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Spain's Securitizations and Covered Bonds Are Adversely Affected by Easier Personal Bankruptcy Laws

From Credit Outlook

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On Sunday, Spain's so-called second-chance rule went into effect to assist individuals struggling with bank debt. The rule facilitates debt forgiveness through personal bankruptcy, among other measures aiming at alleviating individuals' debt burdens. The new law is credit negative for covered bonds and securitizations backed by loans to individuals, mainly residential mortgage-backed securities (RMBS) plus small and midsize enterprises asset-backed securities (SME ABS), because it allows for debt forgiveness of mortgage debt left outstanding after a property repossession. Such debt forgiveness is a clear weakening of the full recourse that existed previously for Spanish secured lending.

This rule increases the ease with which individuals can declare themselves bankrupt and start a bankruptcy procedure (*concurso de acreedores*) in court if they are unable to meet their total debts.

Bankruptcy is well known in the Spanish legal framework for companies, but individuals seldom used it because mortgage debt was not subject to debt forgiveness. Any individual may now ask for bankruptcy protection, with no other limit contemplated than acting in good faith.

If a debtor cannot feasibly pay his mortgage through debt restructuring, payment moratoriums, or maturity extensions, a judge can determine the liquidation of assets. Unlike companies, the most likely case for individuals is that the only asset owned by the borrower to pay his secured debt is the residential property backing the mortgage. This new rule allows the borrower to achieve debt forgiveness once the property backing the mortgage has been repossessed by the creditor. The liquidation of the bankruptcy mechanism moots all debts from the individual, as happens for companies.

Our default assumptions for Spanish secured loans considered the full-recourse nature of Spain's mortgages, although we assigned limited value to recoveries from a borrower's future earnings and assets. The effect of this legal change will depend on how widely borrowers opt for this legal mechanism, which is not straightforward given legal formalities (i.e., court-requested documentation and information and securing legal advice).

The law does not completely mitigate moral hazard. The law gives creditors the right to ask for revocation of debt forgiveness in the cases of fraud or a significant improvement of the borrower's assets. However, lenders have little practical ability to monitor former borrowers.

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