The Banking Regulation Review

Fourth Edition

Editor
Jan Putnis

Law Business Research

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This article was first published in The Banking Regulation Review, 4th edition
(published in April 2013 – editor Jan Putnis).

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Jan Putnis

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Published in the United Kingdom
by Law Business Research Ltd, London
87 Lancaster Road, London, W11 1QQ, UK
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Enquiries concerning reproduction should be sent to Law Business Research, at the address above. Enquiries concerning editorial content should be directed to the Publisher – gideon.roberton@lbresearch.com

ISBN 978-1-907606-59-5

Printed in Great Britain by
Encompass Print Solutions, Derbyshire
Tel: 0844 2480 112

ACKNOWLEDGEMENTS

The publisher acknowledges and thanks the following law firms for their learned assistance throughout the preparation of this book:

ADVOKATFIRMAET BA-HR DA

AFRIDI & ANGELL

ALI BUDIARDJO, NUGROHO, REKSODIPUTRO

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EDITOR'S PREFACE

2012 may be remembered as the year when practical reality caught up with those who thought that the financial crisis that emerged in Western economies in 2007 would result in more effective cooperation between financial regulators across the world. By one measure – the number of new initiatives and proposals for reform – the amount of cross-border financial regulatory activism has never been higher. But by more useful measures – moves towards solutions to the 'too big to fail' problem through the development of effective cross-border resolution mechanisms for banking groups and international cooperation on reform of OTC derivatives regulation – the optimism of the past has faded a little.

Questions are increasingly asked about whether the obstacles to truly productive cross-border regulatory cooperation – political imperatives, different incentives and straightforward differences of view – will ever be surmounted in ways that make international banking groups fundamentally safer. Media speculation in January 2013 that US regulators might not allow banks to assume cross-border regulatory cooperation in the resolution plans that they prepare in 2013 would, if substantiated, highlight this trend.

These apparently negative developments have not made the period since the publication of the last edition of this book in April 2012 any less interesting. It is also worth noting that most of the challenges that we have seen – new law and regulation that creates difficult questions of cross-border consistency and extraterritoriality, differing regulatory philosophies between major financial jurisdictions and the sheer slowness and unpredictability of developments – have rational, if depressing, explanations. For example, fundamental differences between the insolvency law of major jurisdictions, coupled with cross-border recognition issues and disagreements over how to pay for resolution, are nothing if not formidable barriers to the development of workable group-wide resolution plans for banking groups.

However, the past 12 months have not been a period of complete failure of regulatory reform either. Progress has been made, for example, in the enactment of legislation regarding OTC derivatives, most notably the European Market Infrastructure

Regulation (EMIR) in the European Union. But, as noted above, cross-border cooperation in this area remains an issue: it seems that hardly a month goes by without the discovery of a previously unremarked-upon anomaly between the rules in this area in different countries.

Bank liquidity regulation has continued to be the subject of intense debate in 2012, culminating in the Basel Committee's announcement in January 2013 of its decision to relax and to recommend the gradual phasing in of the liquidity coverage ratio ('LCR') for banks. Taking into account the fundamental influence that the LCR will have on many banks' business models, this was a welcome sign of pragmatism and also a sign of the Basel Committee's willingness to move the debate on liquidity forward.

Despite the challenges that have arisen in bank resolution initiatives, legislation and rules are developing in this area in multiple jurisdictions, with, for example, the publication of the draft European Union Recovery and Resolution Directive ('the RRD') in June 2012.

The European Union is, at the time of writing, enjoying a period of respite from the problems that it faced from the eurozone crisis in 2012, but it would be very optimistic to say that those problems have been brought under control. The European Commission is placing much emphasis on finalising the legislation implementing Basel III (CRD IV) and the RRD as soon as possible in 2013, notwithstanding that each of these initiatives may ultimately be affected profoundly by the parallel 'banking union' proposals for the eurozone.

In the United States, the main rules implementing Basel III are also expected to be substantially finalised in 2013. The significance of the restructuring of the financial regulatory regime in the United States, principally under the rules that are emerging from the framework established by the Dodd-Frank Act, continues to unfold and looks set to dominate the careers of a generation of regulators, bankers and their advisers.

The realisation dawned on many banks in 2012 that regulatory reform will be a longer and more drawn-out process than had been anticipated. For this reason, 2012 may also be remembered as the year when the banking sector in Europe, the United States and some other parts of the world began to think seriously about structural change in the long term, accepting that restructuring will have to take place against a backdrop of continuing regulatory reform. We have begun to see more group reorganisations, disposals, and the severe downsizing or closure of some businesses in banking groups, as well as opportunistic acquisitions. Four principal factors have contributed to these developments:

a A little more certainty, or at least the perception of a little more certainty, about rule-making (or, at least, the direction of rule-making) when compared to the past.

b The continuing urgent need that many banking groups have for capital and liquidity, and the related need to ensure that capital is deployed in the most efficient and profitable ways.

c Some specific legal and regulatory initiatives driving structural change, such as the US Volcker Rule (although this rule has not yet been fully defined at the time of writing) and some emerging (though not yet in force) 'ring-fencing' proposals in parts of Europe (so far principally in the United Kingdom and France).

d Continuing regulatory attacks on complexity and actual or perceived barriers to resolution of banking groups.

Accordingly, many banks are refocusing their businesses (or are currently planning how to do so) on what they consider to be the areas that will yield the highest returns relative to cost in regulatory capital and liquidity terms. Consistent with that objective, we are seeing intense competition for capital allocation between different businesses within banking groups and a more widespread appreciation of the relative capital cost (or capital efficiency) of different activities.

2012 was of course also marked by further recrimination about past practices in parts of the banking sector. Allegations that LIBOR and other benchmarks have been manipulated (or subject to attempted manipulation), continuing losses from mis-selling and other past misconduct continue to affect the sector. Attention has turned more recently to the ways in which banking groups quantify and present these problems in their financial statements.

An increasingly orthodox view among senior management of banking groups in Europe and the United States is to conclude that the only way through these difficulties is to adopt a 'whiter than white' approach to compliance. This involves banks taking the initiative to present a new way forward on compliance matters and breaking away from the more reactive stance that some of them held in the past. Some commentators have asked where this will lead. Will it result in banking groups that are so hobbled and diminished by internal policies and rules that innovation, efficiency and, ultimately, service to the 'real' economy, is put at risk? Observation would suggest that this is a concern unless banks keep in mind four critical objectives when developing their compliance strategy and relationships with financial regulators:

Compliance

The first and most obvious objective is to ensure that banking groups are and remain compliant with their legal and regulatory obligations. In many countries this involves developing a good understanding of the purpose and spirit of those obligations in addition to (or, in some cases, instead of) their literal meaning.

Predictability

It is desirable to maximise the predictability of relationships with financial regulators. Good and constructive relationships with regulators generally make it more likely that banks will see what is coming around the corner sooner and will be better able to find positive ways to plan ahead.

Influence

Constructive influence of regulatory policy development in areas affecting banks is also desirable, even if a bank achieves no more than a small proportion of the change that it would like to see. For this purpose I would include within the meaning of 'influence' the conveying of cogent arguments even where regulators do not act in response to them. This is simply because the route to influence for a bank includes convincing regulators that it has thoughtful and coherent ideas, even where political or other imperatives have the result that the regulator does not address the bank's concerns.

Flexibility and pragmatism
Flexibility and pragmatism in the relationships between banks and their regulators is critical. Inflexibility can lead to inappropriate or overly formulaic regulatory approaches to unexpected developments. Flexibility is often difficult to achieve but is worth pursuing in the interests of both banks and regulators, through regular informal contacts and exchanges of views with senior staff at regulators in addition to formal interactions.

Obvious-looking these objectives may be, but serious problems in relationships between banks and their regulators can usually be traced back to a failure to achieve at least one of them.

This updated edition contains submissions by authors provided for the most part between mid-January and mid-February 2013, covering 56 countries (in addition to the chapters on International Initiatives and the European Union). As ever, comments on this book from banks, regulators and governments are welcome.

My thanks go to the contributors to this book, who have once again taken time out from advising on important matters affecting the banking sector to update their chapters – 'update' meaning a fundamental revision in many cases.

Thanks are also due to Adam Myers, Lydia Gerges and Gideon Roberton at Law Business Research Ltd, for their continuing support in the preparation of this book.

Finally, the list of credits would not be complete without mention of the partners and staff of Slaughter and May, in particular Ruth Fox, Ben Kingsley, Peter Lake, Laurence Rudge, Nick Bonsall, Ben Hammond, Tolek Petch and Michael Sholem. Once again, they helped not only to make this book possible but also to keep it as painless a project as is currently possible in the field of banking regulation.

Jan Putnis
Slaughter and May
London
March 2013

Chapter 45

PORTUGAL

Pedro Cassiano Santos[1]

I INTRODUCTION

Similarly to what happened in the second half of 2011, 2012 was a period of many changes, not only at a legislative level, most of them being a consequence of the Portuguese financial and economic restructuring plan, which is being implemented in exchange for the financial aid granted to the country by the EU, the International Monetary Fund and the European Central Bank (collectively, 'the Troika').

Amid the legislative highlights of the beginning of the year, Portugal implemented a new set of rules in respect of the reinforcement of the banking system capitalisation levels – Law No. 4/2012, of 11 January 2012 ('Law 4/2012') and, among other measures, hybrid instruments (i.e., debt that converts into equity at maturity), which ceased to be eligible for the purposes of the core Tier I ratio, have become eligible once again, provided that they are subscribed by the state, thus allowing the goals of banking capitalisation to also be achieved by means of issuing such instruments.

Regarding the financing of the national banking system, it is important to outline that during the first semester of 2012 covered bonds and bonds issued with state guarantee – two important sources of creation of collateral in order to obtain liquidity with the European Central Bank ('ECB') over the past few years – were withdrawn from the relevant eligibility criteria. The main consequence of this change was that Portuguese banks started to repurchase issued debt through cash offers, exchange offers and liability management transactions, which were relatively unknown to the Portuguese market up until last year. This new trend of restructuring transactions, trying to make the best of

1 Pedro Cassiano Santos is a partner at Vieira de Almeida & Associados. The author would like to thank Benedita Magalhães da Cunha of the same firm for her help in the preparation of this chapter.

negotiating bonds below par and the need to use the available assets in the best way possible, may not end here.

In this environment, one of the highlights of the second semester of 2012 was the banking recapitalisation that took place in the context of Law 4/2012, complemented by Public Ordinance 150-A/2012, dated 17 May 2012 (as amended by Public Ordinance 421-A/2012, dated 21 December 2012), with three of the largest Portuguese banks – BCP, BPI and CGD – having been recapitalised with a total amount of €6,150 million, split between subscription by the state of convertible core Tier I instruments and of shares. The recapitalisation amount was received from public sector sources, mostly from the Bank Solvency Support Facility, which has been funded by the Troika, showing the availability of support to Portuguese banks from supranational institutions.

The recapitalisation process involved complex company and regulatory banking law issues, as well as EU law considerations, since this injection of public funds into private banks (or the increase of the state's investment in CGD) constituted state aid, and was treated as such by the European Commission. As a result, all Portuguese banks deemed systemic by the European Banking Authority ('EBA') – including BES, which carried out a successful share capital increase this year in the market with its private shareholder base – satisfy the stringent core Tier I capital ratio (9 per cent) determined by the EBA for 30 June, including a buffer to cover sovereign exposure at market prices as of September 2011. The banking recapitalisation programme has not yet been concluded as, on 31 December 2012, Banco Internacional do Funchal ('Banif') announced that it will receive €1.1 billion worth of support to meet the stricter minimum capital standards. Banif's recapitalisation programme is expected to be concluded during the first semester of 2013.

On the capital markets side, the high level of activity that occurred during the year is notable, particularly motivated by the public takeover bids launched over two listed companies (Brisa and Cimpor), both successfully completed during the year and evidencing the market vitality in spite of the crisis. In both cases, however, the end result will likely correspond to the withdrawal of these companies from stock exchange listing, thereby reducing market density in a small market, and also that these transactions were both completed presumably by virtue of the low prices at which the relevant shares were trading and hence they presumably correspond to opportunistic transactions rather than to new patterns or trends likely to be repeated in the market.

On the privatisation side, and following the measures laid down in the Financial and Economic Assistance Programme for Portugal, the Portuguese government has been extremely active and launched a few privatisation processes, and successfully concluded some of those with the accomplishment of the privatisations of EDP and REN, in which the state sold to international investors from the Middle and the Far East the final tranches of capital that were still publicly held, as well as the privatisation of ANA (airport authority and concessionaire of Portuguese airports), which was sold to a French consortium. In 2012 the Portuguese government decided to reschedule the privatisations of TAP (airline) and RTP (public TV company) but it is fair to say that much has been accomplished in spite of the financial crisis and the resulting difficulties experienced by Portugal.

The end of 2012 was also highlighted by the entry into force of several legislative measures that completely transformed the legal framework applicable to pre-default and

default on residential mortgages loans contracts as a response to the difficulties felt by Portuguese families in complying with their obligations towards the financial system due to the adverse economic context and rising unemployment.

2012 was a year of many changes and challenging events for the Portuguese banking industry, but, as in 2011, the general theme continues to be the banking community's endurance and resilience. As a result of the banking recapitalisation programme, the Portuguese banking sector is certainly in a stronger and more stable position to face the challenges of 2013.

II THE REGULATORY REGIME APPLICABLE TO BANKS

A credit institution qualifying as a bank, as defined in the Credit Institutions and Financial Companies Legal Framework (set out in Decree-Law No. 298/92, of 31 December 1992, as amended from time to time) ('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 Bank of Portugal ('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, and since 2010, the BoP may request of 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 ('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 ('ISP') is responsible for the supervision on insurance and pension funds.

This tripartite model was expected to be replaced between late 2010 and the 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 in the meantime the BoP 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 recent proposals aimed at establishing a single supervisory mechanism ('SSM') that will be made up of the ECB and national competent authorities, the ECB being responsible for the overall functioning of the SSM and having direct oversight of the eurozone banks in cooperation with national supervisory authorities, may mean that Portugal may not, after all, be implementing a new supervisory model.

III PRUDENTIAL REGULATION

i Relationships 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, 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 that holding banks are allowed to have; 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 at 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, on the activities of financial intermediaries and on complex financial products.

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

b the address of the branch in the host country;

c the identity of those responsible for the management of the branch;

d the amount of the credit institution own funds;

e solvency ratio of the parent credit institution;

f detailed description of the deposit guarantee scheme in which the parent credit institution participates, which must also ensure the protection of the branch's depositors; and

g detailed description of the investors' compensation scheme in which the parent credit institution participates, which must also ensure the protection of the branch's investors.

When the branch originates in 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.

With regard to the restrictions on remuneration of management members and employees of banking groups, reference must be made to compliance with the international principles and recommendations set out by the Financial Stability Board, EBA and CRD III (Directive 2010/76/EU, which amended Directives 2006/48/EC and 2006/49/EC). Portugal implemented the CRD III through Decree-Law No. 88/2011, dated 20 July 2011 and following the entering into force of this diploma, the BoP has issued Notice No. 10/2011, dated 29 December 2011, which has been published in the Portuguese official gazette on the beginning of January 2012. This Notice, which revoked the previous BoP rules on the matter, has essentially updated the rules governing the remuneration policies and practices of the members of corporate bodies of institutions subject to its supervision and the respective requirements for information disclosure. Accordingly with Notice No. 10/2011, financial institutions should adopt a remuneration policy appropriate to the size, internal organisation 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. The remuneration policy must be transparent and accessible to all employees, as well as to all members of the corporate bodies of the financial institution.

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

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

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 and 2012 required the strengthening of financial institutions' solvency ratios. In this sense, the BoP's issued Notice No. 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.

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 (that ceased to be eligible for the purposes of the core Tier I ratio and that became eligible once again in the beginning of 2012 with the publication of BoP Notice No. 4/2012, dated 20 January 2012, provided that they are subscribed by the state). In accordance with its powers as the competent supervisory authority, the BoP has issued Notice Nos. 6, 7, 8 and 9/2010 (as subsequently amended) 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.

In respect of the banks' capitalisation plan, Law 4/2012 complemented by Public Ordinance 150-A/2012, dated 17 May 2012 (as amended by Public Ordinance 421-A/2012, dated 21 December 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 the aim of establishing the reinforcement of the financial solidity of banking institutions and contributing to the strengthening of their levels of core Tier I capital.

The preferential methods provided by Law 4/2012 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'.

In this sense, the banking recapitalisation programme that took place in 2012 resulted in an injection of €1,650 million of core Tier I capital into CGD, divided between an increase of share capital entirely subscribed by CGD's sole shareholder – the Portuguese Republic – and an issue of contingent convertible securities representing core Tier 1 by virtue of being fully subscribed by the state. With regard to BCP, the Portuguese state has underwritten for €3 billion of government subscribed core Tier I instruments ('GSIs'), which are direct, perpetual and subordinated instruments that have been classified by the BoP as core Tier I capital. In addition, BCP has raised equity from its shareholders through a rights issue underwritten by the Portuguese state (although the state's subscription has not been used since BCP has successfully completed the share capital increase with private shareholders). As regards BPI, the Portuguese state has subscribed €1.5 billion of core Tier I capital in the form of GSIs issued by BPI. BPI has also raised equity from its shareholders through a rights issue that was used to buy back the outstanding GSIs,[2] a pattern of early reimbursement that BPI has since pursued, signalling a clear intention to reimburse the GSIs received from the state as early as possible.

This recapitalisation programme – still to be concluded during 2013 with the recapitalisation of Banif – has certainly enabled these three banks (and shall also enable Banif) to reach and even to exceed the rigorous capital targets imposed by the EBA.

iv Recovery and resolution

One of the most relevant novelties of 2012 at a legislative level corresponds to the publication of Decree-Law No. 31-A/2012, of 10 February 2012, which substantially amended the regime applying to the restructuring and liquidation of credit institutions and financial companies foreseen in the RGICSF. The new regime is mostly characterised by the existence of three different levels of intervention by the BoP:

a corrective intervention;
b provisory administration; and
c resolution.

In the event of financial distress of a credit institution (i.e., whenever it becomes incapable of meeting its obligations or in the event of reduction of its own funds to below the minimum required by law or of failure to comply with applicable solvency ratios) the BoP may determine the application of one (or more) measures foreseen for each of the above-mentioned levels of intervention and that are subject to the principles of adequacy and proportionality, taking into account the risk and degree of default, the legal rules and regulations governing its activities, the severity of the consequences on its

2 Source: Announcement of the Portuguese Ministry of Finance on the recapitalisation of the Portuguese banking system dated 4 June 2012.

financial soundness and the recovery of the institution in order to avoid systemic risks in the banking sector and the protection of the interests of its creditors.

Corrective intervention

In this context, and whenever the credit institution does not comply with the legal rules and regulations that govern its activities, the BoP may determine the application of one or more of the following measures:

- *a* compliance with the corrective measures foreseen in Article 116-C of the RGICSF;
- *b* presentation of a financial reorganisation plan;
- *c* suspension or replacement of one or more members of the administrative or supervisory bodies;
- *d* appointment of an auditing committee or a sole auditor to the relevant credit institution;
- *e* imposition of restrictions to the granting of credit and to the investment of funds in specific types of assets;
- *f* imposition of restrictions to the taking of deposits, according to the type and remuneration thereof;
- *g* imposition of constitution of special provisions;
- *h* prohibition or limitation to the distribution of dividends;
- *i* submission of certain transactions or acts to the BoP's prior authorisation;
- *j* imposition of additional reporting obligations;
- *k* compulsory presentation of a plan to amend the conditions of debt by the relevant credit institution for the purpose of negotiating with its creditors;
- *l* compulsory audit to all or part of the credit institution's activity by an independent entity appointed by the BoP (at the credit institution's expense); and
- *m* compulsory request, at any time, that the credit institution's general meeting is convened and submission of proposed resolutions.

Where the implementation of the above measures does not succeed, the BoP may:

- *a* in certain circumstances, appoint one or more temporary directors with special management powers in respect of the relevant credit institution;
- *b* apply a resolution measure if it deems necessary to ensure compliance with certain purposes and as long as certain requirements are fulfilled; and
- *c* withdraw the authorisation to exercise banking business, followed by the relevant credit institution winding-up.

Provisory administration

The provisory administration measures implies a much higher degree of public intervention in the credit institution's business and should only occur in situations that could seriously jeopardise the financial stability or solvency of such credit institution, or pose a threat to the stability of the financial system.

In this intervention level, and in certain cases, the BoP may suspend the board of directors of the relevant credit institution and appoint a temporary board of directors.

The period for which the temporary board of directors shall perform its functions will be determined by the BoP and may last for up to one year (extendable once for a second year).

In addition to the above measures, in this intervention level, the BoP may:

a apply one of the corrective measures set out above;

b appoint an auditing committee or a sole auditor to the relevant credit institution; and

c waive, for a maximum period of a year, the timely fulfilment of some of the credit institution's previously incurred obligations.

Resolution

Finally, at the resolution level the following two types of last-resource measures designed to defend essential interests such as the financial stability and the continuity of the payment systems' process may be applied to a distressed credit institution: (1) total or partial alienation of the relevant credit institution's business to another institution or other institutions operating in the market; or (2) transfer of assets, liabilities, off-balance sheet items or assets under management to a 'bridge bank' created for this purpose.

Although the application of these resolution measures does not necessarily imply the prior adoption of corrective intervention measures, they are reserved to extreme situations, when both such measures and provisory administration measures are no longer viable and when:

a the credit institution does not meet or is in serious risk of not meeting the requirements to maintain the authorisation to carry on its business;

b it is not foreseeable that such credit institution can, within a reasonable time frame, perform the necessary measures to return to financial soundness and comply with prudential ratios; or

c such measures are necessary to: (1) avoid systemic risks in the banking sector; (2) avoid potential negative impacts in the financial stability plan; (3) minimise the costs in the public purse; or (4) safeguard the confidence of depositors.

The effective implementation of such measures must ensure that the credit institution's losses are primarily assumed by its shareholders and creditors, according to their hierarchy, and on equal terms within each class of creditors.

If, after the implementation of any of the above-mentioned measures, the BoP determines that the relevant credit institution does not comply with the applicable requirements to maintain the authorisation to exercise banking business, it may withdraw the relevant credit institution's authorisation and initiate the winding-up process foreseen in Decree-Law No. 199/2006, of 25 October 2006, as lastly amended by Decree-Law 31-A/2012, of 10 February 2012, which sets forth the Banking Insolvency Law.

In addition to the measures mentioned above, Decree-Law No. 31-A/2012, of 10 February 2012 has also enacted a range of preventive measures compulsory for all credit institutions, such as:

a presentation of periodic recovery and resolution plans for submission to the BoP, which must approve such plans or request the amendment thereof (and the details of these periodic recovery and resolution plans and of the information to be provided to BoP in respect of it are foreseen in the BoP Notice No. 18/2012, of 18 December 2012);

b duty to report to the BoP situations of financial difficulty that affect the credit institution and duty to report irregularities; and

c establishment of a resolution fund, which aims to provide financial support to the implementation of resolution measures that may be adopted by the BoP at a resolution level ('the Resolution Fund'). The regulation applying to the Resolution Fund has been recently enacted by Public Ordinance No. 420/2012, dated 21 December 2012.

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 CMVM, 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 to be no 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 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 years 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.

V FUNDING

The funding strategies of banks have 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. In any case, and despite the new eligibility criteria, during 2012, ECB borrowings have continued to be an important source of funding for Portuguese banks.

Exchange offers and liability management exercises were another source of bank financing throughout 2012, whereby Portuguese banks started repurchasing issued debt

through cash offers, exchange offers and liability management transactions, which were relatively unknown to the Portuguese market up until last year.

It is also worth noting that 2012 saw the return of some of the Portuguese banks to the debt issuance market, with BES issuance, in October 2012, of €750 million of senior unsecured bonds in what constituted the first issuance of bonds by a Portuguese bank since spring 2010. In November 2012, BES has succeeded in another issuance of US dollar bonds and CGD has followed BES' trend and issued €500 million in senior unsecured debt. These issuances of bonds represented a turnover in the Portuguese banking market and have certainly constituted a starting point for further issuances by Portuguese players.

VI CONTROL OF BANKS AND TRANSFERS OF BANKING BUSINESS

i Control regime

In respect of credit institutions, Decree-Law No. 52/2010 of 26 May has proceeded to the amendment of the RGICSF. This legal framework sets out the rules for the exercise of 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 currently 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 provided therein, are set out in Notice No. 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 information in order to conduct this analysis is duly delivered, is required to inform the relevant entity of its decision within 60 days of 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 and insurance companies. 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, which 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

2012 brought significant challenges to the Portuguese banking industry, although it is fair to say that in the face of such challenges (and adversities), Portuguese banks reacted in a very satisfactory manner that has culminated in the return to the issuance of senior debt by two of the major Portuguese banks.

The implementation of the banking recapitalisation programme was certainly one of the major events of 2012 and is a starting point for future challenges and, it is hoped, a definitive return of Portuguese banks to the markets.

The same rationale applies at a legislative level as the 2012 main novelties – new intervention powers of the BoP in distressed credit institutions, new preventive measures that credit institutions are required to put in place in order to face adverse scenarios and a new legal framework applicable to pre-default and default on residential mortgages loans contracts – will certainly contribute to reinforcement of the Portuguese banking system and Portuguese banks' resilience.

VIII OUTLOOK AND CONCLUSIONS

2012 has definitely been a very tough year for Portugal and the Portuguese. Banks in Portugal have been seriously affected by clear deleveraging instructions (contained in the MoU signed between Portugal and the Troika), scarce liquidity, rising levels of non-performance with a sharp increase on insolvencies and unemployment as well as a great downturn in real estate, topped with a heavy requirement to raise capital, coming both from the EBA and from the local regulator.

But 2012 has also been a year of great resilience, endurance and resistance, marked by the return to debt markets for liquidity, first with the reinvention of the domestic bonds markets, after 20 years of silence. Second, 2012 also marked the return to international markets by a few of the country's large corporates, by two of the Portuguese main banks and finally, already in 2013, by the Portuguese state itself.

2013 will continue to be very demanding for Portugal, the Portuguese and for banks in Portugal, but there is a general feeling that all the efforts endured will make a difference and bring positive readjustments to the market, the Portuguese state and the economy. The greatest doubt at present is how and when the economy will readjust and being to grow again, which will certainly not be easy given all the tax burdens imposed upon market players. Still, with the public expenditure under control, with the banks very well recapitalised, and with help from Portuguese companies that continue to trade internationally, it is hoped that the economy will begin to recover towards the end of 2013.

As in many other times throughout Portugal's history, the country's ability to adapt and to prosper in many locations around the world will bring positive results, already shown by the increase in exports that have made the trade balance positive for the first time since World War II. The expectation is that Portugal, the Portuguese, and the Portuguese banks in particular, will adjust and survive, but this is far from being assured. It will therefore be very interesting to keep an eye on Portugal throughout 2013.

Appendix 1

ABOUT THE AUTHORS

PEDRO CASSIANO SANTOS
Vieira de Almeida & Associados
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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