Financial Stability Report

November 2016

BANCO DE PORTUGAL
EUROSYSTEM

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I

Financial stability: Vulnerabilities and risks

Summary

Macroprudential policy is based on identifying and assessing vulnerabilities and risks to financial stability, in order to introduce measures for their mitigation. A risk is a possible adverse shock that may harm financial stability if it materialises. After the risks are identified, there are various relevant aspects for their assessment: on one hand, the probability of the risk materialising, and on the other, the possible time horizon, intensity and duration of its effects. Regarding the so-called vulnerabilities or fragilities, these are pre-existing conditions that may interact with the risks, increasing their probability of materialising and/or amplifying their consequences.

The nature of the risks has remained virtually unchanged since the last Financial Stability Report, although some of them have materialised in part, including: (i) the risk of prolongation or aggravation of the low interest rate environment; (ii) the risk of the economic perspectives deteriorating in Portugal and in other geographies to which domestic agents are most exposed; (iii) the risk of sovereign debt risk premia increasing, in particular on Portuguese sovereign debt; and (iv) the risk of intensifying negative perception by the market towards banks with higher levels of non-productive assets.

Other important risks, although not materialising significantly in the last few months, arise from the possibility of reputational costs for the financial institutions related to the mis-selling of products to their retail customers, and the possibility of adverse developments in real estate prices. This reputational risk is particularly relevant given the current weak profitability of the "traditional" financial products and the regulatory pressures that require the banks to issue debt and capital instruments. With regard to residential and commercial real estate prices, these may drop if there is pressure on the markets from a deterioration in economic conditions, a change to taxation or an abrupt reduction of the financial sector's exposure to this kind of asset.

The probability of the identified risks materialising, as well as the impact of that, are adversely influenced by a set of vulnerabilities, some general in scope and others specific to the financial system. One of the most important is the weak potential output growth of the European economy, and of the Portuguese economy in particular. Furthermore, in Portugal, high levels of public sector and non-financial private sector indebtedness remain, which highlights the need to pursue adjustment processes.

The specific vulnerabilities of the financial system, and in particular the banking sector, include: (i) the high stock of non-productive assets on the banks' balance sheet (mainly Non-Performing Loans (NPLs) (see Special Issue “IV.3 Concepts used in analysing credit quality”), but also real estate obtained in lieu of repayment, units in real estate investment funds and restructuring funds and deferred tax assets); (ii) the significant exposure to sovereign debt, in particular to domestic sovereign debt and also, in the case of the banks, to credit related to the real estate sector and companies strongly exposed to emerging market economies that have recently performed negatively; and (iii) the sustainability of the business models in the prevailing environment of low economic growth and interest rates.

These vulnerabilities hamper income generation and as a result internal capital, damaging investors' perception of the sector, both for the purposes of capital increase (by current and/or potential new private shareholders), and for the placement of debt in the wholesale financial markets. However, this has not prevented interest over the last few months among private shareholders in acquiring or increasing their holdings in Portuguese banking groups.

II
Financing of the economy

Summary

In the first half of 2016, the Portuguese economy has continued to make a moderate recovery, decelerating versus the year before. Over this period, the growth rate of private consumption has stabilised, gross fixed capital formation has fallen, after recovering in 2015, and the deceleration profile of goods and services exports in place since the middle of 2015 has continued.

The high levels of indebtedness in the public and private sectors and the need to adjust their balance sheets have hampered economic growth, which in particular has seen low levels of domestic investment. In turn, the domestic saving rate has stabilised since 2013 at around 15 per cent of GDP, which is below the euro area average. However, in annual terms, the Portuguese economy has presented a net lending capacity since 2013, largely as a result of the positive performance of the goods and services account. In the first half of 2016, the economy presented a borrowing requirement, as it had in the first half of 2015, reflecting seasonal factors (Chart 1). The most recent projections continue to suggest an external surplus for 2016 as a whole.

The household saving rate has fallen to the lowest levels since 1999. By contrast, the improved profitability of non-financial corporations has led their saving rate to increase to the highest levels since 1999. The developments of the various economic sectors' saving are interrelated, both because there is income that is particularly difficult to assign to a sector, mainly between households and non-financial corporations, and because there are transactions between sectors that directly influence the respective saving. Saving by households and the other economic sectors is an essential domestic source of investment financing, thereby affecting potential economic growth and the sustainability of external debt. Given the low level of the economy's net lending, foreign direct investment or domestic saving will have to increase to support sustainably the greater investment required for the desired increase in the economy's growth.

Regarding the public accounts, the budget outturn for the first half of 2016 led to a borrowing requirement below that of the first half of the previous year. Given this development and the values observed up to September, compliance with the deficit objective in 2016, as defined by the Council of the European Union (EU) – of 2.5% of GDP excluding any support to the financial system – is feasible, although subject to non-negligible risk factors.

Portugal's public debt as a percentage of GDP rose in the first six months of the year, but taken net of central government deposits

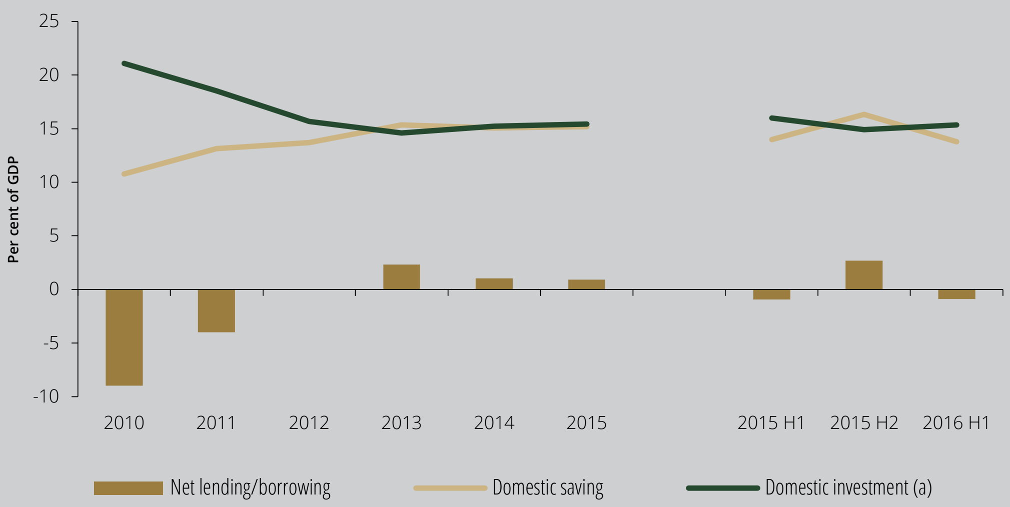

Chart 1 • Domestic investment, saving and net lending/ borrowing

Source: Statistics Portugal.

Notes: Semiannual values are based on quarterly national accounts. (a) It 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.

was stable. Over this period, the Portuguese State made a new partial repayment of the loan from the IMF, under the Economic and Financial Assistance Programme, and continued the issuance programme of securities with different maturities in the sovereign debt markets, although at higher average rates than in 2015. In parallel, over the same period, Portuguese sovereign bond yields grew, increasing the spread against German sovereign bond yields and countercyclical to the movement observed in Spain or Italy. In most euro area countries, sovereign bond yields have trended downwards, influenced by the Eurosystem's activity in secondary debt markets. To this end, in March the Governing Council of the European Central Bank took additional monetary stimulus measures, given the deterioration of economic and financial conditions and the increased risk of falling inflation. These measures include an expansion of the asset purchase programme's monthly purchase amount and its extension to March 2017.

The reduction of the Portuguese economy's external borrowing has essentially reflected the reduced leverage of the non-financial private sector, despite it remaining among the highest in the euro area. However, that falling trend lost momentum in the first half of 2016. Despite the net repayment of loans from the resident financial segment to the non-financial private sector, new loan provision accelerated, both for households and for smaller-sized non-financial corporations. This acceleration went hand-in-hand with a narrowing of spreads applied to lower-risk customers, in a context of increased banking competition.

In the case of households, the acceleration mentioned was seen mostly in the consumer credit segment, with the flow of new car purchase loans in strong growth. The ratio of new consumer credit flows to private consumption has followed an upward trend, reaching levels close to those observed before the sovereign debt crisis (see Special Issue "IV. 1 Recent developments in consumer lending – a macroprudential approach"). In the housing credit segment, the flow of new loans also grew strongly. However, the annual rate of change in the outstanding amounts of these loans remained negative and the ratio of households' total debt to GDP fell versus December 2015, although to a lesser degree than from 2009 onwards.

Although the net repayment of loans by non-financial corporations to the resident financial sector has continued, total lending to this sector have increased overall. This is principally due to loans provided by non-residents, both by companies of the same economic group, and by banks, probably affecting larger-size companies for the most part. The sector's total debt-to-GDP ratio remained virtually unchanged versus the end of 2015.

In parallel with the fall in households' and non-financial corporations' debt, the resident financial system has moved towards providing credit to segments with a better risk profile, mainly in the case of companies. However, despite the low level of interest rates contributing to a substantial fall in the debt service burden for indebted economic agents, the level of credit in default on the banking system's balance sheet remains high, originating principally from the corporate segment (see "I. Financial stability: Vulnerabilities and risks").

The activity of the subsectors operating in financial intermediation continued to contract, reflecting, on one hand, the deleveraging of the domestic non-financial segments and, on the other, portfolio recomposition by investors, penalising the non-banking financial segments mostly. This includes the reduction of households' investments in life insurance and in investment fund units. Deposits of the non-financial private sector in resident banks increased, helping the banking system continue to reduce its financing from the ECB.

In the first half of 2016, the financial flows between the resident and non-resident sectors translated into a net inflow of funds from abroad. The international investment position of the Portuguese economy improved over the period, reflecting above all the falling price of public debt securities and shares quoted in the non-resident portfolio, as well as the effect of the rising gold price on Banco de Portugal's assets.

III
Banking sector

Summary

As a result of the Economic and Financial Assistance Programme (EFAP), the Portuguese banking system underwent profound adjustments, both in terms of size and composition of its balance sheet, and in terms of its cost structure.

The steep decline in assets occurred in a context of a reorientation of credit to the tradable goods and services sector to the detriment of the non-tradable sector, namely construction and property development, in line with the adjustment of the Portuguese economy. The aforementioned asset contraction was accompanied by a significant change in the funding structure, with a reduction in the dependence on wholesale funding (securities), in favour of more stable funding sources, namely customer deposits. This development enabled an increase in Portuguese banks' resilience to changes in international financial markets' sentiment.

In the first half of 2016, the decrease in total assets proceeded, albeit at a slower pace, with a continuing fall in credit to customers. In turn, the growth of the debt securities portfolio was reflected in an increase in the exposure of the banking system to the domestic public sector. The weight of customer resources continued to grow, with the collection of retail deposits in the domestic market remaining robust. The liquidity position of Portuguese banks remains comfortable, with an increasing coverage by liquid assets of short-term funding requirements.

The profitability of the banking system fell significantly in the first half of 2016 in year-on-year terms, due to a reduction in the results of financial operations and an increase in impairments and provisions for non-credit assets. However, the gradual recovery in banking profitability of a more recurrent nature continued. The improvement in net interest income, benefiting from the reduction in funding costs, contributed to this recovery. The flow of credit impairments also fell slightly.

Levels of non-performing loans are high, despite showing signs of stabilisation. The coverage of NPLs increased substantially, reflecting the significant build-up of impairment flows.

Solvency levels fell marginally, as a result of weak profitability in the sector and the gradual elimination of transitional provisions for eligibility of own funds, within the scope of the CRR/CRD IV implementation process.

Despite the progress achieved, the banking sector faces diverse challenges, at a time of transition to a more demanding regulatory framework and adverse economic conditions. In a context of persisting low interest rates, without a sustained recovery in economic activity, as well as uncertainty surrounding the contribution of international activity, the recovery of Portuguese banks' profitability will necessarily require an adequate credit risk control and additional cost rationalisation efforts. Encouraging greater operational efficiency should not, however, compromise the integrity of risk assessment and internal control procedures. Therefore, it is considered indispensable to continue the process of business model adjustment, which should take into account the demands and opportunities associated with the development of 'digital banking'. In fact, the successful adaptation of the banking system to this new paradigm requires a high level of initial investment in technological infrastructures, although it also represents an opportunity for banks to reduce their operational costs in a structural way.

Banks will also have to reduce their high levels of non-income-generating assets, especially NPLs associated with non-financial corporations, which have been penalising their profitability and solvency, thus limiting their capacity to attract funding and capital from international investors. The systemic potential associated with continued high levels of NPLs, the fact that overcoming them requires a multidimensional approach and is a problem common to other European countries, means that this question should be a priority to a wide range of credit institutions and authorities, both at domestic and European level.

IV
Special issues

1. Recent developments in consumer lending: A macroprudential approach

2. Efficiency of the Portuguese Banking System

3. Concepts used in analysing credit quality

1. Recent developments in consumer lending: A macroprudential approach

Summary

Among the intermediate objectives of macroprudential policy, one of Banco de Portugal's responsibilities, is the mitigation and prevention of excessive credit growth and leverage of the economy. Thus, when assessing risks to financial stability, as undertaken by Banco de Portugal, monitoring the evolution of credit to the economy is of the utmost importance.

Considering this, the upward path recently shown by consumer credit is analysed, as well as the possible risk this development may bring to the household de-leveraging process and to the quality of the resident financial system's balance sheet. Despite the reduced weight of consumer credit on total household debt and total loans from banks and other credit institutions, this segment of the lending market presents a significant default risk, and its persistent high growth could also lead to an increase in vulnerabilities, both for households and the banking system.

The recent increase in consumer credit was mainly driven by car loans, and was mostly associated with the effect of the anticipated purchase of cars as a result of the announcement of an increase in Vehicle Tax that came into force in April 2016. Although this evolution is expected to be of a temporary nature, reflecting the growth in the consumption of durables goods (that are projected to decelerate over the second half), the information regarding the third quarter of the year suggests a continued modest increase in annual rates of change. Therefore, given the reduced relative importance on households' balance sheets and the resident financial system, there is not expected to be a significant increase in risk to financial stability. However, further developments in consumer credit will continue to be closely monitored.

2. Efficiency of the Portuguese Banking System

Summary

In recent years, the Portuguese banking system has reduced its use of resources. Despite this reduction, when simple accounting-based efficiency metrics and operational resource utilisation indicators are considered, the Portuguese banking system is classified as being less efficient than many other European banking systems.

This type of simple assessment does not consider factor prices or bank dimension. This motivated an efficiency analysis of Portuguese banks using the so-called stochastic frontier method, which allows the effect of the above variables to be controlled. The results corroborate the initial idea that it is possible to improve use of resources in banking intermediation in Portugal given that, even considering the cost of financing and relatively small scale of Portuguese banks, which makes achieving economies of scale more difficult, the Portuguese banking system is below the European median in terms of the efficiency metrics produced by the model.

From a financial stability point of view, and according to the estimates presented, an increase in efficiency is considered to be a preferential path to be taken, aiming to improve Portuguese banks' profitability. However, the implementation of

solutions, be they cost control or consolidation, have various associated risks that should be considered, especially in the short term. In this context, the challenges and opportunities associated with digital banking and the so-called Fintechs are especially important.

3. Concepts used in analysing credit quality

Summary

Asset quality in banks' balance sheets can be assessed using different concepts, based on prudential, accounting or supervisory reporting benchmarks. Non-performing exposures (NPEs), of which non-performing loans (NPLs) are the chief component, are the main concepts at European level for assessing banks' credit quality. Therefore, it is important to have a clear perception of their definition and scope, as well as how they compare and relate with national concepts – being that in Portugal the credit at risk concept should be highlighted.

Currently, some international institutions, such as the European Banking Authority (EBA) and the European Central Bank (ECB), already use NPE/NPL based indicators to perform international analyses and comparisons on credit quality. In this context, it is relevant to consider the high subjectivity inherent to the application of these concepts and the current insufficient harmonisation across countries, and even across institutions of the same country.