

## New Trends in the Securitisation Market

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## New Trends in the Securitisation Market

### 1. Introduction

This study analyses the legal implications of a range of asset securitisation transactions and aims to describe certain types of securitisation that do not resort to the traditional securitisation structures involving an assignment of debts but to other methods of transferring future receivables.

One of the main purposes of the securitisation of assets is financing the activities of corporate entities through the transfer of the right to collect future receivables by the issue of securities which are linked to those receivables. The securitisation of assets allows corporate entities to receive in advance credits not yet due at the date of issue of the securities or even future receivables in respect of future rights.

In general, two types of securitisation structures may be considered: true sale structures whereby the originator assigns credits not yet matured and synthetic structures whereby the holder of the receivables constitutes a right in favour of a third party to collect future payments, whenever such credits exists prior to the date of the securitisation of the receivables.

### 2. Evolution of the Securitisation Market

Until 1999, several securitisation transactions of bank receivables were carried out in Portugal through the assignment of credits to a foreign special purpose vehicle ("SPV").

In 1999, the Portuguese Government enacted Decree-Law 453/99 of 5 November 1999 ("Decree-Law 453/99"), which sets the legal framework applicable to securitisation transactions carried out in Portugal. Consequently, the securitisation of assets through Portuguese vehicles became possible.

However, few securitisations were carried under Decree-Law 453/99, in part due to the minimum capital requirements applicable to SPVs and to the lack of a clear tax legal framework. To addressing these issues, the Government enacted Decree-Law 212/2001 of 4 August 2001 (the "Decree-Law 212/2001"), setting out the tax regime applicable to securitisation transactions carried out in Portugal. Subsequently, the securitisation legal framework set out in Decree-Law 453/99 was amended by Decree-Law 82/2002 of 5 April 2002 (the "Securitisation Law").

As a result of these amendments, there was a significant increase of securitisation transactions carried out in Portugal through Portuguese SPVs.

More recently, the Portuguese Government enacted Decree-Law 303/2003 of 5 December 2003 which amended the Securitisation Law and Decree-Law 219/2001. Among other things, Decree-Law 303/2003 established certain rules applicable to the securitisation of State credits, eliminated the restrictions on the securitisation of matured credits set out in the Securitisation Law and allowed the securitisation of other classes of assets under the Securitisation Law which may not be deemed credits. Notwithstanding, it should be noted that the securitisation of other classes of assets is still pending the issue of specific regulation by the Securities Commission (*Comissão do Mercado de Valores Mobiliários*).

### 3. True Sale Structures

#### 3.1. Typical true sale structure

In a true sale structure, the holder of the credits - the originator - transfers certain assets to a SPV, which will issue securities guaranteed by the assigned assets. These securities may take the form of units (*unidades de titularização*), when they are issued by credit securitisation funds (*Fundos de Titularização de Créditos* - "Securitisation Funds"), or bonds (*obrigações titularizadas*), when the securities are issued by credit securitisation companies (*Sociedades de Titularização de Créditos* - "Securitisation Companies"). As a rule, the SPV will use the proceeds of the issue of securities to pay the purchase price of the assets.

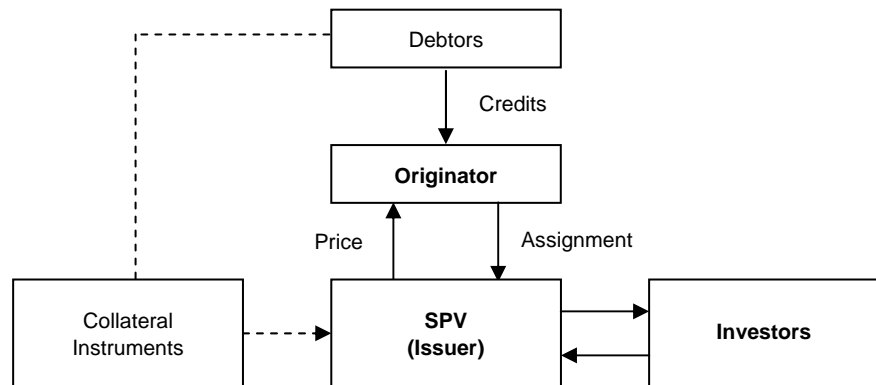
In a true sale structure, the transfer of assets must be effective and definitive, in order to ensure that if the originator becomes insolvent its creditors may not start any proceedings against the SPV or of investors.

As a result of the segregation of the SVP's assets from the originator's estate, the rating assigned to the securities issued by the SPV may exceed the rating of the originator, particularly if credit enhancement instruments are used to reduce the default risk of the underlying debtors of the originator.

To that purpose, the SPV may obtain a guarantee against the defaults in respect of the transferred assets to improve the credit rating, particularly either through the use of credit derivatives or the creation of cash collateral accounts and collateral portfolios.

Lastly, in a true sale structure the management of the transferred assets may be assigned to the SPV, the originator or a third party acting as a trustee. Nevertheless, the Securitisation Law establishes specific rules for the management of the securitised assets.

The following is an example of a true sale structure:



## 3.2. Securitisation Law

### 3.2.1. Legal requirements

In order to carry out a securitisation transaction under the Securitisation Law, the assigned credits must be of a pecuniary nature, freely assignable and unconditional, and cannot be encumbered, pledged, seized or under litigation.

For the securitisation of future credits (*créditos futuros*), the Securitisation Law requires also that the credits:

- (a) result from a prior agreement or other legal relationship; and
- (b) be of an amount previously determined or determinable.

Hence, in addition to the requirement that the amounts be determinable the Securitisation Law requires the credits be originated from an existing agreement. This means that receivables derived from electrical energy, gas, water or telecommunications contracts may be securitised as such receivables will arise as a result of a prior agreement between the public utilities providers and the consumers, even if the underlying goods or services have not been sold or provided.

On the other hand, in accordance with article 3 of the Securitisation Law only Securitisation Funds and Securitisation Companies may acquire credits for securitisation. The incorporation and the management of Securitisation Funds and Securitisation Companies is regulated by the Securitisation Law.

### 3.2.2. Insolvency of the originator and of the debtors

#### (1) Insolvency of the originator

Under Portuguese insolvency laws, some obligations of the insolvent entity are suspended on the institution of insolvency proceedings. The consequences of the proceedings leading to a judgement of insolvency or bankruptcy are presently set

out in the Portuguese Insolvency Law, approved by Decree-Law 123/93 of 23 April 1993, as amended (*Código de Processos Especiais de Recuperação de Empresas e da Falência* – “Insolvency Law”).

Under article 8 of the Securitisation Law, the assignment of credits for securitisation may only be voided under the “impugnação pauliana” if the interested parties prove the existence of the requirements set out in articles 610 and 612 of the Portuguese Civil Code. This means that the presumption of bad faith of the parties established under article 158 of the Insolvency Law is not applicable.

Consequently, the assignment of credits under the Securitisation Law will only be voided in favour of the bankruptcy estate if the interested parties prove that the assignment has actually cause a reduction of the patrimonial guarantee of the originator and that the parties have acted in bad faith.

In this sense, the Securitisation Law establishes that the amounts paid in respect of the credits assigned for securitisation prior to the insolvency of the originator and which become due after the insolvency proceedings are not part of the bankruptcy estate of the assignor.

Insofar, a true sale of assigned credits establishes a division between the assets of the originator and those of the SPV, so that in the event of the insolvency of the originator, its creditors shall not be able to execute the assets of the SPV or the purchasers of the issued notes (noteholders) or units.

Recently, the Portuguese Government enacted a new insolvency code through Decree-Law 53/2004 of 18 March 2004 (*Código de Insolvência e de Recuperação de Empresas* - the “Insolvency Code”) which will enter into force on September 2004. Although the Insolvency Code will introduce substantial changes on the insolvency proceedings and the conditions under which certain acts may be annulled, the impact of the new law on the securitisation transactions performed under the Securitisation Law will not be significant.

The fact that the Securitisation Law has not been amended after the approval of the new Insolvency Code, issues may arise in connection with the application of the new code to securitisations. The first issue that will arise is related with the interpretation of the established by article 8 of the Securitisation Law.

Under the Insolvency Code all acts that purport to reduce the insolvent entity's assets may be voidable in the benefit of the bankruptcy estate if such acts are performed within the four years prior to the insolvency proceedings. All acts that diminish, frustrate, difficult, endanger or delay the satisfaction of the creditors of the insolvent entity are considered to reduce the insolvent entity's assets. In addition to the reduction of the assets of the insolvent entity, the new Insolvency Code requires that the acquisition of the assets be in bad faith, which will be

presumed in the acts that took place during the two years prior to the initiation of insolvency proceedings or the acquirer has a special relationship with the debtor as set out in article 120/4 of the new Insolvency Code.

In our view, the bad faith presumption will not apply to securitisations carried out under the Securitisation Law, the SPV will not be presumed to be in bad faith, as the presumption set out in the insolvency law excluded by article 8 of the Securitisation Law. This means that the sale to the SPV can only be voided if the SPV and the originator acted in bad faith.

Another issue that may arise in connection with the new Insolvency Code is to determine whether it is possible to terminate any acts performed in the year prior to the initiation of the insolvency proceedings under articles 121/1/h of the new Insolvency Code if the obligations of the insolvent party are manifestly greater than those of the other party to the contract, irrespectively of the bad faith of the third party.

In our view, this provision will also not apply to the assignments carried out under the Securitisation Law, as the Insolvency Code establishes that article 121/1/h will not apply whenever the bad faith or any other special requirement is required under a special law.

## **(2) Insolvency of the debtors**

In the event of insolvency of the debtor, the SPV will assume the rights and obligations of the originator.

Therefore, in case the assigned credits do not benefit from any mandatory preference, the SPV will rank as a common creditor after the State, the social security and the employees of the debtor.

### **3.2.3. Tax issues**

#### **(1) Legal framework**

The tax regime applicable to securitisation performed under the Securitisation Law are set out in Decree-Law 219/2001 of 4 August 2001, as amended by Decree-Law 303/2003 (“Decree-Law 219/2001”), as well as under the Corporate Income Tax Code (*Código do Imposto sobre Pessoas Colectivas* – “CIRC”) approved by Decree-Law 422-B/88 and the Personal Income Tax Code (*Código do Imposto sobre Pessoas Singulares* – “CIRS”) approved by Decree-Law 422-A/88, both of 30 November 1988, as amended from time to time.

Decree-Law 219/2001 is applicable to the securitisation of credits carried out under the Securitisation Law, and not securitisations performed by a foreign SPV or a Portuguese SPV which does not takes the form of a Securities Company or a Securities Fund.

## **(2) Tax on the income of the originator**

Under Decree-Law 219/2001 the originator may obtain an income subject to IRC as a result of the assignment of credits if the difference between the assignment price and the book value of the assigned credits is positive. In this case, if the originator is a Portuguese resident entity or has a permanent establishment in Portugal, the positive difference will be included in the taxable net profits and there will be no obligation to withhold tax.

If the difference is negative, which is normally the case as the assignment is carried out at a lower price than the nominal value of the assigned credits, the amount will be considered as a loss.

When the originator retains an interest in the gains arising from the receivables such loss will be deferred in equal parts until the maturity of the receivable. The taxable revenue will be exempt from corporate tax if it is earned by non-resident entities without a permanent establishment in Portugal, except if the non-resident entity is a corporation held at least in 25% by an entity resident in a Country or Territory set out in Resolution 150/2004 of 13 February 2004 ("Resolution 150/2004") issued by the Ministry of Finance, *i.e.* tax heavens. The revenues received by the originator in respect of the management, even if they include a part of the interest assigned, shall be considered as profits. No withholding of tax is due in respect of revenues obtained with the receivables.

## **(3) Tax on the incomes of the SPV**

As a rule, the Securitisation Companies and the Securitisation Funds are subject to the rules set out in CIRC. The revenues they obtain are subject to a tax rate of 25% on the taxable income (article 3/1 of Decree-Law 219/2001). However, Decree-Law 219/2001 establishes certain special rules on the determination of the taxable income.

Under article 3/2 of Decree-Law 219/2001, the positive difference between the value of the assignment and the nominal value of the credits is considered a cost of the activity of the SPV in the years between the date of acquisition of the credits – or the date in which the first such interests mature, in case of future credits – and the date of the last reimbursement of the issued securities, pro rata to the interests accrued in each year. The SPV may offset the amount.

Decree-Law 219/2001 further establishes that, for the purpose of determining the taxable profits of Securitisation Funds, the amounts paid to the holders of securitised units – noteholders – are considered as costs in each year.

Under article 3/5 of Decree-Law 219/2001 there is no obligation to withhold tax in respect of the receivables of the assigned credits.



#### **(4) Tax on the income of the holders of securitisation units or bonds**

The taxation of interest payments and the capital gains obtained as a result of the transfer of securitisation units and securitised bonds are subject to the rules set out in article 4/1 of Decree-Law 219/2001.

The revenues from securitisation units or bonds obtained by resident entities or with a permanent establishment in Portugal to which such income is attributable will be subject to withholding tax at a rate of 20%.

However, the income obtained by non-resident entities without a permanent establishment in Portugal, are exempted from IRC and IRS, except when the non-resident person is a company held, directly or indirectly, in more than 25% by resident entities or when such entity is resident in a country or territory with a clearly more privilege tax regime as set out in Resolution 150/2004.

#### **(5) Value added Tax**

Under Decree-Law 219/2001, the management services in respect of Securitisation Funds or any management services provided under article 5 of the Securitisation Law and other depositary services performed under article 24 of the Securitisation Law are exempted from value added tax (*Imposto sobre o Valor Acrescentado* - "VAT"), under Decree-Law 166/94 of 26 September 1994, as amended from time to time.

For the purpose of securitisation, the SPV may pay the VAT due in connection with the assigned credits whenever such credits are considered to be outstanding in enforcement procedures, insolvency proceedings or other special actions implemented on the reorganisation of companies or when the company's insolvency is declared.

#### **(6) Stamp duty**

Under article 6 of Decree-Law 219/2001 the following transactions are exempted from stamp duty:

- (a) the sale of receivables and the assignment of credits, including any back assignments of the receivables or credits for securitisation purposes;
- (b) the interests charged and the loans granted by banks to the Securitisation Funds and the Securitisation Companies; and
- (c) the fees and commissions charged by the originator that fall under article 5 of the Securitisation Law, as well as other depositary transactions.

### **3.3. Securitisation under article 577 of the Portuguese Civil Code**

#### **3.3.1. Legal requirements**

Credits that do not fulfil the requirements set out by the Securitisation Law may be securitised under article 577 of the Portuguese Civil Code.

The Portuguese Civil Code does not contain any restrictions on the type of credits that may be assigned. Notwithstanding, the assignment will depend on the compliance of two general requirements:

- (a) the possibility of assignment of credits is not excluded by the nature of the credits, the agreement of the parties or under law; and
- (b) the credit must be determinable.

Hence, in contrast to the rules of the Securitisation Law, the assignment of future credits is allowed, even when there is no prior agreement or legal relationship. Furthermore, considering that under Portuguese civil law the purchase and sale of future assets is admissible, we believe there are no obstacles to the assignment of future credits or credits over which the assignee has no right of disposition at the date of the assignment. However, the assignor will be obliged to perform the necessary acts to ensure the acquisition of such future credit by the purchaser/assignee.

We should note that the assignment of future receivables under the Civil Code must consider the following issues:

- (a) the transfer of credits may only be executed after the credit is actually created; however, the parties may agree on paying in advance the price of the such credits;
- (b) the obligation to perform the necessary actions to ensure the creation of the credits, as a rule, will not bind the assignor to achieve such result which means that the assignor is only liable in case of lacking the proper diligence; and
- (c) in case the price has already been delivered, the assignee will have the right to request its return, as, in these cases, the assignment has not a random nature (*natureza aleatória*).

Nevertheless, since the assignment will not cause the immediate and automatic transfer of the credits, these transactions may be deemed a form of synthetic securitisation which will be better described in chapter 4.

#### **3.3.2. Insolvency issues**

### **3.4. Insolvency of the originator**

Under the Insolvency Code, the initiation of insolvency proceedings does not prevent the insolvent party from making payments or fulfilling his contractual

obligations. Therefore, the performance of the originator's duties as collecting agent will still be permitted during the proceedings that may lead to an insolvency judgement.

Notwithstanding, when insolvency proceedings against the originator commence, the purchaser should notify the debtor of the assignment and request that payments be made directly to him or a representative in Portugal, thus avoiding that payments might be considered part of the bankruptcy estate.

The Insolvency Code sets out the transactions that purport to reduce the bankruptcy estate and prevent the satisfaction of the insolvent entity's creditors and which may be voided in certain circumstances. This shall occur when the insolvent party's obligations are manifestly greater than those of its counterparty and are incurred during the year before the initiation of the insolvency proceedings, independently of the existence of a prejudicial intent, or during the four years before the insolvency proceedings if the counterparty has acted in bad faith. The counterparty shall be deemed to act in bad faith if he knew that the debtor was insolvent at the time the transaction was closed or if he was aware of the initiation of the insolvency proceedings. The law presumes the existence of bad faith in certain particular cases.

As to transactions performed outside the Securitisation Law, the effect of these provisions is that the assignment of the receivables could be annulled in the event of the insolvency of the originator if the assignment occurs in the year prior to the insolvency proceedings independently of the existence of bad faith. However, it is unlikely that the sale could be voided if the assignment is made at arms' length and for fair consideration. This means that over-collateralisation is permitted provided the obligations incurred by the SPV are not grossly disproportionate.

Therefore, in order to secure the transaction from the risk of insolvency of the originator, the price of the credits should not be grossly disproportionate in respect of their market value, so that the bad faith presumption may be set aside.

It should also be noted that in the event of assignment of future receivables, such as rental payments, tolls or electricity receivables, the court will consider payments by the debtors as part of the bankruptcy estate after the insolvency judgement. Therefore, the SPV will rank "pari passu" with other common creditors in respect of payments that are due to it under the contract.

In conclusion, it should be noted that the new Insolvency Code imposes stricter bankruptcy rules than the Insolvency Law in respect of the securitisations carried out under the Portuguese Civil Code, taking into account that the assignment of credits may be annulled if it occurs in the year prior to the insolvency proceedings, regardless of the existence of bad faith and in the four years before when certain requirements are fulfilled. Nevertheless, save for these cases, there

is no substantial difference between the previous and the new legal insolvency rules, insofar as it is still possible for the SPV to prove that there was no reduction of the bankruptcy estate of the originator and there was no bad faith of the SPV.

### **3.5. Insolvency of the debtor**

Portuguese insolvency law applicable to debtors, whether they are business or individual, provides for the rescheduling of debts and may involve the acquittance of interest payments.

It is not possible to contract out of these provisions in the sale agreements. The purchaser of the receivables will rank in case of insolvency as the originator. If their credit is unsecured, they will rank as a common creditor after the state, the social security and the employees of the debtor.

#### **3.5.1. Tax issues**

##### **(1) Legal framework**

Decree-Law 219/2001 is not applicable to securitisation transactions carried out by a foreign SPV or a Portuguese vehicle that is not a Securitisation Company or a Securitisation Fund.

Therefore, the general tax rules set out in CIRC and CIRS apply.

##### **(2) Tax on the income of the originator**

As mentioned in respect of the securitisations carried out under the Securitisation Law, the positive or negative difference between the assignment price and the nominal value of the credits will be deemed, respectively, an income or a cost of the originator. Hence, if the assignment is carried out at a discount on the nominal value of the credits, the originator will have a cost for the purpose of article 23 of CIRC.

##### **(3) Tax on the income of the SPV**

As a rule, the SPV will not be subject to IRC insofar as it will not obtain any interests or capital incomes resulting from the purchase of the credits.

It should be noted that, if the SPV is a foreign company, which is normally the case, the profit of its activity will not be taxable in Portugal, nor will it be subject to withholding tax. Therefore, only if the SPV has a permanent establishment in Portugal and its profits are attributable to this establishment will its revenues be subjected to taxation in Portugal.

Whenever the securitised credits consist of interest payments, as will be the case of banking credits, a question may arise as to whether such payments will benefit from the withholding tax exemption of IRC which is given to the banks. Although, in our opinion such interests are part of the assigned credits and should not be

deemed an income generated by the principal amount, insofar as the SPV is not a bank. Consequently, such payments should not be subject to withholding tax. However, the prevailing opinion states that the debtor should be obliged to withhold the relevant IRC, as if the SPV had assumed the position of the lender.

For these reasons, in the securitisation of banking receivables carried out under the Portuguese Civil Code, it is common practice to split the interests and the principal, and then assigning the interests to a Portuguese branch of a European bank and the principal amount directly to a foreign SPV.

#### **(4) Tax on income of the investors**

Whenever the SPV is Portuguese company, the income derived from the bonds will be subject to withholding tax at a rate of 20%, independently of the investor being a Portuguese or foreign person. The tax rate of 20% may be reduced under the relevant double taxation convention.

If the SPV is a foreign company, the payments made under the bonds issued by the SPV and which are obtained by Portuguese investors may be subject to withholding tax on the country of origin of the SPV. In these cases, the income will be considered in the taxable profits or income of the investor which will benefit from a tax credit in Portugal.

We should note that If the holders of the bonds are resident in Portugal, withholding in Portugal may be applicable, even if it is not subject to withholding in the country of incorporation of the SPV, if the payment is made by a third party resident in Portugal which has been assigned by the SPV to collect the interests payments.

#### **(5) Value added tax**

The assignment of credits is not subject to value added tax under article 1 of VAT. Nevertheless, the credits assigned to the SPV may be subject to VAT which raises the issue on who should deliver the amounts of VAT to the tax authorities.

Although the credits are transferred as a result of the assignment of credits, the originator will remain as the debtor of the taxes and will be obliged towards the debtor who has benefited from its goods or services to issue the respective invoice.

If the originator or a third entity resident in Portugal acts as manager of the credits ("servicer") and receives a remuneration for the services rendered, such remuneration may be subject to VAT, regarding the fact that such entities will not benefit from the exemption under the Securitisation Law.

#### **(6) Stamp duty tax**

The assignment of credits under article 577 of the Portuguese Civil Code will be subject to stamp duty only in the amount of five euros under article 8 of the General Table of the Stamp Duty Tax Code. In fact, as the assignment is deemed a true sale it may not be qualified as the granting of credit and, therefore, will not be subject to the rate established for the credit transactions.

Please note that, if the assignment of the credits is not, in substance, a true sale but a facility agreement, stamp duty will be levied from 0.4% to 0.6% on the amount of the facility depending on the maturity of the loan. The use of a true sale may only be assessed in a case by case basis.

### **4. Synthetic securitisation**

#### **4.1. Introduction**

In general, synthetic securitisation structures are based on the transfer of the risk of certain assets without transferring the ownership over such assets. Hence, the securities issued by the SPV will be linked to the receivables of certain assets owned by the originator but which are not object of a true sale.

Unlike true sale structures, synthetic structures allow the originator to obtain funds without performing an off-balance transaction. This may be achieved either by way of an assignment of receivables conditional upon the occurrence of certain events using credit derivatives which replicate the economic effect of the assignment of receivables.

Synthetic structures allow the securitisation of any kind of receivables which are expected to be received in the future independently of deriving from existing credits or not.

In addition, synthetic structures:

- (a) avoid the problems related with the transfer of the assets;
- (b) as a rule, do not require the preparation of any documentation in respect of the assignment of receivables (as the credits will continue to be owned by the originator); and
- (c) are generally more cost effective and more flexible to implement than to true sale structures.

In some countries, synthetic securitisations of bank receivables are usually structured to allow the originators to transfer the risk of the securitised assets to third parties. This allows the originator to release, by way of credit derivatives, its own funds which are mandatory by law without transferring the ownership of the underlying assets. These structures may also be carried out in Portugal, even

though until now no issue of credit linked notes or synthetic securitisations has been achieved.

Synthetic structures may be used to refinance the construction of bridges, high-way or infra-structures, without assignment of the receivables payable by the State, although this may only be assessed in a case by cases basis and after careful review of the relevant concession agreement.

As a rule, the originator may anticipate any kind of future payments due by its clients or other revenues from its activity without having to demonstrate the existence of a previous agreement and despite the fact that the receivables do not result from an existent agreement on the date of the transaction, such as toll gates charges charged to the users of the high-ways, future rents of buildings to be built or tickets to football matches and other sport events.

#### **4.2. Standard synthetic structure**

In this type of structure the originator assigns to the SPV the right to the receivables or the income generated by the assets owned by the originator. The acquisition of the right is financed through the issue and placement of the securities by the SPV.

Unlike true sale structures, synthetic structures involve the transfer of a legal expectation that is the right to receive a potential credit, but no credit is assigned.

With respect to the securitisation of bank receivables, whenever the originator intends to securitise a significant amount of credits, such as mortgage loans and personal loans, it is advisable to incorporate a SPV. On the contrary, if the originator intends to securitise a reduced amount of credits, including but not limited to corporate loans, the originator may issue credit linked notes directly.

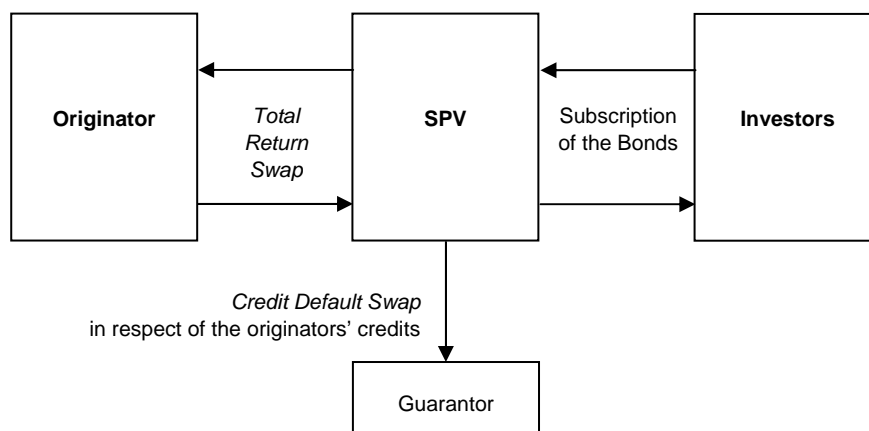
In order to reduce the economic risk in respect of the receivables, the SPV may subject the payment of the price to the originator to the effective collection of the receivables and the amounts received under the sale of the securities to the investors may be charged to guarantee the delivery of the receivables that are collected.

Alternatively, the SPV may deliver to the originator the agreed amount as consideration for the assignment against the granting of a guarantee of the payment of the amount of such credits.

#### **4.3. Steps required to implement a synthetic structure**

Synthetic structures are appropriate for the securitisation of certain types of assets which do not require a true sale of the credits, as the SPVs may only acquire the right to receive the income derived from the assets and not on the assets themselves.

The following is an example of a synthetic structure:



The steps required to implement a synthetic securitisation structure are as follow:

- (a) The originator assigns its rights on the receivables in respect of certain assets by way of a total return swap or another form of non-true sale arrangement. The SPV acquires the right to receive the cash flows arising from the receivables generated by the assets. As a rule, this agreement does not have any tax implications since the assignment does not constitute a true sale of rights;
- (b) The SPV is granted an irrevocable call option on the originator's rights by way of an irrevocable power of attorney and a true-sale assignment of credits agreement with the originator allowing him to take over the receivables upon the occurrence of certain credit events;
- (c) The SPV will enter into a credit default swap with a swap counterparty or another instrument, which may consist of a fixed charge or a personal guarantee granted by a third party, in order to hedge the risk exposure on the receivables and the originator; and
- (d) Last, the SPV issues the notes to be placed with investors.

There are other forms of synthetic structures, where the first two steps above are replaced by other forms of assignment of the receivables.

#### 4.4. Transfer instruments: *total return swaps*

The acquisition of the right to receive certain payments by the SPV on the account of the future cash-flows of the originator may be carried out through several financial instruments, the most common of which is the total return swap whereby the originator accepts to pay the SPV an amount equal to the receivables which the originator expects to collect in the future as a result of the ownership of the assets. This structure permits the relocation of the cash-flows of the assets without transferring the underlying assets.



In essence, the SPV undertakes to perform certain payments to the originator for consideration of the receivables actually collected by the originator which should be equal to the expected receivables guaranteed by the underlying assets, indirectly supporting the risks derived from the fluctuation of the value of the underlying assets.

Under the total return swap agreement the originator delivers any amounts that may receive in respect of the underlying assets as consideration for the payment of a fixed amount or an amount determined in accordance with the underlying assets, equivalent assets or an index. Hence, the originator transfers both the risk of the asset loss or the potential gain which may result from the underlying asset. The remuneration received by the SPV for the return swap will reflect the market value of the underlying assets in accordance with the criteria agreed by the parties.

Therefore, whenever the parties enter into a total return swap there is no true assignment of the credits, but only a transfer of the credit risk. The originator retains the ownership of the payments made by the debtors, since the only person entitled to receive such payments is the originator, even though it is obliged to transfer an amount equal to amounts received from the debtor.

Under the total return swap the credits are not removed from the balance sheet of the originator. In case an event of default or a termination event occurs, the payment obligations assumed under the agreement shall be automatically due. In consequence, the swap counterparty will be exposed to the credit risk of the originator as well as the risk in respect of the underlying assets.

#### **4.5. Security instruments to guarantee the transaction**

##### **4.5.1. Introduction**

The major risk of synthetic structures is the insolvency of the originator. Since there is no true-sale arrangement in respect of the securitised assets, the assets will still be owned by the originator and the rights of the SPV or of the investors against the originator will rank “pari passu” with the remaining debts of the SPV.

In these structures, debtors of securitised credits will continue to pay their debts to the originator even after the beginning of an insolvency procedure against it and there are no means to prevent that such payments continue to be made or to perform a true sale of the credit which may arise.

To minimize this disadvantage, the SPV may obtain a guarantee from the originator assuring that it will comply with all its obligations under the receivables transfer instrument.

For this purpose, the securitisation may be guaranteed by entering into a credit derivative to hedge the risk of default by the originator or, alternatively, the

receivables may be pledged to the SPV or invested in low risk notes, such as treasury bonds, which are then charged in favour of the SPV.

#### **4.5.2. Credit default swap**

The credit derivatives, including but not limited to credit default swaps may also be used to cover the risk of default of the originator as it allow the hedging of the risk of default in respect of each credit and transfer of such risk to a third party.

Under a credit default swap the counterparty undertakes to pay the SPV the difference between the amounts effectively paid by the originator to the SPV against the payment of a remuneration which is determined on the basis of the rating of the originator (usually calculated by reference to the value of the amount of the principal of the securitised assets).

Credit default swaps differ from insurance contracts because the counterparty which assumes the risk is bound to pay not only in the event of default but in any situation which is deemed by the parties an event of default or a termination event, independently of the default being attributable to the originator or not. The payment obligation of the risk buyer may arise from an event of default or a potential event of default.

#### **4.5.3. Cash collateral accounts**

The receivables in respect of the underlying asset may be guaranteed by several guarantees with a view to cover any potential defaults of payment by the debtors of the underlying assets, as well as to cover any default of the originator itself.

The originator may give as guarantee the returns of the issue of the securities subscribed by the investors. This guarantee may take different forms: cash-collateralised guarantee, pledges or a combined guarantee using a credit default swap guaranteed by a pledge of rights.

In the event such agreements constitute fixed charges in favour of the SPV, these charges may be governed by Portuguese law, English law or another law provided that the SPV may use the amounts deposited in the payment of the guaranteed obligations.

If the pledge is governed by Portuguese law, the agreement should provide that the beneficiary is entitled to sell the pledge out of court and it has the right to sell the securities market-to-market in a stock exchange or other regulated or unregulated market, which allows the immediate enforcement of the pledge to satisfy the guaranteed obligations.

## **4.6. Tax issues**

### **4.6.1. Legal framework**

Synthetic structures are subject to the rules established in the CIRC and in the CIRS. Bearing in mind the complexity of the synthetic securitisation structures, the taxation of these transactions should be assessed in a case by case basis.

### **4.6.2. Taxation of the originator**

In the event the assignment takes the form of a promise of assignment (*promessa de cessão*) or the assignment of future credits (*cessão de créditos futuros*), the originator will not obtain any income subject to taxation. When the assignment becomes effective, the originator, in principle, will suffer a loss as the credits will be assigned for an amount lower than the amount received.

Likewise, if the transaction takes the form of a total return swap, the originator will, in principle, suffer a loss equal to the amount paid to the SPV as remuneration under the agreement, that is, the difference between the nominal value of the underlying credits and the amount actually paid to the SPV.

In any event, it should always be considered that the financial structure and the payment mechanisms that are implemented under the assignment instrument chose by the parties may have tax implications which must be considered on a case by case basis.

### **4.6.3. Taxation of the SPV**

Whenever the SPV is incorporated in a foreign country, which is the rule, the SPV will be subject to taxation in the State where it was incorporated. In addition, the payments to the SPV may be subject to withholding tax in Portugal depending on the type of instrument that is used to transfer the receivables.

In general, the promise of assignment and the assignment of future credits will not be subject to withholding tax on the amount received by the SPV even if the remuneration paid to the SPV is higher, since this difference is not deemed a financial income and therefore is not subject to withholding tax.

The income derived from the total return swap or other financial derivative instruments may be subject to taxation depending on the nature of the financial instruments that are used.

### **4.6.4. Taxation of the investors**

The income received by the investors will be subject to the tax rules described above for the transactions carried out under the Portuguese Civil Code.

Therefore, the payments under the bonds issued by a SPV to Portuguese residents may be subject to withholding tax on the country of incorporation of the

SPV. Such payments will be considered for taxation purposes although the investors will be entitled to a tax credit in Portugal.

As to the capital gains obtained as a result of the sale of the bonds, one should consider in the first place the tax rules of the State of incorporation of the SPV in order to determine the application of withholding tax. In Portugal, as it was mentioned above in chapter 3.3.3, such income is subject to IRS when the investor is a person resident in Portugal. If the investor is a legal person, the capital gains will be considered as revenues in the determination of the taxable profits.

## 5. Conclusions

Securitisation carried out under the Securitisation Law present the following advantages:

- the insolvency regime of the originator under the Insolvency Code is more favourable as the Securitisation Law excludes the application of the bad faith presumption. The assignment agreement may only be revoked provided the interested party presents evidence of the bad faith and the reduction of the guarantee to the creditors; and
- the tax regime applicable to securitisations carried out under the Securitisation Law benefits from a clearer tax regime and an the exemption of withholding tax obtained by the assignor and the assignee.

However, the Securitisation Law assumes that both the SPV and the issue of bonds will be subject to Portuguese law, which may increase the costs of implementing the transaction.

In certain cases it may be advisable to use a foreign SPV. This could be carried out by assigning the bonds to a second foreign SPV or having the credits acquired under the Portuguese Civil Code and then performing the securitisation in another jurisdiction.

Synthetic structures allow the transfer of the future receivables which do not fulfil the requirements set out in the Securitisation Law for the assignment of credits, which may permit a reduction of the transaction costs and a higher flexibility of the structure.

Nevertheless, unlike true sale structures, synthetic structures may present the following disadvantages:

- in certain cases, synthetic securitisations may have a less favourable tax regime than the securitisation carried out under the Securitisation Law which benefit from a neutral tax regime, which was designed to regulate true sale structures; and

- whereas in securitisations carried out under the Securitisation Law or under the Portuguese Civil Code the assigned credits are removed from the balance sheet of the originator, in synthetic securitisation the rights of the SPV will be ranked “pari passu” with other creditors. Therefore, the originator’s credit risk must be covered by way of a guarantee or a credit derivative instrument.

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