

17 - 12 = €10bn or the real size of Spain's residential bad loan problem

"Spain accounts for 12% of euro area output but 17% of its residential mortgage stock"

Official Spanish mortgage approvals data for December are due on Thursday 23rd. The approvals data is choppy, but the monthly count is currently running at just over 45k. This is close to the lowest level on record (the series began in January 2003) and around 75% below the January 2007 peak of 180k.

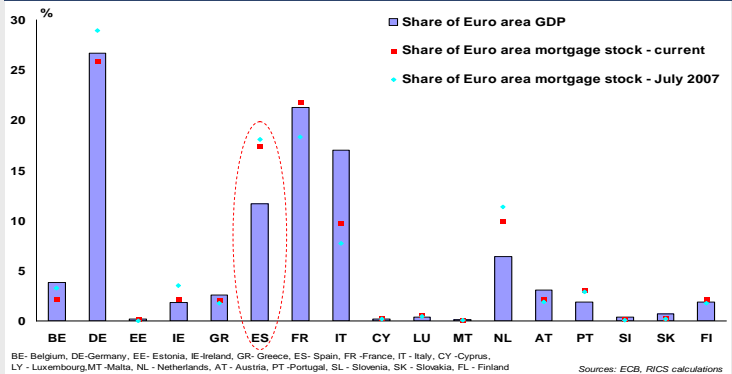
In spite of the dramatic fall in new lending, remarkably, Spain's banks on aggregate are still lending enough to maintain their overall level of exposure to the residential sector. How sustainable this is in the medium to long run is a different matter. One, albeit crude, way of evaluating this is by comparing the relative size of a country's economy (to the euro area total) with that of its mortgage book; these two ratios should be roughly equal and indeed, for almost all countries they are. However, Spain stands out as one of the few countries in the region where there is a massive discrepancy between these two figures; it accounts for 12% of euro area output but 17% of its residential mortgage stock.

Another way of saying 'over exposure' is 'bad debt problem'. To illustrate how big Spain's banks' residential bad debt problem actually is, we just have to calculate the size of the write down it would take to bring the relative size of their mortgage book in line with the relative size of its economy. This figure, it turns out, is €10bn, which is somewhat larger than the €17bn sum quoted by the Bank of Spain only recently (which includes all property and not just residential mortgages). Of course, this kind of 'back of the envelope' calculation is never going to be spot on. However, it indicates the risks of further revisions to the Bank of Spain's bad loan estimate are still skewed heavily to the upside. Given this

situation, alongside the weakness of Spain's economy - with unemployment now 22.9% and output contracting again - we see the number of mortgage approvals falling even lower and unlikely to pick up in a sustained manner at any point during 2012.

"The size of the write down necessary to bring these two numbers in line is €20bn"

Spain's banks still look over exposed to residential property



US housing activity shows modest uptick

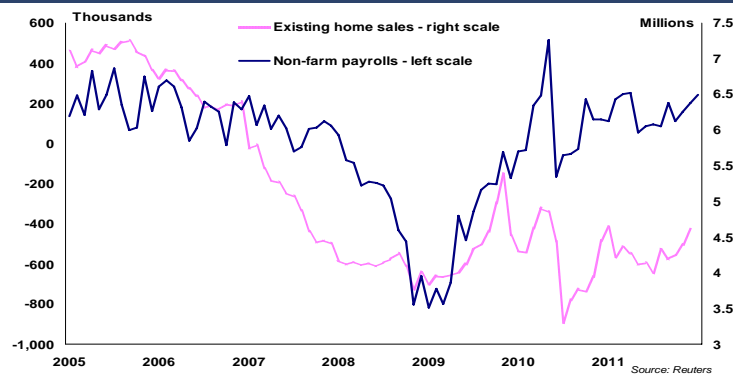
"Existing home sales increased to an 11 month high in December"

Apart from the lack of finance for potential homeowners, the largest factor holding back demand in the housing market has been the weak labour market, but there are signs that that has turned a corner. The latest non-farm payrolls report released this month showed the economy adding 224k jobs in January. Added to this, the upward revision of 60k jobs added in November and December

brings the average for the last three months above 200k. Contrast this to the preceding 6 month period, where the average number of jobs added was 100k a month and one can see the pick up in job creation.

This is feeding through into housing market activity, with existing home sales rising for the third consecutive month in December to an 11 month high (4.6 million annualised – January's figures are released on Wednesday 22nd). That said, it is still a modest recovery, with unemployment levels still elevated (the unemployment rate currently stands at 8.3%) and a large supply overhang putting downward pressure on home prices. This is highlighted by the CaseShiller 20 city house price index, which declined in November to its lowest level since March 2011, and remains 33% below its pre-recession peak. As this measure is not that timely, we expect the index to record modest gains going into December and January on the back of recent labour market strength.

Home sales rise on back of recent employment gains



Turning back to distressed properties, there were 830,000 foreclosed properties in 2011, down from 1.1 million in 2010. This brings the total number of homes foreclosed since September 2008 to a staggering 3.2 million. Added to that, there is approximately 1.4 million homes in the foreclosure process, which will come onto the market as the year progresses. On a brighter note, the government has agreed a \$25 billion settlement with 5 banks over irregularities in their foreclosure processes. This will include \$17 billion in principle reductions to home owners who are behind in their payments and at risk of default, reducing the likelihood of foreclosure. It also provides \$2,000 in compensation to those who have had their homes improperly foreclosed.

"House prices declined in November"



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As sentiment turns sour, Hong Kong mortgage approvals continue to decline

“Housing market sentiment has turned cautious”

Next week, some key economic numbers in Hong Kong are released. This will help determine the health of Hong Kong's economy at the start of 2012. January CPI numbers are released on Monday 20th, followed by employment data on Tuesday 21st.

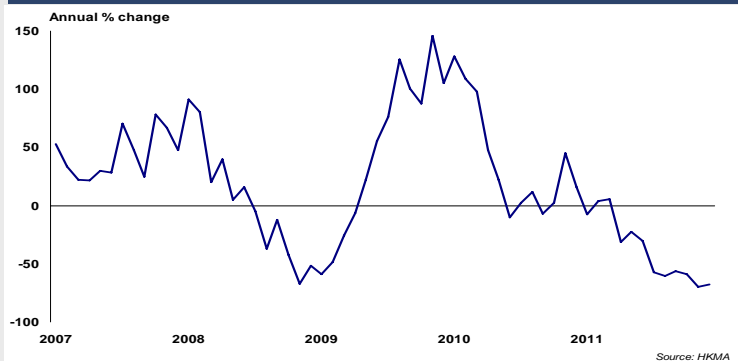
Economic performance in Hong Kong continued to show signs of moderation over the second half of 2011 as the growth momentum slowed amid the global downturn and ongoing eurozone fears. GDP moderated to 3% in Q4, from 4.3% in Q3 as private consumption and export growth lost its vigor. On a positive note, the unemployment rate decreased mildly to 3.3% during the October to December period. The strong growth of Chinese visitor spending should generate additional demand and this, in turn, helps maintain a stable job market. We expect overall conditions in the labour market to stay resilient in the coming few months despite ongoing global instability and weakening corporate hiring sentiment.

Housing market sentiment has turned cautious over recent months due to several rounds of macro-prudential measures and a deteriorating external environment. House prices have continued to rise, but at a slower pace. In December, annual growth in prices moderated to 9%, the first time expansion slipped to single-digit pace since October 2009. The results of the residential mortgage survey for December from the Hong Kong Monetary Authority indicated that the number of mortgage approvals continued the downward trend, declining 15% (from 4,885 in November to 4,158). Alongside this, new loan applications fell by 15% to

6,039. These findings confirm that the sentiment is softening in response to the decline in transactions. Looking forward, transaction volume and prices are likely to continue easing, reflecting the effectiveness of cooling measures and a softer growth outlook.

“Transactions are likely to continue falling”

Mortgage approvals are much lower than year ago levels



UK bank lending to remain subdued

“One key risk to the economy remains tight credit conditions”

Households received a small boost this past week with the news that inflation eased by 0.6 percentage points to 3.6% in January, as last year's VAT hike dropped out the annual comparison. The latest Bank of England Inflation Report suggests inflationary pressures will continue to subside over the coming months due to retreating oil prices, and the bank continues to expect inflation to be below the target range (of 2%) for most of

the forecast period. In addition to a further £50bn in quantitative easing, this will gradually strengthen real incomes, which in turn should support

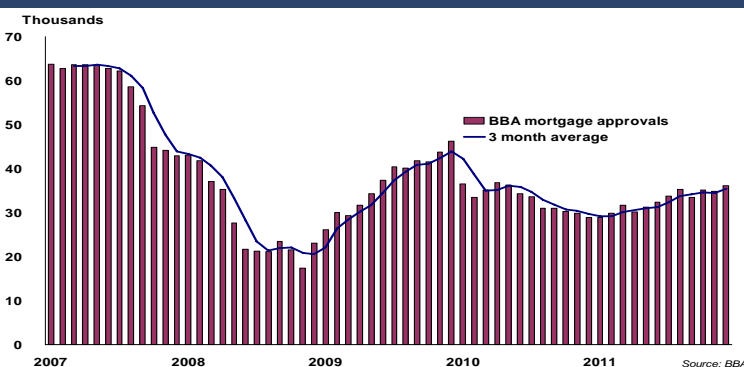
the economy. One key risk to the growth outlook remains the tight credit conditions faced domestically and in Europe.

Euro area tensions intensified in the final three months of the year, causing renewed concern for the UK outlook in 2012. Indeed, the European Central Bank's bank lending survey showed that credit conditions tightened significantly in Q4, and expectations were for standards to tighten further in Q1, albeit at a slower pace. However, the ECB's substantial non-standard liquidity measures has seen stresses yield somewhat in the wholesale money markets. This should help limit the degree of any spill over to the real economy.

To this end, the lending for home purchase data released by the British Bankers Association (BBA) on Thursday 23rd should continue to show lending is broadly flat. Mortgage approvals in December rose modestly by 3.9% to 36,171 from November, but the underlying trend has remained level for much of the past two years. This picture is corroborated by the Bank of England's net lending to individuals report; the January release showed loans approved edging up very slowly, but the trend remains subdued. This is also largely consistent with the outcome from the January RICS Housing Market Survey, which suggests the mood among surveyors is a little better, but on the whole little changed from last month.

“The underlying trend in mortgage approvals is flat”

Mortgage approvals are broadly flat



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