Times of crisis: increased regulation and new market opportunities

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During 2011, banks in Portugal continued under the pressure of the sovereign debt crisis of the EU peripherical Member States, with the Portuguese economy facing structural challenges in light of the financial conditions of the Portuguese sovereign which have sharply worsened. Portuguese public debt instruments were subject to very high interest rates, crossing the 7% threshold in both the primary and secondary markets. These facts together with a government step-down in March 2011, triggered a much accelerated downgrade of the ratings of the Portuguese Republic, state-owned companies, Portuguese banks and other companies and the expected subsequent request for financial aid from the Portuguese Republic to the EU and the IMF.

The Memorandum of Economic and Financial Policies ('Memorandum') signed by the Portuguese government and leading opposition parties with the above mentioned international institutions sets out, alongside with a financial rescue package, an unprecedented deep structural reform programme, which entails, for the banking sector, the strengthening of banking regulation and supervision and also an indication for new market opportunities, which would allow Portuguese banks to regain the trust of international investors and access to the interbank and bond markets. The goal is of course to restore market confidence and raise the potential of the Portuguese economy to generate a balanced growth.

On the increased regulation side, in order to bolster the resilience of the banking sector, one of the measures set out in the Memorandum corresponds to the obligation of the Portuguese banks to strengthen their capital buffer and augment the bank solvency support mechanism. In this sense, all banking groups subject to supervision by the Bank of Portugal are required to reach a Core Tier 1 (or Common Equity Tier 1) capital ratio of 9% by December 31, 2011 and of 10% by the end of 2012 and maintain it thereafter. Such measures have already been imposed by the Bank of Portugal Notice 3/2011 published on May 17, 2011, but naturally correspond to a very demanding stride for Portuguese banks, given that such milestones impose a step forward in the requirements already set out by the Basel III framework. Taking into account indications of solvency assessment framework, the Bank of Portugal may require that some banks reach higher capital levels on an accelerated schedule. In addition, in the event banks are not able to comply with these standards in due time, the Memorandum foresees the possibility of the Portuguese state participating in the banks' capital up to €12bn.

On a similar note, the Bank of Portugal is strengthening banking regulation and the processes for monitoring the banking sector by increasing its solvency and deleveraging assessment policies and also by improving disclosure on non-performing loans.

When it comes to new opportunities, it is worth noting the privatisation programme set out in the Memorandum that is to be implemented by the Portuguese state, which includes companies in the transport universe (ANA (Aeroportos de Portugal), TAP airline and the freight branch of Comboios de Portugal (CP)), the energy sector (GALP, EDP and REN), the communications segment (CTT) and the insurance area (Caixa Seguros, the insurance branch of CGD), as well as a number of smaller firms.

The Memorandum also foresees a continuous deleveraging of the banking sector in order to eliminate the existing funding imbalances, which will be accompanied by a reduction in the relationship between credit granted and deposits held by institutions. This is also backed with the aim of improving banks' liquidity and reducing the reliance of the Eurosystem funding. For such purposes, the Bank of Portugal will set target leverage ratios and require that institutions present specific funding plans in order to achieve a stable funding position.

In this context, bank liquidity remains under pressure and Portuguese banks face the challenge of finding alternatives for raising liquidity – which is becoming ever scarcer, especially following the several downgrades of Portuguese banks and the consequential downgrade rating reviews of the Portuguese originated securitisation transactions and covered bonds issuances by these banks. With the ratings of these debt instruments being downgraded and AAA ratings not being attained for transactions out of Portugal, banks have lost their primary tool as eligible collateral for Eurosystem monetary policy and intra-day credit operations by the Eurosystem. In any case, structured finance transactions of this nature continue to be carried out, both with mortgage loans for covered bonds and with small and medium-size enterprise (SME) and consumer loans for securitisations,

and the issued instruments are being used in repo transactions with international banks and several existing transactions are being restructured to cater for replacement of counterparties and additional rating requirements.

Also on the liquidity front, of vital importance to Portuguese banks is the commitment of the Portuguese state (as set out in the Memorandum) to facilitate the issuance of government guaranteed bank bonds (in line with what had occurred in the aftermath of the 2008 turmoil) of up to €35bn, including the existing package of support measures – and Portuguese banks are already considering this option in their pipelines.

Times of crisis are certainly times of increased regulation and the challenges ahead, for both the country and its banks, are demanding. However, from our point of view, we are certainly also witnessing a context of new pursuits and opportunities namely in light of the structural programme set out in the Memorandum. While undergoing significant reform, the Republic of Portugal and the Portuguese banks will certainly be better placed to deal with the anticipated approaching economic recession and are hoping that these measures will allow for a substantial improvement of the international outlook for Portugal.

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