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# THE BANKING REGULATION REVIEW

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FIFTH EDITION

EDITOR  
JAN PUTNIS

LAW BUSINESS RESEARCH

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The Banking Regulation Review

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Fifth Edition

Editor  
JAN PUTNIS

LAW BUSINESS RESEARCH LTD

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# EDITOR'S PREFACE

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The past year has seen a number of critically important bank regulatory initiatives reach interim conclusions.

In the European Union we have seen the finalisation and coming into force of the primary measures that are required to implement Basel III, as well as – at long last – political agreement on the Recovery and Resolution Directive and the principal elements of the banking union proposals. We have also seen the first foray of the European Commission into bank structural reform, with its controversial proposal for EU legislation on that subject, after the enactment of detailed domestic bank structural reform measures in a number of member states.

In the United States, the past year has seen the culmination of a number of regulatory initiatives, including the issue of final rules implementing the Volcker Rule and the issue of rules that will require large foreign banking groups to establish intermediate holding companies for their US subsidiaries. Both of these sets of rules stem from the Dodd-Frank Act: predictions that numerous legal careers would be made by that legislation are so far proving to be accurate.

I refer to these developments above as ‘interim conclusions’ because, of course, even though a period of primary rule-making has reached a conclusion, the full implications are still emerging. That said, there are helpfully more certainties now about the future direction of banking regulation than was the case a year ago. The combination of that fact, generally improving western economies and shareholder pressure has made many banks take the plunge and start to reorganise and restructure.

Recovery and resolution planning work remains a powerful driver of structural reform. It does not, however, require a particularly sophisticated legal and regulatory view to conclude that the world remains far from a position where we can have confidence that a global systemically important bank could be resolved in an orderly manner today without significant disruption and damage to the world economy. The fact that some regulators occasionally argue to the contrary disregards the detailed work that still has to be done so that governments and regulators may have a good chance of attaining that confidence in the next few years. But that work is, in general, progressing and reassuringly

shows no real sign of faltering yet as memories begin to fade of just how close the world came to economic calamity during the financial crisis.

Divergent approaches to structural reform in different countries could, however, make group-wide resolution more difficult to achieve. Localism, in the form of requirements that banking subsidiaries hold additional, more loss-absorbent capital and additional pools of liquidity, and have boards of directors with a significant independent membership, all have the potential to threaten the concept of a global banking group unless careful thought is given in such groups to how to address these challenges. The ways in which banking groups can best coordinate their relationships with multiple regulators are high on this agenda.

Perhaps the most difficult challenge facing banks in their relationships with their regulators is that of how to reconcile the need for close and cooperative working relationships with those regulators against the backdrop of seemingly never-ending conduct-related investigations and enforcement action. This difficulty varies according to which regulator is carrying out the investigation and the extent to which the investigation relates to matters that are historic and which the banking group concerned has taken steps to address. The challenge is clearly greatest where a major investigation concerns recent conduct and is led by a regulator with which the relevant bank requires good relations in order to achieve its commercial objectives to the satisfaction of its customers and shareholders.

It will be increasingly important for banks to appreciate the capacity of the more material investigatory and enforcement activity to shape business structures as much as structural reform itself. The changes to the ways in which certain markets and trading operations will be organised in the future in response to enforcement activity will be at least as significant as the changes that are brought to those markets and operations by, for example, resolution planning.

The upheaval that all of this implies for some banks' corporate and business structures, as well as for their staff, is combining with changes to previously held assumptions about the profitability of certain activities as Basel III capital requirements bite. The result is uncertainty, but with some grounds for cautious optimism, at least for those banking groups that are less seriously affected by conduct investigations and are firmly on the road to developing simpler, more capital-efficient structures.

Banks that have adopted a properly integrated and global approach to structural reform will, in my view, reap the benefits. While, in the short term, that is likely to be more expensive from a resourcing perspective, in the long term it should achieve savings. It is all too easy to address each regulatory initiative as it comes along, not recognising that this reactive approach runs the risk of structural muddle and missing out on developing business models that address multiple regulatory concerns at the same time. It is to be hoped that more regulators start to recognise positive proactivity on the part of banks not just as commercial astuteness but as a contribution to the restoration of trust that is required to make bank regulatory reform a success.

One increasingly important aspect of reform in the banking sector concerns the capital structures of banking groups. The requirement for more and higher quality loss-absorbing capital under Basel III, coupled with the introduction of bail-in as a resolution tool in a number of important banking jurisdictions, means that banking groups are having to rethink which company or companies they will use to raise capital



and what form that capital will take. Particularly in Europe, the issue of additional Tier I capital and other contingent capital instruments has added complexity to banks' capital structures and a need for banks to engage with current and potential investors to explain those structures.

This fifth edition of *The Banking Regulation Review* contains submissions provided by authors in 56 jurisdictions between late February and mid-April 2014, as well as the chapters on 'International Initiatives' and the European Union. Preparing the chapters has been a particularly onerous task for the authors this year because many of their clients have now moved from observing the regulatory revolution that has taken place in the banking sector to taking tangible steps to reorganise in order to make themselves fit for the new world in which the sector finds itself. My thanks go to all of the authors for their dedication in completing their chapters.

Thank you also to Adam Myers, Shani Bans, Nick Barette and Gideon Robertson at Law Business Research Ltd for their patience, understanding and – above all – great effort in preparing this edition.

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**Jan Putnis**

Slaughter and May

London

May 2014

## Chapter 45

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# PORTUGAL

*Pedro Cassiano Santos*<sup>1</sup>

### I INTRODUCTION

While the first half of 2013 was a period of many changes, uncertainties and contraction of the Portuguese economy, the second half was marked by signs of strengthening in Portuguese economic activity and financial conditions. Ireland's official exit from recession was an indicator of recovery at European level and this was a positive sign for the Portuguese economy, now in the final phase of the Portuguese financial aid package granted by the EU, the International Monetary Fund and the European Central Bank (collectively, 'the Troika').

During 2012, Portugal implemented a 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 at one point ceased to be eligible for the purposes of the core Tier I ratio, became eligible once again, thus allowing the goals of banking capitalisation to also be achieved by means of issuing such instruments. In this respect, 2013 was not as busy in terms of legislative changes but it was certainly a relevant year in terms of implementation of such new rules.

During the year, Portuguese banks have strengthened their liquidity and capital levels, notwithstanding the default rate on loans granted to consumers and enterprises continuing to rise due to the deep recession that Portugal has endured in recent years. Credit risk will likely remain high and banks will have to maintain prudent write-down policies. The Bank of Portugal (BoP) considers that banks with a core Tier I ratio above 10 per cent have enough capital to face such increase.

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

The recapitalisation process involved complex company and regulatory banking law matters, as well as EU law and state aid considerations, since this injection of public funds into private banks (and 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 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 2013, including a buffer to cover sovereign exposure at market prices as of September 2011. The recapitalisation operations of the banks has been successfully implemented (except for the recapitalisation process of Banco Internacional do Funchal SA (Banif)),<sup>2</sup> notably approvals in Brussels for the restructuring plans of CGD, BPI and BCP, completed with fewer impositions than many predicted, but imposing reformist policies. The focus for these banks is now to reimburse the state, the completion of their plans for repayment of contingent convertible bonds (CoCos) still being awaited. In this context, and on the legislative side, the latest change to the Law No. 63-A/2008 of 24 November establishes measures to strengthen the financial soundness of credit institutions, enacted by Law No. 1/2014 dated 16 January. Following precedents from other European jurisdictions, this Law introduces, *inter alia*, a mandatory capitalisation mechanism that resorts to public funds, for use in extreme situations in which a threat to the stability of the national financial system exists; under such circumstances, the BoP should propose to the member of government responsible for financial affairs that the capitalisation transaction take place, as a temporary measure, without the credit institution needing to submit a recapitalisation plan to its general meeting of shareholders for approval.

Regarding the raising of finance for the national banking system a development long awaited by the market has finally taken place. After a few years without the issuance of covered bonds by Portuguese banks, this market segment became attractive again and some banks took advantage of this momentum and relaunched their programmes for issuance of this privileged asset class.<sup>3</sup> 2013 also witnessed the return of Portuguese securitisation transactions to the market, with senior tranches of asset-backed notes from the 'Volta I' transaction (the originator of which is the major Portuguese energy distributor company Energias de Portugal SA) having successfully been placed and distributed to qualified international investors. The Atlantes SME II transaction (prepared during 2013 and closed at the beginning of 2014), originated by Banif, also saw some of its tranches successfully distributed on the international markets.

On the equity side, a high level of activity has also taken place during 2013, particularly marked by the initial public offer of the shares of Portuguese Post Office, Telegraphs and Telephones (CTT), since creation entirely held by the Portuguese

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2 This has already been initiated subject to preliminary European Commission approval, but is still awaiting final EC approval.

3 In particular, CGD, BES and Banco Santander Totta, who did not issue covered bonds for years due to the lack of market appetite and lack of credits to make up the portfolio backing the notes, but have now regained market access.

state. The merger of Zon and Optimus was registered in August 2013, giving rise to a new and powerful telecommunications operator named ZonOptimus. The Revitalizar programme launched equity funds in August 2013 and made €220 million available for equity and quasi-equity investments in small and medium businesses (a boost to raise capital, particularly in a moment of economy recovery). In terms of the level of debt, there were continued successful bond issues to the market – for example, the public offerings of the bonds of EDP and Brisa, both aimed at the international markets – boding well for transactions to come in 2014.

On the privatisations side, the measures laid down in the Financial and Economic Assistance Programme for Portugal led the Portuguese government to be extremely active and launched a few significant privatisation processes. Apart from the postal service CTT, since 2012 the Portuguese government has successfully completed the privatisations of the CGD's insurance company (Caixa Seguros), the airport management entity ANA, the energy grid company REN, and the remaining public shares in EDP. The Portuguese government is currently rescheduling the privatisations of TAP (Portuguese airline) and RTP (public TV company), and it is certainly fair to say that much has been accomplished despite the financial crisis and the harsh conditions the country has endured.

## 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 BoP through notices, instructions and orientations. To name a few, the latter sets 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 RGICSE, 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.

The implementation of the new regulatory framework based on the 'twin peaks' model was discussed between late 2010 and the beginning of 2011, but such restructuring route was not adopted. To overcome vulnerabilities and deficiencies of the supervision system, the BoP proceeded to the restructuring of its internal supervisory structure, creating three new departments (prudential supervision, market conduct supervision and legal enforcement) and implementing working groups for some areas which were not separately supervised such as banks recovery or resolution and credit institutions' management supervision. Furthermore, it shall also be noted that the supervisory system will change generally following the recent proposals aimed at establishing a single supervisory mechanism (SSM) and a single resolution mechanism (SRM) that will be made up of the ECB and national competent authorities, the ECB being responsible for the overall functioning of the SSM and SRM and having direct oversight of the eurozone banks in cooperation with national supervisory authorities.

### **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, 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 allowed 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 the CRD package, which includes CRD IV (Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013) and the CRR (Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No. 648/2012).

CRD III was implemented in Portugal 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 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.

Portugal has not yet implemented CRD IV, but the Regulation rules are already in force. The framework has been further strengthened with regard to the requirements for the relationship between the variable (or bonus) component of remuneration and the fixed component (or salary) and with regard to the disclosure and transparency of the remuneration policy and practices applicable by institutions, including information on the link between pay and performance.

### **iii Regulatory capital**

Capital requirements are of prime importance in maintaining the banking industry's 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, in place since 2011, 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 not 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 (amended by Law No. 48/2013 dated 16 July) 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 I 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,<sup>4</sup> 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. Finally, the Portuguese state became a shareholder of Banif by subscribing to €700 million in shares and €400 million of CoCos to be repaid in tranches during the investment period. Banif has already reimbursed €150 million in terms of the CoCos and has raised private equity worth more than €310 million, with a share increase worth a further €130 million still to take place.

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

This recapitalisation programme – yet to be concluded in 2014 in respect of the recapitalisation of Banif, which is still awaiting EC final approval – has certainly enabled these three banks (and hopefully will also enable Banif) to reach and even to exceed the rigorous capital targets imposed by the EBA and the BoP.

**iv Recovery and resolution**

One of the most relevant developments 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 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 imply 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-resort 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 for 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 out 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 enacted by Public Ordinance No. 420/2012, dated 21 December 2012 and the relevant participants<sup>5</sup> have already initiated to pay their contribution to the Resolution Fund.

#### **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

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<sup>5</sup> Which include (1) credit institutions with head offices in Portugal, (2) investment companies, (3) branches of credit institutions based in non-EU Member States, (4) branches of financial institutions based in non-EU Member States, which perform order execution activities on behalf of clients and trading for own account of one or more financial instruments, and (5) companies that use payment systems subject to the supervision of the BoP.

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 banks' own funds are at all times required to be no lower 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 must also build up special reserves to strengthen their net value or to cover losses that their profit and loss account cannot support.

In the event 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 2013, 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 2013, whereby Portuguese banks started repurchasing issued debt through cash offers, exchange offers and liability management transactions.

It is also worth noting that 2013 followed the same route as 2012 in terms of debt issuance and we have seen some Portuguese banks issue debt to the market, in particular Banco BPI, Banif and Banco Popular Portugal.

## **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 within 15 days of the acquisition of such holding, in order to assess whether 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 asset deal that 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.

Exceptions 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**

During the first half of 2013 Portugal faced some economic and strategic difficulties, which led the seventh review of the Programme of Economic and Financial Assistance, originally scheduled for March 2013, to be delayed until June 2013; also, the Constitutional Court ruled four articles of the state budget for 2013 as unconstitutional, which affected the government's commitments with regard to lending institutions.

Although 2013 has brought significant challenges to Portuguese market players – and particularly the banking industry – it is fair to say that they have also shown resilience and stamina that many would not have expected, with increasing levels in the country's trade balance and exports. Portuguese banks seem to have reacted to their economic weaknesses in a satisfactory manner, albeit enduring severe losses, but ending the year with an apparent return to stability and (at least for some issuers and products) a return to the markets, evidenced by the issuance of senior debt by some of the major Portuguese banks and companies, and furthermore by Portugal's successful placement of long maturities in the international markets, already accomplished early in 2014. In particular, exports increased significantly, with a positive performance in the country's trade balance (something not achieved since World War II) and Portuguese assets in general became more attractive to foreign investors.

In terms of capital markets and privatisations, the successful IPOs of some of the state's former assets may also be seen as an important sign of returning confidence in the Portuguese economy.

At a legislative level, reinforcement of the banking system capitalisation framework implemented in 2012 is now in place, and a stronger Portuguese banking system is being achieved.

## **VIII OUTLOOK AND CONCLUSIONS**

The past three years have been very tough for Portugal and the Portuguese in general. Banks in Portugal were 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 in insolvencies and unemployment as well as a great downturn in real estate, topped by a great need to raise capital, coming both from the EBA and from the local regulator.

2013 was very demanding for Portugal, being subject to successive tests, very restrictive government strategies and many threats from the markets, and 2014 will certainly continue to be challenging. The biggest uncertainty during 2014 will be ascertaining whether (and to what extent) the Portuguese economy is strong enough to adjust and grow without external help. We are conscious that unemployment, taxes (imposed on families and enterprises), insolvencies and default rates all remain high and, hence, the real recovery of the economy is mostly a work in progress.

As in many other times throughout Portugal's history, the country and the people's ability to adapt and to prosper in many locations around the world will inevitably bring positive results, already shown by the increase in exports. The expectation is that Portugal, the Portuguese, and the Portuguese banks in particular, will adjust and survive, but this is not yet assured. It will be very interesting throughout 2014 to keep an eye on Portugal and to see what progress is made.

## Appendix 1

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# ABOUT THE AUTHORS

### **PEDRO CASSIANO SANTOS**

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

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

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