IESE Business School
University of Navarra

Occasional Paper
OP-195-E
September, 2011

LESSONS FROM THE RESIDENTIAL REAL ESTATE CYCLE IN SPAIN. 1997-2007

José Luis Suárez

IESE Occasional Papers seek to present topics of general interest to a wide audience.

IESE Business School – University of Navarra
Av. Pearson, 21 – 08034 Barcelona, Spain. Phone: (+34) 93 253 42 00 Fax: (+34) 93 253 43 43
Camino del Cerro del Águila, 3 (Ctra. de Castilla, km 5,180) – 28023 Madrid, Spain. Phone: (+34) 91 357 08 09 Fax: (+34) 91 357 29 13

Copyright © 2011 IESE Business School.

LESSONS FROM THE RESIDENTIAL REAL ESTATE CYCLE IN SPAIN. 1997-2007

José Luis Suárez[1]

Abstract

Between 1997 and 2007 Spain experienced a particularly strong expansionary cycle in home building, both as regards production and sales volume and as regards price. Although the cycle had a positive impact on the general economy and the quality of the country's housing stock, the downturn and subsequent recession have had devastating effects on the construction, real estate and banking industries. Although these adverse effects are due largely to the inherent inertia of the real estate cycle (there is strong growth during the expansionary phase) and, above all, to the severity of the global economic and financial crisis, certain behaviors on the part of the main industry players (real estate development companies, financial institutions, and central and local government) may have contributed to the depth of the fall. In this paper we point out some of the behaviors that may have made the market players weaker and the negative impact of the downturn stronger. The aim is to draw lessons for the future of the industry.

Keywords: real estate industry, housing, developers, residential, mortgage loans, land use planning.

[1] Professor of Finance, IESE

LESSONS FROM THE RESIDENTIAL REAL ESTATE CYCLE IN SPAIN. 1997-2007

Introduction[1]

Between 1997 and 2007 Spain experienced a particularly vigorous and prolonged expansionary cycle in home building. Average annual housing starts in the five years to 1997 were 248,000, while in the five years from 2002 to 2007 the figure jumped to 657,000 (per year). Also, between the end of 1997 and the end of 2007 the average house price rose 180.4%, i.e., 10.9% per year[2].

This expansion had various effects. The boom benefited society; for example, it generated economic value added (which had a knock-on effect on jobs, corporate earnings, and tax revenue); it improved the national housing stock; and it increased sales of homes to foreigners, which apart from the initial income also generate recurring revenue. The downside has been the huge destructive impact the end of the boom has had on real estate companies (many of which have been forced into administration), with the corresponding loss of value and jobs; the enormous weight of delinquent debt on developers and builders; and the burden of foreclosed assets on the balance sheets of financial institutions.

There are several reasons why the decline in the real estate and financial sectors has been so virulent. Some are exogenous, such as the fact that the change in the home building cycle coincided with a major global economic and financial crisis. Others have to do with particular characteristics of the home building industry that make its ups and downs more pronounced than in other industries. These characteristics include the long project development period, which prevents swift adjustment to changing conditions; the need for, and ease of access to, credit (real estate assets are readily accepted as collateral), which makes companies more vulnerable when the cycle changes; and the low entry barriers, which make real estate development a highly fragmented sector and in expansionary cycles allow the entry of large numbers of new players who lack financial strength and industry know-how and experience.

---

[1] This paper is based on notes taken by IESE Research Assistant Pedro Moragues in the author's classes in the focused program on real estate management, given at IESE in Madrid in June 2011. The author would like to thank the program participants for their comments.

[2] Sociedad de Tasación, S.A. is the source for house prices. The Fotocasa price index (Indice Inmobiliario www.fotocasa.es), which we calculate at IESE, goes back to 2005 (www.fotocasa.es).

The severity of the downturn can also be attributed in part to the behavior of the main players: the developers, the banks and savings banks, and central and local government. Although – in light of historical experience and the previous rapid growth of construction activity and house prices – the change in the cycle can be considered inevitable, certain behaviors contributed to making the consequences of the contraction particularly devastating in what is a crucially important industry for the Spanish economy. The purpose of this paper is to draw lessons from what has happened with a view to future cycles of home building. The intention is not to judge the players' behavior; these lessons come from ex post analysis and were not necessarily easy to imagine before the event.

In what follows we shall discuss specific behaviors of the industry players; but first, there is one general behavior that can be attributed to all the players and that lies at the root of many destructive situations that occurred at the end of the cycle and so is worth mentioning at the outset, namely, the excessive pursuit of growth[3]. Growth was a very clear goal, apparently untempered by other business criteria (in the case of developers and financiers) or considerations of the public good (in the case of central and local government).[4] That all-out pursuit of growth had at least two serious consequences: one was disorderly growth (reflected in the companies and their assets), and the other was a failure to ensure that the players had a minimum financial strength. The former left a trail of unsold, often poor quality assets in unattractive locations, while the latter brought financial difficulties for government, developers and financial institutions. Growth is usually a good thing for an economy, as it is for living organisms; but in business it needs a policy to moderate, guide and consolidate it.

The financial environment

Deposit-taking institutions

Spanish banks pride themselves on having a unique capacity to sell financial products to private individuals (retail banking). In this last business cycle, banks and savings banks made mortgage loans a core element of the retail customer relationship, as mortgage loans were thought to be safer (which proved correct, as in March 2011 only 2.45% of retail mortgages were in default, despite the general economic situation in Spain). Mortgage loans were also thought to bring in more business; it was even said that a mortgage customer could be sold up to eight more products (direct deposit of payroll, life insurance, building insurance, credit and debit cards, and so on). Retail mortgages were used not only to sell other products but also to diversify geographically. Some locally based institutions would look for developers to help them expand into other regions, finance entire developments in the chosen region, and acquire enough end customers to justify opening one or more branches in the new location. In cases such as these, mortgage loans were a tool of geographic expansion.

---

[3] The same excessive pursuit of growth can be seen in local government. It is not unusual in small towns that have had a housing boom to see outsized new government buildings (council and planning offices), clearly out of proportion to the local economy and displaying a blatant lack of the requisite austerity.

[4] A senior manager of a savings bank, who had just explained how fast his bank was growing, was very surprised when asked, "Why are you growing?" He did not have a clear answer.

A peculiarly Spanish product, the "developer loan", which is a type of mortgage loan granted for the construction phase of a real estate development project, deserves special mention. A special feature of the developer loan is that the mortgage can be transferred from the developer to the individual who buys a home by subrogation of the home buyer to the position of the developer as mortgagee. When this happens, the lender that finances the developer becomes a creditor of the developer's end customer, who thus becomes a customer of the bank. In the years of the home building boom, it was said that half of all home buyers took over the mortgage from the developer.

Competition among financial institutions to acquire developers' end customers – the home buyers – led them to move back a step in the production chain: banks started to extend construction loans to developers for the purpose of acquiring retail customers. When the competition in construction loans increased, banks went back another step and started to offer generous loans to buy land. It would be fair to say that the banks did not want the developers as customers – or at least not as much as the amount of finance they provided would suggest – so much as the retail customers. In any case, the rapid growth of mortgage lending, both to home buyers and to developers, led to an obvious problem: risk concentration. The savings banks had as much as 70% of their loan portfolio allocated to the real estate industry. In December 2010, loans by banks and savings banks to developers and builders totaled 430,000 million euros, while total shareholders' equity was 179,000 million.

In lending to end customers, the traditional limits on the amount of the loan in relation to the price of the property (the loan-to-value ratio, or LTV) were not respected. In many cases the LTV ratio was suspected to be above 100%. Added to this imprudent practice were the close ties between the financial institutions and the valuation firms (companies that value real estate using methods regulated by the government). In some cases the valuation firms are owned by the banks; in others they are heavily dependent on the banks for their business.

The race to acquire end customers (on account of the perceived relationship between risk and return and the growth objective) and the cross-selling of products also affected the price of mortgage loans to home buyers and developers. The pricing of mortgage loans did not reflect the risk incurred by the banks in their lending activity. The spread (over the reference rate, which is still mainly the one-year Euribor) could be as high as seventeen basis points for end customers and zero for developers.

In lending to developers, credit approval criteria were relaxed, too. LTV ratios were high and land purchase loans were very generous, breaking a golden rule widely cited in Spain before the expansionary cycle, which says that "land should be financed with equity". Moreover, as the valuation of rural land was often well below the price paid for it and a mortgage loan would not be enough to finance the entire price, purchases of land that would require several years of development before it came into production were financed with short-term credit facilities, as short as a few months, with the intention of rolling them over at each successive maturity!

Perhaps the most pernicious procedure, however, with respect to the quality of the loans that were granted was the use of the loan-to-value concept in lending to developers. LTV makes sense when the collateral is a very liquid asset that can be sold relatively quickly, without having to accept a significant markdown in price. Such ease of sale is associated with leased real estate assets (leased office buildings or shopping centers, for example), which may have that kind of liquidity, but not with land or real estate developments under construction. When the LTV concept is used and a developer wants to obtain the maximum possible financing for a

project, the valuation of the assets is critical. This explains why, during the cycle, developers would complain that the valuation firms failed to reflect all the "value" of the land or projects under construction that the developers wanted financed. Banks calculated the LTV ratio based on the value stated by the valuation firms, which therefore held the key to the financial market.

The concept of loan-to-value was also, erroneously, used to judge the debt policy of entire companies, in association with the concept of net asset value (NAV, the difference between the value of a company's total assets, calculated at "market value", less all the debt held by the company). The concept of NAV comes from the real estate investment business, where the assets are much more liquid than those of a real estate developer (because they generate regular cash flows) and the asset valuation is more "objective"[5]. Thus, a property development company was said to be more or less indebted (implying that the financing was more or less risky) based on the LTV ratio, calculated by dividing the company's debt by the NAV derived from current valuations of the company's land (depending on its land use classification), developments under construction and finished product – when a correct assessment of the degree of indebtedness of any company should be based on its projected cash flows.

The subrogation option (the transfer of the developer's mortgage loan to the home buyer) created the false sensation among developers that the debt was not really theirs, that it would be passed on "naturally" as units were sold (which there was absolutely no doubt they would be); and also among financial institutions that they were not really lending to the developers but to a broad retail customer base (which would become very profitable through cross-selling). If there had not been the subrogation option, the parties would have had to evaluate every loan based on the cash flows generated by the developer, which has been found to be essential in orthodox lending[6].

Another, very closely related factor is that because of certain characteristics of the property development business (the low entry barriers and the relatively large size of individual projects) the most appropriate procedure for analyzing developer loans is the procedure used in project finance. From the point of view of the borrower's liability, project finance can be "corporate", where the debtor is liable for the debt with all its assets, or "non-recourse", where the developer is liable only to the extent of the project cash flows. Given that in non-recourse project finance the lender has less security than in corporate lending, the assessment of the financing tends to be more rigorous and to focus more on the project's capacity to generate cash flows. In most cases, developer loans were treated as corporate debt (i.e., they were analyzed in the context of the overall relationship with the developer and the developer's entire balance sheet and credit history), despite the fact that, although legally the developer was liable with all its assets, the scale of the project was such that if the project failed, the developer would not have sufficient resources to repay the loan. Irrespective of its legal form, a developer loan should be analyzed in terms of the expected cash flows of the project that is being financed.

---

[5] In Spain, one adjective, "inmobiliario", can refer to both real estate investment and home building activities. The role of each player in Spain would probably be clearer if different names were used to refer to residential real estate development, property investment, and real estate agency activities. As it is, companies in all three sectors are called "inmobiliarias".

[6] We are not suggesting that subrogation should be abolished, merely that loans should be evaluated independently of any subrogation.

A general lesson to be drawn from the above is that financial institutions should carry out a more thorough examination of the real estate business they are financing and devote more resources to loan analysis, whether by hiring or training their own staff or engaging external consultants. This is common practice in other industries and in companies' project finance units, even though the amount loaned in many cases is less than the amount of some large real estate projects.

Another behavior of financial institutions that created problems for them when the cycle changed was the practice of getting directly involved in the real estate business by investing their own capital in projects, effectively becoming property developers. This move was motivated by at least two aspirations. One was to obtain a share of the sometimes high margins earned on home building projects. Given that, as lenders, they were already at risk of losing money on projects (the downside risk), some institutions decided that they also wanted a share of the profits (the upside risk). The problem this entailed is obvious: banks were going into a business that was different from banking. One way of bridging the knowledge gap was by partnering with developers, although when the crunch came, it became clear that alliances with developers did not significantly reduce the risk, whatever each party's share in the alliance. Because if things went badly wrong, the bank had no choice but to take over the project because it was not only a partner but also the creditor; and also because of the reputational risk involved.[7]

The monetary authority. The Bank of Spain

A general lesson, not just for Spain, is the great effect that low interest rates have on the price of assets, in this case homes. This is a phenomenon that can be seen all over the world and which in 2011 was felt in Asian countries whose currency is linked to the dollar. In fact, from 2002 to 2006, and occasionally during the boom, Spain had negative real interest rates. In such situations the monetary authorities and financial supervisors should act with extreme caution to prevent price bubbles from forming.

Although bubbles are very difficult to define and identify (they are easier to see after they have burst), it certainly is possible to identify situations of rapid price growth and reduced accessibility of housing, or of diminishing capacity to buy, accompanied by strong growth in real estate finance. The bank supervisory authorities should try to correct such situations by limiting the flow of liquidity toward the real estate sector. The very high correlation during the residential cycle between real estate loan growth and land price growth is easily traceable.

The Bank of Spain cannot be said to have done nothing during the expansionary cycle. Perhaps the best known measure is the so-called "generic provisions", which are built up in good times not to cover doubtful loans but to serve as a "cushion" for bad times. Another successful measure was the limit placed on mortgage securitization, forcing the originating institutions to keep the mortgages on their balance sheets.

---

[7] One way of overcoming this risk accumulation for financial institutions would be for institutions not to hold the debt of projects in which they are shareholders, a rule followed by sophisticated financial institutions in structured projects. In Spain, however, this conflicts with the custom that financial institutions do not finance projects for subsidiaries of competitors. As always, the most prudent policy is, "Let the cobbler stick to his last".

These measures were clearly not enough, however. This is apparent from the fact that in May 2006 the Bank of Spain inspectors wrote a letter to the deputy prime minister and economy minister criticizing the "passive attitude" of Bank of Spain management to the "unsustainable growth of bank credit". In their letter they said: "The Bank of Spain's inspectors do not share the complacent attitude of the governor of the Bank of Spain toward the growing accumulation of risk in the Spanish banking system as a result of the anomalous growth of the domestic real estate market during the six years of his term"[8].

The capital markets. The stock market

The inappropriate application of the NAV concept to real estate developers also wrought havoc in the capital markets, both in the "public" valuation of companies on the stock market and in corporate transactions, such as mergers and acquisitions.

It was striking to see how the stock market valuation of public companies tracked the estimated increase in the appraised value of the land in the companies' portfolios as development progressed, regardless of when or how the land would be used in real estate production. This is not to say that the quality of the land for development purposes is irrelevant, on the contrary. But quality considerations should be combined with an idea of the future use of the land and the cash flows it will generate.

The mere fact that residential real estate companies were listed on the stock market should be viewed more critically, as the stock market is not the right place for every kind of company (and that does not just apply to real estate companies). Being listed requires a certain stability in a company's financial variables that may be more compatible with firms of a certain size, with a more diversified business in terms of products and geographical location and, above all, with a strategy founded on clear, stable criteria. Many real estate developers do not meet these conditions because of the opportunistic element inherent in the real estate business (which we will talk about later), the long project development periods, and the natural variability of the activity. (This disadvantage of real estate development companies may be the reason why worldwide only a small proportion of them are listed.) Being listed may also be harmful to home building companies, as it means having to publish their results at regular intervals and thus attracting considerable media and investor attention, which may drive them to focus on improving short-term results to the detriment of the long term, i.e., of the companies' value.

The M&A consultants did a poor job recommending acquisitions at prices based excessively on NAV, with heavily leveraged financing structures and high LTV ratios.

Real estate developers

The real estate business has the advantage that its raw material (land) and its work in process and finished goods (projects under construction and finished projects) are readily accepted as collateral for loans and advances. This is a big advantage, as it facilitates debt financing; but it also increases the need for prudence when choosing a financial structure. The responsibility for the inappropriate financial arrangements described earlier in relation to lenders belongs in equal amount to the real estate developers that requested and accepted such loans.

---

[8] Cf. Alcalá General Register. Entry. Ministry of Economy and Finance Number 20205/RG 40736. 26-05-2006.

Continuing in the financial sphere, another shortcoming of the recent cycle that can be attributed as much to the financial institutions as to the developers is the widespread dissolution of the customer relationship. The availability of funding and the growth appetite of financial institutions sparked fierce competition among institutions and put developers in a very strong bargaining position. In almost every deal, the developers would run a "beauty contest", with the result that they would end up borrowing from numerous different banks. As a result, when the downturn came, even the smaller ones found they had dozens of creditors. Yet none of them thought it was their problem. That is why there is an urgent need to rebuild the relationship between banks and companies[9].

From an operational point of view, some companies abandoned responsibility for their main management policies. One such policy had to do with the size of the projects they took on, which no longer depended on what management wanted but on whether or not financing was available. In many cases, events confirmed the stereotype that "if a developer builds ten homes and the homes sell well, the next project will be a hundred homes, the next a thousand, and so on, until eventually a project fails, by which time the project will be so huge compared to the company's capacity that the company will collapse".

Other decisions that tended to be dictated from outside the company were the location and type of development, both of which should be essential parts of a company's strategy. The location and the type of product were effectively determined by the availability of land, partly because of the convoluted system of land use management in Spain, which we will talk about later. Real estate development will always have a larger component of opportunism than other sectors of the economy because every plot of land (the essential raw material) is by nature unique, so every real estate development project is special and different. Even so, the singularity of every project must be coupled with a business strategy that recognizes the limits of the company's knowledge in order to get the best possible results and avoid unmanageable risks.

High land prices distorted the developers' cost estimates and led to confusion among management when assessing the other costs incurred. The combination of high land prices and pressure to get developments onto the market in order to free up borrowing capacity prompted companies to incur costs that were incompatible with the efficiency they would have aimed for in calmer times.

As a result of this randomness in project selection and the excessive emphasis on growth, developers lost sight of the end customer. Most of their efforts went into securing land and financing, while less attention was paid to the other activities in the production cycle (including product design). It was not uncommon to hear developers talk about "customer focus", but ultimately all the products they offered were much the same. Product design was determined by considerations other than the interests of the customer, including the need to make homes affordable despite higher development and, above all, land costs, which led developers to build increasingly smaller units, whereas more recent experience, since the downturn, shows that customers value (and need) space. In reality, the companies were more oriented to the product (and how quickly they could get it onto the market) than to the customer. At the time it was jokingly said that "you don't need to sell apartments, they sell themselves".

---

[9] The need to rebuild the relationship between banks and customers applies to all sectors. The effects of the excessive liquidity were felt in all sectors, and the practice of companies splitting their banking business among many different financial institutions was widespread.

The project valuation techniques used were rudimentary, often confined to a static overall income statement of the entire development (which compared total projected revenues, ignoring time, with total expenses), if not merely to the attributable land cost (which compared the property selling price per square meter to the price of the buildable land per square meter). A senior manager of a financial institution once told me she suspected that in some cases developers would submit a project to a bank without a detailed analysis, thinking that if the project was accepted, it must be because the bank thought it was a good project; while the bank would approve the loan without much analysis, thinking that if the developer had submitted it, it must be because the developer knew it was a good project[10].

In the vacation property segment a major strategic error was committed. In many cases it was thought that the holiday homes business was similar to the primary residence business; and that may well have been true so long as homes "sold themselves". But it could only ever be true under those circumstances. This led many developers of primary residences to develop holiday homes. Everybody needs a primary residence, whereas nobody needs a holiday home: that on its own makes the task of selling each product radically different. Another differentiating factor is that a large proportion of holiday homes are sold to citizens of other countries, remote from Spain not only physically but also in customs, preferences, currency and language[11]. The vices of primary home development (such as the lack of strategic orientation and detachment from the customer) were carried over into holiday home development, where they proved even more harmful, as witness the fact that 55% of the stock of new housing remaining unsold in 2011 was situated in the Spanish Mediterranean Arc.

The lack of strategic orientation and bad outside advice led many companies to confuse the home building business with real estate investment, failing to recognize that these are two very different businesses, requiring different types of know-how, which are not usually combined in the same company. The simplistic reasoning, still heard in the industry today, was that developers need to have a property investment activity that will generate sufficient recurring revenue to enable them to survive in lean periods. But if it were that easy to protect against changes in the cycle, all companies should do it, not just developers, most which have no special advantage in the property investment activity (even though both involve "bricks and mortar"), as it obviously requires specific know-how. A developer that wanted stable income should rather look to activities it knows, and diversify in products or geographically, on an appropriate scale, with low borrowing or high liquidity.

---

[10] According to finance textbooks, project evaluation should include a financial analysis to ensure that payment obligations can be met, and a return analysis to determine whether the project delivers the risk-adjusted return when the cash flows are calculated over time. Both analyses should be backed up with a sensitivity analysis to challenge the initial assumptions.

[11] Proof of this were the extremely high fees (up to and beyond 20%) that developers had to pay to brokers for selling to foreign customers whom the developers did not know.

Government

Current real estate industry regulation is not conducive to stability; in fact, it amplifies housing cycles. The main macro policies on land and housing are obsolete and out of step with the industry. Attempts to bring them up to date have been improvised[12], with no overall grasp of the industry that takes account of the wider interests of society[13]. The decentralization of land use planning authority to the autonomous communities has added to the confusion and aggravates the regulatory and management inefficiency.

Land use regulation

Land use law has created a scarce resource where there is none. Spain is a country with low population density compared to the rest of Europe, so land prices ought to be below the European average; yet the opposite is the case. There is no regional planning to coordinate land needs and land management by local government and to reduce the decision-making discretion of civil servants and politicians, which (often driven by misguided local self-interest) creates unnecessary delays in projects and adds costs that push up house prices. In many cases during the boom, councils would demand compensation unrelated to the development itself – such as building a municipal sports center or swimming pool, sponsoring the local fiesta, etc. – in return for granting the necessary licenses. Land use management was a spurious source of revenue for local councils, aside from local tax revenue, as is abundantly clear from the financial distress that has characterized local government finances since the property boom ended.

It is said that three letters (PAU[14]) and ten years stand between a plot of land zoned for development (i.e., land in the process of being prepared for development) and developed land (i.e., land that has the necessary infrastructure to be built on). This may be an exaggeration in some cases, but not in all. Madrid's most recent Land Use Action Plans took some twenty years to complete.[15] These very long time horizons have resulted in inefficient decisions by real estate developers, which found themselves obliged to acquire more land than necessary because of the uncertainty as to the availability of further land during the development process. Accordingly, they would buy as much land as they could, irrespective of whether it would serve their purposes, with a sensation of legal uncertainty hardly befitting of a "constitutional state". This situation was further complicated by the fact that, in Spain, companies beyond a certain size are obliged to operate under different land laws in every autonomous community they operate in.

---

[12] The measures adopted in mid-2011, reducing value added tax (VAT) on sales of new homes for just a few months, illustrates the lack of stable criteria in the regulation of the real estate sector.

[13] The main body of the existing land legislation goes back to the 1956 law. Social housing (VPO) was established by Decree 2131/1963 of 24 July, although it had been spoken of ever since the creation of the National Housing Institute in 1939.

[14] "Programa de Actuación Urbanística", or Land Use Action Plan: an action plan by which a municipality implements part of its overall land use plan.

[15] The action plans in question are those of Arroyo del Fresno, Carabanchel, Las Tablas, Montecarmelo, Sanchinarro and Vallecas, established in the early 1990s but not implemented until well into the 21st century. Cf. Suárez, José Luis (editor), El nuevo Plan General de Ordenación Urbana de Madrid, Estudios y Ediciones IESE, S.L., 1997.

The decision-making discretion of local governments in regulating and managing land use has become restrictive, but paradoxically this has not resulted in less development land but more, owing to the inefficient business decisions mentioned earlier, which gave rise to a large stock of land at various stages of development. Since the end of the boom, this stock of land has been a millstone on the balance sheets of developers and also on those of financial institutions, as a result of foreclosure. The uncertainty as to the timetable of the land use management process, combined with the outcome of this process, drove up land prices.

The strong land price growth dazzled many players, who lost sight of the fact that home building is an industrial business. They mistakenly associated it more with a relationship business, where skillful land use management could easily multiply the investment[16]. As a result, developers swung between being home builders and land managers, and the sector attracted new players who did not necessarily have any experience in the property business.

The legislation should be uniform at the national level, and the constitution could be reformed to that end, as was done in 2011 with respect to other important economic matters. Planning, on the other hand, should be regional, so as to avoid the inefficiencies of inadequate scale; and management should be much less discretionary, giving preference to projects that are presented within the framework of plans that have already been approved. Legal certainty could be strengthened by withdrawing from government authorities the power to decide in matters that could be decided automatically, such as verification by third parties (such as notaries) of compliance with applicable law and planning requirements. Approval should be considered more or less mandatory provided applicable legal requirements are met, and the decision criteria of civil servants and politicians should be modified to orient them more toward business interests and general welfare. As an example of the latter, precedence could be given to projects presented by financially solvent companies with appropriate know-how and experience, rather than inexperienced, first-time “developers” whose main qualifications consist of personal influence and willingness to pander to the demands of local authorities.

If there were more respect for business criteria in land use management, credible, financially solvent projects by developers who are willing to put their own money on the line would be well received. The level of improvisation in land use management has been made all the greater by the intervention of “land development agents”, a figure created in order to speed up the development of land belonging to third parties, sometimes coercively. Apart from possibly infringing the principle of private property[17], the option of becoming a land development agent has opened up the real estate development business to people who lack the necessary experience and resources and whose actions have heightened the destructive impact of the cyclical downturn[18].

---

[16] Some developers thought that the physical construction dented the margin earned in the land development phase. They felt they could make more money by developing the land and selling it to third parties, although if they did, they would damage their standing vis-à-vis the local authorities in subsequent rounds of development.

[17] This apparent violation of property rights, whereby owners are forced to take part in development projects against their will, has seriously damaged Spain’s reputation abroad.

[18] The Valencian Community, which pioneered this management method, has seen swings in the prices of assets and companies on at least the same scale as other regions and has the largest stock of unsold homes compared to its population.

Housing policy. Social housing

Housing policy is misunderstood. It is widely believed that the "constitutional mandate"[19] is to provide cheap owner-occupied housing to beneficiaries selected on a more or less discretionary basis. A more appropriate housing policy, however, would ensure access to housing on reasonable terms to society at large, not to particular groups, which may not be the ones most in need. Social, or subsidized, housing may have been a useful device at one time, many decades ago in very different circumstances; but a change is urgently needed.

Social housing exacerbated the expansionary cycle in at least two ways: first, by giving priority to ownership over rental, which pushed up prices. In Spain 86% of homes are owner-occupied. Such a high percentage signifies innumerable buying decisions by private individuals (many of them inefficient, simply because house purchase is not the best option for everybody), and fewer large-scale decisions by institutional investors who invest in rental housing. If the percentage of property rental were higher, new homes would be cheaper and better adapted to the needs of their occupants.

Another factor that fueled the real estate boom, in this case on the side of prices, was the obligation when building housing for sale on the private market to also build social housing. For a development as a whole to be profitable, the private housing obviously had to subsidize the social housing, giving rise to an unjust and inefficient situation where buyers of private housing pay for a housing policy decided by government.

Housing policy needs to be separated from social housing, as social housing is only one aspect of housing policy. Housing policy should address the whole of society and the overall balance of the housing supply. It should include, for instance, refurbishment (of commercial property, as opposed to private home improvement, which the government tried to stimulate after the downturn). In a country in which property ownership is so highly fragmented, this requires better regulation and coordination of different interests. Another policy objective should be to reduce land prices, as the periods of expansion bear witness to a rise in house prices that causes even steeper increases in land prices, in some cases providing an exaggerated return to land owners (who were the real winners in the 1997-2007 expansionary cycle). Those gains should be limited through fairer treatment of private housing by government.

Perhaps the name "protected housing" (in Spanish, "social housing" is known as "protected housing") should be changed, as we should be protecting citizens, not houses. The term "social housing", used in many countries, is more appropriate, as it prompts consideration of whether the housing should be owned or rented. It may well be that there is no one solution; but there is no doubt that the solution will have more to do with rental than with ownership, in the interests of efficiency in the use of housing (rental is often more efficient than ownership) and in the use of public resources. Giving a social housing tenant the right to buy at a price well below the market price of similar homes in the same location can sometimes be an unfair reward, and although efforts have been made to correct the situation (by imposing a holding period, for instance), they have proved inefficient and merely create additional complications.

---

[19] Article 47 of the Spanish Constitution establishes the right to housing.

In the last few years of the expansionary cycle and in the period since then, the idea that the home ownership rate should be reduced in favor of home rental has gained ground, yet no steps have been taken in that direction. It is easy to see that the proportion of home rental is not going to increase merely through the contribution of rental housing by private individuals who happen to own one or two properties for rent, but that the solution must come from institutional investors. Policies to promote rental must take the publicly owned housing stock into account and must stimulate investment in rental housing, which is a low-return investment and in many countries is subsidized. Besides ensuring that large housing portfolios earn a decent return, steps should be taken to favor the legal forms used by institutional real estate investors. The operating framework for open-end real estate funds (which have had poor results in Spain so far, but which ought to be a means of channeling private savings toward the real estate sector) and publicly traded real estate investment companies, or SOCIMI (the equivalent of Real Estate Investment Trusts, or REITs), needs to be reformed. Such institutions are present in almost every other country in the developed world, but operating under much clearer, more favorable rules of the game than in Spain[20].

Final considerations

In this paper we describe the behavior of financial institutions, real estate developers and government that we consider most important in order to understand the expansionary real estate cycle that took place in Spain between 1997 and 2007. The aim has been to draw lessons that may be of help in other cases, as "a crisis is too important to waste"[21]. We must learn from past mistakes, so that when the recession that started in 2007 finally ends, we once again have a strong real estate industry. Despite the woeful state it finds itself in during the recession, the home building sector will once again be a pillar of the economy, as it is in all countries.

A general lesson from the boom is that the belief that house prices never fall gave a false sense of security to many people, including private individuals, who "invested" in what was called the housing "options market", i.e., buying off plan under a private contract and then, when the house was finished and it was time to sign the deed of purchase, offloading it onto another buyer, reaping a large profit in the process. The belief that home prices never go down also influenced the behavior of real estate developers and financial institutions.

In their defense it has to be pointed out that the real estate industry has extremely low entry barriers (and low exit barriers, too, on account of the high proportion of debt financing), which makes it especially permeable to the entry of new players, who do not necessarily know the business[22], thus lowering the industry's "intelligence", distorting decision making, and hindering, if not utterly preventing, self-regulation, even in extreme situations.

---

[20] The ineffectiveness of SOCIMI regulation is apparent from the virtually zero impact it has had on the real estate industry, although this is also partly due to the fact that the regulation came into effect after the downturn.

[21] A remark attributed to a chief of staff of U.S. President Barack Obama.

[22] At the height of the expansionary cycle, the following joke was heard: "What does a doctor do? Open an office. And two doctors? Open a private clinic. And three doctors? A real estate development."