Spain
Criteria Report

Rating Spanish Financial Institutions' "Cédulas Hipotecarias" and "Cédulas Territoriales"

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Summary
"Cédulas Hipotecarias" (CHs; literally: "mortgage certificates") and now "Cédulas Territoriales" (CTs; "public sector bonds") are bonds issued by Spanish financial institutions that are collateralized by first mortgage loans and by Spanish and European Economic Area (EEA) public sector loans, respectively. Both types of bonds are mandatorily over-collateralized, but CHs enjoy further security cover, in the event of liquidation of their issuer, from other mortgages that do not formally qualify as collateral. Holders of CHs and CTs have a preferred status in comparison with most other creditors in the event of liquidation. On the basis of the probable default and recovery characteristics of these instruments, Fitch Ratings rates CHs and CTs up to three notches higher than their issuer's senior unsecured rating. The degree of upward notching will depend on expected recovery rates and on whether the senior unsecured rating of the issuer is investment grade (implying less upward notching) or non-investment grade (potentially greater upward notching).

The principal characteristics of CHs and CTs are:

Permitted issuers: Regulated financial institutions.

Assets formally eligible as collateral for CHs: First mortgage loans; however, in the event of its liquidation the issuer's entire mortgage loan portfolio whether actually qualifying as collateral for CHs or not, is available as security for its CH issues. There are two exceptions; mortgages which collateralize only "Bonos Hipotecarios", literally mortgage bonds, or those which collateralize only "Participaciones Hipotecarias", literally mortgage participations, are not available as collateral for CHs. N.B. Only domestic mortgage loans are available as collateral.

Assets against which these first mortgages are charged: Fully insured residential and commercial real estate valued by surveyors approved by the Banco de España.

Loan to value: The first mortgage loans must be advanced against such real estate on a loan-to-value ratio of 80% or below for residential properties or 70% or below for commercial properties.

Assets formally eligible as collateral for CTs: All loans to the Spanish state, its autonomous communities and local authorities, as well as their autonomous entities and dependent public companies (the definitions of which have been extended to cover entities of analogous nature in the EEA). The EEA comprises the fifteen member states of the EU, plus Iceland, Norway and Liechtenstein.

Mandatory over-collateralization: For CHs, the issuer cannot issue bonds in an amount greater than 90% of the value of all qualifying mortgage loans (after deducting mortgages that collateralize "Bonos Hipotecarios" or "Participaciones Hipotecarias", if any). In practice, the excess of security available to provide cover for CHs in issue in the event of liquidation is higher than the 11% this implies since, as noted above, security is provided by the whole mortgage portfolio, whether qualifying as collateral for CHs or not. In the case of CTs, the issuer cannot issue CTs in an amount greater than 70% of the outstanding value of all qualifying loans. This implies an excess security of 43%.

Hedging of interest rate risk and maturity mistmatches: There are no formal requirements to match interest rates on CHs, on CTs and on the eligible portfolios or to match maturities This could eventually lead to lower recovery rates in the event of liquidation.

Impact on CHs and CTs of liquidation of issuer: CHs and CTs are not legally insulated from the consequences of their issuer going into liquidation. Thus, their probability of default is directly related to the creditworthiness of the issuer.

Ranking in liquidation: Holders of CHs have a preferential claim over *ALL* their issuer's mortgage loans except those mortgage loans that serve as collateral against "Bonos Hipotecarios" or "Participaciones Hipotecarias" (if any). Holders of CTs have a preferential claim over the portfolio of public sector loans defined above. This preference is constrained only by the prior claims on the issuing banks' entire asset base held by their employees, who have an entitlement to one month's remuneration, and by the "Hacienda Tributaria" (Spanish tax authority).

Status in process of liquidation: If the assets serving as security against CHs in issue prove insufficient to service them, their holders acquire a senior, unsecured claim on the proceeds of sale of all the issuer's remaining assets, except for those serving as collateral for CTs, *pari passu* with all other creditors. If assets serving as security for CTs in issue prove insufficient to service them, their holders would, likewise, acquire a senior, unsecured claim on the proceeds of sale of the issuer's remaining assets, except for those serving as collateral for CHs, *pari passu* with all other creditors. However, even if there is no deficiency of security, the administrator carrying out the liquidation may theoretically elect to suspend servicing the CHs and/or the CTs. (Equally, the administrator may decide to continue servicing them.) There are no precedents of default on CHs or CTs, so that past practice provides no guide.

Impact of issuance of CTs and CHs on senior debt holders: Because of the excess security they enjoy and their preferential status in a liquidation, a high level of issuance of CHs and CTs could result in the position of senior debt holders being prejudiced. The more security is provided to CH and CT holders, the less there remains to secure the position in liquidation of senior debt holders. If such a trend became significant, it could result in our lowering the issuer's senior debt rating.

Impact of the retroactivity rule on CT and CH issues: When a Spanish court declares a company insolvent, it must specify a date when it believes the bankruptcy arose. This is known as the "date of retroactivity" and would be prior to the "date of declaration of bankruptcy" and determined by a balance sheet test. CH and CT issues are not protected from the retroactivity rule. A CH or CT issue made during the retroactivity period would be considered void, and the parties would be obliged to restore each other to their original positions prior to effecting the transaction. If this were to happen, the bond holder would become a senior, unsecured creditor and lose collateral cover. In the case of the collateral available for CHs, these are not affected by the retroactivity rule unless there is proof of fraud. The assets backing CTs can, on the other hand, be affected by retroactivity irrespective of fraudulent activity. The issuers of CHs and CTs are credit institutions, a highly regulated sector, and, to our knowledge, there is no instance of retroactivity ever having been triggered for a Spanish credit institution.

New legislation relating to the insolvency regime in Spain: A new insolvency law is in the process of being passed and we understand that one of the effects will be to enhance the position of the secured creditor by replacing the retroactivity rule with a process known as reintegration. This process should be more transparent as it is expected to affect only transactions completed during a fixed maximum period prior to the date of declaration (expected to be no more than two years) and may only be applied in respect of fraudulent activities. We understand that, once the new law is passed, there will be a transitory period wherein the retroactivity rule will still be applied.

Risk-weighting for capital adequacy purposes: A risk-weighting of 10% is generally applied on CHs and CTs in calculating capital adequacy requirements, at least in eurozone countries.

Notching: The substantial collateral attaching to CHs and CTs, coupled with their privileged position in liquidation and the generally good quality and low loss severity of both first mortgages and public sector loans, have led us to conclude that, other things being equal, their ratings should be notched to a level higher than the ratings of their issuers' senior debt. Models based on the default probabilities and propensity for recovery in the event of default predicated for CHs and CTs support the principle of greater notching at lower rating levels of senior debt. (The degree of notching suggested by these models is more sensitive to variation of probable recoverability than to variation of default probability.) However, the uncertainties deriving from the retroactivity rule could lead to a less favourable bankruptcy environment with respect to recoveries for secured creditors. While the degree of upward notching for CHs and CTs, issued by an institution with a senior unsecured non-investment grade rating, could potentially be higher than those issued by issuers with investment grade ratings, this will be highly dependent on the expected level of recoveries. In applying its notching policy, Fitch will scrutinize each transaction to evaluate the potential for retroactivity and will consider the quality of the collateral pool and recovery levels. The collateral serving as security for CTs has a lower risk profile than that attached to CHs, and the 70% of the outstanding value of all qualifying loans limit on issuance is stricter than the 90% limit on CHs. Even so, Fitch applies the same upward notching policy to both instruments as loss severity on each of them should not vary significantly.

■ Recovery Rates on CHs and CTs

These are dependent on the related collateral:

Recovery rates on Spanish Mortgages: For a variety of reasons it is difficult to obtain exact loss severity statistics for Spanish mortgage loans. However, Fitch's research has not succeeded in identifying losses of any significance on residential mortgage lending by Spanish financial institutions over the past decade. This includes the major recession of the early 1990s. Our rating experience over this period has persuaded us of the high quality of Spanish domestic mortgage lending. Further evidence of this can be inferred from the lower percentage of provisions required by the Bank of Spain on residential mortgages for "statistical" loan loss reserves. (See separate comment on "Banco de España's Loan Loss Reserve Regulation" published in March 2000.) The percentages applied to different credit risk categories are based on past provisioning levels. First residential mortgage loans with a loan to value ratio of below 80% qualify as low risk, requiring a provision of only 0.1% (straight, unsecured, corporate loans require a 0.6% provision).

Recovery rates on public finance lending in the EEA: Public finance debt of EEA countries is generally low risk. On the basis of the experience of different specialised public finance lenders rated by Fitch, we so far conclude that there have been no major asset quality problems. Again, as with CHs, the lack of any record of significant lending problems makes it difficult to collect information to determine loss severity. Spanish credit institutions are not required to build up "statistical" loan loss reserves to cover the public sector loans serving as collateral for CTs. However, in practice, a large proportion of Spanish banks' public sector loan portfolio is domestic, and, on the basis of the institutions' knowledge of the Spanish market, Fitch is more confident of the creditworthiness of this part of their portfolio.