Legal Briefing
November 2021

# REGULATORY CHANGES IN SPAIN TO THE LEGAL REGIME FOR MORTGAGE *CÉDULAS* AND OTHER COVERED BONDS

Royal Decree-law 24/2021 (**"RDL 24/2021"**) has recently been published, transposing Directive (EU) 2019/2162 on the issue of covered bonds and covered bond public supervision (**"Directive 2019/2162"**), among others.

Until the entry into force of RDL 24/2021 on 8 July 2022, the market for covered bonds in Spain (currently known as mortgage securities) is regulated by Law 2/1981, of 25 March, on the regulation of the mortgage market (**"Law 2/1981"**, which RDL 24/2021 repeals) and Royal Decree 716/2009, of 24 April, which develops certain aspects of Law 2/1981, regulating the mortgage market and other mortgage and financial system rules that develop it (**"RD 716/2009"**).

Prior to the publication of Directive 2019/2162, there was no regulation at a European level which governed the requirements for the issue of covered bonds, nor a harmonised definition of this concept. A range of local regimes coexisted in the European Union in relation to these instruments, which hindered the creation of a single market for covered bonds. The spirit in which Directive 2019/2162 was adopted is therefore to provide Member States with a harmonised regulation on the essential aspects of these instruments. In this regard, Directive 2019/2162 is a minimum harmonisation Directive, in view of the need to cover the different regimes already existing in the European Union with the minimum possible disruption to each market.

## 1. General considerations

The purpose of the Decree-law is to regulate the regime for the issue and supervision of covered bonds, establishing their characteristics, disclosure requirements and investor protection mechanisms.

RDL 24/2021 applies to (i) covered bond issues carried out in Spain by credit institutions established in Spain and (ii) when subject to RDL 24/2021, covered bond issues carried out outside Spain by Spanish credit institutions.

Covered bonds are defined as debt obligations issued by a credit institution and secured by cover assets (the **"cover pool"**) to which investors have direct recourse as preferred creditors. Since the principal and interest of covered bonds are especially secured, in addition to a claim against the issuing institution, the cover pool offers a second recourse to the holders of these instruments, by means of a preferential right against the assets comprising the cover pool, without the need for a deed or any registration.

The cover pool is principally made up of primary assets (i.e. the dominant cover assets that determine the nature of the cover pool) and, to a lesser extent, substitution assets, liquid assets and derivative instruments entered into with credit institutions that meet certain requirements (and which allow interest rate risk to be mitigated).

Depending on the type of primary asset that is included in their cover pool, covered bonds are classified as follows:

(i) mortgage *cédulas*[1] and bonds, the underlying assets of which are mortgage loans;

(ii) territorial *cédulas* and bonds, the underlying assets of which are loans granted to public administrations; and

(iii) Internationalisation *cédulas* and bonds, the underlying assets of which are loans linked to export contracts and the internationalisation of companies.

The above covered bonds fall into the category of "European Covered Bond (*Premium*)".

In addition, other covered bonds may be issued under a commercial denomination of the issuing institution's choice (and are referred to simply as "European Covered Bonds").

## 2. Main developments in RDL 24/2021

The analysis below considers the main developments introduced by RDL 24/2021, with special emphasis on covered mortgage *cédulas*, given their unquestionable significance in the market due to their low risk, low cost and favourable prudential treatment.

### 2.1 Designation of the cover pool. Special registration

One of the major new features introduced by RDL 24/2021 is the need for each covered bond programme (including mortgage *cédulas*) to have a **cover pool** made up of specific (and adequately diversified) assets that act as collateral for the issue and which the issuer must assign individually for each covered bond programme.

This provision radically changes the current regime for mortgage *cédulas* in Spain, since under the existing framework the *cédulas* are secured on all the mortgage loans and credits of the issuing credit institution (that are not subject to a mortgage bond issue).

For mortgage *cédulas*, the primary assets consist of loans or credits secured by residential or commercial real estate with a certain LTV ratio, and which meet the requirements of RDL 24/2021 (which are similar to those of Section II of Law 2/1981).

The value of the mortgage loans at the time of incorporation into the cover pool cannot exceed 60% of the appraised value of the property that secures it, rising to 80% if it is a residential property (current exceptions that can increase this percentage up to 95% will no longer apply).

[1] **The main difference between covered *cédulas* and covered bonds is that covered *cédulas* have an open and variable cover pool throughout the life of the instrument, while covered bonds (including the category of "other covered bonds") have a closed cover pool.**

The *cédulas* may also be backed by **substitution assets** (basically fixed-income securities listed on regulated markets and deposits with credit institutions that meet certain requirements, a more limited list than at present) up to a maximum of 10% of the principal (compared with 5% at present).

Assets to be included in the cover pool must be subject to **valuation** upon inclusion in the cover pool, and the valuation must be updated at least once a year.

The calculation of the required coverage must generally ensure that the aggregate principal amount of all cover assets is equal to or exceeds the aggregate principal amount of outstanding covered bonds[2] and, where applicable, the statutory, contractual or voluntary level of **overcollateralisation** required. The level of overcollateralisation depends on the type of primary asset, and its minimum limit in relation to mortgage *cédulas* will be set at 5% in the CRR.

No asset can belong to two different cover pools. In addition, partially including assets in the cover pool is also prohibited. Subject to certain requirements established in Article 8.2 of RDL 24/2021, the inclusion of assets secured by real estate located in third countries outside the European Union is also permitted.

In addition, RDL 24/2021 allows **intragroup pooled covered bond structures**, under which covered bonds issued internally by a credit institution that belongs to a group are used as cover assets for the external issue of covered bonds by another credit institution that belongs to the same group.

The use of cover assets **purchased from other institutions** is also permitted. That would provide for the pooling of cover assets by several credit institutions and would facilitate the funding of smaller credit institutions, especially in Member States where there is currently no well-developed covered bond market.

Article 7.2 of RDL 24/2021 requires issuers to have **internal policies and procedures** in place to ensure that the cover pool is composed of assets that have different characteristics in terms of structural features, lifetime or risk profile.

Lastly, RDL 24/2021 establishes the obligation to have a **special register** for each issuing institution, where the assets that make up each of the cover pools will be recorded.

### 2.2 Liquidity buffer

Another important new feature introduced by RDL 24/2021 is the need for the cover pool to include a liquidity buffer comprising certain highly liquid assets that can cover the net liquidity outflows of the covered bond programme (i.e. the difference between the payment

**[2] Although the excess of the future interest receivable on the collateral assets above the future interest payable on the corresponding covered bond may be taken into account to balance any shortfalls in the coverage of the principal payment obligation attached to the covered bond in certain cases.**

flows of the assets of the cover pool and the liabilities of the covered bond programme maturing within one day) over the following 180 days.

### 2.3 Extension of maturity in certain circumstances

RDL 24/2021 also provides for the extension of the maturity of covered bonds in certain specified circumstances (such as a certain risk of default, or the insolvency or winding-up of the issuing institution), provided that this is expressly stated in the issue documentation and subject to prior authorisation by the Bank of Spain.

### 2.4 Investor disclosure obligations

Among other standards of conduct, covered bond issuers must publish certain information on their covered bond programmes on their website on a quarterly basis.

### 2.5 Enhanced supervision

Covered bond issues are subject to a strict supervisory regime: (i) firstly, the issuing institution must designate an independent monitoring body to permanently monitor the cover pool (known as the **cover pool monitor**) and (ii) secondly, the Bank of Spain is designated as the supervisory body (without prejudice to the powers of the CNMV in relation to the marketing of covered bonds and their trading on AIAF).

#### (i) The cover pool monitor

The functions of the cover pool monitor consist mainly of ongoing monitoring of the cover pool with regard to the requirements set out in RDL 24/2021 and safeguarding the interests of investors at all times.

The cover pool monitor may be independent or part of the credit institution issuing the bonds and its designation must be approved by the Bank of Spain. Once authorised, it will be entered in a specific register identifying the programme to which it has been appointed.

#### (ii) Prior administrative authorisation and supervisory powers of the Bank of Spain

The issue of a covered bond programme will require prior administrative authorisation by the Bank of Spain.

The Bank of Spain will also be responsible for granting the administrative authorisation to the cover pool monitor.

RDL 24/2021 establishes a series of obligations for the issuing institution to provide periodic information to the Bank of Spain and gives it the power to require the issuing institution to modify policies and procedures in relation to the cover pool.

### 2.6 Insolvency and winding-up provisions

The legal regime for these instruments in case of insolvency (and resolution) proceedings is similar to the previous privileged system, although the new regulation is more detailed.

Firstly, it should be noted that the holders of covered bonds (and the counterparties to derivatives) maintain their **immunity** from insolvency or resolution of the issuing credit institution, since in such cases (i) there will be no automatic early termination of the payment obligations associated with the covered bonds, nor will the fulfilment of the other obligations associated with the covered bonds be affected in any way, without prejudice to the provisions of Article 42.2 of Law 11/2015; (ii) the holders of the covered bonds will not be entitled to call for their early maturity; (iii) the accrual of interest on the covered bonds will not be suspended; and (iv) there will be no grounds for early termination of the derivative contracts contained in a cover pool.

In addition, the holders of these instruments (and the counterparties to the derivatives) will enjoy a **special privilege** over the assets contained in the cover pool. For this purpose, Article 43 of RDL 247/2021 establishes that in the event of insolvency of the issuing credit institution, the cover pool will be materially segregated from the institution's assets and will form a **separate estate** (distinct to the insolvency estate) without legal personality that will operate in legal transactions represented by a special administrator (appointed, as the case may be, by the insolvency judge or by the FROB), who will be responsible for administering the covered bond programme and the cover pool forming the separate estate , ensuring that the rights and interests of investors are preserved.

RDL 24/2021 contains detailed rules in relation to the separate estate in the event of insolvency proceedings. In this regard, it should be noted that if the total value of the assets exceeds the total value of the liabilities (plus the statutory, contractual or voluntary overcollateralisation and the liquidity requirement), the special administrator may decide whether to continue with the day-to-day management of the separate estate until its maturity or transfer all or part of the separate estate to another covered bond issuer.

If, on the other hand, the total value of the assets is "less"[3] than the total value of the liabilities, the special administrator must request the liquidation of the separate estate and the early repayment of these instruments to the holders (and derivative counterparties) pro-rata to their claims.

Finally, and also in line with the previous regime, it should be noted that in the event of insolvency, mortgages on collateral assets registered in favour of the issuing institutions, loans and credits, derivative contracts, as well as the incorporation into the special register of these assets and the rest of the assets that make up the cover pool, may only be rescinded or challenged by the insolvency administrator, which will have to prove the existence of **fraud** in the constitution of the mortgage security, in the corresponding contracts or in the incorporation of the cover assets to the special register.

## 3. Entry into force and transitional system

The provisions of RDL 24/2021 relating to covered bond issues will enter into force on 8 July 2022. This date coincides with the entry into force of Regulation (EU) 2019/2160 of the European Parliament and the Council of 27 November 2019 amending Regulation (EU) No 575/2013 as regards

[3] **The third paragraph of Article 44.2 says "superior", which clearly seems to be a mistake.**

exposures in the form of covered bonds and introducing several additional requirements for covered bonds to benefit from the privileged prudential treatment provided for in the CRR.

From the date of publication of RDL 24/2021 and until its partial entry into force on 8 July 2022, issuers of covered bonds will have to adapt their programmes to the obligations under RDL 24/2021, except for the requirement to obtain administrative authorisation from the Bank of Spain. Such exemption from administrative authorisation will only apply to covered bond programmes for which covered bonds have already been issued (although authorisation will be required for future issue programmes or issue programmes in which covered bond issues have not yet begun).

The holders of covered *cédulas* and bonds will not have any recourse against the credit institutions to claim the early maturity of their instruments due to the amendments that issuers would have to make to their programmes in order to comply with the new regime in RDL 24/2021.

## 4. Developments in relation to mortgage shares and mortgage transfer certificates

RDL 24/2021 also adopts the regulation for these instruments contained in the previous legal framework without introducing major changes (pending possible adaptation of the current regulations, which remain in force insofar as they do not contradict the provisions of RDL 24/2021).

The main new features are as follows:

(i) in relation to the doubts that had arisen in RMBS transactions regarding the prohibition on STS securitisations including marketable securities among their pool assets, RDL 24/2021 clarifies that mortgage shares and mortgage transfer certificates will only be considered marketable securities when, due to their specific legal configuration and transfer regime, they are susceptible to generalised and impersonal trading on a financial market; and

(ii) the marketing, distribution or sale of mortgage shares and mortgage transfer certificates to retail customers is prohibited.

This Legal Briefing was prepared by Carlos Pérez Dávila, Antonio Arenas and Soledad Mendiola, Partner and Associates in the Finance practice.



For more information, please contact:

**Carlos Pérez Dávila**
Finance Partner
cperezdavila@perezllorca.com
T: +34 91 432 51 00