The fears of a sovereign debt crisis in the euro zone and the role of structured finance

By Paula Gomes Freire and Benedita Aires, Vieira de Almeida & Associados, Sociedade de Advogados, RL

During the turmoil of 2008-09, banks in Portugal performed better than most in the rich world. Smaller investment banking operations, lower leverage and more stable funding allowed fewer losses. However, the current market conditions, S&P's downgrading of the Portuguese Republic and the fears of a sovereign debt crisis in the euro zone have again placed the Portuguese banking sector in a state of alert. Balancing the right sources of funding, accessing liquidity and paying the right price seems to be the challenge for 2010.

The serious challenge 2010 brings into Portugal for the banking sector is certainly that of a continued access to funding and liquidity, particularly following S&P's downgrading of the Portuguese Republic and, consequently, major Portuguese banks. The role played by structured finance in this context is crucial and from our perspective has been paramount, as securitisation and covered bonds have actually remained, in the current context, as the only serious and acceptable-price alternative funding sources.

Insofar as securitisation is concerned the specific Portuguese feature is very much rating related. It is important to bear in mind that securitisation (and also covered bonds) has been the only way of issuing AAA instruments out of A rated jurisdiction such as Portugal. This means that albeit the absence of a market out there, securitisation has very much constituted the best access to liquidity route for the Portuguese banks, allowing them to issue ECB repo eligible instruments and thereby obtain the required funding. That is probably the reason why, in the particular case of Portugal, we have continued to witness a consistent and regular recourse to securitisation, the number of transactions and volume of assets securitised remaining at pre-summer-2007 levels.

This is particularly true for 2010 where at least 10 transactions have been mandated during the first semester when the maximum number of deals in any given year of Portuguese securitisation has never exceeded 14. Asset- wise, although residential mortgages have continued to feed the pipeline of Portuguese securitisation deals, the trend in 2010 is indeed that of leases and SMEs, something that from a legal perspective has required some innovation in terms of applicable structures, particularly to accommodate short term revolving credit lines.

Considering that 100% of the transactions are aimed at generating assets that are eligible as collateral for ECB repo transactions a reference must also be made to the latest ECB requirements of asset-backed securities eligibility.

In April 2010, the Governing Council of the ECB has announced that the preparatory work for the establishment of loan-by-loan information requirements for asset-backed securities in the Eurosystem collateral framework will begin immediately and should be completed by September 2010. It is said that the ECB will address further the loan-level information requirements, as well as the technical implementation aspects and that market participants would have 12 months before the obligation to submit loan-level ABS information comes into force. This is something that Portuguese originators should easily be able to comply with as such loan-by-loan information requirements have already been somewhat implemented and required to be followed by the Portuguese Securities Commission.

In this particular environment, of important notice is also the fact that, as announced in November 2009 as a contribution to restoring the proper functioning of the asset-backed securities market, the Governing Council of the ECB has decided to amend the rating requirements for asset-backed securities to be eligible for use in Eurosystem credit operations.

The Eurosystem will require at least two ratings from an accepted external credit assessment institution for all asset-backed securities issued as of March 1, 2010. In determining the eligibility of these asset-backed securities, the Eurosystem will apply the "second-best" rule, meaning that not only the best, but also the second-best available rating must comply with the minimum threshold applicable to ABSs (i.e. AAA). As of March 1, 2011, the second-best rule and the requirement to have at least two ratings will be applied to all ABSs, regardless of their date of issue.

While these new criteria certainly ensure that the Eurosystem's requirement of high credit standards for all eligible collateral is met, it certainly imposes on Portuguese securitisation transactions an additional challenge, particularly when this comes together with a downgrading of the Portuguese Republic.

A lot of what has been said so far is also very much true in respect of covered bonds and public sector bonds, namely in what concerns the ability of Portuguese banks to continue to raise funds through this type of instrument.

In fact, over the past 12 months, the generality of Portuguese banks have used their covered bond programmes to access the market and a special highlight may go to public sector bonds as these have also been put in place. Portuguese public sector bonds provide for a collateralisation percentage of not less that 100% and are collateralised by credit assets over central administrations, regional or local authorities of any EU Member State and by receivables secured by an express and legally binding guarantee issued by any of such central administrations, regional or local authorities of any EU Member State, together with other assets not exceeding 20% of the portfolio that may also be included, such as deposits with the Bank of Portugal in cash or securities and deposits with credit institutions.

In any event it should be borne in mind that we are still to witness the impact of the closing down of the ECB programme for the purchase of private debt in order to increase market liquidity - Covered Bonds Acquisition Programme (according to which the ECB may purchase European covered bonds or public sector bonds with at least AA rating and which are Eurosystem eligible, in the primary or secondary markets, up to a maximum volume of €60,000,000,000) – by the end of June 2010.

Overall the financial market turmoil has created a number of serious challenges to the market players worldwide, namely in what concerns access to the right sources of funding and to liquidity.

This search for feasible alternatives to raise liquidity is also strongly felt in the Portuguese market. Portuguese banks are, in this sense, using the possible alternative mechanisms and structures to find a manner of funding their activities and there is no doubt that securitisation and covered bonds (in the particular context of the solutions presented by the European Central Bank) have proved to be the available tools.

This article was written by Paula Gomes Freire and Benedita Aires of Vieira de Almeida & Associados, Sociedade de Advogados, RL,
Avenida Duarte Pacheco, 26, 1070-110 Lisbon, Portugal.
Tel: +351 21 311 3479, +351 21 311 3447, Fax: +351 21 352 2239,
Email: pgf@vda.pt, bla@vda.pt, Web: www.vda.pt