Spanish NPLs – five key themes for 2019

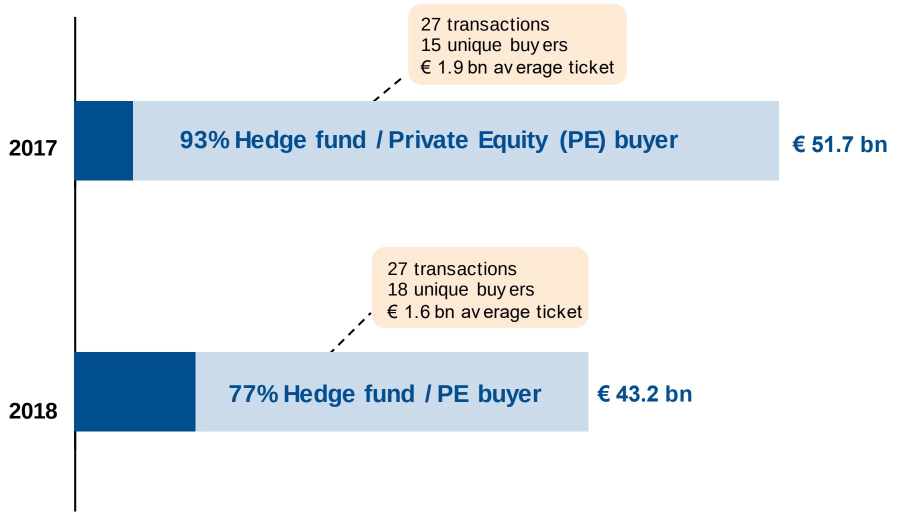
Activity in Spanish NPLs should remain strong in 2019, even amid signs of market maturation. The volume of portfolio sales in 2018 may have dipped (EUR 43.2bn) against a peak in the prior year (EUR 51.7bn), but activity was nonetheless driven by investor confidence in price recovery and the solid liquidity of the Spanish real estate market compared with European peers such as Portugal, Italy or Greece. Scope outlines five key themes for investors and market participants in the Spanish NPL market for the year ahead.

1 Distressed market maturing

The Spanish NPL market is showing signs of maturity with the entry of new types of investors and the consolidation of servicing platforms. For 2019, we expect sales activity focused both on NPL and REO portfolios with smaller tickets on average relative to 2017-2018, as well as upward pressure on pricing, driven by a wider investor base and still-positive economic momentum.

Large ´first-mover' investors in search of higher yields (hedge funds and private equity firms) are starting to offload part of their portfolios, and these are being purchased by new investors, albeit with lower risk appetite, such as pension funds, insurance companies and REITs. For instance, Canada Pension Plan Investment Board (CPPIB), the organisation investing the funds of Canadian pension contributors, entered the market in 2018, acquiring two portfolios for a total of EUR 2.5bn.

Figure 1: Composition of transaction buyers



Sources: Deloitte, Debtwire and Scope

The development of the servicer industry has largely succeeded in improving market liquidity by unlocking the value of legacy portfolios; and servicers are starting to consolidate. One prominent example is the recent acquisition of Altamira Asset Management by the largest Italian servicer doBank. Together, doBank and Altamira will form the largest debt recovery and REO management group in Southern Europe with about EUR 140bn assets under management, mainly located in Italy and Spain but also in Greece, Portugal and Cyprus, reflecting the expected structural growth of the market in the next few years.

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Related methodology

Non-Performing Loan ABS Rating Methodology

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2 First public securitisations

2019 may see the first publicly-rated Spanish securitisations

Along with the maturity of the market, we may see the first publicly-rated securitisations of Spanish NPL and REO portfolios. Securitisation improves market transparency since during the rating process, different parties (investors, rating agencies, auditing firms, law firms) highly scrutinise originators' and servicers' capabilities, as well as the quality of the underlying portfolios.

Recent market players, such as hedge funds and private equity, will drive securitisation activity, while most financial institutions still prefer direct portfolio sales.

Ratings on senior and mezzanine tranches will widen the investor base, since private sales target a smaller universe of specialised investors. As in other markets, such as Italy, we expect the broadening of the investor base will increase bid prices and improve market liquidity.

3 Unequal property price recovery

Positive momentum on average real estate prices

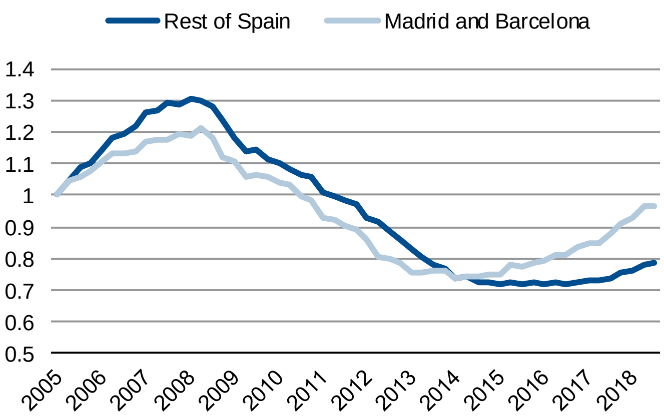
We expect positive momentum on average real estate prices to keep up in 2019. However, the Spanish property market is still characterised by excess stock of about one million units, including new and used homes. Therefore, in the medium term, there is an increasing risk of property price declines as this stock is unlocked; particularly if a recession or a significant economic slowdown kicks-in. While Scope does not expect Spain to fall into recession, the country's economic growth rates are expected to slow to around 2% in 2019 from 2.8% in 2018.

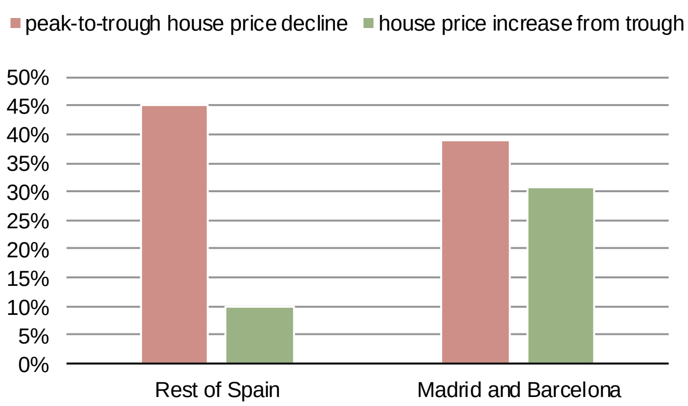
But regional composition will be a key performance driver

The regional composition of NPL and REO portfolios will be a key performance driver. Spain's real estate market is among the most liquid in Europe, because demand has been driven predominantly by institutional investors. However, the property market is non-homogeneous and has exhibited unequal performance since the global financial crisis, with retail activity still sluggish in many regions.

Prices in prime districts of Madrid and Barcelona are beginning to enter over-heating territory in traditional segments (residential, retail, office). Provincial capitals and larger municipalities tend to exhibit more muted but sustainable price recovery while in many peripheral areas, such as municipalities with fewer than 50,000 inhabitants, property prices continue to be depressed at or below 2007 levels.

Figure 2: Property price indexes





Sources: Ministerio de Fomento and Scope

NPL portfolios still offer strong upside in many regions

Investors most concerned about price risk will choose REO portfolios with lower duration risk as opposed to NPL portfolios, particularly in highly liquid (but closer to saturation point) areas of Madrid and Barcelona. On the other hand, Scope believes that special servicers managing NPL portfolios during the legal repossession phase can potentially add significant value, particularly in regions where prices are already depressed.

4 Promising legal developments may reduce litigation

Enforcement timings have more than doubled in recent years

Scope expects that the transposition of EU directives into Spanish law will reduce legal uncertainties, decreasing the number of litigation cases and leading to a reduction in foreclosure timings in the medium term.

The average length of foreclosure proceedings in Spain has almost doubled in recent years, from around 1.5 years in 2004-2010 to almost three years in 2017[1]. This increase has partly been driven by increasing litigation as a result of the reform of the civil procedure law in 2013 (Ley de Enjuiciamiento Civil), which provided borrowers with additional elements to claim invalidity of procedures.

Another driver has been the realisation that the Spanish enforcement framework does not adhere to EU legal standards regarding consumer protection against abusive contractual clauses in mortgages. This has led many tribunals to halt ongoing procedures until these conflicts are resolved.

The new mortgage law will be credit positive in the medium term…

The new mortgage law (Ley de Crédito Inmobiliario), which is expected to enter into force in May 2019, will introduce additional measures to strengthen the protection of mortgage borrowers, such as the extension of the time required to start foreclosure proceedings to up to 15 months[2]. Nevertheless, Scope expects that the transposition of EU directives into Spanish law will have a positive effect on foreclosure timings as clearer rules will contribute to reducing legal disputes.

5 Political fragmentation and policy uncertainty

But political instability is negative for investor confidence

Regardless of the outcome to the 28 April general elections, political fragmentation and regulatory uncertainty may adversely impact investor confidence in the short term.

The composition of the Spanish parliament will be the most widely dispersed among the top five parties since the Spanish Constitution was promulgated in 1978. And the most radicalised: it is likely that the left-wing Podemos and the emerging right-wing party Vox will jointly achieve about 20%-25% of the tally, while the rest of the votes will be mainly distributed among traditionally opposing, but pro-establishment parties: the socialist PSOE, the conservative PP, and the centre-right Ciudadanos party.

[1] Source: Consejo General del Poder Judicial

[2] The time in arrears that gives the lender the right to terminate a contract early has been extended from three to 12 months within the first half of the contract, or to 15 months within the second half of the contract. Alternatively, the lender may terminate the contract if the amount in arrears exceeds 10% of outstanding principal, within the first half of the contract, or 7% within the second half of the contract.

On March 1, the governing party (PSOE) expedited the reform of the law regulating residential rentals via Royal Decree Law, without broad parliamentary consensus. The new regulation extends the minimum contractual rental period from three to five years if the landlord is an individual, or to seven years if the owner is a company.

The new law will not set mandatory caps on rental levels, as requested by Podemos, but opens the door for the autonomous communities to provide tax incentives if rents are contained within certain limits.

Political fragmentation increases the risk of policy reversals

Given the political fragmentation, Scope points to the risks of political paralysis and/or policy reversals. Specifically, a divided parliament could require a significant amount of time to form the next government, extending the period of uncertainty, while a government pursuing a different political agenda than the current one could derogate some laws or propose amendments to laws that have been approved without consensus.

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