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Supervision as a mechanism for promoting and safeguarding financial stability

Note distributed by Carlos da Silva Costa, Governor of Banco de Portugal, on the occasion of his Hearing before the Committee on Budget, Finance and Public Administration regarding the banking institutions' capitalisation process

1 February 2013

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SUPERVISION AS A MECHANISM FOR PROMOTING AND SAFEGUARDING FINANCIAL STABILITY

1. Introduction

Financial stability is a public good and safeguarding stability in the Portuguese financial system is one of the core missions of Banco de Portugal, as expressly stated in its Organic Law. Several of Banco de Portugal's tasks and competencies contribute towards this mission, such as those relating to the role of lender of last resort within the European System of Central Banks, or those relating to oversight of the payment system, and not just the roles of supervision of the financial system and, in particular, the banking sector.

Doubts over the health of a financial institution – whether due to issues of asset quality, exposure to certain segments, capital deficit or others – can in an instant trigger a run on deposits or the closure of the capital markets to bank financing. Therefore, confidence is one of the most valuable assets in the sector, as when it falls, it can trigger a very fast process of liquidity erosion and can threaten the survival of a banking group, irrespective of its intrinsic financial soundness.

To achieve this goal of safeguarding financial stability and making the financial system more robust, Banco de Portugal defined a strategy which was duly disseminated to the public, based on four aspects: strengthening banks' solvency; protecting the system's liquidity, strengthening monitoring and supervision of the banking system; and improving the regulatory framework.

This document aims to provide information on the work performed by Banco de Portugal as part of its strategy to preserve financial stability, focusing in particular on the prudential work and results achieved to-date. The measures to protect liquidity and strengthen solvency, with a focus on the banks' capitalisation under the facility specified in the Economic and Financial Assistance Programme to Portugal (EFAP), are covered in Section 2. Sections 3 and 4 focus respectively on the measures designed to strengthen monitoring and supervision of the banking system and improving the regulatory framework. Lastly, Section 5 summarises the recent behaviour of the banking system and the main challenges ahead.

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2. Strengthening solvency and protecting liquidity

The financial crisis that started in 2007 had a major impact on the foundations of the global banking system, causing a profound change in the way regulators, investors and other parties view the soundness of an institution in terms of capital and liquidity. Regarding solvency, the new regulatory framework has redefined capital, favouring the capacity to absorb losses, and the requirement for capital ratios to be substantially higher. Regarding liquidity, metrics were defined that allow a systematised assessment of the institutions' liquidity levels and the lower limits to be followed in the future by the institutions were specified.

Banco de Portugal reacted swiftly to the deterioration in the external environment and, in line with international regulation trends, adopted a broad strategy designed to strengthen the banking system's resilience. This strategy was later integrated and developed under the EFAP negotiated with the European Union and the International Monetary Fund.

2.1. Liquidity protection

To reinforce the system's liquidity position, Banco de Portugal has been promoting an orderly deleveraging of the banking system as part of the EFAP's adjustment process, which has proved necessary for the transition to more stable and long-term sustainable financing models for banks.

To implement that deleveraging, Banco de Portugal has been issuing recommendations, when deemed necessary, and has sought to ensure at the same time that the pace and nature of this process are compatible with levels of credit granted to the economy and aligned with the macroeconomic scenario of the adjustment programme (see information on the performance of the banking system's liquidity position in Section 5).

In terms of liquidity as well as solvency, the EFAP has recognised the importance of State support as the ultimate guarantor of financial stability, especially while the banks may not resume access to the markets under normal conditions.

In particular, the EFAP included measures to ensure sufficient liquidity in the system, with the upper limit on the issuance of government guaranteed bank bonds increasing from €20 billion to €35 billion, and which, in a situation of scarce collateral, are potentially eligible to secure financing from the European Central Bank (ECB).

In this respect, the ECB plays a crucial role in restoring the monetary policy transmission mechanism through stabilising dysfunctional market segments, namely by adopting several non-standard monetary policy measures, including refinancing operations with full allotment and a longer maturity (three years) and changes to the eligibility criteria for collateral.

These changes led to a significant widening of the pool of assets available as collateral – in Portugal especially due to the acceptance of a wider set of bank loans granted to non-financial corporations and households – and to a greater stabilisation of their value, which as a whole became less sensitive to market fluctuations, such as those arising from falls in the sovereign

rating. These measures have contributed to reducing uncertainty over the Eurosystem's level of financing of the banks, and thus have helped them to manage liquidity.

In parallel, to encourage the distribution of liquidity among Portuguese banks, Banco de Portugal launched a new platform for registering and processing unsecured interbank money market operations, with the facility for secured operations scheduled to be operational at the start of this year.

2.2. Strengthening solvency

Regarding institutions' solvency, from 2010 Banco de Portugal adopted several measures towards preserving adequate capital ratios, recommending the sale of assets, imposing capital increases, limiting the distribution of dividends and setting more stringent capital requirements (Core Tier 1 ratios of 9% by the end of 2011 and 10% by the end of 2012, thereby anticipating some of the main Basel III recommendations).

By imposing more stringent capital ratios, Banco de Portugal has aimed to strengthen the resilience of the national banking system as part of a strong adjustment of the Portuguese economy. This resilience is especially important at times of economic adversity, such as the present time, where recognising impairments for increasing levels of borrowers' defaults is a dynamic exercise with a powerful impact on banks' net income.

The Core Tier 1 ratio of 10% required by Banco de Portugal from the end of 2012 is well above the solvency ratio set as the prudential ratio benchmark in the EU legislation (8%). This more stringent level alone accounts for additional own funds requirements of about €3.8 billion for the eight largest Portuguese banking groups combined.

The recapitalisation measures needed to reach this goal were partly achieved in 2011, when the institutions were required to comply with a minimum Core Tier 1 ratio of 9% by the end of that year. The increase of this lower limit to 10%, plus the impact of the Special Inspections Programme and the partial transfer of banks' pension funds to Social Security, have largely explained the capital needs arising in 2012.

Aside from additional own funds requirements defined by Banco de Portugal, the four largest Portuguese banking groups were included in the European capital exercise promoted by the European Banking Authority (EBA), which aimed to strengthen the solidity of the institutions in a context of strong uncertainty due to the sovereign debt crisis. As part of this exercise, the EBA recommended increasing the capital levels of the institutions covered to reach a Core Tier 1 ratio of 9% by 30 June 2012,[1] after a prudent assessment at market values of the sovereign debt exposures held on 30 September 2011.

Compliance with this recommendation added around €2.5 billion to the requirements mentioned above, to cover the risks arising from unrealised losses in the public debt securities held in the targeted banks’ portfolio, which totalled €3.7 billion.

[1] The Core Tier 1 concept adopted by the EBA involves additional deductions to "core" capital, namely those relating to holdings in financial institutions.

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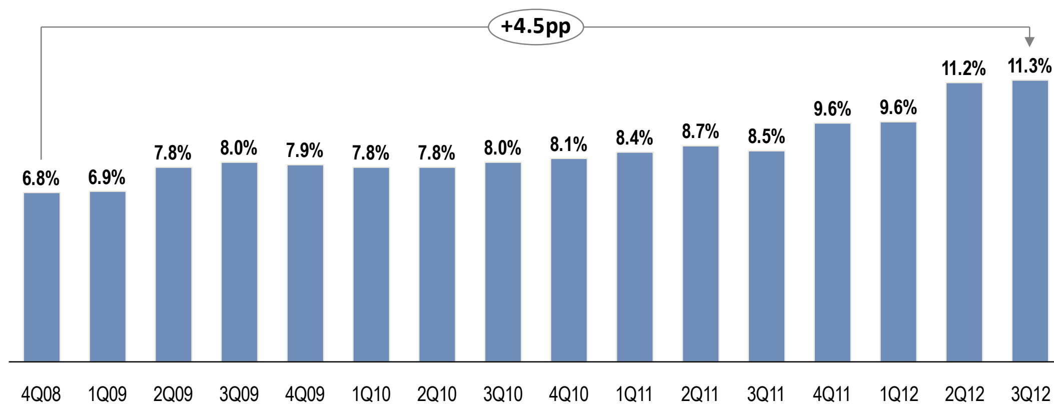
In a context of strongly increasing minimum capital requirements, the solvency ratios in the Portuguese banking system have made remarkable progress over the last four years (Chart 1).

Chart 1: Quarterly developments in the Core Tier 1 ratio

Banking system, excluding institutions under State intervention (BPP, BPN)



Source: Banco de Portugal.

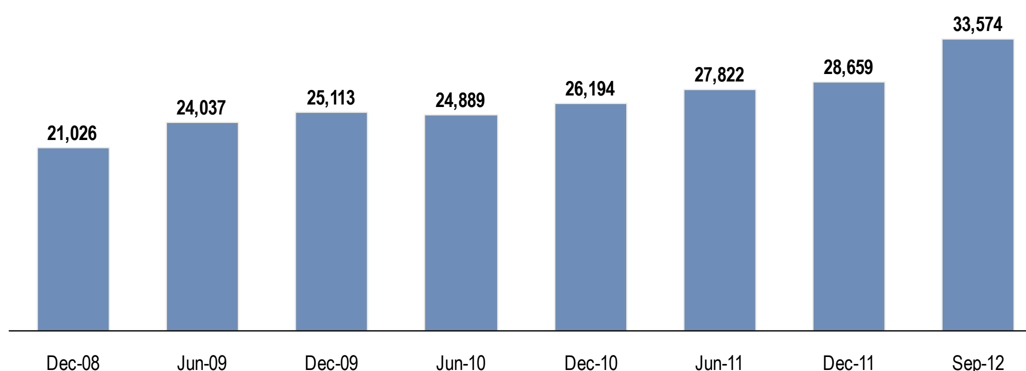
Since the end of 2008, when the financial crisis became truly systemic (following the collapse of Lehman Brothers), the Portuguese banking system's Core Tier 1 ratio has moved from 6.8% to 11.3%, growth of 4.5 p.p.

This performance has been crucial to boosting the resilience of the financial system in a particularly adverse context and could have been achieved in two ways: increasing Core Tier 1 capital (the ratio's numerator) or decreasing the risk-weighted assets (the ratio's denominator).

A breakdown of the ratio's constituent parts reveals that the Core Tier 1 ratio grew above all due to the growth in capitalisation levels. Core Tier 1 capital increased around €12.5 billion between the end of 2008 and September 2012, equating to 60% growth (Chart 2).

Chart 2: Quarterly developments in the Core Tier 1 Capital

Banking system, excluding institutions under State intervention (BPP, BPN) (€ million)



Source: Banco de Portugal.

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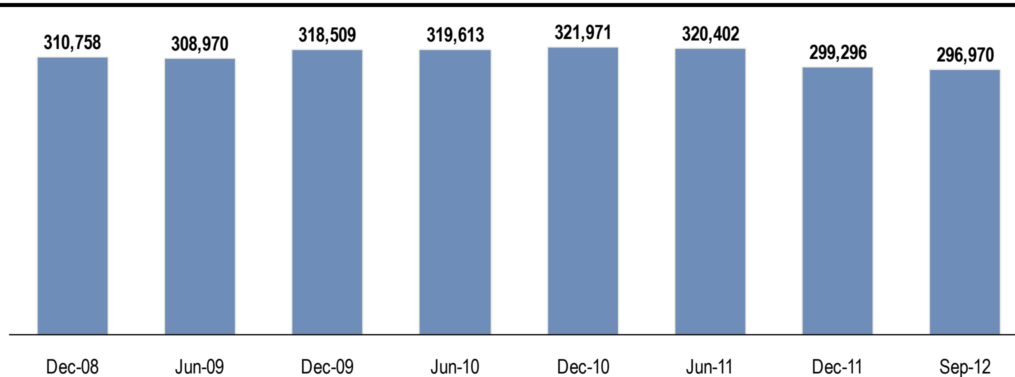
Conversely, risk-weighted assets (RWA) fell by only 5% since the end of 2008 (Chart 3). Taking June 2010 as a reference point, coinciding with the effective closure of the capital markets to Portuguese banks, RWA fell by 7%. If the banks had retained the capital levels held in December 2008, the 11.3% ratio reached in September 2012 would have required the banks to perform a 40% reduction of their RWA.

Chart 3: Quarterly developments in Risk-Weighted Assets (RWA)

Banking system, excluding institutions under State intervention (BPP, BPN) (€ million)



Source: Banco de Portugal.

Since June 2010, Core Tier 1 capital has grown 35% (an increase of €8.7 billion). Thus 69% of the capital increase added by the banking system since the end of 2008 took place in an extremely adverse context, where the capital markets were closed to the Portuguese banking sector. This has justified the need to make use of the Bank Solvency Support Facility (BSSF) in operations of a transitional nature.

Recapitalisation of the banking sector in the context of the EFAP

The EFAP provides for a Bank Solvency Support Facility to the amount of €12 billion, to respond in situations where capitalisation through market solutions is impossible. To introduce this new mechanism, the legal framework for banks' access to capitalisation operations through public investment, established in Law No 63-A/2008 of 24 November, was amended, with the active participation of Banco de Portugal.

The ordinance providing for this amendment (Law No 4/2012 of 11 January) lays down that banks may be capitalised through recourse to public funding as a supplement and solution of last resort. The goal of this system is thus to safeguard the stability of the financial system when market conditions do not allow for funding through the private sector, so that the capital increases needed to fulfil the capital ratios stipulated by regulations may be carried out in good time. The State's interest is safeguarded in particular by the rules establishing the requirement of proven viability of the beneficiary institution, the temporary nature of the public investment and the appropriate remuneration of that investment.

To-date the Portuguese private banks have requested a total of €5.6 billion for recapitalisation under the EFAP, in the form of public investment (with subsequent reimbursement of a part of

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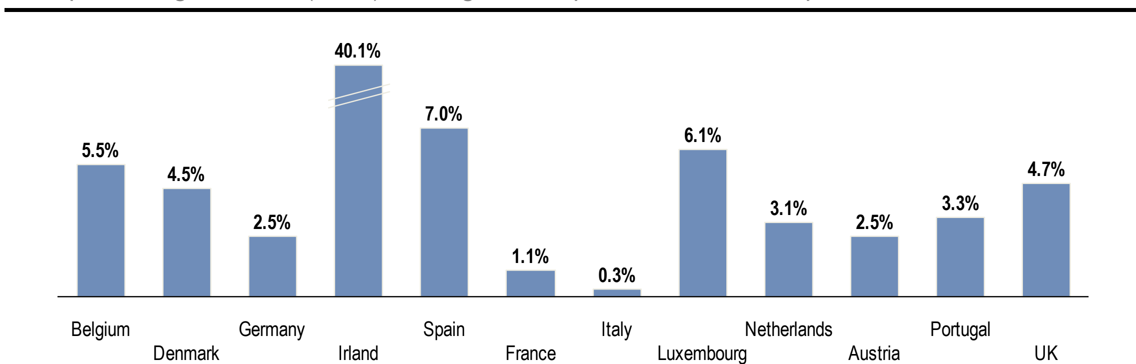
the investment by one banking group). Recapitalisation plans were presented for these capitalisation operations using public funds, which establish the State's entry and exit conditions and the remuneration of the public investment, defining a set of conditions for the institution's activity and management.

It is important to note that the public investment was necessary given the context of the Portuguese institutions' limited access to the capital markets, and took place chiefly as a result of increased prudential rigour. On the one hand, as has been mentioned, the Core Tier 1 ratio of 10% required by Banco de Portugal from the end of 2012 is well above the solvency ratio set as the prudential ratio benchmark laid down in the EU legislation (8%). This more stringent level alone explained €2.5 billion of capital increase requirements for the institutions that benefited from public investment. On the other hand, the need to cover risks arising from unrealised losses in the public debt securities held in portfolio by institutions included in the European capital exercises promoted by the EBA justified a further need to strengthen equity capital (considering the requirements imposed by Banco de Portugal) of around €2.5 billion for the set of institutions that benefited from public investment.

The State has assisted the banking sector in several European countries, whether through guaranteeing debt issuance operations or through public capital injections into institutions' recapitalisation operations. The capitalisation operations using the BSSF represent around 3.3% of Portugal's GDP (2011), which is lower than that of several other European Union Member States (Chart 4).

Chart 4: Public recapitalisation levels by Member State (2008-2011)

As a percentage of GDP (2011), Portugal and Spain for 2008-2012 period



Source: European Commission and Banco de Portugal.

Strengthening solvency through public investment has an inherent goal of ensuring financial stability, safeguarding the interests of taxpayers.

Regarding capitalisation of credit institutions through public funds, the basic principles underlying the law currently in force are as follows (see annex for more details):

– The general principle of adequacy, proportionality and need for the capitalisation measure;

- The principle that the credit institution continues to be managed by its private shareholders (minimal intrusion into the institution's day-to-day management);

- The principle of stability and predictability of the relationship between the State and the institution and its shareholders during the period agreed for the recapitalisation plan, through a set of rights and duties providing a balance based on two key imperatives: on the one hand, the need to ensure financial stability, and on the other the need to ensure adequate remuneration and public disinvestment by the end of the period specified for the recapitalisation operation;

- The principle that, following a materially significant failure to implement the recapitalisation plan, the relationship created with the approval of the public capitalisation plan undergoes deep modification, leading to the State using its powers as shareholder to the full, becoming free to divest the shares it holds in full or in part to whomsoever it wishes as a result of the institution's default, irrespective of legal preference rights;

- The principle that the State’s participation in the capital (acquisition price or share subscription price, significantly discounted from market price) should protect the State's financial interest;

- The principle of safeguarding competition conditions.

The credit institutions' public capitalisation scheme involves significant penalisation of private shareholders. The special share subscription causes a significant initial dilution of the position held by private shareholders, while the remuneration of the public investment (whether through special shares or hybrid instruments) is much higher than would be demanded on the market under normal conditions. Thus there is an incentive to reimburse the sums invested by the State as quickly as possible, without prejudice to the adequate fulfilment of the solvency requirements demanded by Banco de Portugal.

With the aim of strengthening the public funds recapitalisation mechanism, Law No 63-A/2008 is likely to suffer specific amendments, towards ensuring the possibility of public capitalisation being mandatory when the institution in question does not cooperate, forgoing the need for intervention by the shareholders, when the higher public interest of financial stability is at stake and the application of alternative measures currently laid down in that Law prove to be inadequate for the situation (i.e. the appointment of an interim administration, the application of resolution measures or withdrawal of authorisation).

3. Strengthening of supervision and monitoring of the banking system

From the start of the recent financial crisis, it became clear that the supervisory model had to be improved, both in terms of macro and micro-prudential supervision.

In terms of macro-prudential supervision, the crisis has emphasised the need to assess the sources of systemic risk regularly and to complement these assessments whenever necessary

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with timely and appropriate preventive or corrective policies. In this regard, Banco de Portugal has promoted a greater interaction between the micro-prudential and macro-prudential supervisory roles, in order to assess the existence of behaviours that lead to financial imbalances on a systemic scale.

In the micro-prudential sphere, it has been proved vital that supervision understands better the institutions' structure and activity using a forward-looking approach, focusing on the main risk factors for financial stability, supported by the internal and external risk control and auditing mechanisms for the institutions supervised, as well as monitoring the performance of the institutions' managers and qualified shareholders. At the same time, Banco de Portugal has sought to promote greater transparency in the activity and the risks incurred, to allow more effective market discipline. Additionally, it has invested in more intrusive supervision of the banks (including across-the-board inspection programmes), has adopted new assessment mechanisms for the eight largest banking groups' solvency and liquidity situation, based on financing and capitalisation plans presented quarterly, and has developed a new risk indicator (the credit-at-risk ratio) which has been published since September 2011.

Regarding the inspections across institutions in particular, two programmes have already been carried out: the Special Inspections Programme (SIP) and the On-site Inspections Programme (OIP). Annex II presents detailed information on the way in which the programmes were carried out and their results.

The SIP developed under the EFAP, was carried out by Banco de Portugal as part of an assessment of the banks' financial soundness and their ability to withstand adverse macroeconomic trends.

The SIP used an innovative methodology in terms of supervision, simultaneously covering the eight largest banking groups (over 80% of the assets and credit in the financial system) and involving independent audit firms that assessed the credit portfolio against benchmarks defined by Banco de Portugal. Despite the complexity and range of the work, which involved a significant number of people (350, including auditors, consultants and Banco de Portugal staff) and a very demanding timeframe, the internal governance mechanisms adopted by Banco de Portugal led to quality and consistency in the results.

Following the SIP, Banco de Portugal decided to include in its regular banking system supervision periodic and broad-reaching monitoring of the overall credit portfolio, asset classes exposed to macroeconomic or market developments, or other asset classes deserving special attention. Thus Banco de Portugal ran detailed checks and assessments in 2012 on the credit portfolios of the construction and real estate sectors, which included the eight largest Portuguese banking groups, duly publishing the results.

In parallel, Banco de Portugal has widened the scope of the traditional supervisory analysis, strengthening its forward-looking aspect, through analysis of the business model and funding and capital plans for a two to three-year horizon. This analysis is an indispensable complement to the usual prudential reporting analyses which essentially are limited to assessing the capital and liquidity situation for a given point in time.

Banco de Portugal also regularly assesses institutions' ability to withstand adverse economic and financial situations. In this regard, Banco de Portugal holds regular stress tests to assess the main banking groups' future ability to keep their Core Tier 1 capital ratios above 6%, after absorbing simulated shocks, and to assess the soundness of the methodologies and parameters used by the banks in those exercises.

Regarding the institutions' governance issues (structure), steps were also taken to use the existing mechanisms more effectively (namely assessment of the suitability, professional qualifications and abilities of managers or decision-makers for carrying out their roles) or to develop new tools (for example, in the area of remuneration policy), which is an area to be explored in greater depth in the near future through the incorporation into Portuguese law of the EBA's *Guidelines on the assessment of the suitability of members of the management body and key function holders*.

The more intrusive supervision that Banco de Portugal has introduced involves the permanent presence of inspection teams in the larger institutions and various work fronts, such as analysis of the main decisions at different levels of the supervised institutions' internal structure, participation in internal meetings with the relevant decision-makers and in meetings with auditors, exploration of the IT systems of the supervised institutions and the definition of alerts to initiate specific inspections. This approach allows a timely and much deeper awareness of the institution, its organisation, culture, weaknesses and main risks.

As part of strengthening supervision activity, Banco de Portugal has also recently adopted measures designed to ensure appropriate monitoring of the credit at risk and restructured credit in line with international best practice, as well as containing excessive developments in deposit interest rates.

To complement the framework described above, Banco de Portugal has worked towards creating a larger internal capacity for carrying out supervisory work, redefining structures, revisiting the supervision strategy and model, training staff and recruiting in a new skill base.

Promoting and safeguarding financial stability from a micro-prudential perspective

It is therefore important to set out the framework for promoting and safeguarding financial stability as understood by Banco de Portugal, and how this results from the most recent trends in international best practice.

There are three lines of promotion and defence of financial system stability (exclusively in terms of micro-prudential supervision, thus excluding other defence mechanisms, such as deposit guarantee schemes):

- In the first line, we have the institution concerned, with its governance structure and its internal and external controls (and auditing);
- In a second line, there is the regulatory or legal framework and the work of supervision;
- Finally, given the public nature of the good in question, there is the State, as the ultimate guarantor of that stability.

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Regarding the internal control mechanisms, the 20 principles of the Basel Committee – *The Internal Audit Function in Banks*, June 2012 – and the EBA's *(Updated) Guidelines on Internal Governance* constitute a benchmark for the requirements expected of the supervisor, in alignment with Banco de Portugal's stance since 2008, with the publication of Notice of Banco de Portugal No 5/2008.

Regarding the external auditors, greater intervention and accountability are needed, as auditors – despite not being under the internal governance of financial institutions – are an independent quality control mechanism for designed and implemented internal governance, namely through issuing positive opinions. Communication between supervisors and auditors must also be strengthened – given the complementary nature of their missions, but without affecting the responsibilities incumbent upon each of the parties – namely by broadening the definition of situations that require immediate communication to the supervisor and by identifying or carefully analysing upon request of the supervisor the key asset assessment issues that may weaken the institution's situation in less favourable scenarios. In this area, Banco de Portugal has held regular meetings with the main Portuguese audit firms in an open forum, with the aim of analysing and discussing mutually relevant subjects for the financial system. In parallel, Banco de Portugal has held meetings with the auditors of each banking group, to discuss specific topics that result from the financial analysis and the supervision process of institutions.

It is clear that the lines should operate in sequence and the first two should contain the necessary safeguards (in the case of the first) and be oriented (in the case of the second) towards mitigating the need to call on the last line of defence of financial system stability. However, there are no 'zero risk' systems and none of the risk mitigation mechanisms in the second line can replace those of the first. Supervisors' decisions cannot replace those of the institution's management, or those of the shareholders regarding the company, nor can the internal control or audit functions be suppressed. As in any other kind of company, there are risks associated with corporate activity, which must be accepted and when those risks generate losses, those losses must be absorbed by shareholders in the first instance. When this line of defence does not work, there are multiple international examples of institutions that have been resolved or supported by the State, after weighing up questions of moral hazard, public interest and financial system stability.

As it is impossible to know and control all the supervised institutions' activity in detail at all times, the second line of defence, that of regulation and prudential supervision, has to contribute to putting in place mechanisms that prevent or mitigate the risks to financial system stability, and in particular it is up to supervision to act in such a way as to materially reduce the chance of the financial institutions, individually and as a whole, threatening the stability of the financial system and savings protection. This goal can only be achieved on the basis of systematic supervision, focusing on factors behind risk that the institutions represent for the stability of the system, distinguishing between institutions with greater and lesser systemic relevance, and applying to the former greater levels of intensity and intrusiveness of supervisory work. Supervision based on risk accepts the finite nature of the resources available, aiming to allocate them as efficiently as possible towards reducing the risk of disruptions to financial system stability.

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Thus the last line of defence may be called into action when, despite the intervention of the first two lines previously, the reasons for defending financial stability justify the State's support to the institution (which must be deemed viable to benefit from that support).

4. Strengthening the banking sector's legal and regulatory framework

In addition to the measures mentioned above, the strategy to ensure financial stability under the EFAP includes strengthening the banking sector's legal and regulatory framework, in which preparation Banco de Portugal has actively participated.

The following items summarise the key measures adopted in 2012 to meet the legal and regulatory targets.

- **Remuneration policy**

  Regulates the principles and rules governing the remuneration policy of the members of the management and supervisory boards as well as relevant employees of credit institutions, investment firms and branches established in Portugal of credit institutions and investment firms having their head office outside the European Union. Notice of Banco de Portugal No 10/2011 of 9 January 2012.

- **Distribution of dividends**

  In line with the recommendation issued on 7 January 2011 regarding earnings for the year 2010, Banco de Portugal recommends that credit institutions retain their earnings for the fiscal year 2011 or, if earnings are to be distributed, they should be immediately reinvested in capital, in order to ensure an actual increase in their own funds. Circular Letter of Banco de Portugal No 1/2012/DSP of 17 January.

- **Recapitalisation law**

  Introduces the third amendment to Law No 63-A/2008 of 24 November, establishing measures to increase the financial soundness of credit institutions under the initiative to strengthen financial stability and provide liquidity to the financial markets. Law No 4/2012 of 11 January.

- **European capital exercise**

  Identifies the institutions that are subject to the measures laid down in the Recommendation of the European Banking Authority (EBA/REC/2011/1), in the context of a coordinated set of measures aimed at restoring confidence in the banking sector. Notice of Banco de Portugal No 5/2012 of 20 January.

- **Preventive, corrective and resolution regime**

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Confers powers to Banco de Portugal to intervene in institutions under its supervision in situations of financial distress, creates a Resolution Fund, establishes a pre-judicial winding-up proceeding for the institutions under its supervision and changes other winding up-related aspects. Creates a Resolution Fund specifically aimed at financing the implementation of resolution measures; this Fund will be financed, essentially, by the institutions that are subject to the application of such measures. Decree-Law No 31-A/2012 of 10 February.

– **Identification of restructured credit**

  Requests the identification and pointing out of credit restructuring events due to customers' financial difficulties. Instruction of Banco de Portugal No 18/2012 of 4 May.

– **Capitalisation operations through public investment**

  Sets out the procedures required for the implementation of Law No 63-A/2008 of 24 November, under capitalisation operations of credit institutions through public investment. Entrusts Banco de Portugal with the power to monitor and supervise compliance by beneficiary credit institutions with the relevant obligations under this scheme. Executive Order No 150-A/2012 of 17 May.

– **Money laundering prevention**

  Creates a specific reporting instrument on the anti-money laundering and terrorist financing internal control system, to be periodically sent to Banco de Portugal by the entities subject to its supervision or providing financial services related to matters under its supervision. Notice of Banco de Portugal No 9/2012 of 17 May.

– **Contributions to the Deposit Guarantee Funds**

  Updates the calculation method of contributions to the Deposit Guarantee Fund and to the Mutual Agricultural Credit Guarantee Fund by identifying a new reference ratio, as well as a new calculation basis for that ratio, for the purpose of determining the weightings applicable to the calculation of each member institution's contribution rate. Notice of Banco de Portugal No 10/2012 of 27 September and Notice of Banco de Portugal No 11/2012 of 27 September.

– **Recovery plans**

  Regulates the contents of the recovery plans that authorised deposit-taking institutions must submit to Banco de Portugal on an annual basis, with a view to identifying measures which could be adopted to correct in a timely manner a situation of a credit institution which is or is likely to be in financial distress. Notice of Banco de Portugal No 12/2012 of 8 October.

- **Bridge banks**

  Defines the rules applicable to the setting-up and operation of bridge banks. These banks are created by a decision of Banco de Portugal under its legal powers to apply resolution measures. Thus, Banco de Portugal regulates the setting-up and operation of bridge banks, submitting them to certain guiding principles for their activity, and establishes a set of rules regarding their organisation and operation. Notice of Banco de Portugal No 13/2012 of 8 October.

- **Settlement of arrears**

  Defines principles and rules to be observed by credit institutions in preventing and managing arrears situations arising from credit agreements with household customers and creates the out-of-court assistance network for indebted consumers for the settlement of these situations. It is incumbent upon Banco de Portugal to check compliance by credit institutions with the obligations under this Decree-Law and, where appropriate, to apply the respective fines and additional penalties. Decree-Law No 227/2012 of 25 October, Instruction of Banco de Portugal No 44/2012 of 11 December and Notice of Banco de Portugal No 17/2012 of 17 December.

- **Protection of debtors in a very difficult economic situation**

  Establishes an extraordinary regime for protection of housing loan borrowers in a very difficult economic situation. Law No 58/2012 of 9 November.

- **Minimum banking services**

  Establishes the obligations to be complied with by credit institutions as regards the provision of information on their adherence to the legal framework of minimum banking services and on the legally established conditions so that natural persons can have access to and benefit from those services. Notice of Banco de Portugal No 15/2012 of 27 November.

- **Information obligations**

  Establishes the obligation of credit institutions to provide information to their customers on the negotiation of housing loans, related loans (*crédito conexo*) and other mortgage credit, as well as on the negotiation of other credit agreements, which are backed by mortgages or other rights on immovable property, concluded with natural persons acting for purposes other than their business or professional activity. Instruction of Banco de Portugal No 45/2012 of 14 December and Notice of Banco de Portugal No 16/2012 of 17 December.

- **Resolution plans**

  Defines the information to be submitted, on an annual basis, by authorised deposit-taking credit institutions, to enable adequate planning by Banco de Portugal of the

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resolution measures to apply to a particular institution. Notice of Banco de Portugal No 18/2012 of 18 December.

5. Current situation of the banking system and main challenges ahead

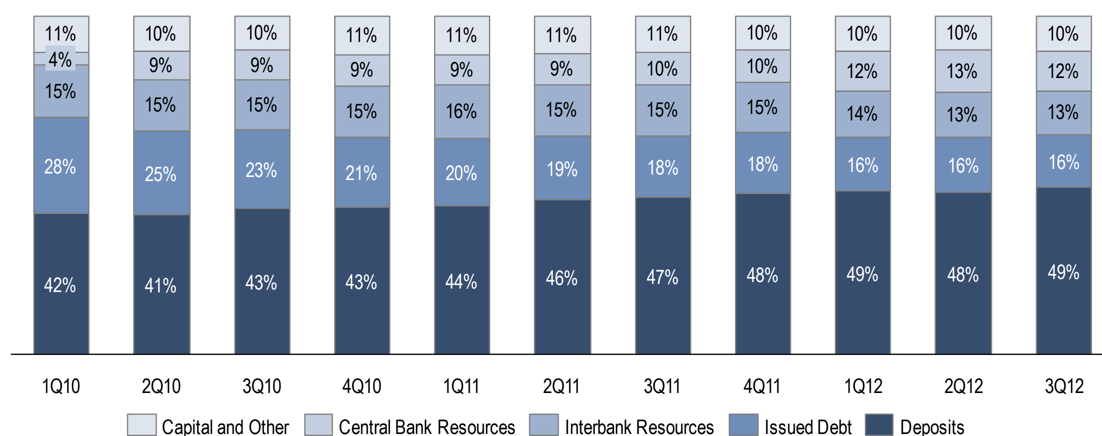
The banking sector's operational environment remains particularly adverse. Over the past two years, banking institutions have faced the combination of a recessive macroeconomic juncture and profound changes in the regulatory framework, while risk perceived by international financial market players remained at high levels.

However, the path followed by the banking sector in the last quarters can be characterised by the successful achievement of several decisive phases in strengthening the liquidity and capital position, which has resulted in this sector's increasing resilience.

The fact that Portuguese banks could no longer access capital markets from the first quarter of 2010 placed increased pressure on the banking system's liquidity situation. As a considerable part of the assets on the balance sheet of most Portuguese banks was funded by debt issued by the markets in addition to deposits, the exit of private investors led to the need to find alternative funding sources.

The evolution of the banking sector's funding structure shows the growing weight of deposits and central bank funding, compared with a sharp decrease in the proportion of debt securities issued (Chart 5).

Chart 5: Developments in the banking sector's funding structure
As a percentage of assets



Source: Banco de Portugal.

The increase in deposits and their proportion in the banking sector's funding structure is one of the most positive aspects regarding the evolution of the banking system in the last two years (Chart 6). On the one hand, because it shows depositors' confidence in the soundness of the

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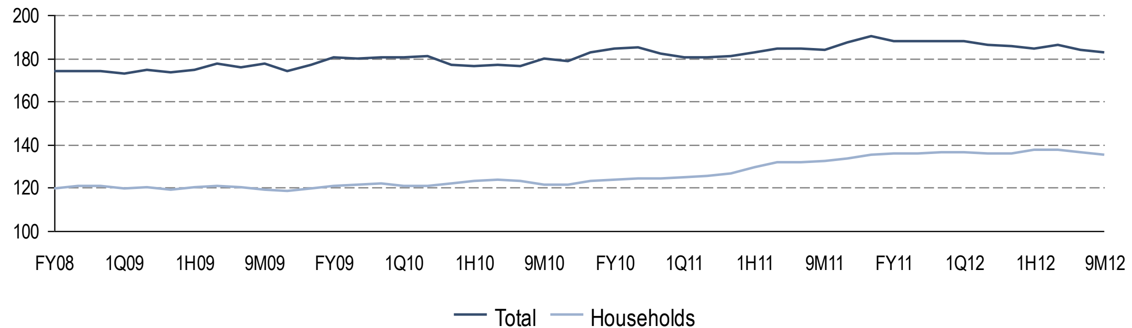
banking system and, on the other, because it contributes to the adjustment of an imbalance identified in the balance sheet of banks, in order to give them a more stable funding source.

Chart 6: Developments in private sector deposits in Portugal
€ billion

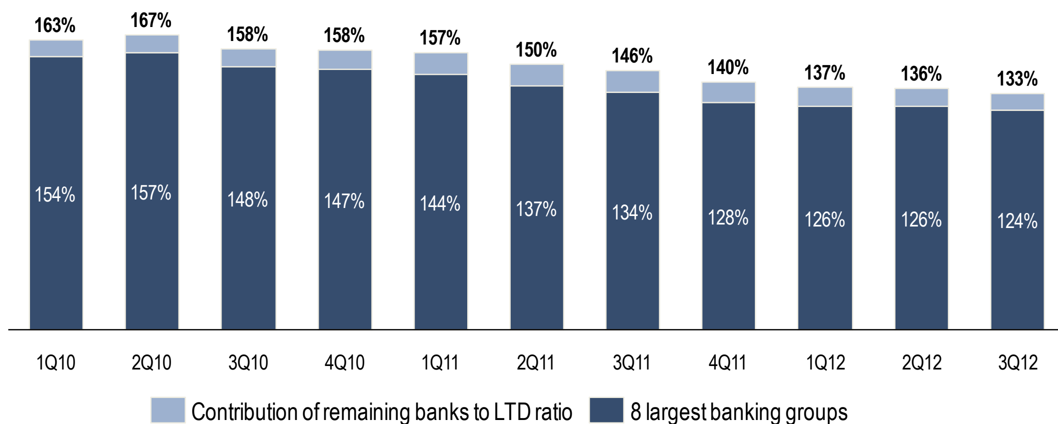


Source: Banco de Portugal.

Between late 2008 and September 2012, private sector deposits grew 4.9% in Portugal, with a strong contribution from households, with a growth rate of 13.2%. From June 2010 until the end of September 2012, private sector deposits grew 3.8% in cumulative terms, supported by the household sector (10.1% rise).

The transformation ratio registered in the banking system thus shows a clear downward trend (Chart 7). The eight largest banking groups show a sustained decline in the loan-to-deposit (LTD) ratio, from 157% in June 2010 to 124% in September 2012. The change in the LTD ratio between June 2010 and September 2012 resulted from 13% growth in consolidated deposits (including international activity) combined with a decrease of 10% in net credit.

Chart 7: Developments in the loan-to-deposit ratio
Ratio between loans net of impairment and customer deposits

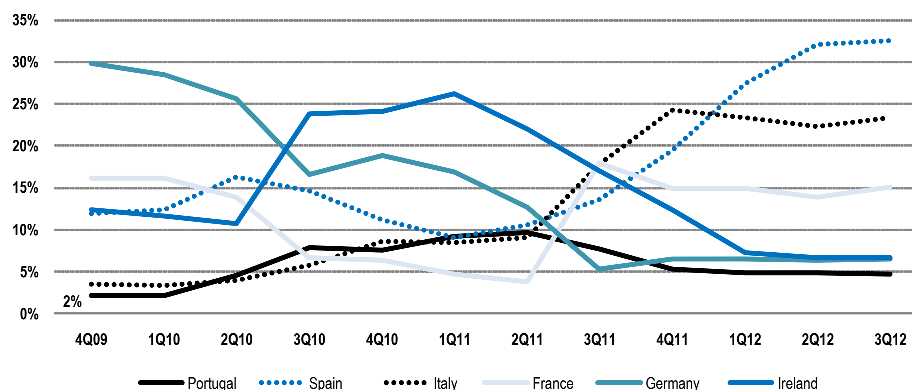


Source: Banco de Portugal.

Funding by the Eurosystem was also essential in supporting banking system liquidity. Representing only 4% of assets at the end of the first quarter of 2010, funding by the ECB more than doubled its share in funding in the second quarter of 2010 and maintained an upward trend until the beginning of 2012, then stabilising at around 12% of assets. Unlike in other countries, the proportion of funding used by the Portuguese banking system in Eurosystem financing as a whole has seen a remarkable stability (around 5%) since the end of 2011 (Chart 8)

Chart 8: Developments in share of Eurosystem financing by country

As a percentage of total financing granted by the Eurosystem



Source: Banco de Portugal.

The Eurosystem's three-year longer-term refinancing operations, as well as the temporary easing of eligibility criteria of assets to be used as collateral in the Eurosystem's monetary policy operations, allowed for considerable enhancement of the national banking system's liquidity and collateral buffers.

As described with more detail in Section 2, the institutions have also strengthened the prudential capital ratios. In September 2012, the system had a Core Tier 1 ratio of 11.3%, higher than the required 10% due at the end of the year (Chart 9).

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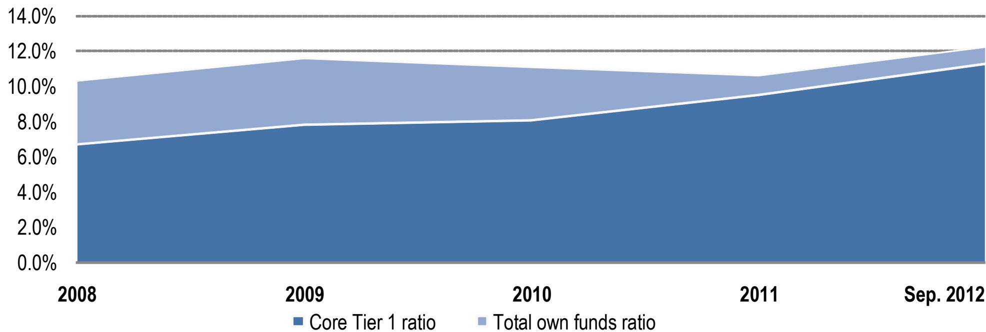
Chart 9: Developments in the solvency ratios

Total solvency ratio and Core Tier 1 ratio



Source: Banco de Portugal.

The evolution of the total solvency ratio's composition attests to the sustained improvement of the quality inherent in the banking system's capital ratio, which is virtually composed of Core Tier 1 capital. The heightened emphasis on the Core Tier 1 ratio by regulators and markets (by contrast to Tier 1 or Tier 2 ratios), in addition to the above-mentioned recapitalisation operations, led to the conduct of liability-management operations, which converted instruments with lower degree of subordination into higher quality capital instruments.

Thus, the improvement in liquidity and capital led to increased confidence in Portuguese banks. One of the most striking developments observed in recent months relates to senior debt issuance by BES and CGD. Although with high final prices (cost just under 6%) and relatively small amounts, these operations send a strong signal to external markets that Portuguese banks regained access to financial markets for unsecured funding.

The 10% reduction in net credit recorded between June 2010 (which coincides with the highest value of the LTD ratio) and September 2012 is explained in part by the institutions' provisioning effort (loans before impairment decreased by 8%) and the sell-off, especially in 2011, of the loan portfolios by segments, such as project finance (loans to non-residents).

Over the same period, the total assets of the financial system fell by 6%. The financial assets held in the securities portfolios (trading, available for sale and held to maturity) decreased by 2%. The securities portfolios represented 16% of total assets in September 2012, a proportion similar to that recorded in June 2010. The evolution of the credit quality points out a clear deterioration of credit risk ratios, which have been rising steadily, particularly since the beginning of 2011 (Chart 10).

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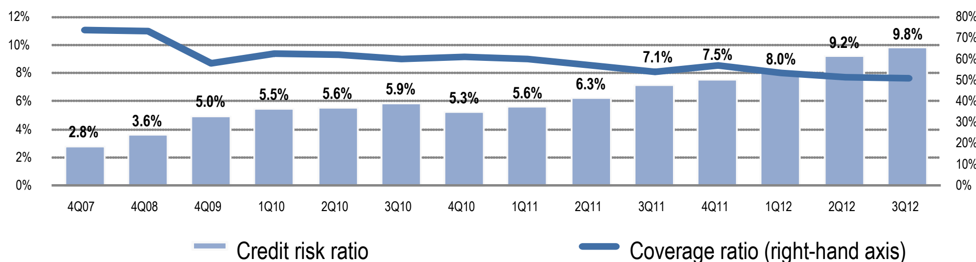
Chart 10: Developments in the banking system's credit quality
Credit risk ratio and credit risk coverage ratio

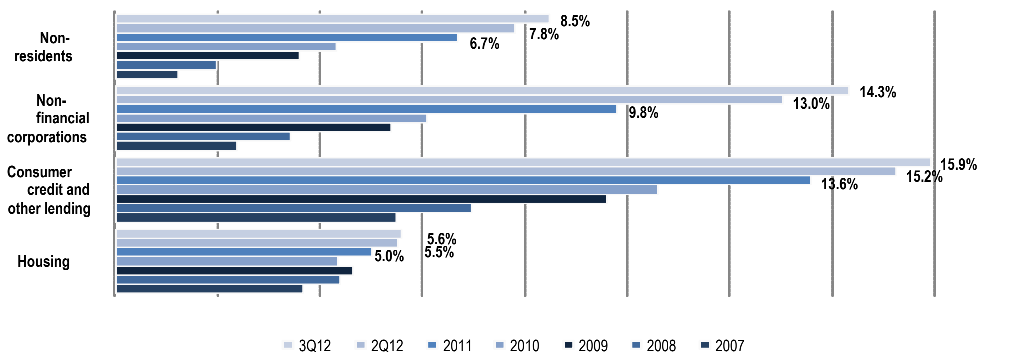


Source: Banco de Portugal.

The deterioration of the loan portfolios has been driven, in particular, by the corporate loan segment, as the levels of arrears in the housing segment have been stable and relatively low (Chart 11). The consumer credit and other lending segment, although with high levels of arrears, represents a small proportion of the banking system's total loan portfolio.

Note that an analysis of the information reported to the Central Credit Register of Banco de Portugal suggests that the majority of loans to non-financial corporations matured in late 2012 had been contracted in the 2006-2009 period. Companies with overdue loans are mostly micro and small businesses, established for ten years or more. In terms of economic activity, overdue loans are concentrated in companies in the construction and real estate sectors.

Chart 11: Developments in the banking system's credit quality
Credit risk ratio by segment



Source: Banco de Portugal.

Banco de Portugal has launched a number of initiatives to determine the major financial groups' impairment adequacy (Special Inspections Programme and On-site Inspections Programme), as well as the loan portfolios' degree of restructuring (update of Instruction of Banco de Portugal No 18/2012), which has allowed for a better assessment of the real evolution of the loan-loss ratio (Section 3 and Annex II).

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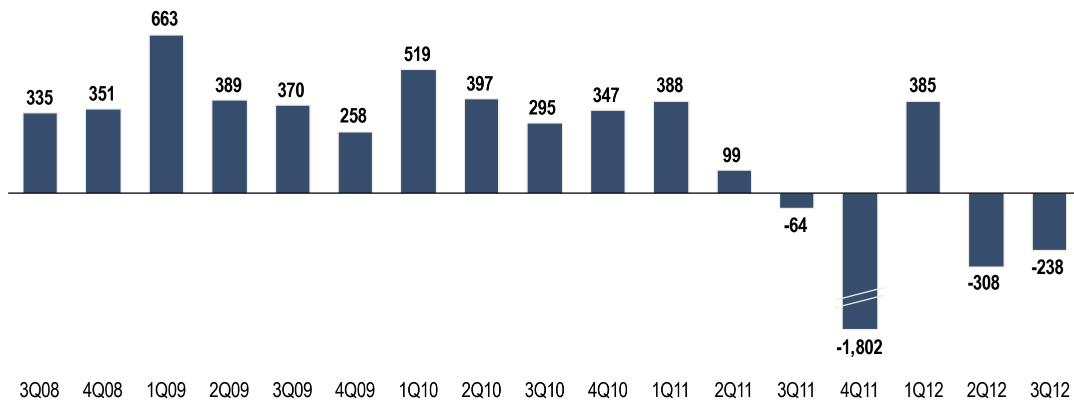
Challenges

The deteriorating rates of return reflect not only the strong increase in impairment levels, but also a clear pressure on the sector's more structural revenue, particularly on net interest income (Chart 12).

Chart 12: Developments in the banking system's net profit
Net quarterly profit (€ million)



Source: Banco de Portugal.

In fact, net interest income has been heavily penalised by historically-low (short-term) interest rates, which are very close to zero. Additionally, the increased cost of domestic funding (whether the structurally more expensive deposit base or the need to use the State recapitalisation through hybrid instruments), the contraction of the banking system's balance sheet and some pressure on margins from international activities were also determinant to the decrease in net interest income.

The estimates contained in the funding and capital plans submitted to Banco de Portugal show that the results generated by the banking sector are likely to remain under pressure in the coming quarters (mainly through net interest income and impairment).

The answer to the profitability challenge requires action on three complementary fronts:

- Better use of resources to achieve a structural reduction in costs;
- Search for solutions to reduce the burden on banks' balance sheets of the mortgage loans contracted with tight spreads and to free up liquidity for new activity;
- Search for strategic partners with available capital and willingness to invest.

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ANNEX I
Credit institutions' public capitalisation principles

1. The general principle of adequacy, proportionality and need for credit institutions' capitalisation through public funding, can be broken down into four aspects:

- Recapitalisation through the State shall be deemed necessary so that the institution maintains adequate capital, above the solvency ratio determined by the authorities;

- The institution to be recapitalised must prove its feasibility at the economic and financial level and the sustainability of its business in the medium and long term (under the assumptions of the recapitalisation plan, which may include changes in the respective business model);

- Recapitalisation shall represent the least costly solution for the State, when compared with other possible alternatives intended to ensure financial stability;

- The operation shall ensure the appropriate conditions for the occurrence of public disinvestment within the period corresponding to the recapitalisation plan.

2. The principle that the credit institution continues to be managed by its private shareholders (minimum intrusion into the institutions' day-to-day management), where the State shall ensure the remuneration of the capital invested and create the conditions for repayment of its financial effort ensured by the non-executive directors or members of the supervisory boards appointed by it.

The State, however, as special shareholder, may exercise its voting rights in decisions of a strategic nature for the institution, such as mergers, acquisitions and general changes to the statutes.

In turn, when the State's stake exceeds a 50% capital threshold, the State may exert its full voting rights inherent in its shareholding, relating to the share exceeding that threshold. A draft amendment to Law No 63-A/2008 will soon be submitted, revoking the threshold currently preventing the State from holding the majority of the institutions' voting rights.

3. The principle of stability and predictability of the relationship between the State and the institution and its shareholders during the period agreed for the recapitalisation plan, through a set of rights and duties (obligation with regard to the means employed and obligation of result) providing a balance based on two key imperatives: the need to ensure financial stability and the need to ensure adequate remuneration and public disinvestment by the end of the period specified for the recapitalisation operation.

The duties required of the institution include the obligation: to implement any defined strategic changes and/or adjustments to the business model and group structure where the institution is included; to provide information on the developments of the assets and liabilities; to adopt principles of good governance; to observe the rules agreed on the remuneration policy of board members; to implement measures in order to avoid competition distortions (including the limitation of new acquisitions during the public investment period); to reduce structural costs with a view to speed up the return to financial balance; and to contribute to the financing of the

economy (although the rules on deleveraging may in practice restrict the extent of this obligation with regard to the means employed).

The decision to pay dividends shall also be subject to approval by the member of Government responsible for finance.

4. The principle that, following a materially significant failure to implement the recapitalisation plan, the relationship created with the approval of the public capitalisation plan undergoes deep modification, leading to the State using its powers as shareholder to the full, becoming free to divest the shares it holds in full or in part to whomsoever it wishes as a result of the institution's default, irrespective of legal preference rights (necessary intrusion of the State into the institutions' day-to-day management).

5. The principle that the State's participation in the capital (acquisition price or share subscription price, significantly discounted from market price) should protect the State's financial interest, whereas the conditions for the sale of shares may offer an incentive for repurchase by private investors, provided that the appropriate remuneration of public capital is guaranteed, according to the relevant Community rules and guidelines.

In particular, the conditions for the State's exit shall contain an incentive for the repurchase of the State's shares by private investors. This will be all the more necessary, the greater the size of the recapitalisation operation and the higher its risk profile (for instance, a ceiling on the State's value added, which will be converted into a discount over the price share as at the time of public disinvestment).

6. The principle of safeguarding competition conditions, through rules ensuring consistency with the Community's State aid scheme and preventing competition distortions, including the prohibition of aggressive commercial strategies, ceilings on the remuneration of board members, limits on the distribution of dividends to private shareholders and prohibition of acquisition of shareholdings in other corporations.

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ANNEX II

Across-the-board inspection programmes

Developments in Banco de Portugal's supervision model, as regards the more intrusive nature of its relationship with institutions under its supervision, are particularly expressive in recent exercises: the Special Inspections Programme and the On-site Inspections Programme.

SPECIAL INSPECTIONS PROGRAMME (SIP)

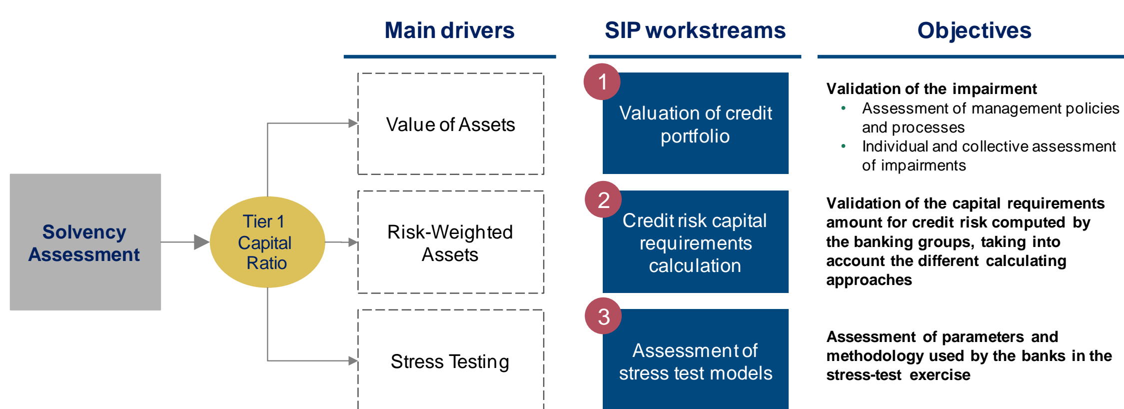
Under the EFAP, Banco de Portugal was responsible for designing a special inspections programme (SIP), with the aim of validating the data underlying the quarterly solvency assessment of the eight major banking groups of the Portuguese banking system, covering the following workstreams (Chart 1):

1. Analysis of the banks' credit portfolios as at 30 June 2011, to confirm that impairment levels, impairment calculation models and associated policies and processes are appropriate;

2. Revision of the credit risk capital requirements calculation process;

3. Assessment of the methodologies and parameters regularly used by banks in stress-test exercises.

Chart 1: SIP Scope



Source: Banco de Portugal.

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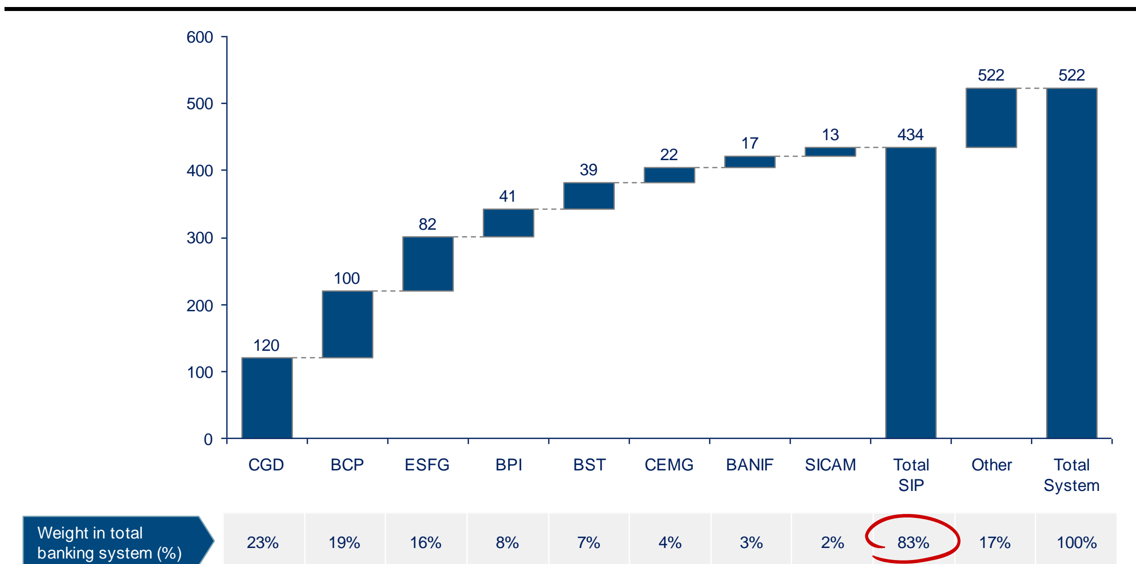
The SIP comprised , on a consolidated basis, the eight largest Portuguese banking groups: Banco Comercial Português (BCP), Banco BPI (BPI), Caixa Geral de Depósitos (CGD), Espírito Santo Financial Group (ESFG), Caixa Económica Montepio Geral (CEMG), Santander Totta (BST), Rentipar Financeira (BANIF) and the Integrated Mutual Agricultural Credit Scheme (SICAM). The assets of these groups represent more than 80% of total assets of the Portuguese banking system (Chart 2).

Chart 2: Banking groups covered by the SIP

Assets on a consolidated basis as at June 2011 (€ billion)



Source: Banco de Portugal.

Considering the objectives, scope and schedule defined, work for the valuation of credit portfolio and adequacy of the methodologies and parameters used in stress-test exercises has been conducted in close cooperation with Banco de Portugal, through specialised external services. The valuation of credit portfolios has been ensured by Ernst & Young Audit & Associados – SROC, S.A. and Pricewaterhouse Coopers & Associados – Sociedade de Revisores Oficiais de Contas, Lda. Stress-test exercises, in turn, have been assessed by Oliver Wyman. The valuation of credit portfolios, the calculation of capital requirements and the assessment of parameters and methodologies used in stress-test exercises have involved around 350 people, from amongst auditors, consultants and Banco de Portugal staff.

The implementation of the programme has been monitored by a Steering Committee chaired by Banco de Portugal, consisting of representatives of the International Monetary Fund, the European Commission, the European Central Bank, and three EU supervisory authorities - Banco de España, Autorité de Contrôle Prudentiel (France) and Banque Nationale de Belgique - and also Banco de Portugal.

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Overall results

SIP results have chiefly validated the correction of data underlying the evaluation of solvency as at 30 June 2011, confirming the resilience and financial soundness of the Portuguese banking system as at that date.

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

Some aspects that could introduce improvements have been identified across all participating banking groups. Banco de Portugal has therefore required the adoption of appropriate corrective measures, with clearly defined priorities and implementation deadlines. Banco de Portugal has adopted procedures for regularly monitoring the implementation of the corrective measures, based on a calendar agreed with the banking groups.

Assessment of credit portfolios

Audit firms have analysed the individual impairment levels of a judgmental sample, covering the 50 economic groups with higher credit exposure to any of the banking groups, as well as other groups and entities whose exposures have been selected based on a wide set of credit risk indicators. Where necessary, independent experts have reassessed the value of the assets pledged as collateral of the loans in the sample. As a whole, 5,516 borrowers and 61,531 credit files, covering more than 50% of eligible credit portfolios, were the object of individual analysis.

As regards impairment assessed though collective analysis, the auditors evaluated the assumptions, methodology and historical background of the information incorporated in the model supporting the respective calculation in each banking group. Sensitivity reviews have also been made to the main parameters and impact estimates of the main opportunities for improvement identified.

Moreover, credit risk management policies have been reviewed, including main control procedures, with special emphasis given to the evaluation of guarantees and problematic loans.

Work undertaken has made it possible to conclude that the credit risk management policies and respective control procedures are broadly appropriate, although some opportunities for improvement have been identified.

As at 30 June 2011, estimates pointed to the need for an increase of €838 million in the impairment value of the credit portfolio under review (not considering impairment buffers existing on that date), in order to reach robust provisioning levels. This amount corresponded to 0.3% of the overall amount of credit analysed.

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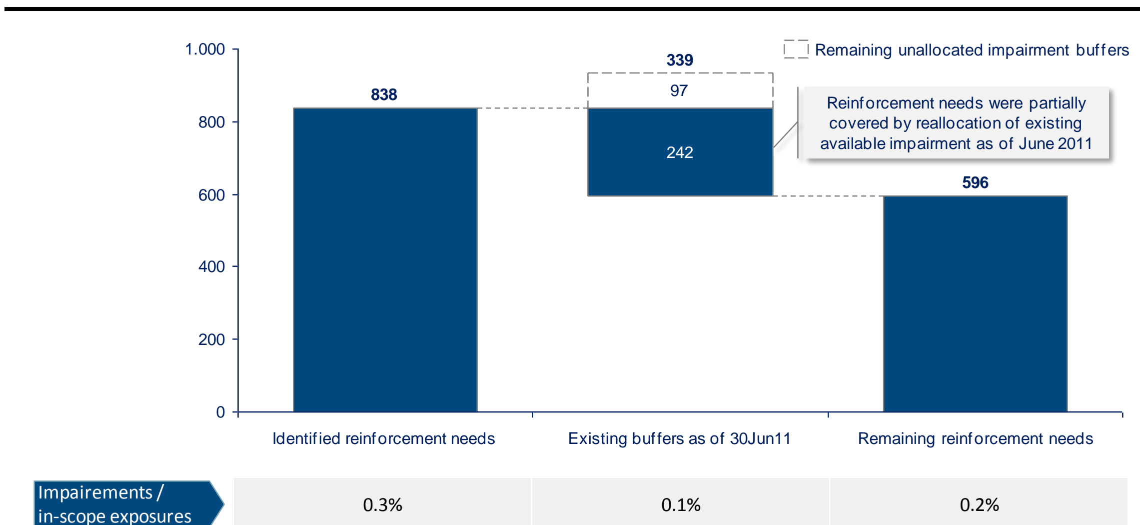
The effect on total impairments of the eight banking groups as a whole, however, was smaller, since the abovementioned increase was partially offset (€242 million) by the allocation of impairments identified as available on 30 June 2011, as regards the overall credit portfolios, totalling €339 million. In addition, in the third quarter of 2011, the eight banking groups registered an impairment increase of €208 million in some of the exposures where an impairment increase was necessary (Chart 3).

Chart 3: Impairment increase as a result of the SIP

Identified needs and reinforcements (€ Million)



Source: Banco de Portugal.

Revision of the capital requirements calculation process

The validation of the calculation of capital requirements involved the collection and validation of relevant data on every one of the eight banking groups and a new calculation of the requirements through a tool especially designed for the purpose.

Work on this workstream of the SIP has been carried out by Banco de Portugal's teams and has included a revision of the calculation of credit risk capital requirements (which represent around 90% of capital requirements for the eight banking groups).

Banco de Portugal has reviewed approximately 16.6 million credit agreements / exposures, relative to around 7.7 million debtors, incorporating the effect of the application of 2.3 million risk mitigation techniques.

As regards the revision of the calculation of credit risk capital requirements, work has pointed to the need for specific adjustments, which, as at 30 June 2011, totalled around 0.6% of the total value estimated of those requirements in the eight banking groups as a whole.

Banco de Portugal has also reviewed the management and risk control procedures underlying the calculation of risk-weighted assets and has concluded that they are broadly appropriate.

Evaluation of stress-test methodologies and parameters

Workstream 3 of the SIP was based on a forward-looking approach, with a view to evaluating the adequacy of parameters and methodologies used by banks in financial projections underlying the evaluation of their future solvency.

Work conducted has made it possible to classify banking groups as follows:

- Institutions using clearly appropriate parameters and methodologies: two banking groups;
- Institutions using appropriate parameters and methodologies: one banking group;
- Institutions using appropriate parameters and methodologies in most aspects under review, although requiring improvements in a few areas: four banking groups;
- Institutions requiring improvements in a range of specific areas, so that the parameters and methodologies used may be considered appropriate: one banking group.

ON-SITE INSPECTIONS PROGRAMME (OIP)

In 2012 (between July and November), within the scope of regular prudential supervision activity, it was decided to develop an On-site Inspections Programme (OIP) on the exposures of the eight largest banking groups to the construction and real estate sectors in Portugal and Spain, with the aim of assessing the adequacy of impairment levels to the exposures to these activity sectors, as at 30 June 2012.

The definition of exposures covered by the OIP was sufficiently widened to include exposures to entities other than those directly engaged in the construction and real estate sectors. Therefore, it also included exposures to (i) holdings of the former entities, (ii) entities in the tourism sector, (iii) entities whose activity is closely related to the construction sector (chiefly suppliers) and (iv) in order to capture contagion effects, entities belonging to the same economic group, whenever the previously selected entities' exposure represented more than 25% of the overall exposure of their economic group.

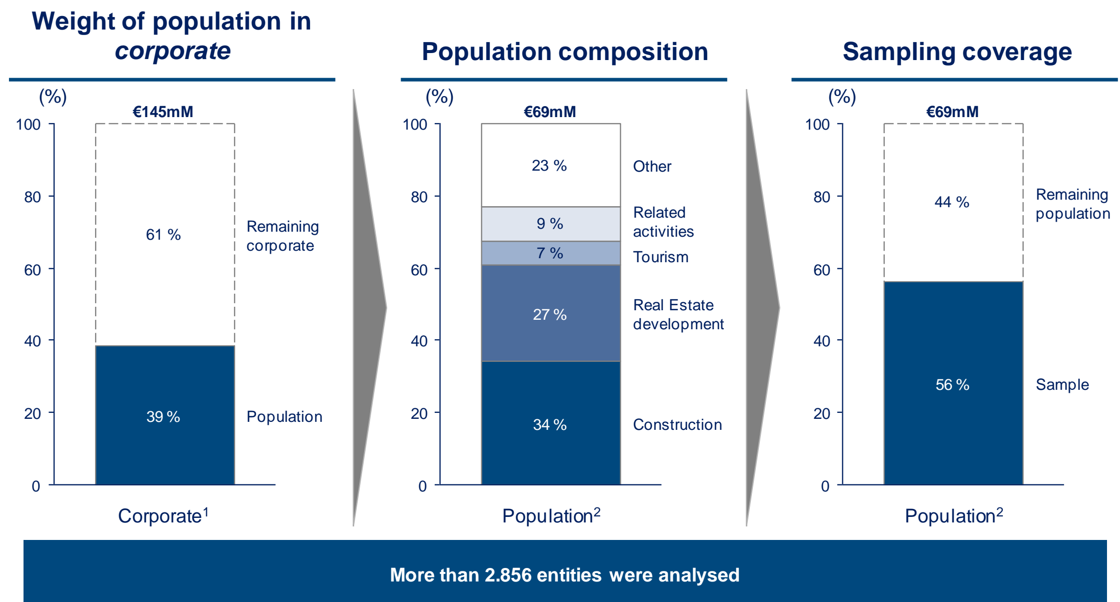
As regards the eight banking groups as a whole, total exposures in scope (population) amounted to €69 billion (61% in the construction and real estate sectors, 39% in other related entities), their total representing around 40% of credit to non-financial corporations (Chart 4).

For the purpose of analysing the amounts of impairments registered, a judgmental sample of 2,856 entities, with an aggregate exposure of €39 billion, was extracted from the population. This sample accounted for 56% of the population (Chart 4), and the sampling selection criteria were designed to capture the cases with higher probability of insufficient impairment levels. The sample also included 20 entities with no signs of deterioration (the largest 10 plus other

random 10) in order to indicatively assess the adequacy of the impairment levels registered in the share of the population not included in the sample.

Chart 4: Sample of the exposure under review in the OIP

As a percentage of the population in the sample



Source: Banco de Portugal.

The evaluation of the impairment levels registered for the exposures in the sample was based on an across-the-board methodology, in order to ensure a homogeneous treatment of all groups covered by the OIP. Especially, evaluations of assets pledged as collateral relating to the credits under review to be submitted by the institutions shall bear a date subsequent to 21 December 2011. As a result, a significant percentage of existing evaluations has been updated.

For the eight banking groups as a whole, as at 30 June 2012, estimates pointed to the need for an increase of €861 million in the value of impairments registered for the exposures under review, in order to reach robust provisioning levels (approximately 2.2% of the overall amount of the exposures reviewed).

€472 million of the above €861 million were the result of the analysis of information and events subsequent to the reference date, such as new insolvencies/bankruptcies and associated collateral re-evaluations (see Chart 5, left-hand side).

As at 30 June 2012, the impact of the results of the OIP on the Core Tier 1 aggregate ratio of the eight banking groups as a whole would translate into a slight adjustment of its value from 11.2% to 11.1%, well above the 9% minimum required as at that date.

The impairment increases built by banking groups up to 30 September 2012 covered part of the identified need for impairment increases, reducing their amount from €861 million to €474

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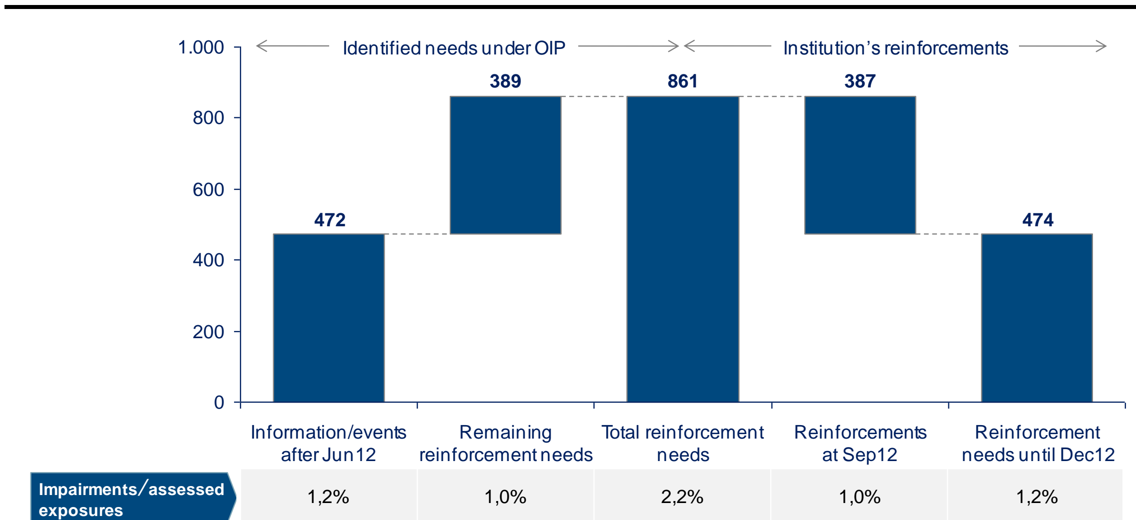
million. The increase of this latter amount must have been made by the institutions by 31 December 2012 (see Chart 5, right-hand side).

Chart 5: Impairment increase as a result of the OIP

Identified need for impaiment increase and its build up by the institutions (€ Million)



Source: Banco de Portugal.

The estimated impact of this impairment increase on the Core Tier 1 aggregate ratio projected for 31 December 2012 for the eight banking groups as a whole is immaterial, and does not jeopardise compliance with the minimum regulatory 10% required by Banco de Portugal since the end of 2012.

ANNEX III

Strengthening of the legal and regulatory framework

In the context of the measures to strengthen the regulatory framework applicable to institutions which comprise the financial system, it is important to highlight the following:

Preventive, corrective and resolution regime

A commitment has been undertaken under the EFAP to strengthen the preventive, corrective and resolution mechanisms applicable to credit institutions under financial distress. For this purpose, Banco de Portugal has actively participated in the preparation of draft legislation allowing for these goals to be reached.

The new system, substantiated in the changes introduced in the Legal Framework of Credit Institutions and Financial Companies (hereinafter referred to as Legal Framework) by Decree-Law No 31-A/2012 of 10 February, has established three different intervention stages: (i) corrective measures, (ii) interim administration and (iii) resolution. The assumptions for their implementation differ depending on the risk seriousness or noncompliance level by a certain institution, the legal and regulatory rules governing its activity, as well as the extent of the potential consequences for the interests of the depositors and/or the stability of the financial system.

As regards corrective measures, the system to be introduced essentially preserves the contents of the reorganisation measures previously laid down in the Legal Framework, but anticipating the timing for their application by Banco de Portugal, in order to ensure their timely and effective implementation.

In turn, the new **interim administration** concept (or possible stage of the sequence of measures to be adopted) is characterised by the possibility that Banco de Portugal may determine the full suspension of the management board of a credit institution and appoint new members, when any situation occurs that may seriously jeopardise the financial soundness or solvency of the institution or constitute a threat for the financial stability of the financial system. The implementation of such measures, according to the Legal Framework, is strongly associated with the detection of (or sufficient grounds to suspect) serious irregularities in the management of the institution, serious and continuous breach of legal or regulatory rules, or the observation that the shareholders or the members of the management board of the institution are unable to ensure sound and prudent management or to financially recover the institution.

Finally, the application of **resolution measures** (or resolution stage) represents a new paradigm of intervention in the institutions facing serious financial imbalances, thereby preventing totally undesirable scenarios of disorderly winding-up or possible nationalisation, with the inherent costs for public funds. In this field, the law establishes the possibility of implementation of two measures:

- Total or partial sale of business to another institution authorised to carry on the activity in question;

- Total or partial transfer of the business to one bridge bank especially created for the purpose.

The resolution measures, however, which are deemed to be last resort measures, can only be implemented where necessary to prevent systemic contagion or possible negative impacts at the financial stability level, minimise costs for public funds, safeguard depositors' confidence or ensure the continuity of essential financial services. In turn, when applying resolution measures, the Bank shall seek to ensure that the shareholders and creditors of the credit institution (excluding guaranteed deposits) first bear the losses, thus avoiding further moral hazard situations.

Banco de Portugal shall decide, on a case-by-case basis, on the type of intervention to be adopted, depending on which is more appropriate to the central objectives of the institution´s financial rebalancing, the protection of depositors and the stability of the financial system, also considering the possible impact on public funds. The Bank's decision will naturally be subject, aside from the respective application assumptions, to the general principles of their need, adequacy and proportionality.

More recently, the Legal Framework has been amended (by the 2012 supplementary budget law), allowing for the application of resolution measures in holding companies (financial holding companies or other parent undertakings of credit institutions), provided that such application is necessary for the efficient implementation of those measures and to preserve, to the extent deemed possible, the value of the financial group in question.

Resolution Fund

The application of a resolution measure tends to imply, in most situations, financing needs that are met through recourse to funds exogenous to the institution subject to such measure, as its financial situation is characterised by a severe imbalance. Therefore, in line with the proposals discussed at the European and international level, and with the solutions recently introduced in other EU legal frameworks, a Resolution Fund has been created, with the main purpose of providing financial assistance to the implementation of resolution measures. It will be chiefly financed by the institutions subject to those measures (member credit institutions).

Although the Legal Framework defines the main features of the system applicable to the Resolution Fund, two legal acts essential for the Fund's activity, should be highlighted.

First, Executive Order No 420/2012 of 21 December that approves the Regulations governing the Resolution Fund, which define the Management Committee's remit and establish the Fund's broad operational guidelines.

Second, the draft Decree-Law that is pending its final approval, enshrining the regime applicable to the definition of initial, periodical and special contributions to be paid by member institutions. Although the Fund's financial resources result mainly from initial and periodical contributions paid by the respective member institutions, as well as from proceeds obtained

from the contribution over the banking sector (created by Law No 55-A/2010 of 31 December), the law sets out that, when the Fund's existing financial resources are insufficient to fund a resolution measure, the Fund may obtain special contributions to be paid by member institutions, under conditions to be defined by an Executive Order of the member of Government responsible for Finance. These special contributions, however, cannot exceed amounts liable to lead other, or any of the other member institutions to non-compliance with the solvency ratios, as this would trigger the opposite effect to that envisaged by the Fund's intervention, in terms of ensuring financial stability. Under certain circumstances, member institutions may pay the respective special contributions in instalments, or partly replace cash payments with irrevocable payment commitments against values pledged as collateral in Eurosystem's monetary policy operations.

In addition, the law may determine that, aside from special contributions, member institutions must provide securities *in rem* and personal guarantees that the Fund needs to obtain loans.

The relevance of this law derives from the need to provide the Resolution Fund with the appropriate financial resources required to finance the implementation of resolution measures that may be adopted by Banco de Portugal. Although the payment of initial, periodic and special contributions to the Fund may be an additional liability for member institutions, within the scope of a particularly difficult situation, the resolution measures – and thus the Resolution Fund – aim to safeguard public interest, essential to maintain financial stability, by mitigating and containing systemic risk that could ultimately result from the collapse of a given financial institutions, producing adverse contagion effects on the other institutions and the whole system.

Deposit Guarantee

Decree-Law No 31-A/2012 of 10 February has also strengthened the system governing the Deposit Guarantee Fund, by limiting and clarifying its purpose, especially by establishing that the Fund's resources cannot be used for purposes other than the repayment of eligible deposits, up to the limits of the guarantee, or the transfer to third institutions of deposits with a credit institution which has been subject to resolution measures (in this case subject to a maximum limit equal to the amount that the Fund would have to disburse, in order to ensure the repayment of the guaranteed deposits).

The Fund's means of financing were also strengthened, particularly when the Fund's resources seem to be insufficient for compliance with the respective obligations. In this case, the law envisages the possibility that the Fund may, inter alia, obtain securities *in rem* and personal guarantees from member institutions, similarly to the system to be adopted for the Resolution Fund.

The new legal regime has also established preferential claims in respect of deposits covered by the Fund's guarantee, as well as claims of the Fund arising from repayment procedures and the financial support provided for the application of resolution measures. These preferential claims increase the possibility of recovery of amounts disbursed, contributing to strengthening the Fund's capitalisation.

Credit institutions' liquidation regime

Decree-Law No 31-A/2012 of 10 February also revised the liquidation regime of institutions subject to Banco de Portugal's supervision. Among the changes introduced, the following should be highlighted:

- The creation of pre-judicial proceedings, namely to better ensure the urgent actions and operations required for the continuity of the vital functions of the credit institution and the preservation of its assets, or to safeguard the stability of the financial system, naturally excluding the actions that, for their very nature, are exclusively judicial;

- Banco de Portugal may require the insolvency of the controlling or manager company, if it has grounded reasons to conclude after scrutinising the net asset position of the controlled credit institution in liquidation, that the assets of the controlling or manager company will likely be insufficient to cover its own liabilities, plus the liabilities of the controlled credit institution. That is, in case the credit institution or banking group controlled by a financial holding have gone into liquidation and the respective assets do not cover liabilities, the holding shall be forced into a liquidation process, in order to dampen the losses undergone by the creditors of the controlled credit institutions.

Recovery plans - Notice No 12/2012

The Legal Framework stipulates that authorised deposit-taking institutions must submit to Banco de Portugal a recovery plan on an annual basis, with a view to identifying measures which could be adopted to correct in a timely manner a situation of a credit institution which is or is likely to be in financial distress.

The purpose of the legislator is to contribute to financial stability, obliging credit institutions to prepare a preventive response to financial crisis situations, thus ensuring that they are in a position to respond faster, but also in a more structured manner, to situations of financial distress.

In this context, Notice of Banco de Portugal No 12/2012 regulates the contents of the recovery plans envisaged in the Legal Framework, as well as the complementary rules necessary for the enforcement of the legal regime. In this regard, the contents of this Notice follow closely the Proposal for a Directive establishing a framework for the recovery and resolution of credit institutions and investment firms, currently under preparation by the European Council.

Resolution plans – Notice No 18/2012

Under the Legal Framework, credit institutions authorised to take deposits shall submit to Banco de Portugal the necessary information so that it may adequately plan the resolution measures to be applied to a credit institution.

This regular exercise will enable Banco de Portugal to detect in advance, under normal business conditions, potential constraints – of a legal or operational nature, or resulting from the

business model adopted by the credit institution – to the application of the corrective or resolution measures envisaged in the Legal Framework. Banco de Portugal is authorised by law to remove such constraints, particularly by:

- Imposing changes to the corporate and legal structure of a credit institution or of the group to which it belongs; or
- Ring fencing between financial and non-financial activities or, within the scope of financial activities, between retail and investment activities.

These measures will contribute to ensure that, if needed, critical functions are preserved through their legal and economic separation within the framework of resolution tools (for instance, through the partial sale of their business).

In turn, Notice of Banco de Portugal No 18/2012 specifies the contents of information to be provided by the institutions to Banco de Portugal, as well as the other complementary rules required for the implementation of the legal regime laid down in the Legal Framework. Similarly to the Notice on the recovery plans, it was also decided to submit in advance the list of information envisaged in the Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms, even though other information, deemed essential to pursue the objectives of the resolution plans, must also be provided.

Finally, institutions are required to update, at least on an annual basis, the information items in their resolution plans, and Banco de Portugal shall seek to confirm the truthfulness of the items submitted by the institutions and their capacity to update and maintain the integrity and permanent availability of the information sources used.

Bridge banks – Notice No 13/2012

Banco de Portugal defined, by means of Notice No 13/2012, the rules applicable to the setting up and operation of bridge banks. It regulates their establishment, submitting them to certain guiding principles for their activity, and establishes a set of rules applicable to their operation. This Notice defines bridge banks' structure, the procedures of appointment and dismissal of the members of the management and supervisory boards and the competences of the management board, which shall be responsible for preparing and presenting regular reports to Banco de Portugal. This Notice also determines which assets bridge banks' management boards will be allowed to sell in the exercise of their management powers, and the respective conditions.