Address by Governor Carlos da Silva Costa at the Portuguese Banking Association Conference "Systemic Risk – Too-Important-to-Ignore" – Opening session

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I. INTRODUCTORY REMARKS

Ladies and gentlemen, good morning. It is a pleasure to be here.

Let me start by congratulating the Portuguese Banking Association for bringing together such an impressive panel of speakers and for having selected the most topical of all themes.

Systemic risk has been brought to the spotlight as the international financial crisis unfolded, and is currently one of the buzzwords in the financial industry and regulatory community.

What exactly is systemic risk?

It's a complex concept which is still evolving, as you will understand after the presentations from the eminent experts who will be speaking to you today.

Just to give a flavour of what is at stake, I will say that, in the context of the economic environment, systemic risk is the threat that certain developments may disrupt the functioning of the financial system, impairing its ability to perform its basic functions, and thereby triggering losses in economic activity.

To make it easier to understand the concept, let me recall an analogy that has been used to illustrate the notion of systemic risk.

Let us suppose the financial system is a forest, populated with many different kinds of plants, be it large oaks or small bushes. If we want to preserve the integrity of this eco-system and prevent it from being destroyed by fire, it is essential to monitor the risk of a fire starting. If a fire should start, it will inevitably destroy a certain part of the forest and some trees will be lost. In that case, what is absolutely crucial is to prevent the fire from spreading, or else the whole forest would be at risk, causing serious damage to the community which depends on its resources for survival.

The financial crisis has made it clear that vulnerabilities may develop in the financial system even if individual players or instruments appear sound. Indeed, huge risks may emerge from the complex interactions between the individual players and instruments, the institutional framework and the broader macroeconomic environment. Detecting this type of underlying vulnerability requires a 'top-down' approach to complement the 'bottom-up' supervision of the financial system's individual components. This is the focus of 'macro-prudential supervision' as it is known. To quote Jose Viñals, who is speaking later this morning, what is needed is "to see both the forest and the trees".

Europe has been the epicentre of the crisis in the past two years. Three European Union Member States – Greece, Ireland and Portugal – lost access to market financing, and had to negotiate financial assistance packages with the European Union and the International Monetary Fund. In recent months, the interplay between public finance and financial sector fragilities intensified and contagion spread to other euro area economies.

The systemic crisis affecting the euro area is threatening one of Europe's greatest achievements – the single currency. Market pressure is no longer about unsound policies, or unsustainable debt paths. Taken together, the fundamentals of the euro area are stronger than those of the US or Japan. However, the crisis has brought to the forefront severe inconsistencies in the governance model, internal organisation and instruments available to manage the single currency.

The initial response of European leaders has been slow and hesitant, but in the past few months, important steps have been taken towards a more balanced EMU governance model and effective 'firewalls'. Decisive implementation of the new procedures and mechanisms is still necessary to reassure markets on the irreversibility of the euro. Failure is not an option: we would risk irreversible damage to the foundations of the European Union itself, with unpredictable geopolitical consequences.

My intention is not to look into the past, and discuss how we got here. The root causes of the global crisis, the euro crisis and the Portuguese crisis have been discussed at length, and I believe the diagnosis is now widely shared. What I would like to do today is two things:

- First, I would like to present and explain the Banco de Portugal strategy to secure financial stability in the context of the Portuguese economy's adjustment and the euro area systemic crisis.

- Secondly, I would like to comment briefly on how the Portuguese banking system is responding to the new environment.

II. A STRATEGY FOR SECURING FINANCIAL STABILITY IN PORTUGAL

Financial stability is a public good and the stability of the Portuguese financial system is a core objective of Banco de Portugal.

Banks are the main actors in converting savings into financing, through their business of transforming maturities and liquidity and promoting scale. A strong and reliable banking system is thus absolutely critical to the successful adjustment and transformation of the Portuguese economy.

The Portuguese banking system has shown considerable resilience throughout the international financial crisis – a resilience that can largely be explained by its negligible exposure to toxic assets and the absence of a real estate bubble in the Portuguese economy. However, banks entered the crisis in a highly leveraged position, depending heavily on wholesale markets for funding. As a result, they were hard hit by the change in markets' perceptions regarding the sustainability of debt levels in the economy.

As the international financial crisis unfolded into a sovereign debt crisis affecting the euro area's most vulnerable economies, banks found it increasingly difficult to obtain market financing and had to rely heavily on Eurosystem funding.

Banco de Portugal responded promptly to the worsening conditions by putting in place a comprehensive strategy to increase the resilience of the banking system. This strategy was later integrated and developed in the context of the Economic and Financial Assistance Programme negotiated with the European Union and the IMF.

Financial stability is – alongside fiscal consolidation and structural reform – a key dimension of the adjustment programme. The aim is to ensure a gradual and orderly deleveraging that does not jeopardise the financing of the economy's productive sector.

The strategy to increase the financial system's resilience rests on four pillars:

- First, strengthening banks' capital base;
- Second, protecting the system's liquidity;
- Third, enhancing the monitoring and supervision of the banking sector;
- And, fourth, improving the regulatory framework.

I believe it is worth looking into each of these four dimensions in some detail.

1. Strengthening solvency

Let me start with bank capitalisation.

In line with international regulatory trends, Banco de Portugal has introduced several measures to strengthen the banking system's solvency.

In September 2010, banks were advised to deleverage through the sale of non-core or non-strategic assets, thereby also improving solvency levels and increasing liquidity.

In January 2011, banks were advised not to pay dividends, so as to improve their own funds. A similar recommendation was issued in January 2012.

In early April 2011, banks were required to achieve a minimum Core Tier 1 ratio of 8 per cent by the end of 2011.

In late May 2011, under the adjustment programme, the Core Tier 1 ratio target was increased to 9 per cent. A minimum Core Tier 1 ratio target of 10 per cent by the end of 2012 was also set. These measures involve bringing key Basle III recommendations forward considerably.

A €12 billion bank solvency support facility is available under the programme to provide for situations where banks prove unable to meet the required capital levels on the basis of market solutions. This powerful backstop mechanism provides full assurance that solvency targets will be met.

2. Protecting the system's liquidity

Let me now comment on our strategy to protect liquidity and promote deleveraging.

The gradual deleveraging of the banking system has been a concern since the early stages of the financial crisis, as it became clear that previous leverage levels would not be possible for some banking groups in the new market paradigm. Banco de Portugal started to monitor Portuguese banks' leverage ratios more closely in pursuit of a medium-term convergence towards a more sustainable and stable financing structure. Recommendations were issued whenever leverage was considered excessive. Also, as mentioned, in September 2010 banks were advised to deleverage through the sale of non-core or non-strategic assets.

In the context of the adjustment programme, banks have to adapt their business models and reduce the current high dependence on wholesale funding. In this context, the loan-to-deposit ratio is to decline from a peak of almost 170% in June 2010 to about 120% by the end of the programme in 2014. The pace and composition of the deleveraging process needs to be consistent with the programme's macroeconomic scenario and should not jeopardise the provision of adequate levels of credit to the economy.

The programme provides for safeguards to ensure sufficient liquidity in the system. In particular, the maximum amount of government guarantees for uncovered bank bonds – bonds that banks may use to obtain financing from the ECB, subject to approval from the Governing Council – was increased from €20 billion to €35 billion.

3. Enhancing banking sector monitoring and supervision

I'd like to mention four lines of action in relation to banking sector monitoring and supervision:

- The special on-site inspections programme;
- The new framework for assessing banks' solvency and liquidity;
- The new non-performing loans ratio;
- Capacity-building to enhance Banco de Portugal's supervisory function.

A comprehensive *programme of on-site inspections* of the banks' asset quality was undertaken with the assistance of external auditing firms. The programme was overseen by a Steering Committee chaired by Banco de Portugal, which included representatives from the IMF, the ECB, the European Commission and other European supervisory authorities. The programme covered the eight largest banking groups, representing more than 83% of the banking sector assets.

The first phase of the inspections programme was concluded in early December. The aim was to assess the banks' valuation of credit portfolios and the calculation of credit risk capital requirements, as of 30 June 2011. This 'point-in-time' analysis confirmed that the Portuguese banking system had adequate capital and dispelled the concerns expressed by many analysts regarding the reliability of banks' balance sheet figures. Corrections to the impairments reported by banks represent less than 0.5% of the assessed exposures. The global impact on the aggregate Tier 1 ratio of the eight participating banks involved a minor revision of this ratio – from 9.1% to 8.8%, remaining above the minimum 8% that was required for June last year.

The second, and final, phase of the Special Inspections Programme is currently in progress, and should be completed during the first quarter of 2012. The aim is to complement the point-in-time analysis with a forward-looking perspective by assessing the parameters and methodologies used by the banks in stress test exercises.

Regarding the programme's *monitoring of solvency and liquidity targets*, I should mention that the eight major banking groups are now required to submit quarterly funding and capital plans to Banco de Portugal. These plans are then evaluated using a new solvency and deleveraging assessment framework, which was developed and implemented by Banco de Portugal.

Indicators of credit quality have also been improved. A new, more transparent, non-performing loans ratio, aligned with international practice, is now reported by banks and has been published by Banco de Portugal since September 2011. The new ratio is more comprehensive than that of overdue credit (which had been the indicator used before) as it considers the possibility of debtors with payments in arrears continuing to fail to meet their credit commitments.

Last, but certainly not least, Banco de Portugal is seeking a continuous improvement in the *efficacy of its supervisory functions*. In this context, let me refer to four relevant developments:

- Firstly, we adapted our internal structure by reorganising the supervisory function into three more focused departments – concerned, respectively, with banking conduct supervision, prudential supervision and legal enforcement. An interdepartmental committee, involving the Board and the senior management of relevant departments, was also set up for the purpose of financial stability monitoring and macro-prudential supervision;

- Secondly, we are recruiting specialist bank supervisors;

- Thirdly, we are developing a project, in cooperation with a university, to offer training focused on risk management and control;

- Finally, our Financial Stability Report is now published twice a year, instead of annually.

4. Improving the regulatory framework

The fourth pillar of our financial stability strategy concerns the regulatory framework.

In this regard, I should mention three pieces of legislation, which have either been approved, or are at the final stages of adoption.

The *framework law for bank access to public capital* was amended by Law No 4/2012 of 11 January. The aim is to ensure that injections of public capital into banks will be temporary and subject to strict conditions, to protect taxpayers' money and to minimise distortions in competition. An important point to make is that, as long as banks abide by their commitments, private management is preserved through the limited voting rights allocated to shares acquired by the State.

A new *framework for early intervention, resolution and deposit insurance* is at the final stages of adoption, reinforcing Banco de Portugal's powers in situations of financial distress. The idea is to provide for two different categories of supervisory intervention into credit institutions: corrective early intervention and resolution. The type of intervention will depend on the severity of the problem, which will also determine the tools that Banco de Portugal may use.

The *insolvency law* is also being amended with a view to facilitating the early rescue of viable firms. The new draft law was submitted to Parliament at the end of December and should be approved soon.

In addition to the three new pieces of legislation that I just alluded to, Banco de Portugal has also worked on promoting more robust *internal governance arrangements in credit institutions*, namely by issuing regulations on internal controls and, more specifically, on the remuneration and compensation policies. The aim is to align the internal incentives within credit institutions and to enhance the resilience of their control mechanisms, in order to prevent excessive risk-taking.

III. THE PORTUGUESE BANKING SYSTEM: RECENT DEVELOPMENTS AND PROSPECTS

Having described the main elements of our strategy to secure financial stability, let me now take a few minutes to comment briefly upon how the banking sector is performing in the new context.

In a nutshell, the main message is that Portuguese banks have been strengthening their capital base and reducing their funding imbalances in spite of extremely adverse external conditions and declining profitability.

I mentioned a while ago that the banking sector has shown impressive resilience throughout the international financial crisis. Indeed, the Core Tier 1 ratio – the ratio of a bank's higher quality capital to its risk-weighted assets – increased steadily from 6.8% at the end of 2008 to 8.5% in September 2011. Banks' financial robustness improved due to a considerable strengthening of the capital base: the cumulative increase of the Core Tier 1 capital in the banking system was 28.6% over the period, with risk-weighted assets increasing by 2.8%.

All but two of the main banks are expected to have met the 9% target by the end of 2011. In the remaining two cases, the Core Tier 1 ratio stood slightly below 9% and the target will be met in the first quarter of 2012. Banks were capitalised through market-based solutions, a clear indication of the Portuguese banking system's overall financial strength.

The strengthening of the banks' capital position will continue into 2012. Current capital needs arise from the combined effect of more demanding capital requirements in the adjustment programme (a Core Tier 1 ratio of 10% by the end of 2012) and three additional factors:

- The recommendation made last December by the European Banking Authority (EBA), aimed at creating a temporary buffer for sovereign exposures in the main European banks;

- The results of the Special Inspections Programme (SIP) on the valuation of banks' assets;

- And the impact of the partial transfer of banks' pension funds to social security.

The EBA's recommendation must be followed by June 2012. The prudential impact of impairment corrections following the Special Inspections Programme and the pension funds' transfer was deferred until June 2012, in line with the EBA timetable and as agreed in the second review of the Economic and Financial Assistance Programme.

Banks are encouraged to find market-based solutions to strengthen their capital positions. However, in the event that not all capital needs can be met from private sources, public funds are available from the back-stop facility created under the programme, with amounts available that comfortably exceed the estimated capital needs.

Deleveraging also proceeded as planned in 2011. The loan-to-deposit ratio stood at 146% in September 2011, declining by more than 20 p.p. from its June 2010 peak. The decline in the transformation ratio resulted both from higher deposits and sizeable asset sales, both domestic and foreign. While remaining at historically high levels, financing from the Eurosystem stabilised, whereas it increased for euro area banks as a whole.

Deposits have been quite resilient, increasing 8 per cent year-on-year in November 2011. Higher resident customers' deposits, particularly households, more than compensated the decline in non-residents' deposits. Households have been adjusting their portfolios in a context of growing risk aversion and higher relative remuneration of deposits. Even if a slowdown of deposits is to be expected, their resilience is a clear indication of the public's trust in the domestic banking system.

Credit granted by resident banks is declining, partially reflecting the deleveraging of the private sector. The composition of loans granted to non-financial corporations raises concerns. Indeed, the decline in loans is concentrated in the segment of small and medium-sized enterprises. In contrast, loans to both state-owned enterprises and to the largest private sector corporations have been increasing, as these corporations are replacing credit previously obtained abroad with loans taken from Portugal-based institutions.

Looking forward, it is crucial that, as deleveraging proceeds, banks continue to provide an adequate level of financing to the most productive sectors and firms in the economy. Banks' deleveraging strategies should therefore continue to focus on the sale of non-strategic assets as well the sale of credit; an increased use of stable sources of financing; and the reinforcement of capital. It is also critical to meet the fiscal consolidation targets and successfully restructure the state-owned enterprises sector to avoid crowding-out credit to the productive sector.

Of course, it is not all good news. As expected, the unfavourable economic and financial environment has taken a toll on banks' profitability. However, the negative results announced for 2011 should be examined closely, to disentangle current results and one-off factors.

Indeed, results in 2011 were significantly affected by non-recurrent factors such as the impact on banks' balance sheets of the transfer of pension funds to social security and the corrections arising from the Special On-Site Inspections Programme. These 'one-off' effects penalised results in 2011, but imply more robust balance sheets going forward. If we put aside these one-off effects, we see that banks' profitability remained positive even if at low level.

IV. CONCLUDING REMARKS

Let me conclude by reiterating that Portuguese banks are now more capitalised, more transparent and less leveraged than a year ago. Monitoring and supervision were significantly enhanced and the regulatory environment is much improved.

The financial assistance programme's financial stability measures and targets are well on track. This said, the challenge remains huge and there is no room for complacency. Combining mounting capital needs with deleveraging requirements, while at the same time preventing a harmful credit contraction in the economy is no easy task – a task that requires a fine balance between 'science and art' in policy-making.

One point that needs to be absolutely clear is that the business model that prevailed before the crisis – based on the expansion of credit sustained by large-scale cheap wholesale funding – is no longer viable. The financial landscape that will emerge once the dust finally settles will demand less leveraged and more strongly capitalised business models in banking. This paradigm shift is underway and is embedded in the international initiatives for regulatory reform.

In this setting, Portuguese banks will need to face two key challenges, which are hurting efficiency levels:

- A lower transformation ratio;
- And narrower margins, reflecting the combined effect of a large share of mortgage credit contracted at very low spreads and more expensive funding.

A comprehensive answer to these challenges will probably require a combination of better resource utilisation, leading to lower costs; the use of new instruments to reduce the weight of cheap mortgage credit; and finding strategic investors with access to market funding.

I am confident that banks will find the best strategies to address these challenges and to further strengthen the competitiveness of the banking sector.

I will not take more of your time. To close, I would stress that the financial crisis has taught us many lessons and brought about fundamental changes in the functioning of the financial system. Banking supervisors around the world are working to bolster the resilience of the financial system. It is my strong belief that Portugal is in the front line of these efforts. It is also my conviction that Banco de Portugal is today much better equipped 'to see both the forest and the trees', and to act decisively if a fire should start.

Thank you.

Lisbon, 3 February 2012