial burden has peaked; this would rule out the second of the risks mentioned: financial risk.

Finally, the gradual slowdown in housing prices will not reduce the willingness to pay of Spanish households, which have taken on debt primarily in order to acquire their primary residence. Therefore, the risks that could affect portfolio quality seem very limited, which means these instruments should remain attractive investments.

¹ For more details see BBVA's "Situación España" report, October 2007, which is available on the internet: http://serviciodeestudios.bbva.com/TLBB/fbin/ESTES_071018_SituacionEspanya_14bis_tcm268-138426.pdf

² See the latest financial stability report, "Informe de Estabilidad Financiera" published by the Bank of Spain.

Housing Investment and mortgage loans

As described in this report, the real estate and credit markets have developed in parallel. Consequently, housing supply and demand have been driven by credit, both to acquire and develop housing, and vice versa.

The scenario in which forecasts for the Spanish economy in 2008 are being made assumes that the current tensions in the inter-bank and wholesale credit markets will ease sooner rather than later. Therefore, the assumption is that there will be no restrictions on the amount of credit required by companies and families, especially to acquire housing. However, given the high level of uncertainty in the markets, it seems relevant to analyse the impact of a hypothetical restriction on mortgage lending in relation to the scenario without this level of restriction. To this end we present the results of a quantitative analysis based on econometric models.

Firstly, we analyse the impact of a mortgage lending shock both on residential investment and the price of housing. The credit shock is defined as a 1% reduction in real terms in mortgage lending volume. This reduction is accompanied by an increase in the real interest rate for mortgage loans, which would rise by around 50 basis points (annualised) according to the model's estimates at the start of the credit shock.

The response of mortgage lending is shown in Chart 1. As we can see, this response is relatively persistent: three quarters after the initial impact, lending volumes remain 1% lower than the level without the impact of the shock. Chart 2 shows the forecast real interest rate for mortgage loans. Interest rates would continue to rise in the two quarters after the impact of the shock, attaining differentials of more than 100 basis points.

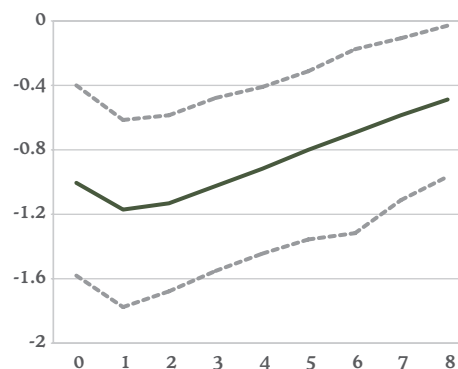
It is estimated that this scenario of tighter lending conditions would have a negative impact on housing investment in Spain, as shown in Chart 3, which depicts the path of the estimated response for this variable. It should be mentioned that the scope of the initial impact is relatively small. This is the result of an identification hypothesis of the econometric model and rests on the conventional economic theory that real economic variables have a slightly delayed reaction to changes in financial variables.

Returning to our analysis of Chart 3, the fall in housing investment is relatively sharp and persistent². Three quarters after the shock, investment volumes remain

¹ Perhaps the clearest example is the response of the real economy to a monetary policy measure. From a methodology standpoint, Vargas-Silva's (2007) work "Monetary policy and the US housing market: A VAR analysis imposing sign restrictions", published in the Journal of Macroeconomics, can be consulted.

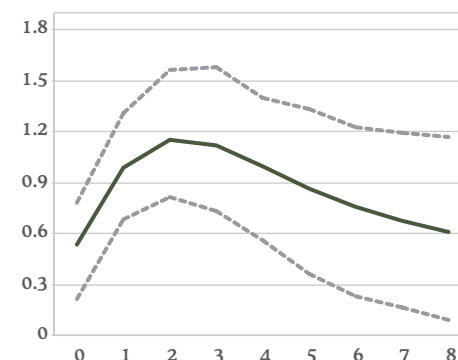
² This result is very similar to that documented for the United States by Ben Bernanke and Mark Gertler (1995) in "Inside the black box: the credit channel of monetary transmission", published in the Journal of Economic Perspectives.

Chart 1.
Response of mortgage loans to initial shock of -1%
(% deviation vs. scenario of no credit restrictions)



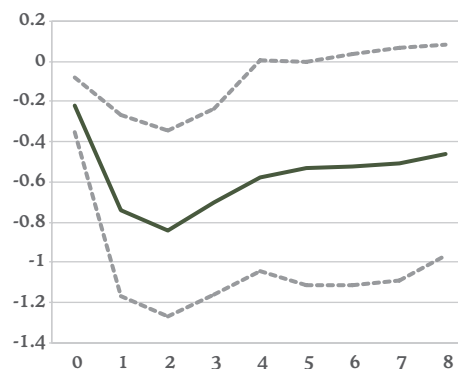
Source: BBVA

Chart 2.
Response of real mortgage interest rates to a mortgage lending shock
(% deviation vs. scenario of no credit restrictions)



Source: BBVA

Chart 3.
Response of housing investment to a mortgage lending shock
(% deviation vs. scenario of no credit restrictions)



Source: BBVA

0.8% lower than the level without the impact of the shock. The negative response persists, and is still significant even two years after the initial impact. This unfavourable trend in housing investment is accompanied by a lower real housing price level than forecast in the base scenario, without a credit shock, as shown in Chart 4. As we can see, the price level is approximately 0.4% lower than it would be if conditions in the credit market had not worsened. This response is certainly persistent, though it should be pointed out that there is a significant degree of uncertainty about it.

Finally, we present an additional exercise which analyses the impact of an aggregate credit shock on economic activity measured by Gross Domestic Product (GDP).

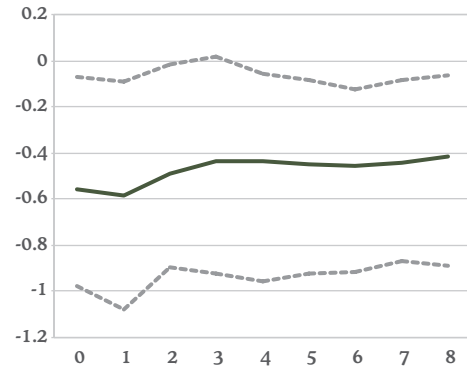
Chart 5 shows the estimated deviation of real total credit volume from levels that do not factor in the shock. As with mortgage lending, the impact has been normalised to 1%. As a result of the general toughening of lending conditions, the response of GDP is negative. Chart 6 shows that in the first year GDP is approximately 0.2% lower than it would have been had this change in the credit market not taken place.

This exercise demonstrates, therefore, that the housing sector seems more sensitive to changes in lending conditions than the economy as a whole. This is consistent with the fact that households, the main agent of demand in housing investment, are relatively more susceptible to possible tightening in bank lending conditions than, for example, companies, since these have easier access to alternative sources of financing.

Pedro Alvarez Lois
Servicio de Estudios BBVA

Chart 4.
Response of real housing prices to a mortgage lending shock

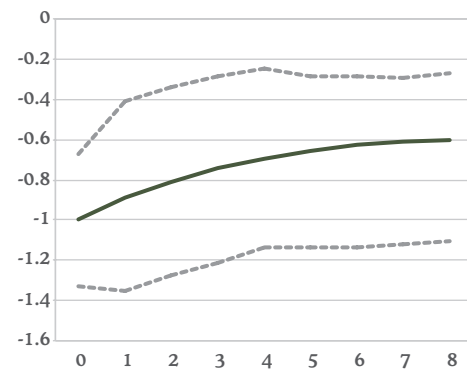
(% deviation vs. scenario of no credit restrictions)



Source: BBVA

Chart 5.
Response of total credit to an initial shock of -1%

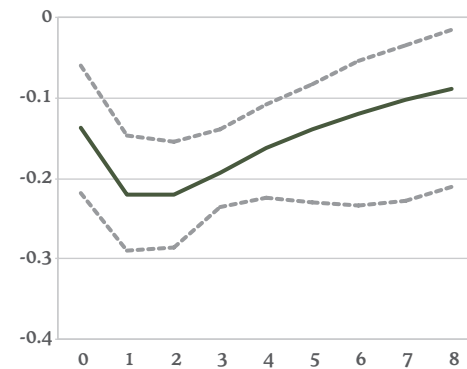
(% deviation vs. scenario of no credit restrictions)



Source: BBVA

Chart 6.
Response of GDP to a total credit shock

(% deviation vs. scenario of no credit restrictions)



Source: BBVA

Challenges facing the Spanish mortgage market in the new regulatory context

Historical performance: interaction between real estate and credit markets

The real estate and credit markets in Spain have reached a high level of development in a relatively short period of time. Housing starts were 349,000 p.a. on average in the 1990s and 701,000 for the current decade. At the same time, mortgage lending has grown from 16% of GDP to an average of 43% in each decade respectively. The interaction between the sectors has boosted their growth.

The Spanish real estate sector has experienced an unprecedented boom primarily driven by the performance of the housing sub-sector, which has accounted for a higher proportion of GDP in recent years than in previous decades, mainly as a result of permanent structural boosts to supply and demand. Factors affecting housing demand include socio-demographic factors such as immigration, the emancipation of the baby boom generation born at the end of the seventies, women joining the labour market, job growth and Spain's solid position as a prime residential tourism destination. At the same time, Spain's joining the European Monetary Union led to a structural reduction in interest rate levels, the convergence of key Spanish financial figures with European levels and improved macroeconomic stability - factors which also contribute to the development of real estate demand.

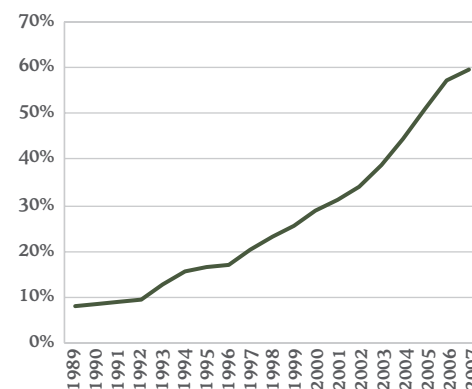
On the housing supply side, various factors have enabled an adequate response to the increase in demand. Generally, urban planning has replied adequately to demand pressures, with a more expansive focus. Also, developers have been able to work on larger projects.

Both housing developers and households demanding housing have benefited from the strong rise in mortgage lending, made possible by the rapid modernisation of the banking system. A series of reforms were introduced in the wake of the banking crisis in 1977, including allowing the entry of foreign banks, the expansion of the universal banking model, the introduction of adequate risk management, the creation of a money market and the acceleration of the consolidation process.

Numerous factors underpinned this strong and sustained growth in lending. Firstly, the structural reduction in global interest rates, caused by permanent factors such as our entry into the Monetary Union and greater competition in the banking sector, was more pronounced in countries such as Spain, which were starting from higher levels. Another factor is financial innovation, which has encouraged the expansion of variable interest rate loans, longer terms and financing a larger proportion of property values. All this has helped to reduce mortgage repayments in real terms. In addition, different legal reforms such as the regulation of the mortgage legal figure and the introduction of Property Registers have boosted mortgage lending.

⁰¹ However, other types of investment have increased more in relation to their average, as mentioned earlier in this report.

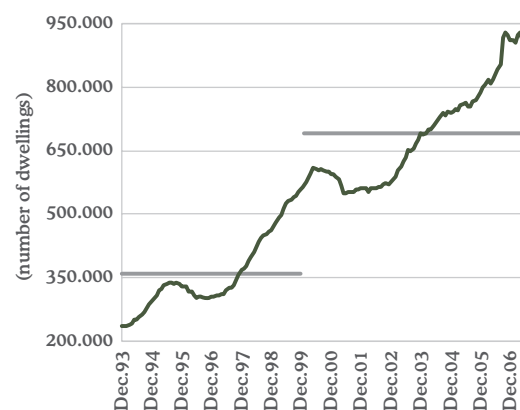
Chart 1.
Mortgage lending as a % of GDP*



*2007 Mortgage loans at September

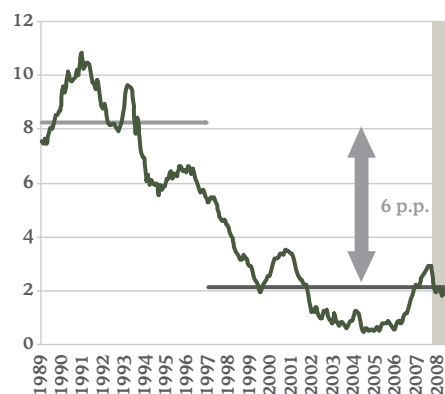
Source: ECB and Eurostat

Chart 2.
Housing starts
(12 months moving sum)



Source: Ministry of Public Works

Chart 3.
Real mortgage interest rate



Source: BBVA

Table 1. Financing conditions

	Interest rates (%)	Avg term - years	Payment €/month	In real terms Base 2006	Housing price (100m ²)
1990	14,0%	10	877	1.552€	56.500€
2000	5,8%	22	590	712€	88.023€
2007	5,2%	28	1.159	1.128€	205.084€

Source: BBVA

Chart 4. Percentage of Variable Rate Mortgages

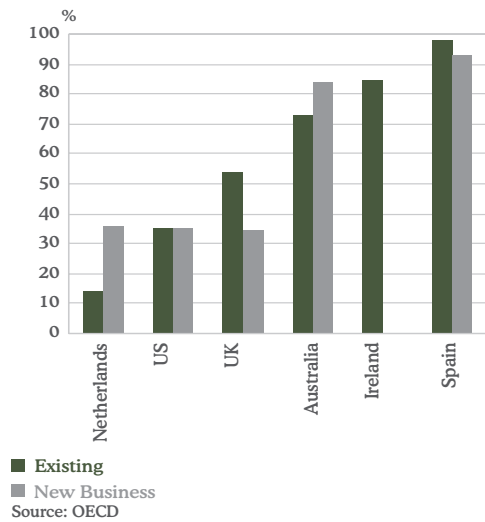
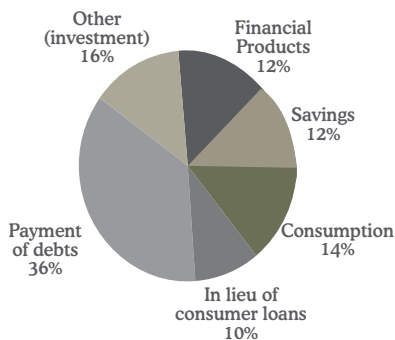


Chart 5. Breakdown of MEWs in the US



Source: Deutsche Bank, Dec-2006

Despite the rapid transformation of the sector, growth has been balanced. Although household indebtedness has reached relatively high levels compared with disposable income, household debt is still low in terms of wealth as most of this debt has been used to acquire property. Moreover, there is no subprime credit in Spain as defined in the US since high risk products, bearing growing interest rates or granted over a very long term are still relatively unknown. Besides, given that mortgages are not sold on or completely securitised in Spain, banks generally keep loans in their portfolios, so there are no incentives to grant risky mortgages. Also, whilst in the US it is still easy to place the riskier tranches on the markets, in Spain banks usually retain the first loss risk. In Spain banks' funding is diversified, with "cédulas hipotecarias" (covered bonds of high quality loans), deposits, senior debt and the inter-bank market all playing an important role.

Nonetheless, the development of the Spanish real estate and credit market has further to run. Regulatory reforms such as the recent changes to mortgage legislation are aimed at improving the framework. Thus, the sector can continue to contribute to economic growth, with a view to meeting the challenges posed by the current normalisation of the real estate market on a sound footing.

Future development of the mortgage market: Challenges and opportunities

In the current economic context, in which supply and demand conditions of the real estate market have become more negative, it would be desirable for credit supply to reduce its reliance on a single, relatively standard product. In this regard, the reform of mortgage legislation provides the legal framework for mortgage supply to be expanded via the introduction of new products. Below we look at three products which have played a small role in the Spanish market: fixed-rate loans, mortgages for purposes other than housing purchase and reverse mortgages.

One way of diversifying mortgages for housing purchase would be to promote fixed-rate loans, given the current preponderance of variable rate mortgages. Under the current system, the financial situation of households is exposed to the fluctuations in the benchmark interest rate, which in turn depends on the decisions of the European Central Bank and based on the needs of the Euro Zone as a whole and not the specific requirements of the Spanish market. This is an ideal setting for a surge in potential demand for fixed-rate loans.

Currently, the supply of fixed-rate loans is relatively limited, even though, in principle, these products could be attractive when interest rates are rising. For banks to include these loans in their portfolios, thereby satisfying this potential demand, the interest rate risk they entail must be sufficiently hedged. The reform of mortgage legislation establishes in greater detail the compensation for interest rate risk for banks and, where this applies, for customers. Also, to avoid the imbalances that could

¹²For more information, see Economic Watch: "Differences between the US and Spanish mortgage markets", Sep 2007, BBVA Economic Research Department.

arise in relatively long-term loans from using fixed rates, refinancing could be used. The refinancing fees have been conveniently reduced in the reform. Nonetheless, it does not seem that the changes introduced are sufficient to compensate the banks for the interest rate risk on such long-term contracts. This means it will be difficult to make them significantly cheaper for customers. The elimination of payment for stamp duty, which was included in the draft of the regulations, would have been a powerful tool for boosting the supply of fixed-rate mortgages.

Another product little used in Spain is **Mortgage Equity Withdrawal** (MEW), the use of mortgage guarantees for purposes other than housing purchase. MEWs became popular during periods of strong housing price growth in Australia, the UK and the United States. In the US, it is estimated that USD133bn were granted in this way in the third quarter of 2007, 5.2% of available household income .

This type of loans offers clear benefits for borrowers, who can finance their expenses at lower rates than via standard consumer credit or personal loans. Furthermore, the use of MEWs should support consumption, helping to ease cyclical fluctuations. In fact, 14% of US MEWs are used to finance consumer spending. In any case, MEWs would help to make liquid real estate wealth, which is significantly higher in Spain than in our neighbour countries. According to the latest Household Financial Survey (2005), 81.3% of households own their primary residence, which is worth 180,300 € in median, but just 26.1% of total Spanish households have outstanding debts because of this acquisition.

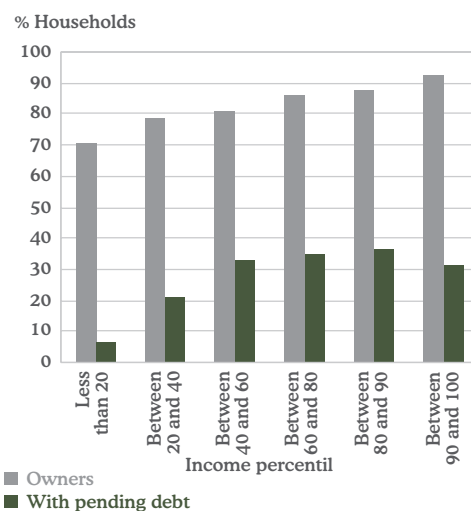
At times of financial difficulties, increasing the amount of existing mortgages (the so-called “rechargeable mortgage”) could help households to sustain their consumer spending. The reform of mortgage regulation supports this option by significantly reducing the fees for mortgage subrogations, modifications and cancellations. In any case, the expected lower growth in the value of real estate assets for the coming years makes it advisable to use MEWs with caution in the short term. Such an option would only be recommendable for households in a relatively comfortable financial situation,

Another option for the future development of Spanish mortgage lending is the reverse mortgage, which involves ceding a dwelling to the bank upon the death of the owner in exchange for an income or a one-off payment whose maximum value would be the value of the home. It is a loan that is paid off when the owner (and his spouse, where this applies) dies. At this moment the inheritors of the home can settle the transaction by selling the property or by mortgaging it to pay off the loan plus interest. Given that a significant proportion of households’ wealth is real estate, especially in southern Europe, making these savings liquid would be a convenient option for households which have cash problems but which also have substantial real estate wealth.

⁰³ Forecast by James Kennedy based on: “Estimates of Home Mortgage Originations, Repayments, and Debt On One to Four Family Residences”, Federal Reserve Board FEDS working paper⁰. 2005-41, Alan Greenspan and James Kennedy.

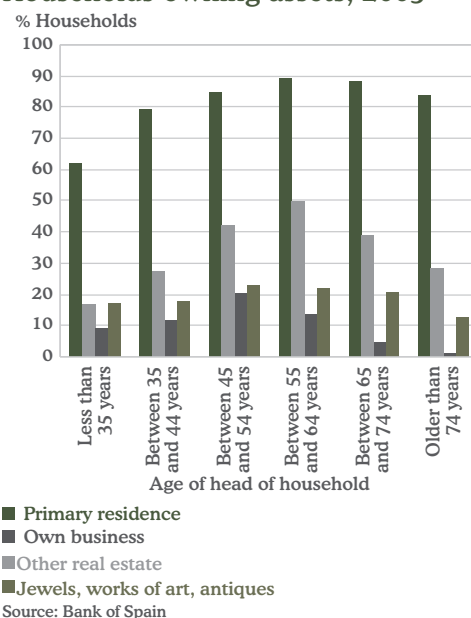
⁰⁴ Deutsche Bank Global Markets Research, Dec 2006.

Chart 6.
Households and Primary Residence, 2005



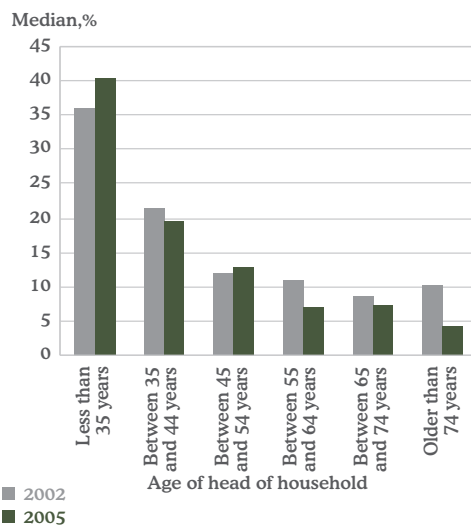
Source: Bank of Spain

Chart 7.
Households owning assets, 2005



Source: Bank of Spain

Chart 8.
Debt/Gross Wealth of Households with Debt



Source: Bank of Spain

One of the reasons why this product is not too popular in Spain compared with English-speaking countries is the reticence of older people, since they are worried about excessive indebtedness, losing their home or not being able to leave it to their family as an inheritance. In order to at least partially allay these fears, the reform of mortgage regulations requires lenders to provide independent advice services, but this requirement has to be clarified by the Economy and Treasury Ministry. In any case, the advisor's impartiality needs to be guaranteed, and the advice offered should not entail an additional charge.

Another obstacle to reverse mortgages is their higher cost in relation to conventional mortgages. This is due to the complexity of the product (especially the need of a longevity insurance, to continue paying customers who exceed their life expectancy), the high administrative, legal and tax costs and the small number of existing transactions, which have prevented any economies of scale. To alleviate these costs, in countries such as the US it is a government body, the Federal Housing Administration (FHA), which provides subsidised insurance contracts. Also, within administrative costs, fees have been reduced as part of the mortgage regulation reform. The benefits of the reform do not apply to reverse mortgages on properties other than the primary residence, limiting its potential benefits.

To sum up, the mortgage market outlook is very uncertain at the moment. However, the financial system must continue developing in order to continue contributing to the growth and stability of the economy.

The mortgage reform

(Law 41/2007, of 7 December, which amended Mortgage Market Law 2/1981 and other rules governing the mortgage and the financial system, as well as the regulation of reverse mortgages and long-term care insurance, and by which certain aspects of law rules were established)

During 2006 and 2007 the main market agents discussed a draft bill about mortgage law reform, sponsored by the Ministry of Justice. Finally the law 14/2007 was published at the end of the year. At this time the Spanish mortgage market was undergoing a period of transition following many years of strong growth. 2006 closed with a mortgage balance of 911.423 billion € and almost 1.6mn new mortgages granted. Nonetheless, the need to carry out a far-reaching reform was something which had been called for by practically all the sectors involved, in order to ensure the model could continue to develop. One only has to recall the conclusions of the Oliver Wyman report, at the request of the European Commission, which described Spain's mortgage system as the worst in Europe in terms of its ability to develop in qualitative terms, and ranked it second last with regard to its ability to develop new products and meet new needs.

The reasons for carrying out the reform included the need to overcome the rigid application of the principle of "accessory"; the need to be able to carry out refinancing without loss of priority, in certain circumstances; and the implementation of new products, which received support at the 3rd National Congress of Spanish Property and Companies Registries (November 2006).

The main features of the reform are:

1. Refinancing mechanisms

Loans or credits which cover the issue of mortgage securities must meet a loan to value ratio of 60% (previously 70%), which can be as high as 80% when the mortgage covers building, refurbishing or purchasing a home. Regulations govern the conditions and assumptions for exceeding the percentages mentioned above, which can reach 95% (for "mortgaged homes", which the law provides for erroneously as the important issue is the purpose of the mortgage, not the type of property), via additional guarantees provided by insurers and credit institutions.

Also, the enactment of the legislation will include a calculation of the equivalent values of real guarantees on properties located in other EU member states.

The institution issuing "*cédulas hipotecarias*" (covered bonds) or mortgage bonds should keep a special accounting register of the loans and credits that serve as collateral of the issues of them and, if any, of the substitute assets fixed that cover them, as well as the derivative financial instruments linked to each issue. These substitute assets could support, in the case of bonds, up to 10% of the principal of each issue

When the bonds are issued in series, setting up a bondholder syndicate is now optional and no longer compulsory. Neither is it now compulsory to register the deed in which the mortgage credits and loans are assigned to the related bond issue.

2. Property Valuation companies

Legislators are concerned about ensuring independence between valuation companies and financial institutions which belong to the same corporate group or whose business makes up 25% or more of their total income, which have to be specified by law. Similarly, regulations cover relations, incompatibilities and conflicts of interest between managers and directors of valuation companies and those of credit institutions. New disciplinary rules for valuation companies have also been laid out in detail.

3. Compensation rules for early repayment

One of the key features of the law are the rules governing compensation for early repayment. These replace the redemption and cancellation fees and are applied to the entire loan or mortgage, whether variable or fixed rate, taken out after the law took effect, as long as one or more of the following circumstances exist:

- That is a mortgage loan or credit and that the mortgage is taken out on a home and the borrower is a private individual.
- That the borrower is a legal entity which pays corporate income tax under the small business tax system (this is currently applicable to companies with a turnover of less than eight million €).

Inclusion within the scope of the new compensation rules, which is clearly designed as a protectionist measure, of this class of legal entities took place in the latter stages of the legislative procedure. Perhaps this is why it seems to be unfair for a private individual who acts as a consumer not to be subject to this regime, when the guarantee offered is, for example, a small business premises, when a business filing under the small business tax system will be subject to this regime, regardless of the type of mortgaged property or the purpose of the financing.

Under the previous legislation, the limits on redemption fees applied solely to variable interest mortgage loans (not credits), regardless of whether the lender was a private individual or a legal entity or whatever the mortgage asset was.

Two types of compensation for early repayment may be agreed:

- Compensation for withdrawal, for an amount equivalent to 0.5% of the capital repaid early when the early repayment occurs in the first five years of life of the loan or 0.25% of the capital when the early repayment occurs after this period.

- Compensation for interest rate risk: This will only be applied when early repayment occurs in an interest period which lasts more than 12 months, and provided the cancellation gives rise to a loss of capital for the credit institution. The law defines how the loss or gain generated by the cancellation is calculated, and how to calculate the market value of the loan or credit. It offers the lender two ways of collecting the compensation (a decision which must be taken on formalising the deed for the loan or credit in the related contract): collecting the agreed percentage or charging the loss incurred, in which case the lender will be obliged to compensate the borrower in the same way when the cancellation gives rise to a capital gain for the lender.

4. A better and more flexible mortgage market

The law amends only three articles and introduces a new one, related to Mortgage Law, together with the articles which reform Law 2/1994 covering subrogation and modification of mortgage loans. Of the former, we would highlight that the clauses covering early repayment and the other financial clauses, provided they are registered favourably, will be registered in the terms as defined in the deed.

The law establishes (new article 153 bis of the Mortgage Law) a new type of mortgage which allows holders to guarantee under the maximum mortgage cover one or more liabilities, either present or future, without requiring a novation agreement for them. These mortgages may only be set up in favour of public administration bodies and financial institutions which operate in the mortgage market, and could undoubtedly make the overall financing of certain businesses and self-employed workers easier and more flexible.

With regard to the reform of law 2/1994 mentioned above, the law includes a requirement to seek a notary's services in all subrogation processes, in order to avoid some of the practices of the past which failed to guarantee the initial borrowers their right to enervate the subrogation.

One of the positive aspects of the reform is that all institutions wishing to subrogate mortgages are obliged to do so for all guaranteed loans or credits in the same property.

A more detailed list is given of the cases which could be subject to novation, subject to tax and tariff advantages under law, which include increasing and reducing the capital and altering the term (previously only lengthening the term was covered). Also, for the first time under the Spanish mortgage system, the mortgage known as the "rechargeable mortgage" is regulated (the name comes from its French precursor, the "hypothèque rechargeable", created by the Ordinance of 23 March 2006). Mortgage loans which are taken out after the law takes effect, when they are subject to a capital increase which does not involve increasing the mortgage liability, will keep the same mort-

gage range as initially registered. The increase will not be in the same range when a request for information about outstanding amounts to be charged in the future has been sent to the Property Register.

5. The reverse mortgage

Although annuity mortgages have existed for many years under Spanish mortgage law, the law regulates them by setting tax exemption for stamp duty and a reduction in notary and registration fees in operations whose main features are: the applicant and the beneficiaries must be aged 65 or over, or receive major or long-term care and the debt can only be called and the guarantee executed when the borrower or the last of the beneficiaries dies. For no apparent reason, the guarantee that is offered is restricted to primary residences.

Only financial institutions and insurance companies authorised to operate in Spain may grant these operations, and the transfer of the mortgaged asset is a cause for early repayment. The amount the creditor can recover is limited to the amount of the assets in the inheritance when the heirs of the mortgage debt decide not to pay the outstanding amounts owed.

Conclusions

Although the final result of the law covered here was well received by the various social and economic agents, it would be wrong to suggest that the reaction was euphoric. This is perhaps because some of the possible reforms, which had been included in the draft bill, disappeared in the final wording, and more importantly, because the costs involved in mortgage operations were not reduced significantly. While it is true that the financial costs on early repayment and notary and registry fees for certain cases were reduced substantially, the tax burden, particularly Stamp Duty, is still very high for new operations and certain novation contracts. Only the new reverse mortgage is exempt from this duty.

Meanwhile, the wording of the law leaves many legal questions unanswered. So, the enactment of the legislation is awaited with interest, as is discovering which criteria are used for implementing and interpreting the law on the part of notaries and property registrars, and particularly the government (the General Directorate of Registries and Notaries) in the day-to-day practice of implementing the new features of this law.

Rafael Sanz Company
Non-Stándard Contracts & Mortgage Lending
BBVA's Legal Services

For further information, contact:

Servicios Generales Difusión BBVA Gran Vía 1 planta 2 48001 Bilbao P 34 944 876 231 F 34 944 876 417 www.bbva.es Legal Deposit: M-3479-1994

Economic Research Department:

Chief Economist:

José Luis Escrivá

Unit Heads:

Europe and Financial Scenarios: Mayte Ledo
 Scenarios and Financial Systems: Carmen Hernansanz
 Spain and Sectorial Analysis: Julián Cubero
 Europe: Sonsoles Castillo

Modelling and quantitative research: Giovanni Di Placido
 Modelling: Rodolfo Méndez

Emerging Markets: Alicia García-Herrero
 Argentina: Ernesto Gaba
 Chile: Miguel Cardoso
 Colombia: Juana Tellez
 Peru: Hugo Perea
 Venezuela: Alejandro Puente
 China: Ya-Lan Liu

North America: Jorge Sicilia
 US: Nathaniel Karp
 Mexico: Adolfo Albo

Global Trends: Joaquín Vial

Previsional Systems Analysis: David Tuesta

other publications



This document was prepared by the Economic Research Department of Banco Bilbao Vizcaya Argentaria, S.A. (BBVA) on its own account and is issued exclusively for the purposes of information. The opinions, estimates, forecasts and recommendations expressed in this document refer to the date which appears on the same and consequently could be subject to changes as a result of market fluctuation.

The opinions, estimates, forecasts and recommendations contained in this document are based on information which has been obtained from sources believed to be reliable but BBVA gives no guarantee, either explicit or implicit, of its accuracy, exhaustiveness or correctness.

This document does not constitute an offer or invitation or incitation for the subscription of purchase of securities.