FINANCIAL STABILITY REPORT

May 2014

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FINANCIAL STABILITY: RECENT DEVELOPMENTS AND RISKS

Overview

This Financial Stability Report is published shortly before the conclusion of the Economic and Financial Assistance Programme (EFAP) to Portugal. Three years after it started, now is the time to review the current situation, identifying risks, challenges and additional adjustment requirements still facing the Portuguese economy and, in particular, the financial sector.

Portugal's integration into the euro area has enabled access to external financing at reduced cost (reflecting the nominal convergence process, and ultimately the elimination of foreign-exchange risk), virtually removing the liquidity restraints faced by the resident sectors. In this context, the conduct of the financial sector has facilitated increased recourse to credit by the non-financial private sector. Against a background of relatively low interest rates, a significant number of business projects may have benefitted from especially favourable financing conditions, while the financial sector has not appropriately evaluated the potential to create value from the resources used and the sustainability of the indebtedness levels of non-financial corporations. In addition, within the framework of an upward revision of households' permanent income, the sector's savings rate declined and bank credit was encouraged, chiefly for house purchase, and often no appropriate attention was paid to debtors' repayment capacity.

With the start of the financial crisis and its gradual effect on sovereign debt, the public sector lost access to the international financial markets, and the Portuguese financial sector had to meet its financing requirements. This introduced further vulnerabilities into the financial sector.

The international financial crisis has therefore very clearly exposed the Portuguese economy's vulnerabilities arising, in particular, from the high indebtedness levels of the private and public sectors, translated into a considerable external debtor position and a significant accumulated deficit in public sector accounts, and from the weak pace of actual and potential economic growth.

Under the EFAP, an adjustment framework was defined for the banking sector, consistent with the correction of imbalances inherent to the private sector balance sheet. Banks were encouraged to carry out an orderly deleveraging of their balance sheets, ensuring that an appropriate flow of financing to the economy would be maintained, in particular to the tradable sectors. However, this process may also have been influenced by adverse economic developments that led to a decline in demand for credit and deterioration in its quality. Nonetheless, the financial sector's solvency and liquidity levels increased significantly during that period.

The adjustment observed during the EFAP has allowed for major progress in other fields: the economy started to show net lending, public accounts were the object of a significant structural adjustment, and some structural reforms were adopted. Indeed, some of the economic imbalances characterising the Portuguese economy before the EFAP, with a bearing on the financial sector position due to the intermediation role it plays, have been addressed. The progress made, however, has been insufficient, as this report clearly shows, calling for continuance of the reforms started during the applicable EFAP period, with a view to ensuring the required sustained improvement of the economy and living standards of the Portuguese population.

The overall financial crisis, which was aggravated by the bankruptcy of the Lehman Brothers in 2008 and was subsequently exacerbated due to the sovereign risk crisis in the euro area, involved a profound risk revaluation by international investors, amid greater uncertainty. In this context, the combination of high indebtedness levels and low potential growth in some economies has raised doubts on the liquidity and solvency situation of a large number of agents in the different institutional sectors. Therefore, financial flows declined abruptly in the euro area, namely from core/surplus countries to peripheral/deficit countries, in tandem with a significant increase in the debt spreads of the latter. In Portugal, the public sector was the most specific target of this risk evaluation, due to developments in public accounts, marked by ongoing deficits and growing debt, and to the dominant role played by international investors. Reflecting these developments, the financial system, which had reached high leverage levels in the period prior to the crisis, was also especially affected, and lost access to the international wholesale debt markets.

Loss of access by resident agents to international financial markets made it inevitable for the Portuguese Government to request international financial assistance in early April 2011. The EFAP targeted the correction of public finance imbalances, the orderly deleveraging of the private sector, including the financial sector, and action at the level of the structural vulnerabilities constraining the economy's potential growth. Within an international framework characterised by financial market fragmentation in the euro area and high uncertainty levels related to the sovereign debt crisis, the EFAP made it possible for the resident sectors to take advantage of stable external financing.

During the applicable EFAP period, the macroeconomic and financial situation contributed to a significant increase in credit default level, and therefore in impairments recorded by banks in the respective balance sheets, and to the expressive decline in banking sector profitability. This result was also due to the adoption by banks, in the past, of risk-evaluation measures that were insufficiently conservative, as well as their excessive exposure to the non-tradable sector, namely the real-estate sector (which goes hand in hand with the strong growth of this sector in the Portuguese economy in recent decades). In parallel with this impact, that resulted from the materialisation of credit risk, bank profitability was also strongly affected by the significant increase in funding costs (compared with money market benchmarks in euro used in credit granting) and the resulting sharp narrowing of the interest margin. These impacts were amplified by the abovementioned high leverage levels of the financial system, mirroring the high indebtedness level of the other sectors in the economy.

With a view to increasing transparency and promoting confidence in the banking sector, measures were taken at national level, which, within the framework of decisions taken at European level, particularly in the euro area, made it possible to improve banking sector resilience, ensuring liquidity and capital levels consistent with the regular implementation of its financial intermediation function.

As regards solvency, measures were taken aiming at a significant capital increase in banks, through more demanding regulatory requirements imposed by the European Banking Authority (EBA) and Banco de Portugal. As a result, the Core Tier 1 ratio was significantly increased during the applicable EFAP period, reaching 12.3 per cent at the end of 2013.

A contribution to this increase was made by the gradual reduction in own funds requirements, associated with the deleveraging process of banks' balance sheets. Another contribution was made, more markedly in 2012, by the increase in own funds, associated with a number of recapitalisation operations, through private investors and public funds. It should be added in this regard that public support to bank recapitalisation reached approximately €6.5 billion, €5.6 billion of which came through recourse to the bank solvency support facility, created under the EFAP. The total amount of this support line reached €12 billion, leaving €6.4 billion available to address contingencies. Actually, this type of support occurred in a number of European countries. Two beneficiary banks have already started repaying support granted in Portugal (totalling around €1.4 billion).

During the three-year EFAP period, there was a significant improvement in terms of liquidity, associated with positive developments of deposits and the ECB's conduct through standard and non-standard monetary policy measures. Deposit developments played a key role in the adjustment process of the banking system's financing sources, contributing to a more sustainable structure, less sensitive to changes in risk perception by international investors.

This increase in deposits, simultaneously with a reduction in portfolio credit, made it possible to significantly reduce the credit/deposit ratio from 158 per cent at the end of 2010 to 117 per cent at the end of 2013.

It is also worth noting the improved supervision model. In this field, the main objectives pursued consisted in improving institutions' risk evaluation, promoting appropriate management practices and ensuring compliance with the banking system's central role as intermediary between savings and financing of the economy.

Since 2011, the strategy adopted had been integrated and developed under the EFAP, covering, for the eight largest Portuguese banking groups, i) external audits to credit portfolios, including one to the construction and property development sectors and another one to "major exposures"; ii) checking the methodologies used for risk evaluation; iii) assessing the methodologies used in stress tests; iv) a re-evaluation exercise of real-estate acquired against own credit; and v) the evaluation of management procedures related to troubled credit, especially regarding loans granted to non-financial corporations. As a result of these programmes, impairments registered by banks rose significantly, which required a significant increase in own funds, as previously mentioned.

As regards the regulatory framework, the legal framework in which Banco de Portugal develops its supervisory activities has been further enhanced, in line with developments observed at the international level. The Bank was formally appointed as macro-prudential and resolution authority, and has also played an active part in the preparation of banking union.

The adjustment and strengthening of banking sector resilience were significant and made it possible to maintain financial stability. At the same time, the importance of banking sector deleveraging during the applicable EFAP period reflected and boosted the correction of economic and financial imbalances of the other sectors in the Portuguese economy.

By implementing the EFAP, Portugal made important progress in correcting its structural imbalances, regained external credibility and returned to financing in international markets. The positive situation of the external accounts – i.e. the external net lending – made it possible to kick-start the gradual reduction of the Portuguese economy's external indebtedness; however, the maintenance of such net lending is not guaranteed nor is the adjustment achieved so far sufficient to dispense with the need to refinance the still high public and private sector indebtedness levels.

In this context, the further correction of macroeconomic and financial imbalances and the access to external financing will remain pre-conditions for Portuguese economic growth. These two conditions are strictly inter-related: on the one hand, ensuring financing under sustainable conditions is key to guaranteeing financial stability and, through concerted action, to phasing out over time the adjustment effort resulting from the accumulated imbalances, minimising its social impact; on the other, ensuring sustainable financing of the economy calls for consolidation and strengthening of the progress made in correcting the imbalances. This is particularly sensitive in the context of the conclusion of the EFAP, which is characterised by high uncertainty over the conditions that in particular the State and the banking sector will face in new government debt issuance in international financial markets. Preserving favourable access conditions calls for credible policies, consistent with increased competitiveness and external balance and based on fiscal discipline, on a robust financial sector, and on the deepening of structural reforms that are critical to underpinning sustainable economic growth.

Therefore, it is important that the end of the EFAP does not create the illusion that the adjustment process may ease off, with particular regard to public finances. Such a situation would affect market perception of the authorities' commitment to correct the Portuguese economy's structural imbalances and jeopardise external credibility for a considerable time. In the medium term, this scenario would imply higher risk premiums for the resident sectors' debt and consequently a more severe fiscal adjustment, with a stronger impact on the loss of income by the resident sectors. In a context of excessive indebtedness, such loss of income would imply increased difficulty in actually meeting the respective credit liabilities, impacting on banking system impairments and restricting its profitability and soundness.

The need to consolidate and strengthen the progress achieved so far also extends to the non-financial private sector. This sector's high indebtedness is a major risk to financial stability and to the recovery of economic activity, affecting the speed of the macroeconomic imbalance correction process, already hampered by low inflation expectations. In the case of households, it is important to consolidate the positive trend of the savings rate and the increase in net lending, in order to underpin the productive investment required for the resumption of robust potential growth without jeopardising the external balance. Non-financial corporations will have to reduce the excessive indebtedness and strengthen their capitalisation, becoming financially sounder, capable of facing increasingly more competitive environments and promoting the investment required to consolidate the economic recovery.

The financial sector will also continue to face a number of important challenges. In the context of the conclusion of the EFAP and the creation of the Single Supervisory Mechanism (SSM), the banking system must continue to reduce its high dependence on financing from the Eurosystem and manage its return to bond and capital markets. In parallel, the low profitability levels require a continued effort by institutions to reduce operational costs and attract key investors.

These challenges are all the more pressing as the regulatory and competitive framework of this sector is undergoing profound changes. At the regulatory level, despite the positive contribution to financial stability of the projected changes, the simultaneous adoption of a wide and complex set of new rules will involve operational risks and induce behaviour adjustment, that may trigger some disturbance in the short run. Particular emphasis should be placed on the rules associated with the establishment of the banking union and Community regulations on resolution mechanisms (Bank Recovery and Resolution Directive and Single Resolution Mechanism). Likewise, uncertainty about the interplay between monetary and macroprudential policies, in particular as regards the effect on the liquidity and/or leverage ratios introduced by the CRD IV/CRR, is a challenge for the system. Still, as regards the entry into force of these regulations, banks will be required to increase their own funds, in particular Tier 2 instruments, for which the market is giving signs of openness, and at a later stage, to issue Additional Tier 1 instruments, bearing in mind that the market is not very receptive for this type of instruments for the time being.

Looking further ahead, it should be noted that within the framework of the banking union, the banking business model will be different from the currently prevailing one. Competition for the best customers will increase, favouring the most efficient institutions. The others will tend to be restricted to poorer quality exposures, which will adversely affect their profitability and growth potential.

Finally, it should be noted that financial stability can also be affected by the materialisation of macroeconomic risks. The Portuguese economy is showing signs of recovery, albeit still moderate and strongly dependent on the external environment. The maintenance of exports as a strong driver of economic growth is key to consolidating the rebalancing of external accounts. This calls for the continued reallocation of resources towards the tradable sectors, the reduction of context costs and strengthened investment in these sectors. Therefore, it is essential to pursue the structural reforms started during the EFAP period, with a view to creating a set of incentives for economic agents' action inducing higher potential economic growth, which is key to ensuring debt sustainability and financial stability. It will be crucial that resident economic agents grasp that the reforms reflect an absolute need to safeguard key economic and financial balances, from an intertemporal perspective, and not as an external imposition.

1. Recent developments

1.1. Macroeconomic and financial environment of the Portuguese economy

> Economic activity in Portugal declined in annual average terms in 2013, but showed signs of picking up from the second quarter of the year

Economic activity in Portugal declined in 2013 in annual average terms by 1.4 per cent (Table 1). This reduction was smaller than in 2012 and positive developments in intra-annual terms were recorded from the second quarter of 2013.

The annual developments in GDP were due, on the one hand, to the contraction of consumption and investment of all institutional sectors, partly offset by some external demand stimulus reflected in the trade balance surplus. In turn, the change in the trend of GDP in intra-annual terms resulted from the positive path of domestic demand from the second quarter of 2013, rising year-on-year in the last quarter of 2013. In annual average terms, the unemployment rate stood at 16.3 per cent, accounting for an increase of 0.6 percentage points (p.p.) from 2012, but with a declining trend throughout the year. Turning to the inflation rate, the annual average change in consumer prices stood at 0.4 per cent (2.8 per cent in 2012), with a downward trend throughout the year.

The international environment remained broadly unchanged from previous years, characterised by weak world economic growth, accommodative monetary policies, relevant levels of uncertainty and financial market fragmentation, although with some signs of growth in the second half of the year.

Table 1 • GDP and main expenditure components | Year-on-year rate of change in volume, (unless stated otherwise)

In percentage

	% of GDP in 2013	2011	2012	2013	2012	2013			
	2013				Q4	Q1	Q2	Q3	Q4
GDP	100	-1.3	-3.2	-1.4	-3.8	-4.0	-2.0	-0.9	1.7
Domestic demand	99	-5.1	-6.6	-2.6	-4.4	-5.9	-2.9	-1.5	0.1
Private consumption	65	-3.3	-5.3	-1.7	-5.1	-4.0	-2.3	-0.9	0.6
Public consumption	19	-5.0	-4.7	-1.8	-3.8	-3.2	-2.3	-1.3	0.1
Investment	15	-11.1	-13.4	-7.3	-2.4	-16.1	-6.2	-4.4	-1.8
GFCF	15	-10.5	-14.4	-6.6	-12.4	-16.2	-6.2	-5.1	2.7
Stockbuilding (a)		-0.2	0.1	-0.1	1.8	0.1	0.0	0.1	-0.7
Exports	41	6.9	3.2	6.1	0.2	0.7	7.4	7.2	9.4
Imports	40	-5.3	-6.6	2.8	-1.6	-4.4	5.2	5.5	5.2
Domestic demand contribution (a)		-5.5	-6.9	-2.6	-4.4	-6.0	-2.9	-1.5	0.1
Exports contribution (a)		2.2	1.1	2.3	0.1	0.3	2.7	2.7	3.5
Imports contribution (a)		2.2	2.6	-1.1	0.6	1.7	-1.9	-2.1	-2.0

Sources: Statistics Portugal and Banco de Portugal calculations.
(a) Contribution to GDP real growth, in percentage points.

The fiscal deficit stood at 4.9 per cent of GDP in 2013 (6.4 per cent in 2012) – i.e. below the target agreed upon in the seventh review of the Economic and Financial Assistance Programme – associated with a fiscal consolidation effort[1] estimated at 1.5 per cent of GDP (3.2 per cent in 2012). This resulted chiefly from an increase in household taxation, partly offset by the reinstatement of the holiday and Christmas subsidies of civil servants and pensioners, and by the impact, albeit limited, of measures of a temporary nature.

In turn, the annual average reduction in private consumption was in line with developments in household disposable income, conditioned by an increase in direct taxation. The fall in consumption was more marked in the non-durable goods component and translated into a further rise in the savings rate, making a positive contribution to a further reduction in the indebtedness level. Despite the progressive acceleration of consumption from the second quarter of 2013, the savings rate continued significantly above the figures recorded in the period prior to the beginning of the crisis, translating a trend rebalance of households' financial situation, with the sector's indebtedness level remaining high.

The recovery in corporate GFCF was driven by Transport equipment and Other machinery and equipment components. GFCF in construction continued to record negative rates of change, albeit with an upward trend throughout the year. The annual contraction in this activity is in line with the trend stabilisation in housing, which had already started before the Economic and Financial Assistance Programme.

It should be noted that developments in economic activity were different across sectors, with the reallocation of resources towards the tradable sector. On the one hand, the contraction was more marked in the sectors traditionally oriented towards the domestic market, such as construction, financial services and public services provided. On the other hand, growth was recorded in sectors such as retail trade services, restaurants and hotels, which also benefited from the growth of foreign tourism in Portugal. Manufacturing industry decreased slightly in annual average terms, although there was an increase throughout the year.

Credit granted to non-financial corporations was also marked by heterogeneity, with more adverse developments for small and medium-sized enterprises and for the traditionally non-tradable sectors, such as construction and real estate activities. In aggregate terms, bank credit declined slightly in 2013, but less than in previous years. Bank lending rates, albeit recording a gradual trend decline, remained conditioned by the high risk perception in the Portuguese economy and by the still high financing costs faced by Portuguese banks (in part justified by the above-mentioned financial fragmentation).

Although declining from 2012, the contribution of exports, net of imports, to the change in GDP remained positive. Against a background of weak external demand buoyancy, the increase in exports reflects considerable market share gains of Portuguese companies over the past few years. As to developments in the trade balance, export growth was partly dampened by imports, which increased in 2013 after recording a decline in two years. These developments may be related not only to the pickup in aggregate demand (in particular consumption), but also to a shift in its composition, based on an increase in the components with higher import content, such as investment in machinery and transport equipment.

As a result, the financing capacity of the Portuguese economy in 2013, as measured by the combined current and capital account, stood at 2.6 per cent of GDP, increasing by 2.3 p.p. from 2012.

The projections for the Portuguese economy point to a gradual recovery of activity in the coming years, in line with developments seen from the second quarter of 2013, to a growth pace close to that projected for the euro area.[2]

World economic growth remained weak in 2013 with signs of growth in the second half of the year and prospects of intensifying in 2014

The slowdown in world economic activity witnessed in 2012 continued in 2013. The advanced economies continued to be adversely affected by reduced domestic demand, amid high unemployment and the fiscal consolidation measures adopted in some European countries. In turn, the emerging economies were affected by the decline in demand in the advanced economies and, in some cases, by the intervention of authorities, given the existence of risks to financial stability related to international capital movements. Moreover, political instability in some emerging market economies may have an economic impact.

From the second half of 2013, signs emerged of higher economic growth in some regions of the globe, namely the United States and the euro area. In the euro area, economic activity started to pick up moderately, chiefly as a result of the robust German economy and the gradual recovery of the economies under pressure. This recovery coincided with considerable risk mitigation associated with the sovereign debt crisis, visible in the evolution of the spreads on the sovereign debt of the said economies and in more favourable public accounts prospects.

2013 was also characterised by the maintenance of low inflationary pressure worldwide. In the euro area, the annual average inflation rate stood at 1.4 per cent (2.5 per cent in 2012), showing a declining trend throughout the year (falling from 2.0 per cent in January to 0.8 per cent in December), reflecting weak economic growth, adverse labour market conditions, the appreciation of the euro and the fall in energy prices, in particular oil prices. Notwithstanding, available evidence suggests that long-term inflation expectations remained anchored around the European Central Bank's objective of price stability.

Against this background, the forecasts of the International Monetary Fund (IMF) point to world GDP growth of 3.6 per cent in 2014 (Table 2). These forecasts take into account the signs of improvement in employment and financial markets and the continuation of accommodative monetary policies in the main economies.

Table 2 • GDP – real growth rates

In percentage

	2012	2013	2014p	2015p
World economy	3.2	3.0	3.6	3.9
Advanced economies	1.4	1.3	2.2	2.3
USA	2.8	1.9	2.8	3.0
Euro Area	-0.7	-0.5	1.2	1.5
Germany	0.9	0.5	1.7	1.6
France	0.0	0.3	1.0	1.5
Italy	-2.4	-1.9	0.6	1.1
Spain	-1.6	-1.2	0.9	1.0
Japan	1.4	1.5	1.4	1.0
United Kingdom	0.3	1.8	2.9	2.5
Canada	1.7	2.0	2.3	2.4
Emerging economies	5.0	4.7	4.9	5.3
China	7.7	7.7	7.5	7.3
Brazil	1.0	2.3	1.8	2.7
Russia	3.4	1.3	1.3	2.3

Source: IMF (World Economic Outlook, April 2014)
Note: p – prediction.

The stance of monetary policy remained accommodative in the main advanced economies, despite the easing of the pace of monthly asset purchases conducted by the US Federal Reserve System

In 2013 the stance of monetary policy remained accommodative in the main economies (Chart 1), in a context characterised by weak economic growth and lack of inflationary pressure worldwide.

The US Federal Reserve System (Fed) in its monetary policy meeting held in December announced that it would ease the pace of its monthly asset purchases beginning in January 2014, as well as its intention to keep the federal funds rate at low levels (between 0.0 per cent and 0.25 per cent).

In Japan, there are expectations that the expansionary policy may be strengthened until the end of 2014, should it be necessary to counterbalance the impact of the increase in the VAT rates in April 2014.

Turning to the emerging markets, interest rates were raised in most countries, in order to prevent capital flight associated with the beginning of the Fed's easing the pace of asset purchases and with periods of tension in some of these markets.

In the euro area, the ECB reiterated its explicit guidance that the key interest rates would remain at low levels for an extended period of time. Hence, at the end of 2013, the rate on the main refinancing operations was kept at 0.25 per cent, the rate on the marginal lending facility at 0.75 per cent and the rate of the deposit facility at 0.0 per cent. In parallel, expectations regarding the adoption of further monetary stimulus measures have increased among market participants, in view of the reduction of the Eurosystem's excess liquidity and the possibility of the inflation rate remaining at low levels for a prolonged period of time. As regards the pass-through to the economy of the monetary stimulus, the completion of the banking union will be important to help reduce persisting weaknesses at this level (namely financial market segmentation), thereby preventing sovereign risk from undermining the confidence in the European financial system.

Chart 1 •
Central Banks' rates

Source: Bloomberg.

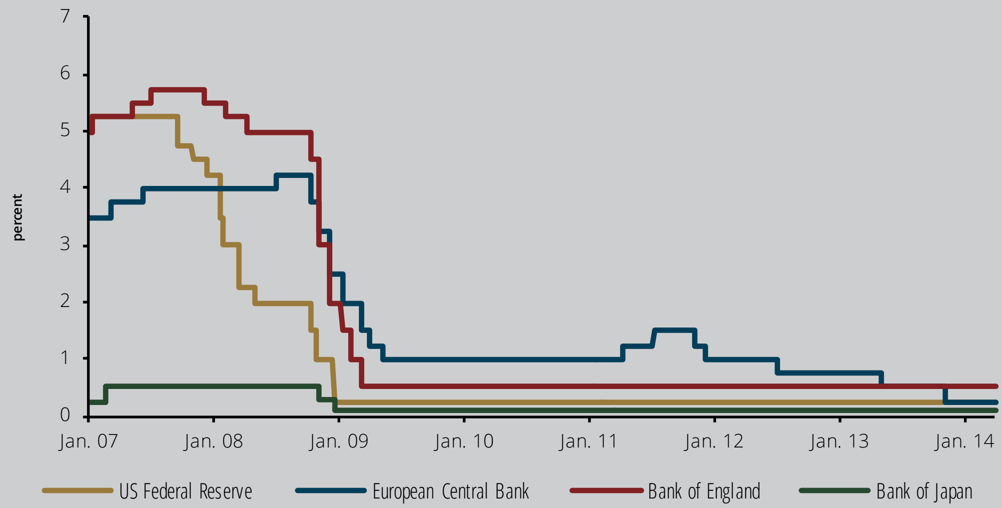
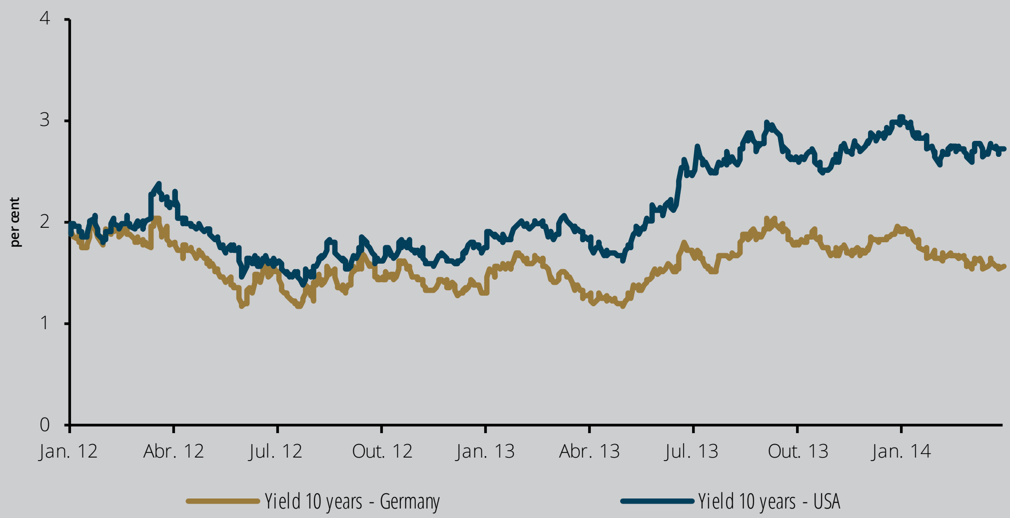


Chart 2 •
Sovereign debt 10 Year Yields

Source: Bloomberg.



The government bond market was recently marked by declining yields in the United States and Germany, after a sharp rise at the end of 2013

Developments in government bond market yields were conditioned in the course of 2013 by more positive sentiment, followed by declining risk aversion and supported by more favourable prospects regarding developments in economic activity and the resolution of the sovereign debt crisis in the euro area. This sentiment induced higher yields on German – and particularly US – government debt bonds, in the latter due to prospects of gradual easing of asset purchases by the Fed (Chart 2).

However, in the early months of 2014, this movement was partly corrected and price developments were conditioned by prospects that the stance of monetary policy in the main economies would remain accommodative, and by occasional rises in risk aversion, in view of negative developments in some emerging markets.

Interest rate differentials between most euro area countries and Germany narrowed

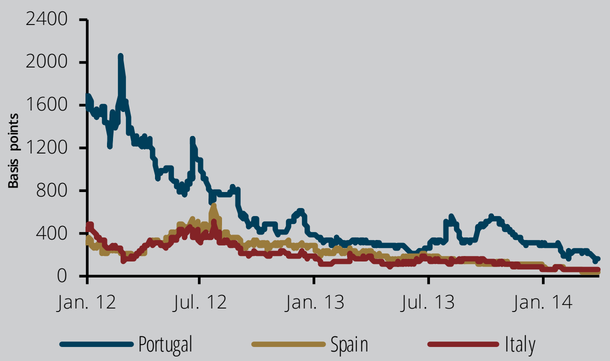
In the course of 2013 risk perception in the euro area countries particularly hit by the sovereign debt crisis improved significantly, benefiting from progress achieved in the respective economic and financial adjustment processes. In this context, and amidst more positive market sentiment and the demand for higher yield securities, spreads vis-à-vis the core markets narrowed sizably (Chart 3 and Chart 4), along all segments of the yield curve.

Ireland and Spain concluded the respective financial assistance programme (which in the case of Spain was only directed to banks) with no need of further support by international authorities. In this environment, the yields on two and ten-year government debt bonds fell to historically low levels.

Equity markets in the advanced economies recorded sizable gains

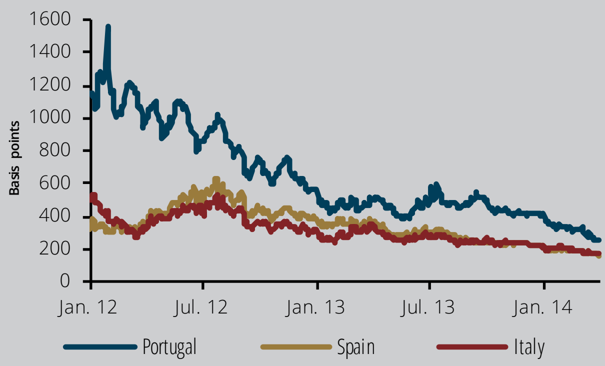
The main stock price indices in the advanced economies recorded gains and in the United States and Germany they reached historical highs (Chart 5). This market segment benefited from the favourable macroeconomic environment and monetary policy, improved corporate data in 2013 and some easing of geopolitical tension towards the end of the year. In the first

Chart 3 • Sovereign debt 2 Year Yields | Differentials vis-à-vis Germany



Source: Bloomberg.

Chart 4 • Sovereign debt 10 Year Yields | Differentials vis-à-vis Germany



Source: Bloomberg.

quarter of 2014, the conflict in Crimea and the involvement of the international community brought about some uncertainty and volatility to equity markets, although they did not prevent further historical highs, in particular by the main US stock price index.

> The Portuguese State has successfully pursued a strategy consisting in building a financial buffer in anticipation of future sovereign needs, amid improved risk perception associated with the country

The more favourable international environment and positive developments in the sovereign debt crisis in the euro area made the Portuguese capital market more attractive for international investors. This market also benefited from a more favourable assessment by the rating agencies of the country's financial situation, based on the economic indicators released and positive fiscal performance.

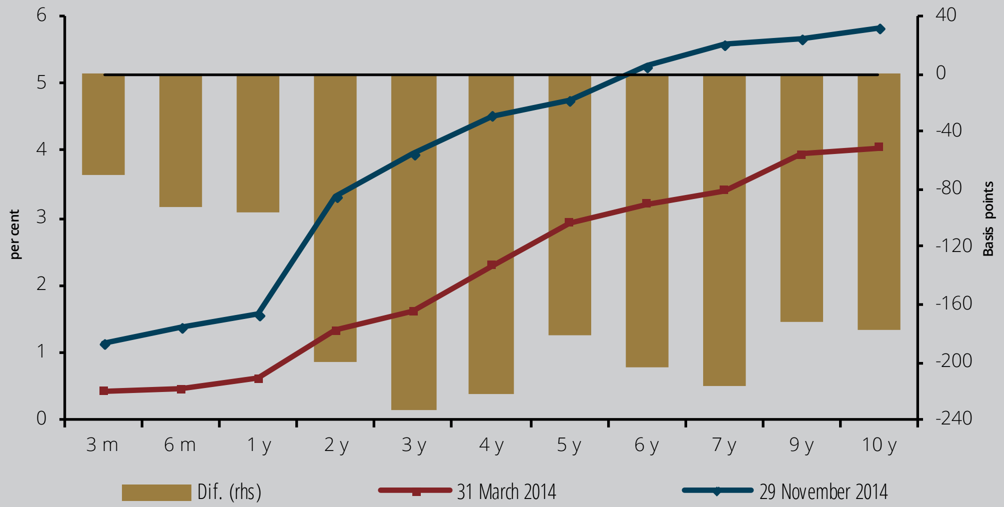
The easing of tensions in financial markets enabled Portuguese authorities to develop a strategy consisting in building a financial buffer in anticipation of future sovereign needs, through syndicated issuance of five and ten-year Treasury bonds, in which bids largely

Chart 5 • Stock market indices

Source: Bloomberg.

Chart 6 • Portuguese yield curve

Source: Bloomberg.



exceeded offer. Treasury bonds maturing in 2014 and 2015 were rolled over for Treasury bonds maturing in 2017 and 2018, thereby easing the redemption burden in the next few years. Moreover, there was also a debt repurchase operation maturing in 2015, amounting only to EUR 50 million, which was interpreted by the market as a sign of investors' confidence in holding Portuguese debt. Finally, there was a non-syndicated issuance of ten-year Treasury bonds in April 2014, at a historically low rate. All these operations represent very important milestones in the consolidation of the strategy of return to the financial market.

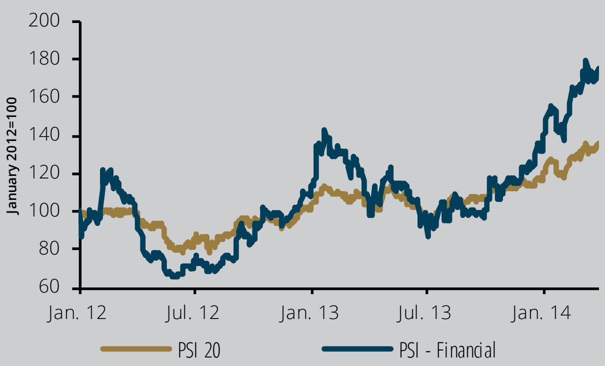
Risk perception regarding Portugal also improved in the secondary market, with yields falling along all maturity segments of the yield curve (Chart 6) and significant narrowing of the differentials vis-à-vis Germany. The yields on five and ten-year Treasury bonds have been pushed down to remarkable levels below 3 and 4 per cent, respectively, for the first time since January 2010. Likewise, trading conditions in the secondary market showed signs of improvement, with an increase in the volume of securities traded and the narrowing of the bid-offer spread.

A strong valuation of the Portuguese financial sector was recorded in the equity market

The favourable scenario to financial investment in Portugal also benefited the stock market segment, with a considerable valuation of the PSI-20 stock price index in the past few months, which exceeded that of most euro area countries. Worth noticing is also the positive evolution of the financial index, underpinned on the one hand by data releases by some banks, which signalled improvements in both the banking product and the profit margin and, on the other, by the actual return to the markets by some Portuguese banks (Chart 7).

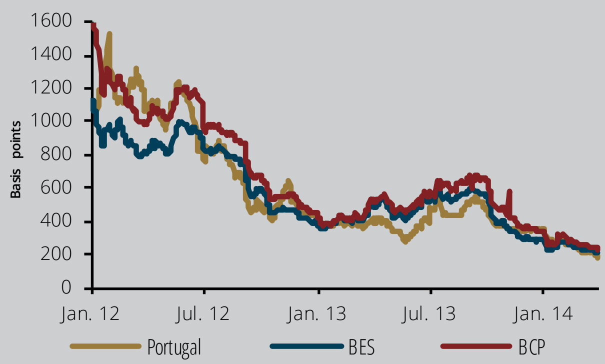
Indeed, a number of Portuguese banks returned to the capital market, showing increasing financing capacity at lower rates, materialised through different types of issuance (secured and unsecured). These developments were due to the sharp reduction in Portuguese banks' credit risk, as measured by the price of the Credit Default Swaps, reaching the lowest values since 2010 (Chart 8). Bank issuance benefited from the favourable market sentiment, also associated with successful issuance by the Portuguese State.

Chart 7 • Portuguese equity indices



Source: Bloomberg.

Chart 8 • Credit Default Swap | 5 years spreads



Source: Bloomberg.

1.2. Financial position of non-financial sectors

Household net lending increased further in 2013, reflecting savings growth and a decline, albeit small, in investment

In 2013 household net lending amounted to 6.8 per cent of GDP (6.4 per cent in the previous year), which mainly reflected an increase in their savings rate (from 8.9 per cent to 9.3 per cent of GDP) and a decline in net acquisition of real assets (2.8 per cent of GDP, after 3.0 per cent in 2012)[3] (Chart 9). The savings rate has peaked since the launch of the euro area, both in terms of level and as a percentage of GDP and disposable income, moving closer to the euro area average.[4]

In 2013 net interest continued to make positive contributions to household income changes, albeit to a lesser extent than in the previous year. Both interest paid and interest received decreased, in line with a decline in money market interest rates, although absolute changes were higher in the case of interest paid.[5] This decline in interest paid reflects, on the one hand, lower outstanding household debt and, on the other hand, the fact that most housing loans (which account for the largest share of household debt) were granted at a floating rate with a fixed spread. In the case of interest received, the drop in money market rates was reflected more slowly than in the case of loans, given that most deposits (the main interest-bearing assets) are remunerated at a fixed rate.[6]

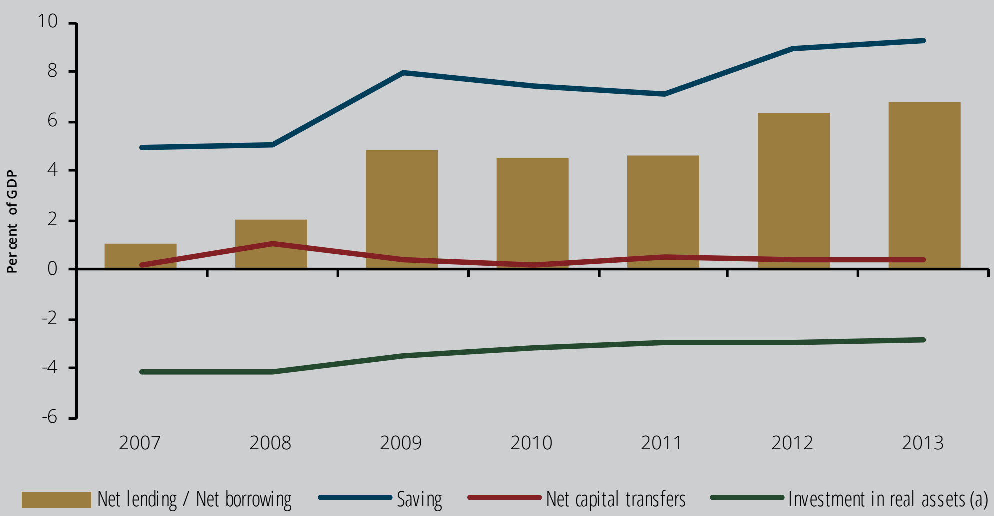
Household net lending was reflected in the continued net repayment of debt by this sector

In 2013 household net lending was reflected in both the continued net repayment of debt and an increase in the sector's portfolio of financial assets (Chart 10). Net repayment of total debt remained unchanged from 2012 (3.9 per cent of GDP), while there was a shift in the financial asset portfolio, in the form of an increase in deposits and other claims on other sectors, as well as a decrease in debt securities and equity securities (Chart 11).

At the end of the year, total consolidated household debt stood at 96 per cent of GDP, i.e. approximately 5 percentage points lower than in 2012. This reflects a decline in total credit granted to households by other sectors, which was slightly more marked than in 2012. In particular, consumer credit continued to record sizeable negative net changes in 2013, amid high interest rates on consumer

Chart 9 • Saving, investment and net lending of households

Source: INE.
Note: (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.



bank loans. However, credit associated with new consumer loans in 2013 increased (gross change) by approximately 15 per cent from the previous year, with monthly credit agreements concluded during 2013 remaining above the level in the same periods of the previous year. In turn, the annual rate of change in loans for house purchase did not change from the previous year (standing close to -4 per cent), while interest spreads applied to these loans declined somewhat during the second half of the year.

According to the Bank Lending Survey,[7] in 2013 credit standards loosened somewhat, while demand continued to be conditioned by low consumer confidence, unfavourable housing market prospects and lower consumption expenditure.

> Against a background of lower household disposable income, the default ratio continued to increase, albeit at a lower pace than in the previous year, and remained muted in the case of loans for house purchase

Lower household disposable income and a high unemployment rate continued to result

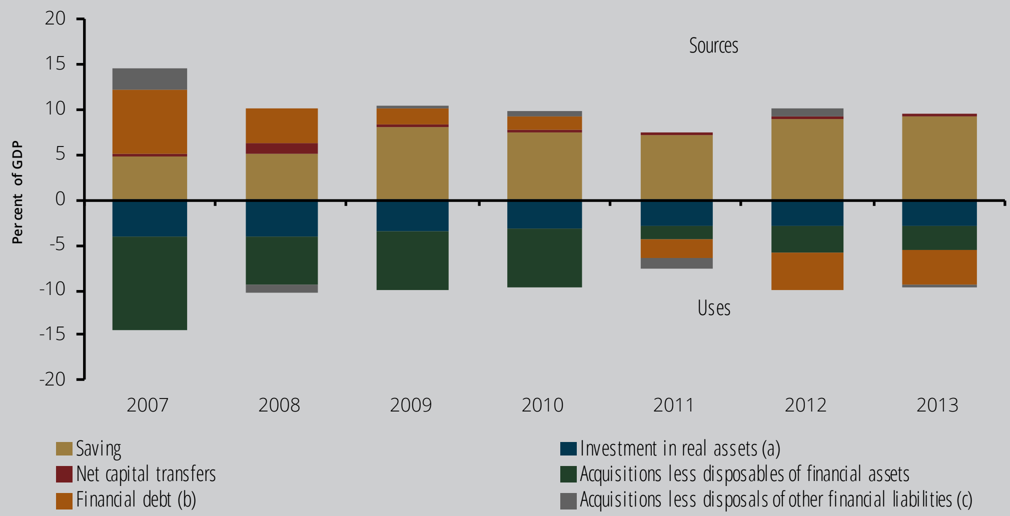


Chart 10 • Sources and uses of funds by households

Source: INE and Banco de Portugal.
Note: (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) Corresponds to the sum of loans and securities other than shares. (c) Adjusted for the discrepancy between national non-financial accounts' and national financial accounts' net lending.

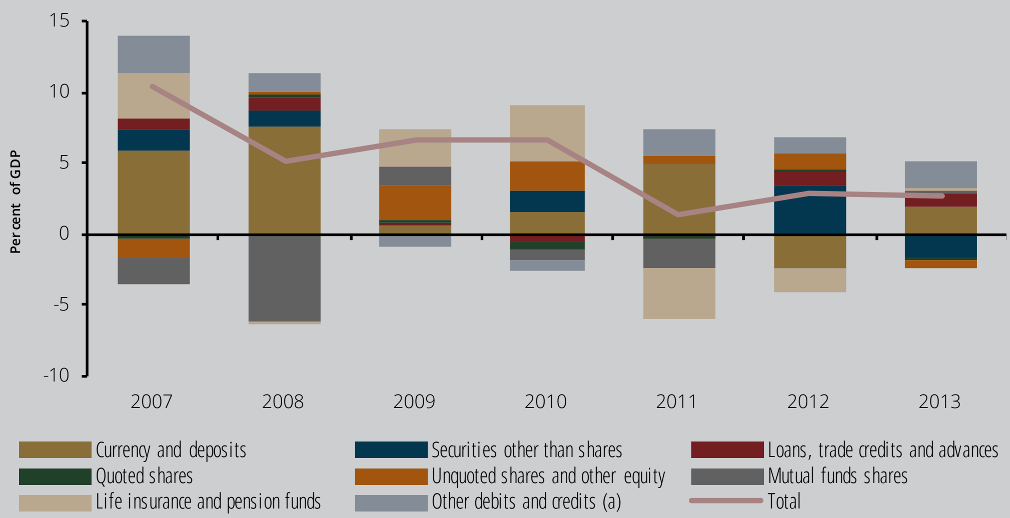


Chart 11 • Financial assets of households | Transactions

Source: INE and Banco de Portugal.
Note: Consolidated figures. (a) Includes other insurance technical reserves and other accounts receivable/payable.

in the materialisation of credit risk, particularly in the segment of bank loans to households for consumption and other purposes, whose non-performing loans ratio has followed an upward path since 2008. Conversely, in the case of loans for house purchase, that ratio continued to be subdued, albeit following a slightly upward path. The containment of default in this segment has reflected a marked decline in interest rates, which has led to a decrease in the average mortgage instalment, making it possible to reduce the household burden associated with these liabilities. In turn, the annual flow of new non-performing loans as a percentage of total lending is on a slightly upward path as regards housing loans, keeping a downward trend in the case of loans for consumption and other purposes.

Developments in the household default ratio led to the adoption of easing measures. In particular, the arrears settlement general regime entered into force on 1 January 2013, through which the principles and rules to be observed by credit institutions in the prevention and settlement of arrears on credit arrangements with household customers were laid down.[8] Still in 2013, other legal and regulatory acts were approved to provide for a suitable protection of over-indebted consumers, namely the revision of the arrears regime and the extension of the housing credit regime to all mortgage credits.[9]

In 2013 non-financial corporate net borrowing continued to decline gradually, as a result of the higher savings rate and lower investment rate

In 2013 the non-financial corporate net borrowing was 2.1 per cent of GDP, which corresponds to a fall from the previous year (3.9 per cent of GDP). These developments reflected an increase in the sector's savings rate (from 6.4 per cent in 2012 to 7.5 per cent of GDP) and a decline in investment to a two-decade low (10.4 per cent of GDP, after 11.6 per cent in the previous year) (Chart 12). This decline in investment resulted from the corporate deleveraging and uncertainty about demand prospects.

The increase in the savings rate of non-financial corporations in 2013 was largely due to a reduction in property income paid (2.2 percentage points of GDP).[10] These developments reflected a decline by 1 percentage point of GDP in both (gross) distributed income of corporations and interest paid. In 2012 the distributed income of corporations reached a historical peak (9.1 per cent of GDP in gross terms and 6.4 per cent in net terms) (Chart 13).

Parallel to these developments, the non-corporate profitability ratio improved in 2013. This improvement was broadly based across all sectors of activity.

Despite developments in the sector's net borrowing, the total debt ratio (in consolidated terms) dropped slightly to 141 per cent of GDP at the end of 2013, i.e. 2 percentage points below the December 2012 value. Net repayment of debt was close to zero, with the fall in outstanding amounts mainly reflecting changes in volume (such as reclassifications and write-downs) and value.

Developments in total credit were highly heterogeneous, mostly favouring exporting firms and state-owned enterprises to the detriment of smaller enterprises

In 2013 changes in total credit granted to non-financial corporations were virtually nil, similarly to the previous year. This trend reflects positive developments in loans granted by non-residents, while loans granted by the resident financial sector continued to decline, albeit less markedly than in 2012.

Developments in credit to non-financial corporations are highly heterogeneous, both in sectoral terms and in terms of corporate size. On the one hand, credit is moving towards the most buoyant sectors of the economy that are less dependent on domestic demand, such as manufacturing and mining. On the other hand, the fall in credit remains concentrated in smaller enterprises, which depend more on access to bank loans (Chart 14). At the same time, loans granted by Portuguese banks to state-owned enterprises have high growth rates, against a background of continued constraints on funding from non-residents.

In turn, interest rates on loans to non-financial corporations continued to follow a downward path, reflecting a narrowing of interest spreads applied by the banking system, amid lower bank funding costs and their improved liquidity position. However, despite a decrease, the interest rate on loans to non-financial corporations remains high, reflecting inter alia high perceived risk by banks and their still significant funding costs.

The low capitalisation of Portuguese non-financial corporations significantly constrains the strengthening of the domestic production structure

According to the Central Balance-Sheet Database of Banco de Portugal, the ratio of own funds to total assets for Portuguese firms as a whole (excluding agriculture, forestry and fishing) stood at 36 per cent at the end of 2013. This ratio is particularly low in the case of state-owned enterprises (10.5 per cent).

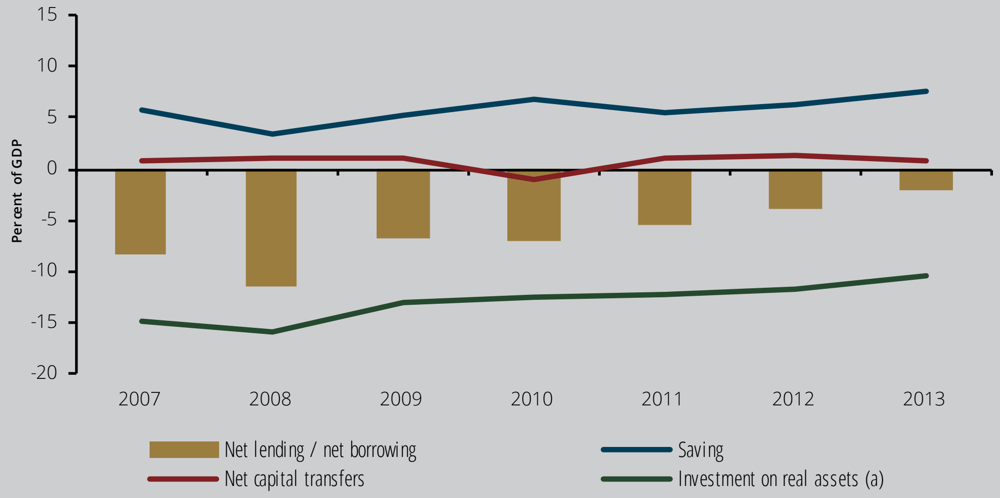


Chart 12 • Saving, investment and net borrowing of non-financial corporations

Source: INE.
Note: (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.

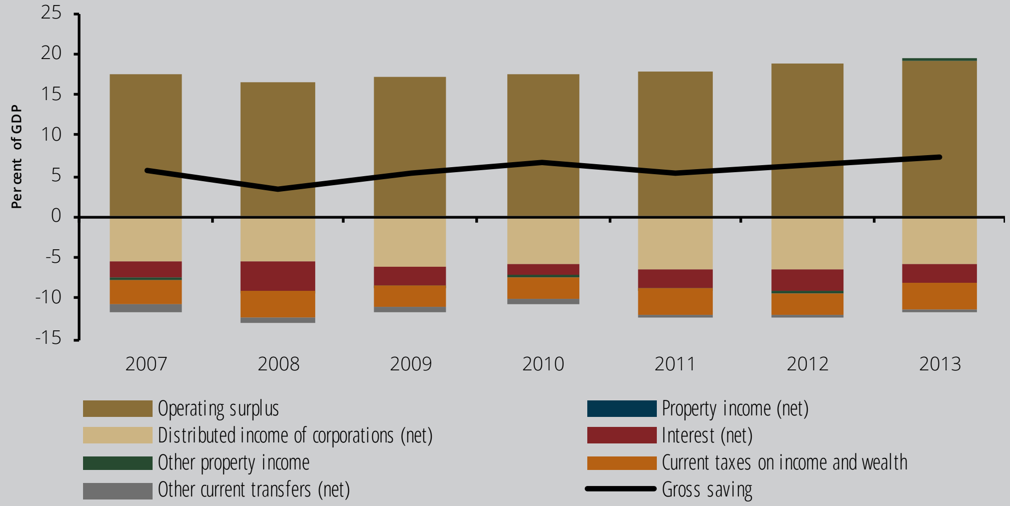


Chart 13 • Uses of non-financial corporations operating surplus

Source: INE.
Note: Net stands for the difference between sources minus uses.

Taking into account private firms and excluding holding companies, the ratio of own funds to total assets is somewhat lower in the case of small and medium-sized enterprises (29 per cent) than for large enterprises (33 per cent). Parallel to a weak capital structure, a considerable share of non-financial corporations have negative own funds (29 per cent in 2012).[11] This has worsened over the past decade, as financial debt has increased considerably.[12] The high financial leverage of Portuguese firms hinders the recovery in investment and economic activity. In the case of private firms, construction, electricity, gas and water and transportation and storage are the most leveraged sectors.

Taking into account that the sector's profitability stabilised at relatively low levels, the decline in interest paid facilitated an improvement in the interest coverage ratio in 2013 (Chart 15). Financial pressure, as measured by the ratio between interest paid and EBITDA (i.e. the opposite of the interest coverage ratio), is the main factor behind a poorer performance of Portuguese firms' return on equity compared with other European countries. In 2012 approximately 40 per cent of firms had an interest coverage ratio below 1, with the recent decline in the ratio being particularly significant in the case of micro-enterprises.[11]

The default ratio of non-financial corporations remains sizeable, in terms of both credit volume and the number of firms

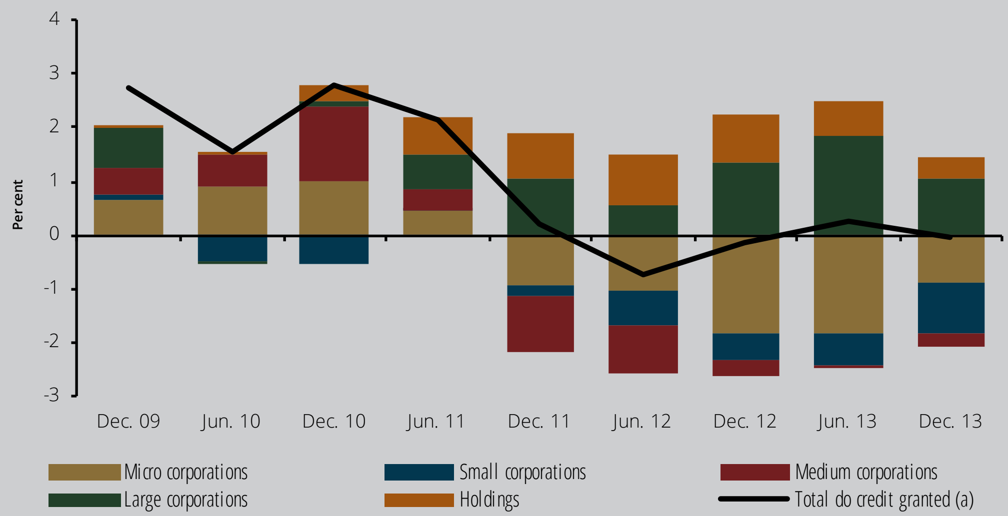
The non-performing loans ratio continued to follow an upward path, reaching peaks since the launch of the euro area in terms of credit volume and the number of indebted firms that had defaulted. This is in line with the usual lag vis-à-vis economic activity developments. In this context, the annual flow of new non-performing loans followed a downward path except for the last quarter of the year.

This wider default ratio was broadly based across most sectors of activity. Construction, real estate and trade posted the highest non-performing loans ratios.

The structural consolidation of public finances continued in 2013, with general government deficit dropping below the previous year and the fiscal projection

In 2013 public consumption and investment contracted further, which is in line with the continued fiscal adjustment process. The general

Chart 14 • Credit granted to non-financial corporations | Contributions to total change, by corporation size



Source: Banco de Portugal. Note: Does not include trade credit. Considers the complete set of credit granted to the non-financial sector by residents and non-residents. The sum of the individual contributions may differ from the annual rate of change of total credit granted due to the non-allocation of some credit.

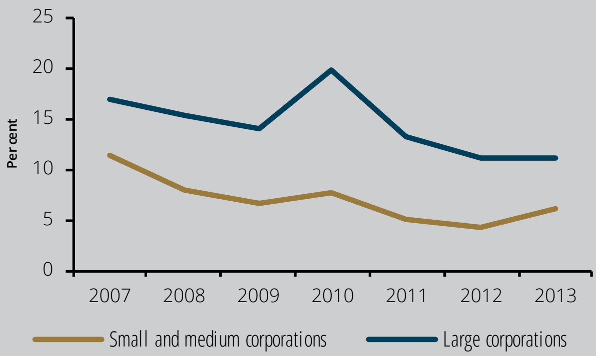
government deficit stood at 4.9 per cent of GDP in 2013 (6.4 per cent in 2012), i.e. clearly below the goal set under the Economic and Financial Assistance Programme. Underlying these developments is a consolidation effort, as measured by changes in the structural primary balance and estimated at 1.5 per cent of GDP (3.2 per cent in 2012) (Chart 16). This mainly resulted from an increase in the tax burden (mainly for households), which was partly offset by the reinstatement of Christmas and holiday subsidies for civil servants and pensioners.

According to the State Budget for 2014, the general government deficit is projected to stand at 4 per cent of GDP. The materialisation of this deficit will imply a primary surplus, which is key to ensure the sustainability of public finances. In 2015 Portugal is expected to correct its excessive deficit situation (i.e. the fiscal deficit must be lower than 3 per cent of GDP). However, this does not warrant a slowdown in the consolidation process.

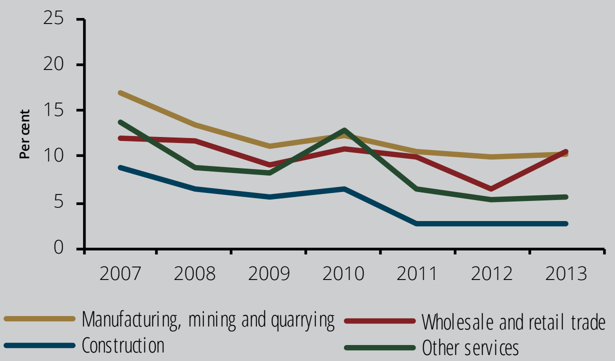
In fact, the consolidation process of public finances must proceed and be upgraded, particularly in a context of expected recovery in economic activity and the need to reduce the still high public sector indebtedness. The structural consolidation of public finances is crucial to correct imbalances constraining potential

Chart 15

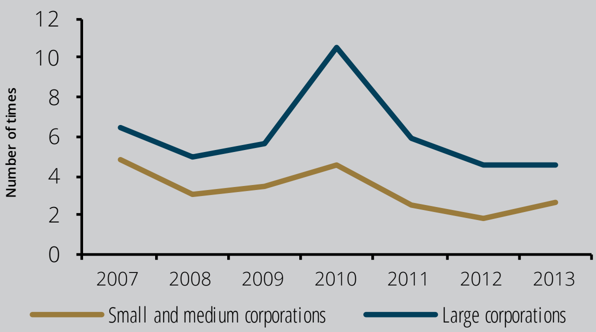
Profitability ratio | Corporation size



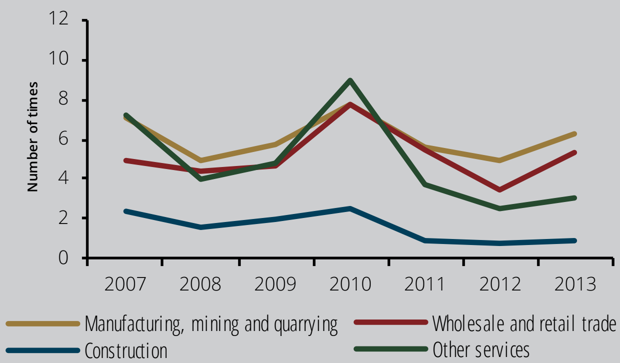
Profitability ratio | Economic activity



Coverage ratio | Corporations size



Coverage ratio | Economic activity



Source: Banco de Portugal.
Note: Extrapolated values. Excludes section A of NACE Rev.2: agriculture, forestry and fishing. 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).

economic growth, and must be strengthened given the medium-term objectives for the Portuguese economy: one of the commitments made at European level under the Treaty on Stability, Coordination and Governance is that the structural balance must decrease by 0.5 percentage points of GDP towards the objective of -0.5 per cent of GDP.

The level reached by public debt in December 2013 stood slightly above the objective set for that end-year

General government debt under the Maastricht Treaty rose further in 2013, to 129 per cent of GDP (124.1 per cent in the previous year), standing slightly above the objective set for that date (127.8 per cent).[13] Excluding central government deposits, general government debt is 118.5 per cent of GDP (114 per cent in 2012) (Chart 17).

In 2013 Portugal returned to the sovereign debt markets, and a new ten-year Treasury bond was issued in May. In the course of 2013, Treasury bills continued to be issued at average rates of 1.5 per cent with a one-year maturity. This debt management programme has continued in 2014, with the issue of a new ten-year Treasury bond together with the repurchase of existing Treasury bonds. The implicit interest rate on public debt (i.e. the ratio between interest expenditure and the simple average of the stock of debt at the end of the year and the previous year) fell from 3.7 per cent in 2012 to 3.4 per cent in 2013.

To ensure that Portugal irreversibly returns to international financial markets, it is key to guarantee the sustainability of public debt in the long run, by fostering confidence among creditors and creating conditions conducive to sustained economic activity growth.

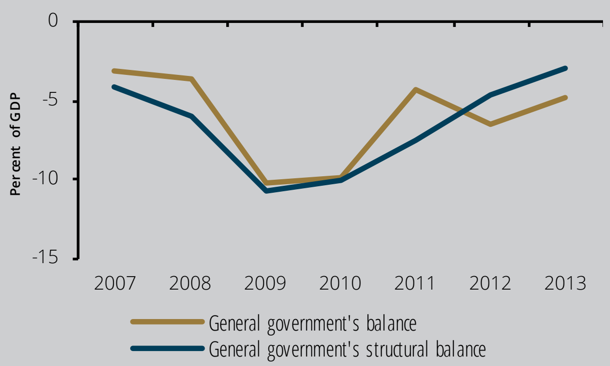
1.3. Financial sector assets, liabilities and prudential situation

1.3.1. Banking sector[14]

The decrease in the Portuguese banking system's assets continued to be supported by a decline in credit granted

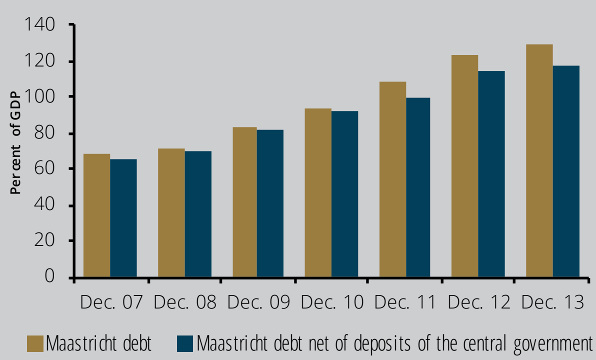
In 2013 the activity of the Portuguese banking system, assessed in terms of total assets, decreased significantly (a year-on-year rate of change of -7 per cent), continuing a process that started at the end of 2010 (with a cumulative change of -13 per cent) (Chart 18).

Chart 16 • General government's balance



Source: Banco de Portugal.

Chart 17 • General government debt



Source: Banco de Portugal.

The change in assets continued to be consistently supported by a decrease in credit. On the one hand, the decrease in activities with residents is part of a process to adjust these sectors' financial position in the past few quarters. The decrease in bank loans has been relatively broadly based across the private sector subsectors (excluding state-owned non-financial corporations that are not consolidated in the general government – see Section 1.2 of this Report) (Chart 19). On the other, loans granted to non-residents decreased markedly in mid-2013, owing to a major Portuguese banking group ceasing operations in Greece.

Developments in banking system assets in the second half of 2013 were also conditioned by a decrease in claims and investments in credit institutions. This mainly reflected a change in intra-group liquidity management by a branch of an international banking group operating in Portugal, which simultaneously reduced its asset and liability positions vis-à-vis its own group.

Credit at risk ratios continued to increase in 2013, albeit at a slower pace

The quality of banks' credit portfolio, specifically its domestic component, remained on a downward trend in 2013, in line with domestic economic developments. Against this background, activity decreased in several sectors, impacting on the financial situation of corporations. In addition, household income decreased and unemployment increased, affecting the financial situation of households.

In effect, the credit at risk ratio[15] further increased in 2013, standing at around 10.6 per cent in December, compared with 9.7 per cent at the end of 2012 (for activities with residents, this ratio went from 10.3 to 11.6 per cent) (Chart 20). These developments result from the combined effect of an increase in credit at risk and a decrease in total credit. In terms of domestic activity segments, a continued deterioration in the non-financial corporation ratio (standing at around 16 per cent at the end of the year) contributed importantly to total credit. In spite of making a residual contribution, the ratio of loans to households for consumption also remained on an upward trend (reaching around 17 per cent). Despite a slight increase, the credit at risk ratio for loans to resident households for house purchase remains low (around 6 per cent). The low level of the Euribor rates contributed to this, as most loan agreements are indexed to these rates through fixed (and usually low) spreads for the duration of the loan (usually a long-term loan).

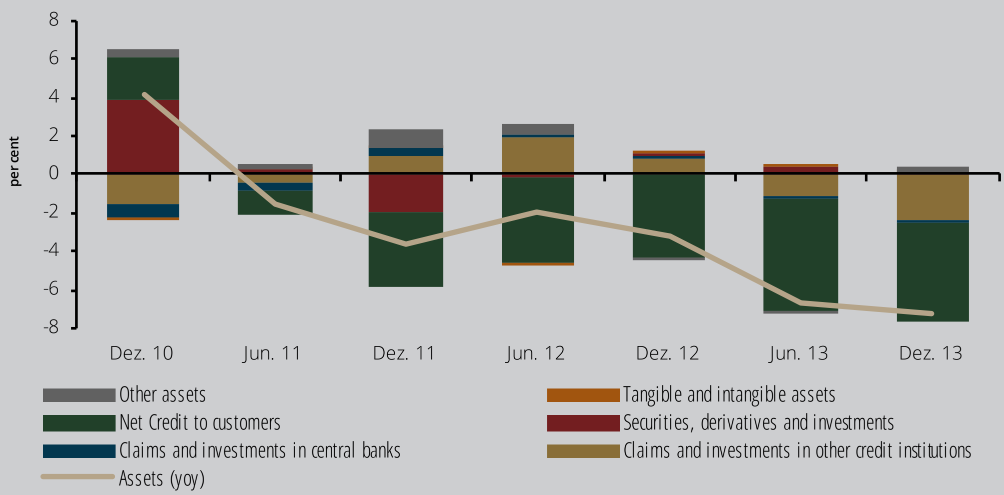


Chart 18 • Contributions to the annual change in assets

Source: Banco de Portugal. Note: 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.

Although the credit at risk ratio increased, the pace of deterioration of the quality of residents' credit portfolio has slowed down somewhat, in line with this variable's pattern of lagging behind the economic recovery and the gradual decrease in lending rates.

The coverage ratios of credit at risk improved, with inspections to ensure that the valuation and provisions of bank assets are appropriate

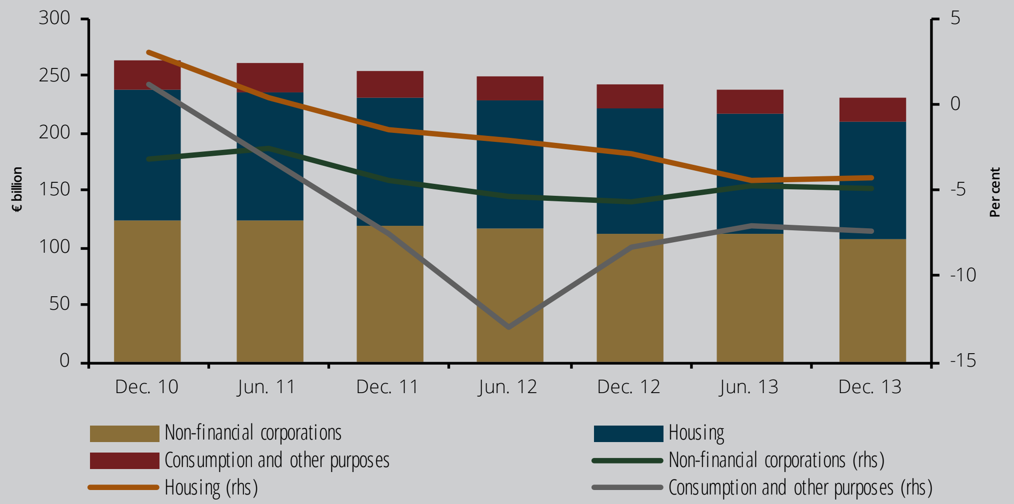
Together with the evolution mentioned above, the coverage ratios of credit by impairment registered an increase. On the basis of the credit portfolio,[16] this ratio therefore increased from 5.5 per cent at the end of 2012 to 6.2 per cent in December 2013. Considering the coverage of credit at risk[17], the ratio went from 53 per cent at the end of 2012 to 55 per cent in December 2013 (Chart 21). This last increase was supported by the non-financial corporation segment (the ratio for this segment increased by 3 percentage points (p.p.) to 63 per cent).

Since 2011, Banco de Portugal has also conducted several cross-sectional inspections on the credit portfolio or focusing specifically on sectors more sensitive to unfavourable economic or market developments.[18] These inspections have been carried out in cooperation with auditing firms – independent from the entities being inspected – and are closely monitored by the European Commission, the European Central Bank (ECB) and the International Monetary Fund (IMF) as part of the Economic and Financial Assistance Programme (EFAP). This is to ensure that bank accounts adequately reflect the value of their assets on a permanent basis and that impairment levels are appropriate. The most recent analysis carried out on the business plans of the banking system's main clients (ETRICC 2), as at 30 September 2013, deemed necessary to reinforce the impairment and provision levels by €1 billion overall. This amount (together with €2.8 billion calculated under the previous exercises) ensures that the risks associated with the economic groups involved are adequately addressed, contributing to the soundness of the Portuguese banking system.

The value of the securities portfolio increased, reflecting developments in the sovereign debt component

The value of the securities portfolio increased slightly in 2013 (1 per cent), increasing its share in total assets to around 18 per cent (16 per cent at the end of 2012). Similarly to recent years, this resulted from developments

Chart 19 • Credit to the non-financial private sector



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

in sovereign debt securities (both Portuguese sovereign debt and debt issued by other countries) (Chart 22). In turn, equity and corporate debt securities issued both by residents and nonresidents decreased (in particular, positions in unsubordinated securities).

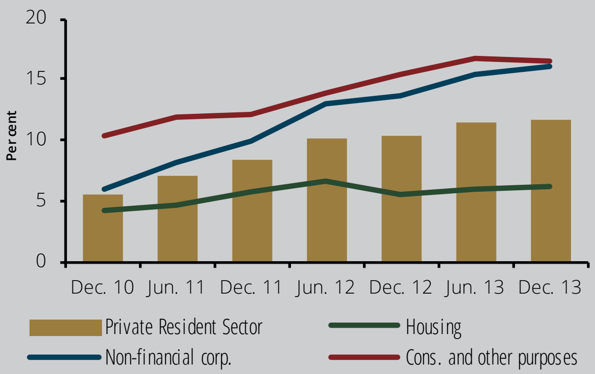
Within the context of a decrease in banking system assets, exposure to Portuguese sovereign risk increased further, reaching around 9 per cent of total assets (7 per cent at the end of 2012), with securities accounting for around 80 per cent of total exposure. This increase makes the banks' financial position globally more sensitive to changes in market sentiment with an impact on the valuation of sovereign debt securities. 2013 saw favourable developments in Portuguese sovereign yields, with a positive effect on the valuation of this securities portfolio component at market prices.

Finally, the share of equity in the total securities portfolio stood at 6 per cent at the end of 2013 (1 per cent of total assets) and other securities accounted for 14 per cent (3 per cent of total assets).

The share of deposits in the funding structure of banks was reinforced and positive developments were seen in liquidity gaps throughout 2013

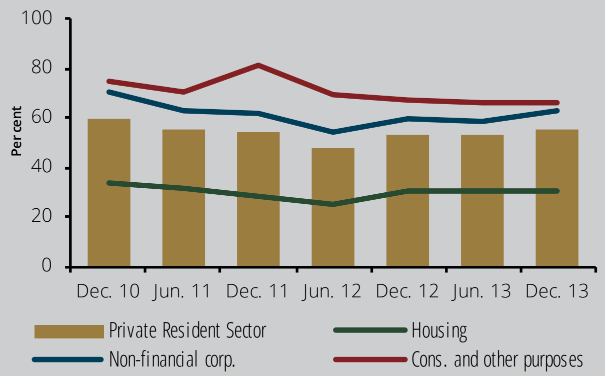
Against a background still characterised by fragmentation in the euro area debt market and, in

Chart 20 • Credit at risk ratio by segment



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

Chart 21 • Credit at risk coverage ratio by segment



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

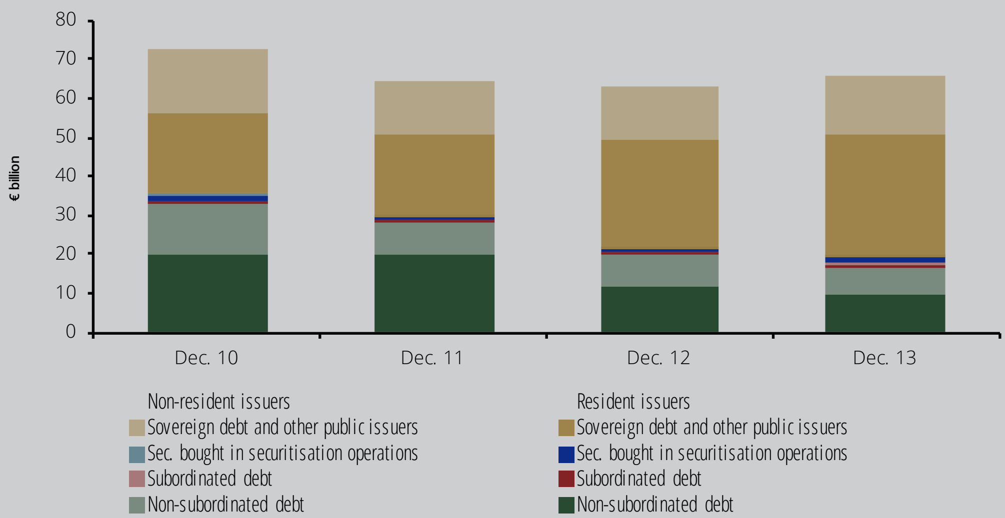


Chart 22 • Debt securities portfolio

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.

particular, interbank market, the banking system's funding sources continued to be adjusted towards a funding structure that is more sustainable and less sensitive to changes in international investors' risk perception (Chart 23).

Growth in deposits has played a key role in this adjustment process, reflecting, to a large extent, bank customers' confidence in the robustness of Portuguese banks. In addition, the contraction in the assets of the Portuguese banking system was accompanied by a decrease in the importance of funding through debt security issuance. Within the context of the euro area financial market fragmentation, this reduction reflected both the difficulties of Portuguese issuers in accessing international wholesale funding markets and some securities repurchase operations to generate income. More recently, against the background of a gradual improvement in market access conditions for the sovereign and corporate issuers, some banks resumed their debt issuance, which should be strengthened in order to better adjust asset and liability maturities and thus align with future liquidity prudential regulations.

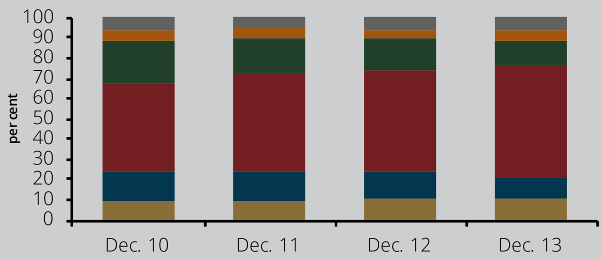
At the end of 2013, deposits reached 55 per cent of total bank funding sources (51 per cent in December 2012). The overall change in deposits in the first half of 2013 was adversely affected by a decline in non-domestic activity deposits (due to one of the major banking groups ceasing operations in Greece, as mentioned above). Controlling for this effect, international activity has continued to make a significant positive contribution to the increase in customer resources.

The slight increase seen in 2013 in deposits taken in Portugal[19] was accounted for by an increase in household and non-financial corporation deposits. In turn, Portuguese general government deposits decreased in 2013 as a whole, remaining nevertheless at significantly higher levels than before the sovereign debt crisis (Chart 24).

Consequently, the decline in the loan-to-deposit ratio[20] was mainly the result of a decrease in credit granted, as the value of deposits increased only slightly. In effect, the banking system's loan-to-deposit ratio stood at 117 per cent in December 2013 (a decrease of 11 p.p. from December 2012), continuing the downward trend that started in June 2010 (when the ratio reached a peak of 167 per cent) (Chart 25).

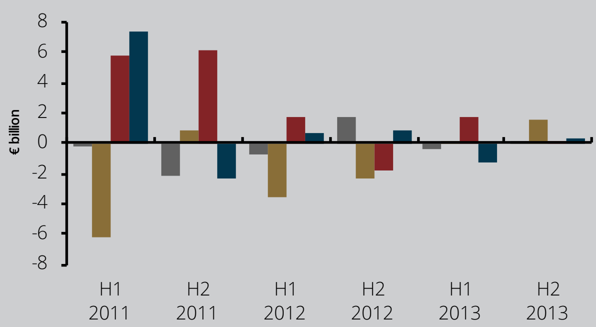
Against the background of these balance-sheet developments, the level of funding obtained by resident counterparties from the Eurosystem decreased by €5 billion (to €48 billion) in 2013. However, expressed as a percentage of assets, it remained relatively stable (at around 10 per cent) and considerably above the Eurosystem's

Chart 23 • Funding structure



Source: Banco de Portugal.

Chart 24 • Customer resources taken in Portugal – six month change



Source: Banco de Portugal.

average (around 3 per cent). Recourse to the Eurosystem mainly corresponds to the three-year longer-term refinancing operations (LTROs) (around 90 per cent) maturing in early 2015.

Recourse to wholesale market funding sources remained conditioned. In this respect, the amount outstanding of debt securities issued by banks decreased by around €15 billion in 2013. Funding from other credit institutions recorded a decrease of a similar magnitude, although strongly affected by a change in intra-group liquidity management by a branch of an international banking group operating in Portugal, as mentioned above.

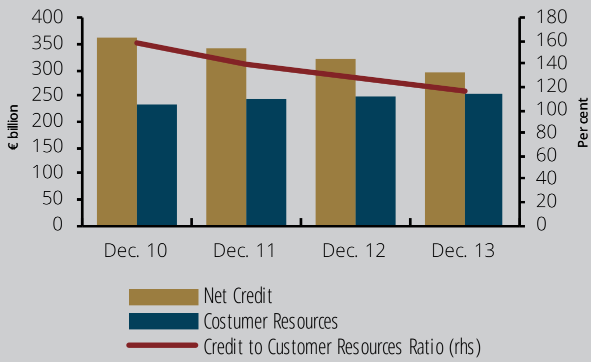
Liquidity gaps,[21] which improved considerably in 2012, increased further in 2013, continuing to signal a relatively comfortable liquidity situation (Chart 26). Nevertheless, developments in these indicators have benefited significantly from the ECB's support measures, particularly the two three-year LTROs conducted in late 2011 and early 2012. If funding obtained in these operations is not replaced in a timely manner by medium to long-term market funding, liquidity gaps are expected to be negatively affected, particularly as the LTRO maturity draws nearer.

Overall, however, a decrease in liquidity gaps is not expected to result in a considerable and proportional deterioration of the Portuguese banks' liquidity position, as the ECB has already announced it will continue conducting its refinancing operations through fixed rate tender procedures with full allotment at least until July 2015 and Portuguese banks have considerable collateral buffers to access these operations. In accordance with the forward guidance provided by the ECB, the monetary policy stance will remain accommodative, with key interest rates expected to remain at present or lower levels.

> The profitability of the banking sector reached a new trough in 2013, pressured by the net interest margin, in spite of a decrease in impairment flows

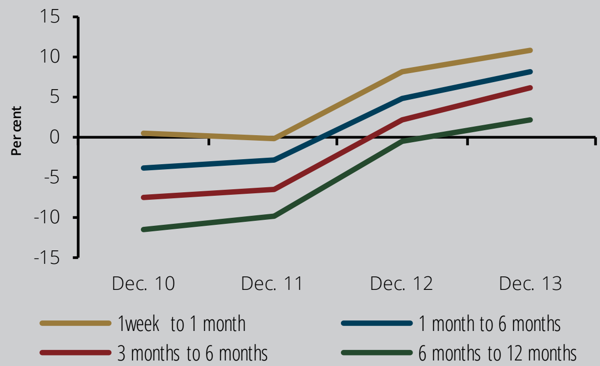
The profitability of the Portuguese banking system deteriorated in 2013, with net losses more than doubling compared with the previous year. These developments – which affected a considerable number of institutions – resulted in a return on assets and return on equity of -0.8 and -11,6 per cent respectively (Chart 27). This decrease in profitability was mainly the result of a decrease in the net interest margin and income from financial operations (in 2012 this benefited considerably from the sale of financial assets and repurchase of debt securities), partially offset by a decrease in impairment flows (Chart 28).

Chart 25 • Loan-to-deposits ratio



Source: Banco de Portugal.

Chart 26 • Liquidity gaps



Source: Banco de Portugal.
Note: According to Instruction of Banco de Portugal No 13/2009. Liquidity gaps are measured as a percentage of total assets minus liquid assets

The contribution of the net interest margin to profitability remained under strain in 2013, against the background of very low key interest rates. The net interest margin was affected by volume effects. At the same time, interest rate differentials between lending and deposit operations decreased, in particular the differential for resident credit and deposit operations (similarly to developments in 2012 – Table 3). Several factors were behind the narrowing of the differential of interest rates in assets and liabilities.

In terms of assets, credit portfolio shifts (specifically a more pronounced reduction in higher interest rate segments), the above-mentioned deterioration in their quality and a decrease in sovereign debt yields are particularly important. In terms of liabilities, the deposit interest rate (on outstanding amounts) continues to be conditioned by a number of operations negotiated in 2011 and 2012 (with a maturity of over 2 years and particularly high interest rates) and funding costs associated with hybrid instruments acquired by the Portuguese State under the recapitalisation of some of the major banking groups.

In spite of a decrease in 2013, the intra-annual evolution shows a recovery in the net interest margin during the second half of the year, mostly as a result of a decrease in interest paid.

Chart 27 • Return on assets and return on equity

Source: Banco de Portugal.

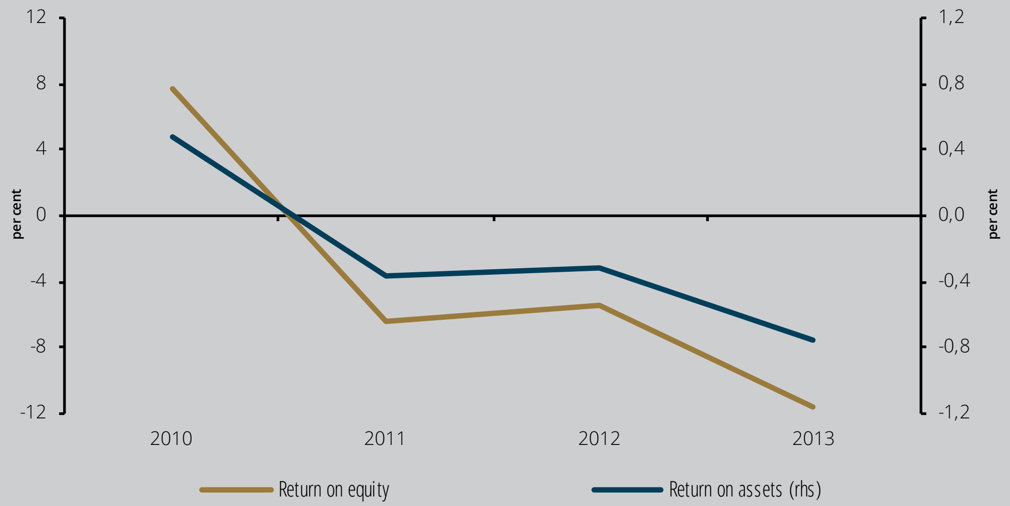


Chart 28 • Breakdown of return by component

Source: Banco de Portugal.

Table 3 • Implicit average interest rates of the main balance sheet items | per cent

	2007	2008	2009	2010	2011	2012	2013
Interbank assets	4.00	4.11	1.59	1.34	1.90	1.46	1.20
Non-interbank assets							
Credit	5.87	6.33	4.16	3.43	4.35	4.23	3.70
Domestic credit	5.87	6.37	4.19	3.29	4.12	3.96	3.32
Non-financial corporations and government	5.92	6.30	3.99	3.25	4.47	4.59	4.11
Households	5.82	6.45	4.41	3.33	3.73	3.33	2.62
Mortgages	5.06	5.60	3.42	2.13	2.62	2.21	1.55
Credit to foreign residents	6.14	6.31	4.42	4.47	5.59	5.52	5.34
Other financial assets	5.34	6.01	3.87	3.40	3.92	4.22	3.36
Financial assets available for sale – securities	5.31	5.52	3.94	4.02	4.75	4.79	3.75
Interest-bearing assets	**5.55**	**6.03**	**3.84**	**3.22**	**4.03**	**3.93**	**3.38**
Interbank liabilities	4.40	4.60	1.86	1.19	1.90	1.54	1.07
Resources from central banks	4.72	4.15	0.97	0.91	1.37	1.00	0.60
Resources from other credit institutions	4.38	4.69	2.09	1.36	2.26	2.04	1.59
Non-interbank liabilities							
Deposits	2.46	3.04	2.00	1.49	2.37	2.64	2.06
Residents	2.24	2.94	1.88	1.28	2.24	2.54	1.99
Non-subordinated securities	4.38	4.79	2.74	2.72	3.36	3.90	4.18
Non-subordinated liabilities	5.30	5.55	3.99	3.25	3.63	5.28	6.42
Interest-bearing liabilities	**3.45**	**3.89**	**2.21**	**1.74**	**2.43**	**2.56**	**2.16**
Spreads (in percentage points):							
Interest-bearing assets – Interest-bearing liabilities	**2.10**	**2.15**	**1.62**	**1.48**	**1.59**	**1.37**	**1.22**
Credit – Deposits (residents)	3.63	3.43	2.31	2.00	1.89	1.42	1.34

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.

Income from financial operations continued to make a positive contribution to the profitability of the banking system, albeit to a lesser extent than in 2012. These developments were mainly associated with sovereign debt security transactions. In early 2014, the strategy of selling sovereign debt securities – in the context of a significant decrease in yields – has enabled some banking groups to generate income, albeit with a subsequent negative impact on the net interest margin.

Although they remain high, impairment costs decreased from 2012 (Chart 29). This trend, which became more pronounced in the second half of the year, resulted mainly from a reduction in credit impairment costs. The fact that a banking group ceased activities in Greece and the improvement in macroeconomic conditions throughout the year (reflected in a relative stabilisation of the credit at risk ratio in the second half of the year) also contributed to developments in total impairment costs.

In line with 2012, operational costs decreased, particularly in the general administrative costs component. Nevertheless, this accompanied developments in assets and its contribution to changes in return on assets was negligible. As such, the cost-to-income ratio worsening (from 59 to 72 per cent) was mainly a consequence of the contraction in gross income. The effects of the business restructuring programmes currently under way in some of the largest Portuguese banking groups should only materialise in a significant manner in the medium term.

Over the past few years, the negative performance of domestic activities has been partially offset in some of the major Portuguese banking groups by a good performance in non-domestic activities. However, in the most recent period the contribution of non-domestic activities to income was affected by a less favourable economic and financial environment in some markets and, in this respect, by the discontinuance of activities in some of these markets, in particular Greece, as mentioned above (Table 4).

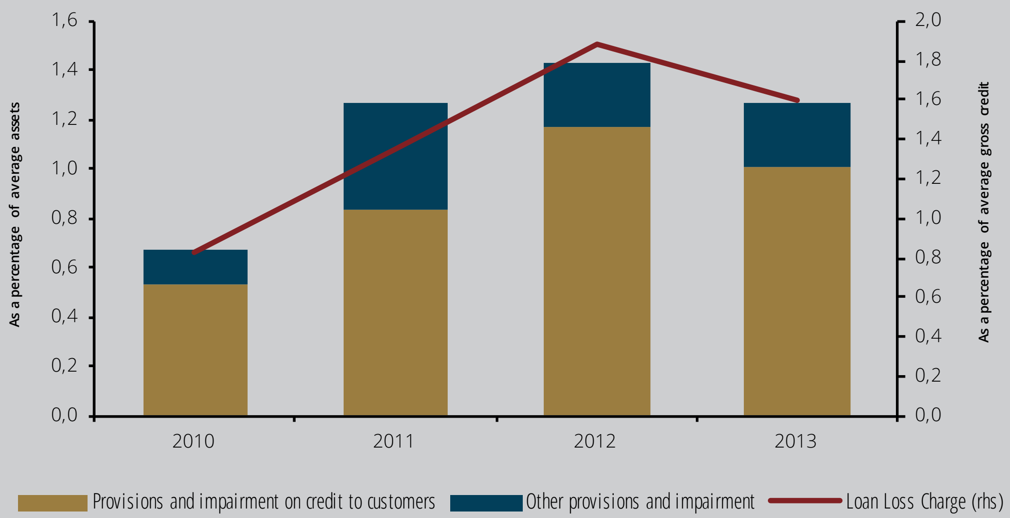
Table 4 • Relevance of international activity for the income of the eight major resident banking groups | Per cent

	Relative weight of foreign subsidiaries		International activity (yoy)		Domestic activity (yoy)	
	Dec. 12	Dec. 13	Dec. 12	Dec. 13	Dec. 12	Dec. 13
Net interest income	30.1	38.8	-14.4	3.9	-20.2	-29.6
Commissions	24.7	22.1	20.2	-13.9	-5.3	-0.3
Gross Income	26.6	32.0	-8.8	-9.9	2.1	-30.5
Operational Costs	27.4	26.3	5.5	-7.2	-8.4	-2.1
of which: Staff Costs	26.2	24.5	7.5	-7.2	-11.7	1.4
Impairment	12.2	10.0	63.5	-22.9	0.2	-4.1

Source: Banco de Portugal.

Chart 29 • Impairments flow and loan loss charge

Source: Banco de Portugal.



In the context of a decrease in assets, overall positive developments were seen in prudential capital ratios, contributing to the transition to the new prudential regime introduced at the start of 2014

At the end of 2013, the Core Tier 1 ratio[22] stood at 12.3 per cent, compared with 11.5 per cent at the end of 2012 (11.9 per cent in June 2013). In turn, the overall own funds adequacy ratio increased from 12.6 per cent at the end of 2012 to 13.3 per cent at the end of 2013. Finally, the leverage ratio, defined by the capital Tier 1 ratio to total assets, remained close to 7 per cent throughout 2013 (6.7 per cent at the end of 2012). The overall positive trend in these ratios in 2013 was in line with previous years.

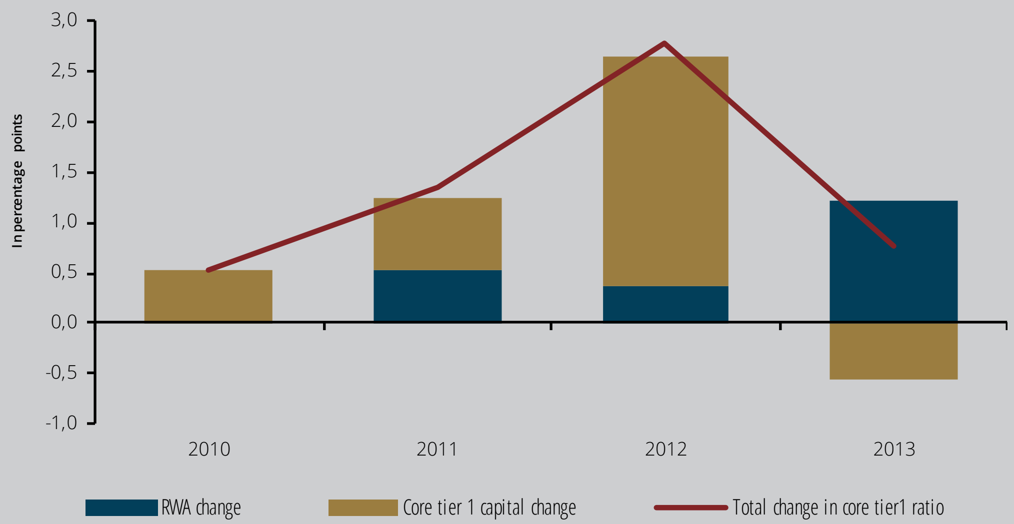
The improvement in the ratios in 2013 was the result of a significant decrease in assets and risk-weighted assets rather than an increase in own funds, in contrast with 2012 (Chart 30). In 2012 some of the largest banks in the Portuguese banking system conducted recapitalisation operations through private investors and/or public funds, but to a lesser extent in 2013. In turn, capital developments were also considerably conditioned by net losses, which worsened in 2013.

The reduction in capital requirements continued to be strongly determined by the ongoing banking sector deleveraging process, which started in 2011 and is supported by a credit portfolio reduction. In addition to this volume effect, these developments are also expected to have reflected recourse to risk mitigation measures by a number of banking groups (such as synthetic securitisation operations to cover credit risk) and an extension of the scope of the Internal Ratings-Based (IRB) Approach for the purpose of calculating minimum capital requirements in domestic portfolios.

To date, the prudential capital ratios of Portuguese banks are relatively small in European terms. This cannot be decoupled from the particularly adverse economic and financial developments seen in Portugal in the past few years, which impacted on the average quality of bank assets and overall profitability.

Finally, Notice of Banco de Portugal No. 6/2013 entered into force on 1 January 2014, establishing a new transitional regime to safeguard capital levels. The new regime was defined under Regulation (EU) No 575/2013 (or CRR – Capital Requirements Regulation), establishing the implementation of a Common Equity Tier 1 capital ratio of 4.5 per cent. This Notice also lays down that credit institutions and investment firms maintain a Common Equity Tier 1

Chart 30 • Core Tier 1 ratio



Source: Banco de Portugal.

capital ratio of no less than 7 per cent until Directive 2013/36/EU (frequently named CRD IV – Capital Requirements Directive) is transposed into Portuguese law. If, at any time, an entity has a Common Equity Tier 1 capital ratio below this threshold, the provisions of Directive 2013/36/EU on the maintenance of a capital conservation buffer are to apply. In order to ensure an adequate transition until the provisions of CRR/CRD IV are fully implemented, Banco de Portugal will likewise endeavour to safeguard the maintenance of adequate capital levels by assessing the circumstances in which credit institutions may carry out operations that have a certain or predictable effect of reducing the nominal value of one or more of their capital components immediately or in the short-term.

At the start of 2014, the major banks of the Portuguese banking system were in full compliance with the 7 per cent regulatory minimum. Nevertheless, institutions are recommended to adopt measures reinforcing their capital structure on the basis of instruments classified as Common equity and the issuance of Tier 2 instruments (to which the market is beginning to be receptive) and Additional Tier 1 (although the market remains less receptive to these).

1.3.2. Insurance sector

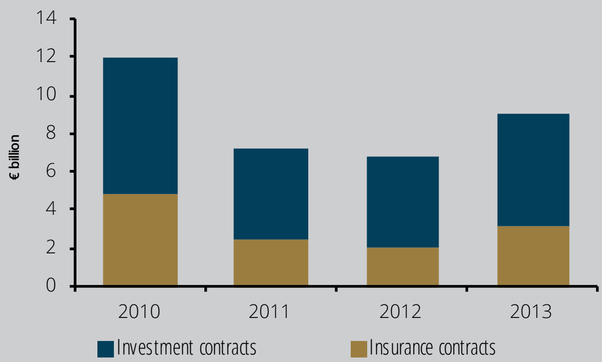
Insurance production increased in 2013 due to the life business performance

Considering that insurance companies operating in the Portuguese market are often integrated in financial groups with a presence in the banking sector, this sector's adjustment needs has a considerable influence on the insurance sector's behaviour. This effect is compounded by the concentration of distribution channels in the banking retail network and by the substitution effect observed in some savings products.

In this context, the banking sector's challenges in the recent past contributed to explain the decline in insurance production in 2011 and 2012. More recently, the signs of economic recovery and the banking sector's relative stabilisation, associated with the rise in households' savings rate, seem to have had a positive influence on the life business in 2013.

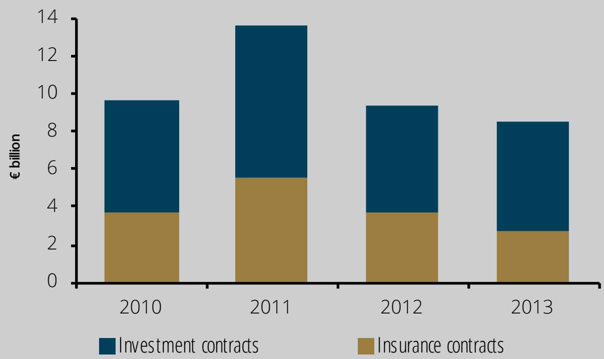
According to the risk analysis report of the insurance and pension funds sector – March 2014,[23] the minimum guaranteed return in the first year of new guaranteed-return life products (launched in 2013) averaged 3.5 per cent.[24]

Chart 31 • Gross written premiums – direct life business



Source: ISP.

Chart 32 • Claims – direct life business



Source: ISP.

However, the sharp decline in the risk premiums of some of the insurance companies' main investments, as well as the prospect of a prolonged low interest rate environment in the euro area, are likely to harm prospects of ongoing high levels of guaranteed returns. In fact, ensuring equilibrium between assets' returns and the financial guarantees offered in insurance products is fundamental for future profitability.

Insurance production[25] increased by almost 21 per cent in 2013, justified exclusively by the growth of the life business (that increased by more than 33 per cent), interrupting the trend observed in the past two years (especially noticeable in 2011) (Chart 31). The cost of claims in the life business declined in 2013, mainly due to decreasing surrenders (reduction of almost 35 per cent), reinforcing the improvement in surrender rates observed since 2012 (Chart 32).

The result of the life technical account amounted to around €818 million in 2013, which corresponds to an increase of almost 14 per cent from the previous year. This result is mainly explained by improvements in financial results and reinsurance operations, the latter as a consequence of two contracts that consisted in the anticipation of cash flows that would be received during the life-time of the reinsured products. A similar operation took place in 2012.

Non-life business production decreased

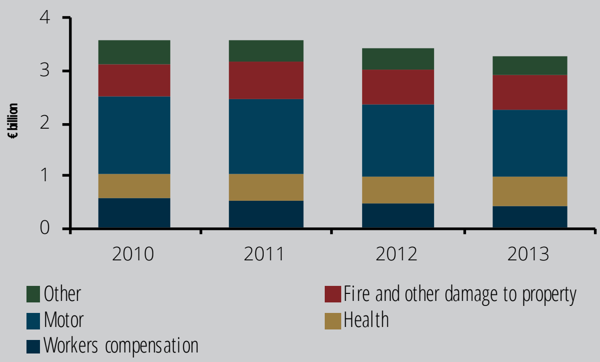
Despite the overall production increase in the insurance sector, gross written premiums declined in almost all non-life business segments (roughly 4 per cent overall), except for health insurance which increased approximately 3 per cent (Chart 33).

The still fragile economic environment and the increased competition in specific segments have contributed to decreasing production levels in some of the most relevant non-life segments (with impact on volume and on average rates), such as motor insurance and workers compensation, whose gross written premiums decreased by more than 7 per cent.

The decline in non-life business production was partly offset by a reduction of almost 4 per cent in the cost of claims, whose behaviour was also due to the motor and workers compensation segments, both declining by more than 10 per cent (Chart 34). Conversely, there was an increase of approximately 32 per cent in the cost of claims in the fire and other damage to property segment, influenced by the storms that took place in the previous year.

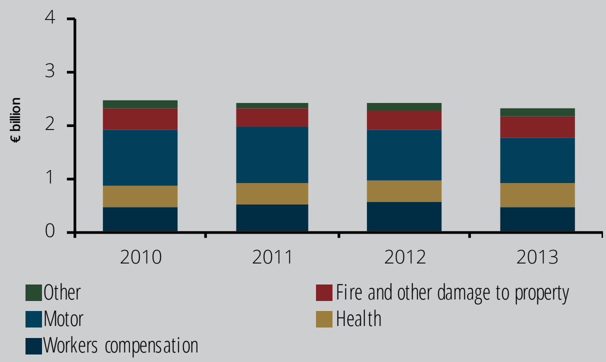
Despite the improvements in motor insurance and workers compensation claims, the overall result of the non-life technical account declined

Chart 33 • Gross written premiums – direct non-life business



Source: ISP.

Chart 34 • Claims – direct non-life business



Source: ISP.

considerably in 2013 (reduction of over 77 per cent), mainly explained by the behaviour of both the operational and financial components.

The technical account of the workers compensation segment has stood at negative levels since 2011, which justified the adoption of supervisory actions by the micro-prudential authority. As far as motor insurance is concerned (the main segment of the non-life business), cost of claims has been declining more markedly than gross written premiums, accounting for an improvement in the loss ratio and the maintenance of the technical account at positive levels.

The decline in Portuguese yields had a positive impact on financial income and on investment portfolios

The overall value of assets held to cover technical provisions amounted to €48.6 billion, of which 87 per cent are allocated to the life business. The overall value of these assets increased by close to 2 per cent in 2013.

Regarding the composition of investment portfolios, reference should be made to the increased weight of public debt, in detriment of corporate bonds (Chart 35). In addition, there were slight increases in exposures to equities and investment funds, as well as deposits.

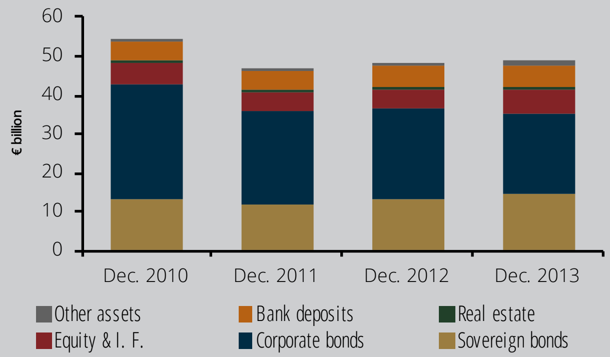
Yields on debt securities issued by domestic entities continued to follow a downward trend in 2013, which had a positive effect on investment portfolios and, consequently, on financial income.

The cover ratio of technical provisions declined by about 0.8 percentage point in 2013, as a result of distinct behaviours in the life and non-life businesses (Chart 36). The former revealed a relatively higher increase in the amount of technical provisions than on assets, which accounted for a slight decline in this indicator. Technical provisions in the non-life business decreased more than its assets, which accounted for an improvement in this ratio.

The considerable increase in aggregate net income was influenced by non-recurrent factors

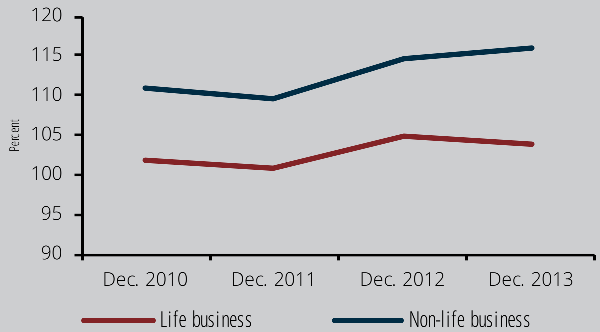
The insurance sector's aggregate net income amounted to approximately €670 million, which accounts for an increase of about €525 million since 2012. Return on assets stood at 1.3 per cent in 2013 (an increase of approximately 0.3 percentage point). Notwithstanding this positive behaviour, it should be stressed that net income in these two years was influenced

Chart 35 • Asset allocation



Source: ISP.

Chart 36 • Cover ratio (assets / technical provisions)



Source: ISP.

by non-recurrent factors, notably the reinsurance operations already mentioned. Given that these operations consisted in the anticipation of future cash flows, they may negatively affect future results.

The solvency ratio declined in 2013, but remains at comfortable levels

The solvency ratio declined by approximately 30 percentage points in 2013, but has remained at comfortable values (220 per cent). This value differs depending on the business segment, with non-life insurance operators recording the highest value (265 per cent) while life operators registered the lowest (210 per cent). Companies that manage both businesses achieved 213 per cent.

1.3.3. Pension funds

The increase in assets managed by pension funds was influenced by the downward trend of the risk premia of domestic debt securities

The total value of assets managed by pension funds was in excess of €15 billion in December 2013, corresponding to a rise of almost 5 per cent from the previous year (Chart 37). The decline of yields on debt securities issued by domestic entities made a positive contribution to this effect.

Discounting the effects of contributions received and benefits paid, the return of pension funds was close to 4 per cent in 2013.

Closed pension funds continued to represent the vast majority of total assets, reaching approximately €14 billion and around 91 per cent of total investment portfolios as of December 2013. As mentioned in the previous issue of the financial stability report, the transfer in 2011 of financial assets and liabilities to social security regarding banking sector pension funds conditioned asset developments, as well as contributions received and benefits paid by the sector.

Contributions received declined considerably in 2013, due to the behaviour of defined-benefit closed pension funds, since they decreased by almost 35 per cent (this resulted from an exceptional increase in contributions in 2012, due to the recognition of contributions for 2011) (Chart 38). This notwithstanding, contributions to open pension funds increased markedly in 2013 (around 52 per cent) (Chart 39).

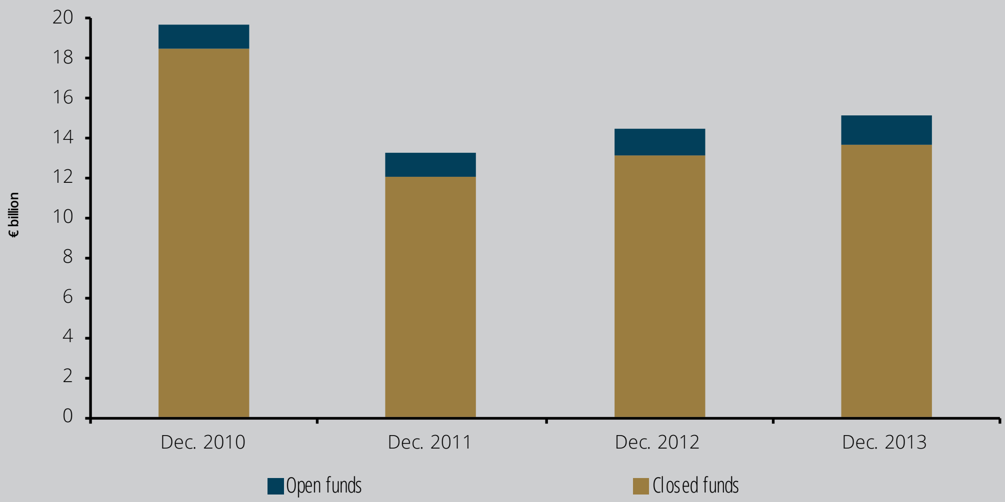


Chart 37 • Assets under management

Source: ISP.

Benefits paid saw a slight increase – of around 3 per cent – in 2013, due to the behaviour of defined-benefit closed funds. Within this scope, reference should be made to a sharp fall in benefits paid by open funds of the PPR (retirement savings plan) type (approximately 79 per cent).

The composition of asset portfolios remained relatively stable

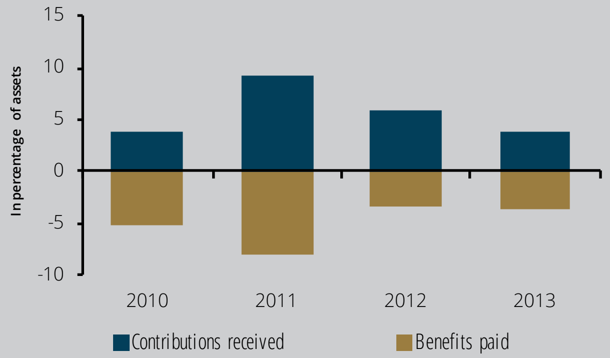
In 2013 the composition of pension fund asset portfolios remained fairly stable, with only a slight increase in exposure to equities and investment funds (Chart 40).

In a scenario of adjusted calculation assumptions, there was a slight decline in the funding level of bank employees' pension funds[26]

It is also important to make an in-depth analysis of the funding level of bank employees' pension funds, taking into account their relevance in the sector and the impact that the evolution of pension funds' liabilities and assets may have on banks' financial statements.

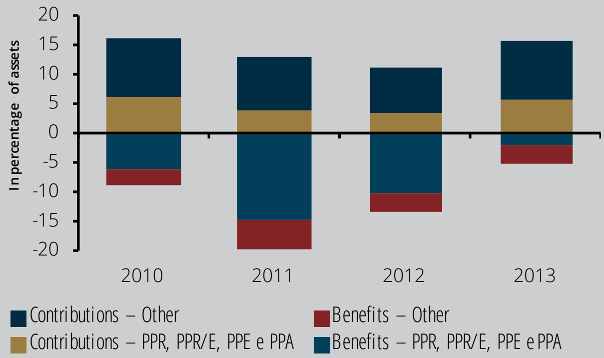
In 2013 there was a slight decline in the overall funding level, from 103 per cent to 101 per cent, reflecting a 10.9 per cent increase in total

Chart 38 • Closed funds



Source: ISP.

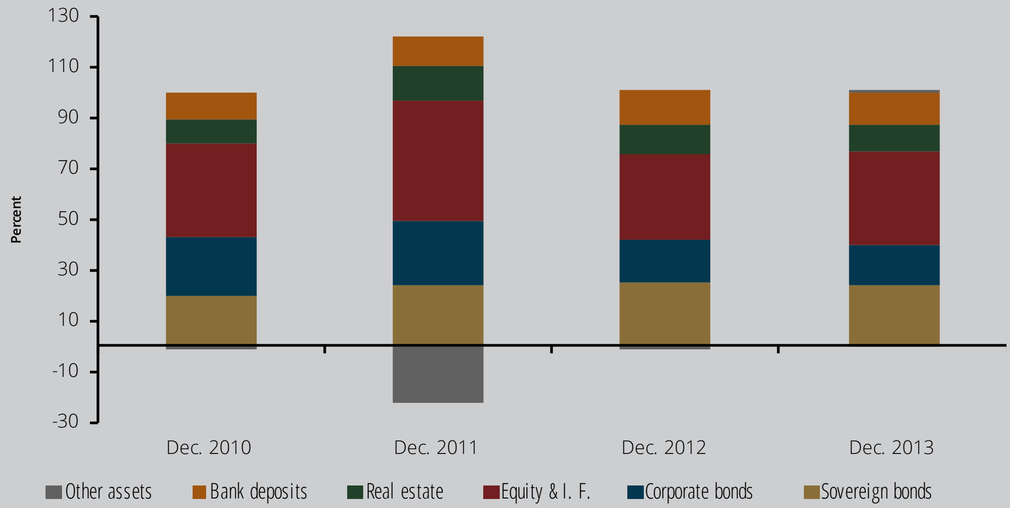
Chart 39 • Open funds



Source: ISP.

Chart 40 • Asset allocation

Source: ISP.
Note: The category other assets reflected, in December 2011, the amount of responsibilities from banking sector pension funds transferred to social security in the first semester of 2012.



liabilities. This trend of pension fund liabilities was chiefly due to an adjustment of actuarial assumptions (started in late 2012), which resulted in a reduction of average actuarial discount rates[27] by about 50 basis points in the course of 2013.

For the banking system as a whole, the negative impact on own funds of actuarial and financial deviations of bank employees' pension funds in 2013 assumed negligible values. However, it may have different repercussions across banks.

1.3.4. Investment funds

Investment funds' assets under management declined in 2013, reflecting the redemption of those instruments by households

In 2013 total assets under management by investment funds declined by 2 per cent to around €27 billion.

This evolution was mainly driven by the behaviour of mutual funds (investment funds other than real estate funds), which declined by 9 per cent, representing around €10 billion at the end of 2013, as a result of bond funds and mixed funds' redemptions.

In a context characterised by real estate devaluations and households' redemptions, the 4 per cent rise in real-estate funds in 2013 was related to the purchase of investment fund units by banks and insurance corporations [see Box "Delimitation of the shadow banking perimeter (entity perspective)"]. Against this background, the established of new real estate funds for rental purposes have been mainly acquired by banks.

The redemption of investment funds has had a negative impact on the bond and equity portfolio. However, both the acquisition of new investment funds' units and shares' valuation have contributed to the rise in shares and other equity in the investment funds portfolios (Chart 41).

As regards the exposure of investment funds to the different institutional sectors, the redemptions in 2013 were reflected in a reduction of exposure to the Portuguese banks' debt and to the non-financial corporations and financial intermediaries of euro area countries'(excluding Portugal) debt. In turn, there was a slight increase in exposure to the public sector and to the debt of Portuguese non-financial corporations that, however, represented only 2 and 3 per cent of total assets respectively in December 2013.

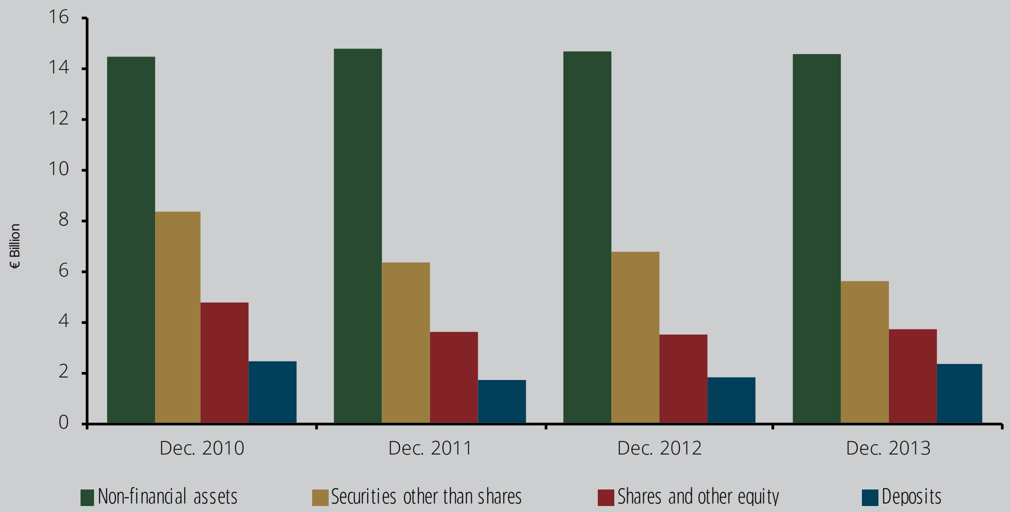


Chart 41 • Asset allocation

Source: Banco de Portugal and Comissão do Mercado de Valores Mobiliários

Financial sector exposure to real-estate risk increased due to the acquisition of real-estate funds

As regards holders of investment fund units, redemption of units by households persisted (bond funds and real-estate funds), as well as the acquisition of real-estate fund units by banks, as mentioned above (Chart 42). In line with this behaviour, insurance corporations and pension funds strengthened their real-estate funds' portfolio, reducing their exposure to mixed funds.

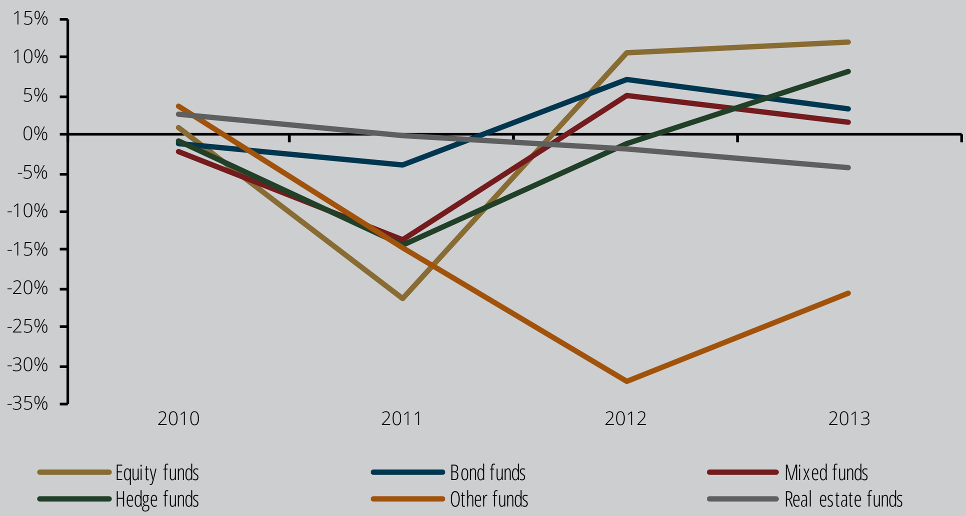
In line with the previous year, real-estate investment funds and other funds showed negative returns in 2013 (Chart 43). By contrast, bond and mixed funds returns were positive, but lower than in 2012, while the valuation of non-financial corporations' shares enabled equity funds and hedge funds to improve their performance in 2013.

Chart 42 • Net acquisition of investment funds units by the resident sector

Source: Banco de Portugal and Comissão do Mercado de Valores Mobiliários

Chart 43 • Yield by type of investment fund

Source: Banco de Portugal. Note: Return is proxied by the amount of price changes as a percentage of the total amount at the end of the period.



Box | Delimitation of the shadow banking perimeter (from the entity perspective)

Banco de Portugal, in its capacity as national macro-prudential authority, is responsible for defining and implementing macro-prudential policy. Therefore, the Bank shall identify, monitor and evaluate systemic risks, as well as propose and adopt measures to prevent, mitigate or reduce such risks, with a view to strengthening resilience of the financial sector as a whole.

According to this reasoning, the G20 has expressed its concern and, at the end of 2010, after the agreement on banks' new capital requirements (Basel III), warned that potential regulatory gaps in the so-called shadow banking (credit intermediation outside the banking system) should be analysed. Following this the Financial Stability Board (FSB) was mandated to prepare a study on the subject. Based on the work developed, the FSB presented a strategy relying on: i) the definition of monitoring mechanisms, and ii) the development of policies strengthening the supervision and regulation of shadow banking.

This box presents a methodology to delimit the shadow banking perimeter, taking into account the FSB's recommendations and proposals, as well as its application to the Portuguese case. According to FSB's reports, in order to characterise shadow banking, it is possible to consider two approaches, depending on whether a broader or narrower concept of this sector is adopted. These approaches can also be analysed either from the entity or from the activity perspective. This box presents the entity perspective, while the activity perspective will be the object of a future analysis.[28]

Considering a broader approach, shadow banking is a "system of credit intermediation that involves entities and activities (totally or partially) outside the regular banking system". Therefore, according to the broad concept, shadow banking corresponds to other financial intermediaries as a whole,[29] excluding insurance corporations and pension funds, and including money market funds.[30]

Insurance corporations and pension funds are not considered in this approach, as the specificity of their business does not show exposure to shadow banking risks. In a context of low interest rates, however, the "search for yield" behaviour may justify an increase in risk-generating non-traditional activities (*e.g.*, provision of credit guarantees, sale of unit links, securities lending operations).[31] Moreover, considering the role of these institutions as financial market investors, it is important to stress their close interlinkage with the banking system.

In turn, money market funds must be considered within the scope of shadow banking, since the characteristics of these funds are similar to those of bank deposits. Indeed, these funds invest in highly liquid assets (*e.g.* deposits and commercial paper), and their units are redeemable at any point in time. Money market funds are an important source of short-term financing in the banking sector, creating potential fragilities in the financial system.

According to a narrower definition, shadow banking is a system of credit intermediation that involves entities and activities outside the regular banking system and covers i) systemic risk, in particular due to liquidity and maturity transformation, credit risk leverage and transfer and/or ii) regulatory arbitrage-related issues.

According to this alternative approach, the FSB proposes to exclude equity funds (since these funds do not finance the economy directly), securitisations retained by banking groups (due to non-actual transfer of risk) and other financial intermediaries that are consolidated into banking groups.

Considering the narrower concept, it is also possible to analyse, by type of intermediary, if the activities developed generate systemic risk, in order to delimitate further the shadow banking population. The characteristics defined by the FSB as potentially generating risk are: 1) funds raising with characteristics similar to those of deposits; 2) maturity/liquidity transformation; 3) credit risk transfer; and 4) direct/indirect leverage.

By applying this methodology to the Portuguese case, it is possible to conclude that, in December 2013, shadow banking in Portugal, measured in terms of total assets, stood at €106 billion according to the broad concept, and at €69 billion, according to the narrow concept (see Table 5).

Table 5 • Shadow Banking in Portugal, entity perspective (€10^6)

Broad concept	Narrow concept
Investment funds (IF) 29 634 d.q.: FMM 2392	Investment funds excluding EF 28 349 d.q.: FMM 2392
SF/SC 41 306	SF/SC excluding retained securitisation 17 061
Other financial intermediaries (OFI) 35 001	OFI excluding entities that consolidate in banking groups 23 216

Source: Banco de Portugal and CMVM
Legend: MMF– Money market funds ; SF/SC – securitisation funds and companies; EF – Equity funds.

In terms of developments, in the period prior to the financial crisis, especially from 2002 to 2007, assets under management (broad concept) grew at a high pace (Chart 44), similarly to other countries. This rise was the result of two factors: an increase in assets under management by investment funds (mutual and real-estate funds) and in securitisation operations.

After the financial crisis, intermediation activities outside the banking system started to restrain in the European Union. In Portugal, however, from 2008 to 2010, a further impetus was provided to securitisation activities, which peaked in 2010, when some credit securitisation operations started to be redeemed, in the wake of changes in Eurosystem funding policy. In addition, investment funds activity declined, chiefly in open bond funds.

In spite of this contraction, shadow banking in Portugal continues to assume a non-insignificant component. In 2013 it represented around 14 per cent of the financial system's total assets (approximately 60 per cent of GDP), compared with 29 per cent in the euro area.

With a view to delimiting the shadow banking concept, we tried to evaluate which entities engage in activities identified by the FSB as potentially generating systemic risk, based on the indicators presented in Table 6.

Table 6 • Indicators by type of risk/intermediation activity[32]

Maturity risk	Short term assets / Total assets Short term liabilities / Short term assets
Risco de liquidez	Liquidity assets / Total assets
Leverage	Debt / Total financial assets
Interconnectedness	Assets with financial intermediaries counterpart / Total assets Liabilities with financial intermediaries counterpart / Total assets
Credit provision	Loans / Total assets

The analysis of these indicators makes it possible to conclude that the risk posed by exposure to other financial intermediaries (interconnectedness risk), particularly to the banking sector, is broadly based across all categories under analysis (see Table 7), enhancing risk contagion channels. In some cases, this exposure has an impact at the level of bank assets and liabilities, which further fuels the contagion effect. For instance, considering early redemptions of investment fund units, it is possible to identify three potential impacts: i) impact on the market value of bank debt driven by the sale of assets that integrate funds' portfolio (bank securities); ii) potential impact of the sale of assets on the value of the units held by banks; and iii) purchase of units in order to prevent a drop in prices and reputational effects (so-called implied support).

Table 7 • Types of risk among different financial intermediaries

Risks	MMF	EF	BF	MF	HF	OF	SF / SC	RF
Maturity risk	X	+++	X	?	?	X	X	+++
Liquidity risk	+	+++	++	+	+	+	X	+++
Leverage	X	X	X	X	X	?	+++	+++
Interconnectedness	+++	+	+++	+	+++	++	+++	++
Credit provision	X	X	++	+	?	X	+++	X

Legend: MMF = money market funds; EF = Equity funds; BF = bond funds; MF = mixed funds; HF = hedge funds; OF = other funds; SF/SC – securitisation funds and companies; RF = real estate funds. +++/++/+ = material risk; X = without material risk ; ? = inconclusive.

According to the abovementioned indicators, equity funds and real-estate funds are those most exposed to liquidity and maturity risk. Nevertheless, if we consider the population of open funds in which units can be redeemed at any point in time, we would conclude that all types of funds in Portugal may undertake liquidity risk.

As regards real-estate funds, in addition to playing a relatively important part in total investment funds, the analysis of the mentioned indicators reveals the existence of maturity risk, liquidity risk and leverage. However, only around 30 per cent[33] of these funds are open funds.[34] Therefore risk arising from early redemptions is partly limited.

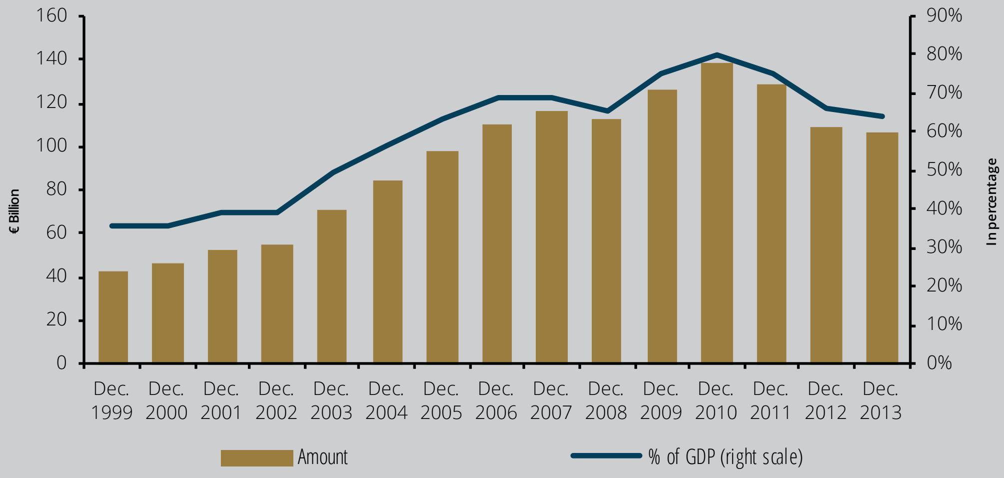
Financial-vehicle corporations and securitisation funds have been assuming growing leverage ratios, highly dependent on the tax situation which favoured operations carried out by financial-vehicle corporations as opposed to securitisation funds. However, as mentioned above, 60 per cent of these operations are retained in the balance sheets of banks that acquire the units/bonds issued, and therefore credit risk is not fully transferred. Moreover, in the current juncture, the quality of the assets transferred should be monitored in order not to jeopardise the purpose of this type of operation. In this context, a range of initiatives have emerged at the international level, intended to boost this type of operation through the possibility of alleviating own funds requirements in those cases in which securitised assets are of high quality.

Hedge funds show a very irregular behaviour in terms of their portfolio composition, therefore there are still doubts as to the characterisation of risks to which they are subject. The importance of these funds has been declining in terms of the total assets under management. Anyway, an analysis should now be made on whether, in the light of the definition of hedge funds[35], there are other types of funds assuming similar characteristics.

Venture capital funds are not covered by this analysis. However, credit transfers to private equity funds received special attention from both the Banco de Portugal (Circular-Letter No 13/2012) and the *Comissão do Mercado de Valores Mobiliários* – CMVM (Portuguese Securities Market Commission), and clarifications were issued regarding the prudential requirements to be adopted in such situations.

Shadow banking risks and benefits must continue to be monitored adding to this analysis and the activities that, within the financial sector, generate systemic risk, and that are not considered in an entity perspective, while recalling in particular the regulatory initiatives developed in the meantime.

Chart 44 • Developments in Shadow Banking from a broader approach in Portugal



Source: Banco de Portugal and CMVM.
Note: To delimit the shadow banking concept, an evaluation procedure was taken on the entities developing activities (identified by the FSB) with the potential to generate systemic risk based on the indicators presented in table 6.

2. Risks to financial stability

High indebtedness of the public and private sectors continues to be the main risk factor for financial stability

In recent decades, the Portuguese economy accumulated significant structural imbalances that translated into rather high indebtedness levels, in both the public and private sectors (Chart 1). Debt was largely raised from non-residents, either directly or through the intermediation of the national financial sector. Total debt by residents to non-residents attained the high level of 95 per cent of GDP, in the context of a serious deterioration of the international investment position (which worsened from around -30 per cent of GDP in 1999 to nearly -120 per cent of GDP at the end of 2013).

The international financial crisis started in 2007, subsequently exacerbated by the sovereign risk crisis in the euro area, made it unfeasible to maintain this trend. The rising pressure on Portuguese debt, associated with successive downward revisions of rating notations assigned to public and private, financial and non-financial Portuguese issuers, and with the resulting growing difficulties in access to funds, made it inevitable for the Portuguese Government to request international financial assistance in early April 2011.

The Economic and Financial Assistance Programme (EFAP) agreed in May of that year, aimed on the one hand, at contributing to the creation of a stable financing framework, namely for public administration and the banking system, and, on the other hand, at promoting the correction of public finance imbalances and structural vulnerabilities constraining potential growth of the Portuguese economy. In the context of the programme, the Portuguese economy saw considerable progress, in particular as regards the structural consolidation of public accounts and the substantial improvement in the external balance (current and capital accounts). Evidence also points to some reallocation of resources to sectors producing tradable goods and services. This

Chart 1 • Total consolidated gross debt

Source: Banco de Portugal.

adjustment, however, was accompanied by a fall in domestic income and demand, reflected in a pronounced decline in economic activity and a significant increase in unemployment. Over the last quarter of 2013 and in early 2014, macroeconomic indicators showed signs of improvement, making it possible to envisage more favourable than expected developments of the economy in 2014. In spite of this scenario, there are still risks for the financial stability of the Portuguese economy that may jeopardise the sustainability of the abovementioned progress.

A public finance adjustment process must be pursued, in order to guarantee its sustainability

One of the main risk factors consists in the adjustment process of public finances. This adjustment, resulting from the need to reduce public debt, ensure public account sustainability and guarantee international investors' confidence, must be pursued, given that, despite restraining the pace of recovery of domestic income and demand in the short run, it paves the way to sustained economic growth in the medium term.

Data available suggests that in coming years this adjustment will occur in a context of weak economic growth, high unemployment and low inflation. Should this scenario be confirmed, the process will tend to be long and bear risks in terms of social impact, which underlines the need to adopt and strengthen policy measures favouring the economy's potential growth. Such measures may cover sundry areas, such as the simplification and stabilisation of the fiscal and legal framework, rising competition in key sectors (*e.g.*, energy, telecommunications), the removal of bureaucracy on public procedures and the rationalisation of public resources.

The conclusion of the EFAP raises the risk of a possible slowdown in the adjustment process of public finances and in the adoption of structural measures. This situation, where occurring, aside from possible internal negative effects, would affect market perception of the authority's commitments to correct the economy's structural imbalances, and might jeopardise external credibility in a lasting manner. In the medium term, this scenario might imply accrued risk premia in internal sectors' debt and therefore a stronger adjustment at fiscal and financial level, with a greater impact in terms of loss of income by resident sectors.

Maintaining positive developments in the households' savings rate is essential to ensure financial stability and external balance in the Portuguese economy

In the past two years, the savings rate by households, which is traditionally the saving sector of the economy, attained its peak since the start of the euro area, reflecting more prudent consumption behaviours, adjusted to permanent income levels that stand below those implicitly anticipated before the request for international financial assistance made by the Portuguese government. Considering the significant imported content of private consumption, these developments, in line with robust export growth, have contributed to a remarkable improvement in the external account balance, and also helped the Portuguese economy to reach a net lending position. This means that the Portuguese economy was able to generate internally more resources than those necessary to finance domestic sector expenditure, and was therefore in a position to reduce external debt.

Latest data suggest a slowdown in this adjustment process. Against a background in which fiscal consolidation must be pursued and productive investment must be recovered, consumption levels consistent with developments in disposable income and a continued reduction in household indebtedness are key to ensure financial stability in the sector and external equilibrium of the Portuguese economy.

Corporations' high leverage and the slow adjustment in their indebtedness represent a risk for financial stability and for sustained macroeconomic recovery

The low capitalisation level of Portuguese non-financial corporations is a significant restriction to the strengthening of the domestic productive structure. Indeed, maintaining an inappropriate and undercapitalised financial structure hampers access to the funds (debt or capital) required for the regular corporations' activity. Even when viable, corporations are prevented from investment possibilities, therefore constraining not only immediate economic recovery but also economy's potential growth. The volume and quality of corporate investment are important determinants of the later. Indeed, the renovation of the productive capital stock of the corporate sector plays a key role in the incorporation of more advanced technologies and in the absorption of more qualified human capital. This is essential to improve the quality of goods and services produced and to increase production efficiency, ensuring competitiveness of the Portuguese economy and sustained economic growth.

In this context, measures should be implemented in order to accelerate the deleveraging of corporations that are viable but highly leveraged, including regulatory and tax incentives to shifts from debt towards capital and to an increase in equity. Given that the participation of shareholders and other group corporations in the financing of non-financial corporations often takes the form of debt (obtained funding from participated and participant companies represent approximately 13 per cent of Portuguese corporations' assets), the introduction of regulatory and tax incentives favouring shifts from additional capital towards equity may contribute to more robust financial structures. Reinvestment of profits or their use to reduce debt should also be promoted, thus contributing to the equilibrium of highly leveraged corporations and increasing their value to shareholders and to the economy.

By contrast, the restructuring processes of non-financial corporations' debt, which translate into mere forbearance practices by the banking system, based on collateral whose value may decline significantly in economic recession periods or in the context of reduced liquidity in relevant markets, may have high costs in terms of financial stability and may delay the reallocation of resources in the economy. In this vein, in 2013 Banco de Portugal developed an initiative to assess the strategies and procedures followed by banks in the recovery of credit of distressed corporations. Following this, recommendations were issued, tending to improve the efficiency and effectiveness of these processes, which have been implemented by banks and monitored by Banco de Portugal.

Uncertainty associated with the external environment of the Portuguese economy is also an element of macroeconomic risk

The recovery of the Portuguese economy depends strongly on external demand for Portuguese goods and services. Therefore, expectations about domestic macroeconomic developments pose inherent risks regarding the external environment, namely related to the pace of growth in the euro area and other economies of destination of Portuguese exports.

In spite of the moderate recovery prospects in the euro area, some risks persist in the pursuance of this scenario. Indeed, fiscal deficits persist in some economies, anticipating the maintenance of contractionary fiscal policies, in addition to the high indebtedness levels of the private sector in some Member States. As a result, domestic demand is forecast to be sluggish, with potential negative results for Portuguese exports.

More recently, the expectations of slowdown in economic growth and increased economic, policy and social instability in emerging economies are an additional element of risk for the Portuguese economy, due to their impact on international trade and capital flows, with potential spillovers to global financial markets.

As regards projections for international trade flows, the deceleration in activity, particularly in Brazil and China, will negatively affect world demand for goods and services. Conversely, that slowdown is expected to have favourable effects on oil and commodity prices, but the manner in which it may influence growth recovery in developed economies is uncertain. Geopolitical instability related to the situation in Ukraine may also result in economic sanctions being taken against Russia, with an impact on world trade and capital flows.

Considering the correction of global external deficits and a possible reversal of capital flows from emerging economies to developed countries, in particular to euro area peripheral countries with higher debt yields, the euro foreign-exchange developments may also have consequences for the external competitiveness of the economies in the area, affecting exports and the pace of output recovery.

Finally, particular attention should be paid to developments in the euro area inflation rate, which is currently very low. The persistence of low average inflation rates in the euro area makes it difficult to correct imbalances within the area, particularly affecting the economies undergoing an adjustment process, such as the Portuguese economy. Moreover, even though evidence available suggests that long-term inflation expectations are anchored around ECB's price stability objective, it cannot be ruled out that the persistence of the current inflation levels may lead to a gradual revision of those expectations. This may be particularly important, to the extent that it may translate into a postponement of decisions relating to investment and consumption, threatening the recovery of economic activity.

The conclusion of the EFAP and developments within the framework of the Eurosystem and the creation of the banking union are challenges to the maintenance of regular conditions in banking system financing

Given the importance of domestic credit institutions in financing to the economy, regular refinancing of the banking sector is a key element for pursuing a sustained growth trend, being an important pillar of financial stability. In this field, it is important to mention that bank financing will be faced with a range of challenges in the near future, especially related to the conclusion of the EFAP and the creation of the banking union (with a focus on the comprehensive assessment exercise within the scope of the Single Supervisory Mechanism, SSM, and on other regulatory measures mentioned below, in particular the Bank Recovery and Resolution Directive, BRRD). These challenges must be appropriately addressed, in order to prevent disturbances and to safeguard the system's financial stability and soundness.

A number of important risks are associated with the market conditions faced by national issuers, in particular the government and banks, when placing new debt with international markets after the conclusion of the EFAP. Insofar as return to public debt markets and access by the banking system to wholesale markets do not occur under favourable conditions and in a sustained manner, this may cause refinancing difficulties for banks. These difficulties will pass on to the funding of the economy, at the level of either costs or the provision of funds, endangering financial stability. Therefore, it is essential to appropriately manage, plan and communicate the conclusion of the EFAP by both Portugal and the euro area partners, in order to avoid disturbances in access by the Portuguese economy to external lending, preserving the banking system stability.

From the point of view of access by Portuguese banks to Eurosystem refinancing, the conclusion of the EFAP may have as a result the end of the waiver of compliance with rating's minimum requirements for assets issued or guaranteed by the Portuguese Republic, for the purpose of their use as collateral in Eurosystem's monetary policy operations. Portugal, similarly to other States under an EU/IMF financial assistance programme, had access to this waiver, under an ECB's public decision, during the applicable period of the respective programme. Therefore, it was possible for Portuguese banks to maintain access to Eurosystem liquidity, to the amounts deemed adequate for the management of the respective liquidity positions, and more generally to the regular financing of the economy. After the conclusion of the EFAP, and as laid down in the Governing Council's decision to grant the waiver, the mentioned assets shall be eligible within the regular framework of the Eurosystem's risk evaluation. Its eligibility function shall depend, inter alia, on the rating levels assigned to them by rating agencies. The best rating currently assigned to Portuguese public debt, "BBBL", is given by DBRS. Since this coincides with the minimum level accepted by the Eurosystem, assets issued or guaranteed by the Portuguese Republic will continue to be eligible as collateral in access to Eurosystem financing. Any possible downgrading of the rating assigned by DBRS to the Portuguese Republic, however, would tend to reduce the financial system's capacity to be refinanced by the Eurosystem, with potential effects on the volume of credit to be granted to economic agents and on financial institutions' profitability. Nonetheless, this risk is highly unlikely in the current juncture. On the contrary, forthcoming changes to the Portuguese rating are expected to be on the upside (Fitch has recently revised the "outlook" for the Portuguese Republic upwards, from negative into positive), provided that the fiscal consolidation process and the improvement in the outlook for the Portuguese economy do continue.

Another uncertainty factor with an impact on the financing conditions of the Portuguese economy may arise from the phasing-out of the monetary policy temporary measures adopted at Eurosystem level. This will depend on the assessment to be made on the fragmentation of euro area financial markets, especially as regards the interbank market, and on the normalisation of the monetary policy transmission mechanism. In addition, attention will be paid to developments in the macroeconomic juncture, considering compliance with the price stability objective in the euro area. In this context, some uncertainty remains as regards the timing and manner in which this phasing-out will occur. It would therefore be desirable that banks would carry on an adjustment process, in line with developments in the euro area as a whole, so that this phasing-out would not give rise to idiosyncratic fragility situations.

The gradual return by banks to international market financing, in tandem with the continued deleveraging process, will tend to allow for the pursuit of a steady reduction of costs with the new deposit operations, which are still somewhat high in relative terms (Chart 2). This is based on the

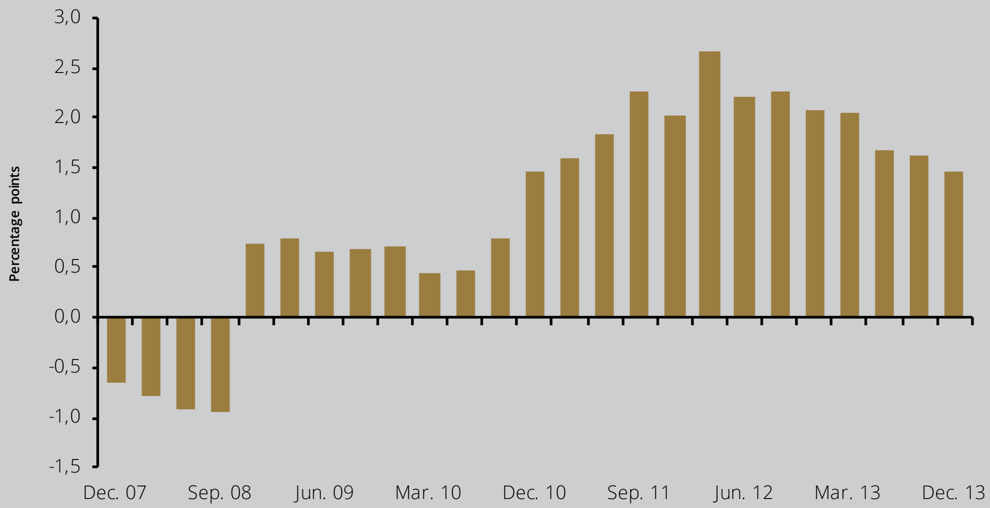


Chart 2 • Spread between the interest rate on new deposit operations and Euribor

Source: Banco de Portugal.

assumption that competing savings instruments (such as *Certificados do Tesouro Poupança Mais*/ Treasury Certificates – Savings Plus) also adjust to the new circumstances.

> Market interest rate developments carry risks to the Portuguese financial system, especially due to a rapid and broadly based increase in current risk premia

A prolonged environment of low interest rates and ample liquidity, on account of the policies adopted by main central banks at the international level, international capital flows and strengthened capitalisation of financial institutions, has contributed to intensified "search for yield" behaviours. Urged by the need to reinvest or to obtain higher return on portfolio assets, financial agents tend to take on more risk, being vulnerable to a reversal in market sentiment or to a sudden rise in risk premia.

Events such as the economic growth slowdown in emerging economies, the focus on political instability and tapering measures led by the US Federal Reserve System may be triggers leading to a sudden assets-related risk revaluation and capital outflows in emerging economies, contributing to raising the risk of financial institutions directly or indirectly exposed to these economies. These outflows may have been more favourable to euro area peripheral countries with higher debt yields, among which Portugal. Moreover, exposure of the Portuguese financial system to emerging economies is not particularly significant. Nevertheless, it cannot be excluded, that a possible intensification of these phenomena may create more widespread disturbances in international markets and contagion effects that may negatively affect the Portuguese financial system.

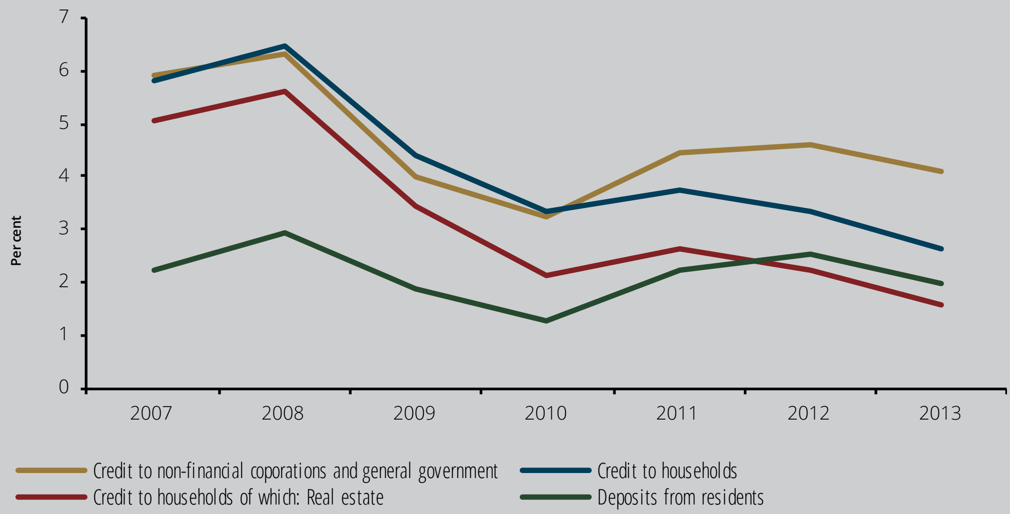
In turn, maintaining the current low levels of money market interest rates for a protracted period will continue to exert a negative influence on the interest margin of Portuguese banks, particularly affecting the one of housing loans (Chart 3). However, maintaining low interest rates has made it possible to contain default in this segment, with positive effects at the level of financial system impairments and households' financial stability.

In parallel, the maintenance of low interest rates poses important challenges to financial institutions holding in their liabilities products with guaranteed interest rates. This is the case of life insurance corporations and of defined benefit pension plans. This raises reinvestment risk and creates incentives to investment in riskier assets.

In addition, in a context of very low interest rates, there is greater willingness to accept projects with reduced yields, which does not favour sustainable economic growth. Nonetheless,

Chart 3 • Average implicit interest rate of the banking system

Source: Banco de Portugal.



the impact on inflation rates of a gradual recovery in economic activity worldwide and in the euro area reduces the probability of occurrence of that scenario, to the extent that it has an upward influence on interest rates at the international level.

> Despite a reduction in real estate market prices and adjustments to financial institutions' balance sheets, there are still risks surrounding developments in this market

Real estate market developments play a major role in financial stability. In the Portuguese case, the portfolio of institutional investors is quite exposed to the real estate sector. This exposure is a consequence of own real estate assets, real estate fund units, participation in restructuring funds with predominantly real estate assets, exposure to mortgage loan securitisations, or real estate assets, residential or commercial, pledged as collateral in financial operations (as regards banks in particular, loans granted for house purchase and to the construction sector and construction development sector). In turn, an important share of household wealth is housing-related, and a majority of the liabilities of households are associated with this housing element. Hence, any changes to housing prices have a considerable impact on household wealth.

Residential real estate prices have been declining considerably since the mid-2010 (Chart 4). In the past few years Banco de Portugal's actions have contributed to mitigating the risk of overvaluation of these assets in the portfolio of the institutions under analysis, through a series of inspections to specific classes of assets that are particularly exposed to macroeconomic or market developments, including real estate assets. However, there are still risks deriving from the important stock held by banks and a possible downward revaluation of real estate assets in portfolio of the financial system and/or taken as collateral. These risks emerge in a context where, on the one hand, real estate prices may not have stabilised yet, given the ongoing adjustment in the sector, and, on the other, some agents (such as real estate funds) still may have not completed the necessary revaluations.

Furthermore, there may still be a prolonged period of weak activity in the real estate sector, with implications on the macroeconomic juncture and the quality of financial sector's exposure to counterparties that are still over-indebted. The slow recovery of activity in this market seems to be a result of excessive investment in the past that is now being corrected, the fact that household liquidity and solvency are conditioned by domestic economic developments and a need

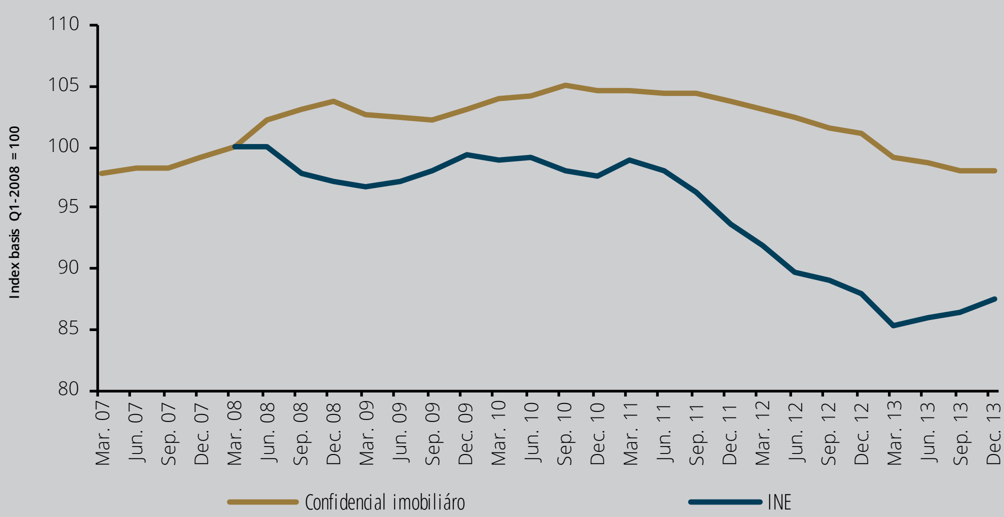


Chart 4 • Residencial real estate prices | Price Indices

Source: Eurostat and Confidencial Imobiliário.

to reduce the respective indebtedness. The sector's adjustment is also hindered by the fact that banks are currently competitors in the placement of assets in this market, since there is a considerable volume of (partly commercial) real estate kept in the banks' portfolio. The purchase by non-resident investors of this type of assets may contribute to a faster adjustment of the Portuguese real estate market, although it should not return to over-indebtedness, as seen before the financial crisis.

Given the importance of this market to financial stability, reference should be made to the publication of Directive 2014/17/EU of the European Parliament and of the Council on credit agreements for consumers relating to residential immovable property. This Directive aims at guaranteeing responsible lending and responsible borrowing. It is expected to be transposed into national law by 21 March 2016, and sets out a wide set of rules of conduct and reporting requirements to be observed by credit institutions and credit intermediaries.

The high inter-relationship among resident financial sectors involves risks for financial stability, despite the stabilising role it had on the development of the financial crisis

The Portuguese financial system shows a high degree of concentration, and is dominated by a small set of banking groups that hold dominant positions in the insurance sector and the securities market.

In this context, Portuguese financial groups have typically concentrated the distribution of financial products in the banking retail network. These strategies have resulted in part of the resources collected by banking retail networks to be invested off banks' balance sheets, especially in investment funds and life insurance, thereby boosting the group's income by exploiting synergies in the already existing commercial network.

Such integration of financial intermediaries assumed particular relevance in liquidity management and the deleveraging process of banks as the financial crisis developed. In particular, banks integrating financial groups, given the impossibility of renewing their funding abroad, have replaced it with domestic funding, channelling into their balance sheets – both directly and indirectly – funds invested in products of other entities of the same group. An example of the measures taken for this purpose is the adaptation of pricing and marketing policies of the group's products, which allowed banks to re-channel savers' choices. Also the trading of intra-group repo contracts made it possible to increase the collateral available for recourse to Eurosystem funding. The integration of financial intermediaries has also increased the diversification of group's consolidated results, both through the various entities' regular activity and special income generating operations. In the past few years some financial groups have conducted operations involving reinsurance contracts of some life business insurance portfolios, which translated into an anticipation of cash flows that would be generated during the lifetime of reinsurance contracts.

Hence, since the start of the financial crisis, sectoral interlinkages in the resident financial system have been deepened, which was also noticeable in increasing concentration levels of investment portfolios. Against this background, in the report *Análise de Riscos do Setor Segurador e dos Fundos de Pensões* (Risk Analysis on the Insurance Sector and Pension Funds sector), the Insurance and Pension Funds Supervisory Authority (ISP – *Instituto de Seguros de Portugal*) released an analysis showing the relevance of intra-group investments of insurance corporations. According to this report, as of December 2013, intra-group investments of insurance companies belonging to the seven major Portuguese financial groups accounted for approximately 22 per cent of total assets held to cover technical reserves.

Although these mechanisms may play a positive role in case of exit of international investors, they also translate into increased concentration risk and greater vulnerability to losses in the other financial sub-sectors, potentially affecting financial stability. Also, the definition of business, capital management and investment strategies at group level should be closely aligned, due to the integration of institutions, which may result in increased exposure to common risks.

Furthermore, the integration of financial intermediaries may give rise to reputational risks that have to be monitored. Traditionally, the Portuguese banking sector benefits from a strong confidence relationship with the non-financial sector, which has been maintained and is instrumental to the preservation of financial stability. However, channelling savings to investments that transfer financial risks to the non-financial sector has not always been accompanied by appropriate awareness of the risks assumed. The promotion of adequate levels of financial literacy plays an important role, as well as the communication channels between financial institutions and investors, that are suitable for each individual's experience and knowledge. In fact, offering complex financial products to individuals who do not fully understand the risks involved may give rise to a loss of confidence in the system, which will lead to a non-negligible increase in the liquidity risk for banks. From this viewpoint, it is important to highlight the protocol agreement signed at the end of 2013 between the Portuguese Securities Market Commission (CMVM) and 19 banks on the marketing of complex financial products targeted at retail investors.[36]

> Without prejudice to a major positive contribution to financial stability, simultaneous implementation of a wide and complex set of new rules will involve operational risks and induce an adjustment of behaviours that may give rise to some disturbances in the short-term

The development of financial system regulation in Europe aims at reinforcing confidence in the sector, thus contributing to financial stability in Europe. In this context, a wide and complex set of regulations on the banking sector, insurance and capital market is expected to be implemented in the near future. As regards the banking sector, reference should be made to Basel III-related regulations, the agreement on the Bank Recovery and Resolution Directive (BRRD) and the establishment of the banking union (in particular the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM)). It is also important to mention the entry into force of Solvency II for insurance, and the agreement relating to the Markets in Financial Instruments Directive/Regulation (MidFID/R) that covers especially the securities market.

Within the scope of implementation of the SSM, there are challenges related namely to the results of the Asset Quality Review (AQR) and the stress test, as well as the respective communication. Within this framework, there is also uncertainty about the definition of specific methodologies to assess banking risk (Pillar 2).

Likewise, implementation of the Bank Recovery and Resolution Directive (BRRD) and the Recommendation of the ESRB on funding of credit institutions (ESRB/2012/2) will tend to affect the funding structure of credit institutions with changes to the relative costs of the various instruments and a potential impact on funding costs, due to the reduction or elimination of implicit guarantees.

Also with possible repercussions on the cost of bank funding, the ESRB imposed a number of rules regarding the disclosure of the share of encumbered assets, notably to obtain central bank funding and increase margin requirements for collateralisation of derivatives.

The adoption of Community acts governing payment systems and payment instruments may also have repercussions on bank profitability levels. In particular, reference should be made to the Regulation on interchange fees for card-based payment transactions and the revision of the Payment Services Directive. In the first case, the proposal under discussion sets limits to interchange fees paid between card issuing and acquiring banks, reflecting on merchant service charges and potentially translating into a decline in revenue from fees in the domestic market; in the second case, the proposal to revise enables, among other aspects, future access to deposit accounts (or payment accounts) by third-party payment service suppliers.

The uncertainty associated with the effects of interaction between monetary policy measures and macroprudential policy measures, particularly as regards possible negative externalities of monetary policy measures on liquidity/leverage ratios introduced by the CRD IV/CRR, is an additional risk factor.

In addition to the risk factors identified, Portuguese banks may face important challenges to maintain capital at suitable levels and composition, given the current profitability levels. Late in 2013 the regulatory minimum set out by Banco de Portugal in Notice No 3/2011 for Core Tier 1 was 10 per cent of risk-weighted assets. That minimum limit was raised on the initiative of Banco de Portugal since the start of the financial crisis in 2007, and was reinforced within the scope of implementation of EFAP. Stricter minimum capital requirements resulted from a need to increase market confidence in the Portuguese banking system, as well as improve their ability to cope with adverse situations at the external and domestic level, thus contributing to the resilience of the Portuguese financial system. Jointly with the reinforcement of the solvency ratio, there was an improvement in capital quality, with total own funds almost fully formed by Core Tier 1 capital. With the entry into force of the CRD IV/CRR, however, measures will be needed to re-balance the capital structure of Portuguese banks. On a first stage, these measures should rely on the issuance of Tier 2 instruments – the market is starting to show signs of being open to these measures – and on a second stage on the issuance of additional Tier 1 instruments, taking into account that in this case the market is still not very receptive.

In addition, compliance with every step needed to fully achieve EMU is key to minimising the risk of a reversal of market sentiment, which would again cause fragmentation in euro area markets.

Notes

1. See Banco de Portugal, Economic Bulletin – April 2014.

2. For details, see Banco de Portugal Press Release of 26 March 2014, “Projections for the Portuguese Economy: 2014-2016”, available at http://www.bportugal.pt/en-US/OBancoeoEurosistema/ComunicadoseNotasdeInformacao/Pages/combp20140326.aspx.

3. A sector’s net lending(+)/net borrowing(-) corresponds to the difference between its gross savings plus net capital transfers and the sector’s net acquisition of real assets (gross capital formation and acquisitions less disposals of non-financial non-produced assets).

4. Since 1999 the households’ savings rate, as a percentage of GDP, has oscillated between 4.9 per cent in 2007 and 9.3 per cent in 2013.

5. Interest adjusted for financial intermediation services indirectly measured.

6. For more details on the level and developments in housing loan market spreads, as well as developments in the simple deposits market, see the 2012 Retail Banking Markets Monitoring Report of Banco de Portugal.

7. See http://www.bportugal.pt/en-US/EstudosEconomicos/Publicacoes/IBMC/Pages/InqueritoaosBancossobreoMercadodeCredito.aspx

8. The arrears settlement general regime includes the adoption of procedures by credit institutions for the prevention of arrears, materialised in a Pre--arrears Action Plan and a harmonised procedure to negotiate with bank customers solutions to promote out-of-court settlement of default situations, i.e. the Out-of-court Arrears Settlement Procedure.

9. For more details, see the 2013 Banking Conduct Supervision Report of Banco de Portugal.

10. Property income corresponds to interest, distributed income of corporations (including dividends), reinvested earnings on foreign direct investment and rents.

11. For a detailed analysis of non-financial corporations in Portugal, see Banco de Portugal’s Central Balance-Sheet Database Study No 13, November 2013.

12. In 2006 the ratio of equity to total assets was approximately 43 per cent.

13. The concept of Maastricht debt, which is relevant for the assessment under the excessive deficit procedure, differs from that on a national account basis used for the remaining non-financial sectors given that, on the one hand, it does not include financial derivatives, trade credits and other accounts payable and receivable and, on the other hand, it uses different criteria for the valuation of liabilities (nominal value instead of market value).

14. 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.

15. The concept of credit at risk was initially defined by Banco de Portugal in Instruction of Banco de Portugal No 22/2011, and amended by Instruction No 24/2012, with a view to incorporating data on restructured loans by segment. Credit at risk corresponds to the following as a whole: (a) Total amount of outstanding loans with principal instalments or interest overdue for a period of at least 90 days. Current account claims that have not been contractually agreed upon should be considered credit at risk 90 days after an overdraft is recorded; (b) Total amount of outstanding restructured loans not covered by the foregoing sub-paragraph whose principal instalment or interest payments (overdue for a period of at least 90 days) have been capitalised, refinanced or their payment date postponed, without an adequate reinforcement of collateral (sufficient to cover the total amount of outstanding principal and interest) or without the interest and other overdue expenses having been fully paid by the debtor; (c) Total amount of credit with principal instalments or interest overdue for a period of less than 90 days, but on which there is evidence to warrant classification as credit at risk (specifically debtor bankruptcy or winding-up). In the event of debtor insolvency, recoverable amounts may cease to be considered at risk following approval by a court of the respective agreement under the Insolvency and Corporate Recovery Code, should there be no persisting doubt as to whether the outstanding amounts can be actually collected. Finally, in this new credit at risk ratio there is no deduction due to the existence of collateral. This ratio is therefore among the most conservative at European level.

16. The concept of credit in this ratio also includes loans securitised but not derecognised.

17. The coverage ratio corresponds to the ratio of the value of accumulated provisions and impairments on credit to the value of credit at risk (gross), referring to the same period, according to data reported within the scope of Instruction of Banco de Portugal No 22/2011.

18. For a detailed description of cross-sectional inspections conducted by Banco de Portugal since 2011, see: http://www.bportugal.pt/pt-PT/OBancoeoEurosistema/ComunicadoseNotasdeInformacao/Documents/combp20140328.pdf

19. On the basis of Monetary and Financial Statistics data (non-consolidated data on deposits taken in Portugal, including offshore activities).

20. The loan-to-deposit ratio corresponds to the ratio of the credit value net of provisions/impairment on credit (including loans securitised but not derecognised) to the value of customer resources and other loans, referring to the same period.

21. Liquidity gaps are defined according to the ratio (net assets – volatile liabilities)/(assets – net assets)*100, for every cumulative scale of residual maturity.

22. The Core Tier 1 ratio corresponds to the ratio of original own funds net of non-core items to risk-weighted assets.

23. Available at www.isp.pt.

24. Based on a simple average of guaranteed returns offered in the first year.

25. As measured by gross written premiums and contributions to products considered for accounting purposes as investment contracts.

26.The analysis focuses on the banks reporting under Instruction of Banco de Portugal No 4/2002.

27. This corresponds to approximately 96 per cent of the value of the banking system's pension funds' assets according to the information reported under Instruction of Banco de Portugal No 4/2002.

28. For an analysis of the activity perspective, please see https://www.financialstabilityboard.org/publications/r_130829c.pdf.

29. See the November 2013 issue of the Financial Stability Report. Other financial intermediaries include, inter alia, investment funds (excluding money market funds), holding companies, leasing companies, factoring companies, and other credit institutions.

30. Venture capital funds are not covered by this analysis. However, credit transfers to venture capital funds received special attention from Banco de Portugal (Circular-Letter No 13/2012) and the Comissão do Mercado de Valores Mobiliários – CMVM (Portuguese Securities Market Commission), and clarifications were issued regarding the prudential requirements to be adopted in such situations.

31. Securities lending operations correspond to transactions, in which a financial agent lends securities in exchange for a fee, based on a guarantee under the form of either a financial instrument or cash.

32.The net asset concept includes public debt deposits and securities of the euro area. The leverage ratio does not reflect the nominal value of the derivatives traded, given that this information is still under analysis.

33. In terms of total assets under management.

34. Closed funds are funds with a fixed number of outstanding units, while in open funds new units may be acquired or redeemed.

35. Hedge funds adopt strategies that make it possible to maximise return. Moreover, the manager of a hedge fund, in addition to the management fee, is remunerated in accordance with fund performance.

36. See http://www.cmvm.pt/en/comunicados/comunicados/pages/20131210h.aspx and also http://www.todoscontam.pt/pt-PT/PNFF/PNFF/Noticias/Paginas/not30012014.aspx.