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PERSPECTIVES ON THE SECURITIZATION OF ASSETS: THE SPANISH CASE

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Abstract

In this paper, we analyze the current status of securitization in Spain within a global context, and taking in account certain factors that have had or may have impact on its recent development and its future. After explaining the historical and legislative evolution, the paper highlights the substantial change that securitization has undergone since the beginnings of the financial crisis, changing from a model of "originate, securitize and distribute" to another model of "originate, securitize and hold".Finally, some related factors that may affect the future of securitization are analyzed, stressing the perception of an increasing Spanish sovereign risk, and concluding with the need to improve the control that supervisors must exercise on banks and rating agencies in order to transmit credibility to investors.

Keywords: Securitization, credit default swaps, sovereign risk, spreads, financial crisis.

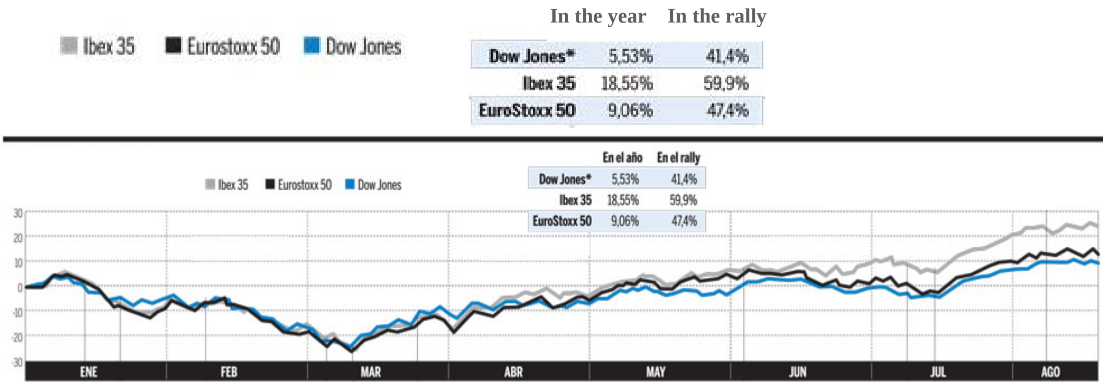
PERSPECTIVES ON THE SECURITIZATION OF ASSETS: THE SPANISH CASE

1. Introduction

There is no doubt that securitization can be considered as one of the principal causes of the current financial crisis, which began in 2007 and shows no reliable signs of ending, in Spain. It is no coincidence that the first symptoms of the bursting of the property bubble - the crashing in July of that year of two *hedge funds* that specialised in mortgages of Bear Stearns - were closely associated with the phenomenon of securitization. The drop in rating suffered by the triple A tranches of those securitizations, whose underlying assets were *sub-prime* mortgages, made their quoted prices extremely volatile.

Pre-existing factors, such as excessive indebtedness, the demonstrated interconnection of the capital markets and the systemic risk entailed by that (Losada, 2006), have propitiated the crisis. In addition, the myopia associated with "short-termism" in the expectation of results, incorrectly-assigned credit ratings, and the lax approach of the supervisors are other factors to consider. Lastly, the paradigm on which securitization has been based (“originate in order to distribute”, instead of “originate in order to hold”, as stated by Roldán, 2009) has acted as a catalyzer in bringing about the expansion of a crisis whose effects have still not come fully to light today, nor been fully quantified. This is demonstrated by the open debate taking place about how to control the risk of those entities that the markets, rightly or wrongly, now consider *too big to fail*. Figure 1 is illustrative of the systemic risk referred to.

Figure 1: Ibex 35, Eurostoxx 50 and Dow Jones: Total returns compared, in percentage terms. 2009 (January – August).



Source: Expansion, 14-8-2009, with information from Bloomberg.

The Bank of Spain has upheld a criterion of maximum prudence in its regulation, and has demanded, among other requirements, anti-cyclical provisions in boom times, and prohibited off-balance sheet securitizations. In addition, the financial entities have maintained an almost zero exposure to *sub-prime* assets, and the regulator has submitted them to close supervision. But, despite this, our country has in no way escaped unscathed from the international penalization of the market for securitization bonds that, as will be confirmed later, has resulted in a practically total drought of new issues. And so a financial tool that, in other circumstances, had been demonstrated to be extremely useful in the expansion of the banking business, was suddenly revealed to be a dangerous weapon for the transmission of credit risk whose power, given the globalization of financial markets, turned out to be lethal.

In this study an analysis is made of securitization in Spain, aiming to set it in its European and global context. With this object, we will deal with the following points:

- In the next section the recent evolution of securitization, within and beyond our borders, will be described and discussed.

- In the third section, the pertinent legislation will be reviewed.
- We will continue, in the fourth part, presenting the current composition of the international markets for debt and the role that securitization has played.
- Then, in the fifth part, the current situation of some of the factors that may affect the future of securitization will be considered.
- Finally we will present, succinctly, some of the conclusions that can be drawn from this article.

2. Recent evolution

At the beginning of the 1970's, the first securitizations based on residential mortgages appeared in the USA. These are known as MBS or *mortgage-backed securities*, and this type of instrument evolved into extremely sophisticated financial structures that few, apart from a very small elite, understood very well. The securitization of credits had become, in few years, an operation taken as a reference in international financing for stimulating growth unrestricted by any risk that might be inherent in such instruments.

Starting from relatively simple products that replicated the income flows from the underlying mortgages on which they were based (known as *pass-through* securities) up to the complex derivative instruments in which only risk is transferred (synthetic securitization) and others that transform previous securitizations into a new instrument (*collateralized-debt obligations* or CDOs), the development of securitization could well be described as vertiginous. Because of the huge amount of assets thus transformed, the wide range of types of underlying credit, the variety of different instruments or securities that have come to be traded, the so-called financial engineering utilised, and the apparently unstoppable international growth in its use, securitization is one of the most prominent financial phenomena of our times.

Securitization began in the UK in 1987 and in France in 1989, and reached Spain in the early 1990's. Although it is true that previous attempts had been made by some banking entities to issue securitization bonds (Barranechea, González and Trujillo, 2007), Spain lacked a specific legal framework to serve as an "umbrella" for the correct development and operation of this market.

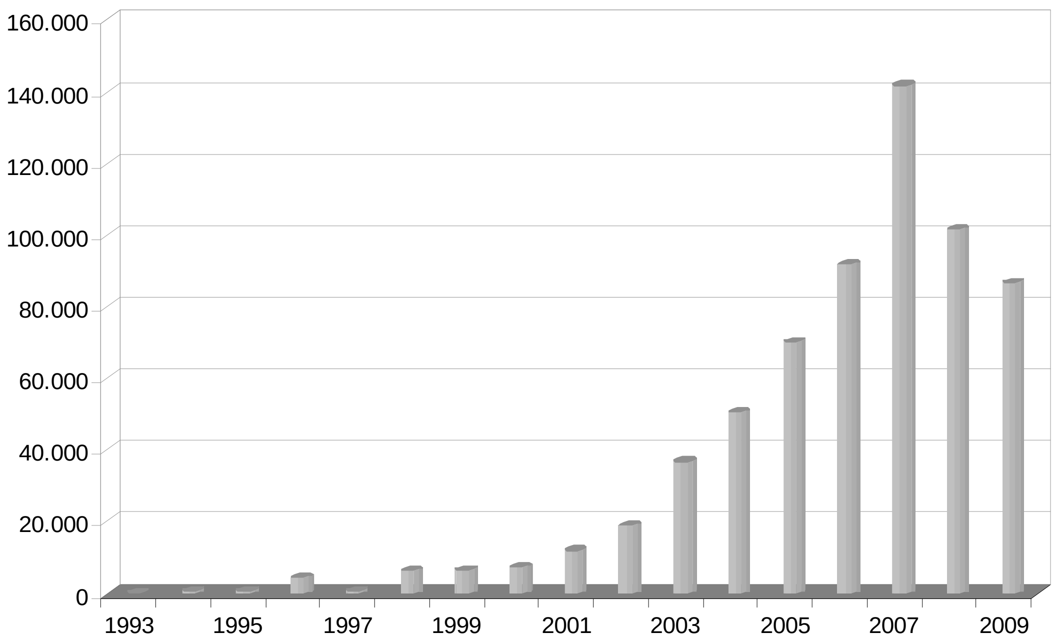
The first Spanish regulation in this field concerned the securitization of mortgage loans, since these constitute very appropriate assets for this purpose due to their long term of amortization and the regularity of their payment flows. The Law 19/1992, under which Property Investment Funds and Companies and Mortgage Securitization Funds were regulated, enabled the securitization market to get started with an initially slow but thereafter continuous development.

Subsequently, with the promulgation of the Royal Decree 926/1998, which made securitization feasible for other types of loans, and even for future cash flows, the growth of the market accelerated, although due not only to the emergence of this regulation but also to other reasons.

With monetary policy centralised in the hands of the European Central Bank, which entered into force on 1 January 1999, the system of guarantees in the form of securities for accessing the Central Bank auctions for the injection of liquidity was institutionalised, with securitization bonds constituting acceptable assets for this purpose. In addition to this reason, the spectacular boom in the mortgage market, fed by low interest rates and easy credit that weakened the perception of risk (Brunnermeier, 2009), led to a parallel increase of the mortgage credits that was reflected in the issues of securitization bonds. Consequently, the volume in circulation in Spain, in 2007, reached the record figure of 141,750 million euros.

During the intervening years, between 1999 and 2007, the balance of these securities in circulation grew at rates of increase unknown until now, while international investors were demonstrating great interest in these products that were flooding onto the market. This voracious demand by investors provided the financing for a good part of the economic growth enjoyed by Spain during this period.

Figure 2: Volume (in millions of euros) of securitization bonds in circulation in Spain (1993-2009).



Source: Intermoney Securitization and CNMV.

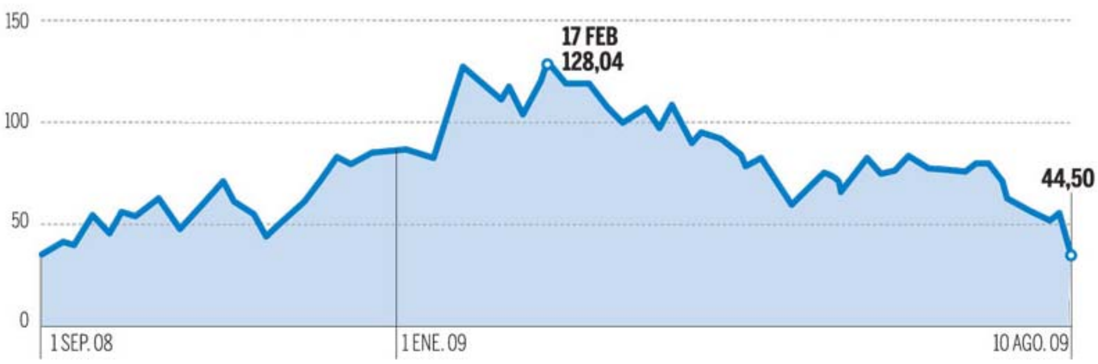
The rapid growth presented by these issues in the period 1999 - 2007 can be readily appreciated in figure 2; in some years inter-annual growth rates of 95% were achieved, and 2007 showed a growth of 55% over 2006, when the market had already increased very substantially in size.

After this spectacular performance, the bankruptcy of the investment bank Lehman Brothers, in September 2008, released a huge wave of uncertainty, based on the lack of transparency in the investments made in securitizations; it was like a tsunami that travelled swiftly and implacably all around the world. The falls in trading suffered during the years 2008 and 2009, left this market practically in dry dock, since, although securitizations continued to be issued, hardly any of them could be placed in the market, and so they had to remain on the balance sheets of the issuers themselves; we will deal with this situation in the fourth part of this paper.

One of the first consequences of the crisis, which broke, as already mentioned, in September 2008, was the phenomenon of contagion, understood as an intense perception of credit risk that spread to many countries. In this stage, the sovereign risk of Spain increased spectacularly. Taking as the indicator of this situation the differential in the *bono-bund* returns, it can be seen, in figure 3 and in chart 1, how this differential almost tripled in the six months following the demise of Lehman, indicating a proportionate increase in the cost of financing the country. The foregoing represented an additional threat, in respect of its extension to Spanish companies, since the interest rate differential for sovereign risk acts as a lower limit, marking a minimum *spread* for the issues of debt of the national companies.

Another indicator of the situation was given by the premiums of *Credit Default Swaps* (CDS's), which, during the same period of time, increased by more than 286%, to reach a level of 170 basis points, against the level of 44.1 where they were before the bankruptcy of the American bank. (See chart 2).

Figure 3: Difference in returns between German and Spanish ten year bonds (basis points).

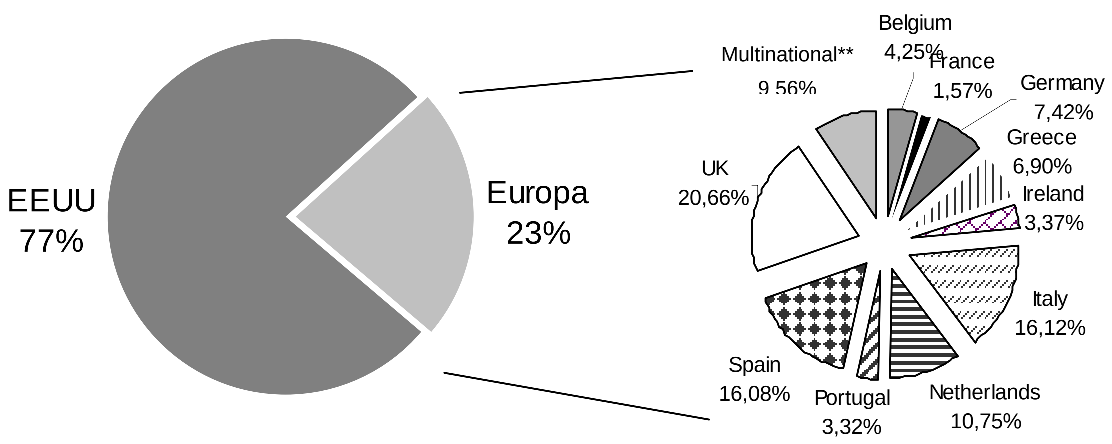


Looking at a larger geographic area, considering the situation within Europe, the results were not that different from the outcome in Spain, as can be confirmed in charts 1 and 2.

Situating the Spanish market for securitizations in the European context, as a prior step, we observe in figure 4 that, according to the European Securitization Forum (ESF), Spain occupies third place, in the ranking of countries by volume of securitization issues within Europe, accounting for 16.08%, similar to Italy and only exceeded significantly by the United Kingdom.

Including the USA in the analysis, as the world's leading issuer of securitizations, Spanish issues recently accounted for 3.66% at the global level.

Figure 4: Securitization issues 2009*



* Third quarter

** Multinational: includes all the categories in which the assets originate from a variety of jurisdictions or countries, whose total amounts are small.

Source: European Securitization Forum (ESF).

Within Europe, as in Spain, after the Lehman Brothers bankruptcy, the market for securitizations suffered a severe setback, from the panic generated (figure 5). The subsequent bank rescues, in both the USA and Europe, together with the reconversion of North American investment banking into commercial banking, ignited a fire that charred the mechanism of reputational trust on which the banking system is founded (Van Rixtel and Romo, 2009).

Chart 1: Indicator of sovereign risk: *bond-bund* differential (in basis points).

	Lehman Bankruptcy	Maximum differential	Date	Return to normality
	15/09/2008			10/08/2009
Spain	46.8	128.04	17/02/2009	44.5
Germany	-	-	-	-
France	25.8	62.77	09/03/2009	19.4
Belgium	40.9	69.2	23/10/2008	30.3
Italy	71.5	158.56	27/01/2009	66.5
Ireland	42.4	283.5	19/03/2009	143.7
United Kingdom	40.9	54.43	29/07/2009	30.3
Holland	25.9	86.58	17/02/2009	22.1
Greece	79.6	300.33	12/03/2009	107.77
Austria	36.9	136.68	18/02/2009	34

Source: Expansión, 11-08-09.

In about March 2009, the market touched bottom, and began to return to levels of trust more in accordance with those of times prior to the crisis, which was achieved around August of that same year. Taking, again, the CDS premiums and the *bono-bund* differential as indicators, we can conclude that, in the first stage of upsurge of the crisis, the mean increase of the *bono-bund* differential in the principal countries of Europe exceeded 216% (see chart 1), and that the mean increase of CDS premiums in these same countries reached almost 670% in mid year (see chart 2).

Chart 2: Indicator of risk of default; CDS premiums (in basis points).

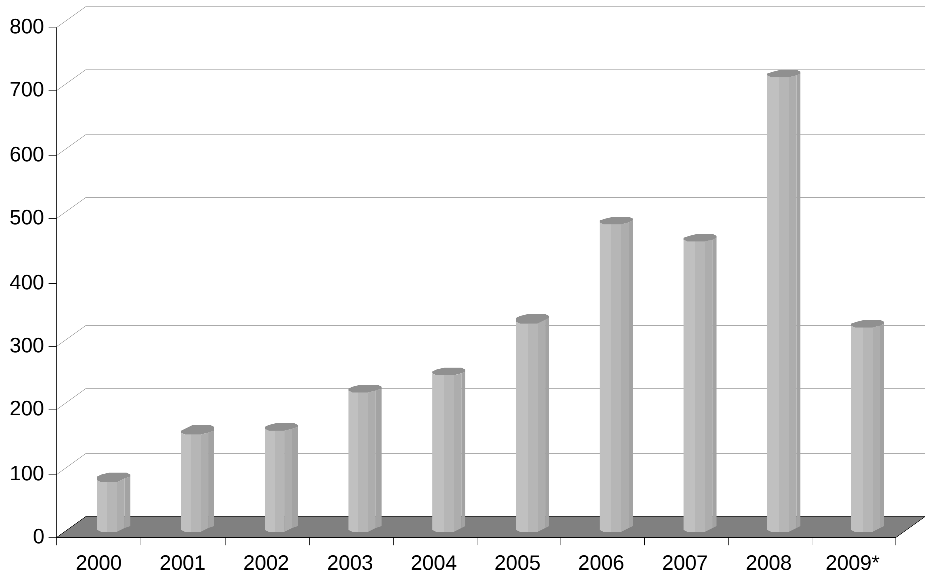
	Lehman Bankruptcy 15/09/2008	Maximum premium	Date	Return to normality 10/08/2009
Spain	44.1	170	17/02/2009	25
Germany	9.8	91.85	24/02/2009	59.88
France	13.7	97.7	06/03/2009	27.18
Belgium	23.3	157.75	24/02/2009	37.05
Italy	47	200.63	06/03/2009	66.62
Ireland	34.4	398.8	17/02/2009	149.53
United Kingdom	22.7	175	17/02/2009	56.89
Holland	12.4	131	24/02/2009	31.74
Greece	56.8	285.1	17/02/2009	106.62
Austria	13.2	273	06/03/2009	63.72

Source: Expansión, 11-08-09.

The later problems of unemployment and, consequently, of defaults and the widespread declines in property prices - in short, the general worsening of the principal macroeconomic magnitudes - were aggravating the situation of the international markets for securitization bonds.

The fear of new cases of insolvent bank portfolios coming to light provoked a sharp increase in the margins or *spreads*, by which issues were remunerated, and a stagnation of these issues. Not only did the volume of issues fall but also investors ceased to be interested in products whose opacity led to them being especially avoided; as a result the new issues were left on the hands of the originators themselves, there being no outlet for them on the international markets. Nevertheless, securitizations continued to be issued since, in order to cope with the crisis of liquidity, the various central banks relaxed their demands with the object of injecting liquidity into the interbank market, diminishing the requirements in respect of the guarantee assets that banks had to produce to be able to participate in the auctions for money.

Figure 5: Issues in Europe (2000-2009). Thousands of millions of euros.



* Third quarter

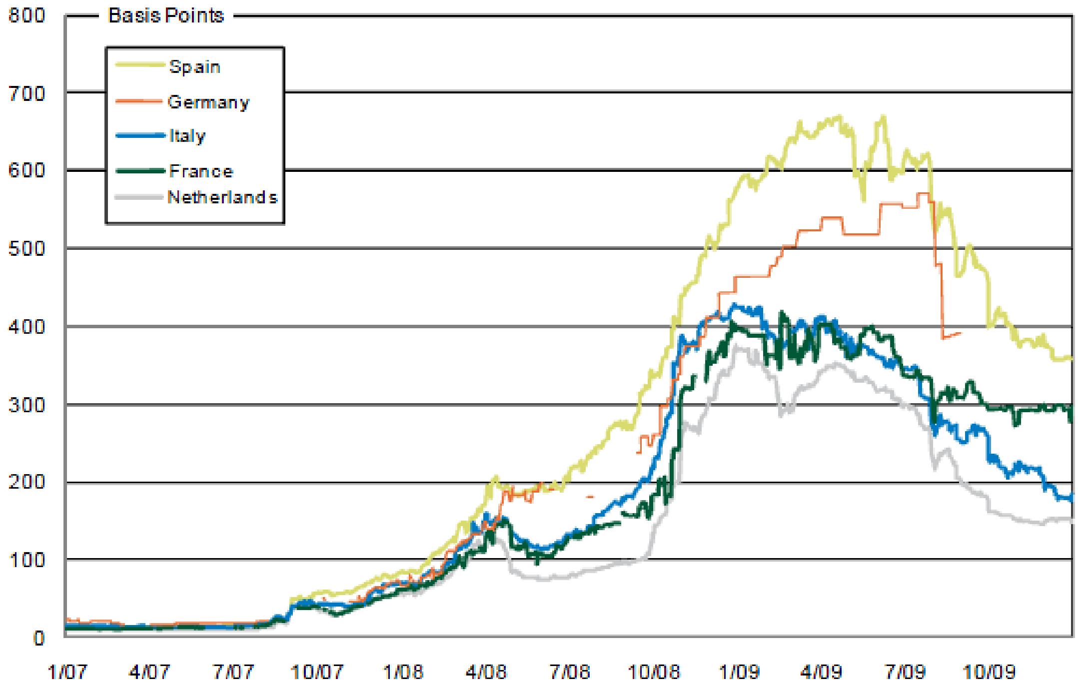
Source: Association for Financial Markets in Europe (AFME), ESF, Securitization Data Report Q3:2009.

In figures 6 and 7 it can be seen how these *spreads* widened in all the countries analysed, especially during the first third of 2009; in some cases, they were almost seven times greater than the levels prior to the crisis. The situation of Spain, in this respect, has turned out to be especially onerous, since it has suffered one of the heaviest penalties at the international level.

Despite the persistence in the markets of the drought situation, signs began to be seen of the return to normality since, both in Spain and in other countries, new placings of issues of securitization bonds have been initiated. Thus, in the spring of 2009, the first Spanish securitization since the Lehman bankruptcy was announced, by a group of Catalan savings banks. Then, the third quarter of 2009 was marked by three European placings in the primary market: Tesco Property Finance2, an issue of CMBS (*Commercial-mortgage backed securities*); VCL 11, securities issued by Volkswagen Leasing (ABS or *Assets-backed securities*) and PERMM 2009-1, a package of British RMBS (*Residential-mortgage backed securities*).

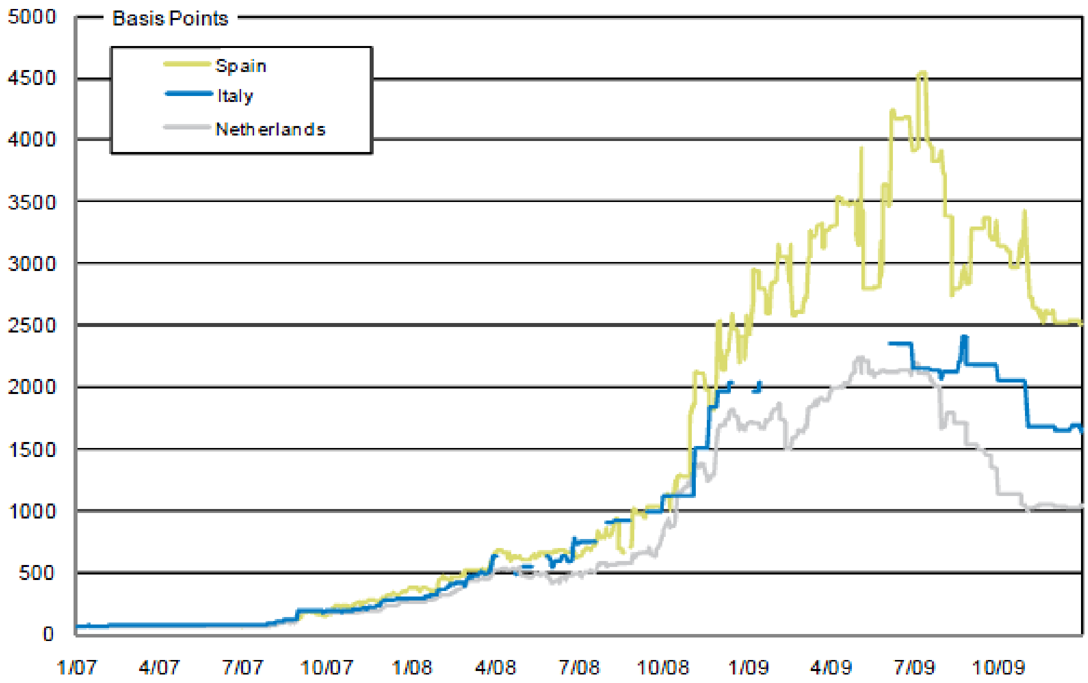
Figure 6: *Spreads* of RMBS (*Residential-mortgage backed securities*)

European AAA, 3-5 years.



Source: Association for Financial Markets in Europe (AFME), ESF, Securitization monthly data supplement (January, 2010).

Figure 7: ***Spreads*** **of RMBS (*****Residential-mortgage backed securities*****) European BBB, 3-5 years.**



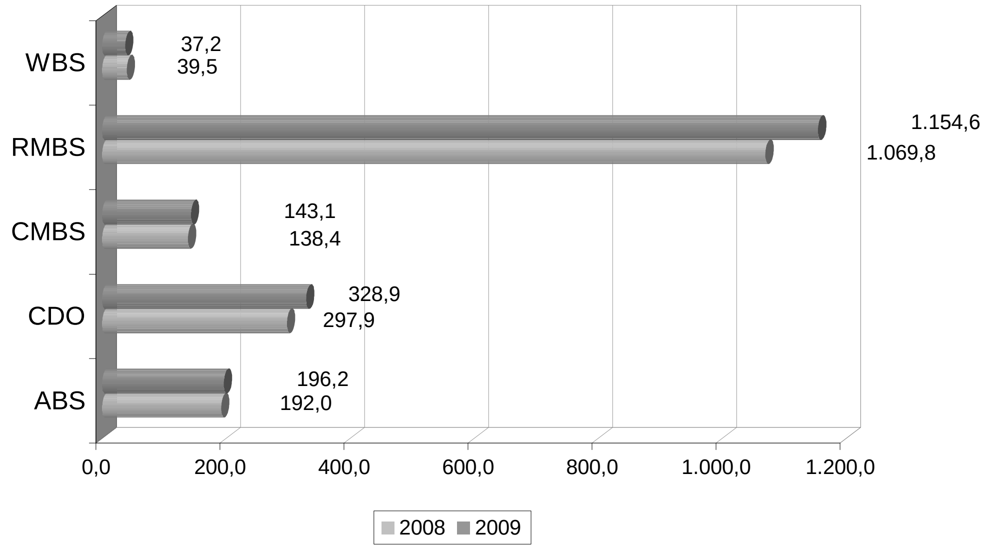
Source: Association for Financial Markets in Europe (AFME), ESF, Securitization monthly data supplement (January, 2010).

Similarly, in figure 8 it can be seen that the principal issues, even during 2009, have continued to be those of residential mortgages.

However, the data given above indicate that it is specifically the mortgages on commercial premises (CMBS) that are suffering the highest rates of default, and that are the main cause of the deterioration in quality of the issues in circulation, rather than residential mortgages. In the initial phase it was the latter that most rapidly suffered payment defaults; however the market has been cleaning up toxic assets of this type, residential mortgages, and now the CMBS issues are beginning to come to light.

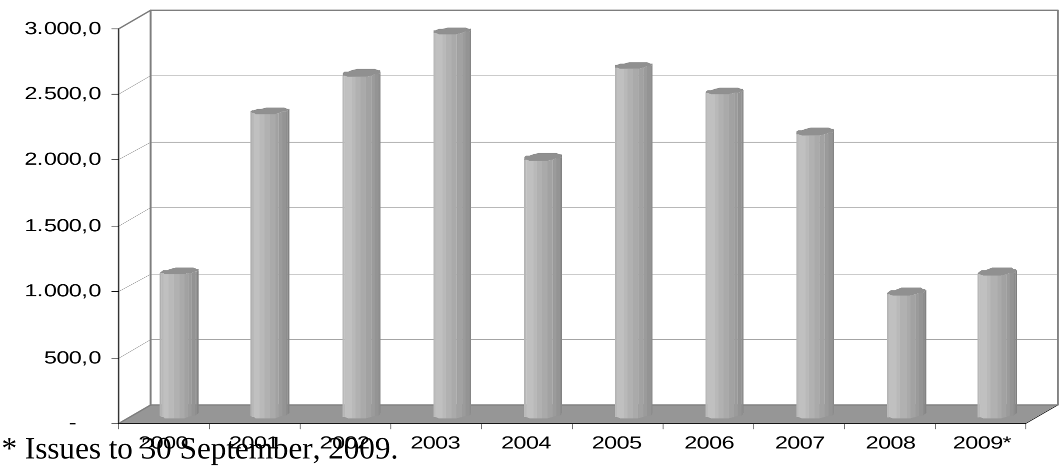
Figure 8: Issues in Europe, by collateral, 2008 - 2009 (third quarter).

Thousands of millions of euros.



Source: AFME, ESF, Securitization Data Report Q3:2009. (ABS: Asset-backed securities, CDO: Collateralized debt obligations, CMBS: Commercial mortgage-backed securities, RMBS: Residential mortgage-backed securities, WBS: Whole business securitization).

Figure 9: Issues of securitization bonds in the US (2000-2009). Thousands of millions of euros.

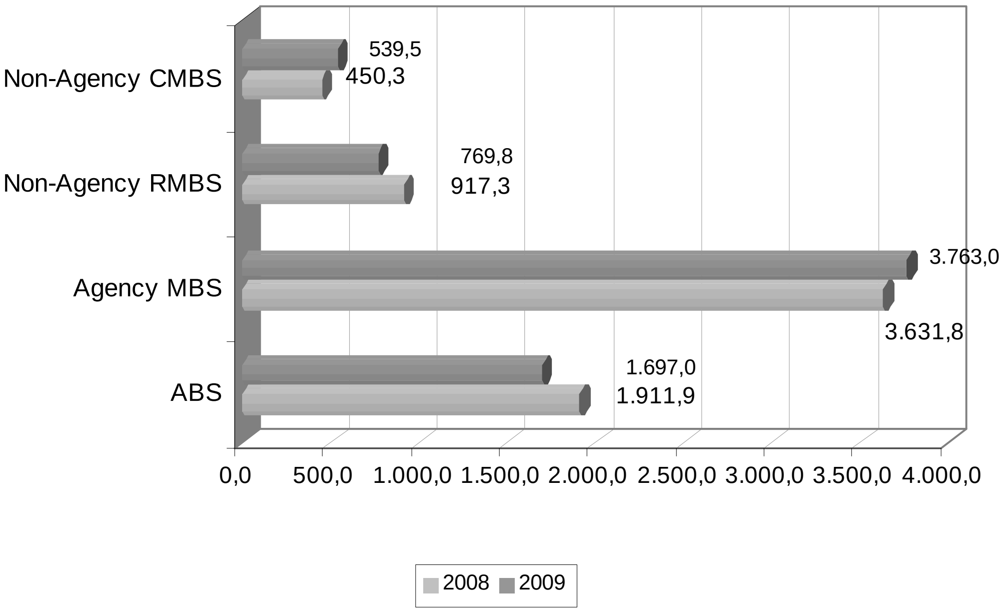


* Issues to 30 September, 2009.

Source: AFME, ESF, Securitization Data Report Q3:2009.

The situation in US is similar to that which occurred in Europe; initially, in 2007, there was a slight contraction in the volume issued, which decreased by 12.6%, but that turned into a steep drop of 56.5% in 2008, as can be seen in figure 9.

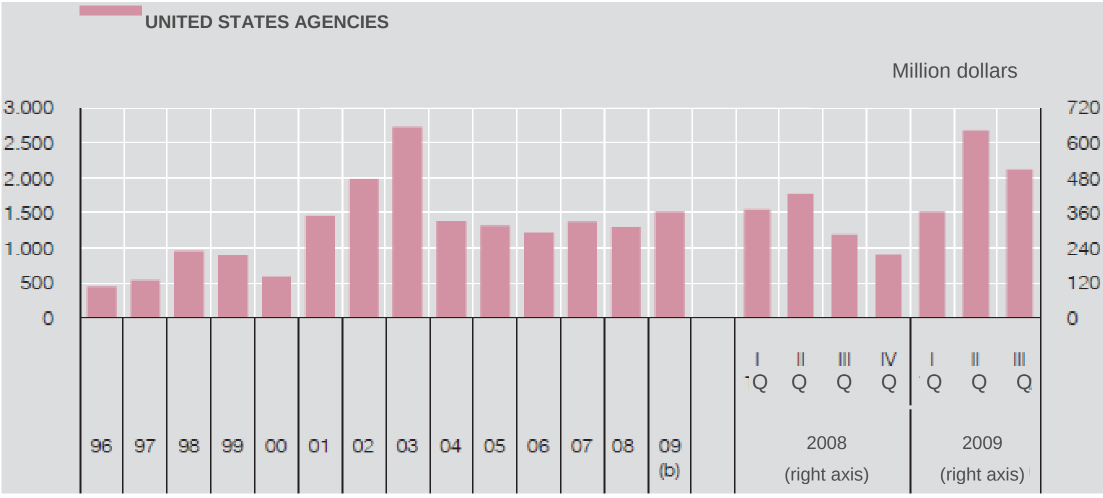
Figure 10: Issues in the US, by collateral, 2008 - 2009 (third quarter). Thousands of millions of euros.



Source: AFME, ESF, Securitization Data Report Q3:2009. (CMBS: Commercial mortgage-backed securities, RMBS: Residential mortgage-backed securities, MBS: Residential and commercial mortgage-backed securities, ABS: Asset-backed securities). Agency refers to the North American mortgage agencies.

Further, the major participation in the US securitization market is accounted for by the public agencies (Freddie Mac, Fannie Mae and Ginnie Mae), whose mortgage-backed bonds again constituted the greater proportion, as can be observed in figure 10. Considering these three large issuers alone, figure 11 shows a recovery with respect to their previous minimum, due principally to the TALF program (*Term Asset-Backed Securities Loan Facility*) of the Federal Reserve, which involved purchasing mortgage securitizations.

Figure 11: Mortgage securitizations issued by US agencies.



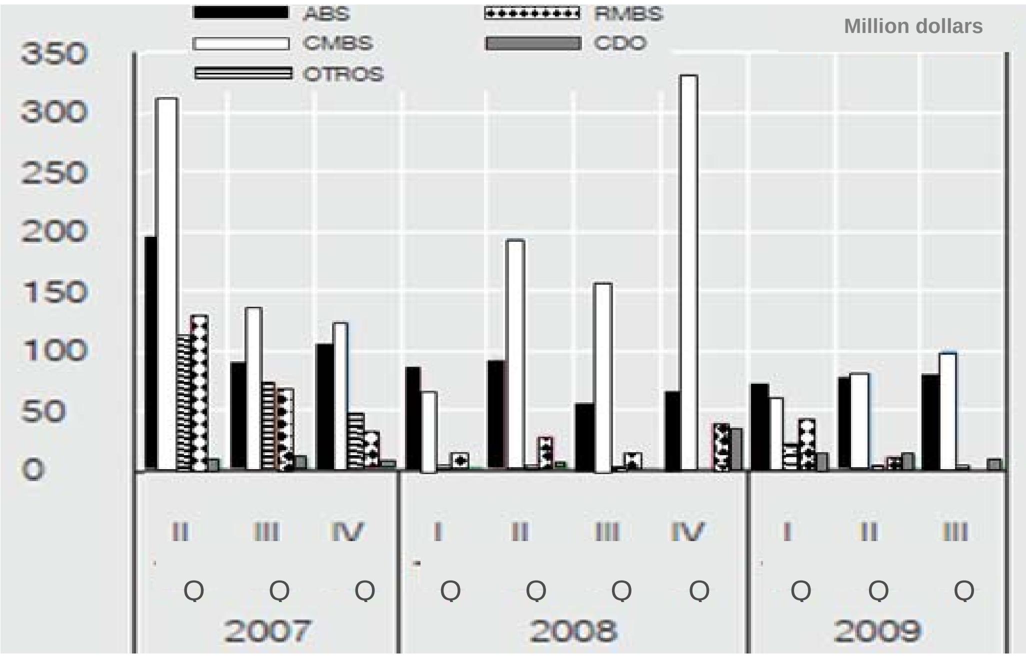
b) Third quarter of 2009.

Source: Van Rixtel and Romo, 2009.

On the world scale, excluding from the analysis the large US agencies, it can be concluded, from figure 12, that the gross issue of securitizations during the last decade increased five-fold in barely six years, from 1999 to its peak in 2006, passing from 0.5 billion dollars to more than 2.6 billion dollars in 2006. Subsequently issues began to fall in the third quarter of 2007, and the decline accelerated in 2008, when the volume of securitizations was less than half of that recorded for 2006.

The data demonstrate that, during the second and third quarters of 2009, world securitization activity has recovered from its previous minimum, due to the reactivation of the issues placed on the markets. The securitizations retained by the originators themselves were dramatically reduced in the second quarter of 2009, and stabilized during the third quarter.

Figure 12: Securitizations on the world scale (excluding the US agencies), by type of guarantee asset.



Source: Van Rixtel and Romo, 2009. (ABS: Asset-backed securities, CMBS: Commercial mortgage-backed securities, RMBS: Residential mortgage-backed securities, CDO: Collateralized-debt obligations).

Finally, in respect of the composition of the international markets for debt, it can be appreciated, also in figure 12, that the issues on the global scale have mainly been mortgage securitizations, in particular residential mortgages (RMBS), whereas securitizations of the CDO and CMBS types have constituted only a very small proportion.

In summary, securitization is a financial mechanism that has been utilised with the object of expanding credit, but based on attempting to disconnect it from the underlying risks implied. This mechanism reached very high levels of development both in Europe and in the USA, but came to an abrupt and destructive halt when the crisis broke.

The opacity of these products, the incorrect credit ratings assigned to them by the principal *rating* agencies, and the absence of effective control by the competent authorities, are the factors at the root of the problems that have occurred. The foregoing factors, together with the dynamism of the originators and investors, and the large volumes traded in the market, led to a steep rise of the *spreads* required (and of the CDS premiums), which finally resulted in the de facto paralysis of the global markets for structured debt.

3. Legislation

a) Laws

In Spain there was no specific regulation of securitization in existence until **the law 19/1992, of 7 July, on the regime of Property Investment Funds and Companies and on Mortgage Securitization Funds.**

In article 5 of this Law, referring explicitly to Mortgage Securitization Funds, the first normative framework for the creation of such funds was presented; it required that the assets of the fund should comprise mortgage participations, and that its liabilities should comprise mortgage securitization bonds, with the condition that the net patrimonial value of the fund should be zero. The securitization funds, therefore, were transforming mortgage loans into fixed income securities; this represented a mechanism of financing that supplied greater liquidity to the market.

With respect to the assets, since they were mortgage participations, their regulation required that their administration and custody should be exercised by their issuer, while the participated loans ceased to be computed as assets at risk on the balance sheet of the originator. But even though mortgage participations were not then computed as assets at risk in the balance sheet of the originator, the Bank of Spain obliged the issuer to consolidate the accounts; therefore the mortgage securitization funds remained subjected to capital requirements and the necessary provisions had to be made.

Lacking juridical personality, the law required that the funds should be administered by the so-called "sociedades gestoras" (management companies) of mortgage securitization funds, which would be responsible for constituting and monitoring them, and would protect the interests of the investors; they also had to request that the securities should be admitted for quotation in an organised official market. These companies were placed under the supervision of the Comisión Nacional del Mercado de Valores (CNMV).

The term of the mortgage participations had to be equal to that of the participated loans; the law also established the obligation for a credit rating to be assigned by an entity recognized by the CNMV.

The **Law 40/1994, of 30 December**, also deserves special mention; this was **a Law regulating the Spanish national electrical system,** not only in respect of the moratorium on new nuclear power station construction but also about the securitization of the State's debt with the electricity generating companies.

With the Law 19/1992, which required the issue of mortgage participations if an entity wanted to transfer mortgage loans to a securitization fund, many restrictions were imposed, since loans eligible to being participated had to meet a series of strict requirements. By way of example, one stipulation was that any loans whose *Loan to Value* (LTV, the active balance of the loan, divided by the assessed value of the dwelling) exceeded 80%, and the flexible mortgage products whose object is not the purchase of the dwelling, were excluded, although this could be utilized as a guarantee.

To overcome this situation, the **Financial Law 44/2002, of 24 November**, defines Mortgage Transfer Certificates, and establishes that mortgage participations, grouped under asset securitization funds, may correspond to loans and credits that do not meet the requirements stipulated in the Law 2/1981, of 25 March, for the Regulation of the Mortgage Market, referred to in the preceding paragraph.

Although synthetic securitization has hardly been developed in Spain, the **Law 62/2003, of 30 December, consisting of fiscal, administrative and social order measures,** regulates this activity; in this type of structure, the credit risk of the assets securitized is either totally or partially transferred to a credit entity, an investment services company or an authorised non-resident entity, by contracting CDS-type credit derivatives with one or more third parties.

b) Royal Decrees

With the 19/1992 law regulating Property Investment Funds and Companies and Mortgage Securitization Funds, the way was opened for securitization in Spain, although it was insufficient for the extension of securitization to credits other than mortgage loans. For that purpose, the **Royal Decree-Law 3/1993, of 26 February, comprising urgent measures on budgetary, fiscal, financial and employment matters**, allowed entities to securitize "others loans and credit rights, included those derived from *leasing* operations and those loans related in general to the activities of small and medium-size companies"; before doing so, however, the entities had first to have a favourable report from the CNMV and the Bank of Spain.

In 1998, the laws existing on this matter had become markedly out-of-phase; consequently the **Royal Decree 926/1998, of 14 May, was promulgated; under this law the Asset Securitization Funds and Securitization Fund Management Companies were regulated,** to make it possible for them to integrate not only financial assets but also other rights, including the concession of present and future credits; thus asset securitization funds came into existence.

Two types of structure were configured: the closed funds, originating from the mortgage securitization funds, and the open funds. These latter could consist of assets or of liabilities, according to whether the incorporation of elements of one or other type was permitted subsequent to the creation of the fund. With this, the securitization of special-risk short and medium term flows (*asset-backed commercial paper securities* or ABCPS) was permitted, since they reproduce the structure of a financial entity (short-term financing and long-term investment) without the safeguards that this possesses: the mechanism of reputation and trust with the customer and the deposit guarantee fund, as well as the possibility of financing through the central banks, since these act as lenders of last resort (Roldán, 2008). ABCPS are securitization bonds supported by short-term company notes, and structures of this sort have had considerable development in other countries (Van Rixtel and Romo, 2009).

Finally, the **Royal Decree-law 6/2009, of 30 April, in which particular measures in the energy sector were adopted, and the social bond,** which provided for the constitution of the so-called Fund for Securitization of the Electricity System Deficit, was approved. The object pursued with this fund was the financing of the tariff deficit. This tariff deficit occurs because the income obtained by the electricity companies does not cover the real costs of generation and distribution. These income flows originate from the tariffs regulated by the central Government and those fixed in the liberalized market.

According to this Royal Decree, the assets of the securitization fund will be constituted by:

a. Rights to payment generated and not ceded to third parties by their initial owners, up to 10,000 million euros to the date of 31 December 2008.

b. The rights to payment deriving from the financing of the deficits generated from 1 January 2009 until 31 December 2012, whose characteristics, including price and conditions of cession, will be established by Royal Decree.

In October 2009 the entity to adjudicate the securitization operation was chosen: this was TdA (Titulización de Activos), a management company in which the following savings banks participated: Caja Madrid, Caja Castilla la Mancha, Ibercaja, Unicaja, Caja de Burgos, EBN and Caja de Ahorros del Mediterraneo, each with a holding of 12.86%, together with J.P. Morgan, which held 10%.

c) Orders

With respect to the credits to SMEs, the **Order of the Ministerio de Economia, of 28 May 1999, covered Agreements for the Promotion of Asset Securitization Funds in order to facilitate company financing**; this Order allowed financial entities to securitize both mortgage and non-mortgage loans, and provided a State guarantee for such securitizations in exchange for the entity's commitment to reinvest the liquidity thus obtained in the financing of small and medium-size companies.

In addition, although the Royal Decree 926/1998 allowed the securitization of future cash flows, it only referred explicitly to the rights possessed by motorway concessionaires to charge and receive motorway tolls. Therefore a subsequent normative extension of the decree was necessary. In this respect, the **Order EHA/3536/2005, of 10 November**, widened the future credit rights that were eligible for incorporation in asset securitization funds; it also authorized the Comision Nacional del Mercado de Valores to dictate specific rules in matters of accounting and obligatory disclosure of information applicable to asset securitization funds and to their management companies. The requirement is that the cession of the future credit rights must be full and unconditional, and whatever contracts to that effect that may be necessary must be signed.

The flows regulated by this Order are the following:

- The right of the property lessor to receive the rent payments due by virtue of the letting contract.
- The fruits or products derived from all or some of the rights of exploitation of a work or performance protected by the Law of Intellectual Property.
- The fruits or products derived from the exploitation of a brand or commercial name.
- The fruits or products derived from the exploitation of an industrial design.
- The fruits or products derived from the exploitation of a patent, a utility model or an industrial property right of analogous nature.
- The right to receive payment in recompense for the sale or supply of goods or for the provision of services, in one single instance or successively, that gives rise to flows of payments of recurring or one-off nature, whenever this amount can be known or estimated.
- The future credit rights corresponding to the income deriving from loans, credits or other types of financing, such as those deriving to the financing entity from the dispositions effected by the creditor by virtue of contracts of credit.
- The right of the usufructuary or owner of some other limited real right, in respect of the economic value of the usufruct or of the right in question.

Faced with the deterioration of the economic situation in 2008 (the rise in the price of petroleum, the increase in unemployment, and the fall in productivity, among others factors), the

Government dictated a series of measures to inject liquidity into the financial system and to unblock company financing. The **Order PRE/2424/2008, of 14 August**, made public an Agreement of the Council of Ministers on measures for structural reform and for stimulating the financing of small and medium-size companies.

In this Order, in so far as it affected securitization, it was established that the Institute of Official Credit would, in 2009 and 2010, renew to the sum of 5,000 million euros, the line of guarantee to those securitization funds whose underlying assets are loans for the acquisition of a protected dwelling. The Order also established that the Ministry of Finance would present a proposal, to the Government's Delegated Commission for Economic Affairs, to grant guarantees backed by the State, to the maximum amount of 3,000 million euros in 2009 and 2010, that would have the objective of guaranteeing fixed income securities issued by securitization funds, whose assets are loans or credits conceded to small and medium-size companies.

d) Circulars of the Bank of Spain and Community Directives

In relation to the fall in the accounting value of the securitized assets, it is essential to clarify that the **Circular of the Bank of Spain** (hereafter the BE) **4/2004**, specifying the accounting standards of the International Accounting Standard, or IAS, established a relationship between the risk really retained by the originator entity and the assets ceded. Except in the case of an asset sale in the strict sense, it is very difficult for assets to disappear from the accounts of an entity, since the ceding of the assets does not relieve the entity of the associated risks.

Subsequently, the **Circular BE 3/2008**, on the determination and monitoring of entities' minimum own funds, adapted the Spanish legislation for credit entities to the European

Community directives relating to the access of these entities to securitization activity, and relating to capital adequacy.

The **Directive 2009/83/CE, of the European Commission of 27 July 2009**, modified certain annexes of the **Directive 2006/48/CE, of the European Parliament, and of the Council, of 14 June**; particularly notable are the modifications introduced in Annex IX, "Securitization", which made specific the circumstances in which it is considered that an entity has transferred a significant part of the credit risk in a securitization, whether traditional or synthetic; these circumstances are:

- When the exposures, weighted by risk, of the semi-subordinated (*mezzanine*) securitization positions retained by the originator entity do not exceed 50% of the total of such exposures.

-When semi-subordinated securitization positions do not exist and when the originator entity does not retain more than 20% of the total of the positions that would be subject to deduction of the own funds or to a risk weighting of 1.250%.

Another circumstance in which it could be considered that a significant part of credit risk has been transferred is when the supervisory authority has been convinced that the credit entity has in place policies and methodologies to ensure that the possible reduction of the capital requirements is justified by an agreed transfer of credit risk to third parties (Bank of Spain, 2009).

4. Current situation of the international debt markets

The crisis of trust, triggered by the events of September 2008 as already commented, affected the size and composition of the international markets for debt and, in a very significant way, all structured financing, since this concerned the most opaque investments existing, and hence the most difficult to understand.

This lack of trust, aggravated by the evident deficiencies in the credit ratings awarded by the *rating* agencies (Losada, 2009), set in train a series of consequences, some of which particularly affected the securitization market:

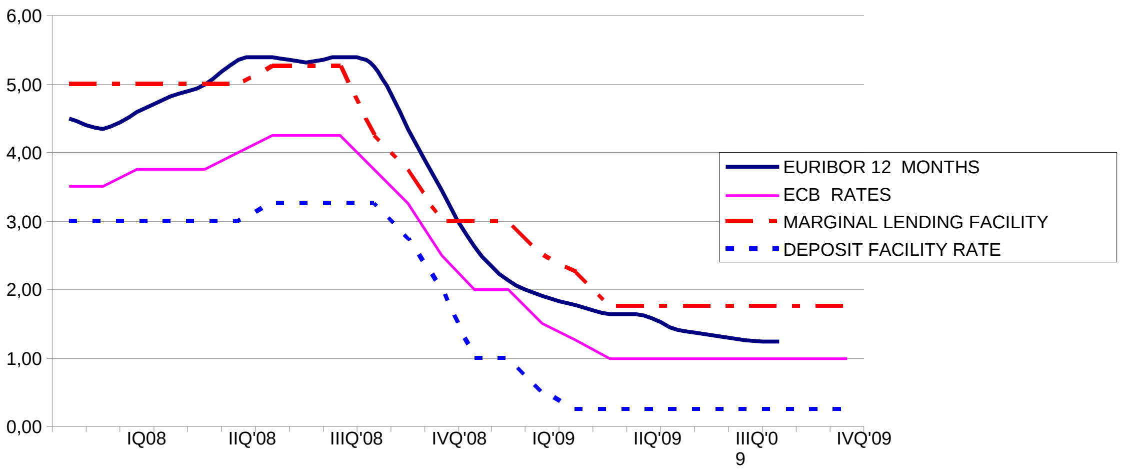
Risk premiums rocketed, leaving the interbank markets practically deserted.

This in turn provoked the central banks all around the world to flood their financial markets with liquidity, since they believed they had no option but to act by assuming the role of *lenders of last resort*.

The fear that gripped the Stock Exchanges made share prices extremely volatile, and caused the widespread collapse of quoted prices at the beginning of 2009. In Spain, the Euribor, overwhelmed and at totally atypical levels (figure 13), rose above the corridor of the permanent facilities of the ECB and did not return to its normal course until the first quarter of 2009. The subsequent injections of liquidity by the US Federal Reserve, the Bank of England and the ECB alleviated the situation of lethargy in the interbank market, which was followed by the steepest drop in rates known by the ECB since it came into existence, down to 1% in May 2009. Despite these events, the distribution of the credit continued to be obstructed, in a situation of liquidity trap: the market was inundated with money that, by the breakdown of the mechanism of trust, was not flowing and, critically, was not reaching the corporate body of the economy.

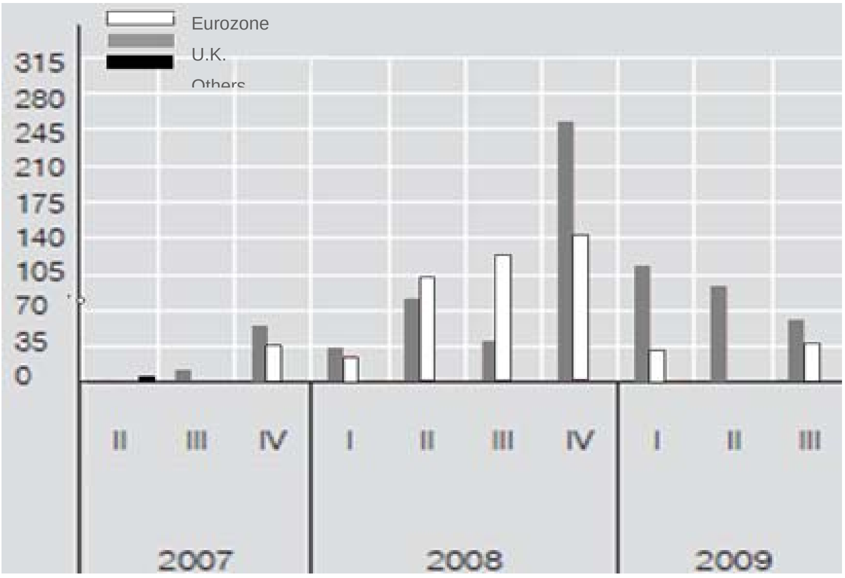
One of the particular measures that the ECB adopted under the strategy of quantitative easing of monetary policy was **to expand the list of guarantee assets**, by reducing the threshold of credit quality rating from of A- to BBB-. In this context, the direction of the new securitizations underwent a radical change, since the entities began to launch new issues with the object of retaining them on their balance sheets, rather than releasing them to the market. The surprising growth of these retained securitizations, during the years 2008 and 2009, has its origin, therefore, in their newly-acquired status as assets acceptable as collateral in the liquidity auction operations of the central banks.

Figure 13: Evolution of the Euribor 12 month rate, and interest rates of the ECB, 2008-2009.



Source: ECB, 2009.

Figure 14: Securitizations retained, globally (excluding the US agencies), by world regions.

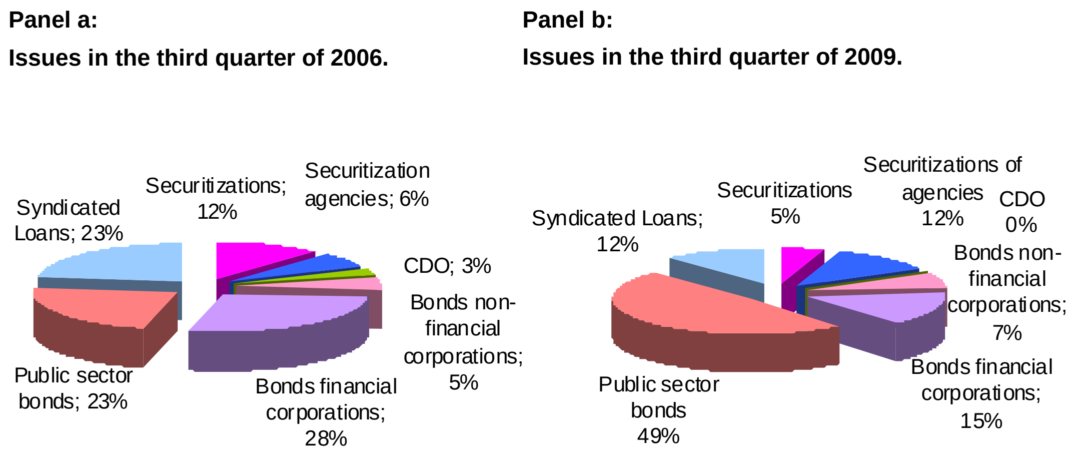


Third quarter of 2009.
Source: Van Rixtel and Romo, 2009.

This situation has generated a change in the composition of the international markets for debt, and has very much affected the securitization sector in particular. Analyzing the data on the size of the markets, it is striking that, despite the penalization suffered, these have now increased up to the level where the size reached in the stage prior to the crisis has almost been recovered: in September 2009 they stood at an outstanding balance of 13.5 billion dollars.

Figure 15, however, reveals that the structure of the international debt market has not emerged unscathed: the proportion of total public debt financing accounted for by securitizations has been reduced significantly, with bonds, both public and private, now being in first place. The bank rescues and the money released by the governments, in the attempt to return lending activity to normality, have caused a level of indebtedness that must be paid for, which is why the issues of public debt have taken such a predominant place in the markets.

Figure 15: Size and composition of the international debt markets.



Source: Van Rixtel and Romo, 2009.

From observing figure 15 we can see the evident preponderance of public sector bonds: they account for 49% of total issues, while bonds issued by financial companies have suffered a notable contraction, falling from 28% in the third quarter of 2006, to 15% in the same period of 2009. For their part, syndicated loans have also undergone a relative decrease in their share of these markets.

Focusing on securitizations, it can be confirmed that the CDO's have disappeared and that the issues of securitizations, whether originating from the US agencies (who are the biggest issuers) or not, have declined from 21% to the current 17%.

5. Current situation and future prospects

The abuse of securitizations, together with the indiscriminate use made of them, has made it impossible to obtain a reliable assessment of the risks to which they are linked. Thus, if anything has become evident from the financial crisis, it is precisely the need to increase public control over the entities on which the flows of capital and their risk rating depend, that is, the banks, intermediaries in general and the international *credit rating* agencies.

The new directive 2009/83/CE of the European Commission, which modifies a previous one of 2006, proposes reforms that will have their principal impact on *hedge funds*, on financial entities' own funds, the *rating* agencies, systemic risk and financial derivatives. As a result of this directive, the banks must have more financial resources available to cover the risks when they invest in re-securitizations, and disclose more information on the risks that they are assuming in respect of complex products. It is stipulated that the risks derived from securitization operations in which the entity acts as investor, originator or sponsor will be valued and supervised by means of the procedures provided in the European regulation, and the correct assessment of those risks must be guaranteed.

New regulations are imposed in respect of entities' own funds, for the activities of securitization, and the transparency of the operations is affected. New regulation is also applied to the credit rating agencies, aimed at increasing the transparency, to prevent conflicts of interest and to regulate how they operate.

In the USA the Government proposes to limit the risks of a new banking crisis occurring by classifying the financial entities more precisely according to their activity, and creating a "financial responsibility" tax or *fee*, in accordance with the size of the entity. The object of this last measure is to avoid problems of moral hazard, making the banks responsible for paying for the consequences of their actions, and recovering the public money that the Government spent to rescue the US banking sector in 2008.

In summary, the goal of the international authorities is to improve public control of the financial system and increase supervision, to prevent the repetition of situations that may put in danger international economic stability.

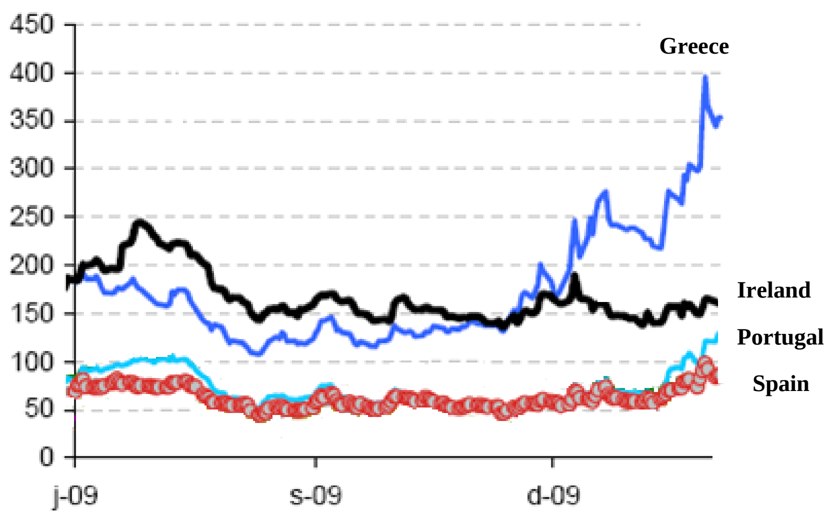
In the next part, some of the factors that may affect the future of securitization in Spain are considered.

The perceived increase in the sovereign risk of Spain

Investors are demanding higher returns from the Public Treasury for purchasing debt; this has caused it to become more expensive compared with what it would have cost in the conditions prior to the crisis (the forecast made in the last national Budget is for the issue of 211,500 million euros of gross debt).

In the first quarter of 2010, the situation has not evolved in the direction expected. Instead, there has been a worsening of the international credibility of Spain, and this has generated various consequences:

Figure 16: Differential with respect to the German 10 year bond, basis points (June 2009 - February 2010).



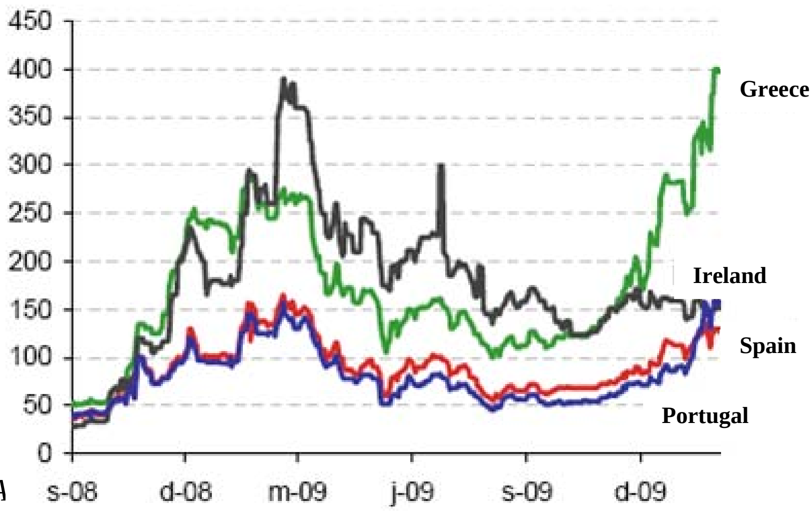
Source: BANIF. Special markets report of 4 February 2010.

As can be observed in figure 16, the Spanish bond has become more expensive since the beginnings of 2010, increasing its differential against the German bond, possibly due to a failure to transmit credibility to the market. As is known, the biggest dangers on this front come from Greece. The capacity to transmit reassurance and confidence with respect to the country's plans for containing public expenditure, will be fundamental for relieving pressures on the cost of financing our public debt.

In parallel, as was to be expected, the cost of insurance to protect against a possible default of the public bonds issued by the Treasury has shot up, in the light of investors' fears of a fiscal crisis.

In February 2010 the total gross value of CDS's exceeded, for the first time, 100,000 million dollars (73,000 million euros), according to Markit, the independent company of financial information services; this represents an increase of 50% with respect to the value a year ago, and Spanish CDS's reached a historical maximum. With regard to premiums, the previous record was 168 basis points, in February 2009. The difference is that, on this occasion, the problem affects not only Greece, Portugal and Italy but also, especially, Spain. See figure 17 on this point.

Figure 17: Sovereign 5 year CDS's, basis points (September 2008 - February 2010).



Source: BA

Another consequence of the levels of deficit and debt reached is the penalization suffered on the Stock Market, principally by the financial sector. The banks are trying to find an outlet for the loans to the property development promoters that they have financed, thus allowing the subrogation of mortgages by private individuals despite the situation of unemployment, although still requiring all the guarantees possible. These factors are aggravated by the lack of confidence that the property assets remaining in the portfolios of the commercial and savings banks have been fully sanitized, and by the fear that the rates of default may continue their upward trend, as predicted by Standard & Poor’s. It must be remembered that the market feeds on expectations and, therefore, that it is crucially important to be able to transmit credibly the assurance that banks and other companies have the capacity to contain these problems.

Messages of global organizations and experts

The messages of various experts, such as Nouriel Roubini and Paul Krugman, who see Spain as a burden holding back the Eurozone, and of various investment firms, such as Citi, Nomura and Goldman Sachs, who recommend that investors should protect their investments in Spanish debt with CDS's, do not help to improve the situation.

In the "misery index" published by Moody's, a *ranking* which takes into account the economic and social risks derived from the levels of unemployment and fiscal deficit of 16 countries in 2010, Spain was ranked first, which represents yet another blow to the international prestige of the Spanish economy.

Standard & Poor's dropped the prospects for the qualification of the Spanish sovereign debt from stable to negative, around the end of 2009, but also kept its rating as AA+. However, in February 2010, Moody's announced that it gave credibility to Spain's Plan for Stability; and Fitch, while qualifying the Plan as ambitious, has maintained the triple A rating.

Standard & Poor's has put out a report analyzing the credits that underlie the Spanish mortgage securitizations. In September 2009, the proportion of these loans that were in default by more than 90 days reached a record of 4.72%, more than double the level recorded a year previously, and significantly much higher than the rate of 0.46% recorded in September 2007. Moreover, the strong growth of the Spanish public debt, plus the high rates of unemployment, point to higher future rates of default for the securitizations.

The strategy of some entities, in the face of the falls in the quoted prices of the securitizations in circulation, at least merits consideration: they repurchase debt at more than its quoted price, but below its issue value (or even above issue value if coverage in derivatives is available), while they use the added value obtained to reinforce the *core capital* (capital and reserves) of which the financial sector is so much in need, in line with the new recommendations of the banking supervisors. In July 2009, for example, the Bank of Santander earned a sum in excess of 700 million euros by converting 9,100 million euros in preference shares and bonds.

Furthermore, the ECB will require a *rating* from two different agencies before accepting the new securitizations as guarantees in the liquidity auctions, from March 2010.

6. Conclusions

In this study an analysis has been made of the current situation in respect of securitization in Spain, situating it within its European and world contexts; the various factors that have had, or may have, significant effects on its development, in the recent past and in the near future, have been analyzed.

As has been demonstrated, securitization has played an important role in the current financial crisis, which has been painted as the most serious since the Great Depression of 1929, and which has been characterized by excessive indebtedness and inadequate risk premiums, that is, by unjustified tolerance of huge risk or incorrect assessment of risk.

One of the lessons of the crisis is that investors (that is, investing entities with international reputations) did not correctly evaluate the risks associated with the assets underlying ABS, but instead were content to depend almost blindly on the assessments of third parties. In this respect, the regulatory regime in Europe supervises securitizations more closely than in the USA; the cases in which securitizations can be taken off-balance sheet are restricted; requirements in terms of the transparency of the information disclosed are stricter, to try and ensure that users may understand as clearly as possible the exposure of any entity to risk.

When the crisis erupted, the issue of securitization bonds was not paralyzed, although the purpose of such issues did change. Most of these issues have been retained, by the issuers themselves, because they have been re-classified as assets acceptable as collateral in the liquidity auction operations carried out by the central banks.

The international debt markets have undergone a substantial change in their composition, with bonds, especially those of public debt, now assuming preponderance at the expense of structured financing (securitization bonds, credit derivatives and re-securitizations), which has seen a notable contraction. However, issues of new securitizations that are being taken up by the markets are beginning to appear.

The perception of the risk inherent in the Spanish national debt has intensified; this is responsible for higher costs of financing debt and will make it difficult, in future, to place issues of debt on the market, especially if these issues are structured financing. Lastly, it is crucially important to transmit confidence, since the valuations that the market makes of the assets issued, and the acceptance of these by investors, depends on confidence. In this matter, the role of the Government seems to us to be crucial. Not only for the securitisation to act as a financial mechanism to grow, but for the interbank market to recover his leadership and the Central Banks stop acting as usual lenders.

Simplifying securitisation operations and turning to the basic structures could also be an incentive to reopen these markets. More transparency, disclosure and standardisation of information would surely help to restore confidence. Also, a good regulation plays an important role on shaping market patterns and participants behaviours.

Finally, the best way to control speculation is to exercise extreme supervision, ask for more and better information and an effective and appropriate supervisory task.

7. Appendix

In September 2010, the Bank of International Settlements (BIS) published, via a press release, the master lines of what will be a new agreement of capital standards for deposit-taking financial entities. This agreement, known popularly as Basle III, would be endorsed by the member countries of the G-20 in their November meeting in Korea.

The new agreement changes radically the structure of the capital requirements for banking entities, making them considerably more severe. Thus, the minimum for core capital is raised to 4.5% instead of the current 2%, and for the so-called TIER 1 capital, the provision becomes 6%, instead of the ruling 4%, always as proportions of total risk-weighted assets. The original capital ratio of 8% is maintained, so the TIER 2 requirement becomes 2%. In addition, a capital conservation buffer of 2.5% is added to absorb losses in the event of periods of turbulence and stress in the financial system.

In short, the capital requirements are increased to 10.5% of total risk-weighted assets; of this, 8.5% (that is, the TIER 1 and the buffer) must be covered by shares or similar assets. But, further, a counter cyclical buffer is also foreseen; this can reach 2.5%, and is intended to protect the banking sector from periods of excessive credit expansion.

It is also intended to establish leverage ratios, liquidity coverage and net stable funding: all of these are still to be defined and quantified.

Given the magnitude of the changes proposed, a calendar is stipulated for the progressive implementation of the new standards, which runs to January 2019. Therefore we are facing a profound reform of the measures of solvency for these entities, and must live with the uncertainty generated by a time horizon as long as eight years.

The consequences for the banking system of the industrialised countries, to which Basle III will apply, and for the Spanish banks in particular, may be considerable. In Spain, the capital amounts necessary to cover the requirements of the new agreement are calculated at some 45,000 million euros; this could lead the entities affected to need massive expansions of share capital. In addition, it will be more complicated for the savings banks, since they will probably need to resort to the issue of preferred shares with voting rights.

However, all these changes described should translate into more secure and solvent but less profitable banks, and hence into less abundant and more expensive loans.

With respect to the securitization of assets, at this point in time it is difficult to pronounce on the possible effects of Basle III, but some educated guesses can be made. The policy of quantitative easing of the European Central Bank, cheap money at 1% and in practically unlimited quantities if the entities present sufficient guarantee assets, has resulted in entities maintaining securitized assets on their balance sheets in order to be able to take part in the corresponding auctions for liquidity. But the policy of quantitative easing cannot continue forever and, when it stops, the practice of securitizing to obtain guarantee assets may cease to have the relevance it has had to date.

On the other hand, according to Cardone, Samaniego and Trujillo (2010), in the period 2000-2007, the Spanish commercial and savings banks have utilized securitization for reasons of liquidity and efficiency, and not for the motives of transferring credit risk to others and of reducing the regulatory capital required. In addition, Spanish regulations make it difficult to take securitized assets off the balance sheet, particularly after the issue of circular 4/2004 of the Bank of Spain.

In the BIS communication of September 2010, mentioned at the beginning of this appendix, there is a passing reference to the capital requirements for securitization activities that should be introduced at the end of 2011. Obviously, we will have to wait to see the new proposals, and these will also need to be enacted in the legislation of each country in question.

In summary, greater requirements of capital, not only in quantity but also in quality, now appear on the horizon for the deposit-taking entities of the developed countries covered by the Basle III agreement. The effects of the new regulation, in the best of cases, will be seen both in the conventional activities of the banks and in their securitization practices.

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