Spain plans its route to premium covered bonds with Cédulas 2.0

The Spanish Treasury's consultation on Cédulas 2.0 provides early indications as to how the country plans to harmonise its covered bond framework. The way the questions are drafted suggests they might move away from the current on-balance sheet set-up. No negative impacts are expected, however.

On 4 March 2020, the Spanish Treasury opened up a consultation on the highly anticipated amendment of the existing Spanish covered bond framework. The consultation runs until 17 March 2020.

Expectations are high. The Spanish market ranks fourth in the EUR 2.5trn global covered bond market. At the time of the 2016 EBA[1] and 2017 European Commission[2] reviews, the Spanish framework was identified early on as the only one where neither the segregation of cover assets nor oversight of cover pool followed best practice. As such, the Spanish covered bond framework is the one needing most attention in order to become aligned with the European covered bond directive. The new framework has to be activated by 8 July 2021.

However, the Spanish Treasury did not provide a detailed draft of any legislation outlining how it wants to pave the way for Cédulas 2.0 to become European "Premium" covered bonds. Instead, they pushed questions to market stakeholders on how they would like the transition to happen. The menu of choices is not that wide, however. The way questions in the consultation are drafted provide some initial insight into the direction regulators want the new framework to evolve.

The 2020 covered bond consultation cannot be a repeat of the 2014 consultation

The publication of the consultation sounds like a déjà vu of the 2014 events. In summer 2014, the EBA published its initial thoughts about European best practices for a sound covered bond framework. Almost instantly, in the autumn of the same year, Spanish regulatory and supervisory agencies (Bank of Spain, Treasury and CNMV) called for a consultation on how to best align the Cédulas framework.

This cannot happen now as the clock for the transposition of the Directive into national law already is ticking. The size of the covered bond market and its importance as a refinancing tool should prevent it from becoming just another of those EU laws and regulations that are not transposed into Spanish law.[3]

The Spanish Treasury's consultation has a short response time: barely two weeks. This could indicate that officials have already made up their minds. Not much new information is expected to be forthcoming. The consultation period might just be a function of a last sanity check ahead of the publication of a more concise draft but one that has already crystallised.

Analysts

Karlo Fuchs
+49 69 6677389-78
k.fuchs@scoperatings.com

Reber Acar
+49 69 6677389-50
r.acar@scoperatings.com

Media

Keith Mullin
k.mullin@scopegroup.com

Scope Ratings GmbH

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Headquarters

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

[1] EBA Report ON COVERED BONDS, 20. Dec 2016, see here
[2] Covered Bonds in the European Union: Harmonisation of legal frameworks and market behaviours, April 2017, see here
[3] See Member States' compliance with EU law in 2018, see here

Main topics of the consultation – Cédulas 2.0 no longer on-balance and more strongly regulated?

The Treasury yet has not provided a detailed draft but is the first regulator from a EU member state regulator to openly start discussions with stakeholders.[4] Some of the questions and the way they are phrased can be read as a soft sounding on its preferences.

We note that the Ministry seems to have a preference for Cédulas 2.0 to be issued out of a separate entity. This also might ease the transition from the current set-up. The Treasury also gives the impression of wanting to strike a fair balance between enhanced security for investors and pragmatism. It often leans towards conservative interpretations of the Directive to ensure the status of Cédulas 2.0 as premium covered bonds. The Treasury is also consulting on optional topics they would not have to transpose but which would generally provide further safeguards. Through this aspect, they will solicit comments on what the reaction would be if they did not then go to the widest extremes.

Cédulas 2.0 as structured covered bonds or issued out of a specialised mortgage bank

A sound transition towards Cédulas 2.0 and how to come up with a more precise definition of a cover pool will be the most significant challenge regulators face. The set-up of a segregated vehicle to which mortgage loans can be sold seems to be the solution being contemplated.

At the same time, question three of the consultation on the entity's legal form suggests it is not just classic SPV-type segregation typical for structured covered bonds on the table. Specialised mortgage banks could also be under consideration. As the Treasury is asking about the preferred timing of the transfer of cover assets, a set-up similar to the French SFH model could become the template for Cédulas 2.0. The underlying mortgages could still remain on the balance sheet of and managed by the parent but would automatically become transferred upon its insolvency.

The diversity of cover asset transfer mechanisms for European covered bonds and their ability to achieve highest ratings demonstrate that all templates can achieve legally sound isolation upon issuer insolvency. As such, the Spanish choice will ultimately hinge on the regulator's willingness to strike a balance between legally robust asset isolation that at the same time provides sufficient flexibility to actively manage a dynamic mortgage portfolio.

Covered bond maturity extension – Spanish Cédulas 2.0 to become soft-bullet bond

The consultation – question 4 – also enquires about soft-bullet bonds and how they should be structured. Even though questions remain relatively open, we expect Cédulas 2.0 to feature soft-bullet structures. Scope expects that extendible maturity structures will become the new normal once the harmonisation is implemented. Issuing soft bullet covered bonds will no longer be looked at with raised eyebrows and will not be considered a disadvantage compared with hard-bullet bonds. We believe the Treasury will prefer this solution, as in its question 6 about short-term liquidity buffers, it asks whether bonds should be accounted for at their scheduled or extended maturity dates.

From a ratings perspective, liquidity risk is one of the most difficult and expensive risks to assess. The introduction of extendible maturities is a good way to mitigate risks, thus are credit positive.

---

[4] Only the Norwegian FSA has been out earlier. See "Norway first out of the blocks to align with EU covered bond directive".

Short-term liquidity coverage – a valid and much-needed addition to avoid payment interruptions

A clear credit positive and one of the most important improvements of the Spanish framework will be the transposition of Article 16 of the Directive. It requires introduction of a short-term liquidity buffer. The Spanish consultation points to an important factor which we believe will become one of the key differentiating factors between an “only just” premium labelled covered bond and a security with truly high credit quality: accounting for soft bullet structures in short-term liquidity calculations.

The Norwegian FSA has already started to introduce this belt-and-braces concept. Most Norwegian covered bonds today have soft-bullet structures, which means that the banks do not provide for additional and more liquid substitute collateral in their cover pools. This means that directly after the insolvency of the issuer, the extension needs to be triggered to allow for timely payment. As the safety airbag is already gone, more weight, care and experience need to be placed on the special administrator for the residual life of the covered bond programme.

We would take a positive view if the Spanish amendment follows the Norwegian proposal to account for the scheduled maturity date and not the extended maturity date in the calculation of the 180-day buffer. The ability to use a readily-available liquidity buffer after regulatory intervention significantly reduces pressure on managers. They could switch the fuel-tank to reserve, continue running and still could resort to the extension option if needed.

Covered bond trustee – potentially weaker internal body envisaged?

Transposition of article 13 of the Directive provides an example on how the Spanish Treasury wants to ensure Cedulas 2.0 premium status but not to go to the extremes. The Directive does not require an independent cover pool monitor or trustee but provides for the possibility of having such a body. Question 1 of the consultation suggests that the Spanish Treasury seems to see value in an independent additional body checking for compliance with the regulation. At the same time, they are consulting on stakeholders’ views of an internal bank solution instead of a fully independent trustee.

If sufficiently empowered and independent, an internal solution can be strong enough. The internal solution is well used in the Nordics. However, the further south one goes in Europe or the more akin to a structured covered bond the respective set-up is, the more common external bodies become.

During less benign times, investors generally favour the belt-and-braces approach. A fully independent trustee responsible to the supervisor is typically a stronger stop gap. An independent and external trustee is often also liable and thus more inclined to interpret the regulation conservatively. This is credit-positive, as the harmonised covered bond framework, even when allowing for the designation as a European Premium covered bond, does not mean achieving the highest ratings. Conservative interpretations of the rules and regulations before segregation of the cover pool can smooth volatility and alter the negative trajectory of the credit quality of a covered bond issued by a bank approaching regulatory intervention.

Covered bond supervision and administration after insolvency – less conflict of interest a plus

We also view positively the fact that the Treasury is contemplating on formalising covered bond administration after insolvency (question 2 of the consultation). According to article 20, this is another optional factor that a regulator can but does not have to transpose. It is a step forward, as the current situation in Spain could give rise of conflicts of interest. Currently, the receiver in insolvency is responsible for both secured and unsecured creditors. A clear delineation between the two will avoid such conflicts and be a credit positive from an operational point of view.

We also view positively that one of the questions in the Spanish consultation suggests that the Treasury is envisaging a special insolvency administrator to operate under a regulated banking institution. If put forward, this could open up the possibility of a cover pool gaining access to central bank liquidity for bridge financings – an option only available for going-concern financial institutions.

The Treasury is also consulting on further technical aspects, such as who should appoint (and when) this administrator – a topic which should become more harmonised at a European level.

Changes to over-collateralisation – lower minimum does not need to be credit negative

The likely leaner covered bond programme structure provides Spanish regulators with the ability to reduce encumbrance of an issuer's balance sheet and reduce the current generous level of OC. From a regulatory perspective, the consultation (question 5) is seeking to understand the preference of stakeholders on definitions i.e. nominal OC vs. NPV-based OC, including whether the running cost of the programme wind-down needs to be provided up front or generated by the assets.

The Directive intends to establish a product of high credit quality. Achieving the highest credit quality typically means that the issuer needs to be able to provide investors more protection (i.e. OC) than generally required Regulation stipulates a static number even though the risk profile of both the issuer and the cover pool credit quality evolves. As such, any amendment should ensure that OC can be dynamic and that the portion that is over and above the legal threshold remains in the cover pool and cannot be clawed back into the residual insolvency estate.

Regular investor information and additional technical amendments – neutral for credit but positive for investors

The consultation also seeks to understand whether minimum transparency standards need to be enhanced and solicits information about additional aspects relating to the sourcing of cover assets from within the same and other groups. Few of the topics here have the potential to negatively impact credit quality – provided potential additional risks can be buffered with additional collateral over and above the minimum OC provided by law.

Transparency requirements and best-practice market standards are evolving over time. The amendment should therefore only ensure that issuers can provide additional information if and when market standards have evolved.

Transition and grandfathering – solely an additional management task?

As the country with the fourth largest volume of covered bond issuance and with remaining covered bond maturities exceeding 20 years under the current framework, a special focus needs to be placed on the way transition is managed and how the protection of existing covered bond investors is maintained.

The consultation seeks feedback on whether the old framework should remain in existence and thus grandfathered, while new covered bonds are issued under the new framework. Or whether old covered bonds are moved into the new regime. In Scope's view, the transition question will ultimately have to be answered by the legal practitioners to avoid legal risk. A clearer definition of a cover pool coupled with more prescriptive risk management guidelines might be preferred by some (speaking to a mandatory conversion into the new regulation) while others might favour the very high OC of the old rules at the expense of less active management (speaking to the co-existence of old and new frameworks).

Maintaining two programmes requires more management attention and creates higher costs without adding successive direct savings. It also demands significant new legal and documentation efforts. In addition, regulators and investors might face challenges in the event that existing programmes have to comply with a different set of rules to the new ones. There are pros and cons for both alternatives. However, investors will not appreciate having the rules of the game changed while it's being played and will only work if investors are better protected than before.

Scope Ratings GmbH

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main
Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris
1 Cour du Havre
F-75008 Paris

Phone +33 1 8288 5557

London
Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 20 3457 0444

Madrid
Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan
Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo
Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com

Disclaimer