

SME CDOs/Prime RMBS
Spain
Special Report

Originator Support for Spanish Structured Finance Transactions

Refinancing Aims to Maintain Repo Eligibility

Structured Finance

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Related Research

- [European SME CLO Performance Tracker \(October 2010\)](#)

Spanish SF Transactions Benefiting from Originator Support

Performance Suggests Support: Fitch Ratings believes some originators are supporting Spanish structured finance (SF) transactions by refinancing loans that are at risk or delinquent. In Fitch's view, this behaviour helps explain higher-than-expected loan prepayments within securitisations and declining portfolio delinquencies.

Limited Motivation for Traditional Refinancing: Fitch believes most performing borrowers are not motivated to seek refinancing in the current environment; since small- and medium-sized enterprise (SME) and residential loans are floating rate in Spain, borrowers already benefit from greater affordability in the current low-interest-rate environment.

Limited Ability for Borrower Refinancing: As most originator credit standards have tightened, performing borrowers have not generally benefited from traditional refinancing. Lenders are generally requiring lower leverage and higher-quality collateral from borrowers.

Fitch Originator Reviews: Banks commonly state they are supporting "at risk" loans through maturity extensions, principal grace periods and longer dated amortisation profiles.

Why are Banks Willing to Provide Support?

Maintaining ECB Eligibility: Fitch believes a primary reason for originator support of SF portfolios is the need to keep collateral eligible for repo with the European Central Bank (ECB). If pledged SF notes are downgraded below the ECB's rating threshold of 'A-', the retained bonds will no longer be eligible collateral with the ECB. This could lead to liquidity constraints for the originator. In addition, originators in need of a second rating for transactions may prefer to refinance non-performing loans (NPLs) to avoid restructuring the transaction in order to achieve higher second ratings.

Increased Flexibility: Furthermore, if originators want to significantly modify a securitised loan, they are forced to refinance and prepay the existing loan. The desire for efficiency and control of loan modifications may be another important motivation behind the refinancing. Also, when a property backing a defaulted loan is assigned to an SPV, the originator needs the approval of the gestora for any action required on that property.

Avoiding Negative Publicity: Finally, originator support may also be a consequence of banks seeking to avoid negative publicity associated with poor performance and downgrades of their securitisations.

How Much Longer are Banks Willing to Provide Support?

Support Expected to Decline: Fitch expects that banks will slowly begin to withdraw support in the near term. Headline risk is reduced because the market is now well aware of the economic downturn in Spain and the collapse of the property sector. In addition, many retained notes are still rated well above the ECB threshold, such that moderate downgrades would not result in loss of ECB eligibility.

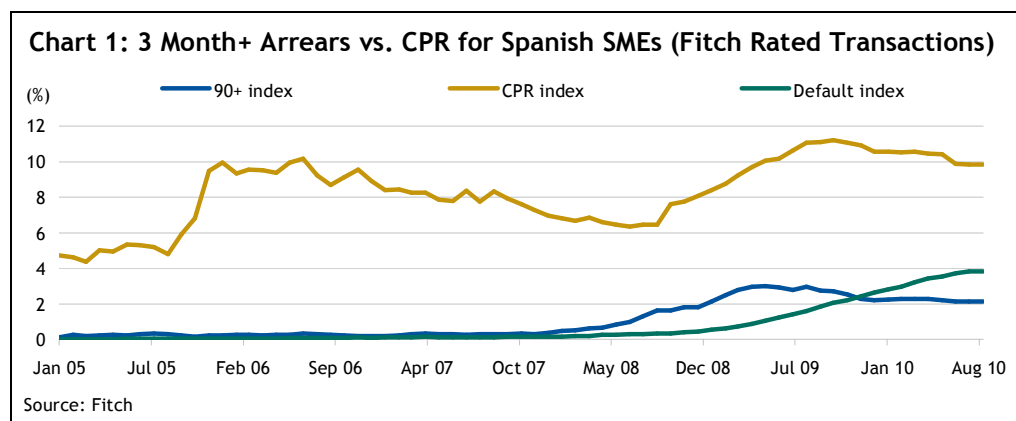
Reported Prepayments – Higher Than Expected

Since most originators have tightened their credit standards, Fitch expected a decrease in prepayment rates in the downturn. As most Spanish SME and RMBS loans are floating rate, borrowers already benefit from low interest rates. Refinancing could therefore result in a higher spread, given the current low risk appetite in the market. Yet SME loan prepayment data shows elevated activity throughout 2009 and 2010.

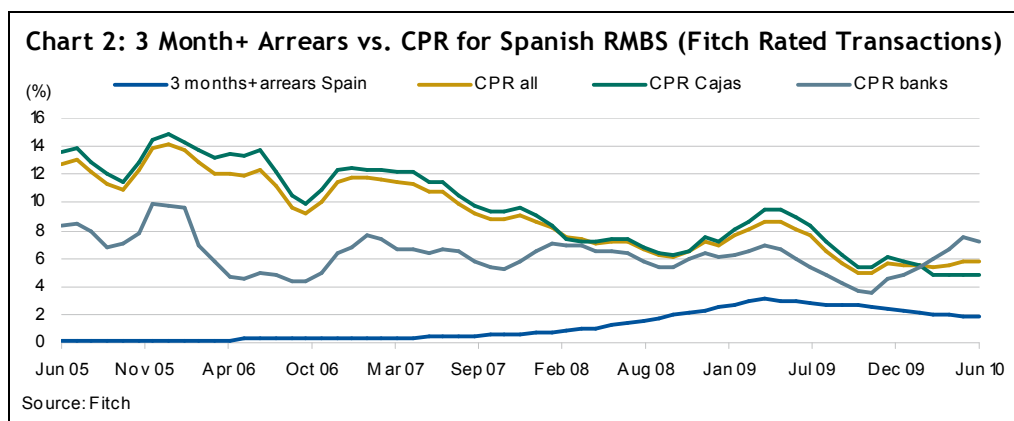
Servicers are proactively identifying borrowers that are in payment difficulty and offering maturity extensions or converting amortising loans into bullet loans, while taking on more guarantees (ie converting unsecured loans into mortgage loans). In order to modify the loans, the loans must be removed from the securitised portfolio. This boosts the prepayment rate, deleverages the securitisation and provides rating stability, particularly for the senior classes.

Arrears and Prepayments Show Some Correlation

Without updated loan-by-loan information, conclusive proof that delinquent or defaulted loans are being refinanced and prepaid is not possible. That said, Fitch has observed some interesting patterns in RMBS and SME transactions. Chart 1 shows average SME prepayments increasing during a time of stress. Given that prepayments and arrears are rising and falling in the same pattern, Fitch views this as evidence that a portion of delinquent loans are being refinanced and removed from SME CLO transactions at par.



Fitch notes that the default index displayed in Chart 1 does not represent cumulative defaults; rather it reflects the current defaulted balance as a percentage of the SME portfolio. As defaulted assets are fully written off after the recovery process is completed, they are removed from the portfolio. Fitch believes most defaulted loans have yet to complete the work out process. Thus, the default index is only a proxy for cumulative defaults.



Aggregate Fitch-rated Spanish RMBS data seen in Chart 2 shows a more intuitive pattern of slowing prepayments and elevated arrears. That said, in the Caja-originated transactions there is an observable increase in constant payment rate (CPR) from the Fall of 2008 to Summer of 2009 – when arrears also peaked. Fitch believes some of the prepayment activity was due to originator support. As some troubled loans were removed, this helped to depress arrears levels (albeit, many loans simply rolled into default). Fitch also notes that larger Spanish banks are showing an increasing CPR trend which could relate to enhanced servicing efforts, while Caja CPR rates have levelled out.

Fitch is currently investigating individual transactions further. Transaction-level performance reporting limitations cast a haze on exactly what is happening within the defaulted loan bucket. Without cumulative default information or loan-by-loan portfolio data, it is unclear whether the arrears are declining simply due to loans rolling into default.

Examples of Originator Support

Defaulted Asset Repurchases

The repurchase of repossessed properties which backed defaulted loans has been a general practise of the market since the beginning of the crisis. Banks repurchased properties from the SPV to facilitate property management. Otherwise, if the property was assigned to the SPV, any action on that property by the servicer would need the approval of the management company as representative of the securitised portfolio.

Bulk Property Sales to Related Affiliate

During 2009, Caixa Catalunya executed a bulk sale of properties which collateralised defaulted loans, some of which were held by RMBS transactions. The buyer of these properties was a bank affiliate and Caixa Catalunya worked with an external consultant to determine a price of 80% of the initial valuation of the properties. Given the difficult housing market conditions, Fitch expected steeper discounts to the initial valuations and considered the outcome favourable to the RMBS transactions (given the LTVs and the house price adjustment seen in the Spanish market).

Restructuring and Reserve Fund Injections

The application of Fitch's updated SME criteria would have resulted in a severe downgrade of a Banco Popular securitisation of a revolving portfolio of unsecured SME loans (IM Grupo Banco Popular EMPRESAS 2). Credit enhancement had not built up because of the revolving nature of the transaction. Banco Popular decided to inject cash (EUR211.5m) into the reserve fund of the transaction in order to support the ratings. Fitch believes part of Banco Popular's motivation for supporting the notes was to maintain the option of pledging the senior notes for ECB funding.

Direct Confirmation During Originator Reviews

From Fitch's recent originator and servicer reviews, servicers (to varying degrees) indicated that they are doing what they can to support any loans they consider viable. Fitch suspects many new loans issued in 2008 and 2009 are the result of support mechanisms.

Fitch also notes that some servicers give priority to securitised loans. Fitch does not believe that this prioritisation will result in the sub-standard refinancing of impaired credits, but it could certainly result in a more diligent and proactive management of impairments. Hence, if the practice was maintained, the average performance for a securitised pool could be better than that of the total loan book of the bank.

Why Protect SF Transactions?

ECB Liquidity Requirements: Need to Maintain Ratings for Eligibility

With the ongoing pressure in the external funding markets, SF transactions continue to be structured for discounting with the ECB. As such, depending on an originator's liquidity needs, it may decide to restructure a transaction to preserve its eligibility for ECB discounting. Fitch believes this to be a strong motive.

Greater Flexibility in Restructuring: Less Administrative Burden

While SF structures and governing contracts have been in place for decades, select aspects – including those related to servicing and managing the foreclosure process – are being tested for the first time in the current downturn. Originators may wish to avoid any potential legal confusion or administrative burden resulting from the SPV's ownership of the loan. By bringing the loans back on to its balance sheet through repurchase or refinance, the originator will benefit from increased control of restructurings or foreclosures.

Reputation and Future Funding Options: Not Burning Any Bridges

If an originator is committed to issuing in the SF market in the future, it may seek to mitigate transaction credit deterioration in an effort to preserve future investor demand and manage funding costs. Another factor that can drive SF transaction support is the reputational implications associated with a default or severe downgrade.

Why Will Support Diminish in the Near Future?

- **Assets purchases must be financed:** banks that choose to repurchase assets must finance those acquisitions. As the credit profiles of some Spanish financial institutions have declined, Fitch expects the rate of asset purchases to decline as the cost of funding increases.
- **Risk of repeat asset defaults:** originators are more likely to repurchase assets of stronger credit quality. If the bank believes the asset will never recover, regardless of changes in loan terms, banks will be reluctant to restructure in order to avoid repeat defaults.
- **Real estate stock accumulation:** a surplus of real estate stock at the financial institution level and difficulties in selling properties may decrease the willingness of servicers to buy back repossessed properties.

Implications for Bank Ratings

Originator support (direct or indirect) clearly benefits the creditworthiness of Spanish securitisations. This has led to increased rating stability and higher prepayment rates. However, if the risky assets are transferred back to the bank's balance sheet, this could potentially impact the creditworthiness of the bank. While restructuring may allow obligors to become current on payments, Fitch considers the risk of repeat default to be higher than average.

Rating Implications of Support Initiatives

Originator support is behavioural and Fitch only gives credit for support after it is crystallised within a transaction. In addition, Fitch's criteria is currently less reliant on historical performance data reported by originators; rather, it is focused on the agency's views as regards the long-term performance of different asset classes.

Fitch continues to be sceptical of performance data which could be biased by support practices which the agency considers to be unsustainable, or subject to a change in an originator's behaviour.

The agency may decide to assign a rating cap to the ratings in cases where originator support is a key factor in the future performance of a transaction. In addition, Fitch assumes that cure rates for delinquent loans will decline in higher rating stresses.

Furthermore, the agency considers it likely that restructured assets could be placed into a new securitisation after returning to performing status. In Fitch's view, this would increase the risk for future vintage securitisations (lower loan payments don't necessarily translate into non-existent credit risk). Fitch will continue to closely evaluate the creditworthiness of newly securitised portfolios.

Legal Framework for Support Initiatives

Spanish Securitisation Law forbids originators from singling out securitised loans for explicit direct support, ie providing a guarantee to repurchase defaulted loans or repossessed properties at a set value.

Transaction documentation describes the role of the servicer. Generally, the servicer will undertake the same servicing procedures for all loans originated, regardless of whether the asset has been securitised or not.

Therefore, if in the normal course of servicing, an entity decided to refinance loans in arrears – both securitised and non-securitised – that would not represent direct support or special treatment for the loans owned by the fund. However, if an originator decided to single out loans for special support simply because they were securitised, this could raise regulatory questions.

While there are many reasons why a bank may support a deal or the refinancing of a delinquent loan belonging to an SPV, in Fitch's experience, most originators state they are simply implementing a practical servicing strategy.

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