Banking Regulation

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Portugal

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Introduction

The Portuguese economy ended 2017 on a reasonably strong footing, with the economy benefiting from healthy dynamics in the tourism sector and improved investment. The momentum has carried with the improvement of leading indicators, the expansion of industrial production, low interest rates and a declining unemployment rate (down to 8.9% in 2017) which has helped boost private consumption. Although fiscal risks remain high, in 2017, the government managed to reduce the fiscal deficit to the lowest level in more than 40 years.

Following the Bank of Portugal's ("BoP") decision on 3 August 2014 on the application of a resolution measure to Banco Espírito Santo, S.A. in the form of transfer to a bridge bank created for such purpose (Novo Banco S.A.), the Novo Banco sale process was launched by BoP, through which the private equity firm Lone Star Funds was selected as the buying entity of Novo Banco. The sale of Novo Banco's 75% share capital to Lone Star Funds, completed on 18 October 2017 – Lone Star having made capital injections in the bank in the amount of €1,000 million and the Portuguese Resolution Fund holding the remaining 25% of Novo Banco's share capital – and the conclusion of such sale process have had a positive impact and been paramount in the external perception of the national banking sector.

A considerable number of new regulatory frameworks will begin to apply in Portugal throughout 2018, which are expected to have a significant impact on the current banking regulatory landscape, from which we highlight a few that are further detailed below:

(i) EU Directive 2014/65 on markets in financial instruments ("MiFID II") and EU Regulation 600/2014 on markets in financial ("MiFIR"), both in force since 2 July 2014, became applicable in EU Member States on 3 January 2018. A proposal for the implementation of MiFID II in Portugal is already being discussed and, as such, no major delays are expected at this stage;

(ii) the PRIIPs Regulation equally became applicable in Portugal on 1 January 2018, aiming to better protect retail investors by increasing the transparency and comparability of investment products;

(iii) the revised Payment Services Directive ("PSD II") should soon be transposed into Portuguese law;

(iv) Law 83/2017, which entered into force on 17 September 2017, introduced several important amendments to the Portuguese legal regime on money laundering and terrorist financing, in line with EU Directive 2015/849; and

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(v) EU Regulation 2016/679, also known as the General Data Protection Regulation ("GDPR"), aimed at unifying the regime on the processing and movement of personal data throughout the European Union, will also start to apply in Portugal from 25 May 2018.

Regulatory architecture: Overview of banking regulators and key regulations

General overview

Portuguese banks – and credit institutions in general – are subject to the supervision of two different authorities: in respect of core banking activities, such as collecting deposits and credit granting, they are subject to the supervision of BoP; whilst as financial intermediaries, acting as such and performing securities-related transactions, they are subject to the supervision of the Portuguese Securities Market Commission ("CMVM"). Consequently, the set of rules to which Portuguese institutions are exposed is twofold: the Portuguese General Framework for Credit Institutions and Financial Companies (enacted by Decree-Law no. 298/92, of 31 December 1992, as amended from time to time, the "Banking Law"), and the Portuguese Securities Code, which accommodates in domestic legislation a wide range of Directives, including the Prospectus Directive, the Transparency Directive, the Takeover Directive and the Directives on Markets in Financial Instruments. Around this legal inner circle, there is a vast number of regulations issued by BoP and the CMVM.

BoP, as the Portuguese central bank, forms part of the European System of Central Banks ("ESCB") which is composed of the European Central Bank ("ECB") and the national central banks of the European Union Member States. Although the securities segment is not so intensively organised, the CMVM is part of the European Securities and Markets Authority ("ESMA"), an association that embraces the European supervisory authorities.

The bank regulatory regime

A credit institution qualifying as a bank, as defined in the Banking Law is an undertaking conducting the business of receiving deposits or other repayable funds from the public and granting credit for its own account to third parties in general. Banking activities in Portugal are governed by the Banking Law, which regulates the taking-up and pursuit of banking business. Banks correspond to one of the several types of credit institutions and financial entities provided for in the law, operate under the concept of a universal financial licence, and may carry out a long list of activities such as the acceptance of deposits or other repayable funds from the public, granting credit, or any form of lending, including the granting of guarantees and other payment commitments, financial leasing and factoring. Banks having their head office in Portugal, as well as branches of banks having their head offices abroad, are qualified to carry on the aforementioned activities subject to Portuguese law.

Branches of banks incorporated in EU Member States may carry out in Portugal the activities listed in Annex I to the EU Directive 2013/36, which the same bank would also be authorised to carry out in its home jurisdiction, provided a number of pre-requisites are met. According to the Banking Law, in respect of the activity of overseas banks not having a branch in Portugal, banks authorised in their home country to provide the services listed in Annex I to Directive 2013/36 may still carry on such activities in Portugal, even if they are not established therein. As a prerequisite for the commencement of such services in Portugal, the supervisory authority of the bank's home jurisdiction must notify BoP of the activities that the relevant institution intends to carry out, and certify that such activities are covered by the authorisation granted in the home country.

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It should also be noted that the supervisory system has generally changed following the recent establishment of a single supervisory mechanism ("SSM") and a single resolution mechanism ("SRM"), which are made up of the ECB and national competent authorities, the ECB being responsible for the overall functioning of the SSM and SRM, and having direct oversight of the eurozone banks in cooperation with national supervisory authorities.

Recent regulatory themes and key regulatory developments in Portugal

The resolution framework

International context and background

The banking crisis that started in 2008, and its effects, triggered deep international reflection on the lack of efficient rules, mechanisms and intervention powers of supervisors in credit institutions.

At the European level, this reflection resulted in the publication of Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 ("BRRD"), which established a framework for the recovery and resolution of credit institutions and investment firms.

The aim of BRRD was to equip national authorities with harmonised tools and powers to tackle crises in banks and certain investment firms at the earliest possible moment, and to minimise costs for taxpayers.

In Portugal, BRRD was transposed by Decree-Law no. 31-A/2012 of 10 February 2012, Decree-Law no. 114-A/2014 of 1 August 2014 and Decree-Law no. 114-B/2014 of 4 August 2014, setting forth a legal discipline for intervention in credit institutions, consisting of a three-pronged strategy: (i) corrective intervention tools; (ii) provisory administration tools; and (iii) resolution tools. Notwithstanding, full transposition of BRRD was achieved with Law 23-A/2015, which not only further amended the Banking Law but also implemented into the Portuguese legal order EU Directive 2014/49 on deposit guarantee schemes, thus protecting the depositors of all credit institutions and further contributing to safeguarding the stability of the EU banking system as a whole.

The resolution tools and financial support

In the present section, we focus on the essential features of the resolution tools under the Banking Law, since before this framework entered into force, the only way out for a credit institution facing severe financial situation with no obvious cure would be licence revocation and subsequent winding-up.

According to the Banking Law, BoP may decide to apply different resolution measures to failing institutions, neither of which involves obtaining previous consent of the intervened institution's shareholders or any third party: (i) the sale of business tool; (ii) the bridge bank tool; (iii) the asset separation tool; and (iv) the bail-in tool.

In a sale-of-business scenario, BoP will decide on the transfer, in whole or in part, of assets, rights or liabilities of the intervened credit institution to one or more institutions authorised to pursue the same activity in the Portuguese market.

When deciding on the bridge bank scenario, BoP resolves on the transfer, in whole or in part, of assets, rights or liabilities of the intervened credit institution to one or more bridge institutions specifically incorporated for such purpose which, in turn and at a later stage, will be sold in the market, or will transfer its assets and liabilities to one or more institutions authorised to pursue the banking activity in the Portuguese market. The remaining assets and liabilities not transferred to the bridge institution stay on the balance sheet of the failed bank, which typically enters into winding-up proceedings applicable to credit institutions.

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In the asset-separation scenario, BoP may determine the transfer of assets, rights or liabilities of an institution under resolution or a bridge institution to one or more asset-management vehicles, so as to maximise the respective value in a subsequent alienation or liquidation.

Finally, in a bail-in situation, BoP may also decide to apply bail-in measures to a given credit institution for the purpose of reinforcing its capital position and own funds, so it may continue to carry out its banking activity whilst complying with regulatory requirements. In this regard, BoP is empowered to reduce the nominal value of credits that constitute credit institution liabilities and to increase the share capital by the conversion of eligible liabilities through the issue of ordinary shares. Through this tool, losses end up being allocated to shareholders and creditors, thus shifting the burden of bank rescues from taxpayers to bank creditors.

Similarly to what happens in other countries, the Portuguese resolution legal framework creates a Resolution Fund, the purpose of which is to provide financial support for the implementation of resolution measures, such as subscribing the share capital of a bridge bank. At this point an inevitable question must be raised: what are the financial sources of the Resolution Fund?

Answering the above, the Banking Law and the Resolution Fund Regulation set forth that the financial resources of the Resolution Fund are essentially revenues from banking sector contributions; initial and periodic contributions by participant institutions; loans, preferably granted by participant institutions; investment revenues, donations and any other revenues, income or values arising from an institution's activities, or that are attributed to it either by law or contract.

Furthermore, should the Resolution Fund not have enough financial resources, the participant institutions and/or the State shall be called upon to make additional contributions, and the former can also be requested to grant guarantees. In the present context, where credit institutions struggle both to meet demanding capital requirements and generate liquidity for injection in a weak economy, it is hard to anticipate how, under what funding pressure and in what timings, the necessary resources for the Resolution Fund could be gathered and maintained. This issue is even more crucial in a bridge bank scenario, where the Resolution Fund happens to be its sole shareholder. Resolution tools must comply with the guiding principle prescribing that shareholders and creditors of the failed credit institution should bear first losses, in accordance with the creditors' hierarchy set forth in the Insolvency Law, and that creditors of the same class should be treated in an equitable manner; however, the general scope of this analysis will not cover burden-sharing issues.

A common framework: Loss-absorbing and recapitalisation capacity of institutions.

In the context of bail-in, in order to ensure there are sufficient financial resources available for the write-down of debt or for the conversion of liabilities into equity, BRRD requires resolution authorities to set minimum requirements for own funds and eligible liabilities ("MREL") which must be met by financial institutions. At global level in 2015, the Financial Stability Board and the Basel Committee on Banking Supervision have adopted a total loss-absorbing capacity ("TLAC") standard, focusing specifically on global systematically important banks, requiring institutions to have an adequate amount of liabilities to ensure absorption of losses and recapitalisation in the resolution phase. According to the Banking Law, BoP is to determine, on a case-by-case level, the set of minimum requirements for own funds and eligible liabilities to be complied with, based on

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each individual financial situation. The ultimate objective to be ensured is that institutions have sufficient loss-absorbing and recapitalisation capacity to ensure smooth and fast absorption of losses and recapitalisation with a minimum impact on financial stability, while aiming to avoid an impact on taxpayers. The TLAC minimum requirement shall be met with subordinated liabilities that rank in insolvency below liabilities excluded from TLAC – such can be achieved by: contractual subordination – legal effects of a contract; statutory subordination – the laws of a given jurisdiction; or structural subordination – a given corporate structure.

In this context, it is important to note EU Directive 2017/2399 (which is to be transposed into national law by 29 December 2018) which amends BRRD by creating a new asset class of "non-preferred" senior debt which ranks in insolvency above own-funds instruments and subordinated liabilities that do not qualify as own funds, but below other senior liabilities. The aim here is to enable institutions to use the less costly ordinary senior debt for their funding or other operational reasons and issue new non-preferred debt to obtain funding, while complying with TLAC subordination requirement. In this scope it is worth mentioning the seniorisation of uncovered deposits in relation to ordinary secured creditors, but below in ranking to covered deposits.

Combating money laundering and terrorism financing

EU Directive 2015/849 was enacted with the purpose of aligning the EU framework with the Financial Action Task Force recommendations, placing a special emphasis on the creation of a European-wide registry of beneficial ownership. For this purpose, corporate and other legal entities incorporated within the Union's territory are required to obtain and hold adequate, accurate and current information on their beneficial ownership, including the details of the beneficial interests held, and this information must be held in a central or public register, ensuring that such information is accessible not only to law enforcement and financial institutions, but also to any person or organisation that can demonstrate a "legitimate interest" in the disclosure of such information.

In Portugal, the regime was transposed by Law 83/2017, which introduced several amendments to the Portuguese legal regime on money laundering and terrorist financing. The legal concept of money laundering was expanded so as to include additional types of behaviour, new national and international cooperation standards and a new set of entities subject its scope. It further consolidates the existing supervisory and reporting duties and amends the previous sanctions framework, with the inclusion of new criminal offences and misdemeanours.

Furthermore, Law 89/2017 approved the legal framework of the Central Register of Beneficial Ownership ("BOCR"), transposing Chapter III of EU Directive 2015/849, which consists of a database managed by the Institute for Registrations and Notaries with updated information on the natural person(s) who, directly or indirectly, or by means of a third party, own or control entities subject to registration. Further to this Law, entities subject to the BOCR must regularly declare sufficient information about their beneficial owners.

The MiFID II / MiFIR legislative package

The MiFID II/MiFIR legislative package has been applicable from 3 January 2018, published with the aim of creating a level playing-field for firms to compete in the EU's financial markets and to ensure a consistent level of consumer protection across the EU. Whereas MiFIR is already directly applicable Portugal, the transposition project of MiFID II is currently at the later stages of parliamentary debate.

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This new regulatory package will ensure greater transparency for all market participants, while also increasing market safety, efficiency and fairness, implementing enhanced governance for trading venues, on-exchange trading of standardised derivatives, more intensive regulation of commodity derivatives, and greater consolidation of market data.

Investor protection has been stepped up through the introduction of new requirements on product governance and independent investment advice, improved pre- and post-trade transparency, the extension of existing rules to structured deposits, and the improvement of requirements in a variety of areas such as responsibility of management bodies, cross-selling, staff remuneration, inducement and information, more extensive transaction reporting, conflicts of interests and complaints handling.

PRIIPs

According to EU Regulation 1286/2014, on packaged Retail and Insurance-based Investment Products ("PRIIPs Regulation"), a PRIIP product constitutes any investment where, regardless of legal form, the amount payable to the retail investor is subject to fluctuations because of exposure to reference values or to the performance of one or more assets which are not directly purchased by the retail investor. The regulation applies to PRIIPs products and services purchased by an EEA Resident Retail Investor, regardless of their nationality, being applicable worldwide, irrespective of where a PRIIP is purchased, as long as it is purchased by an EEA Resident Retail Investor.

Having entered into force on 1 January 2018, the Regulation pursues the objective of increasing the transparency and comparability of investment products through the issue of a standardised short-form disclosure document – the PRIIPs Key Information Document ("KID), thereby making it easier for retail investors to understand and compare the key features, risk and costs of different products within the PRIIPs' scope. The CMVM is the competent authority to supervise the production, marketing and consultancy services relating to PRIIPs and the PRIIPs regulation shall be the sole applicable instrument on this matter until further CMVM regulation are issued.

The KID must be produced by entities operating in the banking, insurance and securities sectors of the financial markets and be submitted to the CMVM, any changes thereof being required to be adequately disclosed.

It is important to note that the PRIIPs Regulation sets out the regulatory context to be complied with for trade and marketing of complex financial products and unit-linked life insurance products, therefore superseding the former regime set out in CMVM Regulations.

The revised Directive on Payment Services ("PSD II")

EU Directive 2015/2366 entered into force on 12 January 2016 and provided that the respective transposition was to take place until 13 January 2018, thereby providing Member States with a two-year period for the introduction of the necessary changes in national law. Currently, the Directive is yet to be transposed into Portuguese Law.

The Directive creates new types of payment services, enhances customer protection and security and enlarges its scope of applicability when compared to the previous Directive. Banks will become obligated to provide free access of customer data and account information to licensed third party businesses, in cases where the customer has given explicit consent. It seeks to promote payment innovation in the current technological context and constitutes an important step toward the Digital Single Market in Europe, the European Commission strategy to ensure access to online activities under conditions of fair competition and a high level of consumer and personal data protection.

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The STS Regulation

EU Regulation 2017/2402, which establishes a general securitisation framework at the EU level (STS Regulation), entered into force on 17 January 2018 and will become applicable to all securitisation products from 1 January 2019 onwards. Besides creating a new framework for simple, standard and transparent securitisations, the regulation will affect due diligence requirements, risk-retention requirements and transparency rules.

EU Regulation on Data Protection

EU Regulation 2016/679, on protection of natural persons with regard to the processing of personal data and on the free movement of such data, known as the GDPR, is aimed at unifying the regime on the processing and movement of personal data throughout the Union, and will begin to apply in Portugal from 25 May 2018.

The new regime replaces the Data Protection Directive 95/46/EC and introduces significant changes, imposing a set of new obligations on companies, with non-compliance resulting in heavy fines (rising up to 4% of annual global turnover). Rules on consent have been strengthened and extra-territorial applicability has been introduced, as the regulation applies to all companies which happen to process the personal data of data subjects residing in the Union, regardless of the company's location.

Bank governance and internal controls

EU Directive 2013/36, on access to the activity of credit institutions and the prudential regulation of credit institutions and investment firms, sets forth the general principles on the internal governance and prudent management of institutions. In this vein, the Banking Law establishes that management and supervisory bodies of credit institutions are responsible for defining, overseeing and implementing the governance arrangements that are adequate to ensuring the effective and prudent management thereof, including the segregation of duties and the prevention of conflicts of interest.

The Banking Law further establishes that it is the duty of management and supervisory bodies, within their respective competences, to:

(i) assume overall responsibility for the credit institution and approve and oversee the implementation of the institution's strategic objectives, risk strategy and internal governance;

(ii) ensure the integrity of the accounting and financial reporting systems, including financial and operational controls and compliance with the law and relevant applicable standards;

(iii) oversee the disclosure process and the information duties towards BoP; and

(iv) accompany and control the activity at top management levels.

Banks should plan and apply, in a proper manner, the remuneration policy, and must record in specific documents the respective procedures and any other items required for its implementation. Pursuant to BoP Notice no. 10/2011, the implementation of a remuneration committee, which must comply with several rules and procedures, is mandatory provided that certain requirements are met by the financial institution at stake.

As regards information disclosure, banks must disclose information regarding the remuneration of both corporate bodies and employees, and the information shall be included in the respective corporate governance report and in the internal compliance report to be sent to BoP or the SSM.

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Portugal implemented CRD IV through Decree-Law 157/2014, dated 24 October 2014. Although the majority of CRD IV rules were already in force, the national legal framework has been further strengthened with regard to the requirements for the relationship between the variable and fixed component of remuneration, and with regard to the disclosure and transparency of the remuneration policy and practices applicable by institutions, including information on the link between pay and performance.

Bank capital requirements

The Portuguese framework for regulatory capital derives from the European regime and follows the framework for Basel III and CRD III.

The Basel Committee on Banking Supervision has developed a comprehensive set of reform measures known as "Basel III" in order to further strengthen the regulation, supervision and risk management of the banking sector. These measures aim, notably, at improving the banking sector's ability to absorb shocks arising from financial and economic stress, improving risk management and governance and strengthening banks' transparency and disclosures. The new capital reserve rules shall be implemented in stages, between 1 January 2014 and 1 January 2019 (and subsequently transposed into the national laws), with a phase-in period beginning in 2014, the common equity requirements coming into force in 2014, the completing measures in 2019, namely noting the amendments to the CRR Regulation introduced by EU Regulation 2017/2401, on prudential requirements for credit institutions and investment firms, applicable from 1 January 2019.

The first stage of the Basel III measures has been put in place on 1 January 2014 by Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 ("CRD IV") implemented in Portugal by Decree-Law no. 157/2014, complemented by the CRR, directly applicable since 1 January 2014. Additionally, European credit institutions are also subject to an annual Supervisory Review and Evaluation Process ("SREP") assessment, which takes into account the general framework and principles defined in the CRD IV. The SREP assessments include capital assessment, business model analysis, assessment of internal governance and institution-wide risk controls, assessment of risks to liquidity and funding, SREP liquidity assessment and broader stress testing. The SREP annual review under which the banking supervisors assess the adequacy of capital of an entity, identify risks that are not covered by own funds requirements and the need of 'Pillar 2' capital requirements. Where the SREP for an institution identifies risks or elements of risk that are not covered by the 'Pillar 1' capital requirements or the combined buffer requirement, competent authorities can determine the appropriate level of the institution's own funds under CRD IV and assess whether additional own funds shall be required.

At a European level the regulatory capital framework is a constant moving target and is rapidly developing. Although market conditions are improving, the economic environment remains volatile and the entry into force of CRD IV/CRR represents an important challenge for the EU banking system. Recent developments in the banking market suggest that even stricter rules may be applied by a Basel IV framework, which would require more stringent capital requirements and greater financial disclosure. Basel IV is likely to comprise higher leverage ratios for the banks to meet, more detailed disclosure of reserves and the use of standardised models, rather than banks' internal models, for the calculation of capital requirements.

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Rules governing banks' relationships with their customers and other third parties

Although the financial crisis triggered an increase of legislation on the protection of banking clients and investors, bank/customer relationships have been on the legislators' and regulators' radar long before harsh times begun.

In reference to deposit-taking activities, it is important to make reference to the abovementioned deposit compensation scheme, designated the Deposit Guarantee Fund (*Fundo de Garantia de Depósitos*, "DGF"), which is aimed at guaranteeing the reimbursement of deposits held with credit institutions incorporated in Portugal and with Portuguese branches of credit institutions incorporated in a non-EU State, in case the latter do not possess a compensation scheme equivalent to the DGF. Reimbursement is guaranteed up to the amount of €100,000 per depositor.

When considering the relationship of both financial intermediaries and banks with their customers, rules set forth in the PSC and the Banking Law must be taken into account. The PSC obliges financial intermediaries to keep effective and transparent procedures to handle non-qualified investors' claims, compliant with some predetermined requirements. As for the Banking Law, it sets forth that credit institutions should adopt codes of conduct which are disclosed to the public and which include all principles and rules underlying the bank/client relationship, as well as information on claims-handling procedures. Furthermore, the Banking Law provides for the possibility of customers directly presenting claims to BoP. Although it is not mandatory, major banks in Portugal currently have their own *Ombudsman*, in charge of claims reception and follow-up.

Banks and other financial intermediaries should also mandatorily comply with the consumer general complaint procedures which, among other measures, obliges those players to have available a complaints book, with any claims being followed up by the competent supervisory authority.

Turning to recent innovations in banking activity, we focus on lending activities, in relation to which Decree-Law no. 227/2012, of 25 October 2012, establishes a set of rules that should be complied with by credit institutions within the follow-up and management of breach of contracts and non-judicial settlement of payment defaults. In a clear protective move of small companies and consumer borrowers in difficult times, this document also creates a banking clients' support network aimed at preventing breach of credit contracts and promoting non-judicial settlement of credit contracts-related conflicts.

The residential mortgage loan product has also been on the radar of the Portuguese legislator and BoP, the corresponding regime being amended by Law no. 59/2012, of 9 November 2012, and establishing a range of measures evidencing the increased difficulties for Portuguese households to comply with their obligations towards the financial system. Some of these changes have a general scope but others specifically target unemployment contexts or special economic needs, essentially applying to pre-default and default situations. In turn, this housing mortgage loan legal framework should be read and applied together with a set of duties that should be complied with by the banks, within negotiation and enforcement of this type of loan.

Finally, it is also worth noting the regulation issued by BoP, in 2014, on the minimum information duties under consumer credit contracts. This regulation has been adopted following Decree-Law no. 133/2009, of 2 June 2009, which established a set of duties of information to be provided by credit institutions prior to entering into consumer credit contracts, having specified the terms, frequency and formalities according to which said information shall be provided.

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