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FINANCIAL STABILITY REPORT

May 2015

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Content

Overview

In 2014, the activity of the Portuguese financial system was carried out in a context of economic recovery, both in Portugal and in the euro area, and by the continued correction of macroeconomic imbalances. In particular, debt of the non-financial private sector was reduced, which was reflected on the maintenance of domestic net lending.

Interest rates remained broadly low, with a sharp decline in government debt yields and narrowing differentials vis-à-vis German government yields. These developments reflect the accommodative stance of monetary policy and strained search for yield by international investors. These financing conditions have chiefly favoured vulnerable economies and promoted favourable conditions for the continued deleveraging process and improving liquidity position of the different institutional sectors.

However, the maintenance for a long period of a low interest rate environment raises risks for financial stability and poses challenges to the implementation of policies. In addition, the levels attained in some market segments, including negative values, make it more difficult to anticipate the behaviour of economic agents, given their exceptional nature.

The current low interest rate levels may provide an incorrect risk assessment and, as a result, an inefficient allocation of resources. They may also act as a deterrent to economic agents' savings and, therefore, spill over into the activity of financial intermediaries. In a context of economic recovery, it is essential that domestic savings are adequate to finance productive investment and to allow for a reduction of the still high Portuguese external debt.

The low interest rate environment also poses risks to financial stability, by penalising the financial sector profitability. In the banking sector, net income, strongly dependent on the net interest income, was negative again in 2014, although recovering in most banks. The adjustment process of the banking sector continued, partly reflecting the adjustment of the other sectors of the economy. For the banking system, it should be highlighted (i) the continued decline in assets, largely influenced by developments in credit to customers, and (ii) the increase in deposits taken in Portugal, both justifying the continued fall in the loan-to-deposit ratio, (iii) the decrease in recourse to Eurosystem financing, (iv) the improvement in liquidity position, financial operations income and net interest income, the latter chiefly reflecting a decline in the average cost of deposits, (v) the maintenance of the effort to reduce operational costs, and (vi) the stability of solvency levels. However, this sector continues to be under much pressure from current low profitability levels, reflecting reduced interest rates, as mentioned above, still low demand levels – in spite of better prospects for growth of the Portuguese economy – and the historically high impairment levels in a context of also high levels of NPLs.

Low sector profitability, if extending, jeopardises future capital accumulation, posing additional challenges to banking business. Especially relevant are, on the one hand, the aspects related to the improvement of the sector efficiency and, on the other hand, appropriate risk management at the time of granting credit and during its lifetime. This should be based on a prospective evaluation of the projects' profitability, an appropriate assessment of assets pledged as collateral and the interest rates applicable in the future, substantially different from current ones. In spite of progress achieved in this field in recent years, the effort must be continued and strengthened.

As regards the insurance sector, return on the portfolios has also restrained the profitability levels achieved, against the backdrop of a decline in activity, in line with the moderation of economic activity. Moreover, the regulatory framework of this sector is undergoing changes, implying a strong adjustment of institutions, and may involve costs in the short term. The evaluation and monitoring of risks taken in the insurance sector were especially strained in 2014, particularly through the stress test carried out at European level, with the participation of main national insurance corporations.

Attention should also be paid to the impact of a possible sudden reversal in market sentiment. Although the expanded asset purchase programme announced by the ECB in 2015 may mitigate the possible occurrence of such reversal, particular importance is currently attached to the high exposure of the financial sector to assets more sensitive to sudden changes in market sentiment, such as sovereign debt. In view of liquidity requirements and possible changes in capital requirements associated with this exposure, it seems prudent to consider larger portfolio diversification, especially by the banking system. In turn, the maintenance of fiscal consolidation efforts by the Portuguese government, public debt refinancing operations benefitting from the low interest-rate environment, and the increase in sustainable financing sources by financial institutions will contribute to mitigate the impact of this risk.

In tandem with the concentration in Portuguese sovereign debt, there are other assets whose exposure must be assessed and monito red, insofar as changes in the respective price render financial institutions' balance sheets more vulnerable. This is the case of exposure to the real-estate sector still reaching high levels, especially in the banking sector. From a macroprudential perspective, it is important that the value of these exposures is appropriately registered – exercises like ECB's comprehensive assessment of the banking system and Banco de Portugal's horizontal inspections gain particular relevance – and that banks make efforts to gradually reduce their exposures to this sector, taking advantage, in particular, of the recovery observed in real-estate market conditions.

Finally, another risk factor is the exposure of the Portuguese financial sector to oil-exporting countries, the price of which declined significantly in 2014. In recent years, some of the main Portuguese banking groups ensured relevant profitability levels of their activity in some of those markets (namely Angola). Adding to this direct exposure, reference should be made to indirect exposure by the resident financial sector to Portuguese corporations with commercial or direct investment relationships with those countries.

Promoting the investors' confidence is also crucial to ensure financial stability. It is important to ensure in this context that financial institutions maintain a transparent conduct adjusted to the financial literacy of their customers. In spite of efforts developed in recent years, there is room for manoeuvre regarding the manner in which financial products are made available. This may include the decoupling of sales channels into 'traditional' banking products (such as, credit, deposits and payment instruments) and investment products, as well as more intrusive supervision of institutions' internal procedures, namely the creation, approval and distribution of financial products. In this context, the entities responsible for financial stability at the international level, as well as the National Council of Financial Supervisors, have developed various initiatives, including in the financial literary field, in this case with longer-term effects.

From a financial stability perspective, it is necessary to maintain efforts towards the correction of the still high levels of private sector indebtedness characterising the Portuguese economy, taking advantage of a context of higher nominal output growth and household disposable income.

In 2014, household debt continued to decline. In recent years, lower interest rates have allowed for a significant decrease in the debt servicing burden, dampening the effects of the decline in disposable income on the respective financial situation, also making it possible to contain default in this sector.

Non-financial corporate indebtedness declined in 2014 as well, more significantly than in 2013. According to preliminary data, in 2014 non-financial corporations recorded a slight net lending, close to that in 2013, in a context of some pick-up in investment.

In this context, the main challenge consists in the maintenance of non-financial corporations' deleveraging efforts, not implying restrictions to productive investment financing. This will make it possible to limit risk premia and reduce the economy's global exposure to possible changes in the macroeconomic context, thereby promoting sustainable economic growth. This framework is essential for recovering the financial sector's profitability levels, thus contributing to financial stability.

Recent evidence points towards a reallocation of credit to more productive sectors and corporations with better risk profile. This process intensified in 2014 and is expected to proceed as economic recovery gains momentum, contributing to increasing competitiveness of the economy and its potential growth. In an environment still characterised by the abovementioned challenges to financial stability, it is essential to create the conditions for pursuing this adjustment process. Financial institutions are an active part in this process and will also benefit from it. Sustainable economic growth is essential to create sound conditions for the recovery of financial institutions' profitability.

FINANCIAL STABILITY

1. Recent developments, vulnerabilities and challenges

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

World economy continued to grow in 2014, amid low inflation rates

In 2014 the world economy continued to grow at the same pace as in the previous two years, accelerating in advanced economies and decelerating in emerging market economies (Table 1).

Economic growth was particularly robust in the United States and the United Kingdom, boosted by domestic demand, along with a recovery in the labour market. By contrast, economic activity decelerated strongly in Japan and entered a technical recession in the third quarter of 2014 (with GDP stagnating in 2014 as a whole). GDP slowed down in China, to a large extent due to developments in investment. Economic activity decelerated in Russia, amid strong geopolitical tensions (which impacted on trade and capital flows) and a decline in oil prices.

Developments in oil prices and commodity prices overall had a very negative impact on other emerging market and developing economies that are more dependent on exports of these goods, particularly economies with limited fiscal room for manoeuvre and less diversified exports.

Economic activity in the euro area is recovering gradually, against a background of correction of imbalances accumulated by more vulnerable economies

Economic activity grew moderately in the euro area in 2014. The heterogeneity seen reflects the fact that a number of countries continued their process of fiscal consolidation and/or private sector deleveraging and adoption of structural reforms. Although these processes have a negative impact in the short term, they contribute to sustainable growth in the medium and long term.

Inflation in the euro area followed a downward trend throughout 2014. The annual rate of change in the Harmonised Index of Consumer Prices (HICP) stood at 0.4 per cent. These developments were mostly boosted by a change in oil prices (and other commodities), although the rate of change in the prices of the other HICP components was also rather low. The low level of inflation was broadly based across euro area countries. Throughout the year, long-term inflation expectations also decreased, to levels below the objective set by the European Central Bank (ECB) for price stability.

Against the supply shock associated with commodity price developments, the monetary policy measures and the depreciation of the euro, projections for economic activity in the euro area have been revised upwards.

Table 1 • GDP – real rate of change | percentage

	2014	2015f	2016f
World economy	3.4	3.5	3.8
Advanced economies	1.8	2.4	2.4
USA	2.4	3.1	3.1
Euro area	0.9	1.5	1.6
Germany	1.6	1.6	1.7
France	0.4	1.2	1.5
Italy	-0.4	0.5	1.1
Spain	1.4	2.5	2.0
Japan	-0.1	1.0	1.2
United Kingdom	2.6	2.7	2.3
Canada	2.5	2.2	2.0
Emerging economies	4.6	4.3	4.7
China	7.4	6.8	6.3
Brazil	0.1	-1.0	1.0
Russia	0.6	-3.8	-1.1

Source: IMF (*World Economic Outlook*, April 2015)
Note: f – forecast

The ECB launched an expanded asset purchase programme in 2015

Over the last few months, the monetary policy conducted by several central banks maintained its accommodative tone, which was reinforced in a considerable number of countries due to low inflation figures and/or the need to counteract a trend of appreciation in their currencies. In the euro area, the ECB has kept the interest rates on the main refinancing operations, the marginal lending facility and the deposit facility at 0.05, 0.3 and 0.2 per cent, respectively, since September 2014 (Chart 1). In January 2015, amid indicators of actual and expected inflation in historical lows, the ECB announced an expanded asset purchase programme (Box 1).

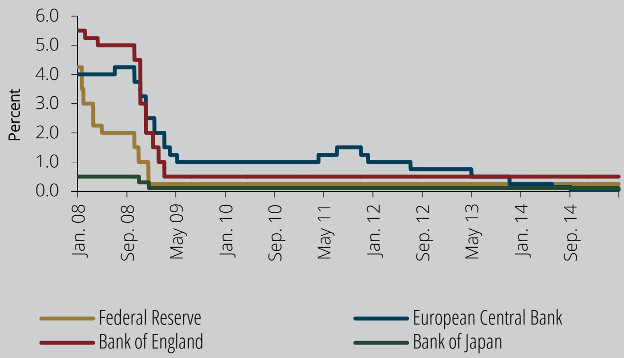
By contrast, in the United States and the United Kingdom, expectations remained that the cycle of official interest rate increases might already start in 2015. In the United States, the Federal Reserve kept the target range for the federal funds rate between 0 and 0.25 per cent and changed its forward guidance, after the quantitative easing programme ended in October, admitting a possible increase in the official interest rates, depending on economic developments.

Against the ECB's expanded purchase programme and expectations of an increase in interest rates by the Federal Reserve, the euro experienced a sharp depreciation and the dollar appreciated overall (Chart 2).

Government debt yields dropped and the differentials between the rates of stressed euro area countries and Germany narrowed

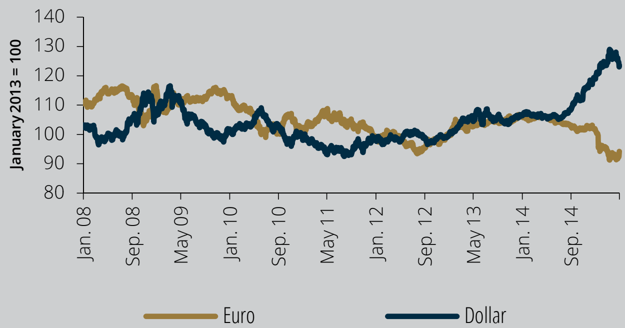
In the euro area, government debt yields dropped considerably, reaching consecutive historical lows in several maturities, a movement broadly based across most countries (Chart 3). The euro area yield curve decreased more markedly in longer maturities, influenced by expectations regarding the public debt purchase programme and its subsequent implementation and a prolonged period of very low inflation. Against this background, government debt yields turned negative in a number of countries (Chart 4). In stressed countries, yields experienced even sharper declines, with investors taking advantage of the premium compared with investment in other countries (Chart 5). Greece was an exception, with an increase in yields reflecting difficulties in the Government and international creditors reaching an agreement.

Chart 1 • Official Central Bank interest rates



Source: *Bloomberg*.

Chart 2 • Euro and dollar effective exchange rates



Source: *Bloomberg*.

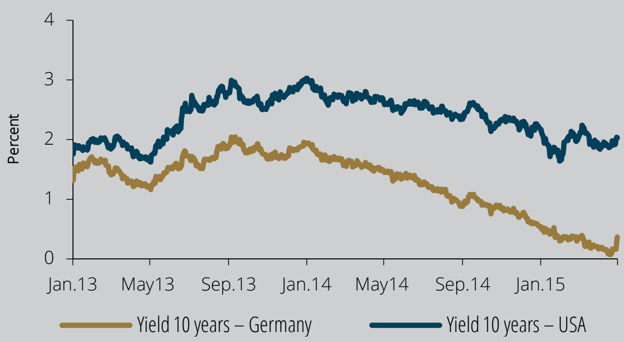
In the United States, yields again experienced different developments in longer and shorter maturities. Expectations that the Federal Reserve might increase the federal funds rate in 2015 led to increases in yields in shorter maturities. In longer maturities, decreases were influenced by expectations of low inflation and search for yield, considering the low yields seen in Europe.

The global downward movement in yields was partially reversed at the end of April 2015, with long positions being abruptly closed in most bond markets. These developments took place amid a more favourable economic outlook in the euro area and decreasing deflationary fears, leading to doubts about whether the extremely low yields were in line with fundamentals. Low liquidity in bond markets amplified the yield upward movement.

Stock market indices recorded gains in several countries, particularly in the euro area

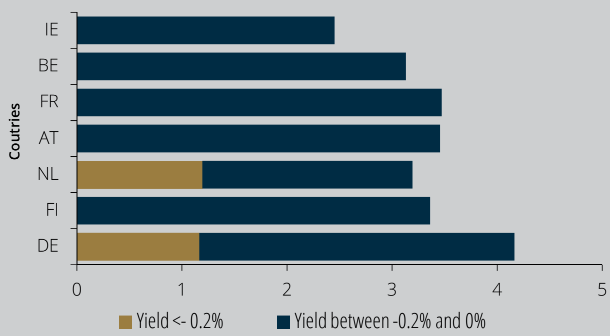
Stock market indices continued to record gains, benefiting from favourable conditions associated with the impact of the accommodative monetary policy, signs of an economic recovery in several countries and an improvement in corporate earnings (Chart 6). These factors offset risks associated with tensions in Ukraine and the Middle East and the uncertainty

Chart 3 • Sovereign Debt 10 Year Yields



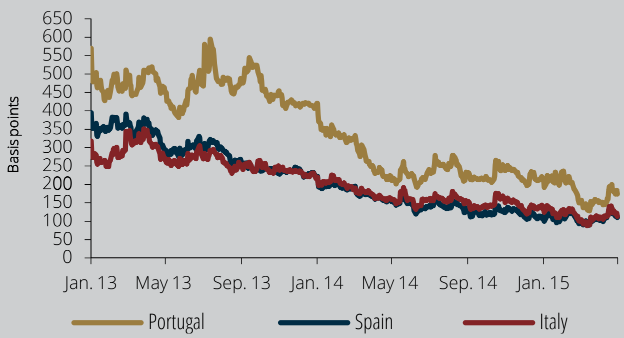
Source: *Bloomberg*.

Chart 4 • Countries with negative yields for sovereign debt in specified maturities (30th April)



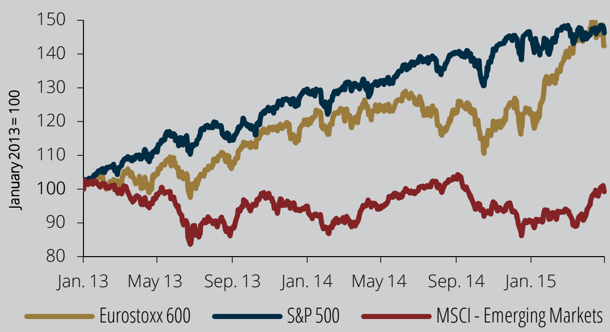
Source: *Bloomberg*.

Chart 5 • 10 Year Sovereign Bond Yields | Spreads *vis-à-vis* Germany



Source: *Bloomberg*.

Chart 6 • Stock Market Indices



Source: *Bloomberg*.

regarding developments in Greece. At the start of 2015, gains were particularly pronounced in Europe, with some indices reaching new historical highs. Gains were less pronounced in the United States.

The Portuguese economy grew moderately. In the next few years, economic activity is projected to gradually recover and grow at a pace close to that forecast for the euro area

After years of marked contraction, the Portuguese economy returned to growth in 2014 (0.9 per cent) (Table 2). The pace of economic recovery has been affected on the one hand by moderate growth in the main trading partners and on the other hand by high indebtedness in the economy as a whole.

The recovery in economic activity, after a drop in the past three years, reflected strong growth in exports and an acceleration in domestic demand. At the same time, an increase in employment, a decline in the unemployment rate and sustained wage moderation were recorded. The inflation rate stood at levels close to zero.

Table 2 • GDP and main components | Real rate of change, percentage

	% of GDP in 2014	2012	2013	2014
GDP	100	-4.0	-1.6	0.9
Domestic demand	99	-7.3	-2.5	2.1
Private consumption	66	-5.5	-1.5	2.1
Public consumption	19	-3.3	-2.4	-0.3
Investment	15	-18.1	-6.7	5.2
Exports	40	3.4	6.4	3.4
Imports	39	-6.3	3.9	6.4
Contribution of domestic demand [(a)]		-7.6	-2.5	2.1
Contribution of exports [(a)]		1.2	2.4	1.3
Contribution of imports [(a)]		2.4	-1.5	-2.5

Source: INE and calculations by Banco de Portugal.
Note: (a) Contributions for the real GDP growth, in percentage points.

The recovery in private consumption was in line with the recovery in consumer confidence, occurring amid a gradual improvement in labour market conditions and a decrease in the household debt service, arising from lower interest rates and debt levels. After three years of sharp declines, investment recorded an increase.

The Portuguese economy maintained a net lending capacity (measured by the sum of the current and capital accounts) as a percentage of GDP. These developments contributed to improve the international investment position.

On 13 May, Statistics Portugal released its flash estimate of the Quarterly National Accounts for the first quarter of 2015. According to this estimate, GDP increased by 1.4 per cent in volume year-on-year, following a change of 0.6 per cent in the fourth quarter of 2014. Compared with the previous quarter, GDP increased by 0.4 per cent in real terms (the same as in the previous quarter), reflecting the positive contribution of domestic demand.

Most recent projections point to an acceleration in economic activity in Portugal in the next few years, supported by growth in exports (Chart 7). The international context is expected to remain relatively benign, helped by the financial environment promoted by measures taken by the ECB, which allows indebted economic agents (both public and private) to reduce their interest burden and experience gains in real estate and financial assets (and thereby also contributes to reduce capital costs).

Financial markets in Portugal showed positive developments at the end of 2014 and start of 2015

Portuguese financial markets showed relatively positive developments at the end of 2014 and start of 2015, with the composite indicator of financial stress for Portugal (*Indicador Compósito de Stress Financeiro – ICSF*) recording a gradual decrease after the peak observed in mid-October.[2] In effect, up until then, Portuguese markets remained affected by ongoing instability associated with a resolution measure applied to BES, the uncertainty surrounding Portugal Telecom and some instability in international markets arising from the situation in Greece and tensions between Russia and Ukraine. Subsequently, prospects of several parties interested in purchasing Novo Banco, the sale of Portugal Telecom and a more favourable environment in international markets all contributed to reduce financial stress in Portugal to levels considered to be normal (Chart 8).

PSI-20 recorded significant gains from the start of 2015 onwards, in an overall environment of stock market gains in the euro area (Chart 9). Financial corporations recorded the highest gains, recovering from strong losses in the previous year, amid the announcement of a

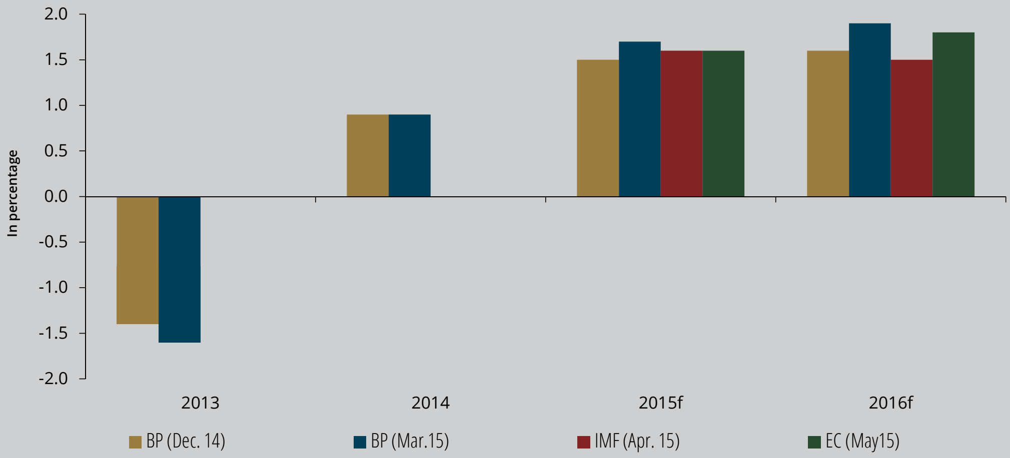
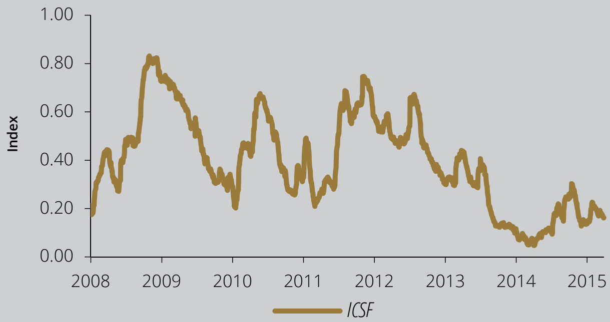


Chart 7 • Annual rate of change of GDP – Portugal

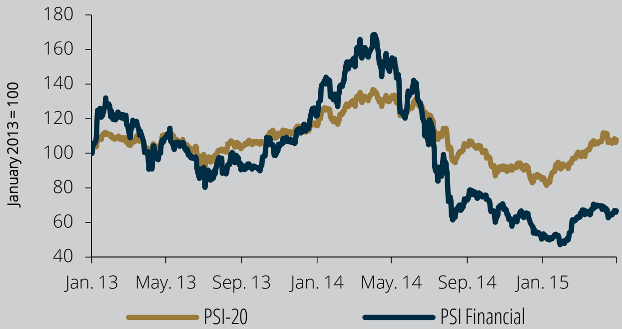
Source: IMF, EC and Banco de Portugal.
Note: f – forecast

Chart 8 • Composite Indicator of Financial Stress (*ICSF*) for Portugal



Source: Banco de Portugal.

Chart 9 • Portuguese Equity Indices



Source: *Bloomberg*.

takeover bid of CaixaBank for BPI, news of a possible merger between BPI and BCP and more positive prospects for the sale of Novo Banco.

An ongoing favourable environment in international markets has allowed the Portuguese State to continue its frontloading financing strategy through a number of debt issues. The announcement by the ECB of the public sector purchase programme helped to implement this strategy and also made it possible to increase the public debt average maturity. The interest rates of allotment of the issues were gradually reduced, benefiting from high demand. As regards the management of public debt, part of the IMF's loan to Portugal was repaid before maturity (around 22 per cent of the total amount). Nevertheless, the main rating agencies, with the exception of DBRS, kept their ratings for Portugal at a non-investment grade level.

In the secondary market, yields decreased significantly for most maturities, reaching historical lows along the yield curve (Chart 10). The search for yield and the announcement and subsequent implementation of the ECB's public sector purchase programme, favoured a decrease in yields. Liquidity indicators improved, with transaction volumes increasing and bid-offer spreads decreasing. The worsening of the situation in Greece did not have a significant impact on Portuguese public debt markets.

Despite an improvement in the financial market environment, the amount of debt securities issued by resident entities (excluding the general government) decreased slightly at the end of 2014 and start of 2015, particularly for monetary financial institutions. By contrast, issuance by the general government increased markedly (Chart 11).

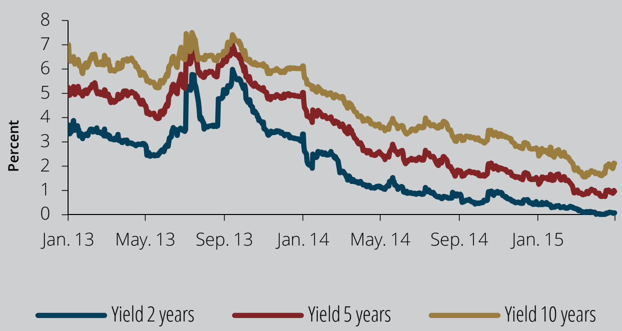
1.2. Financial position of non-financial sectors

In 2014 total household debt continued to decline

The net repayment of household debt that had been observed since 2011 continued in 2014 (Chart 12). Total debt[3] reached 84 per cent of GDP at the end of 2014 (compared with 91 per cent at the end of the previous year), a decrease of 11 percentage points of GDP since 2009, when it reached a peak (Chart 13). This took place amid a significant decrease in household disposable income (from 2009 to 2014, nominal disposable income dropped by 3.2 per cent).

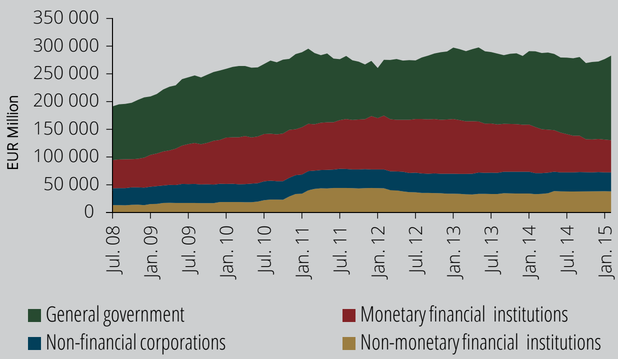
Despite these positive developments, total household debt still remains one of the highest in the European Union. Nevertheless, the ratio of financial assets held by households net of their

Chart 10 • Portuguese Sovereign Debt Yields



Source: *Bloomberg*.

Chart 11 • Securities issued (outstanding amount)



Source: Banco de Portugal.

total debt in relation to GDP is close to that observed for Germany and Austria and higher than that of Spain and other countries with a smaller debt to GDP ratio (Chart 14).

> In the past few years, the decrease in the debt service burden has dampened the effects of a drop in disposable income on the financial situation of households

The decrease in the debt stock and the decline in reference interest rates in the past few years significantly reduced households' interest burden (Chart 15).

Since September 2008, when the six-month Euribor (the main reference rate for mortgage loan agreements, which are the largest share of household debt) reached a high, mortgage instalments have been declining. This mitigated the effects of the decrease in disposable income that occurred during the Economic and Financial Assistance Programme, while limiting defaults in this credit market segment. In the case of a loan agreement with a maturity of 30 years and a spread of one percentage point, the monthly instalment should have nearly halved from September 2008 to December 2014.

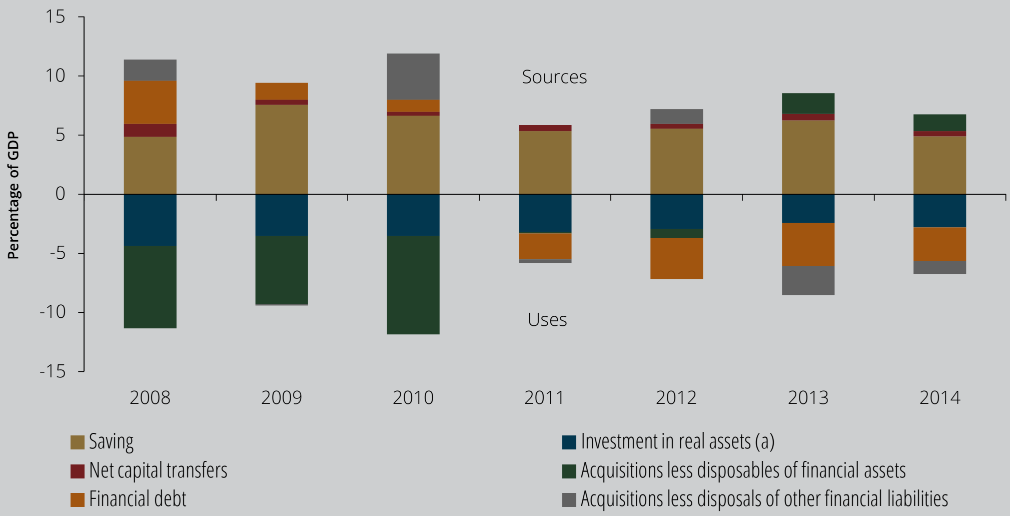


Chart 12 • Sources and uses of funds by households

Sources: 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.

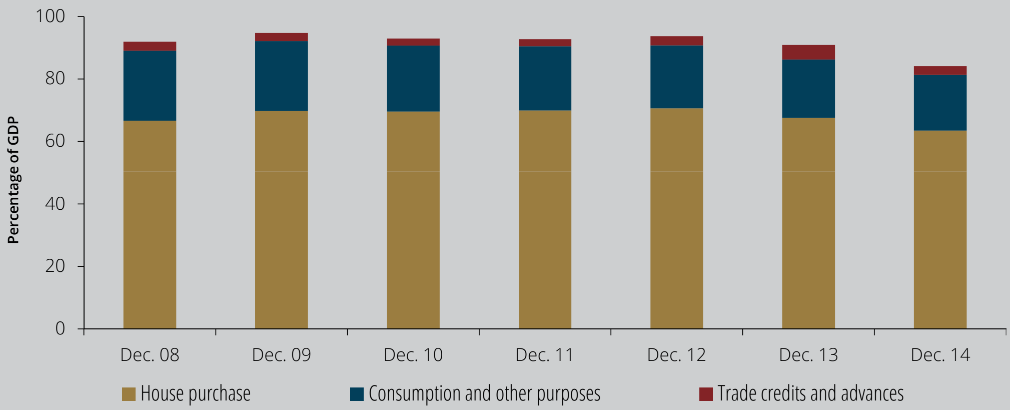


Chart 13 • Households' debt | Outstanding amounts

Source: INE and Banco de Portugal.
Note: Consolidated values.

In the same period, interest payable by households decreased by nearly 40 per cent.

These developments were not accompanied by a decrease in interest receivable, which in 2014 was only around 16 per cent less than in 2008 (Chart 15). From September 2008 to December 2014, the share of deposits and savings certificates in household portfolios increased. Within a context of difficulties in financing the economy, particularly in 2011 and 2012, deposits were made with relatively long maturities (over 2 years) and high and increasing interest rates (benefiting from holding premia), some of which have not yet reached maturity.

After a relative stabilisation during the Economic and Financial Assistance Programme, the household savings rate declined

In 2014 household net lending accounted for 2.5 per cent of GDP and 3.5 per cent of disposable income, decreasing from the previous year (4.3 per cent of GDP, 6.0 per cent of disposable income).[4] This decrease reflected (i) a decline in savings as a percentage of GDP (from 6.2 per cent in 2013 to 4.9 per cent in 2014), mainly as a result of growth in private consumption, and (ii) an increase in the household investment rate[5] (from 2.5 per cent to 2.8 per cent of GDP) (Chart 16).

After a relative stabilisation from 2011 to 2013, against a background of a significant decrease in disposable income, in 2014 the household savings rate stood at 6.9 per cent of disposable income (8.7 per cent in 2013), according to preliminary data from the Annual National Accounts.

Looking ahead, household savings must continue to significantly contribute to finance the remaining sectors of the economy, even in a context of a recovery in their investment and low interest rates.

Household portfolios continued to shift, favouring instruments with low capital risk

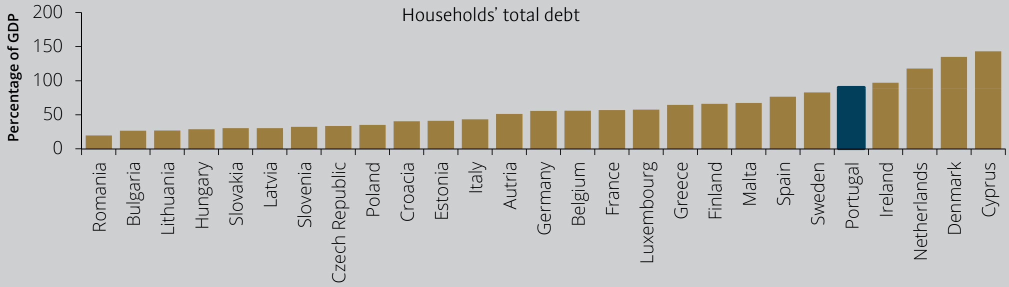
In 2014 households carried out net sales of financial assets and continued to shift their portfolios' composition (Chart 17). Savings and Treasury certificates held in portfolio increased (by 2.9 per cent of GDP), partly reflecting the fact that households brought forward these investments, in anticipation of a change in their rate of return. Investment in debt securities and mutual fund shares recorded a decrease (by 3.9 and 0.7 per cent of GDP respectively). Net investments in life insurance and pension funds were also important, increasing by 0.8 per cent of GDP for each of the instruments.

Total loans to households continued to display negative rates of change close to those seen in 2013 for home loans (around -4 per cent), but less negative for consumer loans (around -2 per cent, after nearly -7 per cent in 2013). Nevertheless, the number and amount of new agreements on car and personal loans increased.

Non-financial corporations recorded a net lending position, albeit close to zero

In 2014, according to the preliminary Annual National Accounts, non-financial corporations' net lending stood at 0.6 per cent of GDP (0.9 per cent of GDP in 2013) (Chart 18). With the recent revision of non-financial accounts by Statistics Portugal (INE), in 2013 and 2014 non-financial corporations no longer showed a net borrowing position and recorded a net lending position[6] for the first time in the annual series that became available from 1995. The marginal decrease in net lending in 2014 was mainly the result of a slight decrease in savings (by 0.2 percentage points of GDP) and an increase in investment in real assets (by 0.7 percentage points of GDP). Gross capital formation increased by 0.6 percentage points of GDP from 2013 to 2014, interrupting the cycle of negative changes from 2008.

The slight decrease in savings in 2014 resulted mostly from a fall in net property income received (0.7 percentage points of GDP), although offset by a decrease in taxes paid by non-financial corporations, as a result of a decrease in the corporate tax from 25 to 23 per cent. Gross



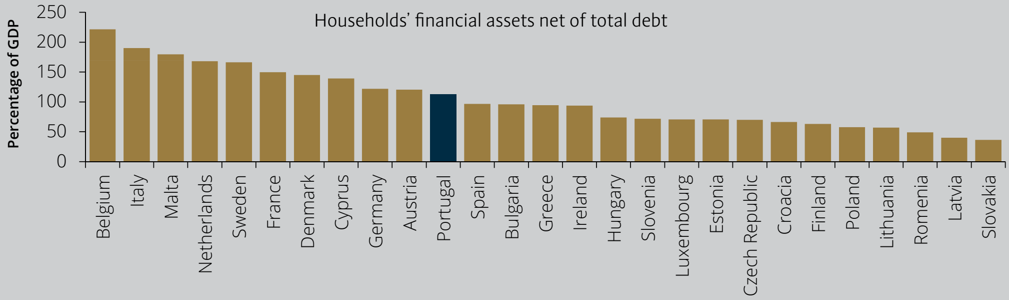


Chart 14 • Households' total debt and financial assets net of total debt | 2013

Source: Eurostat.
Note: Households' financial assets net of total debt exclude other accounts receivable/payable and include trade credits.

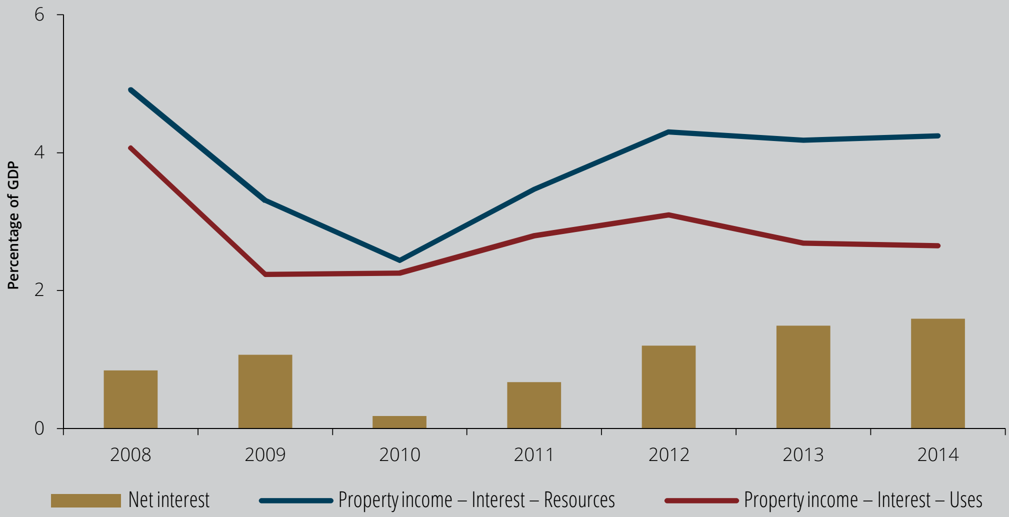


Chart 15 • Households' interest resources and uses

Source: INE.

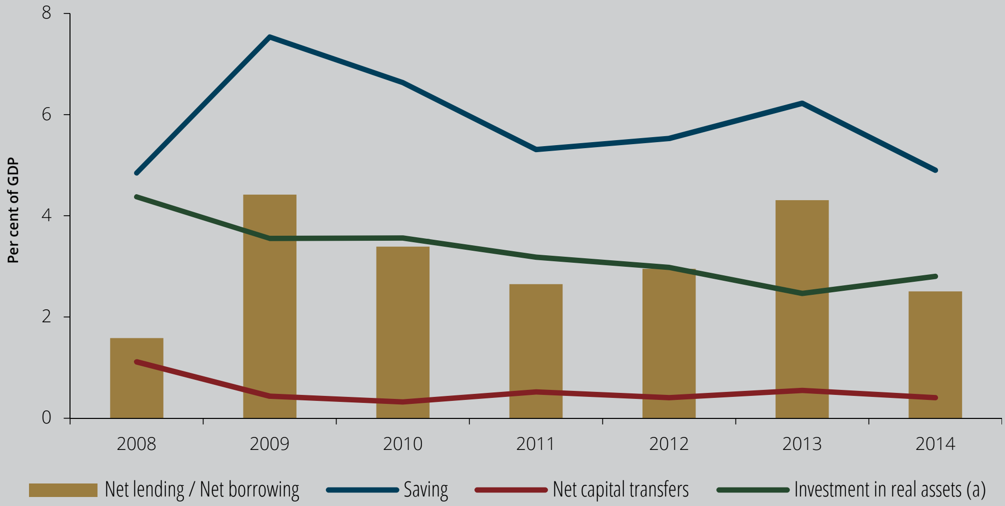
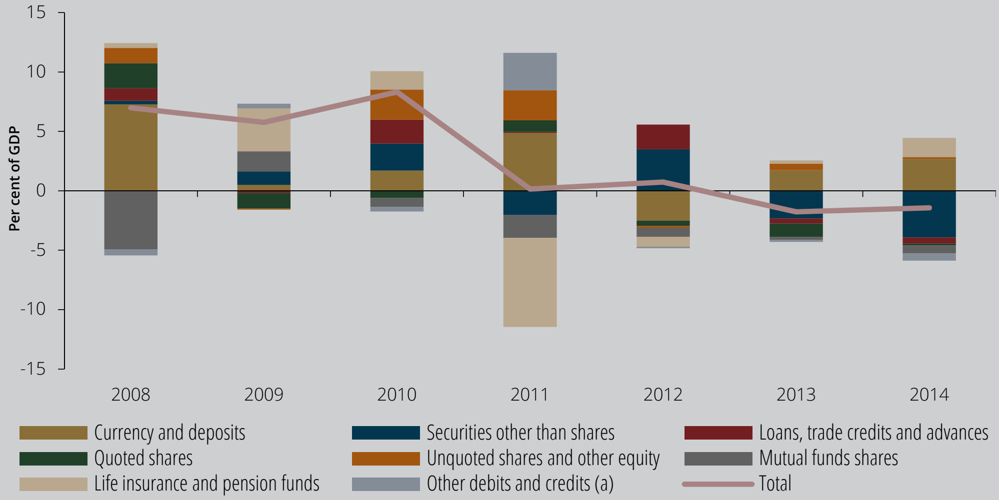


Chart 16 • Saving, investment and net lending of households

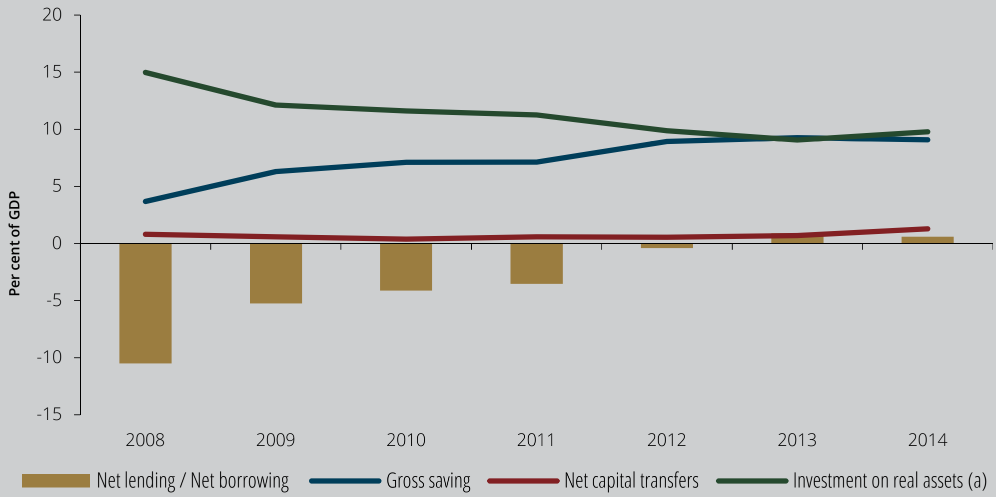
Source: INE.
Note: (a) It equals the sum of gross fixed capital formation, change in inventories, acquisitions less disposals of valuables and acquisitions less disposals of non-produced non financial assets.

Chart 17 • Financial assets of households | Transactions



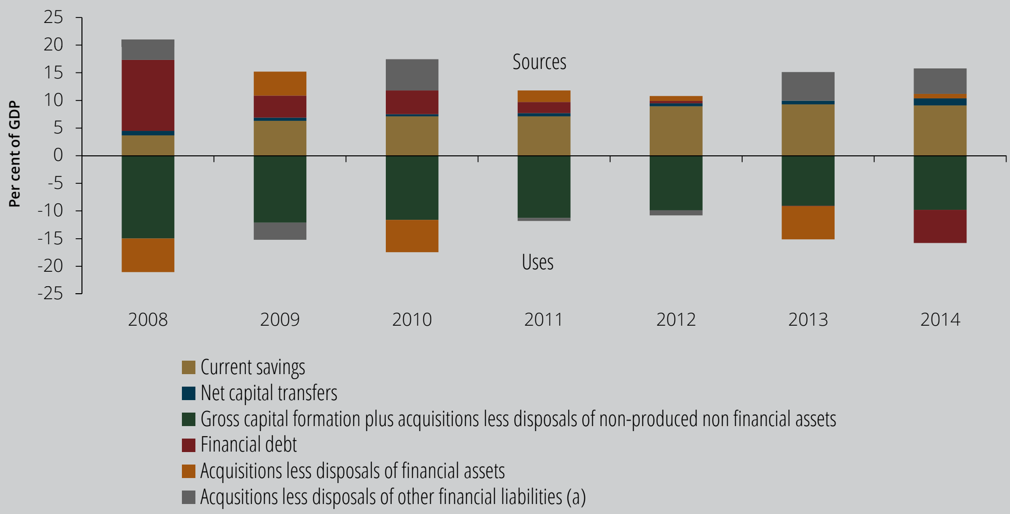
Source: INE and Banco de Portugal
Notes: Consolidated values. (a) Includes non-life insurance technical reserves, provisions for standard activated guarantees and other accounts receivable/payable.

Chart 18 • Non-financial corporations' saving, investment and net lending / borrowing



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 19 • Sources and uses of funds by non-financial corporations



Source: INE and Banco de Portugal.
Note: (a) Corrected for the statistical discrepancy between national financial accounts and national non financial accounts' net lending/borrowing.

operating surplus remained historically high (with reference to data since 1995, when the current series started).

Greater capacity to generate funds internally in a period of rather buoyant economic activity is favourable to deleveraging the non-financial corporate sector. In aggregate terms, the share of financing using own funds has increased since 2008 (reflected in a gradual increase in current savings). This was accompanied by a significant reduction in the share of financing using financial debt (Chart 19). This pattern has continued in 2014, reflecting greater economic growth and a gradual deleveraging of non-financial corporations. This is in contrast with developments seen before 2009, when this sector made considerable use of financial debt to finance itself (namely to invest).

Total debt of non-financial corporations decreased considerably

Total debt of non-financial corporations declined markedly in 2014 (by 9 percentage points of GDP), to stand at 115 per cent of GDP at the end of the year[7] (Chart 20). However, it remains one of the highest in the euro area. To this decrease contributed the positive change in nominal GDP (by around two percentage points) and, most importantly, net debt repayment (which totalled 6.5 percentage points of GDP) (Chart 21). The change in loans granted by resident financial institutions was more negative in 2014 than in 2013. In addition, there was a net redemption of debt securities, partly associated with the

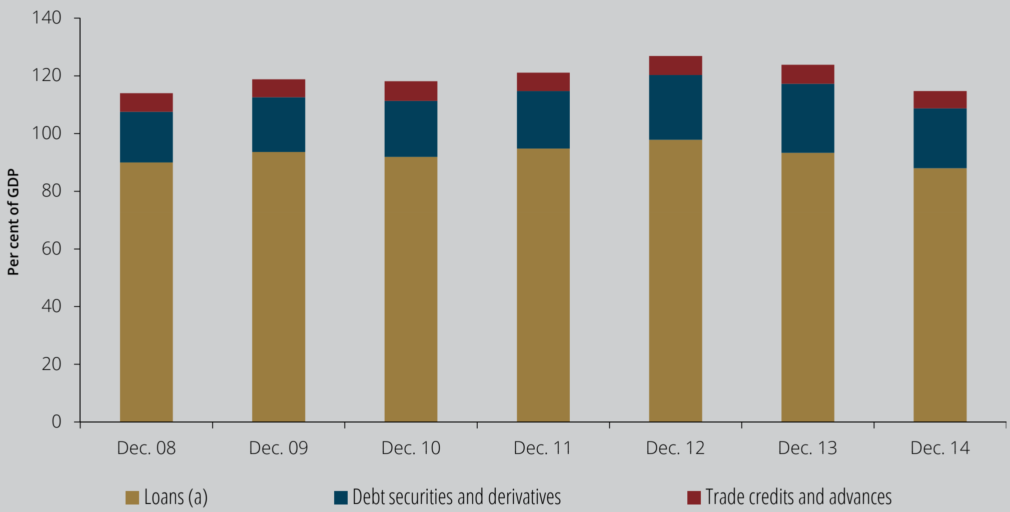


Chart 20 • Non financial corporations' debt | Outstanding amounts

Source: INE and Banco de Portugal. Notes: Consolidated values. (a) Includes loans granted by private individuals, general government, other monetary financial institutions, other financial intermediaries and auxiliaries and rest of the world.

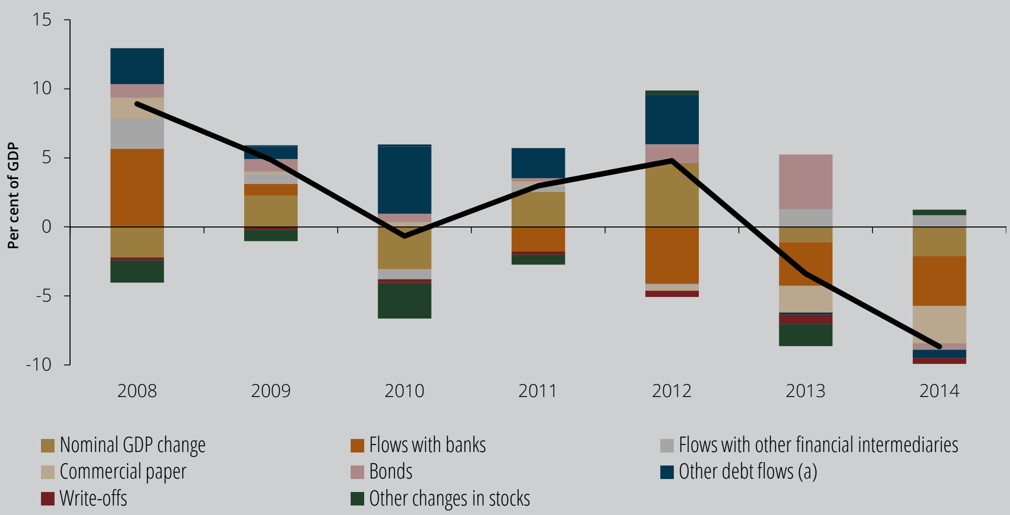


Chart 21 • Contributions to changes in Debt to GDP ratio | Non financial corporations

Source: Banco de Portugal. Notes: Consolidated values. (a) Includes loans granted by the resident non-financial sector and by non-residents, financial derivatives and trade credits and advances.

restructuring of the Portugal Telecom group. This was in contrast with the previous year, which saw a net issue of debt securities.

During the Economic and Financial Assistance Programme, some firms, particularly the larger ones faced with tighter credit supply, issued debt securities and resorted to foreign loans. During this period, loans granted by households (typically in the form of additional capital) and intra-group loans also increased (with no impact on the consolidated figures of the non-financial corporate sector). In 2014 the annual rate of change in total credit to non-financial corporations[8] stood at -5.0 per cent, a steeper decline than in the previous years (when the change was virtually nil).

The possibility of issuing debt in the market is not the same for all non-financial corporations: the enterprises that had no access to debt markets during the crisis were mostly small and medium-sized. This may be due to two structural factors: (i) the amounts issued by small and medium-sized enterprises are typically smaller than those issued in these markets, and (ii) information asymmetries associated with smaller-sized enterprises result in higher risk premia compared with those for debt issued by large enterprises.

Deleveraging by non-financial corporations contributes to financial stability. On the one hand, it limits higher risk premia (financial intermediaries tend to associate more leveraged enterprises with greater risk). On the other hand, it decreases the economy's global exposure to possible changes in the macroeconomic environment that may limit the capacity of non-financial corporations to remunerate the debt. The positive contribution of the deleveraging effort to financial stability is strengthened amid sustained economic growth where resources are reallocated to more productive economic sectors.

Developments in profitability are mixed across economic sectors

The average profitability ratio[9] of non-financial corporations decreased in 2014 (7.1 per cent in December 2014; 7.3 per cent in December 2013), despite a recovery in economic activity. Profitability developments were influenced by the effects of the restructuring of the communications sector that took place in 2014. Excluding these effects, the profitability ratio would have increased compared with 2013. The average coverage ratio[10] (which was also affected by this restructuring) remained virtually stable (3.3 in 2014, compared with 3.2 in December 2013).

Developments in these ratios coincide with growth in business investment (after considerable drops since 2009). Underlying these developments is some heterogeneity when all economic activity sectors are taken into account. The profitability ratio increased in manufacturing and trade. In turn, construction had a profitability ratio of 3.3 per cent at the end of 2014, compared with 4.0 per cent in December 2013.

Comparing the profitability of an average enterprise in each economic activity sector with the sector's implied interest rate makes it possible to assess the ability to remunerate its debt (Chart 22). In 2014 the differential between the return on assets and the implied interest rate increased for manufacturing and trade. In construction, the differential remained negative.

Loans are being granted to sectors with higher profitability indicators

Developments in loans by resident financial institutions to manufacturing, trade and construction and real estate activities are mixed according to developments in the average profitability levels of these sectors and their ability to repay the loans. Within the context of a net reduction in the exposure to non-financial corporations, an increase in the relative share of manufacturing and trade and a decrease in the share of construction and real estate activities are the result of a shift in the loan portfolio towards more profitable sectors (Chart 23). In 2014, in comparative terms, exposure to firms with overall better financial ratios increased, while it decreased in relation to the other firms.[11]

This change is even more relevant given the high level of credit stock overdue for most economic sectors. The ratio of credit overdue continued to increase in 2014 for total non-financial corporations (from 13.4 per cent to 15.0 per cent), albeit at a slower pace than from 2010 to 2013. This indicator therefore remains high, although differences exist between the sectors under analysis: manufacturing (11.7 per cent), trade (16.5 per cent), real estate (21.3 per cent) and construction (28.7 per cent). Persistent high levels of credit overdue in banks' balance sheets may be partly related to the length of judicial proceedings and the tax treatment of the derecognition of credit in banks' balance sheets. In accordance with this treatment, the effects of this derecognition on the financial statements are only taken into account when full or partial recovery of the credit by the creditor is no longer possible.

Spreads of loans to non-financial corporations continue to decrease, particularly for firms with better risk profiles

The maintenance of reference interest rates at historically low levels and a gradual narrowing of spreads applied by banks have resulted, in aggregate terms, in a gradual decline in bank interest rates on new loans and on outstanding amounts of loans to non-financial corporations. This contrasts with developments in

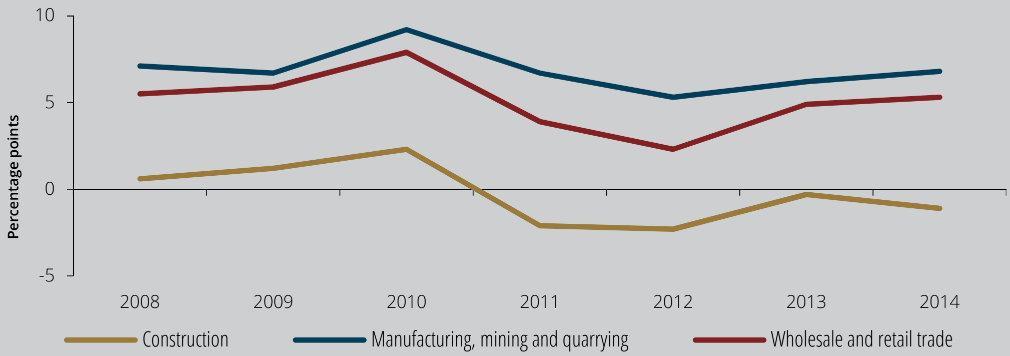


Chart 22 • Non financial corporations' differential on return on assets and implicit interest rate

Source: Banco de Portugal.
Notes: The differential presented is the difference between the return on assets (EBITDA/ (equity + obtained funding)) and the implicit interest rate (interest expenses / obtained funding). End of year figures.

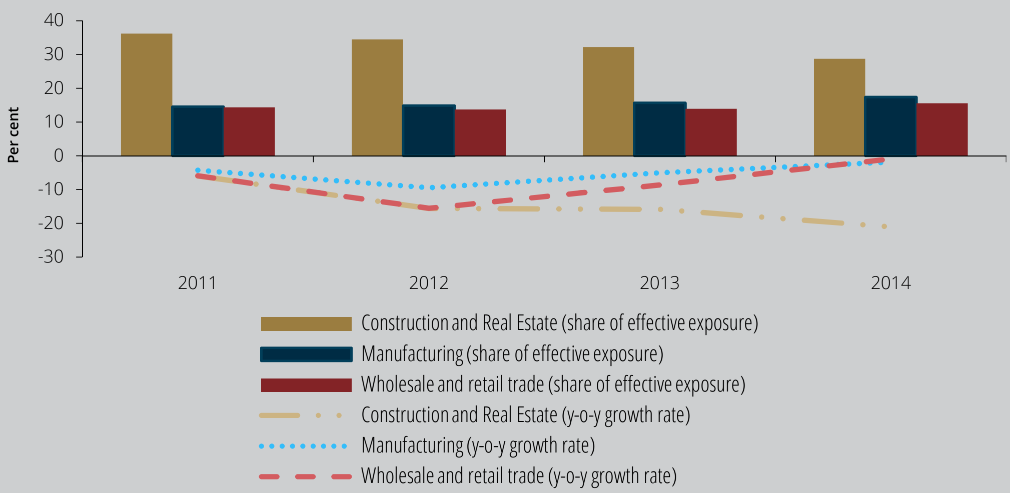


Chart 23 • Credit granted by resident financial institutions to non financial corporations

Source: Banco de Portugal.
Notes: Data from Central Credit Register. Loans granted by banks, savings banks, mutual agricultural credit banks, credit financial institutions, factoring companies, financial leasing companies, credit-purchase financing companies and other financial intermediaries. It includes securitised loans. It does not include written-off loans. Excludes firms for which the increase in exposure for that year equals the increase in overdue credit and other firms for which financial statements are not correctly specified.

2012, when the decreases in the Euribor did not translate into declines in the interest rates on loans to non-financial corporations, given the higher spreads that were partly the result of a tighter credit supply.

According to the bank lending surveys[12] conducted in 2014, the tightening of credit standards and conditions applied to loans or credit lines to enterprises seem to have fluctuated somewhat. At the end of the year, spreads on average risk loans declined, by contrast with spreads applied to riskier loans. According to these surveys, these developments occurred amid an increase in the demand for loans by enterprises.

An improvement in the economic and financial environment leads to an acceleration of credit. It is therefore particularly important that banks adopt lending policies that adequately assess the return on credit granted, and are not excessively based on collaterising operations.

The process of fiscal consolidation continued, mainly reflecting developments in structural primary expenditure

In 2014 general government net borrowing stood at 4.5 per cent of GDP (4.8 per cent in 2013). These developments reflected a more favourable budget execution than was expected when the State Budget for 2015 was prepared (4.8 per cent of GDP).

Excluding temporary measures and special factors, the deficit in 2014 stood close to the estimate included in the State Budget for 2014, at 3.6 per cent of GDP, and improved compared with 2013.[13]

The structural primary balance increased by 0.8 percentage points of GDP (to 2.8 per cent), reflecting an ongoing tight fiscal policy. These developments took place within the context of Portugal's exit from the Economic and Financial Assistance Programme in May 2014. This Programme promoted a convergence of the structural balance towards the medium-term objective, favouring the creation of conditions that would reverse the rising debt ratio.

As for changes in general government financial assets, the following were particularly important: the redemption of hybrid instruments purchased by the Portuguese State under bank recapitalisation operations with recourse to public investment (1.9 percentage points of GDP), sales of equity from Fidelidade, CTT Correios de Portugal and REN, under these firms' privatisation process (1 percentage point of GDP); and, by contrast, an increase in shares and other equity associated with the capitalisation of Novo Banco (2.8 percentage points of GDP).

General government debt (Maastricht debt) totalled 130.2 per cent of GDP at the end of 2014, 0.5 percentage points of GDP up from 2013. Excluding general government deposits, general government debt reached 118.1 per cent of GDP.

Throughout 2014, the Portuguese State issued 5, 10 and 15-year Treasury bonds and maintained the repurchase tender programme. In 2015 the State issued a new 30-year benchmark security. In 2014 as a whole, net purchases of savings and Treasury certificates by households totalled more than €5 billion.

Against a background of primary balance surpluses, nominal activity growth and historically low sovereign debt rates, the debt ratio is expected to decrease in Portugal from 2015 onwards.

Nevertheless, the cost of Portuguese public debt still remains one of the highest in the euro area, reflecting both a high debt stock and the related interest rate. In addition, despite a positive impact of operations carried out by the Portuguese Treasury and Debt Management Agency (Agência de Gestão da Tesouraria e da Dívida Pública – IGCP), the maturity profile of public debt still shows a high concentration in the forthcoming years (Chart 24).

Consequently, the refinancing of Portuguese public debt is still particularly vulnerable to a reversal in current market sentiment. It is therefore vital that the fiscal consolidation process continues, supported by intensified structural reforms to make the Portuguese economy more competitive and increase potential growth, thereby strengthening its credibility with international investors. The maturity managing operations that have been carried out are also expected to help strengthen the sustainability of public debt.

1.3. Financial position of financial sectors

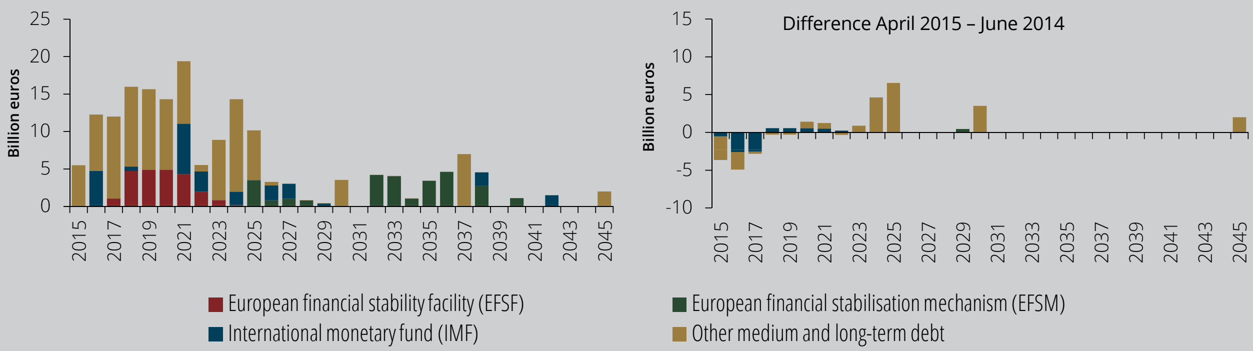
1.3.1. Banking sector[14]

> The banking system's activity continued to develop against a background of deleveraging in the Portuguese economy

The adjustment process of the Portuguese economy continued to constrain the Portuguese banking system's activity in 2014. The still high indebtedness of the resident non-financial sector and the persistence of some fragmentation in financial markets (albeit at levels below those seen during the peak of the economic and financial crisis) have determined the main changes in the balance sheet structure of banking institutions operating in the Portuguese market. At international level, the ongoing transition to the new European regulatory framework and the start of the Banking Union, have posed challenges to capital and liquidity adequacy.

Total assets of the banking system decreased by 6.6 per cent from 2013 (4.4 per cent compared with June 2014), resulting in a cumulative contraction of 19.2 per cent since the end of 2010 (Chart 25). This decline was

Chart 24 • Annual redemption calendar of medium and long term debt | April 2015



Source: IGCP.
Notes: On June 21st 2013, ECOFIN has decided to extend the average maturity of EFSM loans by 7 years, which will bring the average maturity from 12.5 to 19.5 years. Individual loans approaching maturity might be rolled over more than once in order to achieve this objective. It is therefore not expected that Portugal will have to refinance any of its EFSM loans before 2026.

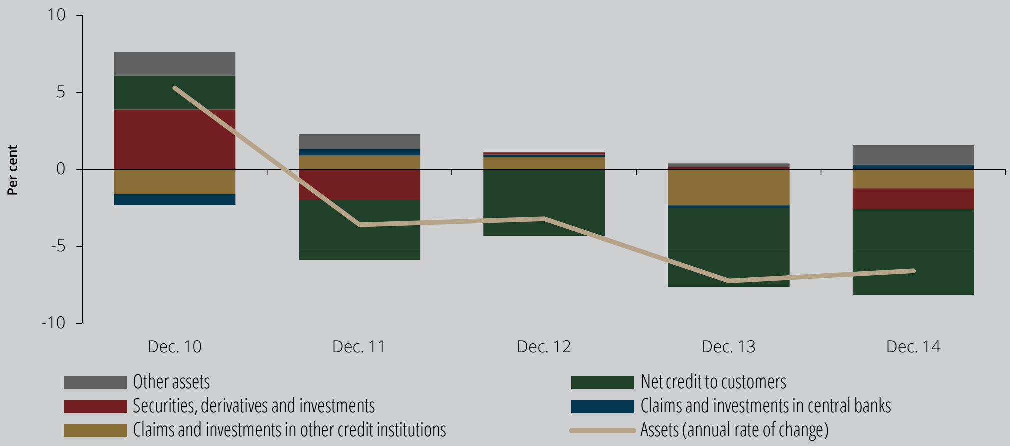


Chart 25 • Contributions to the annual change in assets

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

widespread across most institutions, although some heterogeneity was observed. The biggest contractions in assets were seen in the largest domestic banks. The main non-domestic banks recorded a less marked reduction and, in medium-sized domestic banking groups, the change was virtually nil.

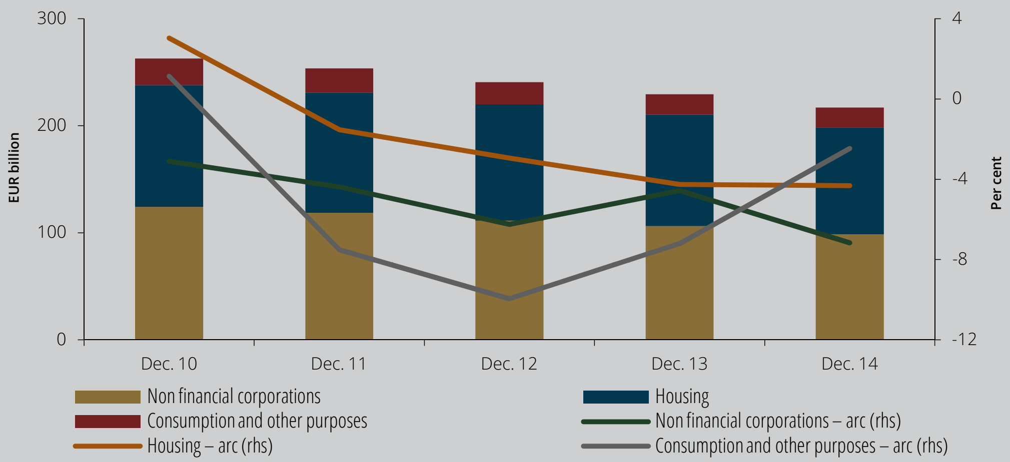
In 2014 the reduction in net credit to customers (adjusted for securitisation operations) continued to be the main factor driving the decrease in assets. However, developments in the main balance sheet items, including credit to customers, were affected by the reclassification of some assets as 'Non-current assets held for sale and discontinued operations'. The reduction in the credit portfolio was widespread across all private sector segments, most notably the non-financial corporations' segment (Chart 26).

Turning to securities, derivatives and investments, changes observed between December 2013 and December 2014 were essentially determined by the reduction in the Portuguese government debt securities portfolio, in spite of the positive effect of the valuation of securities traded in the secondary market (Chart 27). However, total exposure of the Portuguese banking system to the domestic sovereign, including loans to general government, increased as a percentage of assets (from 7.5 per cent to 8.3 per cent), in a context of decreasing assets in the sector (Chart 28).

In this context, the financial position of Portuguese banks remains sensitive to changes in the public debt market, as is the case in other European countries. Assessed on the basis of total securities held and loans granted to the general government, Portuguese banks' exposure to domestic sovereign debt stands in the distribution median of euro area countries, close to Belgium and Germany. New regulations on liquidity provide incentives for the holding of government debt securities portfolios.

The ongoing deleveraging and balance sheet adjustment process in Portuguese banks is likely to continue in the medium run, due to credit demand constraints created by the still high indebtedness of the non-financial sector of the economy and the maintenance of subdued economic growth. Furthermore, the need to reinforce financial soundness, to comply with capital and liquidity requirements established by the new European regulatory framework, could condition the financial intermediation role inherent to the banking sector. Indeed, compliance with regulatory objectives in terms of solvency was mostly achieved in 2013 and 2014 through a reduction in risk-weighted

Chart 26 • Change in the credit portfolio by segment



Source: Banco de Portugal.
Note: Information from Instruction No 22/2011 of Banco de Portugal

assets. As such, improvements in the economy's financing conditions by the banking sector may partly depend and the issuance of instruments in capital markets by banks.

> The share of customer deposits in the banking sector's financing continued to increase in 2014, while recourse to Eurosystem financing continued to decline

The banking sector's financing structure has changed over the past few years, as a result of the sector's adjustment process. Amid a restructuring in the composition and size of balance sheets, the banking system's assets have been increasingly financed by more stable sources.

At the end of 2014 customer resources corresponded to 58.7 per cent of the banking sector's liabilities, which compares to 43.4 per cent in 2010 (Chart 29). Throughout the year, deposits held in Portugal increased markedly, by approximately €4.8 billion (Chart 30). This was essentially due to an increase in deposits by the non-financial private sector, with the balance of household deposits reaching historical high levels. In fact, the resilient behaviour of household deposits is one of the most

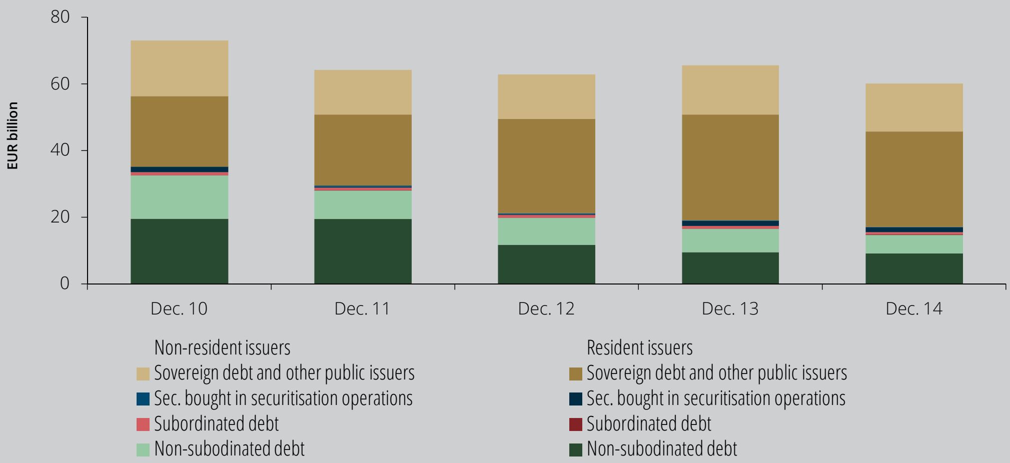


Chart 27 • Debt securities portfolio

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

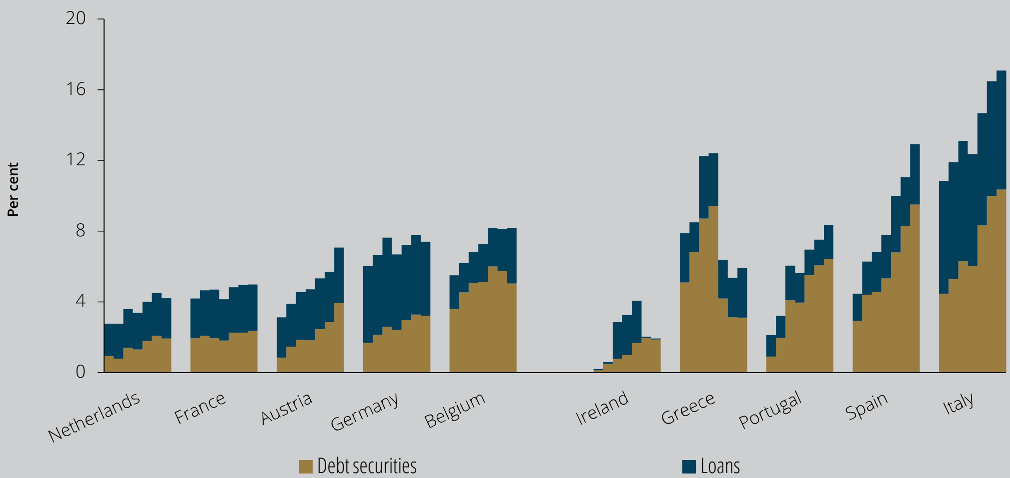


Chart 28 • Developments in the exposure to the domestic sovereign | As a percentage of total assets (2008-2014)

Source: Banco de Portugal and European Central Bank.
Notes: Exposure measured as the holdings of debt securities issued and loans granted to general government by the aggregate of resident banks, on individual basis.

relevant aspects of the adjustment process in the Portuguese economy and banking sector.

In this context, the loan-to-deposits ratio continued to decline, standing at 107 per cent at the end of 2014 (Chart 31). Similarly, the commercial gap (defined as the difference between credit and deposits) decreased from €133 billion in 2010 to €18 billion in 2014. This development was mainly due to a reduction in net credit to customers, even when taking into account the effects of the above mentioned asset reclassification.

Resources from central banks, namely from the Eurosystem, continued to decrease, reaching historical lows since the onset of the sovereign debt crisis in May 2010. In 2014, Eurosystem financing decreased by around €17 billion. This trend continued throughout the first quarter of 2015, with a further decrease of approximately €3 billion. The outstanding amount dropped to €28.2 billion in March 2015, i.e. less than half of the historical peak reached in June 2012. Up to the end of 2014, Eurosystem financing was mostly accounted for by three-year refinancing operations. The decline in the balance of these operations, which was more marked in the second half of 2014 due to early repayments, culminating with the maturity of operations

Chart 29 • Funding structure

Source: Banco de Portugal.

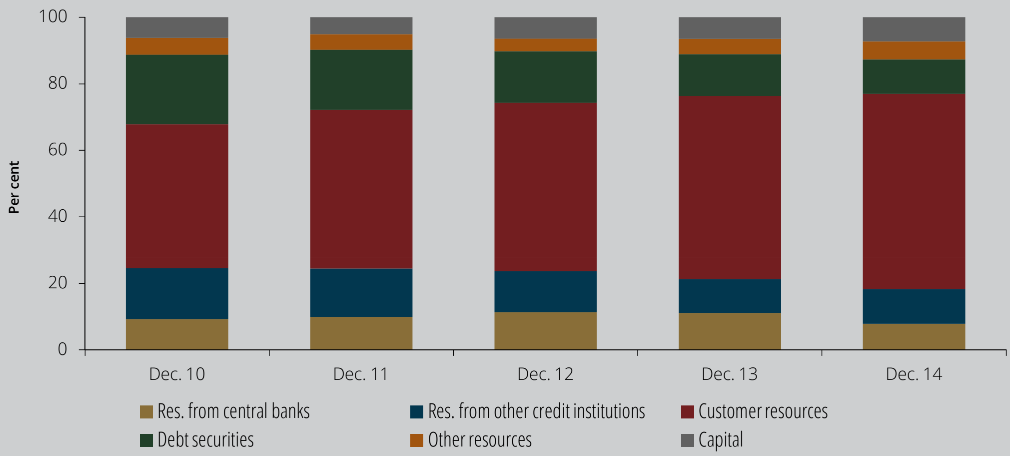
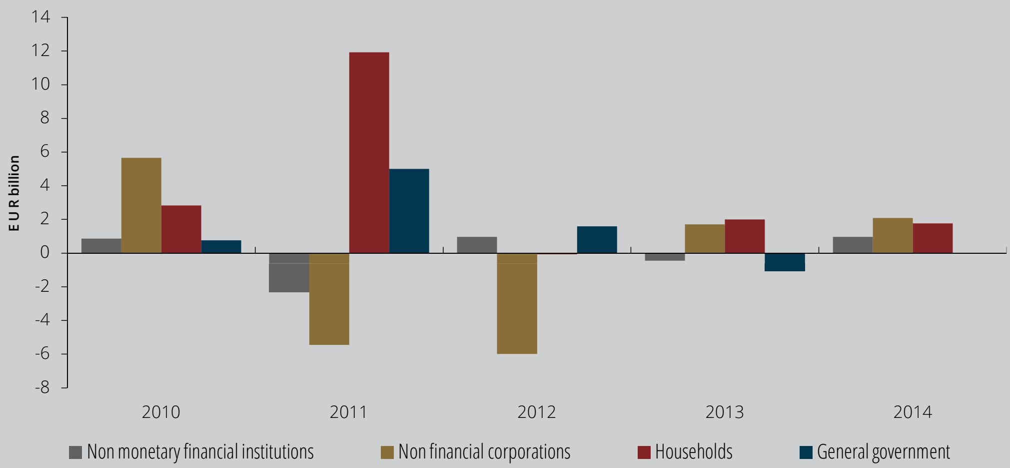


Chart 30 • Deposits taken in Portugal

Source: Banco de Portugal.



during the first quarter of 2015, was partly offset by increases in the balances of other refinancing operations. The increase in the balance of other operations was chiefly due to three-year refinancing operations and the new targeted longer-term refinancing operations, maturing in September 2018 (three of these operations have already been conducted, in September and December 2014 and March 2015). The new asset purchase programmes of the Eurosystem, announced in June 2014 (ABSPP and CBPP3) and January 2015 (PSPP), may have also contributed to a decline in the balance of Eurosystem refinancing operations.

Funding through the issue of debt securities continued to decline in the course of 2014. This seems to have reflected, on the one hand, the persistence of a number of constraints in the access to financial markets, in spite of a reduced fragmentation in wholesale debt markets (Section 1.1). On the other hand, amid an ongoing adjustment in the sector, the trend may also reflect the sector's lower borrowing needs, together with the existence of funding alternatives more favourable in terms of costs.

The results of the *Bank Lending Survey*, released in April 2015, show that most respondents expect the maintenance of the current financing conditions in wholesale debt markets in the short run, particularly for shorter maturities, with expectations reported in January remaining unchanged. With regard to market conditions, two institutions mentioned a slight improvement in their assessment, particularly in the medium to long-term debt securities market; the remaining institutions considered that these conditions remained stable in the first quarter of 2015.

The banking sector's liquidity position, measured by liquidity gaps,[15] has improved significantly since 2012 (Chart 32). This reflects more stable sources of financing for liquid assets and the decrease of maturity mismatches between assets and liabilities, which is in line with liquidity and liabilities' structure requirements established by the new European regulatory framework. Banks' liquidity position has also benefited from standard and non-standard monetary policy measures implemented by the ECB since 2011. The start of the transition period to the liquidity coverage ratio (LCR) envisages, as of the fourth quarter of 2015, the set-up of a liquidity buffer of at least 60 per cent of net liquidity outflows over a 30-day stress period.[16] At the beginning of 2018 a LCR

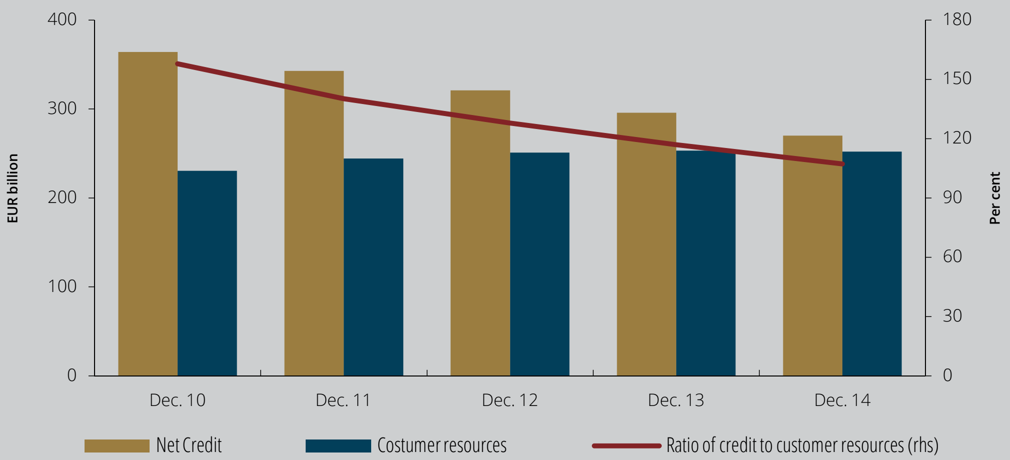


Chart 31 • Loan-to-deposits ratio

Source: Banco de Portugal.

of at least 100% will be required.

In the medium run, it is to be expected that the continued convergence at European level of regulations and prudential supervision processes will contribute to a reduction in financial market fragmentation and make it easier for resident institutions to access the wholesale debt market under adequate conditions.

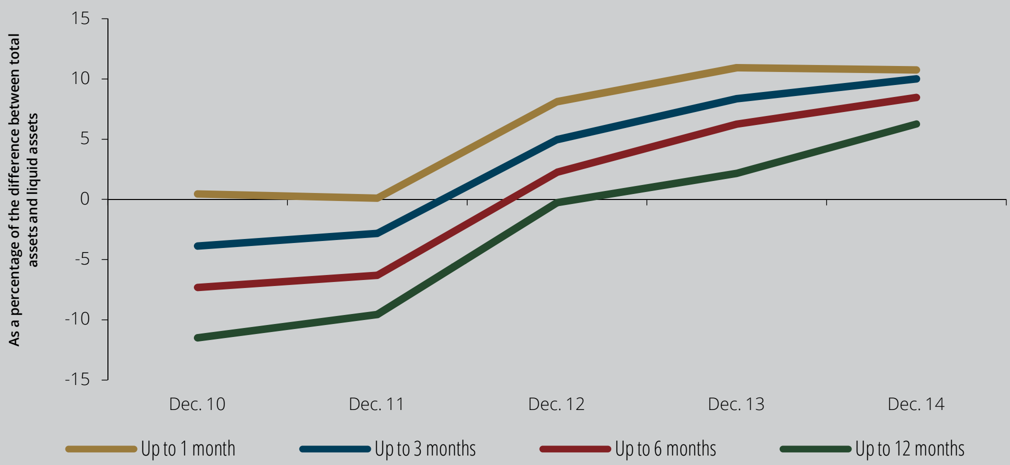
Excluding Banco Espírito Santo's results, the Portuguese banking system's profitability improved in 2014, albeit remaining in negative territory in aggregate terms

As a consequence of developments in Banco Espírito Santo, aggregate profitability of the Portuguese banking system dropped to a historical low in 2014, remaining in negative territory for the fourth year in a row (Chart 33).

Results are somewhat heterogeneous, with a sizeable number of banks reporting negative or close to zero returns. In any case, excluding BES, aggregate losses declined considerably, with relatively widespread improvements from 2013 to 2014 (Chart 34). Smaller banks, which are typically more specialised by type of business (included under the category 'Other'), had a positive performance over the past few years, while the main non-domestic banks posted, on average, less negative returns than large and medium-sized domestic banks (predominant within the aggregate).

International activity results were markedly affected by developments in BES. Excluding this group's branches, the main components in the profit and loss account recorded positive developments, most notably with an increase in net interest income and fees. The landscape of domestic banks' international activity has changed significantly in the recent period. Extraordinary reorganisation measures applied to BES Angola by Banco Central de Angola resulted in a dilution of the shareholder's position of Novo Banco to around 10 per cent. Mention should also be made to Banco BPI, which has been working on a solution to overcome the large exposure limits resulting from the exclusion of Angola from the list of third countries with supervisory and regulatory arrangements equivalent to those of the European Union. Looking

Chart 32 • Liquidity gaps in cumulative maturity ladders



Source: Banco de Portugal.

forward, the importance of international activities will depend on banks' ability to continue to invest in non-domestic operations, which will be conditioned by ongoing challenges at domestic level.

Data for the first quarter of 2015 show that the main Portuguese banks obtained positive net income.

Increases in net interest income and profits from financial operations contributed to an improvement in average profitability of Portuguese banks, amid a still high materialisation of credit risk

In aggregate terms, gross operating income was insufficient to meet impairment losses and other provisions, as has been the case since 2011 (Chart 35). In fact, the flow of impairments increased for a considerable number of

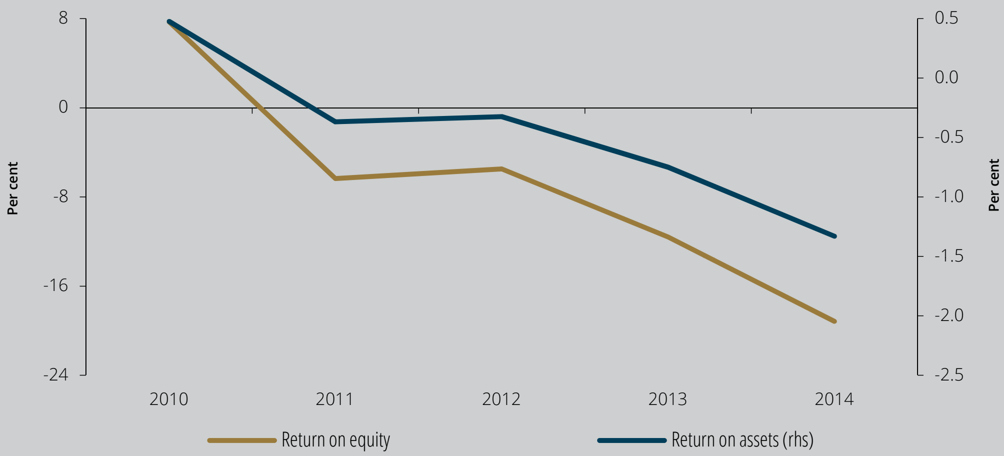


Chart 33 •
ROA and ROE

Source: Banco de Portugal.
Note: Indicator computed considering income before taxes and minority interests.

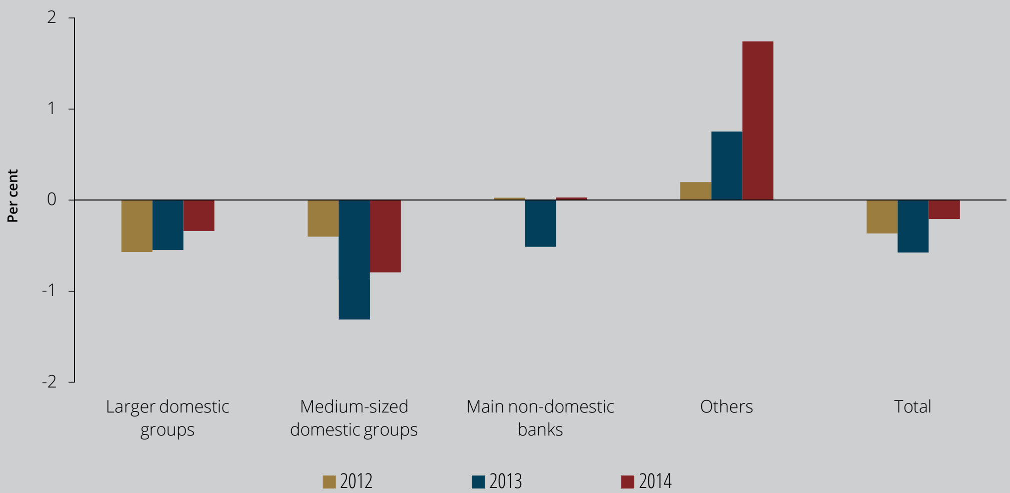


Chart 34 •
ROA distribution – Excluding BES/ Novo Banco

Source: Banco de Portugal.
Notes: Larger domestic groups: BCP, CGD and BPI.
Medium-sized domestic groups: Montepio, Banif, SICAM, Banco BIC and Finantia.
Main non-domestic banks: Santander Totta, BBVA, Popular, Barclays and Deutsche Bank.

institutions (Chart 36). This was due to the combination of the still high materialisation of credit risk and the reinforcement of the coverage ratio of credit at risk (Charts 37 and 38). In this respect, 2014 was marked by a comprehensive assessment of a number of euro area institutions, which followed similar exercises previously conducted by Banco de Portugal. The comprehensive assessment exercise was conducted by the ECB, in cooperation with national competent authorities, and included an asset quality review (AQR), taking 31 December 2013 as reference date. In Portugal, it included Caixa Geral de Depósitos, Banco BPI, Banco Comercial Português and Espírito Santo Financial Group (subsequently, Banco Espírito Santo).[17] In the short to medium run, the materialisation of credit risk is likely to decrease, consistent with lagged developments in this variable in relation to economic activity.

Developments in net interest income made a positive contribution to changes in profitability, with most institutions following a favourable path throughout the year. The positive dynamics of net interest income is chiefly associated with a gradual reduction in the average cost of deposits. In terms of domestic activities, these developments have benefited from a marked decrease in interest rates on new operations and the expiry of operations contracted in 2011 and 2012, with a maturity of over two years and particularly high returns. At the end of 2014 the average interest rate on new deposits of the non-financial private sector (non-financial corporations and households) dropped to a historical low, in nominal terms, standing below 1 per cent. In turn, the interest rate on outstanding amounts amounted to 1.4 per cent, implying the existence of some potential for an improvement in net interest income through a decrease in the average cost of deposits.

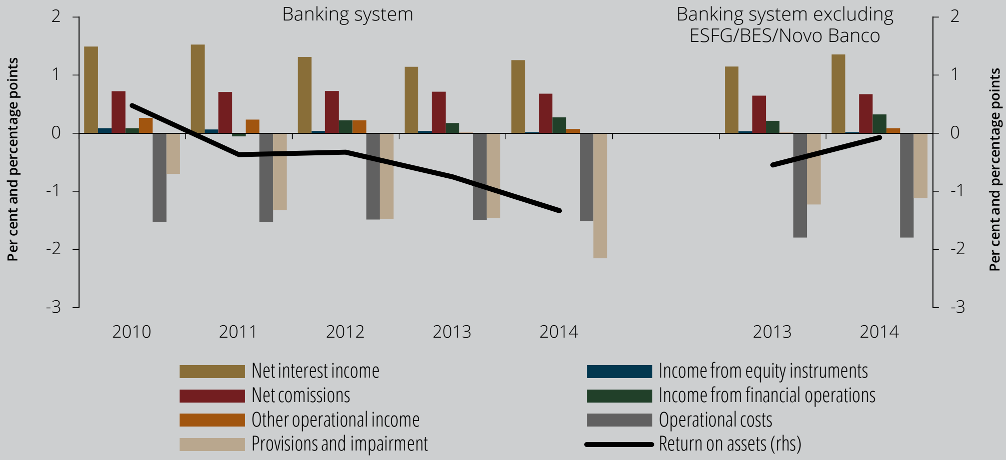
The implied cost of the remaining sources of financing also declined somewhat, namely as regards Eurosystem financing – as a consequence of a cut in the interest rate on the ECB's main refinancing operations –, resources from other credit institutions, non-subordinated debt securities and subordinated liabilities. In the case of subordinated liabilities, the reduction reflects the amortisation of a considerable amount of hybrid instruments acquired by the Portuguese State in the context of recapitalisation operations with recourse to public investment, which bear high costs compared with the remaining subordinated financing instruments.

Against a background of lower money market interest rates and less fragmented financial markets, interest rates on assets recorded negligible changes. Interest rates on credit remained stable (with a slight reduction in rates on domestic operations and an increase in non-domestic operations) and a reduction in the remaining asset classes (most notably, sovereign debt securities).

The interest rate on outstanding amounts of loans to the resident non-financial private sector continued to follow a gradual downward path, particularly in the non-financial corporations' segment. In spite of the challenge faced by banks in terms of a recovery in profitability – where net interest income is one of the main determinants –, the spread associated with new operations has been decreasing, particularly for less risky enterprises, as mentioned in the analysis of the financial position of non-financial sectors (Section 1.2).[18]

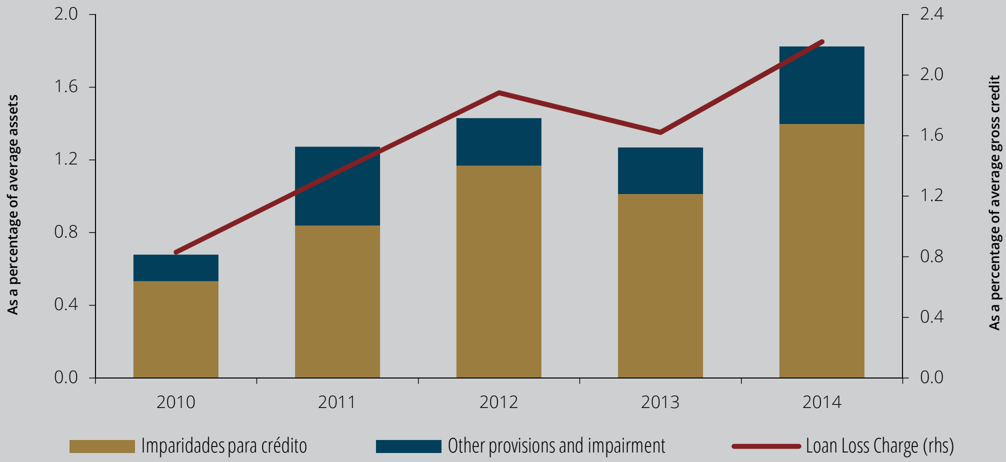
Overall, the price effect on operations with customers was positive. Chart 39 shows developments in the net interest margin on loans, *vis-à-vis* the average cost of deposits – including time deposits and demand deposits –, in operations with enterprises and households. The net interest margin has gradually improved in the various segments since early 2013. Nevertheless, the profitability problem associated with the housing loan portfolio is still rather marked, given that these loans are linked to the Euribor rate and spreads are fixed and, as a rule, low.[19] Given that these loans have been contracted at long maturities, the situation becomes structural. Indeed, albeit a sizeable increase in spreads on new loans – compared with the values seen

Chart 35 • ROA decomposition



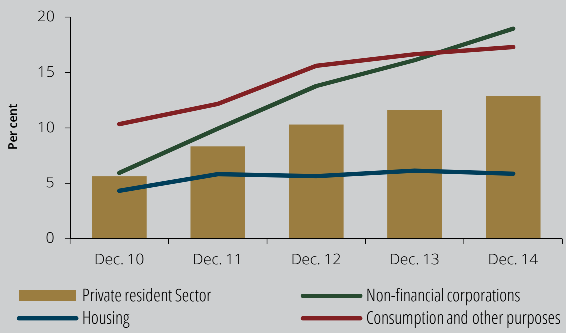
Source: Banco de Portugal.
Note: Return on assets computed considering income before taxes and minority interests.

Chart 36 • Impairment flow and loan loss charge



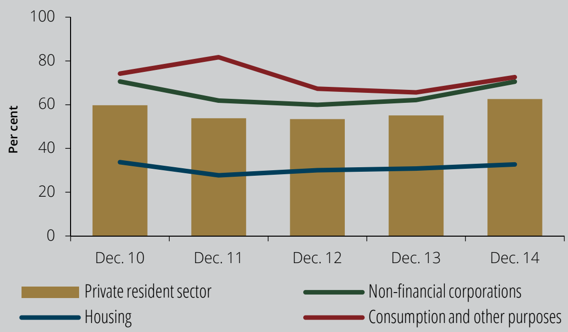
Source: Banco de Portugal.
Note: The loan loss charge corresponds to credit impairments divided by average gross credit.

Chart 37 • Credit at risk by segment



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

Chart 38 • Credit at risk coverage ratio by segment

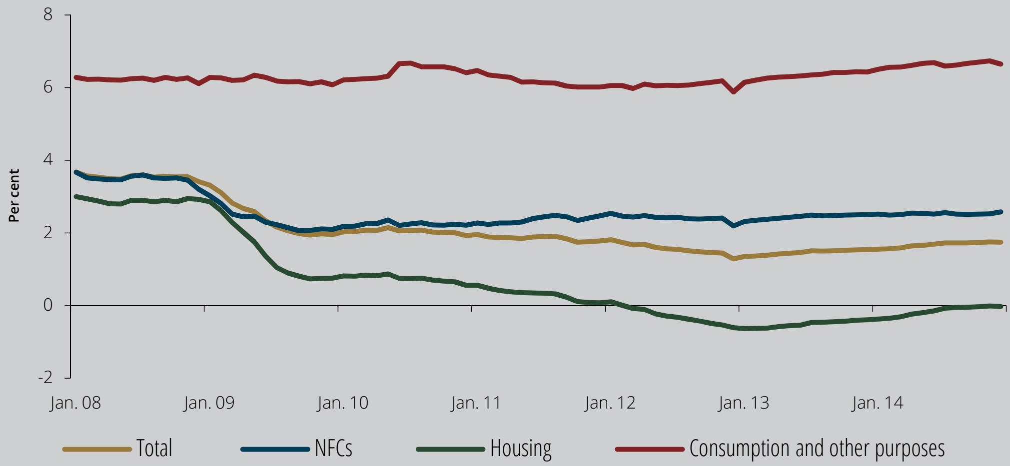


Source: Banco de Portugal.
Note: According to Instruction of Banco de Portugal No. 22/2011.

before the onset of the financial crisis in 2008 – the fact that the volume of new operations remains low means that the change in the portfolio interest rate is more a result of maturing contracts than of new operations. In fact, there was even a reduction in the average interest rate on the outstanding amounts of housing loans over the past few years. In aggregate terms, the housing loan portfolio margin is virtually nil, although positive for banks with lower financing costs. In this context, the dynamics of the overall net interest margin on operations with customers has been essentially determined by loans to non-financial corporations, a segment characterised by shorter maturities, followed by loans to households for consumption and other purposes (Chart 40).

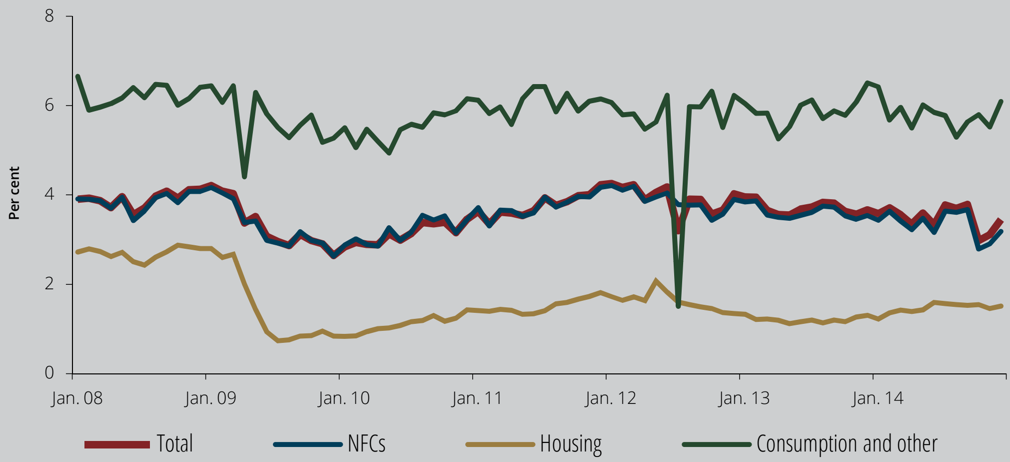
Income from financial operations accounted for 12 per cent of gross income in 2014, chiefly associated with gains on the trading of sovereign debt securities (mostly Portuguese debt). This was rather high in historical terms, which means its magnitude should not remain sustainable in the future, given the already muted yields. In any case, the substantial volume of government debt securities included in banks' portfolios, which are likely to comprise latent capital gains, may make it possible for banks to post gains with relevant financial operations in the short run, benefiting in particular from the ECB's expanded asset purchase programme.

Chart 39 • Net interest margin on operations with resident customers



Source: Banco de Portugal. Note: Average interest rate on loans balance minus the average cost of deposits balance.

Chart 40 • Net interest margin on new operations with resident customers



Source: Banco de Portugal. Note: Average interest rate on new loans minus average cost of deposits balance.

Banks have tried to adjust their operational costs to the ongoing deleveraging process, but these efforts must be maintained

Operational costs remained on a downward trend in 2014, as a result of a reduction of approximately 7 per cent of staff costs. The decline in general administrative costs has been less marked (3 per cent).

Given the current and foreseeable constraints to activity developments and the generation of profitability, banks have sought operational efficiency improvements and cost structure optimisation. Due to this trend, as a percentage of assets, operational costs remained relatively stable. Nevertheless, efficiency developments in banks, measured by the cost-to-income ratio, deteriorated markedly over the past few years, following a decline in net income. Up to 2012 the Portuguese banking system did not stand out in negative terms at international level (Charts 41 and 42).

Developments in the number of branches and banking employees evidence that most banks have already launched downsizing processes. Between the end of 2010 and the end of 2014, resident banks reduced the number of branches by around 15 per cent. This reduction was, naturally, higher in more populated and/or more densely populated districts, while a number of inland districts posted less marked reductions, of approximately 5 per cent. Among banking groups developments are relatively heterogeneous, with more substantial declines in the case of some medium-sized non-domestic banks and reductions of 10 to 20 per cent in the case of larger banking groups. With regard to banking employees, and for the same period, the decline was slightly smaller – of around 13 per cent –, with greater heterogeneity amongst banks. This trend should remain in the medium run, albeit less markedly, according to the intentions announced by some of the main Portuguese banks.

Population per local branch and population per banking employee are two of the main indicators of the banking system's installed capacity. An analysis carried out by the ECB places Portugal, as at December 2013, amongst the countries with the highest installed capacity as regards the number of branches, behind Spain and Cyprus.[20] In turn, as regards the number of employees, the Portuguese banking system has a lower installed capacity than the euro area average. Furthermore, in 2012 Portugal was the euro area country with the highest number of Automated Teller Machines (ATMs) per inhabitant.

Efficiency in the banking sector is a particularly complex subject. Differences across countries may have underlying structural factors related to business models, preferences with respect to the provision of banking services, or even population density and/or polarisation. Furthermore, cost adjustment processes are generally slow, due to the rigidity typically associated with staff costs, rents and other overheads. There are also reputational issues, associated with the closing up of branches and downsizing, strategies to defend the market share and competitive relationships where the surviving party in a given market/geographical area reaps the benefits from keeping present. However, in the case of Portugal, this process must continue, and institutions must adapt to changes in banking business models.

Solvency levels remained relatively stable throughout 2014

The regular analysis on own funds is conditioned by structural breaks, related to the beginning of the transition period to the new prudential regime.

With the entry into force of Regulation (EU) No 575/2013 of the European Parliament and of the Council (or Capital Requirements Regulation – CRR) on 1 January 2014, the regulatory minimum of 8 per cent prevailing up to that date was maintained for the total capital ratio, while a regulatory minimum of 4.5 per cent was established for the Common Equity Tier 1 capital ratio and a regulatory minimum of 6 per cent for the Tier 1 capital ratio, which had not been envisaged in the previous regulations.

The implementation of the CRR was followed by the entry into force of Notice of Banco de Portugal No 6/2013, which set out rules for the preservation of banks' own funds. More specifically, this Notice established that credit institutions should permanently maintain a minimum CET 1 ratio of 7 per cent and, at the same time, abstain from conducting operations that result in a substantial reduction in the nominal value of one or more components of their own funds before providing proof of full compliance with provisions established in the CRR and the CRD IV, i.e. as they will apply following expiry of transitional arrangements.

With the entry into force of Decree-Law No 157/2014, which transposed into national law the CRD IV on 23 November 2014, the provision that established a minimum CET 1 ratio of 7 per cent was tacitly repealed, but the rule on the preservation of own funds that limits the conduct of operations that may result in a substantial reduction in the nominal value of own funds was maintained.

Supervisory authorities may establish additional capital requirements applicable to credit institutions, within the framework of the so-called Pillar 2 measures, with the purpose of coping with activity risks that these authorities

Chart 41 • *Cost-to-income* ratio

Source: Banco de Portugal and European Central Bank (Consolidated Banking Data). Note: Annual data (2008-2013).

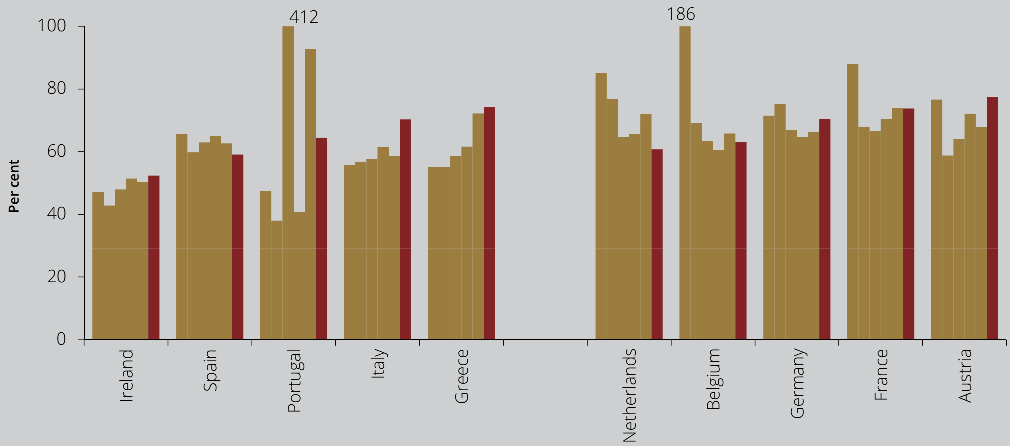
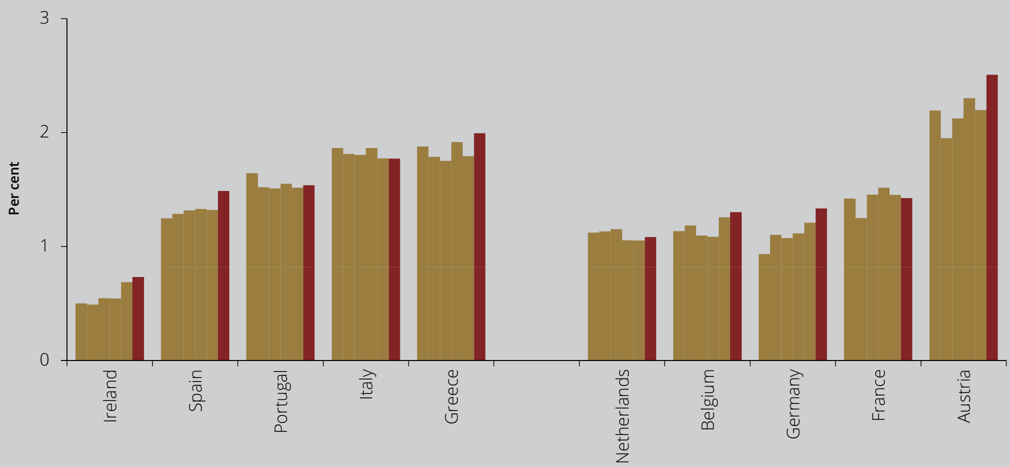


Chart 42 • Operational costs to total assets

Source: Banco de Portugal and European Central Bank (Consolidated Banking Data). Note: Annual data (2008-2013).



consider not to be fully covered by the remaining capital requirements applicable to such institutions. In early 2015 the ECB established Pillar 2 requirements for institutions under direct supervision of the Single Supervisory Mechanism.

In addition to these regulatory minimums, national macro-prudential authorities may also establish or bring forward the application of additional capital reserves, in line with provisions under European law, namely the capital conservation buffer, the countercyclical capital buffer, the systemic risk buffer and the capital buffer for systemically important institutions (as of 1 January 2016).

At the end of 2014 the CET 1 ratio for the banking system as a whole stood at 11.3 per cent (Chart 43). The intra-annual profile was very influenced by the capital position of ESFG/BES/Novo Banco, with a decline in the CET 1 ratio in June and a marked improvement in September, following the application of the resolution measure. The decrease in risk-weighted assets contributed to an improvement in the CET 1 ratio in all quarters of 2014, amid continued deleveraging in banks' balance sheets and, to a lesser extent, a decrease in the assets' average risk-weight (Chart 44). In turn, in the year as a whole the numerator made a negative contribution, reflecting the still negative profitability levels. The significant deterioration in the last quarter of the year, in addition to the recorded losses, also reflects the revision of actuarial assumptions of the main banking institutions' pension funds. This negative impact mainly resulted from an update to the discount rate of future liabilities – in most cases, from 4.0 to 2.5 per cent – that was only partly offset by a reduction in estimates about growth rates in pensions and wages. The net effect on the CET 1 ratio exceeded 1 percentage point in the case of some of the main Portuguese banks.

Up to the full implementation of the CRD IV/CRR in 2018, a series of transitional arrangements (which currently make a positive contribution to the CET 1 ratio) will be gradually eliminated. This fact puts solvency levels of Portuguese banks under a downward pressure over the next few years (differently across banks).

In this context, in line with the ECB recommendation on dividend distribution policies (ECB/2015/2), Banco de Portugal has promoted among supervised institutions a set of prudent management practices aimed at the maintenance of sound capital adequacy levels.

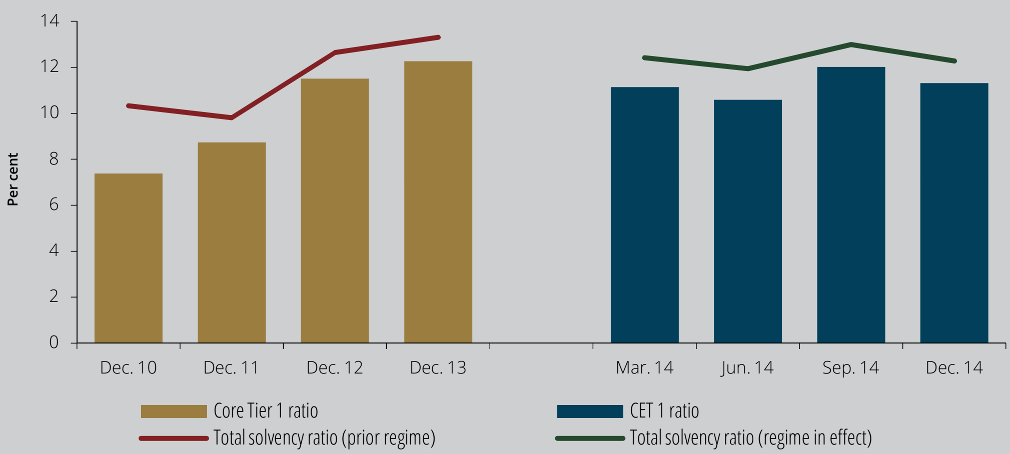


Chart 43 • Capital adequacy ratios

Source: Banco de Portugal.
Notes: The data present a break in time series in December 2013 due to, in a first phase and with transitory character, the entry into force of Notice of Banco de Portugal No 6/2013 and, in a second phase, from the transposition of the Directive 2013/36/UE (or CRD IV - Capital Requirements Directive) to the Portuguese legal framework. An estimate with recourse to data for the eight major banking groups, with reference to December 2013, points to a 1 p.p. differential between the Core Tier 1 ratio and the CET 1 ratio attributable to methodological differences. This differential applies also to total solvency ratios.

The new regulatory framework also comprises the definition of a leverage ratio that became of mandatory disclosure by credit institutions and investment firms on 1 January 2015. This ratio is a measure that does not vary depending on risk, is more comprehensive in terms of exposures taken under account, and is calculated using a simpler and more transparent method. The final calibration of the ratio should be made in 2017, which may become a regulatory requirement in 2018.

1.3.2. Insurance sector

> In 2014 asset developments in the insurance sector reflected growth of direct insurance premiums, which increased at a more moderate pace than in 2013

In 2014 the asset portfolio associated with life business liabilities increased by 6 per cent. These developments are in line with the increase in technical provisions, and therefore the coverage ratio remained stable (Chart 45).

This behaviour was associated with the performance of insurance premiums, which rose by 14 per cent in 2014 (Chart 46). Life business gross written premiums continued to represent around 76 per cent of total direct insurance premiums.

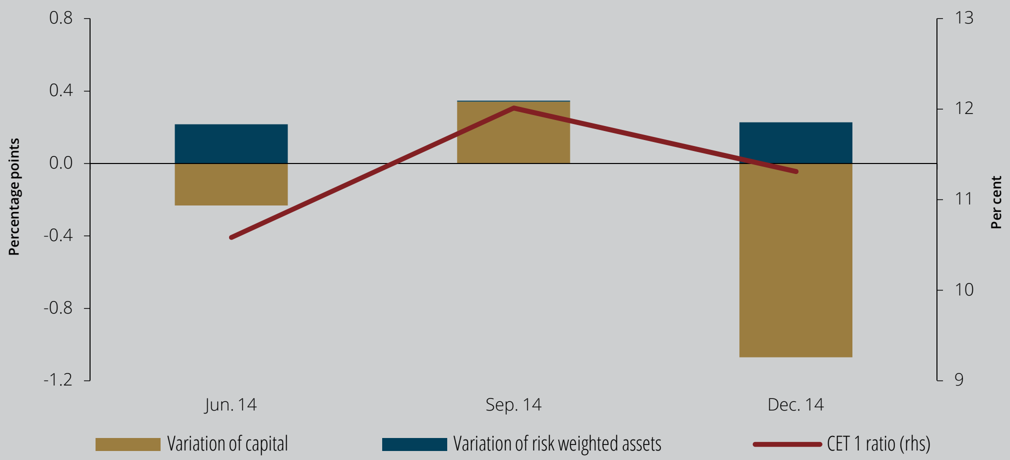
In turn, life insurance claims rose by 7 per cent, with a strong increase observed in the second semester. These developments have largely reflected transfers among insurance operators, with one of the largest insurance corporations registering significant surrenders.

With regards to the composition of the asset portfolio allocated to life business technical provisions, there were no significant changes from the end of 2013. Investments in public and private debt securities represented approximately 75 per cent of the investment portfolio, while exposure to public debt continued to increase to the detriment of private debt. Equity and investment funds saw a marginal increase, its share in the respective asset portfolio rose from 11 percentage points at the end of 2013 to 13 percentage points at the end of 2014.

We should note that, in the insurance sector, a high concentration in debt securities cannot be decoupled from the management of liabilities' risks, due either to the maturity of the debt securities available in the market, or to the coverage of interest rate or inflation risk provided by those instruments.

Chart 44 • Contributions to the change of CET 1 ratio of 7 large banking groups

Source: Banco de Portugal. Note: Excludes BES/Novo Banco.



Assets allocated to technical provisions in non-life business declined slightly in 2014. However, this movement was followed by a sharper decrease in technical provisions, which explains the improvement in the coverage ratio (Chart 47).

Non-life business production remained broadly stable in 2014, as health insurance and work accidents insurance increased and motor insurance declined (Chart 48). The changes observed, however, did not affect the non-life business portfolio structure. In 2014 loss ratio declined by 2 percentage points, standing at 68 per cent at the end of the year. This was associated with a fall in claims of approximately 3 per cent from the end of 2013 (largely explained by the decline in claims in the fire and other damage to property segment in 2014).

The domestic macroeconomic framework continued to put pressure on non-life business gross written premiums, negatively spilling over to the insurable capital or values and to the average premium rates applied, due to market competition. In this context, the Autoridade de Supervisão de Seguros e Fundos de Pensões (ASF, the Insurance and Pension Funds Supervisory Authority) has shown some concern regarding technical results in motor insurance and work accidents insurance, and has issued recommendations intended to help the latter return to balance.

With respect to the portfolio composition of assets allocated to technical provisions in non-life business, there was a significant increase in exposure to shares, whose relative weight rose from 5 per cent at the end of 2013 to approximately 14 per cent at the end of 2014. On the other hand, deposits and other highly liquid assets had the most significant reduction in terms of relative importance to the asset portfolio. Investments in public and private debt securities remained relatively stable, representing around 25 and 32 per cent of the portfolio at the year end, respectively.

Albeit positive, profit of insurance sector declined significantly in 2014; the solvency ratio[21] remains in comfortable levels

Insurance corporations continued to post a profit in 2014, in spite of a significant drop from 2013, on account of the extraordinary results observed in that year, due to the sale of an insurance portfolio by an operator.[22]

The developments in the profitability of the insurance sector can be explained by the weak non-life business technical account, the deterioration of life business technical account and the rigidity of operating costs. Nevertheless, the insurance sector solvency ratio increased by 2 percentage points compared with the end of 2013, reaching 212 per cent in 2014.

This aggregate change is the result, in particular, of the improvement in the solvency ratio of life and composite insurance corporations. In turn, the solvency ratio of non-life insurance corporations declined by around 43 percentage points in 2014.[23]

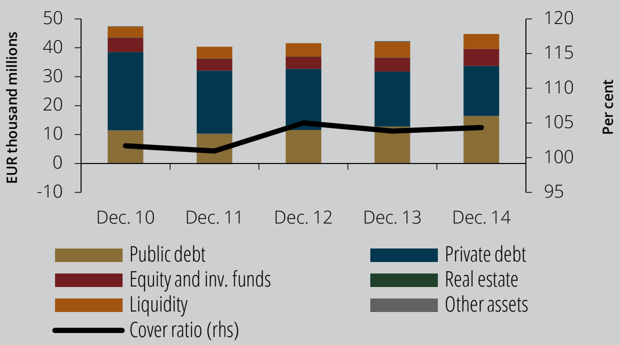
Insurance sector continues under stress by the low interest rate environment and the necessary adjustment to Solvency II implementation[24]

The current interest rate level puts pressure on insurance corporations' profitability, as their revenue depends on financial return generated, which is more relevant in life business products.

An extended low interest rate environment aggravates reinvestment risk, and may encourage search-for-yield behaviour. This will be particularly important in life business, depending on whether responsibilities with long maturities have embedded capital or interest-rate guarantees. In addition, the implementation of the Solvency II framework, combined with an increase of the exposure to assets with longer maturity or higher risk (due to search-for-yield behaviour), may have significant impact on the balance sheets and solvency levels of insurance corporations, in the event of a potential reversal of current market conditions.

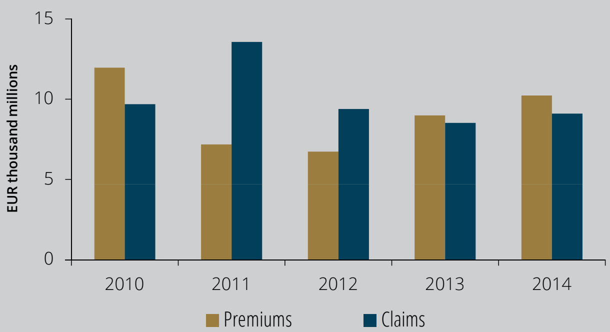
Regarding the financial sector in Europe, the implementation of a wide and complex set of new regulations – especially CRD IV/CRR, BRRD, MiFID and Solvency II – will tend to spill over into prices and specifications of available assets in the market, raising new challenges to the management of liabilities taken up. Solvency II, in particular, will require insurance corporations to adopt risk-oriented management principles, to adjust the organisational structure, and to meet new requirements in terms of disclosure of information. It should be noted that these requirements must be implemented during a relatively short period, and, for that reason, will be particularly challenging, especially at operational level (Box 2).

Chart 45 • Direct life business: investment portfolio and cover ratio



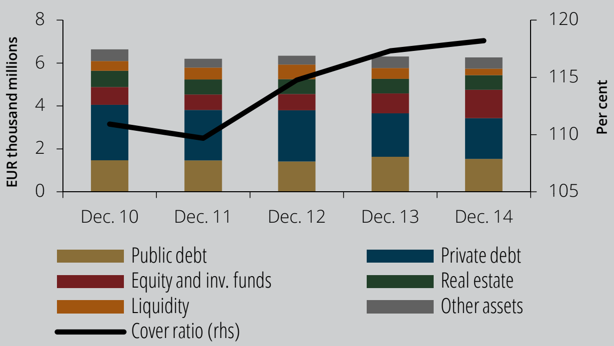
Source: Autoridade de Supervisão de Seguros e Fundos de Pensões.

Chart 46 • Direct life business: gross written premiums and claims



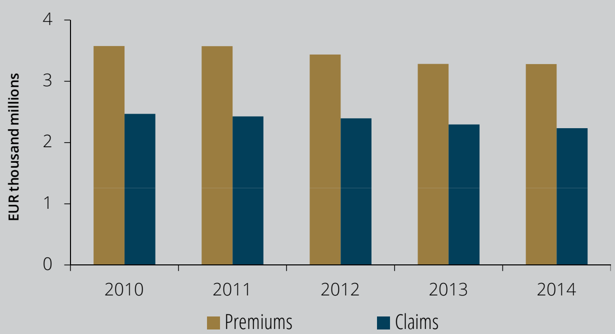
Source: Autoridade de Supervisão de Seguros e Fundos de Pensões.

Chart 47 • Direct non-life business: investment portfolio and cover ratio



Source: Autoridade de Supervisão de Seguros e Fundos de Pensões.

Chart 48 • Direct non-life business: gross written premiums and claims



Source: Autoridade de Supervisão de Seguros e Fundos de Pensões.

1.3.3. Pension Funds

> Pension funds value maintained an upward trend in 2014, due to the sharp growth of contributions in the second half of the year

At the end of 2014, the amount of pension funds' assets under management attained €17 billion, representing a 13 per cent change from the end of 2013 (Chart 49).

This positive change in the value of pension funds was explained mainly by the contributions made to these savings vehicles, although they have also benefitted from the positive revaluation of portfolio assets.

The allocation structure of the pension funds value by type of fund remained stable in 2014, with closed pension funds representing around 90 per cent of the total, chiefly financing defined benefit plans.

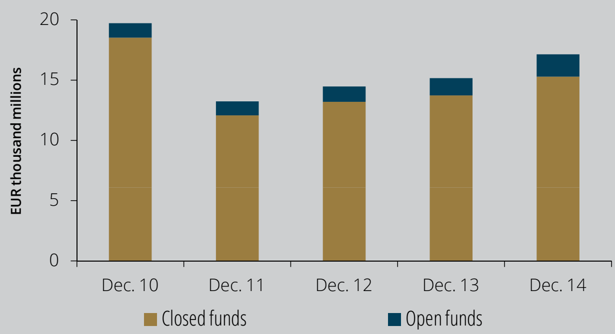
The value accumulated in closed pension funds rose by 11 per cent from December 2013. In addition to increased contributions, this movement reflected the valuation of portfolio assets, which justified 6 per cent of the change observed in 2014 (Chart 50). Benefits paid by closed pension funds remained stable.

The amount of contributions paid to closed pension funds doubled from 2013, due to changes in the assumptions used in the assessment of liabilities related to defined benefit plans. This adjustment led to a rise in pensions' liabilities at the end of 2014, and is therefore behind the mentioned increase in contributions observed in the second half of the year.

The sharp decline in market interest rates for high-quality assets accounted for the change in the actuarial assumptions related to the discount rate (implied in the valuation of future liabilities, as set out in IAS 19). This trend was observed in most pension funds sponsored by banks, as mentioned in section 1.3.1 of this report, for which this rate declined by more than 100 basis points in 2014 (on average).

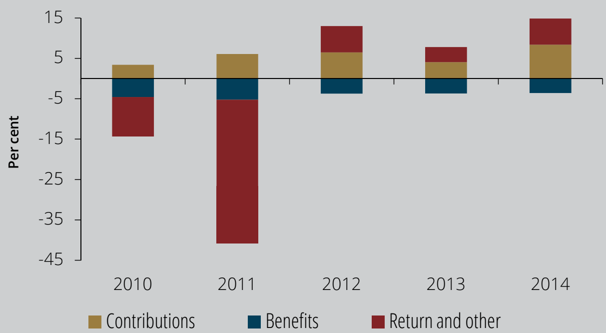
However, the impact of the discount rate change on pension funds' liabilities may have been partly accommodated by a downward revision of the inflation rate implied both in salary or pension growth rate assumptions. Nevertheless, the sponsors of these pension plans have paid extraordinary contributions with a view to preserving financing levels.

Chart 49 • Pension funds: assets under management



Source: Autoridade de Supervisão de Seguros e Fundos de Pensões.

Chart 50 • Closed pension funds: contributions to value change



Source: Autoridade de Supervisão de Seguros e Fundos de Pensões.

In 2014 open pension funds grew, in aggregate terms, by 30 per cent. In 2014 contributions more than tripled when compared with 2013, particularly due to the rise in contributions associated with individual membership of other open funds and PPR-type funds (retirement-savings' plans). Given that such contributions are paid by households, the development of these funds must continue to be monitored, in order to conclude on the (non-)extraordinary nature of this movement (Chart 51). The amount of benefits paid by open pension funds, expressed as a percentage of the funds' value, did not change significantly from the previous year.

In aggregate terms, including open and closed funds, the composition of the pension fund portfolio remained stable in 2014 (Chart 52). Similarly to the previous year, there was an increase in the relative weight of public debt securities (mostly foreign) and more liquid assets (including bank deposits). In turn, the relative weight of shares and investment funds and exposure to real estate saw a decline.

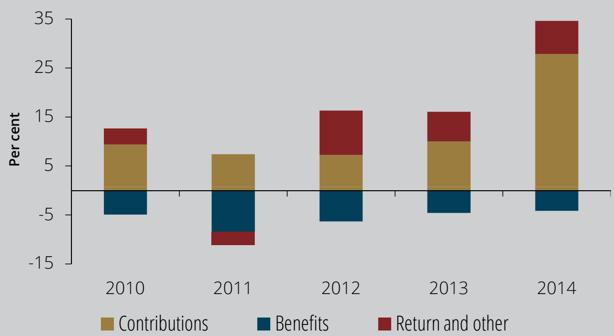
The extension of an environment of low interest rates may act as a disincentive to savings and to financing retirement benefits through capitalisation systems

The low interest rate environment is the main challenge to growth of the pension fund sector, due to the nature of its activity.

Pension funds ensure the coverage of retirement benefits through the capitalisation of regular payments to these savings vehicles. In addition, they ensure the coverage of the longevity risk by guaranteeing direct settlement of lifetime annuities. The investment risk of contributions received by pension funds is incurred by the sponsors, scheme members, or both, in the case of a defined contribution plan, defined benefit plan, or hybrid plan respectively.

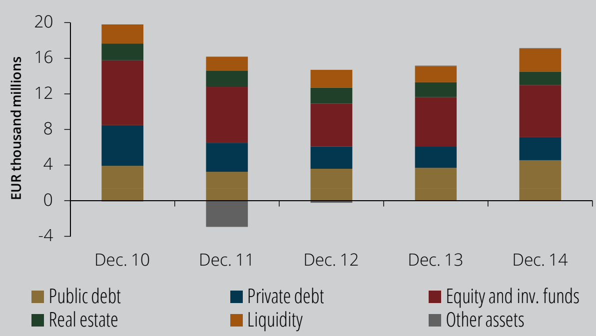
In the case of older pension funds, the extension of an environment of low interest rates spills over into a potential fall in future benefits and/or an increase in the plan's financing costs for sponsors and/or scheme members. This second option is naturally limited by the current indebtedness level of households and non-financial corporations. In parallel, it may

Chart 51 • Open pension funds: contributions to value change



Source: Autoridade de Supervisão de Seguros e Fundos de Pensões.

Chart 52 • Pension funds: assets composition



Source: Autoridade de Supervisão de Seguros e Fundos de Pensões.

create incentives to a change in the risk profile of the funds, with a view to obtaining higher yield, and may increase the volatility of the benefits and/or financing burden.

The current macro-financial context, with low economic growth rates and low interest rates, combined with the need to report pension liabilities in line with *IAS* 19, have been changing the employers behaviour towards assuming long-term liabilities. Some defined-benefit plans have been closed or changed into defined contribution plans. This trend, however, has not been accompanied, in number or value, by an expansion of defined contribution plans.

A possible reduction in the pace of accumulated savings in pension funds may have negative consequences: at the individual level, on the income available in the post-active period, which is particularly critical when an increase is anticipated in longevity and, as a result, a rise in health expenses is expected; at society level, given that it may jeopardise the development of the second Social Security pillar, based on additional pension plans that contribute to the accumulation of capital to long-term financing of the economy.

The sharp decline in interest rates has given rise to a broad debate on the need to introduce more flexibility and adjustments to the decumulation phase of mature pension funds. This debate is strengthened by the extension of the benefit payment beyond the time span embedded in the valuation of pensions' liabilities.

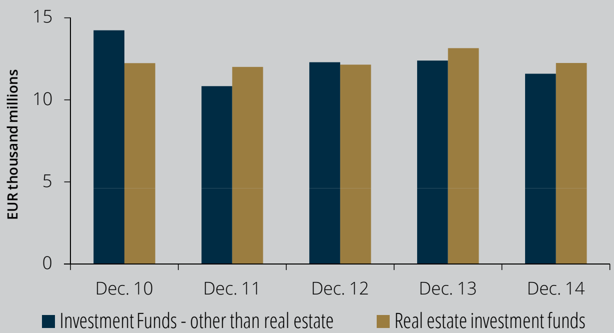
1.3.4. Investment Funds

The net value of mutual and real-estate funds' assets under management declined in 2014, countering the trend observed since December 2011

The net value of investment funds' assets under management[25] declined by 7 per cent in 2014, passing through the negative developments in both the mutual and real-estate funds, although they have had different dynamics over the year (Chart 53).

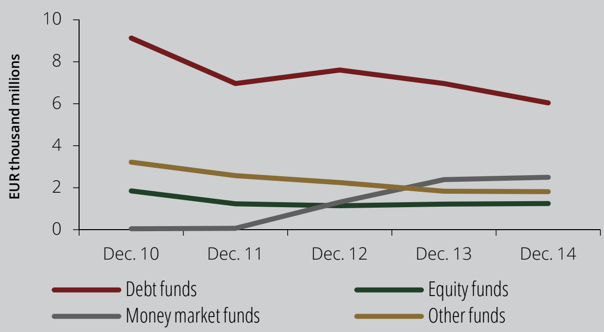
Mutual investment funds increased up to the end of the first semester, due to the rise in investments and the valuation of assets under management. The increase in redemptions in the third quarter of 2014, however, was behind the annual decline in the net value of assets under management, of around 7 per cent. This development was also due to the

Chart 53 • Investment funds: net assets under management



Source: Banco de Portugal.

Chart 54 • Mutual funds: net assets under management by type of fund



Source: Banco de Portugal.

expressive increase in redemptions in mutual funds managed by Espírito Santo Fundos de Investimento Mobiliário (ESAF), in the same quarter.

Developments in mutual investment funds continue to be chiefly due to the behaviour of bond funds,[26] which, at the end of 2014, represented approximately 52 per cent of the net value of mutual fund's assets under management (56 per cent at the end of 2013). This development contrasts with the behaviour of the other types of mutual investment funds, which remained stable or had small positive changes in 2014 (Chart 54).

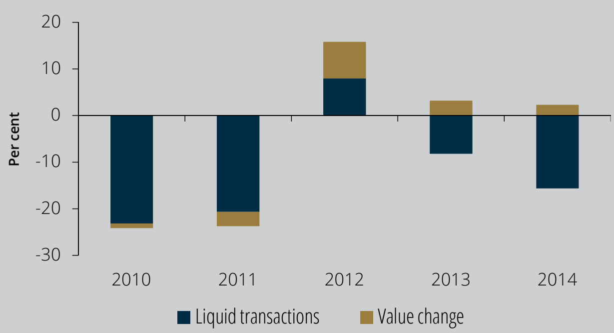
The decline in the value of bond funds was due to redemptions, mainly by households, while a positive valuation effect was also observed in 2014 (Chart 55). Moreover, there were no significant changes in the structure of these asset holders: households continue to hold around 79 per cent of these funds, while insurance corporations and pension funds hold only 5 per cent, similar to the percentage held by banks at the end of 2014.

In 2014 the decrease in the net value of bond funds' assets under management reflected a decline of 22 per cent in debt securities held in portfolio. Simultaneously, there was an increase in the exposure of deposits and shares, which, at the end of 2014, represented around 20 and 14 per cent of net assets under management (3 and 5 percentage point increases respectively).

In aggregate terms, the amount of debt securities in the mutual funds portfolio declined by 24 per cent from 2013 to 2014, which was chiefly due to a decrease in the exposure to private debt securities (domestic and foreign). Regarding public debt securities, the exposure to securities issued by the Portuguese general government declined also, albeit less markedly, while securities issued by other European Union Member States increased.

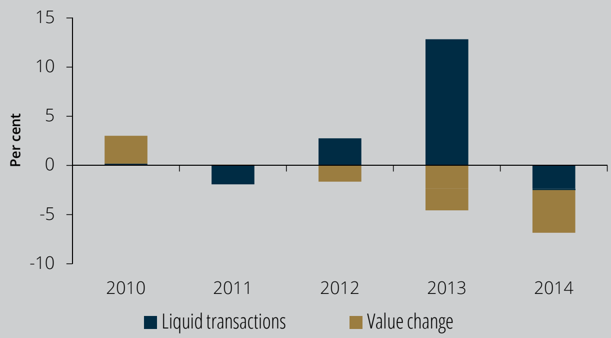
Real-estate investment funds had a downward trend in the course of 2014, more marked in the second half of the year, with an annual decline of 7 per cent. The decrease in the net value of assets under management of real-estate investment funds is explained by the devaluation of property assets held in portfolio (as in recent years) and the negative net transactions observed in 2014, which correspond to the redemption of savings invested in this type of funds, especially by households (Chart 56).

Chart 55 • Bond funds: contributions to value change



Source: Banco de Portugal.

Chart 56 • Real estate investment funds: contributions to value change



Source: Banco de Portugal.

Similarly to developments observed in previous years, in 2014 banks continued to strengthen their position as holders of real-estate investment funds, and held around 40 per cent of those funds at the end of the year (36 per cent at the end of 2013). In turn, the participation of insurance corporations and pension funds remained stable, representing approximately 23 per cent of these funds.

> The main challenges faced by the sector are associated with existing interlinking in the Portuguese financial system and the current context of low interest rates

Due to their nature and regulatory framework, a range of challenges are associated with the investment fund sector.[27] In the current context, the main challenges, even if differing among the several types of funds, derive from low interest rates environment and strong interconnections within the Portuguese financial system.

On the one hand, the environment of low market interest rates, affecting the profitability offered by these vehicles, may give rise to a change in the risk profile of investments. Therefore, it may favour the acquisition of financial products whose remuneration does not exclusively depend on market interest rates or even non-financial assets. Hence, an appropriate control of the funds' investment policies take on particular importance, as well as an improvement of the regulatory framework applicable to the sector, preserving confidence in financial institutions. It will thus be possible to mitigate risks, increase transparency for the investor and preserve the potential benefit for the financial intermediation function associated with the diversity of financial products.

On the other hand, it is important to highlight the risks arising from interconnections within the Portuguese financial system, where banking groups take on a significant role in collecting savings. By way of example, see the impact of the resolution measure applied to BES regarding the redemption of investment funds held by ESAF. The sale of two large insurance corporations by banking groups may have dampened such interconnections.

Finally, as regards investments in real-estate funds, the units held by households continued to decline while units held by banks increased. This is partly explained by the transfer to these funds of property received in lieu of payment by banks. It is also explained by banks' difficulties in reducing their position in these instruments without giving rise to a decline in the respective value, due to their high exposure to such instruments.

Box 1 • Expanded Asset Purchase Programme

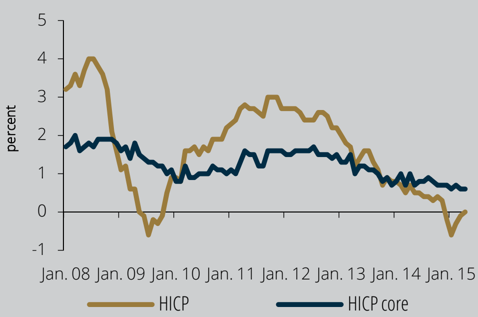
With a broad set of observed and expected inflation indicators showing a downward trend to historical lows (Charts 57 and 58), on 22 January 2015 the Governing Council of the ECB announced an Expanded Asset Purchase Programme (EAPP), with the goal of fulfilling its mandate of price stability.

The EAPP includes the asset-backed securities purchase programme (ABSPP) and the covered bond purchase programme (CBPP3), as well as a new public sector purchase programme (PSPP), which began on 9 March 2015 (Figure 1). The goal is for the total monthly level of asset purchases to reach €60 billion, with purchasing scheduled until September 2016. The schedule may be revised however if the Governing Council of the ECB decides that inflation has achieved a sustained trajectory adjustment, compatible with its goal of rates below but close to 2 per cent over the medium term.

The asset purchasing aims to give a monetary stimulus to the economy, as the key ECB interest rates are at their lowest limit. This aims to loosen monetary and financing conditions, making borrowing more affordable for companies and households, supporting investment and consumption and helping inflation return to levels close to the target set by the ECB.

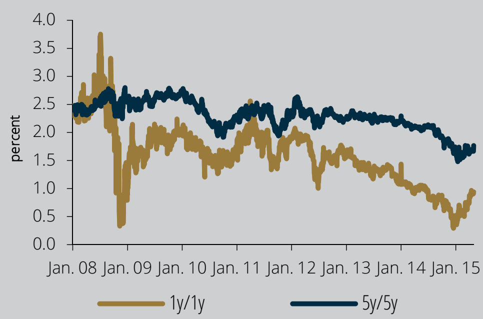
The PSPP includes purchases of securities with residual maturity of two to 30 years. Securities with yields below the deposit facility rate are excluded. It includes purchases of supranational debt securities (12 per cent of total, acquired by national central banks), subject to risk-sharing. The ECB's public debt purchases will also be subject to risk-sharing (representing 8 per cent of assets). The national central banks' other asset purchases (which will be in domestic public debt, proportional to each national central bank's capital in the Eurosystem) will not be subject to risk-sharing. The securities acquired under this programme will be made available for loan, aiming to provide adequate liquidity levels in these markets.

Chart 57 • Harmonized Consumer Price Indices in the euro area



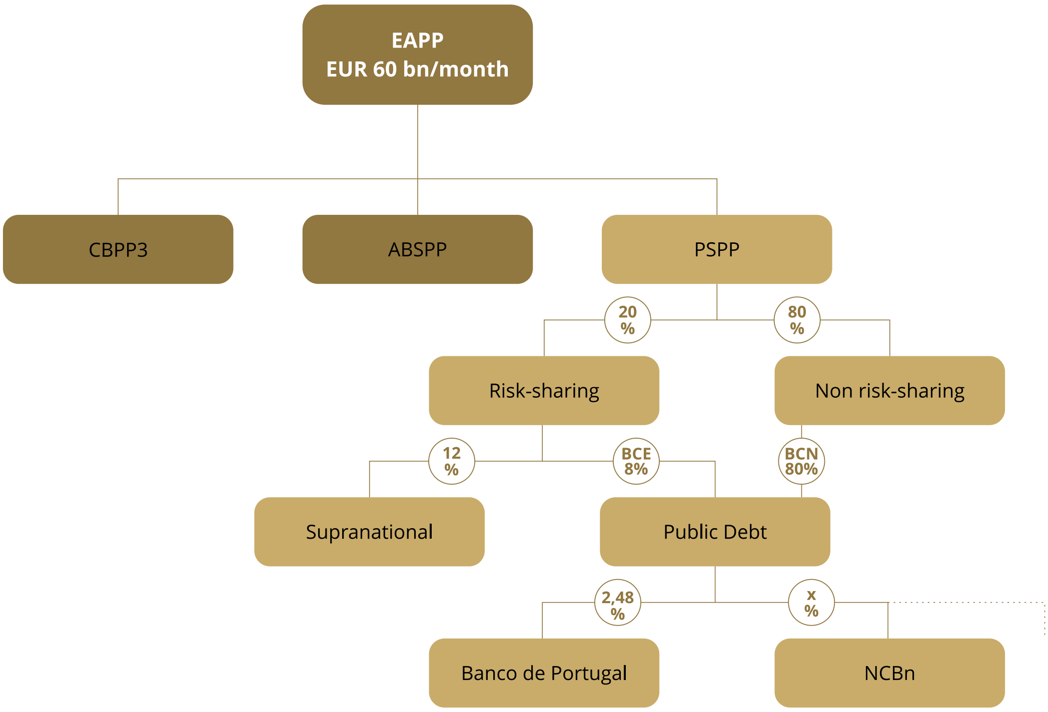
Source: *Bloomberg.*

Chart 58 • Inflation expectations derived from inflation swaps



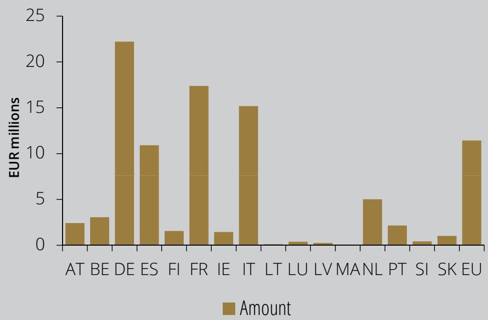
Source: *Bloomberg.*
Note: These values represent the expected inflation rate for a period of x years y years ahead

Figure 1 • Expanded Asset Purchases Programme



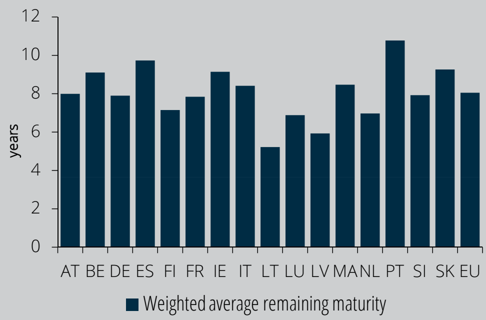
The two first months of the programme proceeded regularly, with the Eurosystem purchasing about €120 billion of assets. Regarding execution of the PSPP, for which more detailed information is made public at country level, purchasing for Portugal came to €2.157 billion, with an average maturity of 10.8 years (Charts 59 and 60).

Chart 59 • PSPP – Amount of securities purchases by country in March and April 2015



Source: ECB.

Chart 60 • PSPP – Average maturity of securities purchased by country in March and April 2015



Source: ECB.

Box 2 • Solvency II – challenges associated with a new regulatory framework

Solvency II is the new regulatory framework applicable to insurance corporations (including reinsurance corporations) from 1 January 2016 onwards. Solvency II is a more risk-sensitive and transparent prudential regime, which promotes the highest possible harmonisation and cooperation among European supervisors, with a view to enhancing the protection level of policyholders, insured persons and beneficiaries. This new regime will safeguard the contribution of the insurance sector to economic growth in Europe, recognising its role as long-term lender of the economy.

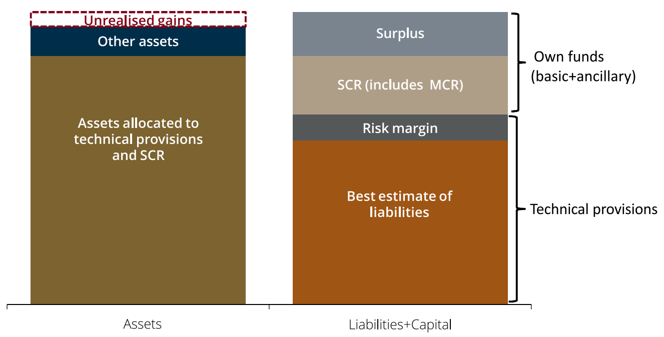
Solvency II defines a single set of prudential rules that are standardised at European level (single book rule), based on a holistic view of the prudential balance sheet (solvency balance sheet), where assets and liabilities are consistently assessed and based on economic principles, reported at market prices, where possible. The Solvency Capital Requirement (SCR) is defined as the own funds necessary to safeguard the coverage of insurance corporation obligations to policyholders and beneficiaries with a probability of 99.5 per cent, over the following 12 months.

The regulatory implementation framework of Solvency II is somewhat similar to the model adopted in Basel II. Commonly known as three-pillar approach, Solvency II covers three different areas.

Pillar 1 sets out quantitative requirements for the calculation of technical provisions, own funds and capital requirements (the latter include the SCR and the minimum capital requirement, MCR).[28] Technical provisions correspond to the best estimate of future liabilities and risk margin. Own funds correspond to the amount of capital an insurer should hold, classified among basic own funds or ancillary own funds, depending on their capacity to absorb losses (Figure 2). The SCR may be calculated using a standard formula or an internal model developed by the insurance corporations, provided that it is approved by the respective supervisory authorities. This requirement takes into account all quantifiable risks to which an insurance corporation is exposed, including underwriting, market, credit and operational risks.

Pillar 2 sets out a wide range of qualitative requirements applicable to (i) governance, risk-management and internal control systems – Own Risk and Solvency Assessment (ORSA), (ii) the identification of key functions in the organisation and (iii) the fit and proper requirements of the human resources. It also establishes a set of principles aimed at strengthening the preventive nature of the supervisory process.

Figure 2 • Prudential balance sheet – Solvency II



Source: Banco de Portugal.

Pillar 3 focuses on transparency and market discipline, setting up a range of disclosure and prudential reporting requirements, also promoting the harmonisation of reporting formats.

This is the result of a long, complex and participated negotiation process, during which several Quantitative Impact Studies (QIS) were carried out at both the European and national level, making it possible to anticipate new capital requirements and to identify sector vulnerabilities. These exercises have promoted the gradual adjustment of business and investment strategies to the requirements of the new regime, and/or have induced the adjustment of the actual solvency regime, until its approval in 2014. By way of example, the final wording of the Omnibus II[29] Directive was only possible after the adoption of a range of additional measures addressing the evaluation of long-term liabilities (including the extrapolation rules of the interest-rate time structure and the matching and volatility adjustment mechanisms).

Other challenges remain, associated with the full implementation of Pillar 1, in particular as regards the improvement of the calculation methods for technical provisions and the SCR, the validation of the assumptions or the process of approval of the internal models (to be used for the calculation of the SCR). It should be mentioned in this regards that the consequences of the implementation of a more risk-sensitive prudential regime in the national insurance sector were assessed by the ASF in 2014 through a QIS.[30] The results of this exercise pointed to a broadly based decline in the capital requirement coverage level in Solvency II (with the overall coverage ratio of the SCR remaining, however, above 100 per cent). According to the ASF, these results were chiefly determined by the high capital requirements for concentration risk, due to high exposures to assets issued by the same entity/economic group. Nevertheless, the Solvency II regime establishes a transition period for adjustment to the new rules, including the postponement of compliance with SCR to the end of 2017, for the corporations which meet the capital requirement defined by Solvency I, as at 31 December 2015.

In addition, up to the end of 2015, insurance corporations must define a governance system ensuring compliance with Pillar 2 requirements, define and document a policy for ORSA and finally establish a procedure for meeting the reporting requirements established in Pillar 3 (considering the new requirements in terms of format and frequency of such reporting).

In spite of these challenges, the gradual implementation of Solvency II will certainly contribute to a more solid insurance sector at European Union level, with aligned risk management and governance practices that will contribute to increasing confidence in the sector and strengthening financial stability. Full integration in the European insurance market, however, will depend on the future standardisation of accounting and tax rules in the European area.

2. Risks to financial stability

The risk analysis presented in this Chapter falls within the scope of the macro-prudential policy regime that Banco de Portugal, as the national competent authority in macro-prudential policy, established in the pursuit of financial stability.

The macro-prudential policy regime comprises four intermediate objectives:

- To mitigate and prevent excessive credit growth and leverage;
- To mitigate and prevent excessive maturity mismatch and market illiquidity;
- To limit direct and indirect exposure concentrations;
- To limit incentives for excessive risk-taking by systemically important institutions.

These intermediate objectives, together with instruments for the implementation of macro-prudential policy, were published by Banco de Portugal in December 2014, in compliance with the European Systemic Risk Board's Recommendation ESRB/2013/1[31].

The Portuguese financial system is highly concentrated as regards specific asset classes

Concentration in the real estate sector

The financial system's exposure to the real estate sector remains high, which renders it particularly sensitive to fluctuations in the value of such assets. The possibility of devaluations in real estate assets poses risks, to the extent that they have negative spillover effects on institutions' profitability and capital.

In the case of banks, exposure takes various forms, such as real estate holdings (e.g. received as repayment of lending) and shares in real estate investment and restructuring funds. There is also exposure due to credit granted to sectors related to construction and real estate activities, as well as real estate collateral associated with credit, most notably to households for house purchase.

At the end of 2014 the Portuguese banking system held, for disposal, real estate assets to the amount of approximately €8 billion (gross of impairments), compared with about €800 million at the end of 2007. These assets corresponded to 1.9 per cent of total assets at the end of 2014 (0.2 per cent in 2007) (Chart 61).

Exposure to shares issued by real estate investment funds (REIFs)[32] and credit restructuring funds increased substantially over the past few years. The weight of REIF shares in total assets of banks increased from 0.3 per cent at the end of 2007 to 1.2 per cent at the end of 2014. On this date, exposure amounted to around €5 billion, accounting for 40 per cent of total shares issued by REIFs (14 per cent at the end of 2007). The total stock of REIF shares at the end of 2014 was approximately 12 per cent higher than in 2007 (respectively, around €12 and €11 billion).

Total exposure of banks to REIFs was distributed among open-ended and closed-ended funds, reaching €2.1 and €2.9 billion at the end of 2014, i.e. 46.3 and 37.0 per cent of total shares issued by open-ended and closed-ended REIFs, respectively. The largest proportion of shares held in open-ended REIFs is due to the fact that they are more easily traded and redeemed. This means that, should a devaluation occur, and to prevent reputational effects, given the close links between investment funds and the banking system, the latter tends to replace other sectors as holder of this type of assets.

Credits transferred by banks to credit restructuring funds totalled around €4 billion at the end of 2014 (1 per cent of total assets of banks), with an increase of around 40 per cent between March 2013 and the end of 2014. These transfers continue to correspond chiefly to credit granted to the real estate activities, accommodation and construction sectors.[33]

The real estate stock held by banking institutions and its exposure to REIFs and restructuring funds remained, in the second half of 2014, close to the values seen at the end of the first half of 2014, which indicates that this type of exposure to the real estate sector stabilised.

At the end of 2014 the outstanding amount of bank loans secured by real estate collateral granted to households and non-financial corporations accounted for 86 and 32 per cent of total bank credit granted to households and non-financial corporations, respectively (26 and 6 per cent of total assets) (Chart 62).

Although clearly on the downside over the past few years, credit granted to non-financial corporations in the construction and real estate activities sectors corresponded in December 2014 to 31 per cent of total credit granted to non-financial corporations, amounting to €27 billion. The value of credit secured by real estate collateral totalled 54 per cent of credit granted to both sectors of activity. Given that the construction and real estate activities sectors have posted substantial non-performing loan ratios (28.7 per cent and 21.3 per cent, respectively, at the end of 2014), real estate collateral will likely be enforced to a

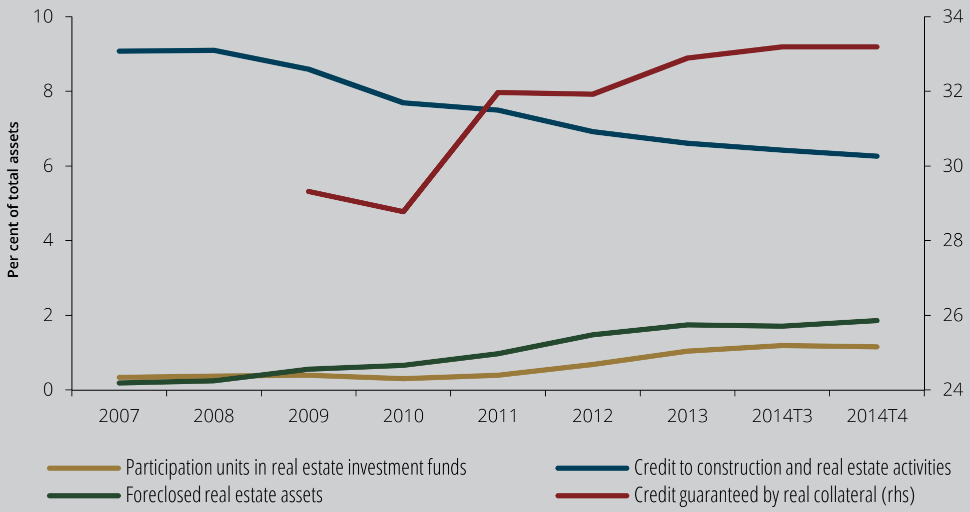


Chart 61 • Banking system exposure to the real estate sector

Source: Banco de Portugal. Note: Lending with real collateral is a proxy for lending with real estate collateral

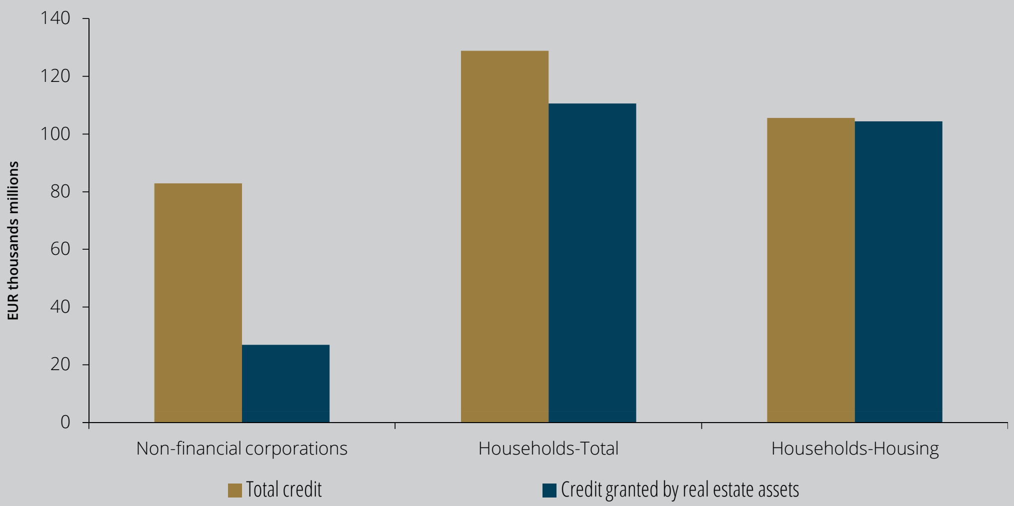


Chart 62 • Total credit and credit granted by real estate assets

Source: Banco de Portugal. Note: As of 31 December of 2014 considerable amount, which could lead to an increase in the real estate assets portfolio of banks.

In turn, the insurance and pension funds sector's exposure to REIFs amounted to around 23 per cent of total shares issued by REIFs as a whole, as at the end of 2014, compared with approximately 14 per cent at the end of 2007. Exposure of insurance companies and pension funds to open-ended and closed-ended REIFs totalled €1.2 and €1.7 billion, accounting for 26.1 and 21.4 per cent, respectively, of total shares issued by the corresponding REIFs (Chart 63).

In 2014 there were some signs of a recovery in the real estate market. The House Price Index produced by Statistics Portugal (INE) increased by 4.3 per cent in the year as a whole (Chart 64). Still according to Statistics Portugal, in 2014 there were 5.6 per cent more housing transactions than in the previous year. In turn, Bank Lending Survey data for April 2015 indicate that respondent Portuguese banks expect a slight increase in demand for housing loans in the second quarter of the year. However, these signs of recovery are still rather incipient and should reflect, in part, the role played by non-residents in the national real estate market, and are more concentrated in a number of regions and market segments.

Moreover, these developments occur against a background of increasing effective tax rates on real estate holdings and high indebtedness of households.

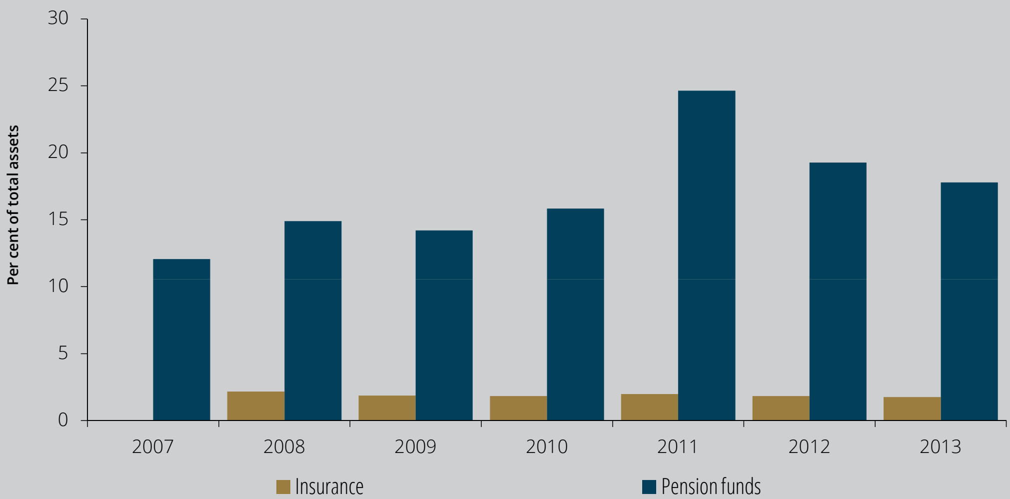
From a macro-prudential standpoint, and given the high exposure to real estate risk, it is important that banks work towards reducing their exposure to such assets. Within the scope of its competence, Banco de Portugal will continue to monitor the banking sector's portfolio assets, while ensuring that these exposures are properly recorded.

It should be noted that, over the past few years, Banco de Portugal has conducted several inspections to specific asset classes, including real estate assets. In addition to these exercises, a Comprehensive Assessment was recently conducted by the ECB in preparation for the Single Supervisory Mechanism. This series of exercises seems to have contributed to a correct assessment of real estate risk in participating banks.

Real estate risk is gauged in the course of the supervision process associated with the specific risk assessment of institutions, and may lead to the strengthening of the capital base or the implementation of specific risk mitigation measures, which may include the presentation of a disinvestment plan or the reduction of these assets on the institution's balance sheet.

Chart 63 • Insurance and pension funds exposure to the real estate sector

Source: Autoridade de Supervisão de Seguros e Fundos de Pensões.
Note: Exposure is calculated as the sum of real estate investment fund participation units and real estate on the balance sheet



Concentration in sovereign debt

Despite some stabilisation over the past few quarters, the Portuguese financial system's exposure to sovereign debt, particularly national public debt, remains high.

The share of Portuguese government debt securities in total assets of banks rose from 0.9 per cent at the end of 2007 to 6.6 per cent in December 2014, reaching a historical peak of 7.3 per cent in September 2013. Although these values are high, Portugal, compared with other European countries, falls within the distribution median in terms of share of public debt in total assets (Section 1.3.1). The insurance sector's exposure to government debt securities has also been increasing since 2008, amounting to 15 per cent of total assets at the end of 2014 (Chart 65).

In spite of a reduction in yields on Portuguese public debt, this exposure may generate risks in the short run, amid an intensification of sovereign debt tensions in the euro area.

In the medium to long run, any changes in the prudential treatment of this type of exposure may increase costs associated with the maintenance of government debt securities on banks' balance sheets. Currently, the CRD IV prescribes a zero risk weight for exposure

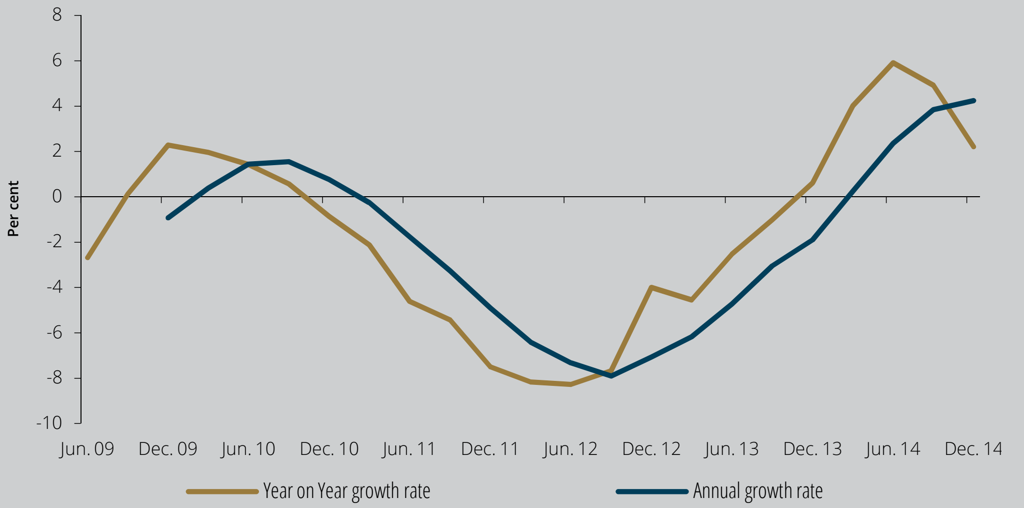


Chart 64 • House price index – Growth rates

Source: INE.

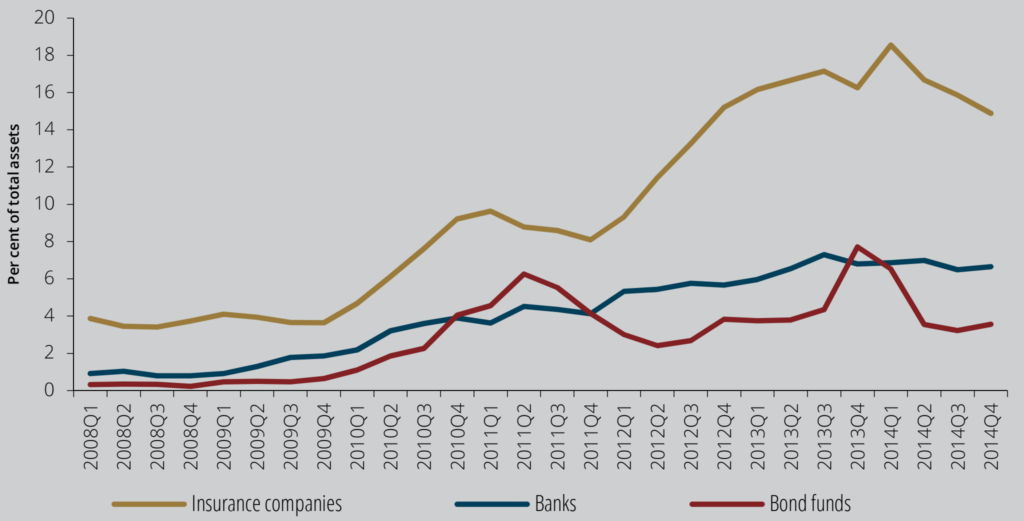


Chart 65 • Exposure to Portuguese public debt securities

Source: Banco de Portugal. Note: Banking system data on a solo basis to sovereign debt securities of EU Member States. However, regulators have paid increasing attention to the prudential treatment of these exposures. In particular, developments in the euro area sovereign debt crisis may warrant that greater weight be given to the risk profile of any counterparty when determining the prudential treatment of these exposures. Accordingly, the European Systemic Risk Board report of March 2015 approaches possible changes to this framework. These changes may entail a positive risk weight, using both the standardised approach and the internal-ratings based approach, even for counterparties considered risk-free until now, or diversification requirements for exposures.[34] However, any changes should be combined with other requirements, such as liquidity requirements, which provide an incentive to holding sovereign debt.

A reversal of search for yield behaviour at international level would contribute to the rapid decline in the value of Portuguese government debt securities, affecting the Portuguese State's new financing costs and the valuation of financial institutions' portfolios.

However, non-standard measures adopted in the scope of the Eurosystem, such as the ECB's Outright Monetary Transactions programme and the expanded asset purchase programme, limit investors' perception of risk and the possibility of contagion in the euro area, further contributing to government debt market liquidity.

In turn, there has been some reallocation of portfolios by a number of resident institutional investors, most notably insurance companies, with the government debt portfolio showing an increase in the share of sovereign debt of countries like Italy and Spain.[35] Furthermore, the Solvency II regime, which will be implemented in the beginning of 2016, calls for greater diversification in the investment strategy of insurance companies, thus favouring a reduction in concentration risk (Box 2).

Finally, systemic risk associated with sectoral exposure to Portuguese public debt has decreased, to the extent that, on the one hand, interconnectedness between banks and insurance companies has decreased (due to the sale of insurance companies by a number of Portuguese banking groups) and, on the other hand, the link between sovereign risk and the banking system has weakened. This is partly due to the launch of the Single Supervisory Mechanism and the adoption of dedicated regulations at European level, namely Regulation (EU) No 806/2014 of the European Parliament and of the Council – establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms – and Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 – establishing a framework for the recovery and resolution of credit institutions and investment firms (Bank Recovery and Resolution Directive – BRRD). The new regulations set out the bail-in regime applicable to banks, establishing solutions that help reduce the guarantee of implied State support that was previously seen in bail-out situations, namely as regards institutions considered too big to fail.

Concentration in countries particularly affected by oil price decreases

Another type of concentration of exposures is associated with the banking sector's dependence on more idiosyncratic economic and financial developments.

Amid very substantial oil price decreases in 2014, a number of oil-exporting countries with which Portugal has close economic links, such as Venezuela and, in particular, Angola, have experienced a slowdown in their domestic economic activity. This slowdown may affect the ability of some economic agents to meet external commitments, most notably those related to the payment of imports.

Despite being associated with a greater international diversification by Portuguese firms – which played a very positive role during the most severe stage of the economic and financial crisis –, exposure to these countries may pose risks to firms and, directly or indirectly, to Portuguese banks.

A decrease in oil prices, despite having a positive impact on economic growth, is still a risk factor for economies dependent on oil exports and, consequently, for economic agents with substantial exposures to such economies.

Over the past few years, the external market activity (including in Angola) brought particularly substantial returns to some of the largest Portuguese banking groups, most notably at a time when domestic activity results were clearly unfavourable. In addition to this direct exposure, the resident financial sector was indirectly exposed to Portuguese firms with commercial or direct investment links to Angola, which accounted for around 17 per cent of total credit to non-financial corporations in December 2014.

In sum, financial institutions should avoid excessive exposure to one sector or asset class in particular

The common concentration of exposures to one sector or asset class in particular gives rise to a higher correlation between the risks of the various institutions and an increased possibility of financial system contagion. This contagion is also heightened by the banking system's interconnectedness, which renders it more vulnerable to risks arising from, most notably, simultaneous sales of assets, and may lead to falls in the prices of the corresponding assets.

Any changes to the prudential treatment of exposures and their concentration may also pose substantial challenges to financial institutions.

The financial sector's low profitability may provide an incentive to demand for risk and, if protracted, condition financial intermediation

The banking system's profitability has been significantly affected since the onset of the financial crisis, as a result of decreased activity, historically high impairment levels, low net financial income (amid reduced or even negative interest rates), a more stringent regulatory framework and changes to business models.

In structural terms, efforts towards an improvement in the banking system's profitability have focused on the reduction of operational and administrative costs and the reform of business models (for instance, through the sale of insurance companies and non-strategic activities). However, an additional adjustment in the resident banking sector's capacity is necessary, against a background of continued deleveraging and subdued economic activity levels.

The profitability levels of other financial intermediaries have also been globally conditioned by historically low returns on assets. To the extent that these intermediary sectors have taken on hedged liabilities, this may pressure them to find investments that help them meet such commitments. In Portugal, this should mainly affect pension funds, which may make it necessary for shareholders (promoters) to increase their contributions. However, thus far, there has been no evidence of excessive risk-taking in this sector.[36]

The maintenance of low interest rates and returns may provide an incentive for financial institutions to take excessive risks, with the purpose of improving profitability. This raises concerns about financial stability given that it may result, in the medium term, in a deterioration in the risk profile of the corresponding asset portfolios, putting pressure on their solvency position. This will be further exacerbated should the lack of lucrative business opportunities in the provision of financial services increase, which could lead institutions to adopt similar investment strategies, to invest in riskier assets and/or, in the case of banks, to ease credit standards excessively. This behaviour may contribute to the emergence of price bubbles in various segments, thus increasing the potential impact of a common shock to these exposures.

The low interest rate environment may also give rise to changes in the risk profile of households. Although no evidence of these changes has emerged, the potential increase in demand for products with higher yields and risks cannot be excluded.[37]

Turning to the banking sector, low profitability levels may, at the most, render financial intermediation activity more difficult, particularly if substantial losses were to accumulate. If this phenomenon should become widespread against a background of conditioned access to capital markets, it could have systemic consequences.

Several factors may hamper profitability levels and, as a consequence, provide an incentive for national credit institutions to adopt investment strategies with excessive risks, namely: (i) the persistence of low economic growth, inflation and interest rates, keeping pressure on returns on assets; (ii) the need to recognise additional impairments associated with credit granted in the past, with underlying risk control policies that are less sound (thus contributing to high levels of non-compliance in the credit portfolio); and (iii) costs associated with the introduction of a new regulatory framework on liquidity and the need to issue bail-inable instruments (i.e. instruments that may be cancelled and/or converted into capital instruments).

However, the ECB's expanded asset purchase programme may reduce financing costs and, for financial institutions that are willing to sell eligible assets, generate capital gains in the short run, thus increasing banks' profitability. By creating an environment of low uncertainty about the policy followed, it may also reduce investors' perception of risk, providing an incentive towards investment and credit demand, and contributing to an increase in economic activity levels.

In sum, demand for riskier assets may become more widespread, should the currently low profitability levels remain for a long period of time. A deterioration in this situation will pose substantial challenges to efforts towards the containment of the systemic impact of misaligned incentives and moral hazard. It is therefore essential that institutions proceed with the adjustment that started during the economic and financial crisis, maintaining their efforts towards the containment of operational costs and adjusting their business model with the purpose of increasing, in a sustainable manner, their profitability levels.

A swift and broadly based increase in current risk premia is a major risk to financial stability

The current situation in international financial markets is characterised by a continuing favourable sentiment and a gradual decrease in risk premia, which has also been favourable to resident issuers. However, the possibility of a sudden change in how financial markets perceive this risk should not be ruled out, with effects that may be as severe as the imbalances created during the period of low interest rates are large. Were this change to occur, it might hamper economic agents' ability to refinance their liabilities in the market at reasonable cost.

The effects of a sudden and abrupt reversal of the current market sentiment may be worsened by a gradual decline in the role played by market makers in the markets, as recently highlighted by the IMF in the Global Financial Stability Report of April 2015. Contributing to this is a decrease in banks' activity in this function (particularly in view of the new regulatory framework on capital and liquidity requirements[38]), their replacement by a relatively small number of financial intermediaries (which tend to be less regulated), greater focus on segments with associated benchmark indices and the prevalence of high-frequency trading. In effect, liquidity provision has become more dependent on programmed reaction functions and less on client-based relationships, which, in riskier situations, hinders market stabilisation.[39]

Several factors may contribute to reverse search for yield behaviour, specifically: (i) increasing concerns about the sustainability of sovereign debt owing to recent developments in Greece; (ii) an increase in geopolitical tensions in Eastern European and Middle East countries; (iii) a normalisation of monetary conditions in the United States, accompanying an increase in market interest rates; and (iv) a perception of greater fragility in international financial institutions.

The net lending of the Portuguese State and financial institutions is being affected by persistent lower risk aversion and search for yield behaviours on the part of investors. This is particularly relevant for the general government, considering its refinancing needs still remain considerable in the short and medium--term. Within this context, the operations carried out by the Portuguese Treasury and Debt Management Agency (Agência de Gestão da Tesouraria e da Dívida Pública) to manage public debt maturities and the ECB's expanded asset purchase programme are particularly important.

The fiscal consolidation efforts of the Portuguese Government and an increase in sustainable financing of financial institutions (specifically through an increase in the share of deposits and a decrease in financing obtained from central banks) have also contributed to mitigate the effects of a possible abrupt reversal of search for yield behaviour. Looking forward, the current market context (particularly the introduction of the ECB's expanded asset purchase programme) must be adequately used to promote an adjustment in the liabilities structure of resident economic agents so it complies from a prudential perspective (where applicable) with the new requirements on liquidity, solvency and resolvability and with a sound management of liquidity risk.

This adjustment is expected to help maintain financial stability, as it prevents excessive maturity mismatches by making institutions more capable of facing possible market illiquidity.

Consumer confidence in financial markets is essential to financial stability

The confidence of bank customers and investors in financial markets is crucial to financial stability and should be preserved.

Given the size of financial institutions and their interconnectedness, conduct risk is particularly relevant. Incentives to excessive risk assumption by institutions and financial groups must be mitigated In order to preserve the confidence of consumers and investors.

The international crisis and other more recent developments, such as the manipulation of interbank interest reference rates, have proven that additional measures are needed to adequately address and prevent conduct risks – both from a prudential perspective and to protect consumers of financial products. Against this background, the Joint Committee of the European Supervisory Authorities (ESMA, EBA and EIOPA) released a report in March 2015 with a set of recommendations and lines of action to address and prevent incidents related to conduct risks. These recommendations refer to: (i) strengthening corporate governance controls, (ii) improving the regulatory framework applicable to the creation and sale of financial products; and (iii) improving supervisory practices to address conduct risks.

In order to promote confidence in the financial system, supervisory authorities must have instruments to be able to assess institutions' corporate governance on a global level. This might include engaging more frequently with the board and its risk and audit committees and carrying out external audits and supervisory action. Peer reviews (by supervisory authorities) of the application of the EU legal framework could also be an important tool to the identification of gaps in the coverage of existing rules (in terms of products/services, practices and institutions) or in the respective supervision and enforcement. Peer reviews may also serve as basis for further promotion of consistent application of enforcement measures and greater harmonisation of sanctions within the EU. Finally, the prudential framework should (i) ensure the inclusion of conduct risk and its materialisations in institutions' stress testing exercises if relevant; (ii) develop supervisory benchmarks for conduct risk (within operational risk); and (iii) ensure factoring in of conduct risk in Internal Capital Adequacy Assessment

Processes (ICAAPs) and insurer's Own Risk and Solvency Assessment (ORSA).

In Portugal, efforts have been made to prevent conduct risks by strengthening the regulatory framework, specifically regarding information to consumers on the sale of savings and investment products. Authorities have strived to ensure that risks associated with these products are communicated in a clear manner and that this information is correctly understood by savers and investors, especially in the retail market.

Despite the progress achieved in the past few years, there is still room for improvement in the sale of financial products. This may be achieved by segregating the sales channels of traditional banking products (such as loans, deposits and payment instruments), most notably savings products, from investment products or by more intrusive supervisory action on institutions' internal procedures, specifically on the creation, approval and distribution of financial products.

The National Council of Financial Supervisors (Portuguese acronym: CNSF) has already identified several types of conduct risks in the Portuguese market, particularly mis-selling and self-placement, and decided, in September 2014, to begin work in this area. This decision is particularly important, irrespective of other longer-term initiatives, such as the work of the Portuguese National Plan for Financial Education, which is also undertaken by the CNSF and is aimed at strengthening the financial literacy of the Portuguese population.

Notes

1. For a detailed analysis, see *Economic Bulletin*, May 2015, Banco de Portugal.

2. For a conceptual and methodological description of the composite indicator of financial stress for Portugal, see Braga, J.P., Pereira, I. and Reis, T. B., 2014, *Composite indicator of Financial Stress for Portugal, Financial Stability Papers*, No. 1, Banco de Portugal.

3. Total household debt includes loans and trade credits and advances. Consolidated figures.

4. National Sector Accounts were revised when Statistics Portugal released the Accounts for the fourth quarter of 2014. These revisions reflect changes introduced in Annual National Accounts detailed for 2012 (final results), with an impact on subsequent years. Overall, accounts for 2012 now incorporate a large set of statistical sources, which improved the estimates that were previously available. For greater detail, see Statistical Portugal's press release on the publication of Quarterly Sector Accounts (2011 base year), fourth quarter of 2014, available at https://www.ine.pt/xportal/xmain?xpid=INE&xpgid=ine_destaques&DESTAQUESdest_boui=211351807&DESTAQUESmodo=2&xlang=en.

5. Investment includes gross capital formation and acquisitions less disposals of non-produced non-financial assets.

6. On the revision of non-financial accounts by Statistics Portugal, see https://www.ine.pt/ngt_server/attachfileu.jsp?look_parentBoui=227410587&att_display=n&att_download=y.

7. Total debt of financial corporations includes debt securities, loans, financial derivatives and trade credits and advances. Consolidated figures.

8. Total credit means loans and debt securities.

9. Profitability ratio defined as EBITDA/ (equity + obtained funding).

10. Coverage ratio defined as EBITDA / interest expenses.

11. Calculated on the basis of information from the Central Balance-Sheet Database of Banco de Portugal. See also *Economic Bulletin*, May 2015, Banco de Portugal.

12. The *Bank Lending Survey* is available at http://www.bportugal.pt/en-US/EstudosEconomicos/Publicacoes/IBMC/Pages/InqueritoaosBancossobreoMercadodeCredito.aspx.

13. For more detailed information, see *Economic Bulletin*, May 2015, Banco de Portugal.

14. There was a break in the series on banking system data in the third quarter of 2014, as a result of the resolution measure applied to Banco Espírito Santo (BES). This break in the series was due, in particular, to the fact that assets/liabilities not transferred to Novo Banco's balance sheet have been excluded from the banking system's aggregate as of August 2014. Given that there was no accounting data for BES on a consolidated basis for the period between 30 June 2014 and the day of application of the resolution measure (closing balance sheet and financial statements), data reported by BES was considered on an individual basis, as of 31 July 2014, when calculating aggregate results for the banking system in the third quarter of 2014. However, adjustments resulting from the resolution measure applied to BES were not taken into account.

15. Defined as the difference between liquid assets and volatile liabilities in proportion of the difference between total assets and liquid assets, for each maturity scale. Indicators were calculated on the basis of data and concepts set out in Instruction of Banco de Portugal No 13/2009. This indicator allows for a comprehensive characterisation of banks' liquidity position, by looking at a wide set of assets and liabilities and their residual maturities.

16. The Commission Delegated Act on the liquidity coverage requirement defines stress as "a sudden or severe deterioration in the solvency or liquidity position of a credit institution due to changes in market conditions or idiosyncratic factors as a result of which there may be a significant risk that the credit institution becomes unable to meet its commitments as they fall due within the next 30 calendar days." For more details, see: http://ec.europa.eu/finance/bank/docs/regcapital/acts/delegated/141010_delegated-act-liquidity-coverage_en.pdf

17. For more details on the results for this exercise, see Box 2 entitled "The comprehensive assessment of euro area banks: main results for the Portuguese banks", in the November 2014 issue of Banco de Portugal's *Financial Stability Report*.

18. For more details, see "Chapter 2: Monetary and financial conditions", *Economic Bulletin*, May 2015, Banco de Portugal.

19. Developments in the Euribor rate in 2015, which were negative for growing maturities, led to a decrease in these operations' returns.

20. For more details, see: *Banking structures report*, October 2014, European Central Bank.

21. The solvency ratio corresponds to the ratio between available capital and required solvency capital and shall be greater than 100 per cent.

22. For further details, see *Análise de Riscos do Setor Segurador e dos Fundos de Pensões*, December 2014, Autoridade de Supervisão de Seguros e Fundos de Pensões.

23. This was explained by the recognition of impairments on assets allocated to work accidents insurance by one operator.

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

25. These investment funds as a whole do not include credit securitisation funds that represented approximately €10 billion at the end of 2014 (or 29 per cent of total investment funds), but include money-market funds.

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

27. See Box "Delimitation of the shadow banking perimeter (from the entity perspective)", *Financial Stability Report*, May 2014, Banco de Portugal.

28. The MCR corresponds to the minimum capital that a corporation should hold in order to operate in the market. In the case on non-compliance with the MCR, the regulator shall define a recovery plan for the insurance corporation in the very short term or, at the most, may be forced to withdraw their authorisation to operate in the sector.

29. Solvency II objectives were defined in Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009. This directive was subsequently adjusted to the implementation rules introduced by the Lisbon Treaty and later to the new European financial supervision architecture, which created EIOPA (Regulation 1094/2010 of the European Parliament and of the Council of 24 November), culminating in the publication of Directive 2014/51/EU ("Omnibus II") of the European Parliament and of the Council of 16 April. Also in 2014, the Delegated Acts were approved by the European Commission. The publication and translation of the remaining regulations defining the rules to be followed by the sector entities (RTS – regulatory technical standards, and ITS – implementing technical standards or guidelines) are expected to occur in the course of 2015.

30. Results presented at the hearing of the ASF's Chairman before the Parliamentary Committee on Budget, Finance and Public Administration (April, 2015). The QIS-2014 took place between May and July 2014. This was a national study, mandatory for all insurance corporations subject to ASF's prudential supervision (as at the end of December 2013).

31. See Banco de Portugal (2014), *Macro-prudential policy in Portugal: objectives and instruments*, available at https://www.bportugal.pt/en-US/EstabilidadeFinanceira/PoliticaMacroprudencial/Documents/Macro-prudential%20policy%20in%20Portugal.pdf and Basto (2013), *Uma política macroprudencial para a estabilidade financeira* (A macro-prudential policy for financial stability), available in Portuguese only at http://www.bportugal.pt/pt-PT/EstudosEconomicos/Publicacoes/Paginas/BdPPublicationsResearchDetail.aspx?PublicationId=580

32. This does not include funds of real estate investment funds, whose shares accounted, as of December 2014, for 2.5 per cent of total shares issued by REIFs and funds of real estate investment funds.

33. For analysis purposes, credit granted to holding companies was reallocated to underlying sectors of activity.

34. In this regard, see ESRB report on the regulatory treatment of sovereign exposures, available at https://www.esrb.europa.eu/pub/pdf/other/esrbreportregulatorytreatmentsovereignexposures032015.en.pdf?393102119ef78ab0b62b807dd8ee0d80

35. For more information, see *Análise de Riscos do Setor Segurador e Fundos de Pensões*, December 2014, Autoridade de Supervisão de Seguros e Fundos de Pensões.

36. See *Análise de Riscos do Setor Segurador e Fundos de Pensões* , December 2014, Autoridade de Supervisão de Seguros e Fundos de Pensões.

37. In more severe situations, this could lead to a deviation of resources to Ponzi or other fraud schemes. For more on this topic, see the press release published by Banco de Portugal on 9 January 2015.

38. For more information on this subject, see HTTP://www.bis.org/publ/cgfs52.pdf.

39. Developments in bonds issued by the United States Government in the flash crash of 15 October 2014 show how these factors may result in market contagion (even contagion to markets considered more liquid) and even disrupt the smooth functioning of the interbank market and monetary policy operations, as they imply the application of more stringent collateral requirements. For further details, see chapter 1 of the Global Financial Stability Report (GFSR) of April 2015.