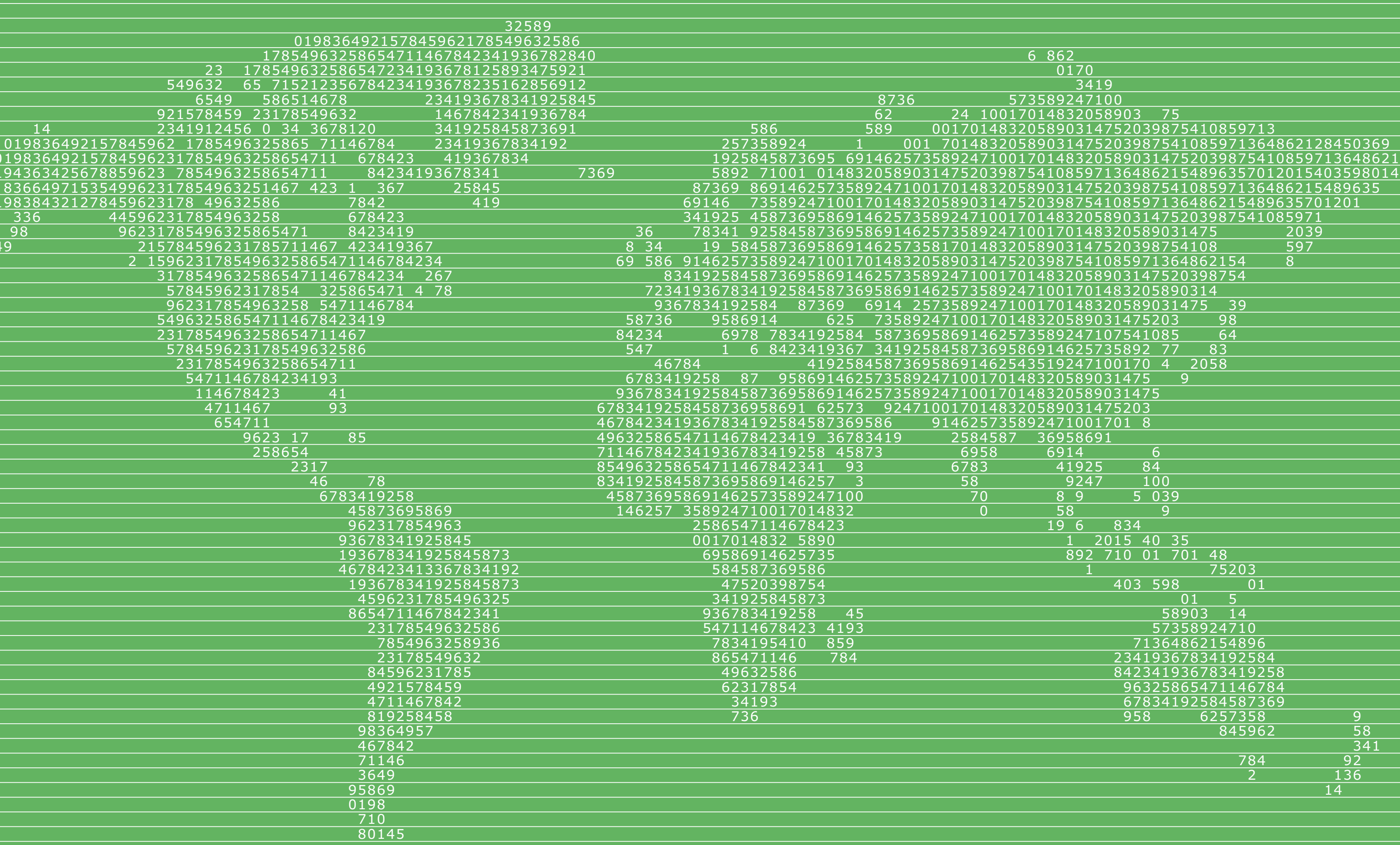
Global Banking & Financial Policy Review 2017/2018



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Reshaping of the Portuguese banking and financial system

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The Portuguese banking and financial system has gone through major changes in the course of the last three years. It was not a mere coincidence that this cycle started on the date of the resolution measure applied by the Bank of Portugal to Banco Espírito Santo (BES).

The Portuguese banking and financial system was in a fragile situation as a result of the international crisis, the serious domestic financial problems that led to a financial assistance programme from the IMF, the EU and the European Central Bank (ECB) (jointly known as 'the Troika') and the decreasing profitability of banks due to low interest policies, tighter regulation (e.g. money laundering and consumer protection), the rise of digital markets, high operational costs and more demanding requirements in terms of capital and liquidity.

Looking back to August 2014 when the resolution measure of BES occurred, it is now crystal clear that the Portuguese Central Bank had no choice but to intervene under a completely new framework, including new European rules on competition and new tools available to address the situation of banks failing or likely to fail. The Bank of Portugal had to use the resolution tools for the first time in the case of BES (historically a major and emblematic bank in Portugal) and create a bridge bank named Novo Banco. This decision was unexpected and its implementation was very complex and costly, triggering a deep concern in the financial system in general, notwithstanding the awareness of certain specific reasons that contributed to the fall of BES.

The banking system has hit by another collapse in December 2015. The Portuguese Central Bank was again forced to intervene and adopt a new resolution measure for Banif (a smaller bank with considerable market share in the islands of Madeira and Azores that was carrying systemic risk). The measure applied entailed a partial business sale to Banco Santander Totta and the transfer of the majority of the remainder of assets to an asset management vehicle (Oitante).

The measures taken by the Portuguese Central Bank ended up working as a trigger for a desirable market consolidation and deleveraging that had been delayed for too long and paved the way for the entire reorganisation of the sector.

In 2016, Barclays exited the Portuguese market and sold its business to newcomer Bankinter and CaixaBank launched a successful tender offer over Banco BPI (one of the largest players in the market). Already in 2017, China's Fosun became the largest shareholder in BCP (the second largest bank in Portugal) whilst Caixa Geral de Depósitos (a state-owned bank) started its recapitalisation process, which was approved by the EU and entailed, amongst other things, the direct injection of more than €2.5 billion and the issuance of circa €1 billion of contingent convertibles (CoCo) bonds. The Resolution Fund then announced the agreement for the sale of Novo Banco to Lone Star. Finally and very recently, the resolution measure applied to Banco Popular Spain led to the indirect acquisition of Banco Popular Portugal by Banco Santander.

It is clear that there is consolidation of the sector through the growth of strong players like Banco Santander (absorbing Banif and Banco Popular Portugal) and the entry of new players with financial strength (CaixaBank, Fosun, Lone Star and Bankinter), as well as a deleveraging process through the sale of non-performing assets (NPAs), namely by Caixa Geral de Depósitos, Novo Banco and BCP.

This is a trend that has come to stay. Pressure to sell NPAs continues as the ECB forces banks to solve exposures to non-performing loans (NPLs) and non-banking assets, such as the units of restructuring funds. Novo Banco has already started the sale process for several non-performing or non-core assets, such as its life insurance company, units of restructuring funds and NPLs. More is to follow considering that the value of Novo Banco's 'side-bank' is €8 billion and is not going to be maintained by Lone Star. Caixa Geral de Depósitos also started sale processes in respect of NPLs (e.g. the Andorra transaction), non-core subsidiaries (Spain and South Africa); and more should come. It is likely that the absorption of Banco Popular Portugal by Banco Santander Totta will also lead to a sale of non-strategic assets owned by Popular and certain NPAs, as well as synergy-driven mergers between entities within the group. This deleveraging process has been an opportunity for new players, such as private equity houses, hedge funds and alternative credit funds, to enter or have more active roles in the Portuguese market.

At a regulatory level, the pressure will increase during the current year of 2017 particularly on capital and liquidity due to: the

Fundamental Review of the Trading Book (FRTB), following its finalisation by the Basel Committee; the requirements on total loss absorbing capacity (TLAC); the minimum requirements on eligible liabilities (MREL); and the standardised credit risk regulatory capital standards. Whilst certain banks such as BPI, Santander Totta and Caixa Geral de Depósitos have now reinforced their capital strength, others may face more difficulties to overcome these new requirements. The entry of other new players is a scenario that should not be discarded.

Still on a regulatory level, the entry into force of MIFID II in 2018 will require market players, namely banks and asset managers, to adapt in key areas such as product distribution channels, inducements, discretionary management and compliance. The distinction between third-party benefits to discretionary portfolio managers that are admissible or non-admissible will be clearer and there will be higher standards for the best execution principle. Profitability issues will also be raised by MIFID II, considering the need for new models on the pricing and costs structures and the way products are distributed. The new requirements may thus demand a change in the business model of market players, including in the way their financial products are placed (with the most likely being a reduction of distributors and additional challenges for independent distributors) and the way their portfolios are managed. Market transparency rules will also pose additional requirements on client and regulatory reporting.

Last, but not the least, fintech and the digital era may be seen as a threat but also represent a clear business opportunity for banks, which are now more conscious of the need to create new tools to compete with fintech. Banks will need to improve and simplify loan origination, particularly in consumer and commercial lending. Fintech firms have already created new and more expedited processes for credit risk analysis by way of publicly available data and financial services information and by focusing on specific client needs without pushing the client to other banking products. Partnering up with fintech firms is also another way that banks are working to keep market share and improve client service. Payment platforms and services is another area where the aggressive competition of fintech start-ups is visible. The Portuguese market is no exception to this movement, as shown by the recent announcement of the sale by the Portuguese banks of their stake in the payment services company (SIBS), which manages the brands Multibanco, MB Way and MB Net. Rumours are that fintech firms and investment funds are in the run for its acquisition.

This overall reshaping is not exclusive to the banking sector. The insurance sector is also seeing important consolidation movements. After the sale by Caixa Geral de Depósitos of the market leader Fidelidade to the Chinese conglomerate Fosun, other new players entered the market in the context of the sale by banks of non-care assets or the exit of existing international players: Ageas bought AXA business; Apollo acquired insurance company Tranquilidade from bankrupt GES group (following the resolution of BES) and insurance company Açoreana from Oitante, the asset management company holding the NPAs of Banif. More movements are currently taking place, with international market players selling their businesses and other market players and private equity houses looking to step in. Consolidation is thus a trend also in the insurance sector.

These are undoubtedly challenging times for the Portuguese banking and financial system and for those that are now playing an active role in the consolidation and deleveraging process. The pressure to improve profitability will continue with the need to reduce operational costs and boost financial innovation as an essential tool to grow market share in the digital era, where clients are increasingly demanding simpler and more friendly client-driven services and where mobile and online banking are rapidly replacing traditional banking.

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