Reform heralds new era for mortgage bonds

The Portuguese legislator has provided the framework for issuing mortgage-backed bonds. Now it's up to the market to respond. Pedro Cassiano Santos and Hugo Moredo Santos

In March 2006 the Portuguese government approved a Decree law that the financial community has long been waiting for: new legislation on mortgaged-covered bonds. Portugal has regulated mortgage-covered bonds since the beginning of the 1990s, when Decree law 125/90 of April 16 addressed mortgage-covered bonds. However, despite being amended twice, Decree 125/90 has never gained support from market participants as a useful and efficient tool, did not create the conditions necessary for debt representative instruments to be issued. So it does not come as a surprise that the preamble of Decree law 59/2006, dated 20 March, states that it aims to reduce bureaucracy and create flexibility by granting certain market players the possibility to issue mortgage-covered bonds, following the European trend and profiting from the experience gathered in more developed markets.

Decree law 59/2006 makes several changes to the legal framework set out by its predecessor. The scope of the types of receivables able to be used as underlying credits for mortgage-covered bonds has been widened, meaning more flexible eligibility criteria and allowing for receivables other than those mortgaged-backed to play the underlying asset role. It has increased the number of entity types that enjoy issuing capability, resulting in the insertion of a new species of credit institution – mortgage loan credit institutions – entities that already known to other EU member states. And the law accepts the useful function that risk coverage instruments perform in the context of a transaction involving debt issuance, and consequently acknowledges derivative instruments as appropriate schemes to address currency fluctuation, interest variation and liquidity shortfalls risk coverage.

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Issuing capacity

Decree law 59/2006 has not accepted the idea that all entities should be entitled to issue mortgage-backed bonds. Taking into account the special nature of the typical asset underlying these debt representative instruments (a mortgage-backed receivable, resulting from a mortgage loan entered into by and between a credit institution and a given borrower), the Decree law has, initially, limited issuing capability to those entities that are allowed to grant mortgage loans in the context of their commercial activity. So the first limitation affects the type of activities a credit institution is allowed to conduct and the type of receivables that, typically, may be used as underlying assets of mortgage-covered bonds. It is understandable that a credit institution that is not entitled to grant mortgage loans should also not be entitled to issue a debt representative instrument that is backed by mortgage loans. This could be said to constitute a statutory limitation, which in practice, however, is not that relevant because all (or, at least, most) credit institutions are statutorily allowed to grant mortgage loans.

However, even if a credit institution is allowed to grant mortgage loans in the context of its commercial activity, it should also meet a second criterion: an appropriate level of own funds, which the law as indicated to be €7.5 million. This constitutes a prudential limitation, aimed at ensuring that credit institutions evidencing a low level of own funds cannot obtain liquidity by issuing this type of bonds.

As mentioned above, Decree law 59/2006 introduces a new type of credit institution: mortgage loan credit institutions. These entities are credit institutions that grant, acquire and sell receivables secured by mortgages over real estate with the purpose of issuing mortgage-covered bonds. They may also grant, acquire and sell receivables due or guaranteed by central administrations or regional and local authorities of EU member states to issue mortgage-covered bonds. To properly conduct their activities, mortgage loan credit institutions may perform all administrative acts relating to the assets that are returned to them as repayment for the receivables they hold, as well as carry out other activities that prove necessary for the accomplishment of their corporate scope.

So credit institutions legally authorized to grant mortgage loans that enjoy own funds amounting to at least € 7.5 million, including the new mortgage loan credit institutions, can be identified as entities that may issue mortgage-covered bonds.

Main features of mortgage-covered bonds

Portugal's new legal framework profits from several investor protection mechanisms that were introduced by the Portuguese Securitization Law, approved by Decree law 453/99, dated November 5 (as amended), some of which were unknown to the former Decree law 125/90, dated April 16.

Mortgage-covered bonds grant certain entitlements to their holders, which are aimed at allowing holders to be separated from the risks that do not form part of the securities they hold (the mortgage-covered bonds) and the underlying receivables (the mortgage loans). In this context, the special creditor privilege (which, for flexibility and to save costs, is not subject to registration) over the underlying mortgage receivables and other assets allocated to the mortgage-covered bonds, from which the bondholders benefit, assumes a predominant position. In its main features, notably the preference status granted and the absence of registration, this entitlement is similar to that awarded to the holders of securitization bonds and entities rendering services connected with

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their issuance under Portuguese Securitisation Law. This entitlement allows for the holders of mortgage-covered bonds to enjoy a preference position in relation with any other creditors for the purposes of principal repayment and interest payment corresponding to their mortgage-covered bonds. This credit privilege is extendable to the counterparts of eligible derivative transactions, as far as the receivables resulting from these transactions are concerned.

Also, because the mortgage receivables and other assets allocated to the mortgage-covered bonds, including the proceeds relating to interest and repayments, constitute an autonomous pool of assets, they cannot be used to pay debts incurred by the issuer, to the extent the amounts due to the holders of the mortgage-covered bonds are not fully discharged. This segregation structure, which is already familiar to investors in securitization units (on a fund-by-fund basis) and on securitization bonds (on an issuance-by-issuance basis) issued by Portuguese securitization funds and companies (respectively *fundos de titularização de créditos* and *sociedades de titularização de créditos*), demand that the mortgage receivables and other assets that form part of the autonomous pool of assets allocated to the mortgage-covered bonds be adequately registered in segregated accounts of the issuer and identified in a codified manner in the issuance documents. (The Portuguese securitization funds dispense with segregated registration, because each fund works as an autonomous pool of assets so can be used for a sole transaction, even if it involves multiple issuances and multiple series of securitization units.) These accounts must include, in respect of each receivable registered, information about the relevant outstanding amount, the interest rate, the term for reimbursement, the notarial office where the relevant mortgage public deed was executed, if applicable, and details of the definitive registration of the mortgages with the relevant real estate registry office. As to the key to the issuance code, and following the solution that, *mutatis mutandis*, is applicable to securitization bonds, similar details must be deposited in the Bank of Portugal, as supervising entity of the issuer. (The key to the code of the securitization bonds' accounts must be deposited with the CMVM, as supervising entity of *sociedades de titularização de créditos*. The Decree law has not provided for rules governing the access by holders of mortgage-covered bonds to the code, rather entrusting the ruling activity to the Bank of Portugal, who must establish, by means of regulation, the conditions under which the holders of mortgage-covered bonds may, in the event of default, have access to that code.

One last but no less relevant feature of mortgage-covered bonds is the ring-fencing mechanism set out by the legislator to safeguard those instruments, and their holders, from events that have a negative impact on the issuer, such as its insolvency. If the issuer dissolves and winds up (including on grounds of insolvency), the mortgage receivables and remaining assets allocated to the mortgage-covered bonds are segregated from the insolvency estate and so do not form a part of it. These mortgage receivables and assets will be separated and autonomously managed until full repayment of the amounts due to the bondholders, notwithstanding the bondholders meeting being entitled to pass a resolution approving the immediate acceleration of the mortgage-covered bonds. Additional input on this issue is expected from the Bank of Portugal, which will outline the proceedings that will be adopted within the autonomous management and the that terms apply to the liquidation of the estate (mortgage receivables and other assets) allocated to the mortgage-covered bonds after the acceleration.

Characteristics of mortgage-covered bonds

As with any other type of bonds, mortgage-covered bonds may be issued on a continuous basis or comprise various series, the issuance being subject to the provisions contained in the Portuguese Securities Code relating to public offers and private placements. The mortgage-covered bonds may be admitted to listing on the terms and with the limitations set out in the applicable laws and regulations.

Regarding the relevant issuing term, mortgage-covered bonds may not have a repayment term less than two years or greater than 50 years. But the average maturity term of the outstanding mortgage-covered bonds may not exceed, at any time, the average maturity term of the mortgage receivables and other allocated assets.

Mortgage receivables and other allocated assets

Decree law 59/2006 has defined two different categories of underlying assets: unconditioned pecuniary non-matured mortgage-backed receivables and other assets.

Unconditioned pecuniary non-matured mortgage-backed receivables include three types of receivables: First, pecuniary receivables that have not matured, are not subject to conditions, are neither encumbered nor judicially seized or apprehended, and are secured by first-ranking mortgages over residential or commercial real estate in an EU member state. Second, receivables secured by junior mortgages as long as all receivables secured by senior mortgages over the same real estate are held by the issuer and are allocated to the same issue. And third, receivables secured by personal guarantee granted by a credit institution or by an appropriate insurance policy, with a mortgage counter guarantee evidencing the characteristics identified above.

Concerning the eligibility criteria that the assets that may back the mortgage-covered bonds must meet, Decree law 59/2006 has followed the Portuguese Securitization Law regarding the definition of the receivables susceptible to assignment for securitization purposes. The characteristics of eligible unconditioned pecuniary non-matured receivables differ from those relating to receivables of eligible securitization for securitization purposes only in respect of maturity and transferability.

Regarding maturity, the original version of Portuguese Securitization Law also prevented the use of matured and unpaid receivables for securitization purposes, leaving "to market players the role of evaluating the quality of the transactions they wish to enter in light of the rating attributed by the relevant rating agency". So securitization regulation has not always been as it is: the legislator has taken a prudent approach on the eligibility criteria subject and afterwards loosened some of the constraints imposed according to market development, maturity and the undertaking by investors, as decision makers, of the investment risk inherent in the purchased securities. It remains to be seen if the same happens in respect of this requisite in terms of mortgage-covered bonds.

Regarding transferability (which is a critical feature of receivables seeking to qualify as suitable for assignment for securitization purposes), its absence among the mortgage-covered bonds eligibility criteria is easy to explain: there is no transfer of the mortgage loan and relevant mortgage to any third party, as happens in standard securitization (as opposed to synthetic securitization). The proceeds inherent to mortgage loans are allocated to the mortgage-covered bonds, the holders of which are entitled to receive all principal and resulting interest collections. However, this benefit is not due to a transfer of title but rather to an allocation of proceeds and security scheme, implying no variation at the creditor position level.

In the *other assets* category, the law has included deposits with the Bank of Portugal, in cash or in securities eligible for credit transactions on the Eurosystem; current or term account deposits with credit institutions (which are not in a domination or group relationship with the issuer) having a rating equal or higher than A- or equivalent; and other assets complying simultaneously with the requisites of low risk and high liquidity.

As with any other type of bonds, mortgage-covered bonds may be issued on a continuous basis or comprise various series

Besides their specific features, the main difference between these two types of underlying assets is that the sum of the value of the *other assets* may not exceed 20% of the global value of the mortgage receivables and other assets allocated as security of the mortgage-covered bonds.

Risk coverage instruments

One of the big concerns inherent to the issuance of bonds and other debt representative securities is the need to ensure, at all times, that period payments are duly performed as and when they fall due. So it is critical to make available to the issuer certain tools that may be used whenever, for any reason whatsoever, proceeds originated by the mortgage-backed receivables and other assets allocated to the issued mortgage-covered bonds prove to be insufficient to meet the scheduled payment obligations.

Therefore, and to face temporary liquidity shortfalls, irrevocable credit lines may be contracted and, if needed, activated, in which case these funds are to be exclusively used for the purposes of repayment and interest payments in the context of the issue of mortgage-covered bonds. Following the same rating level requirement that relates to current or term account deposits with credit institutions (which may be within the *other assets* category), those credit facilities may only be contracted with credit institutions rated A- or higher or with an equivalent rating.

On the other hand, and with the exclusive purpose of ensuring risk coverage, that is, interest rate, currency exchange and liquidity shortfalls, the issuer is entitled to conduct transactions involving derivative financial instruments. These instruments will form part of the autonomous pool of assets allocated to the performance of the corresponding mortgage-covered bonds and should be considered for calculation of the relevant limits and registered in the applicable segregated accounts of the issuer. This registration should additionally include, in respect of each derivative financial instrument: the mortgage-covered bonds to which the instrument is allocated, asset or assets underlying the mortgage-covered bonds, the transaction amount, identification of the counterpart, and the initial date and maturity date.

As with credit facilities, derivative financial instruments may not be entered into wherever the issuer wishes. Decree law 59/2006 identifies as eligible transaction markets the EU member states or recognized markets of a full OECD member. Transactions involving derivative financial instruments outside the referred markets are only acceptable if the respective counterpart is a credit institution rated A- or higher or with an equivalent rating.

As far as the receivables resulting from the transactions are concerned, derivative financial instruments grant to the counterpart of the issuer the credit privilege referred to above. However, the law does not treat the providers of irrevocable credit lines contracted by the issuer to face temporary liquidity shortfalls equally because different treatment seems difficult to find – the inclusion of proceeds resulting from irrevocable credit lines among the other assets category allocated to the mortgage-covered bonds is unquestionable.

The Bank of Portugal may define, by means of regulation, the terms in which the derivative financial instruments should be considered to determine the prudential limits explained below, or impose other conditions to the use of derivative financial instruments.

Prudential rules

The whole idea of mortgage-covered bonds, which is illustrated by provisions concerning segregation and ring fencing, is allocation, asset backing, and the connection between a certain asset and the securities whose performance it secures. So the existence of certain ratios is crucial for the prudent relationship between those two elements of the equation: backing assets and performing securities. Decree law 59/2006 has established that the nominal global value of the outstanding mortgage-covered bonds may not exceed 95% of the nominal global value of the mortgage receivables and other allocated assets. A similar rule applies to interest payments, so the nominal global amount of interest to be paid to the bondholders may not exceed, at any time, the amount of interest pertaining to the mortgage receivables and other assets allocated to the mortgage-covered bonds. However, the calculation of these limits, as well as other limits or conditions and relevant calculation methods, such as that relating to risk coverage and management, might still be complemented by regulation introduced by the Bank of Portugal.

These two references relate to the mortgage-covered bonds themselves, but another reference, which works as an eligibility criterion, can be identified in the law: the relation between the amount of a mortgage receivable and the value the mortgage securing it, that is, the loan-to-value ratio. Contrary to the Portuguese Securitization Law, Decree law 59/2006 has not abandoned the definition of the minimally acceptable ratio to the agreement that parties were able to establish in the transaction documents. The Decree law has determined that the amount of any mortgage receivable allocated to mortgage-covered bonds may not exceed the value of the respective mortgage, 80% of the value of the secured asset, in the case of residential real estate, or 60% of the value of the secured asset, in the case of commercial real estate.

If any of these limits is exceeded the issuer must ensure that the same is neutral for the performance of the issued mortgage-covered bonds and that the balance that the law as defined as minimum – and which is evidenced by the referred ratios – is promptly recovered. The issuer may follow one of two routes: either allocate new mortgage receivables, with or without substitution of the mortgage receivables allocated to the mortgage-covered bonds, or other authorized assets, enlarging the set of assets allocated to the mortgage-covered bonds and improving the deficient backing level (rebalance at the underlying asset level); and/or acquire mortgage-covered bonds in the secondary market, decreasing the number of outstanding mortgage-covered bonds and improving the backing level (rebalance at the mortgage-covered bonds level).

Closing remarks and expectations

Legislation on mortgage-covered bonds has been awaited by Portuguese market players, particularly credit institutions, for several years. To fill the gap, the Portuguese legislator has closely followed the already tested and, until now, efficient framework of the Portuguese Securitization Law. In matters such as the entitlements of bondholders, including the special creditor privilege over the underlying mortgage receivables, the account's segregation mechanism, the ring-fencing structure, the definition of eligible underlying assets, where the criteria applicable to receivables qualifying for securitization purposes have been *mutatis mutandis* adopted, and admissibility of risk coverage instruments, Decree law 59/2006 has choose not to innovate but rather to harbour solutions that, for the last seven years have been the legal framework for many securitization transactions, including those involving mortgage-backed receivables.

Hopefully all the inefficiencies that doomed the former – and revoked – Decree law 125/90 have been properly overcome by this new piece of legislation. The new Decree law market participants, from originators to arrangers, an alternative tool to manage mortgage loan portfolios, which could prove useful in all those cases where balance sheet release is not critical.

Most of the legal solutions with regards to securitization structures have already been tested in the market. The adoption of the same solutions for the issuance of mortgage-covered bonds demonstrates that the Portuguese legislator has followed the path of flexibility, and market and investor protection, for the benefit of transactions to be originated out of Portugal. The legislator has done its job. We look forward to seeing how market participants will respond.

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