Carlos da Silva Costa: Overview of economic and financial challenges for Portugal

Address by Mr Carlos da Silva Costa, Governor of the Bank of Portugal, at the centenary of Crédito Agrícola Mútuo, Lisbon, 25 May 2011.

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The celebration of the centenary of Crédito Agrícola Mútuo (Mutual Agricultural Credit) is an appropriate timing:

1. To highlight the relevance of banking activity in modern economies;
2. To stress the crucial role of trust in the development of this activity; and
3. To make a brief presentation of the key measures included in the adjustment programme in the field of financial stability – one of the three capstones underlying the adjustment programme and the new growth model of the Portuguese economy.

1st – The relevance of banking activity in modern economies

Credit institutions play an important intermediation role between savers and investors, centralising the resources of the former and channelling them to the funding of investment.

This financial intermediation between savings and investment leads to:

1. ***Maturity transformation*** – deposits with typically short maturities are transformed into longer-term credits; and
2. ***Liquidity transformation*** – deposits, liquid, are transformed into credits, more illiquid.

Through financial intermediation, benefits may be reaped of a scale effect when mobilising savings: multiple low-value individual deposits are transformed into large credit amounts, allowing for the financing of large-scale investments.

Finally, savings obtained in a given region (or country) may be channelled to finance investments in other regions (or countries).

Through this intermediation, the banking activity benefits from economies of scale, making it possible to ensure risk diversification and the implementation of procedures for effective risk management and control. This translates into a reduction of risk for a given remuneration, or, alternatively, a better remuneration of savings for the same level of risk appetite.

Hence, the banking sector plays a key role in the efficient allocation of resources in a given economy, as well as in the provision of essential services for making payments, thus decisively contributing to sustained economic growth.

Banking activity can be said to be the “circulatory system” of the economy. A healthy – productive and competitive – economy necessarily requires a dynamic and efficient banking sector.

2nd – The crucial importance of trust and the role of regulation and supervision

This crucial function of financial intermediation of the banking sector requires a relationship of trust between banking institutions and their customers. It also requires that the general public and investors rely on the banking system as a whole.

In view of their role in investment funding and in the functioning of the economy, banking institutions are subject both to stringent regulation – intended to ensure their soundness and the safety of the funds they are entrusted with – and supervision in terms of compliance with the rules governing their activity, in particular as regards the existence of appropriate and prudent risk management.

Contributing to this trust in financial activity are the establishment and implementation of:

1. Rules of access to their activity based on demanding principles of suitability and professional qualifications;
2. Effective and transparent corporate governance models and structures;
3. Comprehensive and demanding procedures for micro and macro-prudential supervision and regulation.

The ***Rules of access*** to the activity and, in particular, the requirements in terms of the ***suitability and professional qualifications*** of the members of the management and auditing boards of the institutions and the integrity of shareholders are critical for the stability of the financial system, as they determine the quality of the management and thereby the trust of stakeholders as a whole.

Furthermore, corporate governance models and structures must be effective and transparent, and they must ensure a high level of control and accountability to the different stakeholders of the financial institution. An appropriate corporate governance model requires clear allocation of powers and responsibilities to the board and management, involving:

1. The definition of strategies and objectives;
2. Levels of risk tolerance;
3. The structure of the organisation, management and control policies and procedures, and reporting lines;
4. The protection of the legitimate interests of the stakeholders;
5. The guarantee of compliance with applicable laws, regulations and rules.

The quality of the corporate governance model must cover two key aspects of the institution:

(i) ***Internal governance***: a management and control structure is essential for the efficient, profitable and sustainable activity of the institutions.

(ii) ***External governance***: a balanced and transparent relationship must be ensured between the institution and external stakeholders (including shareholders, investors, State and the general public)

Internal governance structures shall particularly ensure:

1. An appropriate monitoring environment, which defines and values high standards of ethics, integrity and skills, and establishes the institution's overall risk tolerance profile;
2. A sound risk management system, which ensures systematic, timely and efficient management of internal and external risks (necessarily including procedures for risk identification, evaluation, treatment, monitoring and reporting);
3. An appropriate internal control system, integrating independent control of risk management procedures, audit and compliance;
4. An efficient information and communication system, ensuring that information related to risk management and control is circulated across all institution levels, and that risk identification and control procedures are comprehensive, swift and efficient;
5. An effective monitoring system, by which the management and supervisory bodies of the institution may appropriately and permanently monitor risks and control

failures. This system must be supported by an independent, disciplined and effective internal audit function, endowed with appropriate resources.

In effect, reliable, qualified and competent managers, as well as governance models based on efficient monitoring systems are instrumental for the soundness of the financial system. They are a necessary condition for the sound and prudent management of the institutions, ensuring appropriate practices and procedures for managing risks incurred by the institutions in the course of their regular activity, especially:

1. Credit risk;
2. Liquidity risk;
3. Market risk;
4. Operational risk;
5. Reputational risk.

In turn, the ***external audit*** function (which can also be seen as one of the components supporting external governance) is another important line of defence of financial stability. Sound and independent auditing, in tandem with vigilance by market agents, is also of the essence for the trust of, and in, the markets.

The need to control excessive risk taking, to ensure appropriate incentives, to safeguard the confidence of bank customers, and to maintain financial stability requires a demanding and permanently updated legal framework, i.e. a regulatory framework.

Turning to regulation, the main challenges facing authorities are:

- On the one hand, to obtain a timely diagnostic of risks, ensuring the quality, consistency, clarity and opportunity of the rules; and
- On the other hand, to limit the regulatory initiatives to merely those necessary to carry on the objectives underlying supervisory activities, and thus avoid unnecessarily inhibiting the development of financial activity and innovation in the sector.

In turn, the supervision of institutions must be intrusive, with a strong on-site component – thereby ensuring an active presence in the institutions under supervision. It must also rely on ITC-intensive use, in order to optimise distance regular monitoring procedures, and shall be based on risk.

Its purpose is thus to ensure the timely detection of vulnerabilities and to guarantee opportune and effective supervisory action, imposing corrective measures where necessary, and sanctioning non-compliances.

In short, the purpose is to ensure that institutions and the respective managers actually meet their responsibilities for the safety of the funds entrusted to them, and report to the stakeholders on the performance of the respective institution.

After this general overview, I will make a brief presentation of the key measures included in the adjustment programme in the field of financial stability.

3rd – The role of financial stability in the adjustment of the Portuguese economy

In Portugal, the banking system has been playing a fundamental role in meeting the growing financing needs of both the Portuguese economy and households, offsetting the – chronic – scarcity of domestic savings through recourse to external financing, chiefly after joining the Economic and Monetary Union.

With the participation in the euro area, the country was able to reap the benefits of lower and less volatile interest rates and Portuguese banks gained access to a broader and exchange-rate risk-free funding market.

This environment has enabled credit to grow well above the level accommodated/ allowed by the deposit base, to the extent that external liquidity surpluses have been channelled through the banking system to meet internal financing needs.

An overall context of ample liquidity has led to the perception that the easing of financing constraints would indefinitely be maintained. In effect, there was a false impression that, within the framework of the Economic and Monetary Union, the capacity of banks to absorb resources, and therefore their access to the capital market, would only depend on the respective solvency levels, reputation and risk-management ability.

However, when a financial system corresponds roughly to the territory of a single sovereign state, the sovereign risk strongly binds risk perception by the financial system and therefore fundamentally constrains the financing capacity of the economy.

As the international financial crisis was unfolding, there has been, since late 2009, a significant differentiation of sovereign risk premium in a number of euro area economies. This situation has chiefly affected the countries where substantial and unforeseen rises in deficits and public debt were combined with structural weaknesses, particularly in terms of external indebtedness and the trend growth of the economy.

With regard to the Portuguese economy, imbalances result not only from the deterioration of the fiscal situation or from structural problems, but also from the persistent and significant deterioration of the external position of the economy, in a context of high levels of public and private indebtedness and low economic growth.

The deterioration of expectations in international financial markets regarding the sustainability of public finances in Portugal translated into a strong increase in the risk premium of the sovereign debt, with negative repercussions on Portuguese banks' access to and financing conditions in international wholesale debt markets.

The external borrowing needs of the Portuguese economy have been almost exclusively met through the public sector and the banking system. As a consequence, the difficulties felt by these sectors in accessing international debt markets require stronger and faster adjustment between savings and investment of the Portuguese economy, across all institutional sectors.

Indeed, the increasingly more difficult market funding conditions experienced by banks over the course of the current year require strengthened capitalisation of banks and the contraction of banking activity, which in turn implies an acceleration of the deleveraging process of the private sector.

International investors' rising fears about the sustainability of Portuguese public finances and the intertemporal dynamics of the external debt led to an inevitable request for international financial assistance that could not be postponed.

The interconnection between sovereign risk and the constraints felt by banks in raising capital in international markets will condition prospects for the Portuguese banking system, given the existence of mutually reinforcing contagion mechanisms.

The Economic and Financial Adjustment Programme, in addition to setting strict objectives for the sustainability of public finances and for structural reforms, includes measures to foster a gradual and orderly deleveraging of the banking sector.

These measures include the provision of liquidity to the financial system, increased capital requirements for banks and the gradual deleveraging of the banking sector.

Under the current conditions of difficult access to market financing, the maintenance of liquidity in the banking sector is crucial to avoid a strong and immediate contraction of credit to the Portuguese economy. The adjustment programme explicitly foresees that Banco de

Portugal, in cooperation with the European Central Bank, will take all the appropriate measures to maintain sufficient liquidity in the system. In addition, the amount of government guarantees to the issuance of bank bonds will be increased from EUR 20 billion to EUR 35 billion, encouraging banks to strengthen their collateral buffers.

On the other hand, the need for stronger bank balance sheets to weather the adverse economic conditions that will prevail in the period ahead, requires a new increase in institutions' own funds, in addition to that announced last April. Therefore, the Banco de Portugal required banks to raise their core Tier 1 capital ratio to 9% by end-2011 and to 10% by end-2012. If needed, Banco de Portugal may require some banks, based on their specific risk profile to reach higher capital levels.

By the end of June, banks are requested to present to Banco de Portugal their plans on how they intend to reach the new capital requirements through market solutions. The adjustment programme foresees a temporary State bank solvency support facility up to EUR 12 billion, which may be used if the market-based solutions fail.

Unquestionably, immediate priority must be given to maintaining adequate liquidity conditions in the banking system and to strengthening the capitalisation of banks. However, in the medium term, it is fundamental to ensure that the domestic savings levels will make the country less dependent on international financial markets, bolstering the resilience of the national financial system and the overall financial stability conditions.

To this end, banks are requested to devise by end-June medium-term funding plans consistent with this objective. The plans will be subject to regular quarterly reviews and adjustments in the plans will be requested as needed to ensure their compatibility with the deleveraging objectives. At the same time, the programme foresees the strengthening of the supervisory and regulatory framework of the banking sector, including, inter alia: the adjustment of the legal framework governing the restructuring and resolution of credit institutions; the reinforcement of the Deposit Guarantee Fund (FGD) and of the Mutual Agricultural Credit Guarantee Fund (FGCAM); and the introduction of amendments in the Insolvency Code to support effective rescue of viable firms.

The coming years will be extremely demanding for the financial institutions but also for the Banco de Portugal as the regulatory and supervisory authority. However, I am confident that together we will overcome the challenges and ensure the financial stability conditions required for the sounder growth model we all wish for Portugal.