# Bankia, S.A. - Cédulas Hipotecarias

## Mortgage Covered Bonds

### Full Rating Report

**Rating/Outlook**

| | |
|---|---|
| Mortgage Covered Bonds | A-/Positive |

**Key Data**[a]

| | Sep 15 |
|---|---|
| Asset type | Mortgages |
| Cover assets (EURbn) | 71.1 |
| Covered bonds (EURbn)[b] | 35.2 |
| 'A-' breakeven OC (%) | 62.0 |
| OC relied upon (%) | 70.0 |
| WA remaining term assets (years) | 20.5 |
| WA remaining term liabilities (year) | 6.9 |

**Rating Rationale**

| | |
|---|---|
| IDR/Outlook/VR | BB+/Positive/bb+ |
| IDR uplift | 2 |
| D-Cap | 0 notches (Full discontinuity) |
| Tested Rating on PD basis | BBB |
| Recovery uplift | 2 |

| Discontinuity Analysis D-Cap Components | Risk Assessment |
|---|---|
| Asset segregation | Low |
| Liquidity gap and systemic risk | Full discontinuity |
| Systemic alternative management | Moderate high |
| Cover pool-specific alternative management | Moderate high |
| Privileged derivatives | Very low |

[a] Cover pool data as of June 2015
[b] Includes EUR1.25bn issuance in August 2015
Source: Fitch

**Related Research**

Cédulas at a Glance (October 2015)
Covered Bonds Surveillance Snapshots (October 2015)
Bankia, S.A. - Ratings Navigator (May 2015)
Bankia, S.A. (April 2015)
Potential Development in Cédulas Framework (November 2014)
Cédulas Hipotecarias Legal Framework Review (April 2013)

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## Key Rating Drivers

**Rating Four Notches Above IDR:** The 'A-' rating on Bankia S.A.'s (Bankia) mortgage covered bonds (Cédulas Hipotecarias – CH) benefits from a four-notch uplift from the bank's Long-Term Issuer Default Rating (IDR) of 'BB+' and has a Positive Outlook reflecting that on the issuer's IDR. In addition to the IDR uplift of '2', the overcollateralisation (OC) of 70% that Fitch Ratings relies upon in its analysis exceeds the breakeven OC of 62% and is adequate for a two-notch recovery uplift on the CH assumed to be in default in a 'A-' rating scenario.

**Asset Disposals Drives Breakeven OC:** The large maturity mismatches between the assets and liabilities and the high refinancing spreads applied by Fitch to calculate the stressed present value of Spanish mortgage portfolios, lead to an asset disposal loss component of 37.6%, the greatest contributor to the 62% breakeven OC. The weighted average residual time to maturity (WA RTM) of assets of 20.5 years is far longer than the WA RTM of the liabilities of 6.9 years, creating large refinancing needs under a liquidation scenario.

**Credit Risk Also Influences Breakeven OC:** The weighted average (WA) lifetime credit loss estimate for the cover pool stands at 20.5% under a 'A-' rating stress scenario, which results in a credit loss OC component of 25.7%. This level of credit loss is primarily driven by the commercial sub-pool non-performing loan (NPL) ratio of 34.5%, which includes loans in arrears for more than 90 days and subjective defaults (performing loans that have been classified as doubtful).

**Two-Notch IDR Uplift:** Fitch has assigned a two-notch IDR uplift to the programme given that Spain is considered by Fitch to be a covered-bond-intensive jurisdiction and given Bankia's systemic importance within Spain. The tested rating on a probability of default (PD) basis for Bankia's CH is 'BBB', equivalent to the IDR, as adjusted by the IDR uplift.

**High Recoveries:** A further two-notch uplift from the 'BBB' rating on a PD basis is granted to reach the final 'A-' CH rating, considering the high recovery expectation of more than 91% of the CH outstanding balance in the event of CH defaulting under a 'A-' stress.

**Unchanged Full Discontinuity Risk:** Fitch's overall Discontinuity Risk (D-Cap) assessment for all Spanish CHs, including Bankia's, is "full discontinuity" (0 notches). This is driven by the "liquidity gap and systemic risk" component of the D-Cap analysis, given the hard bullet nature of Spanish CHs with an absence of liquidity provisions to bridge cash-flow mismatches upon the transition to the cover pool from the issuer as the source of covered bond payments.

## Programme Highlights

**Stable Cover Pool Composition:** The cover pool is secured by prime Spanish residential mortgages (81.8%), commercial mortgages (15.3%), and real estate development loans (2.9%). The pool is almost seven years seasoned, with a WA current unindexed LTV of 58.1% for the residential sub-pool.

**Cover Pool and CH Downsizing:** The cover pool and the CH outstanding continued to decrease, by EUR6.1bn and EUR5.7bn, respectively, between end-1H14 and end-1H15 due to liability management and deleveraging. However, nominal OC increased during the same period to 109.4% (from 88.6%) because the relative drop of CH is larger than that of the cover pool.

Figure 1
### Key Parties

| | |
|---|---|
| Issuer, originator, servicer | Bankia, S.A. |
| Paying agent | Bankia, S.A. |

Source: Fitch

**Related Criteria**

Covered Bonds Rating Criteria (July 2015)

Covered Bonds Rating Criteria - Mortgage Liquidity & Refinance Stress Addendum (September 2015)

EMEA RMBS Rating Criteria (August 2015)

Criteria Addendum: Spain - Residential Mortgage Assumptions (August 2015)

Criteria for Rating Granular Corporate Balance-Sheet Securitisations (SME CLOs) (March 2015)

Criteria for Interest Rate Stresses in Structured Finance Transactions and Covered Bonds (December 2014)

Criteria for Rating Caps and Limitations in Global Structured Finance Transactions (May 2014)

## The Issuer

Bankia is the fourth-largest Spanish bank by total assets. It was established in its current form in April 2011 following a restructuring of its primary shareholder, BFA. BFA was created in December 2010 as the central body of an institutional protection scheme (IPS) composed of seven savings banks, the largest being Caja de Ahorros de Madrid and Caja de Ahorros de Valencia, Castellón y Alicante. Under this corporate restructuring, Bankia received most of the assets and liabilities of BFA and subsequently launched an initial public offering (IPO). As a result, BFA became a bank-holding company. The creation of the IPS also included the receipt of preferred stock from the Fund for Orderly Bank Restructuring (FROB) totalling EUR4.5bn.

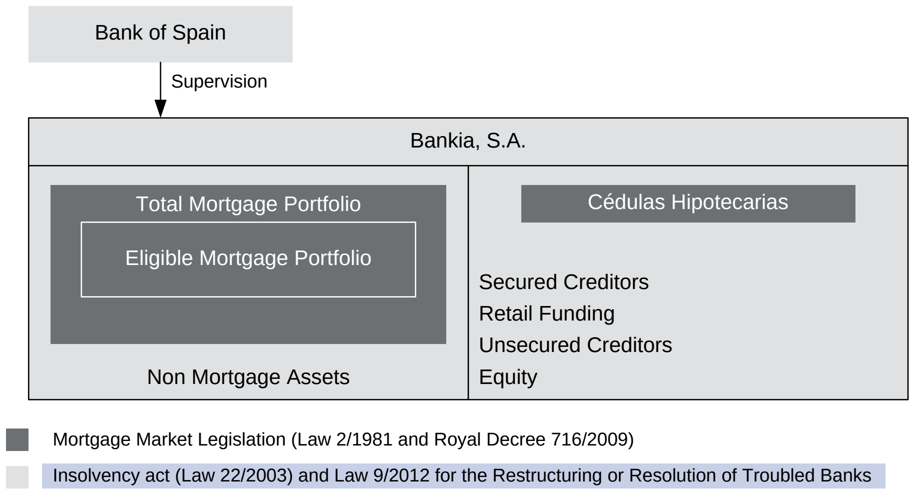
In January 2012 the government introduced tougher real estate coverage rules, which led both BFA and Bankia to fail and subsequently receive further public support from the FROB. This support was in the form of a EUR18bn capital injection into BFA, EUR10.7bn of which was in turn injected into Bankia, and the transfer of a net amount of EUR23bn in real estate assets to Spain's bad bank (SAREB). At the same time, Bankia's capital benefited from the mandatory conversion of hybrid securities of BFA primarily into shares of Bankia, further supporting the bank's capital ratios. As part of the support package, the group agreed on a restructuring plan with the authorities that primarily included de-risking and cost downsizing.

As of November 2015, the restructuring plan had largely been completed and Bankia enjoys a fairly sound and efficient operating model. In addition to arrears management, Bankia's challenge is to expand its SME franchise and thereby rebuild banking revenues, which remain fairly weak.

Bankia's Long Term IDR of 'BB+' is driven by its standalone creditworthiness, as measured by its Viability Rating (VR). This is highly influenced by large, although declining, problem assets that leave capital vulnerable to shocks to asset prices or to economic deterioration. The Positive Outlook on the Long-Term IDR reflects the upside rating potential as the bank continues to materially reduce these problem assets and further strengthen capital.

## Issuance Diagram

Figure 2
**Structure Diagram**




Source: Fitch

Figure 3
**Bankia IDR Uplift**

| | |
|---|---|
| Resolution other than liquidation | Y |
| Covered bond-intensive country | Y |
| % senior unsecured > 5% | N |
| IDR uplift | 2 |

Source: Fitch

Bankia CHs are secured by the entire and dynamic mortgage loan portfolio of the issuer, excluding securitised loans and mortgages used to collateralise mortgage bonds (if any). Mortgages are originated by Bankia in its normal course of business, and can be linked to residential, commercial or real estate development assets. All CHs rank pari-passu with each other and enjoy a status of secured and privileged payment obligations of the issuer.

## IDR Uplift ‘2’

In bank resolution frameworks where covered bonds are favourably treated, such as under the Bank Recovery and Resolution Directive (BRRD) for EU countries, Fitch’s analysis starts with an uplift over the IDR of up to two notches for programmes of issuers rated in the ‘BB’ category and above. A two-notch uplift is granted if at least two of the following three factors are present in Fitch’s view, or one notch if one of the factors is present: Fitch’s favourable opinion regarding the relative ease and motivations for resolution methods other than liquidation; the importance of covered bonds to the jurisdiction’s financial markets; and the extent of buffer offered by senior unsecured debt.

Fitch believes that in the case of a distressed situation of the bank the motivations for other forms of resolution than liquidation for Bankia would be strong given its large size and systemic importance within Spain’s banking system. Fitch also regards Spain to be a covered-bonds-intensive jurisdiction because of the importance of the covered bond market for its financial markets, and the large size of the covered bond market relative to the total covered bond market globally. Lastly, Bankia’s senior debt level in Spain represents less than 5% of total assets and so it does not receive any IDR uplift for this factor.

## D-Cap of Zero Notches

The Discontinuity Cap (D-Cap) captures the risk of a payment interruption on the covered bonds upon the transition from the issuer to the cover pool as the source of covered bond payments. The D-Cap is the maximum number of notches above the IDR (adjusted by any IDR uplift) to the covered bond rating on a PD basis. The D-Cap ranges from zero (full discontinuity) to eight notches (minimal discontinuity) based on a risk assessment of asset segregation, liquidity gap and systemic risk, alternative management and privileged derivatives.

As with all Spanish CH, Fitch assigns Bankia’s CH a D-Cap of zero notches, which implies full discontinuity of cash flows upon the transition from the issuer to the cover pool as a source of CH payments. This is driven by the ‘liquidity gap and systemic risk’ component given the hard bullet nature of Spanish CHs and the lack of specific liquidity protection mechanisms in the Spanish framework to bridge temporary shortfalls after recourse to the cover pool has been enforced. Further details on the D-Cap analysis are provided in Appendix I.

Figure 4
**Summary of Bankia’s Covered Bonds D-Cap Assessment**

| | |
|---|---|
| Asset segregation | Low |
| Liquidity gap and systemic risk | Full discontinuity |
| Systemic alternative management | Moderate-high |
| Cover pool-specific alternative management | Moderate-high |
| Privileged derivatives | Very low |
| Overall D-cap (based on the weakest link) | Full discontinuity |

Source: Fitch

## Data Adequacy and Robustness

Fitch receives cover pool stratification tables and CH information on a quarterly basis from the issuer. Although Bankia does not deliver loan-by-loan details on sub-samples of the cover pool, cover pool stratification data is complemented by default and recovery statistics for vintages since 3Q05, loan-by-loan repossession statistics, and publicly available information about its CH programme. In addition, Fitch conducted an operational visit to Bankia, which included the review of a random sample of mortgage files.

Fitch judges the quality of the data as satisfactory for assigning the ratings, with no material fields missing, apart from some data gaps, such as origination channels, and employment and borrowers' debt to income data. Fitch has addressed these data gaps by applying conservative assumptions and a data quality adjustment factor of 1.1x when determining residential loan default rates.

## Cover Pool

Bankia's mortgage cover pool is almost seven years seasoned and consists of residential mortgages, commercial mortgages to SMEs and loans to developers. In comparison with the average Spanish mortgage cover pool monitored by Fitch, Bankia's cover pool stands out as the largest in terms of euro balance and also because the proportion of residential mortgages (81.8%) is greater than the sector average of 74.4%, with a significant proportion of higher-risk loans having been transferred to Sareb.

Figure 5

### Bankia Mortgage Cover Pool

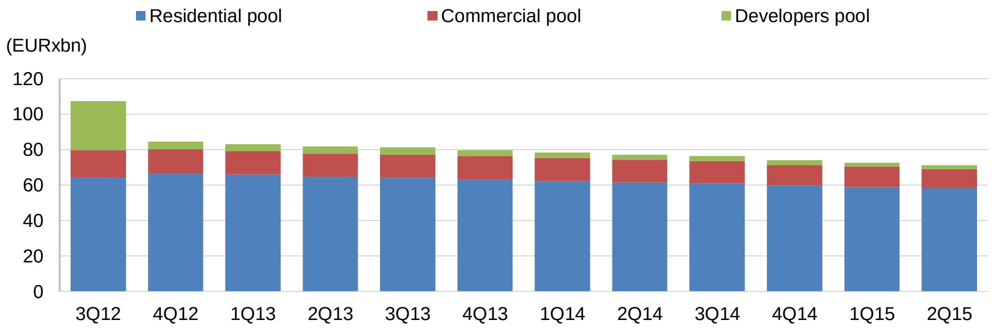
**Characteristics as at end-June 2015**

| | | | |
|---|---|---|---|
| Total mortgage cover pool (EUR) | 71.1bn | **Mortgage characteristics (%)** | |
| Eligible mortgage book (EUR)[a] | 51.6bn | Floating interest rate assets | 98.9 |
| Nominal OC on the total book (%)[b] | 101.9 | Fixed interest rate assets | 1.1 |
| Nominal OC on the eligible book (%)[b] | 46.6 | WA floating interest rate | 1.6 |
| Number of loans | 712,490 | WA fixed interest rate | 3.4 |
| Average loan size | 99,745 | WA seasoning of the assets (years) | 6.5 |
| | | WA residual maturity of assets (years) | 20.5 |
| **Borrower/risk profile (%)** | | Residential assets with instalment build up | 15.5 |
| Residential | 81.8 | | |
| Commercial | 15.3 | | |
| Real estate developers & land | 2.9 | **Loan-to-value (LTV) (%)** | |
| | | WA residential current LTV | 58.1 |
| **Regional concentration (%)** | | WA residential original LTV (Fitch estimate) | 71.5 |
| Madrid | 32.8 | WA commercial current LTV | 77.2 |
| Valencia | 15.9 | | |
| Catalonia | 15.3 | | |
| Andalucia | 9.0 | **Mortgage Covered Bonds (CH)** | |
| Canarias | 5.5 | Outstanding balance (EURbn) | 35.2[b] |
| Castilla la Mancha | 5.0 | WA remaining time to maturity (years) | 6.9 |
| | | Fixed interest rate (%) | 71.3 |
| **Arrears (%)** | | Floating interest rate (%) | 28.7 |
| Non-performing loan (NPL) ratio[c] | 12.6 | Bullet amortising (%) | 100.0 |
| | | Average fixed coupon (%)[b] | 3.9 |

[a] The eligible pool is a higher quality sub-pool of the total mortgage book of the bank, comprised of first-ranking mortgages with LTVs equal to or lower than 80% and 60% for residential mortgages and non-residential mortgages respectively, excluding non-performing amounts and repossessed properties from defaulted mortgage loans. Eligible OC is only used to set a cap on the outstanding amount of CHs issued by an entity at any time, ensuring a minimum 25% OC compared to the eligible book
b Includes EUR1.25bn issuance in August 2015
c Includes loans in arrears for more than 90 days and subjective defaults (performing loans that have been classified as doubtful)
Source: Bankia and Fitch

Figure 6

### Cover Pool Composition by Asset Type




Source: Bankia

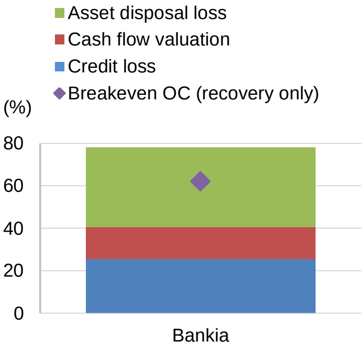
Payment term profiles differ greatly between the cover assets and outstanding CH. For example, while only 1.1% of the mortgages bear a fixed interest rate, the majority (71.3%) of CH outstanding pay a fixed coupon rate. In addition, while the vast majority of the portfolio consists of amortising loans paying a linear annuity on a monthly basis, all outstanding CH have bullet maturities. Both the cover pool and existing CH are predominantly denominated in euros.

## Cover Pool Credit Analysis

Fitch analyses the cover pool according to its rating criteria *EMEA Residential Mortgage Loss Criteria* and *Criteria Addendum – Spain* and *Criteria for Rating Granular Corporate Balance-Sheet Securitisations (SME CLOs)*.

Figure 9

### Breakeven OC Components




Source: Fitch

Figure 7

### Fitch Default Model Output (%)

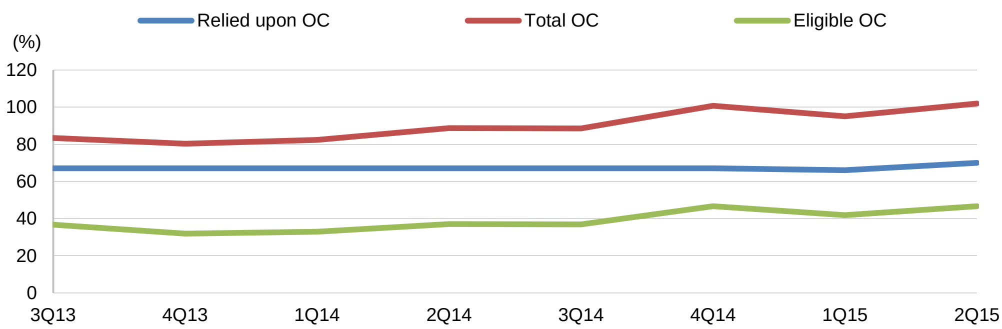
| 'B' Rating stress | Residential sub-pool | Commercial sub-pool | Real estate developers and land loans | Total cover pool |
|---|---|---|---|---|
| WA default rate | 14.5 | 34.3 | 100.0 | 20.0 |
| WA recovery rate | 51.9 | 48.2 | 0.0 | 43.4 |
| WA loss rate | 7.0 | 17.7 | 100.0 | 11.3 |
| | | | | |
| **'A-' Rating stress** | | | | |
| WA default rate | 27.8 | 49.8 | 100.0 | 33.3 |
| WA recovery rate | 43.4 | 37.4 | 0.0 | 38.3 |
| WA loss rate | 15.7 | 31.1 | 100.0 | 20.5 |

Source: Fitch

Bankia's portfolio is linked to a 'B' lifetime credit loss rate of 11.3% which is broadly in line with the 11.1% sector average. This is positively influenced by the relatively high share of less risky residential mortgages, but negatively impacted by the above-average SME commercial sub-pool NPL ratio (34.5%) and the 100% loss rate assigned to the developers sub-pool. Under the 'A-' rating scenario, Fitch assigned a lifetime WA default rate of 33.3% and a WA recovery rate of 38.5% to the cover pool, which is equivalent to an expected lifetime loss rate of 20.5%.

Figure 8

### Over-Collateralisation




Source: Bankia and Fitch

To derive its lifetime default rate expectations, Fitch has taken into account the volume of refinanced loans within the total cover pool of around 18% as of 1H15, which in our view reflect riskier borrower profiles. During the last few years Bankia has proactively refinanced loans as part of its policy to support troubled borrowers in a weak macroeconomic environment. Since 2012, the volume of loans refinanced has been higher than the volume of new loans originated under the same period.

Refinanced loans can be classified as normal, "watch" (substandard) or doubtful, in accordance with the requirements of the Bank of Spain. The refinanced loans in the cover pool totalled EUR13.1bn at end-June 2015 of which 27% have been classified as substandard or doubtful. Fitch has considered these loans as non-performing loans and applied a 100% default probability to them.

### Residential Pool (81.8% of Cover Pool Balance)

Bankia's residential sub-pool is a very granular portfolio of more than 667,000 loans, with second homes representing only 3.9% in euro terms. Fitch's expected lifetime loss rate for the residential cover pool in a 'B' base case and an 'A-' rating scenario is 7% and 15.7%, respectively.

Fitch generally relies on the original LTV and DTI information to produce a lifetime default expectation on residential mortgages. While original LTVs have been estimated by Fitch based on the current LTV ratios provided by the bank, no specific DTI information has been available for the analysis. Therefore, the agency assumed the entire residential cover pool to be linked to a 40% DTI ratio based on the bank origination guidelines, and applied a data quality adjustment as indicated in the *Data Adequacy and Robustness* section of page 3.

Based on the loan-by-loan foreclosure data provided by Bankia in relation to repossessed properties in 2015, Fitch has been able to assess the servicing capabilities and foreclosure strategy of the bank. In Fitch's opinion, such information is comparable to that of other lenders, and therefore no modifications have been made to the agency's standard credit assumptions of foreclosure timing and sale discounts applied to repossessions.

### Commercial and Real Estate Pool (18.2% of Cover Pool Balance)

The commercial and real estate sub-pool has an outstanding balance of EUR12.9bn and comprises more than 45,000 loans granted mostly to SMEs. Within the commercial and real estate sub-pool, 84% in volume and 70% in number are linked to SME and corporates, which are not associated with real estate developments or land loans.

Fitch considers the real estate sub-pool suffers from significant obligor concentration as the top obligor represents 5.5%, the top 10 obligors 24% and top 20 obligors 33.1% of the outstanding real estate sub-pool amount. Fitch has not been provided with disaggregated historical performance data for this portion of the cover pool.

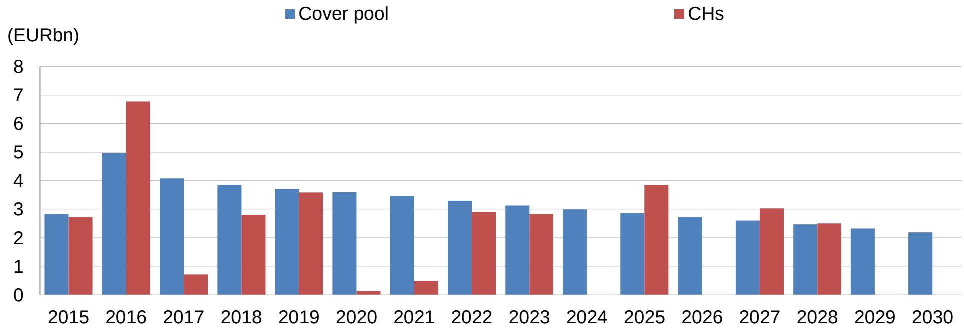
Considering this data limitation, the significant borrower concentration and the fact that developer and land loans are in wind down, Fitch has disregarded this sub-pool providing any sort of protection to noteholders post assumed issuer insolvency, which is equivalent with assigning a lifetime loss rate expectation to developer and land loans of 100%.

Fitch's expected lifetime credit loss rate for the commercial (ie SME borrowers excluding real estate developers) cover pool is 17.7% and 31.1% under a base case and an 'A-' rating scenario respectively. The corresponding figures for the real estate and land loans are 100% both under a base case and an 'A-' rating scenario.

## Cash Flow Analysis

Fitch's cash-flow analysis is conducted in a wind-down scenario assuming no new assets would enter the cover pool to replace maturing loans, and further issuance of covered bonds would be suspended. Fitch assesses Bankia's CH programme to be exposed to full discontinuity in the event of the cover pool becoming the source of repayment. Hence, the cash-flow analysis is solely focused on the recovery expectations for outstanding CH when determining the stressed present value of the cover pool as a proportion of the present value of the CH.

Figure 10
**Amortisation Profile Until 2030**




Source: Bankia and Fitch

Cover pool cash flows have been modified to capture the default and recovery assumptions defined under a 'A-' scenario (Figure 7), together with prepayments and delinquency assumptions. The cover pool stressed present value is materially influenced by the long residual maturity of the mortgage book (20.5 years), which compounds the negative margin between the WA spread of the cover pool of around 1% p.a. and the discounting premium applied by Fitch.

In calculating the cover pool sale value, Fitch has assumed that any purchaser will perform a discount analysis using an annualised rate equal to Euribor plus a certain margin linked to its cost of funding and expected profit. Fitch estimates this margin to be approximately 2.4%, which is half the full magnitude of the agency's 4.7% refinancing spread assumption for Spain in consideration of the asset mix in Bankia's cover pool.

The reduced refinancing spread is driven by the expectation that the alternative cover pool manager would not be under significant time pressure to liquidate the cover pool, but rather have a reasonable time frame to formalise cover pool sales to third-party investors.

## Breakeven OC for the Rating

According to Fitch's stressed cash-flow modelling, a 62% OC between the total mortgage book and the outstanding CH would provide recoveries in excess of 91% under a 'A-' stress scenario, where the CH have been modelled to default. This takes into account the estimated credit and market value losses on the cover pool. The breakdown of the three components on the overall level of breakeven OC is illustrated in Figure 9.

The two main components of breakeven OC are credit losses (25.7%) and asset disposals (37.6%). The credit loss component is the additional OC needed to cover the credit loss of 20.5% resulting from a weighted average default rate of 33.3% and a weighted average recovery rate of 38.3% for the mortgage cover pool. The asset disposal loss component is driven by the large maturity mismatches between assets and liabilities that create heavy refinancing needs under a liquidation scenario.

The lower risk represented by the cash-flow valuation component is influenced by the floating-rate nature of the vast majority of the cover pool. This helps to sustain the stressed present value of the assets in all interest-rate stress scenarios compared to programmes with assets that pay a fixed rate of interest.

## OC Relied Upon

Fitch relies in its analysis upon an OC of 70%, which is Fitch's projection of what it considers to be a sustainable OC of 100% and following the application of a 30% haircut as per its criteria. Fitch believes that this level of OC relied upon in its analysis is more indicative of the evolution of OC, based on Bankia's forecasts and Fitch's estimates, which include stresses. This is in line with Fitch's *Covered Bonds Rating Criteria* which establishes that another OC benchmark may be used where OC levels over the past 12 months are not considered by Fitch to be consistent with their current levels or indicative of expected future levels. The resulting 70% relied upon OC is higher than the 62% breakeven OC in an ‘A-’ scenario.

## Rating Outlook

The Positive Outlook on Bankia’s CH reflects the Positive Outlook on Bankia’s IDR and the positive OC trend experienced by the programme. Fitch expects that the current level of OC would provide for recoveries in excess of 91% in stresses one notch above the current CH rating, allowing for a one-notch upgrade in the event that the bank’s IDR were upgraded.

## Sovereign Impact

Given Spain’s ‘BBB+/Stable’ rating, the maximum D-Cap achievable for a Spanish covered bond programme would, in theory be one notch (very high) as indicated by the liquidity gap and systemic risk component of the D-Cap analysis. However, given the lack of liquidity provisions, a D-Cap of 0 notches (full discontinuity) has been assigned to all Spanish covered bond programmes. Spain has a ‘AA+’ sovereign ceiling which acts as a rating cap for all covered bonds issued out of Spain.

## Rating Sensitivity

Bankia’s ‘A-’ CH rating would be vulnerable to a downgrade if Bankia's IDR was downgraded by one or more notches to ‘BB’ or below, if the IDR uplift were reduced to ‘1’ or ‘0’ or if the relied upon OC used by Fitch in its analysis was lower than the 'A-' rating breakeven level of 62%.

## Ongoing Programme Review

Fitch will periodically review the credit quality of the cover pool and perform a cash-flow analysis to assess whether the OC taken into account by the agency provides protection against identified risks commensurate with the rating of the covered bonds issued by Bankia. Cover pool and covered bonds information will be updated regularly and displayed on Fitch’s covered bond surveillance tool (available at www.fitchratings.com) and in the quarterly *Covered Bonds Surveillance Snapshot* (October 2015).

## Appendix I: D-Cap Analysis

### Asset Segregation

The asset segregation component of the D-Cap is considered as 'low risk' (5 notches) for all Spanish CH, including Bankia's. Fitch believes that it is unlikely any claims would reduce the cover pool available to CH investors once recourse over the cover pool has been enforced. In Fitch's view, Spanish mortgage legislation and the insolvency laws provide a strong legal framework for CH holders to gain full and first priority access to the cover assets.

Spanish law recognises the covered bondholders as secured and preferred creditors, assigning them a senior ranking compared to other creditors. The insolvency administrator or alternative manager must use the cash flows from the cover pool to meet covered bonds interest and principal due, regardless of the insolvency proceedings.

Although Spanish legislation sets a minimum OC ratio by reference to the pool of mortgage loans meeting certain eligibility criteria, Fitch bases its analysis on the assumption that the total mortgage book will be available to satisfy claims of CH holders (after applying OC haircuts if deemed appropriate). This however excludes securitised loans and loans backing mortgage bonds (bonos hipotecarios) if any.

Fitch considers the likelihood of structured finance or covered bond investors incurring losses as a result of the set-off of insured domestic deposits by obligors to be highly remote in most EU countries. This view is based primarily on the high level of political support for protecting such deposits, reflected in deposit guarantee and bank resolution frameworks (see *Deposit Set-Off for EU Structured Finance and Covered Bonds,* dated 27 June 2013).

### Liquidity Gap and Systemic Risk

The liquidity gap and systemic risk component of the D-Cap analysis is the main driver of the 'full discontinuity risk' (0 notches) for all Spanish covered bonds, including Bankia's CH as this is considered by Fitch to be the weakest link. In Fitch's opinion, there is a lack of specific protection against liquidity shortfalls, post transitioning to the cover pool from the issuer as the source of CH repayments.

Bankia's CH and all other Spanish CH have hard bullet maturities and no ancillary liquidity support arrangements, nor maturity extensions (such as those available in multi-issuer transactions of CH). Such extensions would allow the administrator to raise funds in a reasonable timeframe to meet CH principal and interest payments due in the immediate aftermath of a potential transition to the cover pool as the source of repayment. Furthermore, the refinancing of cover pool assets may take longer than the time remaining until the next interest or principal payment date on the CHs.

The mortgage cover pool of Bankia consists of loans secured by residential, commercial and land and developer assets. Granular loan portfolios secured by residential and commercial properties may be considered easier to be sold or transferred to third parties, as opposed to developer and land portfolios, which may be of significantly less interest to perspective buyers. In addition, the cover pool does not contain any liquid substitute assets. Therefore, the current cover pool composition and CH structural features provide weak protection against liquidity shortfalls that may arise if the issuer defaults.

## Alternative Management

The agency considers under the alternative management component the risk that the transition to an alternative manager does not occur smoothly enough to ensure payment obligations due on outstanding CHs. Such risks could materialise if the alternative manager were appointed too late, if its responsibilities were unclear or if the issuer's IT systems made it too difficult for the new manager to isolate the cover pool and covered bonds from the other assets and liabilities of the bank, making it too difficult to manage the cover pool.

### *Systemic Alternative Management*

Fitch assigns a 'moderate-high' (3 notches) discontinuity risk assessment to the systemic alternative management component of all Spanish CHs. In the event of an insolvency of a Spanish issuer, the law does not provide for a separate mortgage pool administrator to organise the transition process from other non-privileged creditors. Instead, the appointed administrators will manage the interests of both unsecured creditors and CH holders. Fitch views this mechanism as weak relative to other jurisdictions with dedicated cover pool administrators, which are able to focus exclusively on the interests of covered bondholders.

While the administrator will respect the CH special creditor status, this could potentially result in conflicts between protecting the interests of the CH holders and those of other creditors, notably if assets have to be sold at a large discount. Nevertheless, the administrator has the obligation to collect and direct all cash from the mortgage cover pool to the covered bondholders when payments are due, and if the administrator chooses to sell the assets, the proceeds must be passed through to all CH holders on a pro-rata basis.

In Fitch's view, the supervising role of Bank of Spain takes place more at an entity level, rather than at an instrument level, where the main parameters monitored are the maximum LTV threshold for the eligible assets (80% for residential, 60% for commercial, and 50% for buildings and land) and the mandatory 25% minimum OC ratio of the CH, relative to the eligible mortgage cover pool. By contrast, some other European regulators impose minimum liquidity enhancement or address interest rate and currency risks between the cover pool and the covered bonds.

### *Cover Pool-Specific Alternative Management*

Fitch's assessment focuses on the likely ease of the transferability of relevant data and IT systems to an alternative manager and buyer, with such quality and ease also judged on the consistency and quantity of data provided to Fitch. Fitch has assigned a 'moderate-high' (3 notches) cover pool-specific alternative management risk score to Bankia, which is mainly attributable to certain limitations of the data provided to Fitch. For example, the cover pool stratification template provided contained some data gaps, such as missing origination channel, missing employment and missing borrowers' debt to income. Although Fitch has addressed missing information by applying conservative assumptions, data gaps may be reflective of the complexities derived from Bankia's merger process, which comprised the integration of the IT platforms of seven savings banks and the transfer of mortgage assets into a consolidated balance sheet.

Fitch conducted an operational visit to Bankia in July 2015, including a review of its IT systems, the result of which was satisfactory. The mortgage loans are registered according to the Bank of Spain's regulations and are immediately identifiable and retrievable. In addition, they are registered in a database of the Bank of Spain, which is updated once a week through an interface. Prospective cash flows for the total mortgage book can be prepared at any time. We believe the satisfactory quality of Bankia's internal systems, and Bankia's experience in managing integration processes, would ensure the smooth transition of cover pool management to an insolvency administrator.

## Privileged Derivatives

Fitch has modified the assessment of Bankia's privileged derivatives D-cap component to 'very low' (6 notches) from 'low' risk. This modification is based on the fact that Fitch no longer considers the derivatives or hedging arrangements in place to be privileged derivatives. Derivatives are allowed by the Spanish legal framework; however, the absence of hedging is a common characteristic of all Spanish mortgage covered bonds. While this means that the administrator duties are not affected by the potential substitution of swap counterparties, it also implies there is no protection post issuer default against an interest rate mismatch between the floating rate paying assets and the fixed rate paying CH.

The absence of any privileged hedging arrangements also means there is no potential termination payment to impact the break-even OC analysis.

## Appendix II: Key Issues in Origination and Servicing

The following are the key issues identified in the operational review conducted by Fitch in July15:

Bankia has divested significant amounts of non-core assets as part of its 2012-2015 Strategic Plan. As a result, its mortgage NPL book has decreased by EUR1.1bn during 1H15 and around EUR5.0bn since end-2013. The most recent divestment is a sale of a mortgage loan portfolio in September 2015 of EUR 1.2bn, which complements the prior two sales earlier in the year.

Underwriting policies have been consolidated into a single policy since the merger of Bankia's constituent entities in 2010. Bankia's current policies are much tighter relative to pre-crisis standards, highlighted by the following developments in recent years: loan origination being focused on retail and SME loans, developer loan origination has been prohibited as per conditions laid out in the bank's restructuring plan, no broker originated loans nor loans to foreigners are granted, LTVs are below 80% and improved assessment of borrowers' payment capacity or loan authorisation levels which is based on scoring results.

Bankia's recovery strategy is heavily focused on avoiding new foreclosures. This is achieved by identifying weakening borrower payment capacity through a system of alerts and quality deterioration indicators, such as late credit card payment. The entity proposes refinancing options to troubled borrowers subject to a favourable assessment of borrowers' future payment capacity or the provision of additional guarantees. In cases where refinancing is not viable, Bankia might accept alternative solutions, such as haircuts to outstanding principal amounts, but will tend to avoid deed in lieu solutions.

During the last few years, Bankia has pro-actively refinanced loans as part of its policy to support troubled borrowers in a weak macroeconomic environment. The entity reported EUR13bn in refinanced mortgages which represents about 18% of its mortgage book and compares to an average for the Spanish banking system of about 15%. Reported CLTV levels are based on updated valuations in the case of refinanced loans. In the case of other loans, reported CLTV levels are based on original valuations and current loan balances.

As part of its operational review, Fitch was presented with a detailed description of the entity's IT systems, including back-up systems and disaster recovery plans, as well as the system's ability to clearly identify those mortgage loans securing the CH. In addition, Fitch conducted a file review on a random sample of mortgages, which raised no material issues

The ratings above were solicited by, or on behalf of, the issuer, and therefore, Fitch has been compensated for the provision of the ratings.