Banco de Portugal
EUROSISTEMA

Financial stability measures of the Economic and Financial Assistance Programme to Portugal

Initial statement of Governor Carlos da Silva Costa at the Parliamentary Ad Hoc Committee entrusted with the task of monitoring the measures of the Economic and Financial Assistance Programme to Portugal

13 April 2012

I. Introduction

Mr. Vieira da Silva, Chairman of the Committee,

Members of Parliament,

Good morning.

This is a particularly appropriate time to take stock of the implementation of the Economic and Financial Assistance Programme's financial stability measures and discuss the next steps.

Ten months have elapsed since the programme implementation began. Last week, the procedures for the third regular review were successfully completed, with the approval of the disbursement of the fourth tranche by the International Monetary Fund's Executive Board. The European Union had already completed its own review process.

By the end of May Portugal will receive around €14.9 billion, thus bringing the amount of financing already received to €53 billion, i.e. over two thirds of the total financing under the programme.

Financial stability, along with fiscal consolidation and structural reform, is a key dimension of the Economic and Financial Assistance Programme. The aim is to ensure gradual and orderly deleveraging in the banking sector that does not imperil the financing of the economy's productive sector.

The Programme incorporated and deepened the strategy that Banco de Portugal was already following to ensure domestic financial system stability. This strategy rests on four pillars:

- First, strengthening the banks' capital
- Second, protecting liquidity in the banking system
- Third, reinforcing monitoring and supervision of the banking sector
- Fourth, strengthening the regulatory framework

As I will explain later, 2011 saw remarkable progress in all of these areas.

II. Financial stability measures – Status update

1. Banking system capitalisation

The banking system capitalisation levels have improved considerably, following the trend seen since 2008. At the end of 2011 the Core Tier 1 ratio stood at 9.6%, i.e. 1.5 p.p. higher than in 2010. This was due to an increase in core capital – achieved by converting debt securities into ordinary shares and introducing policies for retaining earnings; by repurchasing debt traded on the market; and, above all, through deleveraging.

The banking system thus met the 9% Core Tier 1 capital ratio target set under the programme for 2011. All of the eight largest banks met this target, with only two banking groups falling short, albeit by a small margin.

2. Deleveraging and liquidity of the banking system

As I mentioned, banks have begun a deleveraging process. The banking system's loan-to-deposit ratio narrowed substantially, standing at 140% at the end of 2011, from a peak of 167% recorded in June 2010. This reflects a €47.8 billion decline in the financing gap, achieved through an increase in deposits (€27.2 billion) and a reduction of loans (€20.6 billion). If one only takes into account the eight largest banking groups, the transformation ratio was 128% at the end of 2011.

It is worth highlighting the positive behaviour of household deposits, which in 2011 increased by over €11.6 billion, largely offsetting the fall in non-residents' and non-financial corporations´ deposits. Deposits' sustained growth continued in the first few months of 2012. At a time of growing risk aversion and greater relative remuneration from deposits, households have been adjusting the composition of their assets, cutting the weight of other assets such as investment funds, savings and Treasury certificates, and life insurance. Although deposits are expected to slow down somewhat this year, their sustained growth is an important sign of public trust in the domestic banking system – and it is of the essence that such trust is maintained.

As far as credit is concerned, although no abrupt aggregate quantitative restrictions have emerged on the supply side, there are major differences across firms and sectors, which Banco de Portugal is analysing in detail. Developments in the Portuguese economy's financing conditions were widely discussed during the third review mission, and this led to a number of adjustments that I will mention later.

Also in relation to liquidity conditions in the banking system, reliance on Eurosystem funding continued to be a key component of the resident banks' financing strategy. Over 2011 Eurosystem funding remained quite stable, albeit at very high levels – close to €48 billion. This stability contrasts with an increase in recourse to Eurosystem funding by other European banks. Already in 2012 there has been a significant rise in the liquidity obtained from the Eurosystem, which now stands at close to €56 billion, reflecting the results of the three-year long-term refinancing operation conducted at end-February.

3. Banking sector monitoring and supervision

In addition to the reinforcement of capitalisation levels and progress in deleveraging, transparency in the banking system was also greatly enhanced in 2011, particularly through three initiatives outlined in the adjustment programme:

- A wide programme of inspections to the quality of bank assets – the so-called Special On-site Inspections Programme (SIP)
- Disclosure of a new non-performing loans ratio aligned with international practices

- Improvement of statistical reporting on corporate and household indebtedness

Special On-site Inspections Programme – SIP (see annex)

I would like in particular to give a few details on the inspections programme. This programme focused on the eight largest banking groups, which account for over 83% of the banking sector assets, and had the main purpose of reassuring markets about the robustness of the banking system. The programme was organised in three workstreams:

- Valuation of credit portfolios as at 30 June 2011, so as to assess the adequacy of the respective loan impairment levels, impairment calculation models and associated policies and procedures
- Review of the credit risk capital requirements calculations
- Assessment of the methodologies and tools used in stress test exercises to be conducted regularly in the context of the Economic and Financial Assistance Programme

To guide and monitor implementation of the SIP, a Steering Committee was set up, chaired by Banco de Portugal and composed of representatives of the International Monetary Fund, the European Commission, the European Central Bank and three European Union supervisors - Banco de España, Autorité de Contrôle Prudentiel (France) and Banque Nationale de Belgique. The Steering Committee approved the Terms of Reference for the SIP, defining the scope, methodological approach, implementation timelines, and monitoring and control mechanisms. The valuation of the credit portfolio and the assessment of the methodologies and tools used in stress test exercises benefited from specialised outsourcing, in strict cooperation with Banco de Portugal.

The first stage of the SIP had the aim of assessing, as at 30 June 2011, the valuation of the banks' credit portfolios and the credit risk capital requirements calculations and was completed in early December 2011. This 'snapshot' confirmed the robustness of capital adequacy in the Portuguese banking system and dissipated the concerns shown by a number of analysts about the reliability of the banks' balance sheet figures. Impairment corrections reported by banks account for less than 0.5% of the exposures under review.

The second and last stage of the SIP relating to the assessment of the methodologies and tools used by each banking group in stress test exercises was completed in February 2012. The findings led to the conclusion that the methodologies used are broadly suitable, albeit somewhat heterogeneous. Banco de Portugal will ask each institution to adopt the identified methodological improvements and establish procedures for the regular monitoring of the implementation of such measures.

4. Strengthening of the regulatory framework

The financial system's regulatory framework was also strengthened considerably in the past year. Key examples of this include the approval of legislation governing:

- Bank access to public capital
- Early intervention, resolution and the deposit insurance framework
- The Corporate Insolvency Law

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In sum, in spite of the extremely adverse conditions in which Portuguese banks have operated, they are more capitalised, more transparent and less leveraged than a year ago. Banking system monitoring and supervision were significantly enhanced, and the regulatory framework has been considerably strengthened. The Economic and Financial Assistance Programme's financial stability measures and targets are well on track, as evidenced by the generally favourable appraisal by the European Commission, the European Central Bank and the International Monetary Fund within the scope of the Programme's regular reviews.

As expected, the unfavourable economic and financial environment has taken a toll on banks' profitability, which are facing a considerable rise in credit risk and higher financing costs. In 2011 banks' results were also affected by non-recurring factors, such as the impact on banks' balance sheets of the transfer of pension funds to the social security system and corrections arising from the Special On-site Inspections Programme. These one-off effects have penalised results in 2011, but contribute to more robust balance sheets going forward. If they were ruled out, banks' profitability in 2011 would have remained positive, even if at a low level.

III. Next steps in the Programme's implementation

Having analysed the last ten months, I would now like to move on to the next steps.

The generally favourable assessment of progress made to date cannot distract us from the long way still to go. The challenges remain huge and there is no room for complacency. The immediate challenge continues to be to reinforce capitalisation and pursue deleveraging in the banking sector, while simultaneously ensuring adequate financing for the more dynamic firms and sectors, which is instrumental for the Portuguese economy's recovery and structural change.

As is known, the programme sets a 10% target for the Core Tier 1 ratio by the end of 2012. By the end of the first half of the year, banks will have to meet the additional capital needs stemming from the European Banking Authority capital exercise, the partial transfer of banks' pension funds to the social security system at the end of 2011, and the results of the Special On-site Inspections Programme.

Capital requirements to be met by the end of June are estimated at close to €5.5 billion, of which around €1.3 billion corresponds to Caixa Geral de Depósitos. Capital requirements are to be met through a combination of retained earnings, capital increases, lower risk-weighted assets, and in a limited number of cases, resort to the €12 billion capitalisation fund available under the programme. In the case of Caixa Geral de Depósitos, the capital increase will take place without recourse to the capitalisation fund, and the sums required are already allocated in the State Budget for 2012 and in the draft supplementary budget.

As provided for in the memoranda of understanding, Banco de Portugal will issue its opinion on the banks' capitalisation plans and prepare quarterly reports to be submitted to the Minister for Finance on the situation of those banks that resort to public funds to strengthen their capital positions.

A **Ministerial Order** is currently being finalised regulating several aspects of recourse to public funds. In its opinion on the draft Ministerial Order, Banco de Portugal identified a series of key

principles related to the importance of safeguarding the objectivity, predictability, fairness and minimisation of conflicts. This is crucial particularly in relation to sensitive issues under close scrutiny by the general public and international markets such as the conditions of State entry into and exit from bank capital, or the public underwriting of hybrid instruments for Core Tier 1 capital. These elements are key for reaching the objectives that, I believe, we all share, which are to protect the interests of the taxpayer, safeguard financial stability, attract new investors and reinforce the governance and management of credit institutions. The key aim is that the State does not become a hostage to the shareholders and these, in turn, are not held hostage by the State. In fact, it is in the interest of all stakeholders to prevent State participation in the banks' capital position from lingering indefinitely. Hence, incentives must be created so that the State's position is withdrawn as soon as possible.

As far as **deleveraging in the banking sector** is concerned, the programme sets out a loan-to-deposit ratio of 120% by end-2014. Under the third review, this went on to be an indicative ratio, in order to grant a certain degree of flexibility to authorities when weighing targets relating to deleveraging and the economy's financing.

This greater flexibility should not be mistaken for a less firm commitment to the adjustment targets envisaged in the programme. Indeed, it is important that we all understand that lowering our ambitions towards the programme's targets – on top of requiring the agreement of the European Union and the IMF, which would be hard to achieve – would inevitably lead to a deterioration of the Portuguese economy's financing conditions in the medium to long term, insofar as it would mean indebtedness levels at the end of the programme's horizon that would be even higher than currently forecast.

The Portuguese economy certainly faces strong funding constraints. This is not due to the existence of an adjustment programme; rather, it is mitigated by it. The funding constraints we are facing result from indebtedness levels built up over a decade in an artificially favourable financial context; these indebtedness levels have shown up in a highly negative international investment position. Accumulated external indebtedness – made possible by Portugal's participation in the euro area – stemmed from fiscal policies and private agents' behaviour that were deeply inadequate in the new regime that resulted from the adoption of

a single currency. The interruption of access to market funding in early 2011 led to an inevitable balance sheet adjustment in the public and private sectors.

In the absence of access to market funding, the Economic and Financial Assistance Programme allows us to avoid an abrupt and disorderly adjustment as would otherwise occur. Strict implementation of the programme will also pave the way for sustained growth in the Portuguese economy and convergence towards the per capita income levels observed on average in the euro area.

The funding strains currently faced by the Portuguese economy depend on four factors: the adjustment programme's financial envelope, the capacity of resident banks to receive ECB funding, access of non-financial corporations to the external capital market and export performance. Within this global funding constraint, the availability of funds to the non-financial private sector depends critically on the degree and swiftness of public sector adjustment.

The funding amounts envisaged in the programme are very high, and it is unrealistic to think that it would have been possible to negotiate higher sums. With regard to the three remaining factors determining the degree of funding constraints, recent news is encouraging.

The banking system's liquidity prospects over the short term are now more favourable than a few months ago, reflecting the non-standard monetary policy measures that have been adopted by the European Central Bank. I am referring in particular to the two three-year refinancing operations, the reduction of the reserve ratio from 2% to 1%, and a broadening of collateral eligibility criteria, enabling loans to be used under certain conditions. However, one cannot ignore that ECB funding will always be limited by the availability of collateral by Portuguese banks and the rating of that collateral.

With regard to access to external financing, in contrast to the sovereign and banks' situation, a group of companies with a better financial position and external links was able to increase use of external financing at the end of the year. In 2011 as a whole, total financing by non-residents to private companies amounted to around €4.3 billion. This shows that total lending

to private companies increased marginally at the end of 2011, in contrast to a contraction in domestic bank lending.

Finally, with regard to the export sector, signs are also encouraging. Exports have grown by almost 7.5% in volume in 2011 and continued to show sustained growth in the first two months of the year. However, due to the deterioration of the external demand outlook, they are still expected to slow down considerably.

These encouraging signs do not exempt us from remaining highly vigilant and, where necessary, from being proactive towards mitigating the impact of the banking sector's deleveraging process on the economy's financing conditions.

In fact, the manner in which deleveraging takes place in the banking sector is not neutral to the economy's financing conditions. Banco de Portugal has stated publicly that deleveraging should be carried out through sales of assets, notably of credit and other non-strategic participations, thus seeking to mitigate the impact on the flows of new credit. However, one must recognise that market conditions have not facilitated this approach.

In this context, detailed monitoring by Banco de Portugal of banks' funding and capital plans will continue to play a key role in the implementation of the Economic and Financial Assistance Programme. As explained in the memoranda, Banco de Portugal will continue to discourage ever-greening, i.e. the successive renewal of loans with a low probability of repayment. In particular, so as not to jeopardise or discourage deleveraging via asset sales, Banco de Portugal seeks to ensure neutrality between asset holding and selling, by taking prudential measures to ensure that institutions do not keep assets on their balance sheets as a way of avoiding or postponing the recognition of losses.

The programme also requires that measures are defined to encourage the diversification of financing alternatives to the corporate sector: one of the structural benchmarks set out in the wake of the third review is precisely the submission by the Portuguese authorities of such a proposal by the end of July. The programme also emphasises implementation of the recently introduced amendments to the Corporate Insolvency Law by mid-June (also a structural benchmark).

IV. Conclusion

Allow me to conclude by reiterating that financial stability is a public good and the stability of the Portuguese financial system is a core objective of Banco de Portugal and the Economic and Financial Assistance Programme.

The Portuguese banking system has shown remarkable resilience throughout the international financial crisis, largely 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, relying on wholesale markets for funding. As a result, they were hard hit by changes in markets' perceptions regarding the sustainability of indebtedness levels in the Portuguese economy.

The pre-crisis business model – based on strong credit expansion relying on large-scale access to cheap wholesale market funding – is no longer viable. The new financial landscape requires less leveraged and more strongly capitalised business models in banking. This requirement is fully in line with those of the Economic and Financial Assistance Programme to Portugal.

From a medium-term perspective, Portuguese banks face the challenge of adapting their activity to lower transformation ratios and narrower margins. Tackling these challenges will call for three-pronged action:

- Better resource utilisation leading to lower costs
- Use of instruments to reduce the weight of cheap mortgage lending and
- To find strategic investors with access to market funding

Future developments in the Portuguese economy's banking system and financing conditions will largely depend on the strategies that are eventually adopted by banking institutions. Banco de Portugal is entrusted with ensuring that supervision and the regulatory framework give banks the necessary incentives for actions that are compatible with a sound financial system and the minimisation of systemic risk.

Thank you very much for your attention.

ANNEX

SPECIAL ON-SITE INSPECTIONS PROGRAMME (SIP)

- **OBJECTIVES**

The Special On-site Inspections Programme (SIP) had the chief goal of reassuring markets about the robustness of the banking system and was organised in three workstreams:

1. Valuation of credit portfolios as at 30 June 2011, so as to confirm the adequacy of the respective impairment levels, impairment calculation models and associated policies and procedures
2. Review of the credit risk capital requirements calculations
3. Assessment of the methodologies and tools used in stress test exercises to be conducted regularly under the Economic and Financial Assistance Programme

- **TIMELINE**

The credit portfolio valuation and the assessment of credit risk capital requirements calculations were concluded in early December 2011, whereas the review of stress test methodologies and tools was completed at the end of last February.

- **BANKING GROUPS**

Special inspections focused on the eight largest domestic groups, which represent around 80% of the banking system: Banco Comercial Português (BCP), Banco BPI (BPI), Caixa Geral de Depósitos (CGD), Espírito Santo Financial Group (ESFG), Caixa Económica Montepio Geral (CEMG), Santander Totta (BST), Rentipar Financeira (BANIF) and Sistema Integrado do Crédito Agrícola Mútuo (SICAM, Integrated Mutual Agricultural Credit Scheme).

- **ORGANISATION**

Given the defined objectives, scope and timeline, both the credit portfolio valuation and the assessment of the adequacy of the methodologies and tools used in stress test exercises were carried out with recourse to specialised outsourcing, in strict cooperation with Banco de Portugal. Credit portfolios were valuated by Ernst & Young Audit & Associados – SROC, S.A. and PricewaterhouseCoopers & Associados – Sociedade de Revisores Oficiais de Contas, Lda. Four banking groups were allocated to each audit firm, taking into account the need to ensure a balanced workload as well as the minimisation of any conflicts of interest.

As regards stress test exercises, Oliver Wyman provided the specialised outsourced services.

Valuation of credit portfolios, capital requirements and tools and methodologies of the stress test exercises involved auditors, consultants and Banco de Portugal staff, totalling around 350.

- **STEERING COMMITTEE**

To monitor implementation of the programme, a Steering Committee was set up, chaired by Banco de Portugal and composed of representatives of the International Monetary Fund, the European Commission, the European Central Bank and three European Union supervisors – Banco de España, Autorité de Contrôle Prudentiel (France) and Banque Nationale de Belgique – as well as Banco de Portugal.

In July 2011 the Steering Committee approved the Terms of Reference for the work to be carried out, which defined the scope, methodological approach, implementation timelines, and monitoring and control mechanisms to be adopted.

- **RESULTS**

The Special On-site Inspections Programme results on the credit portfolios of the eight main Portuguese banking groups as at 30 June 2011 essentially validate data used to support their solvency assessment, confirming the resilience and financial soundness of the Portuguese banking system as at that date.

The overall impact of SIP results on the aggregate Tier 1 ratio of the eight banking groups as a whole would imply a minor revision of this ratio at the end of June 2011, from 9.1% to 8.8%, remaining above the minimum 8% required on that date.

Impairment

Audit firms have analysed individual impairment levels of a judgmental sample, covering for each banking group the 50 economic groups with the highest credit exposures, as well as other groups and entities whose exposures were selected on the basis of a comprehensive set of credit risk indicators. For some credits updated valuations performed by independent experts were considered for a few assets pledged as collateral. In total, 5,516 borrowers and 61,531 credit files were assessed on an individual basis, covering more than 50% of the credit portfolio under inspection.

As regards collective impairment, there was an assessment of the assumptions, methodology and the historical information incorporated in the model supporting the respective calculation in each banking group. Also, sensitivity analyses were performed on the main parameters and on the estimated impact of the main areas for improvement identified.

In addition, credit risk management policies were analysed, including the main control procedures, with emphasis on the valuation of collateral and problem assets.

The work done led to the conclusion that credit risk management policies and their control procedures are generally suitable, although there are areas for improvement.

As at 30 June 2011 estimates pointed to a need to reinforce the value of impairment recorded for the credit portfolio analysed by €838 million (not considering impairment buffers existing on that date), so as to achieve robust provisioning levels. This amount corresponded to 9.1% of total impairment recognised for credits within the scope of the SIP and 0.3% of the total amount of such credits.

The impact on total impairments of the eight banking groups was nevertheless smaller, given that the above reinforcement needs were partly offset (by €242 million) by the reallocation of impairments identified as available on 30 June 2011 – regarding the overall credit portfolios – amounting to €339 million. Additionally, in the third quarter of 2011, the eight banking groups recorded an impairment reinforcement of €208 million for some of the exposures where the need to reinforce impairment was identified.

Capital requirements

The validation of the capital calculations involved the collection and validation of relevant data for each of the eight banking groups and a recalculation of the requirements through a specially developed tool.

Work related to this SIP workstream was carried out by teams from Banco de Portugal and included revising credit risk capital requirements calculations (which accounted for about 90% of capital requirements for the eight banking groups).

Banco de Portugal has processed around 16.6 million contracts/exposures relating to nearly 7.7 million debtors and incorporating the effect of 2.3 million risk mitigation techniques.

With regard to the assessment of credit risk capital requirements calculations, the work has identified a need for one-off corrections. As at 30 June 2011, this totals, in the eight banking groups as a whole, around 0.6% of total estimated capital requirements.

Banco de Portugal also assessed risk control and management procedures underlying the calculation of risk-weighted assets and concluded that these are generally adequate.

Stress test methodologies and tools

Under the Economic and Financial Assistance Programme, Banco de Portugal was tasked with conducting regular stress test exercises, in order to evaluate the resilience of the largest Portuguese banking groups should the identified risks materialise in an adverse scenario.

Workstream 3 of the SIP was forward-looking, with the purpose of gauging the adequacy of the tools and methodologies used by banks in financial forecasts supporting the assessment of their future solvency.

The work carried out led to the following classification of banking groups:

- Institutions that have used clearly adequate tools and methodologies: two banking groups
- Institutions that have used adequate tools and methodologies: one banking group
- Institutions that have used adequate tools and methodologies in most aspects analysed, but need to improve a number of areas: four banking groups, and
- Institutions that need improvement in a series of specific areas so that the tools and methodologies used may be considered adequate: one banking group

- **FOLLOW UP**

Once the aspects marked for improvement were identified for all banking groups, Banco de Portugal required the adoption of adequate corrective measures, with clearly defined priorities and implementation timelines. Banco de Portugal has adopted procedures for the regular monitoring of implementation of the corrective measures, based on a timeline agreed with banking groups.