Portuguese covered bonds – an example of the struggle against new and long-lasting adversities

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Current trends in capital markets are very difficult to describe and they are certainly marked by very significant volatility, increased perception of risk and liquidity scarcity. Portugal is no doubt a perfect example of these current trends, after a political change from left to right was decided in the general elections that were heavily marked by a rescue plan implemented by the so-called *troika*, comprising the European Commission, the European Central Bank (ECB) and IMF.

This plan was made necessary to enable public debt to continue to be issued to meet liquidity requirements of public entities, as well as to enable state guarantees to be issued in connection with a new generation of guaranteed bonds issued by many local banks, who are themselves facing treasury difficulties.

The positive aspects of this situation are essentially associated with the circumstance that said rescue plan came with a package of relevant reforms which the country and its economy have been in need of for quite some time, with an assumed intention of significantly cutting public deficit and the country's indebtedness. The implementation of such a plan is currently in progress, as evidenced by the removal of the former golden shares held by the State in some listed companies. These have essentially been highlighted as a generalised tax increase, which some say may even lead to increased stagnation and impoverishment of families, companies and public bodies. Also, a privatisation plan is being devised with what may be seen as the last crown jewels being placed for sale now.

Very few securities have defied all odds in these high and rough seas and the country's resistance and resilience are indeed being tested to the limits. So far, in spite of the

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period of liquidity scarcity market players have faced for three consecutive years, the financial, economic and legal systems have resisted and seem to be responding to the requirements and onuses placed on their shoulders but, without an economic upturn, dark skies will continue to hang over the Portuguese beaches.

We have, in this context, selected one of the few types of securities that seems to be surviving relatively well, undoubtedly as a consequence of the upgraded position it enjoys from a credit risk perspective thanks to its association with a special pool of assets, ring-fenced and isolated in order to increase investor protection: covered bonds. These securities have now been issued by a total of 10 Portuguese mortgage lending institutions, enabling issuers to enjoy a lifeline with the ECB where these securities continue to be accepted as collateral in exchange for liquidity generally unavailable elsewhere.

In this context, Portuguese covered bonds have proved to be one of the most important segments of privately-issued bonds, as they continue to prove to be robust, particularly in times of financial distress – sometimes even safer than sovereign bonds, essentially by virtue of the collateral associated therewith and the protective features these instruments entail, both in terms of ring-fencing of the associated assets and of asset quality and over-collateral requirements.

In Portugal, since the approval of the Decree Law No. 59/2006, the Portuguese legal framework on covered bonds (mortgage covered bonds and public sector covered bonds) (referred to as 'DL 59/2006' hereafter), market players have viewed covered bonds as a very attractive and reliable instrument and, even when issue prices vary significantly from those we had seen in the early days (the record Portuguese covered bond issuance was made at a spread below 4bps, a mark that currently looks completely unachievable for many years), new issues have still been made – sometimes to discount liquidity with the Central Bank and other times to be placed (at a price) on private placements.

No doubt there is a legal factor which is also contributing to this because covered bonds issued under Portuguese law have particular advantages and features making them quite robust indeed.

Firstly, DL 59/2006 provides a holders' preferential status, under which they benefit from a special preferential claim over the assets assigned to the issue, with precedence over any other creditors. Consequently, bankruptcy remoteness is instituted, as the law implements a special regime applicable on the originator's bankruptcy – superseding the general bankruptcy regime – setting bankruptcy remoteness features that operate as protection to the bondholders in extreme scenarios.

Furthermore, DL 59/2006 establishes a full identification and complete segregation of the cover assets, as the assets allocated to the issues of covered bonds are held by the issuer in separate accounts, legally constituting an independent estate. In addition, the holders benefit from a special claim in case of bankruptcy or insolvency – when the issuer becomes insolvent – and covered assets are integrated in a separate legal estate, administered in favour of the bondholders, which means that there is no automatic acceleration of the covered bonds.

Due to this cover register in segregated accounts, there is no need for the special creditors' privilege to be subject to public registration and, as for creditors' privilege that is resting over the relevant assets, it is set up immediately following the issue of the relevant covered bonds, identification of which is always being lodged with the Bank of Portugal.

A further advantage of Portuguese covered bonds is the respect for, and the enforcement of, the aforementioned segregation principle, which is granted and closely monitored by an independent auditor appointed as a Cover Pool Monitor, and also under the close eye of the Bank of Portugal (which is required by law at all times to keep and record the full identification of the cover pool, segregated in a codified manner).

In fact, the assets forming part of the cover pool are registered and held in separate accounts, duly identified under a codified form, which is deposited in the Bank of

Portugal. Along with this procedure, the Bank of Portugal requires the issuers to report information on a monthly basis, and the Cover Pool Monitor – generally an independent auditor engaged among the international auditing firms and legally and contractually required to analyse and evaluate the cover pool instantly – also reports composition and performance of the cover pool on an annual basis.

Covered bonds also enjoy an interesting tax regime, particularly as they have no stamp duty taxation and they also enjoy a withholding tax exemption on interest payments made by Portuguese issuers to non-Portuguese resident investors.

These advantages are justified by the fact that historically higher ratings were assigned to covered bonds, compared to those assigned to issuers of these instruments or the country out of which the bonds are issued. This is a trend that is still relevant today, albeit the significant downgrade movement which we have witnessed over the last few months (the debt capital markets in general, particularly in the eurozone area, and even more severely in Portugal).

As such, since the first covered bond issue in 2006 by Caixa Geral de Depósitos, the largest Portuguese commercial bank fully-owned by the Portuguese state, there are nine other active issuers of covered bonds in Portugal, including the six major commercial/retail banks operating within the Portuguese market.

Since the beginning of the liquidity crisis, the market has been following an ever greater trend in European and international markets, characterised by the liquidity tightness, increased volatility and investor's risk, even for top class assets such as covered bonds, with evident consequences on price.

Nevertheless, for the past few years Portuguese mortgage covered bonds have been very resilient and compare well with other more established European jurisdictions also active in this field. In recent times, no less than four Portuguese banks went to the market, issuing five new jumbo covered bonds (corresponding to outstanding volume amounts of more than €1bn), totalling €5.65bn with a weighted average maturity of 2.4 years for much higher prices and shorter maturities than the bonds issued in the past by the same issuers, though still functioning as a viable source of liquidity and fully operational. All major Portuguese banks have now set up a covered bonds programme, while the market's resilience is also demonstrated by the arrival of a few newcomers, such as Banif and Banco Popular (the Portuguese subsidiary of the Spanish bank under the same name).

Higher prices (evidenced by ever larger spreads) and shorter maturities (indicating the increase in risk to which investors are exposed to), greater volumes, and new issuers still arriving to the market seem to correspond to the defining features of the current conditions of this product out of Portugal.

There have not been many opportunities for the issuance of covered bonds since 2009, mainly following the rating downgrades that have characterised Portugal and its issuers during the last couple of years (and particularly during the first months of 2011). However, the announcement that the ECB purchase programme was to be retained, despite the rating downgrade, distressed the market and increased the market players' expectation that major Portuguese banks would return to the covered bonds market again on a more regular basis, indicating that covered bonds remain a secure option for investors.

2010, and even more so the first semester of 2011, have been significantly marked by the downgrade of the Portuguese Republic ratings, which had a significant impact on the ratings of Portuguese banks and also in the creation of a new environment of doubt and awareness within rating agencies and investors.

At a global level, the highly volatile conditions that characterise capital markets in general, Portuguese ones in particular, and also reaching out to refuge values such as covered bonds, were accompanied in 2011 by a series of multi-notch downgrades of sovereign, bank senior and other issuers, which inevitably had a major impact on their ratings.

This very unforgiving scenario, together with the economic uncertainty, especially concerning Portuguese public finances, led to a revolution of the rating criteria, with emphasis given to the availability of liquidity and the costs of refinancing, leading inevitably to an increased need for overcollateralisation.

These new criteria adopted by rating agencies surely stand for a more cautious approach and naturally appear to be less positive and more demanding for covered bonds issuers. Nonetheless, given the inherent quality and robustness of Portuguese features applicable to this instrument, together with the statutory requirements of quality of assets in the cover pool and overcollateralisation, there seems to remain room for a substantial dissociation between the rating of the issuer and that of the instrument itself, following a pattern that has been in place since implementation of the instrument back in 2006.

The clear advantages of Portuguese covered bonds' legal regime, such as the preferential status of holders, the full identification and segregation of cover assets, the application of risk management techniques, the constant reporting of information, the monitoring of the cover pool and the tight control by the Bank of Portugal, are all good reasons for the assignment of higher ratings to covered bonds, especially when we compare these features to those associated with similar instruments existing in other jurisdictions.

As far as the Portuguese market is concerned, and despite the negative events concerning the sovereign bond market, in Q1 2011 covered bonds were still trading with less than expected difficulty due to the relative stability of the Portuguese housing market – even with prices increasing with diminutive restraint. To cope with the hostile environment of the market, overcollateralisation requirements have been placed at around 120% – i.e., above the regulatory standard level of 105% – and loan-to-value (LTV) ratios below 60%, concerning the pool of Portuguese major issuers.

Again, the numbers show that investors who valued covered bonds' intrinsic characteristics, and particularly their legal framework, as well as the performance of the relatively stable evolution of the Portuguese real estate market – which is not perceived to be as overvalued as other markets – are granted with a great level of security, strengthened by the safety characteristics of these instruments, while still enjoying interesting prices and yields.

Twenty five different European jurisdictions have relied significantly on these instruments since they proved to be one of the key components of European capital markets and one of its robust pillars. Today, the amount of outstanding covered bonds is equivalent to around 20% of outstanding residential mortgage loans existing in the EU, according to the ECBC European Covered Bond Fact Book 2011. The outstanding volume at the end of 2010 amounted to 2.5 trillion, representing an increase of 5% from the previous year and clearly highlighting the nature of this instrument as a refuge value in the European capital markets arena. For all these reasons, there is a strong expectation that the covered bonds market will continue to grow, notably due to the fact that national and European legislations have approved modern covered bonds' legal instruments and, despite the forces to which the economy and the issuers of these instruments have been subject to during the last few years, covered bonds still exist and are still performing their function.

With regards to the Portuguese covered bonds market, we will have to wait and see how Portugal (and particularly its banks and housing market) manages against what seems to be quite challenging times. Taking into account the ongoing compliance with the boundaries set by the *troika*, the stable parliamentary majority which now exists in the country, and the relative stability of the Portuguese housing market, can it be expected that the country overcomes the onuses placed on its shoulders?

As one of the top securities that can be issued out of our jurisdiction, covered bonds will certainly play a relevant role in opening up the access way to liquidity, wherever it may be found, and continue to help the balanced development of the Portuguese economy.

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