3.27 PORTUGAL

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I. FRAMEWORK

In Portugal, the legislation on covered bonds (*Obrigações Hipotecárias and Obrigações Sobre o Sector Público*) is regulated by Decree-law no. 59/2006 of 20 March 2006 and complemented by secondary legislation – Notices and Regulatory Instruments of the Central Bank (*Avisos e Instruções*), which address issues such as the segregation of assets from the insolvent estate in case of issuer insolvency, the compliance of asset and liability matching and mortgage valuation methodology.

The exemption of withholding tax for non-resident investors for bonds issued by Portuguese entities was passed in November 2005 (Decree Law n. º 193/2005).

II. STRUCTURE OF THE ISSUER

Obrigações Hipotecárias (OH) and *Obrigações Sector Público* may be issued by credit institutions legally authorised to grant credits guaranteed by mortgages on real estate and with own funds amounting to no less than EUR 7,5 m. These credit institutions are either universal banks or special issuance entities – Mortgage Credit Institutions (MCI).

If the issuer is a universal bank, a direct issue will take place with the cover assets remaining on its balance sheet. If the issuer is a MCI, its authorised business activity is restricted to the granting and acquisition of credits guaranteed by a mortgage or loans of the central government, regional or local authorities or credits guaranteed by these entities. They may also undertake the management of assets that have been repossessed from credits in default, and undertake the activities necessary to obtain additional liquidity and adequately manage the pool.

Assuming the MCI is wholly-owned, the asset originator then transfers the cover assets to this institution and the assets and liabilities will consolidate on the originator's balance sheet. However, it is also possible for the MCI to have multiple owners and, in this case, the assets may or may not consolidate back to the originator.

Considering the MCI has a limited business activity which only makes sense within the context of covered bond issuance, one could expect the MCI to be a 100% owned subsidiary and, as such, act as a complement to the originator's business and funding activity. In this sense, it seems reasonable to expect that it could draw on the parent company's resources to operate.

However, the Bank of Portugal will always determine, on a case by case basis, the necessary conditions that must be met in order to set up an MCI.

III. COVER ASSETS

Credit mortgage loans are eligible as collateral for mortgage covered bonds i.e. credits guaranteed by first ranking mortgage loans. Second mortgage loans can be assigned to the pool if the first mortgage loan was previously assigned as well – therefore both loans are attached to the same property, provided that the total amount of these loans does not exceed the maximum Loan to Value (LTV) level permitted.

Public sector assets are eligible as collateral for public sector bonds i.e. loans granted to the central governments, regional or local authorities or guaranteed by these entities.

The Law specifies that the registration of the assets must assure mortgage credit and public sector segregation. This means that separated pools will have to be set up.

Substitution assets (up to 20%) can be included in the pool:

- Deposits with the Bank of Portugal in cash, government bonds or other eligible bonds (ECB Tier 1 assets)[1];
- Deposits in other credit institutions rated at least "A-";
- Other low risk and high-quality assets – if necessary, to be defined by the Bank of Portugal.

Even though the Portuguese Covered Bonds Decree Law allows up to 20% of the cover pool for substitution assets, Bank of Portugal's regulation establishes that the pool can only trade with credit institutions qualifying for credit quality assessment step 1 and that the aggregate risk positions cannot exceed 15% of the aggregate nominal value of the outstanding covered bonds or public sector covered bonds (with the exception of those positions with a residual maturity of 100 days or less), thus complying with what is established by Article 129(1)(c) of the Capital Requirements Regulation (CRR).

The geographical scope of eligible assets is restricted to loans guaranteed by first lien mortgages on property located in the European Union (EU) or loans granted to the central governments and regional or local authorities located in an EU Member State.

Derivative contracts are permitted in the cover pool for hedging purposes, namely to mitigate interest rate, exchange rate and liquidity risks. The transactions involving derivatives must be executed in a regulated market of a Member State of the European Union, in a legally established exchange of a full member of the OECD, or entered into with a counterparty that must be a credit institution rated "A-" or above. The legal documentation (agreement between the parties) should be standardised, however this will have to safeguard the preferential claim for the counterparty. If the currency of the issue is not in EUR, the use of exchange rate derivative contracts is mandatory in order to hedge the inherent risk of the issue.

The cover pool is dynamic while the originator is solvent and issuers are required to maintain a record of all the assets in the cover pool, including derivatives contracts.

IV. VALUATION AND LTV CRITERIA

The value of the mortgaged asset[2] is the commercial value of the real estate, considering:

- Sustainable characteristics over the long term;
- Pricing under normal market conditions;
- The peculiarities of the local market; and
- The current and alternative uses given to the mortgage asset.

The value of the mortgage asset ascertained by the issuer cannot be superior to its market value, which is the price that the object could be sold at the time the appraisal is made. This assumes that the real estate is placed on sale and that market conditions allow for a regular transmission of the mortgaged asset within an adequate timing.

The property appraisal should be carried out by an independent appraisal specialist, previous to the respective mortgage credits being assigned to the covered bond pool.

Appraisals already carried out by a property appraisal expert are also accepted as long as the following conditions have been met:

- Appraisals have been carried out by an expert independently of the credit analysis and decision process of the bank;

1 Notice n.º 6/2006.

2 Notice n.º 5/2006.

> Appraisals have been documented in a written report that includes, in a clear and rigorous form, the elements that allow for an understanding of the analysis conducted and the conclusions arrived at by the expert;

> The property was appraised from a market value perspective or a property value perspective as defined in the law;

> There is no evidence that the property appraisal, arrived at from the perspective above mentioned, was overvalued at the time the loan was assigned to the covered bond pool.

The value of the mortgaged property must be checked by the institution on a periodic basis, at least every three years for residential mortgages and at least once a year for commercial properties. More frequent checks must be carried out if market conditions are prone to significant changes.

In order to check the value of the mortgaged property or to identify those properties that require periodic appraisal by an expert, the institution may use indices or accepted statistical methods that it considers appropriate. When indices or statistical methods are employed, the credit institution must submit to the Bank of Portugal a report detailing the foundations for the use of those indices or statistical methods along with an opinion on their adequacy by an external independent appraisal specialist.

Property appraisal must be revised by an expert whenever there is relevant information that indicates that a substantial reduction of the asset value has occurred or that the asset value relative to the general trend of the market has declined significantly.

For loans that exceed 5% of the institutions' own funds or exceed EUR 500,000 for residential mortgages and EUR 1m for commercial mortgages, the appraisal must be carried out at least every three years.

Revision of the value of an asset must be documented by the credit institution, in a clear and rigorous way, namely a description of the criteria and frequency of such a revision.

The property appraisal should be carried out by an independent appraisal specialist, with qualifications, competency and professional experience to perform this function.

The appraisal specialist is deemed not to be independent if he is in a situation susceptible of affecting his unbiased opinion, namely if he has any specific interest in the real estate being appraised or any relationship – commercial or personal – with the debtor, or if his compensation is dependent on the appraisal value of the property. The appraisal specialist may belong to the institution; however, he must have independence from the credit analysis and decision process.

The selection of the appraisal specialist by the institution must assure both diversification and rotation, and the credit institution must maintain an updated list of the selected appraisal specialists, identifying the criteria justifying their selection and the real estate appraised by each specialist.

This list should be sent to the Bank of Portugal until the end of January of each year, reporting up to 31 December of the previous year, and indicate any changes from the last report. If there are any doubts on the performance of the appraisal specialist, the Bank of Portugal can refuse to accept the valuations, demanding the appointment of another appraisal specialist by the credit institution.

When choosing the appropriate method, the appraisal specialists should consider the specific characteristics of the real estate and its local market. The appraisal of the real estate performed by the specialist should take the form of a written report and include all the elements that allow for an understanding of the analysis carried out and conclusions arrived at.

The maximum loan to value accepted for assets to be eligible into the pool is 80% for residential mortgages and 60% for commercial mortgages loans.

V. ASSET – LIABILITY MANAGEMENT

There are various asset and liability matching requirements established in the decree-law:

> The global nominal value of the outstanding mortgage bonds cannot exceed 95% of the global value of mortgage credits and other assets at any point in time assigned to the bonds (i.e., mandatory overcollateralisation of 5.3%);

> The average maturity of outstanding mortgage bonds can never exceed the average life of the mortgage credits and substitution assets assigned to the issues;

> The total amount of interest to be paid by the mortgage bonds shall not exceed, at any point in time, the amount of interest to be collected from mortgage credits and other assets assigned to the bonds – cash flows from the cover pool must all be sufficient to meet all scheduled payments due to covered bond holders.

The law also promotes a sound cover pool management by allowing the issuer to apply the funds (for example, funds received from early repayment) to other assets and assign new mortgages to the pool. This option allows issuers to avoid potential cash-flow mismatches. It is also possible for issuers to establish a credit facility to provide for liquidity. This credit facility counterparty is required to have a minimum credit rating of "A-".

Issuers may use derivatives contracts to hedge the interest and exchange rate and liquidity risks. The derivatives are included in the cover pool and derivative counterparties – who also benefit from preferential claim – have to be rated "A-" or above.

If the limits defined in the Decree Law are exceeded, the issuer shall immediately resolve this situation by assigning new mortgage credits, purchasing outstanding bonds in the secondary market and/or assigning other eligible assets. These will, in turn, be exclusively assigned to the debt service of the bond.

Regarding these matters, the secondary legislation[3] determines the application of the following criteria:

> Loans must be accounted according to their outstanding principal, including matured interest;

> Deposits shall be accounted according to their amount including accrued interest;

> Interests eligible for Eurosystem credit transactions shall be accounted according to the value resulting from the rules regarding valuation margins defined by the Eurosystem or, if lower, according to its nominal value, including accrued interest;

> Covered bonds and public sector covered bonds shall be accounted according to the corresponding outstanding principal, including accrued interest.

Interest rate or FX derivatives must be accounted in accordance with their market value and in the event that the corresponding loans and other substitute assets are denominated in different currencies, the issuer must ensure hedging of the relevant currency risk, and the reference exchange rates published by the European Central Bank shall be used for this purpose.

Single name risk is also addressed. The aggregate in risk positions with credit institutions - excluding those with a residual maturity date of 100 days or less - cannot exceed 15% of the aggregate nominal value of the covered bonds or public sector covered bonds outstanding.

The net present value of the liabilities arising from the issuance of mortgages covered bonds or public sector covered bonds cannot be higher than the net present value of the portfolio allocated to such bonds, taking into account any derivative instruments put in place. The ratio established shall be able to comply even when 200 basis points parallel movements of the curve are considered.

3 Notice n.º 6/2006.

Each issuer must deliver in writing the specific and individual policies in written form for risk management, namely exchange risk, liquidity risk, interest rate risk, counterparty risk and operational risk and any other procedures aimed at ensuring compliance with the applicable regulatory regime and with any devised risk limitation policies set by the issuer.

The Bank of Portugal may also make use of its regulatory role to require additional steps by the issuers to meet with all the asset-liability criteria that it sets out.

VI. TRANSPARENCY

In order to provide consistent data and transparency for their issues, thus complying with Article 129(7)(b) CRR, Portuguese labelled covered bond issuers disclose information on their covered bonds programmes using the Harmonised Transparency Template (HTT), which also includes the Common National Transparency Template based on the CBIC Template, in order to ensure standardisation and comparability of the data provided by its covered bond investor reports. The Template can be found on the Covered Bond Label website.[4]

These investor reports are published on each bank's website, encompassing specific, relevant and detailed information on the Portuguese covered bonds and the cover pools and are updated on a quarterly basis. Key concepts explanations are available for a better comprehension.

Should investors require additional financial information they deemed relevant on the Bank's consolidated accounts or Groups Balance Sheet, they can obtain it on the respective website or directly by contacting the issuers.

VII. COVER POOL MONITOR AND BANKING SUPERVISION

The Board of the issuer will appoint an independent auditor who must be registered with the Portuguese Securities Commission, with the task of defending the interests of the bondholders and of verifying the compliance to applicable legal and regulatory guidelines. An annual report must be published. The Bank of Portugal will review its content and may make use of its regulatory role to request additional information[5].

In the law, there are no specific rules on the cover pool monitor's responsibility. General rules on civil and contractual responsibility apply. The cover pool monitor will only be liable in case it does not comply with rules applicable to its activity or with its contractual obligations. If the cover pool monitor has complied with all its obligations, it will not be liable in case the issuer has not respected the applicable regulation.

Also, a bondholders' joint representative – common to all mortgages or public bond issues – is to be appointed by the Board of Directors of the issuer in order to represent the interest of the bondholders and supervise the cover pool.

The Bank of Portugal and the Portuguese Securities Commission (CMVM) are responsible for banking and capital markets supervision. The law grants powers to the Bank of Portugal to regulate and supervise the issuers of covered bonds, so they must comply with the requirements of the law and all applicable regulations. Non-compliance by the issuer could imply the application of fines and other sanctions and, ultimately (in a worst case scenario), could determine the revocation of the issuer's licence.

Additionally, the Bank of Portugal has been granted powers to control compliance of the applicable rules for as long as the bonds remain outstanding, namely it may:

> Refuse asset valuations made by a valuation's expert if it has doubts concerning its performance, and demand to the issuer its replacement;

> Require new asset valuations by different experts; and

> Ask for clarifications or additional documents concerning all reports required and received.

4 https://www.coveredbondlabel.com/issuers/national-information-detail/19/.

5 Regulatory Instrument n.º 13/2006.

VIII. SEGREGATION OF COVER ASSETS AND BANKRUPTCY REMOTENESS OF COVERED BONDS

Preferential status for Portuguese covered bonds holders and bankruptcy remoteness

Holders of covered bonds benefit from special preferential claim over the assets assigned to the issue, with precedence over any other creditors – the covered bond law supersedes the general bankruptcy regulation – for the redemption of principal and payment of interest.

The mortgages that guarantee these credits prevail over any real estate preferential claims. The derivatives contracts are part of the pool and derivatives counterparties rank pari passu with bondholders in terms of preferential claim over the assets in the pool, and consequently, their contracts are not expected to be called in case of insolvency of the originator.

Despite the absence of a direct link between the cover assets and the outstanding covered bond issuance, there is a legal provision that links the cover pool to the payment of capital and interest on the covered bonds thus rendering covered bonds direct, unconditional obligations of the issuer. The issuer of covered bonds holds the claims on the cover assets and these, in turn, will guarantee the covered bonds until all payments due to bondholders have been met.

If the issuer becomes insolvent, cover assets form a separate legal estate – a pool that is to be administered in favour of the covered bondholders, and consequently there is no automatic acceleration of the mortgage bonds.

However, bondholders may convene a bondholders' assembly and may decide by a majority of 2/3 with regard to the outstanding bond volume to call the mortgage bonds, in which case, the administrator shall provide for the liquidation of the estate assigned to the issues and thereafter the payment of creditors in accordance with the provisions defined in the decree-law.

If the cover assets are not sufficient for the covered bonds, bondholders and derivative counterparties will rank pari passu with any common creditors of the issuer in relation to all other assets of the issuer (not included in the cover pool), after all guaranteed and privileged creditors have been duly paid up, for the payment of the remaining debt due to them.

Asset segregation

The assets – mortgage loans or public sector loans and substitute assets – and derivative contracts assigned to the issues are held by the issuer in separated accounts – cover register – and can be identified under a codified form. This information is deposited in the Bank of Portugal in the form of a code key. The Bank of Portugal regulates the terms and conditions by which the bondholders will have access to such key in case of default[6].

The legal effect of registration is to segregate those assets from the insolvent estate over which bondholders will have a special claim in case of insolvency/bankruptcy. In this situation the assets pledged to one or more issues of mortgage bonds will be separated from the insolvent estate for the purpose of its autonomous management until full payments due to the bondholders have been met. Despite this, the law stipulates that timely payments of interest and reimbursements should continue. In that way, cover assets form a separate legal estate, a pool administered in favour of the covered bondholders.

In an insolvency situation of the issuer two situations may occur:

> The issuer voluntarily assumes that it is insolvent and will present a project to the Bank of Portugal pursuant to article 35-A of the Credit Institutions General Regime, containing the identification of the credit institution that will be appointed to manage the cover pool, together with the terms under which those services will be rendered;

6 Notice n.º8/2006.

> The revocation of the authorisation of the issuer with outstanding covered bonds or public sector covered bonds takes place, and the Bank of Portugal shall appoint a credit institution[7] to undertake the management of the cover pool.

The cover pool will be managed autonomously by this credit institution, which should prepare, immediately upon initiating its management, an opening balance sheet in relation to each autonomous portfolio and relevant bonds, supplemented by the necessary explanatory notes and should perform all acts and deals necessary for a sound management of the loan portfolio and its guarantees with the aim of ensuring a timely payment on the covered bonds, including selling credits, assuring their servicing all administrative procedures pertaining to these credits, the relationship with the debtors, and all modifying and extinguishing acts relating to their guarantees and must carry out and keep updated a registry, in off-balance sheet accounts, the details of the cover pool, in the terms set forth in the Decree-law No. 59/2006.

IX. RISK-WEIGHTING & COMPLIANCE WITH EUROPEAN LEGISLATION

The legislation when taken together with the practices, processes and procedures across the industry should fall within the criteria of Article 129 CRR. Portuguese covered bonds meet the requirements of Article 129 CRR.

Credit institutions investing in covered bonds within the scope of the Portuguese jurisdiction qualifying under Article 129 of Regulation 575/2013 (CRR) are allowed to apply a 20% risk weighting[8]. The risk-weighting of derivatives that are included in the cover pool will be 20%. Investment funds can invest a maximum of 25% of their own funds in a single issuer's covered bonds.

X. ADDITIONAL INFORMATION

Developments in the Portuguese covered bond market

Portuguese issuance in the covered bond market in 2017

On 20 April 2017, Banco Santander Totta launched its new €1 billion 7-year covered bond benchmark transaction priced at MS+62 bps, taking advantage of the stable market environment and reopening the Portuguese covered bond market for institutional investors, which was not active since 2015.

On 23 May 2017, Banco Comercial Português tapped the market on the back of equally favorable market conditions and successfully priced a €1 billion 5-year covered bond at a reoffer spread of MS+65 bps fixing a coupon of 0.750%. The deal attracted strong interest from a broad range of high quality accounts with final orders of over €1.8 billion.

On 19 September 2017, Banco Santander Totta, once again tapped the market with a second benchmark of €1 billion 10-year covered bond priced at MS+48 bps. The transaction gathered a granular and high quality order book, which closed at €3.25 billion with more than 150 accounts involved, mainly driven by Fund Managers (54%), Central Banks and Official Institutions (23%) and Insurance and Pension Funds (12%). Geographically, it was well diversified with Germany and Austria representing 30% of the demand, followed by the UK with 20% and Portugal and France with 19% and 8% of the allocation, respectively.

On 17 October 2017, Caixa Económica Montepio Geral (CEMG) accessed the market with a €750 million 5-year Conditional Pass-Through Covered Bonds (CPT), at an annual interest rate of 0,875%, representing a spread of 65 bps over the MS. Investors demand – in excess of 140 institutional investors – led the order book to be more than four times the issued amount.

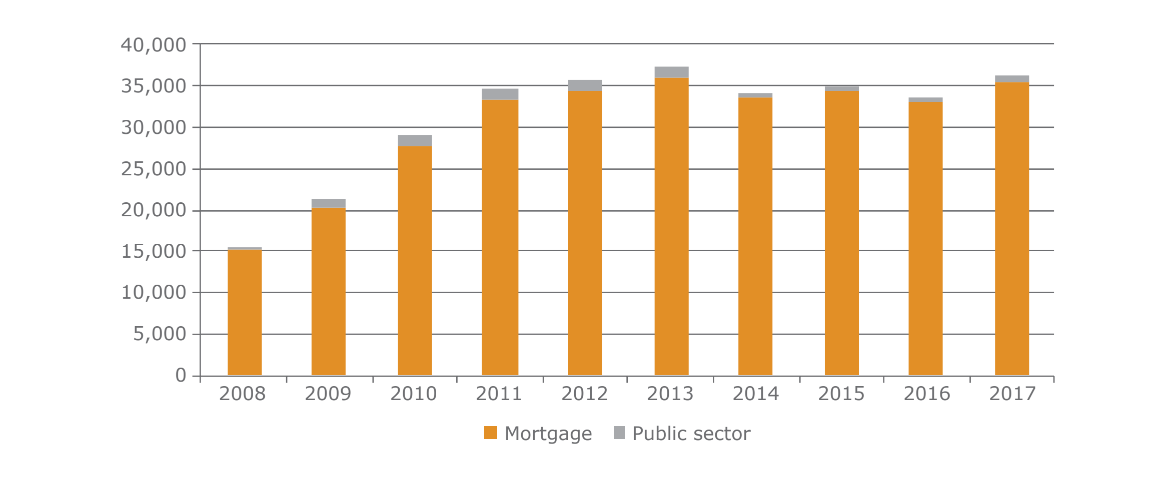
7 Designated Credit Institution.

8 Please click on the following link for further information on the UCITS Directive and the Capital Requirements Regulation (CRR): https://hypo.org/ecbc/covered-bonds/.

During 2017, CEMG, has replaced its soft bullet covered programme for a new CPT structure. Under this new programme, the issue maturity extension is triggered should there be an Insolvency Event or if a payment of principal or interest became overdue (Default Payment Event). Additionally, in case of need, the cover pool administrator will undertake his best effort to sell a part of the pool in order to repay investors. This way, additional guaranties to investors were included permitting rating upgrades for the new Programme.

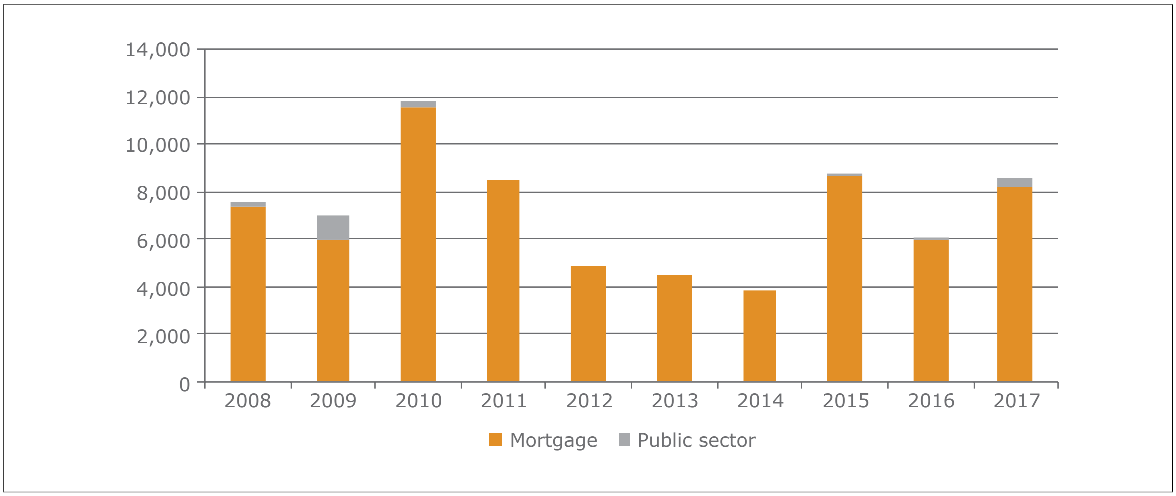
The major Portuguese covered bonds were labeled and, in a timely manner, published its Harmonized Transparency Template (HTT) – which normally includes the National Transparency Template – ensuring that the information disclosed through the Label website is easily accessed by all the participants in the market.

> Figure 1: Covered Bonds Outstanding, 2008-2017, EUR m



Source: EMF-ECBC

> Figure 2: Covered Bonds Issuance, 2008-2017, EUR m



Source: EMF-ECBC

Issuers: Banco Comercial Português, Novo Banco, Banco de Investimento Imobiliário, Banco Português de Investimento, Caixa Económica Montepio Geral, Caixa Geral de Depositos, Banco Santander Totta and Banco Popular Portugal, Banco Internaiconal do Funchal S.a (BANIF).

ECBC Covered Bond Comparative Database:
http://ecbc.eu/framework/38/Public_Sector_CB_%28Obriga%C3%A7%C3%B5es_sobre_o_Sector_P%C3%BAblico%29 and
http://ecbc.eu/framework/39/Mortgage_CB_%28Obriga%C3%A7%C3%B5es_Hipotec%C3%A1rias%29.

Covered Bond Label : Banco BPI (1 pool), Banco Comercial Português S.A. (1 pool), Caixa Geral Depósitos S.A. (1 pool), Caixa Económica Montepio Geral (1 pool) Banco Santander Totta S.A. (1 pool), NOVO BANCO S.A. (1 pool).