FINANCIAL SYSTEMS

Securitization in Spain: Past developments and expected future trends

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Summary

- ### The Spanish model of securitization
  The Spanish securitization market differs in many aspects from those of other countries. **The Spanish market tends to be a "plain vanilla" market, as it is dominated mainly by simple, traditional structures** whereas synthetic securitizations are rare. Securitized asset portfolios are very homogeneous and they are predominantly, although not restricted to, mortgage credits. As opposed to originate-to-distribute models, which use securitization as a risk transfer instrument, **the Spanish model uses securitization as a funding mechanism that allows the transformation of illiquid claims into tradable securities.**

- ### Evolution of the securitization market in Spain
  The first securitizations in Spain were issued in 1993 and from this year to 2000 the volume of issued bonds was slowly increasing. **Since 2000 the securitization market started to grow at a faster pace**, as a consequence of the quick development of financial markets in Spain, an increasing real estate bubble and a credit boom. By type of underlying assets, mortgages have traditionally been the most popular, followed by loans to small and medium enterprises. **After the crisis of 2007 and the burst of the housing bubble, however, ABS issuance diminished abruptly** due to a hostile attitude towards securitization –since it was blamed as one of the crisis causes–, a fall in demand as investors were losing their appetite for securitization bonds and a deleveraging process in originators. More recently, some years after the crisis, ABS market is still sunken, although a more favorable attitude is emerging and calling for a revival of the market.

- ### The role of Regulation in securitization issuance
  Regulation has played an important role in the way securitization has evolved in Spain. Before the crisis, regulators were focused on contributing to the market development and several royal decrees and laws were passed to build a legal framework for securitization. **With the arrival of the financial crisis the reputation of off-balance sheet asset-backed securities, especially those issued by financial institutions, was extremely damaged and several regulation initiatives were developed,** with a penalizing bias, to correct vulnerabilities in the process and to prevent excessive risk taking.

- ### Changes in the way regulators deal with securitization and new proposals
  As credit scarcity is becoming a crucial impediment for economic recovery and European regulators are increasingly aware of the excessive penalization of securitizations in recent reforms, **regulators are choosing securitization as a key instrument to reactivate credit and restore the monetary transmission mechanism.** Even if credit ultimately depends on economic fundamentals, a revival of the securitization market would definitely serve to credit reactivation. As a funding tool, ABS issuance can contribute to the diversification of funding sources for banks. As a risk transfer instrument, it can allow banks to relief capital and hence generate new credit to the real economy. Regulators are then moving from a hostile attitude towards all types of securitization to a **more favorable treatment for simple and transparent structures.**

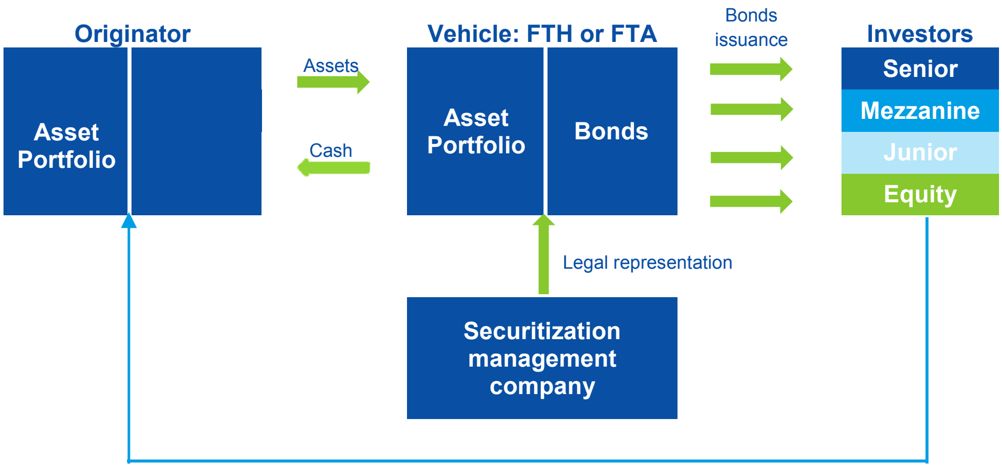
The Spanish model of securitization

Since the first securitizations took place in 1993, the Spanish market has evolved in a different manner in comparison with other countries. The securitization process in Spain has mainly followed the traditional model, in which less complex structures are used and in which higher-quality assets are securitized. In the traditional model the originator transfers a pool of assets to a special purpose vehicle (SPV) which issues bonds to the market. The proceeds generated by the sale of these securities to investors are used by the vehicle to repay the originator. Under this context securitization in Spain has been conceived as a funding mechanism for credit institutions rather than a risk transfer instrument. In fact, the Spanish securitization market has been based on the originate-to-hold model, in which originators retain those securitization tranches with the highest associated default risk (the equity tranches) and are also responsible for the management of the underlying asset portfolio. In most cases, therefore, the securitized assets have not obtained off-balance sheet treatment, nor have they liberated capital consumption.

Other characteristics of the Spanish securitization relate to the agents that take part in the process. In Spain securitization is implemented predominantly by banks (the originators), which, as mentioned, are responsible for the underlying assets portfolio administration. There are two types of vehicles, depending of the type of assets that are securitized, namely Mortgage-backed securitization funds (FTHs, for their Spanish acronym)[1] and Asset-backed securitization funds (FTAs)[2]. FTHs are used to securitize those eligible mortgages which meet certain quality requirements (called mortgage certificates, PHs in Spanish)[3] while FTAs are used to securitize any type of receivable (including all mortgage credits that do not meet the minimum quality standards). These vehicles do not have legal personality and therefore they have to be represented by a securitization fund management company, which is also responsible to safeguard bondholder’s interests.

The following figure summarizes the securitization process.

Figure 1
Securitization process in Spain



Source: BBVA Research

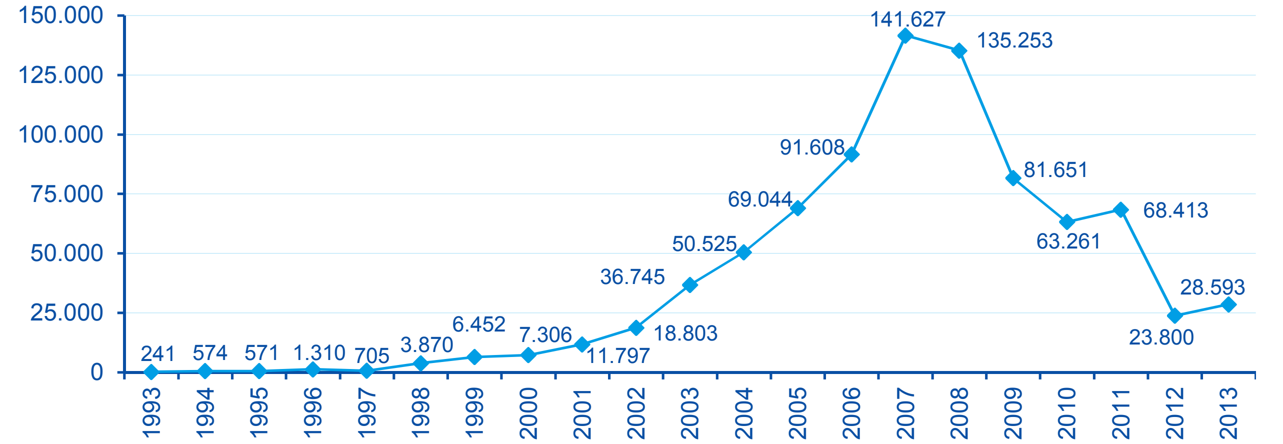
1: Fondo de Titulización Hipotecaria (FTH).
2: Fondo de Titulización de Activos (FTA).
3: Participaciones Hipotecarias (PHs). Mortgage certificates are FTHs’ assets which represent credit mortgages that fulfilled the minimum quality requirements established by RD 685/82 such as, among others, a LTV < 80%.

Finally, depending on whether the assets or liabilities structure of the fund can be modified or not throughout its duration, it can be considered a closed or an open fund. FTHs are always closed funds, whereas FTAs can be either closed or open. Closed funds, which have been the most popular structures in Spain, are more rigid but also less complex and easier to manage. In addition, the majority of the Spanish funds follow a pass-through model, which implies a direct relationship between bondholder's repayment and cash flows derived from the underlying assets, meaning that investors have a direct exposure on the portfolio performance.

Evolution of the securitization market in Spain

Figure 2 shows the evolution experienced by the securitization market since 1993 until 2013, measured by the total volume of securitization bonds issued. Three periods can be observed from the graph, namely a smooth upward trend during the first years of securitization issuance, a sharp upward trend before the financial crisis of 2007 and a severe downward trend after the crisis outbreak.

Figure 2
Total securitization bonds gross issuance (Euro Millions)

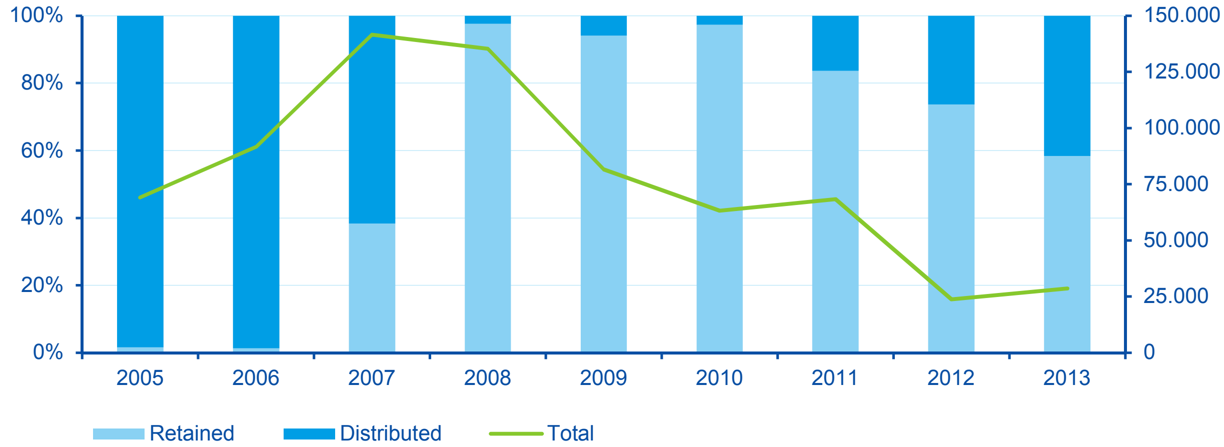


Source: CNMV

The first securitizations in Spain were issued in 1993. From this year to 2000 the volume of issued bonds was slowly increasing. The expansion of the housing bubble and the credit rise experienced during the next years were crucial for the growth of the securitization market. From 2000 to 2007, a total volume of 428bn€ of securitization bonds was issued, of which almost 71% were backed by mortgage assets. Total ABS issuance reached its peak in 2007 –year in which the financial crisis emerged in the US subprime market–, with around 142bn€ of securitization bonds issued on that year (of which 63% were backed by mortgages).

The years after the crisis were accompanied by an abrupt decrease in ABS issuance due to a hostile attitude towards securitization –since it was blamed as one of the crisis causes–, a fall in demand as investors were losing their appetite for securitization bonds and a deleveraging process in originators. From mid-2007, with the closure of the wholesale financial markets, originators had to retain almost the 100% of issued bonds. Figure 3 compares the amount of ABS issuance that was distributed to the market versus the amount that was retained by the originators. Although increasingly diminishing the volume, during this period banks continued issuing some ABS mainly with the intention to retain these bonds and use them as collateral to access to liquidity facilities of the European Central Bank, as they had lost access to wholesale funding.

Figure 3
Distributed v. s. Retained securitization bonds, gross issuance (Euro Millions)

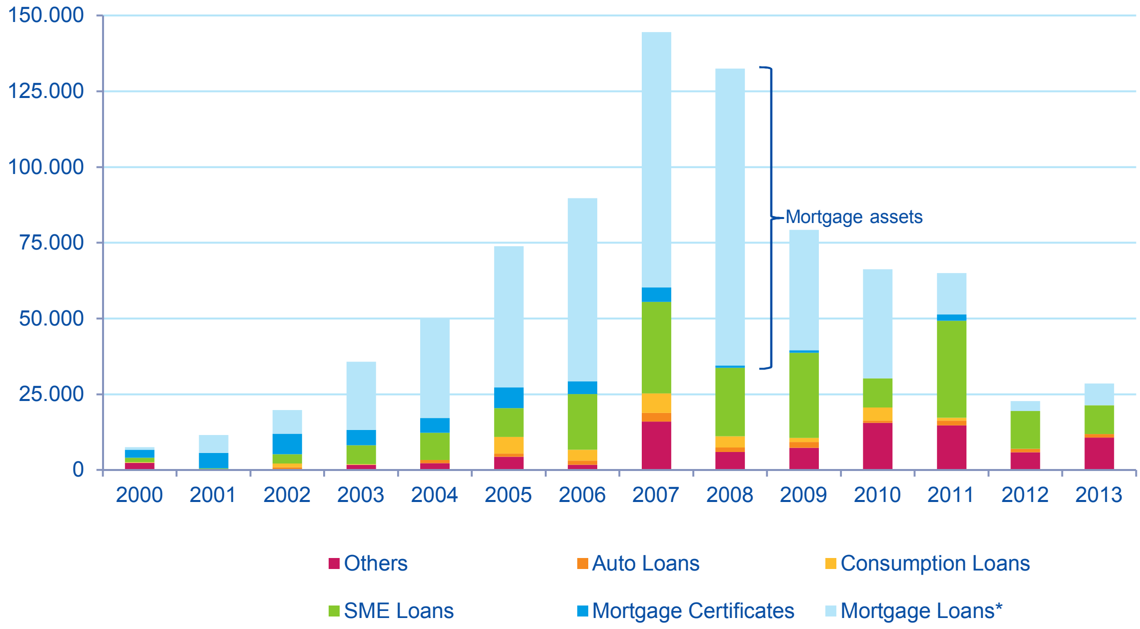


Source: CNMV

In a second phase of the crisis, although distributed amount of securitization bonds was slightly recovering, total volume of ABS continued to decrease, particularly for those backed with mortgage assets. The impairment of the real estate market and the drying up of the credit supply reduced the amount of mortgage loans granted by banks, hence contributing to the reduction of Residential Mortgage Backed Securities (RMBS) issued. This fact, together with the still limited investment appetite, resulted in the shrink of the securitization market. ABS issuance reached its trough in 2012, with a total volume of 24bn€ issued bonds, of which only 14% were backed by mortgage assets. From that moment to the present the market has not been able to recover.

Figure 4 displays the evolution of securitizations issuance by underlying assets. Mortgage loans have traditionally been the most frequent type until 2009. In 2009 and 2010, just a half of the underlying assets were mortgages, and in 2011 this percentage was reduced to less than one third. Loans to SMEs have traditionally been the third asset type most securitized, until the fall in mortgage-backed securitization, which resulted in an increasing proportion of SME loans in total securitized assets.

Figure 4
Securitization bonds gross issuance by underlying assets (Euro Millions)



Source: CNMV
* Within "mortgage loans", besides other mortgage assets, covered bonds are also included as underlying assets of securitization bonds.

The role of Regulation in securitization issuance

Regulation evolution has played an important role in the way securitization has developed in Spain. As an antecedent to securitization, Law 2/1981 allowed credit institutions to issue covered bonds backed by mortgage loans. Law 19/1992 approved securitization of mortgage certificates and regulated the creation of FTHs with the objective to reduce the cost of financing for house acquisitions, resulting in the first issuance of securitization bonds in 1993.

During the first years mortgage securitization was low but it was slowly increasing. RD 926/1998 extended regulation to any other claim, defined the creation of FTAs and the role of securitization fund management companies. Hence, from that moment not only mortgage certificates could be securitized but also other types of mortgage loans, as well as any other receivable, included those derived from SMEs' operations. In addition, the creation of the FTAs allowed the existence of open funds, which meant the possibility to modify the asset and liability structure throughout the duration of the fund. The flexibility introduced by this RD, together with the increasing development of financial markets in Spain, boosted the market which started to grow at an exponential rate. During the following years, regulators continued to have a positive attitude towards securitization, which resulted in Law 62/2003 authorizing synthetic assets securitization and Order EHA/3536/2005 complementing regulation to include future credit rights as assets that could be securitized.

The growth of the securitization market, together with other factors, fueled the rise of a credit boom which contributed to the formation of a real estate bubble in Spain, which in turn derived in a higher issuance of ABS. The financial turmoil coming from the US subprime market in the second half of 2007 and later the burst of the Spanish housing bubble changed the market perception of ABS, and the attitude towards this type of products turned towards hostility, blaming it as one of the causes of the financial crisis.

The international scope of the financial crisis and the role that securitization played on it derived in the search of regulatory agreements at a global scale. New regulations were then proposed with the aim of reducing the potential negative effects of securitization and hence to avoid repeating the same mistakes of the past. Basel III reviewed the minimum standards on bank capital adequacy. Proposed capital and liquidity Basel III rules confer a punitive treatment for securitizations as risk weights are higher for both the banking and the trading book. At the European level, Basel III rules on capital requirements are applied through the Capital Requirements Directive IV (CRD IV). These regulations are directed to address misalignments of interest and information asymmetries between originators and investors. They treat securitization in a rather conservative way in comparison to other similar financial instruments and no distinction is made between simple, prudent ABS and more opaque and complex structures.

Changes in regulation attitude and new proposals

A damaged reputation and punitive regulation have both contributed to the shrinkage of the securitization market. It is paradoxical that, despite the fact that securitization was far riskier in the US than in Europe (cumulative default rate from mid-July 2007 to the third quarter of 2013 has been 1,5% in the EU whereas US ABS has presented a default rate of 18,4% for the same period, according to Standard & Poor's), aggregate issuance levels of ABS have remained robust in the US (US$2,2 trillion in 2013), whereas in Europe they have dramatically decreased since the crisis (€174 billion in 2013). In Spain, ABS issuance has notably reduced since the crisis outbreak and it continues at very low levels (€29 billion in 2013). Nevertheless, as credit scarcity is becoming an important problem for economic recovery, attitude towards ABS is changing. Regulators are becoming increasingly aware that appropriately designed and prudently regulated securitization is an important diversification funding tool and a risk sharing mechanism that can lead to the reactivation of credit and contribute to an efficient allocation of resources. Over the past few years there has been a growing debate regarding the role of securitization in financial stability and monetary policy transmission. Securitization behavior in Europe has also been recognized to be much better than that in the US.

At the global level, new proposals for securitization regulation have emerged. However, although they are less punitive, excessively high capital charges are still required for ABS when comparing to other instruments. The Basel Committee on Banking Supervision (BCBS) published on December 2013 a revision of the bank capital requirements framework for securitizations in which, although they are given a more favorable treatment than in the previous consultative document, however, there is still a bias against ABS as compared to other instruments such as covered bonds. In addition, according to an study carried out by Risk Control Limited (RCL)[4], implementation of BCBS's new framework for securitization would result in non-comparable risk weights for each asset class among the suggested calculation methods, namely the Internal Rating Based Approach (IRBA), the External Rating Based Approach (ERBA) and the Standardized Approach (SA), which in turn would give place to different capital requirements that lack consistency (particularly when using the IRBA and ERBA). Moreover, even in those cases where risks weights are comparable across the three approaches, the study concludes that rank orderings of regulatory capital for individual tranches would be very different and would not properly reflect risk exposures. With respect to liquidity adequacy requirements, new regulation is also punitive for ABS, as the current Liquidity Coverage Ratio (LCR) proposal states that RMBS should be included in Level 2B, thus facing a 25% haircut in contrast with the 15% haircut for covered bonds (Level 2A). In addition, the European Insurance and Occupational Pensions Authority (EIOPA) has also revised in April 2014 the Solvency II Directive to include a less severe treatment for ABS that is however still punitive for high quality securitizations (HQS). Instead of the currently uniform 7%, EIOPA has proposed a capital charge of 4,3% for type A, less risky issues, against a 12,5% for the riskier ones.

4 Perraudin, W. (2014). "Quantitative Impacts of BCBS 269 Securitisation Capital Approaches".

The debate towards the role of securitization in economic recovery has led the ECB and the Bank of England (BoE) to publish in April a short paper about “the impaired securitization market in the European Union” and on May a more comprehensive discussion paper based on the first one, “the case for a better functioning securitization market in the European Union”. They underline the need for the securitization market revival as a way of canalizing credit to the real economy, including SMEs, and restoring the monetary policy transmission channel. In addition, they point out that by using securitization as a credit risk transfer mechanism, banks may relieve capital and employ it to generate new lending. The short paper lies down on the importance of differentiating high quality securitization (HQS) and implementing a regulatory preferential treatment for them. With respect to differentiating HQS, it is considered that they could be defined as “simple structures and well-identified and transparent underlying asset pools with predictable performance”. A preferential regulatory treatment would be then justified due to the lower risk associated to these structures. The deeper discussion paper focusses on determining several principles for a “qualifying securitization” –to be included in all tranches– that would facilitate risk assessment. Those principles refer to particular features and considerations with regard to the pool of assets, the structure of the instrument, the transparency in the whole process and to the role of external parties (i.e. credit rating agencies). With these documents the BOE/ECB make clear their position in favor of reviving the securitization market.

After the publication of the discussion paper a first action has been undertaken by the ECB, which has announced its intention of conducting an ABS purchase program with the aim to outright purchase “simple and transparent ABS” with claims against the euro area non-financial private sector as underlying assets. Although the Basel III and Solvency frameworks are virtually closed (BCBS’s final framework is expected to be published by the end of the year), as well as the European regulation (CRD-IV), the BOE and the ECB have considerable influence in standard-setting bodies at the global and European level to move them towards a better treatment for securitization. If the global framework proves difficult to change, at least the European one has scope for less punitive treatment, considering their simpler and more transparent features.

Conclusions

Since the first securitizations in Spain in 1993, the market grew continually until the arrival of the financial crisis. From 2000 onwards ABS issuance exponentially increased fueling an excessive expansion of credit and contributing to the creation of a real estate bubble. Since the crisis outbreak and the burst of the housing bubble, the market has been shrinking and securitization issuance has dramatically decreased.

Regulatory attitude towards securitization has been changing over these years. Before the crisis, Spanish regulators were focused on contributing to the market development and several royal decrees and laws were implemented to build a legal framework for securitization. With the arrival of the financial crisis securitization reputation tightened considerably and several regulatory initiatives were developed to correct vulnerabilities in the process and to prevent excessive risk taking. However, as credit scarcity is becoming a hurdle for economic recovery, regulators are becoming aware that the penalization to simple and transparent securitizations in the new regulation is excessive and are moving from a hostile attitude towards all types of securitization to a more favorable treatment for less risky ones. In this context, it is reasonable to expect that a revision of European regulation to a more favorable treatment in the coming years.

In conclusion, a revival of the securitization market will definitely contribute to credit reactivation. Although credit ultimately depends on economic fundamentals, “plain vanilla” structures –such as those that have been issued in Spain– can importantly contribute to restore the impaired lending channel and hence to catalyze funding for the real economy. Therefore, it is important to eliminate the stigma attached to all types of securitization and differentiate HQS from more complex and opaque structures –those that have been at the origin of the crisis. Regulators should then revise the legal framework for securitization to confer a preferential treatment for simple and transparent structures that better reflects their lower risk.

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