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Covered Bonds in Portugal

A Feasible Regime, At Last

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Portugal has yet to witness meaningful issuance of covered bonds despite the fact that the appropriate legislation has been in place since 1990. This is essentially due to heavy registration formalities associated with this instrument and the inadequacy of the old regime.

A new long-awaited covered bond regime was put in place in March this year and the market is eager to see covered bonds launched before the end of the year.

Although important features of this new regime still require further regulation by the Portuguese Central Bank, it is clear that covered bonds will now be more appealing to investors and compliant with rating agencies' requirements.

The principles contained in the new law may be summarized as follows:

1. Special vehicle principle – contemplated but not on an exclusive basis

The new regime provides for a combined issuing structure whereby alongside universal banks, which freely issue covered bonds without any special type of license to this effect, specialized credit institutions – the newly created and so called mortgage credit institutions – can also issue covered bonds. This provides much-needed flexibility to the market.

2. The congruence principle – fully covered

Congruence between the covering pool and the covered bonds is ensured under the new law insofar as the most important features are concerned: (i) principal (the global nominal amount of outstanding covered bonds may not exceed 95% in the case of mortgage covered bonds or 100% in the case of public sector covered bonds) of the global nominal amount of the assets in the pool; (ii) interest – the global amount of interest payable under the covered bonds cannot exceed, in any given moment, the amount of interest generated by the assets in the pool; (iii) time – the average maturity of covered bonds cannot exceed the average maturity of the assets in the pool; and (iv) currency – derivative instruments may be used to cover exchange rate variation risks.

3. The covering pool monitor – common representative of covered bondholders

The new law provides for the existence of a common representative of the covered bondholders along the lines of what has been

established for securitization purposes. This means that there is an entity in place to represent the interests of the bondholders and preventing the issuer from mismanaging the covering pool.

4. The covering pool register – segregated accounts and codified identification

In order to determine which assets constitute the cover pool for the covered bonds of an issuer the new regime provides for the following mechanism: the cover assets allocated to a certain issue of covered bonds are to be adequately registered in segregated accounts of the issuer and identified under a codified form in the issue documents. The key to the code is deposited with the Bank of Portugal who must still define, by means of regulation, the conditions under which the covered bondholders may, in the event of a default, have access to such key.

5. The privilege and segregation principle

These two principles are crystal clear under articles 3 and 4 of the new covered bond regime: the covered bondholders enjoy the privileged entitlement of being repaid with preference over any other creditors of the issuer in relation to the pool of covering assets and, in the event of bankruptcy, the pool of covering assets will not be available to meet any debts of the issuer until the covered bondholders have been repaid in full.

6. Accurate and secure collateralization

Finally, the new law also clearly establishes that not every asset is suitable to cover covered bonds and it therefore imposes a double test: (i) the mortgage lending value and (ii) the market value of the charged land, distinguishing, in this case, between housing and commercial properties. Under article 16 of the new law, the amount of a mortgage asset allocated to covered bonds cannot exceed (i) the mortgage value nor (ii) a certain percentage of the property value: 80% in the case of housing properties and 60% in the case of commercial properties.

In short, the new law will help to provide a new source of funding to the Portuguese banking sector resulting in investors and rating agencies viewing Portugal as a new covered bond market with significant growth potential.

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