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Spanish Banks Try to Build Their Way Out of Home Glut

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MADRID—On a weedy dirt lot here, lender Bankia is pursuing its answer to a banking and property crisis that has left Spain with a glut of around one million vacant homes. Its approach: Build even more.

Bankia and a local developer plan to build a 212-unit housing complex featuring a gym and movie theater on the central Madrid site where a bus station once stood. Construction begins early this year, even though sales of existing properties are practically nonexistent and only 45 of the planned new units have been sold in advance.

"The market is at a standstill," said César Cabal, a real-estate broker working with the developers.

The drive to keep building in a housing market drowning in empty properties shows the depth of Spain's banking crisis. The country's housing bust saddled banks with not just vacant homes, but also billions of euros worth of undeveloped land.

Yet rather than writing off the land as a loss and attempting to sell it, Bankia and its peers have begun selectively building on empty lots. In some cases there are buyers lined up but in other cases there aren't.

A Bankia spokesman said the bank is building only in high-demand areas, like central Madrid, and that the new projects are a smart way to give a dud asset new value.

There were about 700,000 vacant newly built homes at the end of 2010, the most recent numbers available, according to Spanish government figures. Including repossessed properties, some economists and real-estate consultants estimate the total could be as high as one million, or even 1.5 million. There were 19,457 housing starts in the third quarter of last year, down 7% from the second quarter and down 5% from the year-earlier period. Ernesto Tarazona of consultant Knight Frank España SA estimates that Spanish banks and cajas will develop 5,000 to 6,000 new units in the next two years.

Lenders are hoping that the moribund Spanish property market will pick back up. But that is hardly a sure thing in a country with more than 22% unemployment and uncertain growth prospects.

Banks are trolling for foreign buyers, and last year—with Spanish officials in tow—they went on property roadshows in the U.K., the Netherlands, Germany and Sweden. They served wine and Spanish ham, and pitched Spain's sunny climate and relaxed lifestyle.

Even meager home sales could benefit certain lenders in Spain. But there are concerns that building more homes will drive prices down further, compounding the problems of the housing market, and by extension, the banking sector.

Since its property bubble burst in early 2008, the Spanish financial sector has been dogged by fears that it has put off doing a deep clean of the estimated €176 billion ($224 billion) in troubled assets sitting on its books. Banks have set aside funds to cover about a third of that amount.

The Bank of Spain has forced a wave of bank consolidation and recapitalization, resulting in new entities like Bankia, created by the forced merger of seven regional savings banks. Over the past two years, Spain has injected a total of

€22.3 billion into its banking sector, from the state or its deposit guarantee fund, and dodged the market cross-hairs as concerns about euro-zone debt shifted to Italy.

Spain's new finance minister, Luis de Guindos, said earlier this month the sector will need an additional €50 billion to swallow losses on its bad property holdings. Eager to avoid a state-financed bailout, Mr. Guindos said the money would come from banks' own profits over several years, after another round of mergers in the sector.

But some economists fear such moves still don't go far enough. Unless the now-struggling banks start generating enough profits to absorb these losses, the sector could face a state-backed or international bailout, said José García Montalvo, an economics professor at the University of Pompeu Fabra in Barcelona.

"Spain's strategy has been 'wait and see. We'll inject money but little by little,'" said Mr. García Montalvo. "We are no longer in 'wait and see.' Now we are in 'wait and pray.'"

The same drawn-out approach to bank woes has been seen elsewhere in Europe. French banks fought for several years to avoid shoring up their loss-absorbing buffers. But worries about their health have persisted, hitting their share prices hard and restricting their access to funds.

Even if the Spanish government wanted to intervene, it has become very expensive to do so. Spain has been paying a record premium on its debt and would have much more difficulty raising needed funds that it would have had even six months ago. The interest rate it must pay its borrowers has hovered between 5% and more than 6% in recent months, close to an unsustainable level of payments for the government in the long term.

Problems with property exposure have plagued Spain's banks since its housing boom began to collapse in 2007. The year before, Spain built more housing units than Germany, the U.K. and Italy combined, according to data from the European Mortgage Federation.

Especially hard-hit were Spain's regional savings banks, known as cajas de ahorro—or savings boxes. Local lenders often controlled by regional politicians or even the Catholic Church, they lent heavily to local construction firms and projects.

When the market crashed, the banking sector acquired €60 billion in properties, either through repossession or assets required in exchange for debt forgiveness. Savings banks were particularly saddled with these assets: They own €40 billion of the total, according to government and bank data.

In the past two years, the former government of Prime Minister José Luis Rodríguez Zapatero made strides in addressing the issues through broad reforms in Spain's financial sector. The government shepherded the consolidation and strengthened the savings banks, shrinking the number of players as stronger ones merged with weaker ones.

Some investors remain skeptical. Graham Neilson, chief investment strategist at Cairn Capital Ltd., a London-based fixed-income asset manager, said many banks still are carrying real estate at unrealistic valuations on their books. "Some of these assets are close to worthless but have not been marked as anywhere near to that," he said.

Problems have continued to emerge. The Bank of Spain took over troubled lender Caja de Ahorros del Mediterraneo in July, and in December the government decided to inject several billion euros from the Spanish bank insurance fund to help ease its sale for a single euro to Banco de Sabadell SA. In early December, it nationalized Banco de Valencia, infusing a lifeline of €1 billion.

Analysts and investors say that the practice of building on empty lots is one among several moves that have helped banks obscure the size of inevitable losses. They say that banks also have been refinancing loans to developers that in many cases have little hope of paying them back.

Spain's banks have €338 billion in exposure to the real-estate sector, mostly through loans to developers, according to Bank of Spain data. This number has hardly budged in the past three years, despite a wave of developer bankruptcies following the property market decline.

Joaquín Maudos, a professor of economics at the University of Valencia, said that statistic indicates banks are continuing to refinance loans, instead of writing them off. "They are putting makeup on these bad loans," he said.

A division of Sergesprom 2000, a struggling midsize developer in Catalonia, is one example. It received about a €30 million loan from a local savings bank to build 200 homes during the property boom. But the market collapsed, and Francisco Gómez, the building firm's chief executive, said he hasn't been able to sell the homes, or even pay interest on the loan, for the past three years.

Instead of foreclosing, he said the bank—which he won't name—has been lending him more money to cover the interest payments, adding an extra €3 million to the total debt. Mr. Gómez isn't confident he can pay it off. He has said he has been "on my hands and knees to ask the banks to please give me work" completing unfinished homes the banks have repossessed.

A spokesman for CECA, Spain's savings-bank association, said that some developers still have some ability to pay. "We're in a down cycle right now," he said. "These things take time."

A Bank of Spain spokesman said it doesn't permit banks to disguise bad loans in any way, and has strict rules that require disclosure and funds to be set aside cover such loans.

Things were looking up at the beginning of last year, with a 32% increase in foreign investment in Spanish property. But now euro-zone fears have taken a deeper hold on the continent, and buyers have pulled back. Home sales were 81,310 units in the third quarter, down 2.6% from the previous quarter, and down 34% from a year earlier, according to Spain's national institute of statistics. The situation is growing still worse, as cash-strapped Spaniards have trouble paying their mortgages.

Home repossessions totaled 10,869 in the third quarter, up 14.2% from the period a year earlier, according to data from Spain's courts.

Selling down banks' housing inventory "is like bailing out a boat as more water is coming in," said Robert Evans, a real-estate agent for several Spanish banks.

Yet banks are building in strategic spots, where they say there is more demand. Banco de Sabadell, a midsize lender based in Barcelona, is building or planning to build 50 new construction projects, and also funding the completion of 150 projects that developers wouldn't have otherwise finished because of slack demand, said Salvador Grané, director of the bank's real-estate division. Meanwhile smaller Banco Pastor is working on five new apartment buildings around Madrid and the northwest.

Mr. Cabal, the real-estate broker, is pitching properties for the Bankia project in central Madrid. The bus-station location sits near the intersection of two freeways, and homes will have features like floorboard heating systems and a device that can automatically draw the blinds, start the clothes washer or call the fire department. The bank is selling them for about €4,500 a square meter and sharing the proceeds with the developer.

"People are hiding their money under the floor boards, and they won't take it out until things are better," Mr. Cabal said. "With the euro fears, we're all scared stiff" about whether the homes will sell.

In some instances, banks are waiting until they have lined up buyers before starting construction. Banco Pastor took possession of a parcel in one of Madrid's upscale districts in 2008. It is now continuing to round up home buyers for Mindanao House, with 104 of its 130 apartments spoken for. It started construction early last year, when about 50 units were already spoken for.

In all, Banco Pastor is involved in building or completing 10 projects assessed at €160 million. The bank and clients are putting up an additional €35 million to build and finish the structures.

This year, Pablo Rodríguez-Losada, Banco Pastor's director of real estate, says the bank plans to put into motion another €150 million worth of its land portfolio.

Mr. Rodríguez-Losada says market studies have shown there is a demand from well-off buyers for high-end new housing in and around big cities.

As the new homes go up, older developments languish. The Valcastillo development in Pioz, northeast of Madrid, comprises about 500 homes on the outskirts of town that were built by a developer at the height of the boom. Yards in the developments are overgrown with weeds, metal sockets have been torn out, and plaster is crumbling off brick walls.

About half of the Valcastillo homes are occupied. For two years, Manuel García of real-estate agent Básico Homes has been trying to sell 108 of the rest.

The bank that owns them, Grupo Caixa Catalunya, contracted Mr. García's company to help sell the empty homes. The initial developer had been pitching them for €169,000, but Básico thought they would move if priced under €120,000. The plan at first was to sell the homes at around that price and then slowly raise it as demand grew, unloading all the property in two years, he says.

"It was optimistic," says Mr. García. So far, he has only sold 27 homes.

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