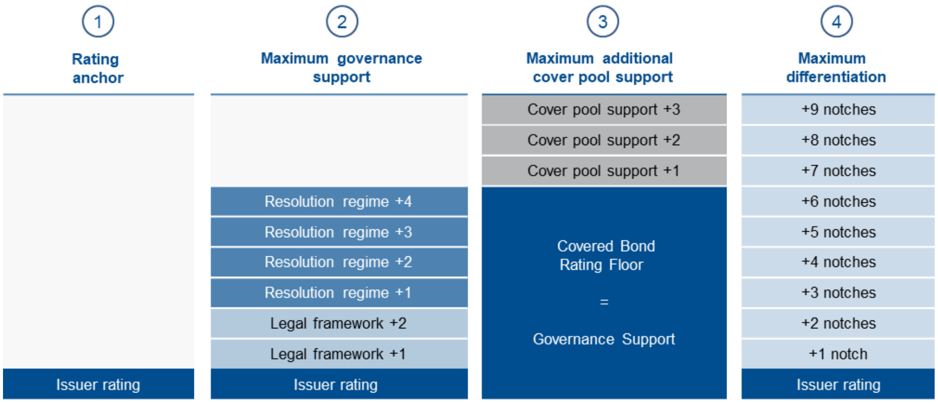
Legal framework analysis: Spain

Spanish Covered Bonds

Spain's covered bond framework has been significantly improved following its alignment with the European Covered Bond Directive. It is now stronger and more robust, reflecting significantly enhanced legal clarity and transparency. This report provides Scope's view on the governance support factors common to Spain's covered bonds and their issuers.

Spanish covered bonds can achieve the maximum six-notch governance support uplift according to our covered bond methodology. Governance support provides a floor to how much a covered bond can be rated above the issuer's rating and constitutes an anchor for additional credit differentiation based on cover-pool support.

Figure 1: Maximum rating differentiation for Spanish covered bonds



Source: Scope. Credit differentiation is expressed as a rating notch above the issuer's rating.

Our credit-positive view of the strength of the improved Spanish legal framework generally translates into the maximum two-notch uplift. Transposing the European Covered Bond Directive (CBD) into local law lifted the framework in most aspects to "European best practice" and ensures that Spanish covered bonds can use the "European Covered bonds (Premium)" label.

Compared to other European framework updates, Spain's experienced the most substantial changes. Instead of recourse to the full mortgage book, Spanish covered bonds now also have the concept of a clearly defined and more easily segregable cover pool. This required more concise eligibility criteria that serve as security for investors throughout the lifetime of the bonds.

Over-collateralisation (OC) has fallen to 5% from the previous 25% for mortgage covered bonds (Cédulas Hipotecarias, CH) and from 42.9% for public-sector covered bonds (Cédulas Territoriales, CT). There are additional changes, among other things, to liquidity provisions and the rules guiding maturity extensions as well as strict loan-to-value requirements and frequent valuation updates. Also, a mandatory requirement to provide regular investor information improves the transparency of covered bond programmes.

Our assessment of the resolution regime for Spanish covered bonds is unchanged. This recognises their systemic importance, their preferential status in a resolution scenario as well as our view that, in most cases, regulators would maintain the issuer and its covered bonds upon regulatory intervention. An issuer's relevance is also driven by its size and sustained funding activity.

Our assessment is predominantly applicable to CH. Other types of bonds regulated by the framework are more niche products, have lower systemic relevance so would not be able to provide the same governance support uplift.

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Legal framework assessment

Covered bond framework

We consider the Spanish covered bond framework to be strong. It fully meets our investor protection expectations. We assign Spanish covered bonds the highest credit uplift of two notches.

EU directive transposed in national law

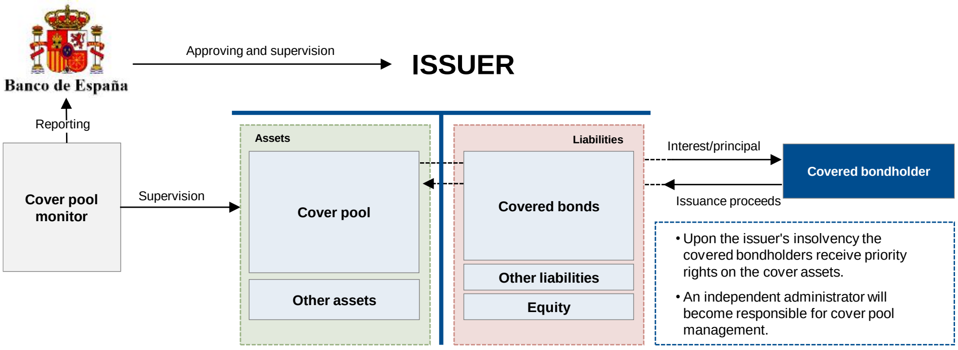
The Spanish legal covered bond framework is based on Royal Decree-Law 24/2021, of 2 November, which among other things transposes the European Union's Covered Bond Directive (CBD). The law came into force on 8 July 2022 and repeals earlier legislation going back to the initial law of March 1981 and constitutive regulations (e.g. 44/2002 regarding public-sector covered bonds. As of the date of this report, no secondary legislation is available.

Spain's new law defines seven covered bond types that in part were earlier addressed under separate laws. The most relevant (by size) are mortgage covered bonds (Cédulas Hipotecarias - CH). The law is also applicable for other mortgage bonds (Bonos Hipotecarios), public-sector covered bonds (Cédulas Territoriales - CT), public sector bonds (Bonos Territoriales), export finance covered bonds (Cédulas de Internacionalización) and export finance bonds (Bonos de Internacionalización). It also opens the possibility for "other covered bonds". Only CH and CT qualify for the "European Covered Bond (Premium)" label.

Unlike Cédulas (in particular CH and CT), bonos (mortgage/public or export finance bonds have closed/static cover pools and do not benefit from active management. Our analysis focuses on CH and CT, although most of the fundamentals are also applicable to other types of covered bonds.

Spain's covered bond structure

Figure 2: On balance sheet issuance structure:



The Bank of Spain needs to formally approve covered bond issuance and maintain a public register of approved issuers and covered bond programmes. The most important changes for CH and CT are the introduction of a dedicated cover pool that can be separated from the general estate in case of an issuer's insolvency, mandatory short-term liquidity coverage, as well as an option to issue soft-bullet bonds with maturity extensions subject to objective triggers.

Segregation of cover pool

Segregation through registration of cover assets

Eligible covered bond collateral will be registered in a ringfenced cover pool which can be legally segregated upon resolution or insolvency of the issuer. The cover assets will form a separate estate, represented by a special administrator responsible only for the interests of covered bond holders. This is credit positive compared to the previous framework as the potential conflict of interest of the administrator being in charge of both the workout of the bank and the covered bonds has been resolved.

Covered bond holders have dual recourse to the bank and a preferential claim over the cover pool, including derivatives. Bond holders and derivatives counterparties have exclusive, equal and pro rata preferential claims over the cover pool, and the administrator is tasked with assuring timely payments, as long as the asset pool provides full cover to claims.

Ability to continue payments following issuer insolvency

Public administrator ensures management and timely payments

Covered bonds will not be subject to automatic acceleration in the event of special administration or liquidation under public administration of an issuer. The risk of payment suspensions or acceleration under a scenario where covered bond scheduled payments are only reliant on securing cover assets is broadly mitigated by over-collateralisation, liquidity provisions and maturity extensions.

However, it remains at the discretion of the special administrator to decide if an asset sale (partial or total) to another covered bond issuer prior to the final legal maturity of the covered bonds is a suitable solution. Only in the case of under-collateralisation must the administrator try to liquidate the separate estate.

In order to avoid a discontinuation of payments under the covered bonds, the administrator has wide-ranging rights to manage liquidity of the programme.

Liquidity and other risk management guidelines

Maturity extensions and liquidity buffer mitigate liquidity risks

The credit institution must ensure that payment flows from the cover pool enables it to honour its payment obligations towards covered bond holders and derivatives counterparties. It must establish a liquidity reserve in the cover pool for maturing hard-bullet instruments or can issue optional soft-bullets that can extend beyond their scheduled maturities.

Liquidity risk

The legislation includes a mechanism to avoid payment disruption to covered bond holders shortly before, during or after the issuer's insolvency.

Under the new law, Spanish covered bond issuers have the option to issue soft-bullet (extendable maturities) and hard-bullet bonds. Co-existence within one programme is possible. The law determines four objective triggers that allow an extension of the covered bonds.

- Breach of the liquidity buffer requirement or measures taken by the Bank of Spain relating to the liquidity of the issuer
- Insolvency or resolution of the issuer
- Declaration of non-viability on the recovery and resolution of the issuer
- Serious disturbances affecting national financial markets as assessed by the Macroprudential Authority Financial Stability Board (AMCESFI)

These factors must be determined in the bonds' terms and conditions and must not be at the discretion of the issuer. Any extension must be authorised by the Bank of Spain at the request of the issuing institution or the special administrator.

Additional protection against liquidity shortfalls is supported by a mandatory liquidity buffer. The law requires issuers to maintain liquid assets to cover the net outflow of the covered bonds over the next 180 days. The anchor point for the outflow calculation takes into account the extended maturity. Consequently, the buffer to be maintained will be minimal or zero for programmes benefiting from soft-bullet mechanisms, while this buffer strictly applies for hard-bullet bonds.

We have not yet received clarification whether coverage of outstanding bullet covered bonds should be included in the calculation or whether it will only apply to covered bonds issued after the enactment of the new law. In the case of the latter, investor benefits will only gradually be realised. Similarly we understand that only upon investor consent can existing hard-bullet covered bonds transform into extendible soft bullet covered bonds.

Liquid assets must qualify as level 1, level 2A or level 2B, in accordance with the Capital Requirements Regulation. Short-term exposures to credit institutions in risk class 1 or 2 and short-term deposits in credit institutions that qualify for risk class 1, 2 or 3 also qualify (e.g. lowest eligible rating is BBB-). Assets in default cannot be counted in the liquidity buffer. The liquidity buffer can count against any other EU legal liquidity requirement such as the LCR.

The liquidity buffer is not applicable for covered bonds subject to the "matched funding requirement". These are defined as bonds where the asset cash flows match those of the liabilities regarding the amount due as well as the maturity profile applicable. For now, we see this applicable only for Bonos Hipotecarios, Bonos Territoriales or Bonos de Internacionalización where there is no active asset management and the maturity is determined.

Interest-rate and currency risk

Non formalised stresses…

The law does not foresee the application of specific and formalised stresses. However, it does require internal rules and tests on potential maturity, duration and interest-rate as well as exchange-rate mismatches. Such rules and tests require the formal approval of the governing body and shall be included in the bond's terms and conditions.

Derivatives

Market risks can be hedged, no must

Spanish issuers can use derivatives to limit or fully remove FX and interest-rate risk. If a derivatives agreement has a positive mark-to-market value, the contract is part of the cover pool. If the value is negative, the derivatives counterparty has a preferential claim on the pool and ranks pari passu with covered bonds. Derivatives must not terminate during special administration (including maturity extension) or liquidation. They can be actively managed and new contracts can be entered into before and during special administration or liquidation. Secondary legislation is expected to provide further details on qualified counterparties, format of contracts, reporting and valuation requirements.

Cover asset valuation

Valuation updates mandatory

The Act specifies valuation requirements for the mortgage portfolio. A mortgage only qualifies for registration if its valuation is not older than six months. In the absence of a full appraisal, we understand that upon inception of the cover pool and for existing issuers, the-then current (typically statistically) updated valuation can be used instead. Valuations must be reviewed and updated at least annually, in accordance with the internal policies and procedures (based on rules set by the Bank of Spain in Circular 4/2017) and as implemented by the credit institution.

Value cap isolates from inflating valuations

As a credit-positive novelty in the new framework is a provision whereby the framework establishes a maximum LTV for the valuation of underlying properties. The value of a property cannot be higher than that established in the initial appraisal. This isolates the cover pool from inflated real-estate valuations. Using updated statistical valuations in a boom scenario could artificially reduce the cover pool's LTV.

Should the loan-to-value exceed this threshold after the loan has been registered, it will continue to form part of the cover assets but only qualifies for the calculation of over-collateralisation up to its threshold. The valuation and its updates must be carried out according to recognised principles by a competent and independent person and can be based on statistical models.

Programme enhancements remain available

The special administrator must ensure that rights and interests of covered bond investors are preserved following the issuer's insolvency.

According to the law, assets must at all times cover the payment obligations of outstanding covered bonds, derivatives and expected maintenance and administration costs. While the law lacks additional details on how these costs shall be calculated, we expect secondary legislation to provide additional clarity.

The calculation of required coverage will ensure that the aggregate principal amount of all cover assets is at least equal to the aggregate principal amount of the outstanding covered bonds (nominal principle).

Minimum OC at 5%

The regulation specifies minimum over-collateralisation levels that are independent of collateral type. Spanish covered bonds benefit from nominal over-collateralisation that has decreased to 5% (from 25% and 42.9% for CH and CT, respectively). For "other covered bonds" the minimum level of over-collateralisation stands at 10%.

Beside the minimum mandatory OC, each programme may set higher contractual or voluntary OC levels according to their terms and conditions.

Eligible assets consist of the primary cover pool assets, the liquidity buffer, substitute assets and hedging derivatives, if any. For all but "other covered bonds", the law refers to the criteria laid down in article 129 of the EU Capital Requirements Regulation.

For "other covered bonds", eligible assets must comply with Art. 6 of the CBD (eligible cover assets) that allow for other assets that are not specified in the law. Accordingly, such bonds could include assets not contemplated in Art. 129.1 of the CRR and would likewise not be LCR eligible.

Asset criteria now in line with 129 CRR raising the max LTV to 80%

The updated law specifies that cover assets must comply with a loan-to-value threshold of 80% for residential mortgages and 60% for commercial mortgages. The amount of substitute assets is restricted according to their credit quality step category and is limited to 10% of outstanding covered bonds.

Covered bond oversight

Bank of Spain supervises and is supported by independent monitor and special administrator

Spanish issuers are subject to a supervisory regime involving both an independent monitor (cover-pool monitor) and the national supervisor, the Bank of Spain.

The Bank of Spain is the supervisor responsible for ensuring compliance and enforcement of the requirements applicable to the issuance of covered bonds. It performs supervisory, investigative and sanctioning activities and is allowed to require modification of the policies and procedures as well as the assets in securing the covered bonds. The Bank is also responsible for approving the issuer's application and authorising the cover-pool monitor.

Aligning with best practices, the updated Spanish framework now requires issuers to appoint a cover-pool monitor that can be an external or, if certain conditions are met, internal. The cover-pool monitor is in charge of permanently monitoring the cover pool in the interest of investors, ensuring compliance with the issuer's legal and contractual requirements (such as asset eligibility, registration and de-registration of cover assets and maintaining minimum OC), including supervision of the inflows and outflows of cover assets and the performance of stress tests on the solvency and liquidity of the programmes.

In the event of insolvency or resolution of the issuer, a special administrator is in charge of administering the covered bond programme. The administrator will be proposed by the resolution authority, Fondo de Reestructuración Ordenada (FROB), and appointed by a judge. The administrator can manage and sell the cover assets but also transfer them together with corresponding bonds to another covered bond issuer. Among other things, the administrator can use the liquidity reserve, buy back covered bonds, obtain bridge financings and pledge cover assets.

Spain's securities regulator, the Securities Market Commission (CNMV) will supervise compliance with the requirements related to public offerings, and the secondary covered bond market.

Transparency

Regular cover pool reporting according to minimum standards

The Spanish framework stipulates mandatory quarterly cover-pool disclosures that have to be published on the issuer's website. The required information must meet the minimum requirements under the Capital Requirements Regulation and thus allow for using preferential risk weights for the covered bonds.

In practice, Spanish issuers already provide such information using the ECBC's 'Harmonised Transparency Template' which itself goes beyond the minimum regulatory requirements so is credit positive.

Other legal framework considerations

Except for "other covered bond", Spanish covered bonds comply with the provisions of the EU's Capital Requirements Regulation which is credit positive and can be used for LCR purposes by investors.

There is no material difference in legal framework for different types of covered bonds. All types of Spanish covered bond receive the full legal framework rating uplift.

Resolution regime assessment

Translation of BRRD into national law

Covered bonds exempt from bail-in

Spanish covered bonds are explicitly excluded from bail-in as a consequence of the transposition into national law[1] of the EU Bank Recovery and Resolution Directive.

This law sets out the responsibilities, instruments, and powers to enable Spanish authorities (Bank of Spain and FROB) to resolve failing banks in an orderly manner by protecting critical functions without exposing taxpayers to the risk of loss.

Ability of regulators to maintain the issuer and its covered bonds as going concern

Resolvability of an issuer requires bespoke analysis

The issuer's business model, systemic importance, liability and capital structure can further incentivise regulators to use available resolution tools. We assess on an issuer-specific basis the likelihood that covered bond programmes will be maintained as actively managed going-concern funding programmes.

Going concern most likely for systemic important banks…

The Spanish banking sector has undergone far-reaching consolidation, shaped by numerous mergers and acquisitions following the global financial crisis. This is reflected in the reduction in covered bond issuers from 69 in 2007 to only 19 as of 2021. Because of consolidation, the Spanish banking market is dominated by three large banks that have received the EBA status of either a global (G-SII) or other systemic important institution (O-SII). For such banks, a going concern using available tools is seen highly likely.

[1] (Ley 11/2015 de recuperación y resolución de entidades de crédito y empresas de servicios de inversión

…while less likely for very small banks

Our assessment of going concern for small or specialised Spanish covered bond issuers with opportunistic covered bond issuing activities and market share will likely also translate into an assessment of low to moderate systemic importance, thereby limiting the uplift. This also reduces negative repercussions on other issuers in the event of a failure. Due to their size and relevance, the most likely resolution scenario would be a transfer or takeover by another bank. An orderly wind-down of the covered bond issuer is another plausible scenario.

Systemic relevance of covered bonds in Spain

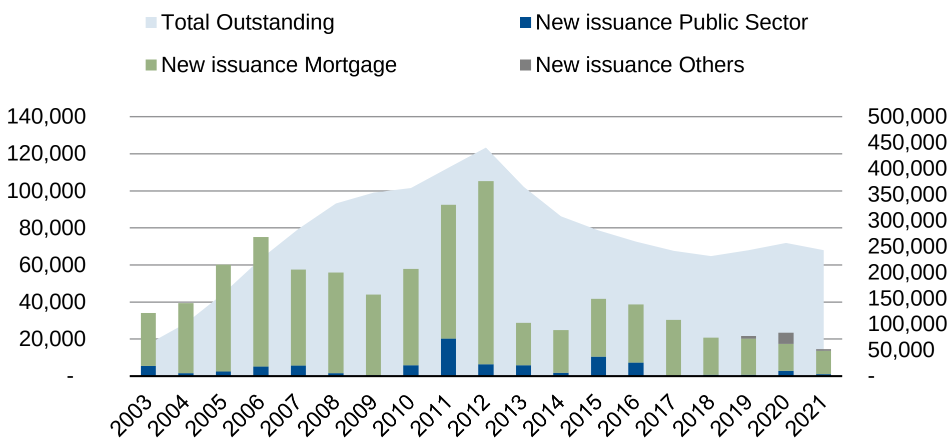
Spanish mortgage covered bonds with high systemic relevance

We classify CH as a systemic important refinancing product. Other covered bonds, including CT, have a smaller portion of the market which we believe makes them less relevant. CH are a key pillar in most Spanish banks' funding toolkits even though most banks have lately only issued for opportunistic, TLTRO or other ECB targeted funding.

This was in particular visible during the Spanish financial crisis (2008-2014). Outstanding covered bonds in Spain peaked in 2012 at EUR 406bn, as during the European sovereign debt crisis, most Spanish banks were unable to access capital market funding so reverted to ECB funding using retained covered bonds instead. Since then, both new issuance as well as outstanding covered bonds have reduced significantly. Despite a 20% drop, Spanish covered bonds still accounted for EUR 216.8bn by the end of 2021 even though the number of issuers dropped by more than 70% because of sector consolidation. Outstanding covered bonds to GDP stand at 15% (and up to 40% in 2012) underpinning covered bonds as an important refinancing product.

Globally, Spain ranks 4th by total outstanding covered bonds in 2021 and 11th by new issuance.

Figure 3: Spanish covered bond issuance



Source: ECBC. Scope Ratings

Public Sector and other (covered) bonds are of moderate systemic importance

CH make up around 89.3% (around EUR 216.8bn) of the total and are mainly secured by residential mortgages. CT account for 7.2% and others for the remaining 3.5%. Public-sector and other covered bonds are a niche and not seen as an essential part of banks' funding mix. Therefore, we distinguish between the systemic importance of covered bonds secured by mortgages and public-sector or other assets.

Stakeholder support

Active stakeholders and proactive regulatory support

Spanish covered bond issuers are not organised under a dedicated association, though the Spanish Mortgage Association does promote the product and has been supportive in initiating changes to the framework. Although the EU judged Spain as being late in the process of transposing the European directive into national law, the country managed to pass the law just in time to meet the 7 July 2022 deadline. Considering that Spain had massive changes to make compared to other EU members, this underpins the co-operation of Spanish stakeholder to support the product.

Strong support has also come the European Central Bank, which has actively purchased covered bonds through several programmes and keeps them eligible within the Eurosystem.

Spanish resolution tools have been tested multiple times since they were introduced, even before covered bonds were widely going-concern irrespective of resolution tools applied. Typically, covered bonds of a distressed issuer were merged into the programme of larger, solid issuers because of a strong collaboration between banks, the resolution authority (FROB) and supervisors.

Appendix I: Key characteristics of the Spanish covered bond framework

Issuer	Credit institutions with authorisation from the Bank of Spain can issue covered bonds. Traditionally only universal credit institutions have issued covered bonds.
Cover assets	Mortgage assets (residential and commercial assets) within the EEA, Switzerland and the United Kingdom. Underlying properties must be adequately insured against physical damage and the insurance must be part of the cover pool. Mortgage terms may not exceed 30 years. Exposures to public-sector entities or public-sector-guaranteed entities in the EEA, Switzerland and the United Kingdom. Substitute and liquid assets can comprise exposures to eligible public-sector issuers, financial institutions, deposits and cash. Other 'high-quality' assets, given that these are credit claims with appropriate collateral. Derivatives (only to hedge risks – no specific restrictions on volumes) For "other covered bonds" assets in line with Art 6 of the CBD (eligible cover assets).
Loan-to-value restrictions	Residential mortgages are eligible up to 80% of the properties' market or mortgage lending value; commercial mortgage loans are eligible up to 60% of the properties' appraised value. Full loan amount is part of the cover-pool register while the portion up to the threshold determines the maximum funding potential. Covered bond investors have a preferential claim on cover assets, including recovery proceeds from non-eligible loan parts above the LTV threshold. Valuations must be reviewed and updated at least annually, in accordance with the internal policies and procedures established by the institution. The valuation and its updates must be carried out according to recognised principles by a competent and independent person and can be based on statistical models.
Market and liquidity risk guidelines	Minimum 180 days of liquidity coverage, including interest and principal payments. In addition, the framework allows soft-bullet structures of up to 12 months. Extension criteria must be in line with the provisions in the directive. Issuers must establish processes and risk management systems to identify, assess and control risks including interest-rate and foreign-exchange risks.
Coverage principle/minimum OC	5% over-collateralisation on a nominal basis for mortgage and public sector covered bonds. 10% for "other covered bonds".
Treatment upon insolvency	Insolvency of the issuer does not impact the ability to make uninterrupted payments on the covered bonds; No automatic acceleration upon insolvency.
Mandatory transparency	Yes; information needs to be provided on a quarterly basis.
CRR compliance	Spanish premium covered bond (unlike "other covered bonds") types generally fully comply with Capital Requirements Regulation.
Cover Pool Monitor	Cover pool monitor can be internal or external
Trustee/special supervision	Special administrator, proposed by the resolution authority and appointed by judge.

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