

# Increased legal uncertainty credit negative for Spanish NPL portfolios



Scope  
Ratings

The Spanish NPL market will emerge less liquid on the other side of the Covid-19 crisis. A series of debtor-friendly national and regional decrees introduced before the pandemic was already weighing on investor sentiment. But the sharp economic downturn has exacerbated uncertainties that were building up and will depress recovery rates on NPL portfolios even further.

## Under the microscope: the framework for foreclosure proceedings

The legal framework applicable to Spanish NPLs has received a lot of scrutiny in recent years, as concerns have grown around debtor-friendly legal developments that could be detrimental to investors' interests.

Law 5/2019 increased protection to consumers around mortgage termination clauses. As a result, the course of foreclosure proceedings related to consumer mortgages significantly slowed in recent years, following increased litigation over several standard mortgage contract clauses that banks traditionally included but which borrowers claimed were abusive<sup>1</sup>.

Royal Decree Law 6/2020 increased levels of protection for vulnerable borrowers by extending the moratorium on evictions from primary residences by another four years (up to May 2024) and broadening the scope of borrowers protected under its provisions.

At the regional level, recent amendments to Catalonia's housing legislation are aimed at increasing consumer protection. The intent behind decree laws 17/2019 and 1/2020 is to improve access to housing via expansion of social leases, forcing empty housing into use, and assisting those at risk of homelessness from foreclosure or eviction.

## Impact on NPL portfolios

Recent legal developments in Spain will lead to lower cash flows and higher risk premiums. The Covid-19-induced crisis is exacerbating legal risks for Spanish NPL investors, as the need to apply debtor-protective measures is much more likely to crystallise in a recessionary environment. In addition, there is still room for national and regional governments to pursue new policies that could be detrimental to asset holders.

## Lower net cash flows

Scope expects lower nominal and discounted net cash flows from NPL portfolios because of:

1. Higher legal costs as a result of prolonged legal proceedings.
2. Higher haircuts on out-of-court agreements. For instance, negotiations with squatters to vacate properties may be complex in the current legal environment.
3. Lengthy legal proceedings and mandatory long-term social leases will likely push collections further out, depressing the net present value of cash flows.
4. Potential expropriation of REO assets located in Catalonia (albeit unlikely to be enforced in the current circumstances) or mandatory social leases at below market rates.

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<sup>1</sup> See "Supreme court ruling is reassuring for Spanish NPL investors", published by Scope

### Legal uncertainty risk premium

Recent developments in Catalonia have been a particular concern for Spanish NPL investors, who have even questioned the constitutionality of decree laws 17/2019 and 1/2020 (see next section for a comprehensive summary). But the law is binding at present and there is a risk that other regional governments might approve similar policies undermining individual property rights, at least to some degree. For instance, the Government of the Balearic Islands recently approved Decree Law 3/2020, which includes measures similar to those approved in Catalonia. The implementation of rent controls in certain metropolitan areas is also a plausible scenario.

Uncertainty around future changes to regional and national legal frameworks may increase investors' required rate of return, thus decreasing even further the present value of expected cash flows.

The extent to which legal risks may affect investors will largely depend on the composition of NPL portfolios, in particular regarding regional composition as well as exposure to squatters and vulnerable debtors. Scope estimates that up to 10% of residential REO assets from securitised portfolios may be occupied without title (i.e. squatted). As regards non-performing loan collateral, data from the Bank of Spain shows that only about 10% of households in the lowest quintile of income distribution have a mortgage, compared to more than 27% for the broader population<sup>2</sup>.

However, it is likely that these households are over-represented in non-performing loan portfolios. Analysis of data from a 2014 Spanish survey of household finances shows a 35% incidence of arrears in the lowest quartile of income distribution compared to 21% for the broader population<sup>3</sup>.

### Post-Covid-19: a less liquid market for Spanish non-performing credit?

The impacts of Covid-19 will slow real estate market activity, depressing collateral values. Scope also expects a negative impact on recovery timing. Court activity and court deadlines in Spain were suspended from March until end of April<sup>4</sup>. While legal proceedings will be resumed gradually, Spanish courts will probably not prioritise foreclosure or bankruptcy proceedings.

Investors will likely take more conservative views on their projections for recoveries, both in terms of timing and amount, leading to a widening of the bid-ask gap, and reducing liquidity for Spanish non-performing credit.

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<sup>2</sup> Survey of Household Finances (EFF) 2017: methods, results and changes since 2014.

<sup>3</sup> Spanish household debt defaults: results of the Spanish Survey of Household Finances (2002-2014)

<sup>4</sup> Royal Decree 463/202

### I. New Catalanian decree laws at a glance

The intent behind decree laws 17/2019 and 1/2020 is to improve access to housing via expansion of social leases, forcing empty housing into use, and assisting those at risk of homelessness from foreclosure or eviction. The new laws expand the definition of major housing owners, which now includes securitisation vehicles.

Before any legal proceedings can be filed, major housing owners are obliged, provided certain conditions are met, to offer social housing leases to occupants at risk of residential exclusion. This obligation applies both in case of mortgage foreclosures or enforcement proceedings arising from claims against mortgage debt, evictions arising from non-payment of rent, expiry of legal title to occupy or the lack of title to occupy i.e., squatting. Figure 1 summarises the new requirements for securitisation vehicles, while Figure 2 provides details on legal timing.

Provided a dwelling is deemed empty by law, owners must offer social housing leases of a minimum term of five or seven years (depending on whether the lessor is a natural or a legal person) with a mandatory one-time renewal if the risk to beneficiaries of continued homelessness (residential exclusion) persists. Scope expects these provisions will lead to a delay and reduction in recovery proceeds on affected assets, as securitisation vehicles can only initiate foreclosure proceedings after seven years or 14 years if debtors continue to be at risk.

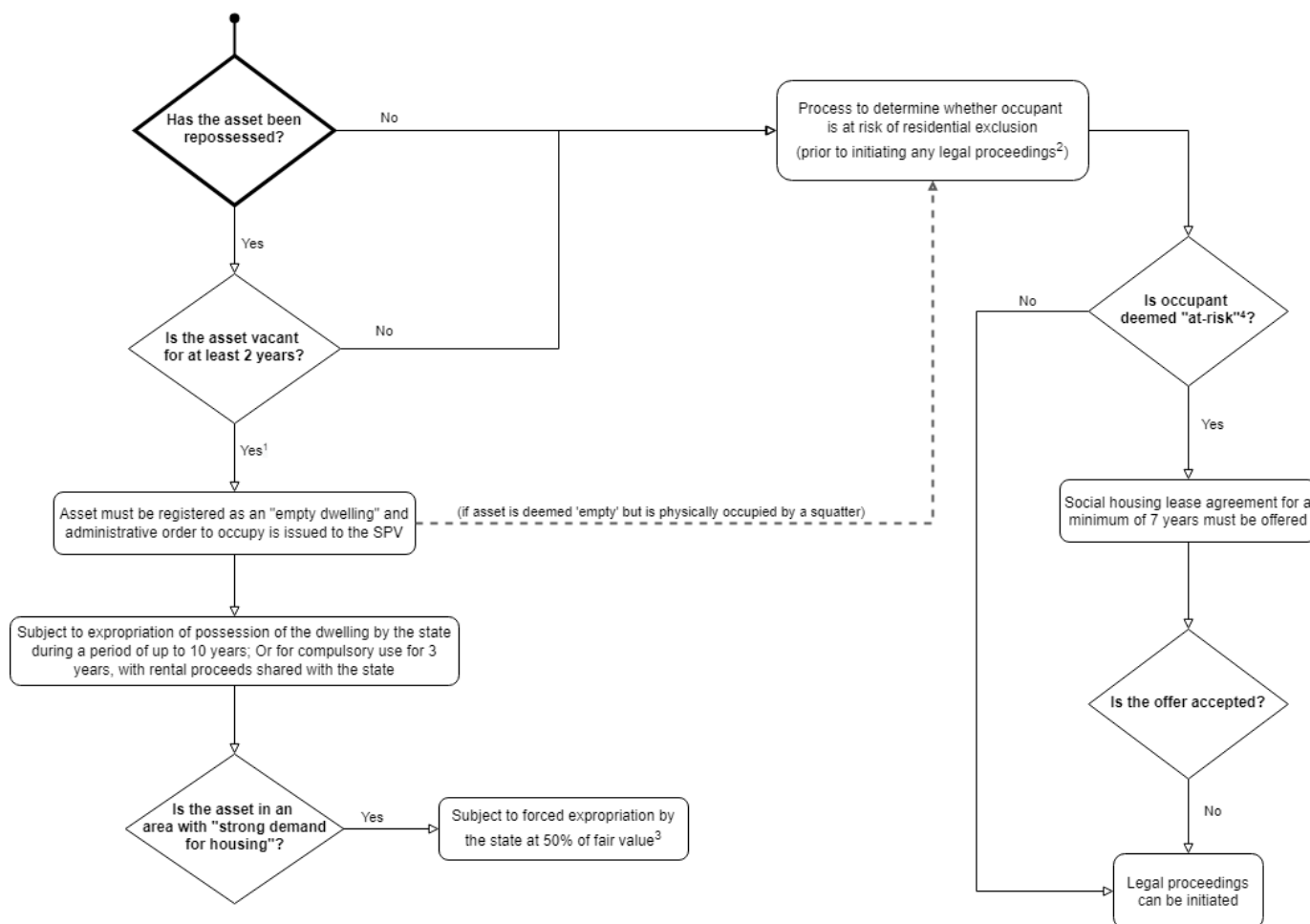
For the purpose of the law, dwellings are considered empty if they have been vacant without just cause for two years. The following is not considered just cause:

- Occupation without legal title to inhabit (i.e. squatting)<sup>5</sup>.
- Existence of legal proceedings on the possession of the asset, even if these were initiated before the two years during which the house has been empty.
- Unfinished properties but more than 80% complete two years from the period they were meant to be completed.

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<sup>5</sup> However, if occupation started less than six months before the effective date of the new law (i.e. after 1 July 2019), eviction proceedings can be initiated.

Figure 1: Path to be followed by a securitisation vehicle in Catalonia



<sup>1</sup> Irrespective of whether all of those two years have passed under the ownership of the SPV or a prior owner.

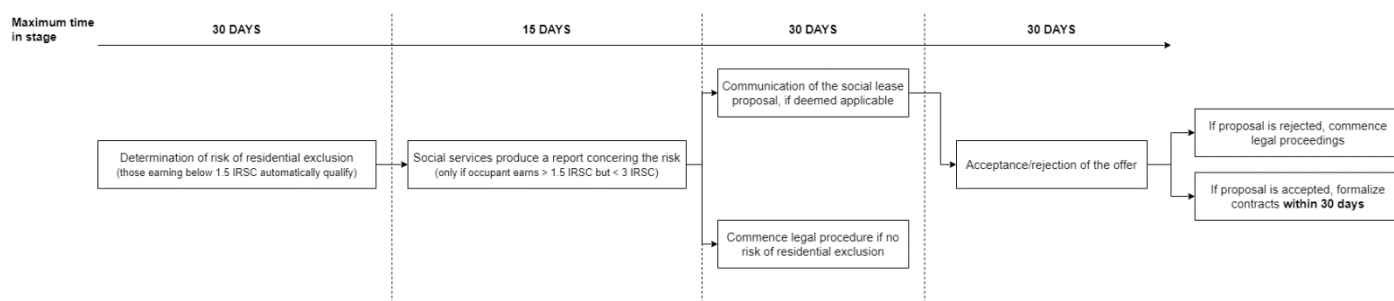
<sup>2</sup> Legal proceedings already in process are not expected to be impacted. Timeline of the process to determine "at-risk" status is illustrated in Figure 2.

<sup>3</sup> Appeals or out-of court arrangements with administrative authorities remain feasible. In addition, conditions note that applicable to assets in areas without strong demand for housing also apply.

<sup>4</sup> Any occupant with no alternative residence in Catalonia and income <1.5 times the "Indicador de Renta de Suficiencia" (IRSC) automatically qualifies, otherwise, if income is <3 times IRSC, qualification is contingent on report from Social Services. Under royal decree law 6/2020, eviction of at-risk occupants is also restricted nationwide until (up to) 2024.

Source: Scope Ratings

Figure 2: Timeline to offer a social lease to an occupant at risk of residential exclusion<sup>6</sup>



Source: Scope Ratings

Failure to have dwellings occupied after an administrative order has been issued will incur penalties of up to EUR 1,000 per month for each empty dwelling, up to a maximum of 50% of the estimated price of each dwelling. The regional administration can also levy administrative fines of between EUR 90,001 and EUR 900,000. If empty dwellings are subject to being assigned to the

<sup>6</sup> Indicador de Renta de Suficiencia or "IRSC" is currently set at EUR 569.12 per month, according to the current Budget Law.



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regional administration, owners are entitled to receive 40% of the maximum rent they could charge on subsidised dwellings under the special rent regime, unless agreed otherwise.

The regional administration has wide preferential acquisition rights<sup>7</sup> in certain transfers of dwellings, which include REO portfolio sales and reposessions in the context of foreclosure proceedings.

If owners infringe orders to have empty dwellings legally occupied, the administration can temporarily expropriate properties for up to 10 years. Owners failing to comply with administrative orders can be permanently expropriated and entitled to 50% of the fair value of the expropriated asset. The other 50% is levied as a sanction for infringing the social function of property regulations.

There are certain conditions for permanent expropriation, one of which is that the legal person currently owning the property must have acquired it from a previous owner who registered it in the Empty Dwellings Register. This applies even if the current owner is a securitisation vehicle (*fondo de titulización de activos*) or if acquisition of the property was a result of a business transfer of shares or stakes.

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<sup>7</sup> Preferential acquisition rights are those of first refusal and setting aside. Whereas the right of first refusal allows its holder to acquire an asset under the same conditions as those agreed upon with another acquirer, the right of setting aside allows to take the place of the acquirer once the transfer is formalised.



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