

Informative Note

New rules for distressed debt financial restructuring

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On 31 December 2013, Banco de Portugal issued instruction no. 32/2013 implementing new rules on the **identification and flagging of distress debt financing restructures** ("**Instruction 32/2013**") and revoking its instruction no.18/2012 on the same matter.

Instruction 32/2013 is applicable to credit institutions and to financial institutions with lending activity as well as branches of credit institutions with head offices outside the EU ("**Institutions**").

The purpose of this instruction is to strengthen the compliance with existing prudential rules by extending the circumstances where Institutions are required to identify and flag a "**restructured credit facility of a client in distress**", inter alia, by adding new cases to be considered as amendments to the terms and conditions of an existing credit facility and new situations where a client is deemed to be in distress.

For the purpose of Instruction 32/2013:

1. "Amendment to the terms and conditions of an existing financial arrangement" shall mean any of the following:

- a) Alterations that improve the client's ability to pay the existing debt, including material forgiveness, or postponement, of principal, or interest, establishing grace periods or allowing for capitalization of interests;
- b) Agreeing on a new credit facility to repay the client's existing debt or a part thereof, or the debt of an individual pertaining to the client's economic group; or,

- c) Granting the client conditions that are more advantageous than the conditions normally granted to clients with the same risk profile.

2. A client in distress shall mean a client in default of financial obligations under a contract with the institution or that is likely to default such financial obligations.

The following situations shall be considered for the purpose of determining if a client is likely to default its financial obligations:

- a) Registration of defaults with Banco de Portugal Credit Liabilities Central Credit Register in the preceding 12 months;
- b) Registration in the list of cheque users that present a risk profile;
- c) Continuous use of revolving credit facilities for at least 12 months, above 95% of the limit amount granted;
- d) Activation of the institution internal alert levels, namely due to the deterioration of the client's internal risk profile;
- e) Increase of coverage ratio in case of impairment or recognition of economic loss;
- f) Transfer of assets made in lieu of payment of existing loans;
- g) other situations that may indicate distress, such as the existence of overdue debts to the tax authorities or to the social security,

enforcement of bank guarantees, entering the zone of insolvency, seizure of bank accounts, delayed salaries, alterations to the by-laws with adverse effects on the governance capacity, absence of financial statements for more than 18 months or the breach of contracts with the institution.

3. Other situations shall also determine the obligation to identify and flag a “restructured credit facility of a client in distress”, in the case of modification to the terms and conditions of an existing facility, as follows:

- a) The credit facility operation is rated as a credit risk or would be rated as a credit risk in the absence of the restructure;
- b) The client has other operations that are rated as credit risk;
- c) The credit facility was delinquent for more than 30 days in the three months preceding the restructure;
- d) The client transferred assets to the financial institution in lieu of payment of an existing credit facility or a part thereof.
- e) When the institution offered a partial forgiveness of capital and interest.

According to Instruction 32/2013 Institutions are obligated to collect information that is accurate, complete and reliable, notably in relation to the date, type and interconnection between financial operations, in order to improve rating of credit risk, determine impairment and in general comply with the applicable prudential rules.

Additionally, each time that an institution wishes to release information on the quality of a given credit it is required to include in that information debt ratio indicators, *i.e.* (i) the relation between the restructured distressed credit and the total credit (calculated as per instruction 22/2011) (ii) and the relation between the restructured credit (that is not distressed) and the total credit (calculated as per instruction 22/2011).

Once a credit facility is flagged as “restructured credit facility of a client in distress” **the flag cannot be removed before a period of two years and is made subject to the fulfillment of certain financial conditions**, such as, the regular payment of capital exceeding in aggregate half of the amount of capital that would be due if an installment plan had been agreed. In case a subsequent restructure is agreed the refereed two year period will restart counting from the closing date of that subsequent restructure. Finally, Institutions are required to maintain **record of the restructured credit facility in distress for a period of five years after it is un-flagged.**

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