

Mortgage Lending in Southeast Europe: Heading for International Best Practice

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**“Secondary Market Trends –
The Spanish Experience”**

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European Covered Bond Council



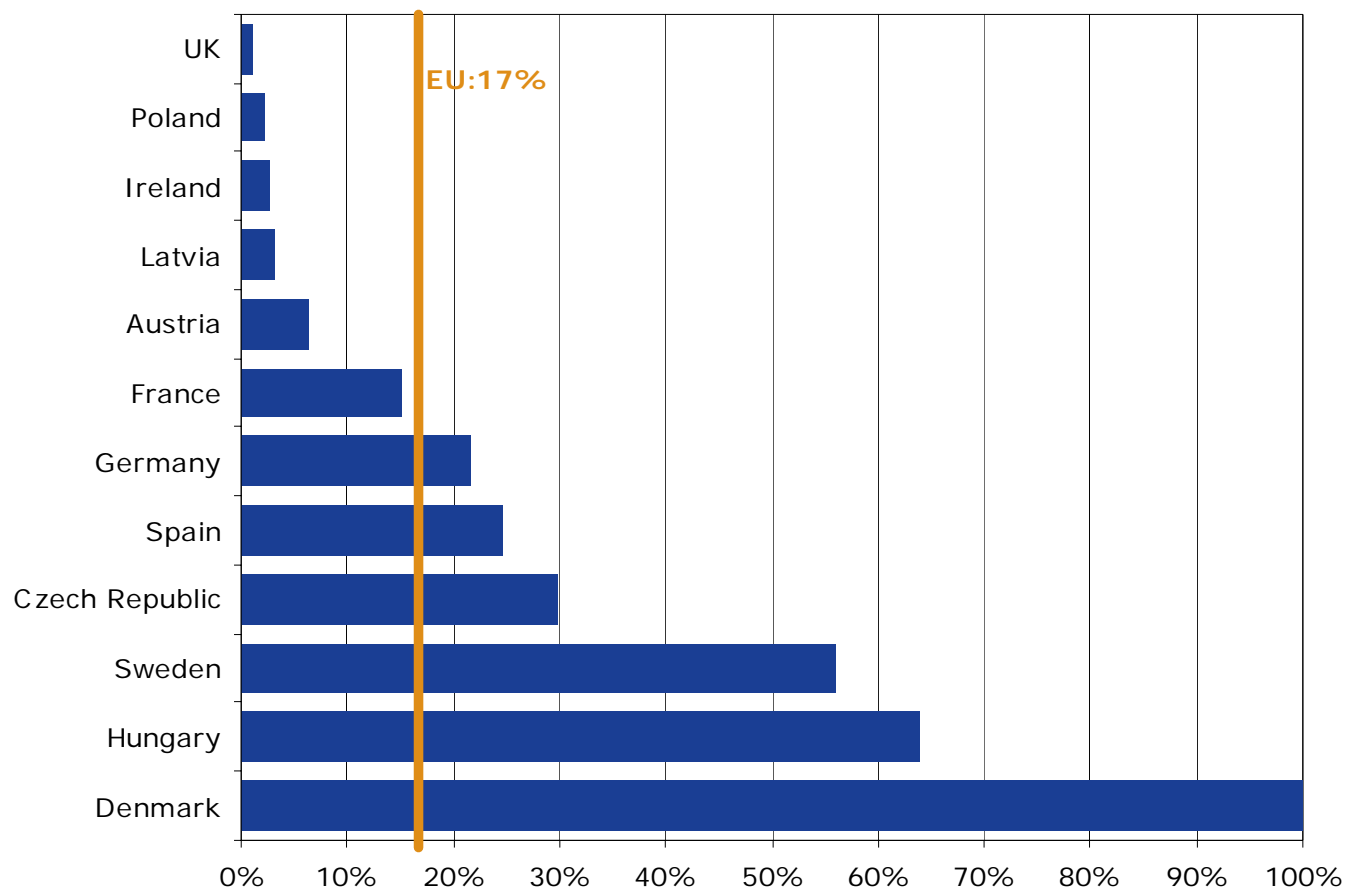
- ECBC created in November 2004 to represent the interests of covered bond market participants
- Creation of ECBC arises due to:
 - Tremendous growth of covered bond market
 - Increased investor awareness of covered bonds
 - But no common representation and strategy at EU level, especially in the light of the capital requirements directive (CRD) discussions
- ECBC 15 months on:
 - 75 members representing 84% of covered bond issuers
 - Creation of 6 working groups:
 - Active lobbying at EU-level to obtain special treatment for cb
 - Work on common standards for cb
- **Goal:** to confirm the ECBC as the voice of the covered bond industry

Agenda

- I. Covered Bonds: an attractive funding source**
- II. The Spanish Experience**
- III. Hungary**
- IV. Conclusions**

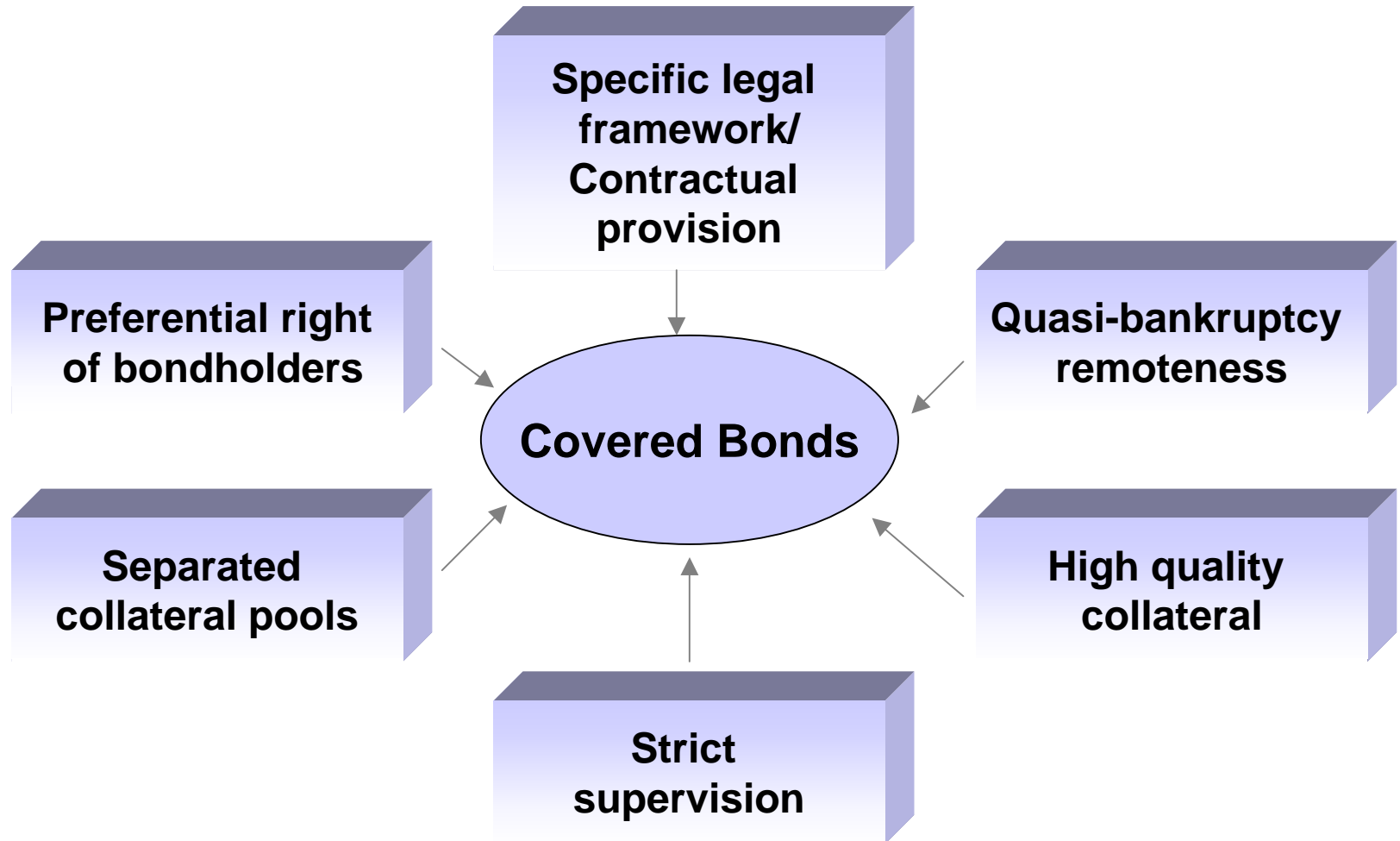
Mortgage Funding in Europe

Covered bonds outstanding as % of mortgage debt outstanding (2004)



Source: European Mortgage Federation

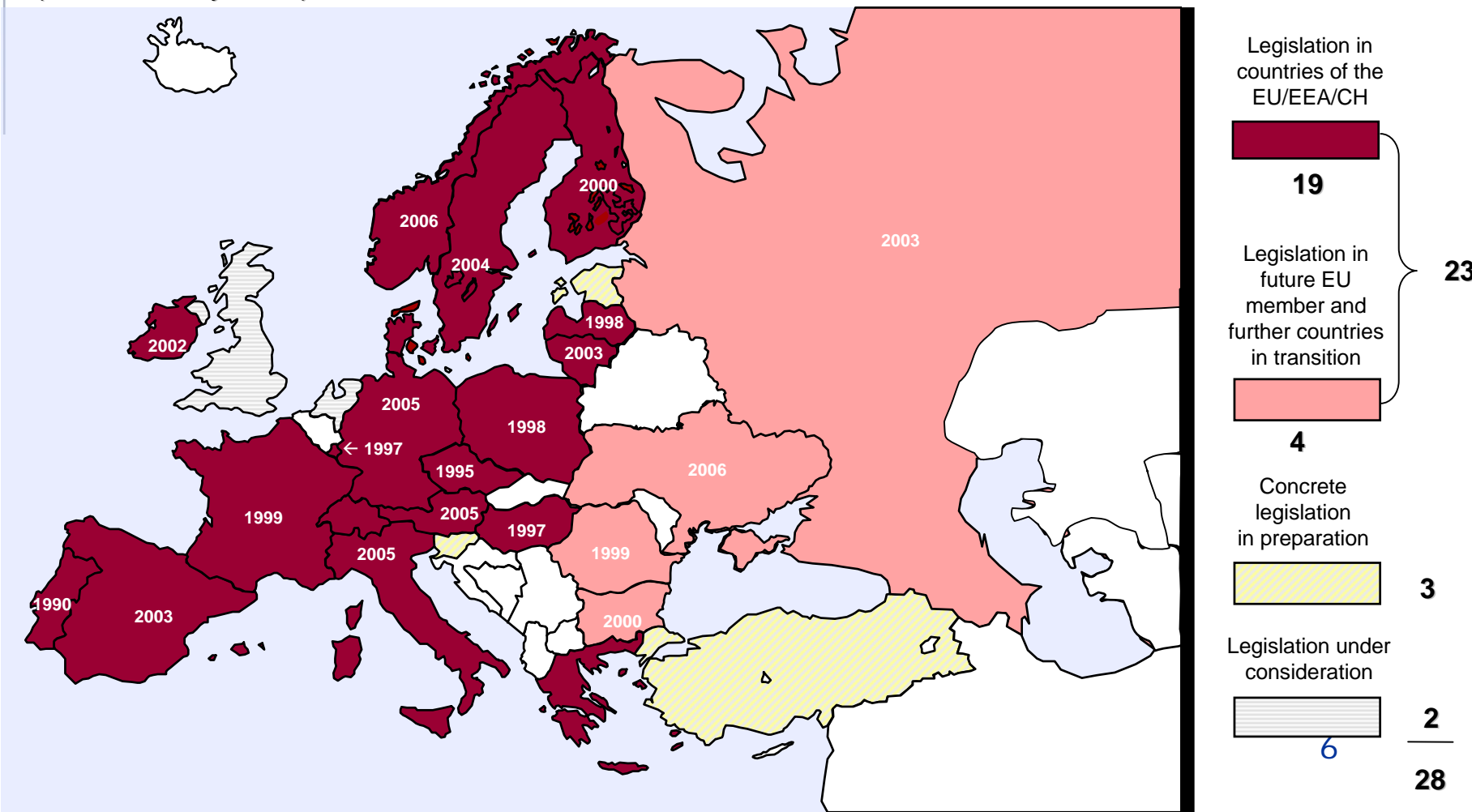
Special character of covered bonds



Source: ABN Amro

Cb Legislation

Geographical Overview - Covered Bond Legislation in Europe
(as of January 2006)



Covered Bonds

- Most European countries have adopted cb legislation
 - Competition has driven legislation to ever higher (safety) standards without sacrificing funding flexibility
 - No trend towards lowest common denominator
- Regulated at EU level (Art. 22(4) of UCITS):
 - Issued by a credit institution
 - Subject to special supervision
 - Priority claim of bondholders on subset of assets
 - Investment of proceeds effected in eligible assets
 - Outstanding issues covered by eligible assets until maturity
- Recently adopted CRD lists set of eligible assets 7

CB: an attractive funding source

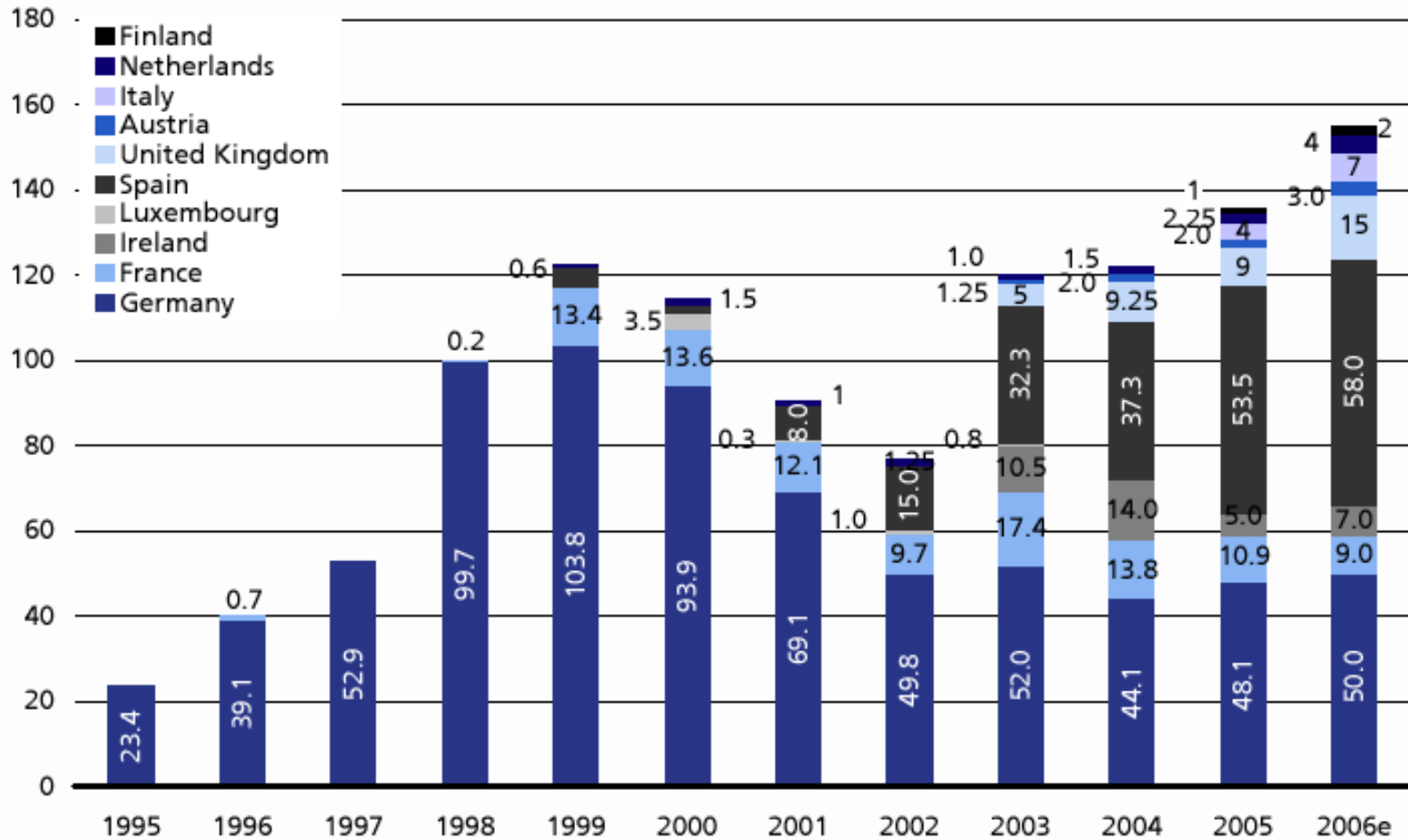
■ For issuers

- Low funding costs
- Flexible alternative to deposits and senior bonds
- Possibility of extending the maturity profile of banks' liability side to make it match with mortgage loans loan maturity

■ For investors

- Alternative to Government bonds (yield pick-up)
- Secure instrument in case of issuer insolvency - double protection (claim against issuer & cover pool)
- Higher liquidity due to large issue sizes and market maker commitments
- Geographic and asset class diversification

Record supply in European jumbo covered bonds



Source: HVB

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Milestones

- 1869: Introduction of Cédulas Hipotecarias
- 1975: Death of Franco (end of international semi-isolation)
- 1980: Spain joins the Council of Europe
- 1981: Mortgage Market Law
- 1977 – 1985: Banking crisis and bank restructuring
- 1986: Spain & Portugal join European Union
- 1992: Maastricht Treaty (Spain one of initial members)
- 1999: Legislation applies a 10% risk weighting to CH
- 2002: Euro single currency; rapid integration into very deep Euro debt market
- 2004: after 30 years of economic & political success, “a second transition” begins for Spain

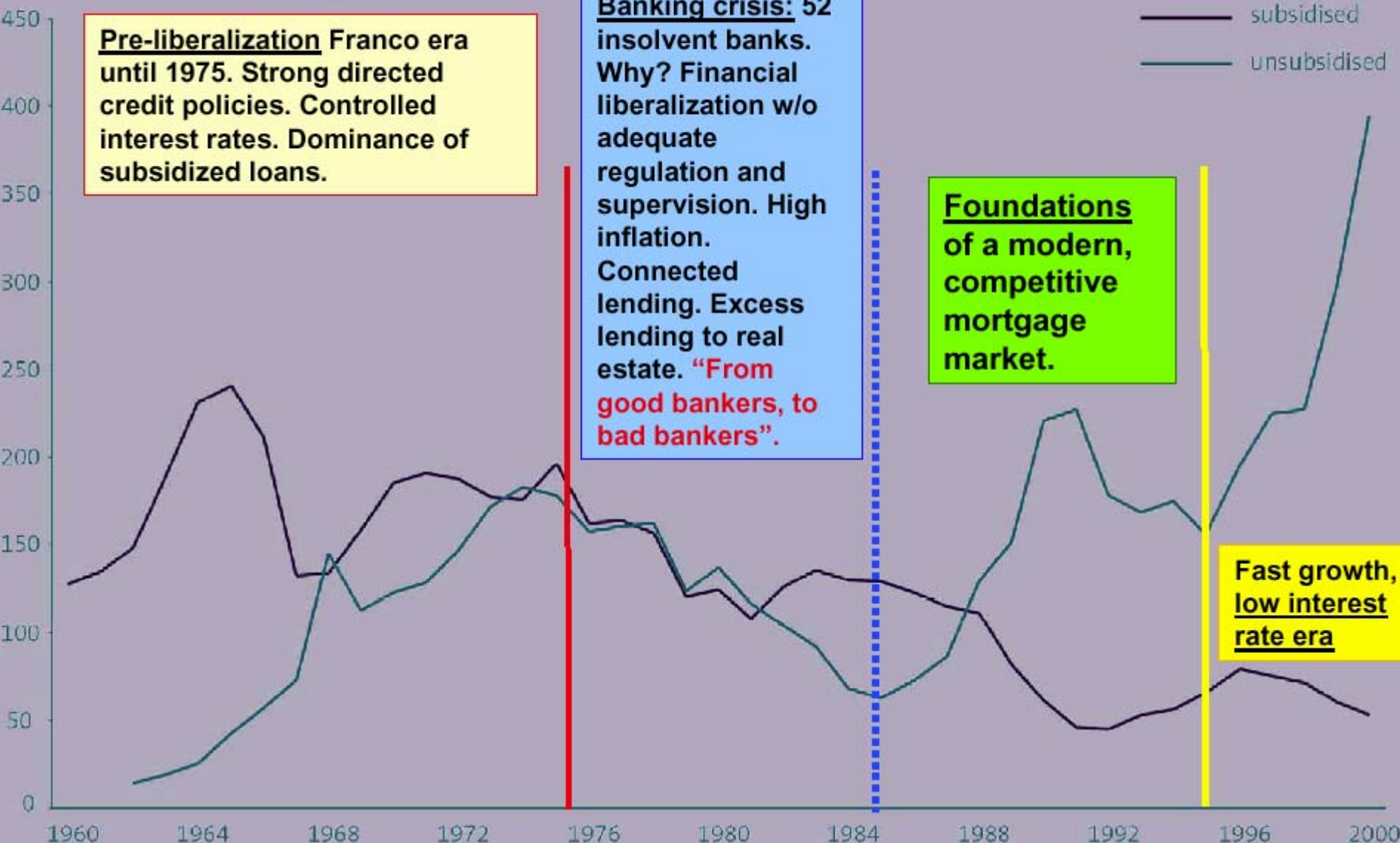
Stages in development



Subsidised and non-subsidised housebuilding 1960-2000

Source: M. Ball, *RICS European Housing Review 2002*, p.96

Number of units completed (000s)



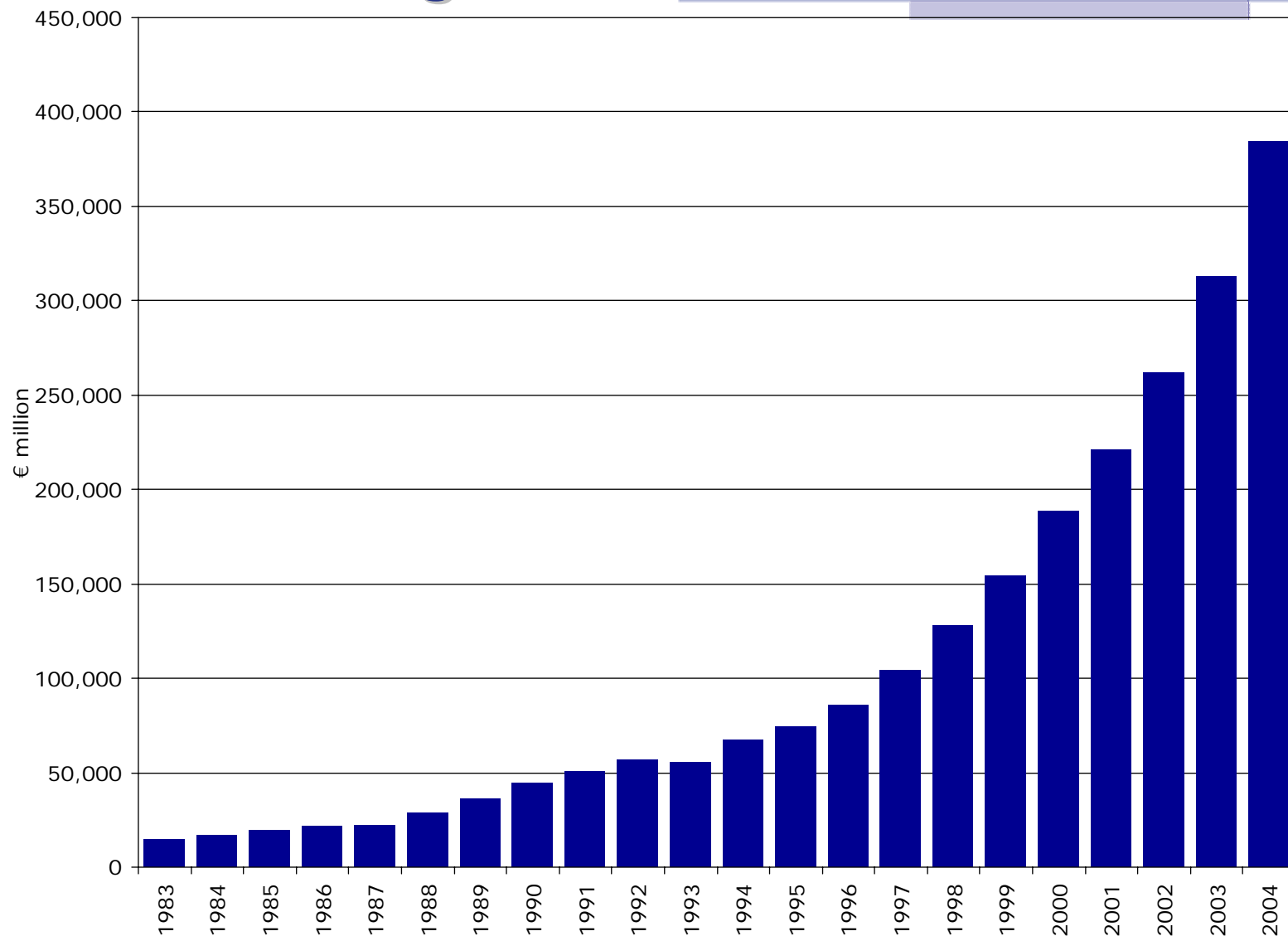
The Spanish Experience

- Legislative framework has influenced the economy & housing sector
 - Laws date back to 1872 which saw first law allowing 'Cédulas hipotecarias'.
 - Mortgage Law 1946 (legal & operational security)
 - Moncloa Pact 1977 (removal of obstacles)
 - 1981 Mortgage Market Law
 - Securitisation law introduced in 1991

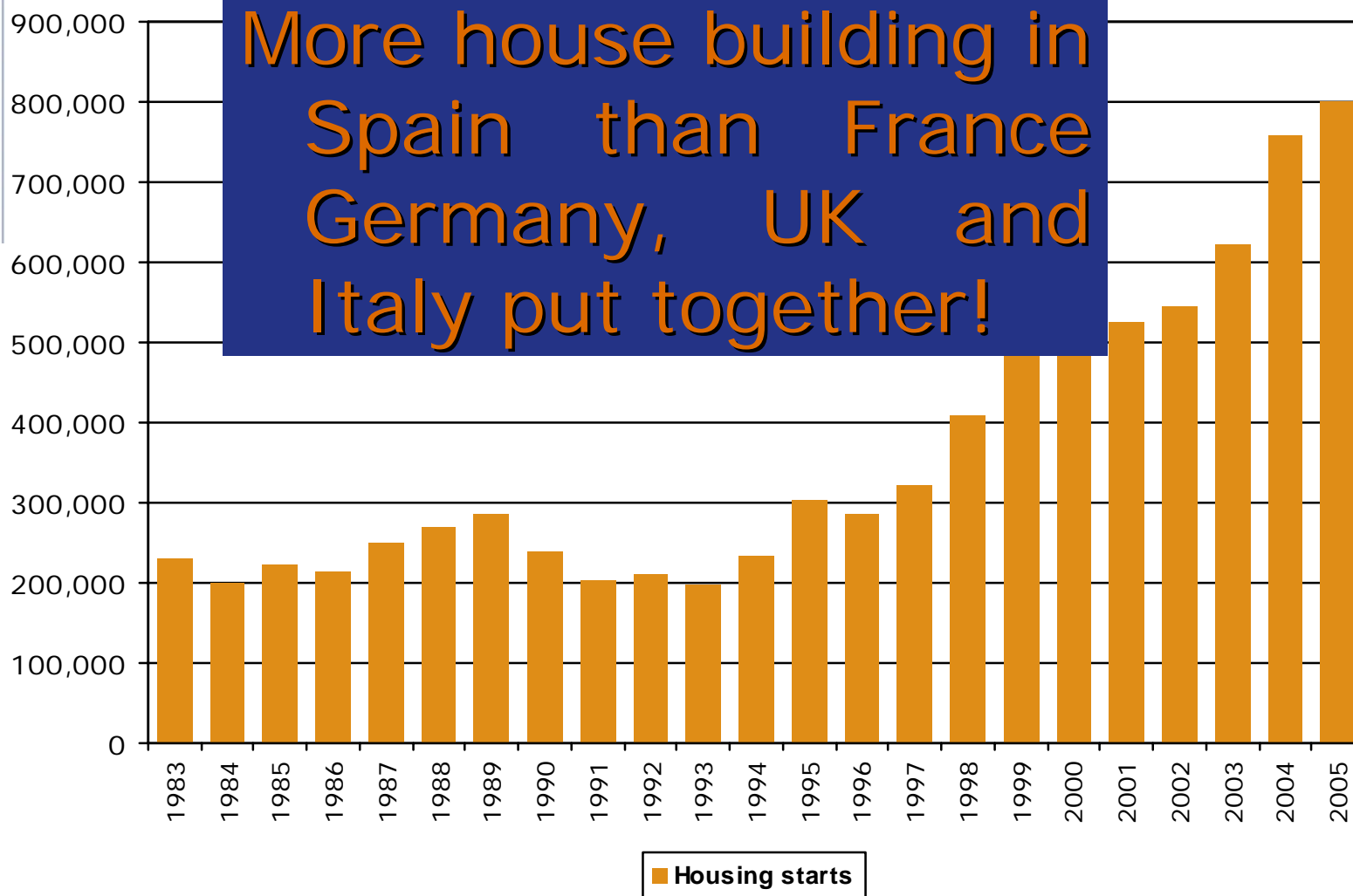
Spanish Economy:

- Steady fall in unemployment from 26% to around 10%
- Falling interest rates (Eurozone membership)
- Cut National debt; Big increase in per capita income
- Result - Housing, construction and Mortgage Markets booming

Residential mortgage loans outstanding 1983-2004



Housing starts - 1983-2005

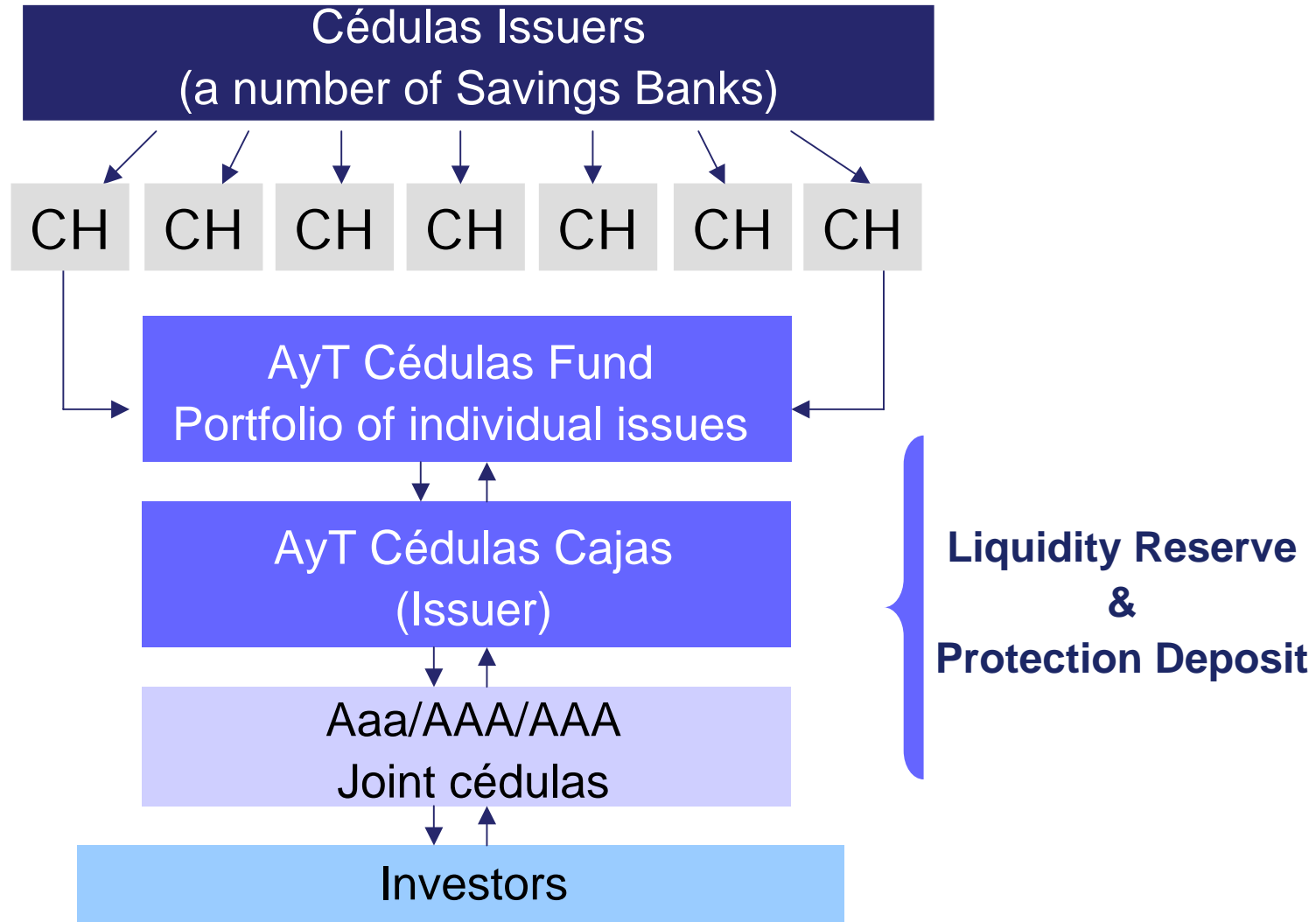


Source: European Mortgage Federation

Covered Bonds in Spain

- Almost 1/5 of mortgages funded by Cédulas, and 1/3 of new lending
- In 2005, issuance highest in Europe surpassing that of Jumbo Pfandbriefe
- Issuance open to all types of institutions
- CH guaranteed by mortgages over the entire mortgage book
- 80% LTV limit on residential or 70% for commercial property
- Strengthening status & demand of cédulas through:
 - 2004 Insolvency Act
 - 2005 Modification to Withholding tax regime
- Increased level of investor interest (CEE, Asia)
- Expected Jumbo issuance for 2006 is approximately EUR 58 Billion.

Spanish Multi-cédula structure



Concerns

- Rise in interest rates – risk of defaults (although likely to be concentrated among first-time buyers with high debt-to-income ratios)
- Very high transaction costs (c. 10%), of which property taxes form the highest share (7.5%)
- Covered bond structural factors:
 - High degree of over-collateralisation required – covered bonds are guaranteed by all mortgages registered in favour of the issuing institution
 - Insolvency remoteness: in Spain, not even the mandatory overcollateralisation is insolvency remote

... BUT track record of cedulas speaks for their reliability

NO CEDULA HAS EVER DEFAULTED

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Case Study: Hungary

- Regulatory Environment:
 - Legal framework – Mortgage Banking Act (1997)
 - State subsidy scheme (introduced 2001)
- 3 covered bond issuers - FHB, HVB, OTP
- CB fastest growing market (6% of GDP) - total outstanding volume EUR4.9bn (EMTN Programme)
- Since 2004: market based development
- BUT ...
 - Limited size of market; liquidity concerns
 - Cut in subsidy scheme in Dec 2003 and growing FX lending decreased the incentive of cb funding for non mortgage bank lenders
 - concern that the domestic capital market can not fund the spiraling issuance of mortgage bonds.

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Lessons to be learnt from Spain



Spanish Experience

- Highest home ownership rate in Western World
- Lowest State Housing in Western World
- Thriving covered bond market and securitisation market
- One of Europe's fastest growing mortgage markets

Achieved by...

- Diversified Funding Strategy
- Building programme to ensure supply of quality housing
- Macro-economic reform
- Solid primary market laws to ensure safety of collateral
- Minimising State involvement

CB: Conditions for success

Governments should play a constructive role in securing stable legal, regulatory and primary market infrastructure.

- Sound macro-economic policies
- Efficient “primary market” – cb work well in relatively stable banking systems
- An effective and quick foreclosure procedure makes lenders/investors willing to lend/to invest
- An easily accessible and secure title registration system
- Transparent markets & consumer protection
- Standardised funding instruments to tap capital markets
- Ease in establishing and transferring liens
- Well functioning independent appraisal system

European Covered Bond Council



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