

THE FUNDING OF THE MORTGAGE LOANS IN SPAIN BY THE ISSUE OF MORTGAGE SECURITIES. THEIR LEGAL STRUCTURE

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Abstract

This paper studies how the mortgage loans are funded by the credit institutions in Spain by the issue of mortgage bonds and mortgage-backed securities, which have some important particularities in their structure and security when compared with the German and the Anglo-Saxon models.

1 Introduction

The need for the mortgage funding is specially important in countries like Spain in which huge quantities of mortgage loans are given, as people rather prefer acquiring a dwelling in property than renting it. Banks and other credit institutions, then, have a risk not to have enough cash for lending in each moment. In consequence they must have an effective process of mortgage funding, in order to have always enough cash to lend. The Spanish mortgage market law (*Ley del Mercado Hipotecario* 1981, LMH) serves the legal frame for the creation of this market according to the article (art.) 47 Spanish Constitution of 1978, which establishes the constitutional obligation of facilitating to everybody the access to a dwelling. The more effective the mortgage funding is, the cheaper the mortgage loans for the mortgage debtors are.

The process of mortgage funding differs from one country to another. Normally the retail deposits are used for this purpose (also in Spain), but if what the credit institutions want (or need) is a medium or a long term sure cash, the better way to achieve this is to structure some kind of passive operations of the lenders, based in a mortgage securities market. There are two great systems of mortgage securities markets nowadays: the German model (*Pfandbrief*) and the Anglo-Saxon model (mortgage-backed securities), each one with special characteristics, advantages and disadvantages. Both are available and regulated in Spanish law and may be successfully exported to countries that

would possibly need some kind of ground credit to enhance their agricultural productivity or to promote the construction of cities; this might be the case of third world or East-European countries.

2 A quick economic perspective

Studying what happens around Europe (end-1998) may be seen that 62% of the “European mortgages” are funded by retail deposits, whereas 19% of them are funded by mortgage bonds. Only 1% of the whole European mortgages are funded by mortgage-backed securities.

The main issuers of mortgage bonds are Germany (44%), Denmark (29%) and Sweden (15%). Spain is the fifth issuer of mortgage bonds in Europe (1,5% end-1998) after France (6,6% end-1999). On the other hand, the mortgage-backed securities are more used in the United Kingdom, followed by Ireland, France and Spain [1]. The first countries in each list reflect the two main systems of mortgage funding.

In February 2002 the total outstanding volume of mortgage loans in Spain has been 305.657 million €, which around 5% are funded by mortgage securities [2].

3 Spanish mortgage bonds and mortgage-backed securities

Both types of securities have special particularities in Spain that make them unique in the European mortgage securities market.

3.1 The *cédulas hipotecarias* (Spanish mortgage bonds)

The structure of the Spanish *cédulas hipotecarias* may be found in the LMH and follows basically the structure of the German model of the *Pfandbrief* [3] [4], as can be seen in Fig. 1.

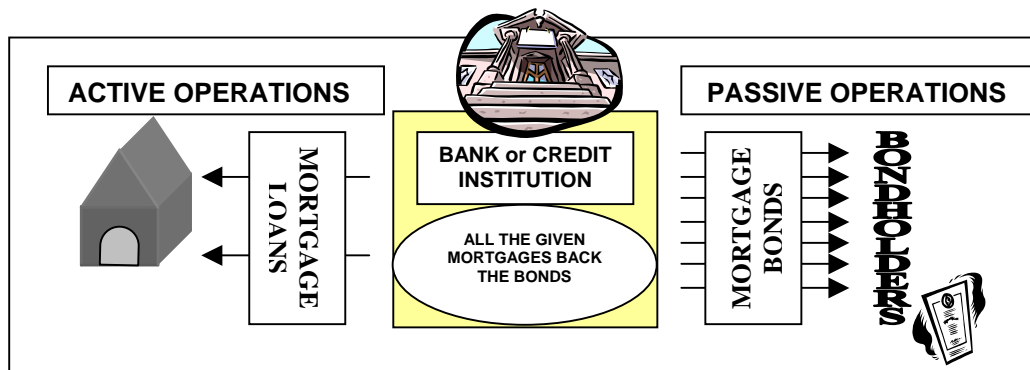


Figure 1: Structure of the Spanish mortgage bonds.

A land credit institution concedes a number of mortgage loans that conform a pool of mortgages with specific features. This pool of mortgages may be funded by issuing mortgage bonds whose value cannot exceed the 90% of the value of all the mortgages of the pool. The mortgage bonds represent debt to the issuing credit institution.

The owners of the mortgage bonds (not only institutional but also particulars) receive the interests periodically until the security becomes amortised. The global amount of outstanding mortgage bonds is backed by all the mortgages owned by the issuer.

Now the question is which is, in fact, the security of the mortgage bonds, that is to say, which is the legal relationship between the securities and their backing mortgages. In our opinion the mortgage bonds holders have only a **preferential credit** against the pool of mortgages (not a sub-mortgage [5] [6]) owned by the issuer of the securities (the land credit institution).

This security would have been ideal if there had not been more preferential credits before this one, but this is not the case. In the Spanish civil and commercial laws there is a plurality of preferential credits. Some of them are more preferred than the one of the mortgage bondholders. In fact, the mortgage bondholders are placed in the 7th rank (art. 14 LMH and art. 1923.3 Spanish Civil Code) after other privileged creditors over the same debtor in case of non-payment of the security and in the 6th rank (art. 208.1 and 913.2 Spanish Commercial Code) in case of winding up of the debtor.

In our opinion, the legal dispositions about the security of the mortgage bonds must be replaced by other ones which follow the German system of the *Pfandbrief* (after the reform of the *Hypothekbankgesetz* of 1998) [7], which establishes a special security of the mortgage bonds consisting in the separation of the backing pool of mortgages from the global patrimony of the debtor in case of its insolvency. With this structure, the insolvency or winding up of the debtor (the land credit institution) will not affect the credit of the mortgage bondholders because the pool of mortgages will become an independent mass dedicated exclusively to their satisfaction.

3.2 The bonos de titulización hipotecaria (Spanish mortgage-backed securities, SMBS)

3.2.1 The regulation and the structure of the SMBS

The Spanish mortgage-backed securities (SMBS) were not regulated until the Act 19/1992 and, therefore, were not present in the LMH of 1981. Even though they are relatively new securities in Spanish law, their importance may be compared to the one of the mortgage bonds.

The regulation of this kind of securities in the Spanish law is influenced by the Anglo-Saxon model of mortgage funding: the securitisation of mortgages. This model has been carried on with great success in the United States since the 60s and it has been exported to many other countries of all the continents [8] [9] [10] [11]. However in the European Union it has only an economic significance in the United Kingdom, although it is present in other EU-member countries (France and Spain especially).

“Mortgage securitisation” means that the mortgages are “transformed” in some way into securities. This means, in a strict sense, that the investors acquire the mortgages themselves by acquiring the MBS (*pass-through model*). As the MBS are securities, they are much easier to be traded than the mortgages themselves. With the sale of the mortgages from their originator (mortgagee) to an insolvency-remote special purpose vehicle (SPV), the mortgages are placed off the balance of the originator and become more secure for their buyers (investors) as they won’t be affected by the winding up of the originator and the SPV is an insolvency-remote institution.

All this structure is possible thanks to the **trust** institution, which is present in the Anglo-Saxon systems of private law but, in general, it is not in the ones derived directly from Roman law, like the Spanish one. This is one of the grounds why the securitisation process of mortgages cannot be openly or completely admitted in these countries. Therefore, for the admission of the securitisation model in Spanish law its structure must have been re-adapted [12], as can be seen in Fig. 2.

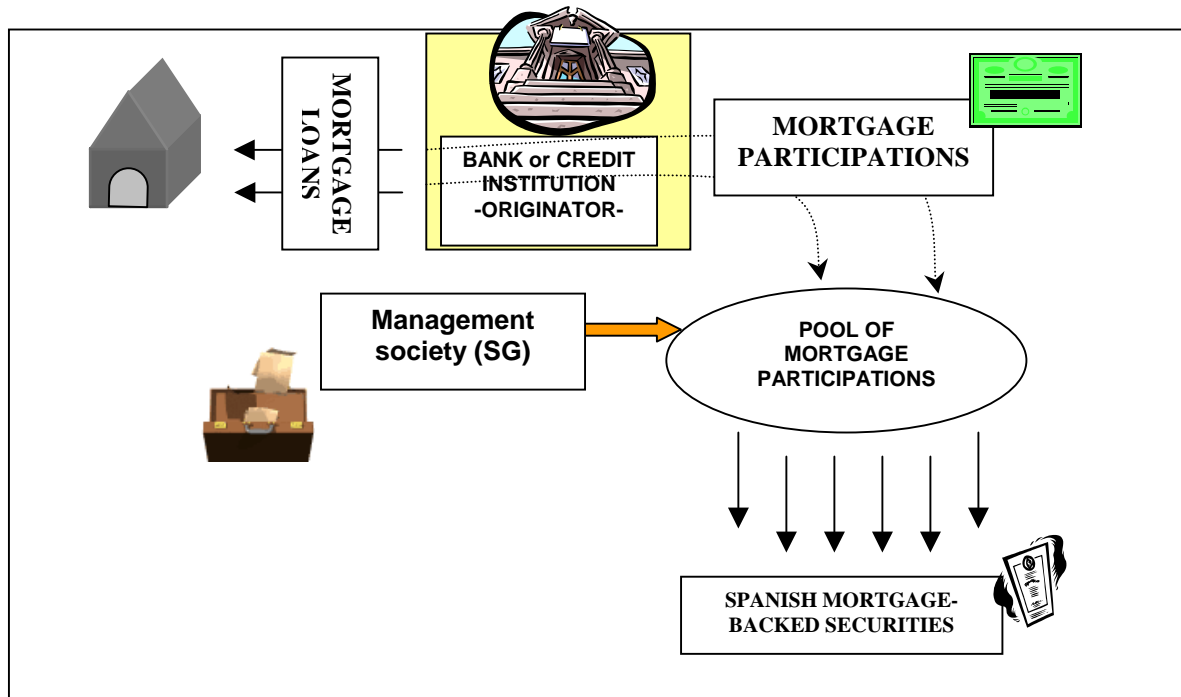


Figure 2: The Spanish mortgage-backed securities structure.

In general, there are two great Anglo-Saxon models to structure the securitisation of mortgages:

- The pass-through securitisation model (USA): in this model, the MBS holders have a property right over the pool of mortgages, because their capital and interests pass through the mortgage debtor directly to the securities holders. In this model the trustee of the issue is at the same time the SPV [13].
- The pay-through securitisation model (USA and UK with the UK-mortgage-backed securities [14]): in this model, the MBS holders have only a credit right against the pool of mortgages and the security of this credit (either a charge (USA) or a sub-mortgage (UK)) is held in their benefit by the trustee of the issue.

The Spanish model is a **hybridization** of both models and it adapts their structure to the Spanish civil and commercial legislation.

The Spanish mortgage-backed securities do not securitise the mortgages directly as they are not issued on their basis. Before the issue of MBS it is necessary to “*participate*” the mortgages, which means, to issue another kind of mortgage securities, called “mortgage participations” (*participaciones hipotecarias*), which represent a percentage of each participated mortgage. This percentage determines which amount of each mortgage may be securitised afterwards. The mortgage participations are also securities, the holder of which becomes co-mortgage creditor (co-mortgagee) beside the originator of the mortgage. The mortgage participation holder receives the main amount and interests corresponding to the percentage of the “participated” mortgage from the issuer (originator of mortgages), who has received them from the mortgage debtor (borrower of the mortgage loan). It is a true cession of a mortgage loan, which means that the mortgage participation holder may claim not only against the issuer of the mortgage participation (the land credit institution) but also against the mortgagor -against whom the mortgage participation holder may enforce the mortgage- depending on who has defaulted. With the issue of the mortgage participations, the mortgage securitisation process has just begun and it would not end until the formation of a pool of mortgage participations (in fact, a pool of parts of

mortgages) takes place. The mortgage participations may be issued not only for professional investors but also for the public in general.

The issue of mortgage participations is what the Spanish legislator has foreseen to substitute the Anglo-Saxon trust (1st trust) which may arise between the originator of the mortgages and the SPV: although the originator continues on the relationship with the mortgage debtor all what is made is for the benefit (on trust for) of the SPV which is controlled, in one way or another, by the activity of the trustee of the issue (2nd trust) on behalf of the securities holders. In the Spanish law, the originator of the mortgage continues on the relationship with the mortgage debtor, who will never know that the mortgage has been “participated” unless he defaults in his periodical payments and, as a consequence of this, occurs a non-payment of the mortgage participation holder; the Spanish mortgage originator is acting like a trustee of the mortgage participations bondholders.

When the ultimate purpose of a mortgage originator is to securitise the mortgages, he needs to sell (true sale) the mortgage participations to a management society (“Sociedad Gestora”, SG) (like the trustee of the issue) which must, in fact, create with them the “Fondo de Titulización Hipotecaria” (FTH), that is, the pool of mortgage participations over which the SG would be allowed to issue the SMBS (“bonos de titulización hipotecaria”). The SG buys the mortgage participations in the name of the pool (FTH). Here several problems arise: namely, to determine the nature of the FTH, the nature of the SG and the nature of the SMBS or which are the rights that they incorporate, for instance. There is no easy solution to these problems and none of them are completely solved until today. However we will try to find out a possible solution.

The FTH is an **independent patrimony**, a rare figure in Spanish civil law. In our opinion, the FTH has been imported from a foreign private-law system and it is impossible to find its true nature from the traditional Spanish law; but what it is sure is that it is a patrimony that will respond for the SMBS and will be used to repay them in accordance to the art. 1911 of the Spanish Civil Code. The FTH is, in fact, the **debtor** of the SMBS’ holders and it is managed by the SG which is some kind of trustee of the issue but **without any property or security right** over the pool of mortgage participations (FTH); it is only its administrator and must act always looking for the benefit of the SMBS’ holders.

3.2.2 The liabilities for the non-payment of the SMBS

The SG has only an objective: the protection and punctual payment of the SMBS’ bondholders. To achieve this, the SG may manage the pool freely and it may enforce each one of the mortgage participations in case of their non-payment against the guilty whoever he is: either the originator of the mortgage or the mortgagor. Thus, we may conclude that if one or some SMBS become unpaid is because the SG has not succeeded in its duty (this would be the most normal cause of non-payment of the SMBS: the SG does not have the due diligence, like a breach of trust) and it becomes responsible in front of the SMBS holders, who have an action against it. The Spanish law does not allow any other **direct** action of the securities holders neither against the originator of the mortgages nor against the mortgage debtor.

As the only objective of the SG is to manage the FTH, it is practically sure that it will not have enough own patrimony to satisfy the SMBS’ holders. Thus, in our opinion, they must be allowed to become satisfied from the pool of mortgage participations. But, which is the relationship between the securities holders and the pool? Are they the owners of the pool or do they have only a credit against it? Is this credit secured in any way? How can be enforced an action against an independent patrimony without own personality if the Act 19/92 only allows an action against the SG’s own patrimony and not against the independent patrimony of the FTH? The different authors who have studied this matter have arrived to two completely opposed solutions: either the securities bondholders have *de facto* an action against everybody (SG, originator and mortgage debtor) or they have no actions except the one against the patrimony of the SG. We do not agree with the latter position, as it would be very

prejudicial for the securities bondholders since in case of non-payment they would not be able to do anything (neither against the pool) and, of course, this situation should not be possible. They must have an action to protect their interests but it must be very well argued, as the Act 19/1992 does not allow specifically any more actions except that weak one against the SG.

The solution should come from the art. 1111 of the Spanish Civil Code, which deals with the subrogation of the creditor in the position of the debtor, that is, the case that the securities holders subrogate themselves in the position of the SG if they are unable to find in its patrimony enough goods to become satisfied. And then, they are allowed to choose between two possibilities: either to continue on the administration of the pool after having enforced all the actions against the responsables of the default or to proceed with the execution and sale of the pool of mortgage participations.

The securities' holders do not have in any case a property right over the pool: they are not co-owners of the FTH like the holders of the USA pass-through securities. They are only **creditors** of the pool like the holders of pay-throughs in USA and the holders of the UK mortgage-backed securities. But the credits of the SMBS bondholders against the pool are unsecured because they do not have any charge or sub-mortgage over the pool of mortgage participations (unlike the pay-throughs in USA and the UK mortgage-backed securities). The only secured actions they have are the ones against the mortgage debtor (secured with a mortgage) derived from each one of the mortgage participations in case that a mortgage debtor defaults.

3.2.3 Protection of the SMBS' bondholders in case of winding up of the originator of mortgages or the SG

Another aspect is what happens in case of winding up of the originator and in case of winding up of the SG:

a) Winding up of the originator of the mortgages: the mortgage participations (also the ones that are included in a pool to be securitised) must not be included in the winding up mass of the originator, which means, that the mortgage participations are not affected by the insolvency of the originator: they are considered not to be of the originator's property (moreover, they have no owner if they have been incorporated to a pool to be securitised). If the mortgage participations are not affected by the originator's winding up, neither are affected the SMBS that had been issued over the first ones.

b) Winding up of the management society (SG): in this case there is a bit more risk for the SMBS's holders. First of all, another SG must be found but if the search remains unsuccessful for four months, the FTH must be extinguished and the SMBS's holders must be paid in the order that was established in the public document of the FTH's creation.

3.2.4 Conclusions

To sum up, there are different ways for the mortgage funding in Spain. The two mortgage funding systems by the issue of securities, the German and the Anglo-Saxon, do exist in the Spanish mortgage market. But both have special features due to the particular Spanish civil and commercial laws.

The structure of the *cédulas hipotecarias* (Spanish mortgage bonds) is quite similar to the structure of the German *Pfandbriefe*: they represent a credit against the issuer, who is the same as the originator of the mortgages. But the Spanish *cédulas hipotecarias*' security must be improved to reach the level of the German *Pfandbriefe*, as the former only represent a preferential credit against all the mortgages of the issuer and the latter allows the creation of a insolvency-remote pool of mortgages separated from the general patrimony of the issuer.

The Anglo-Saxon securitisation process of mortgages was introduced in Spain for the first time with the *bonos de titulización hipotecaria* (Spanish mortgage-backed securities, SMBS) in 1992. But as the trust is unknown in the Spanish civil law, new adapted formulas were adopted. In consequence, the SMBS are not issued properly over a pool of mortgages but over a pool of

participaciones hipotecarias (mortgage participations), which are securities that represent a percentage of each participated mortgage. The security of the SMBS is almost too unclear but, in our opinion, the SMBS bondholders may enforce the securities directly against the *Sociedad Gestora* (SG) of the pool of mortgage participations and indirectly against the originator of mortgages or the mortgage debtor, depending on who has defaulted in the payments. Our interpretation approaches the rights and securities of the SMBS bondholders to the ones of the mortgage-backed securities holders in USA and in UK, although there are still differences. Nevertheless, from our point of view it should be interesting to regulate some kind of trust in Spain -Catalonia is about to regulate it in its new Civil Code [15]- in order to increase the security of all these fiduciary operations [16].

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