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## Guarantees and collaterals value in NPLs

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### Abstract

The burst of the subprime mortgage crisis affected on a large scale the Italian real estate industry. The Italian real estate market underwent and is still undergoing a severe stagnancy due to the credit crunch worsened by the banking system and the resulting lack of liquidity. In financing real estate property investments, security packages play an extremely important role and guarantees have become a major tool for risk management and financial innovation in order to facilitate credit enhancement and hedging of risks. In this context the evaluation of guarantees and collaterals becomes extremely important. A robust measure of the value of collaterals is more than a key issue in times of financial crisis, when the value of the guarantees is questioned. Aim of this paper is to investigate, on a sample of 89 foreclosures, whether the collaterals were overestimated and the mortgage lending value represents a robust measure of the mortgage underlying guarantee.

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*Keywords:* Collateral; foreclosure; guarantee; mortgage; non-performing loan.

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### 1. Introduction and related literature

The financial crisis erupted in late 2006 in the United States had such a severe impact, still evolving, on the world economy that is considered as the worst economic crisis since the Great Depression. The crisis began approximately in the second half of 2006, when the U.S. real estate bubble began to deflate and, at the same time, many holders of subprime mortgages became insolvent because of the rise in interest rates. On the one hand, the financial crisis considerably affected the Real Estate (RE) market in all European countries, but on the other hand,

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the performances of the RE market and construction industry contributed to worsen the global crunch. Economic history suggests that some of the most severe systemic financial crises have been associated with boom-bust cycles in real estate markets (Bordo & Jeanne, 2002; Crowe *et al.* 2013; Antonucci & Marella, 2014).

The Italian RE market underwent and is still undergoing increasing difficulties due to the credit crunch worsened by the banking system and the resulting lack of liquidity. A significant quota of the Italian RE market is based on the segment of the credit market. Therefore, the financial and the real estate crisis had a heavy relapse on loans supply. The decrease of new granted mortgages was mainly related to the weakness and decline of the housing market and the negative phase of the economic cycle, characterized by an increase in the unemployment rate and a reduction in household incomes. At the same time, the crackdown of budget constraints and the deterioration in loan quality caused a reduction in the availability of credit independent of a rise in official interest rates. *De facto*, loan interest rates and the opportunity cost of capital have a strong influence on the performance of the RE market. From 2008, Non-Performing Loans (NPLs) have exponentially increased (20% per year), reaching in 2014 the total amount of 333 billion Euros (Jassaud & Kang, 2015). In the last quarter of 2014 the annual flow of new bad debts as a proportion of total household loans came to 1.4%. The ratio of bad debts to loans recorded a small increase and the share of NPLs (including those that are past-due, restructured or substandard) rose to 10.8% in December 2014 (Banca d'Italia, 2015).

In financing residential property investments, security packages play an extremely important role. A financial guarantee is a promise from a guarantor to make good on payments to the funds providers in case of default of the debt borrowers. Last but not least, financial guarantees have become a major tool for risk management and financial innovation to facilitate credit enhancement and hedging of risks (Gendron, Lai, & Soumaré, 2002; D'Alpaos & Canesi, 2014; D'Alpaos & Marella, 2014).

In this context the issue of underlying guarantees and the evaluation of collaterals becomes of paramount importance. A robust measure of their value is mandatory for lending institutions to the granting of loans, and it is more than a key issue in times of financial crisis, when the value of the guarantees is questioned. In what is now a familiar recurring history, during the credit boom, underwriting standards are violated and guarantees are inadequately funded; subsequently, defaults increase and investors in mortgage-backed securities attempt to dump their investments. In order to avoid these negative outcomes, it is important to strengthen the credibility of the system of guarantees.

Aim of this paper is to investigate whether assets used as collaterals are overestimated and how much of the mortgage lending value (MLV) can be recouped by the property forced sale price (FSP), as defined in Canesi (2015).

This in turn is crucial to make evidence whether there is an overestimation of properties security packages that may increase the probability of registering such an increasing number of NPLs. For this purpose, we analyzed the Italian auction market, by sampling 89 forced sales, that occurred between 2006 and 2014 in the provinces of Treviso, Venice and Padova. The analysis is meant to identify the qualitative and quantitative relationship existing between the foreclosed property, its urban context and its characteristics. In other words, we examine whether peculiar property and location-specific characteristics are recurrent in foreclosed properties. It is argued in the literature that foreclosed properties, ex-collaterals offered to secure a loan, are usually located in low-priced neighborhoods and that their FSP is influenced by the home's age, size and conditions as well as by numerous neighborhood characteristics (Yavas & Yang, 1994; Stevenson & Young, 2004; Campbell, Giglio, & Pathak, 2009; Sumeli, 2009; Immergluck & Law, 2014; Manganelli, Morano, & Tajani, 2014; Calabrò & Della Spina, 2014; Camagni, Micelli, & Moroni, 2015; Antonucci, D'Alpaos, & Marella, 2015).

The remainder paper is as follows. Section 2 describes materials and method, Section 3 and 4 illustrate and discuss the findings respectively. Section 5 concludes.

## 2. Materials and Method

To verify the quality of the RE guarantees and the way they could be affected by the urban context we collected data on foreclosures and created a database by cooperating with financial institutions, courts of law and different associations of public notaries (ANPEV Associazione Notarile Procedure Esecutive Venezia, APET Associazione Professionale per le Esecuzioni della Provincia di Treviso and APEP Associazione Professionale Esecuzioni Padova). This database represents the major novelty of the paper. In Italy, information on foreclosed homes,

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