Overview

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

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

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

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

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

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

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

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

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

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

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

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

During the three-year EFAP period, there was a significant improvement in terms of liquidity, associated with positive developments of deposits and the ECB's conduct through standard and non-standard monetary policy measures. Deposit developments played a key role in the adjustment process of the banking system's financing sources, contributing to a more sustainable structure, less sensitive to changes in risk perception by international investors. This increase in deposits, simultaneously with a reduction in portfolio credit, made it possible to significantly reduce the credit/deposit ratio from 158 per cent at the end of 2010 to 117 per cent at the end of 2013.

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

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

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

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

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

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

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

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

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

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

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

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