GLOBAL LEGAL INSIGHTS

Banking Regulation

First Edition

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Vieira de Almeida & Associados

Introduction and regulatory architecture

The summer of 2007 may be referred to as one of the most significant periods in contemporary financial history − not only because it contains the roots of the so-called sub-prime crisis, but also (and perhaps more relevant in terms of impacts) because it comprises the origins of the financial crisis which affected the world in 2008. This crisis eventually triggered the bankruptcy of Lehman Brothers and the near-collapse or rescue via State intervention of a significant number of financial institutions worldwide, and more recently the sovereign debt and eurozone crises. These in turn have led to an unprecedented level of intervention in European countries, with more or less challenging stabilisation programmes – many of which have indeed been challenged in the courts.

Naturally, the banks were at the epicentre of all these phenomena. On the one hand, they played a critical role in the financial world and therefore the crises alluded to were seen by many as resulting from poor management, weak regulation, inadequate governance, etc. On the other hand, banks continue to be an obvious source of finance for companies and individuals in general. Hence, fine-tuning a balanced solution is critical to ensure that imposing more strict rules will neither deny the banks the flexibility to run their business nor leave their clients unprotected.

Portugal escaped neither these crises nor their impacts. In 2008, Banco Português de Negócios, S.A. was nationalised (and in the meantime privatised), and in 2010, Banco Privado Português, S.A. (a small private banking boutique) was declared bankrupt, after a long period of controlled management and suspension of payments. In 2011, Portugal agreed to the memoranda on the Portuguese Financial Assistance Programme with the European Union, the International Monetary Fund and the European Central Bank (the "**Financial Stability Plan**"), setting out guidelines to the banks to increase their own funds, deleverage and restructure. In this context, a vast number of Portuguese banks conducted liability management exercises and four Portuguese banks were actually recapitalised. Throughout this period, Portuguese banks faced an extreme challenge in obtaining liquidity, which was available only through Eurosystem transactions – although the tide changed in late 2012, when two Portuguese banks acceded to international debt capital markets for the first time in many months.

In this scenario, and particularly because Portugal and Portuguese legislation to a great extent reflect European legislation and European policies, the financial crisis and the sovereign debt and eurozone crisis determined the variation of some rules applicable to banks. Without prejudice to further detail below, we would stress the following: new rules in relation to depositors' protection (since 2008); new rules in relation to information regarding complex financial instruments (since 2008); new rules in relation to minimum capital requirements (since 2011); and new rules in what concerns State intervention in banks, with the purpose of supporting the recapitalisation thereof. But perhaps one of the most relevant changes is yet to come: the Recovery and Resolution of Credit Institutions and Investment Firms Directive, currently in the pipeline, which will be further discussed below.

Bank governance and internal controls

Portuguese banks – and credit institutions in general – are subject to the supervision of two different authorities: in what concerns core banking activities, such as collecting deposits and lending money,

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they are subject to the supervision of the Bank of Portugal; as financial intermediaries, acting as such and performing transactions relating to securities, Portuguese banks are subject to the supervision of the Portuguese Securities Commission ("**CMVM**"). Naturally, this exposes Portuguese banks to two essential sets of rules: the Portuguese General Framework for Credit Institutions and Financial Companies (enacted by Decree-Law no. 298/92, of 31 December 1992, hereinafter the "**Banking Law**"), which was enacted about 20 years ago with the purpose of implementing the first and second banking directives, as amended from time to time; and the Portuguese Securities Code, which accommodated in domestic legislation a wide range of directives, including the prospectus directive, the transparency directive, the takeover directive and the directive of markets in financial instruments. Around this legal inner circle, there are a vast number of regulations issued by the Bank of Portugal and the CMVM.

In this scenario, it is easy to understand the level of influence to which the Portuguese regulators and Portuguese legislation is exposed. The Bank of Portugal, 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 as the banking one, the CMVM is part of the European Securities and Markets Authority (ESMA), an association that embraces the European supervisory authorities.

Recent regulatory themes: a resolution framework

International context and background

As previously mentioned, 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, the financial situation of which has been showing signs of deterioration. Experience has shown that the existing mechanisms do not allow for the adoption of measures aimed at the financial recovery of credit institutions and at the avoidance of systemic contagion.

Attentive to the international *fora*, the Portuguese legislator has followed the on-going work of the European Commission, the Financial Stability Board and the G20 on this matter, as well as the developments on the awaited EU Directive establishing a framework for the recovery and resolution of credit institutions and investment firms[1] (hereinafter the "**Proposed Directive**") and related works, such as the technical document designated "*Technical details of a possible EU framework for bank recovery and resolution*", dated January 2011.

Additionally, an increase of both financial sector stability and depositor protection have been two paramount issues within the Financial Stability Plan. This explains the undertaking by the Portuguese State to reinforce the legal framework on due intervention when situations of potential or effective financial instability arise in credit institutions, even if in anticipation of the awaited future European framework on the matter.

This context explains the changes to the Banking Law enacted in 2012 through Decree-Law no. 31-A/2012, of 10 February 2012. These changes essentially set forth a new 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, the respective choice depending on the risks involved and on the level of breach by a credit institution of the legal and regulatory rules applicable to its activity, as well as on the dimension of the respective consequences and impact on depositors' rights, and on financial sector stability as a whole. It should be pointed out that the choice of any of the said intervention tools, and of the measures related therein, should always be subject to the general principles of necessity, adequacy and proportionality.

The resolution tools and financial support

In the present section, we focus on the essential features of the new resolution tools under the Banking Law, as the most significant innovation enacted by the Portuguese legislator within the intervention legal framework. In fact, before this framework entered into force, the only way out for a credit

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institution facing a severe financial situation with no obvious cure would be licence revocation and subsequent winding-up.

Resolution tools should in principle be applied as last-resort tools, i.e. the Bank of Portugal should only choose them in extreme contexts where application of the remaining tools – either corrective intervention or provisory administration ones – are no longer adequate in light of the relevant scenario. This being said, and notwithstanding the above-mentioned general principles, it is also important to note that the choice of resolution tools is conditional upon the related measures being deemed necessary to avoid systemic contagion or an eventual negative impact in the Financial Stability Plan, to minimise public costs or to protect depositors.

In line with the Proposed Directive, resolution under Portuguese law comprises two possible tools, neither of which involves obtaining previous consent of the intervened institution's shareholders or any third party: the sale of business tool; and the bridge bank tool.

In a sale of business scenario, the Bank of Portugal will decide on the transfer on commercial terms, 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, the Bank of Portugal resolves on the transfer, in all or in part, of assets, rights or liabilities of the intervened credit institution to one or more bridge institutions – bridge banks – specifically incorporated for such purpose, which, in turn, should at a certain point in the future, transfer the same to one or more institutions authorised to pursue the banking activity in the Portuguese market. As for the remaining assets and liabilities, which the Bank of Portugal chooses not to transfer on the above terms, they stay on the balance sheet of the failed bank, which typically enters into general winding-up proceedings applicable to credit institutions[2].

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 the whole 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[3] set forth that the financial resources of the Resolution Fund are essentially revenues from banking sector contributions; initial and periodic contributions by participant institutions (credit institutions incorporated in Portugal, Portuguese branches of credit institutions incorporated in a non-EU State, companies that are relevant for the management of payment systems subject to Bank of Portugal supervision and some categories of investment companies); 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 the State manages a strict Financial Stability Plan and 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.

Transfer of assets and liabilities: the losses burden

Both resolution tools must comply with a 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,[4] and that creditors of the same class should be treated in an equitable manner.

Within the resolution universe, this principle could, in our view, be one of the most difficult for the Bank of Portugal to deal with, particularly when it comes to the selection of the transferable liabilities (claims of depositors and other creditors). It may happen in practice that when deciding on which liabilities should be transferred from the failed credit institution to a transferee entity or to

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a bridge bank, the supervisor faces the need to choose some of them, leaving others behind, even if they all qualify as claims of creditors belonging to the same class. Such choice may indeed become mandatory to the supervisor when, in a given context, it concludes that treating creditors of the same class equally could jeopardise the main goals of the resolution measure: prevention of systemic risk, financial stability, continuity of critical financial functions, safeguard of taxpayers' interests, protection of public funds and depositors' confidence.

This issue has also been targeted in the memorandum on the Proposed Directive (dated 6 June 2012), which expressly states that:

"(...) the resolution framework establishes certain principles for the allocation of losses that would have to be respected, irrespective of what each national insolvency regime establishes. These principles are: a) that the losses should first be allocated in full to the shareholders and then to the creditors; and b) that creditors of the same class might be treated differently if it is justified by reasons of public interest and, in particular, in order to underpin financial stability. These principles apply to all the resolution tools."

In this respect, the insertion in the Banking Law of a rule similar to the "no creditor worse off" (the "**NCWO**") safeguard set forth in the Proposed Directive, could probably ease the supervisor's burden. Pursuant to the said rule, when applying the resolution tools and exercising the resolution powers, authorities ought to take all appropriate measures to ensure that no creditor incurs greater losses than would be incurred if the institution had been wound down under normal insolvency proceedings[5].

However, in order to be effective in a resolution context, the NCWO safeguard would have to be complemented by an independent evaluation that makes it possible to calculate the amounts that would be received by all creditors of the same class, should the failed bank be immediately wound-up (at the time the resolution measure takes place). Such a measure would make it possible to calculate any eventual differences between what is received by the creditors whose claims are not transferred to a transferee entity or to a bridge bank, and what is received by the creditors whose claims are transferred to any of the said entities, and hence compensate the former for any differences found.

In our understanding, the referred safeguard and associated evaluation would grant the supervisor an important tool which would enable it to freely decide on the transfer of liabilities in accordance with the given context needs, even if in breach of the same-class creditor's treatment rule. The only thing that would remain to be assured is that those creditors whose claims were left behind were duly compensated, i.e. paid in the exact terms, and on equitable terms, as creditors of the same class who were paid within the transferee bank or bridge bank universe, as the case may be.

However, the NCWO safeguard raises a practical major issue which, in a country facing a financial assistance programme, is not easy to ascertain: where do the necessary funds to meet NCWO-related compensation come from? From the Resolution Fund? From a State struggling against a heavy public debt and committed to limit taxpayers' exposure to costs? Could it not be invoked that payment of the said compensation by the State would mean having to use public funds to bail out the failed bank's creditors? These are some of the issues that would very likely be put forward while structuring a legal solution to meet NCWO implementation.

The resolution of holding companies

A final remark in respect of credit institutions belonging to a group subject to consolidated supervision is also due.

Resolution tools enacted in February 2012 had not provided for the inclusion of the respective holding companies in the resolution sphere. However, this scenario changed recently when, profiting from due amendments introduced by Law no. 64/2012, of 20 December 2012[6], in the Banking Law, the Portuguese legislator decided to finally recognise that resolution tools should also apply to parent companies of failed credit institutions subject to consolidated supervision. In our perspective, this change is most welcome, and an improvement of the resolution legal framework, since leaving parent companies out of the resolution scope could lead to situations where resolution goals could not be achieved, due to the fact that the most significant and relevant assets and/or liabilities of the group could stay parked in the parent company rather than in the failed credit institution.

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Portugal has not yet experienced any resolution measure and therefore the resolution legal framework has not been tested. Only time will tell how, under a Financial Stability Plan, a country would face the challenges of eventual interventions in its credit institutions, and what decisions the Bank of Portugal would take when exercising its powers, should a resolution measure ever need to be applied.

Recent regulatory themes: a recapitalisation framework

In addition to the above, and in light of the financial conditions of the Portuguese sovereign debt, together with widespread international reflection and discussion on rules and mechanisms applicable to credit institutions, the Portuguese legislator has also put forward a range of tools aimed at reinforcing the financial soundness of credit institutions and, more widely, supporting financial stability, as well as making liquidity available in the financial markets.

On the one hand, the government put forward a State guarantee programme in an aggregate amount of €20bn in relation to bonds issued by credit institutions in the context of their financing and refinancing operations. From this, over €10bn in government guaranteed bonds has been issued to date by Portuguese credit institutions.

On the other hand, also for the purposes of reinforcing the financial soundness of credit institutions, Portugal has enacted a regime for the recapitalisation of credit institutions with recourse to public investment, aimed specifically at restoring the banks' regulatory capital ratios, such regime being in force until 31 December 2013. For such effect, the Financial Stability Plan foresees a budget specifically aimed at intervention in credit institutions and in line with EU State aid rules, designated the Bank Solvency Support Facility, in the amount of €12bn. The intention of this framework is to ensure a mechanism that preserves the control of the management of the banks by their non-State owners during a first phase, and later allows them the option of buying back the government's stake. During 2012 and the first quarter of 2013, three Portuguese private banks (Banco BPI, S.A., Banco Comercial Português, S.A. and Banif – Banco International do Funchal, S.A.) and the State-owned bank Caixa Geral de Depósitos, S.A., have resorted to public recapitalisation operations in an aggregate amount of €7.25bn, complying thereby with Core Tier capital ratios above the 10% threshold set by the Bank of Portugal.

The recapitalisation with recourse to public funds may be carried out by either State subscription of special shares of the credit institution, or by subscription of contingent convertible instruments to be held exclusively by the State, or by way of a combination thereof, and such investment may have a maximum duration of five years. As has been seen in the Portuguese market, alongside the public funds, the Portuguese banks have carried out, or will be conducting, private share capital increases for the purposes of capitalising the credit institution – and despite the stressed conditions of the Portuguese market, such issuers have proven to be resilient and have successfully fully placed their private share capital increases.

Under this framework, the shares that can be issued are designated special shares and constitute a new category of the bank's shares, being governed by the regime of ordinary shares, but enjoying entitlement to a priority dividend and certain limitations to shareholders' voting rights, except for voting on certain reserved matters, and in the context of a material breach of the recapitalised institution. In such context, the recapitalisation framework currently provides that, regardless of State participation in the voting rights of a recapitalised bank, the State cannot exercise control over such entity. One important remark is that the acquisition of such voting rights by the State does not trigger the requirement to launch a mandatory takeover of the recapitalised entity (which would occur after reaching certain thresholds under general securities law), given that the recapitalisation framework expressly waives such requirement.

The second alternative corresponds to the issuance of hybrid instruments which must be held by the State in order to be eligible for Core Tier 1 ratio purposes and which remuneration, ranging between 7% and 9.3% and carrying a step-up feature throughout the investment period, is determined by the State in accordance with EU State aid rules. These hybrid instruments include three special features: (i) firstly, an alternative coupon satisfaction mechanism, allowing for coupon payments in kind in ordinary shares of the bank, in case cash payment would jeopardise the respective regulatory capital

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ratios; (ii) contingent possibility of conversion of the instruments into ordinary or special shares of the bank upon reaching certain contractually established triggers; and (iii) a mandatory conversion trigger into special shares upon a material breach of the bank's recapitalisation plan (approved by the Bank of Portugal and by the shareholders of the bank), or upon the ineligibility of the instruments qualifying as Core Tier 1 capital. Naturally the concept of material breach becomes the cornerstone of this matter, and corresponds to any failure to complete structural milestones or targets identified as essential in the bank's respective recapitalisation plans, or non-compliance with the obligations and undertakings of the recapitalised entity in such context.

The equity injections benefiting the banks make them naturally subject to specific management rules and restrictions, and also to a restructuring process in line with EU competition and State aid rules. In terms of management, the State is entitled to appoint non-executive members to the board of directors, or members to the supervisory board of the recapitalised banks, and such corporate bodies, as a whole, will be subject to a 50% reduction in their respective remuneration, when compared to the remuneration paid in the two years prior to the public injection. Further commitments for restrictions on lending to shareholders, and minimum thresholds for investing in the economy will apply, alongside behavioural restrictions set by the Directorate General of Competition in accordance with State aid rules.

As of March 2013, a proposal of law for amending the recapitalisation framework has been submitted to Parliament and is pending discussion and approval, providing namely that the State may exercise control in a publicly recapitalised entity in those circumstances where the exercise of control is possible, in accordance with EU state aid rules, and further creating a mechanism of mandatory recapitalisation with recourse to public funds. In extreme situations, and with the aim of safeguarding the public interest and ensuring financial stability of the national banking system, the Bank of Portugal may propose following this last-resort alternative, avoiding the need to complete in advance certain corporate requirements and approvals.

Bank capital requirements

In light of the previous section, one can feel how crucial the regulatory capital regime has been in the last couple of years for Portuguese banks in general. In Portugal, the core regulatory capital framework is set out by the Bank of Portugal in Notice 6/2010 (as amended).

The Portuguese framework for regulatory capital derives from the European regime and follows the framework for Basel III and CRD III, and has even been set by the Bank of Portugal at more demanding levels than those set by CRD III and those established by the European Banking Authority. Indeed, the EBA exercise for reinforcement of regulatory capital, announced on 8 December 2011 and assessing the exposures to sovereign debt held as at 30 September 2011, was intended to create a temporary capital buffer and strengthen institutions in a scenario of uncertainty due to the sovereign debt crisis. In such context, the EBA determined that banks should comply with a minimum Core Tier 1 capital ratio of 9% by 30 June 2012 and, on the Portuguese front, even more demanding thresholds were set.

In fact, further to Bank of Portugal Notice 3/2011, Portuguese banks have been required to comply with a Core Tier 1 ratio, on a consolidated basis, of 9% until 31 December 2011, and of 10% until 31 December 2012. These more stringent ratio requirements have been justified by the need to provide greater resilience to the Portuguese banking system, and follow demanding levels set at an international level, and have been the trigger for the recapitalisation operations described above and carried out by Portuguese banks (given that such Bank of Portugal notices confirmed that the contingent convertible hybrid instruments, when held by the State, would be eligible for the Core Tier 1 ratio).

Naturally, 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 we are waiting for the entry into force of CRD IV/CRR, which represents an important challenge for the EU banking system. The introduction of CRD IV/CRR in 2013 will change the legal setting for assessing capital levels: no longer will we monitor the Core Tier 1 ratio but a nominal amount of capital instead, and it is understood that the current thresholds will be required to be maintained. At a Portuguese level, we will watch the banking regulator following the same international steps.

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

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

In reference to deposit-taking activities, it is important to mention the existing 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 the Bank of Portugal. 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, set forth in Decree-Law no. 156/2005, of 15 September 2005 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 the Bank of Portugal, the corresponding regime being recently 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.

A sound and well monitored system to prevent money laundering and terrorist financing should be on the agenda of responsible States at all times, and Portugal is not an exception. Within this purpose, the Bank of Portugal issued during 2012 a regulation creating new reporting rules and procedures.

Finally, we would refer to Regulation no. 2/2012, issued by the CMVM, which establishes a set of information duties to be complied with, within the trade and marketing of complex financial products and unit-linked life insurance products. This regulation also clarifies the contents of the documentation to be provided to investors within the marketing of said products, and requires the preparation and delivery to investors of a document containing the key information.

Conclusion

Some of the mechanisms and regulations mentioned above are very recent, which makes it difficult to assess their practical effects and impact. However, regardless of their respective objectives, they all have in common a reinforcement of both the protection of customers and the soundness of the banking system, in a vulnerable context where difficulties and pathologic scenarios are more likely to occur.

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Endnotes

1. Proposal of Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directives 77/91/EEC and 82/891/EC, Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC and 2011/35/EC and Regulation (EU) No. 1093/2010.
2. Winding-up of credit institutions and financial companies is currently ruled by Decree-Law no. 199/2006, of 25 October 2006, as amended.
3. Approved by Ministerial Order no. 420/2012, of 21 December 2012.
4. Enacted by Decree-Law no. 53/2004, of 18 March 2004, as amended.
5. Article 29, no. 1 (f).
6. Law that proceeded to the second amended 2013 State Budget Law.

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Ana Rita Almeida Campos
Tel: +351 21 311 3447 / Email: arc@vda.pt
Ana Rita Almeida Campos joined Vieira de Almeida & Associados in 2006 and is currently managing associate at the Banking & Finance area of practice where she has been actively involved in several transactions, namely in Portugal and abroad, mainly focused on the issue and placement of debt and equity instruments and other structured financial products. She has also been actively working in securitisation transactions and other types of asset-backed transactions as well as on insurance and pension funds related matters. She is the Head of Business & Practice/VdA Mozambique, working, since March 2009, in the follow up of VdA clients in that African country. She is admitted to the Portuguese Bar Association and to the Law Society of England and Wales.

Hugo Moredo Santos
Tel: +351 21 311 3479 / Email: hms@vda.pt
Hugo Moredo Santos joined Vieira de Almeida & Associados in 2001 and is currently managing associate of the Banking & Finance practice area. In such capacity he has been involved in several transactions, in the Portuguese and international markets, mainly focused on structured financial deals, including the issue and placement of debt and equity instruments, securitisation and other types of asset-backed transactions and preferential shares. He has also been quite active in public offerings of securities and takeovers, rendering regular advise in capital markets-related matters. Further, he provides legal guidance in aviation finance deals. He is admitted to the Portuguese Bar Association.

Benedita Aires
Tel: +351 21 311 3447 / Email: bla@vda.pt
Benedita Aires joined Vieira de Almeida & Associados in 2003 and is currently a senior associate in the Banking & Finance practice area where she has been actively involved in several transactions, in Portugal and abroad, mainly focused on the issue and placement of debt and equity instruments and other structured financial products and classic financing. She has also been actively working in securitisation transactions, covered bonds issuances and other types of asset-backed transactions and recently in bank recapitalisation transactions. She was seconded to Clifford Chance LLP, London office, integrating the Structured Debt team during 2007 to 2008. She is admitted to the Portuguese Bar Association and registered as a European Registered Lawyer.

Vieira de Almeida & Associados

Av. Eng. Duarte Pacheco, nº 26, 1070-110 Lisboa, Portugal
Tel: +351 21 311 3400/500 / Fax: +351 21 311 3406 / http://www.vda.pt

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