NEWS LEXTTER

March 2012

BANKING & FINANCE

REGULATORY NEWS IN FINANCE

COMPLEX FINANCIAL PRODUCTS

Not long ago, returns on traditional investment products, for example term deposits, were quite low and did not generate a great deal of interest among those who could spare and would like to invest money with the prospect of some return. Alternatives nearly always carry a higher risk and the various solutions, such as mutual funds, were not well known and poorly understood. Given the need to find alternatives that could attract the investment of private clients, not only in private banking but also in retail, banks have developed products in a traditional looking «jacket» but which contain formulas for calculating return on underlying assets of different nature. And so the first complex financial products or structured savings instruments, as they were called by the financial supervisory authorities, came into being.

In terms of investment products, research and development is, almost always, ahead of regulation. It is therefore not surprising that the efforts, especially in the last 10 years, to establish a set of rules on how these products are presented, explained and «sold» to private investors, have been reactive. This reactive nature is also reflected in a draft regulation on this matter that has recently been submitted for public consultation by the Portuguese Securities Market Commission (CMVM). The big question that arises is whether the reaction is proportionate to the need or whether the result of this «concern» will be counterproductive. Consider the following:

The aim of CMVM is to make financial products more understandable and more transparent for investors. However, the regulation itself, that is, the rules contained in it, has precisely the reverse result. After reading the draft regulation, one must conclude that, all good intentions aside, the only result that will be achieved - unless the draft regulation currently under consideration is substantially changed - would be a tangle of rules and conditions which, above all, rather than protecting investors, will consequently lead to complexity and uncertainty regarding the regulatory framework and have a huge impact on operating costs of regulating marketing entities.

In fact, some aspects of the draft regulation will need to be revised. On the one hand, its scope is not clearly defined. It makes specific provisions for the positive scope using indeterminable and undefined concepts without expressly excluding

CONTENTS

COMPLEX FINANCIAL PRODUCTS
Hugo Rosa Ferreira

IS STATE INVOLVEMENT IN BANK CAPITALISATION INEVITABLE?
Rodrigo Formigal
José Miguel de Albuquerque

EUROPEAN BANKING AUTHORITY GUIDELINES ON ADVANCED MEASUREMENT APPROACHES
Marisa Larguinho
Joana Rodrigues de Brito

BASEL III - REVIEW AND NEWS
Hugo Nunes e Sá
Maria José Sousa Leite

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similar instruments which, we believe, should not be subject to the specific rules of complex financial products. On the other hand, and among other solutions worthy of consideration, the draft regulation confuses capital investment with the product price. This kind of confusion cannot be allowed to exist in respect of an investment product. On another level, the draft regulation includes rules on distance marketing, advertising and investment eligibility obligations which apparently do not consider the rules that already exist on the matter. In addition, for benchmarking purposes the regulation also covers parameters supposedly emerging from practical reality but whose values are either unobtainable or will always be subjective. This draft regulation will bring enormous uncertainty in a matter as important as the clear warning it is supposed to include and that will literally become the most visible face of the product. Finally, it should be noted that with this draft regulation, CMVM wants to redefine the concept of conflicts of interest far beyond the understanding that is currently normally accepted in this respect.

This draft regulation still requires deep reflection and all stakeholders are expected to participate in the public consultation and submit their contributions to be able to make the necessary revisions. As has been the case on many other occasions, PLMJ will not fail to make its contribution.

Hugo Rosa Ferreira

IS STATE INVOLVEMENT IN BANK CAPITALISATION INEVITABLE?

Notwithstanding the fact that the Portuguese banking system has demonstrated strong resilience to the international financial crisis, this year will bring its own challenges for financial institutions as they will need to enhance the quality of their own funds, in particular their «Core Tier 1» ratio needs to be brought up to a minimum of 10% by the end of this year.

Aware of the considerable effort that is required by Portuguese financial institutions to achieve this, the Portuguese Government passed law no. 63-A/2008 of 24 November which was subsequently amended and restated by law no. 4/2012 of 11 January 2012. This law sets out measures to strengthen the financial soundness of financial institutions by using public investment in capitalisation to increase the «Core Tier 1» ratio. Some Portuguese banks have already submitted their plans for capitalisation to the Bank of Portugal, detailing the manner in which they wish to achieve and fulfil their «Core Tier 1» ratio goals using public investment.

Although the Bank of Portugal still has to analyse these recapitalisation plans and the outlines of planned transactions are not yet public knowledge, it is already clear that, in order to strengthen the financial soundness of credit institutions, one or a combination of the following mechanisms will be necessary:

1. Acquisition of own shares by the credit institution.
2. Capital increase of the credit institution.
3. Other financial instruments eligible as «Core Tier 1» capital as defined in the relevant announcement by the Bank of Portugal.

It is relevant to assess the different consequences that the choice for one or the other mechanism may have when recourse to private capital is insufficient and recourse to state investment becomes inevitable.

In the case of the first two capitalisation mechanisms, the State assumes the capacity of shareholder with all the corporate rights associated with that position, even though, regardless of the size of the stake it acquires, its voting rights are limited to resolutions which require a qualified majority. The exception is when the State's stake exceeds a threshold yet to be defined by Order in Council. The criteria the Portuguese Government will need to adopt to determine the value of these banks' shares, is still unclear (for example, current market price or by reference to valuation done by the bank). In the case of a capital increase, one must also consider the fact that some banks already have share capital represented by shares without a nominal value.

Regarding the third mechanism, Notice No. 4/2012 was recently published by the Bank of Portugal. This allows hybrid instruments that are underwritten by the Portuguese State in the context of bank capitalisation to be eligible for the calculation of the «Core Tier 1» ratio up to a maximum of 50% of the value of the core capital. We should clarify that these are hybrid financial instruments (also known as contingent convertible instruments or «CoCos»). Very briefly, these are "custom made" instruments which are technically debt that automatically converts into shares upon the occurrence of a certain event, for example, from the moment the «Core Tier 1» ratio reaches a certain level. Up until the occurrence of the event, the «CoCos» combine characteristics of both capital and debt. However, how these types of instruments will work, always depends on their specific conditions (which may make them more like shares or bonds).

In making the choice between the acquisition of shares or the issuance of hybrid financial instruments as a mechanism of preferential capitalisation of credit institutions, the potential corporate governance consequences coupled with the acquisition value of acquiring shares can be decisive elements for the State. It is easy to see that credit institutions tend to favour capitalisation by way of issuing hybrid financial instruments, because, for now at least, they prevent direct State involvement. Instead of having a share in a company, the State merely has a credit right over that share.

Rodrigo Formigal
José Miguel de Albuquerque

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EUROPEAN BANKING AUTHORITY GUIDELINES ON ADVANCED MEASUREMENT APPROACHES

Directives 2006/48/EC and 2006/49/EC introduced a set of rules on equity capital requirements for credit institutions and investment firms («institutions»), determining, in general terms, that institutions must hold sufficient equity capital to cover their operational risks.

The test to check whether sufficient equity capital is available to meet targets can be done by three different methods, one of which is the Advanced Measurement Approach (the «AMA»).

Article 105 of Directive 2006/48/EC allows institutions to use the AMA based on their own operating systems for risk assessment, provided that: (i) they meet the criteria laid down in the directive and (ii) the competent authority expressly approves the use of those models. These rules were, in general, transposed into Portuguese law by Decree-Law no. 104/2007 of 3 April and in regulations developed by the Bank of Portugal.

In line with expectations, on January 6, the European Banking Authority («EBA») issued a set of guidelines on the procedures for approval or notification of changes to the AMA by the institutions to the competent authorities (the «Guidelines»). These Guidelines provide institutions with rules on how to communicate to the competent authorities any changes to their AMA as well as on how to define their internal policies in this respect.

The main objective of these Guidelines is to improve the communication process between institutions and competent authorities and the approval procedure for changes to the AMA that institutions have adopted and wish to introduce. Guidance on the operational risk management models or systems requirements and, consequently, the implementation of calculation methods, are expressly excluded from the scope of the Guidelines.

Institutions must adopt the AMA and, at all times, ensure that it is suited to the specific needs of the institution to ensure that their real risk profile is effectively covered. To this end, institutions are required to regularly examine and modify their AMA, to ensure this is adequately achieved.

The Guidelines suggest a categorisation of the changes introduced by the institutions to their respective AMA, based on their level of relevance. The most relevant changes should be subject to prior authorisation by the competent authorities, as they can have a significant impact on the quality and reliability of the AMA and the institution's capital ratios. In contrast, changes with a lower degree of relevance will only have to be notified to the competent authorities.

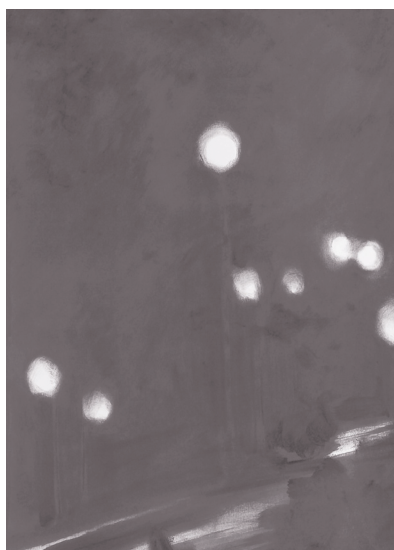
In order to help categorise the changes that institutions may wish to make, the Guidelines provide a non-exhaustive set indications as to what they should do.

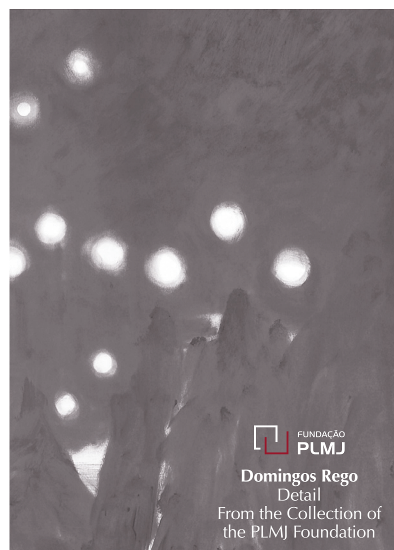
The real value of the Guidelines is to harmonise procedures which institutions that adopt the AMA must follow with the competent authority when they want to make amendments to the AMA. It does this by clarifying those situations for which the prior approval by the competent authority is required.

Moreover, the Guidelines establish rules and criteria to categorise changes to the AMA which may also benefit institutions by allowing them to develop and improve of their AMA in line with expectations and procedures of the competent authorities.

At a national level, there is expectation as to how the Guidelines will be implemented by the Bank of Portugal and, in particular, with regard to its approach to categorising the changes, bearing in mind that the Bank has the power to reassess the level of relevance of the change.

Marisa Larguinho
Joana Rodrigues de Brito





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BASEL III REVIEW AND NEWS

In response to the international financial crisis of 2008, in December 2010, the Basel Committee on Banking Supervision published new standards relating to capital and liquidity of financial institutions, known as Basel III (revised on June 2011).

Basel III has three main objectives: (i) to strengthen the quality of capital of financial institutions used to cover the risks taken by these entities (quality, consistency and transparency), (ii) increase levels of liquidity and (iii) decrease levels of financial leverage.

In order to ensure these objectives are achieved, the Basel III proposals relate to the following points: (i) reclassification of eligible capital for the purpose of calculating capital ratios, (ii) increase of minimum capital ratios, (iii) and the introduction of capital conservation buffers (capital margins).

As a result of the guidelines issued in Basel III and the implementation of the Portugal's financial assistance program, on 18 October 2011, the Bank of Portugal published Notice no. 3/2011 (amended on 25 October 2011 and 20 January 2012).

In its current version, Notice no. 3/2011 requires credit institutions to strengthen their «Core Tier 1» ratios on a consolidated basis to values above 9% by 31 December 2011. It also requires that strengthening to reach 10% by 31 December 2012 (exceeding Basel III requirements).

Depending on risk profile and the results of a solvency and deleveraging assessment to be developed under the program, the Bank of Portugal has the right, on a case by case basis, to set higher «Core Tier 1» ratio levels and bring forward the deadline those rules to be complied with.

Notice no. 3/2011 also results in a limitation of equity capital which can used to calculate the aforementioned ratios, and that only «quality assets» should be used in this respect. In this context, it should also be noted that the use of a portion of reserves and the results from deferred tax assets is considered eligible for the purposes of calculating the «Core Tier 1» ratio up to a maximum of 50% of core capital.

On 20 July 2011 the European Commission announced its proposal to incorporate the standards set out in Basel III into the European Union by including it in the so-called CRD IV. This proposal provides for a regulation and a directive, the latter seeking to amend Directives 2006/48/EC and 2006/49/EC – the «Capital Requirements» directive – which is currently in force.

In January 2012, the Bank of Portugal published the results of a survey carried out among five Portuguese banking groups on the state of the Portuguese credit markets and, among others, the impact of Basel III on such market.

Under that survey, three of those institutions reported that in the last half of 2011 there was (i) a substantial reduction in risk weighted assets, (ii) an increase in funding capital and (iii) more restrictive criteria for granting credit were applied.

For the first half of 2012, most institutions who took part in the survey expect a reduction in risk weighted assets and higher risk loans, revealing that the application of the new regulatory requirements will increase the uptake of equity capital including by way of share issues.

Hugo Nunes e Sá
Maria José Sousa Leite

"Portuguese Law Firm of the Year"
Chambers European Excellence Awards, 2009; Shortlisted 2010, 2011/ Who`s Who Legal Awards, 2006, 2008, 2009, 2010, 2011/The Lawyer European Awards-Shortlisted,2010, 2011

"Best Portuguese Law Firm for Client Service"
Clients Choice Award - International Law Office, 2008, 2010

"5ª Most Innovative Law Firm in Continental Europe"
Financial Times – Innovative Lawyers Awards, 2011

"Corporate Law Firm of the Year - Southern Europe"
ACQ Finance Magazine, 2009

"Best Portuguese Tax Firm of the Year"
International Tax Review - Tax Awards 2006, 2008

Mind Leaders Awards ™
Human Resources Suppliers 2007

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