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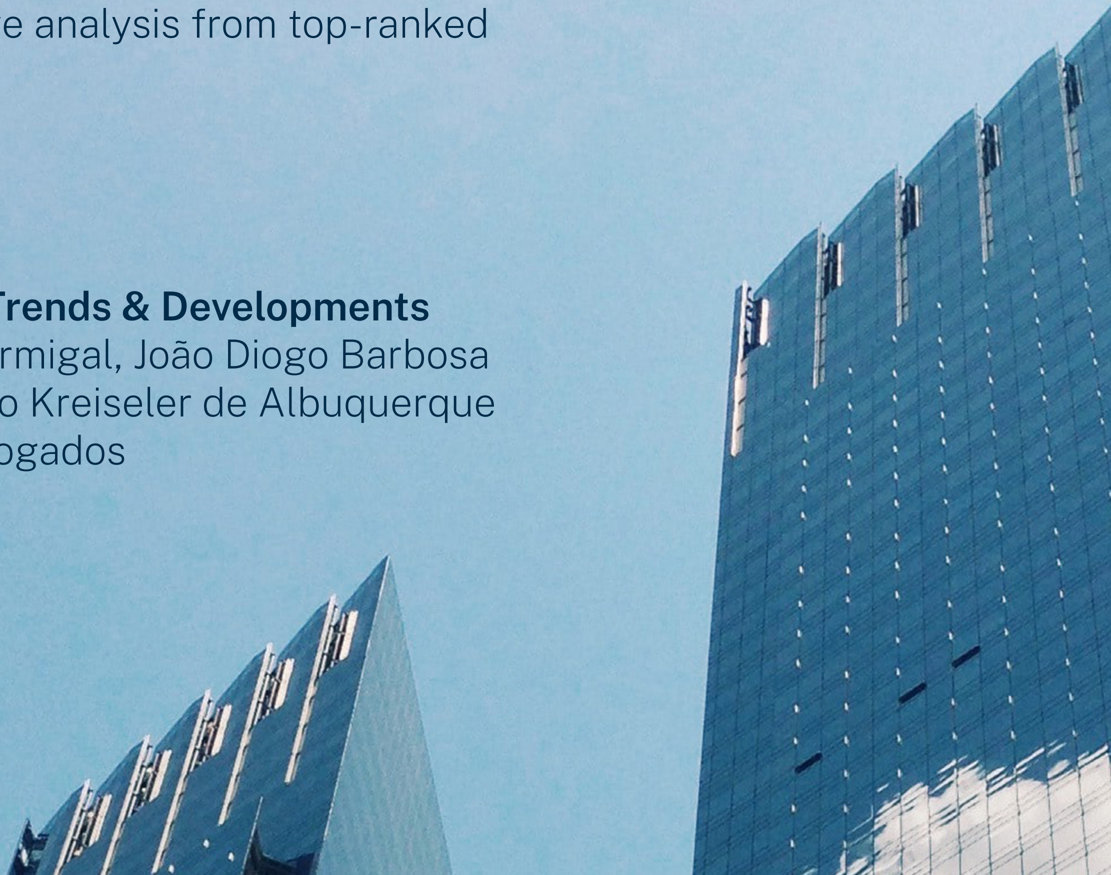

Portugal: Trends & Developments

Rodrigo Formigal, João Diogo Barbosa and António Kreiseler de Albuquerque
Abreu Advogados

Trends and Developments

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Abreu Advogados

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The Portuguese Market at a Glance

Amidst a challenging backdrop, the Portuguese economy will reportedly grow by 1.6% in 2024 (and 2,1% in 2025), according to the Bank of Portugal's forecast. This notable result within a depressed European context follows a slowdown in inflation and interest rates. Regardless, the banking market saw a year of borrowers' increasing borrowing costs (as a result of the increase in their benchmark rates) and lenders tightening their documentation and loan approval criteria.

Even so, the Portuguese banking sector continues to show positive signs, notably in asset quality, returns and solvency ratios. The non-performing loans (NPLs) ratio published by the Bank of Portugal has showed a steady decrease in such liabilities for several years, remaining at 2.6% for Q2 2024, whilst the ratio of stage two loans for corporate borrowers experienced a 0.3% decrease in Q1 2024, compared to the previous quarter, also according to the Bank of Portugal's data.

Simultaneously, banks' returns have improved both for assets and equity, increasing to 1.40% and 15.5%, respectively, in Q1 2024, according to the Bank of Portugal. In fact, Portuguese banks have achieved levels of profits that had not been reached in recent years. Solvency, total own funds and common equity tier 1 (CET1) ratios remain in an upward trajectory and Q1 of 2024 witnessed a rise of value in total assets by 2.6%, mainly due to an increase in debt securities held in portfolio, with sovereign debt having an important role.

As the inflation curve begins to flatten, an uptick in confidence by market participants and a return in M&A activity in Portugal is widely 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, persistent inflation and interest rates (combined with factors such as high energy costs), are a significant source of risk for distressed debt. Debt restructuring, recovery and placement in the secondary market will remain a key challenge for banks and borrowers throughout 2025.

On the upside, digital and artificial intelligence-driven solutions are expected to continue to be strongly implemented by banks with a view to transforming and enhancing today's banking services and keep up with new market entries from fintech players.

ESG criteria will also remain a top priority for 2025, with an expected increase in green and sustainability-linked financial products in loan and debt securities (notably bonds with the EU Green Bond Standard becoming effective from 21 December 2024). There are signs of growing demand for sustainability-linked offerings from lenders, investors and other stakeholders and broader society, and thus many, if not the majority, of financing arrangements already incorporate sustainability elements.

Efforts are being made to incentivise the set-up and investment of loan funds in Portugal. Loan funds' income is exempt from corporate income tax and stamp duty. Equally, investors in loan funds also benefit from beneficial taxation. These measures reflect a commitment from lawmakers to loan funds that operate or may be interested in operating in Portugal and it is expected that the market will respond appropriately from 2025 onwards.

Artificial Intelligence and Fintech

On the fintech side, innovation has focused mainly on areas such as digital onboarding, payment solutions, 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, is contributing to the increased dynamism of the Portuguese fintech market.

It is anticipated that innovation in fintech will continue to be a key driver in 2025, with new opportunities and innovation-driven models arising in the banking and financial sectors, namely under the EU's Digital Finance Package.

Furthermore, the Portuguese banking sector has showed interest in implementing artificial intelligence as an integral part of the customer relation and financial services. Artificial intelligence technologies are seen as having the potential to revolutionise customer service, credit scoring, fraud detection, decision-making and general automation for the industry. In 2025, the expectation is that investments in artificial intelligence in the financial sector will continue to exponentially increase to drive beneficial innovation.

Restructuring, Recovery and Loan Trading

In recent years, the market has been largely driven by maturity-driven refinancings and amend-to-extend transactions. On the other hand, secondary market activity has remained 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.

From a regulatory perspective, great expectation remains for 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.

The deadline for transposition of this directive was not respected, and as at the time of writing, no local implementation law has been approved or even publicly discussed. Nonetheless, once transposed, 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.

Large-Scale Public Works

In 2025, Portugal's banking sector stands to benefit from a range of ambitious public infrastructure investments, particularly in transportation, healthcare, and sustainability. A major focus is the construction of a high-speed rail network connecting Lisbon and Porto, which will improve regional connectivity and economic integration. The long-anticipated development of a new Lisbon airport at Montijo aims to expand air travel capacity, boosting both passenger and cargo traffic. Urban mobility is also being prioritised, with significant expansions to the subway systems in Lisbon and Porto to reduce congestion and enhance public transport efficiency. In healthcare, key projects include the expansion of *Hospital Central do Algarve* and new healthcare facilities in major cities like Lisbon and Porto.

In addition to these developments, Portugal is heavily investing in renewable energy infrastructure, such as offshore wind farms and solar energy parks, particularly in the Alentejo and Algarve regions. These projects align with the country's push for green energy and sustainability, creating new opportunities for banks in sustainability linked and green finance. Urban regeneration, including the revitalisation of Lisbon's waterfront and the creation of business hubs in Porto, is also expected to attract significant investment. While road infrastructure expansion has been de-emphasised, efforts are focused on improving traffic flow and safety through smart technologies rather than expanding highways. This shift toward sustainable transport and infrastructure offers considerable financing opportunities for the banking sector, aligning with broader European climate goals and enhancing Portugal's long-term economic competitiveness.

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 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 will be in place with the transposal of the Alternative Investment Fund Managers Directive 2 (AIFMD2), 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 2025 within the general financing landscape. Although some forms of alternate lending have been visible, credit granting in Portugal remains a strictly

regulated activity and therefore 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 taking part in 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 2025. Recent data from the Bank of Portugal showed that the stock of ESG-linked bonds was above EUR12 billion as of August 2024, a relevant figure for a relatively small market that saw its first issuance in 2019. Clients' and investors' 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.

For 2025, sustainability will remain a cornerstone of Portugal's economic strategy, closely aligned with European Union laws and directives aimed at fostering a green transition across member states. Key regulations include the EU Green Bond Regulation (which shall become effective from 21 December 2024), aiming to create a robust framework for green bonds, ensuring that proceeds are used for environmentally sustainable projects. The regulation enhanced transparency and accountability, enabling investors to confidently finance initiatives that align with the EU's climate goals. Additionally, the Sustainable Finance Disclosure Regulation (SFDR) has required financial institutions to disclose the sustainability risks associated with their investments, promoting greater transparency in the financial sector and generating compliance requirements for banks.

As a result, banks in Portugal are increasingly integrating environmental, social, and governance (ESG) criteria into their organisation, lending and investment practices. The SFDR mandates that firms categorise their financial products based on their sustainability characteristics, encouraging the development of products that support the EU's objectives for a greener economy. Furthermore, the EU Taxonomy Regulation provides a classification system for sustainable economic activities, guiding financial institutions in identifying which investments are aligned with environmental objectives. This regulatory landscape not only drives banks to enhance their sustainable finance offerings but also compels them to assess the impact of their investment portfolios on climate change and biodiversity loss. With rising regulatory scrutiny and growing consumer demand for sustainable practices, the banking sector in Portugal is well-positioned to lead in green financing initiatives that not only comply with EU laws but also contribute to a more sustainable and resilient economy.

Artificial Intelligence in Banking Services

Recent developments in the field of AI, with the broader and increasing use of generative AI systems and Large Language Models (LLMs), have generated a great interest in the industry and have already been reflected – still in a limited capacity at this stage – in banking services.

The integration of generative AI and LLMs into the banking sector is expected by some to sig-

nificantly reshape how financial institutions operate and engage with their customers. Leveraging these technologies, banks may automate and enhance various processes, such as risk assessment, fraud detection, credit scoring, customer service, and compliance management. Generative AI could have the potential to analyse vast datasets and generate predictive models that inform business (and lending) decisions, helping to reduce defaults and improve profitability. Additionally, LLMs can enhance customer interactions through personalised communication, enabling chatbots and virtual assistants to provide tailored financial advice and support, thereby improving customer satisfaction and engagement. In the realm of compliance, such models could in the future assist in monitoring transactions for anomalies, ensuring adherence to applicable regulations, and streamlining reporting processes by automatically generating necessary documentation. Furthermore, generative AI can facilitate product innovation by analysing customer preferences and market trends to help banks develop new services that better meet client needs. As these technologies continue to evolve, their ability to drive efficiency, enhance security, and deliver personalised experiences positions banks to remain competitive in an increasingly digital financial landscape.

This year has also marked the entry into force of the European AI Act, which will guide the first phase of AI adoption by relevant market players. European lawmakers employed a risk-based approach setting the obligations for processors and controllers of these technologies. Regulating these matters through the AI Act reflects an alignment of the legal framework at the EU level, as new AI technology is required to comply with fundamental rights, presenting a similar commitment to the one that exists on a data protection level, where individuals may not be subjected to a decision solely based on automated processing. This has also had an impact on different legal orders, which have closely followed European rules on this matter. This could benefit operators in Europe from a compliance perspective.

Nonetheless, the lack of experience in implementing AI technologies in the sector presents non-neglectable risks and close scrutiny of the systems and processes that are in place is required to ensure regulatory expectations are met. With more players in the market, banks are forced to compete, not only with each other, but also with other entities, notably fintech companies. As part of a larger effort to integrate generative AI in the financial sector, the Securities Market Commission (CMVM) has committed one of their goals of 2024 to incorporate AI into the regulatory and supervision field. Amongst recent efforts and initiatives in the banking market is Project Gaia, a system that facilitates the analysis of climate-related risks in the financial system, integrating LLMs for the analysis of climate-related indicators, at an unprecedented scale.

Digital Banking

Digital Banking has kept a tendency of exponential growth, and its influence is expected to become increasingly more relevant in the banking industry. Key developments include embedded finance, banking-as-a-service (BaaS), generative AI as a power for personalisation and automation, and Central Bank Digital Currencies (CBDCs).

In the coming years, some areas will enhance the potential of digital banking. Consumers' awareness on the relevance of their personal data enables banks to portray themselves as the safest place for consumers' data. Equally, business models have already started a move towards platformisation. As more players in oth-

er sectors begin bundling financial services with their own, banks will ideally allow customers to choose a more need-centred approach.

In terms of regulation, governments and regulating bodies are required to shift entirely their way of identifying and managing risks. There is a move towards a focus on the outcome, rather than monitoring the activities of institutions. Equally, this regulation may become progressively more dependent on AI, personal data and the blockchain.

Digital Banking is starting to impact the Portuguese market, with increased focus on convenience for costumers, competition amongst credit institutions – that are being forced to diversify their services and utilise automation and fintech – and a bigger awareness on cybersecurity and protection of personal data.

Basel III

The recently published CRD VI and the CRR III will fully integrate the Basel III framework and have been thoroughly reviewed by local institutions. While the CRD VI must be transposed only by 10 January 2026, the CRR III enters into force from 1 January 2025.

Besides the implementation of Basel III final reforms, and confirmation of the banks' internal risk measurement to yield, the European banking package will also bring forward:

- the introduction of an output floor to reduce excessive variability of banks' capital requirements calculated with internal models;
- the implementation of the agreement to strengthen EU's banks' resilience to face credit, market and operational risks
- the strengthening of provisions related to ESG risks;
- clearer rules for third-country banks operating in the EU; and
- a stronger supervision and governance, requiring a proper assessment for bank managers.

One notable change is the introduction of a new notification and approval requirement for corporate transactions involving acquisition of material holdings by institutions, financial holding companies and mixed financial holding companies or mergers or divisions of the aforementioned entities.

There has not been any public discussion on the legislative implementation of both acts in the Portuguese banking framework yet, but in-scope institutions have already started to adapt their internal organisation in light of the existing rules, given the tight deadline for entry into force.

In addition to the Basel III reform of capital requirements within CRR III, the CRD VI foresees an amended framework for third-country banks to operate within the European Union, including through branches, as well as a review of supervisory powers and the introduction of ESG criteria in internal policies and procedures of in-scope institutions. The proposed changes, when transposed into national law (hopefully in 2025), will force the industry to once again adapt its structures to ensure compliance.

Revision of the Countercyclical Capital Reserve in Portugal

The Bank of Portugal has launched an official public consultation to revise the countercyclical capital reserve in Portugal, to allow for a gradual increase in the reserve of releasable capital, that would allow the mitigation of losses resulting from unforeseen system shocks, without significantly restricting the granting of credit. The

concept of risk adopted by this measure is quite broad, varying from external circumstances (such as pandemic crisis or geopolitical uncertainty) to simply the overvaluation of real estate that leads to the correction of prices. Rather than triggering this reserve when a cyclical systemic risk occurs, the aim is now to trigger it in a neutral environment.

This is the first time the Bank of Portugal is considering setting this reserve at a value above 0%, with a proposal of 0.75%. The total value of reserves to be created through this measure is expected to be around EUR1 billion, although it is difficult to provide a definite forecast at this stage. This measure is backed by international institutions such as the IMF, the Basel Committee and the Governing Council of the ECB.

MiCAR

The Markets in Crypto-Assets Regulation (MiCAR) will become fully enforceable by the end of 2024, representing a legislative shift towards a unified European framework for the crypto sector, even if its implementation does not directly interfere with the DLT/Blockchain technology underlying the crypto-asset markets. New rules encompass asset referenced tokens, e-money tokens and other crypto assets, although they notably excludes non-fungible tokens.

It is expected that a local implementation act will be approved to adapt the Portuguese framework in light of MiCAR requirements. This has not yet been published, although authorities have made public that discussions are ongoing. There is uncertainty regarding the applicable regime for established entities which seek to be authorised under MiCAR during a potential transition period, and the rules on cross-border service provision within the European Union during the same period. It is expected that the first months of 2025 will bring challenges to established and potential new operators (as well as regulators) in navigating the new framework.

Amongst notable changes, there is great expectation as to the appointment of a national competent authority for MiCAR matters. Prior to the MiCAR, the Bank of Portugal was the only entity responsible for monitoring and regulating crypto-assets on AML/CFT matters.

In early 2024, the Securities Market Commission (CMVM), launched a public consultation to engage in a dialogue focused on identifying the potential interested parties in assessing the impact of the MiCAR in Portugal. It is likely that future supervision will be at least partially attributed to the CMVM, as has been the case in other member states.

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