PORTUGAL: An Introduction to Portugal

Contributed by Vieira de Almeida & Associados Financial Stability, Flow of Credit and Corporate Debt Reduction – the challenges of 2014

Two contrary-sign events shaped the economy and banking activity in Portugal in 2014: the "clean exit" from the three-year EU-IMF financial assistance programme and the collapse of Grupo Espírito Santo, leading to the resolution of Banco Espírito Santo.

It was good news to witness Portugal exit the programme the "Irish way" and watch the markets regain confidence in the country. It has been widely acknowledged that the Troika-supported financial assistance programme, which expired at the end of June 2014, succeeded in stabilising Portugal's economy and restoring access to sovereign debt markets.

However, making the economy more dynamic, flexible and resilient remains an ongoing challenge and, if sustainable growth is the mantra for the economy as a whole, safeguarding financial sector stability in a low profitability and low growth environment, against the backdrop of vulnerable debt dynamics, is key for the desired orderly reshaping of the banking sector in the aftermath of the resolution of Banco Espírito Santo ("BES").

Safeguarding financial stability

"During the last week there was a significant deterioration of Banco Espírito Santo's financial situation and of the uncertainty surrounding it. Due to this situation, a capitalisation solution through private funds became unfeasible. Under these conditions and given the imminent risk of failure of Banco Espírito Santo, S.A. to meet its obligations, Banco de Portugal decided to apply a resolution measure to Banco Espírito Santo (…). The solution adopted by Banco de Portugal had as major concern the preservation of financial system stability and the protection of depositors' interest." (Televised speech by Governor of Banco de Portugal on the decision regarding the application of a resolution measure to Banco Espírito Santo, S.A. on 3 August 2014)

Just over one month after the successful expiry of the financial assistance programme, Portugal was confronted with the application of an unprecedented measure under an untested European resolution regime to one of its major banks.

There was widespread concern that such an event would completely undermine the recently regained feeble market confidence but it seems to constitute a fair statement to say that the shock waves were duly contained and that 'business as usual' is what best describes the aftermath of the resolution.

The 2008 financial crisis prompted deep international reflection on the lack of efficient rules, mechanisms and intervention powers of supervisors to adequately tackle failing credit

institutions and to avoid systemic contagion. The works of the European Commission, the Financial Stability Board and the G20 on this matter led to the preparation of the EU Directive establishing the framework for banking recovery and resolution (Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 ("BRRD")).

Given the then-existing preparatory works for the BRRD and the financial assistance environment in Portugal in 2012, the Portuguese Banking Law was then amended (through Decree-Law no. 31-A/2012, of 10 February 2012), precisely to immediately accommodate a new legal discipline for intervention in credit institutions which was (in 2012) already very much in line with the technical details of the (then) future BRRD, published in May 2014.

It was under this framework (a recently published and not fully transposed BRRD and a 2012 (with some 2014 amendments) national resolution regime that the Bank of Portugal applied a resolution measure to BES in August 2014.

This was done through the incorporation of a bridge bank – Novo Banco – to whom certain assets, rights and liabilities of the intervened credit institution were transferred. While Novo Banco is now in the process of being sold, the assets and liabilities, which were not transferred, stayed on the balance sheet of the failed bank, which is expected to be wound up.

Novo Banco was incorporated by the Resolution Fund (a fund participated in by the various banking and financial sector players) who paid up the full capitalisation of the bridge bank in the amount of EUR4.9 million, on a loan from the Portuguese Republic and using the revenues resulting from the banking sector ordinary and extraordinary contributions.

The Resolution Fund will need to repay this amount out of the proceeds of the sale of Novo Banco. If the proceeds fall short of this amount the banking sector as a whole will need to continue supporting the Resolution Fund until repayment in full is made.

While there is no doubt that financial stability has been preserved, repayment of this loan may constitute a potential further constraint for the Portuguese banking sector.

Ensuring the flow of credit to the economy and corporate debt restructuring

"Access to bank credit at reasonable cost is still constrained for viable but highly indebted companies, notably for small and medium-sized enterprises."

"High levels of indebtedness in the economy, combined with continued high financing costs in a low-inflation environment, underscore the need for decisive measures to reduce corporate debt and associated risk."

These are conclusions of the latest reviews by the Troika in 2014, which clearly state what we also see as absolutely critical going forward. This needs to be achieved while promoting financial stability.

Credit is crucial for economy pick up and growth but it needs to tie in with restructuring the corporate sector debt overhang with a particular focus on economically viable SMEs and supporting the necessary capital reallocation towards the productive sectors of the economy.

It was in this exact context that we witnessed the incorporation of the Development Financial Institution (DFI) in 2014. DFI's mission is that of addressing market failures in the financing of viable small and medium non-financing enterprises namely by contributing towards the execution of public policies promoting growth and employment and improving funding conditions of the economy. There was intensive national debate as to whether this would be better achieved through this route but the DFI is there and we trust it will successfully accomplish its mission.

In a nutshell

Overall operating conditions for the financial sector remain difficult, prolonging the process of banks' balance sheet deleveraging and repair but it is true that, notwithstanding the recent challenges presented by the resolution of one of the major banks in the system, financial stability has been preserved in Portugal.

What the August 2014 events reveal is that recovering from an economic crisis tends to be a dragging process, replete with unpleasant surprises.

As per the first Troika Post-Program Monitoring Discussion: *"It is important that the opportunity provided by the ECB's Comprehensive Assessment of the largest banks is a catalyst to strengthen the resilience of the banking system. Moreover, banks need to avoid taking excessive risks to compensate for weak profitability prospects, creating additional challenges for supervision. Looking ahead, the authorities' strategy for Novo Banco will need to strike a fine balance between preserving financial stability and safeguarding public finances."*