

Bank Loans and Residential Property Market
EURO Reflexes in Portuguese Property Markets

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Presented at the conference of the
European Real Estate Society
Alicante, Spain.
26th to 28th June 2001

1 Introduction

Portuguese economy development has been considered by several authors as one of the few examples of an economy that has progressed from a under-developed economy to a rising and mature economy in the course of four decades.

At the present, Portuguese economy is moving towards a real convergence with the European Union. It is however clear that only a sustained growing process will allow to achieve this goal.

Portuguese economy has seen a high development during the past decade, particularly after 1995. The decision taken by portuguese government to be one of the founding members of the European Monetary Union (EMU) has lead to an effort to reform and stabilise the portuguese economy (ICEP, 1998).

According to Melro (2000) economic growth was founded on three major components of the internal demand:

Families demand – there was a “boom” on families’ expenditure, especially the acquisition of residential properties and durable goods;

Companies demand – a strong growth of companies investment, especially in equipment and machinery;

Public demand - public infrastructure projects, as the Expo 98 or the highway and rail infrastructure, were the most important factors that have contributed to the rise of the public demand.

Families are considered to be the weakest link of this development model, as the most part of their investment was made using bank loans. Families’ insolvency is a mater of concern at the present, in Portugal. Families’ debt service has risen with the inversion of portuguese interest rates comporment pattern occurred in the end of 1999. This has introduced a discussion on the consequences of the high debt rates of portuguese families, estimated to be 85% of the disposable income at the end of 2000 (Banco de Portugal, 2000a).

This paper will aim to analyse the recent development of portuguese residential credit loans and its consequences to the banking system exposure to property risk.

2 Real Estate Risk and the Banking System

Credit risk channel, especially through bank exposure to real estate sector, is considered to be the most important source of concern for banking stability (ECB, 2000).

Banking and Real Estate systems relations have been a matter of concern over the last decade. The recession in property markets of the late 1980s and the beginning of the 1990s has highlighted the consequences of property crashes to the banking system. Comparing the UK property crises of the 1970s and 1990s, Crosby (2000) concludes that both periods have been preceded by a property boom, with substantial increases in the money lent on property.

An explanation to this fact is provided by Herring and Wachter (1999). According to those authors the low-frequency shocks of real estate sectors, the inadequate data and weak analysis and the perverse incentives for the real estate investor to increase the risk

are the main factors that contribute to an increase of the bank system exposure to property market risk.

With the Council Directive 2001/12/CE EU has introduced new rules for the valuation of properties, that serves as guarantee to bank loans and for residential mortgage, and new risk ratios.

Portugal has fully adopted this Directive (Aviso do Banco de Portugal nº 1/2001) with small adjustments. With no limits to the Loan-to-Value-Ratio the portuguese supervisory authority (Banco de Portugal) as introduced a limit to the use of the 50% risk ratio previewed in art. 43-c) of the Council Directive 2001/12/CE only to the credit loans with a Loan-to-Value-Ratio inferior to 75%.

3 10 years of Portuguese Economy

Two main factors have conditioned portuguese economy during the last decade: The decision of portuguese government to be a member of EMU since the beginning, in January of 1999, and the privatisation process of the industrial and financial sectors.

Portugal was one of the EU's fastest growing economies, with a growth rate up to 5% during 1986-90 when the average of EU was 3,3%. During the European recession of 1991-95 the growth rate has drooped to 1,4% to rise again to 3,7% in 1998, against 2,8% of the European average (ICEP, 1998). During the past two years portuguese economy as slowed down and the estimated economic growth to 2001 vary from 2,5% to 3% (Banco de Portugal, 2000a).

During this period, portuguese traditional high inflation has consistently falling, from 13,4% in 1990 to the minimum of 2,2% in 1997 (IECP, 1998). Interest rates have also falling from 17,1% in the beginning of the decade to the minimum of 4,1% in 1998. From 1999, being a member of EMU, portuguese interest rates reflect those from the European Central Bank. Rates have increased in this last two years and have stabilised in 5,2% in the beginning of 2001 (Banco de Portugal, 2001).

Unemployment has been less severe than in the most part of European countries. This rate was 3,9% in 1992, as a consequence of portuguese economic growth after his EU entrance. Following the European recession of the early 1990s this rate has risen to a maximum of 7,5% in 1996 (ICEP, 1998) and has stabilised at 4,5% in 1999 (Banco de Portugal, 2000b).

4 Portuguese Banking System

Portuguese banking system has seen in the recent years a process of acquisitions and has become more concentrated.

At the end of 1999, the portuguese banking system comprised 64 active institutions, 56% of which were domestic branches.

In the last years aggregated assets of banking system have highly increased, due to the growth of domestic credit demand, who represented 46,9% of total assets in the end of

1999 (Banco de Portugal, 1999). This increase of credit demand has been higher than those from client's deposits.

Credit demand and client's deposits ratio of private non-financial residents has quickly developed in recent years, from 60% to 65% between 1989 and 1995 to 110.7% in 1999. To comply with this increase of credit demand portuguese banking system have required financing to international banks with sever consequences to portuguese external debt (Banco de Portugal, 2001)

5 Portuguese Residential Market

If all the construction planed in portuguese Council Urban Planing's (Planos Directores Municipais) was consummated Portugal will need 30 millions habitants (Viana, 2001). In the last Census at 1991, portuguese population was 9.9 million people and it is expected to be 8,1 millions in 2050.

This number reflects the last years portuguese residential policy, with an emphasis in the construction of new houses and the defect of urban regeneration. During 1998, 39.888 construction permits have been issued to residential purposes only and 53.799 new constructions were concluded for the same purpose. From those, 80,1% were new constructions, in opposite of European average, with 22% of new constructions (Viana, 2001).

In the beginning of the 1990s portuguese residential property market has started a sustainable growing, with the benefit of a several factors conjunction: increase of the real disposable income and the reduction of unemployment and interest rates (Martins, 2000). During this decade a average of 69.000 new residential units have been delivered to the market each year, 21.000 less than those needed to fulfil housing needs, which causes an upward pressure in residential prices (Martins, 2000).

6 Portuguese Economy and the Residential Property Market

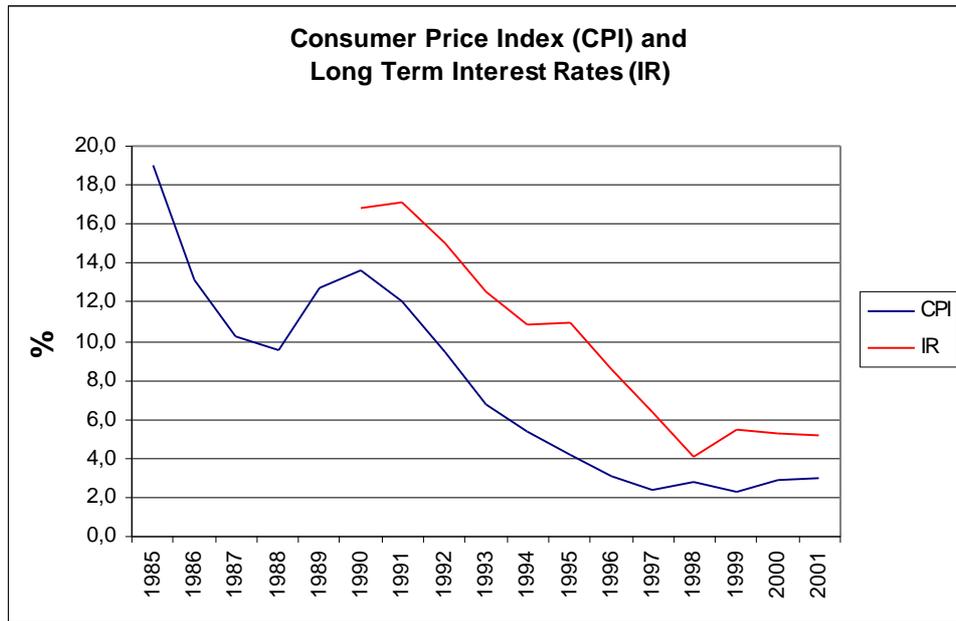


Figure 1- Source: INE, Mateus (1998) and Banco de Portugal (2001)

Since 1990 portuguese consumer price index and long term interest rates have consistently fall. This tendency was altered between 1998 and 1999.

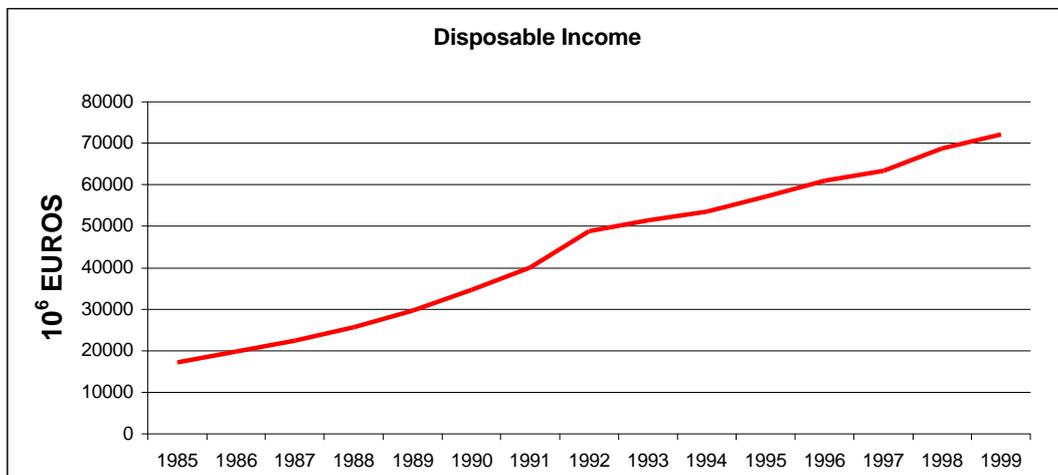


Figure 2 - Source: Mateus (1998) and Banco de Portugal (2000b)

Disposable income has quickly risen after the portuguese entrance in the EU in 1986, with the highest variation rate of 21,7% in 1992. This growth has slowed down after that date, and the only significant difference was in 1998 (at the same time with the lowest interest rate).

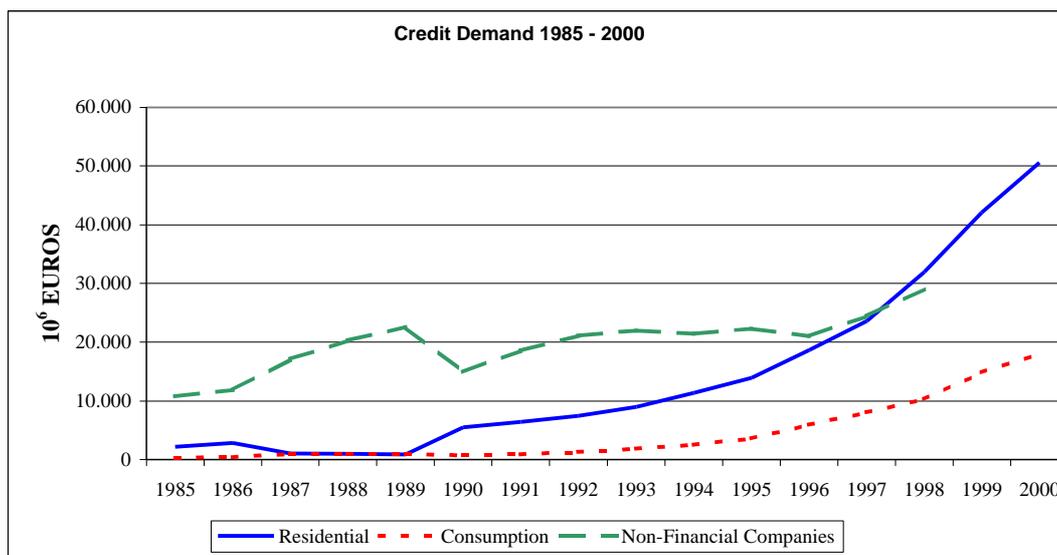


Figure 3 – Sources: INE and Henriques (2001).

Credit demand to residential properties has consistently grown since the beginning of 1990s.

Until 1990/1991 there were quantitative constraints to banking credit in Portugal. The lift of this constraint, associated to a unfavourable economic context of the early 1990s, with a high level of unsettlement's by companies, has stimulated banking system to develop the credit to individual segment (Banco de Portugal, 1996). This situation associated with the rapid falling in interest rates and the growth of disposable income was responsible for the growth of credit demand for residential purchase.

The privatisation of the banking system has also contributed to this growth. New financial groups were competing to market share, and the spreads to residential credit have been reduced drastically to 1% (or even lower to preferential customers).

The variation rate of credit demand for residential purchase has mounted from 16% in 1991 to 35,8% in 1998. In 1997, credit for residential purchase has exceeded for the first time the amount of credit to non-financial companies.

In 1999, the augment of interest rates has cooled portuguese optimism and the growth of the credit for residential purchase has drooped to 32% and it is expected to be 20% in 2000 (Henriques, 2001).

7 Domestic Credit Structure

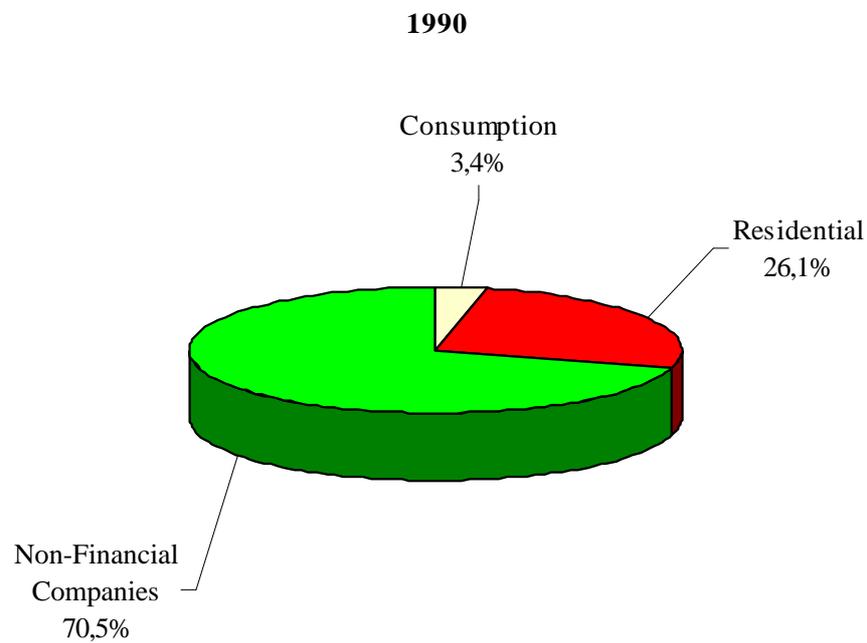


Figure 4 - Source: INE

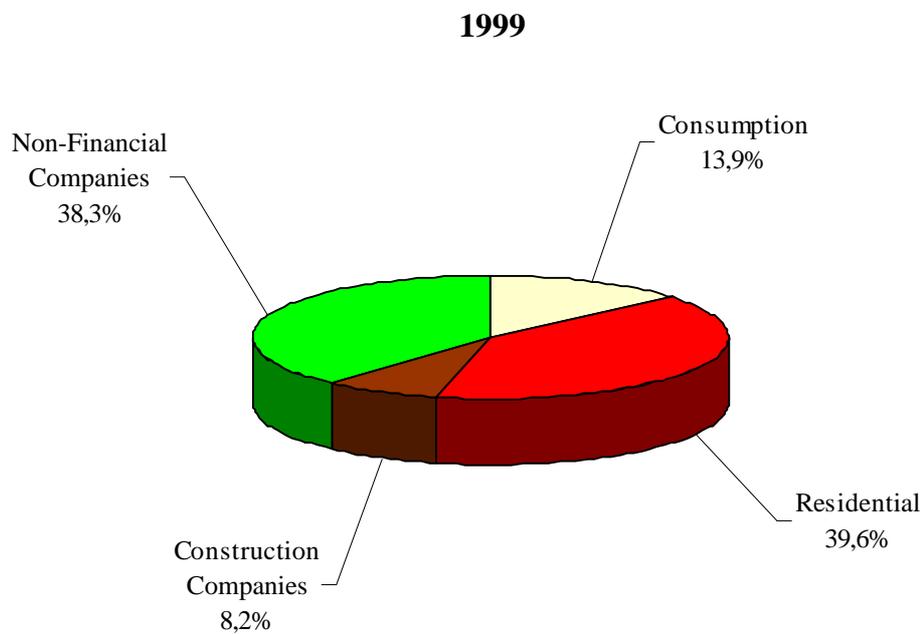


Figure 5 – Source: Banco de Portugal (2000b)

Comparing the evolution of the domestic credit demand structure we can verify that credit for residential purchase has grown 51,7% and it is now the most important group of the banking domestic credit structure. At September of 1999, 71% of the total families' debt was due to house purchase.

Residential, construction companies and real estate related companies credit represented 52,1% of the total credit in 1999 (Banco de Portugal 2001b).

8 Residential Credit and Banking Total Assets

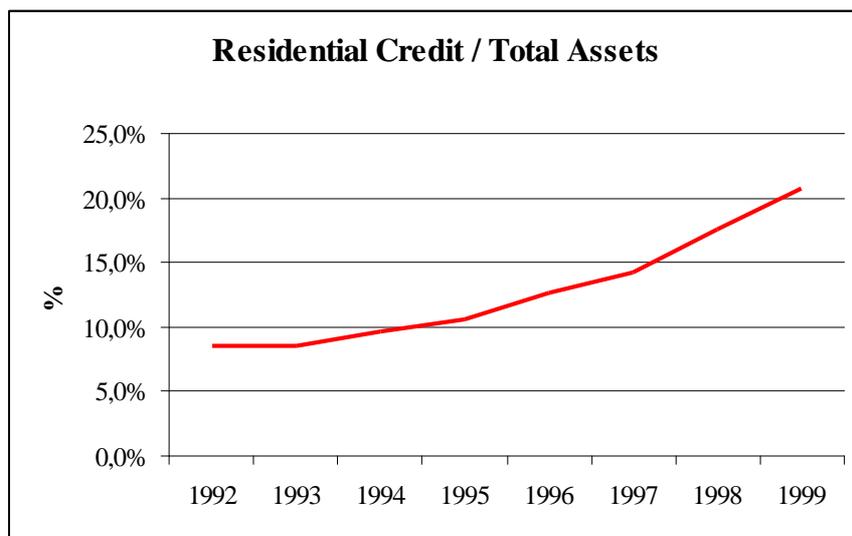


Figure 6 – Source: Banco de Portugal

Banking assets structure has changed in recent years, with the growth of the credit to portuguese entities.

The credit to residential purchase has showed the highest growing rate during the past decade. The relative weight of this credit in the total banking assets has consistently grown, from 8,5% in 1992 to 20,8% in 1999.

The high level of families debt, that is estimated to be 85% at the end of 2000 (Banco de Portugal, 2000a) or even higher than 100% to some market analysts, is the cause of major concerns at the present to the portuguese banking system.

The high debt rate allied with the recent developments of portuguese economy, where it is expected a reduction on disposable income and a growth of the unemployment rate (Semanário Económico, 2001) make us expect the rise of unsettlement's of residential credit. In 1998 the unsettlement rate for the residential credit was of 1,2% of the total credit. The usual practice of renegotiate loan conditions has maintained the low level of unsettlement (Henriques, 2001).

To this concern, contribute also the usual Bank practice to use loan-to-value-ratios close to 1 (or even higher) and the reaction of residential property market to the reduction of demand.

We will add to the previous two other subjects of concern, until now almost ignored by the portuguese supervisory entities: the unregulated portuguese valuation practice and the lack of a property information system.

9 Summary

Banking exposure to property market risk is one of the most important concerns for banking stability.

The economic changes occurred in Portugal after his EU entrance, and especially after the decision of become a member of EMU have considerably changed the domestic credit demand patterns. Consequently, banking exposure to residential property markets has more than doubled in the last decade.

This exposure is now a source of concern to portuguese banking system. Provisions of families' unsettlement become more frequent, due to the high rate of families' debt and the decrease of portuguese economic growth.

The overall exposure of portuguese banking system to general property market is yet an unknown. Real estate used to collateralise non-financial companies' credit and credit to real estate companies is not disclosed in the banking financial statements.

10 References

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