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CREDIT INSURANCE AND SURETY IN SPAIN (1)

Whenever Spain's former Prime Minister José Maria Aznar was asked about the situation of the Spanish economy, he would always reply: "Spain is doing well". If the question were to be asked today, I think the reply would be the same: "Spain is doing well; Spain is still doing well".

Before I start speaking about Credit Insurance and Surety in Spain, I would like to show you some macroeconomic data, which I hope you will find interesting.

Growth of the Spanish economy in 2005 and 2006 (2) will follow the pattern of recent years, conserving the difference of one percentage point - maybe even more – (3) over the EU average. (I should point out that when I refer to the EU during this presentation, I mean the EU-15 and not the enlarged EU-25.) This growth is supported by a highly dynamic domestic demand that is partly offset by the external sector's drain on growth; the major factors contributing to this growth are first, a favorable climate for investment and sustained job creation, which will continue to boost Spanish household expenditure, and second, the relatively favorable external environment. The major uncertainty in the scenario I have just described will be the evolution of oil prices – an uncertainty that is more pronounced in the case of Spain, owing to the fact that the Spanish economy is more oil-intensive than other developed countries and therefore, more exposed to the effect of higher oil prices over a prolonged period of time. Household income and wealth are expected to maintain their impetus through 2005 and 2006, and no change is foreseen in prevailing interest rates, which are at a historic low.

Only a few days ago, the Spanish Statistics Office updated Spain's economic data, following a review of Spanish National Accounts and the application of some methodological changes proposed by the European Union, as a result of which, we have learned – not without a certain degree of surprise, I may say - that the growth (4) of the Spanish economy over the past four years has been greater than what I have just told you. The data now on the screen shows the difference between the former GDP and the new reviewed GDP. Undoubtedly, this new method for calculating the GDP will lead to growth rates of over 3% for the years 2005 and 2006. In fact, the growth of GDP in the first quarter of 2005 has been 3.3%.

The year 2004 was a good year for the Spanish economy as you have seen, and it was also extremely positive in terms of global growth, (5) which reached its highest level in 30 years. So far, the significant increase in oil prices has had less impact on world growth than expected. The BBVA forecast for oil prices during the second-half of 2005 through 2006 is fairly optimistic and prices are expected to drop from their current maximum levels to approximately 40 dollars per Brent barrel by the end of 2005 and to remain somewhere in the region of 37 dollars in 2006.

The continued growth of Spanish GDP compared to the EU average has meant that Spain's Per Capita GDP (6) rose from 71% to 86% of the EU average between 1986 and 2003 (in the enlarged EU-25, this percentage would now be 100%). This convergence process is driven by a major increase in employment (7) (the number of people employed in Spain was 12,400,000 in 1980, rising to almost 18,000,000 in 2004) and is further enhanced by a drop (8) in unemployment, which has fallen from 13.9% in the year 2000 to a projected 10.4% in 2005.

As I have already mentioned, the growth of the Spanish GDP was higher than the EU average; however, the same can be said of inflation (9) in Spain compared to the EU. Inflation in 2004 was slightly higher than 3% and the BBVA forecast for 2005 and 2006 is that it may fall to 2.7% and 2.5% respectively, meaning that the inflation differential of approximately one percentage point over the rest of the EU will persist.

Yet, as the saying goes: "All that glitters is not gold". The Spanish economy also has certain weaknesses: on the one hand, it is highly dependent on construction and on certain market services - especially trade and the hotel and tourism industry, which are activities that operate without the risk of external competition. All of the industrial sectors in Spain have experienced a loss of competitiveness, influenced by the upsurge of goods from emerging countries whose competitiveness is gradually extending up-market to encompass new technologies and this could affect industrial production in sectors that, until now, seemed capable of withstanding this competition from abroad. In recent years, Spain has followed a strategy based on less-sophisticated production sectors. In the short term, this strategy is conducive to growth; however, in the long-term, the potential for growth is decreased, since the jobs that are created are low-productivity jobs - which means that it would be advisable to start diversifying the growth model. On the other hand – and I am referring here to the near future, there are several factors that could affect Spain's growth over the next few years: slower external growth - and particularly, the slower growth of the EU countries, will mean less growth in exports (10) (74% of Spanish exports are made to the EU) and will act as a damper on business investment; furthermore, (11) the expected decline in the growth of employment that will be brought by this situation, will subsequently have a negative effect on the building sector, particularly home building. Apart from the possible negative impact of slower external growth, there is also the risk I already mentioned of an increase in oil prices and the possible appreciation in the euro/dollar exchange rate.

Under the assumption that the slower growth of the Spanish economy, as a result of the external environment, were to occur during the second half of 2005, the BBVA believes that the downward effect on Spanish GDP this year would be marginal; however, growth in 2006 could be approximately half a point less than the expected level. Obviously, there is also the possibility of a more negative scenario, where slower growth would be accompanied by an increase in oil prices, an appreciation of the euro... and this would clearly affect employment and the available income of Spanish households; this scenario would also have a direct impact on consumption and construction, where there would be a sharp deceleration. Considering that construction accounts (12) for 25% of GDP growth in Spain, the scenario I have just described would reduce the GDP by between 1 and 1.5 percentage points.

I have mentioned the importance of the construction sector in Spain - particularly the home construction sector, and I know that analysts and - more importantly in our case - re-insurers, are concerned about the fact that in Spain we may be experiencing the so-called "real estate bubble", which, if it were to burst, would produce some highly negative effects for the Spanish economy and particularly for surety insurance, where 40% of premiums - and more importantly, risk - is directly related to the home building sector.

(13) This overhead shows the total house purchase debt in different countries with respect to their GDP. As you can see, house purchase debt in Spain represents 42% of its GDP, whereas the average of countries in our environment stands at 46% - in other words, Spain is below the average; ten years ago, however, debt in Spain was very different: only 16% compared to 31% in the whole of the area.

So, what is the reason for this continued increase of home building and prices in this sector and which, in Spain, represents an increase (14) of 151% over the past eight years and the second highest rate in Europe - placing Spain just behind Ireland and very close to the United Kingdom? Well, there are several reasons for this growth: (15) first, the major tax benefits of home-purchasing; second, the increase in employment which I mentioned earlier; third, the arrival of a significantly high number of immigrants in Spain. Immigrants nowadays account for 8% of the more than 42 million inhabitants in Spain; furthermore, a very high percentage of the people arriving in our country from abroad are of working age. I should insist on the contribution of the immigration (that reduces both the cost of construction and of services such as tourism, and creates new consumers). The integration of around 500.000 people each year is probably the most relevant issue of the past period, both socially and economically; and fourth, the historically low interest rates for mortgage loans.

I would like to make two more reflections regarding the real estate market in Spain – a further two reasons for the strength of this sector: first, from a cultural and sociological point of view, Spaniards do not rent their homes – they buy them; the percentage of families living in rented housing is less than 20%, by far the lowest rate of rented homes in Europe; and second, according to the estimates of Spain's Ministry of Housing, up to three/four million Europeans could retire to Spain and set up their homes, mainly along the Mediterranean Coast. (16)

As a result of the facts I have just described regarding home-purchase habits in Spain, employment, historically-low interest rates, unprecedented foreign real estate investment and the tax benefits of home purchasing, the demand for new homes in our country has been constantly growing since 1997, without any noteworthy effect on household economies; furthermore, this growth is expected to continue over the next few years – albeit at a more moderate rate.

(17) This overhead shows the evolution of interest rates and the amount of the monthly re-payment per 1000 euros borrowed; the data refers to mortgage loans taken out over a 20-year period. As you can see, the monthly payment during the first few months of 2005 is almost 60% lower than what a person would have had to pay back in 1990. If we look (18) at the effort required to purchase a home, as you can see, in 1990, it took an effort of 64.9% of the income household; nowadays, it takes an effort of 47.5%; bearing in mind that the data shown refers to a single-income household (i.e. where only one member is working) and that female (19) employment in 1987 was slightly below 30% and had risen to 49% in the year 2004, representing an increase of 20 points compared to eighteen years ago (although it is still below the European average), it can be said that a very high percentage of new home purchases are made by households where both members are working. This does not rule out the risk of the home construction sector and home prices experiencing a slowdown; however, all economic agents - including the Bank of Spain and the Government - are of the opinion that if deceleration does occur, it will not be sharp, unless there is a drastic change in the macroeconomic scenario, leading to high employment rates and coinciding with significant increases in interest rates.

Bearing in mind the importance of bad debt and the fact that it has a direct effect on credit insurance, perhaps it would be important to mention that the bad (20) debt ratio for the Spanish financial system (in respect of the total amount of credit granted) is practically at a minimum historic level, as you can see on this overhead.

I would now like to show you some data from an excellent report published by Euler-Hermes, titled *Insolvency Outlook*. Before doing so, I would like to point out that the statistics I am going to show you are not wholly comparable. You can see in this overhead (21) excellent insolvency ratios in Spain and although they are truly excellent, they are nonetheless hard to believe if we compare them to the ratios for other countries in our environment. The explanation lies, among other factors, in the different bankruptcy laws existing in each country and in whether or not individual entrepreneurs are included in the ratio.

The first data shows the number of insolvencies in some of the most industrialized countries in the world; you can see the stability of the Spanish market. If we relate insolvency to the number of companies, we can see (22) that the Spanish ratio is by far the smallest among the industrialized countries; however, you should bear in mind what I have just mentioned about the different legislation applying in each country. If we look (23) at the number of business insolvencies by sector in Spain, as of 30.06.04, we might say that they could almost be counted on one hand.

In the context I have described, it is not surprising, therefore, that Credit Insurance in Spain (24) should show such a positive development – at least, so far: the volume of premiums is growing smoothly and the claims ratio is also positive.

Since 2002, premiums have increased by 14% that year, by 14.7% in the year 2003, and by 8.7% in 2004. During these three years, the figure for premiums rose from 452 million to 564 million euros – in other words, an increase of 25%. The figures I have just mentioned refer to Credit Insurance as a whole – without differentiating between Domestic Credit and Export Credit, since the majority of credit insurers in the market sell policies covering both branches of insurance. If I had to give an estimated breakdown of total premiums, I would say that Domestic Credit would probably represent 80-85%, with Export Credit accounting for the remaining 15-20%.

Claims ratio in Credit Insurance has also shown a positive trend, dropping from 65.8% in 2002 to 59.8% in 2003 and closing at 56.2% in 2004. Claims ratio in Export Credit is possibly 10 percentage points higher than in Domestic Credit.

The situation resulting from this positive data has made the Credit Insurance market highly competitive in Spain - perhaps more so than in other European markets - to a point where we are concerned about its possible future evolution; and our concern arises not so much from the theoretical changes I have already described in the macroeconomic frame, but more from the continued fall in premium rates, which could become wholly insufficient, from a technical perspective. And in saying this, I am making a call for prudence to the Spanish market. It should be borne in mind that there are six major companies operating in the branch of Credit Insurance in Spain: the three multinational insurers and a further three local insurers, all of whom are major players. (25) Local companies controlled 92.9% in 2002, 90.7% in 2003 and 90.12% in 2004 – in other words, a persistently high market share. The Spanish market (26) – with 7% of world premiums in 2003 and more than 34,000 policies – is the fifth largest market in the world, ranking just behind Germany, France, UK and USA; it also has the highest penetration rate with a ratio of insurance premiums to GDP of 0.07%, ranking well ahead of Holland, which holds second place with a ratio of less than 0.05%.

The distribution channels used by the local insurance companies are either agents or their own sales networks, with less than 30% of total premiums being channeled through brokers. In the case of the multinational companies, brokers account for between 50% and 100% of premiums.

There are also six companies operating in Surety, three of which operate solely and exclusively in this type of insurance and hold the three leading positions in the ranking. The volume (27) of Surety premiums in the Spanish market is low – undeniably low: 45 million euros in 2002; 53 in 2003; and almost 57 in 2004. Growth is relatively modest (16.9% in 2003 and 7.3% in 2004), bearing in mind that it is based on a small business volume. Brokers amount for 60% of the business in 2004.

There are two reasons for the size of the Surety market: first, Spanish banks control a very high percentage of the market, just as they do in other European countries; second, the percentage of the performance bond with respect to the contract price is the lowest in the world, being only 4%. If we compare this to the 100% in the USA, 50% in Canada and 10-20% in a large number of European countries, we will understand why the Surety market in Spain is limited in size. We truly believe what the saying goes: "small is beautiful" – but maybe it is cold comfort nonetheless.

As an example of how "Surety is beautiful", let us take a look at claims levels: 0.7% in 2002; 19.5% in 2003 (over 60% of which stemmed from a single company); and 0.7% again in 2004.

You are probably wondering: What about in housing? **(28)** Surety in housing is a success – a great success, I would say - since it represents almost 40% of the market and for the past three years, claims have been less than 7%. Believe me: we are prudent underwriters.

And what about the prospects for 2005? Well, growth in Credit Insurance is expected to be under 8%, with claims ratios remaining at similar levels to 2004; a slightly higher growth is expected in Surety, with claims probably not reaching 5%/10%.

I would like to thank you for your attention and I hope that you found my presentation interesting.

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