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## Research:

### Spanish Cédulas Hipotecarias Fail to Take Off

**Publication Date:** 22-Feb-2001

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In 1999, Standard & Poor's published its criteria for rating Spanish cédulas hipotecarias--bonds issued by Spanish financial institutions and secured by the issuer's entire book of mortgages. Since then, these instruments have been launched in the international capital markets, although their degree of success has been far below initial expectations despite the instruments' high degree of overcollateralization and a long default-free track record in the retail domestic market. The unenthusiastic welcome received by cédulas hipotecarias in the international arena can be largely attributed to the fact that, in the search for highly creditworthy instruments, investors' demands for a degree of transparency and instrument characteristics closely resembling those of the successful German Pfandbriefe have not been met. Uncertainties regarding provisions in the Spanish legal framework for post-insolvency workout and the lack of any explicit mechanisms in the law to ensure timely payment in the event of issuer insolvency are key features differentiating the creditworthiness of cédulas hipotecarias from that of other European mortgage bonds. While in several other countries legal frameworks and mortgage bond characteristics have recently been, or are in the process of being, changed to emulate those of German Pfandbriefe, Spanish cédulas hipotecarias run the risk of missing the opportunity of joining the promising European mortgage-bond asset class.

This article expands on Standard & Poor's approach to rating cédulas hipotecarias, and on its assessment of these instruments' credit quality and the implications of uncertainties in the Spanish legal framework regarding insolvency.

### ■ The Rating Approach in Brief

Standard & Poor's incorporates in its analysis of cédulas hipotecarias the consideration of ultimate recovery based on collateral protection; in such an analysis, the degree of confidence with respect to recovery and the time taken to realize ultimate recovery are regarded as paramount. According to Spanish legislation, cédulas hipotecarias enjoy a preferential claim on the cover assets. This preferential claim, coupled with the high degree of overcollateralization of cédulas hipotecarias, increases the probability of recovery on these instruments compared with the issuer's unsecured obligations. Consequently, the rating on these instruments may be higher--up to two notches--than the issuer's counterparty credit rating. The degree of rating enhancement, if any, depends primarily on the quality and amount of underlying collateral, and is determined on a case-by-case basis. Variations in the characteristics of underlying collateral may lead to changes in the rating on the instruments. According to Standard & Poor's ultimate recovery criteria, the amount of rating credit for recovery is tempered for issuers with very high counterparty credit ratings; the higher the issuer's rating the more weight should be given to timeliness, and the lower the rating the more it should incorporate a post-default perspective.

The fact that, in the event of the issuer's insolvency, cédulas hipotecarias are subject to payment interruption means the creditworthiness of these instruments is linked to that of the issuer. Changes in the issuer's counterparty credit rating may therefore also lead to changes in the rating on the cédulas hipotecarias. The lack of a provision in Spanish law under which cédulas hipotecarias would be insulated from issuer insolvency in such a way that payment delays would not occur precludes the decoupling of the rating on these instruments from that on the issuing entity. The absence of such a shielding mechanism ensuring timely payment in an issuer insolvency scenario also excludes the possibility of cédulas hipotecarias achieving an 'AAA' rating from Standard & Poor's, regardless of the rating on the issuer or the assessment of the underlying collateral.

The vulnerability of cédulas hipotecarias to payment interruption is in contrast to secured debt instruments in other European countries with similar characteristics to cédulas hipotecarias, such as Germany's Pfandbriefe, France's obligations foncières, and Luxembourg's lettres de gage. As a key

aspect of the process of these instruments becoming a new asset class in Europe, legal frameworks have been amended in the two latter countries and efforts are underway in certain others. The changes introduced by France's law of June 25, 1999, and the amendments to the Luxemburg Act on the Financial Sector (passed in May 2000) have introduced elements of protection for the timely servicing of these types of debt in the event of issuer insolvency, as is the case for German Pfandbriefe. Thus, Pfandbriefe, obligations foncières, and lettres de gage may achieve an 'AAA' rating from Standard & Poor's irrespective of the issuer's counterparty credit rating, provided they are backed by a sufficient amount of high-quality collateral.

Standard & Poor's considers there exist several uncertainties pertaining to the Spanish legal framework on insolvency that additionally constrain the ratings on cédulas hipotecarias. These factors affect primarily--but not solely--the time it would take holders of cédulas hipotecarias to recover the full value of the obligation in the event of issuer insolvency. Since the creation of cédulas hipotecarias in 1869, however, no issuer of these instruments has undergone bankruptcy proceedings (nor defaulted on the instruments), and, therefore, there is no precedent as to the application of the law in this respect.

## ■ Overview of Cédulas Hipotecarias and Their Market

Cédulas hipotecarias are general recourse obligations of the issuing entity. Unlike in the case of securitization, both cédulas hipotecarias and the cover mortgage loans remain on the issuer's books.

Cédulas hipotecarias are regulated by Spain's 1981 Mortgage Market Law. The latter defines cédulas hipotecarias as bonds secured by the issuer's entire book of mortgages, except those serving as collateral for other mortgage securities (which are also regulated by the aforementioned law). The other mortgage instruments that may be issued are "bonos hipotecarios" (mortgage bonds) and "participaciones hipotecarias" (mortgage units). In practice, the entire mortgage portfolio serves as collateral for the cédulas hipotecarias, as the issuance of bonos hipotecarios is virtually negligible (due to the cumbersome and costly process of taking a mortgage over the underlying loans), and mortgages backing participaciones hipotecarias are removed from the issuer's portfolio via securitization.

Cédulas hipotecarias may be issued by all types of financial institutions regulated by Banco de España (Spain's central bank). These include commercial banks, savings banks, credit cooperatives, and finance companies. From their creation until 1999, however, cédulas hipotecarias were only issued by savings banks and the former Banco Hipotecario, S.A. (the mortgage-lending unit of the former Argentaria, Caja Postal y Banco Hipotecario, S.A. (Argentaria), now merged into Banco Bilbao Vizcaya, S.A. (BBV) to form Banco Bilbao Vizcaya Argentaria, S.A. (BBVA), rated 'AA-/Stable/A-1+'). Limitation of cédulas hipotecarias issuance to these institutions was driven by the latter's historical calling of acting as mortgage lenders, which--rooted in legal restrictions that are no longer in force on the activities of different types of financial institutions--led to savings banks and Banco Hipotecario, S.A. having large portfolios of (mainly residential) mortgage loans on their books.

The driver behind the creation of these instruments was, as in many other European countries, the provision of a low-cost funding instrument for mortgage portfolios to aid the development of the residential real estate market. Unlike their Danish counterparts (realkreditobligationer), however, cédulas hipotecarias have not been the main funding instrument of the mortgage portfolios of Spanish savings banks, as the latter have historically been predominately funded by cheap, stable, and ample retail-customer deposit bases.

Issues until 1999 were small, and almost entirely placed among domestic retail investors through these institutions' dense branch networks. As an example--according to information provided by Spain's Securities Exchange Commission--the average issue size in 1997 and 1998 was €88 million and €172 million, respectively, while the average maturity was three years in both years.

Although commercial banks have also been allowed to grant mortgage loans since 1977, residential mortgage lending by these institutions has grown more strongly in the past few years. Thus, residential mortgage books now account for a more significant part of commercial banks' portfolios. This, coupled with the increasing popularity of mortgage bonds in Europe, has led to a significant change in the cédulas hipotecarias market. Although the issuance by savings banks of small issues of cédulas hipotecarias placed among retail customers has continued, two commercial banks (the former Argentaria and BBV) debuted in 1999 with three "jumbo" issues (€1 billion and over) placed among

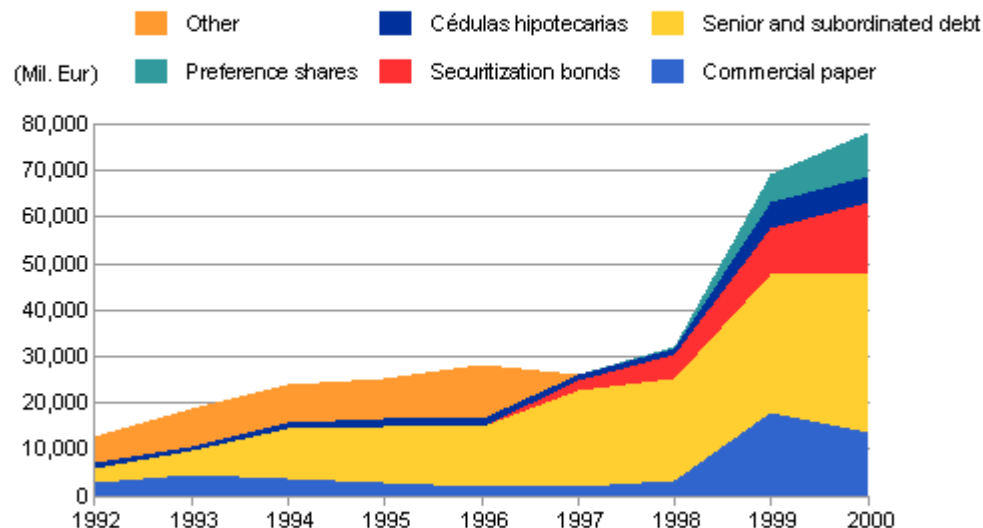
international institutional investors, and with longer maturities (10 years). Only one savings bank--Caja de Ahorros y Monte de Piedad de Madrid (Caja Madrid; 'AA-/Negative/A-1+')--has launched an issue with similar characteristics. (See table 1.)

Table 1 Jumbo Issues of Cédulas Hipotecarias Since Year-End 1998				
Issuer	Issue date	Amount (Bil Eur)	Maturity	Markets
Argentaria	March 1999	1.0	10 years	Madrid
Argentaria	July 1999	1.5	5 years	AIAF & Paris
BBV	September 1999	1.0	10 years	AIAF & Luxembourg
Caja Madrid	October 1999	1.0*	10 years	AIAF, Luxembourg, & Paris
BBVA	September 2000	1.5	10 years	AIAF, Luxembourg, & Paris
*This issue was increased in 2000 by Eur500 million				

Despite these changes, the importance of cédulas hipotecarias in the Spanish debt markets is still relatively minor (see chart 1); outstanding cédulas hipotecarias represented slightly less than 8% of outstanding domestic private-sector fixed-income securities at year-end 1999. Nevertheless, the potential for growth in the issuance of these instruments is great, with an estimated underlying asset base (of mortgage loans) amounting to about €258 billion (Spanish peseta (Ptas) 42 trillion) at Sept. 30, 2000. The possibility of increasing issuance of cédulas hipotecarias and their growth beyond domestic borders is of particular relevance at a time when this new asset class is developing in Europe. As issuance of government bonds is decreasing throughout Western Europe, and with the convergence of markets with the arrival of the euro, other European mortgage bonds are enjoying a significant amount of renewed interest following the success in international markets of German Pfandbriefe. With an outstanding nominal amount of €841 billion (deutsche mark (DM) 1.7 trillion) at Oct. 30, 2000, Pfandbriefe already accounted for about 37% of the German domestic bond market (including public-sector issuers). Danish realkreditobligationer have for long been one of the main funding instruments of Danish mortgage institutions; their outstanding nominal amount totaled about €255 billion (Danish krone (DKr) 1.9 trillion) at July 31, 1999, or 43% of Denmark's GDP. Issuance of French obligations foncières and Luxembourg's lettres de gage is taking off following changes in their respective legal frameworks.

Chart 1

### Total Outstanding Amounts Quoted - Secondary Fixed-Income Market (AIAF)



Source AIAF. Outstanding amounts issued by all economic sectors. Data for 2000 is accumulated outstanding amounts at Oct. 31, 2000.

## ■ High Credit Quality Instruments

**Strict issuance limits and significant, relatively low-risk excess collateral.**

By law, the maximum amount of cédulas hipotecarias that an institution may issue is restricted to 90% of outstanding eligible mortgage loans. Eligible mortgages are defined by the 1981 Mortgage Market Law as domestic loans guaranteed by a mortgage on residential or commercial real estate and that are not serving as collateral for other securities (mortgage bonds or mortgage participations). In addition, mortgage loans serving as collateral for cédulas hipotecarias must comply with the 1981 Mortgage Market Law requirements of having a maximum loan-to-value ratio of 80% in the case of residential property and 70% in the case of commercial property; being guaranteed by a first-lien mortgage; having underlying real estate that is the full property of the mortgage debtor; and insurance being taken out on the asset for the full amount of the valuation. Mortgages loans in Spain must be registered in the Spanish property register.

Given the maximum issuance limit on cédulas hipotecarias, their legal overcollateralization is at least 11% in the case where the issuer's entire mortgage portfolio is eligible under the issuance limit. This legal minimum level of overcollateralization is the highest among secured mortgage debt instruments in Europe, followed by that of Danish realkreditobligationer, which is set at 8%. Although many issuers of Pfandbriefe, obligations foncières, and lettres de gage maintain higher levels of collateral than the legal minimum (as may indeed be required by Standard & Poor's in order for issues of these instruments to be assigned an 'AAA' rating), their respective legislations do not require that they be backed by excess collateral, but just by the same amount as for outstanding secured bonds.

The overcollateralization of cédulas hipotecarias is, in practice, much greater than the legal minimum, however, as banks and savings banks have not made extensive use of these instruments in the past. The amount of cédulas hipotecarias outstanding compared with the mortgage portfolio is therefore rather low, increasing overcollateralization to much higher levels: the ratio of cédulas hipotecarias to total mortgages is currently below 25% for all issuers, which means that overcollateralization is at least 300%. In addition, not all mortgages on the issuers' mortgage books are eligible for issuance limit purposes, which means that, even in cases where the maximum issuance limit is reached, collateral exists in excess of 111% of outstanding cédulas hipotecarias (although "noneligible mortgages" would obviously be considered as lower quality collateral).

The existence at present of a significant amount of excess collateral underlying cédulas hipotecarias provides a substantial cushion, which increases the probability that there would be enough value to recover in the event of issuer insolvency. Nonetheless, in rating cédulas hipotecarias, Standard & Poor's may require higher levels of excess collateral than those set by the legal maximum issuance limit in order to provide credit enhancement (that is, to rate the instruments one or two notches above the issuer's counterparty credit rating).

In addition to the amount of collateral, Standard & Poor's considers the quality of the underlying loans to be a key rating factor. The fact that cédulas hipotecarias are guaranteed by a revolving pool of assets means that the analysis is focused not only on the quality of the existing loan book at the time of issuance, but also on the issuer's underwriting standards, credit-risk management systems, and asset-quality track record throughout the economic cycle. Thus, the emphasis of the analysis is not just on the existing stock of collateral, but allows for the best estimate of the quality of the loans that will be continuously added to the book and that will also serve as collateral for outstanding cédulas hipotecarias. For example, the issuer's focus on analyzing and monitoring the ability of borrowers to repay loans punctually, and lending limits set accordingly, are features that enable Standard & Poor's to determine the likelihood that a higher or lower frequency of default will occur.

The quality of the cover assets of cédulas hipotecarias benefits from the maximum loan-to-value ratios required by the 1981 Mortgage Market Law, as these limits afford a significant cushion in the event of a market value decline of the mortgaged assets. Assuming that the entire portfolio of eligible mortgages is composed of residential mortgage loans (required to have a maximum loan-to-value ratio of 80%), the legal minimum excess collateralization compared with the property value would be 28%. The real overcollateralization is much greater because the average loan-to-value ratio of the entire portfolio is reduced as mortgages mature. For example, in the case of a bank with an average loan-to-value ratio of 60%, the overcollateralization in respect to the property value would be 55%. Standard & Poor's also monitors, as part of the process of rating cédulas hipotecarias, the existence of more conservative policies in respect to loan-to-value ratios for different types of loans, as well as the evolution of the average loan-to-value ratios of the portfolios of different classes of mortgage loans.

In order to assign a rating to an issue of cédulas hipotecarias and subsequently monitor it, Standard & Poor's performs due diligence and an assessment of the issuer's underwriting criteria and credit-risk management, as well as of the existing loan portfolio; these elements are part of the ongoing surveillance process that Standard & Poor's performs for those institutions that have a counterparty credit rating.

As highlighted above, the current levels of issuance of cédulas hipotecarias are very low. Nonetheless, to the extent that cédulas hipotecarias have a priority claim on the issuer's entire book of mortgages, a substantial increase in the proportion of cédulas hipotecarias compared with underlying assets would translate into a material disadvantage for unsecured creditors, as a smaller pool of assets would be available to them for recovery of the full value of their claims in the event of issuer insolvency. Standard & Poor's issue credit ratings reflect the differences in asset protection of creditors' claims and their ranking. Hence, much greater levels of better-positioned cédulas hipotecarias may put pressure on an issuer's unsecured debt ratings, reflecting these claims' worsened prospects for recovery.

### **Tight monitoring of compliance.**

In order to ensure that the required issuance limits and characteristics of eligible mortgage portfolios (legal rights to issue, registrations, mortgage requirements, loan-to-value ratios, overcollateralization, and asset valuations) are respected, the 1981 Mortgage Market Law provides that the Ministry of Finance has the role of monitoring compliance; the Ministry of Finance has delegated this role to Banco de España. Valuation of the mortgaged assets must be performed by the issuer's own appraisers or by outside experts. Banco de España verifies compliance with valuation criteria set out by the Ministry of Finance. In addition, Banco de España inspects the banks' loan portfolios on a regular basis, and mortgage loans are also verified as part of Banco de España's supervision of capital adequacy requirements.

The 1981 Mortgage Market Law also sets out the mechanisms for ensuring that the limits in respect to overcollateralization are efficiently restored in the case of a breach. Thus, if at any time the amount of cédulas hipotecarias outstanding exceeds the limit of 90% of the eligible mortgage portfolio, the issuer must restore the legal limit by posting cash collateral or government bonds with Banco de España within 10 days; and within four months it must either buy back cédulas hipotecarias in the market, prepay cédulas hipotecarias, or add in new mortgages to the cover assets. If the value of the mortgaged property falls by more than 20% compared with its initial valuation, the borrower must post extra collateral to bring the coverage level back to an equivalent loan-to-value ratio of 80% or 70% (depending on the type of mortgaged property). Alternatively, the borrower may choose to repay the loan in full or in part so that the coverage levels required by the law are met within two months.

Banco de España is vested with extensive powers to perform its duties and verify compliance. Breach of regulatory requirements is subject to certain sanctions also set out in the 1981 Mortgage Market Law. These range from imposing fines, as a consequence of small breaches, to withdrawal of authorization to act as a credit institution and forceful liquidation and dissolution of the institution in cases of grave infringements.

The Law does not require the appointment of a trustee, although this can be done by private agreement. In fact, some of the institutions that have issued in the international markets have appointed a trustee, as it is perceived as a mechanism that not only reinforces monitoring of underlying collateral, but would also aid enforcement of cédulas hipotecarias holders' rights in an eventual liquidation process.

### **Interest rate risk and risk of cash flow mismatches.**

The 1981 Mortgage Market Law does not establish any specific requirements in respect to matching of interest rates between cédulas hipotecarias and underlying mortgage loans. It does stipulate, however, that in cases where cédulas hipotecarias are indexed to variable rates, the margin over the index rate must be fixed, and that the average interest rate paid on variable-rate-indexed cédulas hipotecarias must never exceed the average interest rate of underlying variable-rate mortgage loans. Cédulas hipotecarias are typically issued with fixed rates, which have been historically lower than those of the cover mortgage loans. Variable-rate mortgage loans (usually indexed to Mibor (Madrid Interbank Offered Rate) or Euribor (Euro Interbank Offered Rate)) are the largest component of most institutions' mortgage portfolios, and, with the fall in interest rates during the 1990s in Spain, the

difference between their interest rates and those of cédulas hipotecarias has narrowed. The risk of interest rate drops reducing interest rates paid on underlying mortgage loans to below those of cédulas hipotecarias is relevant in the event of issuer insolvency as a potential source of cash flow risk (which rises as the level of overcollateralization declines).

The 1981 Mortgage Market Law contains no mechanism to limit the risk of mismatch of cash flows between the interest received from the underlying mortgage loans and the coupon payment on cédulas hipotecarias. This risk is at present minimized, however, by the high level of overcollateralization cédulas hipotecarias enjoy.

#### **Minimized prepayment risk.**

Risk of mortgage prepayment introduces two potential risks in the case of cédulas hipotecarias: in an unstressed scenario it may lead to the issuer prepaying cédulas hipotecarias (thus introducing interest rate risk for holders of cédulas hipotecarias) as one of the mechanisms established by law to re-establish compliance with maximum issuance limits; or, in the even of an insolvent issuer, it may reduce underlying collateral. Currently, however, this risk is mitigated by the substantial overcollateralization that cédulas hipotecarias enjoy. Another mitigating factor is the historically reduced prepayment risk associated with mortgage loans in Spain. This risk is significantly reduced by the costs incurred by a borrower when obtaining a mortgage (notary, originator, and registrar fees and stamp duty), plus the prepayment penalties charged by institutions. Originator fees and prepayment penalties charged by Spanish financial institutions are currently up to 1.5% of the amount loaned and 4% of the remaining part of the loan to be paid, respectively.

### **■ Issuer Insolvency and Implications of Uncertainties in the Spanish Insolvency Legal Framework**

In the event of insolvency, Spanish financial institutions become subject first to the 1988 "Ley de Intervención y Disciplina de Entidades de Crédito" (financial institutions law on discipline and intervention), by which Banco de España has the power to intervene at the issuing entity and take actions to rehabilitate it. Should this not occur, it would enter judicial liquidation. Standard & Poor's believes that, in the event of issuer insolvency where Banco de España intervened, the time needed for recovery of cédulas hipotecarias would be relatively fast, but that a judicial liquidation might delay recovery substantially. Even though cédulas hipotecarias are "executive instruments" (which entitles them to "summary execution proceedings" or a fast-track judicial process), the judicial liquidation process may be lengthy depending on its complexity (that is, number of creditors, debtor's assets, and processes necessary to determine the debtor's liabilities).

If a bank were placed into judicial liquidation, it would fall within the general bankruptcy law. "Sindicatos" (trustee creditors in charge of managing the bankrupt's estate, supervised by a judicial delegate or "comisario") are nominated by the "Fondo de Garantía de Depósitos" (FGD; Deposit Guarantee Fund). Four out of the eight appointees of the Fondo de Garantía de Depósitos are representatives of Banco de España. Their appointment and management of the bankrupt's estate must be approved by the judge.

Standard & Poor's considers the priority claim of holders of cédulas hipotecarias to be well established, based on the "specially privileged creditors" ("acreedores singularmente privilegiados") status afforded to holders of cédulas hipotecarias by the 1981 Mortgage Market Law. The claim of cédulas hipotecarias holders on the cover assets in the event of issuer insolvency would rank only behind employees' claims to 30 days' worth of wages, and state or public creditors. Given the costly and rather cumbersome registration process involved, Standard & Poor's considers remote the possibility that judgment lien creditors will register liens in the real property register on the mortgages that also back up cédulas hipotecarias. This is relevant because, were these mortgages to be registered, judgment lien creditors would have priority over cédulas hipotecarias holders in the ranking of creditors in accordance with Spanish law.

There is uncertainty with respect to the ranking among the different issues of cédulas hipotecarias themselves, however. This is because the legal framework is unclear as to whether, in the case that mortgage loans acting as cover assets are not sufficient to pay all cédulas hipotecarias, the latter would be paid out pro rata or in order of date of issue (which would mean that subsequent cédulas hipotecarias issuances would be de facto credit support for the oldest issue outstanding). Although this

is not a concern at present, given the high levels of overcollateralization these instruments enjoy, ranking of issues is relevant nevertheless as, should there not be enough value to pay off all *cédulas hipotecarias*, unmet claims would no longer have a preferential claim over the issuer's assets, but would rank *pari passu* with the issuer's senior unsecured claims.

The main area of concern is, however, how the priority claim of *cédulas hipotecarias* on the cover assets would work in practice. The guarantee of *cédulas hipotecarias* on the underlying mortgage loans is constructed as a mortgage on these loans. However, this mortgage lacks the characteristics required under Spanish law in respect to specificity of collateral and registration of the mortgage (without which a mortgage does not come into existence).

The spirit of the law appears to be that the priority afforded to holders of *cédulas hipotecarias* would operate as a mortgage even without these attributes as the Mortgage Market Law states that, "The principal and interest of *cédulas hipotecarias* are specially guaranteed, without need of registration, by a mortgage on all of the issuer's mortgage loans...." Nevertheless, the law does not include a provision that specifies, in the absence of the two aforementioned requirements, how this guarantee would actually be applied. This, and the lack of a history of application of the law in this respect, introduces uncertainty as to how the liquidator of an insolvent issuer would proceed in order for the claims of *cédulas hipotecarias* holders to be met in an issuer insolvency scenario, and has important consequences for the creditworthiness of these instruments.

The consideration of the guarantee from which holders of *cédulas hipotecarias* benefit as a mortgage over the loans would give holders the right to post-insolvency interest, to access the underlying loans through execution of their guarantee in a separate proceeding from other creditors, and to abstain from entering a creditors agreement in which a discount on the debt ("*quita*") may be accorded. The judicial liquidator may take the view, however, that the mortgage created is actually defective and, therefore, the possibility exists that holders of *cédulas hipotecarias* might not be able to enforce the abovementioned rights. In general, most of the existing legal doctrine concurs that the mortgage created is not a "real mortgage" under Spanish law.

Furthermore, the Law does not include a post-insolvency mechanism specifying the fate of the underlying loan portfolio. The legal framework does not therefore establish whether the loan book would be segregated from the issuer's assets and managed so that the outstanding *cédulas hipotecarias* (regardless of any eventual payment interruption) could continue to be serviced until maturity, or whether the underlying book of mortgages would be liquidated so that outstanding *cédulas hipotecarias* could be repaid. The lack of a provision in the Law clarifying how the post-insolvency situation would be worked out means that acceleration of *cédulas hipotecarias* can occur.

In reality, as current proportions of *cédulas hipotecarias* compared with underlying mortgage books are so remarkably low (although growing issuance of these instruments may cause proportions to reach much higher levels in the future), segregation of the cover assets in order to continue servicing the debt would imply setting apart huge amounts of collateral for comparatively small amounts of debt. This would naturally be done at the expense of unsecured creditors (and among them depositors), whose prospects regarding the time it would take to realize recovery would then be notably damaged. It seems highly improbable that the judicial liquidator would seek to avoid this by selecting from a heterogeneous pool of mortgages a specific amount to be segregated and remain as cover assets for outstanding *cédulas hipotecarias* (so that the latter would continue to be serviced). Moreover, the compatibility of this second scenario with the claim of *cédulas hipotecarias* holders over the issuer's entire portfolio of mortgages could also be questioned.

These factors reinforce the likelihood of a sale of the underlying portfolio and acceleration of the *cédulas hipotecarias* in the event of issuer insolvency. This possibility introduces interest rate risk for holders of fixed-rate *cédulas hipotecarias*. In addition, the closer the amount of outstanding *cédulas hipotecarias* to the maximum legal issuance limit, the likelier it would be that the sale of the portfolio at an eventual discount would materially affect the recovery prospects of *cédulas hipotecarias* holders.

Standard & Poor's believes that the possibility of an issuer being significantly out of compliance with the maximum legal issuance limit at the time it is declared insolvent is minimized by the monitoring role of Banco de España. Furthermore, it is unlikely that a troubled institution would be allowed to issue mortgage bonds or units and, thus, reduce the amount of mortgage loans available for collateral. The deposit that the issuer is legally required to post with Banco de España if it is no longer in compliance with issuance limits provides certain comfort in this respect. Nonetheless, the Law does not expressly extend the priority claim of holders of *cédulas hipotecarias* to any deposits the issuer might have made

at Banco de España while the outstanding amount of cédulas hipotecarias was being brought within legal maximum limits in respect to underlying collateral.

Finally, there is some uncertainty relating to a judge's power to declare null and void--in certain instances--issuance of cédulas hipotecarias and mortgages underwritten in the period during which a bankrupt entity is deemed insolvent. This period can last as long as two years prior to the filing of the insolvency. If the cédulas hipotecarias are declared null and void, the mortgages remain the general assets of the bank and the holders become general unsecured creditors of the bank for the purchase price of the cédulas hipotecarias. If the view is taken that the cédulas hipotecarias' mortgage is not defective, it could be argued that the cédulas hipotecarias cannot be nullified without proof of actual fraud on the other creditors. The risk of a significant reduction of the collateral base due to invalidation of underlying mortgage loans is lower, however, because to void mortgage loans proof of actual fraud on creditors is needed.