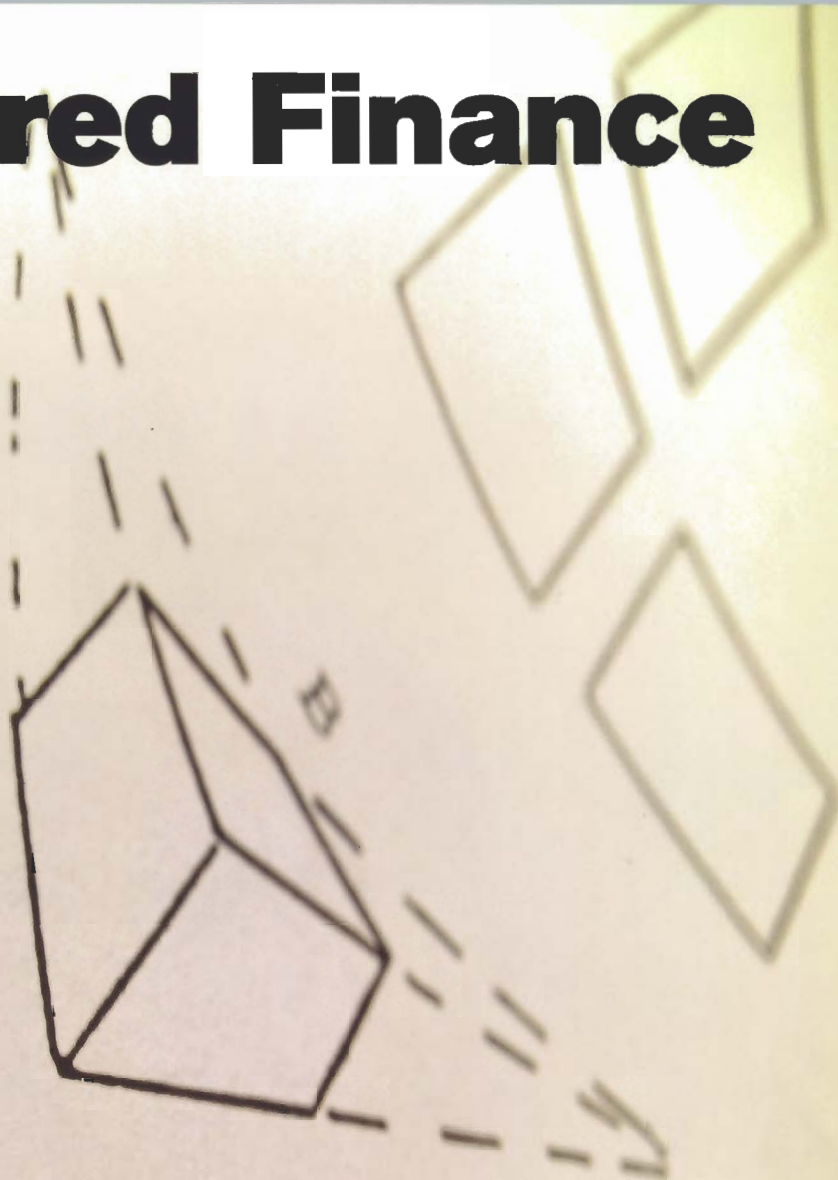


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Portugal ready to embrace new asset classes

The securitization of more diverse asset classes is yet to become reality in Portugal, despite changes in the law that make new types of deals possible.

By Paula Gomes Freire and André Figueiredo of Vieira de Almeida

The legal framework for securitization in Portugal has reached maturity over the past few years and now provides the necessary legal tools to promote and enhance the diversification of asset classes by Portuguese originators.

Some asset classes that are popular in other European countries and elsewhere are yet to be securitized in Portugal despite features of the Portuguese Securitization Law that enable originators to overcome the problems that have held such deals back.

Banking and financial assets

Banking-originated assets continue to dominate securitization issuances out of Portugal. This is not a special feature of the Portuguese securitization market (quite the contrary) but it is an unquestionable market trend in Portugal, which the past year has again confirmed.

However, even within the category of banking and financial assets, diversification is still not as much as it could be a reality. Indeed, what might be called the *classic* banking assets continue to predominate: retail mortgage-backed securities (RMBS) account for almost all asset-backed issuances in the past year, and small and medium-sized enterprise (SME) and consumer loans account for the rest.

Other banking and financial receivables are yet to be monetized. However, the same reasons that have led Portuguese banks to securitize classic banking assets (off-balance-sheet treatment, low cost financing, transfer of risk into the capital markets, access to a broader investor base) also apply to these new asset types yet to be securitized.

Collateralized debt obligations (CDOs) are one example. In Europe, these structures have grown and become established in the past few years, mainly because investors have become more comfortable with the legal structures they

use. The last revision of the Portuguese Securitization Law cleared the way for securitization deals involving these types of assets. Hence the opportunity exists, at least from a legal perspective, for banks to dispense with certain portfolios of loans and bonds from their balance sheet in exchange for financing at low cost.

Commercial mortgage-backed securities (CMBS) form another asset class with securitization potential in the Portuguese market. Bearing clear similarities with the (already well known) RMBS transactions, CMBS deals have been the focus of limited attention so far. However, that does not seem to be the case in Europe, where CMBS have accounted, in the previous year, for more than 10% of all mortgage-backed securitizations. It seems probable that this increase in CMBS structures will occur also in Portugal. The rising value of commercial properties because of current interest rates helps make the product attractive to investors. At the same time, the experience that the Portuguese market has acquired with RMBS deals will assist the implementation of CMBS structures in Portugal.

A third area of potential growth is credit card securitization. Despite being hugely popular in Europe and in the US, the securitization of credit card receivables is yet to be tried in Portugal as a financing source for banks and other financial companies. The short maturity of this category of receivables and the consequences of that for the size of portfolios, are usually pointed to as the reasons why credit card receivables have not yet been securitized.

But the current legal framework will

allow, and indeed will help, originators find ways around these difficulties. The Portuguese Securitization Law has a number of features that may be used in this specific context. For example, the Law clearly allows the acquisition of new credits from time to time, with or without issuance of new securities. But structures that use a revolving mechanism have been scarce. It is possible that the benefits of securitizing credit card receivables will change this trend.

Future flows

Outside the banking and financial asset classes there also is much room for growth in the market in the area of corporate securitization. In this area, (due to the specifics of corporate securitizations, namely the volume and maturity of the receivables) arrangers and originators will probably focus on deals backed by future cash flows. By doing so they aim to avoid the risks that non-banking assets securitizations usually trigger.

The Portuguese Securitization Law allows the structuring of future cash flow securitizations in a smooth, successful way. For this purpose, the Portuguese Securitization Law establishes two eligibility criteria: to be eligible to be included in a securitized portfolio, future cash flows must: (i) result from an existing, ongoing relationship, and (ii) be quantifiable or determinable.

The existence of an ongoing relationship that produces the relevant

cash flow is clear in those cases where we find a specific contract between the originator and the debtor or debtors that serves as the source of the future receivables to be securitized. This type of asset will be commonly

found in activities based on long-term contracts, such as those for the supply of water, electricity, natural gas, telecommunications services, mobile phones, cable television and so on.

However, in the view of the authors, the Portuguese Securitization Law allows securitization even when there is no specific contract between the originator and debtors. This is the case where, for example, there is a *cliente relationship* that due to its solid and consistent nature

Banking-originated assets continue to dominate securitization issuances out of Portugal

Author biographies



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Paula Gomes Freire is a senior associate specializing in banking and financial law who has joined Vieira de Almeida & Associados in 1996. Since then she has been involved in the preparation and execution of most of the firm's securitization transactions, since the establishment of the first Portuguese transactions in the late 1990s, and other structured finance transactions.

Paula has a law degree from the University of Lisbon, Faculty of Law and a post-graduate degree in English commercial law from the University of London, College of Law. Paula is admitted to the Portuguese Bar Association and the Law Society of England and Wales (non-practising). She speaks Portuguese, English, French and Spanish.



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André Figueiredo joined Vieira de Almeida & Associados in 2001 and forms part of the firm's banking and finance team. He has been involved in the preparation and execution of several of the firm's securitization transactions, as well as in the incorporation process of various Portuguese securitization vehicles and follows the drafting and negotiation of the contractual documentation of the most relevant structured finance transactions in which the firm has been involved.

André has a law degree and a post-graduate degree in securities law from the University of Lisbon, Faculty of Law. In 2004, André graduated from the New York University School of Law LLM – masters of law program in corporation law. André is admitted to the Portuguese Bar Association. He speaks Portuguese, English and Spanish.

will produce, over time and under reliable conditions, the future cash flows to be securitized. In these cases, the authors believe the requirement set forth in the Portuguese Securitization Law is also met. Accordingly, future cash flows arising from a wide range of business come into play: supermarket and other retail business, ticket proceeds from movies and theatres, as well as from museums and monuments; football club ticket and merchandizing receivables; restaurants and pubs, and so on.

It is possible to go a step further in the interpretation of the law and consider that this legal requirement may also be met in cases where the ongoing legal relationship from which the future cash flows arise is not established between originator and debtor, but instead between originator and a third party. This would be the case, for example, where the third party is the Portuguese state, and where there is an ongoing legal relationship between the state and the originators, based on concessions, licenses, authorizations or other administrative entitlements, from which the future cash flows will then arise. This interpretation of the law will thus allow for the securitization of a number of

future credits and revenues, originated by toll roads, transportation, car-parking and ferry and port operations.

As to the second legal requirement (that is, that future cash flows are quantifiable), this raises few legal doubts or difficulties. Hence, without prejudice to the need to ensure rigorous modelling and calculation of the future cash flows, this legal requirement should not be seen as an obstacle to the setting up of transaction using this kind of assets. To ensure this legal requirement is met, arrangers must use objective and reliable tools and financial models, which ensure adequate forecast of the volume of the future cash flows that are to be securitized. The growing resources of historical data, market analysis and monitoring of performance of corporate entities, together with an adequate level of disclosure of the methodologies used, will help make this task easier.

Finally, the securitization of future cash flows is of particular importance for the financing of Portuguese public utilities, one of the areas where opportunities may arise in future. The requirements seem to all be in place: steady and predictable cash-flows, significant volume, and originators in need of lower cost of

borrowing to face their investment needs. Hence, securitization of future cash flows may serve as an important tool to ensure a lower overall cost of borrowing and thus to reduce the relevant utility's costs, to the benefit of consumers.

Public sector deals

Securitization is also an attractive tool for public sector entities wishing to access diversified sources of funding. Securitization provides the opportunity to raise funds, while ensuring (provided certain circumstances are met) off-balance sheet accounting treatment for the purpose of debt and deficit calculation, which is now subject to constraints. Securitization thus enables public sector entities to reduce their debt burden, by monetizing a wide range of assets, so that the corresponding proceeds are treated as budgetary revenues and thus used to reduce both public debt and budget deficit.

A further benefit, particularly relating to types of assets such as real estate and equipment, is that securitization can enhance efficiency, by introducing market pressure into the management of the securitized assets or by imposing the engagement of specialized servicers, who will operate the assets according to more efficient standards, and thus rationalize and improve their revenues.

The legal framework now in force (in particular the specific rules applying to the public sector) provides an attractive and flexible basis for setting up new transactions involving public sector assets, particularly in times where the control of state budgetary deficits is and will continue to be a priority.

Portfolio size

Despite these areas of potential growth, a number of difficulties have stalled progress on some types of deal in the Portuguese market until now. One such problem usually raised when originators, banks and lawyers come up with ideas for securitizing new asset classes is that of the volume of portfolios. Other than the possibilities created by the securitization of future cash flows, there are a number of features in the Portuguese Securitization Law that may help in building up portfolios that are big enough to ensure reliable and profitable deals.

To begin with, the inclusion of overdue credits in securitized portfolios is no longer prevented in Portugal. After

lobbying from market participants, the Portuguese legislator removed this legal constraint, which was in place when the Portuguese Securitization Law was first enacted.

This is clearly a sign of the maturity of the Portuguese securitization market because it shows that market participants are able to assess the quality of the credits forming portfolios and thus to assess the underlying risk. For certain types of credits this may allow bigger portfolios. The fact that the legal instruments that are normally used to address this additional risk factor (such as liquidity facilities or hedging arrangements) are well known and tested in the securitization context, ensures that the inclusion of a portion of overdue credits will not necessarily prevent the setting up of the structure.

The creation of portfolios with different types or categories of assets owned by one originator is also possible. There is no legal obstacle to pursuing this route, as the Portuguese Securitization Law makes an express reference to the possibility of a securitized portfolio including more than one type or category of assets.

This alternative could be useful in the case of originators with different types of activities or business, where one asset type only would be too little to set up a profitable deal. In these cases, whole business securitizations, with portfolios made up of different credits, with different kinds of collateral or having different types of debtors, should therefore be considered. Also, this possibility of selecting different categories

of securitized assets could even be combined with the issuance of different categories of securities (securitization notes or units) something that is also expressly allowed by the Portuguese Securitization Law.

Setting up securitization transactions with more than one originator is also possible. Although, from a legal perspective, this alternative is straightforward (with no obstacles being posed by the Portuguese Securitization Law) the truth is that it has not been frequently considered, despite providing a sound means for corporate entities to set up a financing structure at a lower cost.

Debtors' notification

One final legal feature that often raises issues when setting up securitization transactions is the need to notify the relevant debtors for the assignment of the assets to be effective. Under the Portuguese Securitization Law, when the

assignor is the Portuguese state, a credit institution or financial company, the assignment of the assets to be securitized regardless of notification, is effective towards the debtors when it becomes effective between the

originator and the purchaser. However, the general rule remains applicable to all other types of originators, namely to corporate entities, with notification of the relevant debtors still being required.

Needless to say, the existence of these two different legal rules has posed an obstacle to corporate securitization. This is due essentially to the additional risk the structure of the transaction would bear, as a result of the assignment of the collateral not being perfected, such

additional risk having a direct impact on the overall cost.

However, since the last revision of the Portuguese Securitization Law, it is now possible for all kinds of originators to apply to the Portuguese Securities Commission (CMVM) for a notification exemption. This has been a crucial innovation of the Portuguese securitization framework. In particular, this legal feature may help overcome the difficulties raised by future cash flows where notification might be virtually impossible.

Innovation

Many of the ideas, structures and asset classes identified here will not always be easy to undertake, due to the size of the Portuguese market, the volume of the relevant portfolios and legal constraints existing outside the securitization framework.

Nonetheless it is vital to put ideas such as these forward, even those that seem to be more ambitious for a market such as Portugal. Only by examining the new structures and new asset types being securitized elsewhere in Europe will it be possible to help the Portuguese securitization market keep the characteristics for which it is known: a small but highly inventive, creative and, of course, profitable market. In this case it is only fair to say that Portugal and its market have done well up till now and that they are more than ready for future, and greater challenges.

The Portuguese Securitization Law allows securitization even when there is no specific contract between the originator and debtors

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