THE SPANISH MORTGAGE MARKET AND THE AMERICAN SUBPRIME CRISIS

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December 2007

The recent US mortgage crisis was brought about by the increased arrears in the subprime mortgages (loans with low credit rating) and non-conforming mortgages (clients with insufficient information about their solvency), mainly distributed by mortgage providers not subject to the banking regulations or supervision, which grant loans to be immediately sold on the market. It has also been caused by the increase in Equity withdrawal loans (home loans to cover other non-property requirements of the family).

Meanwhile, the US financial system's normal mortgage credit has much more moderate levels of arrears, which can be compared to the other Western markets.

This is an endemic in the USA, partly due to the low bank records of the family economies, the low levels of personal loans to individuals and families, the high levels of social and economic mobility and its peculiar non-integrated management model of mortgage loans through entities specialised by functions. In short, a "transactions" market and not a "clients" market, in which equity withdrawal has a considerable weight.

This pathology has been present for decades in the US market and has expansive cycles when there are low interest rates accompanied by economic growth and bullish house prices, leading to the typical periods of low quality mortgages described many years ago by M. Lea and others, and provokes more or less serious momentary crisis when the expansive periods are followed by significant interest rate rises. Its intensity depends on the importance of the expansive cycle and the harshness of the counter cycle.

The share of the subprime and non-conforming markets in the US market has increased substantially over the last 10 years. Thus, in 2006 they represented 46% of all of the new contracts on the market while the rest were distributed between conforming loans (36%), jumbo loans with superior credit rating (15%) and those guaranteed by the Federal Housing Association and the Veterans Affairs Department (3%).

The rapid spread of problem to other markets is the US out of balance securitisation model which is quite lax and very poorly regulated, which transfers the risk of non-payment to the investors and which, given the weight of the US economy and mortgage market, can easily contaminate the world capital markets.

Apart from the direct harm caused to the capital markets contaminated by the investments in these securities, it also has collateral negative effects in the form of more or less generalised confidence crisis.

Unlike what happens in the USA, the Spanish social customs, the regulations and the market structure make it impossible for subprime mortgages to be generated and circulate in the Spanish mortgage market.

Our national mortgage market has its origins in Law 2/1981, of 25th March, as "a complete structure for the financing of certain activities through the issue by financial institutions of mortgage securities which will have the guarantee of mortgage loans", as stated in the Preamble of Royal Decree 685/1982, of 17th March, which further develops it.

This initial framework, which was perfected with Law 19/1992, of 7th July, which regulates the securitisation of mortgage loans and the new *Law 41/2007, of 7th December, regulating the mortgage market,* continues in full force for issues and is prepared with the main objective of guaranteeing for investors in mortgage securities the utmost security that can be provided by the national financial and civil legislation, thereby ensuring the mortgage market's ability to access the capital markets and obtain the resources needed in order to finance its credit activity.

First of all, it restricts access to mortgage market operations to the entities in the financial system, which are suitably regulated and supervised.

Secondly, it regulates the strict conditions to be met by the mortgage loans which can be used as collateral for the issues.

Thirdly, it regulates the valuation procedure for the mortgaged assets, creating valuation companies for this purpose, and submits them to the supervision and control of the Bank of Spain.

And fourthly, it establishes the characteristics and regulations for the functioning of the secondary market.

Amongst the conditions that the loans which are used as collateral must meet for the issues are:

Be guaranteed with first mortgage over the freehold of the mortgaged real estate assets which must entirely belong, also in freehold, to the mortgagor. The freehold can not be subject to conditions or prohibitions on alienation or any kind of limitations. The registration of the property must be in force without any contradiction or limitation due to registration matters.

The properties which are used as guarantee must be previously valued in accordance with certain legally established standards and the amount of the loan can not exceed 60% of the property value, or 80% in the case of houses.

If there is a subsequent depreciation in the property value by over 20%, the issuer can demand from the debtor an additional guarantee over another property and if this is not forthcoming it can cancel the guaranteed credit.

The properties which are used to guarantee the loans must be insured against damage and cover the valuation value.

The issuers can not cancel the mortgages on grounds other than for payment of the guaranteed credit, and neither can they perform any act which reduces the legal effect or the economic value of the mortgage or credit.

On the other hand, the mortgage credit institutions can not issue guaranteed securities for over 80% of the portfolio of loans which meet all of the requirements in order to guarantee the over-collateralisation of the *cédulas hipotecarias* (covered bonds).

Furthermore, unlike what happens in the USA, the Spanish mortgage market is client-based and not transaction-based.

In fact, the Spanish credit institutions have been using the mortgage loan as a strategic instrument to win clients and to cultivate their loyalty and to support their geographic growth and expansion, putting the global profit of the account of the client that they are trying to attract before the specific return of the credit.

As such they devote priority to the quality of the most important loan that the client will probably have and which will in the long term condition the result of their global financial relationship.

There are three securities in the Spanish mortgage market: *cédulas hipotecarias* (covered bonds), mortgage bonds (*bonos hipotecarios*) and passthroughs (*participaciones hipotecarias*).

The *cédulas* and mortgage *bonds* are obligational securities and as such their capital and interest have the universal asset guarantee of the issuer.

The *cédulas* are also specially guaranteed by mortgage over all those which at any time are entered in favour of the issuer (*Law 21/1981, article 12; see the new drafting in Law 41/2007, article 2, p.5*) and the *bonds* by the credits in the deed of issue (*Law 21/1981, article 12; see the new drafting in Law 41/2007, article 2, p.5*)

Neither the cédulas nor the mortgage bonds directly transfer the risk of the mobilised loans, as they remain on the balance of the issuer which integrally administers them.

The *participaciones* transfer all or part of the mortgage credit, and as such they are not counted within the institution's risk and their titleholder enjoys the full right of segregation.

Responsibility for the collection administration and management of the secured loans legally corresponds to the issuer of the participations and their titleholder has the rights to act against the issuer if it breaches its obligations and to be subrogated in the execution process.

Due to their nature, mortgage passthroughs can not be directly transferred to the markets, but rather through mortgage securitisation funds which are "separate and closed assets lacking legal status (...) with their assets made up of mortgage participations and their liabilities by securities issued with the amount and conditions so that the Fund's asset value is zero".

These funds incorporate financial instruments which guarantee their over-collateralisation and additional protection to the investors. They are legally issued, managed and represented by an authorised manager, and evaluated by a rating company in order to guarantee their composition, structure and quality.

The total volume outstanding balance of the Spanish mortgage market securities at July 2007 was 353,735 million Euros, of which 75% corresponds to mortgage *cédulas* and 25% to *participaciones*. There are no issues of *bonds* because their legal issue costs make them unprofitable in practice.

All of the issues of mortgage market securities are authorised and controlled by the CNMV (National Stock Market Commission). The Bank of Spain on the other hand supervises and controls the transparency of the credit and all of its generation and administration processes.

COMPOSITION OF THE OUTSTANDING BALANCE OF MORTGAGE SECURITIES (MILLION €)

COMPOSITION:	JUL-07	% On total
Mortgage *Cédulas Hipotecarias* (Covered Bonds)	**264,716**	**74.83%**
Mortgage Passtroughs *(Participaciones)*	**89,019**	**25,17%**
Mortgage Bonds	**0**	**0,0%**
TOTAL MORTGAGE MARKET SECURITIES	**353,735**	**100,0%**

It is clear that the Spanish mortgage market institutions, insofar as they are also universal bank institutions, can contract and do contract loans which do not meet the conditions required for their mobilisation in the mortgage market.

These loans, until 2002, should remain on their balances until their total repayment because the inflexibility of the accesoriness concept in the Spanish mortgage legislation only allows for the transfer of these mortgage loans by public deed and the corresponding registry entry, which makes their mobilisation in the market financially unviable due to their high tax and tariff cost, just like for mortgage bonds.

In order to overcome this artificial economic barrier, Law 44/2002 of 22nd November created new ad hoc securities different to those on the mortgage market which “are issued and marketed under the name of Mortgage Transfer Certificates, *C.T.H. - Certificados de Transmisión Hipotecaria* – (Law 44/2002, art.15).

These instruments, copying the transfer models of the Mortgage *Participaciones*, avoid the notary and registry expenses and allow these loans to be mobilised exclusively in the **Asset Securitisation Funds**, just like other credit assets without mortgage guarantee are securitised like the nuclear moratorium, other commercial credits or future credit rights, but never as “mortgage market securities”.

At present, the *C.T.H.*s that are used as collateral for Asset Securitisation Funds amount to a volume of 51,529 million Euros, which represents barely 5% of the total mortgage credit portfolio.

It is clear that the Spanish economy and our mortgage market in a globalised world are exposed to the collateral effects of the US mortgage market, particularly in the facet that affects confidence in the capital markets.

However, the Spanish mortgage market is completely shielded from the appearance of any equivalent phenomena.

It is foreseeable that when the definitive calmness returns to the capital markets, the Spanish mortgage securities will be stronger than most of its competitors, given the improvements that Law 41/2007 introduced.

It would be advisable that the administrative and control authorities monitor and provide the measures necessary so that Spain does not undergo a similar situation outside of the mortgage market.