

NEWS

BANKING & FINANCE / CAPITAL MARKETS

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Following the takeover attempt over Cimpor and the purchase by Telefónica of Portugal Telecom's holding in Vivo, last year ended with an important capital markets transaction by Brisa.

This operation involved the segregation of Brisa's main concession in a separate company, which became the issuer, borrower and originator of Brisa's transactions. Unprecedented at European level, this operation allowed a higher rating to be granted to this separate company, thereby lowering future financing costs and corresponding to a very rare rating upgrade in Europe in the more recent times. The last semester continued under pressure of the sovereign debt crisis of the peripheral Member States. Portuguese public debt instruments were the subject of very high interest rates, crossing the 7% threshold, in the primary as well as the secondary markets. This circumstance, together with the Government's step down, pushed a very accelerated downgrade of the ratings of the Republic, State owned enterprises and also of Portuguese banks and other companies, and the subsequent request for financial aid from the Portuguese Republic to the international institutions.

However, a time of crisis is also an indication for new market opportunities. It is likely that new privatizations will be undertaken, both in respect of companies where the Portuguese Republic is currently a minority shareholder and companies where it is the majority or sole shareholder. This, as well as other relevant matters will be dependent on the negotiations with the European Commission, the ECB and the IMF, and, naturally, on the next parliamentary elections scheduled for next 5 June.

On the securitisation front, the past six months have equally been fervent, with several transactions being carried out by national banks, in an approximate total amount higher than €15,000,000,000 and with high amount of senior AAA rated tranches, allowing for a reinforcement of such banks' eligible assets. It is worth highlighting one of such transactions which was AAA rated by three rating agencies, a fact which had not occurred since 2008. Also worth noting that the asset class in the majority of these transactions has been corporate loans. Until the end of March and in line with the deadlines set out by the ECB, several processes

EDITORIAL

Pedro Cassiano Santos

were carried out for the inclusion of a second rating in certain transactions which had been completed in the past years with a single rating, therefore allowing the corresponding senior tranches to maintain its nature as eligible assets for ECB operations and therefore continuing to attain liquidity, where it exists.

Finally, we would stress that the last months have been distinguished by an increased demand in own funds by national issuers, both listed and non listed entities, being them banks or other types of companies. This tendency will certainly be maintained over the upcoming months. Likewise, new venture capital funds have been incorporated, which represents an important and enthusiastic sign, namely bearing in mind the strength that venture capital may inflict on national achievement in the current difficult environment.

In this context, this Newsletter comprises a range of topics which we understand to be of interest for our clients and other addresses, with special reference in this edition to the regulatory banking framework.

We would like to thank all comments and suggestions received with regard to this publication which you may wish to convey to us and which may be transmitted to amn@vda.pt.

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BASEL III – MORE CAPITAL, MORE LIQUIDITY

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Paula Gomes Freire

On December 2010, The Basel Committee on Banking Supervision (BCBS) issued the “Basel III Accord”, which changes significantly the capital and liquidity rules for international banks.

The new Basel III international standards are essentially aimed at raising the resilience of the banking sector, by strengthening both the quality and quantity of the regulatory capital base, and hence enhancing the risk coverage of the capital framework. Simultaneously and learning from the specific market failures revealed by the financial crisis, it is clear today that strong capital requirements are a necessary condition for banking sector stability but, by themselves, are not sufficient. A strong liquidity base is of equal importance. The BCBS is therefore introducing internationally harmonised global liquidity standards.

The main changes may be summarised as follows:

1. More Capital

“More capital” is two-fold: it means (a) a narrower definition of regulatory capital and (b) an increase of quantitative requirements.

On the one hand we witness a redefinition of the components of capital which will consist of the sum of the following elements: (i) Tier 1 capital (going-concern capital, or regulatory capital with loss absorption features in the context of the continuation of an institution’s activity), made up of Common Equity Tier 1 (corresponding to the best quality capital comprising common shares, reserves and retained earnings) and Additional Tier 1 Capital; and (ii) Tier 2 capital (gone-concern capital, or regulatory capital with loss absorption features in the context of the liquidation of an institution). For example, in this context, the generality of hybrid instruments currently qualifying as Tier 1 Capital will need to be replaced

by instruments which are more loss-absorbing and which have no incentives to redeem.

On the other hand it is the actual quantum of capital that increases: between 2013 and 2019 Common Equity Tier 1 will increase from 2% of a bank’s risk weighted assets (before certain deductions) to 4,5% (after such deductions) and the Total Capital requirement (Tier 1+ Tier 2) will increase from 8% to 10,5%, a direct result of the introduction of new capital buffers, namely of a new capital conservation buffer of 2,5%.

The implementation of these requirements is to be made in various steps, a reasonable transition period being in place and ending in January 2019 only. The table below shows the envisaged calendar:

	2011 (BII)	2012	2013	2014	2015	2016	2017	2018	2019 (BIII)
Common Equity Tier 1 Ratio	2 % 8% in Portugal*	2 %	3,5 %	4 %	4,5 %	4,5 %	4,5 %	4,5 %	4,5 %
Capital Conservation Buffer	0 %	0 %	0 %	0 %	0 %	0,625 %	1,25 %	1,875 %	2,5 %
Common Equity Tier 1 Ratio + Capital Conservation Buffer	2 %	2 %	3,5 %	4 %	4,5 %	5,125 %	5,75 %	6,375 %	7 %
Phase-in of deductions	0 %	0 %	0 %	20 %	40 %	60 %	80 %	100 %	100 %
Tier 1	4 %	4 %	4,5 %	5,5 %	6 %	6 %	6 %	6 %	6 %
Total Capital (Tier 1 + Tier 2)	8 %	8 %	8 %	8 %	8 %	8 %	8 %	8 %	8 %
Total Capital + Capital Conservation Buffer	8 %	8 %	8 %	8 %	8 %	8,625 %	9,25 %	9,875 %	

Transition period

* Bank of Portugal’s Notice nr. 1/2011 of April 14 has brought forward the Portuguese banks’ convergence towards Basel III standards and requires the strengthening of their Core Tier 1 (or Common Equity Tier 1) ratios to no less than 8% of their risk weighted asset, by December 31, 2011.

2. More liquidity

The idea of more liquidity lies essentially on the concept of two minimum standards for funding liquidity: (a) a liquidity coverage ratio or “LCR” and a (b) new net stable funding ratio (“NSFR”), which were developed to achieve the following objectives:

(i) Promoting short-term resilience of banks’ liquidity risk profile by ensuring they have sufficient high quality liquid resources to survive an acute stress

scenario lasting for 30 days – LCR (to be adopted from January 1, 2015); and

(ii) Promoting resilience over a longer time horizon by creating incentives for banks to fund their activities with more stable sources of funding – the NSFR (to be adopted from January 1, 2018, has a time horizon of one year and has been developed to provide a sustainable maturity structure of assets and liabilities).

It is in this context of increased capital and liquidity requirements that banks in general and the Portuguese banks in particular must face the challenges of the current economic environment (namely when required to strengthen their capital base in very difficult capital markets’ conditions). In a more regulated and prudential world they will certainly need to assess their business models to adjust to the new requirements.



AIRCRAFT FINANCING - INTRODUCTION TO THE DEAL STRUCTURE *

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Hugo Moredo Santos e Tiago Correia Moreira

In the previous edition of our newsletter we have introduced some basic concepts on Aircraft Financing transactions, including matters concerning the assets being financed, the risks and parties involved. Following up on the specifics of an aircraft financing deal, we should now focus on its basic structure and the main features related therewith.

The banks' goal

The banks' goal is to ring fence the aircraft being financed. Basically, the financing structure needs to ensure that, on an insolvency scenario, the security created over the aircraft protects the lenders against claims raised by other creditors that have not financed the acquisition of the aircraft. Such protection is usually achieved through the creation of a security package over the aircraft. Being this asset, whenever registered in Portugal, subject to manda-

tory registration with INAC (Portuguese Civil Aviation Authority), it is usual that the security package includes a first ranking mortgage over the aircraft. The financiers, after having been registered as beneficiaries of such mortgage, shall enjoy a secured credit entitlement that will allow senior ranking towards the generality of the creditors of the aircraft company.

The SPV and the risk

The nature of the asset being financed requires the banks to be isolated from the risks associated therewith. The banks must not be exposed to the rules concerning any liability related with either the aircraft itself (including in respect of passengers liability) or with the jurisdictional risk of having a foreign law determining that the owner of the aircraft is to be held liable for damages caused while the aircraft

was in use by the airline, for example. This is the main reason why the financing of an aircraft generally involves the setting up of an SPC (single purpose company) or an SPV (special purpose vehicle) that owns the aircraft. Actually, it is not uncommon to set up a SPC/SPV for each of aircraft forming part of the airline fleet.

The basic structure

The banks will finance the aircraft acquisition by entering into a loan agreement with such SPC/SPV and providing for contractual mechanisms that ensure the banks control over the SPC/SPV.

* This article is part of a series of articles from the authors about aircraft financing.

RETENTION OF NET ECONOMIC INTEREST IN SECURITISATIONS

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Benedita Aires

Article 122-A ("Article 122-A") of the Capital Requirements Directive (amended by Directive 2009/111/CE, dated 16 September) requires that securitisation originators retain a portion of their securitised exposures, ensuring that any misalignment between the interests of investors and originators has been removed. Article 122-A will apply to new securitisations on or after 1 January 2011 and to existing securitisations where new underlying exposures are added or substituted.

Article 122-A, which has been widely implemented throughout the European jurisdictions (1), has been transposed in Portugal by Bank of Portugal Notice n.º 9/2010, dated 30 December, applicable to credit institutions and investment companies. In this sense, an investing institution cannot be exposed to the

credit risk of securitisations, if the originator has not explicitly disclosed (2) that it will retain, on an ongoing basis (3), a material net economic interest which shall not be less than 5% (4).

Retaining a net economic interest can be achieved in four manners identified in Article 122-A, either by reference to the securitised tranches (5% of the nominal value of each tranche transferred to investors – vertical slice – or first loss tranches or tranches with more severe risk profile) or by retention of the securitised exposures (5% of the nominal value of the securitised exposures or randomly selected exposures, equivalent to no less than 5% of the nominal amount of the securitised exposures).

The manner of retention may be fulfilled by compliance with any one of the above options (but not

a combination thereof) and cannot change during the life of the transaction, these and other points being clarified in the CEBS Guidelines dated 31 December 2010.

[1] As of April 2011, implementation of Article 122-A was only outstanding in Spain and Sweden.

[2] Public and appropriate disclosure has been carried out by originators in the prospectuses for the relevant securitisations, being made at origination of the transaction and with investor reporting frequency.

[3] Cannot be sold or hedged.

[4] Retention percentage may be increased by the originator, as clarified in the CEBS Guidelines dated 31 December 2010.

HYBRID INSTRUMENTS AS TIER 1 OWN FUNDS - BANK OF PORTUGAL NOTICE NO. 6/2010

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Pedro Bizarro

The main innovation introduced by Notice no. 6/2010 of the Bank of Portugal ("Bop"), which substitutes Notice no. 12/92 on own funds, consists in clarifying requisites that shall be met for the proceeds arising from the issue of hybrid instruments to be treated as tier one own funds of the relevant issuer. The alluded requisites include the inexistence of a maturity date or a maturity date of no less than thirty years. Call options are admitted, although they may only be exercised after the fifth anniversary of the issue date. The issuer's incentives to redemption may only apply on the maturity date (when there is one) or at least ten years after the issue date (if there is no maturity date). Payment of income on the instruments shall be cancelled when the issuer is unable to comply with the minimum capital requirements. However, in these cases remuneration may be replaced by the delivery of shares.

Hybrid instruments may constitute an alternative to strengthen the relevant issuers' balance sheets, however subject to certain constraints. Redemption requires the prior consent of the Bank of Portugal, which may also suspend or prevent payment of the relevant remuneration, as well as demand the replacement of redeemed instruments. These prerogatives are not limited by objective criteria, notably the existence of a risk that the issuer would fail to comply with applicable solvency requirements.

The success of this innovation shall be ascertained progressively and measured by the reaction of the market and the regulators. However, in present day, the efforts of Notice no. 6/2010 of "Bop" are a good sign in order to open new possibilities with regard to the capitalisation of credit institutions.

IN BRIEF

The Bank of Portugal Notice no. 1/2011

Bank of Portugal's Notice no. 1/2011, published on April 14, 2011, brings forward the convergence of Portuguese banks towards the new Basel III standards and imposes the strengthening of their Core Tier 1 (or Common Equity Tier 1) ratio to no less than 8% of their risk weighted asset, by December 31, 2011. Although this requirement is significantly higher than the minimum requirements imposed by Basel III (2% until December 31, 2012, reaching 7% only by January 1, 2019) and implies capital strengthening by certain institutions, the truth is that the Portuguese banking system as a whole presented, in December 31, 2010, an average Core Tier 1 Ratio of 8,2%.

CMVM Regulation no. 2/2011 on OTC derivative transactions having listed underlying assets

The Portuguese Securities Market Commission ("CMVM") Regulation no. 2/2011, which entered into force on 15 April 2011, serves the purpose of preventing market abuse practices and amends CMVM Regulation 2/2007 accordingly. With this Regulation, financial intermediaries with registered office in Portugal or in any other EU Member State but with a branch in Portugal shall disclose to CMVM, up to the business day immediately after, any derivative transactions executed outside of a regulated market (OTC) having an underlying asset admitted to trading on such a market. Derivatives with multiple underlying assets are exempt, unless the assets are issued by a single issuer.

ECB eligible collateral - Changed criteria

As from 1 January 2011 the European Central Bank hardened the eligibility criteria imposed on collateral posting by counterparties obtaining liquidity from Eurosystem monetary policy operations.

The only acceptable currency is now the Euro, subordinated debt is no longer eligible and debt instruments issued by credit institutions and trading on certain non-regulated markets are no longer eligible.

The expanded criteria introduced in response to the financial crisis in late 2008 on rating thresholds remains in place.

Microcredit

Decree no. 1315/2010, of 28 December, sets forth the economic activities which can be financed through microcredit, as well as the maximum amounts of this type of financing. Pursuant to this document, the microcredit granted by microcredit financial companies should aim at financing (i) small company and professional projects that enable a sustainable creation and maintenance of jobs; and (ii) activities which prove necessary to enable the candidate to develop the projects referred to in (i). In what concerns credit maximum amounts, this Decree establishes that microcredit financial companies can grant microcredits up to €25 000 per borrower.

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