Carlos da Silva Costa: Portugal – Progress on financial stability

Address by Mr Carlos da Silva Costa, Governor of the Bank of Portugal, to OMFIF (Golden Series Lecture), London, 30 October 2013.

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Ladies and Gentlemen,

It is a great pleasure for me to be here with you today. I would like to take this opportunity to talk about progress made on financial stability in Portugal over the last three years.

Safeguarding financial stability is one of the three pillars of the Economic and Financial Adjustment Programme of Portugal – in place since June 2011 – together with fiscal consolidation and structural reform.

The safeguarding of financial system stability is one of Banco de Portugal's core missions. To achieve this goal, we have put in place a comprehensive strategy aimed at reinforcing bank solvency, protecting banking system liquidity, enhancing the effectiveness of the supervision of the financial system, and improving the regulatory framework.

This strategy has been implemented over the last three years and has delivered on several fronts. Today, the Portuguese banking system is more capitalized, more transparent and in a more favourable liquidity position. Today, we benefit from improved supervision and a stronger regulatory framework. This was achieved in the context of a very demanding domestic and external environment, characterized by the structural rebalancing of the Portuguese economy and the persistence of financial fragmentation and economic weakness in the euro area.

Thus, let me outline the steps taken so far to strengthen the resilience of the Portuguese financial system.

Strengthening solvency and liquidity

The core Tier 1 ratio of the banking system increased from 8.1% at the end of 2010 to 11.9% at the end of the second quarter of 2013.

From 2010 on, Banco de Portugal has adopted several measures towards preserving adequate capital ratios. In particular, we have imposed more stringent capital requirements: a Core Tier 1 ratio of 9% by the end of 2011 and of 10% by the end of 2012. This is well above the 8% benchmark in the EU legislation. In addition, we have recommended the sale of assets and set limits to the distribution of dividends.

The more stringent capital ratios aimed at strengthening the resilience of the banking system in the context of a very strong adjustment of the Portuguese economy. This resilience is especially important at times of economic adversity, where the recognition of impairments is a dynamic exercise with a powerful impact on banks' net income and capital positions.

The recapitalisation operations undertaken by the main banking institutions in 2012 – financed largely by the Bank Solvency Support Facility of the Economic Adjustment Programme – made a key contribution to boosting solvency in the system.

Besides solvency, the liquidity position of the main banking institutions has also improved considerably.

At the end of 2010, the loan-to-deposit ratio of the Portuguese banking system was around 160%. At the end of 2012 it has come down to 128%, decreasing further to 123% in June 2013.

The shutdown of capital markets to Portuguese banks in 2010 put pressure on the banking system's liquidity. In this context, banks had no option but to embark on a deleveraging process towards a more sustainable funding structure – a funding structure that would be less sensitive to changes in the risk perceptions of international investors.

Deleveraging has been continuously monitored by Banco de Portugal so as to ensure that it takes place in an orderly and gradual manner. We have emphasised that deleveraging strategies should concentrate on the sale of non-strategic assets, on increasing recourse to stable funding (notably in the form of customer resources) and on capital increases.

The positive trend in the loan-to-deposit ratio reflects the behaviour of households' deposits – which, after growing sharply in 2011, remained relatively stable from 2012 onwards – and a fall in credit granted by banks. The behaviour of bank deposits contrasts with developments in other Programme countries. It is a sign of depositors' confidence in the soundness of the Portuguese banking system, something that we must absolutely preserve.

The more comfortable liquidity situation was, of course, greatly facilitated by the non-standard monetary policy measures adopted by the European Central Bank. These have led to a significant increase in assets eligible for use in monetary policy operations and to an extension of maturities in financing operations.

In addition, to encourage the distribution of liquidity among the Portuguese banks, Banco de Portugal has also launched a new platform for processing secured and unsecured interbank money market operations.

In the interim, two large Portuguese banks initiated a return to the bond markets. This is also an encouraging sign, even if the cost and volume of bond issues held do not yet allow these operations to be seen as a relevant alternative source of financing.

Strengthening the regulatory framework and the supervisory model

The improvement in the banks' solvency and liquidity position was accompanied by a major upgrade in both the regulatory framework and the supervision approach.

Let me highlight three points.

First, the legal framework of supervision was considerably enhanced in parallel with developments at the European level. In particular, Banco de Portugal has been entrusted with an explicit mandate for macroprudential policy and has been designated resolution authority. Also, a comprehensive and coherent legal framework for the recapitalization of banks, the deposit guarantee system and the prevention and management of arrears situations was adopted.

Second, a major reorganization of the supervisory function within the central bank has taken place, and the resources devoted to supervision are being considerably enhanced, both in terms of headcount and qualifications.

In line with international best practice, we have attributed responsibilities for macroprudential policy, prudential supervision, conduct supervision and legal enforcement to different departments within the bank. At the same time, internal coordination mechanisms among the different areas were created, with the highest instance of coordination – the so-called Specialized Commission for Supervision and Financial Stability – being headed by the Governor.

As far as resources are concerned, the number of staff devoted to these different supervisory areas increased from 255 in 2009 to 358 estimated for the end of 2013. At the same time, in order to enhance qualifications on a lasting basis, Banco de Portugal has entered into a partnership with Nova School of Business and Economics to create a new Major in Banking, Financial Regulation and Supervision as part of the Nova's MSc in Finance, which by the way is ranked 21st by the Financial Times amongst the best Master's degrees in Finance in the world (pre-experience). It is worth noting that Nova was chosen through a competitive process in which the most significant business schools in the Lisbon area took part. The second edition of this Major in Banking, Financial Regulation and Supervision is now running, and we are already benefiting from the competencies acquired by those students that attended the first edition.

Third, the range of instruments was considerably expanded in tandem with a complete overhaul of the conceptual and operational approach to supervision. This led to micro and macroprudential functions interacting more closely. The traditional static analysis focusing on individual institutions has been complemented with a forward-looking and systemic view in order to better appraise the existence of financial imbalances with systemic impact. Moreover, there was a shift towards a more risk-focused and intrusive supervision approach. The more intrusive supervision involves the presence of permanent inspection teams in the larger institutions and the conduct of various on-site inspections.

The new approach has relied on a new set of instruments, of which I would highlight the banks' funding and capital plans, the stress tests and the horizontal inspections carried out by Banco de Portugal.

Let me explain these instruments in a little more detail.

Banks now submit medium term funding and capital plans to Banco de Portugal on a quarterly basis. Underlying such plans is a set of principles and restrictions, including the need for a gradual and orderly deleveraging process that does not compromise – but rather redirects – funding towards the economy's more competitive sectors and firms. These plans are important instruments for evaluating the adjustment of the banking sector and the economy in general, as they contain detailed information on the medium and long-term projections for the banks' balance sheets and profit and loss accounts. We have also conducted quarterly stress tests on the biggest banking institutions, based on a common macroeconomic scenario. The results of the tests have pointed to the resilience of the institutions against particularly adverse macroeconomic scenarios.

In 2011, Banco de Portugal launched a wide-ranging on-site inspection programme under the Economic and Financial Adjustment Programme, which came to be known as the SIP (Special Inspections Programme). This involved an external assessment of the banks' credit portfolios, verification of the risk assessment methods used by the institutions and assessment of the methodologies used in the stress tests. The credit portfolio assessed amounted to €281 billion, representing 65% of total assets. The results of the exercise revealed the need to reinforce impairments by €838 million euros. This amount corresponds to 0.3% of the total of such credits.

The SIP provided a snapshot of the quality of the banks' assets. As the situation is dynamic, Banco de Portugal decided to include in its regular banking system supervision periodic horizontal monitoring of the overall credit portfolio, or of specific asset classes particularly exposed to macroeconomic or market developments. The goal is to ensure that at any given moment banks' balance sheets accurately reflect the real value of their assets.

In 2012, Banco de Portugal ran a detailed assessment of the construction and real estate sectors' credit portfolios. The exercise covered exposure to entities operating directly in the construction and real estate sectors, exposure to holdings of those entities, to tourism sector entities, to entities whose activities have close links to the construction sector and to entities belonging to the same economic group. The credit portfolio assessed amounted to €69 billion, representing 16% of total assets. The results of the exercise pointed to a need to reinforce the value of impairments by €861 million, around 2.2% of the overall amount of exposures assessed.

In 2013, Banco de Portugal ran a new exercise focused on credit portfolio impairment assessment and on the fair value calculation of the participation units held in restructuring funds. It was directed to credit granted by banks to all segments, with the exception of mortgage and consumer credit (which are assessed by collective impairment models) and of credit to public sector entities. The credit portfolio assessed amounted to €93 billion, representing 23% of total assets. As a result of the exercise, it was considered necessary a reinforcement of €1.1 billion of the value of impairments, approximately 2.1% of the overall amount of exposures assessed.

In all exercises, the valuation of the credit portfolio was performed by independent external auditing firms (Ernst & Young Audit & Associados – Sociedade de Revisores Oficiais de Contas, S.A. and PricewaterhouseCoopers & Associados – SROC, Lda) without any relation with the inspected institution. Moreover, a strict governance structure was defined to monitor the exercises. A Steering Committee was created, chaired by the Banco de Portugal and comprising experts appointed by the EC, ECB and IMF, by three euro area supervisory authorities (Banco de España, National Bank of Belgium, Banque de France/ACP) and by Banco de Portugal.

It goes without saying that all these exercises have been subject to close scrutiny by the Troika. It is also worth mentioning that the asset quality review of European banks recently announced by the ECB will follow the same type of approach that we have followed in our horizontal inspections.

Other instruments worth mentioning include:

- The adoption of a new, more stringent, non-performing loans (NPL) ratio, based on international best practice. It is more comprehensive than the concept used previously, as it incorporates the possibility of debtors with payments in arrears continuing to fail to meet their credit commitments. It is in line with the NPL definition used by the IMF, reinforcing the comparability and transparency of information on credit quality. The new non-performing loans concept is more conservative than the European average (collateral is not deducted from the NPL ratio).
- The adoption of measures to discourage evergreening. In particular, Banco de Portugal required banks to earmark and report any changes in the terms of a loan triggered by financial difficulties of the borrower.
- The adoption of measures to increase the robustness of credit institutions' governance models (in particular related to internal controls and remuneration policies).

Main challenges ahead

These developments are encouraging and show that significant progress has already been achieved. I have no doubt that we are now much better equipped to deal with emerging financial strains then we were at the outset of the current financial crisis. Nevertheless, there are still major domestic and external challenges facing the future evolution of the Portuguese banking system.

Domestically the main challenge to the banking system is profitability.

As you know, the banks' profitability has been under great pressure. The RoA declined from 0.48% in December 2010 to –0.55% in June 2013. In the same period, the RoE declined from 6.7% to –7.19%. This is due to a variety of factors.

Firstly, default in the credit portfolio has been increasing due inter alia to the prolonged economic recession, even though the flow of new defaults has been declining, consistent with the signs of recovery in the real economy. The decline of NPL was accompanied by an increase in impairments and as a consequence the NPL coverage remained relatively stable throughout the period.

Secondly, net interest income has narrowed (from 1.5% in December 2010 to 1.05% in June 2013) due to various causes, of which I would like to stress the following five:

- The low level of short-term interest rates, which reduces spreads on demand deposits. Of course this also means that the return to normal interest rates values will contribute to the improvement of the net interest income of the Portuguese banks.

- High financing costs related to the increase in the deposit base and the costs of hybrid instruments;
- Decreasing activity in the credit market;
- Increasing defaults in the credit portfolio;
- The low profitability of the mortgage credit granted in the past.

Thirdly, despite the adjustment achieved to-date, banks currently bear operating costs that are out of step with the "new normal", in which the economy will be less leveraged than before the financial crisis.

This low profitability, coupled with the increasing application of Basel III rules, will continue to force institutions to manage their capital levels with particular care and pro-activity.

To respond to these challenges, the institutions must take action on various fronts:

- On the one hand, they need to find ways to reduce the proportion of legacy assets with low interest rate spreads, thereby freeing liquidity for new activity. In this respect I would like to point out that, when Portuguese banks benefit from a more adequate rating (for example, if acquired by an institution with a high-quality rating), they will automatically benefit from a re-rating of their mortgage portfolio and realize gains.
- On the other hand, they need to execute their rationalisation plans with determination, in order to bring about structural cost reduction.
- Lastly, they need to actively seek out strategic investors that can bring new capital to the institutions.

At European level, the negative interaction between sovereigns and banks has to be credibly and effectively broken, and the normal functioning of the money and debt markets in the euro area must be re-established. The creation of the Banking Union is key in this process.

With the Banking Union, the European Central Bank becomes responsible for the prudential supervision of euro area credit institutions, through the so-called Single Supervisory Mechanism. From November 2014, the ECB will be responsible for direct supervision of the credit institutions which are deemed to be "significant" and the national supervisory authorities will directly supervise all the other institutions, always following a common framework.

Over the past few months, detailed preparatory work has been undertaken to put the Single Supervisory Mechanism into operation. Banco de Portugal has taken an active role in this process.

In the context of the preparatory work, the next big challenge is the comprehensive balance sheet assessment of "significant" institutions by the ECB and the participating national competent authorities. This exercise, which starts in a few days, will comprise an assessment of key risks, an asset quality review and a stress test. As pointed out, this approach is very similar to the one followed by Banco de Portugal over the last three years. Four Portuguese institutions will be included in the comprehensive assessment: Banco BPI, Banco Comercial Português, Caixa Geral de Depósitos and Espírito Santo Financial Group.

This exercise is very important for ensuring transparency and enhancing investors' confidence in the euro area banks and the quality of their balance sheets. From the SSM perspective, the exercise is like "due diligence" before the start of the banking union.

In my view, to enhance credibility in the system the comprehensive assessment exercise should be based on three main principles:

- First, the appropriate course of action should follow a “going concern” approach;
- Second, the methodologies used in the asset quality review and in the stress test exercise should be well tested and proven.
- Finally, backstops must be established before they are needed. In Portugal, we have already in place a backstop mechanism to provide temporary capital injections for banks that might not be able to reach the requirements on time through market-based solutions.

By way of conclusion, I would like to come back to where I started. The Portuguese banking system is currently more capitalized, more transparent and in a more favourable liquidity position. We benefit from improved supervision and a stronger regulatory framework. I am sure that we are now in a much better position to handle financial strains then we were at the outset of the current financial crisis.

Thank you for your attention.