Portuguese Banking System: latest developments

4th quarter 2016

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EUROSYSTEM

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Methodological note

The current version of the latest developments of the Portuguese Banking System reflect the change of the banking system universe, as well as, the revision and the introduction of indicators.

The main driver for these changes is the adoption of new supervisory data requirements, foreseen in the Implementing Technical Standards on Supervisory Reporting (ITS) issued by the European Banking Authority and adopted by the European Commission in their Regulation (EU) No 680/2014. The main purpose of ITS is to have uniform reporting requirements at a European level in order to promote the converge of supervisory practices. The new data reporting encompasses financial and credit quality information (FINREP), as well as data on own funds, large exposures, leverage, liquidity, funding (COREP) and asset encumbrance. The new data requirements applies to credit institutions and investment firms as defined in the Legal Framework of Credit Institutions and Financial Companies (RGICSF), which was revised by the Decree-law No 157/2014, October 23rd.

Therefore, under this publication, until the third quarter of 2015, the developments of the banking system relies on data requirements stated in the Instruction of Banco de Portugal No 23/2004, and from the fourth quarter of 2015 onwards, it is based on the new European data requirements specified in the EBA's ITS. As the revision of the RGICSF determines the exclusion of some types of financial institutions from the universe of credit institutions and investment firms, the data until the fourth quarter of 2015 was revised accordingly in order to guarantee consistency with the universe encompassed by the ITS.

As the ITS also revises the content of the information, the definition of certain variables covered by this publication were also revised accordingly. For instance, the revision of the loans to deposits ratio is related with the exclusion of other credit and advances that takes the form of securities.

Moreover, the introduction of new data requirements allowed the inclusion of new information:

- Assets quality: Non-performing loans (NPL) and Coverage Ratio;
- Solvability: Leverage Ratio[1];
- Liquidity: Liquidity Coverage Ratio.

In what relates to assets quality, the main indicators used to assess banks loans quality at the European level were added. The definition of NPLs follows international standards and is a broader concept when compared with the concept of credit at risk[2].
Non-performing loans are loans and advances that comply with at least one of the following conditions: i) material exposures that are more than 90 days past-due (quantitative criterion); ii) the debtor is assessed as unlikely to pay its obligations in full without realization of collateral (qualitative criterion); iii) impaired assets, except incurred but not reported (IBNR) impairments; and iv) defaulted credit, in accordance with the CRR prudential concept.

Taking into account the new European framework, this publication also comprises the leverage ratio[3] as a supplementary measure to the risk-based capital requirements previously published. This ratio is defined as the institution's capital (Tier 1 capital) in relation to institution's total exposure (on-balance and off-balance exposure), with the assets being non-weighted.

In order to assess the liquidity position of the banking system, this publication starts to

1. See the November 2016 Financial Stability Report of Banco de Portugal and the article 429 of the Regulation (EU) No 575/2013.
2. See the Special Issue "3. Concepts used in the analysis of the credit quality" of the November 2016 Financial Stability Report of Banco de Portugal.
3. See article 429 of the Regulation (EU) No 575/2013.

include the Liquidity coverage ratio[4]. This ratio (which should correspond to a minimum value of 100%) aims to ensure that a bank has an adequate stock of unencumbered high quality liquid assets (e.g. cash or assets that can be converted into cash at little or no loss of value in private markets) to meet its liquidity needs for a 30 calendar day liquidity stress scenario[5]. The Liquidity coverage ratio is being implemented on a step basis: 70% since 1st of January 2016; 80% since 1st of January 2017 and 100% since 1st of January 2018.

Finally, under the revision of this publication, the macroeconomic framework was also shortened, supporting the fact that the core part of this publication are the most recent developments of the banking system.

4. Delegate Act (EU) 2015/61 of the European Commission, of October 10 of 2014 to supplement Regulation (EU) No 575/2013 of the European Parliament and the Council with regard to liquidity coverage requirement for Credit Institutions.
5. According to the Delegate Act of the European Commission "'stress' shall mean a sudden or severe deterioration in the solvency or liquidity position of a credit institution due to changes in market conditions or idiosyncratic factors as a result of which there may be a significant risk that the credit institution becomes unable to meet its commitments as they fall due within the next 30 calendar days".

1. Portuguese Banking System – Main Highlights

Balance sheet

Banking system’s total assets continued to decline gradually in the fourth quarter of 2016. The reclassification of some assets/liabilities, as part of the process of the partial sale of BPI's participation in the Angolan operation, led to a change in the structure of the banking system's balance sheet.

Liquidity and funding

The loan-to-deposit ratio and the commercial gap increased slightly vis-à-vis the previous quarter, while the financing obtained from the Eurosystem diminished.

Asset quality

The credit at risk ratio and the non-performing loans ratio declined in the fourth quarter of 2016, reflecting primarily the developments observed in the non-financial corporations segment.

Profitability

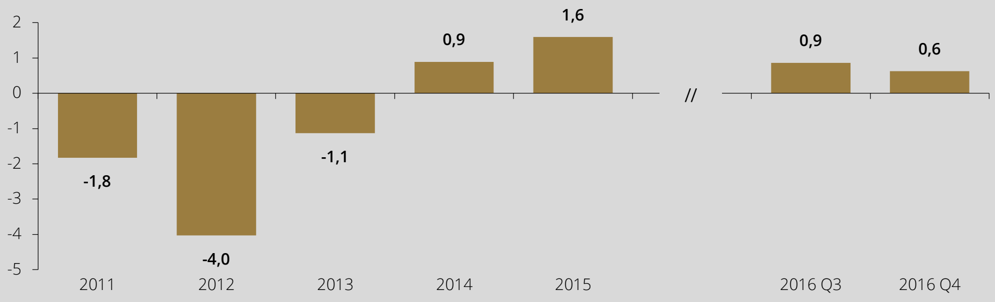
In 2016, as opposed to 2015, the banking system's profitability was negative, as a result of a considerable reduction in income from financial operations and, above all, a substantial increase in impairments.
Net interest income remained fairly stable compared with 2015.

Solvency

Solvency levels diminished in the fourth quarter of 2016 driven by a fall in capital that resulted from the losses recorded in the year.

2. Macroeconomic and Financial Indicators

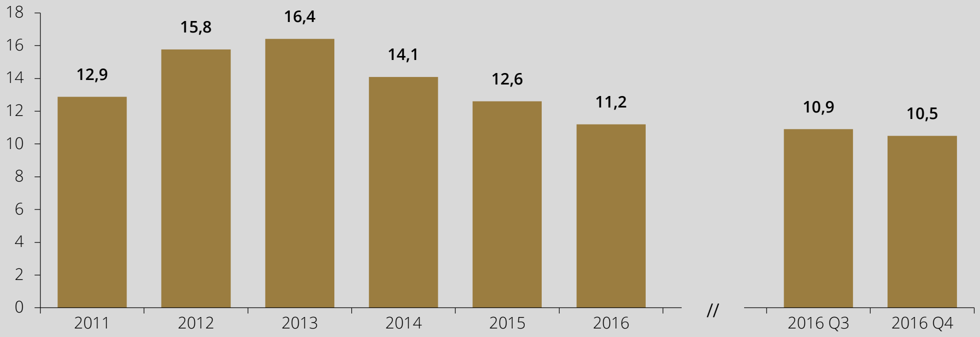
Chart 1 • GDP growth rate, in % | Volume



Sources: Banco de Portugal and INE.
Note: Quarterly figures correspond to q-on-q rates of change. National Accounts and Balance of Payments figures are already presented according the rules of the European System of National and Regional Accounts (ESA 2010) and Balance of Payments and International Investment Position Manual (BPM6).

- The quarter-on-quarter GDP growth rate was 0.6% in 2016 Q4, while the year-on-year growth rate stood at 2.0%.
- In 2016, the GDP grew by 1.4% (1.6% in 2015).

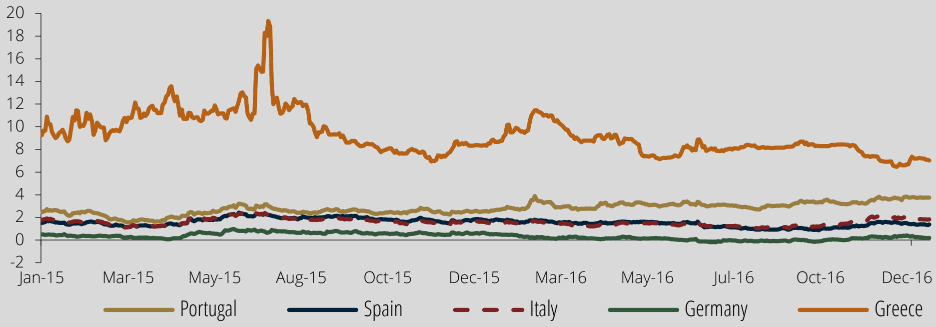
Chart 2 • Unemployment rate, % of active population



Sources: Banco de Portugal and INE.

- The unemployment rate was 10.5% in 2016 Q4, falling by 0.4 p.p. vis-à-vis the previous quarter and by 1.7 p.p. vis-à-vis 2015 Q4.

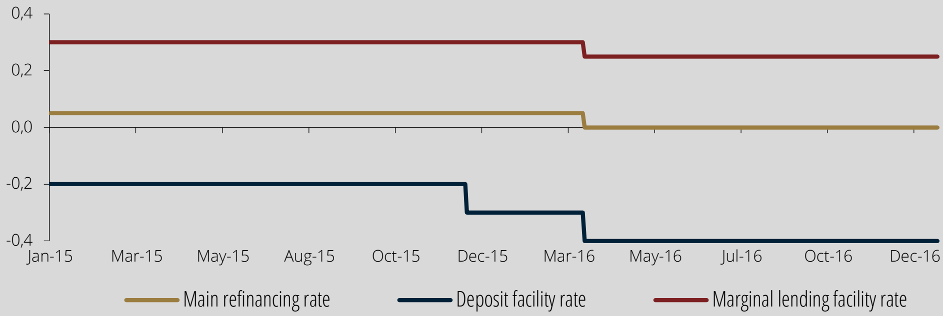
Chart 3 • Sovereign debt yields 10Y, in %



Source: Thomson Reuters.

- The Portuguese 10-year government bond yield increased about 40 basis points between 30 September 2016 and 30 December 2016, while the spread vis-à-vis the German 10-year government bond yield augmented by approximately 10 basis points.

Chart 4 • ECB rates, in %



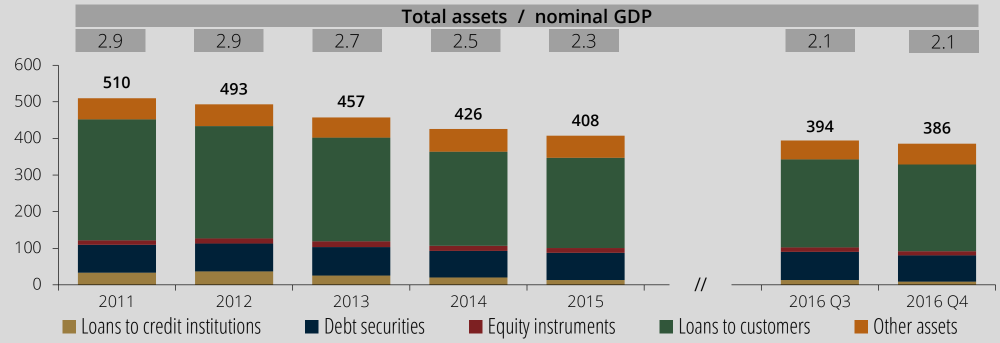
Source: ECB.

- ECB rates have been kept unchanged since March 2016: the deposit facility interest rate at 0.40%, the main refinancing operations interest rate at 0% and the marginal lending facility interest rate at 0.25%.
- The ECB's accommodative monetary policy continues to be reflected in the levels of benchmark interbank market interest rates.

3. Portuguese Banking System

3.1. Balance sheet

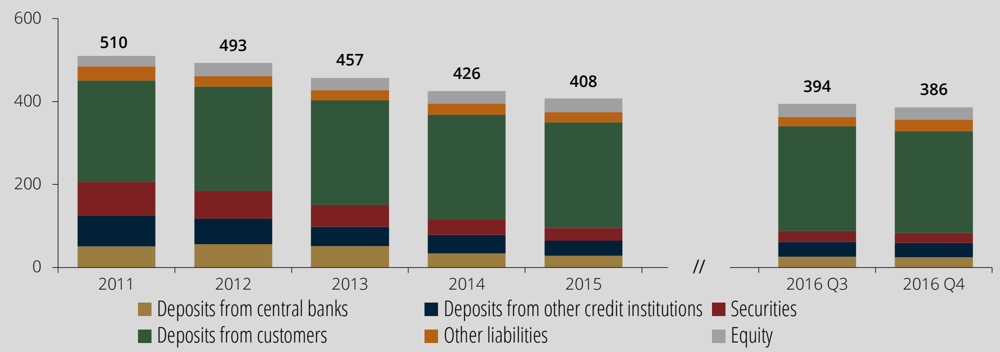
Chart 5 • Assets, in €Bn | Value at end of period



Source: Banco de Portugal.

- Banking system's total assets declined by 2.1% in 2016 Q4. This development was chiefly driven by a reduction in loans to credit institutions and, to a lesser extent, loans to customers and debt securities. Total assets decreased by 5.3% vis-à-vis end-2015.
- Even though without impact in total assets and liabilities, the structure of the banking system's balance sheet was altered by the reclassification of some assets/liabilities to "other assets/liabilities" within the ambit of the partial sale of BPI's Angolan operation.

Chart 6 • Bank financing structure, in €Bn | Value at end of period

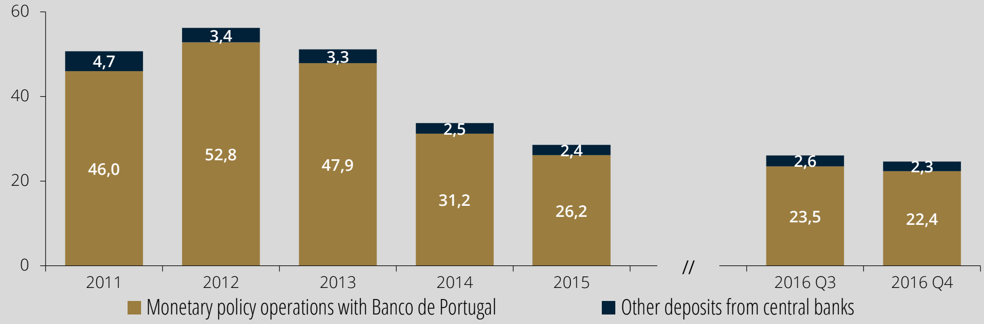


Source: Banco de Portugal.

- In 2016 Q4, there was a significant decrease in the liabilities represented by securities and deposits from central banks.
- Deposits from customers diminished vis-à-vis the previous quarter, mainly due to the reclassification to other liabilities under the abovementioned operation. Without this effect, deposits would have decreased 0.5% in the quarter.

3.2. Liquidity and funding

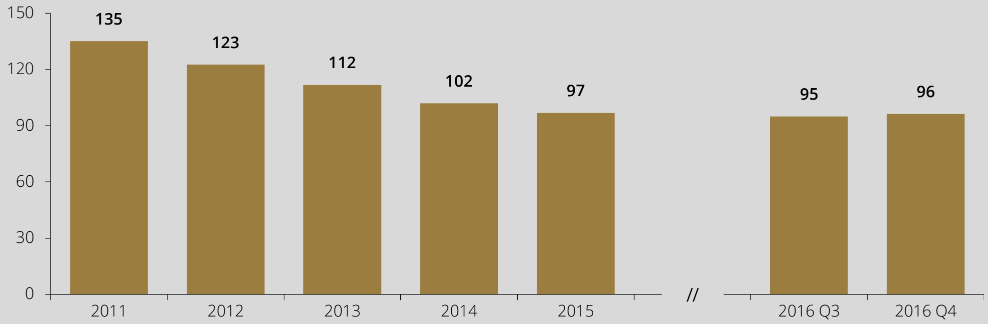
Chart 7 • Central banks' funding, in €Bn | Value at end of period



Source: Banco de Portugal.

- In 2016 Q4, central banks' funding continued to decline accounting for 6.4% of the banking system's total assets, which is the lowest figure since the beginning of the Economic and Financial Assistance Programme (the highest was recorded in June 2012: €64.1 Bn, 12.6% of total assets).

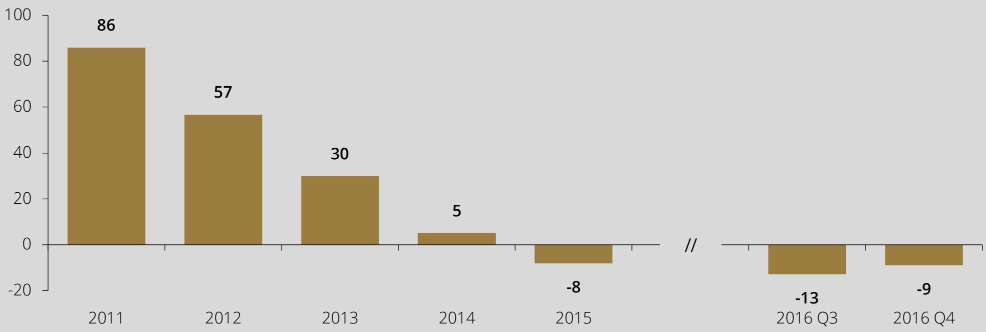
Chart 8 • Loan-to-deposit ratio, in % | Value at end of period



Source: Banco de Portugal.
Note: This ratio was revised taking into account the new data requirements stated in the Implementing Technical Standards on Supervisory Reporting.

- The loan-to-deposit ratio increased slightly in 2016 Q4, yet it was still lower than in 2015 Q4. Excluding the aforementioned sale by BPI, the loan-to-deposit ratio remained fairly stable compared to the previous quarter.

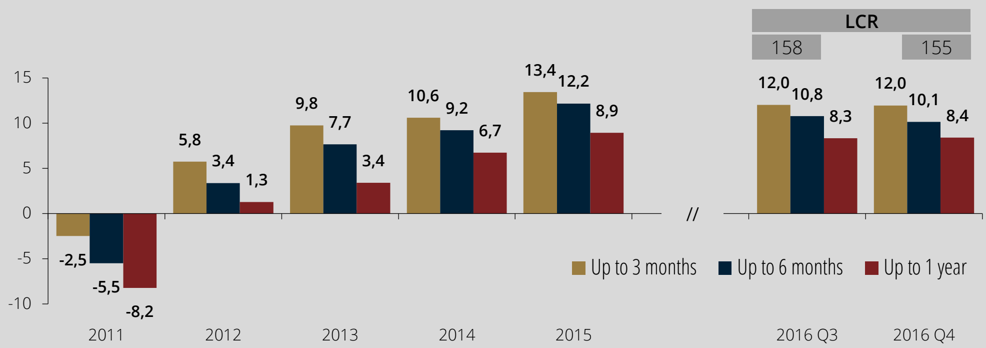
Chart 9 • Commercial gap, in €Bn | Value at end of period



Source: Banco de Portugal.
Note: This indicator was revised taking into account the new data requirements stated in the Implementing Technical Standards on Supervisory Reporting.

- The commercial gap (loans minus deposits) recorded in 2016 Q4 is similar to the one registered in 2015 Q4, despite having increased vis-à-vis the previous quarter. Yet, excluding the impact of the abovementioned reclassification, the commercial gap continued its downward trajectory.

Chart 10 • Liquidity gaps for domestic institutions[(a)] and Liquidity Coverage Ratio (LCR)[(b)]
% of stable assets, in % | Value at end of period

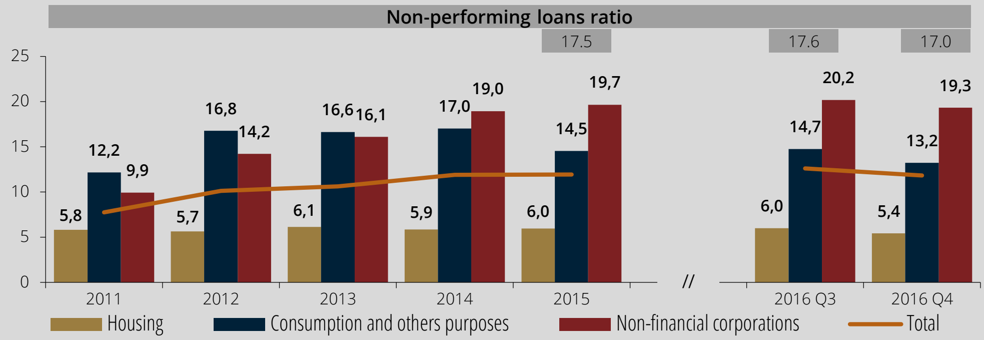


Source: Banco de Portugal.
Notes: a) The liquidity gap is defined as the difference between liquid assets and volatile liabilities in proportion of the difference between total assets and liquid assets, for each cumulative maturity scale. An increase of this indicator reflects an improvement of banks' liquidity position; b) The liquidity coverage ratio is expressed as the ratio between the value of the stock of high quality liquid assets and the total net cash outflows for a 30 calendar day liquidity stress scenario.

- Liquidity gaps for domestic monetary financial institutions remained at high levels for all maturities in 2016 Q4.
- The Portuguese banking system recorded a liquidity coverage ratio well in excess of 100%, in line with the previous quarter.

3.3. Asset quality

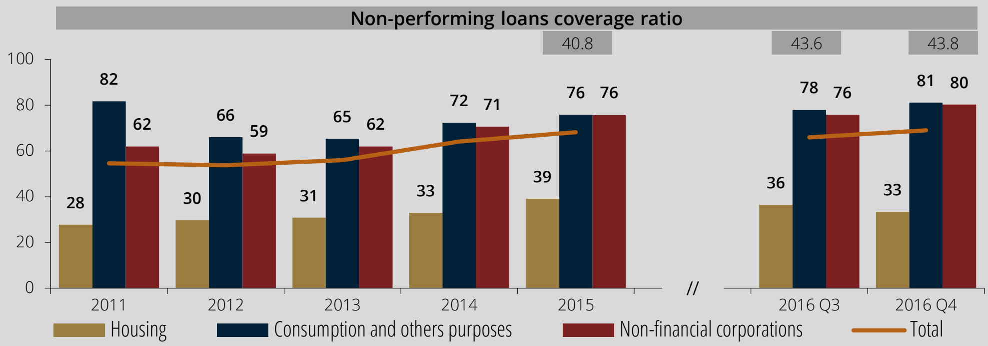
Chart 11 • Credit at risk ratio[(a)] and Non-performing loans ratio[(b)], in % | Value at end of period



Source: Banco de Portugal.
Notes: a) The credit at risk ratio is the amount of credit considered at risk in relation to total credit; b) The non-performing loans ratio is the amount of loans non-performing in relation to total loans, according to EBA's ITS on Supervisory Reporting.

- The credit at risk ratio stood at 11.8% in 2016 Q4, declining by 0.8 p.p. compared to the previous quarter. This reduction resulted from a greater decrease in credit at risk than the one occurred in total credit.
- This development of the credit at risk ratio was observed in the Housing segment, as well as in the Consumption and Non-financial corporations segments.
- The non-performing loan ratio stood at 17.2%, which corresponds to a reduction of 0.4 p.p. vis-à-vis the previous quarter. This decrease reflects positive developments in all segments.

Chart 12 • Credit at risk and Non-performing loans coverage ratios, in % | Value at end of period

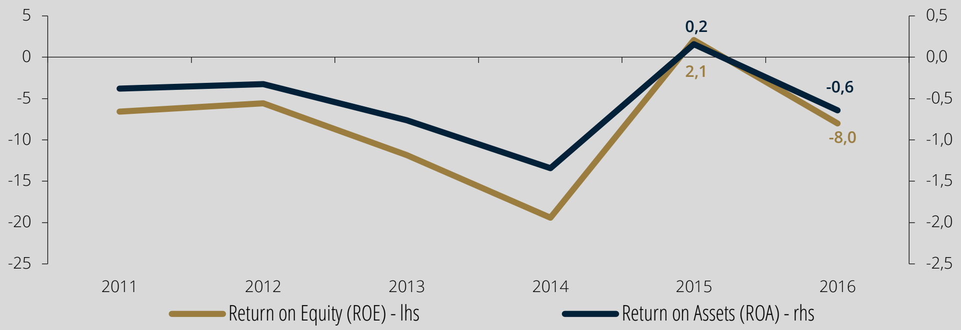


Source: Banco de Portugal.
Note: The coverage ratio is the percentage of credit at risk, or of non-performing loans that is covered by impairments.

- The credit at risk coverage ratio increased in 2016 Q4 for the majority of the segments.
- The non-performing loans coverage ratio increased from the previous quarter to 45.0%. In comparison with the end of the previous year, this ratio rose about 4 p.p.

3.4. Profitability

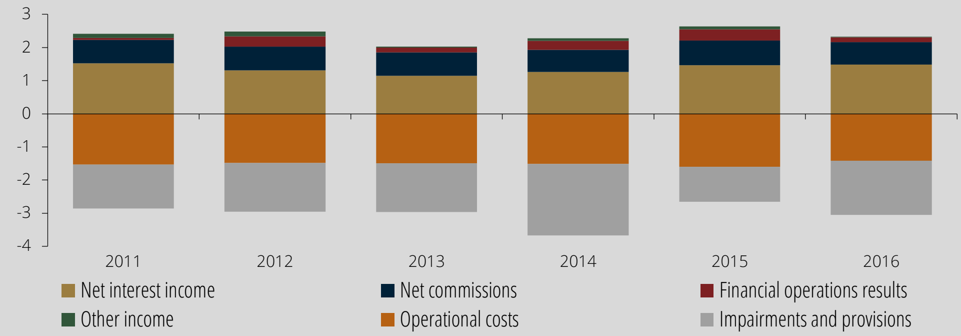
Chart 13 • ROE and ROA, in % | Value in the period



Source: Banco de Portugal.
Note: Return is measured by profit or loss before tax.

- The return on equity and the return on assets were negative in 2016, having diminished from the previous year.
- In 2016 Q4, there was a significant increase in the flow of credit impairments, which determined that the positive profitability recorded in the first three quarters, turned negative for the year as a whole.

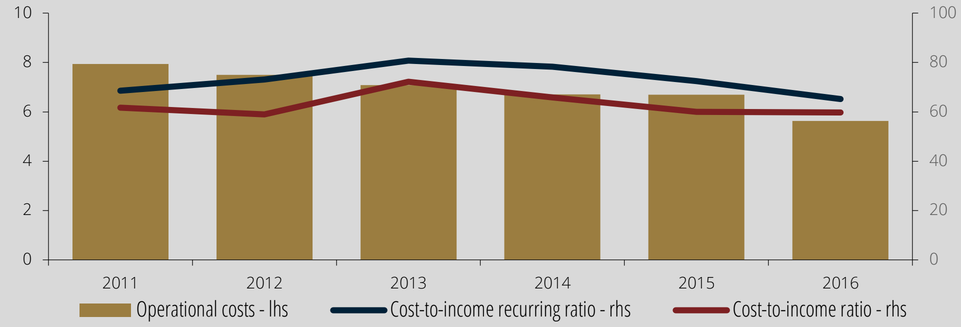
Chart 14 • Income and costs, in % of average total assets | Value in the period



Source: Banco de Portugal.

- The decline in profitability vis-à-vis 2015 was originated by a substantial fall in income from financial operations, which are non-recurring by nature, and, above all, by an increase in impairments.
- In 2016 the net interest income remained virtually unchanged compared to 2015, as a consequence of a similar reduction in interest income and interest expenses.

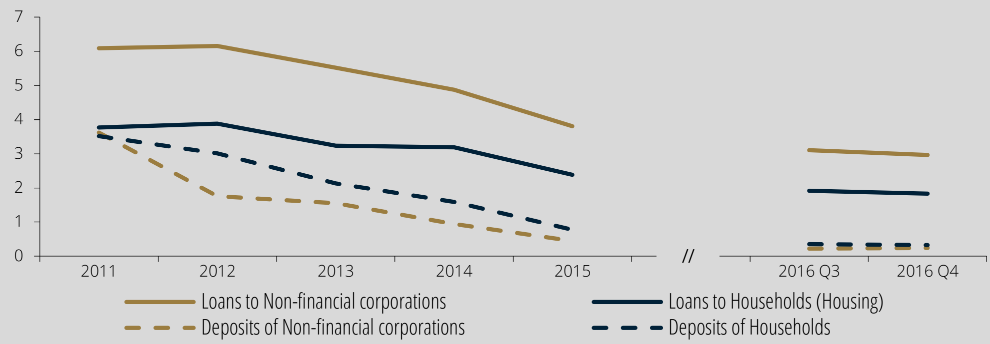
Chart 15 • Operational costs and Cost-to-income, in €Bn and in % | Value in the period



Source: Banco de Portugal.
Note: The cost-to-income recurring ratio corresponds to operational costs as a percentage of the aggregate of net interest income and net commissions.

- The cost-to-income ratio stood at approximately 60%, remaining stable in comparison to 2015, as a result of reductions of similar magnitude in operating costs and in net operating income.
- Operating costs decreased more sharply than the aggregate of net interest income and net commissions in 2016, which led to a decline in the cost-to-income recurring ratio vis-à-vis 2015.

Chart 16 • Banking interest rates (new business), in % | Average value of period

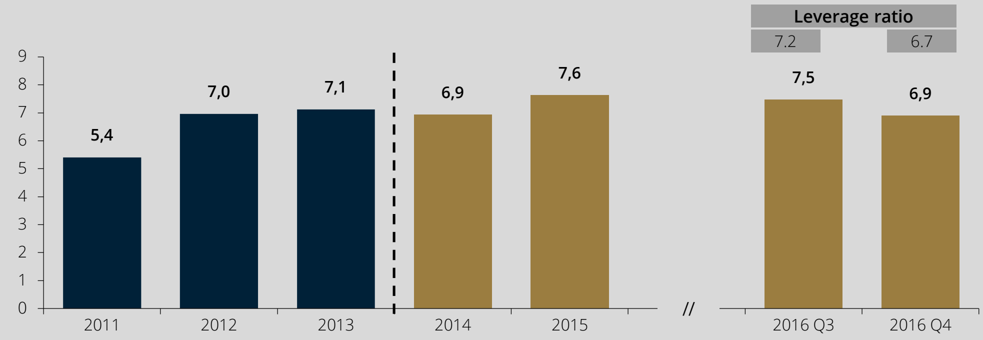


Source: Banco de Portugal.

- In 2016 Q4, interest rates on new loans to Households (Housing) and to Non-financial corporations fell by 8 and 15 basis points, respectively.
- The cost of new deposits decreased by 3 basis points in the Households segment and rose by 2 basis points in the Non-financial corporations segment.

3.5. Solvency [a]

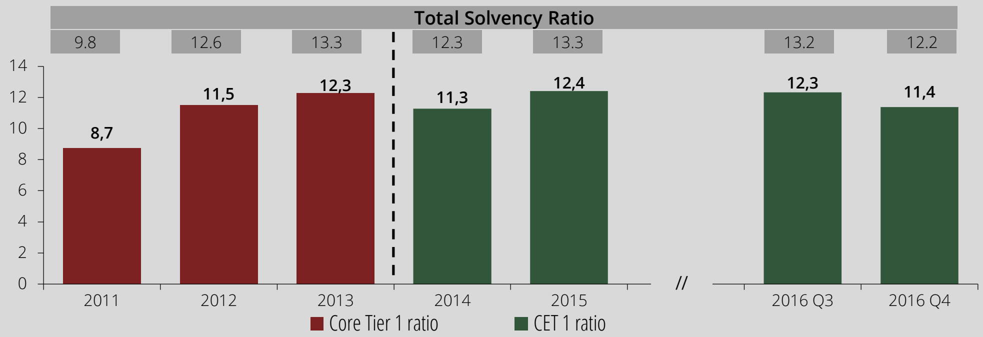
Chart 17 • Tier 1 capital to total assets ratio and Leverage ratio, in % | Value at end of period



Source: Banco de Portugal.
Note: The Tier 1 capital to total assets ratio serve as a proxy for the leverage ratio, allowing for a more comprehensive period of analysis. The leverage ratio is calculated as the capital measure (Tier 1 capital) divided by the total exposure. The leverage ratio is calculated in accordance with the methodology set out in article 429 of the Regulation (EU) No 575/2013.

- The ratio between Tier 1 capital and total assets diminished in 2016 Q4, reflecting a fall in capital, associated with the losses for the year, in an asset reduction scenario.
- The leverage ratio stood at 6.7% in 2016 Q4, which corresponds to a 0.5 p.p. contraction from the previous quarter.

Chart 18 • Own funds ratios, in % | Value at end of period



Source: Banco de Portugal.

- The Common Equity Tier 1 ratio (CET 1) and the total solvency ratio decreased by approximately 1 p.p. vis-à-vis 2016 Q3 due to a reduction in capital, which is explained, once again, by the losses incurred in the year. However, it must be stressed that in the course of the current year the own funds of some institutions were reinforced.

(a) In 2014, the transition to a new prudential regime determined the existence of breaks in the series of solvency indicators justified by methodological differences in the calculation of own funds components, affecting the comparability of ratios with previous years.