ASSOCIAÇÃO PORTUGUESA DE BANCOS

CONFERENCE 'THE PORTUGUESE FINANCIAL SYSTEM 40 BILLION EUROS IN IMPAIRMENTS LATER'

Law Faculty Auditorium, Lisbon University
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I would first like to thank Professor Eduardo Paz Ferreira for inviting me to take part in this event. I was pleased to accept so that I could talk about some aspects of the banking sector, such as the current situation it is experiencing and the challenges that it has to face.

The reputation of the Portuguese banking sector is poor, mostly due to regrettable cases like those of the BPN and BES, although in this sector more than any there is a tendency for the innocent to pay for the sins of others.

There are two things that need to be done to restore the sector's reputation. We must recognise the mistakes made and take corrective action and take steps to guarantee customers' and the public's trust, with particular focus of transparency and commitment to ethics. We must take coherent action to reinforce a banking culture based on the values of integrity, honesty, strictness, responsibility and demanding corporate governance.

Banking is based on trust, and banks' decisions entail risk (risk management and assessment are crucial to their performance). The fact that they are managing their depositors' money means maximum responsibility. But trust does not only depend on the banks' performance. It is closely linked to political and macroeconomic stability and markets' and customers' perception.

A strong, responsible, modern, reliable, well capitalised, profitable and competitive banking sector is essential to economic and social development. The government and the authorities therefore have a key role to play in promoting and defending the stability of the financial system. Does the situation in the Portuguese banking sector warrant particular attention today?

We must not hold back from a strict analysis of reality. The first fact that we must remember is that it was not the banking sector's difficulties (even recalling the BPN and BPP) that led us to a need for a bailout and negotiations by the government at the time and the MoU that resulted in the EFAP. It was the state of the country's public finances.

After demonstrating great resilience and one of the best performances among European banks during the 2008-2010 international crisis, our banking sector was affected by the sovereign debt crisis and the consequent, profound and inevitable recession between 2010 and 2014.

The banking sector was a victim of the sovereign debt crisis and was forced to take repair, restructuring and strengthening measures that in some cases are still under way. But it is alive and kicking (responding to the title of this panel) and needs more favourable and much more realistic and coherent conditions to return to satisfactory levels of profitability.

Calling the banking system into question is absolutely absurd. We will have no growth, we will not be able to create wealth and distribute it to generate more social justice with investment or funding of the economy. And we are well aware that the banks are responsible for satisfying around 75% of companies' funding needs. On the other hand, people's lives would be much more difficult if the banks did not provide and manage one of the most modern, efficient and secure payment systems in the world.

In brief flashes, because time is short, I am going:

- To describe the current situation in the Portuguese banking sector

- Talk about the intensive internal work done the since the crises began and make a comparison with what happened in other member states

- Stress that, while it is true that the banks are the heart of the economy, the way the economy works is decisive to the soundness and profitability of the sector

- Say a few words about the largest short- and medium-term challenges that the banking system will have to face

1 - Current situation in the sector

(a) **Assets**:

- insufficient demand for loans and advances;
- surplus capacity (indicating potential consolidation);
- high favourable lending rates for low and medium-risk companies ;
- ongoing increase in the weight of credit for export loans to companies from 4.5% to 20.1% of the total between December 2009 and May 2015;
- companies' debts as a percentage of GDP still very high (115%), lower only than Sweden, Belgium the Netherlands, Luxembourg and Cyprus.

(b) **Liquidity**:

- banks with no liquidity problems;
- substantial reduction in dependence on ECB (from 60.5 billion euros in June 2012 to 25 billion in September 2015), though it is vital for the Republic to maintain its investment grade rating;
- good performance of deposits (stable), responsible for almost 50% of resources;
- current loan to deposit ratio of 104%.

(c) **Profits**:

- great pressure on profitability: net interest income crushed, fees under pressure (unjustifiably, as they are among the lowest in the euro zone), very high resolution and regulation costs;

- very low profitability that explains the lack of interest of private investors in the sector (if share capital increases are advisable or necessary, this is important).

(d) **Solvency**:
- appropriate capital ratios (although they are in the lowest quartile compared to their European counterparts;
- the sector's average CET1 in September 2015 was 11.6%, well above the required 7%.

(e) **Balance sheet**:
- Improving some banks' balance sheets is still the subject of attention and action.

The legacy assets left by the crisis, especially for mortgages, are still weighing on the banks' balance sheets, in spite of the significant impairments and progressive increases in provisions, along with a huge effort made in tough deleveraging and restructuring processes, which included the sale of non-core and non-productive assets and writing down of assets. The amount of NPLs (non performing loans) that some banks have also weighs a lot on results. Recovery of loans is also delayed by slow company insolvency processes. It would also be important to promote the market for non-performing loans given the potential benefits of selling them.

2 - Changes in the sector since January 2008

The title of this conference is "The Portuguese financial system 40 billion euros in impairments later", and draws attention to the amount of impairments accumulated since 2008 and especially after the MoU signed due to the sovereign debt crisis.

It is important to note this effort made by the banks and understand the deep-seated causes of the sector's current situation.

In 2007, when the subprime and global financial crisis broke out, the Portuguese banks were sound and modern and had even reached high levels of excellence in some areas. ROE was over 17%, solvency levels were comfortable and loans and advances were growing in double digits.

Given the ease of access to liquidity on the market, they were also in debt due to the high amount of loans and advances granted, as shown by the loan to deposit ratio of around 160%.

Banks were trying to respond to economic and social policies and abided by European benchmarks in terms of risk assessment. The context and circumstances naturally weighed on lending decisions, which were based on the prevailing risk assessment methods.

Loans and advances were concentrated in non-tradable sectors, particularly mortgages and the real estate and construction sectors (although there were no real-estate bubbles in Portugal).

The banks naturally earned money from their business, which was and is that of granting loans and advances. But the main beneficiaries were the country and their customers, who had access to cheap, easy money.

The banks' weakest point was their policy of procyclical provisions, which was normal in periods of economic expansion and resulted in low provisions. Very low default ratios and few overdue loans facilitated this policy, which was current in other European countries.

In 2008, the recession hit and the banks were urged to make an effort to stimulate the economy, with access to state guarantees. At the same time, their profitability was affected, but they displayed excellent resilience in the face of the crisis. And under the aegis of the G20, new regulation and supervision began to take form, with new requirements and implications. Meanwhile, the capital market suffered huge losses and the banks recorded high impairments in their portfolios of shareholdings and other assets. Defaults on loans start to increase.

In 2010, we were hit by the sovereign debt crisis and in the first phase the banks were called on to help finance the state, when the international banks closed their doors to it. Companies' and households' borrowing had also reached very high levels: 118% and 93% of GDP respectively.

When the EFAP MoU was defined in May 2011, the treatment chosen for the financial system was gradual recognition of the banks' capital needs on the basis of impairments actually recorded from the point of view of a going concern and deleveraging, with a consequent reduction in capital needs. Indeed, this was the approach most compatible with the recapitalisation programme, with public aid fixed at only 12 billion euros. The alternative, which would have been frontloading of capitalisation of the banks, would have required much higher needs and the EFAP financial package would not have been able to meet them.

Therefore, following the sovereign debt crisis, the Portuguese banking system had to take drastic action to enter the new paradigm in European banking: rapid, orderly deleveraging, capitalisation, restructuring and reduction of costs and adjustment of business models. In the recapitalisation of the banks using the line of 12 billion euros, due attention was not paid to the impact of the use of CoCo's, whose extremely high interest, which benefited public accounts, adversely affected the banks' profits and even their capital. On the other hand, especially, vehicles, which the APB proposed at the time, were not used to remove from the institutions' assets part of the long-term or high risk loans.

In the context of the international and sovereign crises our banking system recognised around 40 billion euros in impairments between 2008 and 2014, with a huge impact on profitability. The impairments recorded were lower than those in other Southern European countries and Ireland.

Meanwhile defaults sky-rocketed. Among companies, NPLs rose from 3.5% in 2008 to 17.6% in 2014. As pointed out in the Working Paper *The Vulnerability of Europe's Small and Medium-Sized Banks* by the BRUEGEL Think Tank, "Bankrupt debtors hurt banks, which led to reduced credit availability and more stress on debtors (...) The weakest small and medium sized banks are burdened by non-performing loans."

This is the deepest cause of recording impairment and stems largely from under-capitalisation and over-borrowing by companies and households. The impairments recognised between 2008 and 2014 resulted in losses.

The efforts to recapitalise the banks between 2008 and 2014 were substantial. They reached 26.3 billion euros, 14.2 billion of which were from private resources, 7.2 billion from public resources (including the CGD) and 4.9 billion from the Resolution Fund.

The impact of public aid to the financial system was similar to that in the euro area, representing 8.7% of GDP without the loan to the Resolution Fund, and 11% of GDP with it. The guarantees given to the financial sector reached a maximum of 9.5% of GDP in 2012, but represented around 3.6% of GDP in 2014 and were within the euro zone average.

3 - Short- and medium-term challenges for the banking system

In the current context of great political, geopolitical, economic and financial uncertainty, the main challenges facing the banks are as follows:

1) Recovering profitability;

2) Adapting to the new regulatory framework and Banking Union, emphasising that the responsibility for prudential supervision and resolution now lies with the European authorities (in the new Banking Union framework Banco de Portugal has the role reserved for national supervisory and resolution authorities and is still responsible for financial stability and supervision of conduct);

3) Adjustment of the banks' operating and business models, due to the need to complete the deleveraging and balance-sheet repair processes and seek profitability, profound changes resulting from interaction between new digital technologies and customer behaviour and the appearance of new financial players, such as shadow banking, and new operators;

4) Restoration of the reputation and further improvement of banks' corporate governance;

5) Intense monitoring of the resolution of BES and BANIF, where it is essential to minimise the banks' contributions to the resolution fund;

Regarding profitability let me quote Ana Botín in a recent speech.

"When a bank is profitable, there is a lot that it can do:

- it can grant more loans to customers;

- it can help create jobs and support economic growth;

- It can reinvest its earnings to provide better products and services;

- it can pay out higher dividends to investors (and attract more);

- It can develop philanthropic programmes"

Where our banks are concerned, increasing their profitability is the top priority, so that they can reinforce their equity and become stronger.

In the wake of any crisis, there are lessons that can and must be learnt. But the process must be constructive, dealing with the causes and being realistic. Scrutiny, which is natural and necessary, must be associated with knowledge of the causes. We sometimes hear comments that defend something and its opposite at the same time. For example, people demand much greater strictness and caution when granting loans, but at the same time they point a finger at the banks and say that they are not meeting companies' funding needs, or people want profitability and soundness but at the same time protest against legitimate means of obtaining income. We must realise that the banking sector is not only the heart but also a mirror of the economy. Solving structural problems in the economy, especially problems of under-capitalisation and over-indebtedness, largely determines the challenges that the banks are facing.

It is therefore vital to take on board how fundamental the banking system's health is to our country's economic and social development and to work tirelessly – government, regulators, banks and their stakeholders – to strengthen it, involving strategic action that is as consensual as possible.

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