The Banking Regulation Review

Third Edition

Editor

Jan Putnis

Law Business Research

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THE BANKING REGULATION REVIEW

Third Edition

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EDITOR'S PREFACE

Jan Putnis

When the first edition of this book was published in mid-2010, banking regulation seemed to be undergoing a transformation driven by a reasonably coherent international agenda. There were questions about how long it would be before nationalist and protectionist tendencies fractured the broad consensus that seemed to have built up on such issues as the need for more and better quality capital resources, liquidity requirements and the strengthening and reform of vital market infrastructure. However, there appeared to be a reasonable degree of certainty about the direction and speed of reform, at least among the G20 countries.

Events, as they always do, have since conspired to make the position considerably more complicated, in two separate ways. First, achieving many of the regulatory reforms agreed in principle at the meeting of G20 leaders in London in 2009 has proved to be a far more complex and difficult task than even those expert in the field of banking regulation had expected. Secondly, as concerns about solvency have spread to governments, sovereign debt has assumed centre stage. The eurozone crisis, as it has come to be known, rumbles on with no obvious short-term solution that would avoid significant economic and social upheaval in parts of the European Union. There is also the potential existential threat that sovereign defaults of eurozone countries would pose to banks that are either established in those countries or have significant exposure to banks or assets in those countries. Events in the eurozone have given the frenetic activity in the area of financial regulatory reform in the European Union a slightly surreal quality against the backdrop of the consequences of potential economic and financial upheaval in one or more eurozone countries. Meanwhile, in the United States, the rule-making process under the Dodd-Frank Act has continued, behind its original schedule, and banks continue to digest the consequences of the Volcker rule.

On both sides of the Atlantic the volume and complexity of new and proposed rules has continued to be a cause of criticism and frustration. A banking sector that was roundly blamed for creating the complexity in products, markets and business structures that exacerbated aspects of the financial crisis is facing the irony of a wall of new regulation of such complexity that the complexity itself might end up being the main reason that the new regulation fails to achieve its objectives.

Separately, in many Asian financial centres reforms are underway but are, in general, far behind those proposed and enacted in the United States and the European Union. Many governments, regulators and bankers in Asia saw (and continue to see) the western financial crisis of 2007–2009 as exactly that, a western financial crisis, and view the gradual liberalisation of the Chinese banking system and greater convertibility of the renminbi as the greater challenge and opportunity.

If we set ourselves the task of summarising the positive things that have emerged for banking regulation from that western financial crisis, what would we say now, three years on? There is little doubt that there is now much greater awareness among policymakers and regulators in all major jurisdictions of two important factors that will probably dominate any future international banking crisis:

a Banks, however well capitalised, risk collapse in sufficiently extreme circumstances and the crisis demonstrated that those circumstances should never be regarded as too extreme to contemplate. Assumptions about the credit quality and liquidity of assets, and about withdrawal of sources of funding (including deposits), may cease to apply in stressed market conditions. That means that the maturity transformation role of banks ('borrowing short term and lending long term', as it is often simplistically described) makes them subject to existential threats that are, by their very nature, difficult to anticipate and address accurately.

b Contagion can spread through financial systems in unexpected ways, or at least in ways that are unexpected by governments and regulators. Studying the potential routes of contagion and considering whether there are ways of closing down those routes without adverse unintended consequences for economies that are recovering from recession is therefore an important aspect of regulatory endeavour.

It might seem incredible now that these points were not appreciated sufficiently by governments and regulators before the financial crisis first erupted in the United States in 2007 and then spread to Europe in the following year. But that was undoubtedly the case.

The past year has seen international banking groups grappling with the practical realities of regulatory reform. Doubts about the ability of some banks to raise the additional capital (particularly Tier I capital) that they will require in order to meet the gradually increasing capital requirements set out in the Basel III agreement are feeding concerns about the long-term viability of some banks' business models and, more generally, about previously long-held expectations as to returns on equity of banking groups. Banks have begun to respond to actual and prospective higher capital requirements, in some cases by raising equity with varying degrees of success (which has been difficult in the market conditions prevailing in most of the world in the past year) and in other cases by selling or preparing to sell assets and business units, or simply by closing down business lines.

Politics have intervened in banking in the past year in ways that have made the debate about the direction of regulatory reform in the banking sector more complicated. In some countries, concern about the remuneration of senior management of banking groups has reached fever pitch in the media while, at the same time, a less emotive and generally more thoughtful debate has continued on the need for more financing for businesses, particularly small and medium-sized enterprises.

The apparent shortage of finance for businesses in many economies, coupled with expected further pressure on the ability of banks to provide that finance as their capital requirements continue to increase, has led to concerns about the development of other sources of finance. Is credit risk, and the contagion to which it can give rise if borrowers default, shifting in dangerous ways out of the banking sector into the so-called 'shadow banking sector'? The European Commission looks set to start investigating this topic in earnest in 2012. The consequences of regulatory intervention in this area are currently very difficult to predict, not least because any attempt to regulate non-bank sources of finance more heavily is bound to attract criticism from those who claim that it will only reduce further the sources of finance available to the 'real' economy.

Another area of regulatory reform that banking groups continue to grapple with in 2012 is transparency with regulators. There are various examples of the ways in which this is starting to affect the sector. The most immediate and relevant example concerns the work that many of the largest banking groups in the United States and Europe are currently involved in to draw up 'recovery plans' and to draw up, or to assist their regulators in drawing up, 'resolution plans', those plans being collectively (and somewhat misleadingly) referred to as 'living wills'. The phrase of the moment is 'barriers to resolution', describing factors that would prevent or inhibit the orderly resolution of a bank at or close to its collapse. Plenty of barriers to resolution are being identified as recovery and resolution plans are prepared. The second half of 2012 and 2013 will likely be an interesting period in which regulators ponder these barriers and deepen their discussions with banking groups as to what might be done about them.

Fears of enforced structural reorganisations and changes to business models have led some banking groups to spend considerable amounts of time and resources developing their own solutions to perceived barriers to resolution. More immediately, the process of preparing recovery and resolution plans has proved difficult, the main challenges including how to reconcile differences between the statutory resolution and insolvency procedures for banks in different jurisdictions and to understand the cross-border elements of those procedures. Fundamental questions about the availability of cross-border services to banking operations in a crisis, the treatment of banks' global hedging arrangements, and ultimately the resolvability of banking groups, are at stake. It seems likely that we are many years away from having recovery and resolution plans that carry the benefit of clarity around how regulators would operate them on a cross-border basis in a crisis. It also remains to be seen whether cross-border cooperation between regulators would work in such circumstances given the significant differences between national resolution and insolvency procedures and the desire in many jurisdictions to protect local depositors. Another major area of uncertainty concerns the proposals by some regulators that debt issued by banking groups be 'bailed in' (i.e., written off or converted into equity) in a crisis and how that could happen without spreading contagion through the banking system and the wider economy via the holders of that debt.

Meanwhile, scrutiny of the structure of banks themselves has continued in some countries. The likely implementation in the United Kingdom of proposals to require the 'ring-fencing' of retail banking activities within banking groups may be the start of a trend that spreads to other countries. Despite the prevalence of 'universal' banks, combining retail and investment banking activities in single legal entities in many of the other Member States of the European Union, the European Commissioner for the Internal Market has commissioned a study into the structure of banks with a remit to consider ring-fencing of retail banking.

Liquidity has remained a central concern for many banking groups in the past year. Short-term liquidity problems at banks (arising, in particular, from concerns about the strength of some banks as counterparties) have resulted in an increase in the range of funding for which banks generally are now expected to provide collateral. This trend is expected to be exacerbated by longer-term developments such as the Basel III requirements on liquidity and the proposed introduction of depositor preference in some countries for the first time. Liquidity pressures have led to many banks engaging in new types of transactions, such as so-called 'liquidity swaps', to increase the amount of high-quality collateral that they have available for their funding operations. This ongoing search for liquidity, and for the collateral required to obtain liquidity, has made some financial regulators concerned about the potential spread of contagion within the banking sector and from the banking sector to other sectors. For example, some liquidity swap transactions have involved banks receiving liquid assets from insurers in return for assets that are less liquid.

This third edition of *The Banking Regulation Review* updates the position on important aspects of banking regulation in the countries covered, in most cases to February 2012. While the book is aimed principally at staff in the legal and compliance departments of banks, it is to be hoped that senior management also find it helpful. The book focuses most closely on the deposit-taking activities of banks. The constraints of space and time mean that it will never be possible to do full justice to all of the subjects covered in each chapter, but readers are of course welcome to contact me if they have any suggestions for future editions.

Preparing successive editions of this book continues to be an onerous task for the busy lawyers who contribute the chapters and who are otherwise much in demand. My thanks go to them for their dedication to the task. Significant changes to a book such as this also mean much more work than would otherwise be the case for the publisher. I am therefore very grateful to the publisher's team for their understanding, hard work and patience with a group of authors who often have many other commitments.

Finally, I would like to thank the partners and staff of the financial regulation group at Slaughter and May for appreciating this book's value and for encouraging our involvement in it for a third successive year.

Jan Putnis
Slaughter and May
London
April 2012

Chapter 42

PORTUGAL

Pedro Cassiano Santos[1]

I INTRODUCTION

2011 was a year of intense market turbulence, mainly due to the sovereign debt crisis and the lack of economic and market confidence, with the banking sector being caught well in the middle of the storm.

Portugal was particularly affected by the turmoil and the liquidity scarcity that is nowadays so characteristic of current trends in other markets and jurisdictions. The market's increasing suspicion of a potential country's bankruptcy, accompanied by severe consecutive downgrades of the Portuguese Republic's rating, resulted in soaring yield rates on Portuguese sovereign bonds, with the government being left no choice but to lodge a bailout request with the EU, the International Monetary Fund ('the IMF') and the European Central Bank ('the ECB') in early April. A three-year financial package of €78 billion was then approved against the signing of a memorandum containing significant cutbacks in the public expenses, as well as several measures in order to ensure the stability of the financial system (the Financial and Economic Assistance Programme for Portugal). By the third quarter of last year, the government's financial indicators already showed some improvement, and there is a generalised environment of endurance shown in the current harsh conditions; however, such efforts and a potential stabilisation of the public finances are still overcast by a feeble economic recovery, with the latest available data pointing for a recession in 2012 and virtual stagnation in 2013.

Accompanying the worldwide tendencies, the Portuguese banking industry was severely hit by last year's convulsions (in a trend that we would present as the Portuguese banking sector having been shaken but not broken). Losses resulting from sovereign debt exposure, the worsening of the wholesale interbank available funding and the deterioration of confidence among financial institutions almost led to a liquidity dry-

1 Pedro Cassiano Santos is a partner at Vieira de Almeida & Associados. The author would like to thank António Antunes Gomes of the same firm for his help in the preparation of this chapter.

out, only tackled by significant resilience and effort towards promoting confidence among the funding lines still available, as well as strong promotion and proximity near the domestic depositors' base, which have proven more resistant than many may have expected. In addition, the levels of Non-Performing Loans ('NPLs') in the corporate and household sectors, usually used as an indicator of financial difficulties, reached levels last seen in 2002. According to the latest data available at the Bank of Portugal ('the BoP'), between 2007 and 2011, in the corporate sector only, NPLs went from 1.7 per cent to 5.6 per cent but there is still a generalised performance trend and the various sectors of the economy seem to be devoting all their efforts to resist and to maintain, as much as possible, performance of outstanding debts.

On the regulatory side, the banking industry was also required to deal with several new challenges, particularly those imposing heavier capitalisation requirements. The year started with the transposition of the EU Directives 2007/44/EC on qualifying holdings, and 2009/111/EC on new capital requirements, resulting in a major amendment of the Legal Framework of Banks and Financial Companies ('RGICSF'). The newly implemented rules were aimed at reinforcing the solidity of Portuguese financial institutions, making acknowledgement of rating agencies more demanding, improving and reinforcing the powers of supervisory authorities, making the operations developed in Portugal by branches of foreign financial institutions more transparent and auditable, and establishing stricter rules on the financial operations involving securitisations. Also, the coming into force of the new rules concerning the Portuguese credit institutions' own funds requirements, including the terms of Tier I and II admitted for such purpose, securitisation transactions and risk of exposure, were laid down by the BoP through Notices 6, 7, 8 and 9/2010. These required strong conjunction between banks, legal counsel and the regulator in order to correctly put the latter in practice within the relevant institutions, but the situation seems to have been contained and no generalised defaults or service events have been triggered. The additional levels of protection that issuers and originators have put up for their transactions have so far resisted the challenges raised upon them by prevailing (and demanding) market forces.

Additionally, the Financial and Economic Assistance Programme for Portugal requires the implementation of several measures aimed at ensuring the stability of the Portuguese banking system. The main goal is to slowly reduce the leverage ratio, while reinforcing the financial institutions' solvency ratios. In this vein, the BoP's issued Notice 3/2011 that required banks to comply with core Tier I capital ratios of at least 9 per cent until December 2011 (then postponed to 30 June 2012 in order to match the dates of the European Banking Authority ('EBA') stress tests to be conducted on Portuguese banks) and of at least 10 per cent by 31 December 2012. This naturally represents a significant challenge to the banking industry, particularly at a time when the available sources of liquidity are so scarce. To assist the implementation of these measures, the programme entailed a commitment to facilitate the issuance of government-guaranteed bank bonds up to €35 billion, and also a €12 billion line foreseeing the possibility of the Portuguese state to participate in the banks' capitalisation process.

In the interests of fairness, praise must be given to the Portuguese banking industry which has shown strong resistance to such an adverse scenario (no new institution has gone into insolvency or recovery during 2011). This is mostly thanks to the relatively conservative business model that was adopted, comprising a responsible approach to the real estate market (which did not reach a 'bubble status', contrary to what seems to have happened in neighbouring markets) and the exposure to relatively 'safe' counterparties posing low default probabilities.

Regarding liquidity, the eligibility criteria imposed on collateral posting by counterparties seeking liquidity from the Eurosystem Monetary Policy Operations were hardened by the ECB from 1 January 2011. For further details see Section V, *infra*.

As for deals, the Portuguese government seems to have finally now been successful in the (re)privatisation of Banco Português de Negócios ('BPN'), nationalised due to a lack of liquidity and capitalisation during 2008. However, the exact terms, and the price to be paid, remain to be seen. The government is expecting to sell to BIC, an Angolan bank, by mid-February 2012. With the Portuguese Competition Authority's approval already in place, the parties are now apparently just awaiting Brussels' green light.

2011 was a year of many changes and challenging events for the Portuguese banking industry, but the general theme seems to be the banking community's endurance and resistance. The banking sector is expected to continue re-adapting and restructuring throughout 2012 and, considering the slightly more favourable yet prudent forecast, will hopefully be in a stronger and more stable position at the start of 2013.

II THE REGULATORY REGIME APPLICABLE TO BANKS

A credit institution qualifying as a bank, as defined in the RGICSF, 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 RGICSF, which regulates the taking up and pursuit of banking business, banking corresponding to one of the several types of credit institutions and financial entities provided for in the law and by the regulatory framework issued by the BoP, namely, through Notices, Instructions and Orientations. To name a few, the latter set out the composition of financial institutions own funds, disclosure requirements on salaries and compensation packages of employees and members of the board, as well as the terms and conditions to be included in the financial institutions' internal control policies.

Banks operate in Portugal 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 European Directive 2000/12 of 20 March 2000, as amended from time to time, which the same bank would also be authorised to carry out in its home jurisdiction. These activities must be mentioned in a programme of operations when opening a branch, setting out, *inter alia*, the types of business envisaged to be conducted and the structural organisation of the branch. This programme of operations must be delivered by the relevant bank to its home jurisdiction authority and thereby notified to the BoP, which then is granted a relatively short period to organise its host jurisdiction supervision operations. Furthermore, in accordance with the recent legislative amendments, the BoP may request the host Member State that the branch of a financial institution is treated as a 'significant branch', pending that its activity is fairly relevant in Portugal. This triggers additional disclosure of information duties, which are considered to be essential in order for the BoP to carry out its supervisory task in an integrated market.

According to the RGICSF, 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 2000/12 may still carry on such activities in Portugal, even if they are not established here. As a prerequisite for the commencement of such services in Portugal, the supervisory authority of the bank's home jurisdiction must notify the 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. The current financial supervision system in force in Portugal is based on the coexistence of three supervisors, with responsibility for the three sectors of banking, capital markets, and insurance and pension funds; this corresponds to an organisational model in which the BoP acts as a central bank as well as the entity responsible for the supervision of banks and financial companies, focusing on the stability of the financial system, while the Portuguese Securities Market Commission ('the CMVM') has the responsibility for supervising the securities market and derivative instruments as well as the activities of agents and financial intermediaries. Finally, the Portuguese Insurance Institute ('the ISP') is responsible for the supervision on insurance and pension funds.

This tripartite model was expected to be replaced during late 2010/beginning of 2011 by a 'twin peaks' model, with the number of supervisory authorities downsized from three to two. The main goal of this change was to appropriately respond to the overstress that tripartite models have been subjected to worldwide due to the changes in the financial services business.

The implementation of the new regulatory framework has, however, come to a halt and the BoP, by means of an informative letter dated 10 January 2011, has proceeded to the restructuring of its internal supervisory structure, creating three new departments: prudential supervision, market conduct supervision and legal enforcement. This course of action, as well the lack of the required further steps for such change, has raised the idea that Portugal may not be implementing a new supervisory model as soon as expected. Nonetheless, the regulatory changes attributing more powers to the supervisory authorities, especially to the BoP on the prudential side, seem to have regained momentum.

III PRUDENTIAL REGULATION

i Relationship with the prudential regulator

The BoP is currently responsible for the prudential and market conduct supervision of banks with the aim of ensuring the stability, efficiency and soundness of the financial system. The BoP has also the power to monitor and supervise the level of compliance with the rules of conduct and transparency requirements towards bank customers, thereby ensuring the safety of deposits and the protection of consumer interests. The powers and responsibilities of the BoP as a supervisory authority are stipulated in its Organic Law and in the RGICSF.

Banks subject to the supervision of the BoP are required to comply with prudential rules aimed at controlling risks inherent in their activities. On one hand, these rules aim to ensure the solvency and creditworthiness of banks and, therefore, maintain the stability of the financial system (and to increase and maintain the level of trust of depositors, investors and economic players for such a purpose). On the other hand, they also aim to protect users (depositors and investors) against losses stemming from bad management, fraud or bankruptcy of financial services suppliers or providers.

The RGICSF plays a central role in Portuguese prudential regulation, largely mirroring the EU Directives on financial activities. It is a set of harmonised rules covering a wide range of subjects such as the capital adequacy regime, banking and financial activities and the applicable codes of conduct, the limits on risk concentration and the rules on balance sheet consolidation, as well as the supervision conducted on a consolidated basis. One particular aspect should be mentioned in light of the transposition of the Capital Requirements Directive IV and of the steps taken towards a tighter cooperation between the European supervisory authorities; the BoP is now required to, whenever carrying out its activities, to assess the impact of its decisions on the stability of the financial system of other Member States, especially in situations of emergency and to take into account the convergence of the supervisory rules and practices, pursuant to Directive 2006/48/EC, namely, by following the guidelines of the European Securities and Markets Authority ('ESMA') and by participating in the activities of this entity as a member thereof.

It also includes prudential rules or limits pertaining to certain non-harmonised areas that fall under the responsibility of the national authorities; for example, the provisioning framework, internal control requirements or limits that holding banks are allow to have in fixed assets.

Most limits established in the context of prudential rules rely on the concept of own funds and the relationship and ratios that are required to be maintained with equity and quasi-equity instruments on both the asset and the liability side of the balance sheet.

In order to monitor compliance with prudential rules, the BoP analyses information reported on a systematic basis by all of those institutions subject to its supervision. This mandatory reporting is defined and specified in instructions and notices published by the BoP, which is also entitled to conduct visits and inspections its own initiative, having unlimited access to all premises and systems for such purposes.

As far as banks acting as financial intermediaries are concerned, reference is also made to the CMVM as the relevant supervising entity for activities integrating financial intermediation and the conduct of business in capital markets generally. Supervision by the CMVM focuses on the monitoring of all products and securities that are trading or placed in organised capital markets and on the granting of licences and permits that are necessary for the professional exercise of financial intermediaries' activities, as well as on the level of compliance by these entities with market rules and the requirements for the operation of capital markets generally.

The CMVM also has the capacity to publish rules and regulations covering the relevant segments of financial activity and there are various instructions that are issued by the CMVM covering many aspects, including rules on the disclosure of information imposed on either (or both) issuers of securities and on the activities of financial intermediaries.

In its supervising capacity and within its powers, the CMVM complies with the main goals as supervising entity for the capital markets, namely, fostering the protection of investors, particularly those designated as 'not professional' or 'not qualified', by promoting efficiency, equity, security and transparency of financial markets.

ii Management of banks

The BoP has a key role to play as it establishes the rules governing the prevention of entry into the market of institutions that could jeopardise the stability of the financial system. The requirements for the taking up of business (also applicable to the acquisition of relevant participations in existing entities, particularly relevant when they contain an element of control or participation in the management of the relevant entity) may be broken down into three main groups, with different but interrelated goals:

a suitability and professional qualification of the members of the management and auditing boards and fitness of the character of the shareholders – contributing to increase the efficiency of the system as a whole and maintaining the confidence of depositors and other consumers of financial services;

b feasibility of the programme of operations – this relates to profitability levels that guarantee the long-term solvency of the institution as well as the safety and security of its operations; and

c human, technical and financial resources that allow for adequate management and control of risks underlying financial activities – they create a minimum basis for the protection of the entities forming part of the financial sector and help prevent contagion effects and systemic risks.

The setting up of banks is subject to prior authorisation by the competent authority, which is normally the BoP except in exceptional situations where this power has been retained by the Ministry of Finance.

The establishment of a branch is usually initiated by the supervising authority in the local jurisdiction and then communicated to the BoP, along with the information requested by the latter, which includes:

a the country in which the proposed branch is to be established;

b a programme of operations, setting out, *inter alia*, the types of business envisaged and the structural organisation of the branch;

c the address of the branch in the host country;

d the identity of those responsible for the management of the branch; and

e the scope of activity to be authorised.

When the branch originates in it a non-EU Member State, the process is essentially assessed by the BoP in the same way as would be applicable to the creation of a local bank and the branch is required to hold allocated capital. In these cases, the capital earmarked for operations to be carried out by the branch must be sufficient to adequately cover such operations and be no less than the minimum amount required by the Portuguese law for banks of the same type.

Banks with their head offices in other EU countries may also provide services, even if those institutions are not established in Portugal, once the BoP has received the relevant information from the competent authority in their home country on the activities that the institution intends to carry out in Portugal.

In terms of decision-making policy, a general 'four-eyes policy' is required to be implemented by all banks and branches operating in the country, irrespective of whether they qualify as international subsidiaries of foreign banks or local banks. Branches operating in Portugal are required to have such decision-making powers that enable them to operate in the country, but this requirement generally does not prevent them from having internal control and rules governing risk exposure and decision-making processes, as customary in international financial groups.

Referring to the latest restrictions on remuneration of management members and employees of banking groups, reference must be made to compliance with the latest international principles and recommendations set out by the Financial Stability Board, including those published following the recent financial crisis. In this respect, the BoP has issued several recommendations to be taken in a 'comply or explain' perspective, which requires justification in the event of non-compliance by the supervised financial institution. Financial institutions should therefore adopt a remuneration policy consistent with effective management and risk control, avoiding excessive risk exposure and potential conflicts of interest, and being coherent in its objectives, values and long-term interests. Remuneration policy should be appropriate to the size, nature and complexity of the activity being carried out or developed by the bank and, in particular, with regard to the risks taken or to be taken.

Banks should adopt a clear, transparent and appropriate structure on the definition, implementation and monitoring of the remuneration policy, which objectively identifies which employees are involved in each process, as well as their roles and responsibilities. The implementation of this remuneration policy must be monitored by the parent company for its subsidiaries on an annual basis.

As part of the Financial and Economic Assistance Programme for Portugal, the largest eight Portuguese banks are required to present a quarterly financing and capitalisation plan in order for the BoP to monitor the ongoing deleveraging process, as well as the fulfilment by the banks of the solvency ratios.

iii Regulatory capital

Capital requirements are of prime importance in maintaining the banking industry financial stability as they form the first line of defence in the event of a crisis and reduce the risk of bank failure. The role of capital requirements works in two ways: it provides a loss-absorption cushion for unexpected events and, if properly designed, introduces incentives for banks to limit the risk of their activities.

The Financial and Economic Assistance Programme for Portugal implemented during 2011 required the strengthening of financial institutions' solvency ratios. In this sense, BoP's issued Notice 3/2011 that required banks to comply with core Tier I capital ratios of at least 9 per cent until December 2011 (then postponed by the BoP to 30 June 2012 in order to match the dates of the EBA stress tests to be conducted on Portuguese banks) and of at least 10 per cent by 31 December 2012.

This represented a hardening of the previous framework, that required a core Tier I capital ratio for financial institutions of at least 8 per cent.

The quality of the financial institutions' own funds has also been reinforced, in particular regarding the tightening of the criteria for the eligibility of financial instruments as Tier I and Tier II, with a focus on the eligibility of hybrid capital as such. In accordance with its powers as the competent supervisory authority, the BoP has issued Notices 6, 7, 8 and 9/2010 setting out new rules in respect of own funds, securitisation transactions and concentration exposures of banks.

In terms of securitisation, a more restrictive regime is now in force; namely, it has created a barrier to exposure to credit risk in securitisation positions for institutions that do no act as assignors or sponsors in this type of transaction.

It is important to note the legal framework applicable to a bank's exposure as the imposing of limits on the concentration of exposures to a single client or group of connected clients (i.e., a group of clients so interconnected that, if one of them were to experience financial problems, some or all of the others would be likely to face repayment difficulties) is an important mechanism for reducing the exposure of financial institutions to that client risk. Under Portuguese law, the range of exposures to one client (or a group of connected clients) must not exceed a given percentage of the banks' own funds.

Under the scope of prudential rules, there are also limits on holdings in other companies as well as limits on the holding of real estate assets that, whenever not used for the installation of the bank's own services, may only be held for a period of three years (extendable to five in certain situations) when they result from the enforcement of security or from other recovery measures in respect of credit exposure.

In addition, in order to avoid conflicts of interest, there are limits on loans to shareholders with qualified holdings, and loans to members of the management or supervisory bodies are prohibited (unless when for purposes specified in the law).

It is worth noting the rule that parent banks acting in Portugal, as well as banks controlled by parent financial companies in Portugal or in other EU Member States that are supervised on a consolidated basis by the BoP, must comply with large exposure limits and own funds requirements, particularly in respect of consolidated financial positions.

As of 2011, new rules on the calculation of risk weighted assets (BoP's Notice 9/2011), on the salary packages to members of the board (BoP's Notice 10/2011) were also put into place with objective of a better regulation of financial institutions.

In respect of the banks' capitalisation plan, Law 4/2012 of 11 January 2012 implemented measures to be adopted pursuant to the Financial and Economic Assistance Programme for Portugal, amending Law 63-A/2008, of 24 November 2008, with an aim to establish the reinforcement of the financial solidity of banking institutions and to contribute to the strengthening of their levels of core Tier I capital.

One of the more visible measures provided by the new law is the extension of its scope of application in relation to the former regime, expressly including banking institutions established in Portugal which are not public limited corporations, as well as savings banks and, in particular, the Caixa Central de Crédito Agrícola Mútuo, as beneficiaries of capitalisation transactions.

With the purpose of encouraging the stability of the financial system and the protection of depositaries, public intervention for the capitalisation of these institutions tends to assume a voluntary (generally through the filing of an application by the relevant banking institution with the Bank of Portugal), transitory (it shall last for a maximum period of five years) and subsidiary nature (it shall operate as an extraordinary measure against other investment alternatives, such as, for instance, injections of capital by private shareholders, be they Portuguese or foreign). Together with public intervention, the law provides the mechanisms applicable to public divestment, taking place once the maintenance of adequate Core Tier I capital levels is ensured, which is to be verified by the BoP and to be performed in accordance with market conditions and to preserve the appropriate payment and security of the capital invested, always taking into account the aim of financial stability.

The preferential methods provided by the Law to the capitalisation process are the purchase by the state of the credit institution's shares (or, if the institution is not a public limited company, other securities representative of its capital) or an increase in capital of the credit institution, whereby the purchased shares by public investment are automatically converted into a new class of 'special shares'.

This new class of 'special shares' does not provide the state, in a first stage of capitalisation which cannot exceed the period of five years, with the right to overcome or control the relevant institution, as well as with the voting rights concerning matters resolved by qualified majority. Throughout this stage, 'special shares' grant the state a right to a primary dividend, the application of the available amounts above the own funds of the relevant institution being mandatory with regard to the payment of the state's intervention.

However, this new law innovates by establishing a new stage of the capitalisation process, reinforcing the state's powers regarding the relevant banking institution where a materially relevant breach of the capitalisation plan occurs. At this stage, the law provides the state with the free exercise of all voting rights related with its social participation in the relevant institution, as well as the power to nominate the members of both the board of directors and the supervisory board who may represent the state to the extent of its participation, the right to the primary dividend being preserved. During this second stage, the distributable profits are allocated to state divestment.

The legal framework laid out in this law, in an extremely difficult state of affairs brought about by the atmosphere of economic and financial instability, allows for an adequate and proportional balancing of the interests of all parties involved, permitting the defence of the public interest, on one hand, while respecting the legal autonomy of the credit institutions and the rights of their shareholders.

IV CONDUCT OF BUSINESS

Banks, while conducting their business, must ensure that their clients are treated with high levels of technical competence in all the activities that they carry out, providing their business organisation with the human and material resources required to ensure appropriate conditions of quality and efficiency.

We would like to point out, in particular, the following:

a In respect of market conduct supervision, banks must:

- act expeditiously;
- provide information and assistance to customers;

- comply with the general regime on advertisements;
- adopt codes of conduct and disclose them to their customers, including, through the bank's website; and
- impose professional secrecy, binding to all members of management and auditing boards, employees, representatives, agents and other persons providing services to them on a temporary or permanent basis. Facts or data subject to professional secrecy may only be disclosed to the BoP, the Portuguese Securities Market Commission, the Deposit Guarantee Fund and to the Investor Compensation Scheme, within the scope of these institutions' powers; similar confidentiality duties are imposed on their officers and agents under the terms laid down in the criminal law and the law of penal procedure (being subject to imprisonment of up to one year), except when any other legal provision expressly limits the obligation of professional secrecy, or upon the client's authorisation transmitted to the institution.

b In respect of prudential supervision:
- the initial capital of banks set up originally or as a result of alterations to the purpose of a given company, or of a merger of two or more banks, or of a spin-off, shall be no less than €17.5 million. Likewise, the own funds of banks is at all times required be less than the minimum capital;
- banks shall invest their available funds in such a way so as to ensure appropriate levels of liquidity and solvency at all times;
- own funds shall never be lower than minimum equity capital, and at least 10 per cent of net profits in each fiscal year must be allocated to the building up of legal reserves up to the amount of equity capital;
- instruments eligible as own funds must be eligible to the cover risks or losses, whenever they occur;
- no less than 10 per cent of the net profits of a bank for each fiscal year must be earmarked for the building up of a legal reserve, up to an amount equal to the capital stock or to the sum of its set up free reserves or the carried forward results, if higher; and
- banks shall also build up special reserves to strengthen their net value or to cover losses that their profit and loss account cannot support.

In the case of non-compliance by banks with these rules, the BoP may rapidly adopt the measures or actions that are needed to remedy the situation, by issuing recommendations and specific determinations and when necessary, by imposing fines that can amount to €2 million and related penalties (in the case of a breach of the professional duties including banking secrecy, banks may even be subject to heavier penalties).

With respect to the conduct of banking business in Portugal over the past few months it should be noted that the BoP has invested significantly in the 'behavioural supervision' aspect and insisted on undertaking a policy devoted to the protection of customers of banking and financial products.

Along these lines, the BoP has published semi-annual reports covering behavioural aspects of banking in Portugal and took a more active position as a mediator of conflicts between consumers and banks. With the implementation of the 'twin peaks' supervision model, this is a tendency that will certainly increase (particularly if the behavioural supervision is located within the scope of the new regulatory and supervisory authority, it is likely to devote more efforts and resources to these matters).

V FUNDING

The funding strategies of banks has changed substantially as a result of the financial market crisis. The economic environment prior to the crisis favoured funding structures that were highly dependent on ample liquidity. When that liquidity ceased to be available, banks that relied heavily on market funding were forced to make significant adjustments, not only to their funding strategies, but also in some cases even to their business models. This was necessarily the case with Portuguese banks that had been adapting their funding structures to cushion the impact of this turbulence on their activity, profitability and solvency.

The groundwork for this adjustment has been the expansion of customer funds, deposits as a source of funding playing an important part in the improvement concerning the structural liquidity situation of the Portuguese banking system. Risk aversion on the part of investors became the watchword and substantial withdrawals from unit investment funds became the norm. Portuguese banks have also used their avenues of recourse to central banks, in line with what happened with other European banks, even though they have also managed to maintain some access to wholesale debt markets.

In terms of liquidity, the eligibility criteria imposed on collateral posting by counterparties obtaining liquidity from the Eurosystem Monetary Policy Operations were hardened by the ECB from 1 January 2011, with subordinated debt and debt instruments issued by credit institutions and trading on non-regulated markets – including such instruments as the Short Term European Paper – being no longer eligible. This posed another difficult task for Portuguese banks. To counter these factors, banks increased their activity in the debt markets, with covered bonds and securitisation transactions still playing a fundamental role as a source of financing, due to still being eligible as collateral by the ECB, particularly, taking into account that the international funding window is still closed. Nonetheless, the issue of covered bonds slowed down in relation to 2010.

Also, several banks made use of the state guarantee set out in the Financial Assistance Programme for Portugal when issuing bonds in order to attract more investors and to make use of the Eurosystem.

Exchange offers and liability management exercises were another source of bank financing throughout 2011, whereby new senior debt (issued at currently prevailing market conditions) was offered in exchange for subordinated debt that was trading below par, at a significantly discounted price (this also corresponded to an opportunity for issuers to obtain a premium for their early reimbursement of the respective debts), allowing banks to deleverage their balance sheet.

Finally, commercial paper programmes, EMTN programmes and hybrid instruments continued to be used as in 2010, although at a lower level.

The call for tighter capital requirements as well as the more restrictive ECB lending policy pose a challenge to the banks' funding strategies, particularly taking into account that the state aid is deemed as subsidiary to main sources of funding such as private investment. A certain imagination shall inevitably be required and hybrid instruments under the new rules governing own funds are certainly going to be a valuable option.

VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i Control regime

In respect of credit institutions, Decree-Law 52/2010 of 26 May has proceeded to the amendment of the RGICSF. This legal framework decreases the BoP's discretion when approving the acquisition or increase of a qualifying holding in this type of entity as it provides specified criteria for the assessment of shareholders and management in relation to a proposed acquisition and a clear procedure for their application.

Pursuant to the rules now in force, any natural or legal person who intends to acquire, directly or indirectly, a qualifying holding in a credit institution or to further increase, directly or indirectly, such a qualifying holding in a credit institution as a result of which the proportion of the voting rights or of the capital held would reach or exceed 10 per cent, 20 per cent, one third or 50 per cent or so that the investment firm would become its subsidiary, shall notify the BoP.

The terms of such notice, including the information to be provide therein, are set out in Notice 5/2010 of the BoP. The BoP, is then required to assess the proposed acquisition or increase of a qualifying holding in order to ensure the sound and prudent management of the relevant financial institution – and having regard to the likely influence of the proposed acquirer on such credit institution – appraise the suitability of the proposed acquirer and the financial soundness of the proposed acquisition.

In this regard the following criteria are to be taken into account:

a the reputation of the proposed acquirer;

b the reputation and experience of any persons that will direct the business or participate in the management and supervision as a result of the proposed acquisition;

c the financial soundness of the proposed acquirer; and

d whether there are reasonable grounds to suspect that, in connection with the proposed acquisition, money laundering or terrorist financing is being or has been committed or attempted, or that the proposed acquisition could increase the risk thereof.

The BoP, provided that all necessary data and/or information in order to conduct this analysis is duly delivered, is required to inform the relevant entity of its decision within 60 days from the aforementioned notice.

Failure to notify the BoP or carrying out the acquisition or increase of a qualifying shareholding during the decision period of the BoP or non-compliance with the refusal of the proposed transaction by the BoP, regardless of the application of further sanctions, may determine the blocking of the acquired voting rights.

Furthermore, any acquisition of a holding equal or in excess of 5 per cent of the voting rights or of the capital of a credit institution is also required to be notified to the BoP in order to assess whether or not it is to be considered a qualifying shareholding.

The criteria for determining whether or not a qualifying holding is met, the voting rights and the conditions regarding aggregation thereof are also laid down in RGICSF and are the same as those already set out in Articles 20, 20A and 21 of the Portuguese Securities Code. This means that these concepts are introduced into the legal frameworks of all financial undertakings, thus allowing an essential harmonisation of criteria, not only among financial sector players but also among the issuers of shares admitted to trading on regulated market. In essence, this will mean that the criteria for imputing rights will be enlarged to cover all cases of indirect control or ability to influence the exercise of voting entitlements. This course of action was the result of an extensive work carried out by the National Council of Portuguese Financial Supervisors, comprising the BoP, the CMVM and the ISP, that focused on better regulation measures aimed at improving transparency and control over qualifying holdings within the Portuguese financial sector.

ii Transfers of banking business

The more relevant transactions regarding the transfer of banking business in the Portuguese legal framework are the transfer of commercial undertakings integrated within the activities of banks and, in respect of corporate reorganisations, mergers and demergers.

A transfer is a type of an asset deal, which has as a direct object the commercial undertaking of the bank itself, or of a part of its business relationship within a certain clientele. This transaction usually aims at ensuring the transfer of each and every element of the relevant business undertaking as an ongoing concern and has been construed as a business that must necessarily be announced to third parties (including the concerned employees) in writing, under penalty of nullity. However, the absence of a specific legal regime governing transactions of this nature leads to the necessity of complying with different legal rules foreseen in respect of each class of elements of the transferred company, such as:

a in respect of real property, transfer implies the need of a formal legal act and the update of the applicable register;

b in respect of moveable property also enjoying some sort of registration, the need for such registration to be updated; or

c in respect of credits or debits, the possible need for consent of the relevant third parties or their notification, or both, depending on their position being either active or passive.

The transfer of a business concern is, therefore, a process of business transmission governed by both principles of unity of legal title (which is reflected in the transfer agreement in itself) and of diversity of modes of circulation of the various assets contained therein, as set out in specific transmission laws.

The uniqueness of this process (often making it particularly complex and time-consuming) necessitates a case-by-case analysis, in order to determine what steps need to be taken to ensure that the right result is provided for, and to avoid the transfer affecting in a negative way the maintenance of the business and the relationships with clients and third parties in general.

Since the universal and automatic transmission of contracts, credits and debits is not, as such, provided for in the Portuguese legal framework applicable to transactions of this type, it needs to be governed by general civil rules, therefore forcing creditors' consent to be obtained for the transfer to take place and imposing the requirement that debtors be notified thereof.

Exception should be made in respect of transfers of credits, when an express or tacit agreement to this effect is obtained upfront between the transferor and the relevant party. This usually requires a case-specific analysis to be conducted in order to ensure that the transfer becomes enforceable against each consumer (as debtor) only upon notification or acceptance by the latter (no express consent being then required).

Please note that the aforementioned elements (contracts, credits and debits) may also be transferred in part or individually on an asset-by-asset basis. Should this be the case, the consent notification rules stated in the paragraphs above should be complied with in respect of any transferred asset, but naturally this will also have to be seen in light of the contracts governing the relevant situations.

In respect of corporate reorganisations, mergers and demergers in particular, a specific legal regime is applicable much in line with the other EU legislation. Thus, mergers and demergers are complex legal transactions, the validity and effectiveness of which is subject to a wide range of legal steps and procedures, in particular, merger proposal, internal and external audit, approval by board members, register and publication requirements, etc.

The effects of such transactions are characterised by a unitary legal regime resulting in the transmission of the entirety of the absorbed, merged or demerged entity without the need for any individual compliance requirement with transmission laws in respect to the various components forming part of the relevant transaction, under a principle of universal transfer (such as real estate, contracts, credits, debits etc.).

However, it must be remembered that, under the contractual freedom principle established in the Portuguese legal framework, this set of rules may not be applicable whenever this is otherwise agreed between the parties, as provided for in the working of any relevant agreement entered into in respect of the analysed transactions.

VII THE YEAR IN REVIEW

2010 brought significant challenges to the Portuguese banking industry. On one hand, the several changes that occurred in the regulatory framework, in particular the new core Tier 1 solvency ratios imposed by the Financial and Economic Assistance Programme for Portugal, the new criteria for the eligibility of certain instruments as own funds, the higher scrutiny in respect of the acquisition of qualifying holdings in credit institutions, and the more restrictive rules in respect of credit risk transfer in securitisation transactions required much work in order to adapt from the financial institutions' side.

In addition, the hardening of the ECB's eligibility criteria imposed on collateral posting by counterparties obtaining liquidity from the Eurosystem Monetary Policy Operations, 2011 also saw an additional challenge in respect of funding strategies. As a countermeasure to these constraints, the Financial and Economic Assistance Programme for Portugal enacted a commitment to facilitate the issuance of government-guaranteed bank bonds up to €35 billion and also a €12 billion line foreseeing the possibility of the Portuguese state to participate in the banks' capitalisation process.

Nonetheless, it would be fair to say that in the face of such adversities, Portuguese banks reacted in a satisfactory manner. Despite slightly reducing the credit made available to the Portuguese market, banks showed commitment not only in complying with the new regulatory aspects but also in continuing to play their role in the economy.

VIII OUTLOOK AND CONCLUSIONS

It is fair to say that 2011 was anything but easy among the global financial markets; certainly this is even more the case when the Portuguese players are considered. The sovereign crisis, allied with a decrease in the world's financial institutions, set back any recovery from a crisis that many already call the worst ever. For Portuguese players, these general trends have been even more demanding as a consequence of the ratings downgrade, the scarcity of liquidity and the more demanding environment that was caused by the economic downturn. So far, local players have shown resistance and resilience and there is a general environment of praise for this effort, as well as a call on all resources for performance to continue; but these very demanding conditions may still bring further casualties.

2012, therefore, still appears to be a year of many questions. In this sense, the most relevant seem to be the state's entry in the capital structure of the banks so that the latter may fulfil the new core Tier I solvency ratios. In addition, it is unlikely that the international funding window will be opened to Portuguese banks any time soon and, therefore, as in 2011, the year ahead seems to represent a whole new challenge in relation to the few sources of funding that are available to the Portuguese banking industry. But it is felt that the crisis will ultimately bring more a frugal, cost-minded and careful mentality, enabling significant deleverages to take place and certainly bringing many fruitful consequences.

It is vital to note that Portuguese banks' funding needs for the next 10 years will peak in 2012, when €17.8 billion of long-term principal is due. This, not only enhances the importance of short-term financing but will also require a tight cooperation between banks and regulators, namely, the BoP in order to develop and implement the best possible strategy to avoid new casualties, as much as possible, and to enable the convoy to arrive at a safe harbour.

Lastly, the main conclusion is that next year's prognosis is still quite reserved. Portugal and its banking industry do not depend strictly on themselves, in terms of recovery. With the current crisis, the difference between 'national' and 'international' have become significantly blurred. Nonetheless, and on a note of prudent optimism, it is expected that, if 2012 is tackled successfully, then there is all probability that in the years to come the economy will start to pick up its pace and Portugal shall then be ready to participate in better shape.

Appendix 1

ABOUT THE AUTHORS

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Pedro Cassiano Santos joined Vieira de Almeida & Associados in 1989 and is currently the partner in charge of the working group specialising in banking and finance law. In this capacity, he is regularly involved in the provision of legal advice in banking and capital markets regulatory matters as well as in the structuring of financing transactions, such as the issue and placement (both national and international) of debt, hybrid and equity instruments, and the issue and placement of warrants in both cash and synthetic financial products. He has a law degree from the University of Lisbon's Faculty of Law, and a postgraduate qualification in European legal studies from the College of Europe in Bruges. He was admitted to the Portuguese Bar in 1991 and has been recognised since 2004 as a financial law expert.

He has also been actively working in securitisation transactions and other types of asset-backed deals, together with the preparation of structured finance transactions. He is a regular speaker on these topics at conferences and a guest teacher for various masters and postgraduate courses organised by different institutes and universities.

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