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Portugal

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Introduction

2020 was unprecedented in every sense of the word. Besides causing worldwide unrest and uncertainty about the future and the sustainability of life as we all knew it, the COVID-19 pandemic forced a halt to the activity of several industries, thereby inevitably impacting the regulatory and transactional realms of the banking and finance universe, which is largely dependent on other sectors. Although fund finance was no exception, several thrilling developments took place during 2020 in this particular sector, including the introduction of transformative regulation, which we briefly outline below.

Overview: Dependency on bank loans

In the aftermath of the 2008 financial crisis and the devastating global economic downturn caused by it, essential parcels of the real economy in several countries of the Old Continent craved financing. The banking sector was unable to satiate the funding needs felt by small and medium enterprises, thus exacerbating the want of tangible alternatives to bank loans.

Recent studies demonstrate that the Portuguese finance market remains rather traditionalist with respect to its dominant sources of funding. In fact, roughly 85% of the 275 companies surveyed under a recent OECD study indicated that their main source of finance amounted to internal funds, in the form of retained earnings, whereas bank loans and facility lines ranked second and third, with 67% and 52% of the respondents, respectively, confirming access to said sources of external financing.[1] Interestingly, almost one-third of the surveyed companies that confirmed their use of bank loans as a source of financing claimed that they sought bank loans to obtain funding due to the absence of alternatives. This trend is not novel either – in fact, Portugal's corporate dependency on bank loans is a decades-old phenomenon.[2]

Other European countries had opted to implement regulatory changes to accommodate alternative vehicles that tackle the need for sources of financing, notably through the adoption of rules allowing for investment funds to grant credit. Moreover, the European Commission included the limited possibility of European venture capital funds and European long-term investment funds originating loans in the Action Plan on Building a Capital Markets Union,[3] published on 30 September 2015, in which the Commission also contemplated a coordinated approach to loan origination by funds and a future framework at EU level. By 2016, Germany, Ireland, Spain, Italy and Malta (among other EU Member States) had established bespoke frameworks for loan origination by funds.[4] At last, Portugal has now followed suit.

Key developments: The creation of loan funds

With significant delay in comparison to other European jurisdictions, loan funds (*organismos de investimento alternativo especializado de créditos*, in the lengthier

Portuguese designation, which can be loosely translated to "alternative investment vehicles specialised in credit") were passed into Portuguese law in the last quarter of 2019 and formally introduced through regulation in 2020 by the Portuguese regulator – the Portuguese Securities Market Commission (*Comissão do Mercado de Valores Mobiliários*, "**CMVM**").

Importantly, loan funds have been inserted into existing legislation and regulation, which means that legal practitioners are largely familiar with the applicable legal constructs and mechanisms. Loan funds were introduced into the Portuguese legal system by way of an amendment to the legal act that provides the legal framework for venture capital, social entrepreneurship and specialised investment (*regime jurídico do capital de risco, empreendedorismo social e investimento especializado*)[5] and are regulated under the regulation pertaining to venture capital, social entrepreneurship and specialised alternative investment (*regulamento da CMVM n.º 3/2015, capital de risco, empreendedorismo social e investimento alternativo especializado*).[6]

Loan funds are a brand-new type of entity that offer several novelties in the context of finance transactions. These entities are allowed to engage in lending activity and to participate in syndicated loan structures. Loan funds are also authorised to acquire credits (including the infamous non-performing loans) from credit institutions.

In similar fashion to what occurs in other continental European jurisdictions, these vehicles were created as sub-types of collective investment undertakings. These structures are subject to rather strict prudential supervision and regulatory requirements in relation to managers' experience and general background, thereby affording investors with a significant degree of comfort in relation to the management of their investments. Finally, and as mentioned above, legal practitioners are familiar with the applicable legal mechanisms, which can significantly contribute to pre-empting any growing pains in the investment funds market.

Main takeaway for fund finance transactions

Loan funds were announced as a tool to improve the overall financing mechanisms available in the context of the Portuguese economy. Such improvement is expected to occur essentially through loan origination, loan restructuring and loan participation. Accordingly, loan funds will act as the initial and sole lenders or participate in lender syndicates, originating and restructuring the respective credits. Notably, and in addition to their direct credit provision ability, loan funds can also serve as a vehicle for the acquisition of loans, in which case loan funds can acquire credits directly from the borrowers or through the secondary market. As such, loan funds can serve an important restructuring role by providing a platform for banks and other conventional credit institutions to clean up their balance sheets by way of transferring loans to loan funds, which, in turn, allows for such banks and institutions to resume and focus on their primary activity of granting loans and offering other essential services to households and firms.

Moreover, loan funds can also borrow credit with the aim of financing their core task of lending to third parties, insofar as the following legally imposed limits are complied with: (i) said loans must have a maturity that is equal or superior to the maturity of the respective assets that they seek to finance; and (ii) such loans cannot surpass a limit of 60% of the fund's total assets.

Loan funds face additional legal restrictions in respect of the eligibility of borrowers, as funds cannot grant credit to individuals, credit institutions, other investment funds, or related entities, such as their own direct or indirect investors, their management company or related entities (including entities within the same corporate group), their depositary or outsourced service providers (including any entities included in the same corporate group). The law also sets out that loan funds are not authorised to short sell financial instruments, to enter into transactions regarding direct or indirect financing of securities, nor to enter into derivative transactions (other than for hedging purposes). Since loan funds are prohibited from granting loans to credit institutions but not from acquiring credits from such entities, loan funds can serve as a platform for asset segregation, allowing banks to liberate capital and to increase solvency and liquidity ratios.

Pertaining to the composition of their assets, loan funds face further restrictions – loan funds can hold mobilisable bank deposits, deposit certificates, participation units in investment funds investing in money markets and financial instruments issued or guaranteed by a Member State of the European Union with a maturity of less than 12 months, so long as such assets do not represent more than 20% of the loan fund's total assets after the first six months of life of the loan fund. Debt securities issued by eligible borrowers can also be held by loan funds until the limit of 20% of the loan fund's total assets. After the first year of life of the loan fund, regulation requires that such loan fund's credits be sufficiently diversified and imposes a limit of 20% of the loan fund's total assets on any credits owed by the same entity or entities within the same corporate group.

Regulatory requirements also apply to loan funds' management companies. Accordingly, such management companies must adopt a system of risk analysis, including, among other elements: (i) a credit-granting model detailing selection criteria with respect to credits and debtors; (ii) a security and collateral management policy; and (iii) management procedures for default situations, including the monitoring, restructuring and extension of credits. In addition, management companies are obligated to establish monitoring procedures, endure stress tests and to comply with information requirements towards borrowers.

Loan funds are thus highly anticipated – and potentially game-changing – candidates for Portuguese law fund finance transactions. Presumably, loan funds will need to resort to external financing in order to boost their own financing activity. Lenders to these structures will therefore have to bear the aforesaid restrictions in mind and tailor the finance documentation to such legal and regulatory limitations. Given that loan funds must comply with the above legal and regulatory covenants in respect of incurred debt, the finance documents in fund financing transactions involving loan funds as borrowers will entail very particular representations, warranties and undertakings. We expect that the latter category should include several ongoing information obligations on the part of the borrowing funds to provide lenders with proof of satisfaction of regulatory standards, including the abovementioned financial covenants.

Importantly, the activity carried out by loan funds implies a significant amount of specific risk. In effect, lenders to loan funds are indirectly exposed to the default risk of the respective loan funds' borrowers. Accordingly, lenders will likely agree with the Portuguese legislator and regulator's concerns with respect to the potential liquidity issue inherent to loan funds' primary activity and may take the view that the requisite financial covenants do not suffice to cover such risk – should that be the case, such lenders could consider imposing more stringent covenants to minimise the risk of their exposure.

On a related note, lenders should also be wary of the legal and regulatory constraints with respect to the activity of loan funds' management companies and the requisite procedures and requirements. Loan funds are quite significantly regulated and supervised – which should provide some comfort to lenders, from one perspective, although it also signifies that any shortcoming in relation to the law and regulation could result in monetary sanctions, which could, in turn, imperil such non-compliant loan funds' creditors.

Fund formation and finance

As hinted towards above, loan funds can be set up as either corporations (*sociedades de créditos*) or investment vehicles (*fundos de créditos*) and they can be managed by management companies of investment funds (*sociedades gestoras de organismos de investimento coletivo*) or by management companies of venture capital funds (*sociedades gestoras de fundos de capital de risco*). Such management companies must obtain authorisation from the CMVM ahead of commencing their management activities. If set up as a corporation, the loan fund can be self-governed (*autogerido*) instead of resorting to the use of a management company.

The year ahead

Loan funds are still in their infancy in the context of the Portuguese fund finance market. However, we expect this concept to gain visibility in the coming months and years. This time period will be pivotal to determine the market's propensity to engage in fund finance transactions involving loan funds. The volume of non-performing loans in the Portuguese economy had been decreasing yearly until 2020, although the values always remained above the Euro area ratio.[7] The market currently awaits clarification in respect of the tax regime that will apply to loan funds – and this is probably not uncorrelated with a general prospective sentiment *vis-à-vis* loan funds and their potential impact on the functioning of the economy.

Admittedly, Portugal does not have a history as an epicentre of activity of investment funds. As indicated in recently gathered data,[8] Portugal's investment funds' assets fall short of 0.5% of the total numbers for the Euro area. For such reason, the tax treatment of loan funds and respective participations that is yet to be developed by the Portuguese legislator (or, in the absence of any action on the part of the legislator, through the customary route) is of utmost importance to ensure that loan funds incorporated under Portuguese law are competitive in relation to its European counterparts.

We are anxiously awaiting the market's reaction and the consolidation of the legal and regulatory regime applicable to loan funds.

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Endnotes

1. Improving Access to Capital for Portuguese Companies (https://www.oecd.org/corporate/ca/Improving-Access-to-Capital-for-Portuguese-Companies.pdf).
2. Financing Costs of Portuguese Companies (https://www.bportugal.pt/sites/default/files/anexos/papers/ab200710_e.pdf).
3. Action Plan on Building a Capital Markets Union (https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A52015DC0468).
4. ESMA publishes Opinion on EU framework for loan origination by investment funds (https://www.esma.europa.eu/press-news/esma-news/esma-publishes-opinion-eu-framework-loan-origination-investment-funds).
5. *Regime jurídico do capital de risco, do empreendedorismo social e do investimento especializado* (https://www.cmvm.pt/pt/Legislacao/LegislacaoComplementar/CapitaldeRisco/Pages/Regime-Jur%C3%ADdico-do-Capital-de-Risco,-do-Empreendedorismo-Social-e-do-Investimento-Especializado.aspx?v).

6. *Regulamento da CMVM n.º 3/2015, capital de risco, empreendedorismo social e investimento alternativo especializado* (https://www.cmvm.pt/pt/Legislacao/Legislacaonacional/Regulamentos/Documents/Regulamento%20da%20CMVM%205-2020.pdf).
7. UTAO: *Fim das moratórias comporta riscos para administrações públicas, sistema financeiro e economia em geral – Banca & Finanças – Jornal de Negócios* (https://www.jornaldenegocios.pt/empresas/banca---financas/detalhe/utao-fim-das-moratorias-comporta-riscos-para-administracoes-publicas-sistema-financeiro-e-economia-em-geral).
8. 1.2 Breakdown by country – 1. Aggregated balance sheet – Euro area – Investment funds balance sheets – Financial corporations – Reports – ECB Statistical Data Warehouse (https://sdw.ecb.europa.eu/reports.do?node=1000003517) – Portugal's investment funds' national total assets for the second quarter of 2021 amounted to €35.2 billion, representing 0.2% of the total assets of the Euro area's investment funds with respect to the same period, according to data gathered by the European Central Bank (as of 18 October 2021).

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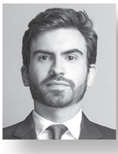

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