

PORTUGUESE SECURITISATION MARKET: DIVERSIFICATION OF ASSET CLASSES AND LEGAL CONTEXT

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I. INTRODUCTION

In this article, we purport to show how the Portuguese securitisation legal framework currently in force, having reached its maturity stage over the last few years, provides for the necessary legal tools which we believe are necessary to promote and enhance the diversification of asset classes used for securitisation purposes by Portuguese originators.

For this purpose, we will divide the article into two different parts. We will first look into certain categories of asset classes, and try to draw attention to those which, despite being popular in other European countries and elsewhere, are yet to be securitised in Portugal. In the second part, we will go through certain useful legal features contemplated in the Portuguese Securitisation Law¹, which we believe have not yet been totally taken advantage of and considered by originators and arrangers when setting up securitisation transactions involving new asset categories, particularly when size and volume are a problem.

¹ 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*; “The Portuguese Securitisation Market”, in

II. DIVERSIFYING SECURITISED ASSETS

Banking / Financial Assets

Starting off with the overview of some of the asset classes still to be used in Portugal for securitisation purposes (at least in a consistent way), we should first take a look at banking and financial assets, and try to understand whether everything has already been done in this area or whether, instead, there is still room for innovation.

Banking originated assets continue to dominate in an overwhelming fashion securitisation issuances out of Portugal. This is naturally not a special feature of the Portuguese securitisation market – quite on the contrary – but it is an unquestionable market trend in Portugal, which the last year has again confirmed.

However, even within the category of banking and financial assets, diversification is quite not yet a reality. Indeed, we continue to see a predominance of what we could already call the “*classic*” banking assets, with the RMBS accounting for almost the totality of asset backed issuances in the last year, and SME and consumer loans accounting for the rest.

This shows that there are other banking and financial receivables out there ready to be monetised and in respect of which the reasons that make the *classic* banking assets attractive and which have lead the majority of Portuguese banks to pursue the securitisation route – off balance sheet, low cost financing, transfer of risk into the capital markets, access to a broader investor base – also apply when we look into these new, yet to be securitised asset types.

One of the examples that deserves a reference are CDOs transactions. In Europe, these structures have built a substantial growth and stabilisation in the past years, mainly due to the fact that investors have become more comfortable with the legal structures being implemented. Moreover, since the last revision of the Portuguese Securitisation Law, which recognized the innovation of the international capital markets in respect of these CDOs transactions, the legal path has been opened for the setting up in Portugal of securitisation deals involving these types of assets. Hence, we believe the opportunity is there, at least from a legal perspective, for banks to relief their balance sheet of unwanted portfolios of notes and bonds, enhancing their own funds and in exchange for financing at low cost.

Another asset class with securitisation potential in the Portuguese market are CMBS. Bearing clear similarities with the (already well known) RMBS transactions, CMBS deals have deserved little attention insofar as its securitisation potential is concerned. However, that does not seem to be the case in Europe, where CMBS have accounted, in the previous year, for more than 10% of the mortgage backed securitisations in Europe. The question is therefore whether or not this increase in CMBS structures will also occur in Portugal. The current context, with the commercial properties recovering and appreciating in the favourable interest rate environment, clearly helps making this product attractive to investors. Moreover, the synergies that may result from importing the vast experience the Portuguese market has acquired with RMBS deals may add value to the implementation of CMBS structures in Portugal. That is why we believe the near future may show us developments also in this area

And finally, credit card securitisation. Hugely popular in Europe and in the US, securitisation of credit card receivables is yet to be tried in

Portugal as a financing source for banks and other financial companies specialized in this type of banking activity. The short maturity of this category of receivables, and the consequence that that may have on the size of portfolios, are usually pointed out to justify why credit card receivables have not yet been used for securitisation purposes. In any event, we believe that imagination may play a role here in setting up structures having the adequate features that will allow us to mitigate the problems usually raised in this respect. Moreover, we believe that the current legal framework allows, and even helps, the implementation of such inventive solutions. Indeed, we believe the Portuguese Securitisation Law provides for a number of legal features which may be used in this specific context. In particular, structures set up according to a revolving mechanism may be the beginning of the solution for this type of assets. Although expressly provided for in the law and having a somehow clear and predetermined legal regime, this legal mechanism – which will allow the acquisition of new credits from time to time, with or without issuance of new securities - has been scarcely used by Portuguese originators. Maybe credit card receivables will be the most adequate assets to change this trend.

Non-banking assets: the turn of future cash-flows

An article on diversification of assets, in order to really touch the point, must however move outside the banking and financial asset classes and focus on corporate securitisation. That is where, we believe, the room to grow and innovate clearly is.

In this context, and due to the specifics of corporate securitisations – namely volume and maturity of the receivables – the solution, in the eyes of arrangers and originators, seems often to be that of future cash-

flows, probably the most adequate means to address the risks that non-banking assets securitisations usually trigger.

Hence, and although future cash-flows are not the only solution for corporate securitisations, our goal in the following pages is to briefly go through the Portuguese legal requirements applicable to the securitisation of future cash-flows, and thus to try to demystify this concept as a feasible and reliable tool for setting up corporate securitisations, particularly when, again, size is a problem.

In a nutshell, it is our opinion that the Portuguese Securitisation Law allows the structuring of future cash-flows securitisations in a smooth, successful way. For this purpose, the Portuguese Securitisation Law establishes two eligibility criteria: in order to be eligible to be included in a securitised portfolio, future cash-flows must (i) result from an existing, ongoing relationship and (ii) be quantifiable or determinable.

As to the first requirement - the existence of an ongoing relationship which produces the relevant cash flow - no doubts exist in those cases where we find a specific contract between the originator and the debtor or debtors which serves as the source of the future receivables to be securitised are. 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 TV, etc. This is thus, we believe, one first example of future cash-flows which already gives a good idea of the broad reality this legal solution may reach out to.

However, in our view, the Portuguese Securitisation Law allows us to go a bit further, and to look into other cases with securitisation potential, even where we find no specific contract entered into between the originator and debtors. Indeed, bearing in mind the applicable legal regime and the underlying rationale, there is one other situation where we

believe future cash-flows should be considered eligible for securitisation purposes. This is where, in spite of the absence of a specific, long lasting contract between (future) creditor and (future) debtor, there is however a relationship which we can qualify as a *clientele relationship* and which, due to its solid and consistent nature, will produce, overtime and under reliable conditions, the future cash-flows to be securitised. In these cases where the referred *clientele relationship* is strong and consistent enough to ensure a safe and reliable production of the future cash-flows, we believe that the requirement set forth in the Portuguese Securitisation Law is also met. Accordingly, future cash-flows arising from a wide range of businesses come suddenly into play: supermarket and other retail business, ticket box proceeds from movies and theatres, as well as from museums and monuments; football club ticket and merchandising receivables; restaurants and pubs, etc. The sky (and fees) are the limit.

Furthermore, we trust it is possible to go a step forward in the interpretation of the law and consider that this legal requirement may also be met in the cases where the ongoing legal relationship from which the future cash-flows will arise is not established between originator and debtor, but instead between originator and a third party, provided such relationship, in light of its specific scope and characteristics, allows for the safe and reliable production of the future cash-flows to be securitised. This will namely be the case where such third party is the Portuguese State, and where we find an ongoing legal relationship established between the State and the originators, based on concessions, licenses, authorizations or other administrative entitlements, from where the future cash-flows will then arise. This interpretation of the law will thus allow for the securitisation of a number of future credits and revenues, originated by toll roads, transportation, car-parking and ferry and port operations.

As to the other legal requirement we have mentioned (i.e. that future cash-flows are quantifiable), we believe it does not raise significant legal doubts or difficulties. Maybe this requirement will burn somebody's brain, but we believe – and hope – not that of lawyers. Hence, without prejudice to the need to ensure a very rigorous modelling and calculation of the future cash-flows, this legal requirement shall not be seen as an obstacle to the setting up of transaction using this kind of assets. All we believe is necessary, in order to ensure this legal requirement is met, is for arrangers to use objective and reliable tools and financial models, which ensure adequate forecast of the volume of the future cash-flows that are to be securitised. In any case, 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 surely make life easier in this respect.

Finally, insofar as future cash-flows are concerned, we would like to mention its particular importance for the financing of Portuguese public utilities, one of the areas where we anticipate opportunities may arise for securitisation of future cash-flows. The requirements are all there: steady and predictable cash-flows, significant volume, and originators in need of lower cost of borrowing to face their investment needs. Hence, securitisation of future cash-flows may serve as an important tool in order to ensure lower overall cost of borrowing and thus to reduce the relevant utility's costs, to the benefit of consumers.

Public Sector

Finally, we believe that an overview of diversified assets that may be used for securitisation purposes must also include – in particular in

public deficit oriented times – a reference to securitisation of public sector assets.

Indeed, already widely used by private entities, asset securitisation seems also to be an attractive tool for public sector entities wishing to access diversified sources of funds. This derives essentially from the fact that securitisation provides 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, now subject to serious constraints. Securitisation may thus enable public sector entities to reduce their overall public debt burden, by monetising a wide range of assets, the proceeds of which being treated as budgetary revenues and thus used to reduce both public debt and budget deficit.

Moreover, other relevant advantages of public sector securitisation can be highlighted. One we believe should be particularly stressed, at least concerning certain types of assets (such as real estate and equipments), is the fact that securitisation can work as an efficiency enhancing tool, by introducing market pressure in the management of the securitised assets or by imposing the engagement of specialised servicers, who will run such assets according to more efficient standards, and thus rationalize and improving their revenues.

In this context, the message we believe is important to retain is that the legal framework currently in force (in particular the specific rules applying to the public sector) provides for an attractive and flexible ground for the setting up new transactions involving public sector assets. In particular where control of state budgetary deficits certainly is – and will in the next years certainly continue to be – a priority².

III. WHEN SIZE (AND VOLUME) MATTERS

One of the problems that is usually raised when originators, banks and, why not, lawyers come up with ideas for securitising new asset classes is that of volume of portfolios. Other than the possibilities raised by the securitisation of future cash-flows, we believe there are a number of features in the Portuguese Securitisation Law which may provide useful help in building up portfolios that are big enough (to pay everybody's fees and also) to ensure reliable and profitable deals. Let us then go through some of those legal features, highlighting their advantages and showing how they can contribute to the diversification trend the Portuguese market is clearly envisaging.

Overdue Credits

One of the points which we believe is noteworthy relates to the fact that overdue credits are no longer prevented from being included in securitised portfolios. In fact, following the position of the majority of the market players, the Portuguese legislator has removed this legal constraint that was in place when the Portuguese Securitisation Law was first enacted, thus allowing the inclusion of overdue credits in portfolios for securitisation.

Our perspective is that this is clearly a sign of the maturity of the Portuguese securitisation market as it shows that market participants are able to assess the quality of the credits forming part of the portfolios and thus to assess the underlying risk. This thus means that the legal obstacle that prevented overdue credits from being securitised is no longer in

² For a more in depth view of public sector securitisation, see by the authors: "Public Sector Securitisation in Europe", in *Securitisation of Derivatives and Alternative Asset Classes – Yearbook*

place. We believe that, for certain types of credits this may be important by allowing greater sizes of portfolios. Moreover, the fact that the legal instruments that are normally used in order to address this additional risk factor – such as the liquidity facilities or hedging arrangements – are well known and tested in the securitisation context, ensures that the inclusion of a portion of overdue credits will not necessarily prevent the setting up of the structure.

Different categories of receivables in one portfolio

One other alternative that we believe should not be overlooked when identifying portfolios of assets with securitisation potential is the possibility of creating portfolios with different types or categories of assets, owned by one same originator. Indeed, as a general rule, there is no legal obstacle to pursuing this route, as the Portuguese Securitisation Law makes an express reference to the possibility having a securitised portfolio including more than one type or category of assets.

We believe this alternative could be useful in the case of originators with different types of activities or business, and where one asset type only would not be enough to set up a profitable deal. In these cases, whole business securitisations, 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 securitised assets could even be combined with the issuance of different categories of securities – securitisation notes or units – something that is also expressly allowed by the Portuguese Securitisation Law.

Multiple originators

Also when size is a problem, one can also consider the possibility of setting up securitisation transactions with more than one originator. Although, from a legal perspective, this alternative is rather straightforward, no significant obstacles being posed by the Portuguese Securitisation Law, the truth is that it has not been frequently considered, despite providing – we believe – for a sound alternative for corporate entities to set up a financing structure at a lower cost.

Debtors' notification

One legal issue that often raises issues when setting up securitisation transactions is that of the need to notify the relevant debtors for the assignment of the assets to be effective. In this respect, the Portuguese Securitisation Law has provided for a special regime whereby regardless of notification, when the assignor is the Portuguese State, a credit institution or financial company, the assignment of the assets to be securitised 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 the setting up securitisation transaction by corporate entities, which do not benefit from the special exemption. 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 Securitisation Law, it is now possible for all kinds of originators – namely corporate entities - to apply to the Portuguese Securities Commission (“CMVM”) for a notification exemption. This has been, we believe, a crucial innovation of the Portuguese securitisation framework as it removes an additional obstacle for corporate securitisations, thus providing additional incentives for the setting up this kind of deals. In particular, this legal feature, being dependent upon CMVM’s approval, may help overcome the virtually unsolvable problems that are raised by some types of assets in what relates with the necessary notification, namely when involving future cash-flows. How would car drivers or theatre attendants be notified of the assignment of the (futures) cash-flows?

IV. FINAL REMARKS

We are aware that many of the ideas, structures and asset classes we have identified will not always be easy to undertake and pursue, due to all kinds of factors: the size of the Portuguese market, the volume of the relevant portfolios, legal constraints outside the securitisation framework, etc.

We have nonetheless decided to be deliberately provocative, and to put all these ideas forward, even those that seem to be more far stretched for a market such as ours. We have, in any case, done that in a conscious way, as we firmly believe that that is the best way in which we can contribute to the innovation and growth trends of the Portuguese securitisation market. Only if we look at what is going on out there, to what new structures are being set up, to which new asset types are being securitised, will we be able to help the Portuguese securitisation market keep the characteristics for which it is known Europe wide: although a

small market, an highly inventive, creative and, of course, profitable
European securitisation forum.