The Present and the Future of the Banking Sector

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I would now like to leave you with some messages that represent the sector's point of view. The reports of recent events in the banking sector are sometimes demeaning or even inaccurate or biased, either because they are taken as part of a whole or due to prejudices or ideologies. This does not mean that we, the banks, don't want to discuss what has gone wrong, gloss over poor management or insufficient control or deny accountability for mistakes. On the contrary, lessons are there to be learned and used.

But we need to conduct a profound, factual analysis of these events and their causes so that we can draw the right conclusions for the good of the country and its people. We are aware of the importance of the health of the banking system, the need to strengthen it by taking consistent, coherent action, as the banking sector is structural, strategic and vital to development. The banking system reflects the state of the economy and its performance depends on that of the economy and, *mutatis mutandis*, has a decisive influence on it.

Firstly, the situation in the banking sector is a legacy from the sovereign debt crisis and long negative economic cycle.

It has been compounded by the new framework for the sector, which is much more demanding. This coincided with the AFAP to place the Portuguese banks at a disadvantage in relation to their peers.

And we also must not forget:

(i) The implications of the BES, BPN and BPP cases and, in a different way, BANIF, have resulted in significant impacts and damage in terms of reputation.

(ii) In spite of the onset of the crisis, the Portuguese banking sector, in accordance with the circumstances at the time, was in a highly positive position, with very good ratings, no funding problems, high profitability, low capital ratios that were still well above the minimums required at the time and very low default rates, though there were already some vulnerabilities:

  (a) A very high loan to deposit ratio due to the credit boom, which was good for the country (which undertook in-depth modernisation of its infrastructures), for households (who were able to buy homes) and businesses (which were able to obtain funding)

  (b) A procyclical provision policy, which is normal in periods of expansion and was followed in other countries, with no particular objections from supervisors, auditors or rating agencies, but leading to levels of provisioning that proved totally insufficient to face crises – a great lesson that we must never forget

  (c) Credit decisions dictated by the context (our perception of risk reflects the reality that we know), which today would not have been made or were, in some cases, absolutely wrong, and the heavy weight of mortgage and real estate loans

(d) The amount negotiated to reinforce the banking system in the EFAP, 12 billion euros, limited the option to repair balance sheets to increases in share capital as impairments were recorded.

(e) The use of this recapitalisation line was parsimonious and insufficient in some case and remuneration from CoCos was violent or even counter-productive.

(f) No vehicle capitalised in part by the Recapitalisation Fund was created, as the banks suggested at the time, which we could have identified as monetisation of assets with the main goal of freeing up liquidity and accelerating deleveraging.

(g) The level of default and non-performing loans sky-rocketed as the crisis progressed, due to the high degree of corporate borrowing and decapitalisation.

(iii) These factors were joined by other unfavourable components:

(a) Structural inefficiency: the unfavourable economic context is worsened by some structural inefficiency in the country, in areas such as the justice system and taxation framework, especially when it comes to recovery or insolvency processes with a direct impact on the ability to recover loans rapidly. They contribute to the persistence of high levels of unprofitable assets on the banks' balance sheets and the non-existence of a market for non-performing loans.

(b) Low interest rates have highly negative effects on banks' ability to generate earnings via financial margins.

(c) Resolution costs: in addition to the challenge of facing up to an unprecedented economic cycle, the Portuguese banking system has been a pioneer in applying a new European framework for the resolution of banks, with the banks in the system having to bear the heavy cost of resolving two of the country's largest financial institutions in addition to their contributions to the Single Resolution Fund.

(d) There has been an adverse effect on our presence in Africa. The degree of interdependence with these economies has grown over the years with greater trade, emigration and financial flows. Maintaining and strengthening these ties is natural and beneficial to the Portuguese banking system and to the country itself. However, the failure by the European authorities to recognise the equivalence of supervision adversely affects our continued presence in these countries and creates an incentive for banks to remain mainly local and unable to reap the benefits of their natural competitive advantage in these markets and the diversification of business that this international presence allows.

- In some cases, the internal legal and regulatory framework tends to worsen the already demanding European framework, introducing discriminatory negative conditions for Portuguese banks compared to their EU counterparts.

This is the reality that the banks are having to face at the moment. But what we need to focus on is the search for solutions that will allow the Portuguese banking system to look to a currently uncertain future with confidence. The success of the road that lies ahead requires everyone – government, regulators, banks and their stakeholders – to act together, strategically and consistently, all propelled by the country's greater interest in order to find consistent, coherent, rapid national and European solutions that will enable us to overcome the obstacles and meet the challenges head-on.

And there are a number of challenges that the sector will have to beat:

1 - Recovery of profitability and increased soundness

The two most pressing challenges in the sector are:

(a) Recovering appropriate profitability, higher than the cost of capital

(b) Satisfying capital needs and increasing solvency ratios

Indeed, these two issues are closely connected. The difficulties in recovering profitability (in which the banks went from an ROE of 17.6% on 31 December 2007 to a negative ROE from 2011 on) are the result of a number of negative factors:

On the earnings side:

- Crushed financial margin
- Fees under unjustified populist pressure
- High exposure to the national sovereign debt, which, in the event of reversal of yields or changes in regulations, may have highly negative impacts

- Very high defaults, particularly by companies (ratio of 2.1% in 2008 and 17.6% in 2014). Non-performing loans are not an exclusively Portuguese problem. According to an IMF report on 15 December 2015, in the European Union they total over 900 billion euros and in Portugal 18 billion euros, just under 2% of the total, equivalent to Portugal's size in the European Union.
- High impairments
- Low demand for high-quality loans and advances (low-quality demand comes up against risk criteria and capital consumption).

On the cost side:

- New, weighty costs from the new regulatory framework
    - Supervision
    - National and European resolution
- High costs of CoCo's
- Taxation costs
- Reduction in costs of structure requiring capital

In this framework of historically low interest rates that can be expected to continue for some time and the persistence of the lingering adverse effects of the crisis, it is absolutely critical for the conditions in which the banks operate not to get any worse, as they are already extremely stringent. Any worsening of the situation, for example growing pressure on profit and loss accounts, may have serious, irreversible consequences for the country's stability.

The legislative initiatives currently being debated in the Portuguese parliament are an obvious example of the path that we must avoid if we want to recover profitability and reinforce the soundness of our banks.

The sector is obviously aware of the importance of its services to the economy and the public and we are the first to defend increasing transparency in banking practices and the protection of consumers' rights, but it is necessary to be aware of the effects of measures that may be taken. In a complex framework of high pressure on the sector, if these measures are approved they will not only go against the fundamental principles of the market economy, free competition and contractual freedom but would also represent higher costs for the banks and seriously threaten the stability and sustainability of the sector. There must be a fair balance between the prudential component and the protection of consumer groups, on pain of affecting all of them and the country itself.

There must also be a change in attitude in the way the issue of remuneration of banking services is handled in Portugal.

It is vital to be aware that there is no economic or legal reason for banking services not be to properly remunerated by those who benefit from them, so that they not only cover the costs but also allow an appropriate profit margin, which is essential to the banks.

Last but not least, beating the challenge of profitability depends greatly on the banks' ability to increase their lending. The Portuguese banks today are fully prepared, with no liquidity restrictions, to lend to companies who meet the requirements. The problem that we are facing is that, contrary to the banks' interests, demand for solvent credit is still scarce.

There must be initiatives (and some of them are already under way, such as the mission structure for the capitalisation of businesses) that allow companies to obtain capital and have appropriate equity to assets ratios and transparent balance sheets and optimise their accounting and management information so that they can obtain funding from banks to complement other sources of capitalisation that must be developed.

Low profitability has an adverse effect on the capitalisation of banks:

- There is no sustained accumulation of profits to allow internal generation of capital;
- Increasing their capital base from outside sources, be it equity or other capital instruments, is very hard at a time of low profits or even losses.

Even so, the recapitalisation of the banks so far has totalled 26.3 billion euros, 14.2 billion of which with private funds and 7.2 billion with public funds (4.1 billion of which was returned to the state with 1.1 billion in interest and 4.9 billion allocated to the Resolution Fund). And these capital increases by the private sector took place in a period when the banks had an accumulated loss of 13.1 billion euros after the sharp falls in their share prices.

Some needs for more capitalisation on the part of some banks to increase their solvency ratios may arise as a result of supervisory assessments:

- Assessment of business models, which may require more capital depending on projections of profits/losses
- Assessment of quality of assets and treatment of NPE and NPLs, one of the most sensitive problems
- Assessment of management quality
- Progressive elimination of national discretions, to be corrected, such as DTAs by time differences
- New regulatory requirements, such as the MREL (Minimum Requirements for Own Funds and Eligible Liabilities) which may pose a problem if there are no conditions for placing subordinated debt

2 - Adaptation to the new EU regulatory framework

Banking Union has also introduced a more demanding framework in terms of supervision and resolution, based on a requirement to promote homogeneous rules on fair competition at European level.

However, this requirement is based on a serious structural fault, as the different banking systems in the European Union do not share the same starting conditions and have different capacities for generating profits and, when all is said and done, for recapitalisation. The idea of a level playing field raises questions of proportionality, suitability to the system's needs and consistency of economic goals and financial stability of which the supervisors are the final guarantees. And they will even raise questions of fair competition. The regulatory framework sets out growing capital requirements but, by discouraging private investment (bail-in and burden sharing) and disciplinary rules on state aid, they block the intervention of national authorities. The absence of a mechanism for preventive action and the inflexibility of the new resolution framework tend to delay the necessary interventions even more. This is common to many Member States. It is important to review and recalibrate measures.

Due to a particular national context, the Portuguese banks are facing a starting point that is very different from many of their European counterparts. It is therefore extremely important for decisions with an impact on the system's stability to be taken on the basis of a holistic view of the economic, financial and structural challenges that the Portuguese banking sector is facing.

At this point it is important to mention the especially demanding context for the Portuguese banks in terms of resolution. In addition to being subject to a new European regulatory framework on resolution, which imposes added demands, such as compliance with the MREL, the Portuguese banks will have to contribute to the costs of the resolution of BES and BANIF. It is absolutely vital to the viability of the system for these costs to be minimised.

Finally, in recent years, we have also witnessed substantial development in the supervision of conduct in the area of good practices and ethics in banking, increased consumer protection and financial education and institutions' governance. Customer confidence is an essential pillar in banking and so the sector supports increases in consumer protection but everything must be done with fair checks and balances so that solutions are effective and do not have undesired effects on the banks' soundness or the system's stability. Bank customers' protection must involve the banks' soundness.

3 - Adjustment of operating and business models

The need to complete deleveraging processes and repair balance sheets currently under way and the quest for profitability will inevitably lead to a change in operating and business models in Portuguese banks and it is actually already ongoing.

But the deepest, most structural change will occur as a result of the digitisation of banks, which is a challenge facing banking all over the world and involves changing the traditional operating and business model to adapt it to the new digital age. The arrival of new players and the development of shadow banking are considerable challenges.

The banking business model that we know today will undergo profound changes in upcoming years. And this whole context of profound change will inevitably bring alterations in the structure of the European banking sector.

Bank consolidation can be justified for a number of reasons, ranging from excess supply to the use of synergies, economies of scale, complementarity and the convenience of merging a sounder institution with another needing to increase its capital base and naturally the banks' strategy.

There are two components to be considered in a consolidation process: financial stability, which is fundamental, and politics, aimed at safeguarding the country's interests.

4 - Recovery of reputation and attention to corporate governance

Banks operate on three pillars: their customers' confidence, which is their essence; risk, which is a specificity; and social and fiduciary responsibility to depositors, all of which distinguish them from other businesses.

The reinforcement of banking culture, understood to be a set of values that govern the conduct of banks and their employees, which include codes of conduct, honour and a sense of ethics, along with more attention to corporate governance and internal control are vital on the road that the sector is following to recover its reputation.

Confidence in the banks naturally depends on their performance and is closely linked to the market's and customers' perception, as they are paying more and more attention to these issues.

Political, macroeconomic and financial stability naturally also influence confidence in the sector.

In conclusion:

The context has changed a lot and the paradigm is very different. The banks are subject to stricter regulation and supervision and are already having to adjust to a new business setting that is strongly influenced by the framework that I have described.

The banks are working hard to make our banking system solid, strong, modern and reliable.

But the important thing is for us to remember that this sector is and always will be special and different, and essential to economic growth and the people's wellbeing. Because it is, in fact, the heart of the economy, everyone – governors, parties, local authorities – must support the current transformation process and speed up measures both in Portugal and in Europe aimed eliminating obstacles in a context that is already unfavourable. They must help to rebuild confidence in and the reputation of the

Portuguese banking sector among European supervisors, the banks' customer base and investors.

For our part, we are determined to take on the task of doing everything in our power to have a sound, working banking sector that contributes to economic growth, employment, prosperity, the safekeeping of depositors' money and minimisation of efforts from taxpayers.

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