Banco de Portugal
EUROSISTEMA

The Portuguese financial system and the role of Banco de Portugal

Address by Governor Carlos Silva Costa at the Financial Forum[1]

Macao, 10 October 2012

I. INTRODUCTION

Good afternoon ladies and gentlemen.

I would like to thank the Monetary Authority of Macao and its Chairman, Mr. Anselmo Teng, for the opportunity to address this distinguished audience and to debate with you the challenges ahead, which go well beyond the borders of my country and indeed Europe.

In keeping with my purpose for this session, I will start by highlighting the main features of the Portuguese financial system and commenting on recent developments, followed by a brief presentation of Banco de Portugal's role and the strategy for promoting financial stability. I will close with a reference to the main challenges ahead.

II. THE PORTUGUESE FINANCIAL SYSTEM

Allow me to start with a brief description of the Portuguese financial system and its recent developments.

Similarly to most continental European countries, financial intermediation in Portugal is dominated by the banking sector, which provides the bulk of private sector funding. This characteristic, which is particularly marked in Portugal, contrasts with the situation in Anglo-Saxon countries, where the importance of the capital market in financing the economy is far greater.

The Portuguese banking sector is more concentrated than most European banking systems, albeit significantly less than in countries such as Finland or the Netherlands. The market share of the five largest banking groups in Portugal is 76 per cent in terms of credit granted and 79 per cent in terms of deposits taken. Banks hold substantial shares in other economic sectors, including the insurance sector. Foreign ownership of banks is considerable, as is state ownership, to the extent that one of the largest banks in the system – Caixa Geral de Depósitos – is wholly owned by the State.

The volume of bank lending to residents amounts to nearly 200 per cent of GDP, i.e. well above most euro area countries. This indicator reflects the banking system leveraging as well as the economy's dependence on bank financing.

[1] As prepared for delivery.

The composition of banks' credit portfolios has remained stable over the past few years. Credit to households accounts for around half of the credit portfolio to residents, of which approximately 80 per cent corresponds to mortgage credit. In turn, non-financial corporations absorb around 40 per cent of total credit to residents. The construction and real estate segments account for around one third of credit to non-financial corporations, which, in addition to the weight of mortgage credit, reflects banks' strong exposure to the real estate sector.

The Portuguese financial system underwent a radical transformation in the three decades before the onset of the international financial crisis. This transformation was driven by the Portuguese economy's integration in the European Union as of the mid-1980s and the adoption of the euro in the late 1990s.

This transformation process can be broken down into three periods:

First, a period of *financial repression and macroeconomic instability*, between the mid-1970s and the mid-1980s. The Portuguese banking system was almost entirely state-owned and there were strict regulatory restrictions on financial activity and capital movements to and from abroad. Credit to the private sector was subject to quantitative limits and interest rates were set administratively.

A second period, between the accession to the European Union, in 1986, and the mid-1990s, was characterised by rapid *liberalisation and economic and financial integration*, macroeconomic stabilisation and convergence of the Portuguese economy to EU levels.

The third period, between the mid-1990s and the onset of the international financial crisis, corresponded to the transition to economic and monetary union and subsequent adoption of the euro. This period was characterised by the *accumulation of macroeconomic imbalances*, which has led us to the current crisis.

The reduction of costs and easy access to funding made possible by the monetary union resulted in a strong expansion of credit and a decline in savings. The figures involved were striking: between mid-1995 and the end of 1998, on the eve of the adoption of the euro, the long-term interest rate in Portugal fell from over 12 per cent to approximately 4 per cent. In turn, the interest rate differential between Portuguese and German 10-year government bonds narrowed by more than 5 percentage points, to around 30 basis points. This differential remained at very low levels for almost a decade – in 2007, the average differential was still below 20 basis points.

In this context of easy and cheap financing, consumption of durable goods and investment in housing by households increased significantly, along with corporate leveraging. The expansion of private spending resulted in persistent current account deficits. These imbalances were exacerbated by unsustainable fiscal policies and the absence of a macro-prudential policy, amid financial market complacency. Between the mid-1990s and 2010, the international investment position of the Portuguese economy worsened significantly, moving from -10 to -107 per cent of GDP. Over the same period, gross external debt increased from 64 to 230 per cent of GDP.

The rise in indebtedness of households, enterprises and the public sector was funded by the international financial markets, and was to a large extent intermediated by the Portuguese banking system. The transformation ratio of the banking system, as measured by the relationship between credit granted and deposits taken, rose from approximately 65 per cent, in 1996, to around 160 per cent, in 2010.

Similar developments were observed in other European countries, such as Italy, Ireland, Spain and Greece. This new world of low interest rates and abundant financing seemed to offer a ‘free lunch’ to the then-called ‘converging economies’. This was the era of the so-called ‘great moderation’, when the accumulation of imbalances and cross-border divergences went largely unnoticed.

When the international crisis began in 2007, Portuguese banks were highly leveraged, dependent on wholesale markets for their financing and heavily exposed to the construction and real estate sectors. However, the Portuguese banking system proved to be remarkably resilient during the early stages of the crisis, which corresponded to the collapse of the US subprime credit segment and its repercussions on northern European banking systems. This resilience may be largely explained by a negligible exposure to toxic assets and the absence of a real estate bubble in the Portuguese economy.

As the crisis unfolded and spread from the United States to Europe, investors’ attention moved to macroeconomic imbalances in euro area peripheral economies, the inconsistencies and fragilities of the single currency’s governance model and the correlation between sovereign and banking risks. With the upturn in mistrust, sovereign and domestic banking systems’ access to the international financial markets became more uneven and the interbank market in the euro area dried up. As a result, a heterogeneous monetary union has emerged, with sharp differentiation between euro area countries in their access to financing and increasing difficulties in the transmission of the standard Eurosystem monetary policy.

Portuguese banks were severely hit by shifts in market perceptions regarding the sustainability of the domestic economy’s indebtedness and started to face growing difficulties in obtaining market financing. Indeed, the rise in public and private indebtedness during the first decade of the monetary union had rendered the Portuguese economy very vulnerable to the international financial crisis and its contagion effects. Against a background of very low potential output growth, the trajectory of external indebtedness in the Portuguese economy resulted in growing doubts among international financial investors about Portugal’s ability to service debt. Such doubts led to the closure of international financial markets for the Portuguese economy in the first half of 2011, which led inevitably to reliance on official financing within the framework of a Financial Assistance Programme negotiated with the European Union and the International Monetary Fund.

Safeguarding financial stability, together with the lasting consolidation of public accounts and the structural transformation of the Portuguese economy, is a key aspect of the adjustment programme. Given its supervisory powers over the Portuguese financial system, Banco de Portugal plays a central role in the adjustment strategy of the Portuguese economy.

It is precisely the role of Banco de Portugal that I will address in the second part of my talk.

III. THE ROLE OF THE CENTRAL BANK IN THE ADJUSTMENT OF THE PORTUGUESE ECONOMY

Pursuant to its Organic Law, Banco de Portugal shall "provide for the stability of the national financial system, performing for the purpose, in particular, the function of lender of last resort". This liquidity provision function to the banking system in emergency situations is, naturally, in line with EC regulations, especially with regard to full respect for the primary objective of maintaining price stability and for the prohibition of monetary financing of the public sector.

Banco de Portugal has extensive powers in the field of supervision of the Portuguese financial system, which includes macro-prudential, prudential and banking conduct supervision.

As part of this, the Bank establishes regulatory rules, supervises credit institutions, financial corporations and payment institutions and imposes sanctions upon non-compliance with regulations in force. The main goal of prudential supervision is finding a proper balance between efficient resource management (use of capital and profitability of institutions) and risk-taking. In turn, banking conduct supervision focuses on the behaviour of credit institutions in their relations with customers. As a whole, both supervisory fields are key to maintaining and strengthening confidence in the financial system among customers and investors.

Moreover, Banco de Portugal has acquired new powers in the area of macro-prudential supervision. These powers are shared with the Portuguese supervisory authorities responsible for the insurance and capital market sectors. In this context, Banco de Portugal regularly analyses sources of systemic risk and has developed new instruments to perform stress tests on the banking system on a regular basis. The current financial crisis has made it clear that vulnerabilities in the financial system may arise even when stakeholders or instruments seem sound when taken on their own. Complex interactions between individual agents, instruments, the institutional framework and the macroeconomic environment may generate very significant risks. The identification of these vulnerabilities requires a top-down approach that complements the bottom-up supervision of individual financial system components. This type of analysis must result in preventive or, where necessary, corrective action.

A major objective of the Financial Assistance Programme consists in ensuring the gradual and orderly deleveraging of the Portuguese banking system, which does not jeopardise the financing of the economy's productive sector. The strategy set out for this purpose within the Programme was integrated into and deepened the strategy that Banco de Portugal had been following, and relies on four key pillars:

- To strengthen banks' capitalisation levels;
- To protect liquidity in the banking system;
- To strengthen monitoring and supervision of the banking sector;
- To improve the regulatory framework.

Over this past year, marked progress has been made across all these areas. In fact, Portuguese banks have strengthened their capital base and reduced financing imbalances, in spite of extremely unfavourable external conditions and a decline in profitability.

In June 2012 the Core Tier 1 ratio of the banking system amounted to 11.3 per cent, i.e. above the 10 per cent objective set in the Financial Assistance Programme for the end of the year. Core own funds increased by 25 per cent in the first half of 2012, reflecting recapitalisation operations by major banking groups, partially funded by the facility provided for that purpose within the framework of the Financial Assistance Programme. In addition, a reduction by 6.6 per cent in risk-weighted assets also contributed to the improvement in the system's solvency ratios.

Monetary policy measures adopted by the ECB, particularly relating to the extension of maturities of refinancing operations and to the expansion of eligible collateral, have positively contributed to improving the liquidity position of Portuguese banks, in a context where they were forced to increase their recourse to Eurosystem financing after capital markets were closed.

As no market financing was available, Portuguese banks were also forced to redirect their commercial strategies, with the aim of increasing their deposit-taking and reducing credit granted. It should be noted that, despite unfavourable macroeconomic developments, deposits from households have increased, reflecting high public confidence in the banking system. In turn, bank loans have dropped markedly, which has particularly affected small and medium-sized enterprises in the non-tradable sector. Credit to exporting enterprises has continued to grow and, in terms of overall debt financing, the fall in loans has been offset by greater recourse to external financing (chiefly by larger enterprises).

At the end of 2011, the loan-to-deposit ratio of the eight major Portuguese banking groups stood slightly below 130%, representing a reduction of around 30 p.p. from the maximum recorded in June 2010. This trend continued in 2012, which suggests that the indicative target envisaged in the Programme of a 120 per cent transformation ratio will be reached at the end of 2014.

Moreover, transparency about the state of the banking system has been enhanced, particularly through the screening of the quality of bank assets provided by stringent horizontal inspection programmes. The regulatory framework was also improved, namely through the approval of legislation on the correction, resolution and liquidation of credit institutions and the deposit guarantee scheme.

Naturally, the unfavourable economic and financial environment has negatively affected the profitability of banks.

Non-performing loans have increased substantially and reached particularly significant levels in the construction sector and also with regard to consumer credit. These developments, together with an unfavourable capital market performance, have resulted in an increase in impairments associated with credit and securities portfolios.

At the same time, revenues have declined, reflecting both a reduction in banking activity and a contraction in the net financial margin, which resulted from an increase in banks' financing costs at a time when a substantial share of banks' assets corresponds to mortgage credit with low spreads.

It is important to stress that unfavourable developments in the profitability of domestic activity has been partly offset by favourable developments in Portuguese banks' international activity, which currently accounts for more than 20 per cent of the banks' profits.

IV. CHALLENGES

We are on the right path. The successive Financial Assistance Programme review assessments by the European Union and the IMF have shown that the Programme is broadly on track. The effort of adjusting the Portuguese economy has been quite substantial, but it is starting to bear fruit in the form of a marked correction in external accounts and a gradual improvement in financing conditions faced by the Portuguese Treasury.

I have highlighted significant steps forward to strengthen financial system stability: our banks are now more capitalised, more transparent and less leveraged than a year ago. The monitoring and supervision of the banking system have been substantially enhanced and the regulatory framework is much stronger.

However, major challenges remain and transcend the Portuguese borders. As such, I will end this talk with reference to the main challenges ahead, distinguishing between three levels: the global, European and Portuguese levels.

At **global level**, efforts to increase the financial system's resilience must be stepped up and accelerated. As highlighted in the well-known de Larosière report on the causes behind the international financial crisis,

> "… *The world's monetary authorities and its regulatory and supervisory financial authorities can and must do much better in the future to reduce the chances of events like these happening again*."

The business model that prevailed before the crisis is no longer viable. The financial landscape that will emerge in the context of a 'new normal' will be characterised by less leveraged and more capitalised banks.

This paradigm shift is ongoing and is being incorporated into an international effort to reform the regulatory framework, which will need to respond appropriately to trends as important as:

- The growing complexity of financial institutions, their activity, financial instruments and financial systems in general;
- The dynamics of institutions, in particular resulting from innovation in financial activity associated with the use of new technologies;

- Emergence of shadow banking as a response to the limitations and rigidities imposed by regulations;
- The integration of the banking system within a (geo)political and (macro)economic framework characterised by a growing complexity due to the multiplication of interconnections and contagion channels and the speed of transmission.

At **European level**, the strengthening of fiscal discipline mechanisms and the creation of a European stability mechanism are important decisions that aim at deepening and bolstering the economic and monetary union. These are, however, necessary additional steps.

We now need to break the negative interaction between sovereign and banking system financing in a credible and effective manner. This co-dependence, which in the euro area has turned into a vicious circle of reciprocal contagion, requires a decoupling of the 'fortunes' of banks and sovereigns. For this purpose, monetary union must be complemented by banking union, providing for a European authority and an integrated supervision process, as well as shared deposit guarantee, resolution and bank capitalisation mechanisms.

Finally, at **Portuguese level**, I would like to differentiate between the challenges faced by the authorities and equally significant challenges faced by banks themselves.

Authorities must continue to promote a delicate balance between, on the one hand, bank capital needs and deleveraging requirements and, on the other hand, the need to prevent a contraction in credit impeding the sustained recovery of the Portuguese economy.

Enhanced prudential supervision of financial institutions must be maintained and widened. In this respect, I would like to stress the importance of institutions' transparency and governance, which is top priority for Banco de Portugal and involves:

- Introducing best governance practices in institutions, through the strengthening of internal control mechanisms and improved management information;
- Revising rules and the relationship between internal and external auditors and supervisory authorities, improving the communication and interaction between auditors and supervisory authorities and strengthening their independence to combat capture phenomena;
- Increasing transparency and comparability of relevant information on institutions for market discipline purposes.

Portuguese banks face the significant challenge of paving the way for a structural improvement in their efficiency levels in a new paradigm characterised by lower transformation ratios and lower financial margins.

In order to respond to these challenges, it is necessary to act on three complementary fronts:

- A better use of resources with a view to a structural reduction of costs;

- The search for solutions to reduce the weight of cheap mortgage credit on banks' balance sheets and to free up liquidity for new business;

- The search for strategic investors with capital and access to market financing.

We are aware that crises entail difficulties, but they also produce new opportunities. I am confident that both the authorities and private agents will rise up to the challenges ahead.

Thank you for your attention.