Transparency, liquidity, enforcement in the Portuguese covered bonds market

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Banks in Portugal continued under the pressure of the sovereign debt crisis of the European Union peripherical Member States during 2011, with the Portuguese economy facing structural challenges in light of the financial conditions of the Portuguese sovereign.

Sovereign risk and covered bond markets

In global terms, the risks inherent to the Portuguese banking system are significantly higher than the corresponding historical references and the interaction between sovereign risk and the financial system affects a wide range of countries, revealing the systemic nature of the crisis. In this context of increased volatility and uncertainty and the remaining doubts in respect of the mechanisms for resolving the sovereign debt crisis, greater and more generalised troubles have been experienced by the euro area banks in accessing funding in the gross debt markets, namely for medium and long-term maturities. Such developments are reflected in an increase in financing costs in medium and long-term debt and difficulties in issuing debt into the primary market, even in respect of covered bonds. The sovereign debt crisis in the euro area in the summer of 2011 and the consequential increase of systemic risk at a European level have also contributed to the worsening of stressing funding conditions for the Portuguese banks.

The access to funding through the European Central Bank (ECB) has allowed mitigation of these difficulties. Such intermediation of the Eurosystem is increasingly present in the funding of Portuguese banks. The covered bonds


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purchase programmes (CBPPs) established by the ECB, have played an important role, the first of such programmes having been approved in June 2009 as a temporary measure for a twelve month period and therefore ended, as planned, in June 2010 when it reached an overall nominal amount of €60bn. The programmes are designed to allow the national Central Banks and the ECB to purchase eligible covered bonds outright from eligible counterparties both in the primary and the secondary markets, the Eurosystem intending to hold the assets bought until their respective maturities.

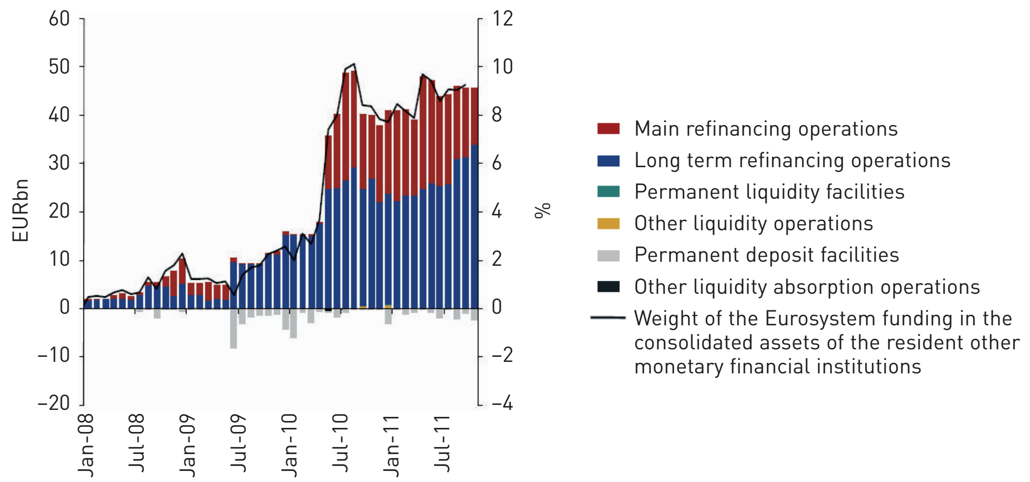
In light of the current market conditions and the Eurosystem's monetary policy needs, in November 2011, the ECB decided to launch the second programme (CBPP2) with a view to ease funding conditions for credit institutions and enterprises and encouraging credit institutions to maintain and expand lending to their clients. Under the CBPP2, eligible covered bonds for a targeted total nominal amount of €40bn are to be purchased up until October 2012. Provided such covered bonds comply with the eligibility criteria set forth in ECB Decision ECB/2011/17, namely that bonds are denominated in euro, are held and settled in the euro area, have a minimum issue size of €300m, have a minimum rating of BBB or equivalent awarded by at least one of the major rating agencies, have a maximum remaining maturity of 10.5 years at the time of purchase of the security and have been issued pursuant to legislation governing covered bonds that is in force in a euro area Member State.

The CBPPs present the alternative solution for Portuguese covered bonds in the current market scenario and justify the volume of covered bonds issued therein throughout 2011. In fact, the aggregate amount of covered bonds issued by Portuguese banks totals approximately €4.975bn in 2011, which corresponds to 10 issues by some of the Portuguese biggest covered bonds players.

Indeed, despite the struggle to access the international debt markets by the Portuguese banks, due to price and quantity considerations, the recourse to ECB funding has maintained itself at high levels, but stable, in comparison to the year 2010 (see Exhibit 1).

There is no question as to the nature of a covered bond and definitely covered bonds are seen as credit instruments, but currently with the background of the sovereign debt crisis, investors always seem to have in

Sum of Monetary Policy Operations of Portuguese Banks **Exhibit 1**



Source: Bank of Portugal

mind a link to sovereign ratings and exposure thereto of such covered bonds. Long seen the time and the market scenario where Portuguese covered bonds have been allocated AAA ratings, investors now need to do their homework to understand the structure at stake and the instrument in itself before investing in covered bonds and consequentially the level of information provided to investors is of the utmost important, now more than ever.

Transparency: a call for harmonised approach

So far there has been no known initiative at a transnational level to harmonise transparency frameworks for covered bonds or imposing common regulatory requirements in this respect and the set of regulations and information requirements for these types of instruments are dependent on national initiatives and on the regulatory power of the national Central Banks.

Transparency in the covered bond markets and also in the Portuguese market, is a hot topic for covered bonds issuers, investors, regulators and analysts and much is being said about transparency, however, steps forward need to be taken in terms of defining the level of documentation and information made available to investors, required by regulators and presented by the issuers.

Presently, the covered bond programmes for Portuguese issuers contain information on a four prong strategy:

i. *summary information*: the base prospectus for the programmes include a summary description of the main features and characteristics of the contractual documentation underlying the programme and a description of the requirements of the respective cover pool, including namely eligibility criteria, overcollateralisation requirements, valuation procedures and methods and coverage of hedging contracts;
ii. *documents available*: as indicated in the base prospectus, the issuers have available for inspection by the bondholders, at its office or at the offices of the respective paying agents, the contractual documentation package pertaining to the covered bonds. For Portuguese issuers, such list of available documents have not included, in the past, hedging contracts, despite of the predisposition to do so in line with other European issuers;
iii. *investor reports*: reports detailing the performance of the covered bonds throughout the previous reporting period; and
iv. *loan level information*: the issuers prepare and present information on loan by loan basis for the mortgage assets included in the cover pool.

Much has been said about loan level information and investors' strict need for such information for the sake of full transparency by the issuers and such has been a strong requirement from regulators. Nevertheless, one may question the effective use of such loan level information and its genuine value for investors, namely given the extensive nature of such files and the format of the information presented, which ultimately correspond to thousands of entries for one given cover pool. A step forward towards a more user-friendly solution, which could comprise a different format and certainly a varied volume would be desirable, for example in having the cover pool information prepared in a similar format to stratified tables, where information is easily accessible and comprehended under various categories, alike what is also presented for asset-backed securities (ABS) transactions. In light of the above and considering the information available, undoubtedly one cannot say that there is a lack of transparency in the covered bonds market, however a harmonised approach to defining these matters, both at a national and European level, would be advantageous.

Liquidity: dealing with short term shortfalls

Another topic of significant focus by the rating agencies has been the matters of liquidity of the cover pool in the covered bond programmes and the issuers have been recently incorporating additional features into the existing programmes in order to tackle any hypothesis of liquidity shortfalls on the cover pool. Even though in some jurisdictions, transactions are including features to address liquidity of the portfolio for periods of 180 days or more, considering the current ratings of Portuguese covered bonds, issuers have been accounting for liquidity mechanisms covering shorter periods up to 90 days. Some examples of the solutions adopted in the context of Portuguese covered bond programmes are the possibility of the issuers including, in the cover pool, other assets, which are typically defined as highly liquid assets, such as deposits in cash with national Central Banks (or credit institutions rated at least 'A'), or securities eligible for credit transactions in the Eurosystem, or assets complying simultaneously with the requisites of low-risk and high liquidity. Such possibility ties in with the undertaking by the respective issuers that such other assets included in the cover pool comprise, on any day, an amount of 'AAA' or equivalent rated sovereign bonds at least equal to the interest payments due by such issuer under the outstanding covered bonds for the following 90 days. Other Portuguese covered bond issuers have opted for a solution of creation of a liquidity reserve with another bank having a minimum rating requirement in the amount corresponding to three months of interest payments in respect of the covered bonds, if the issuer falls below certain predefined rating triggers.

Enforcement: clarification is desirable

Furthermore, concerns have also been raised in respect of the enforcement and acceleration procedures set out in the covered bond programmes, namely considering that only in the event of insolvency of the issuer may the acceleration of the covered bonds be determined by approval from the holders of covered bonds representing at least two-thirds of the principal amount outstanding of the covered bonds of all series then outstanding, in which case all outstanding covered bonds shall immediately become due and payable at their early redemption amount (defined in the relevant final terms) together with accrued interest. It is important to note that if such majority is not reached, then the bondholders of a given series will be prevented from acting individually against the issuer, namely considering that the acceleration of the bonds may trigger conflicts of interests for holders of covered bonds with different maturities.

In case of failure to pay the covered bonds in the context of an issuer insolvency, two scenarios would apply:

i. either the covered bondholders decide to accelerate the bonds, which will then be immediately due and payable on a *pari passu* basis; or
ii. the covered bondholders do not decide to accelerate the bonds and the issues continue outstanding, in which case an independent entity being a replacement credit institution will be appointed by the Bank of Portugal to continue to manage the cover pool and timely payout amounts due on the covered bonds. In such continuity event, the substitute credit institution appointed to manage the cover pool shall perform all acts necessary for the prudent management of the respective pool in order to ensure the timely payment of all amounts due to holders of bonds, the details of such role being set forth in the Bank of Portugal notice 8/2006. In any event, the Bank of Portugal regulations do not provide an envisaged timeline for acceleration or realisation of assets, neither guideline principles to be adopted in such respect, which procedures remain somewhat uncertain. Additionally, in an event of default regarding non-payment of principal or interest under the covered bonds, acceleration is not an available option, but the Bank of Portugal regulations determine that the bondholders will have access to the asset code that identifies the cover pool, even though no additional procedures are set out which indicate applicable actions for realisation of assets. In the above mentioned points, undoubtedly further clarification would be desirable in order to provide certainty to market players.

In conclusion

In times of turmoil for the Portuguese market and also the covered bonds sector, Portuguese players are facing new challenges to increase level or quality of information provided to regulators, rating agencies and investors, are incorporating new features in the covered bond programmes to cater for new concerns raised by counterparties and are searching for certain regulatory clarifications in the applicable framework. All such steps are crucial in preparing the Portuguese covered bonds instruments to expectedly return to the market and to satisfy investor appetite in the near future.

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