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14. Public Sector Securitisation in Europe

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1. INTRODUCTION

Already widely used by private entities, asset securitisation is now being promoted in the public sector as an innovative and yet solid tool for accessing diversified sources of funds. Following the Italian and Greek experiences in previous years, it was now the turn of the Portuguese government, pressured by Eurozone budgetary commitments, to (successfully) enter the securitisation market for the first time. Others are expected to follow in Europe and elsewhere in the world. These experiences showed how and to what extent asset securitisation can, also in the public sector, serve as an effective management and financial mechanism available to state and other public entities, suitable not only to improving public accounts and budgets, but even to working as an indirect means to achieve economic and social goals.

In this article, we purport to provide a general overview of where public sector securitisation in Europe now stands, addressing mainly issues concerning the governments' motivation to set up these transactions, the classes and types of assets that may be considered attractive for these purposes, and the accounting treatment of asset securitisation within the public sector. After this more general outline of the subject, we will then present as a case study the Portuguese Explorer Tax and Social Security Securitisation, completed in December 2003 and launched publicly in April 2004 (hereinafter referred to as 'Explorer'). Focusing on the specific features of this deal, we will nevertheless outline those that we consider to be general issues and problems that are likely to be raised in any public sector securitisation. Finally, we will attempt to draw an overview of what the near future of public securitisation may be, in light

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of the challenges and demands that we perceive existing in this segment of the market.

2. MOTIVATION

The main attractiveness of public sector securitisation to sovereign issuers derives essentially from the fact that it can provide the opportunity to raise extra funds, while also ensuring, provided certain circumstances are met, an 'off-balance sheet' accounting treatment for the purpose of debt and deficit calculation. This enables governments to reduce their overall public debt burden, by monetising a wide range of public assets, the proceeds of which are treated as budgetary revenues and can thus be used to reduce both public debt and budget deficit.

In light of these features, public sector securitisations in Europe have been essentially driven by the need to comply with the public debt and budget deficit limits established by both the Maastricht Treaty and the Stability and Growth Pact, which call for a higher financial and economical stability following the introduction of the euro as the European single currency. As a result of such financial and budgetary restrictions, and particularly given the significant effects of the recent stagnation in the Eurozone's economies, both central and local governments, in addition to other consolidated public entities, have been required to consistently reduce their debt in accordance with both European Union level guidelines and internal provisions. Hence the push towards new financial tools, such as asset securitisation, as a means to efficiently monetise diverse categories of assets and receivables owned by the public sector.

In addition to working as a macroeconomic and budgetary tool, other relevant advantages of public sector securitisation can be highlighted. Securitisation transactions can provide the grounds for a more effective and structured recourse by the state and consolidated entities to the debt markets. In particular, securitisation deals might be used by states for the purpose of restructuring longlasting, highly onerous public debt relating to essential public services (such as the health or education social systems), namely by providing for the exchange of short-term, high interest debt, by long-term, low interest debt. Moreover, it allows the diversification of the public sector debt through new markets and diversified investors, thus reducing the risk of potential defaults. It further provides the opportunity to put into relief the public balance sheet from significant portfolios of non-performing assets, in particular in the tax and social security areas, thus providing an improved balance sheet structure, free of impaired assets. Plus, at least concerning certain types of assets (such as real estate and equipments), securitisation deals can work as an efficient tool, by

introducing market pressure in the management of such assets. In fact, certain transactions might involve the need to create or increase revenue flows determined in market circumstances or the engagement of specialised servicers, who will run such assets according to higher, more efficient standards, thus rationalising their use and improving their revenues.

Finally, another important incentive for governments to promote securitisation deals relates to the externalities that these deals might trigger. Indeed, securitisation transactions are likely to involve an enhanced scrutiny of the legal and administrative environments, thus producing the potential for enormous benefits, by making valuable information available both to the government and to investors, something that can ultimately lead to reforms of the legal and administrative environment that can provide for an increased efficiency of the functioning of the public administration services, as well as facilitate the development of control and monitoring procedures, with a view to stimulating a more productive approach by public administrative services.

There are naturally risks that have to be considered when setting up a securitisation transaction, both speaking in general terms and particularly considering transactions completed within the public sector. Firstly, it is necessary to ensure that the returns of the deal are sufficient to cover the standard costs of securitisation, bearing in mind that, in the public sector as in other private securitisation transactions, there is certainly always an issue of size to be considered from the start. It is further necessary, considering the nature and specificity of the entities acting as the originators in these deals, to make realistic and, where possible, independent valuation both of the assets to securitise and of the future streams that will collateralise the issuance of the relevant notes. We believe additionally that not all the assets and not all risks are capable of being properly offloaded from the government's sphere and therefore the nature and quality of the assets is certainly also to be duly considered. Finally, as not all transactions are likely to be well received by both public opinion and the existing political opposition, the image concerns and the impact these deals might have on public opinion shall also matter significantly in the evaluation of this type of transaction.

Nevertheless, we believe (and real life practice confirms) that these risks are not significantly different from those that arise in private sector transactions and thus, particularly when the right classes of assets are chosen and when the envisaged objectives are attainable, a cost-benefit assessment will highlight the advantages of setting up securitisation deals in the public sector.

3. PUBLIC SECTOR SECURITISATION IN EUROPE

As referred to above, public sector securitisation in Europe has been used by Member States' governments to improve the public accounts, in view of the restrictions posed by the European Monetary Union rules on the context of public debt and the budget deficit (generally denominated as 'Maastricht criteria', using the name of the city where the Treaty that created such criteria was signed).

The groundbreaking deal set up by a sovereign entity was the issue by the Republic of Italy, in 1999, of notes backed by delinquent social security claims. The goal was to increase current revenues and reduce expenses, as part of a plan to reduce overall public debt and budgetary deficit as imposed by the Maastricht criteria. Since this deal, which set an important precedent for other European governments, the Italian government has been the most active in Europe, having set up six other deals, all amounting to over EUR 20 billion, involving, in addition to the social security claims, other classes of assets such as real estate assets and lottery revenues.[1] In the context of the funding for the 2004 Olympics, Greece has also been active in the securitisation market, with four securitisations arranged by the Greek government since 2000, involving receivables from the European Union under the CSF III and from the European Organisation for Safety of Air Navigation, as well as lottery and banking revenues.[2]

In this context, the recent Republic of Portugal's securitisation of certain tax and social security claims represented a landmark in public sector securitisation in Europe. It was not only the first securitisation carried out by the Republic of Portugal, but it also corresponded to the first deal set up in Europe to include a wide range of defaulted tax revenues. Moreover, it was the first transaction using a Portuguese securitisation company[3] ('STC'),[4] the first using a common representative of the noteholders,

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[1] *See* C. Flanagan and E. Reardon, 'European Public Sector Securitisations' (JP Morgan Global Structured Finance Research, 2003). For more information on public sector securitisations in Italy, see also P. Messina, 'New Horizons for the Italian securitisation Market' in *Global Securitisation and Structured Finance 2004* (Globe White Page, London, 2004).

[2] *See* Petros P. Dracopoulos, 'Securitisation in Greece' in *Global Securitisation and Structured Finance 2004*, ibid, p. 318.

[3] For a more general and comprehensive treatment of the Portuguese securitisation legal framework, see by the authors: '2003 A Landmark Year for Portuguese Securitisation' in *International Financial Law Review: The 2004 Guide to Structured Finance* (London, 2004) 'The Portuguese Securitisation Market', in *Global Securitisation Review 2003/2004* (London, 2004) and 'Securitisation in Portugal', in *Asset Finance International: Portugal Supplement* (London, 2000).

[4] The other Portuguese securitisation vehicle is the '*Fundo de Titularização de Créditos*', a securitisation fund allowed only to issue securitisation units as funding for the acquisition of assets.

devised under a continental European jurisdiction instead of the more common Anglo-Saxon inspired institute of the trustee, as well as the first transaction allowing for direct issuance out of Portugal using Portuguese law as the governing law for the securitisation notes.

A key objective of the deal was to enable the Portuguese government to record the proceeds of the sale of the relevant tax and social security credits as budgetary surplus, something that proved to be essential to meet the deficit commitments for the year of 2003. Indeed, after concerns that the Portuguese public deficit could break the Eurozone 3% guideline, the extraordinary funds that resulted from the deal, together with the necessary EUROSTAT approval of the accounting treatment of the deal, ensured Portugal's compliance with the limit set forth in the Growth and Stability Pact, closing 2003's public accounts showing a deficit down to 2.8% (a result that, without the Explorer transaction, the Portuguese government was rather incapable of achieving, particularly in a period of downturn of the economy).

Apparently the resort to securitisation as a financial tool for central governments is not slowing down. As recently as July this year, the German government has announced its intention to monetise some of the official debt owed to Germany by Russia.[5] Given Germany's budget law restriction on further governmental borrowing, the concept is to raise close to EUR 5 billion through the issuance of credit-linked notes, the final goal being to reduce a significant EUR 10 billion hole in Germany's budget. Others are expected to follow, with increased diversification of the securitised assets likely to occur.

4. EUROSTAT RULES: THE ACCOUNTING TREATMENT OF PUBLIC SECTOR SECURITISATIONS

Aware of the relevance of these transactions in the context of the EU Members' public accounts, EUROSTAT, the Statistical Office of the European Community, situated in Luxembourg – and the entity which is, *inter alia*, in charge of monitoring the various Member States' compliance with the Maastricht Criteria – has issued a series of decisions on the accounting treatment of securitisation deals undertaken by public sector entities.[6] In

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5 *See* 'Soviet Solution', *The Economist*, 1 July 2004.

6 *See* EUROSTAT Release No. 80/2002, of July 2003, *Securitisation operations undertaken by general government*, available at http://europa.eu.int/comm/eurostat/. Said rules were further incorporated in EUROSTAT's ESA Manual on Government Deficit and Debt (Part V).

particular, EUROSTAT sought to clarify according to which rules a given transaction might qualify for off-balance sheet treatment for the purpose of public debt and deficit calculation. The general rationale of these rulings was to refuse an off-balance sheet treatment to those transactions that do not constitute an effective risk transfer over the relevant assets from the relevant public sector entity to the securitisation vehicle or to the market. Given said rules' importance in the context of European public sector securitisation, we briefly summarise below EUROSTAT's main rulings concerning the accounting treatment of this type of deal.

EUROSTAT's first understanding was to determine that the securitisation of future cash flows, which are produced by assets not previously recorded on the state's balance sheet, but instead result from an activity undertaken by the government, shall always be treated as government borrowing. This was justified by EUROSTAT on grounds that, in such a case, the relevant public sector entity involved in the transaction will have no control on the generation of the future cash flows, unlike the case where it had the full ownership of an asset.

Second, EUROSTAT acknowledged that the granting of guarantees by state governments to securitisation vehicles (whatever the creative format in which they may be devised) does not constitute a complete transfer of the risk attached to the securitised asset, as there is not an effective change in ownership thereof ('true sale'). As a consequence, EUROSTAT ruled that, in transactions where government guarantees are made in favour of the relevant securitisation vehicle, such vehicle shall be reclassified within the public sector, or such deal shall be recorded as an implicit loan from such vehicle to the relevant government or public entity. Hence, on the grounds that in these cases there is not an effective risk transfer to the vehicle, public sector securitisations involving state guarantees shall also be recorded as 'on-balance sheet' and shall therefore fail to meet their main objective.

Additionally, EUROSTAT ruled that deals with a deferred purchase price in excess of 15% of the estimated market value of the assets shall also be treated as on-balance sheet transactions. Again, it was considered that if a given deal provides for possible future payments, and where the initial purchase price is significantly lower than the observed market value (assessed and certified by independent experts, with the view of determining the proper market value thereof), then it would neither constitute a true and effective sale, nor an effective risk transfer over the relevant assets to the securitisation vehicle.

The final rule issued by EUROSTAT concerned the accounting recording of the transaction by the relevant public entity and determined that the value of the transaction must be booked according to the cash effectively

received pursuant to the deal and at the time of said deal, any further future payments having to be booked if and only when, and to the extent, realised in cash.

The above rules had a significant impact on the public sector securitisation framework, even with respect to previous public sector securitisations undertaken in Europe, some of which had to be reclassified as on-balance sheet deals when judged to be in breach of the new guidelines, with the necessary consequences at the public accounts level.[7] Anyway, and going forward, the issuance of these rules by EUROSTAT, and the crucial clarification it provided for governments, will greatly influence the future setting up of public sector securitisation transactions in Europe. In particular, given the 15% rule and the restrictions on the granting of governmental guarantees, alternative credit enhancing mechanisms will have to be sought and implemented, with plenty of room being left for lawyers to come up with the concepts and the legal and contractual structures to ensure that, without prejudice to their EUROSTAT-friendly nature and the due respect of the above explained requirements, transactions may still be implemented smoothly with the AAA-rating these deals have been awarded in the past.

5. CASE STUDY: THE EXPLORER DEAL

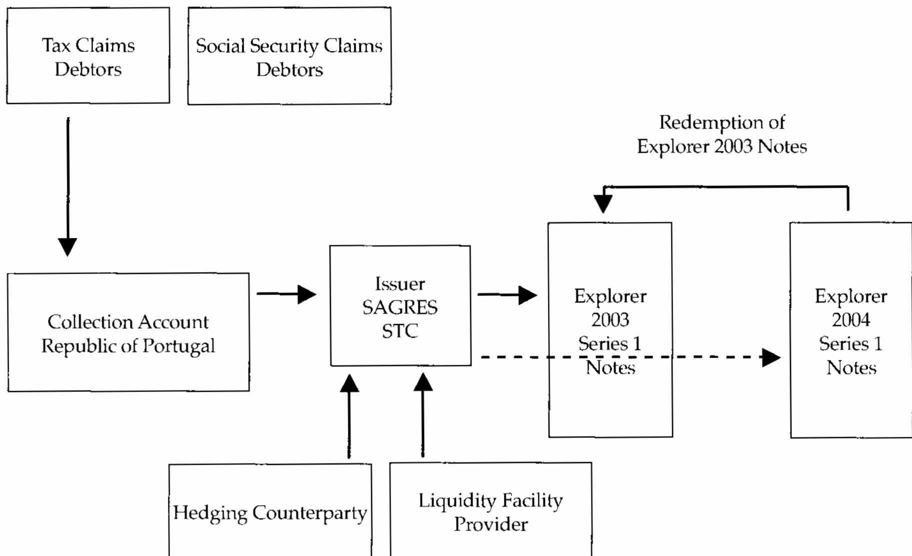
5.1 The Structure of the Deal

Briefly described, the Explorer deal involved the assignment by the Republic of Portugal and the *Instituto de Gestão Financeira da Segurança Social* (the social security administrative body) to SAGRES – Sociedade de Titularização de Créditos, S.A. ('SAGRES'), a wholly-owned subsidiary of Citigroup – of a portfolio of non-performing tax and social security claims, globally amounting to EUR 11.95 billion in terms of the maximum nominal amount of the credit entitlements being sold by the Portuguese government. Approximately 46% of the securitised portfolio comprised defaulted VAT receivables, 22% defaulted corporation tax, 10% defaulted personal income tax, the remaining 18% corresponded to social security claims, and all these credits corresponded to entitlements of the Portuguese government or of the Portuguese Social Security Institute that

[7] In July 2001, EUROSTAT refused to accept Italy's reduction of its budget deficit pursuant to a securitisation of lottery and property sales and, as a consequence, Italy's 2001 deficit rose from 1.6% to 2.2%.

were being enforced and claimed in court from the relevant tax or social security debtors.

To fund the acquisition of the portfolio, SAGRES issued first, in December 2003, the Explorer 2003 Series 1 securitisation notes, globally worth EUR 1.765 billion, which were fully purchased by Citigroup, and after, in April 2004, the Explorer 2004 Series 1 securitisation notes, which were only then sold publicly to investors throughout Europe, the proceeds of which were used to redeem in full the Explorer 2003 Series 1. The bridging of the transaction proved to be the most adequate solution for both the Portuguese government and SAGRES: the acquisition of the portfolio and the resulting proceeds allowed the Portuguese government to get the necessary budgetary contribution to comply with the deficit reduction goals for the year 2003; and the issuance of the second series of notes allowed SAGRES to sell the securitisation notes in much better market conditions in April 2004 than those prevailing in the market towards the end of December 2003. Indeed, the Explorer 2004 Series 1 met significant demand on the part of investors, not only in Portugal but significantly throughout Europe and placement thereof in April 2004 proved to correspond to a great success that undoubtedly would not be attainable in December 2003.



Bearing in mind the above brief description, we will in the following chapters address in more detail the major difficulties raised during the setting up of the Explorer deal, as well as the legal and contractual solutions that were implemented in order to overcome such difficulties. Although the following considerations refer to the particular deal under analysis, we believe most of the issues raised are of a general nature in the context of public sector securitisations, and that, therefore, significant lessons can be learnt form this Portuguese experience and transported to many other transactions carried out in other European jurisdictions and elsewhere in the world.

5.2 *Setting the Stage: Changes to the Securitisation Legal Framework*

Although the Portuguese securitisation legal regime allowed, from the very beginning, the state and other public entities to assign credits for securitisation purposes, the nature of the assets at stake (tax and social security credits in arrears and being claimed in court) required the enactment of new pieces of legislation. On the one hand, it was necessary to ensure that certain basic principles, namely those relating to the protection of the rights and guarantees of taxpayers, would be maintained without prejudice to the fact that the relevant credit entitlements were being sold to an entity deprived of any sovereign nature. On the other, the fact that the transaction involved the first use of a STC vehicle, legislative clarification of certain aspects of this structure were required.

First, Law 103/2003 of 5 December 2003 (the 'State and Social Security Securitisation Law'), was passed through the Portuguese parliament, defining the basic legal principles applying to the assignment, for securitisation purposes, of tax and social security credits. As a first goal, it aimed at ensuring the maintenance of the same level of protection of the fundamental rights and guarantees of taxpayers, namely by setting out that such rights and guarantees should remain totally unaltered following completion of the transaction and that the taxpayers' personal data were to remain fully confidential.

Second, Decree-Law 303/2003, of 5 December 2003, approved by the Portuguese government, amended the then existing Portuguese securitisation legal regime[8] (hereinafter 'Securitisation Law'[9]) and Portuguese

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[8] See footnote 3, above.

[9] Approved by Decree-Law 453/99, of 5 November 1999 and amended by Decree-Law 82/2002, of 5 April 2002.

securitisation tax regime (hereinafter 'Securitisation Tax Law'[10]). The purpose of these further amendments was, essentially, to incorporate the basic principles applying to the securitisation of state and social security credits, pursuant to the State and Social Security Securitisation Law, into the general Portuguese securitisation legal regime so as to allow for an integrated legal definition of the terms and conditions applying to securitisation of both public and private assets in Portugal.

Furthermore, the opportunity was also used to correct certain inefficiencies the Securitisation Law presented, particularly with respect to the implementation of the STC structure. Indeed, one of the most significant and legally interesting changes was the widening of the concept of a common representative of noteholders, a crucial player to ensure that the direct issuance of securitisation out of Portugal by an STC is possible and marketable among the envisaged investors base, who are used to the protection that is commonly granted by the legal institute of the trust. This, as further detailed below, was fundamental to win the market's confidence in the STC structure, which saw the common representative's role as similar to the one performed regularly by the trustees appointed under English law.

Also the Securitisation Tax Law was amended to allow for the certification of non-Portuguese residents (who enjoy a withholding tax exemption on any interest payments) to be made through the clearing systems on behalf of the issuer, rather than by the issuer directly with the holders of securitisation notes issued, thus making the certification process for the purposes of said tax exemption easier and capable of being conducted at international clearing houses, further contributing to the feasibility of the direct issuance of notes by a Portuguese vehicle.

Finally, *Portaria* 1375-A/2003 of 18 December 2003 was enacted, setting out, as required by the Securitisation Law, the specific terms and conditions of the particular transaction, namely the nominal amount of the assigned credits, the initial purchase price, the servicers' remuneration, among others.

5.3 Specific Legal Issues

Given the nature of the assigned credits and the foreseeable impacts of this transaction on Portuguese public opinion and investors, the Portuguese government was keen to issue the securities backed by the assigned tax and social security claims directly out of Portugal. Hence, the STC

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[10] Approved by Decree-Law 219/2001, of 4 August 2001.

structure seemed more appealing, allowing for the direct issuance of securitisation notes by a Portuguese vehicle, whereas the FTC structure would be likely to follow the previously devised structure used in previous securitisation transactions, involving the issuance of said notes by an SPV (as the Portuguese FTC is only allowed to issue securitisation units, an asset-backed security with which the investors are not so familiar and comfortable). However, being the first deal using the STC structure, the Explorer transaction raised a number of important and new legal issues, which had to be addressed from a legal standpoint in order to allow for the successful issuance and placement of the transaction. Additionally, the special and sensitive nature of the assigned portfolio triggered various legal problems concerning the rights of both the taxpayers and the purchaser of the credits. In this context, we outline below three of the major legal difficulties that had to be overcome in order to smoothly launch the transaction.

5.3.1 Taxpayers' Rights and Guarantees

Given the special and sensitive nature of the assets that comprised the securitised portfolio, a crucial issue that had to be dealt with by the players involved in the transaction was to ensure that the taxpayers' constitutional rights and guarantees remained unaffected once the assignment had been conducted, but in no event hindered the true sale nature of such assignment. On the other hand, from the investors' standpoint, it was necessary to ensure that SAGRES, the purchaser of the credits, although a private entity, was given the same sovereign privileges the originators of the securitised credits enjoyed in connection with the enforcement of the respective claims.

These major concerns were addressed by the enactment of the previously mentioned State and Social Security Securitisation Law, which sought to ensure the neutrality of the assignment of the relevant assets with respect to both the qualification of the credits as enjoying the original privileges and to the relevant debtors. Hence, and although expressly establishing that the public credits transferred for securitisation purposes were to be assigned in an irrevocable, effective and complete manner (in order for such assignment to correspond to a true sale of the relevant assets), the State and Social Security Securitisation Law acknowledged that such credits had to fully retain their nature, entitlements, privileges and other ancillary rights (of important note in this respect is the fact that tax and social security credits in Portugal enjoy a special creditors' privilege in terms of ranking and further enjoy the advantage of being collected through special courts, with recourse to special rules of procedure that usually make them faster to be collected). In particular, the taxpayers

and social security debtors could continue to use, against SAGRES, those means of defence (e.g. the right to challenge or to continue to challenge the validity and amount of the claims corresponding to the assigned credits, the rights to invoke counterclaims and set-off) that they would have been able to use against the originators prior to the assignment, in full compliance with the crucial neutrality principle.

On these terms and from the debtors' point of view, the assignment effected between the Republic of Portugal and SAGRES was legally neutral, the latter having no procedural legitimacy to intervene directly or to be called upon to intervene in any administrative or court proceedings relating to the assigned tax and social security claims, commenced either prior to or after such assignment, once the servicing of these claims remained (and remains) necessarily entrusted to the state and the state's collection mechanisms and work force.

Also critical to ensure the neutrality of the assignment for the taxpayers was the need to ensure compliance with the constitutional and legal provisions concerning the tax secrecy. In this respect, the State and Social Security Law established that the assignment of these types of credits for securitisation purposes, as well as its servicing, had to be made in such a way that ensured the confidentiality of the taxpayers' personal data, and prevented the communication of any element that could allow the identification of any taxpayer to the relevant purchaser of the credits. Hence, the credits forming part of the securitised portfolio were identified in a codified form, the corresponding key being deposited with a special department existing within the servicers, and SAGRES never having access to the personal data of the relevant debtors.

Of significant relevance in this context was the already mentioned fact that the servicing of the tax and social security credits was required to be ensured necessarily by the corresponding originators, but with a special system of incentives and requirements aimed at increasing the time and value of the relevant collections. This allowed for the relationship with the taxpayers to actually remain on exactly the same terms, and also kept investors happy. In fact, given that the performance of a transaction of this nature was of great importance to the Portuguese government, and also bearing in mind that the Portuguese government's additional interest in the performance of the transaction once it retains the entitlement to collect all residual value existing through the deferred purchase price mechanism, investors got comfortable with the fact that it was the Portuguese government itself who retained the servicing role, further avoiding potential problems in the structure and stability of the deal that could be raised by having a private entity servicing the tax and social security claims.

5.3.2 *Common Representative of the Noteholders*

Although the Securitisation Law clearly established a strong asset segregation principle for each specific deal and, additionally, a creditors' privilege, to the benefit of the noteholders, over the assets exclusively allocated to a given issuance, a major concern of both the rating agencies and the potential investors was the fact that the Portuguese Law did not recognise the concept of the trust and therefore the use of a trustee for the protection of investors' interests was not possible. Raters and investors were essentially worried that, with the securitisation notes being directly issued out of Portugal by SAGRES, the function of the '*security trustee*' could not be implemented in terms that are widely used in European debt issuances and, in particular, in terms that are similar to those used in other securitisations set up in Portugal, using a securitisation fund (the 'FTC' structure) rather than a securitisation company, where the trust is inserted and incorporated into the transaction structure at the level of the intermediate SPV that acquires the entirety of the securitisation units issued by the Portuguese FTC and then issues the 'final' notes directly to the financial markets.

However, the abovementioned changes in the Securitisation Law which widened the concept of the *common representative* of the noteholders convinced the worried minds that the STC structure did not require the existence of the 'traditional' *security trustee*. We briefly explain below why.

The concept of a common representative of noteholders, whereby a given entity may be appointed to represent the holders of the notes of a given issue, had long existed under Portuguese law but, given its specific features and the limited number of entities that could qualify for such a role, it had only been used in the domestic context and not even broadly. In fact, only law firms, chartered accountants and individuals could perform such a role. Moreover, it was clear that, in the securitisation context, other entities, namely credit institutions, could better perform investors' representation services. Hence, considering that the holders of asset-backed securities are investors familiar with a type of structure where their interests are represented by professional providers of investors' representation services, the direct issuance of asset-backed securities by a Portuguese law-governed entity and their direct placement near investors was just not commercially feasible (even if legally possible and tax efficient) without engaging such a professional provider of investors' representation services.

In light of this difficulty, the Securitisation Law was changed so as to allow for the role of a common representative of holders of securitisation notes to be performed by not only the abovementioned entities but also by credit institutions and, most importantly, by any entity who is authorised

to render investors' representation services within the European Union. As a result, the representation of the holders of notes issued by an STC could be ensured by an entity with whom investors were familiar, being even possible that such an entity, now wearing the hat of a Portuguese law common representative, had in the past performed, or usually performs, the role of trustee. This ended with the scepticism surrounding the STC structure, and made it commercially possible to set up the deal without an intermediary SPV (who would be required to purchase the STC notes and issue notes to noteholders who could be represented by a 'traditional' trustee).

In this context, according to the newly reviewed wording of the Securitisation Law and pursuant to the detailed contractual instruments governing this matter, the common representative was then entitled to perform all the necessary acts and operations in order to ensure the protection of the interests and rights of the noteholders in the context of the deal (which are placed on a privileged position in respect of the assets pertaining to such deal), acting rather like a representative or 'spokesman' of the noteholders.[11] We recall in this respect, nonetheless, that in so far as security interests are concerned, the Securitisation Law provided for a principle of segregation of the assets allocated to each transaction by each STC and had put in place a creditors' privilege protecting the creditors of each series of securitisation notes and placing them at senior ranking level in respect of all such assets exclusively allocated to the relevant transaction.

This proved to be of fundamental importance to the success of the structure chosen to implement the Explorer deal and, ultimately, to attain the objective of issuing the securitisation notes directly out of a Portuguese vehicle, something that corresponded to an understandable goal of the Portuguese government.

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11 Namely, the common representative is entitled to (a) represent the noteholders in respect of all matters arising from the issuance of the notes and to exercise on their behalf their legal or contractual entitlements, on the terms set forth in the relevant agreements; (b) enforce any decision taken by the noteholders' meetings calling for the delivery of an event of default notice declaring the notes capable of being accelerated; (c) represent the noteholders in any judicial proceedings, including in judicial proceedings against SAGRES and, in particular, in the context of any execution proceedings and bankruptcy proceedings commenced against it; (d) provide the noteholders with all the relevant information regarding SAGRES and the issuance of the notes it may become aware of. Additionally, and as a matter of Portuguese law, the common representative would also be entitled to, without incurring any costs, give notice to CMVM of any event that could give rise to the revocation, by CMVM, of the authorisation granted to SAGRES to operate as a credit securitisation company.

5.3.3 *Bankruptcy Remoteness of the STC*

A third major concern of potential investors and rating agencies corresponded to the bankruptcy risks of SAGRES and to the effects thereof in the performance of the latter's obligations under the securitisation notes issued in the context of the Explorer deal. However, clarification of certain aspects of the Securitisation Law showed clearly that SAGRES' bankruptcy was a remote possibility which, in any case, would not prevent the noteholders from establishing and keeping their privileged entitlements to the portfolio of assets. Two main factors contributed to this conclusion.

Under the Securitisation Law, the obligations of an STC under any issuance of securitisation notes are collateralised only by the credits and other assets exclusively allocated to such issuance, i.e. they are of limited recourse to the specific assets collateralising the relevant issuance of notes. This means that collections in respect of credits forming part of the ring-fenced pool of assets allocated to a given issuance of securitisation notes are only available to the general creditors of the STC if and when all the obligations in respect of such issuance of notes have been fully discharged. Moreover, and to render this segregation principle effective, the holders of the securitisation notes issued by the STCs are entitled to a legal creditors' privilege over all the assets that back the respective issuance.

On the other hand, SAGRES' activity, as in general the activity of any STC incorporated in Portugal, may only be financed with equity or through the issuance of securitisation notes, it being expressly forbidden to issue any other kind of debt securities or to otherwise borrow from other entities outside the securitisation transactions it conducts.[12] Accordingly, besides the noteholders and other series' creditors of each issue of securitisation notes, the only creditors SAGRES would have in practice would be the providers of services required for the carrying out of its activity, which are limited in type and number, and other noteholders with respect to each other issue of securitisation notes operating under the ring-fenced, limited recourse concept.

Having regard to the above, it was understood by the parties to the transaction, and in particular by the rating agencies and the market participants in general, that the segregation principle imposed by the Securitisation Law and the related privileged nature of the noteholders'

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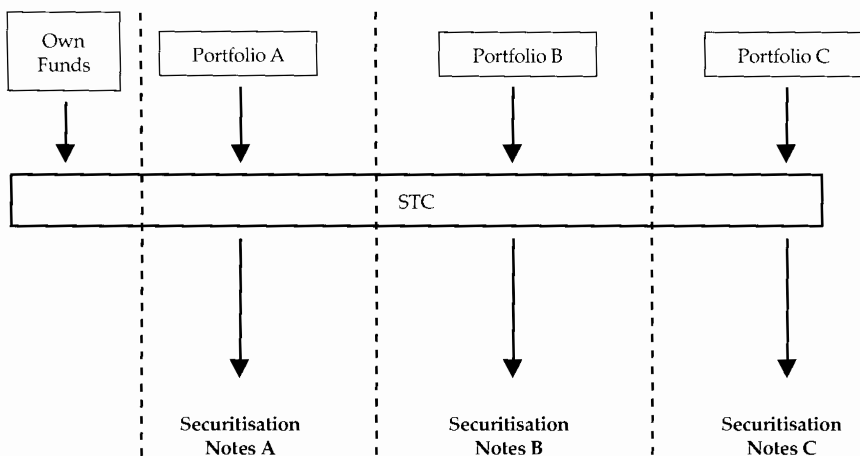
[12] In any event, pursuant to the Securitisation Law, STCs may enter into liquidity loans with third parties to secure liquidity for the purposes of the payment of interest on, and the payment of principal in respect of, the securitisation notes they issue, but these are seen as arrangements contracted inside the pool of assets pertaining to the relevant transaction and inserted therefore on the same ring-fenced, limited recourse concept.

entitlements, on the one hand, together with the own funds requirements and the limited number of general creditors SAGRES will have, on the other, would render the possible bankruptcy of SAGRES an extremely remote possibility, compatible with a maximum rating. Additionally, it was clearly acknowledged that, even in the remote event of SAGRES' bankruptcy, the system of legal rankings and preferences in terms of payments, would not impair the noteholders' rights.

Moreover, the parties to the transaction got additional comfort from the fact that the credits forming part of the securitised portfolio were identified in a codified form, the corresponding key being deposited with the Ministry of Finance, who, in a bankruptcy scenario and in compliance with the Securitisation Law would certainly not allow such assets to be used for the purposes of paying the general debts of SAGRES and would ensure compliance with the legal creditor's privilege provided for in the Securitisation Law.

STC – Legal Segregation Principle



5.3.4 The Rating Approach

As in private sector securitisations, the rating process of the Explorer securitisation notes assumed a crucial importance in the setting up of the transaction. Yet naturally, given the special nature of this deal and following what had already happened in other public sector securitisations

carried out in Europe, the rating methodology focused on specific features that were contemplated in the transaction structure and that were crucial to its stability and consistency, on top of the requirements that were already common in private sector securitisations. As to the legal structure of the deal, two issues were of major importance in order to ensure the triple-A rating of the two largest tranches of the Explorer securitisation notes, worth EUR 629 million and EUR 546 million each.

The first regarded the credit enhancement mechanisms that were put in place, and that contemplated both a significant over-collateralisation and a deferred purchase price. Briefly described, the structure of the deal involved the acquisition of a EUR 11.95 billion portfolio of credits in arrears according to an initial purchase price corresponding to the proceeds of the issuance of the Explorer securitisation notes, globally worth EUR 1.765 billion.

Additionally, the relevant transaction documents established that, once all the amounts due under the referred issuance, together with all the transaction costs and expenses, have been paid and discharged in full, all the excess amounts resulting from the enforcement of the assigned claims or otherwise recovered in connection therewith shall be returned to the Portuguese government as deferred purchase price (i.e. as a second instalment of the purchase price at the end of the transaction).

These mechanisms, plus the EUR 100 million liquidity facility that was also created to the benefit of SAGRES and also forming part of the isolated pool of assets corresponding to this transaction, ensured the necessary credit enhancement and liquidity structure needed to obtain the envisaged rating.

The other relevant issue had to do with the assessment of the servicing of the assigned claims and with the procedures relating to the continuation of the enforcement thereof. Here, and as already referred to, the rating agencies got crucial comfort from the fact that the servicing would necessarily be retained by existing public sector servicers and, in particular, from the fact that the authority entitlements and administrative prerogatives relating to the enforcement procedures – and that already existed pursuant to Portuguese tax procedural laws – would in any case also be kept after the assignment of the claims was conducted. Another of the rating agencies' concerns was to obtain detailed and insight information regarding the relevant enforcement and collection procedures, so as to assess the probabilities and time frames of the recoveries relating to the assigned tax and social security claims. Once these issues were properly dealt with in the context of the relevant transaction documents, the rating agencies accepted the servicing structure proposed for the deal.

Finally, we would further stress that the rating agencies gave significant credit to the fact that the assigned portfolio showed reliable historical data, with consistent recovery rates, matters which, from a factual viewpoint, are certainly of importance in any other context where securitisation (be it public or private) is an option to consider.

6. FINAL REMARKS: PUBLIC SECTOR SECURITISATION IN THE FUTURE

The diversification of securitised asset types, the implementation and success of new and innovative legal structures and the promising results achieved by public sector securitisation show that securitisation can indeed serve as a powerful financial tool, suitable to attain not only budgetary or purely financial goals, but also to help governments in implementing social and economic policies on a wider basis.

Indeed, provided the reliability of the cash flows produced by the securitised assets is ensured – through a proper selection of the eligible assets, a comprehensive due diligence (both legal and economic), a thorough assessment of the relevant historical data produced by the relevant assets and a close monitoring of the performance of the transaction – we firmly believe public sector securitisation will become a 'fashionable' financial instrument in Europe, where close control of state budgetary deficits certainly is – and will in the next years certainly continue to be – a priority. Moreover, the legal harmonisation carried out at the European Union level – particularly with respect to the accountancy treatment of these deals, and to the relevant banking and financial regulations – can also be said to have created the grounds for the solid and sustainable evolution of the public sector securitisation market in the 'old continent'.

With the stage set the way it is, securitisation transactions sponsored by states and public entities are likely to increase in the next years, and the range of assets used in such context also likely to widen. Tax, social security, bilateral debts existing among states and other established cashflows having significant volumes and medium to long-term tenures (or having the ability for revolving structures to be implemented) are certainly among the list of possible asset classes to be considered whenever governments are short of cash (aren't they always?).

Additionally, following the previous Italian deals involving property-related assets that are occupied by the state and other public entities, we believe real estate assets owned by the states are in the frontline to be monetised through securitisation transactions. Indeed, our prediction is that the number of transactions securitising state-owned real estate is likely to grow, involving the sale and lease back of the relevant proper-

ties (such as public services buildings, other office buildings occupied by governmental departments and even national monuments), and then the issuance of debt securities backed by the cashflows produced by the rents paid by the public entities for the use of the sold property or by other types of revenue.

Who knows if one of these days governments will securitise the revenues of their cultural heritage and patrimony? Maybe we should not be surprised if that actually happens in Europe and elsewhere.