Contributed by Pedro Cassiano Santos and Paula Gomes Freire, Vieira de Almeida & Associados

Changes, challenges and difficulties – interesting opportunities in the Portuguese banking sector

Banks and financial institutions are facing unparalleled challenges: first banks need more capital as stricter capital requirements flow from Basel III and take shape under the CRD IV, secondly banks need to change their asset book composition as risks are re-evaluated and require downsize of portfolios of assets and thirdly they need to think hard about their funding cost because with declining internally generated profits and virtually no access to the markets, reliance on either the European Central Bank or government funds naturally plays a key role. In parallel, banks are urged to ensure the flow of credit to the real economy.

This, together with the framework imposed by the Financial Assistance Programme to Portugal, constitutes the backdrop of market conditions that has shaped the provision of legal advice to the banking sector over the past 12 months and as ever, changes and difficulties, usually offer interesting opportunities.

More Capital

This has clearly been the case of the Euro 7.75 billion capital injection by the Portuguese State back in June 2012 and January 2013, into four Portuguese banks - BPI, BCP, CGD and Banif - under the form of either contingent convertible capital instruments or special shares.

In fact, within the negotiations for the Financial Assistance Programme to Portugal (which includes a bank solvency support facility in the amount of €12 billion), it was agreed to strengthen the capital base of national banks, in line with the need to strengthen their resilience and to bring forward the convergence to the new Basel III requirements, implementing more demanding solvency ratios for credit institutions. Accordingly, on May 2011, we witnessed the publication of Bank of Portugal Regulation no. 3/2011 which introduced the Core Tier 1 ratio concept and imposed the strengthening of this ratio to no less that 9%, by end 2011 and no less than 10%, by end 2012.

Subsequently, on 12 January 2012, new measures to strengthen the financial system came into force, as approved by Law no. 4/2012, dated 11 January and regulated by Portaria 150-A/2012 of 17 May (the “Recapitalisation Regime”). These measures focused on the obligations of Portuguese credit institutions to comply with Core Tier 1 ratios, setting out the terms and conditions under which the Portuguese State could participate in recapitalisation operations, until 30 June 2017.

This corresponded to a totally unprecedented exercise in the Portuguese banking sector, particularly when after a wave of nationalization of banks in the mid-seventies (followed by privatization in the early nineties), State participation in banks’ capital continues to be seen as a very sensitive issue. The good news was that

Recapitalisation Regime allowed for the ability to resort to hybrid capital instruments subscribed by the State to meet the Core Tier 1 ratios and hence allowing for the use of public funds without, at least for the time being, causing the State to become a shareholder of the relevant credit institutions (without prejudice to the State full ownership of CGD, as before the recap transaction for this bank, and noting that the State's participation in Banif is partially represented in special shares, entitling the State to special rights and dividends but allowing the bank one chance to remain private).

The end result was that while avoiding nationalisation of the Portuguese banking sector the same has become one of the most highly capitalised of Europe with an average Core Tier 1 ratio above 10%.

Also driven by the higher capital requirements imposed on the banks is the liability management trend followed by banks in 2012. In order to take advantage of the lower trading prices, the generality of Portuguese banks conducted, in 2012, liability management exercises, offering to buy back, subordinated debt, covered bonds, public sector bonds and asset backed securities or to exchange these for newly issued securities. These exercises have allowed for extra results, something that naturally helped building up the necessary level of capital.

Delevereging and Re-structuring

Another important trend over the past 12 months generating new opportunities for differentiated legal advice in the Portuguese banking sector is also resulting directly from the Memorandum of Understanding entered into between Portugal and the so called Troika (IMF|EU|ECB): *"We see a balanced and orderly deleveraging of the banking sector as critical to eliminating its funding imbalances on a permanent basis. The process should take place in an orderly manner within the Eurosystem framework and consistent with the IMF/EU adjustment program,(…)."*

In this context we witnessed the stepping up by the Bank of Portugal of the application of its Solvency and Deleveraging Assessment Framework (SDAF) for the system as a whole and for each of the eight largest banking groups. This is essentially a tool for assessing bank's solvency and deleveraging and their consistency with the macroeconomic framework .The Bank of Portugal also launched a Special on-site Inspections Program (SIP) to validate the data on assets that banks provide as inputs to the SDAF. In parallel, the Bank of Portugal has continued to conduct an evaluation of banks' impairment levels and to "discourage ever-greening of problematic loans".

Asset disposals, prompt sales of non-core assets, securitisation or other forms of transfer of non-performing loan portfolios as well as the restructuring of problematic loans has naturally come as an answer to the imposed deleveraging exercise. Law firms have seen their restructuring teams getting refocused and busier.

Furthermore the legal framework for corporate debt restructurings has been improved. In fact a revised Portuguese Insolvency Code entered into force on 20 May 2012. The new changes are essentially aimed at better supporting early rescue of viable firms namely by simplifying formalities and procedures rendering insolvency proceedings swifter and more efficient. A new special procedure for the revitalisation of companies has also been created and we trust this will prompt the need for legal advice in connection with an increased level of negotiations between the debtor and its creditors with a view to reaching an agreement on the recovery of the companies.

Tighter Liquidity

Under conditions of heightened risks in the euro area, exceptional Eurosystem liquidity support at longer maturities and a broadening of the collateral eligibility criteria played a pivotal role in easing liquidity pressures.

Notwithstanding the above, on the asset backed securities or covered bonds front in Portugal things have been quieter. We trust this is essentially due to the significant reduction of rating levels in the country and consequential more difficult access to ECB eligibility. But while new origination has been scarce a lot of restructuring of existing transactions (with significant legal innovation being required) and first time ever early redemptions have taken place.

Against all the odds BES and CGD (together with big names on the corporate side such as EDP, BRISA and PT) have, in 2012, successfully placed debt in international markets. This is a major happening in a context of very limited and challenging access to markets by both Portugal and Portuguese issuers.

Also worth mentioning is that notwithstanding low deposit rates (and direct competition from corporates issuing huge volumes of corporate retail bonds - overall issued volume corresponding to circa € 2bi - in a clear innovative trend in the debt market considering that for many years the retail market was not targeted by corporate issuers) the deposit base has remained stable.

Flow of credit to the economy

Ensuring the flow of credit to the economy is probably the new national debate. Credit is naturally crucial for economy pick up and growth.

As per the latest Troika review: *"The easing of liquidity pressures and attendant augmentation of banks' capital is helping alleviate risks of an excessive credit contraction. However, with funding strains evident in certain segments, we are taking measures to ensure that the productive sectors of the economy are able to secure continued access to credit as deleveraging proceeds."*

While talks on the creation of a new governmental agency to inject funds into the economy continued to feed the news, policy actions aimed at improving and implementing support mechanisms to facilitate access to credit, encourage internationalization and improve competitiveness of SMEs are also being discussed.

Source: *http://www.chambersandpartners.com/Europe/Editorial/74249#commentary*