

Restoring confidence

The effects of the financial crisis on banking are now familiar; primarily risk aversion and slow lending. Paulo Câmara of Sérvulo & Associados looks at how the Portuguese government reacted to mitigate the situation

Following the international economic downturn, the Portuguese government reacted by taking essential policy measures to offset the exposure arising from the dramatic downturn in the market and to relaunch the Portuguese economy. Each measure taken by the Portuguese government has been devised and administered in order to restore confidence, integrity, stability and growth in the market.

Integrity and confidence

Since the start of the crisis, the primary concern for Portugal was reducing the risk aversion and strengthening the inter-bank market. So the Portuguese government reacted by establishing a state scheme for granting guarantees to Portuguese credit institutions, through Law 60-A/2008. These state guarantee schemes are aimed at re-establishing liquidity in financial markets to preserve financial stability and regain investors' confidence.

Under the state guarantee scheme, the Portuguese government was authorised to offer personal guarantees, up to the aggregate amount of €20 billion, to credit institutions and international banks with registered offices in Portugal. This guarantee scheme was approved by the European Commission and considered to be in line with state-aid rules under the EC Treaty.

The terms of the guarantee scheme sets forth that until full repayment of the guaranteed debt, the state can, if and to the extent deemed necessary to protect the public interest: convert the credit against the credit institution into share capital; adopt corporate governance principles on dividend policies and on the remuneration of the credit institution's officers; and appoint one or more temporary directors. According to follow-up reports, seven Portuguese credit institutions have been granted a state guarantee, between the start of the scheme and June 2009, totalling €4.35 billion.

Portugal also introduced a recapitalisation scheme for credit institutions registered in Portugal. This was tailored to improve the financial soundness of Portuguese credit institutions, to avoid systemic risk and bolster the financing of the real economy. The measure, Law 63-A/2008, November 24 2008, which was approved by the Portuguese Parliament, improves the financial soundness of Portuguese credit institutions by making up to €4 billion available to Portuguese banks to strengthen their capital ratios.

The measure would make new capital available to eligible credit institutions, whether financially sound or not, in exchange for instruments eligible as Tier 1 capital (according to European Directive 2006/49/EC). It is intended to enable credit institutions to strengthen their own funds against potential losses, in-line with the recommendations of the Portuguese Central Bank to establish a Tier 1 ratio not lower than 8%. Furthermore, the recapitalized Tier 1 ratio should not exceed 8% on the day the recapitalisation is implemented. Under the recapitalisation scheme, two different regimes are anticipated: an increase in the level of own funds of credit institutions already having an acceptable solvency and stability, seeking to bring them in-line with their European counterparts; and a direct state intervention in the recovery and remedial processes.

The scheme is also temporary in nature and divestment by the government should be concluded after a period of three years, which may be extended in exceptional circumstances to five years. The stringent state intervention measures that accompany this recapitalisation plan lead to its unattractiveness to credit institutions. In fact, up to present it was only used once.

“A mandatory say-on-pay rule was introduced, covering members of public interest entities”

Deposit guarantees

The Portuguese government was intent on curing the dwindling confidence in its banking system, and took as many measures to regain trust. Accordingly, on October 6 2008, in the interests of its depositors, investors and other creditors and for the safeguard of normal functioning in the market, the Portuguese government increased its guarantee of bank deposits from €25,000 to €100,000 per depositor and institution, anticipating the transposition of European Directive 2009/14/EC. The same grounds lead to a reduction of maximum payment period to 20 business days.

The legal framework of the Portuguese investor compensation scheme (Sistema de Indemnização dos Investidores) also suffered some amendments, through Decree-Law 162/2009, although maximum compensation amount remained unchanged at €25,000 per investor. These changes to the regime on the Portuguese investor compensation scheme proved to be controversial. This is because the Portuguese Constitution imposes that such changes, once affecting mandatory financial contributions from financial intermediaries, must be approved by the Parliament and be solely valid for the future, while the Government approved them and labelled them as being of interpretative (retroactive) nature.

Short-selling regulation

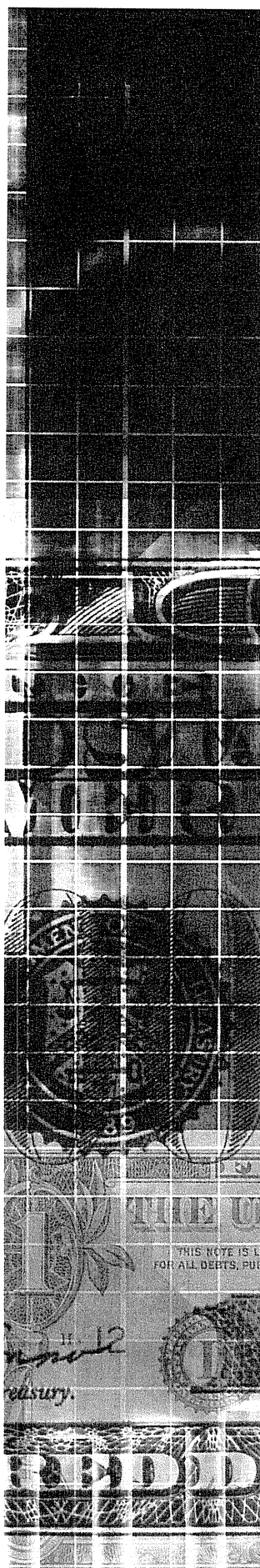
Among the measures to tackle the current challenges facing the market were new prohibitions and regulations for short-selling transactions. Beginning in September of 2008, Portugal's securities market regulator (CMVM) decided to implement prohibitions and regulations on short selling of financial stocks, as a reaction to the extraordinary instability of the market. The CMVM decided that for a limited period, the members of Euronext and PEX should refuse orders for selling shares and other relevant securities relating to financial firms listed on Euronext Lisbon, in the event that the person issuing the order is not in a position to ensure in advance that the said securities will be available.

The CMVM also stipulated that market members shall disclose information to the public on investors who assume short positions on the shares of financial firms that surpass 0.25% of said financial firm's capital. A regulation was also approved that extends the obligation to disclose to its own investors, and likewise imposes the duty on its investors to report to the CMVM the said short positions and others held in the shares of non-financial firms listed on Euronext Lisbon.

As of January 2009, the CMVM repealed instructions that required daily reporting duties of short positions since the gathering and processing of such information was no longer called for in light of the costs involved. However, under its supervisory powers the CMVM may request information from any market member carrying out short-selling transactions on its own or client's behalf, where it is deemed necessary.

Remuneration policies

Another area garnering increased attention is the reform of remuneration policies. As it is commonly recognised, the general concern is to ensure that the level and structure of remuneration is consistent with the long-term



performance of the company, and that the remuneration of directors aligns interests of directors and shareholders. It is also desirable that rewards for managerial failure are, to the extent possible, avoided.

These are global concerns that were reinforced during the crisis, although generally in Portugal remuneration packages are more modest than in other comparable European countries. Nevertheless, according to the widespread *zeitgeist*, it was felt as important that a reform be adopted in Portugal to address such a highly visible corporate governance topic.

A mandatory say-on-pay rule was the result, covering all members in supervisory and managing board roles in all public interest entities. This comprised financial firms, listed firms, venture capital funds and pension funds. Law 28/2009 required such companies to submit their remuneration policy for shareholder approval. The policy must describe: i) the mechanisms for alignment of interests between members of the corporate bodies and the company; ii) the criteria for variable remuneration; iii) the existence of stock-option plans; iv) the possibility of deferred compensation; and v) the mechanisms of remuneration limitation once financial results deteriorate considerably.

It could be said that the Portuguese say-on-pay rules are paradoxical. In fact, officially the legal intervention is aimed at giving shareholders more influence over determining directors' salary, although general Portuguese company law already gave shareholders direct or indirect power to establish directors' remuneration (article 399 of the Portuguese Companies Code). However, it is expected that the Law will considerably increase awareness in respect to the structure of remuneration of corporate bodies' members and will hopefully allow best practices to disseminate.

Restructuring the banking system

In an effort to strengthen the position of key financial players in the market, Portugal created rescue packages for the banking system to ensure individual banks' sustainability.

Notably, in November 2008, the government nationalized Banco Português de Negócios (BPN), which had run up accumulated losses of €700 million and was facing an imminent breakdown of its ability to meet payments. BPN was nationalised to contain systemic risks and protect deposits. Through this nationalisation, BPN became a public limited company fully owned by the state, but continues to be governed by the legal provisions, as well as its statute, regulating its activity except as otherwise provided for in the legal framework of the State corporate sector. Also, BPN management is now the responsibility of Caixa Geral de Depósitos. A privatisation of BPN is likely to occur in the upcoming months and some financial groups have publicly displayed manifestations of interest.

In December 2008, the Portuguese government decided to increase Caixa Geral de Depósitos' capital by €1 billion to strengthen its lending capacity. Caixa Geral de Depósitos is a bank wholly owned by the Portuguese state and, apart from significant shareholdings in several listed companies, holds about one-third of the mortgages in Portugal. The Portuguese government also passed a law enabling a consortium of six banks to grant Banco

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Privado Português (BPP) a €450 million loan and to draw on a state guarantee to back the loan. The state guarantee underwriting the loan was approved by the European Commission on March 13 2009 as a temporary measure, and Portugal has committed to provide a restructuring plan for BPP within six months of the law being passed. At present, the future of BPP remains very uncertain, as a recent buy-out and re-capitalisation proposal, presented by the Portuguese group Orey, was turned down by the Government.

Strengthening sanctions

Parliament recently approved a law that increased the maximum penalty for crimes against the financial market, which is regulated under Title VIII “Crimes and Administrative Offenses” of the CMVM’s Securities Code (SC). Within the SC, there is a system of administrative offences for violations to the securities laws and regulations. Sanctions include warnings as well as fines that depend on the offences. In addition, the system is complemented with criminal sanctions for insider

trading and market abuse.

Within the scope of crimes approved to have the maximum penalty increased to five years are crimes for exercising illegal activity of deposits or other repayable funds, transmission or action based on insider information and market manipulation, and unlawful practice of insurance, reinsurance and pension fund management operations. Parliament also approved lifting the maximum amount of fines, now set at €5 million, which may be increased by twice of the economic benefit if it exceeds that amount. Furthermore, a summary process was created, resulting in a quicker administrative process in the insurance and banking regime. This follows the example of the regime already in force in the capital markets sector.

Improving transparency

One of the central lessons the Portuguese state rightly drew from the financial crisis concerned the need for increased transparency. Therefore, the Portuguese government took measures to significantly strengthen transparency duties in order to boost informed investment decision-making, and to reduce the level of financial illiteracy in retail financial consumers.

Through amendments to the credit and financial companies’ regime, the amount of required pre-contractual information was strengthened on consumer credit, in addition to explaining the duties of clarity and completeness in contractual and advertising terms. In the latter case, it requires that whenever possible advertising messages are illustrated by representative examples.

A regulation was also approved that strengthened the information requirements relating to disclosure of banking services, particularly through advertising. The duty to report to the supervisory authorities of credit institutions, financial intermediaries and insurers with respect to their degree of solvency and liquidity and the risks that it incurs has also been increased.

Within the framework of the banking business, certain regulations sought to introduce greater transparency in the relationship between the bank and its clients. A financial ombudsman (Mediador do Crédito) was created in order to respond to queries and concerns of banking clients, through

Decree-Law 144/2009. Furthermore, regulations have imposed uniform criteria for determining the interest rate on credit contracts by imposing the convention 30/360, aiming at greater comparability in banking contract terms.

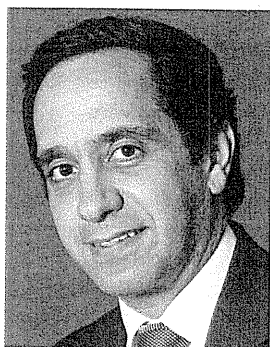
In the same vein came a change in the Securities Code (new article 350-A), which forced financial intermediaries to notify the CMVM the assets held by them or by a company dominated by them, who are domiciled or managed by entities based in states that are not members of the European Union. Moreover, publicly held companies have now to notify shareholdings in countries that are not members of the European Union. The concern behind these duties was, in particular, the risk underlying investments in offshore jurisdictions.

Lastly, an additional disclosure obligation (Law 28/2009 of June 19) was recently approved requiring disclosure, on an aggregate or individual basis, of the remuneration of the corporate bodies’ members. This legislative intervention emerges as a result of the failure of a soft law approach in this field. In fact, the mandatory disclosure obligation follows a recommendation from the CMVM’s Corporate Governance Code of voluntary disclosure of remuneration of directors on an individual basis, which for years remained unobserved by a the majority of listed companies. This disclosure duty also adds to the duty to present annually the remuneration policies to shareholders (say on pay), as discussed above.

Duties of information

After the market turmoil, many new demands resulted, among them being the greater demand, from retail investors, for clear information in sophisticated financial products. In Portugal, the call for transparency as regards contractual conditions focused on financial contracts and instruments of the national financial system whose profitability depends on other financial assets, the so-called complex financial products. This was mainly the case for derivative securities, structured deposits, dual deposits and unit-linked insurance contracts.

These complex financial products are legally defined as financial instruments that, while assuming the form of a financial instrument already have



About the author

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characteristics that are not directly identifiable with that instrument, because they have associated with other instruments of development depends wholly or partially, its profitability.

A comprehensive set of duties was imposed to the issuers of these products through Decree-Law 211-A/2008. This includes, on the one hand, the duty of identification of the financial product as complex in the information rendered to investors and clients and in the advertisements thereof. On the other hand, during the distribution of complex financial products, either in private or public placement, clients must previously receive a note (prospecto informativo) that summarises the basic features of the product, in order to enable the said investors to understand the investment proposed. The information it contains must be: complete, real, updated, clear, concise, objective and legible.

Advertisement messages must also now be previously submitted for approval to the competent supervisory authority when related to complex financial products. Subsequent to the imposition of these duties, the CMVM prescribed in detail the content of the note and the advertisement requirements (Regulation 1/2009), when it takes the form of a capital markets instrument. The Portuguese Central Bank (Banco de Portugal) also imposed further disclosure duties to complex financial products that are based in deposits (*inter alia*, structured deposits and dual deposits). It should be noted that the content of the note has in this case has to follow Order 5/2009.

“Financial crises do not terminate by decree”

This difference in the regime of complex financial products according to their banking or capital markets nature leads to the crucial need to clearly distinguish complex financial products that are deposits from other financial instruments. In the first case, the Central Bank Order is applicable, while in the latter it's not. Paramount is the indication that, regardless of its calculation method, the interest rate in a deposit cannot be negative (Order 6/2009).

A bigger role for regulation

Financial crises do not terminate by decree. Nevertheless, the role of regulators and supervisors, in any jurisdiction, is decisive in order to restore confidence and to safeguard the integrity of the markets. Crises demand therefore a bigger role for regulation and enforcement in the market. In this respect, Portugal proved to be no exception. The state and financial regulators acted timely and broadly followed the same guidelines as other European countries.

In their essence, most of these measures have a clear temporary nature; they are aimed at being in force solely while the crisis lasts. But overall, investors and market participants have regarded these measures as both necessary and adequate as responses to challenging times experienced after the summer of 2007. So this regulatory setting presents itself as a facilitator for financial recovery, and has played and will continue to play a role in the change of the economic cycle in the direction of greater stability, prosperity and growth.

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