FINANCIAL STABILITY REPORT

November 2014

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Content

Overview

In May 2014 Portugal concluded the Economic and Financial Assistance Programme (EFAP). During the Programme's three years, a set of important adjustments was made in the Portuguese economy regarding fiscal consolidation and deleveraging of the non-financial private sector, with a significant impact on the deleveraging of the banking sector and the correction of the external imbalance. Financial system supervision and the solvency of credit institutions were enhanced and structural reform was introduced, with a view to boosting potential economic growth.

In spite of the progress made, vulnerabilities remain in the Portuguese economy that may amplify the consequences of financial stability risks coming to fruition. Such vulnerabilities require the continuation and, in some areas, the deepening of the adjustment process.

These vulnerabilities include low potential growth of the Portuguese economy. In recent quarters economic activity and labour market conditions improved. However, the low growth rates observed and forecast for the near future, in tandem with low inflation levels, represent a challenge for the activity and profitability of the financial sector.

In addition to the low economic growth, indebtedness levels in the private and public sectors are high, constraining economic growth further. One of the greatest challenges now is to carry out an adjustment process that promotes deleveraging in the various sectors of the Portuguese economy while at the same time promoting growth. This should be based on investment in sectors with high productivity levels and sustainable demand. The banking sector must play a key role in the reallocation of resources to the sectors mentioned. This is a critical factor for the success of the adjustment process in the Portuguese economy.

However the various resident sectors have behaved differently.

Among households, the savings rate has increased significantly and indebtedness has declined. The adjustment was notable, given that it occurred within a context of declining disposable income.

Non-financial corporations developed less positively than households. For a significant set of corporations, indebtedness levels are still excessive. This has a considerable impact on the investment required to stimulate potential growth in the Portuguese economy.

As regards the public sector, the structural balance underwent an unprecedented adjustment under the EFAP. However, the high levels of public debt allow no easing of the fiscal consolidation effort.

The banking sector's liquidity and solvency situation improved significantly and the adjustment in the other sectors resulted in the deleveraging of the credit institutions. However, fragilities remain over the sustainability of the financing structure and the recovery of profitability.

To promote economic growth, it is essential to continue structural reform, whose scope, in some instances, may have fallen short of the targets originally set. This process is essential for increasing factor productivity and mobility, for absorbing the still high unemployment levels, and for raising the economy's external competitiveness. It should favour sustainable economic growth, and a consolidation of the performance in goods and services exports achieved under the EFAP.

It is also essential to define a coherent and comprehensive strategy that addresses the still high indebtedness of a wide range of Portuguese corporations, with a view to freeing up resources that may boost economic growth. The indebtedness levels require action at different stages, accelerating the restructuring processes of corporations that, although indebted, are still viable. This also allows the enhancement of the deleveraging process in a context of financial stability, and fosters the capitalisation of non-financial corporations. Investment, economic growth and deleveraging can only be mutually compatible if the corporations are adequately capitalised.

In spite of the positive signals reflected in the improved results reported by most of the main credit institutions – an improvement partly based on a restructuring and cost containment effort – it is vital that the adjustment process of banking sector profitability may be deepened and consolidated, despite constraints from developments in economic activity. This process should monitor the correction of macroeconomic imbalances still observed in Portugal. Profitability recovery must not involve excessive risk-taking, nor excessive concentration levels in certain activities or markets. It will be important for institutions to adjust their business models to a macroeconomic context that will probably involve low potential growth, declining interest rates, and, in the specific case of the banking sector, increasing competition due to the creation of the Banking Union. Against this background, the transition to the new regulatory requirements also poses significant challenges for financial institutions. This will come in terms of financing costs and volume, considering, in particular, further requirements in relevant issues, such as liquidity, the dissemination of information on encumbered assets and the definition of a minimum amount of bail-in-able liabilities on the balance sheet.

The recent developments of the Portuguese economy described above have been analysed within an international context of moderate growth of major economies and low inflation rates. In this framework, main monetary authorities have maintained accommodative policies, leading the benchmark rates (risk-free) to very low levels.

This has led to financial risk taking – to the extent that some investors have a search-for-yield behaviour. The increased demand for higher risk assets has compressed risk premia favouring countries under pressure in the euro area.

Although the maintenance of money market interest rates at very low levels has contributed to a decline in Portuguese banks' profitability – due to the fact that a significant part of the credit portfolio is indexed to those interest rates, with low spread levels –, domestic economic agents have had access to financing under relatively favourable conditions. This framework has also contributed to the increasing value of fixed-rate debt security portfolios, particularly affected in the most acute period of the sovereign debt crisis in the euro area. The current situation represents an opportunity that credit institutions should seize to obtain uncollateralised financing at a low relative cost and for long maturities.

In this context, the reversal of that search-for-yield behaviour may have adverse consequences for financial stability. This reversal may be triggered by different factors. At international level, there may be a revaluation of the relative value of euro area assets associated with uncertainty over economic recovery in the region or a possible divergence between market expectations and central bank communication in terms of monetary policy. For Portugal, these risks may include the possibility of more unfavourable economic developments than anticipated in current forecast scenarios. As previously mentioned, notwithstanding the adjustment made under the EFAP, the Portuguese economy depends on changes in the external perception of specific vulnerabilities. Therefore, the deepening of the adjustment process of the different sectors of the economy is crucial for maintaining the country's external credibility and for limiting the rise in financing costs of the different sectors of the economy.

The possibility of losses in value of financial institutions' portfolios affects other asset categories, in addition to debt securities. The high exposure of financial institutions to real-estate assets represents an additional risk that must be monitored. Indeed, banks' and insurance corporations' exposures to real-estate risk have been increasing, either due to the use of property as collateral in credit operations (in the case of banks), or to the direct holding of property or units in real-estate investment funds. Despite the recovery signs in the real-estate market and evidence pointing to the alignment of residential property prices with some fundamental determinants, a decline in prices is not to be excluded. These developments, which may be associated with the banks' adjustment process leading to a sale of those assets and/or a possible more adverse economic and financial situation, may have a significant impact on the banks' balance sheets.

High exposure to real-estate risk therefore warrants permanent monitoring of the banking sector's portfolios. This will come through regular and far-reaching inspections, and appropriate impairment registration, in line with the initiatives conducted by Banco de Portugal since 2011 and the more recent exercise performed by the ECB in the context of the creation of the Single Supervisory Mechanism.

Finally, there is a need to preserve economic agents' confidence, a key pillar of financial stability. The conduct of financial institutions cannot jeopardise confidence in the system. All economic agents are responsible for safeguarding financial stability and preserving public interest. In this context, it is particularly relevant to create a range of incentives and to define organisational and intervention frameworks, inside and outside the financial institutions, favouring the alignment of individual and collective interests. In the current context it is also important to closely monitor the consequences resulting from the sudden decline in the solvency levels of Banco Espírito Santo which, in turn, resulted in the application of a resolution measure to this bank. Even though developments in a significant range of indicators show that the impact on financial markets was temporary, the situation must be monitored, ensuring the continued confidence of economic agents and the stability of the national financial system.

FINANCIAL STABILITY

1. Recent developments, vulnerabilities and challenges

1.1. Macroeconomic and financial environment of the Portuguese economy[1]

Global economic growth remained subdued in the first half of 2014, amid low inflation

In 2014 world economic growth should be close to that seen in 2013 (Table 1), i.e. below the levels recorded before the economic and financial crisis and the initial stage of recovery. This weaker-than-expected growth is largely associated with the behaviour of advanced economies, where domestic demand has been subdued in a context of high unemployment. The geopolitical tension in Ukraine and the Middle East, a particularly severe winter in the United States and the effects of the tax hike in Japan have also added to the smaller pickup in domestic demand in these economies. A large number of emerging economies have continued to grow at a strong pace, despite being affected by reduced demand from advanced economies, some uncertainty and low investment levels.

The euro area should continue to grow moderately, in a context of weaker labour market recovery than in other advanced economies, where some countries continue their process of fiscal consolidation and/or private sector deleveraging, and where the adoption of structural reforms deemed crucial for fostering economic competitiveness, stimulating employment and thereby economic growth, has not been concluded so far. This is particularly important as a wide group of countries faces ongoing balance sheet adjustments in their various economic sectors, thus accounting for a protracted process with implications on aggregate demand.

Inflation remains low worldwide. In the euro area, the inflation rate is currently close to zero (0.3 per cent according to the figures published by the ECB for September 2014) and inflation expectations over the medium to long term have been falling somewhat.

Table 1 • GDP – Real growth rate

Per cent

	2012	2013	2014p	2015p
World economy	**3.4**	**3.3**	**3.3**	**3.8**
Advanced economies	**1.2**	**1.4**	**1.8**	**2.3**
USA	2.3	2.2	2.2	3.1
Euro Area	-0.7	-0.4	0.8	1.3
Germany	0.9	0.5	1.4	1.5
France	0.3	0.3	0.4	1.0
Italy	-2.4	-1.9	-0.2	0.8
Spain	-1.6	-1.2	1.3	1.7
Japan	1.5	1.5	0.9	0.8
United Kingdom	0.3	1.7	3.2	2.7
Canada	1.7	2.0	2.3	2.4
Emerging economies	**5.1**	**4.7**	**4.4**	**5.0**
China	7.7	7.7	7.4	7.1
Brazil	1.0	2.5	0.3	1.4
Russia	3.4	1.3	0.2	0.5

Source: FMI (*World Economic Outlook*, October 2014).
Note: p – prediction.

The monetary policy stance remained accommodative in the main advanced economies

Monetary policy conditions remained accommodative following the relatively small growth in the main advanced economies and low inflation rates. This trend became more marked over the course of 2014 (Chart 1), with the ECB cutting its key interest rates in June and September. The rate on the main refinancing operations was set at 0.05 per cent and the rates on the marginal lending facility and the deposit facility were set at 0.3 per cent and -0.2 per cent respectively. The ECB also announced a range of additional stimulus measures, namely

(i) a set of targeted longer-term refinancing operations maturing in 2018, (ii) a purchase programme of asset-backed securities (ABSs) and bonds issued by the public sector, (iii) the extension of the fixed rate tender procedures with full allotment in the main refinancing operations and longer-term refinancing operations and (iv) the suspension of the weekly fine-tuning operation sterilising the liquidity injected under the Securities Markets Programme.

In the United States, the amount of monthly asset purchases was gradually tapered off (until the end of the programme in October) and the federal funds rate was kept at 0.25 per cent, with the Federal Reserve reaffirming that the official interest rates would be kept low for a relatively long period of time.

In the bond market, yields declined and differentials between euro area countries under stress and Germany narrowed

The bond market benefited from the maintenance of accommodative monetary policies in the main economies (Chart 2). Yields fell to historical lows along the yield curve in a large number of euro area countries and the government bond yield differential between euro area countries under stress and Germany has been substantially compressed, particularly for Portugal, Greece, Spain and Italy (Chart 3). These developments were partly due to Ireland and Portugal's successful exit from the financial assistance programme and a major reallocation of funds to higher-yield securities in advanced economies, in a context of low yields in core countries.[2]

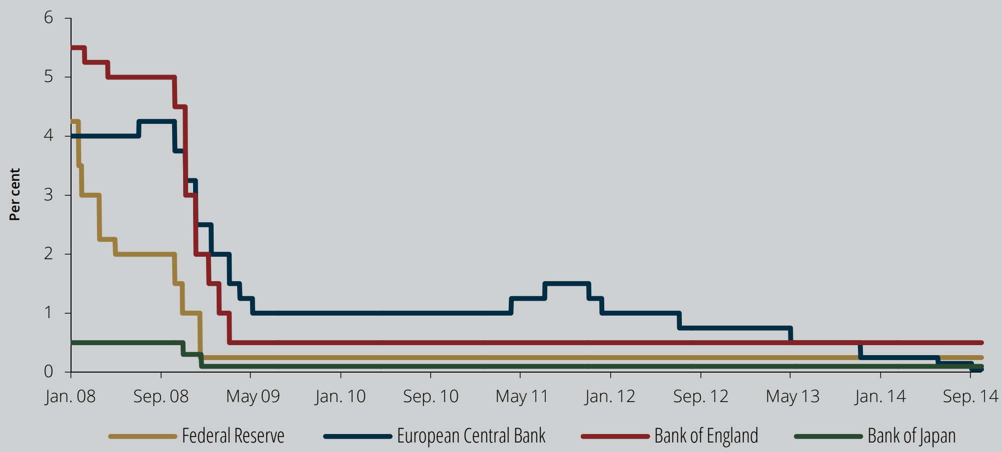
In the United States, the behaviour of yields was mixed along the yield curve, with a fall in 2014 for intermediate and longer maturities. However, the gradual tapering of the Federal Reserve's asset purchases and expectations that the Fed may start to raise key interest rates in 2015 resulted in an increase in two-year yields, particularly as of June.

Following gains in the first half of the year, there was a sharp correction in equity indices

The main equity indices of advanced economies posted gains in the first half of 2014. These gains were more substantial in the United States (Chart 4), where the S&P 500 reached successive historical highs, compared with lower gains in Europe, although Germany also posted histori-

Chart 1 • Central Banks' rates

Source: *Bloomberg*.



cal peaks in 2014. However, most equity markets subsequently started a correction process, amid increased uncertainty about economic growth developments in the near future and the geopolitical situation.

> The Portuguese economy continued to grow moderately, close to that expected for the euro area

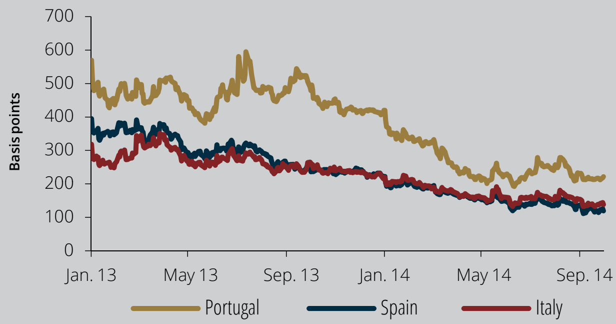
In the first half of 2014, economic activity in Portugal continued to follow a subdued upward path that had started in 2013 (Chart 5). Developments in GDP reflected a recovery in domestic demand and a slowdown in exports. In this context, labour market conditions continued to improve, leading to a decline in the unemployment rate and an increase in employment (Chart 6).[3] Furthermore, the inflation rate decreased, falling into negative territory. Over the past few months, Banco de Portugal's coincident indicator has suggested some interruption in the acceleration of economic activity.

Private consumption has recovered, in line with a gradual improvement in labour market conditions and a decrease in household indebtedness. In the first half of the year, investment recovered year-on-year, continuing to

Chart 2 • 10 Year Sovereign Bond Yields

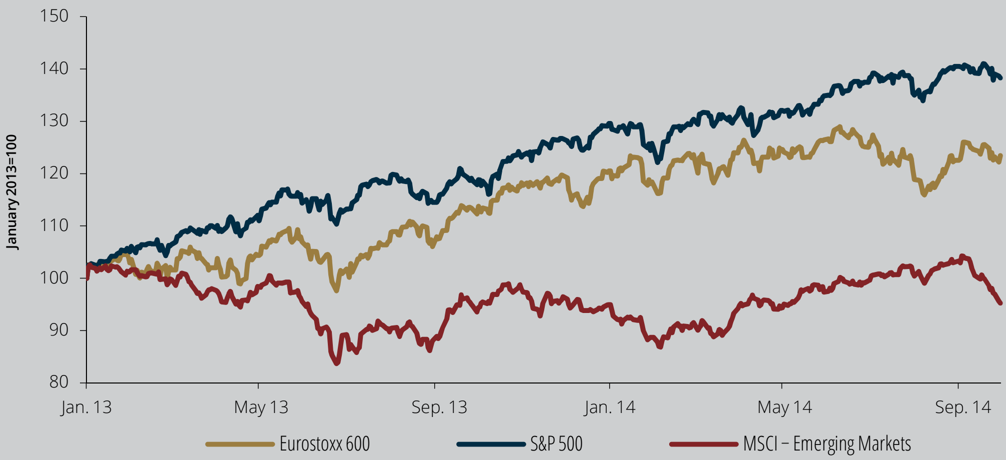
Source: *Bloomberg*.

Chart 3 • 10 Year Sovereign Bond Yields | Spreads vis-à-vis Germany



Source: *Bloomberg*.

Chart 4 • Stock Market Indices



Source: *Bloomberg*.

reflect a reallocation stemming from the correction of cumulative economic imbalances and a balance sheet adjustment in the various sectors of the economy. As such, investment in construction continued to record negative changes in the first half of 2014, in line with the trend seen over the past few years. This trend is associated with a structural decline in public investment in infrastructure and the current size of housing stock, and has been influenced by constraints in funding conditions. In turn, investment in machinery and equipment has recovered considerably.

In the first half of 2014 exports of goods and services grew slightly less than external demand for Portuguese goods and services. These developments – determined by temporary factors that have affected exports of fuels – seem to have prevented the retention of market share gains posted in previous years. In turn, imports accelerated in the first months of the year, reflecting a pickup in domestic demand.

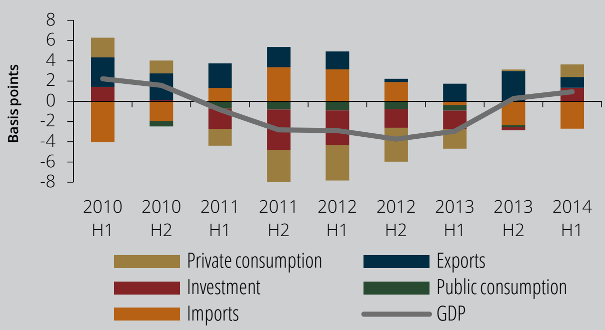
The Portuguese economy's financing capacity, measured by the combined current and capital account balance, remained virtually unchanged in the first half of 2014 compared with the same period of the previous year.

Portugal maintains a frontloading financing strategy for general government

The more favourable international environment and positive evaluations from rating agencies regarding Portugal's financial situation made it possible for the Portuguese State to develop a strategy of frontloading their borrowing requirements, more specifically through the re-opening of syndicated issues of 5, 10 and 15-year Treasury bonds. Demand exceeded supply by several times, while allotment rates fell.

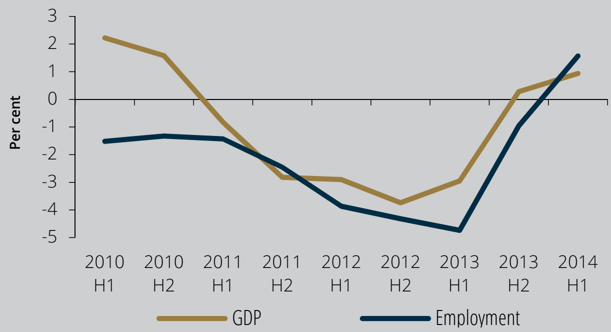
In the secondary market, yields declined significantly (Chart 7), reaching historical lows for the various maturities along the yield curve, and differentials vis-à-vis Germany narrowed substantially. The Portuguese 10-year yield stood at 3.1 per cent at the end of September, posting a 221 b.p. differential vis-à-vis the German yield.

Chart 5 • Contributions to the year-on-year rate of change of GDP



Sources: INE and Banco de Portugal.

Chart 6 • Evolution of GDP and employment | year-on-year rates



Sources: INE and Banco de Portugal.

The outstanding amount of debt securities remained relatively stable, with non-resident entities significantly increasing their exposure to Portuguese debt

The outstanding amount of debt securities issued by resident entities did not change significantly in 2014 compared with the end of the previous year, standing at around 0.2 per cent below that seen in December 2013 (considering the market value). The general government issuance increased by approximately 12.5 per cent, which was offset by a marked reduction in debt issued by credit institutions (Chart 8).

Debt held by non-residents has increased substantially, as investors find the Portuguese market more attractive, in their search for yield. Conversely, debt held by other monetary financial institutions has declined (Chart 9).

The increase in the PSI-20 during the first half of the year was fully reversed

In the first half of the year, the PSI-20 increased markedly (Chart 10), above that seen for most

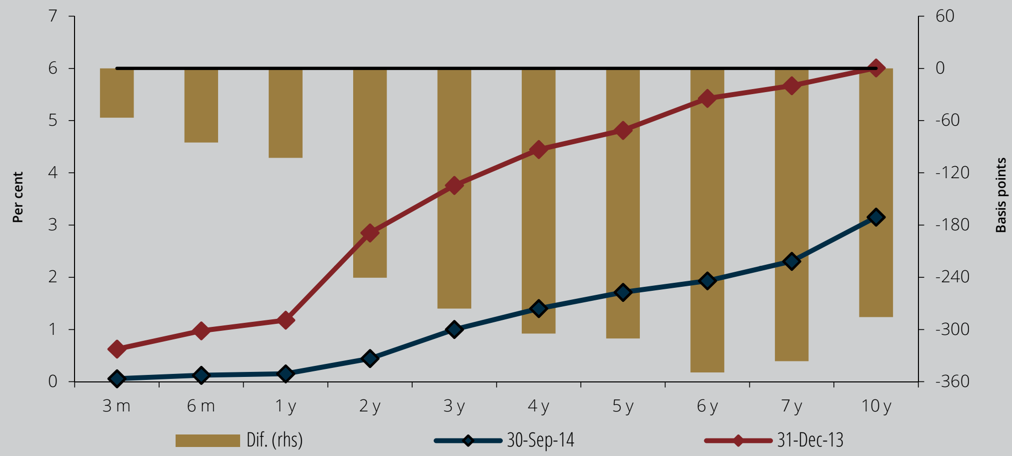
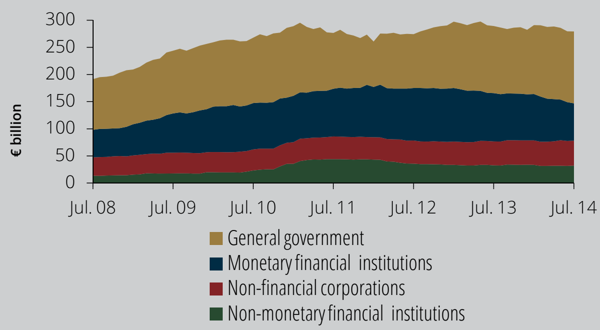


Chart 7 • Portuguese Yield Curve

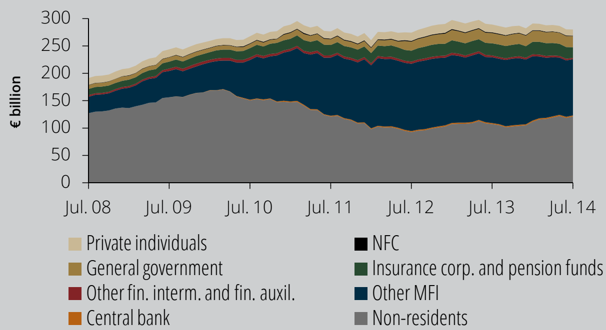
Source: *Bloomberg*.

Chart 8 • Securities issued by residents | Outstanding amount



Source: Banco de Portugal.

Chart 9 • Securities issued by owner | Outstanding amount



Source: Banco de Portugal.

euro area markets, in a favourable environment for financial investments in countries that have successfully exited financial assistance programmes following the sovereign debt crisis.

More recently, the PSI-20's behaviour was affected by developments in major European markets, including a deterioration in economic growth for the euro area and concerns about low inflation levels. The Portuguese equity market posted considerably more negative developments than most European indices, mainly due to price developments for Banco Espírito Santo (BES) and Portugal Telecom.

1.2. Financial position of non-financial sectors

In year-on-year terms, the savings rate continued to grow, resulting in increased household net lending

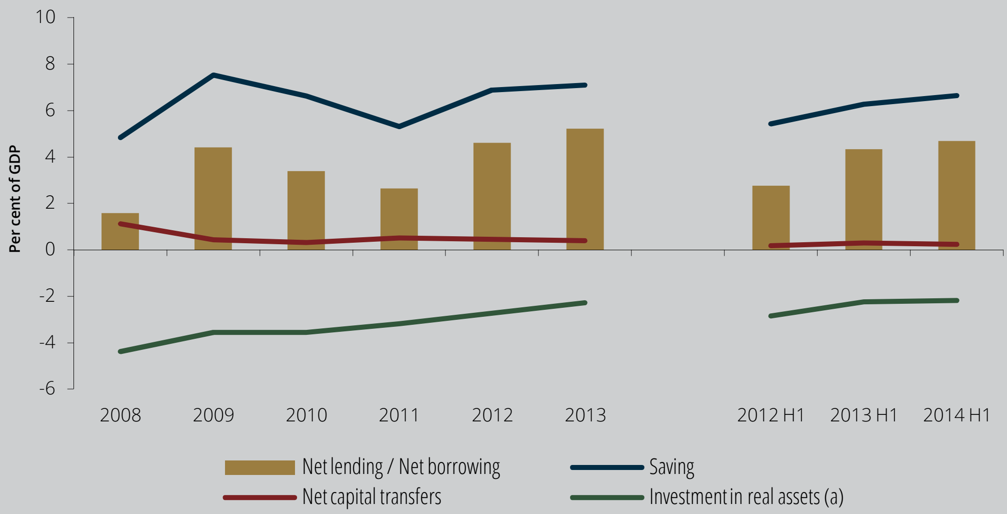
In the first half of 2014, household net lending improved, compared with the first half of the previous year (4.7 per cent of GDP, after 4.3 per cent in the first half of 2013), reflecting a slight increase in the savings rate and the near stabilisation of the investment rate in this sector (Chart 11).[4] The increase in the households' savings rate is essen-

Chart 10 • Portuguese Equity Indices

Source: *Bloomberg*.

Chart 11 • Saving, investment and net lending of households

Source: INE.
Notes: Semiannual values use quarterly national accounts as underlying values. (a) It equals the sum of gross fixed capital formation, change in inventories, acquisitions less disposals of valuables and acquisitions less disposals of non-produced non financial assets.



tial for the continuation of the deleveraging process in a sustainable manner. It also contributes to the correction of external imbalances of the Portuguese economy, since it reflects the growing domestic capability to finance the domestic investment needed for economic growth.

In the first half of 2014, net repayment of household loans continued (Chart 12), for both housing loans and loans for consumption and other purposes. Moreover, since the second half of 2013, private consumption of durable goods has accelerated, which was reflected in a smaller drop in loans for this purpose. In replying to the Bank Lending Survey (BLS), some participants reported an improvement in consumer confidence and the development of consumer expenditure relating to durable goods as supporting demand for credit for that purpose. However, the need to further reduce indebtedness, the maintenance of tight credit standards for bank lending, and developments in disposable income may continue to constrain demand for credit associated with private consumption.

Household indebtedness is still high, in spite of the rise in the savings rate

Household indebtedness has fallen considerably since 2010, from 95 per cent of GDP at the end of 2009 to 87 per cent of GDP in June 2014,[5] in spite of the decline in disposable income and GDP. In the European Union as a whole, however, this figure is still high (Chart 13). Household indebtedness and the fact that this debt is mainly floating-rate debt,[6] are an important vulnerability of the Portuguese economy, as it makes the financial position of households especially sensitive to income and interest rate changes. Nevertheless, the context of very low interest rates has allowed for a reduction in the debt service burden, thus favouring the financial position of households.

In the first half of 2014, households' financial asset portfolio had a positive change. This portfolio represented 214 per cent of GDP in June 2014 and exceeded the euro area average. In the first half of 2014, net acquisitions of savings and Treasury certificates were significant (around 2 per cent of GDP), and there were also net investments in mutual fund units and life insurance and pension products. Deposits showed relative stability in this period. At the same time, households disinvested in debt securities and quoted shares (Chart 14).

The ratio of households' credit overdue continued to increase, reflecting rises in both housing loans and loans for consumption and other purposes. However, the ratio of the annual flow of new credit overdue and other non-performing loans[7] to total credit maintained a downward trend, in

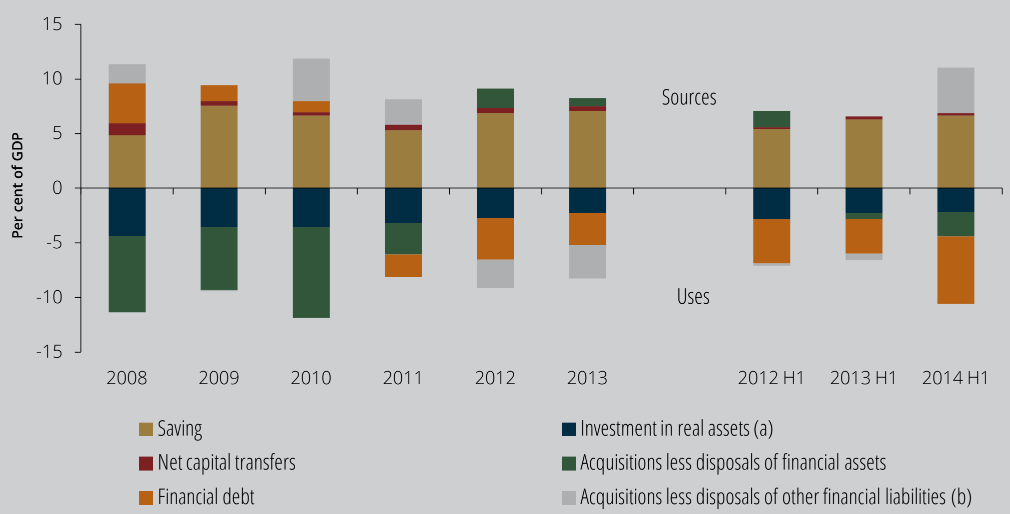


Chart 12 • Sources and uses of funds by households

Source: INE and Banco de Portugal.
Notes: Semiannual values based on quarterly national accounts.
(a) Corresponds to the sum of gross fixed capital formation, changes in inventories, acquisitions less disposals of valuables and acquisitions less disposals of non-produced non financial assets. (b) Includes other debits and credits and, in the first semester of 2014, it is adjusted for the discrepancy between National Financial Accounts and National Non Financial Accounts' net lending.

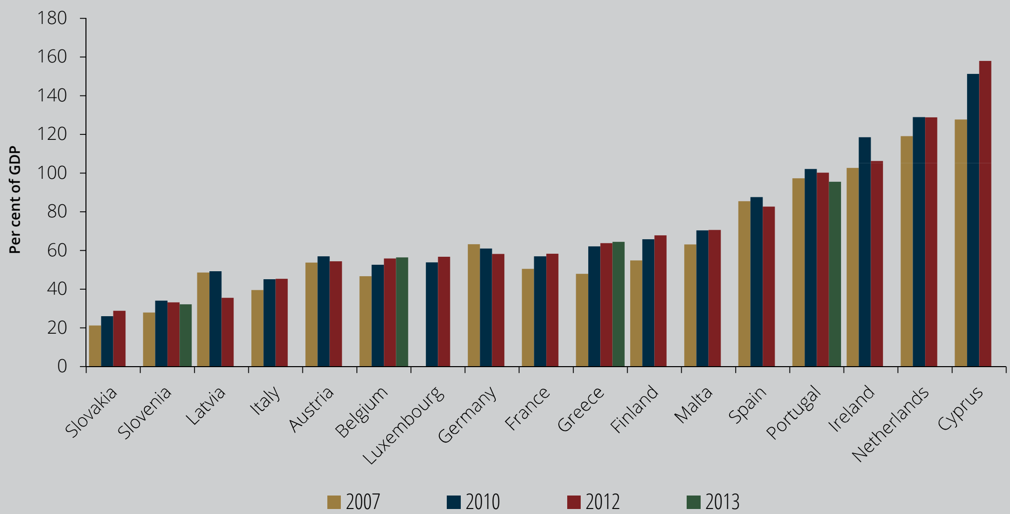
line with the more recent recovery of disposable income and labour market developments.

Law No 58/2014 of 25 August entered into force in September. It amends the extraordinary framework to protect home loan borrowers in serious economic difficulties, that had been approved by Law No 58/2012 of 9 November. The new law gives more flexible conditions to bank customers in accessing to the extraordinary framework to protect home loan borrowers. This regime provides a range of rights and guarantees to bank customers in serious economic difficulties who are not complying with their obligations under housing credit agreements. Overall, those amendments allow households with higher income or owning property with higher asset value to have access to the framework. Moreover, a possibility is introduced where access to the extraordinary framework is permitted to guarantors of housing credit agreements who are required to meet the obligations of the original debtors and who are in serious economic difficulties.

Non-financial corporations' net borrowing declined further, maintaining the trend observed since 2009

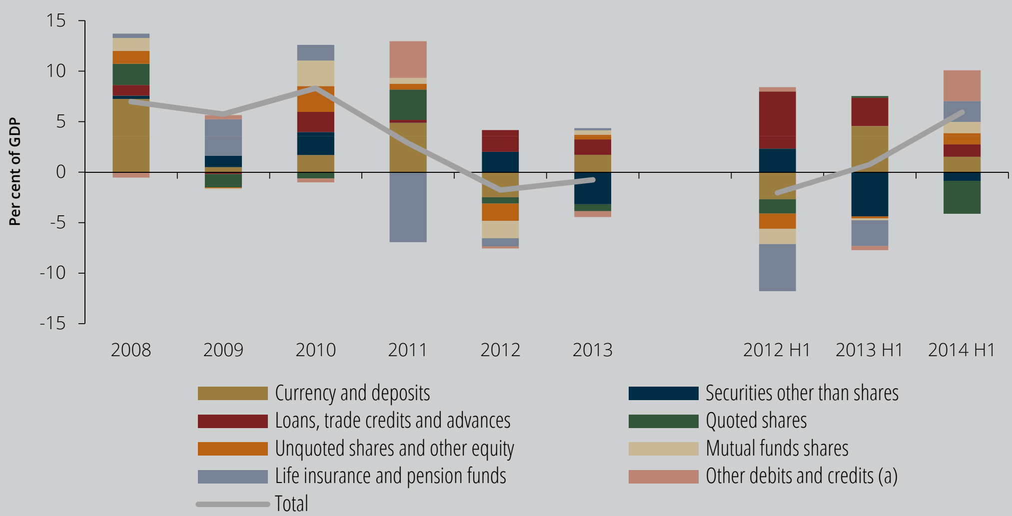
In the first six months of 2014, non-financial corporations' net borrowing represented 1.7 per

Chart 13 • Households total debt | EU comparison



Source: *Eurostat*.
Notes: Financial accounts defined as in ESA95. Data allowing for comparisons as in ESA2010 are not yet available. Values in crescent order with reference to 2012 values.

Chart 14 • Financial assets of households | Transactions



Sources: INE and Banco de Portugal.
Notes: Consolidated values. Semiannual values based on quarterly national accounts. (a) Includes non-life insurance technical reserves, provisions for standard activated guarantees and other accounts receivable / payable.

cent of GDP (2.1 per cent in the same period of 2013). The investment rate continued to be low, in spite of a slight recovery year-on-year (Chart 15). According to INE's investment survey, the deterioration of sales prospects is mentioned by more than half the surveyed corporations as the main factor limiting investment. Approximately one fourth of the respondents in manufacturing reported that investment profitability was the main factor limiting investments in 2013 and 2014, which is an increase from previous years.

The decline in fixed capital investment seriously undermines the potential growth of the Portuguese economy. The low growth of the Portuguese economy, in a context of low inflation, makes it more difficult to reduce the debt-to-GDP ratio and implies less income generated, thus aggravating the debt service burden by the different players. This is especially relevant in view of the high debt of Portuguese corporations. It is therefore an important vulnerability in the Portuguese economy, with potential consequences for financial stability.

In 2013, non-financial corporations' return on invested capital, measured by the ratio of EBITDA to the sum of equity plus obtained funding, exceeded that registered in 2012 (rising from 6.3 to 7.4 per cent). Most activity sectors contributed to this result (Chart 16). In the first half of 2014, however, there was a slight decline in this ratio, particularly due to the negative contribution of large enterprises and other services sector (reflecting the ongoing restructuring in the telecommunications sector).

The interest coverage ratio improved in 2013 and in the first half of 2014 in the case of small and medium-sized enterprises and in the industry and trade sectors.

Loans granted by resident credit institutions to non-financial corporations recorded a negative annual rate of change in the first half of the year. The decline is smaller for total loans, due to the positive contribution from non-resident institutions (Chart 17). In turn, the change recorded in debt security issuance (included in total credit) is more negative than that in total loans.

Mention should be made to the paper of Farinha and Félix (2014)[8] where results indicate that credit supply mostly depends on the firms' ability to generate cash-flow and to reimburse its debt, and on the amount of assets available to be used as collateral.

Interest rates for new loans to non-financial corporations continued on a downward path, reflecting a significant reduction in the spreads applied to loans granted by banks in the first half-year. Yet, these spreads have still not reached the levels of the start of the sovereign debt crisis.

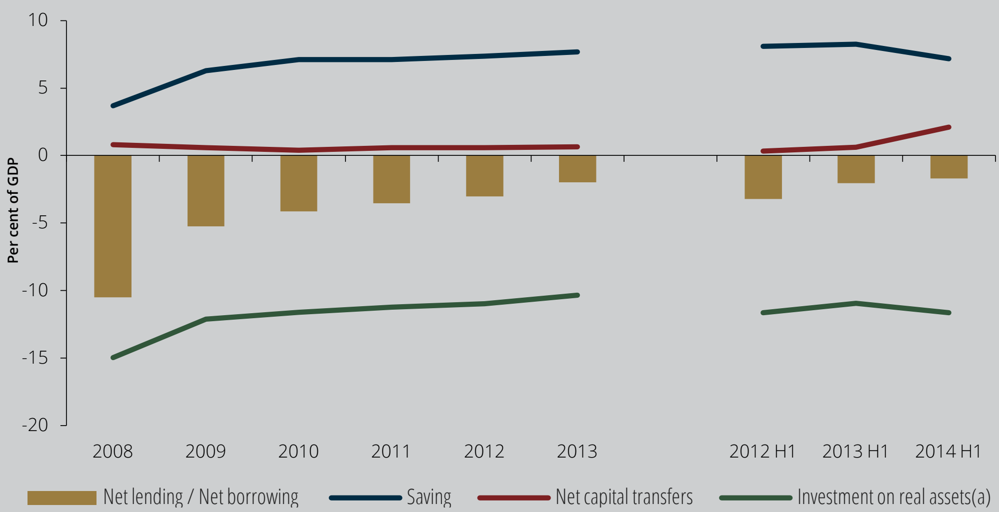
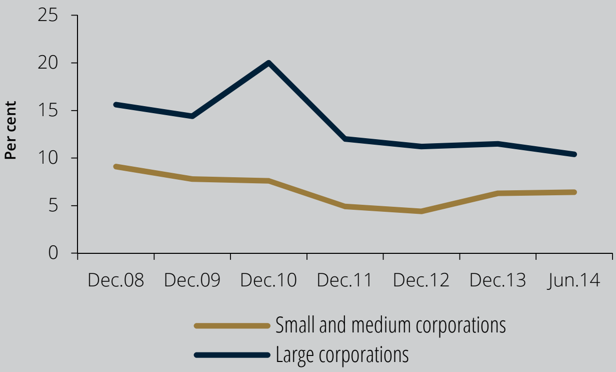


Chart 15 • Non-financial corporations' saving, investment and net borrowing

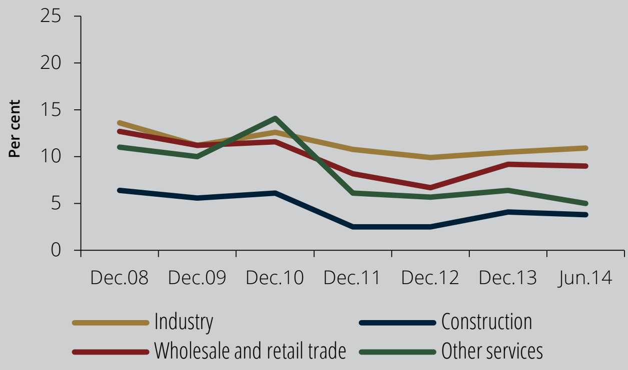
Source: INE.
Notes: Semiannual values are based on quarterly national accounts.
(a) It equals the sum of gross fixed capital formation, change in inventories, acquisitions less disposals of valuables and acquisitions less disposals of non-produced non financial assets.

Chart 16 •

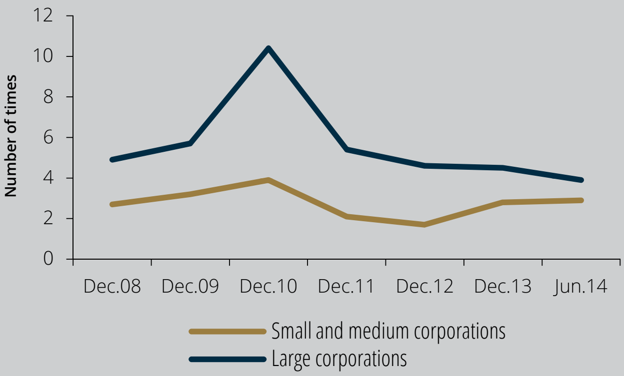
Profitability ratio | Corporation size



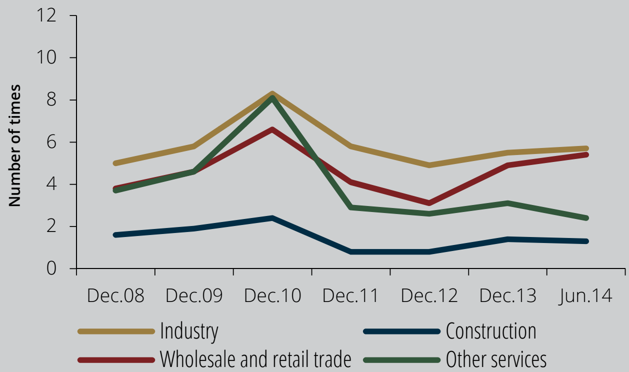
Profitability ratio | Economic activity



Coverage ratio | Corporation size

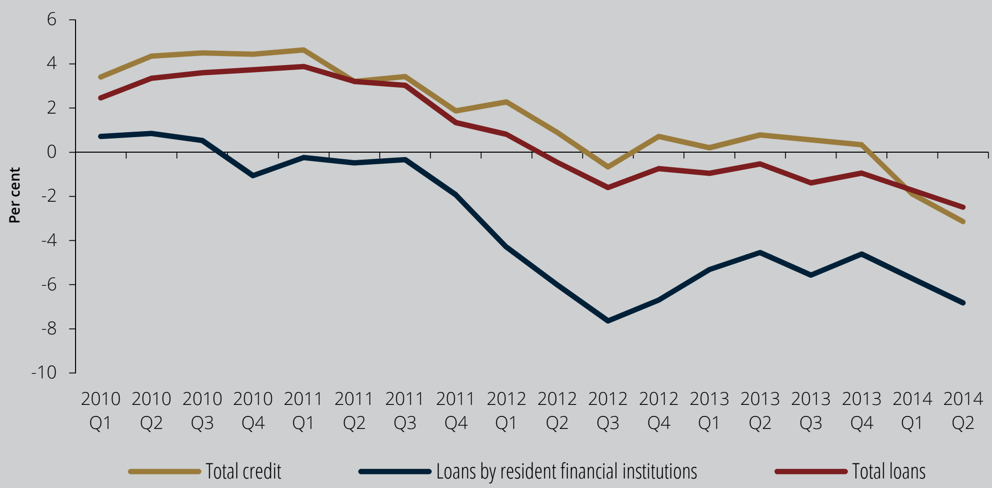


Coverage ratio | Economic activity



Source: Banco de Portugal.
Notes: Extrapolated values. Other services includes information and communication activities and excludes agriculture, forestry and fishing, electricity, gas and water, transportation and storage and holdings. Profitability ratio = EBITDA / (equity + obtained funding). Coverage ratio = EBITDA / interest expenses (no. of times).

Chart 17 • Total credit granted to non-financial corporations | Annual rate of growth



Source: Banco de Portugal.

Credit granted by resident banks is concentrated in a low number of corporations, with credit quality deteriorating significantly since the end of 2011.

At the end of June 2014, around 90 per cent of credit to the non-financial corporate sector was concentrated in 10 per cent of the non-financial corporations with bank credit. Among the corporations with greater exposures, the ratio of credit overdue to total credit has increased sharply since the last quarter of 2011, despite being lower than that of the small exposures (which also continue to grow). The deterioration of the credit quality in this bracket is also visible in the significant increase in the percentage of corporations with credit overdue (Table 2). Essentially, the construction sector contributed to this situation, in which around half the debtors with greater exposure have credit overdue.

Table 2 • Credit default indicators | Non-financial corporations[(a)] Per cent

	Dec. 09	Dec. 10	Dec. 11	Jun. 12	Dec. 12	Jun. 13	Dec. 13	Jun. 14
Total exposure								
Debtors in default[(b)]	18.7	20.1	24.4	27.6	28.8	30.5	30.3	31.2
Overdue credit and interest[(c)]	4.1	5.2	8.1	11.3	12.3	14.2	15.3	16.6
Exposures for more than the 90th quantile[(d)]								
Debtors in default[(e)]	14.4	16.0	23.7	28.8	30.1	32.4	31.0	32.6
Overdue credit and interest[(f)]	3.6	4.6	7.5	10.8	11.8	13.7	14.9	16.1
of which: Exposures for more than the amount of the 99th quantile[(d)]								
Debtors in default[(e)]	11.6	12.8	21.7	30.4	29.7	33.5	31.4	32.4
Overdue credit and interest[(f)]	2.3	2.9	5.3	8.9	9.2	11.0	12.5	13.5
of which: Exposures for more than the amount of the 99,5th quantile[(d)]								
Debtors in default[(e)]	9.4	11.0	19.7	29.3	27.4	31.5	27.8	29.3
Overdue credit and interest[(f)]	1.9	2.4	4.2	7.9	7.8	9.4	11.2	12.2
of which: Exposures for more than the amount of the 99,9th quantile[(d)]								
Debtors in default[(e)]	6.7	6.6	15.4	26.4	23.9	29.4	25.7	25.2
Overdue credit and interest[(f)]	1.2	1.3	2.1	5.9	5.9	7.3	9.5	10.2
Smaller exposures[(g)]								
Debtors in default[(e)]	19.2	20.5	24.5	27.5	28.6	30.3	30.2	31.0
Overdue credit and interest[(f)]	7.9	9.3	12.7	14.9	16.9	18.4	19.1	20.2

Source: Banco de Portugal.
Notes: (a) Indicators based on Central Credit Register data (CRC). Comprising credit from banks, savings banks, mutual agricultural credit banks, credit financial institutions, factoring companies, financial leasing companies, credit-purchase financing companies and other resident financial intermediaries. Also includes loans made (or held) by entities outside the financial sector which report to the CRC, *i.e.* Parvalorem, Instituto de Turismo de Portugal and, since September 2011, some debt collection companies. Only exposures to a specific institution of more than EUR 50 were considered with unused lines of credit being excluded. A non-financial corporation is in default if the amount of overdue credit is more than 0,5 per cent of its exposure to the financial system. (b) As a percentage of the number of non-financial corporations with debts to financial institutions participating in the CRC. (c) As a percentage of the total credit from financial institutions participating in the CRC to resident non-financial corporations. (d) Percentiles defined on the basis of the number of companies ranked by their total amount of exposure. (e) As a percentage of the number of debtors in this portfolio. (f) As a percentage of the total credit in this portfolio. (g) Exposures whose amounts are less than the 90th percentile, comprising 90 per cent of the companies with debt to institutions participating in the CRC.

In a context of credit quality being affected by moderate economic growth, the process of restructuring balance sheets and specific exposures becomes particularly important. It is essential that the credit is put into viable projects, not compromising non-financial sector deleveraging. Thus credit granting and monitoring criteria must be rigorous, so that new credit is used effectively to finance profitable and productive projects.

The results of the BLS for the first half of 2014 show that demand for credit by small and medium-sized enterprises increased, above all to address the financing needs for inventory and working capital, as well as to restructure debt, reflecting persistent liquidity management concerns. In a scenario of prolonged low interest rates, it is important to ensure that incentives are not created to delay recognition of losses by the banks. In order to avoid that situation, Banco de Portugal has carried out a series of horizontal inspections on the banks.

Under the Economic and Financial Assistance Programme, Banco de Portugal was involved in a plan to promote debt restructuring among non-financial corporations in Portugal. This plan has resulted in tighter supervision of the credit institutions, through the identification of corporations with a high probability of default due to indebtedness levels, and the issuance of recommendations for the implementation of procedures for identification and management of credit at risk. Debt restructuring tools have been made available to debtor corporations and incentives to capitalise have been set up. The legal and out-of-court procedures introduced (PER and SIREVE)[9] were developed with these objectives, with both now being reanalysed in order to increase their efficiency and effectiveness.

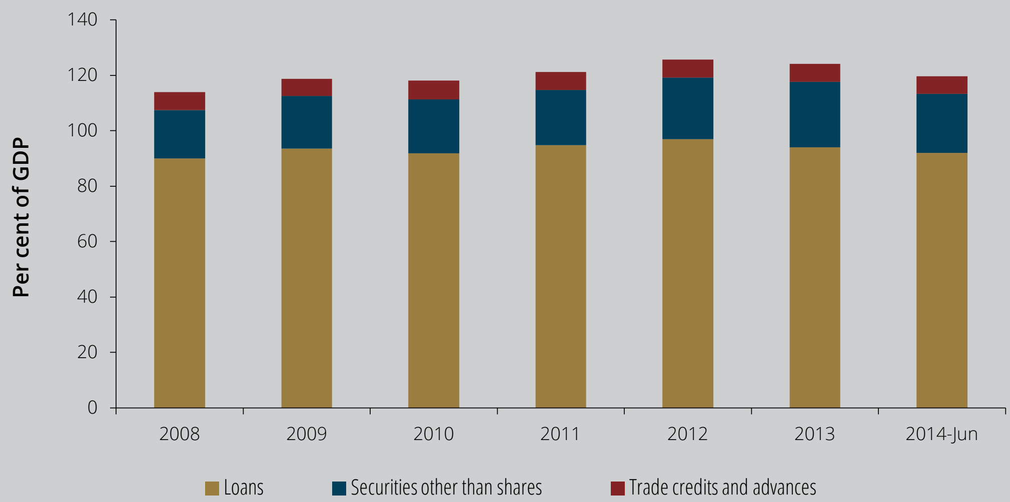
Non-financial corporations' capital increase is key to the sector's financial soundness

At the end of June 2014, non-financial corporations' total debt represented 120 per cent of GDP (124 per cent in December 2013) (Chart 18) and was one of the highest of the European Union. This value, calculated under ESA2010, is significantly less than that previously released based on ESA1995. This reduction was driven by methodological factors, namely the change of the sectoral scope for non-financial corporations, which no longer includes holding companies, (which are now in the financial corporate sector) and certain other corporations that are in the general government sector according to ESA2010 rules.

In a context of deleveraging in the economy's various sectors, the use of alternative sources to bank credit will support the financing of corporations with potential for contributing to economic growth. Along with additional recourse to the capital markets, which in the case of small-sized corporations is particularly difficult and onerous, it is important to increase capitalisation of the non-financial corporations. According to the information held in Banco de Portugal's Central Balance-Sheet Database, the own funds of Portuguese corporations represent a little over a third of their assets. However, financing obtained from participated and participant companies (additional

Chart 18 • Non financial corporations debt | End of period stocks

Source: Banco de Portugal.
Note: Consolidated values.



capital) represented around 13 per cent of assets in June 2014, which raised the proportion of assets financed by shareholders and group corporations to nearly 50 per cent among Portuguese corporations. The use of additional capital, aside from its tax advantages, allows the shareholder to retrieve the funds more easily should the corporation get into difficulty. This fact makes additional capital particularly attractive, despite reducing the soundness of the corporations' financial structure when compared to equity. In addition, the practice of heavy distribution of income restricts accumulated saving in the sector. This practice has continued despite the financial crisis, with consequences for corporations' equity level (Chart 19). Thus the introduction of tax and regulatory incentives to transform additional capital into equity and stimulate the reinvestment of profit (instead of distributing it) will help strengthen the non-financial corporations' financial structures and create value in the sector.

Greater capitalisation and the pursuit of profitable projects are crucial factors for the development of the non-financial corporations' productive structure, and as a result for the sector's financial soundness.

In spite of the unprecedented budgetary consolidation during the EFAP, public debt levels allow no easing of fiscal adjustment effort

In the first half of 2014, the general government deficit on a National Accounts basis[10] came to 6.5 per cent of GDP (6.6 per cent in the same six months of 2013). In turn, the public debt-to-GDP ratio was 129.4 per cent at the end of June, representing an increase versus the end of 2013 (128.0 per cent) (Chart 20). Considering the debt net of central government deposits, the ratio comes to 117.2 per cent of GDP (slightly below the December 2013 level of 117.5 per cent of GDP). In the first half, the interest expense on general government debt represented 5.1 per cent of GDP (unchanged from the same period a year earlier).

According to the Excessive Deficit Procedure (EDP) Notification of September, the estimate for the general government deficit in 2014 was revised to 4.8 per cent of GDP. When adjusted for temporary measures and special factors,[11] this level is compatible with the annual target of 4.0 per cent set under the Economic and Financial Assistance Programme and

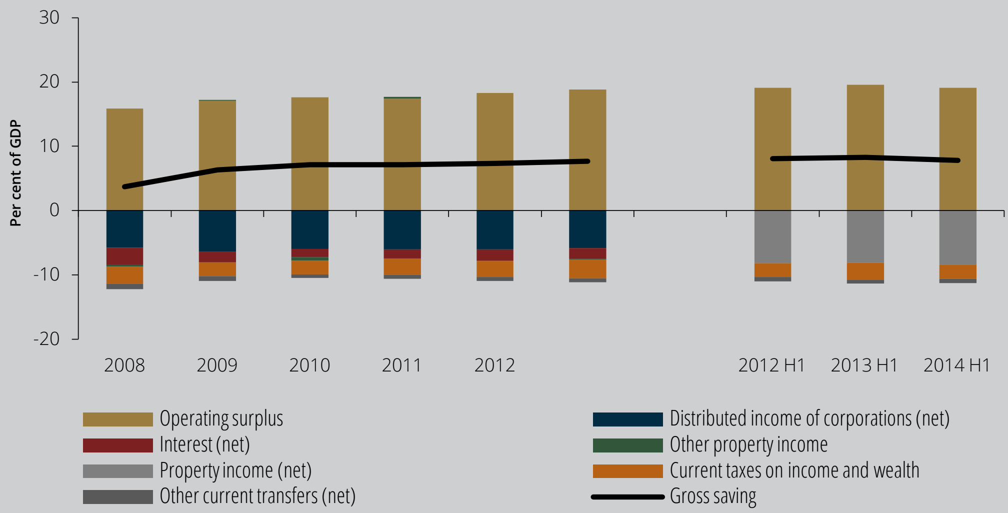


Chart 19 • Uses of non-financial corporations operating surplus

Source: INE.
Notes: Net stands for the difference between sources and uses. Semmiannual values are calculated from quarterly values. Information on interest, distributed income of corporations and other property income is not available on a quarterly basis.

reiterated in the second amendment of the State budget for 2014, approved at the start of September. On 15 October, the Government presented the draft State budget for 2015, which confirmed the forecast for the general government deficit in 2014 reported under the EDP. Regarding the debt ratio as a percentage of GDP, a fall to 127.2 per cent at the end of 2014 is forecast.

In the State budget for 2015 the Government set the target for the general government deficit in 2015 at 2.7 per cent of GDP. Regarding public debt, the State budget for 2015 forecasts it to fall to 123.7 per cent of GDP at the end of 2015.

It remains critical to continue fiscal consolidation at a sound pace, to ensure external credibility of the Portuguese economy and to support sustained economic growth, thus assuring financial stability. For this the structural balance must continue on a path compatible with the targets set for the medium-term objective. This must be a fundamental goal for the Portuguese economy's medium and long-term strategy.

1.3. Financial position of financial sectors

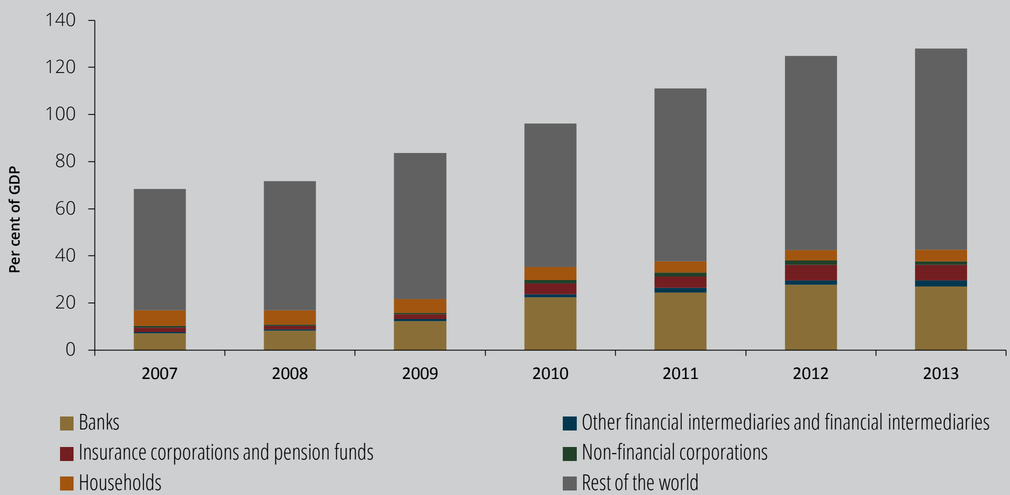
1.3.1. Banking sector[12]

Amid an adjustment in banks' balance sheets, the decrease in the credit portfolio made the greatest contribution to the decline in assets

The Portuguese banking system's activity continued to progress amid an adjustment process, while constrained by the dynamics of correction of resident sectors' high aggregate indebtedness and the fact that access to debt and interbank funding markets remains limited. To the endogenous constraining factors are added the challenges associated with the convergence to a new international regulatory framework, which is more demanding in terms of capital adequacy and liquidity. In the first half of 2014, total assets of the banking system decreased by 2.4 per cent (Chart 21) – 1.5 per cent, excluding BES – with a cumulative decrease of 15.5 per cent since the end of 2010.[13] This development is observable both for the subset of domestic institutions and for the aggregate of branches and subsidiaries of non-domestic banking groups, whose assets

Chart 20 • General government debt

Source: Banco de Portugal.
Note: Maastricht debt.



decreased by 1.6 per cent from the end of 2013.

The deleveraging process and consequent resizing of the Portuguese banking sector have followed a broadly based movement in banking sectors across euro area economies, including countries less affected by the sovereign debt crisis, despite some differences in terms of magnitude and starting point of the adjustment (Chart 22). The ratio of total assets to GDP amounted to 2.8 at the end of 2013, *i.e.* close to the value of the euro area as a whole.[14]

In the first half of the year, in aggregate terms, the main contribution to the decrease in assets was made by a reduction in credit to resident customers, which was broadly based across institutional sectors. Furthermore, there was a decrease in claims and investment in credit institutions, mainly associated with BES-related developments, and a decrease in claims and investment in central banks.

Conversely, among factors that made positive contributions to changes in assets were developments in the portfolio of financial assets (securities, derivatives and shareholdings), particularly debt securities (Chart 23). In the first half of 2014 the debt securities portfolio increased by 3.9 per cent (around EUR 2.5 billion), amounting to roughly 15 per cent of the banking system's

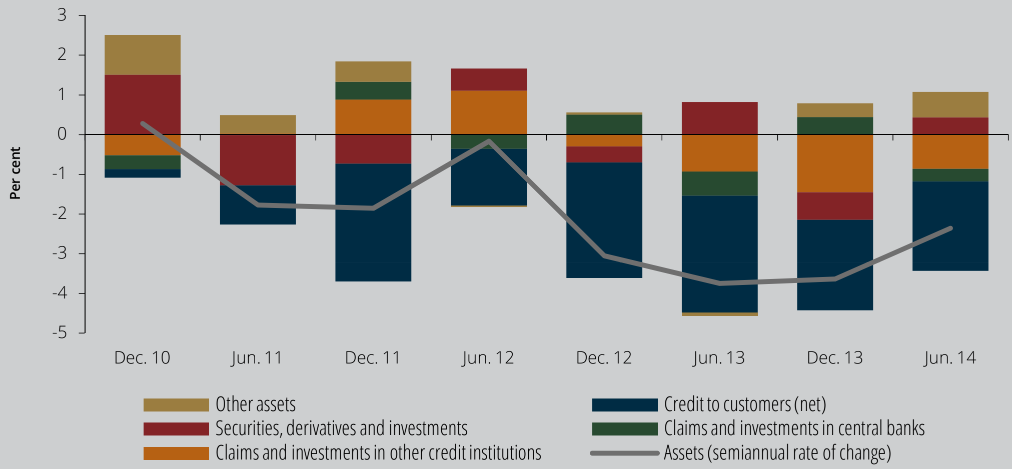


Chart 21 • Contributions to the semiannual change in assets

Source: Banco de Portugal.
Notes: Securities, derivatives and investments include financial assets at fair value through profit or loss, available for sale financial assets, investments held to maturity, investments in subsidiaries and hedge derivatives. Credit to customers is adjusted by securitisation operations.

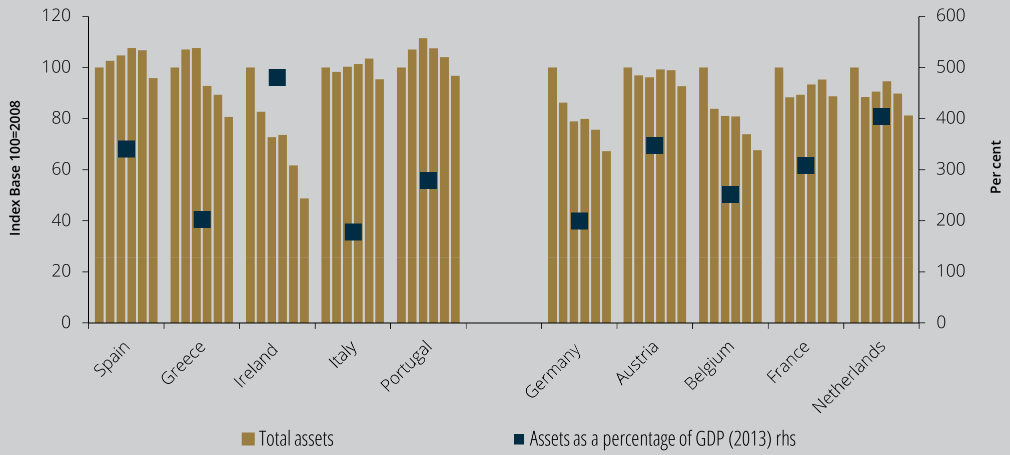


Chart 22 • Banking asset developments in selected countries (2008-2013)

Source: BCE – CBD (*Consolidated Banking Data*).
Note: Annual data. End-of-period figures.

total assets. This mainly reflects an increased value of the portfolio of government bonds.

Amid a broadly based decline in sovereign yields across euro area countries, particularly on Portuguese public debt, the increase in the value of the portfolio of government bonds reflects price and volume effects. As regards Portuguese public debt, the decline in the quantity of securities held was partially offset by the increased value of securities that remained in the portfolio. Turning to the portfolio of public debt of other euro area countries, in addition to the positive price effect, there was also a positive quantity effect. Concerning the remaining types of instruments, the private debt securities portfolio, issued by both residents and non-residents, also increased somewhat.

Given the continued adjustment of the banks' balance sheets, exposure to sovereign risk, as a percentage of assets, has been increasing. This increase makes the banks' financial position more sensitive to market changes, with an impact on the valuation of sovereign debt securities. However, the Portuguese banking sector is no exception in terms of exposure to domestic sovereign debt, assessed by total securities held and loans granted to the general government. Chart 24 illustrates developments in this indicator for a group of euro area countries, with Portugal standing in the median of the distribution, close to countries like Belgium or

Chart 23 • Debt securities portfolio

Source: Banco de Portugal. Note: Debt securities portfolio includes financial assets at fair value through profit or loss including derivatives for trading (net of financial liabilities held for trading), available for sale financial assets and investments held to maturity, net of hedge derivatives.

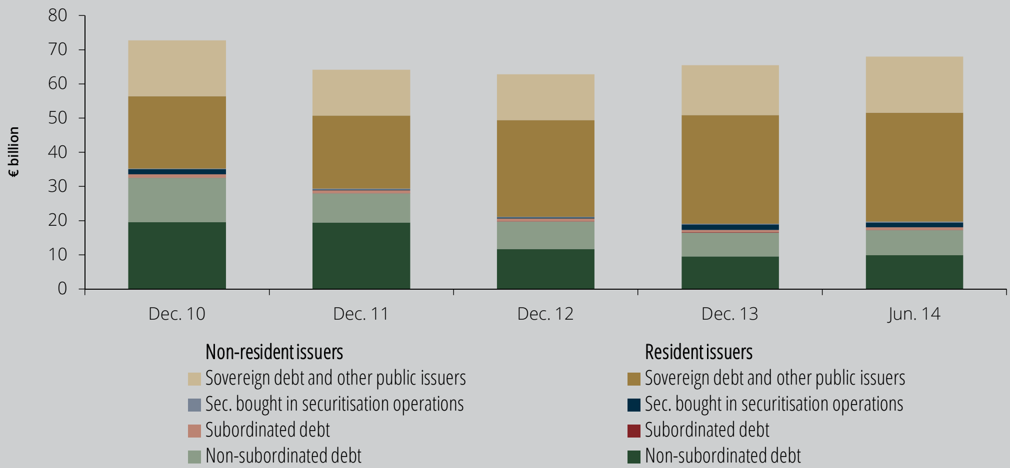
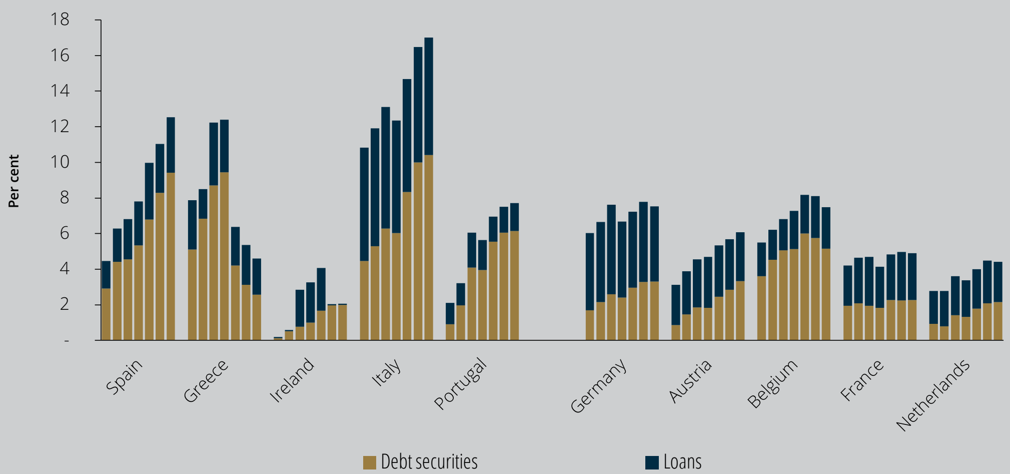


Chart 24 • Developments in exposures to the domestic sovereign | As a percentage of total assets (2008 – August 2014)

Source: European Central Bank - Monetary and financial statistics. Notes: Annual data. End-of-period figures, with the exception of 2014.



Germany, although the exposure has increased more markedly since 2008.

In the medium term, the Portuguese banking system is expected to proceed with its balance sheet adjustment process, performing its intermediation function in a context where domestic savings may not increase substantially and where the high aggregate indebtedness in the public and private sectors, and consequent debt servicing, should continue to represent a binding constraint on demand for credit.

Furthermore, according to the new regulatory framework, banks must comply with increasingly demanding capital ratios over the transition period up to its full implementation, as transitional provisions are being eliminated and new capital buffers are being applied. The decline in risk-weighted assets may make a relevant contribution to the fulfilment of these objectives, depending on the degree of internal financing capacity and capital instruments issuance ability in the market.

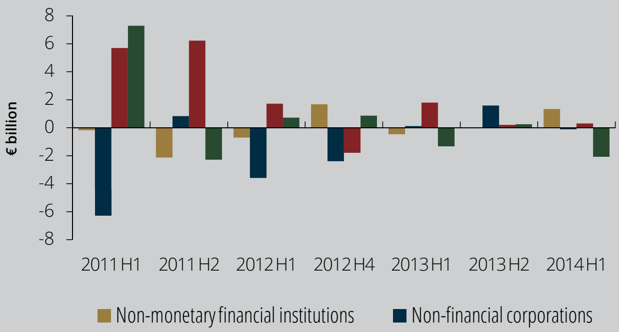
Despite a slight reduction in customer deposits, recourse to the Eurosystem declined considerably

In the first half of 2014 the balance of customer deposits declined slightly in absolute terms, mainly due to a reduction in deposits by general government, whose developments are typically more volatile (Chart 25). As regards deposits from the non-financial private sector, there was also a slight decline in the non-financial corporations segment, while household deposits remained stable, at historically high levels. In aggregate terms, the weight of deposits from customers in total assets increased, amounting to 56 per cent at the end of June 2014. In this context, the loan-to-deposits ratio continued to decline, mainly as a result of a reduction in the portfolio of credit to customers, standing at 114 per cent on the same date (Chart 26).

Between June and August, following developments leading to the application of the resolution measure to BES, household deposits[15] and deposits from non-financial corporations increased, reflecting a decrease in riskier savings products sold by mutual funds or other financial intermediaries and auxiliaries.

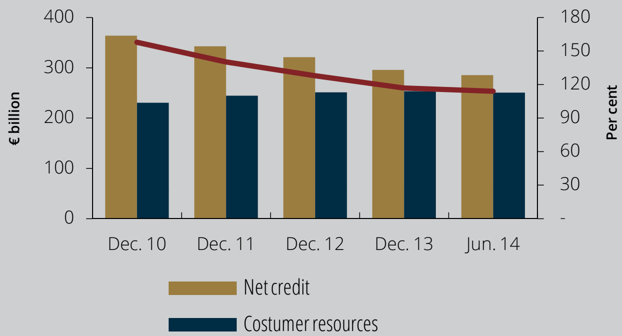
Amid a contraction in banks' assets, developments in deposits were consistent with a substantial reduction in resources from central banks, namely from the Eurosystem. In the first half of the year, Eurosystem funding declined by more than EUR 9 billion (approximately 20 per cent of the balance at the end of 2013), to historically low levels since the beginning of the Economic and Financial Assistance Programme.

Chart 25 • Customer resources taken in Portugal – semiannual change



Source: Banco de Portugal.

Chart 26 • Loan-to-deposits ratio



Source: Banco de Portugal.

In the third quarter, this trend remained, with a further decline of EUR 5 billion, to a balance of EUR 33.5 billion, accounting for a 45 per cent decrease from the historical peak in June 2012. Recourse to the Eurosystem corresponds mostly to (three-year) longer-term refinancing operations conducted in December 2011 and February 2012. The fact that these operations will reach maturity in early 2015 may render the set of measures announced by the ECB in June particularly relevant, namely the conduct of (four-year) targeted longer-term refinancing operations, the continuation of main refinancing operations conducted as fixed rate tender procedures with full allotment, and the conduct of three-month operations.

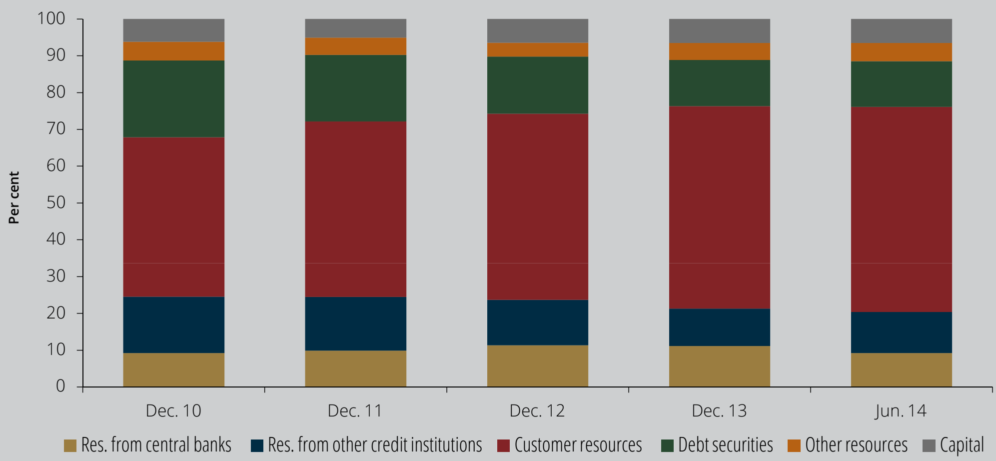
However, there is an initial maximum amount of 7 per cent of loans granted to the non-financial private sector (excluding loans to households for house purchase) allocated to each counterparty in the scope of targeted longer-term refinancing operations. In this context, a significant share of liquidity needs must be met through shorter-term operations. Nevertheless, it is desirable that the reduction in recourse to the Eurosystem proceeds, given that, in relative terms, this source of financing is still very important to the Portuguese banking system, compared with the other euro area countries.

Funding through the issue of debt securities continued to decline (Chart 27). This may still reflect some difficulty in accessing wholesale debt markets, on appropriate terms, amid a decreasing, albeit still significant, fragmentation in the financial markets. However, it may also reflect lower borrowing needs for banks. In fact, available information shows an increase in gross issues in the first half of 2014, which was offset by the high volume of repayments, namely of mortgage covered bonds. Bank funding through this type of instrument was still quite substantial at the end of June 2014 (EUR 35.6 billion; approximately 7 per cent of total assets). Likewise, recourse to repo and to other securities lending operations has been decreasing.

Overall, the banks' improved liquidity position has allowed a transition to a more stable and balanced financing structure between encumbered assets and unencumbered (but eligible) assets.[16] Given the stricter requirements in terms of liquidity and liability structures (namely, in the context of the new resolution regime),[17] these developments should be analysed in greater detail so as to better prepare banks to face any possible funding disrturbance.

Chart 27 • Funding structure

Source: Banco de Portugal.



The launch of the Single Supervisory Mechanism and the convergence to a full Banking Union should contribute to reduce financial market segmentation based on sovereign risk in the medium run, thus helping restore resident banks' access to market funding, on appropriate terms. Nevertheless, the creation of the Single Supervisory Mechanism raises new challenges. In particular, it is important to avoid an asymmetry between significant institutions (under direct supervision of the ECB) and less significant institutions (under supervision of national authorities). For that purpose, procedures should be implemented in line with best supervisory practice.

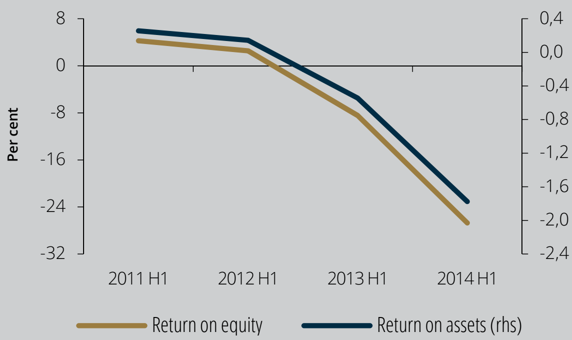
> The increase in the net interest margin and income from financial operations contributed to an improvement in average profitability among Portuguese banks, which continues to be one of the main challenges faced by the sector

In the first half of 2014 the Portuguese banking system's aggregate income deteriorated significantly, mainly due to BES-related developments (Chart 28). Excluding BES, the banking system's profitability would be slightly positive. Nevertheless, a substantial number of banks continued to post negative or close-to-zero profitability. Chart 29 illustrates developments in the Portuguese banking system's profitability distribution, weighing each observation by total assets of the corresponding institution, with a slight shift in the curve to the right, but significantly concentrated around zero.

Portuguese banks' profitability has decreased significantly since the onset of the financial crisis in 2008. This decline was broad-based across most banking systems of developed countries, particularly in the euro area, albeit with a varying magnitude. Various structural and conjunctural factors have contributed to these developments:

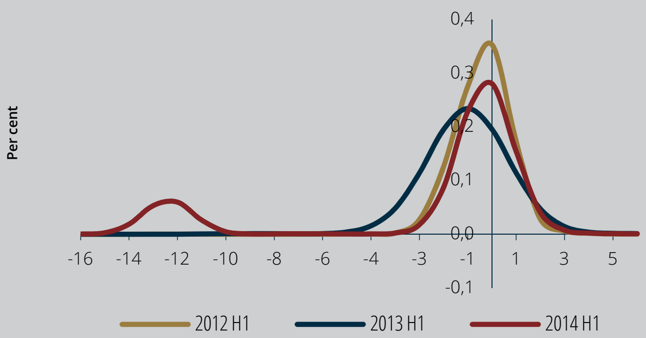
- Banks' activity is now carried out against a more demanding regulatory framework in terms of capital;
- Balance sheet adjustment in banks, which were too leveraged going into the crisis, namely through a reduction in assets;
- Shift in banks' business models, namely towards less risk in lending operations, as opposed to excessive risk-taking practices, which provided high profitability in the pre-crisis period;
- A decrease in money market reference rates (Euribor), remaining at very low levels,

Chart 28 • ROA and ROE



Source: Banco de Portugal.
Notes: Indicator computed considering income before taxes and minority interests. Annualised figures.

Chart 29 • ROA distribution | Per cent



Source: Banco de Portugal.
Notes: Empirical distribution using a gaussian kernel in which institutions are weighted by total assets. Indicator computed considering income before taxes and minority interests. The density cumulated in the left tail of the distribution, with reference to 2014H1, is due to the non-recurrent loss by BES.

in historical terms, over a protracted period of time;

- An increase in impairments due to the materialisation of credit risk;
- The reassessment of credit risk analysis models and the conduct of horizontal inspections on banks' asset quality.

In the short to medium run, the recovery of banks' profitability should go together with the continued improvement in economic activity, namely as regards the materialisation of credit risk. Since 2011 gross operating income has been insufficient to meet impairment losses and other provisions (Charts 30 and 31). One of the main challenges faced by the banking system is how to reverse this situation. In the first half of 2014, excluding BES, the flow of impairments and other provisions has declined significantly, both compared with the same period in 2013 and the previous half of the year. However, impairment costs remain historically high. Values for the first half of the year reflect the still high materialisation of credit risk – consistent with the increase in credit at risk – and an increase in the coverage ratio, across most credit purposes and resident banks (Charts 32 and 33). Nonetheless, the slowdown in credit quality deterioration is in line with lagged developments in this variable compared with economic activity, whose continued improvement is, therefore, crucial to future developments in the banking system's profitability.

Medium to long-term profitability also hinges on the increase in money market interest rates, which, in turn, also directly depends on the ECB's monetary policy and, indirectly, on potential economic growth in euro area countries as a whole. The net interest margin, which is the main gross income component, has declined by around 50 per cent since its peak in the last quarter of 2008. These developments were due, on the one hand, to a decline in banks' activity against a deleveraging background (volume effect) and, on the other hand, to a reduction in interest rate differentials between lending and deposit operations (price effect). In particular, the interest rate differential between resident lending and deposit operations fell from over 3 percentage points, in 2007 and 2008, to a little over 1 percentage point in early 2013. Despite the positive impact that it may have on economic activity in the current juncture, also contributing to the mitigation of default due to lower debt servicing, the maintenance of low money market interest rates over a protracted period of time places active constraints on the recovery of Portuguese banks' profitability. In fact, a significant share of the banking system's assets is characterised by its indexation to Euribor, with fixed and mostly low spreads, while these rates ceased to reflect banks' funding costs.

In addition to this difficulty, one should mention the tension between the urgency of a recovery in profitability and banks' intermediation function, *i.e.* the financing of the economy on terms and conditions that reflect debtors' fundamentals and the uptake of savings, offering competitive returns vis-à-vis alternative products with comparable risk.

In the first half of 2014, the net interest margin recovered somewhat, mostly reflecting a favourable price effect (Chart 30), in particular a reduction in the implied rate on banks' liabilities (Table 3). In fact, since the first quarter of 2013, the average cost of deposits has declined progressively as operations contracted in 2011 and 2012, with a maturity of over two years and particularly high interest rates, reach maturity. Furthermore, the cost of recourse to the Eurosystem has declined, while the cost of liabilities represented by senior debt and subordinated debt, which includes hybrid instruments purchased by the Portuguese State in the scope of recapitalisation operations with recourse to public investment, remained high.

Similarly to previous years, income from financial operations made a positive, non-negligible contribution to the gross income, posting an increase of over 40 per cent, compared with the first half of 2013 (Chart 30). Income from financial operations accounted for 16 per cent of the gross income generated in the first half of the year, which was very high in historical terms, mirroring substantial gains on Portuguese public debt amid a marked decrease in yields. It is not foreseeable that the magnitude of this income component will remain sustainable in the future, taking into account evidence over the past few years regarding its weight in the gross income (pointing to values consistently below 10 per cent).

Table 3 • Implicit average interest rates on the main balance sheet items

Per cent

	2011		2012		2013		2014
	H1	Year	H1	Year	H1	Year	H1
Interbank assets	1.80	1.90	1.60	1.46	1.23	1.20	1.24
Non-interbank assets							
Credit	4.03	4.35	4.52	4.23	3.69	3.70	3.53
Domestic credit	3.79	4.12	4.32	3.96	3.33	3.32	3.32
Non financial corporations and government	3.81	4.47	4.81	4.59	4.07	4.10	4.07
Households	3.75	3.73	3.79	3.33	2.66	2.62	2.67
Mortgages	2.57	2.62	2.67	2.21	1.53	1.55	1.56
Credit to foreign residents	5.47	5.59	5.57	5.52	5.22	5.34	4.34
Other financial assets	3.63	3.92	4.24	4.22	3.37	3.34	3.17
Financial assets available for sale – securities	4.37	4.75	4.86	4.79	3.66	3.73	3.50
Interest bearing assets	**3.74**	**4.03**	**4.15**	**3.93**	**3.35**	**3.37**	**3.27**
Interbank liabilities	1.70	1.90	1.66	1.54	1.21	1.07	0.98
Resources from central banks	1.20	1.37	1.14	1.00	0.77	0.60	0.29
Resources from other credit institutions	2.01	2.26	2.14	2.04	1.59	1.58	1.55
Non-interbank liabilities							
Deposits	2.06	2.37	2.76	2.64	2.15	2.06	1.83
Residentes	1.89	2.24	2.69	2.54	2.07	1.99	1.74
Non-subordinated securities	3.19	3.36	3.84	3.90	4.06	4.16	4.12
Non-subordinated liabilities	3.41	3.63	3.84	5.28	6.33	6.42	6.15
Interest bearing liabilities	**2.19**	**2.43**	**2.62**	**2.56**	**2.24**	**2.16**	**1.97**
Spreads (in percentage points):							
Interest bearing assets – Interest bearing liabilities	**1.55**	**1.59**	**1.53**	**1.37**	**1.10**	**1.22**	**1.29**
Credit - Deposits (residents)	**1.90**	**1.89**	**1.62**	**1.42**	**1.26**	**1.33**	**1.58**

Source: Banco de Portugal.
Note: Implicit average interest rates are calculated as the ratio between interest flows in the period under consideration and the average stock of the corresponding balance sheet item.

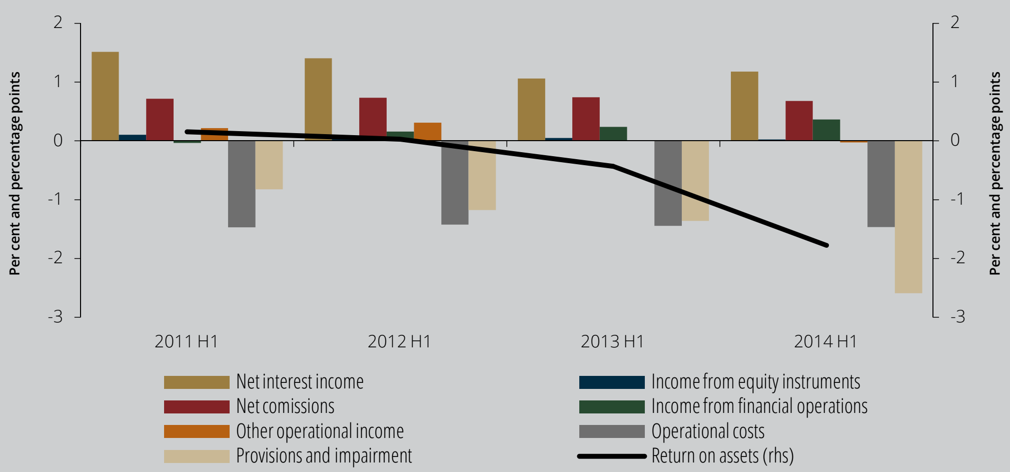


Chart 30 • ROA decomposition

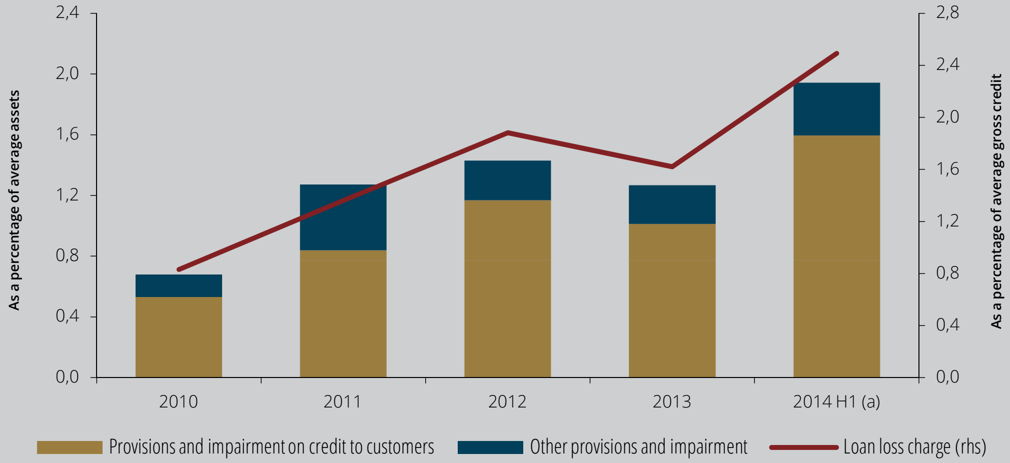
Source: Banco de Portugal.
Note: Annualised figures.

Given that any recovery in profitability through an increase in activity (volume effect) will be conditioned by the economic environment and the deleveraging process and that the price effect is also limited by the ECB's monetary policy, a crucial contribution to profitability is likely to stem from operational efficiency gains and a reduction in the cost structure.

In the first half of 2014 operational costs kept a downward trend in both the general administrative costs component and staff costs (Chart 30). For the banking system as a whole, the decline in the cost-to-income ratio compared with the same period in 2013, from 69 to 66 per cent, reflected a reduction in operational costs. Excluding BES, developments would have been more substantial. The cost-to-income ratio for the first half of 2014 would amount to 55 per cent, with the predominant contribution of a higher gross income.

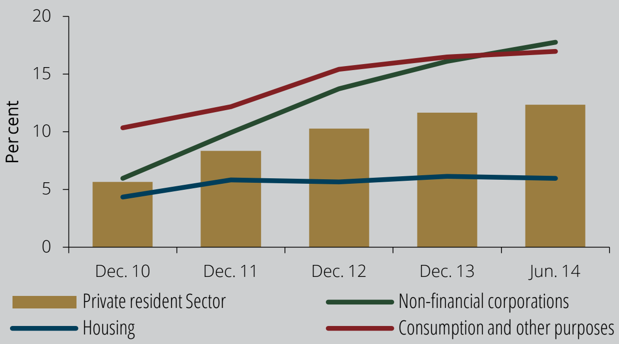
However, the margin for efficiency gains is conditioned by the starting point. Over the past few years, the cost-to-income ratio for the Portuguese banks' aggregate has broadly stood around or slightly below the average of European countries. Nevertheless, a 10-percentage point improvement in the cost-to-income ratio, through a decline in the numerator, to a position close to that for the first quartile of the distribution at European level, would

Chart 31 • Impairment flow and loan loss charge



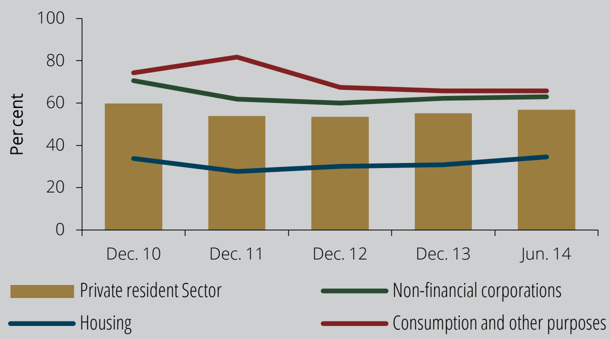
Source: Banco de Portugal.
Notes: The loan loss charge corresponds to credit impairments divided by average gross credit.
(a) Annualised figures.

Chart 32 • Credit at risk ratio by segment



Source: Banco de Portugal.
Note: According to Instruction of Banco de Portugal No. 22/2011.

Chart 33 • Credit at risk coverage ratio by segment



Source: Banco de Portugal.
Note: According to Instruction of Banco de Portugal No. 22/2011.

account for a cut of between EUR 1,000 and 1,250 million in annual operational costs and, consequently, a key contribution to an increase in asset / own fund profitability. It should be noted that cost-reducing measures may be rather complex and involve material changes in banks' business models, thus warranting close monitoring so as to prevent any implications for banks' operational costs, namely in internal control systems.

Finally, one should mention the recent developments and the potential contribution from international activity. Since the onset of the financial crisis in 2008, Portuguese banks' branches abroad have made a non-negligible contribution to the banking system's consolidated income, thus offsetting the weak performance of domestic activity. However, over the most recent period, that contribution has been less significant, as a result of a less favourable economic and financial environment in a number of non-domestic markets and the interruption / disposal of some non-strategic operations.

In the first half of 2014, the international activity's results were considerably affected by developments in BES. Excluding this group's branches, developments in the main income components were positive, with an increase in net interest margin and a decline in impairments. The international activity's importance, in prospective terms, will hinge on the banks' capacity to continue to invest on non-domestic operations, which should be conditioned by the remaining challenges on the domestic side. In any case, the low diversification both in geographical and business terms makes the international activity's results rather sensitive to macroeconomic developments in a small number of countries – particularly in Portuguese-speaking African countries, more specifically Angola. To the extent that it may imply changes to rules currently in force, the adoption of EU legislation may pose challenges to Portuguese bank's international activity, depending on the jurisdictions where it is carried out.

Solvency levels have remained broadly comfortable in most Portuguese banks

2014 marked the start of a transition to a new prudential regime.[18] The analysis of recent developments in capital adequacy indicators, namely compared with the end of 2013, is affected by breaks in the series. In particular, an estimate based on data for the eight major banking groups, with reference to December 2013, points to a 1-percentage point differential between the Core Tier 1 ratio and the Common Equity Tier 1 (CET 1) ratio due to methodological differences.

At the end of the first half of 2014, the CET 1 ratio for the banking system as a whole stood at 10.6 per cent, in the context of a 7-per cent regulatory minimum established by Banco de Portugal (Chart 34).

BES has a considerable impact on the system's ratio and its recent developments. Excluding this institution, the banking system's average CET 1 ratio amounted to 12.3 per cent, reflecting a slight increase from the end of the first quarter, which is the single comparable benchmark. Chart 35 illustrates developments in the distribution of the Portuguese banking system's CET 1 ratio, weighing each observation on the basis of the corresponding institution's total assets. The distribution shows that its density was almost entirely concentrated around values of over 7 per cent.

In May 2014, with the purpose of ensuring an adequate transition to the full implementation of CRR / CRD IV and preparing major Portuguese banks for the ECB's comprehensive assessment exercise,[19] Banco de Portugal issued a series of recommendations on banks' capital plans. In particular, it recommended the reinforcement and maintenance of the following minimum thresholds for the various regulatory ratios:

- Minimum CET 1 ratio of 8 per cent for the eight major banking groups (7 per cent for the other groups);

- Minimum Tier 1 ratio of 9.5 per cent for the eight major banking groups (8.5 per cent for the other groups);
- Minimum total solvency ratio of 11.5 per cent for the eight major banking groups (10.5 per cent for the other groups).

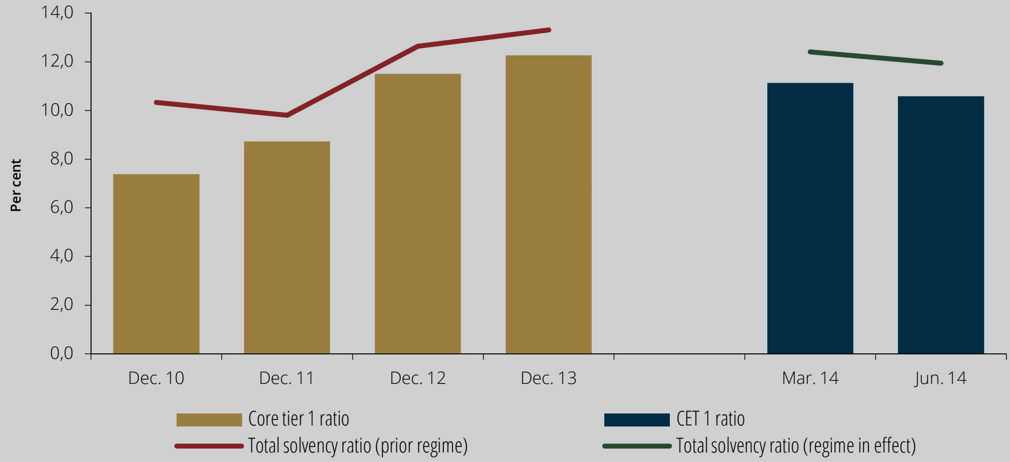
At the end of the first half of the year, solvency levels were broadly comfortable in most Portuguese banks. Where necessary, institutions should continue to adopt own funds-strengthening measures, not only on the basis of Common Equity elements, but also through the issuance of Tier 2 and Additional Tier 1 instruments.

1.3.2. Insurance sector

Direct insurance production increased, reflecting developments in life business, as non-life business continued to decrease at a moderate pace

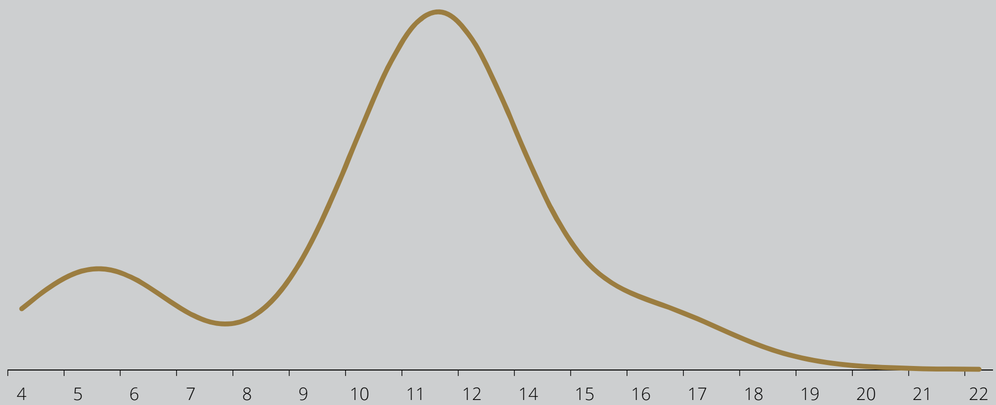
In the first half of 2014, direct insurance production increased by 18 per cent in aggregate terms compared with the same period a year earlier, owing to life business, as direct insurance premiums in non-life business declined slightly.

Chart 34 • Capital adequacy ratios



Source: Banco de Portugal.
Notes: Since 1 January 2014 is in effect the Notice of Banco de Portugal 6/2013 which establishes a new, transitory, regime of own funds adequacy. The new regime establishes inter alia that credit institutions and investment firms preserve a common equity Tier 1 (CET 1 ratio) not below 7 per cent until the Directive 2013/36/UE (or CRD IV – Capital Requirements Directive) is transposed to the Portuguese legal framework. An estimate with recourse to data for the eight major banking groups, with reference to December 2013, points to a 1 p.p. differential between the Core tier 1 ratio and the CET 1 ratio attributable to methodological differences. This differential applies also to total solvency ratios.

Chart 35 • CET 1 ratio distribution as of June 2014 | Per cent



Source: Banco de Portugal.
Notes: Empirical distribution using a gaussian kernel in which institutions are weighted by total assets. The densitity cumulated in the left tail of the distribution reflects the capital ratio of BES.

Life business accounted for 74 per cent of the sector's gross written premiums at the end of the first half of 2014, growing by 27 per cent compared with the same period a year earlier.

At the same time, life insurance claims decreased by 2 per cent (Chart 36). Developments in surrender rates[20] are likely to have contributed to this decrease, as the rates continued to decline year-on-year (standing at 4 per cent in June 2014). In spite of the legislative changes[21] that broadened the conditions for the surrender of retirement savings plans, this product's surrender rates remained low.

Reflecting combined developments in premiums and life insurance claims, technical provisions in life business increased by 5 per cent in the first half of 2014.

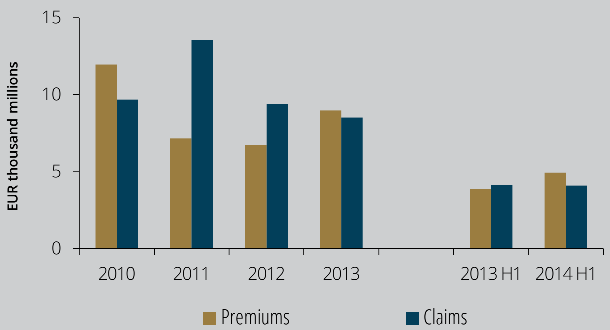
Non-life business production continued on a downward path, with the first half of 2014 slightly down compared with the same period a year earlier (Chart 37). Similarly to the past few years, motor insurance made the largest contribution to these developments. The contribution of work accidents insurance was virtually nil, in contrast with the negative contributions observed in the past years. Nevertheless, in total non-life business the drop in gross written premiums has been accompanied by a decrease in life insurance claims.

Insurance gross written premiums, in particular non-life insurance premiums, are affected by developments in insurable amounts and by the changes in premium rates applied by insurance corporations. In effect, an increase in competition, boosted by a decrease in economic activity and income, tends to lead to a decrease in average rates to the extent that, individually, insurance corporations seek to maintain and / or increase the overall gross written premiums. In time, this behaviour may result in technical imbalances that must be monitored, as they contribute to an erosion of these corporations' profits. In this context, *Instituto de Seguros de Portugal* (the Insurance and Pension Funds Supervisory Authority) has been regularly carrying out risk analyses,[22] specifically on work accidents insurance and motor insurance.

Cover ratios of technical provisions improved in both businesses and the asset portfolios composition remained stable

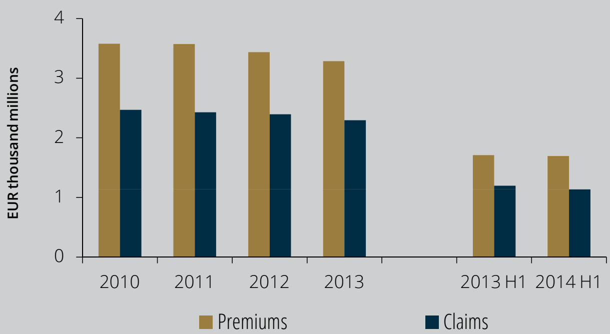
Cover ratios of technical provisions improved in the first half of 2014 (Charts 38 and 39). In life

Chart 36 • Direct life business: gross written premiums and claims



Source: Instituto de Seguros de Portugal.

Chart 37 • Direct non-life business: gross written premiums and claims



Source: Instituto de Seguros de Portugal insurance, the increase in the asset portfolio allocated to technical provisions exceeded the rise in provisions recorded in the same period. By contrast, the decrease in activity in non-life insurance partly explained the reduction in provisions established, while assets allocated to technical provisions increased marginally.

In the first half of 2014, the composition of the asset portfolio remained stable. Investments in public and private debt securities accounted for more than 76 per cent of the life insurance investment portfolio and for more than 57 per cent of the non-life insurance investment portfolio. The share of public debt held in the portfolio continued to increase in both businesses, representing around one third of the overall life insurance portfolio. The non-life insurance portfolio has a more diversified structure than the life insurance portfolio, being more exposed to real estate.

The sector continued to post a net profit and the solvency ratio recovered slightly

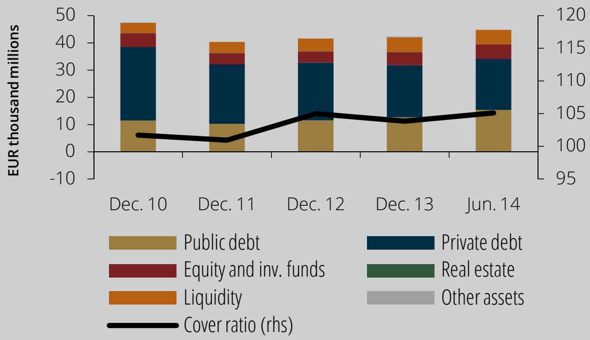
In spite of a drop of around 40 per cent from the same period a year earlier, insurance corporations continued to post a net profit. Similarly to gross written premiums, the insurance sector's aggregate profit / loss is highly dependent on life insurance profit / loss. However, it has benefited from a positive contribution from non-life insurance profits and the non-technical account.[23]

The solvency ratio increased by 19 percentage points for insurance corporations as a whole compared with the end of 2013, standing at 229 per cent at the end of the first half of 2014.

The recovery in economic activity and the adoption of Solvency II Directive[24] will affect the sector's future activity

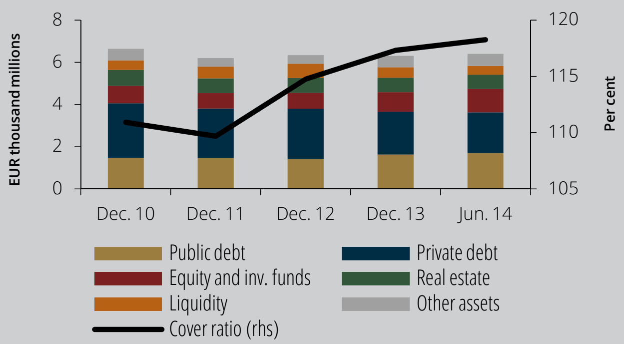
The future performance of the insurance sector will not be immune to developments in economic activity, the financial markets (including interest rate developments) and the legislative and regulatory framework. These factors may limit the regular flow of written premiums or have an impact on the return on assets, hampering the coverage of liabilities, which often have embedded financial guarantees, and

Chart 38 • Direct life business: investment portfolio and cover ratio



Source: Instituto de Seguros de Portugal.

Chart 39 • Direct non-life business: investment portfolio and cover ratio



Source: Instituto de Seguros de Portugal.

may therefore become potential constraints on the insurance sector. In addition, the sector underwent a restructuring process with the sale of some of the largest insurance corporations held by banking groups to non-resident entities. In time, these constraints may decrease covers offered, increase the price of insurance products or limit the sector's ability to act as a financial intermediary.

Within this context, the main challenges to the sector are expected to be associated with a continued low interest rate environment (which may give rise to reinvestment risks and / or search-for-yield behaviours, particularly in life business). In turn, the adoption of the new financial sector regulation (in particular the Solvency II regime) may affect the asset-liability management and the optimisation of results against a background of more risk-sensitive capital requirements.

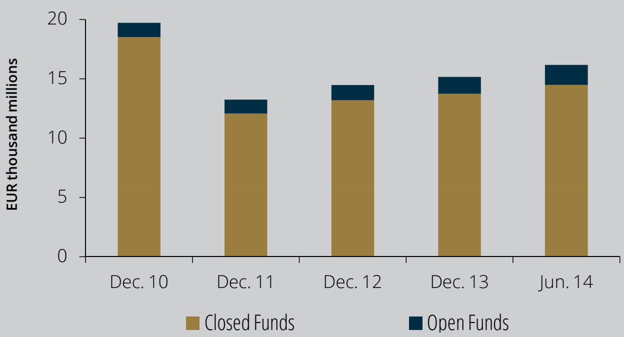
1.3.3. Pension Funds

Pension funds value increased in the first half of 2014

In June 2014, the amount of pension funds' assets under management had increased by 7 per cent from December 2013 (Chart 40). In aggregate terms, these developments emerged from the increased value of assets under management, the gradual increase in contributions received and the contained rise in benefits paid.

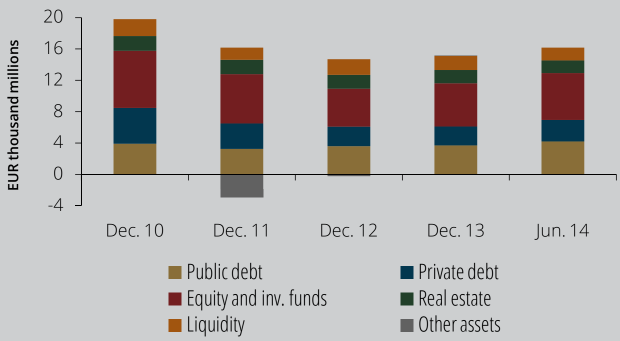
The investment portfolio composition did not undergo significant changes in the first half of 2014. The weight of public and private debt increased by 3 percentage points, representing 43 per cent of total assets (Chart 41). These developments may have benefitted from the behaviour of market interest rates. There was also a slight increase in the weight of investment in equity and investment funds, which totalled approximately 37 per cent of the total portfolio at the end of the half year. On the contrary, the percentage of real estate and more liquid assets (such as bank deposits) declined slightly during the period under review.

Chart 40 • Pension Funds: assets under management



Source: Instituto de Seguros de Portugal.

Chart 41 • Pension funds: assets composition



Source: Instituto de Seguros de Portugal.

Closed pension funds continue to benefit from the increased value of portfolio assets

Closed pension funds represented approximately 90 per cent of the sector's funds at the end of the first half of 2014; 94 per cent of the closed funds ensure the coverage of liabilities related to defined-benefit pension plans.

The 6 per cent rise in the value of closed funds, compared with December 2013, was chiefly the result of the increased value of its assets, given that benefits paid, expressed as a percentage of the fund's assets, continue to be stable and contributions had a marginal impact on half-yearly developments (Chart 42).

Contributions declined from 2011 to 2013. In the first half of 2014, however, there was a significant increase in this item, due to the effect of the change in contributions to defined-benefit pension plans and health insurance plans.

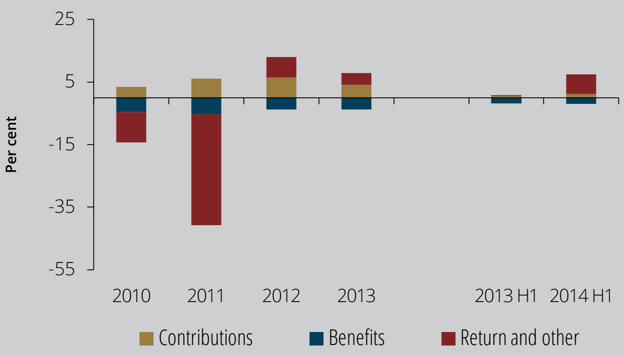
As regards closed pension funds, contributions made by the fund's scheme members and beneficiaries remained stable over the period under review. Therefore, the decline in contributions reflected the fall in sponsors' contributions.

Open pension funds value grew, as a result of increased contributions to other open funds and PPR-type pension funds, with individual membership

At the end of the first half of 2014, open pension funds represented around 10 per cent of the sector's assets, with 18 per cent growth from December 2013. In that period, contributions increased by 479 per cent (Chart 43), due to a rise in the amount associated with individual membership of other open funds and PPR-type funds (retirement savings' plans). Benefits paid maintained the downward trend observed since 2011.

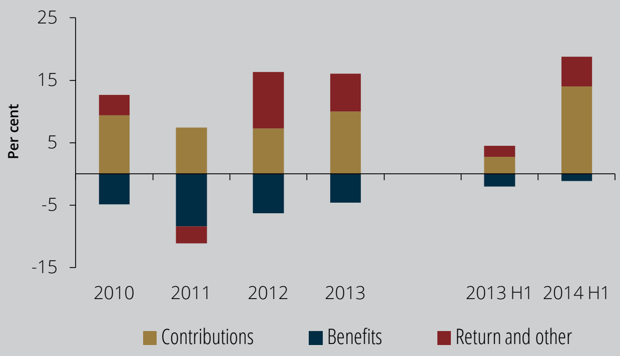
Although contributions in open-end funds are more equally distributed among sponsors and scheme members, there is still a downward trend in contributions from sponsors, which is offset by an increase in contributions from scheme members.

Chart 42 • Closed pension funds: contributions to value change



Source: Instituto de Seguros de Portugal.

Chart 43 • Open pension funds: contributions to value change



Source: Instituto de Seguros de Portugal.

Low yield of underlying assets may lead to increased risks for the funds' originators, in particular defined-benefit pension plans, or may render investments in these products less attractive.

Pension funds financing defined-benefit plans represent the most substantial share of the sector in Portugal. Since benefits are determined a *priori*, their amount is not dependent on return generated. Therefore, investment risk falls on the plan originator, which may need to increase contributions made so that the fund's financing level is maintained in balance.

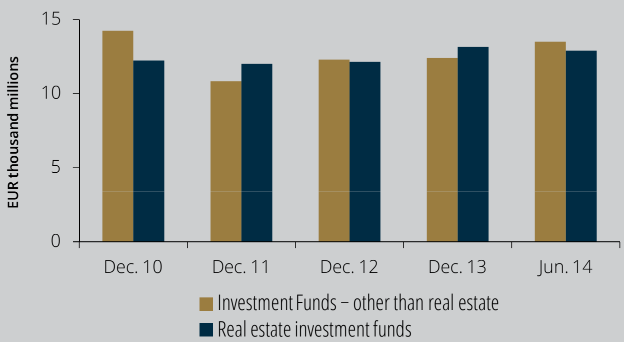
A framework has been created to boost changes in defined-benefit pension plans, following the adoption of IAS 19[25] as a benchmark for reporting liabilities related to pension funds, the introduction of changes in the nature of labour relations that translated into greater mobility, and developments in the capital market in recent years. As a result, pension plan conditions have been changing, frequently resulting in closing defined-benefit plans to new members and setting up defined-contribution plans. The plan originators thus try to contain the exposure of their balance sheets to risk associated with developments in pension fund liabilities.

This change is particularly relevant in the current context of low financial asset yield and weak economic growth, since it exposes the plan beneficiaries to investment risk, insofar as the adequacy of retirement income (even if supplementary) may depend on the profitability of pension funds. Against this background, one of the challenges of this sector is to obtain, in the medium term, positive real value growth rates that incentivise private agents – sponsors and individuals – to invest their savings for the long term.

From a long-term perspective, these vulnerabilities may be potentially amplified by the longevity risk[26] which, although slowly materialising, will spill over into a rise in the current amount of pension fund liabilities, raising the financing costs of defined-benefit plans, and / or into a deterioration of the adequacy of retirement benefits offered by defined-contribution plans.

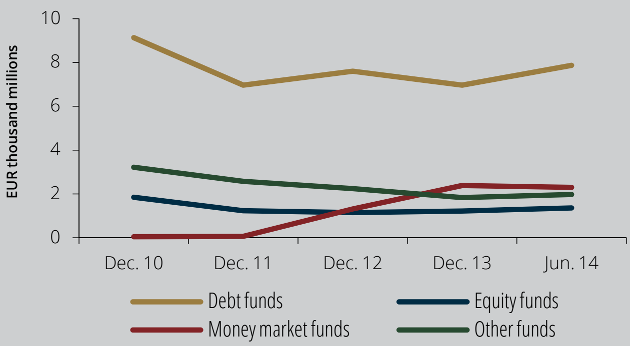
In a context of continued decline in retirement benefits from social security, the setting up of financing vehicles for additional pension income gains further importance. Moreover, pension funds, as institutional investors managing very long-term liabilities, contribute to the stable financing of the economy, and are therefore essential to the implementation of longer-term investment projects that raise and improve the productive capacity of the Portuguese economy.

Chart 44 • Investment funds: net assets under management



Source: Banco de Portugal.

Chart 45 • Mutual funds: net assets under management by type of fund



Source: Banco de Portugal.

1.3.4. Investment funds

The net value of mutual funds' assets under management increased on account of household investments and favourable market developments

The first half of 2014 saw an increase in the net value of investment funds' assets under management.[27] This increase was due to developments in mutual funds that grew by 9 per cent, while real-estate funds declined by 2 per cent in this half year (Chart 44).

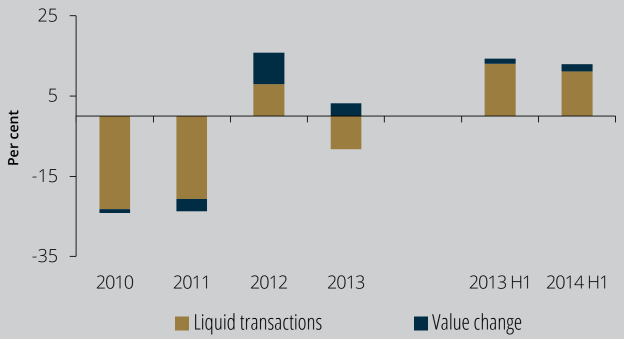
The increase in mutual funds was influenced by the behaviour of bond funds[28] (Chart 45) that represented, at the end of June 2014, around 58 per cent of the net value of mutual funds' assets under management. Developments in the value of bond funds' assets under management are largely dependent on investments and savings redemptions. In particular, the growth of asset value made a positive contribution from 2012 (Chart 46).

The composition of the investment portfolio of bond funds shows a change in deposits from 17 per cent of net assets under management at the end of 2013 to 22 per cent in June 2014. In turn, the percentage of debt securities in the total portfolio of these funds stood on that date at historical lows (representing around 71 per cent of the net value of assets under management).

In aggregate terms, the importance of public debt securities in the mutual funds portfolio remained stable in the first half of 2014, in spite of a decline in securities issued by the Portuguese general government and a corresponding increase in securities issued by other EU countries. The decline in the weight of bonds in the total mutual funds portfolio is the result of a decline in investments in private debt securities, particularly issued by non-residents.

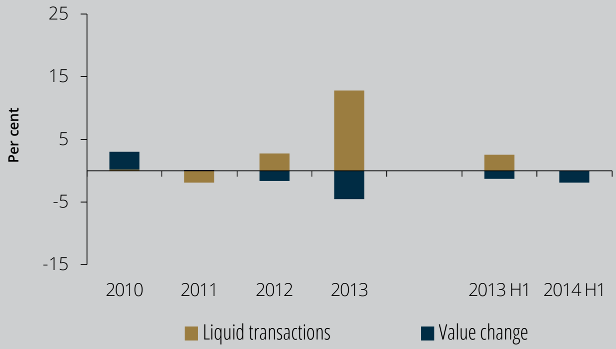
In the first half of 2014, households were mainly behind rising investments in bond funds, holding approximately 80 per cent of those funds at the end of June 2014. Insurance corporations and pension funds held 5 per cent of bond funds and 12 per cent of equity funds on that date, whereas banks held 4 and 0.7 per cent respectively.

Chart 46 • Bond funds: contributions to value change



Source: Banco de Portugal.

Chart 47 • Real estate funds: contributions to value change



Source: Banco de Portugal.

Real-estate investment funds declined in the first half of 2014, due to the devaluation of the underlying property

While in 2013 the development of investments in real-estate investment funds explained the rise in the value of these funds, in the first half of 2014 the very low value of net transactions showed the devaluation of real-estate funds, due to a contraction in the value of property held in portfolio (Chart 47).

Banks continued to raise their exposure to real-estate funds, holding around 44 per cent of these funds at the end of the first half of the year, followed by insurance corporations and pension funds, with 22 per cent. By contrast, the amount held by households continued to decline.

Mutual and real-estate funds showed substantially different leverage levels,[29] due to the nature of assets under management. In the case of real-estate funds, the leverage level attained 23 per cent at the end of the first half of 2014 (the same indicator was 2 per cent in mutual funds).

The banking sector continues to influence resources and assets allocated to mutual and real-estate funds

In recent years, developments in mutual funds were closely associated with adjustments in the Portuguese economy, including at banking sector level. Since banks are a privileged channel to place mutual funds with private individuals, they are capable of influencing their decisions, which therefore will not depend exclusively on fund management results.

Taking into account the considerable percentage of savings allocated to bond and money-market funds, the maintenance of low market yields creates an incentive to transfer those savings to other higher-yield and riskier products, implemented through mutual funds or directly acquired from credit institutions, such as debt securities or equity. This situation must be monitored.

In the recent past, negative profitability recorded by real-estate investment overall has been followed by an increase in the respective asset portfolios, largely reflecting asset transfers by banks. Real-estate funds' performance will ultimately depend on the development of domestic economic activity, although also depending on portfolio composition. Still, from a risk management perspective, the transfer of real estate to funds enables assets to be managed by specialised entities, and changes in the value of those assets may be perceived by the agents through the development of the value of those funds' units.

Box 1 | A financial stress indicator for Portugal

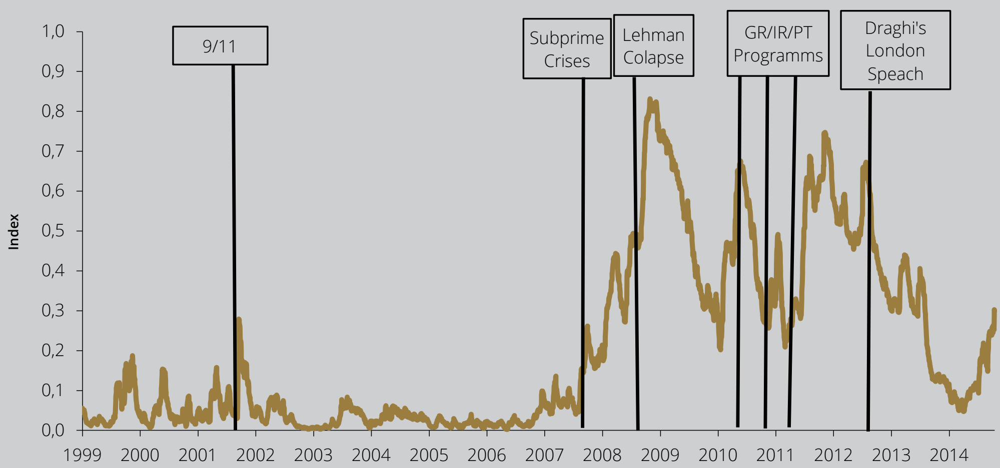
The recent international financial market crisis brought to light the impact of financial instability periods on economic activity developments and the population's well-being. This fact in itself justifies the creation of an adequate instrument to measure and monitor stress levels in financial markets.

In this context, a Composite Indicator of Financial Stress for Portugal (ICSF) was developed with the purpose of providing an aggregate picture of the existing stress in the Portuguese financial markets. In spite of the degree of integration of Portuguese financial markets with international financial markets, particularly with the euro area, a number of idiosyncratic events have affected Portugal and justify the creation of a specific financial stress index.

The first aspect for building the ICSF is based on the choice of core financial stress indicators for five market segments: money market, bond market, equity market, financial intermediaries and foreign exchange market. For each market segment, three indicators were selected to capture different stress components, being perfectly correlated only in situations of extreme stress. These indicators are subsequently standardised so as to be aggregated. The first aggregation stage involves the construction of five indices, one for each market segment. In the second stage, these indices are aggregatedinto the composite indicator of financial stress. This aggregation takes into account the relative impact of a shock in each market segment on economic activity, as well as the time-varying cross-correlations matrix between the different sub-indices for the the five market segments. It is due to this latter characteristic that the indicator posts more substantial signs when all market segments deteriorate at the same time. It also allows the ICSF to be broken down by the contribution from each market segment and the cross-correlations component. For a more detailed description of the indicator's construction, see Braga, Pereira and Reis (2014).[30]

The obtained indicator appropriately captures the main stress events in national financial markets (Chart 48). Peaks of tension were most

Chart 48 • Composite indicator of financial stress for Portugal and main risk events since 1999

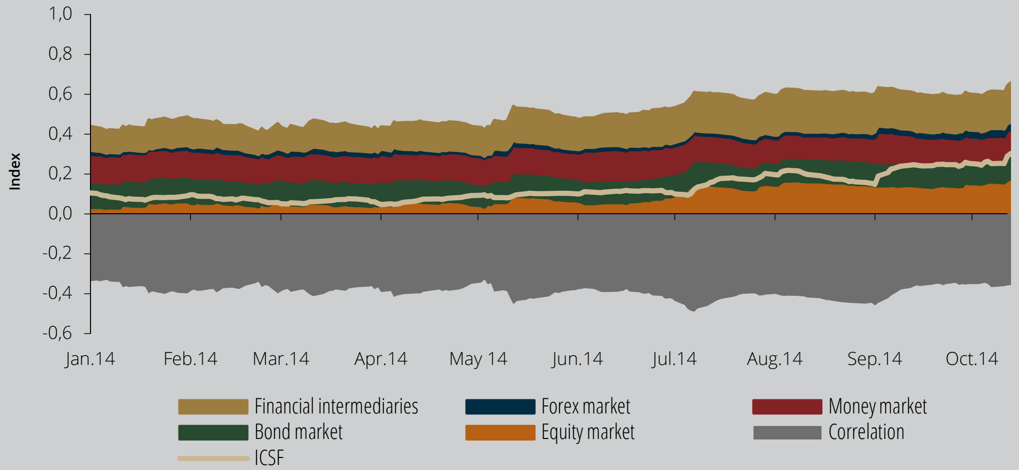


Source: Banco de Portugal.

noticeable surrounding the bankruptcy of Lehman Brothers and the sovereign debt crisis that affected a number of euro area countries.

Turning to recent developments in the ICSF (Chart 49), over the first half of the year the indicator remained low (around 0.10), reaching in April its lowest value since 2007. However, since then, the indicator started to follow an upward path, which was particularly marked in July, leading the indicator to exceed 0.20 (the reference value for significant financial stress situations). Further financial market instability in September and October led the indicator to increase again, reaching its highest value since August 2013. By segment, this deterioration is mostly due to increased tension in the equity market and in the financial intermediaries segment, which are directly linked to developments in Grupo Espírito Santo that resulted in the application of a resolution measure to BES. Subsequently, this movement was amplified by an overall risk aversion sentiment in international financial markets. Indices for money market, bond market and foreign exchange market segments remained relatively stable. The correlation component remains low, mirroring diverging behaviours across segments.

Chart 49 • Composite indicator of financial stress for Portugal and contributions from the different segments



Source: Banco de Portugal.

Box 2 | The comprehensive assessment of euro area banks: main results for the Portuguese banks

In October 2013, the European Central Bank (ECB) announced that it would conduct a comprehensive assessment of euro area banks, in collaboration with the national competent authorities responsible for supervision. The assessment was expected to be concluded prior to the ECB assuming full responsibility for supervision as part of the Single Supervisory Mechanism (SSM) on 4 November 2014.

The comprehensive assessment reviewed 130 banks of euro area countries. The objectives of this exercise were to (i) strengthen banks' balance sheets by repairing the problems identified, (ii) enhance transparency and improve the quality of information on the condition of the banks and (iii) build confidence in banks.

The comprehensive assessment included an Asset Quality Review (AQR) and a stress test, which was carried out using methodology prepared by the European Banking Authority, similarly to the EU-wide stress tests developed in previous years. These two exercises were designed in an articulated manner, and the AQR and stress test results were integrated through the join-up process defined for the purpose.

In Portugal, the assessment initially included Caixa Geral de Depósitos, Banco BPI, Banco Comercial Português and Espírito Santo Financial Group. As a result of the resolution measure applied to Banco Espírito Santo, it was decided not to include this bank in the disclosure of results of the comprehensive assessment, given that it would not be possible to timely conclude this exercise for Novo Banco.

Within the AQR, a detailed review was performed of banks' balance sheets as at 31 December 2013, examining whether assets, collateral and the respective provisions were properly valued, thus enhancing the level of transparency associated with banks' exposures.

The stress test provided a forward-looking examination of the resilience of banks' solvency under two macroeconomic scenarios: a baseline scenario and an adverse scenario. The latter, although plausible, is unlikely to occur.

The comprehensive assessment results were calculated on the basis of the Common Equity Tier 1 (CET1) ratio. This ratio in December 2013 adjusted for the AQR results had an assessment threshold of 8 per cent. In the baseline scenario, the ratio adjusted for the AQR results, and projected up to 2016, also had an assessment threshold of 8 per cent. Finally, the ratio adjusted for the AQR results, and projected up to 2016, for the adverse scenario had an assessment threshold of 5.5 per cent.

AQR – Asset quality review

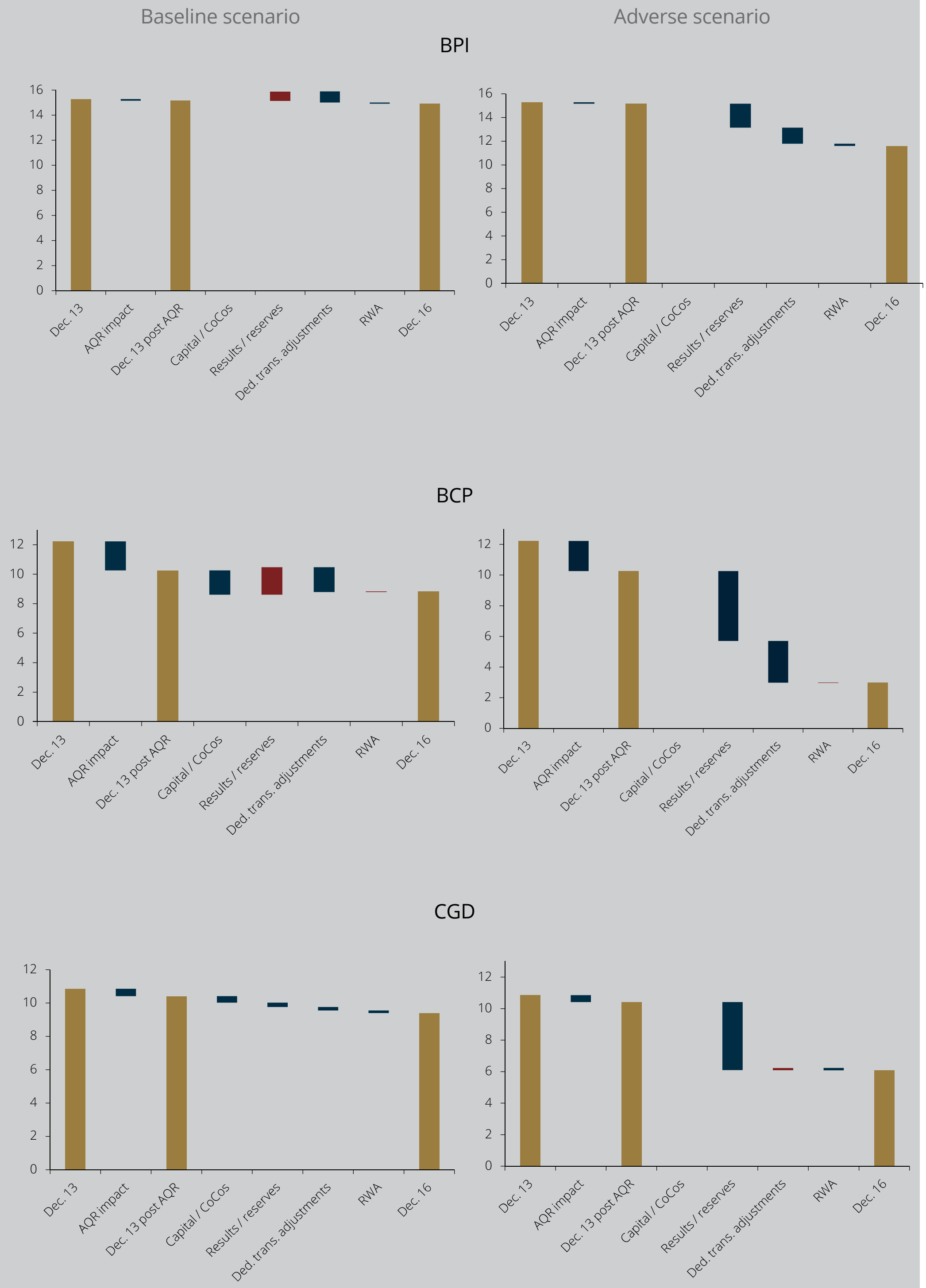
The AQR focused on the most risky balance-sheet items, selected in accordance with a uniform methodology and harmonised definitions. This exercise therefore sought to maintain a level playing field across the different jurisdictions within the SSM, in a context where there are still differences among countries as regards the definition of regulatory capital.

This evaluation delivered, where necessary, a review of the impairments associated with each bank's exposures. The increase in impairments as a result of the AQR led to the calculation of adjusted CET1 ratios, allowing for an actual comparison of all 130 banks that are part of the SSM. In Portugal, adjustments due to the AQR correspond to 0.1 percentage points of the CET1 ratio for Banco BPI, 0.4 percentage points for Caixa Geral de Depósitos and 1.9 per cent for Banco Comercial Português (Chart 50).

Stress test

In the stress test, the institutions' financial and prudential statements were projected on the basis of balance-sheet data for December 2013, adjusted for the AQR results. Projections have a three-year time horizon, *i.e.* up to December 2016. The relevant variable for the analysis is the CET1 ratio.

Chart 50 • Developments in the CET1 ratio | per cent



Source: Banco de Portugal.
Notes: columns in yellow correspond to the CET1 ratio as at December 2013, before and after the AQR results, and December 2016. Positive/negative contributions to developments in the ratio are shown in red/blue. The column "Capital / CoCos" refers to capital increases and reimbursement of hybrid instruments; the column "Profit and loss and Reserves" refers to cumulative profit and loss and changes in reserves; the column "Deductions and transitional arrangements" refers to deductions from own funds in accordance with the CRR / CRD IV and respective transitional arrangements; the column "RWA" shows the impact on the ratio of changes in capital requirements.

The macroeconomic and financial scenarios

The stress test was performed in two different scenarios. The baseline scenario was prepared by the European Commission and reflected the then official macroeconomic projections.

The adverse scenario was set by applying deviations from the baseline scenario stemming from low-probability shocks, albeit plausible, with an impact on the macroeconomic and financial variables. These shocks corresponded to the materialisation of the main systemic risks: an increase in global government bond yields; a further deterioration in credit quality in economies with feeble aggregate demand and still vulnerable banking systems; stalling reforms raising concerns on the sustainability of public finances; and the lack of necessary balance sheet repair to maintain affordable market funding.

The scenarios for Portugal

The baseline scenario of the stress test assumed a gradual recovery in activity economic in Portugal.

The adverse scenario includes particularly stringent assumptions:

- A protracted recession period in the Portuguese economy, with a cumulative reduction in economic activity of more than 10 %, over the 2011-16 period;
- A projected unemployment rate for 2015 of more than 18 %, with only a slight decline in the following year;
- A significant increase in long-term government debt yields, with an impact on the economy's financing and the valuation of banks' debt securities portfolios.

Both scenarios assumed a substantial reduction in housing prices: around 10 % in the baseline scenario and 20 % in the adverse scenario (in cumulative terms).

Compared with the latest projections, only the GDP growth rate for 2014 is identical to that foreseen in the baseline scenario. Developments have been more favourable in variables for unemployment, government bond yields and housing prices. Given such developments, the adverse scenario projections, which are much more severe than those for the baseline scenario, are much less likely to materialise.

Table 4 • Main variables of the macroeconomic and financial scenarios

	Portugal			European Union		
Baseline scenario	2014	2015	2016	2014	2015	2016
GDP at constant prices (annual rate of change)	0.8	1.5	1.7	1.5	2.0	1.8
Unemployment (as a % of labour force)	16.8	16.5	14.5	10.7	10.4	10.1
Long-term interest rates (10-year Treasury bonds)	5.1	5.4	5.5	2.9	3.2	3.3
Residential property prices (annual rate of change)	-5.6	-3.9	-1.3	0.9	2.7	3.8
Adverse scenario	2014	2015	2016	2014	2015	2016
GDP at constant prices (annual rate of change)	-0.8	-2.3	-1.1	-0.7	-1.5	0.1
Unemployment (as a % of labour force)	17.2	18.2	17.4	11.3	12.3	13.0
Long-term interest rates (10-year Treasury bonds)	7.4	7.1	7.2	4.4	4.3	4.4
Residential property prices (annual rate of change)	-9.3	-7.5	-4.6	-7.9	-6.2	-2.1

Notes: Figures as a percentage.

Methodology

The stress test was performed under a general static balance sheet assumption. Under this assumption, balance sheet items remain constant (as at December 2013) and the financial instruments are replaced at maturity, keeping the same characteristics.

Exceptions were granted to this assumption, albeit within certain limits, in the case of banks with restructuring plans agreed with the European Commission before 31 December 2013 within the scope of capitalisation operations through public investment. Banco Comercial Português and Caixa Geral de Depósitos opted to benefit from this exception.

In the exercise, the projection for the net interest income was conditioned by constraints regarding funding costs and the intensity with which banks can pass on the increase in funding costs to lending rates. For banks under the static balance sheet assumption, the net interest income could not increase in relation to the starting point (2013). Other income and cost items were also restricted by the value recorded at the starting point or by historical values of these variables.

The assumptions of the exercise were particularly stringent for banks whose starting point of the stress test exercise coincided with a particularly adverse year, as was the case for Portuguese banks. Indeed, Portuguese banks recorded in 2013 the worst results of recent history, resulting from the adverse macroeconomic context.

On the one hand, the net interest income of Portuguese banks has been squeezed by low interest rates. On the other hand, the increase in credit default and the inspections carried out by Banco de Portugal, in the context of the Economic and Financial Assistance Programme, led to the recognition of very high impairment for credit risk.

Main results of the Comprehensive Assessment

The results of the AQR and the baseline scenario of the stress test (2014-2016) make it possible to ascertain the resilience of the Portuguese banks covered in the test and show that they have adequate capitalisation levels. In both cases, all banks register capital ratios above the threshold of 8 %.

Under the adverse stress test scenario, which is deemed unlikely, the CET1 ratio projected for Banco Comercial Português in December 2016 falls short of the 5.5 % threshold. The institution has already identified a set of measures to fully cover the shortfall detected. These measures are included in the capital plan submitted to the ECB.

It should be noted that the adverse stress test scenario is particularly severe, as mentioned above. Moreover, in the particular case of Banco Comercial Português, the stress test did not fully reflect the globally positive developments resulting from the implementation of the restructuring plan agreed with the European Commission.

Box 3 | Resolution measure applied to Banco Espírito Santo, S. A.

In mid-2014 Banco Espírito Santo, S. A. (BES) was the third largest bank in the Portuguese banking system, with a market share of around 11.5 per cent of total deposits received from residents in Portugal, approximately 14 per cent of total loans granted and 19 per cent of loans granted to non-financial corporations. Also, its market share of the financial and insurance sector financing amounted to 31 per cent, which shows a strong interconnection with the rest of the financial services industry. BES, an integral part of Espírito Santo Financial Group (ESFG), belonged to a larger group (Grupo Espírito Santo – GES), which was active both in the financial sector and also the non-financial sector, with a broad geographical scope (25 countries on four continents). The bank therefore played a very significant role in the national economy and financial system, especially in the financing of non-financial corporations.[31] In this context, it is important to monitor closely the consequences of the sudden decline in BES's solvency levels which, in turn, have led to the application of a resolution measure to this bank.

Resolution measure applied to BES

The Horizontal Review of Credit Portfolio Impairment[32] (ETRICC 2), carried out at the end of 2013, found a significant increase in the financial liabilities of Espírito Santo International (ESI), the main shareholder of ESFG, when compared with information previously reported by the latter to Banco de Portugal and reflected in the respective financial statements. This increase had an impact on ESFG's financial position, resulting from links within GES, the uncertainty generated around the group's corporate governance structure[33] and the risk of contagion to BES arising from GES's non-financial arm, and signs of potential losses from BES Angola's credit portfolio, had a negative impact on BES's liquidity, especially in the course of July. The downgrading in this month by the main rating agencies and the request to open controlled-management processes submitted by some GES entities have been reflected in investors' confidence and the capital markets, leading the counterparties to close financing lines.

At the end of July 2014, BES released the results for the first half of the year, with losses of around € 3.6 billion (on a consolidated basis). This included the negative impact of approximately € 1.5 billion resulting from management acts infringing determinations previously issued by Banco de Portugal. As a result of those acts, losses attained a value greatly in excess of the capital buffer available to the bank, stipulated in a determination of Banco de Portugal.

The situation described above had very serious consequences for BES:

- A substantial reduction of the Common Equity Tier 1 (CET1) ratio to around 5 per cent (on a consolidated basis), significantly below the minimum required by Banco de Portugal;
- The ECB's decision, effective as of 4 August, to suspend BES's counterparty status (and therefore to suspend its access to liquidity provided by the Eurosystem), and, in parallel, to oblige the bank to repay its credit to the Eurosystem in full, to an amount of around € 10 billion;
- The significant deterioration of confidence conditions, which are a key factor for BES to operate as a bank;
- The growing pressure on the bank's liquidity;
- Increased uncertainty over BES's balance sheet, making a private capitalisation solution unfeasible in the short run.

These facts placed BES at severe risk of not meeting, in the short run, its commitments and, as a result, not fulfilling the requirements to retain authorisation to operate. Given the relevance of the institution in the Portuguese banking system and in the financing of the economy, this situation has put the stability of the national financial system at serious risk, making it therefore imperative and urgent to adopt a solution that would simultaneously ensure the protection of depositors, the stability of the financial system, and the continued financing of the economy, while minimising the impact on public funds.

Since the bank could not be capitalised through private capital, in the absence of another alternative from among those defined to address credit institutions with insufficient capital, and due to BES's importance in the banking system and in the financing of the economy, Banco de Portugal applied a resolution measure to BES on 3 August 2014, pursuant to the legal framework in force. A bridge bank was thus set up, called Novo Banco, S. A., to which was transferred most of the activity until then conducted by BES, as well as a significant tranche of its assets and liabilities, off-balance-sheet items and assets under management, with a view to their subsequent sale to (an)other financial institution(s).

This measure made it possible to (i) protect depositors and contain systemic risk, (ii) safeguard the continuity and the smooth functioning of the banking activity previously conducted by BES, (iii) impose the absorption of losses by the bank's shareholders and subordinated creditors,[34] without prejudice to the existence of a legal mechanism ensuring that those losses shall not exceed those inherent in a winding-up proceeding, and (iv) segregate the risks that led to the sudden decline in BES's solvency levels.

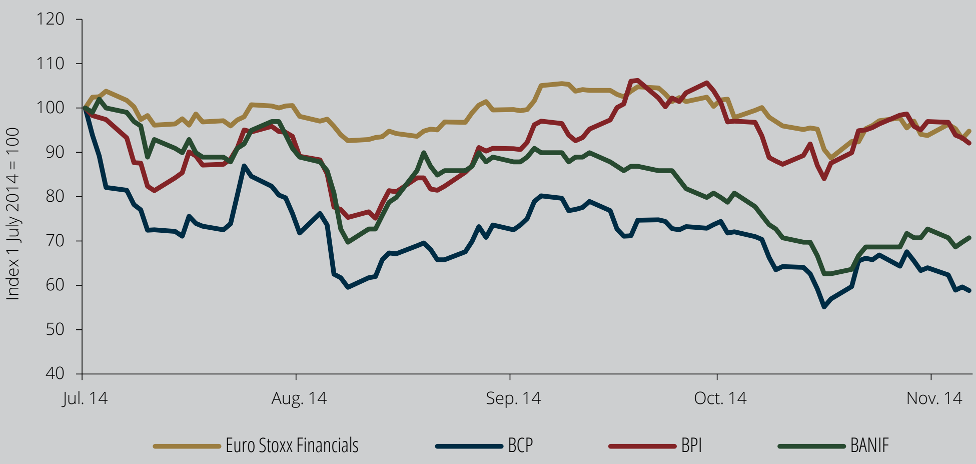
Developments after applying the resolution measure

Analysis of the main market indicators and data available up to early November show that, overall, the application of the resolution to BES made it possible, as mentioned above, to maintain stability and confidence in the Portuguese financial system and contain the systemic effects, even though this is one of the most important national banks.

Indeed, in both the equity and debt segments, the sudden decline in BES's solvency levels and its consequences may have had a temporary contagion effect on the other Portuguese listed banks. This effect has been unwinding since the second half of August (Chart 51).

In turn, the resolution measure's financing characteristics – in particular, the fact that shareholders shall bear first the losses of the

Chart 51 • Stock market prices: portuguese banks and european financial index



bank in question, and that the respective creditors shall bear second, under equitable conditions, the other losses of the bank, and also the fact that the Resolution Fund will finance the resolution measure – made the contagion effect on the risk and cost of financing of the Portuguese Republic smaller and shorter-lived. Therefore, Portuguese sovereign debt yields continued in line with developments in other euro area sovereign debt markets, pursuing the compression of spreads vis-à-vis German public debt, in the context of the expansionary monetary policy promoted by the ECB (as detailed in section 1 of this document) – see Chart 52.

As regards developments in deposits, the confidence of Portuguese bank depositors continued to show striking resilience after the adoption of the resolution measure, as observed since the start of the financial crisis in 2008 (Chart 53).

Chart 52 • 5 Year Sovereign Bond Yields | Spreads vis-à-vis Germany

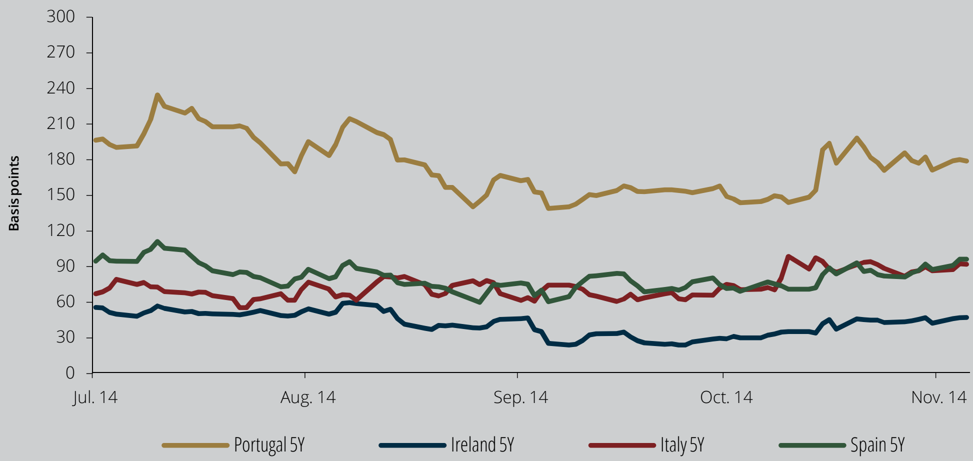
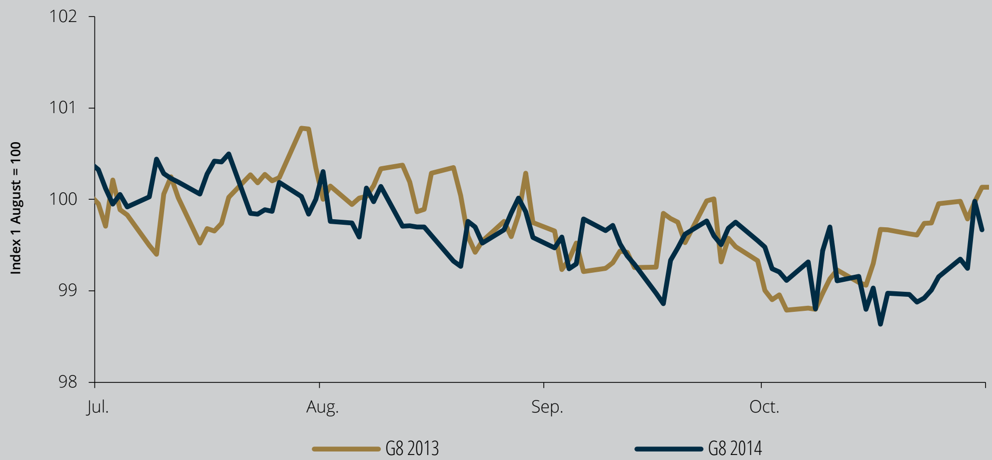


Chart 53 • Deposits of the eight largest Portuguese banking groups: comparison with the previous year



In spite of this revealing evidence of a limited and temporary impact on financial markets, it is necessary to monitor closely the potential effect that the situation that led to a resolution measure for BES may have on the economy, in view of the scenario based on the information summarised above.

Among the factors that may have implications for the current economic and financial context is the wealth effect resulting from losses borne by BES's shareholders and subordinated creditors, resident in Portugal, as well as losses borne by resident shareholders, creditors and / or holders of other financial assets issued by GES companies under insolvency proceedings. Due to the difficulty in evaluating the importance of the wealth effect – since it depends, among other factors, on the marginal propensity for consumption and investment capacity – it is important to monitor its possible reflection on domestic demand and, therefore, on economic activity.

In turn, corporate governance failures, as well as the assumption of losses by BES's shareholders and subordinated creditors, may generate confidence effects, negatively affecting (i) the perception of the economic agents on the quality of corporate management and (ii) their investment decisions in the short run, damaging the operations of the capital markets.

Finally, the potential impact of the current transition on the unfolding of the banking sector's financial intermediation function, which is vital for ensuring the financing of the economy, must also be closely monitored. On the one hand, it is essential to monitor developments of credit granted, focusing not only on potential volume and price effects, but also on the manner in which credit is allocated among the different sectors of the economy. Most recent data show that year-on-year rates of change of credit granted by the resident financial sector, although remaining in negative territory, have been increasing in both non-financial corporations and households. However, the adjustment process that began with the Economic and Financial Assistance Programme and the positive signs of gradual reallocation of funds to more productive activities must be continued, enhancing the sustainable growth of the economy. On the other hand, the final cost of the resolution measure applied to BES, to be supported by the Resolution Fund, will depend on the sale conditions of Novo Banco.

In short, the application of a resolution measure to BES has made it possible to preserve the stability of the financial system, to protect depositors, to ensure the continuity of the provision of essential financial services, to minimise the costs for public funds and to hold the institution's shareholders responsible. The range of previously mentioned indicators reveals that the effects on financial markets were limited and temporary. However, further close monitoring of the current situation will be necessary, ensuring the maintenance of economic agents' confidence and the stability of the Portuguese financial system.

2. Risks to financial stability

The reversal of search-for-yield behaviour at an international level is currently one of the main risks to financial stability

Against a background of low inflation and weak economic growth, accommodative monetary policies pursued by several central banks have led to a prolonged low interest rate environment (see Section 1.1.). These policies were designed to promote domestic demand and employment, encouraging economic risk taking. However, their effectiveness on investment and capacity utilisation has not yet become apparent, which may stem from balance-sheet adjustments in the economic sectors of some countries and ongoing impairments in the monetary policy transmission mechanism. In effect, given the implications of monetary policy on interest rates, there has been financial risk taking to the extent that low interest rates have favoured demand for investment alternatives that provide investors with higher yields (although associated with higher risk) without any clear correspondence with economic risk taking.[35]

This search for yield, which is increasingly more visible both in the United States and Europe, results in a shift in the portfolios of institutional investors, especially those with capital guarantee and yield responsibilities (insurance corporations, pension funds and certain investment funds) towards riskier assets. This search for yield, against a background of low volatility, only interrupted by one-off episodes, has led to a generalised decrease in risk premia, which is also visible in stressed euro area countries.

Nevertheless, there are factors that may boost a reversal in this movement, with marked consequences in highly indebted countries, namely: (i) a reassessment of the relative value of euro area assets compared with emerging market assets, associated with uncertainty about the economic recovery in the euro area; (ii) a sudden increase in risk aversion due to geopolitical tensions; (iii) economic and financial developments in stressed euro area countries, in spite of the positive effects associated with the creation of the Banking Union; and (iv) a possible divergence between market expectations and central bank communication (specifically from the US Federal Reserve), although the latter have signalled their forward guidance to the market.

The consequences of a reversal of the search for yield may be amplified against the current background of low liquidity levels in the private debt securities market, associated with several factors, such as (i) new regulatory requirements, which may discourage market makers from acting, (ii) holdings of less liquid debt securities (in the light of the introduction of the ratio internationally known as the Net Stable Funding Ratio into EU legislation) and (iii) the impact that technological innovations have had on the dissemination of transactions via trading platforms. The proliferation of trading platforms has on the one hand contributed to greater market transparency and on the other to a fragmentation of a market that is still not liquid enough.

Idiosyncratic factors in the Portuguese economy and financial system may add to international risk factors

In addition to the aforementioned international factors, a few developments inherent to the Portuguese economy and financial system may lead to increased market interest rates associated with the debt of resident entities. Albeit temporary, the impact felt in the financial markets in July 2014, following the problems detected in Grupo Espírito Santo, is a good example of an idiosyncratic factor potentially impacting on yields. Possible changes in the external perception concerning the process of fiscal consolidation, were it to continue, may therefore have an impact.

For resident issuers, interest rates are expected to become more sensitive to disturbances, taking into account the reduced depth of financial markets for their assets. In effect, the current rating of the Portuguese sovereign debt by the three largest international rating agencies, excluding it from the main investment grade benchmarks, limits demand for these securities from a significant share of international institutional investors and is one of the factors contributing to this market's liquidity not returning to the levels observed before the crisis. This situation tends to affect most of the other resident issuers in a similar way.

Within this context, (i) continuing a strict fiscal policy; (ii) following or even accelerating the downward trend of private sector indebtedness (particularly of non-financial corporations); (iii) deepening structural reforms; and (iv) strengthening the solvency and liquidity of the banking system are key to maintaining the country's credibility abroad and limiting an increase in sovereign yields and in the cost of funding for economic sectors. In this regard, the entry into force of the Single Supervisory Mechanism and the adoption of regulations developed at a European level, specifically the entry into force of the Bank Recovery and Resolution Directive, are expected to play a fundamental role in ensuring the separation of sovereign risk and the banking system.

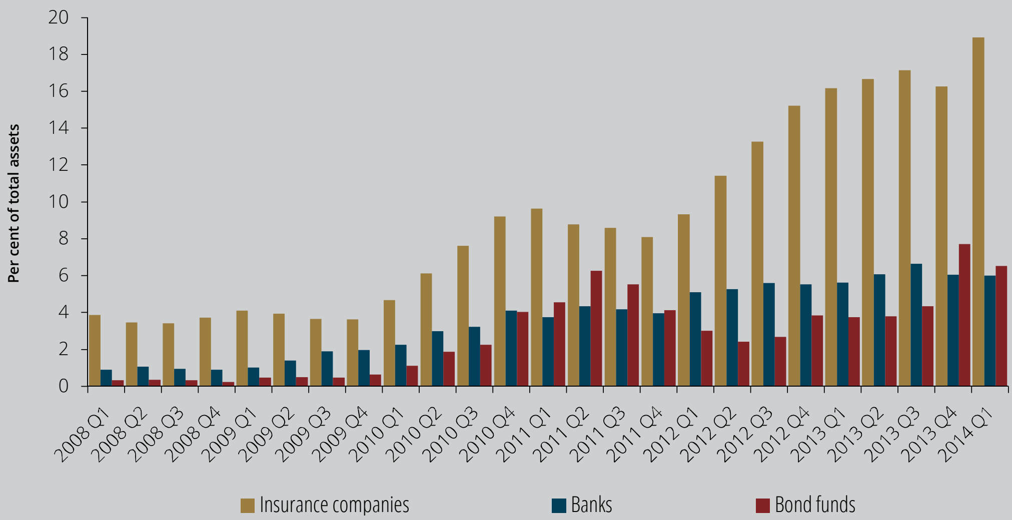
The increase in market interest rates affects the cost of new funding and portfolio valuation...

If at least one of the aforementioned factors were to materialise, this would have a direct impact on the cost of new funding by resident economic agents, in particular the State and the banking system (which is heightened by the close link between the sovereign and the banking system). This might also adversely impact the valuation of assets held by economic agents. This phenomenon is even more relevant to the extent that, over the past few years, resident institutional investors have increased their exposure to public debt securities of stressed countries, thus reducing their exposure to highly-rated European Union countries. In the case of bond funds, this portfolio shift has been accompanied by a widening of residual maturities, thereby increasing their vulnerability to a reversal of interest rates.

In spite of a recent portfolio change, the exposure of the Portuguese financial system to Portuguese public debt (Chart 1) remains high (see Section 1.3.). In the financial system as a whole, insurance corporations have an exposure accounting for 19 per cent of total assets (compared with 6 per cent for banks).

Chart 1 •
Exposure to Portuguese treasury bonds

Source: Banco de Portugal.
Notes: Banking system data on a solo basis.



The search for yield may also potentially generate risks for other economic agents, specifically non-institutional investors. However, according to information available for Portugal, there is no significant increase in the subscription of complex financial products by retail investors. Still, due to the existence of online distribution channels facilitating the subscription of highly complex and risky products, regardless of the issuing country, exposure to this risk cannot be completely ruled out.

... and banks' ability to converge towards sustainable funding structures

A reversal of the search for yield is expected to impact on demand for financial assets, potentially affecting the financial institutions' ability to adjust their funding structure. A change in market sentiment may have a direct impact on the cost of funding of the banking system, as well as an indirect impact owing to the need for additional collateral to be allocated to secured funding. This situation is worsened for institutions with high asset encumbrance ratios and / or low asset over-collateralisation ratios.

Although secured funding tends to be a more efficient type of funding both in terms of cost and incentives for banks to guarantee good-quality loans, high encumbrance levels have an amplifying effect, and may jeopardise new funding due to a lack of assets. Therefore it is important to assess the sustainability of banks' funding structures and, in particular, monitor the levels of asset encumbrance (and unencumbered but encumberable assets), as well as the policies and contingency plans developed by credit institutions (in line with the Recommendation of the European Systemic Risk Board of December 2012 already mentioned in previous issues of the *Financial Stability Report*). These procedures will give institutions greater resilience to deal with disturbances in funding markets, such as those jeopardising existing confidence in credit institutions and which may give rise to liquidity constraints in these institutions, with an impact on the financial system.

Funding conditions for credit institutions were significantly affected by the financial crisis, in particular since 2008, with the reaction of interbank markets partly reflecting the strong link between the banking system and sovereigns. Although Portuguese banks benefit from a stable deposit base, this situation has led them to adapt their funding structures over the past few years, increasing recourse to secured funding (Eurosystem funding, covered bonds and securities lending transactions) and consequently the level of encumbrance of their assets (Chart 2).[36]

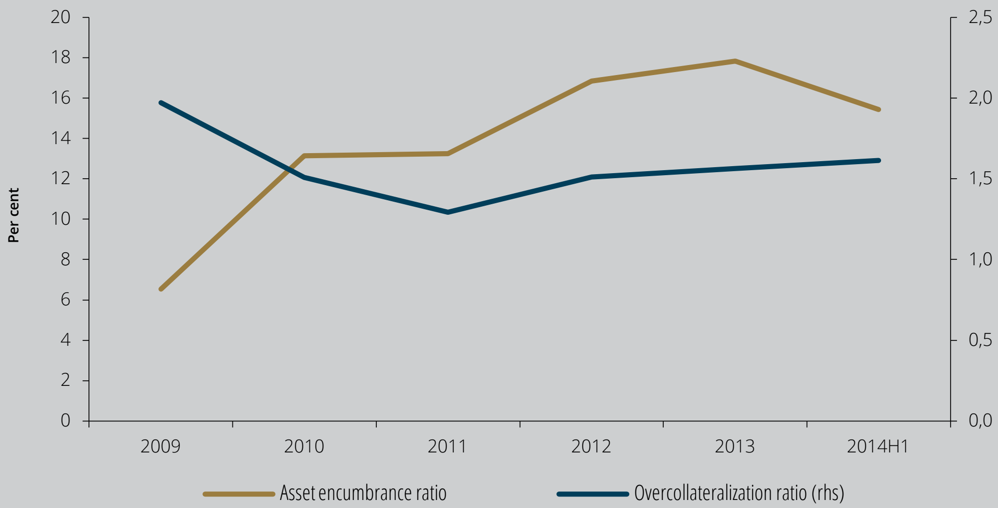


Chart 2 • Eurosystem refinancing

Source: Banco de Portugal. Notes: The asset encumbrance ratio is defined as the ratio between the level of encumbered assets and the total assets and the overcollateralization ratio as the ratio between the level of encumbered assets and Eurosystem refinancing. The graphic comprises the eight largest banking groups.

A low interest rate environment, resilient deposits (in spite of competition from the issuance of saving certificates) and lower fragmentation of interbank markets (gradual return to unsecured funding markets and greater convergence of funding costs) create favourable conditions for the banking system to continue adjusting its funding structures in order to evolve towards a sustainable funding structure.[37] In effect, an increase of retail funding sources and decreasing reliance on short-term interbank funding and wholesale funding in general (albeit in maturities that match the maturity of assets) is expected to be positive for overall bank resilience. This is broadly in line with the Recommendation of the ESRB on funding of credit institutions.

The favourable conditions to the ongoing adjustment should be taken advantage of, given that in the medium term the new regulatory framework may pose a challenge both in terms of funding cost and volume for the banking system, specifically through the definition of new liquidity requirements, the disclosure of information on encumbered assets and the definition of a minimum amount of bail-in-able liabilities on the balance-sheet (to be enforced by the BRRD).

It is important to monitor financial institutions' exposure to the real estate sector

Banking institutions continue to hold significant real estate stock (of around EUR 8 billion in gross amounts), more specifically (residential or commercial) real estate assets received as settlement for collateral in financial transactions (including, in particular, housing loans and lending to the construction and property development sector). The need to continue the banks' balance sheet adjustment process may result in a quicker and more substantial sale of part of such assets, putting pressure on real estate prices and reversing the recovery signs seen since mid-2013. In fact, in the second quarter of 2014 Statistics Portugal's (INE) House Price Index increased by 5.9 per cent from the same quarter one year earlier, when the index series reached a trough. Available evidence suggests that housing prices are close or even below the levels suggested by developments in the relevant demand drivers (namely, disposable income, interest rates and labour force).

Credit institutions' exposure to real estate investment funds (RFs) has increased, amounting to 44 per cent of total issues by these funds at the end of the first half of 2014 (11 per cent at the end of the first half of 2005). Insurance companies and pension funds' exposure to RFs reached approximately 22 per cent at the end of June 2014 (compared with 13 per cent at the end of the first half of 2005). The stock of total RFs' shares / units at the end of these periods amounted to around EUR 13 billion and 8 billion respectively. According to data from the Portuguese Association of Investment Funds, Pension Funds and Asset Management (Portuguese acronym: – APFIPP), real estate funds have posted negative profitability since 2010, standing at around -3.2 per cent in June 2014 (profitability for the past 12 months) (Chart 3). The growing exposure to these funds is a substantial risk to financial system stability. A drop in the price of real estate assets results in the devaluation of shares / units of RFs and a greater need to purchase shares / units by the banking system, in lieu of its customers, so as to prevent reputational effects and additional devaluations of such shares / units.

The banking system's potential exposure to real estate risk stemming from lending to entities in the construction and real estate sectors, albeit decreasing, is still very significant (32 per cent of total credit as at June 2014). This risk is more substantial against a background of high credit overdue in the construction and real estate sectors (26 and 20 per cent respectively).

Credit transferred to credit restructuring funds totalled approximately EUR 4 billion at the end of the first half of 2014, increasing by 38 per cent between March 2013 and June 2014. These transfers mostly corresponded to credits granted to the real estate, accommodation and construction sectors (Chart 4). 27 per cent of total credit transferred corresponded to non-performing loans. Underlying these transfers of assets is the retention of shares / units (with a greater or lower degree of subordination) by banks in the same proportion as pledged assets. As such, a devaluation in these funds' assets, due to the non-recovery of the companies in question or the inadequate valuation of associated property, will have a direct negative impact on banks' balance sheets. This type of operation should be mainly aimed at restructuring companies facing financial difficulties, but which are still economically viable. For this purpose, restructuring procedures should not extend over time and the sale of these viable companies should be quick, thereby minimising any destruction of their economic value.

High exposure to real estate risk warrants permanent monitoring of the banking sector's portfolios, through regular and far-reaching inspections, and an adequate impairment registration. Exposure to real estate risk should cover all portfolio assets held directly (real estate received as settlement for collateral pledged) or indirectly (through real estate investment and restructuring funds) by the banks. For this purpose, Banco de Portugal has conducted regular inspections on the banks, on specific asset classes, namely real estate assets, with the purpose of minimising risks stemming

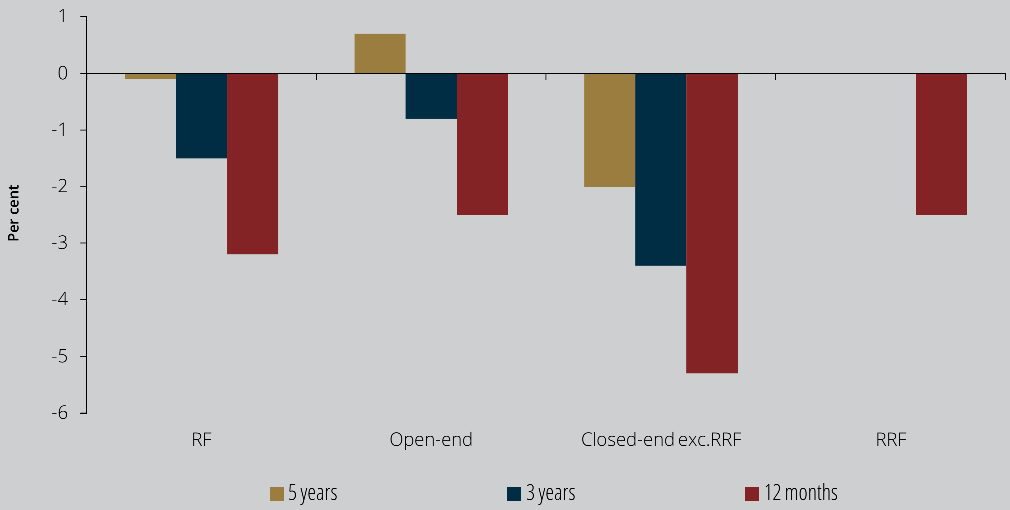


Chart 3 • Real estate funds' returns

Source: APFIPP.
Notes: Referring to 30 of June 2014. Real estate funds (RF) include open-end funds, closed-end funds and residential rent funds (RRF).

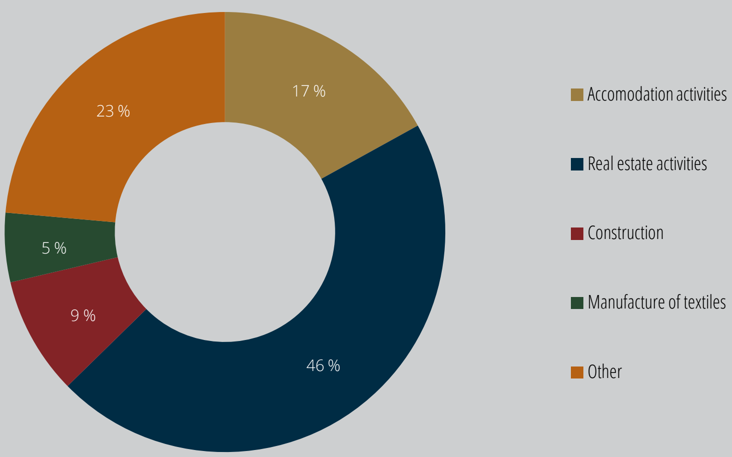


Chart 4 • Transferred assets (assets by economic activity classification)

Source: Banco de Portugal.
Notes: Referring to June 2014.

from a potential need to correct the valuation of these assets and guarantee that the level of recorded impairment is adequate. Also in the scope of the National Council of Financial Supervisors (Portuguese acronym: CNSF), a real estate assessment and valuation methodology was developed. In the meantime, it has been the subject of a public consultation, and the respective legislation is now under preparation. The aim of this methodology is, namely, to strengthen real estate assessment, to guarantee that consumers are more protected and to set out the assessment criteria and frequency, which should be adjusted to financial supervision goals. Finally, the comprehensive assessment exercise conducted by the ECB in the context of the Single Supervisory Mechanism under extremely conservative assumptions, has led to the adjustment of impaired loans collateralised by real estate (residential and commercial).

Promoting confidence in the financial system is crucial to financial stability

Economic agents' confidence is a key pillar of financial stability. If the conduct of financial institutions jeopardises confidence in the system, it will hamper the financial position of such institutions and pose risks to the system's stability.

Conduct risks may materialise in situations such as market benchmark manipulation, the inappropriate sale of financial products, non-compliance with Anti-Money Laundering and Counter-Terrorism Financing rules or breach of trade sanctions, IT-related shortcomings, insider trading or any other type of irregularities and fraud. These risks arise from factors as diverse as conflicts of interest, inadequate incentive and compensation structures and internal control shortcomings.

In order to prevent events that may jeopardise a banking institution's financial strength, including those related to conduct, any protection system must rely on four successive and complementary lines of defense: (i) the board and senior management; (ii) audit mechanisms (audit board, internal control and financial function); (iii) external auditors; and (iv) (micro-prudential and macroprudential) supervision, as well as the regulatory and legal framework and respective enforcement. Overall, the first two lines of defense are responsible for the institutions' internal governance.

The recent international crisis brought to light numerous irregularities and fraud situations within the banking system[38] and showed that, no matter how efficient supervision is, there is no absolute solution to guarantee that they will cease to occur. However, the widening of the scope and magnitude of this type of practice and the ensuing substantial financial and reputational damages show how urgent it is to guarantee an effective functioning of all lines of defense of financial stability. In particular, there is a need to reinforce the effectiveness of governance and internal control mechanisms at various levels – management bodies, audit and internal audit bodies, in addition to external auditors.

Given that financial intermediation is based on mutual trust, corporate governance and financial institutions' values and culture are key factors behind the strength of institutions and the system's stability. To promote confidence in the financial system among investors and consumers it is therefore crucial to empower the institution's bodies so that they can fully perform their tasks, to adopt internal mechanisms for the prevention of conflicts of interest, to reinforce internal supervisory and audit functions, to adapt the composition and operation of internal control functions. More broadly, it is key that the institution is able to disseminate a shared culture of values and rules. Notice of Banco de Portugal No 5/2008 confers a wide set of responsibilities on the board to ensure there is an effective internal control system.

The internal control system and, in particular, the compliance, risk management control and internal audit functions are key to monitoring incurred risks adequately. As such, it is crucial that these functions have the necessary material and human resources indispensible to an efficient performance of their tasks, as well as the necessary powers so that they can act independently and autonomously, with total access to all activities and all information that may prove to be necessary. This principle is enshrined in EU legislation, more specifically Directive 2013/36/EU of the European Parliament and of the Council of 26 June (CRDIV).

The external auditors' function is also very relevant, as it provides credibility to financial statements and acts as an independent mechanism to monitor internal governance quality. Therefore, it is important, on the one hand, to implement adequate external auditor rotation practices and, on the other hand, to strengthen communication between supervisors and auditors.

Financial reporting also plays a key role in the mitigation of conduct risks, due to the dissemination of relevant, timely, transparent, reliable and unbiased information. There is still room for improvement and, as such, efforts must still be made to influence competent bodies (standard-setters). Furthermore, the effectiveness of supervision also depends on the quality of information reported by financial institutions.

Finally, conduct risks shall not be overcome only through regulations, their enforcement or any potential sanction, but mostly on the basis of best practice. In particular, mechanisms should be put in place to deter excessive risk-taking, so that activities are based on a long-term perspective and take into account all stakeholders' interests (depositors, investors, shareholders, creditors, workers and the society in general). For that purpose, management and audit boards, as well as control functions, must be actively involved, a leadership-by-example culture must be implemented (tone at the top), and functions must be appropriately divided within the board (thus preventing the centralisation of functions and exclusive leadership).

Notes

1. For more detailed information, see Banco de Portugal, *Economic Bulletin*, October 2014.

2. In Germany, yields stood at negative values up to the 3-year maturity.

3. As mentioned by Statistics Portugal (Portuguese acronym: INE) in the Employment Statistics for the first quarter of 2014, the sample rotation is now selected from a sample basis extracted from the Ficheiro Nacional de Alojamentos (National Dwelling File), built from Census 2011 data. Therefore, between the third quarter of 2013 and the third quarter of 2014, the Labour Force Survey sample is made up of rotations selected from the so-called 'Master Sample' and the National Dwelling File. As of the fourth quarter of 2014, all sample rotations from the Labour Force Survey will be made up of dwellings selected from the National Dwelling File.

4. National Account financial and non-financial data considered in this section includes the new Portuguese National Account series on a 2010 basis for the period from 1995 to 2014. Special reference should be made to sectoral changes, which are described in Banco de Portugal, Statistical Press Release No 11 of October 2014. As regards methodological changes, see http://www.ine.pt/xportal/xmain?xpid=INE&xpgid=ine_cnacionais_metod, http://www.bportugal.pt/en-US/Estatisticas/MetodologiaseNomenclaturasEstatisticas/AlteracoesMetodológicasSEC2010BPM6/Pages/AlteracoesMetodológicasSEC2010BPM6.aspx and the Box: Revisions of the national accounts and balance of payments series, Banco de Portugal, *Economic Bulletin*, October 2014.

5. As a percentage of disposable income, household debt was 122 per cent in June 2014 (132 per cent at the end of 2009). Household debt represented 41 per cent of financial assets at the end of the first half of 2014, corresponding to a better relative position of Portugal within the EU as a whole than in the GDP and disposable income cases.

6. According to the Market Monitoring Report of 2013, variable rate agreements correspond almost in full to the whole housing loan market, representing 97.4 per cent of the number of agreements outstanding on 31 December 2013. Housing loans represent almost 80 per cent of household debt.

7. The flow of new credit overdue and other non-performing loans corresponds to the sum of the change in the stock of credit overdue and the flow of loan write-offs.

8. Luisa Farinha and Sónia Félix, Credit rationing for Portuguese SMEs, Banco de Portugal, *Financial Stability Papers*, 3|2014.

9. PER – Processo Especial de Revitalização (Special Revitalization Process); SIREVE – Sistema de Recuperação de Empresas por via Extrajudicial (Out-of-court business recovery system).

10. The quarterly accounts for general government for the first half of the year, as well as the information reported in the Excessive Deficit Procedure notification of September, follow ESA2010 (the new European System of Accounts), which was adopted following significant methodological changes to the balances for prior years. The main changes involved revision of the classification criteria for the public institutional units (with several entities previously classified under other institutional sectors moving into the general government sector as a result) and new rules for recording flows relating to the transfer of pension funds

(which are no longer included in the net figure). For more details, consult Statistics Portugal's Press Release, "Excessive Deficit Procedure (2nd notification of 2014)", of 30 September 2014, and Box: Revisions of the national accounts and balance of payments series, Banco de Portugal, *Economic Bulletin*, October 2014.

11. See Banco de Portugal, *Economic Bulletin*, October 2014.

12. In general, the concept of banking sector (and the remaining financial sectors considered in this section) is defined in Box 1.3.1 "Portuguese financial system: from the statistical classification to the prudential approach", in the November 2013 *Financial Stability Report*.

13. Data on the banking system include the Espírito Santo Financial Group (ESFG) up to March 2014 and BES, on a consolidated basis, up to June 2014, due to changes in the entity subject to supervision by Banco de Portugal. These changes, together with substantial impairments leading to the resolution measure applied by Banco de Portugal, has a non-negligible impact on the banking system's aggregate data. As such, where relevant, a comment is made, for analysis purposes, on indicator developments excluding the relevant institution (ESFG up to March 2014 and BES, on a consolidated basis, up to June) from the system's aggregate, worded in the text as "excluding BES". For a detailed analysis of recent developments in BES, see Box 3: "Resolution measure applied to Banco Espírito Santo, S. A.".

14. In some of the selected countries, a significant volume of credit transfers was made to entities outside the banking system's consolidation perimeter (*e.g.* Spain and Ireland).

15. Household deposits have a seasonal pattern. Typically, substantial increases are recorded in June and July, following payment of summer bonuses. In turn, August sees a decrease, due to the shift of a part of the bonus to other savings products or to expenditure. In any case, the net flow of household deposits, over these three months, was higher than that for recent years.

16. 'Encumbered asset' is an asset explicitly or implicitly presented as collateral or subject to an agreement to guarantee, collateralise or improve credit quality in any operation.

17. Defined in the Bank Recovery and Resolution Directive (BRRD).

18. On 1 January 2014 Notice of Banco de Portugal No 6/2013 entered into force, establishing a new transitional capital adequacy regime. The new regime establishes, inter alia, that credit institutions and investment companies shall preserve a Common Equity Tier ratio (CET 1) not lower than 7 per cent, until Directive 2013/36/EU (or CRD IV – Capital Requirements Directive) is transposed to the Portuguese legal framework.

19. For a detailed analysis of the exercise's results, see Box 2: "The comprehensive assessment of the euro area banking system: main results for the Portuguese banks".

20. Expresses the relationship between the surrender amounts and the value of provisions and financial liabilities of redeemable products.

21. In accordance with Decree-Law No 57/2012, these saving plans may be redeemed in order to pay housing loan installments to purchase owner-occupied homes (in the event of default on the credit agreement by the participant / insured person).

22. The results of these analyses are published in *Relatórios de Análise de Riscos do Setor Segurador e dos Fundos de Pensões* (Risk analysis reports on the insurance sector and pension funds).

23. Other profit not directly related to life or non-life insurance activities.

24. The Solvency II regime is the result of the transposition of Directives 2009/138/EC (Solvency II), 2012/23/EU (Quick Fix1) and 2013/58/EU (Quick Fix 2).

25. *International Accounting Standard* No 19.

26. This is an increase in average life expectancy that, particularly in the retirement period, results in an increase in the expected number of future pensions.

27. These investment funds as a whole do not include credit securitisation funds that represented approximately € 10.8 billion at the end of the first half of 2014 (or 29 per cent of total investment funds). However, against the definition in Box 1.3.1 "Portuguese financial system: from the statistical classification to the prudential approach" from the *Financial Stability Report*, November 2013, it includes money-market funds.

28. This classification of mutual funds is in line with note B.8.1.1.2.a. of the *Statistical Bulletin*, *i.e.* the funds are classified in terms of investment policy, taking into account the majority composition of the asset and the investment strategy indicated in the respective management regulation (this classification includes other retirement-savings open funds reviewed in section 1.3.3 of this report).

29. The leverage level corresponds to the ratio of loans taken to the fund's total assets.

30. José Pedro Braga, Inês Pereira and Teresa Balcão Reis, Composite financial stress indicator for Portugal, Banco de Portugal, *Financial Stability Papers*, 1|2014.

31. Reflecting its systemic importance, BES had been considered a significant credit institution under the Single Supervisory Mechanism and, for that reason, became one of the institutions directly supervised by the ECB.

32. This exercise came at the request of Banco de Portugal and included the eight largest Portuguese banking groups. For further information on this and other inspection exercises in the Special Inspections Programme, see http://www.bportugal.pt/pt-PT/OBancoeoEurosistema/ComunicadoseNotasdeInformacao/Documents/combp20140328.pdf (only available in Portuguese).

33. As shown in Moody´s Press Release of 26 June on the downgrading of BES.

34. Capitalisation with recourse to public funding also involves the absorption of losses by the shareholders and subordinated creditors of the bank.

35. On this subject, see the October 2014 *Global Financial Stability Report* (GFSR).

36. In this respect, an analysis of recent developments is presented in Section 1.3.1 Banking sector.

37. Sustainable funding structure means a funding structure that can be perpetuated without public intervention and in respect of which the cost of funding does not affect the viability of the institution. (Recommendation of the European Systemic Risk Board of 20 December 2012 on funding of credit institutions).

38. Also in this context, the Bank for International Settlements (BIS) listed as corporate governance principles for banks: (i) the reinforcement of the board's importance; (ii) the importance of the board's qualifications and composition; (iii) the existence of an independent risk management function; (iv) the importance of monitoring risks on a regular and individual basis; (v) the reassessment of compensation systems; and (vi) the board's involvement in the assessment of the bank's operational structure and risks. Furthermore, other supranational entities have focused on this topic, in particular, the European Supervisory Authorities (ESAs) and the European Systemic Risk Board.