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INTERNATIONAL FINANCIAL LAW REVIEW

BANK CAPITAL REPORT 2015: PORTUGAL

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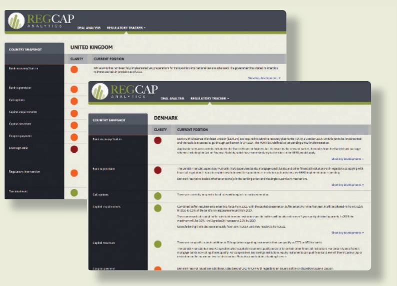

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Portugal

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Pedro Cassiano Santos, Orlando Vogler Guiné and Dominik Costa,
Vieira de Almeida & Associados

1. Bank supervision

The Bank of Portugal supervises credit institutions and financial companies in general on the prudential side (when acting as the competent authority on the home jurisdiction of such entities). As far as their banking activity is concerned, the Bank of Portugal also supervises their conduct, in this case in its role of host jurisdiction authority, and therefore also in relation to the activity of other European Union-incorporated entities whenever acting in relation to Portugal. Since November 4 2014, the ECB/SSM assumed decision power in the supervision of the four largest Portuguese banks (Caixa Geral de Depósitos, Banco Comercial Português, Novo Banco and Banco BPI). CRD IV was implemented in Portuguese law by Decree-law no. 157/2014, of October 24 2014, which introduced substantial amendments to the Portuguese banking law (Banking Law).

2. Bank recovery/ bail-in

On March 26 2015, Law no. 23-A/2015 introduced some major changes in the area of banking resolution tools in Portugal by implementing missing parts of Directive 2014/59/EU of May 15 2014, establishing a framework for the recovery and resolution of credit institutions (EU Crisis Management Directive or BRRD). From this moment on the Portuguese resolution regime foresees two new resolution tools: (i) the bail-in (article 145-U of the amended Banking Law) and (ii) an asset management tool (article 145-S of the amended Banking Law). Beside of the mentioned amendments, Law no. 23-A/2015 provides several alterations to Law no. 63-A/2008, of November 24 2008, taking into account the BRRD.

The key features and a regime in many terms substantially aligned with the final BRRD regime has been in place since 2012, in the context of the legislative reforms that were agreed with the Troika when Portugal was under the Financial Assistance Programme, which ended in May 2014.

Decree-law no. 31-A/2012, of February 10 2012, introduced a resolution regime in the Banking Law, some further amendments having been made in 2014, particularly taking into account the BRRD.

In this context, the principles of shareholders and subordinated creditors bearing losses first and the last resort nature of resolution tools were already in place and the possibility of transferring part or all of the activity and assets, liabilities, off-balance sheet items and assets under management to another credit institution or a bridge bank were already hard law, before the resolution of BES on August 3 2014.

The Portuguese recapitalisation framework enacted back in 2008 when the early days of the crisis prompted it, and the first signs of the need for rescue in the financial sector emerged, was amended in early 2014. This amendment came through Law no. 1/2014, of January 16 2014, which republished Decree-law no. 63-A/2008, of November 24 2008, and incorporated a few of the lessons learned with the four successful recapitalisation transactions that occurred in Portugal in 2012 and 2013.

An injection of funds by the state, as a shareholder or holder of hybrid capital, is now generally dependent on the advance approval of a restructuring plan by the European Commission and the advance implementation of bail-in measures, inspired in the European Commission's Banking Communication of 2013 and is therefore a step ahead of the regime that governed the Portuguese recapitalisation transactions implemented in June 2012 and January 2013.

3. Buffers

The general principles inherent to the capital buffers regime are naturally aligned with CRD IV. Accordingly, capital buffer requirements (i) are cumulative with the ordinary regulatory capital demanded under CRR, (ii) need to be covered with the highest quality capital (CET1), (iii) are calculated over a total risk exposure figure, and, (iv) have an impact, among other things, on distributions to be made by the institutions.

The capital conservation and countercyclical buffers are cumulative with each other and any other buffers. In case institutions are subject to more than one of the G-SII, O-SII and systemic risk buffers, the general principle is that only the harshest of the three will apply.

Capital conservation buffer

Phasing-in details:
- 2016 – 0.625%
- 2017 – 1.25%
- 2018 – 1.875%
- 2019 (end of phase-in) – 2.5%

Countercyclical buffer

Phasing-in details:
- 2016 – cannot exceed 0.625%
- 2017 – cannot exceed 1.25%
- 2018 – cannot exceed 1.875%
- 2019 (end of phase-in)

Under Article 138-I of the Banking Law, the Bank of Portugal publishes the countercyclical buffer rate on a quarterly basis on its website.

G-SII buffer

Phasing-in details:
- 2016 – ¼ of the buffer
- 2017 – ½ of the buffer
- 2018 – ¾ of the buffer
- 2019 (end of phase-in)

In accordance with Article 138-O and 138-P of the Banking Law, G-SIIs (determined by the Bank of Portugal) will be required to maintain a G-SII buffer of 1% (lowest category), 1.5%, 2%, 2.5% and 3.5% (highest subcategory).

O-SII Buffer

From 2016, in accordance with Article 138-R of the Banking Law, the Bank of Portugal may (but is not required to) demand from the O-SII institutions an O-SII buffer of up to 2% on an individual, sub-consolidated or consolidated basis.

Systemic risk buffer

This is already in force. The systemic risk buffer is regulated by Articles 138-U to 138-Z of the Banking Law. Should the Bank of Portugal decide to introduce a systemic risk buffer for the Portuguese financial sector (or one or more sub-sets thereof), it may demand from the credit institutions a systemic risk buffer of at least 1%, based on the relevant exposures on an individual, consolidated or sub-consolidated basis, as applicable.

The institutions that fail to meet the combined buffer requirements set out above will have to use the calculation of the maximum distributable amount (MDA) in accordance with the formulas set out in Article 138-AB of the Banking Law, which transposes the content of Article 141 of the CRD IV.

4. Call options

Portugal has so far not issued additional rules on regulatory or tax calls in addition to CRR regulation.

5. Coupon payment

In addition to the CRR, the Banking Law empowers the Bank of Portugal to limit a Portuguese institution's discretion to distribute coupons/dividends on own funds instruments, should doubts arise as to the institution's ability to comply on a permanent basis with certain regulatory requirements, in particular with capital requirements. The Bank of Portugal may use such powers in the event of a large decrease of the own funds ratio (Article 141 no. 1 h) of the Banking Law).

According to Article 116-C no. 2 h) of the Banking Law, the Bank of Portugal may limit or prohibit at a more general level payments of interest or dividends if the credit institution fails to comply with the laws and regulations relevant to its activity.

6. Credit default swap contracts

Portugal has not issued so far rules regarding the use of credit default swaps or other tools to mitigate credit risk in addition to the CRR.

7. Disclosure

Banks that are not complying with the specific laws and regulations relevant to its activity, or which are at risk of not complying, must under the terms of Article 116-F of the Banking Law immediately notify the Bank of Portugal of this fact.

Special information obligations towards the Bank of Portugal – such as information about the liquidity and solvency level – are foreseen in Article 120 of the Banking Law.

According to Article 120 no. 2 of the Banking Law the competence to regulate the provision of information necessary to assess compliance with the CRR falls upon the Bank of Portugal. The regulator has so far only established specific obligations for mutuals (Notice 5/2014 of the Bank of Portugal).

8. Leverage ratio

Portugal has so far not issued rules with regards to the leverage ratio requirements in addition to the CRR, save for a more generic coverage of the matter, as contained in the Banking Law. See Article 115-U no. 1 of the Banking Law and further Article 9 of the Bank of Portugal Notice 11/2014. Credit institutions must have available at all times high liquid assets to resist stressful funding conditions during the period of 30 calendar days. Note that this regulatory minimum level has not yet been adjusted to the financial cycle or the structure characteristics of the Portuguese financial system.

9. Loss absorption features

Loss absorption features set forth for AT1 and T2 instruments follow the CRR.

Under the Banking Law, credit institutions will be required to produce suitable recovery plans to resolve liquidity or solvency problems, while the Bank of Portugal has been given preventive powers, including the powers to limit or modify exposure to risk, require additional information, set restrictions or prohibitions on certain activities and changes to group structures. Within the scope of preventive interventions, Article 116-C of the Banking Law empowers the Bank of Portugal to prohibit the distribution of dividends to shareholders and to require credit institutions to transfer assets that constitute an excessive or undesirable risk to the soundness of the institution. Such preventive measures may have a direct effect on credit institutions' expected returns and result in putting shareholders at the forefront in the event of the adoption of loss absorption measures.

Under the Bank of Portugal Notice no. 6/2013, paragraph (3) of article 4, in the event of a large deterioration of a credit institution's own funds, as a result of loss absorption, the financial institution must submit a recapitalisation plan to the Bank of Portugal, with a view to recovering the level of own funds.

10. Minimal Capital

The Bank of Portugal Notice 6/2013 phases-in the own funds requirements under CRR. It accepts the minimum capital requirements (4.5% for the CET1 ratio and 6% for the Tier 1 ratio) under CRR, but phases-in a number of requirements, which minimise the negative effect CRR criteria could immediately entail (namely gradual deduction of unrealised losses at fair value, temporary exclusion of unrealised gains at fair value and gradual application of deductions to the different components of own funds). As a counter, this Notice establishes a 7% CET1 requirement, in the absence of which own funds conservation measures may be applied by the Bank of Portugal. Given that the CET1 requirements established by Bank of Portugal Notice 6/2013 are higher than those foreseen by Regulation (UE) 575/2013 and considering further that Art.141 no. 2 a) of the Banking Law only contains a general reference to the CET 1 ratio, the 7% CET1 requirement, as a special regulatory requirement, must still be applied by Portuguese credit institutions. In spite of this, note that Article 13 of the Bank of Portugal Notice 6/2013 makes it clear, that all Portuguese credit institutions listed in the 'List of Banks' contained in annex II of the EBA recommendation 'on the creation and supervisory oversight of temporary capital buffer to restore market confidence' (EBA/REC/2011/1) must comply with the EBA recommendation EBA/REC/2013/03 for Core Tier 1 preservation. Concerning the total capital requirements, note that no specific percentage was determined by the Portuguese legislator and/or the Bank of Portugal. This being the case, the total capital ratio of 8% required under the CRR is applicable in Portugal.

11. Pillar 2

Local law provisions under pillar 2 focus on the provision of adequate information to the Bank of Portugal and the compliance with a strict set of risk management requirements, organisational and documentation duties. In some aspects, the Banking Law may be seen as stricter than CRD IV. Simultaneous to those requirements determined by the Banking Law, the Bank of Portugal developed the risk assessment model – MAR – which aims at broader objectives than those set forth in pillar 2 and was designed to include all relevant aspects under supervision in terms of risk and risk control in a systematic and articulated manner.

12. Qualifying capital

Instruments recognised as CET1 in Portugal include:
- ordinary or special shares
- government-subscribed hybrid core tier 1 capital instruments
- institutional capital
- participation units
- ordinary or special cooperative shares

CRR requirements apply to instruments that qualify as AT1 and to instruments that qualify as T2.

The 'no-acceleration' requirement in case of default in interest payments, required under CRR for T2 instruments, has been raising legal discussion among a number of banking regulators, including the Bank of Portugal.

The point of dispute concerns the range of application to T2 instruments of general provisions of law, which could jeopardise the CRR requirement. We do not agree with the position which has been growing within the regulators (following Germany, which amended the banking law to clarify this issue), as our firm view is that such legal provisions are not at all applicable to instruments with very particular features and issuance contexts as T2s. In any case, it is possible that, without a legal change, the regulator may impose that Portuguese T2 instruments include an interest deferral condition to the benefit of the issuer.

Deferred tax assets

Law no. 61/2014, of August 26 2014, approved a special regime applicable to deferred tax assets (DTA) arising from the non-deduction of expenses and negative asset variations regarding impairment losses and post-employment benefits or long term benefits. The DTA regime applies to expenses and negative asset variations accounted in tax periods that began after January 1 2015, and to DTA registered in the taxpayer annual accounts of the last tax period of 2014. A number of banks, including the listed banks, have applied for and been granted the DTA regime.

The DTA are converted into a tax credit when the taxpayer:

1) has registered a negative net result in the tax period; or,

2) has entered into voluntary liquidation, insolvency enacted by court decision or, when applicable, the authorisation is revoked by the competent supervisory authority.

Conversion of DTA into tax credits may lead to the issuance to the state of equity subscription rights (entitling the subscription of shares for free), which the state may dispose of or convert. Shareholders will have the right to acquire those subscription rights.

Available-for-sale assets or liabilities

Paragraph (1) of Article 7 of Bank of Portugal Notice 6/2013 excludes unrealised gains or losses on exposures to central governments of EU member states from the elements of own funds.

Grandfathering

According to Article 12 of Bank of Portugal Notice 6/2013, instruments that no longer qualify as own funds will be de-recognised over the course of an eight-year period. They will be counted for in the following percentages:

- 80 % during the year of 2014;
- 70 % during the year of 2015;
- 60 % during the year of 2016;
- 50 % during the year of 2017;
- 40 % during the year of 2018;
- 30 % during the year of 2019;
- 20 % during the year of 2020;
- 10 % during the year of 2021.

As from 2022, instruments that no longer qualify as own funds will be no longer recognised.

13. Regulatory intervention

In June 2012, three of the largest Portuguese banks (Caixa Geral de Depósitos, Banco Comerical Portugês and Banco BPI) were recapitalised with public funds. Banco BPI has repaid all the state funds of €1.5 billion ($1.64 billion) CoCos up to last year; and Banco Comercial Português has repaid most of it up to the end of last year, with less than €1 billion of the initial €3 billion CoCo still outstanding). The fourth recapitalised bank, in January 2013, was Banif (€700 million shares and €400 million CoCos), having already repaid €250 million of the CoCos.

The landmark event of 2014 in Portugal was the crisis of Grupo Espírito Santo and Banco Espírito Santo (BES). A cascade of events culminated with the first ever resolution of a Portuguese bank by the Bank of Portugal. This followed very closely the principles laid down in the BRRD, as referred to above, leading to the transfer of most of the assets, liabilities, off-balance sheet items and assets under management from BES to a bridge bank (Novo Banco), which is in the process of being sold.

14. Stress tests

Four Portuguese banks (Caixa Geral de Depósitos, Banco Comercial Português, Banco BPI and BES / Novo Banco) were part of the latest EBA/ECB stress test. The results of Novo Banco, due to its very specific situation, are yet to be published. The other three banks all passed the tests, except that Banco Comercial Português showed a shortfall in the more adverse scenario. However, at the time the stress test results (based on end 2013 data) were finalised and disclosed, Banco Comercial Português had already adopted measures to strengthen its balance sheet, including by having raised €2.24 billion in a rights issue, and no additional measures were required to be implemented.

The holding of national stress tests has not been announced.

15. Tax treatment

Although there seems to be an increasing trend in a number of jurisdictions (for example, the UK and the Netherlands) allowing tax deductibility of AT1s when they are accounted for as equity under IFRS, we are not aware of any binding tax ruling, guidelines or positions of the tax authorities on these matters, either favourable or unfavourable to the banks' position as hybrid-issuers. In this regard and at this stage, interest payments will be tax deductible only if those instruments are accounted for as debt under IFRS. We would not exclude that legal changes are approved to tackle this matter. The same applies to the possibility of issuing these instruments under the special tax regime foreseen in Decree-law no. 193/2005 applicable to debt instruments trading in capital markets in general, to benefit from the broader withholding tax exemption on the interest payments arising from the instruments. If those instruments qualify as debt securities and are integrated in clearing systems allowed under this decree law (for example, CVM managed by Interbolsa, Euroclear and Clearstream), non-resident investors may benefit from a Portuguese withholding tax exemption on interest payments, provided the required evidence of their non-resident status is duly complied with.

16. Treatment of mutuals and SIFIs

None of the Portuguese financial institutions have been identified as G-Sifis.

However, the European Central Bank has decided that, due to their size, the following financial institutions are subject to its direct supervision: Banco BPI, Banco Comercial Português, Caixa Geral de Depósitos and Novo Banco.

CRR provisions also apply to mutuals.

Pedro Cassiano Santos
Partner, Vieira de Almeida & Associados

Lisbon, Portugal
T: +351 21 311 3427
E: pcs@vda.pt
W: www.vda.pt

About the author

Pedro Cassiano Santos joined Vieira de Almeida & Associados in 1989. He is head of banking and finance, taking responsibility for clients and transactions across the financial sector. He regularly advises on banking and capital markets regulatory matters. He also advises on the structuring of financing transactions, such as the issuing and placement (both national and international) of debt, hybrid and equity instruments, both cash and synthetic. He also works in the area of securitisation and other types of asset-backed transactions, as well as structured finance. He is a regular speaker at conferences and a guest teacher on numerous Masters and post-graduate courses of leading institutes and universities.

He graduated from the University of Lisbon, faculty of law, and from the College of Europe, Bruges, Belgium post-graduate European Legal Studies programme.

Orlando Vogler Guiné
Senior associate, Vieira de Almeida & Associados

Lisbon, Portugal
T: +351 21 311 3404
E: ovg@vda.pt
W: www.vda.pt

About the author

Orlando joined Vieira de Almeida & Associados in 2006 and he is a senior associate in the banking and finance and capital markets practices. He has been actively involved in numerous transactions, namely in securities issues and acquisitions, including liability management, securitisation transactions, undertakings for collective investments, attribution of voting rights, and the setting up and disclosure of long and short positions, while assisting leading institutions in the financial and non-financial sectors.

He has a Masters degree in business law from the University of Coimbra and a post-graduate degree in Securities Law from the faculty of law of the University of Lisbon.

Dominik Costa
Associate, Vieira de Almeida & Associados

Lisbon, Portugal
T: +351 21 311 3660
E: dmc@vda.pt
W: www.vda.pt

About the author

Dominik Costa joined Vieira de Almeida in 2014 and is an associate in the banking and finance practice group. Before joining the firm, he completed his legal clerkship in Kempten/Augsburg, during which time he was particularly committed to the legal areas of tax and banking and finance. He graduated from the faculty of law of the University of Augsburg. After his second state examination in law, he worked on his doctoral thesis in comparative law (Germany and Brazil).