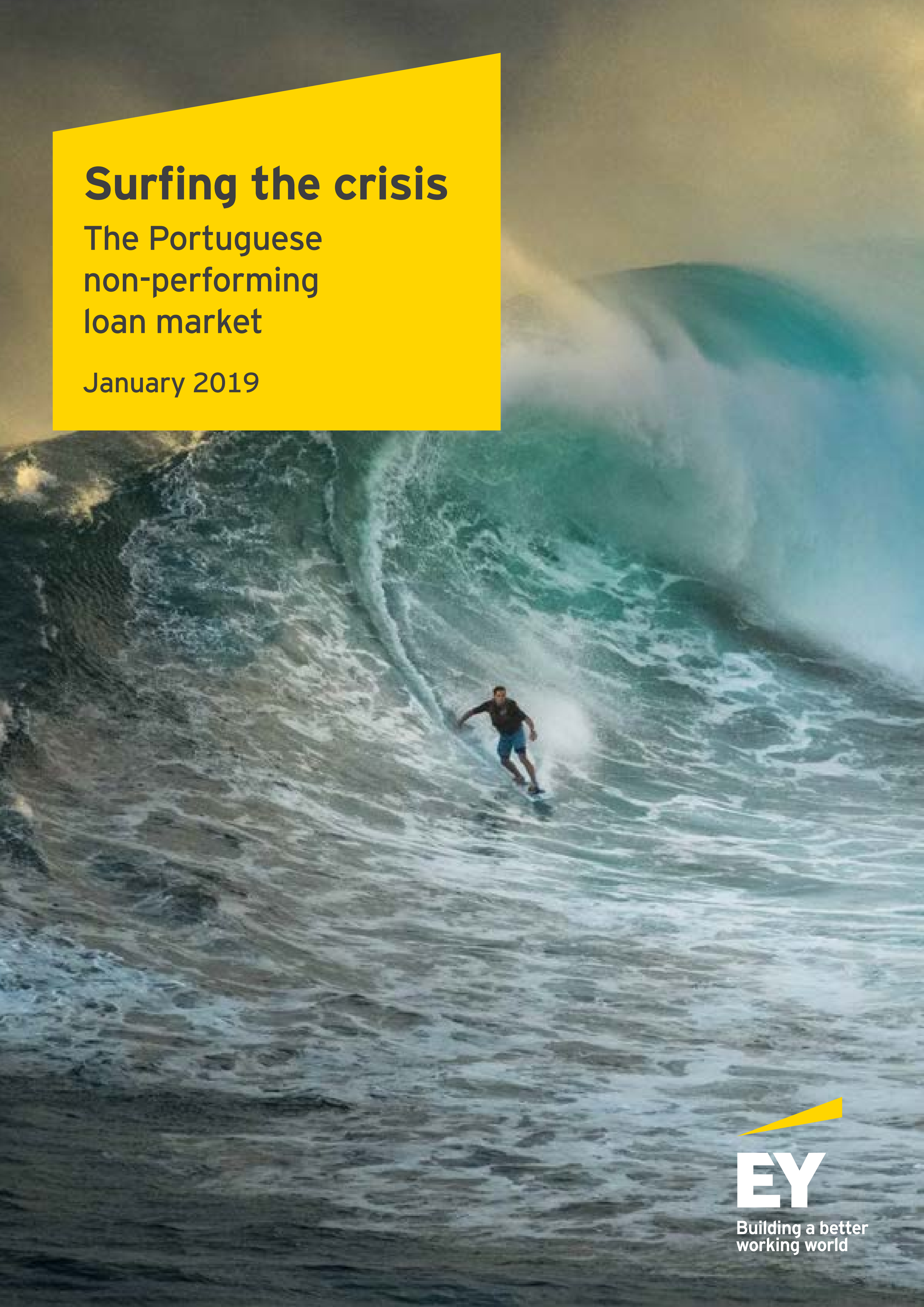
Surfing the crisis

The Portuguese non-performing loan market

January 2019



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Foreword

Welcome to the EY review of the Portuguese non-performing loan (NPL) market.

Portugal was heavily impacted by the financial crisis and in 2011 was forced to request a €78b bailout package from the European Union (EU), the European Central Bank (ECB) and International Monetary Fund (IMF). Since then, the Portuguese economy has experienced a positive resurgence. Standard & Poor (S&P) has upgraded Portuguese sovereign debt back to investment grade.[1] In addition, public sector wages, working hours and holidays have been restored to pre-bailout levels, and state pensions have risen.

Gross Domestic Product (GDP) growth in Portugal is expected to remain positive due to improved macroeconomic fundamentals. As per the IMF forecast, GDP is expected to grow at 1.8% and 1.5% in 2019 and 2020 respectively.[2] However, a high debt to GDP ratio is still a cause of concern. Though the debt to GDP ratio is expected to decline from 129.9% in 2016 to c.102% in the year 2022, it is still expected to remain over 100%.[3]

Despite improvements, Portuguese banks' bad debt ratios remained in excess of 15% in 2017, the third highest in Europe after Greece and Cyprus.[4] As at Q2 2018, the NPL stock in Portugal was €32.5b.[5] The scale of existing NPLs require that loan sales will be a significant part of the solution. We therefore expect the significant transaction volumes seen in 2018 to continue into the new year.

With regulatory and political pressure mounting against the backdrop of high NPL ratios, Portuguese banks are committed to resolve their NPL books predominantly through sales of small and medium-sized enterprises (SME) and retail secured and unsecured loan portfolios.

This document sets out the opportunities and challenges of investing in the Portuguese NPL market. In particular, we have provided an overview of the economic and political context before outlining the current evolution of Portuguese NPLs. We also provide an overview of the Real Estate market, and the current status of the Securitization and Servicing landscapes. Finally, we considered the regulatory and legal hurdles.

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[1] "Financials Watch — The Portuguese path to recovery," ABN AMRO website, 27 September 2017.
[2] International Monetary Fund, World Economic Outlook Database, October 2018.
[3] European Commission, Directorate General Economic and Financial Affairs, Assessment of the 2018 Stability Program for Portugal, May 2018.
[4] European Banking Authority data.
[5] "Financial Stability Report" Banco de Portugal, December 2018.

Economic backdrop

Portuguese economic recovery

Before the crisis, Portugal experienced consistently low rates of economic growth, with severe imbalances in both its external deficits and budget deficits. This situation was then aggravated by the 2008 global economic crisis.

In 2008, the Portuguese current account deficit was over 12% of GDP, reflecting a lack of competitiveness relative to the rest of the Eurozone. While Portugal's current account was temporarily financed by capital inflows, this funding dried up after the credit crunch. Additionally, increasing public spending and falling public revenues made access to international financial markets increasingly difficult.

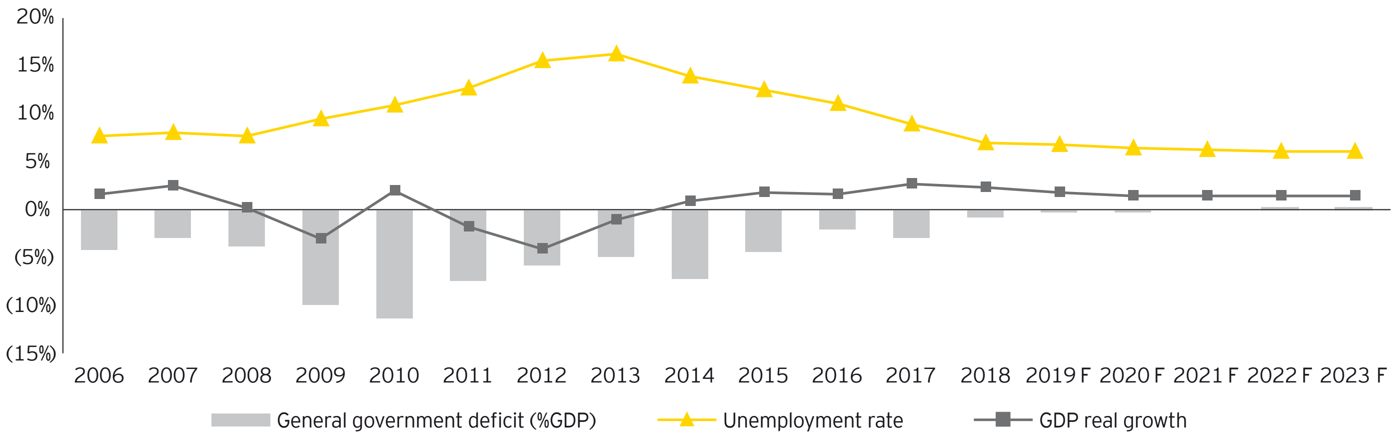
As a result of the deep recession, Portugal requested financial assistance in April 2011. The EU, ECB and IMF provided a joint financing package of €78b, negotiating an economic adjustment program with the Portuguese authorities.

The program contained structural reforms to promote growth, employment and improve competitiveness; fiscal measures to reduce the public debt-to-GDP ratio and public deficit (with the aim of reducing it to below 3% of GDP by 2014); and strategies to ensure the stability of the country's financial sector, with a focus on recapitalization and deleveraging.

Portugal successfully exited its three-year economic adjustment program in June 2014 and will remain under post-program surveillance (PPS) until at least 75% of the financial assistance received has been repaid, which is expected to take until at least 2026.

The objective of PPS is to monitor Portugal's capacity to repay its outstanding loans to the European financial stability mechanism (EFSM) and European financial stability facility (EFSF).[6]

General government deficit, unemployment rate and GDP real growth evolution[7]



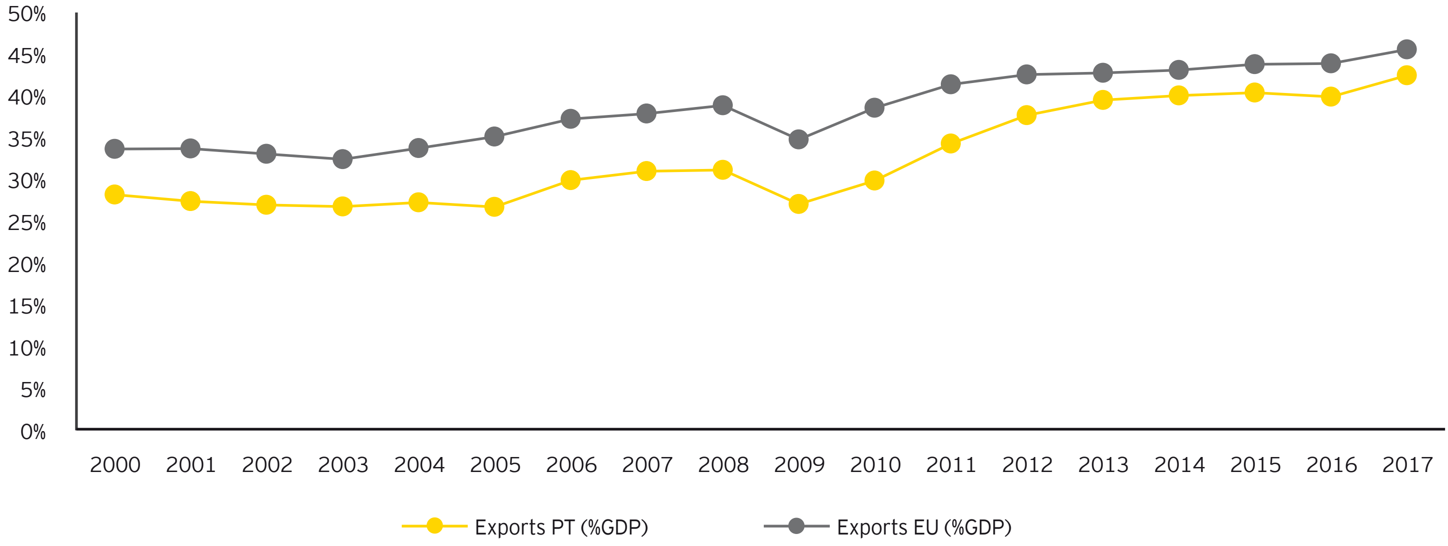
[6] "Financial assistance to Portugal," European Commission website.
[7] International Monetary Fund, World Economic Outlook Database, October 2018.

Between 2011 and 2014, Portugal completed a challenging financial and economic adjustment program, thereby fulfilling its obligations under the EU/IMF bailout. Despite the challenges, these austerity measures reduced the general government deficit, improved the country's long-term debt sustainability and has gradually reduced the unemployment rate.

The improvement in the Government's fiscal position has contributed to Portugal's return to growth, with the country now outperforming the Eurozone average.[8] International forecasters now predict annual growth of around 2% per annum, driven primarily by domestic demand and exports (mainly due to tourism). Portugal's initial growth has facilitated a virtuous cycle of falling unemployment, stronger consumer confidence and increased private consumption. These developments have not gone unnoticed by the capital markets, and in 2017 S&P and Fitch upgraded Portugal's sovereign debt to investment grade.

Employment has recently grown faster than GDP, specifically in labor-intensive services related to tourism and construction. However, the majority of the jobs openings were in sectors with low-skill profiles and lower-than-average salaries.

Evolution of exports



[8] Datasets: World Economic Outlook (October 2018), IMF.

Economic backdrop

Currently, national exports represent 43% of national GDP, up from 28% in 2000 and 27% in 2009, and close to the European 46% average. Despite the deep financial crisis, Portugal has intensified its integration into the global economy, with exports growing faster than internal consumption.

Looking ahead: an attractive investment opportunity

Forecasters predict economic growth of around 2.3% in 2018 and 1.8% in 2019, driven by both domestic demand and exports. The unemployment rate is falling at one of the fastest rates in Europe, from 16.2% in 2013 to 11.1% in 2016, and 7.8% in 2017. It is projected to further decline to 6.5% in 2020, which compares favorably to the projected Eurozone figure of 7.7%.[9] A stronger than expected recovery in Portugal's trading partners may lead to even higher exports and investment than has so far been anticipated.

Portugal is steadily returning to financial health with the fiscal deficit declining from 7.4% in 2014 to 2.1% in 2016. It is currently expected to decline to 1.7% by 2020. The Portuguese government 10 year bond yield has declined from 7.508% (12 Jul 2014) to 1.946% (26 Jan 2018). However, Portugal's high debt-to-GDP ratio is still a cause of concern. The debt-to-GDP ratio increased from 96.2% in 2010 to 126.2% in 2012, further increasing to 130.6% in 2014. The ratio is expected to decline but will likely remain over 100% over the next 4–5 years.[10]

Political stability has contributed to economic growth, enabling the adoption of less restrictive measures than had previously been agreed with the IMF and EU during 2011–2014. Public sector wages, working hours and holidays have been gradually restored to pre-bailout levels along with state pensions.[11]

In light of this, there is a growing consensus that the Portuguese economy will continue to expand over the next 24 months, improving the prospects of the country's currently non-performing borrowers. These growth projections, in combination with increasing political stability, are likely to make Portugal an attractive investment opportunity in the coming years.

[9] Datasets: World Economic Outlook (October 2018), IMF

[10] IMF World Economic Outlook Database, Oct 2017, European Commission, Directorate General Economic and Financial Affairs, Assessment of the 2018 Stability Program for Portugal, May 2018.

[11] "Portugal's economic revival brings "crisis of good news"," FT website, 5 June 2017.

In respect to the Banking sector, during 2017, there were several foreign transactions and investments into the Portuguese banking sector. Lone Star acquired 75% of Novo Banco, Fosun International increased their stake in Banco Comercial Português (BCP) to 23.92% and following a global transaction Banco Santander's purchased Banco Popular. Additionally, Spain's CaixaBank SA increased their ownership in Banco BPI to 85%.

Portugal's largest bank, state-owned Caixa Geral de Depositos (CGD) completed a €4.4b recapitalization during the early part of 2017,[12] significantly increasing its capital ratios to a phase-in common equity tier (CET) 1 ratio of 12.3% and a total ratio of 14.2% as at 31 March 2017.

Caixa Economica Montepio Geral (CEMG) completed a capital increase of €250m in June 2017 and was converted into a public liability company in September 2017. This latter step enabled the bank to benefit from a change in the treatment of some deferred tax assets, in turn reducing the regulatory capital deduction due to these assets.[13]

Despite these transactions and measures taken by banks, asset quality still constitutes a problem and the Portuguese Authorities continues to work with banks to solve the NPL and capital issues, including announcing plans in 2017 to safeguard institutional depositors by placing them above traditional liabilities.[14] At the end of the year, non-performing loans ratio stood at a high 13.3% and NPL impairment coverage remained low, at around 49.3%.

With the combined measures of foreign investment, government intervention, restructuring and capitalizations, Portuguese banks are expected to see a reduction in NPLs and an eventual return to profitability.

[12] CGD Annual Report 2017.
[13] "Fitch Upgrades Caixa Economica Montepio Geral to "B+"; Outlook Stable" Reuters website, 21 December 2017.
[14] "Financials Watch — The Portuguese path to recovery" ABN AMRO website, 27 September 2017.

NPL evolution in Portugal

Portuguese authorities are analyzing potential solutions and adopting initiatives to help minimize the negative impact of NPLs and reduce the NPL ratio.

The most recent venture – PNCB or "The Integrated Bank Credit Trading Platform" – was set up as an integrated platform for the management of NPLs under the possession of the three Portuguese banks: CGD, BCP and Novo Banco. It will operate for a period of three years, during which time the banks will be able to jointly negotiate outstanding loans that are common to at least two of the three banks.[15]

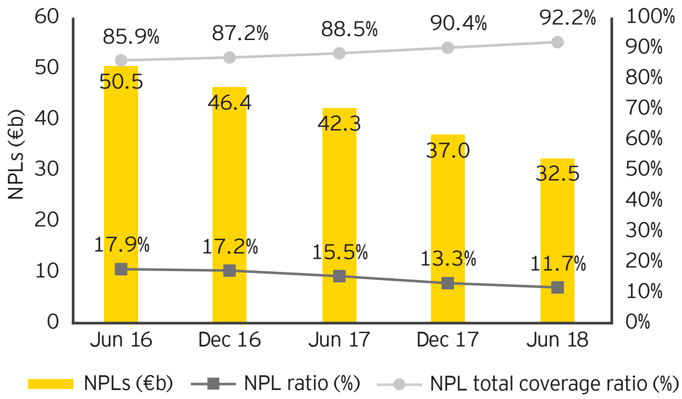
Diversifying the strategies and solutions to resolve these exposures will be key to a positive outcome. Relying solely on the current internal management of NPL's by the banks will not suffice. Internal reorganization of the NPL units, incorporation of securitization solutions, the establishment of an Asset Management Company (AMC), intensifying NPL sales and creating the conditions for a developed secondary market are a set of solutions that will likely foster resolution volumes and have already proven to be effective in other countries.

The NPL Mountain and high pressure to deleverage

There is intense regulatory and political pressure to reduce the NPL stock in Portugal and increase the pace of deleveraging.

2H 2017 saw a sharp fall in NPLs and an increase in impairment coverage, in the context of increasing flows of write-offs and NPL sales. NPLs declined to €32.5b (NPL ratio-11.7%) after reaching €50.5b (NPL ratio-17.9%) in June 2016.[16]

NPL ratios in Portugal (FY 2018)[17]



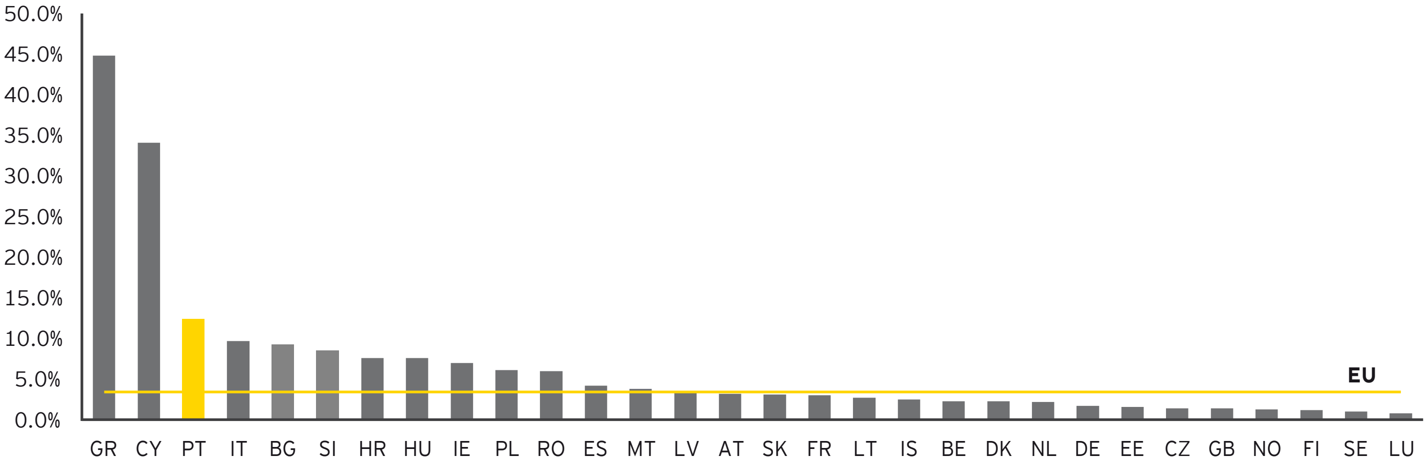
The main factors that contributed to these outcomes were an increase in NPL transactions and write-offs, with the latter recording a higher value in 1H 2017.

The sale of Novo Banco to Lone Star and the government's decision to create a solution to accelerate the workout of NPLs are also factors likely to push up the level of deal activity in Portugal in the coming years.

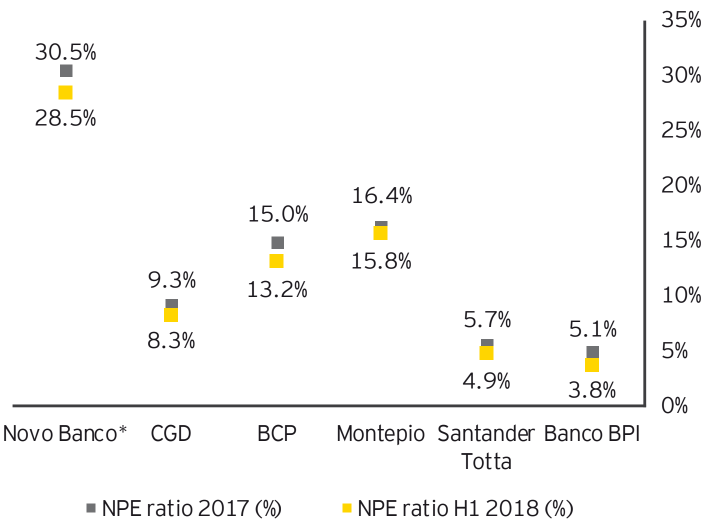
The strong potential business pipeline in Portugal, with existing NPL stock of €32.5b, is one of the key drivers for boosting transactional activity, as well as the growing interest of existing and potential new investors.

[15] "NPL Platform May Take on Novo Banco's Portfolio of Bad Debts" AURA website, 11 April 2018.
[16] "Financial Stability Report" Banco de Portugal, December 2018.
[17] "Financial Stability Report" Banco de Portugal, December 2018.

NPL ratios across the EU (as at Q2 2018)[18]



NPEs across banks[19]



*NPL ratio

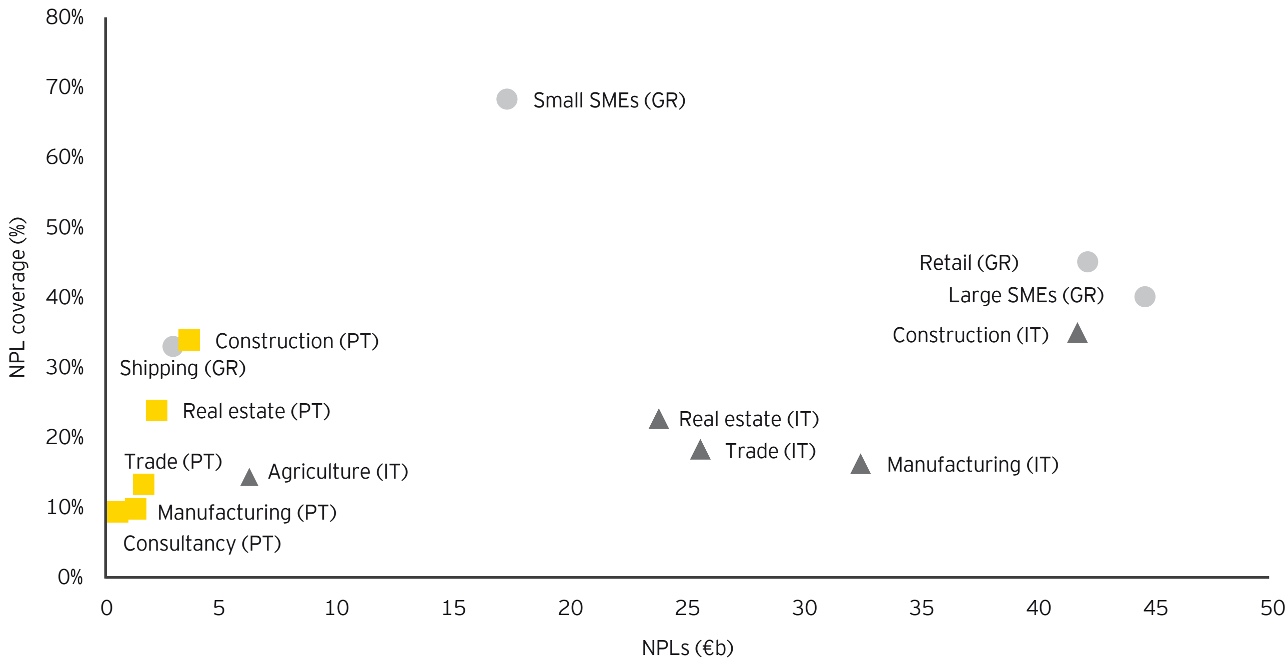
The six Portuguese banks most exposed to NPLs have made a commitment to regulators to reduce their bad debt ratios by more than 10% by the end of 2021.[20] The main strategies proposed to achieve this are NPL sales and bank repossessions, both of which point towards an increase in transactions. Last year alone was marked by NPL transactions activity totalling c.€9b, this is level of activity is expected to continue into 2019.

Novo Banco has the highest NPL ratio from the six most affected major Portuguese banks. As such, there has been some pressure from the European Authorities and the Government for the lender to accelerate the NPL sale process. CGD has completed several NPL sales for 2018 totalling c.€2b (€0.6b in mortgages, €0.4b in real estate and €1b in corporate loans).

[18] "2018 Risk Assessment Report," European banking Authority website.
[19] Various Q2 2018 Results Announcements.
[20] "Banks Promise to Lower NPL Ratio from 22% to 10% by 2021" AURA website, 19 January 2018.

NPL evolution in Portugal

NPL coverage by sector[21, 22]



Transactions as part of the solution

Despite the increase in the number of transactions in the last three years intended to accelerate the deleveraging process for Portuguese banks, the NPL ratio has been driven mainly by a reduction of the credit book (limited origination), rather than sales of loan portfolios.

According to the European Central Bank's recent surveys, the NPL workout in Portugal continues to face several limitations to a higher deal flow due mainly to the price gap and the following reasons:

- Judicial insolvency processes (in-court procedures are complex and lengthy).
- Judicial recovery processes for companies (despite a new process which facilitates faster recovery agreement of still-viable non-financial companies with creditors, the number of insolvency cases continue to exceed the number of cases processed).
- Collateral enforcement (electronic auction hopefully will help to reduce the time to realize collateral).
- NPL market and servicing firms (NPL market activity has been limited; and only a few servicers are active in the market mainly specialized in retail loans).

Several transactions from the major banks have already completed in 2018. CGD have sold multiple corporate and SME portfolios with a total outstanding value of approximately €1b. Santander is transacting 2 SME unsecured portfolios, following the commitment from Portuguese banks to resolve the NPL problem.

We can see an increase in interest in the NPL Portuguese market from foreigner investors like Carval, Arrow, Bain Capital Credit, Black Rock and TPG which in turn will increase the competitive tension in the sale process with a positive impact on sale prices.

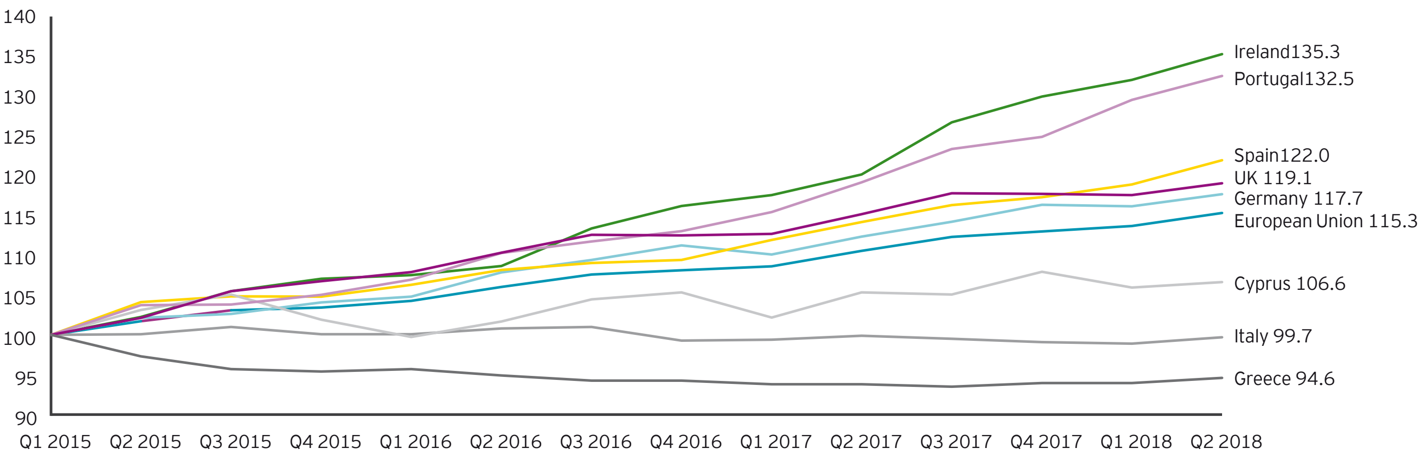
[21] Data from Central Bank of Greece, Italy and Portugal; Notes: Italy: NPLs stands for bad debt; Greece: NPLs correspond to NPEs; Portugal: NPLs stands for non-performing loans.
[22] EY analysis.

Selected 2018 NPL transactions

Date	Project Name	Vendor	Buyer	Asset region	Asset class	Nominal value (€m)
2018	Snipe	Bankinter	Arrow Global	Portugal	Retail secured	228
2018	Veleiro	Bankinter	Arrow Global	Portugal	Retail secured	135
2018	Crown	Millennium BCP	LX Partners	Portugal	Corporate	520
2018	Atlantic	Caixa Geral de Depósitos	Bain Capital	Portugal	Corporate	1,000
2018	Artic	Caixa Geral de Depósitos	Undisclosed	Portugal	REOs	350
2018	Pacific	Caixa Geral de Depósitos	Anacap	Portugal	Residential mortgage NPL	350
2018	Indian	Caixa Geral de Depósitos	Undisclosed	Portugal	Residential and REOs	300
2018	Cascais	Caixa Económica Montepio Geral	In progress	Portugal	Real Estate	120
2018	Atlas	Caixa Económica Montepio Geral	Mimilus Finance DAC	Portugal	Undisclosed	239
2018	Évora	Caixa Económica Montepio Geral	Undisclosed	Portugal	Secured & Unsecured	123
2018	Nata	Novo Banco	KKR, HipoGes and LX Partners	Portugal	Large exposure and SME	1,800
2018	Viriato	Novo Banco	Anchorage capital	Portugal	Residential and REOs	718
2018	Golden	Fidelidade	Apollo	Portugal	REO	400
2018	Tagus	Santander	Cerberus	Portugal	REO	650
2018	Guincho	Santander	Undisclosed	Portugal	Secured + Unsecured	481
2018	Pool XLV	Santander	Undisclosed	Portugal	Unsecured	360

Real estate market

Real estate prices (Q1 2015 indexed to 100)[23]



The real estate market in Portugal accounts for c.40% of the banking sector's total assets (as of December 2017). This exposure is mostly indirect and is related to:

- Housing loans, which are typically guaranteed by a mortgage on the property.
- Loans to firms in construction and real estate activities sectors, which accounted for around 5% of total assets. Although they represent approximately 25% of loans to NFCs, 40% of firms' NPLs are concentrated in these sectors.[24]

During the period in which Portugal experienced a severe economic crisis between 2007 and 2013, residential investment in Portugal fell at an average annual rate of about 12%. The price decline ranged from 9% in the North and 21% in the Algarve and Madeira. Lisbon recorded a 16% drop.[25,26] The international financial crisis resulted in a significant decrease in credit to developers from 2007, which negatively impacted the supply, aggravated by the significant tightening in lending conditions which had a negative impact on housing credit demand.

This negative trend was inverted from 2015 onwards mainly driven by general optimism around economic recovery, political stability and strong performance in the labour market. This led to a lack of supply, primarily in residential areas of Lisbon, Oporto and Algarve. Growing demand from the tourism sector encouraged many investors to acquire real estate to meet the increasing demand for tourist accommodation.

Several government measures contributed also to boost this trend through the adoption of the following programs, which helped to increase investment in residential property by non-residents:

- Establishment of a tax regime for non-regular residents in 2009, which, over a ten-year period provides a reduction or total income tax exemption.
- The Golden Visa program introduced in 2012, which is aimed at attracting non-EU professionals and investors to buy residence permits for investment activities.

Between 1H 2013 and the FY 2018, prices grew approximately 27% in real terms (32% in nominal terms). Over the same period, average house prices in the Euro area grew by 8% in real terms (c.11% in nominal terms). The share of transactions in household dwellings that have been funded by credit has increased since 2015, after dropping to a low of c.20% at the end of 2013, standing at 41% in 4Q 2017, but is still below the 65% in 2009.[27]

[23] "House price index," Euro Stat, 18 January 2018.
[24] "Financial Stability Report – December 2017," Banco de Portugal, December 2017.
[25] "The Dynamics and Contrast of House Prices in Portugal and Spain," Banco de Portugal, December 2014.
[26] International Monetary Fund, World Economic Outlook Database, October 2017.
[27] Financial Stability Report" Banco de Portugal, June 2018.

In 2017, prices grew on an average of 7.6% year-on-year at the national level. In Lisbon, prices increased approximately 18% year-on-year. According to projections, prices will increase by an average of 5% in the next year[28] as a 3.8% increase was observed in the first quarter of 2018 compared with the last quarter of 2017.

The sale of new and existing dwellings reached c.45,619 in 2Q 2018, corresponding to €6.2 billion (average value of c.€136,000).[29]

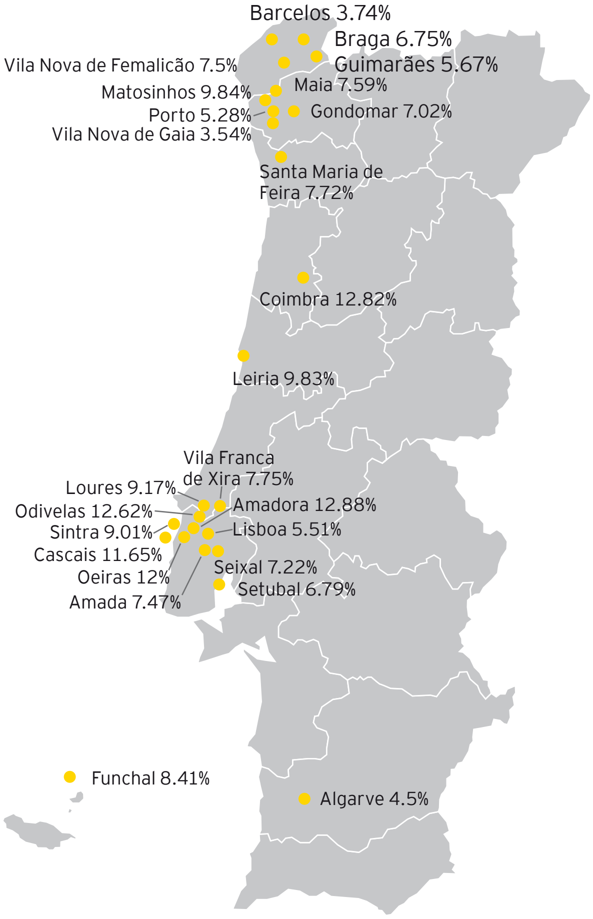
- c.38,880 existing dwellings were sold in 2Q 2018, corresponding to €5.0 billion (average value per transaction of c.€129,000)
- Number of new dwellings sold stabilized around 6,000 in each quarter of 2018, with an average value per transaction of c.€176,000

Transactional volumes have grown at an average rate of c.20% during the period 2013 to H1 2018.

The positive growth in real estate prices was not uniform across the country as we can see in the diagram.

- In Lisbon's metropolitan area, property prices were up by 4.9% year-on-year in 2017, to an average of €1.386 per sq m.
- Amadora recorded the highest increase of 12.88%, followed by Coimbra 12.82%.
- The north of the country also benefited from an increase in the property prices: Matosinhos, Santa Maria da Feira and Vila Nova de Familicao recorded the highest increase.
- The Algarve region saw a modest increase of 4.5% on house prices.

Regional Real Estate price growth, 12 months to November 2017 (%)



[28] "Financial Stability Report", Banco de Portugal, June 2018, OECD Statistics.
[29] Statistics Portugal, National Accounts Department.

Securitization

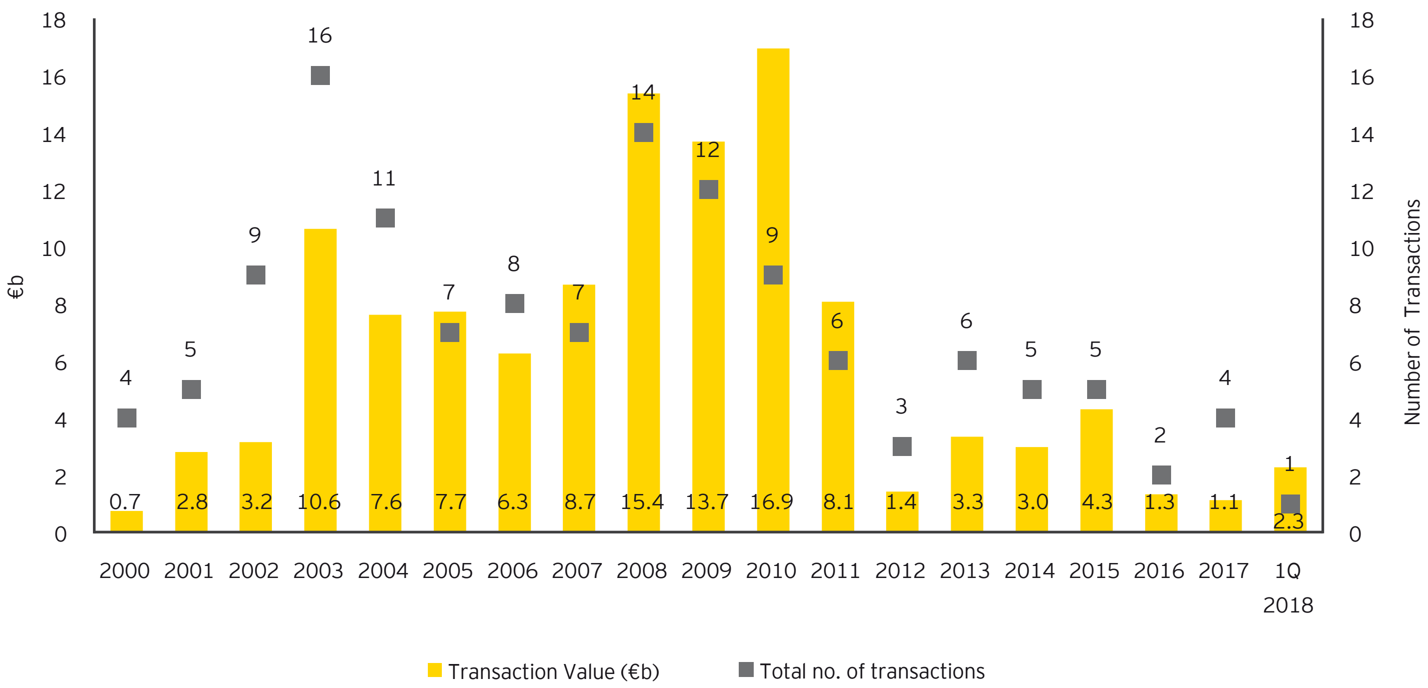
The first Portuguese securitization transaction was completed in 2001 and the first securitization fund "FTC" was established in 2003. Since then, there have been several successful securitization and SPVs created either by banks or investors. Although at first mainly based on residential mortgage backed securities (RMBS), the Portuguese securitization market has evolved to encompass other asset classes, such as SME loans, corporate loans, non-performing loans and electricity receivables. While securitization has spread to new sectors, the banking and finance sector continues to be the most relevant and active.

The legal framework for securitization transactions, defining the legal requirements applicable and regulating the constitution and functioning of the securitization vehicles was formalized through the approval of Decree-Law n. 453/99 of 5 November.

The legal framework of Loan Portfolio Securitization is more beneficial and less formal in some aspects compared with a true sale:

- There are fiscal benefits regarding withholding tax from Portuguese obligors payments to securitization vehicles and from the interest on paper issued by FTCs and securitization companies "STCs".

Securitization deals in Portugal[30]



[30] Bloomberg data; Bank of Portugal

- Full portfolio separation and insolvency remoteness are established under the Securitization Law. This is partly achieved by the FTCs and STC being exclusively engaged in carrying out securitizations.
- Under the securitization there are no specific formalities for an assignment of receivables. A written private agreement between the parties is enough for a valid assignment (including mortgage assets or other guaranties subject to registration under Portuguese law), a notarial deed is not required.
- In relation to effectiveness against third party obligors, the general rule is that notification is required for the assignment to be effective. However, when the assignor is, among others, the state, a social security institution or a credit institution, and the assignor remains the servicer of the assigned assets, no notification to the obligors is required.

According to Bloomberg data, €117.6b worth of securitization transactions have taken place in Portugal between the period of 2001 — 1Q 2018. The chart above shows that securitizations continued to be used as a solution for NPLs throughout the financial crisis. Securitization volumes decreased significantly post 2010 due to the Bank of Portugal's (BdP) program, whereby loans could be posted directly with BdP as collateral against liquidity.

The value of securitization transactions almost doubled from €8.7b in 2007 to €16.9b in 2010 and has declined since then. The majority of the transactions are Residential Mortgage Backed securities constituting over 63% of the total value and c.46% of the total deal volume over the period 2001-1Q 2018, followed by collateralized loan obligation (CLO) with a total value of €21.8b.

Servicing landscape

The servicing landscape in Portugal have seen progress in the last 10 years and there are a few key players with a strong position in the market, mostly with expertise managing Retail secured, unsecured and insolvent Small Businesses. There is still a lack of companies with an ability to manage SME and Corporate exposures both for distressed and insolvent companies. As a result, Banks are still required to provide servicing capabilities to investors which impacts de-recognition of these exposures on their balance sheets.

The development of a servicing sector with more independent companies specialized in managing performing, sub-performing and non-performing loans in all asset classes will be key to the development of the Portuguese NPL Market. With an estimated €37b of assets to be run down, of which €24b are from non-financial corporations, sellers will be pressured to dispose of these portfolios. Having specialized and robust servicers will enhance performance and resolution of these exposures, which will increase investors returns and appetite to invest in the market.

Large SMEs and corporate loans are perceived to be less suitable for servicing due to relatively weaker process efficiency; however, this is not the sole factor determining effectiveness. We believe servicers with a holistic view and multidisciplinary teams would be able to create tailor-made solutions to significantly enhance performance, and increase both confidence and interest from the buy side.

Legal status of servicers[31, 32]

The servicing activity in Portugal lacks special regulation and official governance. Currently, there's no specific law that regulates the extrajudicial recovery activity nor the companies that perform this activity. Recently, the Government proposed a law that would regulate this industry and officially legalize it. However, this law is still under discussion. Currently the legal framework is fragmented and generic.

Under Portuguese law, the purchase, management, collection and enforcement of a portfolio of receivables do not in themselves require a license or authorization, as they do not qualify as banking or financial activities. This applies even in cases where the assignor or seller (bank, credit institution or other financial company) of a securitized pool of assets remains in charge of the collection of receivables.

[31] "Getting the Deal Through — Structured Finance & Securitization 2016," Vieira de Almeida & Associados website.
[32] "European debt sales – 2016," KPMG, June 2016.

Key players in the Portugal NPL servicing market

The current major key players in the market are listed below:

Servicer	Owner	Business description	Sector focus	NPLs under management
Algebra Capital	LX Partners	Focus on distressed debt, capital solutions, private equity and special situations	Residential unsecured and secured	n/a
Altamira	Apollo and Santander	Management of Real Estate and financial assets	Real Estate	n/a
Domus Venda	Privately owned	NPL Management and asset recovery	Retail secured and unsecured	€5.4b
DUO Capital	Privately owned	Specialized in distressed assets investing and management solutions	n/a	n/a
Finangeste	Privately owned	Engaged in loan servicing and Real Estate management	SME and Residential secured and unsecured	n/a
Finsolutia	Privately owned[51]	Finsolutia offers independent loan and real estate management services in Portugal and Spain	Residential secured and unsecured	€3b
HipoGes	KKR	Provides Primary Servicing, Master Servicing and Special Servicing	Corporate, SME, residential and consumer unsecured	n/a
Intrum Justitia	Intrum Justitia AB	Credit management and collection services company	Consumer and invoice financing	n/a
Recactiv	Privately owned	Provision of services in the credit management and asset management activity	Unsecured	n/a
Servdebt	Privately owned	Specialized in the management of distressed debt with and without guaranties in performing, sub-performing and non-performing loans	Residential secured and unsecured	€3.5b
WhiteStar Asset Solutions	Arrow Global & Carval Investors	Whitestar manages sub-performing and non-performing loans secured and non-secured and Real Estate portfolios	Residential and SB secured and unsecured	€7b

Non-Performing Loans: Portuguese legal framework

While some measures have been taken to improve the legal framework applied to enforcement procedures and Insolvency proceedings, with the aim to streamline the time to realize or repossess the collateral and simplify the court process, legal procedures are still lengthy and costly.

In the following sections we will point out the main legal and governance aspects that can have an impact on the management of NPL.

Legal, judicial and extrajudicial framework

Sale of portfolios	▶ According to the Portuguese legal framework it is possible to sell performing, sub-performing and non-performing loans. Lenders can transfer existing loans to third parties, as well as the collateral and securities without the consent of the borrower, and allow loans to be sold even if "denounced" (legally and economically written off). Professional loan buyers can be third-party banks or other institutional investors, hedge funds and credit-servicing companies. Banks can also cooperate with investment firms to set an AMC, although there is no specific regulation on AMCs.
Enforcement Procedure	▶ Legal framework is well designed for collateral enforcement, allowing individual creditor claim actions (civil courts). Portugal implemented the European Directive 2002/47/EC on financial collateral arrangements, which enables reasonable streamlined out-of-court enforcement of collateral and financial guarantee contracts. Nevertheless, complexity remains and enforcements can take over 24 months depending on the court. Several legal changes were implemented since 2003 to promote celerity and efficiency to the process, e.g., simplification of the process, a web platform that supports the management of the judicial cases, the digitalization of the judicial process and the electronic auction.
Corporate insolvency and restructuring	▶ Corporate insolvency and debt restructuring procedures are still a hindrance to private debt resolution. To help revitalize the corporate sector (including the PER), in 2012 the Portuguese Government implemented the Revitalizar program, a national legal framework dealing with the insolvency and recovery companies. Since the inception of the program, the number of insolvency cases exceeds the number of cases under the new procedures. New changes were introduced in 2017 with the aim to create a more favorable environment for companies when it comes to approving recovery plans.
Household insolvency and restructuring	▶ The national legal framework dealing with insolvency and recovery of households includes three different components: i) PARI and PERSI general regime (decree-law nº227/2012), focused on out-of-court settlements on credit agreements; ii) the extraordinary regime (Law nº58/2012 amended by Lay nº58/2014), that governs the rights of housing loan debtors facing severe financial difficulties (ceased in 2016) and iii) the credit mediator framework (Decree-Law nº144/2009), which is a free out-of-court mediation mechanism, hosted by the BdP. The main purpose is to defend and promote the rights and interests of any legal person than have been refused a loan by a credit institution or that have been denied a restructuring or a consolidation of previously granted loans.
Tax regime	▶ In 2014, Portuguese tax authorities issued a binding interpretation regarding write-offs of doubtful loans and receivables: losses are tax deductible only if all of the legal claims are extinct. This is subject to the following cumulative conditions: i) credit is overdue by more than two years: ii) credit is fully provisioned/impaired, and iii) de-recognition was driven by the extinction of the creditor's rights. Tax deductions are granted for loan write-offs, for collateral sales and for limited liability partnerships (LLPs), where there is also a tax loss carry-forward mechanism.

Regulatory and governance framework

Additional to CRR/CRD IV, the National Crime Agency (NCA) issued specific guidelines/requirements concerning credit risk management.

Recognition and classification of NPEs	▶ Portuguese banks follow the European Banking Authority Implementing Technical Standards (EBA ITS), no additional criteria from Banco de Portugal (BdP) was defined and no specific guidance on sub-categories was provided. For forborne exposures banks are required to follow EBA ITS and BdP Instruction that provides more detailed instructions and clarifies EBA generic guidance (Instruction No 32/2013).
NPL measurement and provisioning	▶ Portuguese banks follow International Accounting Standards (IAS)/International Financial Reporting Standards (IFRS) accounting requirements and BdP issued specific non biding guidance (Circular No 02/2014/DSP).
NPL write-offs	▶ BdP has issued specific guidance (Circular No 15/3009/DSB).
Collateral valuation	▶ Portugal has detailed prudential guidance on collateral valuation that can be found on Comissao do Mercado de Valores Mobiliarios (CMVM) website.
NPL governance/workout	▶ BdP performed special NPL management inspection jointly with external consultants. During this exercise banks were required to align themselves with best practices (most of the recommendations have been already implemented). BdP has instructed Central Credit Register (CCR) to record and monitor information regarding credit obligations.
Supervisory reporting	▶ Credit institutions provide Common Reporting (COREP)/Financial Reporting (FINREP) templates on a quarterly basis. Banks must also report to BdP credit exposures classified as "credit at risk" and loans restructured due to financial difficulties. On a biannual basis, they also submit the external auditor's opinion on provisioning. For quality assurance of the EBA non-performing exposures (NPE) template, Portugal does not have additional automatic rules, besides the validation rules, but did conduct several on-site inspections to NPEs. Currently, there are additional benchmarks analysis procedures being implemented for regular risk assessment purposes.
On- and off-site supervisory practices and methodologies	▶ Between 2012-14 Portuguese banks were subject to several AQRs (mostly focused on impairment losses), and in 2013 to the special NPL management inspection to assess the largest Portuguese banks' policies, procedures and controls for managing NPLs. Currently, monitoring of NPEs is reviewed by BdP through on-site inspections, based on recent guidelines published by EBA. BdP also performs on-site inspections of impairment losses of individually assessed debtors, as well as those of collectively assessed debtors.

Non-Performing Loans: Portuguese legal framework

Progress in overcoming regulatory and legal barriers to investment[33, 34, 35, 36, 37, 38]

Challenge	Recent progress
Improving the legal framework The judicial, extra judicial insolvency and recovery processes, and collateral enforcement procedures need to be enhanced. Difficulties related to the judicial collateral enforcement proceedings can cause the process to take 40 months in Portugal against a European average of eight months.	To encourage the corporate sector to change its financing mix by giving priority to equity financing rather than debt, legal changes to decrease the debt bias in the fiscal code are ongoing. The Government has allocated more resources to accelerate insolvency proceedings, including enforcement of collateral, and the use of new IT systems in the insolvency and liquidation procedures.
Tax disincentives to impairment and write-offs While the granular examination of loans is moving in the right direction, a timeline together with a clear framework of incentives for banks to undertake this costly exercise requires further development.	The Government is planning to implement a law to allow impairments identified under European banking regulations to be considered as a tax credit, which could increase capital ratios of the banks. With the transition to the new system, the stock of banks' impairments will be registered as of the end of 2016. Afterwards a deadline of 15 years will be established and deducted off corporate tax over that time.
Under developed NPL market Implementation of ECB guidance is recommended, especially in the context of the NPL reduction plans currently being reviewed by the ECB and BdP for significant and less significant institutions, respectively. In addition to streamlining the internal workout strategies, the recent increase in the provisioning coverage of NPLs needs to be furthered and viewed as an incentive for banks to develop their NPL sales to third parties.	A task force was set-up to analyze the NPL problem, which provided a tripartite strategy to address the problem, consisting of the following steps: ► Revision of existing legal and judicial package, including provisions to streamline and accelerate processes under PER and SIREVE. ► Internal review conducted by the banks under supervision of the central bank of each NPL to assess its viability and propose a restructuring solution for each case. ► Encourage banks to outsource the servicing of their NPLs to external agents. In addition to these plans, some measures taken include: ► Improvements in the early warning systems for non-financial corporations. ► Recognition for tax purposes of write-offs for loans overdue for more than two years and with 100% impairments.
Constraints related to the Bank Recovery and Resolution Directive (BRRD) and State-aid rules The alternative of a market-wide solution in the form of an Asset Management Company could be worth exploring, however, only with due consideration of the key constraints related to the BRRD and State-aid rules.	As per the government, Portugal's banks have enough capital to deal with their NPLs and economic recovery in the country will also improve the ability of businesses to repay their liabilities. Thus, there is no requirement to set up a national bad bank. The government is working with Portugal's central bank to establish a platform where banks can coordinate their lending activity. As the communication between banks improves, it would be easier to recover outstanding credit volumes.

[33] "Financials Watch — The Portuguese path to recovery," ABN AMRO website, 27 September 2017.
[34] "Portugal — Selected Issues," International Monetary Fund website, September 2017.
[35] "Post-Program Surveillance Report," European Commission website, March 2017.
[36] "Portugal preparing law to offset banks' impairments against tax," Reuters, 17 May 2017.
[37] "Portuguese prime minister rules out further state aid for banks," SNL, 30 May 2017.
[38] "Portugal eyes change to tax treatment of bank impairments," SNL, 18 May 2017.

Credentials

EY is a proven leader in the European loan sale market. The European Loan Portfolio Solutions Group has led multiple buy-side and sell-side engagements across the continent in addition to strategic and product reviews of various portfolios.

Spain	**Project Zip** Lead sell-side advisor on the sale of a secured portfolio for a leading bank.	**Project Voyager** Provided valuation services to a bidder on a non-performing portfolio with an unpaid balance of c.€760m.
Italy	**Project Fino** Lead buy-side advisory in relation to the potential acquisition of a non-performing Corporate/SME portfolio of c.€20b.	**Project Sun** EY advised Banco BPM on the sale of two unsecured bad-loan portfolios totalling c.€1.8b to J Invest SpA and Hoist Finance AB.
Ireland	**Project Glas** Lead sell-side advisor on the disposal of a c.€2.2b portfolio of non-performing buy-to-let and principal dwelling home mortgages.	**Confidential** EY teams provided buy-side portfolio diligence and deal co-ordination in relation to the acquisition of a c.€1.1b loan portfolio.
Greece	**Project Amoeba** EY teams provided sell-side support on data remediation, Real Estate revaluation and transaction structuring.	**Project Arctos** Lead sell-side advisor on the disposal of an unsecured portfolio of c.€2b.
UK	**Lloyds Banking Group** Appointed as the ongoing sell-side advisor. Advised LBG on multiple deals with transaction values exceeding £6b.	**Project Yasmin** Sell side advisory on the secondary sale of a consumer unsecured debt portfolio.
Other	**Multiple CEE Transactions** EY teams provided buy-side due diligence in relation to the acquisition of multiple non-performing secured portfolios totalling over €1b.	**Major German Lenders** Provided sell-side valuations and transaction support advisory services on multiple shipping transactions totalling over €15b.

Our network

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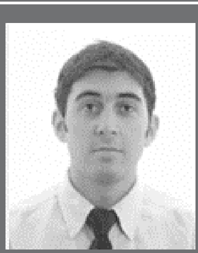

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