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Portugal: Trends & Develoments

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PORTUGAL

Trends and Developments

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Abreu Advogados

Abreu Advogados is an independent law firm with nearly 30 years of experience in the Portuguese market and has offices in ten locations. As a full-service law firm, Abreu is one of the largest law firms in Portugal, working with the most prestigious law firms in the world in cross-border projects. The firm's banking and finance practice is particularly experienced in cross-border finance transactions, asset management, debt issuance (including structured products), advising credit institutions and investment companies on prudential and conduct issues, and advising on OTC derivatives, the acquisition and sale of non-performing loans, and structured financial transactions.

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The Portuguese Market at a Glance

Amidst the challenging economic backdrop, the Portuguese economy will reportedly grow by 2.1% in 2023 (according to the Bank of Portugal). Rising inflation and the increase in interest rates have had a chilling effect, particularly in the Portuguese leveraged finance market in 2023, with borrowers facing increased borrowing costs (as a result of the uplift in their benchmark rates) and lenders tightening their documentation and loan approval criteria.

Still, the Portuguese banking sector continues to show positive signs, notably in asset quality, returns and solvency figures. Non-performing loans (NPLs) and stage 2 loan ratios for corporate borrowers remained stable in the first semester of 2023 (averaging around 3% and 15% respectively). The sector's returns have improved both in terms of assets and equity, increasing to 1.16% (return on assets) and 13.7% (return on equity) in Q1 2023 (Bank of Portugal). As regards solvency, total own funds and common equity tier 1 (CET1) ratios continued their upward trajectory during 2023.

As the inflation curve begins to flatten, an uptick in confidence by market participants and a return in M&A activity in Portugal is expected. At the same time, Portuguese banks will likely continue to exercise some restraint in future deals, making room for alternative and private credit lenders acting on a cross-border basis. Still, as a result of inflation and the increase in interest rates (combined with factors such as high energy costs), it is likely that an increase in distressed debt will follow. Debt restructuring, recovery and placement in the secondary market will remain a key challenge for banks and borrowers throughout 2024.

On the upside, it is expected that technology- and AI-driven solutions will continue to be strongly implemented by banks with a view to transforming and enhancing the present banking services and keeping up with new market entries from fintech players.

ESG concerns will also remain on the agenda for 2024, with an expected increase in green and sustainability-linked financial products in loan and debt securities (notably bonds) documentation. There is growing demand for sustainability from lenders, other stakeholders and broader society, and thus many, if not the majority, of financing arrangements already incorporate sustainability elements.

Crypto-assets and Fintech

On the fintech side, innovation has focused mainly on areas such as digital onboarding, robo-advisory, and open banking, fuelled by collaborations between incumbents and fintech start-ups. Since its creation in 2018, Portugal's FinLab has contributed to the fostering of innovative projects, in close connection with the national regulators. The recent creation of "technology-free zones" (*zonas livres technológicas* – ZLTs), the regulatory sandboxes for sponsors to develop and test their technology-based goods and services, will contribute to the dynamism of the Portuguese fintech market. Crowdfunding, on the other hand, remains fairly untapped in the Portuguese market, with only four platforms and four platform managers registered with the Securities Market Commission (*Comissão do Mercado dos Valores Mobiliários* – CMVM).

It is anticipated that crypto and fintech will be key drivers in 2024, with new opportunities and innovation-driven models arising in the banking and financial sector, namely under the EU's Digital Finance Package.

Restructuring, Recovery and Loan Trading

Having "survived" the end of COVID moratoria schemes – which covered a significant portion of bank loans – without major impacts on performance indicators, the looming effects of inflation and rising interest rates are expected to bring additional pressures to borrowers and lenders.

During 2023, the market was largely marked by maturity-driven refinancings and amend-to-extend transactions. On the other hand, secondary market activity remained fairly slow. As a result of efforts to strengthen their position since the global financial crisis, Portuguese banks have focused mainly on smaller disposals, even as the macroeconomic challenges of 2023 intensified.

However, as the risk of maturity walls increases, the number of stage 2 and NPLs is expected to increase in Portuguese banks' sheets. NPL volumes are expected to bounce back in 2024, with banks turning to disposal tools such as portfolio sales and securitisations. Nonetheless, economic indicators will likely play a key role in determining the pace of NPL activity in 2024.

From a regulatory perspective, changes will flow from the transposition of the Directive on Credit Servicers and Credit Purchasers, which sets forth a harmonised framework for addressing NPLs originating in EU banks through the creation of a level playing field secondary market. Once transposed (which should occur by the end of December 2023), servicers will need to obtain an authorisation in their home EU member state, which may be passported to other member states. While originators will need to adopt the data disclosure templates for NPL transactions, servicers will, among other things, have to ensure that the assignment remains neutral to the borrower, as well as comply with a set of information duties vis-à-vis the borrower. In turn, purchasers will be required to appoint a credit institution or an authorised servicer to perform servicing activities in respect of consumer loans.

Diversifying Sources of Funding

Another major driver of legislative changes in the Portuguese financial landscape has been the need to facilitate access to alternative sources of financing, especially for SMEs, so as to reduce their indebtedness and dependency on banks. Traditional bank loans remain the most relevant source of financing for businesses in Portugal (around 42%), while the total amount of loans is averaging 80% of the country's GDP.

Participating loans were introduced in 2022 as a form of hybrid (or quasi-equity) funding. In a nutshell, participating loans are remunerated and/or repaid based on the borrower's results and any outstanding amounts may be converted into equity, notably upon default.

Loan funds were also recently introduced into Portuguese law as a subtype of alternative investment funds (AIFs). These funds are expressly authorised to originate loans, to participate in loan syndicates or to acquire loans originated by banks (performing or non-performing). Certain changes are expected from a cross-border perspective with the approval of the Alternative Investment Fund Managers Directive 2 (AIFMD2) Proposal, notably with the introduction of a "loan issuance passport" for EU loan-originating AIFs.

It will be interesting to see how these – and other – alternative types of lending will play out in 2024 within the general financing landscape. Although some forms of alternate lending have been visible, credit granting in Portugal remains a strictly regulated activity, restricted to duly authorised entities. In an effort to prevent and combat unauthorised financial activities and to protect consumers, a recent legislative act set forth a general duty for market operators to refrain from marketing and recommending financial products provided by unauthorised entities. The act also establishes reporting duties in relation to unauthorised banking practices, while expanding the supervisory powers of Portuguese financial regulators.

ESG and Sustainable Finance

ESG concerns are also expected to remain a focal point in the Portuguese financial sector for 2024. Green and hybrid bond placements in Portugal have already surpassed EUR6 billion in volume. Clients' awareness of green loans, ESG-linked loans or sustainability-linked loans has increased, and banks and other lenders are facing increasing pressure to make their loan books "greener". There has also been a progressive increase in the incorporation of ESG KPIs in loan transactions during the past couple of years, associated with better pricing for borrowers and other more favourable debt conditions.

As regards changes in hard law, the Sustainable Finance Disclosure Regulation is now in full force (with very few exceptions), and asset and portfolio managers will need to be prepared to report and disclose ESG-related information in an appropriate and efficient manner, taking into account the framework set out in the Taxonomy Regulation and the Low Carbon Benchmark Regulation. It will be interesting to monitor how investors react to the available data and labelling, and how the information translates into the funds' performance (if at all).

Alongside this, the EU Green Bond Regulation (EuGBR) has recently been adopted and, following publication in the EU's Official Journal, is expected to start applying by the end of 2024. By laying down uniform requirements for issuers that wish to use the designation "EuGB" for their environmentally sustainable bonds, it is expected that the EuGBR will pave the way for a true EU green bond market. The level of adherence to the EuGB is still uncertain, at least in an initial phase. Whilst there is increasing appetite for green-labelled products, issuers will need to consider key challenges such as alignment with the EU Taxonomy in the application of proceeds, disclosure and reporting costs (including costs associated with the prospectus, fact sheets and periodic reports, as well as with external reviewers) and risk of non-compliance.

The New Portuguese Banking Act

In 2021, the Bank of Portugal approved a final draft of the new Portuguese Banking Activity Code which, if passed by parliament, will replace the current legal framework governing banking activities and the provision of financial services in Portugal. The proposal for a Banking Activity Code represents a significant change to the banking landscape.

The draft aims to consolidate, in a single piece of legislation, the framework for banking activities in Portugal. It also proposes to introduce legislative changes that reflect the recent developments in the Portuguese banking sector. Key changes proposed in the draft include:

- the adoption of a single type of financial company;
- a more stringent regime for cross-border transactions with non-EU countries;
- new rules on transparency, conflict of interests and transactions between related parties;
- new standards for subcontracting by financial companies; and
- the expansion of the Bank of Portugal's supervisory powers, especially regarding qualified holdings.

The new Code is expected to be approved in 2024.

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