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Building a new financial architecture

New regulatory requirements

Ricardo Salgado, CEO

Lisbon, March 26, 2010

Agenda

1. **Drivers of the worst financial crisis in history**
2. **Role of governments and regulators in response to the crisis**
3. **A new wave of regulatory reform: perspectives on future regulation**
4. **Implications of future regulation for banks and the economy: How far can we go?**

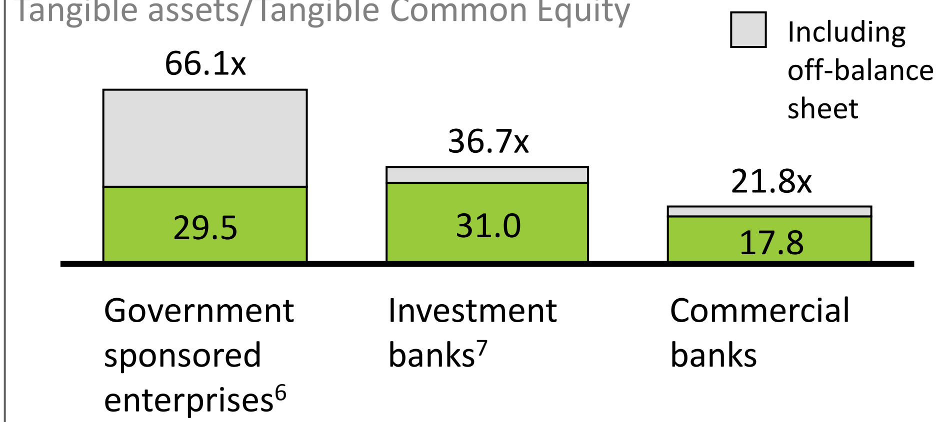
Fragmented regulation in the US with near-banking institutions highly leveraged

Complex and fragmented oversight of many un/under-regulated businesses

		Regulators	
Banks	National	FRB, OCC[2], FDIC	Financial Holdings regulated by FRB (national/ state bank), OTS (thrift), or SEC (largest securities firms)[1]
	State	FRB, States[3]	
	Thrift	OTS[2], FDIC	
Mortgage brokers		States[3]	
Consumer finance		States[3]	
Investment advisors		SEC, States[3]	
Securities		SEC, FINRA, CFTC, NFA, MSRB, States[3]	
Insurers		SEC, FINRA, States[3]	

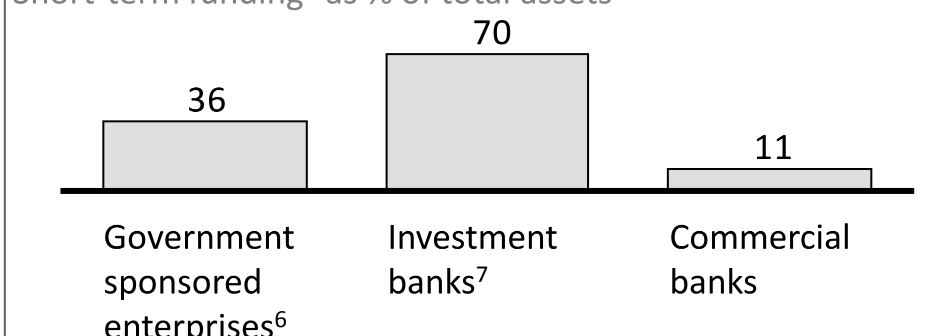
Leverage of selected financial intermediaries pre-crisis

Tangible assets/Tangible Common Equity



Funding profile of selected financial intermediaries pre-crisis

Short-term funding[5] as % of total assets



1 Until September 2008 when the last independent investment banks converted to Bank Holding Companies
2 Bank Regulators retain primary regulator responsibility for all products sold by banks and bank subsidiaries – which include equity, futures, etc.)
3 Specific regulatory agencies and functions differ by stat. States maintain primary oversight for the insurance industry and generally maintain some version of a financial services regulator
4 Estimated based on size of relevant securitized asset-baked security (ABS) pools, private ABS pools allocated to private intermediaries by asset size
5 Includes repos, capital market funding, all other short-term borrowing (e.g., commercial paper) and current portion of long-term debt
6 Examples of GSE include: Freddie Mac, Fannie Mae, Federal Home Loan Bank
7 Weighted average for 5 large broker dealers: Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, Morgan Stanley

Nota: FRB – Federal Reserve Bank; OCC – Office of the Comptroller of the Currency; OTS – Office of Thrift Supervision; FDIC – Federal Deposit Insurance Corporation; SEC – Securities and Exchange Commission; FINRA – Financial Industry Regulatory Authority; CFTC – Commodity Futures Trading Commission; NFA – National Futures association; MSRB - Municipal Securities Rulemaking Board

Source: SNL Financial; Federal Deposit Insurance Corporation; Securities Exchange Commission; McKinsey Global Institute

Drivers of the financial crisis

Real estate bubble burst caught highly leveraged institutions off-guard

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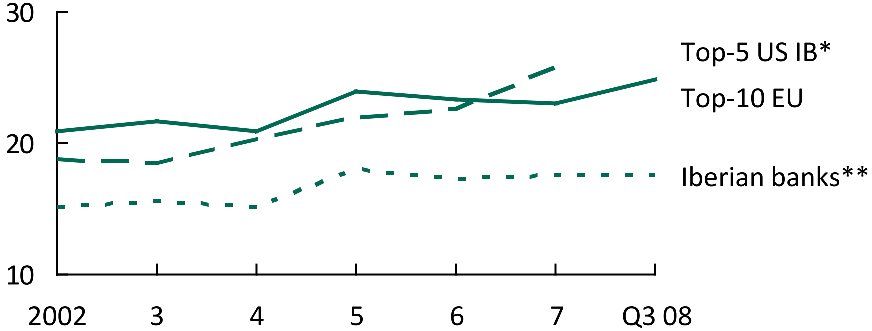
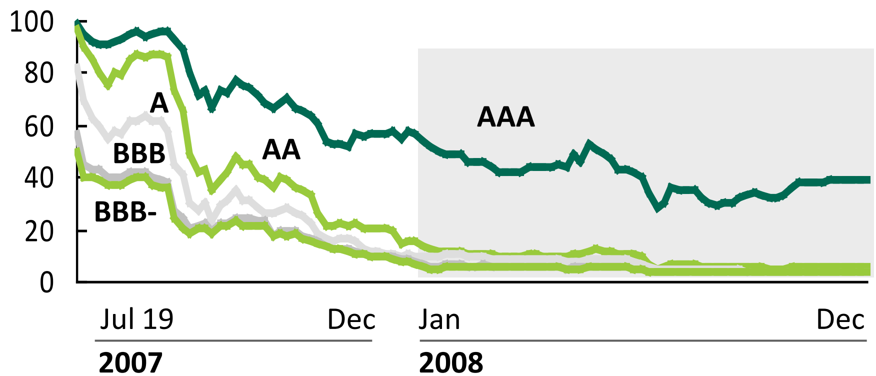
Banks had been increasing leverage whilst Real Estate bubble affected valuation of sub-prime backed securities…

Asset-to-equity ratio



Value of CDOs (collateralized debt obligation) of subprime mortgages

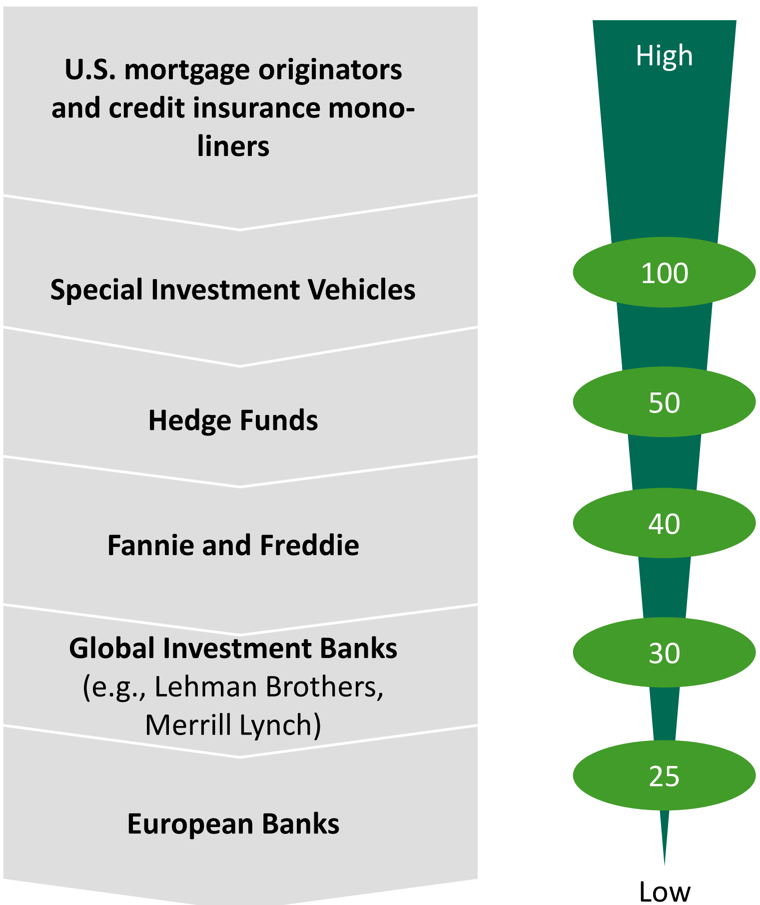
ABX*** US index, percentage



… and financial institutions were hit by the crisis according to the respective leverage ratios

Timeline of crisis casualties

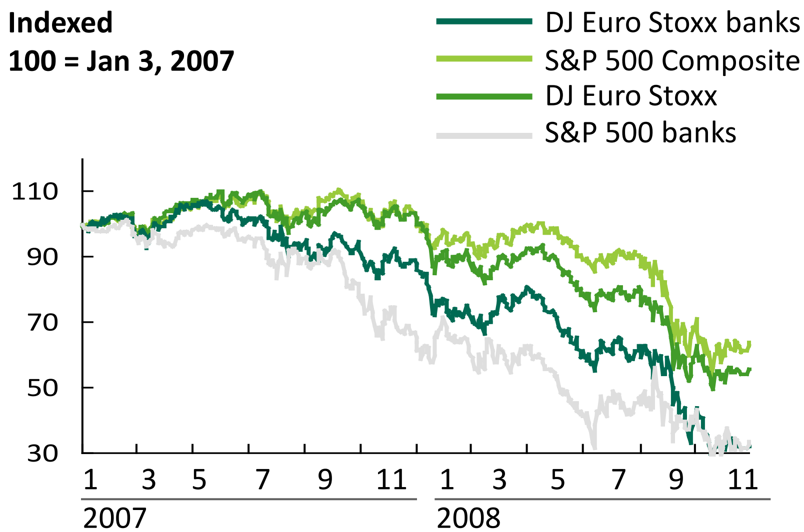
Assets/equity



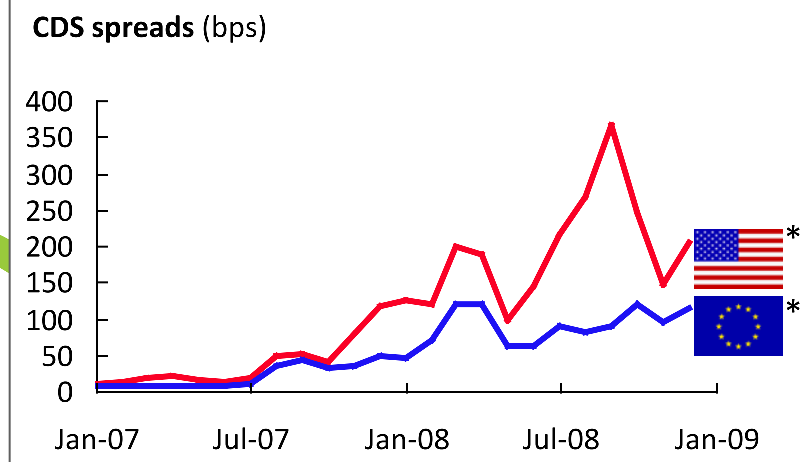
* Two of the banks were acquired and lost data.
** Top 5 Spanish banks and Top 5 Portuguese banks
*** US synthetic tradable index referencing a basket of 20 subprime mortgage-backed securities
Source: Bloomberg; McKinsey Financial Institutions Practice

Equity and debt markets reaction reinforced a vicious cycle that fuelled a "domino" effect

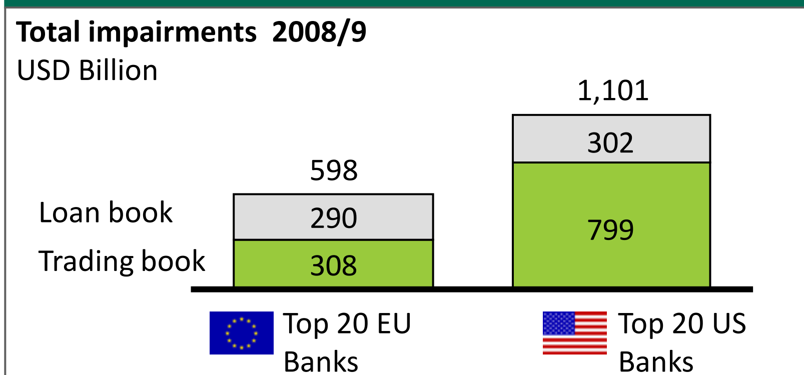
Abrupt reaction of capital markets accelerated by uncontrolled naked short-selling…



… as well as debt markets…



… reinforced a vicious impairment cycle



* US banks sector CDS index 5Y
** iTraxx Europe Financials Senior 5Y
Source: Bloomberg; Bank reports

As a response to the crisis, governments took decisive measures

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Main actions	**Troubled Asset Relief Program** (TARP) Measures	Total amount $bn	**EU program** Measures	Total amount €bn
Guarantee/ acquire debt	• Guarantee new senior unsecured debt issued by banks with up to 3 years of maturity • Acquire high-quality 3-month commercial papers issued by businesses • Guarantee money market mutual funds	**4,534**	• Guarantee newly issued debt of banks (e.g., France guarantees interbank loans of up to 5-year maturity and Germany guarantees interbank loans of up to 3-year maturity)	**2,738**
Recapitalize banks	• Acquire nonvoting common or preferred shares in publicly traded banks or senior debt in non-publicly traded banks	**664**	• Acquire stake in banks directly and through state-owned companies	**231**
Guarantee deposits	• Raise deposit insurance coverage to $250,000 • Offer unlimited cover of non-interest-bearing accounts	**N/A***	• Raise minimum coverage to €100,000 per depositor (in 2008)	**N/A***
Purchase troubled assets	• Acquire troubled assets from banks	**332**	• Acquire troubled assets from banks	**588****
Other initiatives	• Try to mitigate mortgage foreclosures • Restrict executive compensation • Try to recoup any losses incurred from the program within 5 years	**N/A***	• Restrict executive compensation	**N/A***

Similar measures were taken In Portugal

* Not applicable
** Includes all individual ad hoc measures not executed through direct intervention
Source: IMF (Fiscal Implications of the Global Economic and Financial Crisis); Commission of the European communities (State Aid Scoreboard); press clippings

In addition to direct intervention, regulatory bodies developed specific proposals to address key crisis drivers

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Prevent incentives for off-balance sheet securitizations

- **Shortcomings in the Basel capital** framework were removed
- **Accounting practices for off-balance sheet exposure improved** (relationship with the Special purpose vehicle more transparent)
- **Material improvement on disclosure of on and off balance sheet risk exposures**

Regulation of non-bank entities

- New principles defined to **oversee hedge funds**
- **Clear best practices for asset managers** due diligence when investing in structured finance products
- **Oversight over rating agencies**

Increase control on trading books

- **Higher capital requirements** against risk in bank's trading activities
- **New principles to counteract risks of abusive short-selling**

Improve overall risk management

- **New risk management standards**
  - Governance
  - Liquidity risk
  - Compensation risk
  - Stress testing
- **Introduction of central counterparts to credit default swaps**

Increase coordination between authorities

- **Establishment of supervisor/colleges** for all the large complex financial groups
- **Contingency planning meetings among relevant authorities on major cross-border banks**

Review Executive compensation

- **FSB (Financial Stability Board) principles on compensation practices** integrated into the Basel capital framework

Source: Financial Stability Board – "Improving financial regulation"; "Report of the financial stability board to G20 leaders", September 25th, 2009

Most banks have already raised their capital and are now above regulatory requirements

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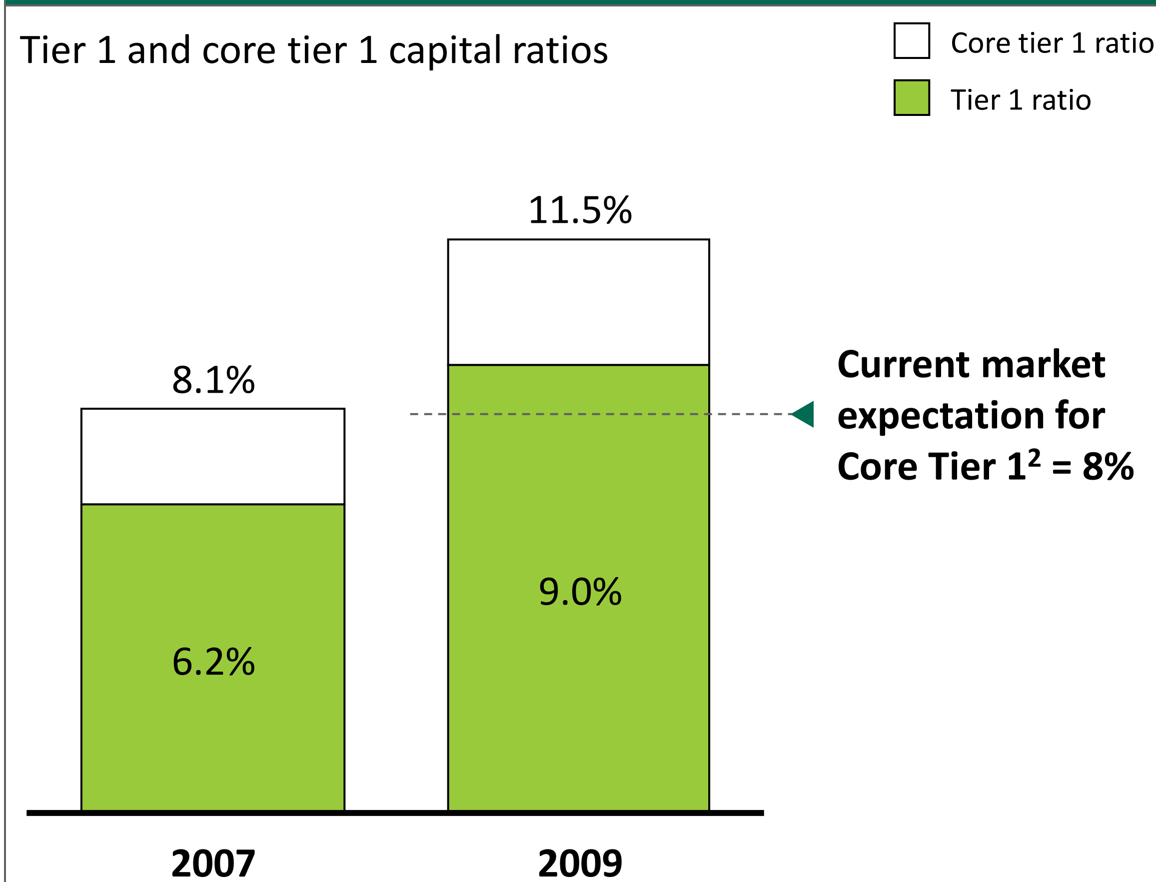
Since January 2008, European banks have raised their capital base

- 178 billion euros from private sources
- 210 billion euros from governments and sovereign funds

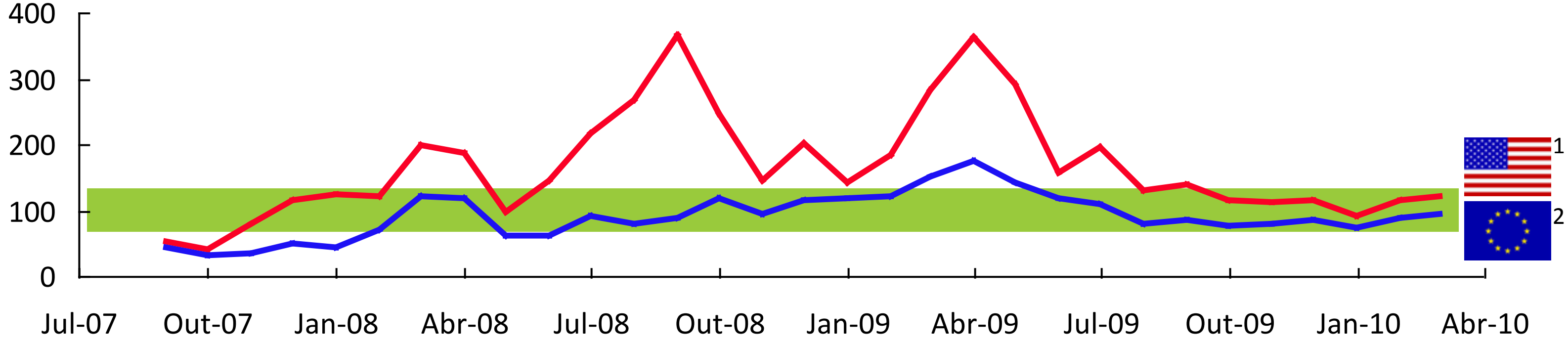
Sample of 13 European banks[1]



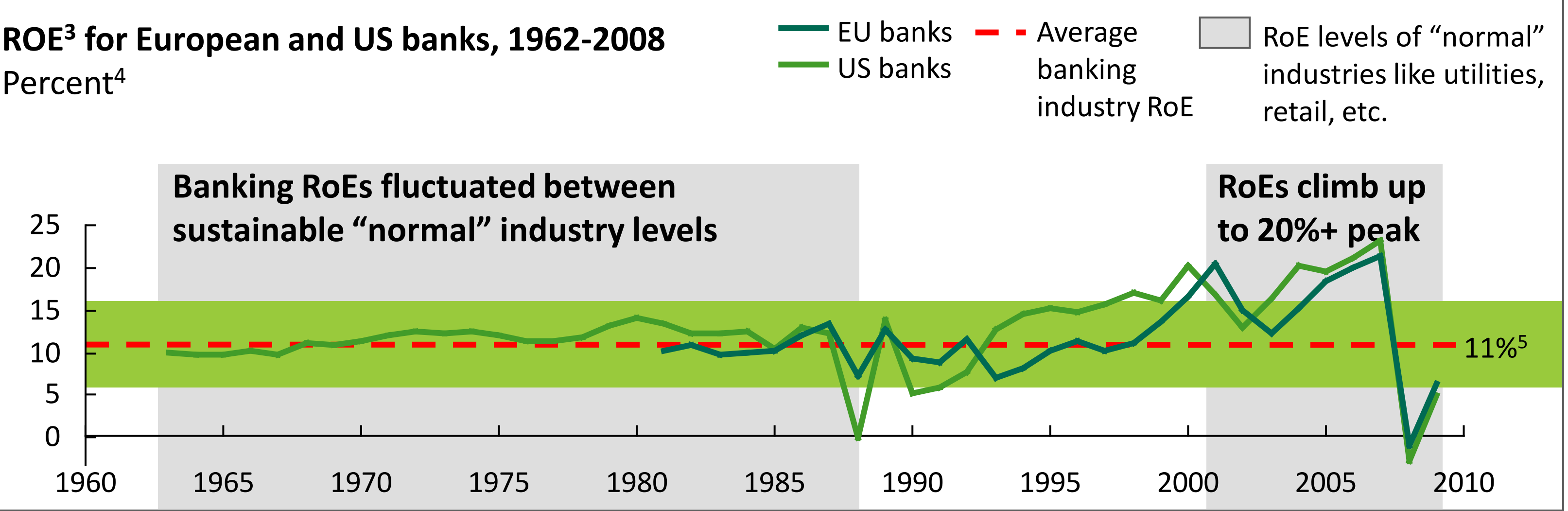
1 Includes Credit Suisse, UBS, Deutsche Bank, Barclays, BNP Paribas, HSBC, Standard Chartered, Santander, Unicredit, BBVA, Societé Generele, RBS and Intesa SanPaolo
2 Core tier 1, which is permanent, absorbs losses, and gives issuer freedom on dividend payment; must form at least 50% of tier 1
Source: CEBS Committee of European Banking Supervisors; SNL Financial; Morgan Stanley; JP Morgan; Company data

CDS and banking returns are back in line with historical levels, following period of abnormal gains

CDS Credit Spreads for EU and US indexes, bps



ROE[3] for European and US banks, 1962-2008
Percent[4]



1 US banks sector CDS index 5Y
2 iTraxx Europe Financials Senior 5Y
3 Operating RoE, i.e. net income as percentage of equity excluding net goodwill
4 Based on consolidated financials and valuation over time of 113 EU banks, of which 107 active, 957 US banks, of which 346 active
5 Average historical cost of equity for developed market banks calculated using a market risk premium of 5%, the end of year risk free 10 year Eurozone government swap rate, and beta based on the 3 years average beta of the European banking index
Source: Compustat; Datastream; Bloomberg; McKinsey & Company Financials Institutions Practice

New wave of regulation will impact multiple dimensions

Detailed in the following pages

- Capital require-ments
  - Increased capital quality
  - Deductions
  - Higher weighting of assets
  - Higher target ratios
- Introduction of leverage ratio
- Mitigation of pro-cyclicality
- Stricter liquidity management
- More transparent accounting
- Too big to fail
- Supervisory bodies
- Consumer protection

All elements of the capital framework will change according to "Basel III" consultation documents

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	Major changes	Most affected areas
Capital	• Common equity to form predominant part of Tier 1 • Remainder of Tier 1 with restricted inclusion rules	• Hybrid capital • Potentially silent participations
− Deductions	• E.g., deductions for minorities, deferred tax assets, pension funds, unrealized losses • Substantial deductions proposed	• Minority interests • Investments in insurance companies (and other financial institutions) • Pension funds • Deferred tax assets, unrealized losses, etc.
÷ RWA	• Trading book RWA to increase x 2 - x 3.5 • Increase of correlation of exposures to financial firms to 25-30% leading to a ~5% increase in financial institutions RWA	• Re-securitizations, correlation book • Exposures to financial institutions • OTC derivatives
= (Core) Tier 1 ratio	• All above measures will cause reduction in Tier 1 ratio • At the same time, higher target (Core) Tier 1 ratio expected	• Uncertainty remains but a minimum of 8% core tier 1 ratio is emerging as a target

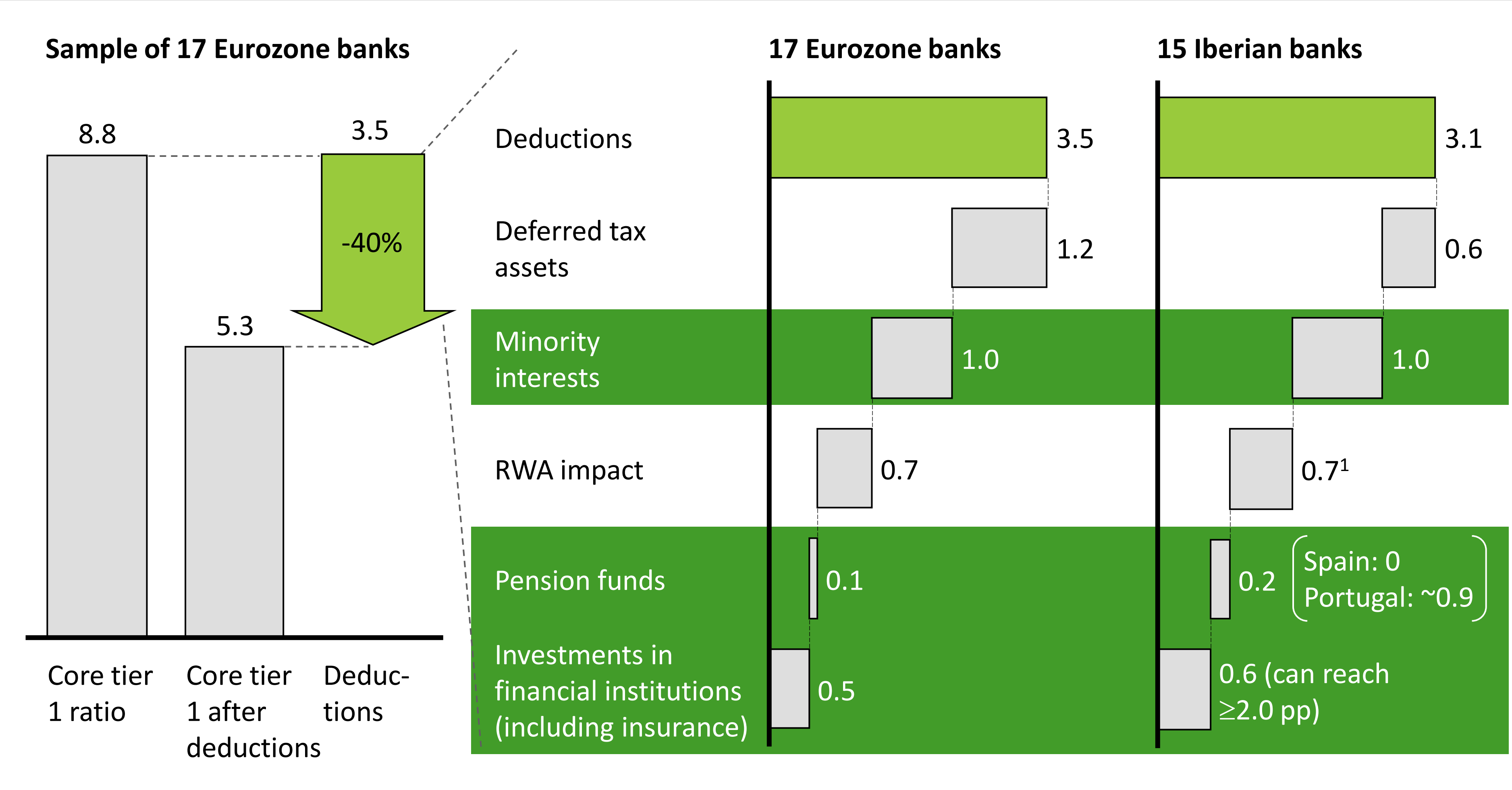
* From 6.5% 2006/07 average before changes in the framework

Source: BCBS

New regulation will hinder banks' current strong capital position

2009

Detailed on the following pages



1 Assuming analog impact as for the sample of 17 Eurozone banks

Source: Annual reports; JP Morgan; McKinsey Financial Institutions Practice

The approach to deduct capital from minority interests may favour the riskier situations it tries to prevent

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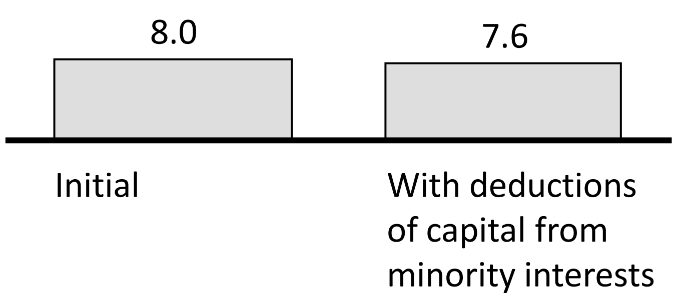
Group A: large stake of small subsidiary

Group A
Initial CR*: 8%

75% — **Subsidiary 1**
- Initial CR*: 8%
- Share of group RWA: 20%

100% — **Other subsidiaries** (totalling 80% of group's RWAs)

Group capital ratio (%)



Deduction (subsidiary 1) $= [1 - 75\%] \times 20\% \times 8\% = 0.4\%$

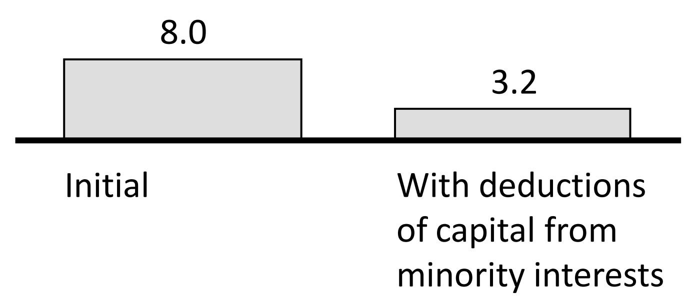
Group B: small stake of large subsidiary (e.g., Holding Co)

Group B
Initial CR*: 8%

25% — **Subsidiary 1**
- Initial CR*: 8%
- Share of group RWA: 80%

100% — **Other subsidiaries** (totalling 20% of group's RWAs)

Group capital ratio (%)



Deduction (subsidiary 1) $= [1 - 25\%] \times 80\% \times 8\% = 4.8\%$

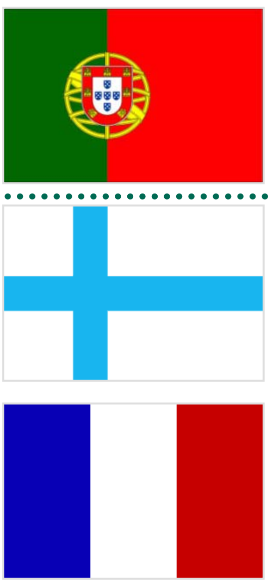
Under new proposals minority interests will not be eligible for Tier 1 because they can only support risk in the subsidiary

However, in the example **group B** is more penalized despite common equity being more available to support risks (group distress)

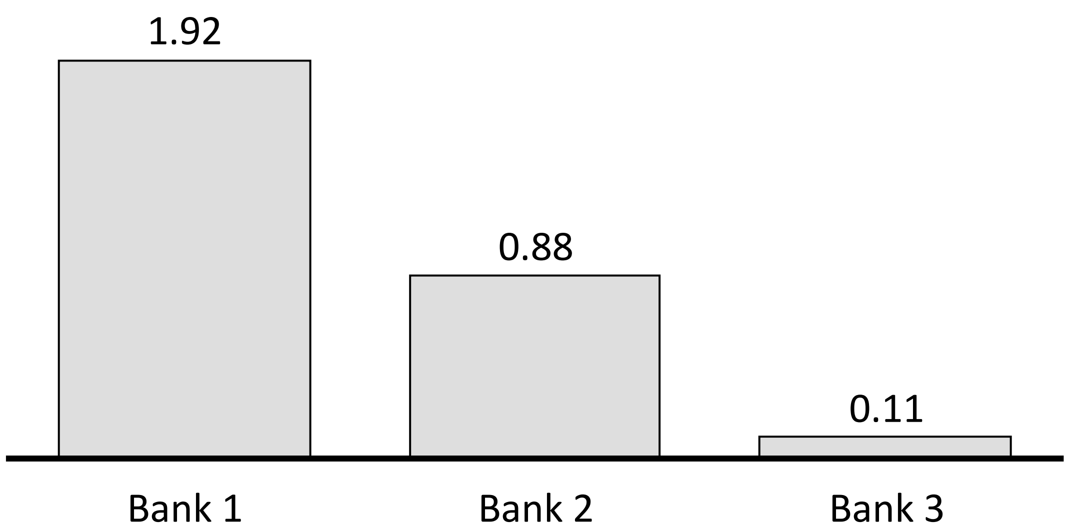
* Capital ratio (CR): capital/RWA
Source: BCBS

Defined benefit pension fund in Portugal, among the only 3 EU countries with such a program, will severely affect capital requirements

Only three countries in EU still have wide-spread defined benefit pension funds schemes in the banking sector (Portugal, Finland and France)



Indicative estimated impact of Basel III on core capital (2009)
Percentage points



Portuguese banks

Different pension fund regimes will lead to a unlevelled playing field, particularly severe in Portugal

Highly cyclical, very conservative in "bad times“

Note: Methodology= Equity incl. Retained earnings + Pension fund assets - Pension fund liabilities
Source: JP Morgan; Company information; Spanish Banking Association; CECA

The strategically sound bancassurance model will be penalized with proposed regulation

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Regulatory proposals will decrease attractiveness of investments in insurance companies …

Basel III	Description
Capital deductions (Basel III)	• Equity discounts for non-consolidated equity investments to be fully deducted from core tier 1 (vs. 50% tier 1 and 50% tier 2 in Basel II)
Exposure limited	• Insurance investments will be limited for holding companies • Excess investments will increase holding capital requirements (50% tier 1 and 50% tier 2)
Solvency II – Increased capital requirements	• More volatile capital with dynamic market-based approach • More differentiated requirements, affecting specially traditional life and "long tail" P&C[1] business[2] • Strong penalties for investments in equity and corporate bonds (45% and 3% respectively)

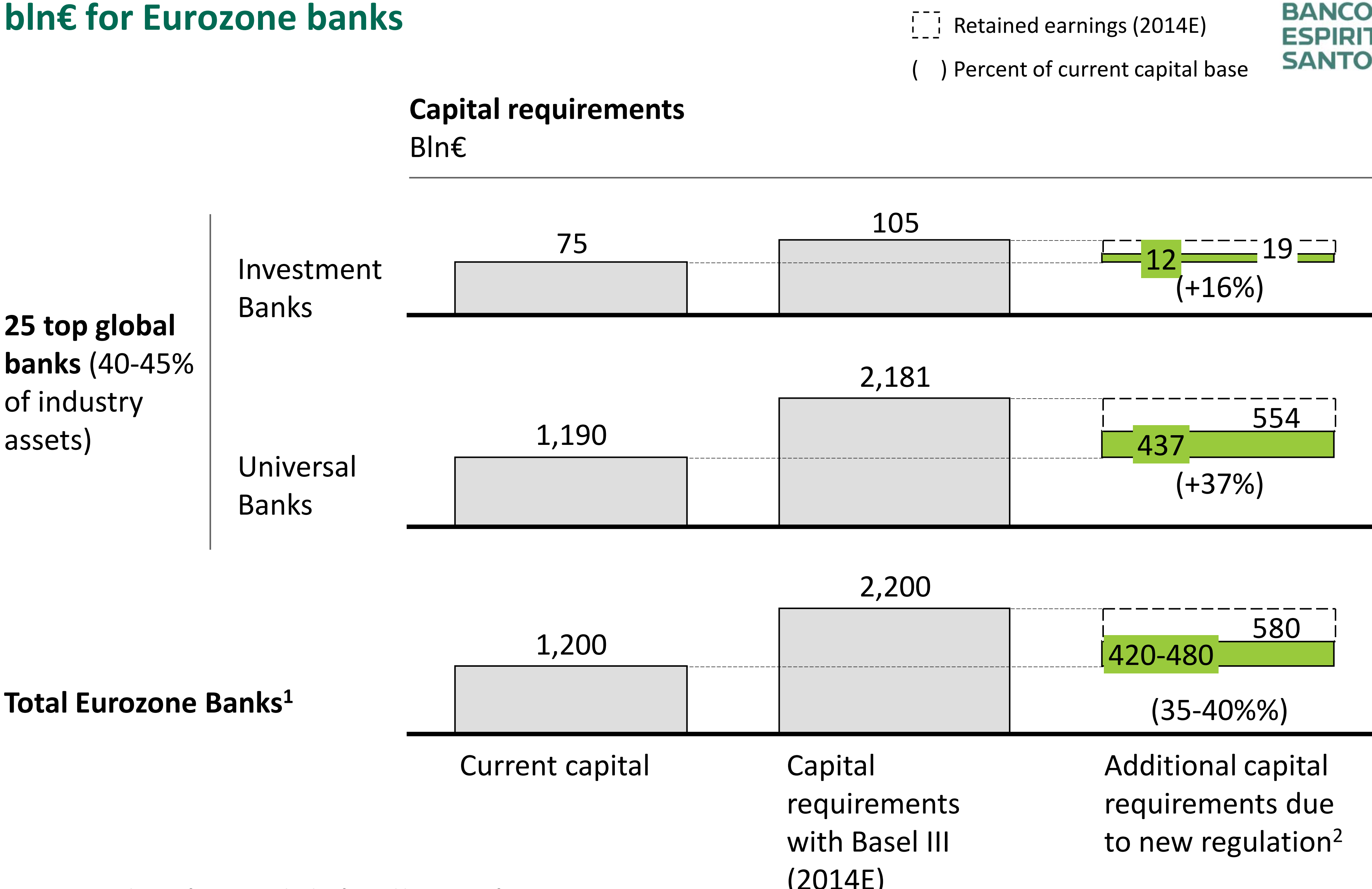
… despite clear strategic and risk benefits of bancassurance model

	Advantages of bancassurance
Non-correlated risks	• Anti-cyclical stabilization factor, since banking and insurance risks are largely uncorrelated
Comple-mentary Balance Sheets	• Complementary business cycles improves maturity-match, as insurance liabilities are of long duration (specially in Life), whereas banks have short-term liabilities
Increased customer loyalty	• Increased loyalty of bank's customers that hold insurance policies contributes to deposit stabilization and better risk management (increased customer information)

1 Property & Casualty
2 E.g., increase in SCR (Solvency Capital Requirements) for Fire&Property of +200% and +70% for Motor
3 Solvency Capital Requirements

Source: "Basel III" Consultation Documents; Committee of European Insurance and Pensions Supervisors

Large capital needs foreseen, specially for commercial banks, up to 400 bln€ for Eurozone banks



1 Total equity for Eurozone banks of 1,200 bln euros as of Dec 31, 2008

2 After accounting for expected retained earnings and needs of capital to fund growth

Note: Considering the higher flexibility of investment banks to "off-load" assets from balance sheet vis-à-vis universal banks (mainly credit)

Source: JPMorgan; ECB; McKinsey & Company Financial Institutions Practice

Excessive discrimination among EU states in access to liquidity further impacting cost of debt, constraining the real economy

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New liquidity ratios imply more stringent control over short and medium-term outlook[1]

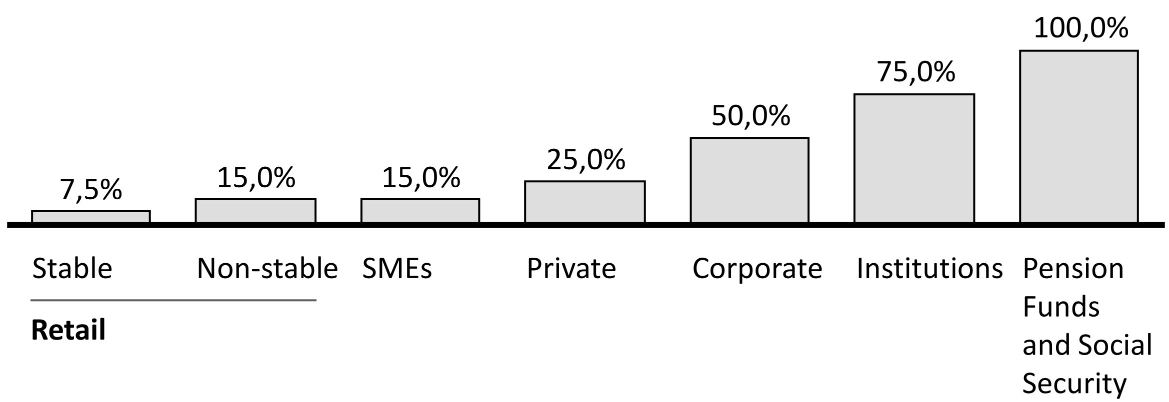
30-day liquidity coverage ratio

$$\frac{\text{Stock of high quality liquid assets}}{\text{Net cash outflow over a 30-day period}} \geq 100\%$$

Longer-term net stable funding ratio (NSFR)

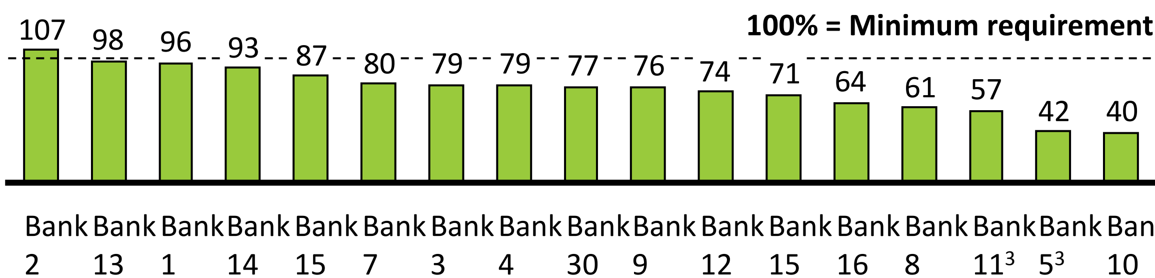
$$\frac{\text{Available amount of stable funding}}{\text{Required amount of stable funding}} > 100\%$$

Haircut for liquidity purposes



Long term NSFR[2]
Percent. Q4 2008

LT funding represents up to €1.5TN (Morgan Stanley, January 27, 2010)



Sovereign debt rated below AA not included in funding with 5% haircut
(significant increase in haircut, 4x to 10x)

1 Implementation only after consultation period – substantial changes possible
2 Net Stable Funding Ratio (NSFR): (available amount of stable funding)/(required amount of stable funding) >100%
3 Based on 2008 data, conservative assumptions in case of bad data quality
Note: Key input factors for 30-day coverage ratio: liquid positions (cash, government bonds, etc.); B/S stress test (worse if significant size trading book)
Source: McKinsey, Morgan Stanley; BCBS December 2009; Analyst reports

In all, liquidity regulation is not adapted nor to current economic challenges, nor to recent market evidence

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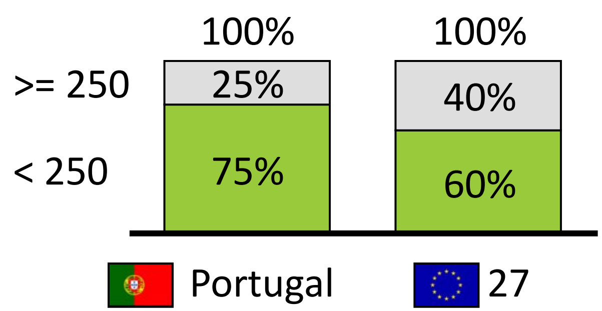
Liquidity rules might induce a fundamental shift in banking business…

- **Run-off rates are very demanding for Corporate and Institutional deposits**
  - 15% for unsecured funding by SME
  - 25% for unsecured funding by Sovereign, Central Banks and Public Sector
  - 75% for unsecured funding by Corporate
- Link between lending and deposits will result in a fundamental shift in banking business **forcing a reduction on exposure to Corporate businesses**

… which will impact markets with a concentration of small businesses in spite of positive experience during crisis

Business size distribution by number of employees*

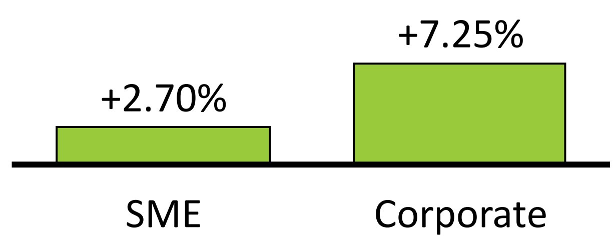
2007, % of number of businesses



- Small businesses with no access to capital markets
- Hurdles for banks to access ECB liquidity lines

BES deposits

Jan 07-Jun 09. CAGR



- During the crisis BES was able to capture growth in the Corporate sector deposits

* Classes defined in terms of the number of employees

Source: INE; EIM on the basis of Eurostat

Unavailability of funds will force banks to reduce their loan books, with negative impact on the economy

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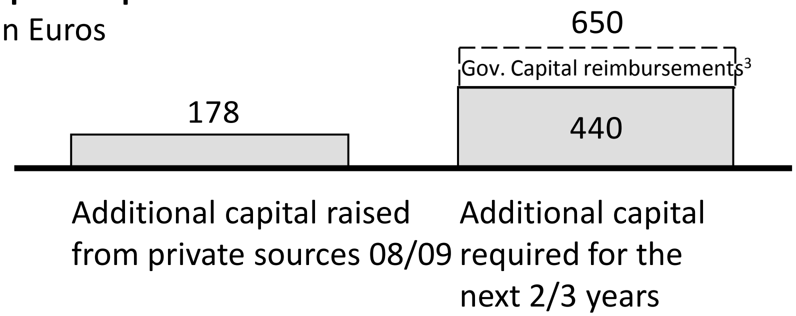
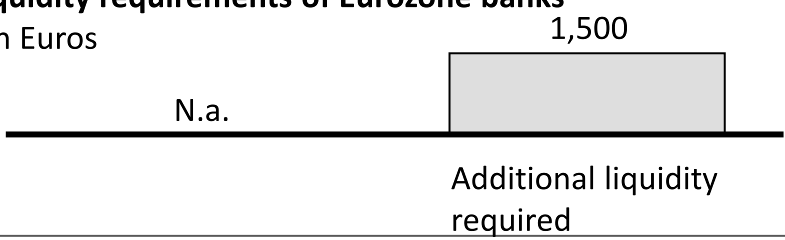
Banks will be challenged to meet Basel III requirements…

Capital requirements of Eurozone banks
Bln Euros

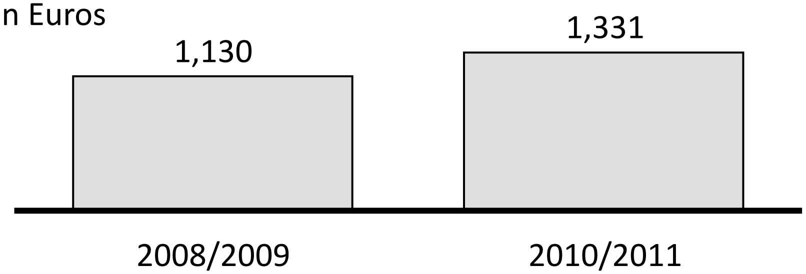


Liquidity requirements of Eurozone banks
Bln Euros



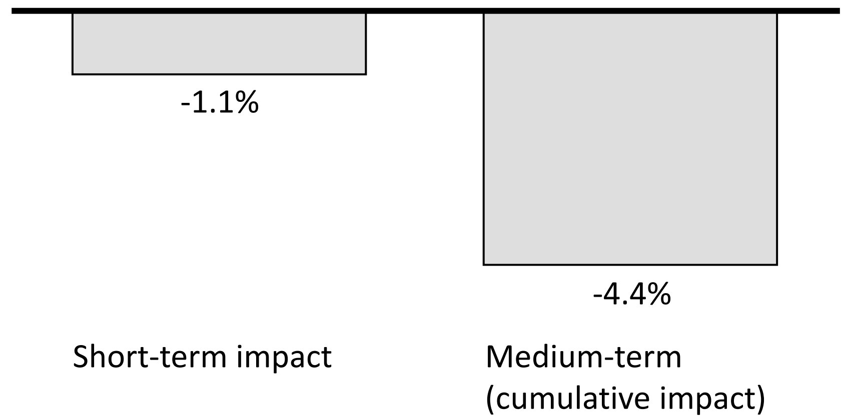
…while facing competition from governments in funding…

Funding needs of Eurozone governments[1]
Bln Euros



… instilling significant changes to balance sheets, namely reducing loans, with negative impact in the economy

Total estimated impact in Eurozone GDP[2] of loan book reduction (assuming equivalent effort from banks increasing capital and decreasing RWA)
% of GDP



Private credit needs will induce other less regulated players to replace banks in fulfilling funding needs, promoting a "shadow banking system"

1 Net actual and expected increase in nominal public debt 2007-2011 (EIU viewswire)
2 Assumes banks only raise 50% of the required amount of capital, which implies a ~13% simultaneous reduction in RWA; impact on GDP based on ECB elasticity estimates (10% decrease in loans implies a short-term GDP reduction of ~0.8% and long-term correlative GDP reduction of 3.25%)
3 Government capital injected in banks in 2008 and 2009
Source: JP Morgan; ECB; EIU viewswire; McKinsey & Company Financial Institutions Practice

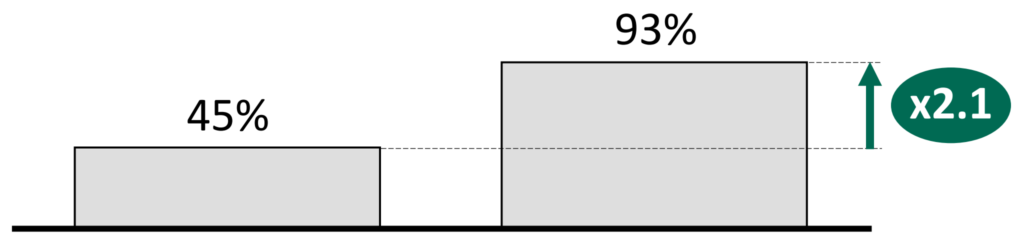
New regulation will impact US and Europe asymmetrically

New regulation with limited impact in US…

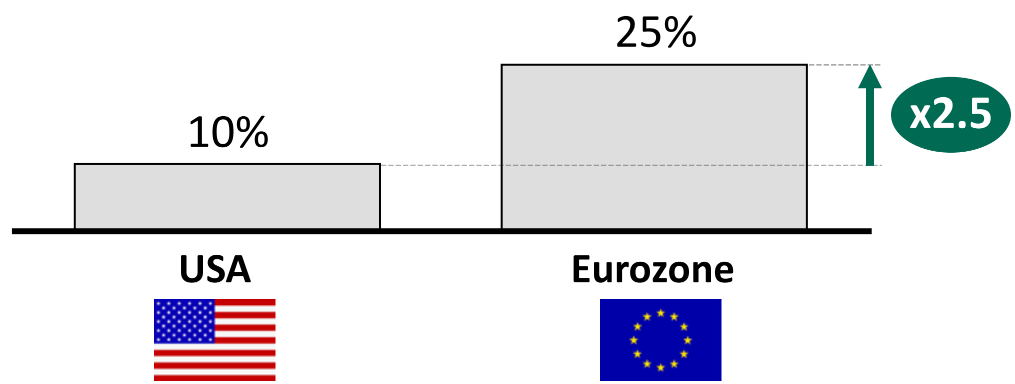
- Supervision is still in political discussion with intervention of different areas and experts
- Implementation of Basel II more advanced in Europe than in the US (only "core banks" in Basel II)
- Based III not expected in the short-term in the US considering the actual roll-out status of Basel II
- US economy much less dependent on banking credit given liquidity of capital markets

… reflecting different leverage and funding structure of corporate entities

Corporate debt as a percentage of GDP



Weight of banking debt in non-financial corporate funding structure



1 Banks for which Basel II applies (significant international exposure or relevant balance sheet) - ~50% of US banking sector assets
Source: Global Banking Pools; Bank of International Settlements

In summary...

- Burst of real estate bubble in US and selected European markets caught off-guard a set of highly leveraged near-banking institutions and investment & wholesale banks. Decisive action by governments, regulators and banks was effective in containing the contagion on the financial sector

- New regulatory wave with profound impact on industry profitability through stringent capital, leverage, liquidity requirements, stricter scrutiny of risk management practices and compensation

- Effects on the economy will be stronger in Europe where
  - (i) commercial banks are much more relevant to fulfil Corporate funding needs and
  - (ii) competition, between US and EU, is further distorted as US Banks have access to a larger base of investors through hybrid capital as Tier 1 prevails in the US vs. Core Tier 1 in Europe. Therefore, it is important to establish regulatory changes simultaneously in the US and EU.

- In particular, Southern European economies will be more penalized given a more fragmented business fabric (with a smaller average turnover) that has fewer financing alternatives

- Economic funding needs will, given capital scarcity from banks, be fulfilled in the market by less regulated entities/markets further jeopardizing objectives

- Paradoxically, Basel Committee new proposals will induce a severe credit and capital scarcity, strongly impacting an already fragile economy further contributing to economic recession and unemployment