Basel II, securitisation and prudential rules – a Portuguese perspective

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Portugal has recently implemented EU Directive 2006/48/CE on the taking up and pursuit of the business of credit institutions. The relevant Decree-Law, nr. 104/2007, dated April 3, 2007 establishes that the requirements of own funds applicable to credit institutions which hold a risk position in a securitisation transaction are determined by the Bank of Portugal (BoP), which, for such purpose, has issued Rule 7/2007, further complemented by Instruction 13/2007.

For prudential reasons, securitisation transactions have always been subject to notification to the BoP whenever the relevant originator is a credit institution. Bearing in mind that the supervision of securitisation transactions is, under Portuguese law, entrusted to the Portuguese Securities Commission, this is and has always been a way for the BoP to exercise a certain degree of control over transactions originated by entities that fall under its supervision scope. What the BoP now clarifies through Rule 7/2007 is the need for the own funds of the relevant credit institution to reflect all risks associated with a securitisation transaction, taking into account the economic substance thereof and not only its legal framework.

In light of these new provisions, in case the securitised notes are held by entities under the same consolidated supervision perimeter as that of the originator, the latter should treat those notes as if they formed part of its own estate. On the other hand, if the credit institution transfers a substantial part of the risk inherent to the securitised portfolio it may, in the case of a cash securitisation, exclude the amount of the more senior notes from the calculation of the amount of risky notes and, to the applicable extent, from the amount of estimated losses.

Securitisation has been defined as "the process of homogenising and packaging financial instruments into a new fungible one"[1] and, as commonly known, depending on the motivation of the originator in the relevant case, securitisation transactions may aim at achieving one or more of the following purposes (or a blend thereof):

- reduce funding costs;
- reduce asset-liability mismatch;
- obtain liquidity;
- diversify financing sources; and/or
- benefit from attractive prudential and regulatory treatment.

For the purposes of the new rules under analysis, both the European and the Portuguese legislators, as well as the BoP, have taken the concept of "securitisation" from a slightly more in-depth and technical perspective, directly linked to the credit risk associated to the exposure or pool of exposures which constitute the main object of the relevant transaction.[2] This approach makes full sense, taking into account that one of the main goals is to establish rules about the requirements on the originator's own funds, which are directly linked to the risk of the positions held by the relevant credit institution. By following this route, the supervising authorities purport to create the necessary conditions to achieve an even greater goal: financial stability, however this is aimed at being made without prejudice to competitiveness and innovation, on the one side, and neutrality, on the other side.

What the BoP has clarified following the implementation of the EU Directive 2006/48/CE is that in order for securitisation to actually correspond to a transfer of risk tool with no post-sale concerns for the originator – evidence of the true sale concept, the core of securitisation transactions and the foundation of off-balance-sheet accounting treatment – it should continue to comply with certain prudential criteria that are already familiar to originators using the concept and with other few requirements that, following the enactment of rules elaborating on the Basel II prudential rules, have not been experienced until now by market participants.

Focusing on the concept of transfer of a substantial part of the risk associated to the securitisation portfolio for securitised notes to enjoy the prudential treatment that has been described as follows, they must comply with a wide set of cumulative requisites:

- the transaction documents must reflect the transaction's economic substance (substance over form);
- securitised notes may not be under the control of the originator or its creditors, notably in the event of bankruptcy or insolvency (the main ground for securitisation lies in giving rights to investors over specific assets formerly belonging to the originator, which are not affected by the financial performance or the insolvency of the originator);
- the securitised notes may not trigger any payment obligations for

the originator (the originator ensures the existence of the receivables backing the notes and the absence of vices therein as represented in the transaction documents but not the solvency of the relevant debtors);

- the purchaser of the receivables backing the securitised notes shall be a Portuguese securitisation vehicle (credits securitisation fund or credits securitisation company);
- the originator may not enjoy an actual, either direct or indirect, control over the transferred receivables (there is a full legal and patrimonial segregation of the assets sold for securitisation purposes);
- in case the originator holds a clean-up call option, certain conditions have to be met for such call not to undermine the envisaged transfer of risk (accordingly, the existence of clean-up calls in itself does not jeopardise the transfer of a substantial part of the risk, although said entitlement needs to bear features disqualifying the existence of control by the originator); and
- the transaction documentation may not include clauses which provide for credit enhancement (otherwise the aforementioned criteria could be subverted).

We will now focus in particular on the requirements that the clean-up call option needs to observe so as to have the securitised portfolio falling outside of the control of the originator and thus to ensure that the transfer of a substantial part of the risk inherent to the receivables backing the securitised notes is not disqualified.

In order for these requirements to be duly fulfilled, it is necessary to establish that the clean-up call option is to be exercised by the originator on a discretionary basis. Additionally, it is necessary to establish that such clean-up call option may only be exercised if and when the aggregate outstanding amount of the transaction is equal to or less than 10% of the initial amount. Finally, the clean-up call option may not be structured in such a way that it provides for credit enhancement nor to avoid the allocation of losses to specific positions held by the investors, namely by establishing an option price above market price for the remaining transaction assets.

As regards the limitations to credit enhancement, the new rules provide that the transaction documentation may not include clauses (save for early termination):

- which allow for the modification of the obligations due under the receivables transferred for securitisation purposes, in order to enhance the average credit risk of those positions;[3]
- which allow for variations designed to enhance the credit risk of the positions held by the originator as from closing; or
- which establish an increase in the remuneration of the holders of securitisation positions, other than the originator, as a result of a decrease in the quality of the credit inherent to the relevant positions at risk.

These rules clarify some prudential aspects that, until now, were scarcely and unsystematically governed and evidence the concern of BoP with the preservation of an adequate level of own funds by credit institutions that originate receivables capable of being transferred for securitisation purposes, thus creating the conditions for the prudential regime suggested by Basel II to be achieved, and harbouring the three main references thereof – minimum requisites of own funds for the coverage of credit, market and operational risks, supervision process and financial and solvency information disclosure ensured.

We do not believe that this will raise any unfriendly obstacles to the structuring of securitisation transactions originated by Portuguese credit institutions, rather clarifying certain requisites that need to be complied with in order for a given prudential treatment of transactions to be achieved. However, the need to comply with the aforementioned rules will imply the fine tuning of the terms and conditions of the transaction documentation (notably in respect of optional redemption conditions and the repurchase of mortgage assets forming part of the assigned portfolios) so as to allow, whenever the originator so wishes, the transaction to achieve the transfer of a substantial part of the risk associated to the securitised portfolio.

Notes:

1 Black's Law Dictionary.

2 "Securitisation" is defined under Portuguese law as the transaction or mechanism pursuant to which the credit risk associated to a receivable or set of receivables is divided in tranches and allocated to the acquirer(s) thereof once the payments pertaining to the transaction or mechanism depend conceptually on the income originated by the receivable or set of receivables forming the object of such transaction or mechanism and the subordination of the tranches determines the allocation of losses during the life time of the transaction or mechanism.

3 In the case of substitution clauses, a maximum substitution limit shall be set forth taking into account the global aggregate amount of the securitised receivables and corresponding to a reduced amount when compared with such aggregate amount. Furthermore, in order for substitution clauses to be accepted, the contractual variations that lead to the substitution of receivables need to be attributable to causes that are not related with the solvency/financial condition of the debtor and ?the changes in the market conditions that trigger the substitution need to be identified in the transaction documentation.

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