Carlos da Silva Costa: The Portuguese banking system – challenges and possible responses

Opening note by Mr Carlos da Silva Costa, Governor of the Bank of Portugal, at the 4th Money Conference, Lisbon, 22 November 2019.

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As prepared for delivery.

Good morning,

It is with great pleasure that I take part in the 4th edition of the Money Conference.

In this opening note I aim to comment on some of the challenges that the Portuguese banking system faces and highlight some of the possible responses.

Let me begin with a summary of some relevant indicators.

In recent years, the Portuguese banking system has been characterised by a series of positive developments. Portuguese banks are today more capitalised and are more stable in terms of resource intermediation. They have abundant liquidity and have improved their productivity indices. Observed in quantitative terms in[1]:

- An increase in the total capital ratio from 10.3% to 16.1% (between the end of 2010 and June 2019);
- An increase in the liquidity coverage ratio (LCR) from 151.5% to 212.3% (between the third quarter of 2016[2] and June 2019);
- A reduction in the loan-to-deposit ratio (LtD) from 150.6% to 88.2% (between the end of 2010 and June 2019);
- An increase in the total average assets per branch from 81.5 to 94.9 million euro (between the end of 2010 and the end of 2018).

In the first half of 2019, there was an increase in profitability of the Portuguese banking system. The return on equity (ROE) in June 2019 was 8.4%, compared with 6% of the average of significant institutions supervised by the Single Supervisory Mechanism[3] .

For this increase there were, on the one hand, factors of a structural nature, namely the increase in the sector's efficiency and, on the other, the lower weight of losses associated with the assets generated over the period of great credit expansion, observed in the reduction of costs with provisions and impairments.

However, there are enormous challenges for the sector against a background of moderate future economic growth, low interest rates and high indebtedness of public and private agents.

Thus, in the **first place**, banks must continue to reduce their non-performing assets in line with the guidelines and reduction plans submitted to the supervisory authorities. It must be considered that the ratio of non-performing loans (NPLs) net of impairments in the Portuguese banking system remains one of the highest in Europe, notwithstanding the progress already made since 2016.

In **second place**, there remains a need for the banking system to continue to reinforce its loss-absorption capacity. Despite the improvement observed in recent years, with the increase in capital ratios, these remain below the euro area average.

Furthermore, challenges remain for compliance with the minimum requirements for own funds and eligible liabilities able to cover losses and enable recapitalisation of the institution in case of resolution (MREL) in a context where profitability is expected to be challenging.

In **third place**, it is necessary to ensure (i) that rates charged, namely on credit, reflect the nature and risk of investments and (ii) actively accompany the credit quality of borrowers over the time horizon of the operations.

Against a background of low interest rates, it is necessary to avoid inadequate search for yield behaviour, whose impact on institutions' solvency may be reflected several years hence.

In **fourth place**, it is necessary to consider that in a context of a general reduction in sovereign yields – currently at exceptionally low levels – the possibility of a reassessment of risk premia and a greater differentiation among sovereigns is higher.

This means that portfolio diversification in terms of issuers and a reduction in the correlation of their specific risk profiles are desirable. This imperative is ever greater as the portfolio adjustment is more easily absorbed by the market without affecting the issuers. On the other hand, portfolio diversification allows possible regulatory developments to be anticipated.

This is also an issue of undeniable interest not only to the sovereign, but also to the Portuguese financial system considering the incomplete Banking Union in which the doom loop remains.

In **fifth place**, banks have to be prepared for a situation in which capital markets have a greater importance in financing the real economy. This means (i) that for an identical raising of funds, banks will have a different asset composition and (ii) that the raising of funds will be subject to competition from non-bank financial institutions and non-financial issuers of debt and investment instruments.

In this context it is noteworthy that at European level the non-banking financial sector has significantly expanded its role in financing the real economy, corresponding to 55% of the total financial sector in the euro area. Total non-banks' assets have almost doubled over the last 10 years in the euro area. In comparison, the size of the banking sector stagnated over this period.[4]

The most recent impetus to deepen the Capital Markets Union is in line with greater integration of the European financial markets[5], which brings new challenges and opportunities where promoting sustainable finance gains prominence.

Attracting savings and financing through the capital markets, as an alternative to the traditional banking sector, will bring about an increase in shared private risk on a cross-border basis, simultaneously creating competitive pressures that will reveal an excess of installed capacity, generating movements towards consolidation as a response to the need for greater scale and efficiency.

In **sixth place**, banks, just like any other incumbent financial institutions, will face competition from new entities based on digital transactional platforms and models that will challenge them from a technological and market share point of view. This has made the need for investment and absorption of new technologies more urgent in terms of both the processes and the relationship with the market (so-called digital banking).

In this context, the banking system needs to adopt a proactive stance, assessing the competitiveness and viability of its business model(s) in a timely way, in view of the different segments and products.

In **seventh place**, an approach is needed that assimilates and anticipates, whenever possible, the regulatory dynamic making the observance of the supervisory rules – compliance with capital and liquidity ratios, stress tests etc. – a competitive advantage generating confidence in the market.

In **eighth place**, it is essential to ensure the confidence of the capital markets and the public in general. Such confidence is dependent on the elimination of uncertainties as to the nature and valorisation of assets as well as business models and strategies, moving from an approach of limited transparency to one of transparency adjusted to the information requirements, in terms of content and form, for each stakeholder.

Allow me to elaborate on this latter aspect.

Regarding institutions' governance, to avoid the materialisation of events that may jeopardise their financial soundness, it must be ensured that the four lines of defence are fully operational and focused on the sustainability of the institution and the safeguard of public confidence in its activity.

Thus, the Board of Directors is responsible for ensuring sound and prudent management as well as anticipating and adapting the business model based on developments in the business environment. Namely, it is responsible for interpreting shareholders' appetite for risk, both in terms of capital requirements and risk taking and acting with diligence, neutrality and conscientious respect for the interests of the depositors, investors, creditors and customers in general, whilst retaining the principle of risk-sharing and the safety of the funds entrusted to it.

The supervisory bodies and control functions are responsible for rigorously and substantially overseeing the remits conceded by law.

Particular regard should be given to the role of the supervisory body for the relevance and coverage of the competences attributed to it by law, including overseeing the management body of the undertaking; verifying the precision of the reporting documents and correct assessment of its assets and results; and overseeing the effectiveness of, inter alia, its risk management, internal control and internal audit systems.

The internal control mechanisms (compliance, risk management control and internal audit) are also essential, especially to guarantee suitable control of risks incurred in banking activity.

The external auditor is responsible for exhaustively certifying the veracity and completeness of the information, namely the risks that the institution incurs and the costs for the different stakeholders.

For the duties of independence, integrity and objectivity attributed to it by law, as well as the public interest duties that such a function covers, the external auditor is the element that has the greatest influence on the external credibility of the financial statements, to which, naturally, the legal certification of the accounts contributes.

Finally, it is the supervisor's responsibility, as I said when I took office in 2010, "to apply the principle of systematic doubt [...] to carry out a role that is countercyclical". This implies a "check [...] on the soundness of its fundamentals, its future risks and the way these are recorded on the supervised institution's balance sheet"[6].

This demands the adoption of a perspective that is sceptical, intrusive and proactive, not only in verifying the veracity of the information and its compliance with the regulatory framework, but also in monitoring the sustainability of the institution vis-à-vis the risk taken and its ability to absorb that risk. The supervisor is also responsible for demanding a capital enhancement to address the business model/risks incurred and the risks of the economy (stress testing).

Considering the need to permanently reinforce the mechanisms designed to prevent or mitigate risks to financial system stability, Banco de Portugal is due to launch a public consultation into a Notice that will repeal and replace Notice No 5/2008 relating to internal control, in light of the developments in European and Portuguese legislation, the guidelines of the European Banking Authority, international best practice, reflection and practical supervisory experience accumulated by Banco de Portugal, as well as for reasons of legal certainty and security.

This consultation will take place in a context in which, in the significant institutions supervised by the Single Supervisory Mechanism as a whole, there remains a significant number of opportunities for improvement at internal governance, risk management, data aggregation, reporting and internal audit.[7]

Being undoubtedly a common aim, I hope that you are able to participate actively in this consultation, contributing with your experience to the final design of a fundamental instrument in the defence of financial stability.

Thank you all.

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1 Banco de Portugal (2019), *Séries Longas – Setor Bancário Português 1990–2018*, , available at www.bportugal.pt/sites/default/files/anexos/documentos-relacionados/series_longas_setor_bancario_portugues.xlsx and Banco de Portugal (2019), *Sistema Bancário Português: desenvolvimentos recentes – 2.º trimestre de 2019*, available at: www.bportugal.pt/sites/default/files/anexos/visaosistemabancarioportuguesdados_pt.xlsx both in Portuguese only.

2 First date from which data are available.

3 Banco de Portugal (2019), Portuguese Banking System – 2nd quarter 2019, available at: www.bportugal.pt/sites/default/files/anexos/pdf-boletim/overviewportuguesebankingsystem_2019q2_en.pdf and ECB (2019), Supervisory Banking Statistics Q2 2019, available at: www.bankingsupervision.europa.eu/banking/statistics/html/index.en.html.

4 Guindos, L. (2019), “Key vulnerabilities for euro area financial stability”, remarks at the meeting of the Financial Stability Contact Group, Frankfurt am Main, 2 October.

5 See discussions within ECOFIN informal session, September 2019 (eu2019.fi/documents/11707387/15400298/CMU+Reboot+Informal+ECOFIN+final+Issues+Note+2019–09–09_S4.pdf/05142af6-25f0-74d0-7d2a-7eb68a2bcb39/CMU+Reboot+Informal+ECOFIN+final+Issues+Note+2019–09–09_S4.pdf) and the Next CMU High-level Group (joint initiative between finance ministers of Germany, France and Netherlands: minefi.hosting.augure.com/Augure_Minefi/r/ContenuEnLigne/Download?id=7AEFAF36–7449–471F-B86F-08E8B9E1CE71&filename=1470%20-%20Savings%20and%20Sustainable%20Investment%20Union%20joint%20press%20release%20(004).pdf e www.economie.gouv.fr/files/2019–10/The_Next_CMU_HL_DO.pdf).

6 Costa, C. (2010), Address on the occasion of his taking office as Governor of Banco de Portugal, 7 June, available at: www.bportugal.pt/en/intervencoes/address-mr-carlos-costa-occasion-his-taking-office-governor-banco-de-portugal.

7 See www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.srep_methodology_booklet_2018~b0e30ced94.en.pdf p. 9.