Yale University
EliScholar – A Digital Platform for Scholarly Publishing at Yale

YPFS Documents (Series 1) Browse by Media Type

10-1-2006

Portugal: Financial System Stability Assessment

International Monetary Fund (IMF)

Follow this and additional works at: https://elischolar.library.yale.edu/ypfs-documents

Recommended Citation
International Monetary Fund (IMF), "Portugal: Financial System Stability Assessment" (2006). *YPFS Documents (Series 1)*. 13227.
https://elischolar.library.yale.edu/ypfs-documents/13227

This Document is brought to you for free and open access by the Browse by Media Type at EliScholar – A Digital Platform for Scholarly Publishing at Yale. It has been accepted for inclusion in YPFS Documents (Series 1) by an authorized administrator of EliScholar – A Digital Platform for Scholarly Publishing at Yale. For more information, please contact elischolar@yale.edu.

© 2006 International Monetary Fund

October 2006
IMF Country Report No. 06/378

Portugal: Financial System Stability Assessment, including Reports on the Observance of Standards and Codes on the following topics: Banking Supervision, Securities Regulation, and Insurance Regulation

This Financial System Stability Assessment on Portugal was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on September 22, 2006. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of Portugal or the Executive Board of the IMF.

The policy of publication of staff reports and other documents by the IMF allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

Copies of this report are available to the public from

International Monetary Fund ● Publication Services
700 19th Street, N.W. ● Washington, D.C. 20431
Telephone: (202) 623 7430 ● Telefax: (202) 623 7201
E-mail: publications@imf.org ● Internet: http://www.imf.org

Price: $18.00 a copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

PORTUGAL

Financial System Stability Assessment

Prepared by the Monetary and Capital Markets and European Departments

Approved by Jaime Caruana and Michael Deppler

September 22, 2006

- This Financial System Stability Assessment (FSSA) is based on work undertaken during the Financial Sector Assessment Program (FSAP) for Portugal, which included visits to Lisbon in December 2005 and May 2006. The findings were further discussed with the Portuguese authorities during the Article IV consultation mission in July 2006. The team comprised Mark Swinburne (mission chief), Alessandro Giustiniani (deputy mission chief), Ana Carvajal, Alvir Hoffmann, Peter Lõhmus, Philip Schellekens and Jan Woltjer (all IMF/MCM); Yuan Xiao (IMF/EUR); Marcel Maes (BCP expert, formerly MCM and Belgian Banking Commission) and Henning Goebel (ICP expert, Bafin). The main findings are as follows:

- Portugal's financial system is sound, well managed and competitive. Short-term vulnerabilities appear well contained, as confirmed by the stress test exercise, although banks are more than usually sensitive to equity market risk through their employee pension funds. Over the medium term, rising household and corporate sector debt and significant concentration of banks' exposure across sectors (especially real estate) and borrowers may become important potential risk factors, especially if economic conditions remain sluggish, and will need to be monitored closely. Banks appear to be managing adequately the risks involved in their substantial foreign borrowings. Potential domestic channels for contagion risk amongst banks and cross-sectoral spillovers appear quite low.

- In the last few years, the performance and soundness of the insurance sector has strengthened. While relatively sensitive to various types of market and underwriting risks, the insurance sector seems able to withstand a number of severe shocks even though the impact on individual insurers varies widely.

- Supervision of financial institutions as well as of payments and settlement systems is professional and active, comparing very well with international standards. In the insurance and securities sectors, additional enhancements to supervisors' autonomy would be desirable, but other recommendations are mainly of a technical nature. The infrastructure for the settlement of payments and securities transactions is highly developed, efficient, technologically well advanced and robust from a risk management perspective.

FSAPs are designed to assess the stability of the financial system as a whole and not that of individual institutions. They have been developed to help countries identify and remedy weaknesses in their financial sector structure, thereby enhancing their resilience to macroeconomic shocks and cross-border contagion. FSAPs do not cover risks that are specific to individual institutions such as asset quality, operational or legal risks, or fraud.

Contents Page

Glossary 4

Executive Summary 5

I. Financial System Features 8

II. Potential Sources of Risk 10
A. Macroeconomic Environment 10
B. Main Counterparties 10

III. Strengths and Vulnerabilities 16
A. Institutions 16
B. Markets and Intermediaries 23
C. Infrastructure 23

IV. Structural Issues 25

V. The Financial Stability Policy Framework 26

Tables
1. Market Concentration Indicators in Selected euro-Area Countries (1997-2004) 8
2. Contract Features in Selected Mortgage System 14
3. Risk Management Methods for Basel II 20
4. Recommended Action Plan to Improve Compliance with the Basel Core Principles 33
5. Recommended Action Plan to Improve Observance of IAIS Insurance Core Principles....37
6. Recommended Plan of Action to Improve Implementation of the IOSCO Objectives and Principles of Securities Regulation 42

Figures
1. Key Features of the Financial System 9
2. Selected Economic Indicators; 2000–05 11
3. Household and Corporate Sector Debt and Debt Service, 2000-05 12
4. Property Prices, 2000–06 13
5. Credit Growth, 2000–06 14
6. Bank Lending by Sectors, 2005 15
7. Banking System Selected Financial Indicators; 2005 17
8. Bank Loan Securitization; 2000─06 19
9. Selected Stock Market Indicators 24
10. Share of Banking Sector Assets in Majority State-Controlled Banks in Selected Countries, 2003 25

Boxes
1. Main Recommendations of the FSAP 7

2. Summary of Stress Testing Results 22

Annex
Observance of Financial Sector Standards and Codes: Summary Assessments..........29

Appendix
Methodological Aspects of Stress Testing in the Portugal FSAP..........44

Appendix Tables
7. Overview of Banking and Insurance Stress Tests..........44
8. Macroeconomic Aggregates 45
9. Probabilities of Default Projections 45
10. Banking Sector: Overview of Sensitivity Shocks..........47
11. Insurance Sector: Overview of Shocks Under the Bottom-Up Approach 48
12. Structure of the Financial System 50
13. Financial Soundness Indicators of the Banking Sector..........51
14. Financial Soundness Indicators of the Non-Banking Sectors..........52

GLOSSARY

AML/CFT	Anti-Money Laundering/Combating Financing of Terrorism
BdP	Banco de Portugal
BCP	Basel Core Principle
BSCH	Banco Santander Central Hispano, S.A.
CAR	Capital adequacy ratio
CDD	Customer due diligence
CEIOPS	Committee of European Insurance and Occupational Pensions
CGD	Caixa Geral de Depósitos
CIS	Collective Investment Scheme
CMVM	Comissão do Mercado de Valores Mobiliários (Stock Exchange Commission)
CNSF	Conselho Nacional de Supervisores Financeiros (National Council of Financial Supervisors)
ECB	European Central Bank
EMU	European Monetary Union
ESCB	European System of Central Banks
EU	European Union
FATF	Financial Action Task Force on Money Laundering
FGCA	Fundo de Garantia de Crédito Agricola Mútuo
FGD	Fundo de Garantia de Depósitos
FIU	Financial Intelligence Unit
FSSA	Financial Sector Stability Assessment
FSAP	Financial Sector Assessment Program
IAIS	International Association of Insurance Supervisors
ICP	IAIS Insurance Core Principles
IFRS	International Financial Reporting Standards
IOSCO	International Organization of Securities Commissions
ISP	Instituto de Seguros de Portugal (Insurance supervisory and regulatory authority)
LFCIFC	Legal Framework of Credit Institutions and Financial Companies
LTV	Loan-to-value ratio
MAR	Modelo de Avaliação de Riscos
MoU	Memorandum of understanding
NPLs	Nonperforming loans
OL	Organic Law of the BdP
QIS	Quantitative impact study
ROSC	Report on the Observance of Standards and Codes

Executive Summary

Overall, Portugal's financial system is sound, well managed and competitive, with shorter-term risks and vulnerabilities quite well contained for now, and with the system buttressed by a strong financial policy framework. Despite being relatively small and concentrated, Portugal's banking system generally compares well with other European Union (EU) countries in terms of efficiency, profitability, and asset quality, with solvency also close to European levels. Across all the financial sub-sectors, and with particular reference to the larger institutions, supervision of Portuguese financial institutions is active, professional and well organized.

Nevertheless, the risks and challenges for the financial system may increase over time, especially if the economic environment remains difficult. As the authorities clearly recognize, continued close vigilance will be required, not least given already high household and corporate debt levels, and there could be new tests for policymakers and the policy framework. In recent years, the authorities have invested considerably in the development of a high quality macro prudential surveillance framework

The main findings of the FSAP are as follows. Box 1 summarizes the main FSAP recommendations.

- Portuguese banks' profitability, asset quality, and solvency have held up well in recent years, despite a difficult operating environment. Banks' risk management processes appear adequate and are being further upgraded in the transition to Basel II. The banking system is more than usually exposed to equity price risk through employee pension funds, but beyond that, other market risks seem to be of a lesser significance. Stress testing confirmed that, overall, Portuguese banks would be able to absorb fairly comfortably an array of severe but plausible shocks to the macroeconomic environment.

- Nevertheless, household debt levels are well above EU average and mostly carry floating interest rates thereby transferring interest rate risk to borrowers. Given the uneven distribution of debt burden and assets, potential vulnerabilities are more concentrated amongst younger and newer borrowers. If household borrowing continues growing robustly, the system may become more vulnerable to substantial shocks to interest rates and household income/employment in future, especially if they were to occur simultaneously. If such shocks materialize, the direct impact on banks of potential mortgage defaults could be compounded by the effects of reduced household consumption on corporate sector profitability and capacity to repay. One factor that does not appear to be present in Portugal, however, is an overinflated housing market.

- Corporate debt levels are also high, although bank credit to corporates has been growing moderately in recent years; and external debt levels, including bank borrowing, are substantial. Banks' credit exposures remain concentrated across sectors (especially real

estate) and in a number of large enterprises. Although these concentrations appear to be adequately managed and within prudential limits, where applicable, they may nevertheless become an element of vulnerability under more adverse conditions.

- The insurance sector has performed well in recent years, partly reflecting a rapid deepening of the market in Portugal. While sensitive to various types of market and underwriting risks, both the life and non-life sectors, overall, are estimated to be able to withstand a number of severe shocks, even though the impact on individual insurers varies widely.

- Potential domestic channels for contagion risk and cross-sectoral spillovers amongst banks appear quite low. The importance of insurance business within bank groups is not large; most interbank borrowing and other shorter-term market transactions are conducted with international counterparties; and the domestic payments and settlement systems are well designed to minimize potential spillovers. Cross-border exposures (other than the funding aspect) are also moderate, with an important element of system-level diversification given different banks' strategies and regions of interest.

- The authorities will need to continue to carefully monitor the key risk areas and potential concentrations, and to this end, the FSAP made some recommendations for priority work under the Banco de Portugal (BdP)'s ongoing macroprudential surveillance function, including the need to improve (as planned) data on property prices. Likewise, the authorities will also need to continue to ensure bank capital remains consistent with the risk outlook in future, and if necessary—for example, if mortgage debt levels keep growing strongly—impose higher capital requirements (under Pillar 2 of Basel II).

- Supervision of financial institutions as well as of payments and settlement systems is professional and active, comparing very well with international standards (as noted in the attached ROSC Annex). *Inter alia*, following some regulatory changes in 2002-03, loan classification and provisioning arrangements for banks were assessed as fully in line with the standard. Safety net arrangements also appear sound, though untested in the face of major problems. Remaining areas for improvement include more formally safeguarding the financial autonomy of the insurance and securities supervisors, while the former agency should shed, over time, some non-supervisory functions. Other desirable enhancements for the supervisory and safety net frameworks are mainly more technical in nature. Underlying these arrangements, the judicial framework for debt recovery needs to be strengthened to speed up court processes in particular. A newly announced review of the legal system is expected to cover this.

Box 1. Main Recommendations of the FSAP [1/]

Short-term stability issues

- Continue to carefully monitor key risk areas: household debt, especially toward more vulnerable sub-groups of household borrowers; corporate debt developments; banks' lending concentrations; and banks' external borrowing and the associated pricing and liquidity risks.
- Continue to ensure bank capital levels are consistent with the evolving risk outlook and if necessary impose additional capital requirements using the discretion available under Basel II.
- Improve statistics on housing market, in particular, as regards property prices.
- Continue to foster banks' systems to accurately measure, monitor, and adequately control risks, and further strengthen the BdP's supervisory capacity in this area.
- Perform further stress testing on the financial system at appropriate intervals, taking into account banks' linkages with the insurance sector and their employee pension funds.

Structural and longer-term issues

- Improve the judicial framework for debt recovery by speeding up court processes in particular.
- Enhance the financial independence of the securities and insurance supervisors, Comissão do Mercado de Valores Mobiliários (CMVM) and the Instituto de Seguros de Portugal (ISP).
- Transfer the management of the guarantee fund for Motor Third Party and workers compensation from the ISP to other organizations.

Refinements to supervisory and safety net arrangements

A number of more technical recommendations for further enhancement of supervisory and safety net arrangements are contained in the report, including:

- fully implement the new system for risk profile assessment of credit institutions and other financial intermediaries, as planned; and
- in insurance supervision, set appropriate fit and proper criteria for members of governing bodies of insurance undertakings and intermediaries, strengthen corporate governance requirements, and establish rules or guidelines on market conduct regarding the problem of fraud.

1/ Priorities according to macro-economic relevance.

I. Financial System Features

1. **Financial intermediation in Portugal is dominated by the banking sector**. While Portugal's financial market depth is somewhat lower than the euro-area average, bank loans represent a larger source of financing for the private sector (Figure 1). Portuguese banks hold strategic stakes in other sectors of the economy, including the insurance sector. Foreign bank participation is relatively high as is state ownership through the Caixa Geral de Depósitos (CGD).

2. **Although the banking market is somewhat concentrated, competitive conditions are robust.** Financial liberalization and deregulation, and the creation of the European Monetary Union (EMU), helped bolster consolidation in the banking industry in Portugal. As a result, market concentration has increased, as measured by the usual market-structure indicators (Table 1). Nevertheless, a number of empirical studies suggest that competitive conditions in the Portuguese banking have remained strong.[1]

Table 1. Portugal: Market Concentration Indicators in Selected Euro-Area Countries (1997-2004) 1/

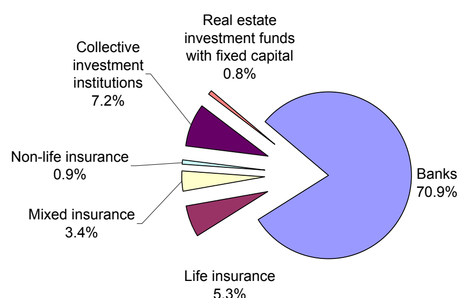
	Herfindahl Index 1/			Share of the 5 largest credit institutions		
	1997	2001	2004	1997	2001	2004
Portugal	577	991	1,093	46	60	67
Belgium	699	1,905	2,100	54	78	84
France	449	606	623	40	47	45
Germany	114	158	178	17	20	22
Greece	885	1,113	1,069	56	67	65
Italy	201	260	230	25	29	26
Spain	285	551	482	32	45	42
United Kingdom	208	282	376	24	29	35
EMU12	383	544	600	45	39	41
EU25	...	506	569	...	38	40

Sources: European Central Bank, "EU Banking Structures," October, 2004 and 2005.
1/ Based on a solo data. The Herfindahl Index is the sum of squares of the markets shares of all firms in a sector. When the index is between 1,000 and 1,800, the market structure is somewhat concentrated; when it assumes values above 1,800, the market is highly concentrated.

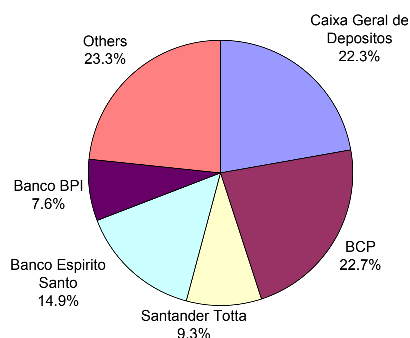
[1] See IMF (2005) "Portugal—Selected Issue," IMF Country Report No. 05/376, "The Portuguese Banking Sector" and the articles quoted therein.

Figure 1. Portugal: Key Features of the Financial System

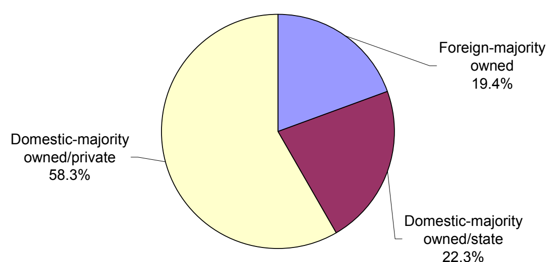
Portuguese Financial Sector; 2004
(Percentage share in total financial sector assets)



Share of the Top-5 Bank; 2004
(In percent of assets)



Banking Sector Structure by Ownership, 2004
(Percent of banking sector assets)



Financial Intermediation in Portugal and Euro Area

	Euro area		Portugal	
	2001	2004	2001	2004
	(in percent of GDP)			
Bank credit to non-monetary private sect	113	116	132	136
Domestic debt securities 1/	38	39	25	28
Stock market capitalization	70	72	42	44
Total	221	226	199	208
Memorandum items:				
Total bank assets	251	263	215	221
Bank deposits	94	96	116	115

1/ Excluding government.

The share of banks and banking groups in financial sector activities, 2004 (In percent)

	CGD	BCP	Santander	BES	BPI	Other banks	Total by banks	Total
Banking	22.3	22.7	9.3	14.9	7.6	23.3	100.0	100.0
Life insurance 1/	16.9	22.2	9.4	13.2	21.9	9.5	93.1	100.0
Non-life insurance 1/	35.9	3.6	…	10.4	0.7	11.8	62.4	100.0

1/ Direct insurance premiums (activity in Portugal only).

Sources: Portuguese authorities, Bank for International Settlements, ECB, Eurostat, World Bank, and IMF staff estimates.

II. Potential Sources of Risk

A. Macroeconomic Environment

3. **The macroeconomic environment has been challenging for the Portuguese financial system**. In the last few years, the Portuguese economy has been one of the weaker performers in Europe, mainly due to disappointing productivity growth and waning external competitiveness. Since 2001, the economy has been virtually stagnant; domestic investment has collapsed; public finances have significantly deteriorated triggering two consecutive EU excessive-deficit procedures; the current account deficit has widened to more than 9 percent of GDP in 2005; and the negative net international investment position has worsened to almost 66 percent of GDP, reflecting significant government and bank borrowing from abroad (Figure 2).

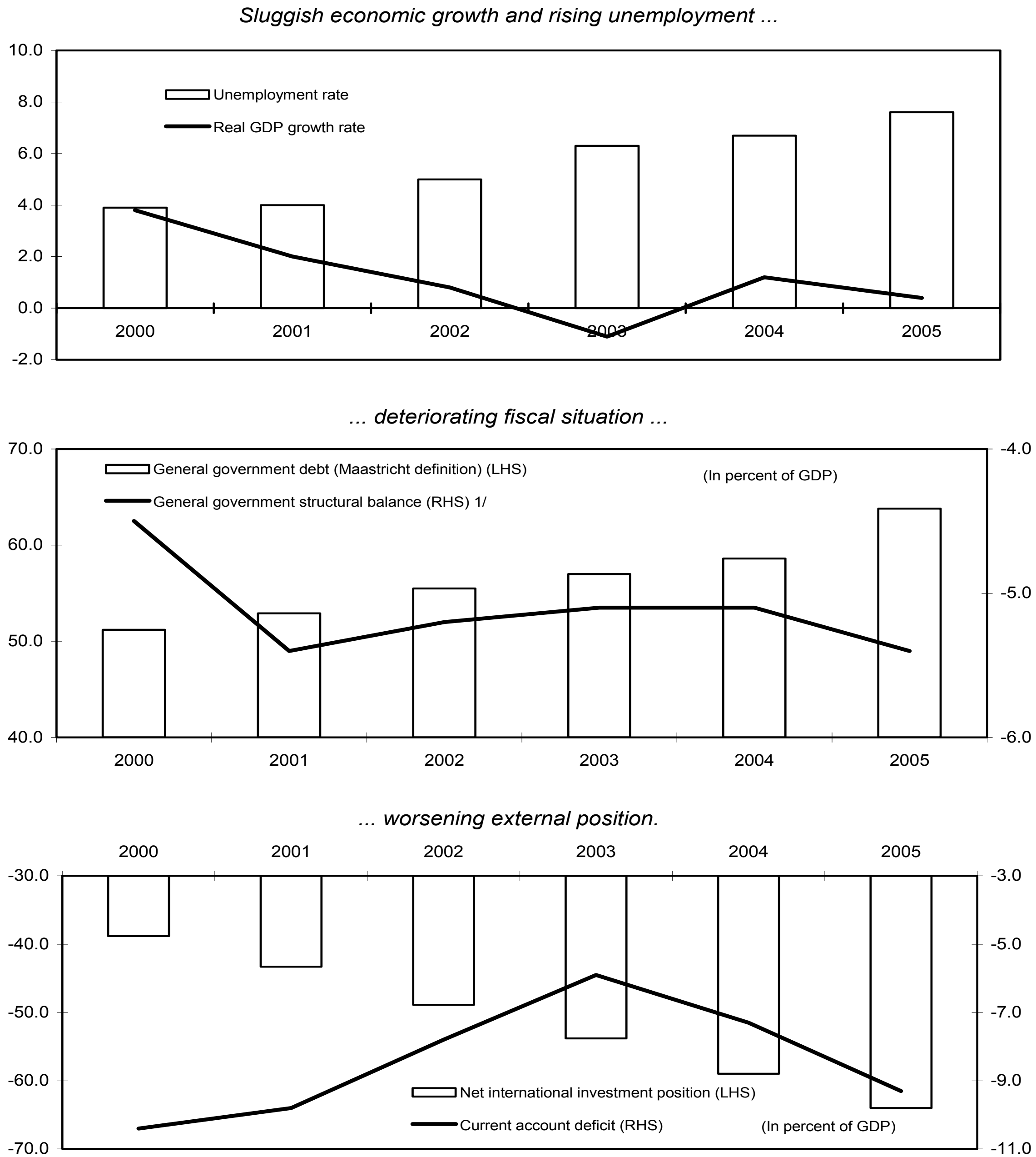
4. **The near term economic outlook is for growth to remain relatively slow and if there were to be any significant dampening of economic recovery prospects, it could significantly affect banks' asset quality and earnings capacity**. In the period ahead, slow employment growth, poor external competitiveness, fiscal consolidation, and the need for household and firms to work off their high indebtedness will weigh on banks' operating environment. Further risks may arise from deterioration in the external environment. A more-rapid-than-expected increase in Euro area interest rates, or strengthening of the Euro exchange rate, for example, would likely further depress domestic demand and economic activity, requiring still further fiscal adjustment to achieve the Stability and Growth Pact targets. If substantial concerns about fiscal policy were to develop, this could translate into higher risk premia for Portuguese borrowers in general.[2]

B. Main Counterparties

5. **Household borrowing has grown robustly, despite the weak economic performance, and high household indebtedness is an important source of potential risk for banks.** Since mid-1990s, favorable monetary conditions have fostered household borrowing, mainly for mortgages, which has significantly outpaced household disposable income growth (Figure 3). As a result, in less than 10 years, household debt has more than tripled, reaching around 120 percent of disposable income in 2005, the second highest figure in the euro area. Debt service remains moderate given low euro-area interest rates. However, since household mortgages are typically floating rate loans, interest rate risk is shifted to the household sector, which in turn generates greater credit risk for banks, other things being equal. Intensified competition in the mortgage market has also resulted in some easing of

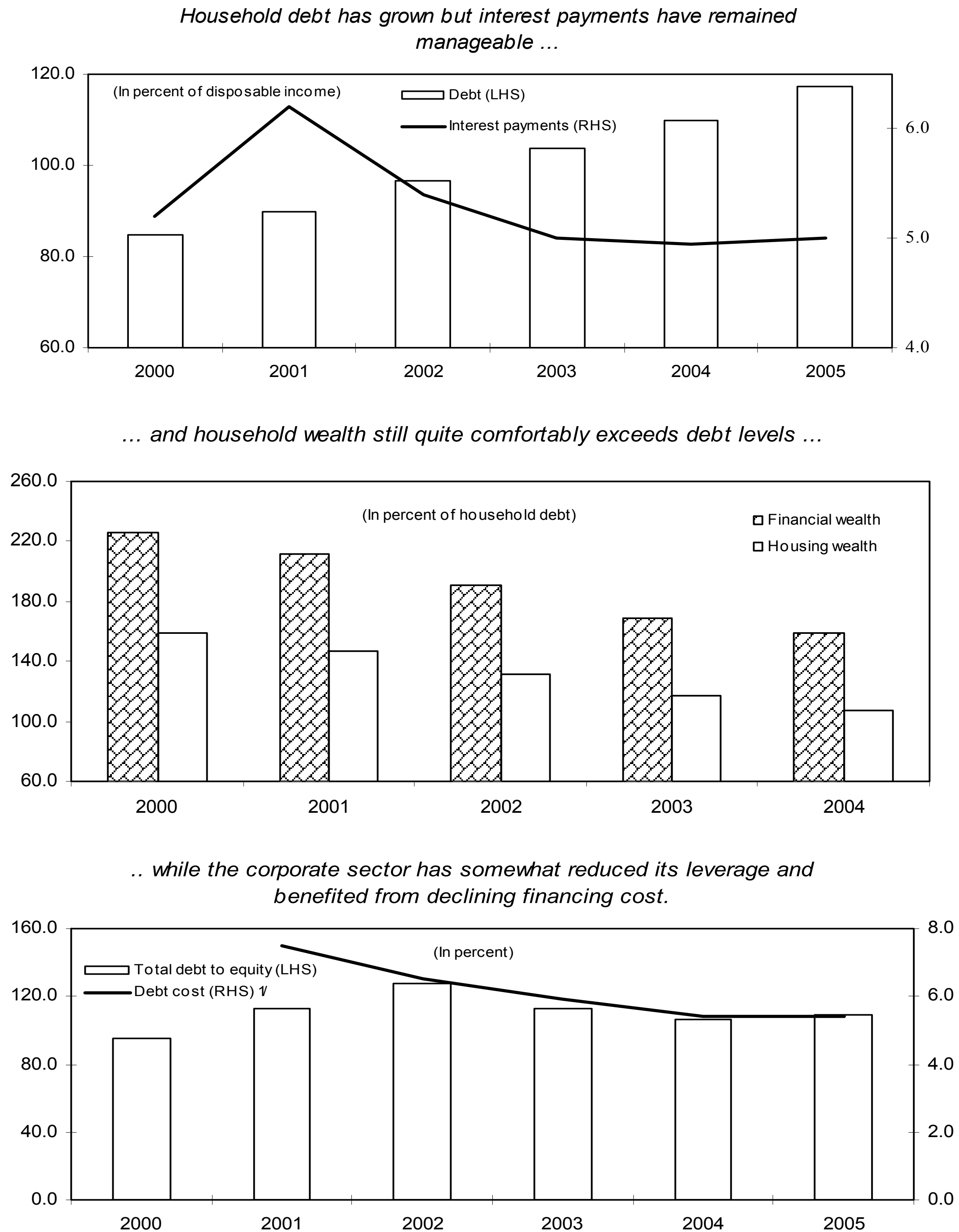
[2] However, it should be noted that the significant deterioration in fiscal performance that has already occurred appears to have had no impact on risk premia to date.

Figure 2. Portugal: Selected Economic Indicators; 2000–05



Sources: Banco de Portugal; and IMF staff estimates.
1/ Structural balances are calculated using the staff's estimates of potential output. Asset sales, including UMTS receipts, the transfer of pension funds, and securitization are netted out for purposes of calculating structural balances.

Figure 3. Portugal: Household and Corporate Sector Debt and Debt Service; 2000–05



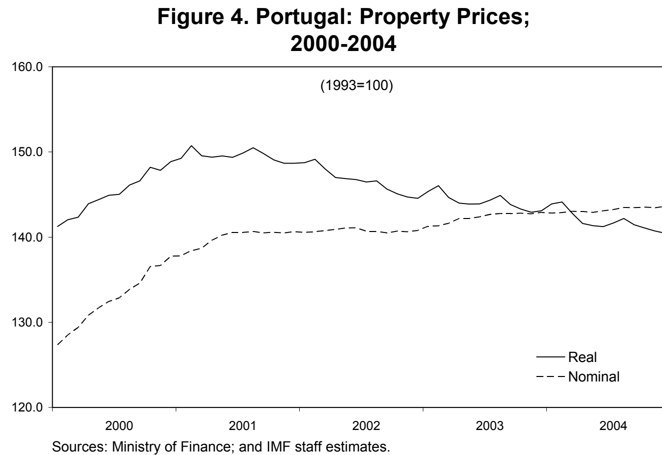
Sources: Banco de Portugal; Cardoso, F. and Cunha, V. (2005), "Household wealth in Portugal: 1980-2004," Banco de Portugal Working Paper No 4, June; and IMF staff estimates.
1/ Interest cost to financial debt ratio.

credit standards over time, new types of contracts delaying principal repayments, and higher loan-to-value ratios (LTVs).

6. **Nevertheless, there are a number of potentially mitigating factors**:

- **Contrary to other European countries' experience, Portugal has not suffered a significant boom in real estate prices** (Figure 4). House prices have slowed quite significantly after 2000–01 and have been almost flat in nominal terms in recent years (and negative in real terms), reflecting, *inter alia,* some gradual correction of the earlier upswing and some increase in the supply side.[3]

Figure 4. Portugal: Property Prices; 2000-2004



Sources: Ministry of Finance; and IMF staff estimates.

- **Net household wealth appears broadly comfortable, with net financial wealth still in excess of the growing household debt levels**. Nevertheless, beneath the aggregate picture, household wealth remains highly concentrated, and the debt-to-asset ratio is markedly higher for the age group of less than thirty years old, which makes this group more vulnerable to interest rate and unemployment shocks.[4] It will be important to monitor whether there are any concentrations of lending to such more vulnerable borrowers.

- **LTV ratios are broadly in line with other EU countries** (Table 2)**.** The average LTV ratio on new mortgages has risen to about 85 percent on average—and can be up to 100 percent in specific cases—but remains broadly in line with other EU countries.

[3] BdP, Financial Stability Report, 2005. However, recent house price data need to be interpreted with caution because of a break in available series. Nevertheless, anecdotal evidence supports the picture of a flat market overall, with stronger pockets in some places offset by weaknesses in other places.

[4] Banco de Portugal (2004), Financial Stability Report.

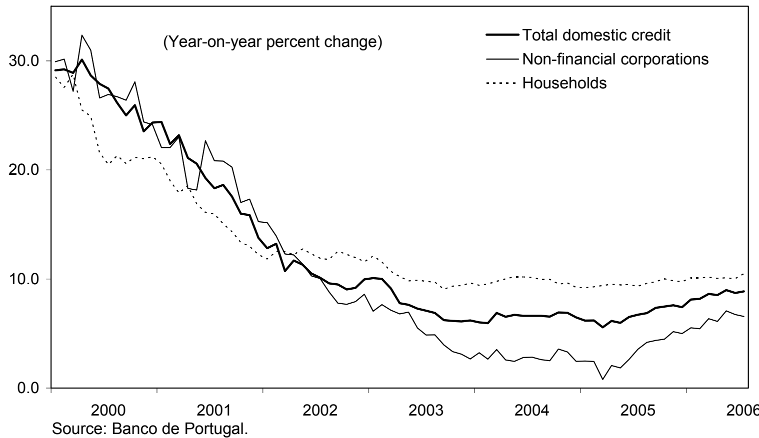
Table 2. Portugal: Contract Features in Selected Mortgage System 1/

Country	Length of contract (years)	Typical LTV	% variable rate loans	Home owners with a mortgage
Portugal	25-30	about 85%	>90%	Most
Austria	25	60%	30%	
Belgium	20	80-85%	25%	56%
Denmark	30	Max 80%	25%	
France	15-20	Max 60%	20%	38%
Germany	20-30	70-80%	30%	
Greece	15	55%	95%	25%
UK	25	70%	72%	60%
Japan	20-30	70-80%	n.a.	n.a.
United States	30	about 85%	n.a.	65%

Sources: Banco de Portugal; European Mortgage Federation; ECB; Eurostat.
1/ Most recent information.

7. **Although corporate lending has sharply decelerated since the late 1990s, mainly reflecting weak domestic and foreign direct investment, concentration across sectors and borrowers may represent an important risk for banks** (Figure 5). Corporate lending has recovered somewhat recently, thus providing banks with some diversification from household lending. However, corporate debt has reached 97 percent of GDP in 2005, which is one of the highest levels amongst EU countries. Despite weak economic activity, corporate nonperforming loans (NPLs) have remained low but this situation might suddenly change if the economy continues to perform poorly and/or interest rates rise substantially. Two issues deserve particular attention:

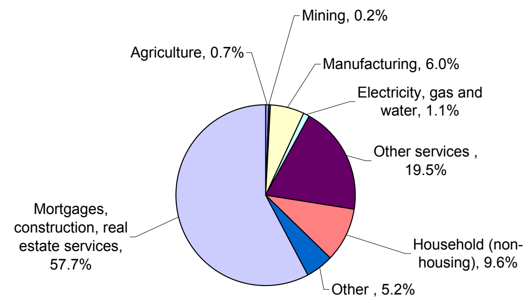
Figure 5. Portugal: Credit Growth; 2000-06



Source: Banco de Portugal.

- **Significant exposure to real estate-related activities** (Figure 6). Taking into account loans to construction, rental service, households' mortgage loans on the banks' books and property-related securitization activity, total exposure of the banking sector to the real estate sector is more than half of total loans originally granted to the non-financial private sector. This makes the banking sector particularly vulnerable to developments in this sector.

Figure 6. Portugal: Bank Lending by Sectors; 2005



Sources: Banco de Portugal; and IMF staff estimates.

- **Significant concentration in a few large corporate borrowers.** In recent years, almost half of corporate lending was concentrated in a few large non-financial corporations (some 0.5 percent of total borrowers, by number), mainly in the service sector.[5] While the sum of these exposures was equivalent to almost twice the regulatory capital of the banking system as a whole, they are closely supervised and within the prudential limits.[6] Although these large borrowers are mainly in the nontradable sector, and hence not directly exposed to harsh international competition, uncertainties surrounding the domestic economic outlook may nevertheless make these exposures more risky.

8. **Banks have significant foreign borrowing.** As bank credit growth has outpaced the expansion in domestic customer deposits, Portuguese banks have increasingly tapped international capital markets, mainly in the euro area, by issuing securities through subsidiaries abroad and to a much lesser extent direct interbank borrowing.[7] In recent years, they have succeeded in lengthening the maturity of their borrowings in these markets. While currency risk is small, the banks could be affected by pricing and liquidity risks if market sentiment deteriorated.

9. **Banks' exposures to emerging and developing markets are quite small**. Overall, the foreign operations of domestic banking groups are a rather marginal aspect of their balance sheets, although in some cases, foreign activities contribute more to group revenue

---

[5] The data refer to borrowers with total loans from resident credit institutions equal to or greater than EUR 10 million.

[6] In compliance with the European Banking Directive, the total of large exposures incurred by a credit institution cannot exceed 800 percent of its own funds.

[7] Foreign borrowing (securities issuance and interbank) at end-2005 was equivalent to 16 percent of the total assets of the largest domestic banks and would be slightly lower for all domestic banks in aggregate.

than to balance sheets.[8] While some banks sold off foreign operations to clarify focus, some larger banks currently appear interested in further foreign expansion. However, banks' vulnerability to adverse developments in those markets appears rather limited, given their size and the diversity amongst banks.

III. Strengths and Vulnerabilities

A. Institutions

Credit institutions

10. **Portuguese banks continue to enjoy robust growth and strong profitability despite a difficult operating environment**. Against a background of anemic economic growth and narrowing interest margins—albeit still somewhat higher than in other euro-area countries—banks have strengthened alternative sources of income (mainly commissions), rationalized operating costs (notably for personnel), and enhanced credit procedures. Overall, Portuguese banks compare well with the average of euro-area countries (Figure 7).

11. **Banks' liquidity position, asset quality, and solvency ratios have improved.** Increasing loan securitization and the capacity to tap the long-term segment of capital markets at declining spreads has helped Portuguese banks to improve their liquidity position. Reflecting, inter alia, improved risk management practices, the burden of NPLs has declined to historical lows, while provision coverage has been strengthened.[9] Market-oriented risk indicators such as spreads on credit default swaps, although available for a limited number of banks, compare well with euro-area averages.[10] Although affected by changes in the actuarial assumptions for the banks' pension schemes, the capital adequacy ratio (CAR) for the system is broadly in line with (but a little lower than) the Euro-area average, and is more closely in line for the larger banks.

---

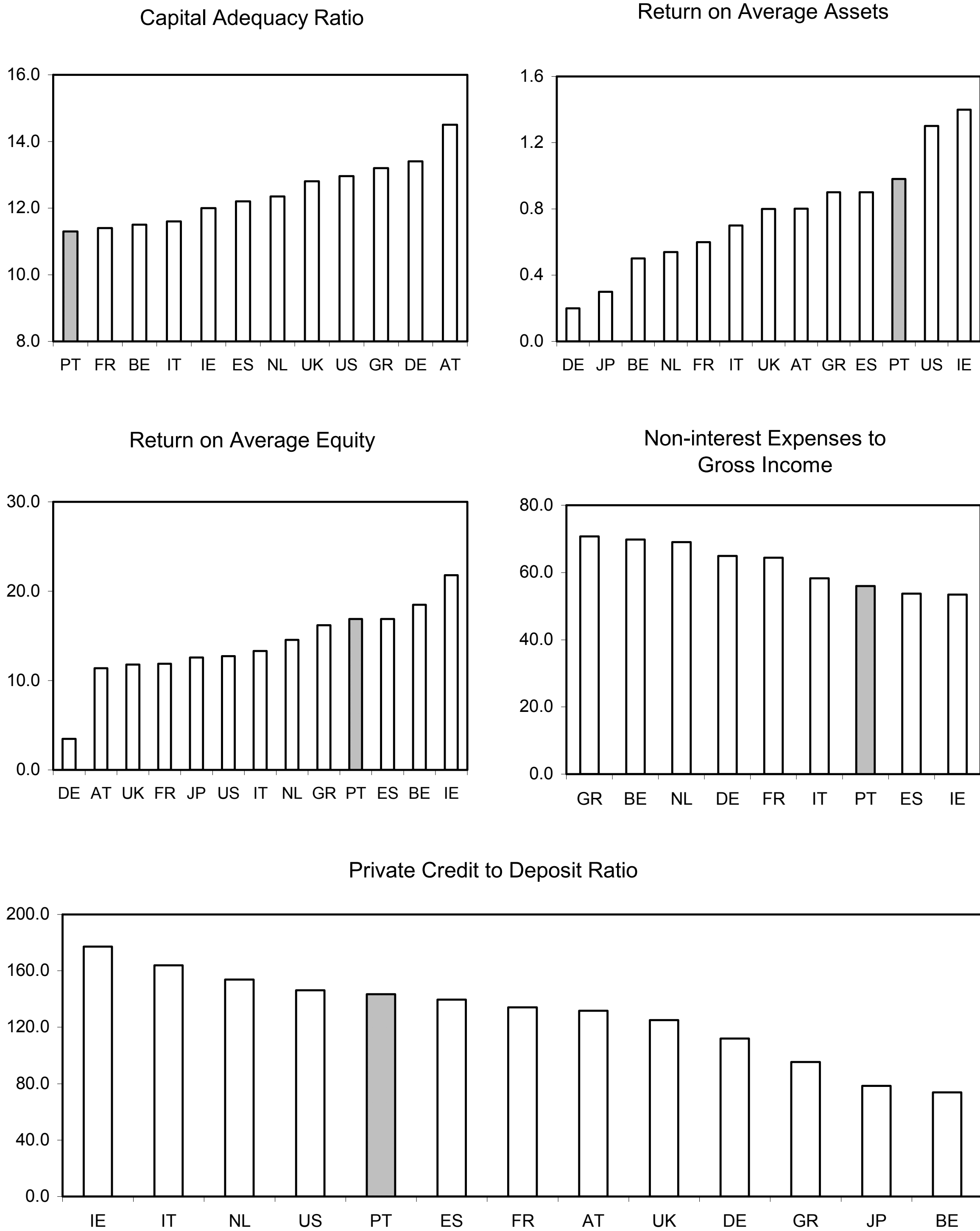
[8] Overall, claims on emerging and developing countries amounted to about 5 percent of banks' total assets. In the case of one major bank active internationally, lending by each of its two main foreign operations amount to only around 4 percent of the lending of the Portuguese parent.

[9] Banks' adoption of International Financial Reporting Standards (IFRS) in 2005 has complicated the comparison of financial sector data with previous years, especially earlier than 2004.

[10] Banco de Portugal (2004, 2005), Financial Stability Report.

Figure 7. Portugal: Banking System Selected Financial Indicators; 2005

(In percent)



Sources: Banco de Portugal; ECB; and IMF staff estimates.

12. **However, several aspects of credit risk will need to be (and are being) closely monitored,** as they could become still more important as risk factors in future, if current trends continue. Notwithstanding the mitigating factors outlined above, increased bank competition, especially in the mortgage market, may have contributed to some easing of lending and pricing standards. Portugal's uncertain economic outlook casts some additional risks on banks' exposure to large non-financial corporates, including their equity holdings. At the same time, the recent expansion of some banks' lending to small and medium-sized enterprises, while providing some beneficial diversification, may increase their risk profile in other ways, owing to limited availability of financial information, and less demanding transparency and accounting standards.

13. **While liquidity and direct market risks appear to be relatively small, banks are more than usually sensitive to equity price risk.** Despite the continued significant reliance on external borrowing, overall banks' liquidity situation appears adequate and has generally improved in recent years, despite a downturn in some liquidity indicators in the latest year.[11] Of particular importance in this regard has been the lengthening of the maturities of external borrowing in recent years, both through a general shift from interbank borrowing to bond issuance (the latest year excepted) and a shift towards longer maturity bonds: in 2005, the share of foreign bonds with maturities over 5 years increased from 29 percent to 37 percent of total debt securities issued by subsidiaries and branches abroad. As noted above, as part of this, mortgage and other securitizations have grown significantly in recent years (Figure 8). With almost all this borrowing being in the euro markets, currency risk is minimal, while the depth of these markets helps to further mitigate liquidity risks. As regards equity price risk, direct equity investment on the banks' own books represents a relatively small share of banks' assets, but their employee pension funds are particularly exposed to stock markets.[12]

14. **Employee pension funds may represent a significant challenge for the banks.** It is estimated that the implementation of the IFRS principles for evaluating pension and health care liabilities would imply a 9.2 percent fall in the level of banking system regulatory capital. While this impact can be spread over several years under current arrangements, a large burden remains to be borne, as only one-sixth of that impact was absorbed during 2005. Further, these costs are distributed unevenly across banks.

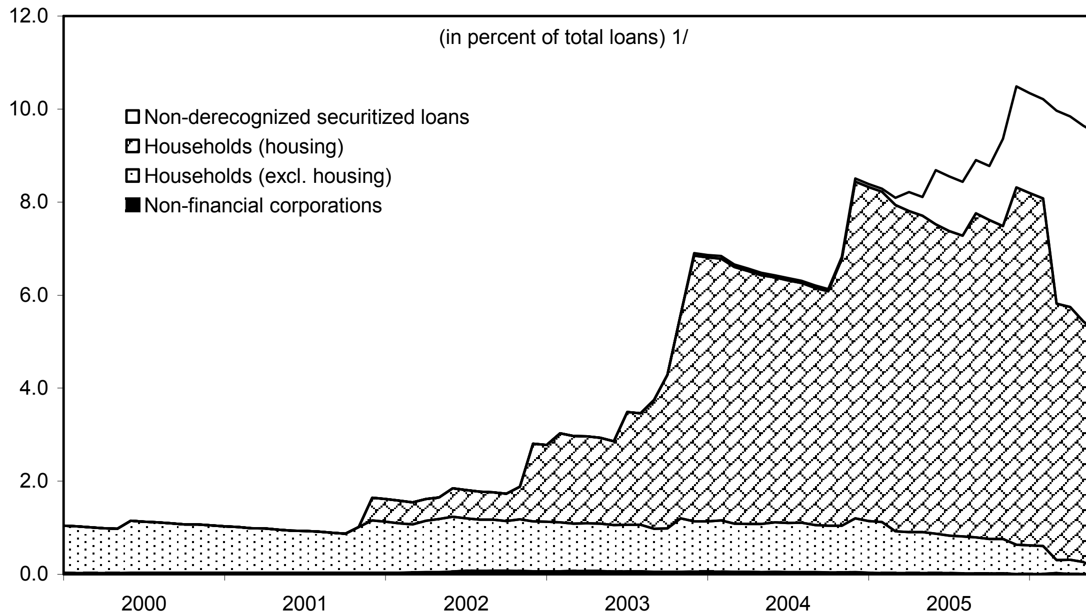
---

[11] Liquidity gaps deteriorated somewhat in 2005 after improving in the previous two years, with the aggregate coverage of interbank liabilities by highly liquid assets declining as interbank borrowing increased (some liquidity indicators are reported in Table 13). For the domestic banking system however, the latter ratio actually improved slightly further, while the deterioration for non-domestic banking groups appears to at least partly reflect a debt restructuring process.

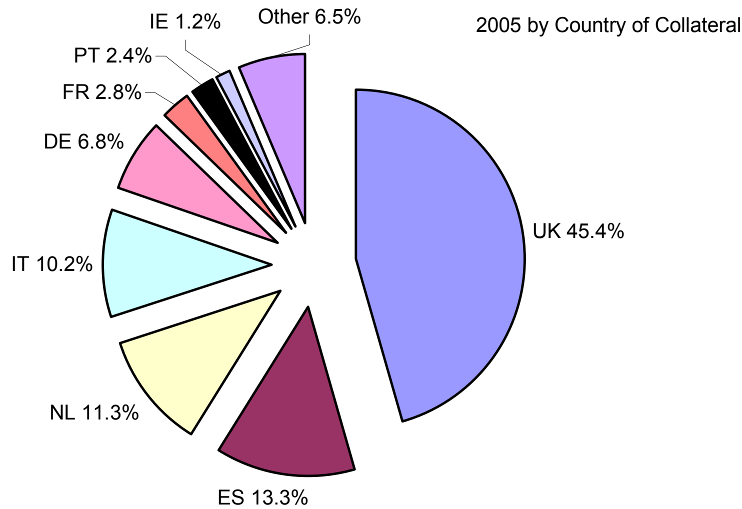
[12] Banks' employee pension funds dominate the private pensions sector (over 80 percent of assets), with most of the rest accounted for by the communications industry's pension funds. The sector itself is relatively small with global assets equivalent to a little over 11 percent of GDP in 2004. In aggregate, investment in equities accounts for around 22 percent of assets, though it is higher for some individual banks' pension schemes.

Figure 8. Portugal: Bank Loan Securitization; 2000–06

Bank loan securitization has significantly increased in recent years ...



... and Portugal accounts now for an important share of the European residential mortgage-backed security market.



Source: Banco de Portugal; European Securitization Forum; and IMF staff estimates.
1/ Data for the different sectors/segments refer only to loans securitized and derecognized from banks' balance sheet. No sectoral/segment breakdown is available for securitized loans non-derecognized from banks' balance sheet.

15. **The risks of direct contagion and spillover amongst Portuguese financial institutions appear quite low, given the relatively limited interlinkages between them.** Although cross-sectoral financial conglomerates are relevant in the Portuguese financial system, the non-banking arms are not yet as significant as in some other countries. Besides, Portuguese bank's direct interbank exposures to each other are very low (about 3 percent of total assets).

16. **The vulnerabilities Portuguese banks are facing have to be assessed against the background of their improving risk management procedures**. While currently used internal control and risk management systems differ considerably in terms of sophistication and complexity, Portuguese credit institutions have made considerable investments to update them in preparation for Basel II. According to a recent survey of the BdP, most of the larger Portuguese banks intend to adopt sophisticated methods to calculate capital requirements under Basel II (Table 3).

Table 3. Portugal: Risk Management Methods for Basel II

	Banks and savings banks	Mutual agricultural credit banks
Credit Risk		
Standard Method	14	5
IRB Method	12	1
Foundation	8	
Advanced	4	
Market Risks		
Standard Method	9	6
Internal models	9	
Both methods	1	
Operational Risk		
Basic Indicator Method	11	6
Standard Method	10	
Advanced Measurement Method	3	

Source: Banco de Portugal.

Insurance sector

17. **The financial soundness of the insurance sector has strengthened in recent years, after a dismal performance in 2001-02.** Better alignment of premiums to risk in some categories, positive investment yields, slower growth in claims, some rationalization in personnel costs, and continuing market deepening have contributed to improve the performance and solvency of the insurance sector in Portugal.

18. **Insurance companies are somewhat vulnerable to various market risks, although their portfolios are fairly well diversified.** Following a more conservative approach to equity investment, Portuguese insurance companies have gradually shifted their investment

portfolios toward fixed-income securities, mainly issued in other euro-area countries, although the share of variable-yield securities remains sizable. While insurers' exposure to credit risk through credit derivatives, securitization and special purpose vehicle bonds is reportedly minimal, it remains a potential vulnerability given the relatively large (20 percent) share of investments in non-investment grade and unrated bonds.

Stress testing of banks and insurance companies

19. **The results of the stress tests indicate that the larger banks' shock-absorbing capacity is quite robust.** (See Box 2 for more detail on the results and the Appendix for more information on methodology). This message comes through from both the bottom-up and top-down scenario-based exercises, which tested the effect of two internally consistent sets of multiple-variable shocks. Neither the "disruptive unwinding of global imbalances" scenario nor the "significant cyclical asynchrony" scenario seems to cause a substantial impact for the system as a whole. The results suggest that the impact of these shocks on the system-wide capital adequacy ratio has an order of magnitude of only 1 to 2 percentage points.[13] However, beneath this aggregate picture, there is some degree of heterogeneity in banks' ability to absorb different shocks, though none falls below minimum CAR levels.

20. **Among the risk factors, credit as well as equity price risk matters for banks.** Unsurprisingly, credit risk is important for banks but banks' capitalization provides a comfortable buffer to withstand even sizeable shocks relatively comfortably. Somewhat unusual, however, is banks' vulnerability to equity price risk, mainly reflecting the exposure of banks' employee pension schemes. Actuarial losses in excess of the 10 percent "regulatory corridor" are deducted directly from bank's Tier 1 own funds, even though the impact on profits can be amortized over several years. As for other risk factors, shocks to the yield curve, the euro-dollar exchange rate, and implied volatility have only limited effects. For those banks particularly exposed to international capital markets, the effect of tightening market conditions on their liquidity position was also assessed as part of the broader stress testing exercise: banks have established quite rigorous contingency procedures to cope with such reversals, and the assessment indicated that liquidity buffers would be adequate to deal with a quite significant market reassessment.

21. **Likewise, the insurance sector shows resilience to various financial and insurance-specific shocks.** Within this overall result, equity price risk appears to be relevant for both life and non-life sector, but the former is relatively more vulnerable to interest rate

[13] The same general picture holds, even if the expected credit loss projections were 50 percent higher than in the scenarios modeled.

Box 2. Summary of Stress Testing Results

Banking sector

- While projected credit losses are more severe under the cyclical asynchrony scenario, the disruptive adjustment scenario proves to be the more costly in terms of the average CAR. Table 1 shows the three-year cumulative impact of the shocks on the CAR. The solvency ratios in Figure 1 take also into account the accrual of income not directly impacted by the shocks. No bank falls under the minimum regulatory requirement in both scenarios. The same general conclusions hold even in the event that the estimated default probabilities and loss-given-default rates turned out worse than assumed in the main scenarios.
- Credit risk has a greater impact in the cyclical asynchrony scenario, since the effects of a domestic output slump are aggravated by a hike in Euro interest rates.
- The larger CAR reduction in the disruptive scenario mainly reflects banks' direct and indirect vulnerability to equity price risk. While a 30-percent fall in equity price is estimated to reduce the average CAR by a quarter of percentage point, the impact through employee pension funds is even higher. Beyond that, other risks seem to be of a lesser significance (Table 2).
- Nevertheless, as expected, profitability takes a significant hit. Top-down stress tests show, for example, that the disruptive adjustment scenario could reduce the return on equity from 16.3 percent initially to 3.8 percent in the year after the shock, before picking up again to 11.3 percent in the third year.
- For liquidity risk, a qualitative exercise was undertaken to assess banks' ability to handle a tightening of international market funding conditions. Even in the case of a sovereign ratings downgrade by one or two notches, major banks appear able to avoid major difficulties, although in the latter case at least, not only funding costs but possibly also credit availability might be affected.

Insurance sector

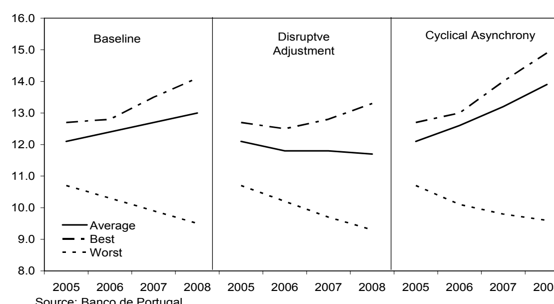
- The most important risk drivers for the sector as a whole are equity price risk, interest rate risk, non-life premium and reserve risk, and credit risk (Table 3). The life sector is most exposed to equity price risk, followed by interest rate. Credit risk and lapse risk are important in individual cases. Biometric risk is not very important. The non-life sector appears most exposed to premium and reserves risks (non-life solvency risk) and equity price risk. Other risks are of limited importance.

Table 1. Portugal: Banking Scenario Stress Tests; Cumulative Impact on CAR
(In percentage points)

	Disruptive Adjustment	Cyclical Asynchrony
Credit risk (expected losses)	-0.25	-0.43
Credit growth	-0.05	0.00
Equity price risk	-0.22	0.00
Interest rate risk	0.03	-0.10
Exchange rate risk	-0.04	0.02
Pension funds	-0.77	-0.06
Total	-1.30	-0.58

Source: Banco de Portugal.

Figure 1. Portugal: Banking Stress Tests; CAR after Scenario Shocks



Source: Banco de Portugal.

Table 2. Portugal: Banking Sensitivity Stress Tests; Impact on CAR
(In percentage points; unless otherwise indicated)

Risk	Shock Size	Up	Down
Exchange rate	15	0.02	-0.03
Equity price	30	0.24	-0.25
Volatility	30	0.00	0.00
Interest rate	200 bps short, 100bps long	-0.08	0.06

Source: Banco de Portugal.

Table 3. Portugal: Insurance Stress Tests; Impact on Free Surplus

	Shock Size	Impact on Free Surplus (In Percentage Points)
Shocks		
Credit risk	Adoption Basel II simplified approach	8.2
Interest rate risk	94 bps down	10.0
Equity price risk	35 percent down	28.8
Real estate price risk	5 percent down	1.9
Exchange rate risk	15 percent down	0.3
Life biometric risk	15 percent up	3.9
Nonlife risk	Adoption Solvency I	25.2
Life lapse risk	50 percent up	4.0
Catastrophic risk	8.5 Richter earthquake	5.6

Sources: Instituto de Seguros de Portugal; and IMF staff calculations.

risk and the latter to premium and reserves risk. Compared to the banking sector, the results indicate a greater diversity in the resilience of individual institutions. A top-down stress test for catastrophic risk suggests that the financial consequences of an 8.5 Richter magnitude earthquake can be easily absorbed, since the sums insured are rather small.

B. Markets and Intermediaries

22. **Short term interbank, money and foreign exchange markets are fully integrated with major European markets.** Hence, they are very liquid and easily accessible for the main Portuguese financial institutions. Eurolist, which is a cash market, integrates the Lisbon market with those of Amsterdam, Brussels, and Paris, while Liffe, which is a derivative market, includes all these markets and London. MEDIP, which is the market for Portuguese government securities, is connected to the MTS market, which is the main platform for government bonds in Europe. Two other nonregulated cash markets exist but are marginal.

23. **The Portuguese securities market plays a limited role as a source of financing for companies** (Figure 9). Reflecting the relatively limited number of larger companies, as well as the convenience of listing in other, larger and more liquid stock markets in the region, the number of listed companies is limited. As of end-2005, only 51 companies were listed in the stock market and 46 companies in the bond market. Market capitalization has shown modest growth and it is highly concentrated, with only one company (Banco Santander Central Hispano, S.A.─BSCH) accounting for almost half of the total. Turnover in secondary markets is likewise modest, except for the Portuguese government debt market.

24. **While banks have increasingly used securitization, domestic derivative markets are thin**. To mitigate risk and improve liquidity, banks have increased securitized operations, particularly related to mortgage loans. Foreign institutions and investors have been major buyers. In contrast, the importance of domestic derivative markets has declined, reflecting the possibility for market participants to have access to more sophisticated and liquid European markets.

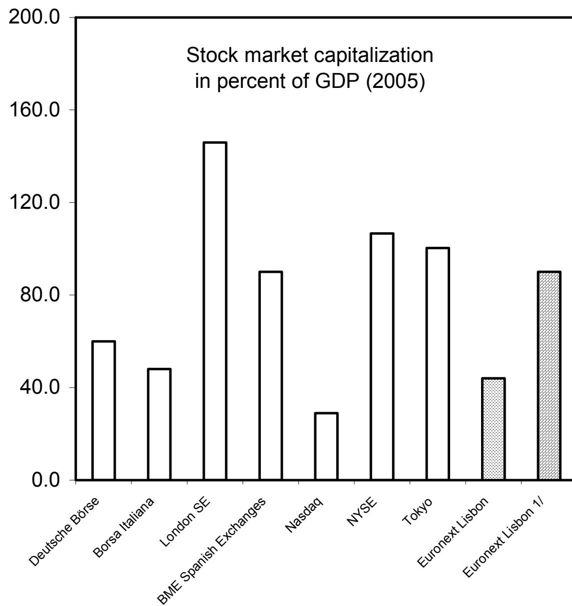
C. Infrastructure

Payments and settlement systems

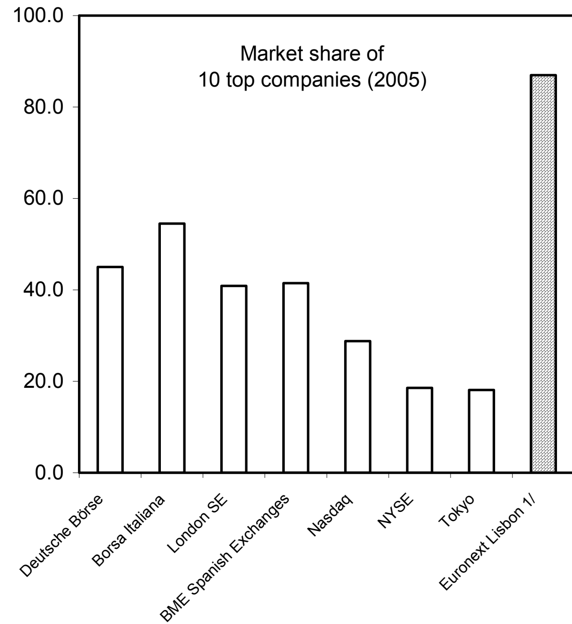
25. **The infrastructure for the settlement of payments and securities transactions in Portugal is highly developed, efficient, technologically advanced and—from a risk management perspective—robust**. The legal basis for clearing and settlement is also sound, with a clear definition of finality and irrevocability, recognition of netting and novation, and protection of collateral arrangements. No-zero-hour rule exists and transactions settled with finality cannot be unwound, not even in case of a bankruptcy. The infrastructure for payments ensures a high degree of security and operational reliability. The Portuguese Sistema de Pagamentos de Grandes Transacções is highly liquid and the amount to be settled in the netting of Sistema de Compensação Interbancária is relatively limited, thus reducing

Figure 9. Portugal: Selected Stock Market Indicators

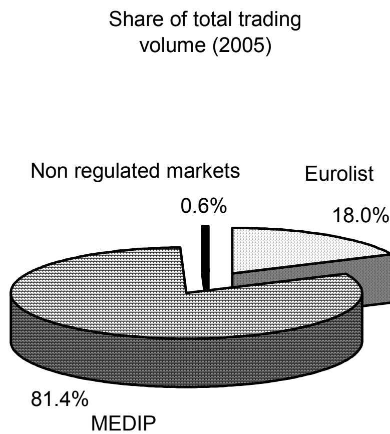
Portugal's equity market is small ...



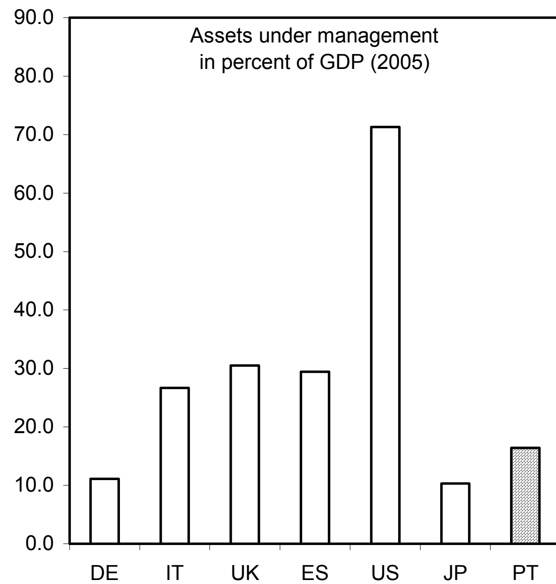
.. and very concentrated ...



... the secondary market is dominated by government debt ...



... and the mutual fund industry is growing.



Sources: Comissão do Mercado de Valores Mobiliários; World Federation of Exchanges; Investment Company Institute; and IMF staff estimates.
1/ Including BSCH S.A.

risks in this retail payment system. Securities transactions are all settled on a delivery versus payment basis.

26. **Nevertheless, the system would benefit from a few technical refinements in specific areas.** In particular, Interbolsa might strengthen its security policy, especially with respect to preventing data losses in case of a major operational problem. Cooperation between the BdP and the CMVM on the oversight of Interbolsa could be buttressed by more formal arrangements. Business continuity planning on the industry level could be further strengthened, for instance with respect to coordination and simultaneous testing of the emergency procedures of all system providers as well as with respect to coordination and upgrading of business continuity plans of financial institutions and system providers in order to deal with wide-area disasters and serious lack of staff, including due to an avian flu pandemic.

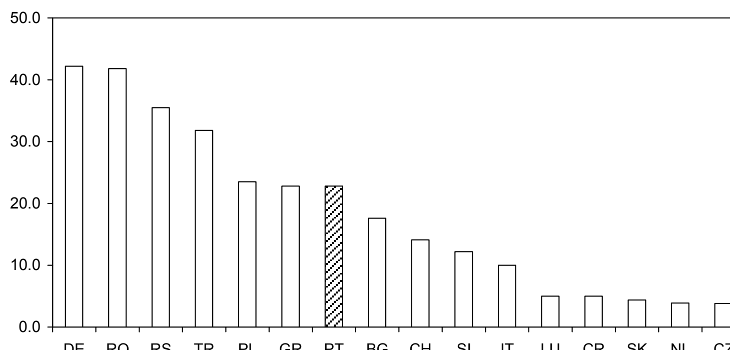
Legal framework

27. **Priority should be given to improving the legal framework for debt recovery, especially speeding up the court system.** Although debt recovery and foreclosures currently work quite satisfactorily, *de facto,* this is mostly through bilateral (re)negotiations, with the judicial system being the fallback, serving largely as a final threat. However, where the judicial route is used, it is reportedly a lengthy process. If there were to be a more widespread problem of mortgage or other loan defaults, more recourse to the judicial route might be needed, and the legal system could become an important bottleneck in the system. This issue is expected to be covered in a wider-ranging review of the legal system just announced by the Government.

IV. Structural Issues

28. **The state continues to hold significant ownership in the banking sector** (Figure 10)**, although it is not generally perceived as a factor distorting the market.** Financial deregulation and integration have somewhat eroded its dominant position, but CGD remains a leading institution in a number of sectors (namely, retail deposits, mortgage lending and insurance), and also has significant participation in other state-owned enterprises.

Figure 10. Portugal: Share of Banking Sector Assets in Majority State-Controlled Banks in Selected Countries; 2003



Source: G. Caprio, J.L. Fiechter, R.E. Litan, and M. Pomerleano (eds.) *The Future of State-Owned Financial Institutions*, Brookings Institution Press, Washington, D.C., United States, 2004.

29. **CGD is overseen in a prudent and market-oriented way, and it is subject to the same (high) standards of prudential supervision as other**

banks. It therefore enjoys a strong franchise and a high international rating. Especially given its market position, it will be important that the arms-length relationship between governments and CGD continues to be maintained in future, and that the commercial autonomy and accountability arrangements for CGD continue to help ensure prudent management and equitable competition in the financial sector in future. From a longer term perspective, ongoing financial market globalization, consolidation trends and active international competition raise the issue of whether state ownership—or at least, full ownership—will continue to be the best way of achieving the government's policy objectives. (The Staff Report notes the authorities' views on this point.)

V. The Financial Stability Policy Framework

30. **It will be important to continue to monitor closely the key potential risk sources, both at the macroprudential surveillance level (financial stability analysis), and the micro (institution-specific) supervision level.** As discussed above, these include especially household debt and property market developments; corporate borrowing and exposure concentration; and bank borrowing trends, including pricing and liquidity risk in major markets. In addition, the authorities should be prepared to use the room for discretion under Pillar 2 of Basel II to raise capital requirements, if the risk outlook warrants it (e.g., if debt levels continue growing strongly). Relatedly, to the extent that the current mortgage lending growth may reflect expectations of reduced capital requirements under Basel II (Pillar 1), BdP should consider whether some offset to this, through, e.g., an increase in capital requirements for such lending, would be desirable. The BdP's macroprudential surveillance analysis, meanwhile, should (as planned) attach priority to improving property price indicators. It would also benefit from more use of extensive (bottom-up) stress testing to supplement the current top down analysis.

Regulation and supervision

31. **Supervision of financial institutions is active, professional, well organized, and highly compliant with international standards.** The supervision framework is organized as a combination of a traditional sectoral approach with a partially integrated functional approach. Prudential supervision is entrusted to the BdP (credit institutions, investment firms and other financial companies) and to the ISP (insurance and pension funds), while cross-sectoral supervision of rules of conduct in securities market rests with the CMVM. The coordination of these institutions' activity is the task of an overarching high-level committee, the Conselho Nacional de Supervisores Financeiros (CNSF), and is underpinned by bilateral memoranda of understanding (MoUs).[14] This framework has worked well in general, and it

[14] The CNSF has the responsibility to promote co-ordination and co-operation among the different entities, to promote the development of supervisory rules and mechanisms for financial conglomerates, and to formulate proposals for the regulation of matters related to the scope of activity of more than one of the supervisory authorities.

will be important that in coming periods there is no distraction from the key tasks of implementing major supervisory initiatives such as Basel II and Solvency II. In the longer run and with the benefit of more experience locally and internationally, the authorities may wish to revisit the institutional structure and examine whether ongoing financial sector and regulatory developments warrant further refinements of one form or another.

32. **Some technical refinements in a few areas could further enhance banking supervision.** In particular, credit and financial institutions should further strengthen their systems to accurately measure, monitor, and adequately control market risks. Likewise, the BdP should step up its expertise and operational capability in this area. The BdP should also enhance risk-oriented supervision by fully implementing the recently established risk rating system.

33. **A few aspects of the securities market and insurance supervision could also be improved.** The financial autonomy of CMVM and ISP should be more formally enhanced to remove the possibility that their fee-based revenues or surpluses can be frozen or appropriated by the government. The CMVM should also persist in its recent efforts to implement a more vigorous enforcement policy. The ISP should shed its management functions of the Motor Third Party guarantee and worker compensation funds to other organizations. The insurance supervision framework should be further enhanced by better determining fit and proper criteria for external auditors and senior management; strengthening corporate governance arrangements; and establishing rules or guidelines on market conduct, particularly regarding fraud.

Safety nets and crisis management

34. **The crisis management framework is comprehensive and well developed, although a few improvements might be beneficial.** While the BdP can take a wide range of corrective measures against problem financial institutions to restore them to health, its full discretion might be somewhat tempered, for example by establishing internal guidelines, mainly with the aim of minimizing potential costs for the deposit insurance. Although the BdP has established specific procedures to deal with crises of a systemic nature, coordination mechanisms amongst different institutions could be further formalized by creating a full-fledged, high level crisis management committee, chaired by the Minister of Finance, who is finally accountable publicly for the management and resolution of a systemic crisis, and including the current members of the CNSF.

35. **The Portuguese deposit insurance schemes provide an appropriate level of protection and are well managed under BdP oversight**.[15] However, the transparency of the

[15] In Portugal, there are two funds in operation: the Fundo de Garantia de Depósitos (FGD) and the Fundo de Garantia de Crédito Agricola Mútuo (FGCA), which deals with mutual agricultural credit institutions. Both

(continued)

framework could be further enhanced by explicitly referring to the "least cost" principle in guiding deposit insurance involvement in a bank's restructuring process and clearly identifying an adequate target level for the deposit insurance resources.

36. **In performing its role of lender of last resort, the BdP follows a policy of "constructive ambiguity" without prejudice to the requirements derived from its participation in the European System of Central Banks (ESCB)**. While the terms and conditions of the provision of emergency liquidity assistance are not publicly disclosed, the BdP has a policy of presumed ex post disclosure.

Anti-Money Laundering/Combating Financing of Terrorism (AML/CFT)[16]

37. **The Portuguese legal framework for combating money laundering and terrorist financing is comprehensive, although a relatively small number of cases have been successfully prosecuted.** The money laundering offence is broadly defined. The terrorist financing provisions are generally satisfactory, but do not appear to sanction the financing of an individual terrorist. Portuguese authorities have broad powers to confiscate, freeze and seize proceeds of crimes, but there are some limitations on the scope and length of time for freezing terrorist-related funds (i.e., some freezes are only in effect for the duration of the inquiry and judicial proceedings). The statistics that are maintained are not comprehensive in all areas, making a full assessment of the effectiveness of these regimes difficult.

38. **A broad range of financial and non-financial institutions are required by law and by supervisory implementing regulations to conduct customer due diligence (CDD), report suspicions of money-laundering and terrorist financing, and meet other AML/CFT obligations**. These laws and regulations are generally complete, but the CFT legislation does not explicitly extend CDD to the risk associated with terrorist financing, and the mechanisms for determining the beneficial owner do not fully meet the FATF requirements. Suspicious transactions are reported to the Attorney General's office, which then immediately forwards the reports to the financial intelligence unit (FIU). The FIU thus receives its suspicious transaction reports and cash transaction reports indirectly and it uses both types of reports for developing cases that are forwarded to the public prosecutor for action against money laundering. The FIU is generally effective in its functions. The national authorities have adequate legal powers for gathering evidence and compelling the production of documents, as well as a broad range of special investigative techniques. Portugal has a generally clear and complete framework for providing international co-operation.

---

funds have very similar features. While the FGD has never been activated, the FGCAM has played a more active role mainly to help some consolidation among mutual credit institutions.

[16] Based on the initial findings of the Financial Action Task Force on Money Laundering (FATF) evaluation that took place in March 2006. The assessment report is to be discussed at the October 2006 FATF Plenary, following which a ROSC will be prepared by the FATF and circulated to the Board for information.

ANNEX—OBSERVANCE OF FINANCIAL SECTOR STANDARDS AND CODES: SUMMARY ASSESSMENTS

The annex contains summary assessments of three international standards and codes relevant for the financial sector. The assessments have helped to identify the extent to which the supervisory and regulatory framework is adequate to address the potential risks in the financial system.

The following detailed assessments of financial sector standards were undertaken:

- The Basel Core Principles for Effective Banking Supervision (BCP), by Mr. Marcel Maes (Consultant, formerly IMF-MCM and Belgian Banking Commission) and Mr. Alvir Hoffman (IMF-MCM);
- IAIS Insurance Core Principles (ICP), by Mr. Henning Gobel (Bafin); and
- IOSCO Objectives and Principles of Securities Regulation and Transparency of Securities Regulation, by Ms. Ana Carvajal (IMF-MCM)

The BCP and IOSCO assessments were carried out during the first FSAP mission to Portugal in December 2005, and the IAIS assessment was carried out in January-February 2006. All the assessments were based on the laws, regulations, policies, practices, and data in place at the time the assessments were made.

The assessments were based on several sources including:

- Self-assessments by the supervisory authorities;
- Reviews of relevant legislation, regulations, policy statements and other documentation;
- Detailed interviews with the supervisory authorities;
- Meetings with other relevant authorities and independent bodies and with a range of financial sector firms and associations.

In addition, an AML/CFT assessment was conducted by FATF in March 2006, and is expected to be considered by the FATF Plenary in October 2006, after which a ROSC will be prepared.

I. BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION

Overview of the institutional and macroprudential setting and market structure

39. In Portugal, financial intermediation is dominated by banking institutions, one of which is organized as a financial conglomerate. As of end 2005, there were 61 banks, including 22 branches of institutions authorized in other EU member states, 168 other credit institutions, and 105 financial institutions under the BdP's supervision. The Portuguese state continues to hold a significant stake in the banking sector through the fully state-owned CGD, one of the two largest banks in the country.

40. Notwithstanding the difficult operating environment of the last few years, marked by slow economic growth and narrowing interest rate margins, Portuguese banks have maintained a solid profitability and strengthened their capital position. As of end-2005, the average CAR has reached 11.3 percent; NPLs have fallen to a historically low level of 1.6 percent of total loans while provisions, applying IFRS, stood at 65 percent of NPLs. However, potential vulnerabilities remain, mainly associated with the high level of household

and corporate debt as well as the significant concentration of banks' exposure across sectors (especially real estate) and borrowers.

41. The supervisory framework is organized as a combination of a traditional sectoral approach with a partially integrated functional approach. While prudential supervision is entrusted to the BdP (in the case of credit institutions, investment firms and other financial companies) and to the ISP (in the case of insurance and re-insurance intermediaries and pension funds), cross sectoral supervision of the market rules of conduct of financial intermediaries in the securities market rests in the hands of the CMVM. The three Portuguese supervisory agencies coordinate their activities within an overarching high-level committee, the CNSF. Bilateral memoranda of understanding provide the framework for day-to-day coordination.

General preconditions for effective banking supervision

42. The BdP, which is an integral part of the ESCB, is a public legal entity with administrative and financial autonomy and its own property. The members of the Board of Directors are nominated for renewable terms of five years, and they can only be removed from office under circumstances envisaged by the ECB statute. As a result, in performing its tasks, including that of supervisory authority, the BdP enjoys a high degree of independence from government institutions or other forms of political influence. Portugal's framework of laws, accounting, payments, transparency, and financial sector oversight practices is in line with international standards and EU Directives. The law provides a comprehensive and flexible framework to deal with financial institutions in distress and the overall financial safety net is adequate, albeit so far untested.

Main findings

43. Portugal's regulatory framework is modern and sound, and highly compliant with international standards. The supervision of Portuguese financial institutions by the BdP is active, professional, and well organized. In particular, the supervision of banks' loan classification and provisioning policies—an area that raised some controversy a few years ago—was assessed to be in full compliance with international best practices, following some regulatory changes in 2002–03. However, there is still room for improvement in the institutions' risk assessment processes and in supervisory risk management and planning, although important progress has been recently made.

Objectives, Autonomy, Powers, and Resources (CP 1)

44. BdP's Organic Law (OL) provides a clear framework, objectives, and responsibilities for carrying out the supervision of credit institutions, financial companies and other entities legally subject to the BdP's regulation. The principle of BdP's independence is enshrined in the ESCB's by-laws and OL provisions. The OL also ensures that the BdP has administrative and financial autonomy and its own property, and is not subject to the financial rules

governing the public sector. The BdP derives its income basically from its central bank operations with no fees being levied on supervised institutions.

45. The BdP has the exclusive power to authorize, refuse or withdraw banking licenses. In the cases of branches or subsidiaries of banks authorized in non-EU countries, the BdP examines the proposal and submits its recommendation for the approval of the Minister of Finance (MoF). The OL enables the BdP to take appropriate action to ensure compliance with the laws and maintain the safety and soundness of banking activities. To this end, the BdP can impose, at its discretion, a range of sanctions and remedial actions on a case-by-case basis, depending on the severity of a situation. Legal protection of the BdP staff is ensured by the Legal Framework of Credit Institutions and Financial Companies (LFCIFC). The CNSF and bilateral memoranda of understanding promote cooperation and information sharing with other domestic supervisory agencies.

Licensing and Structure (CPs 2–5)

46. The permissible activities of financial institutions are established in the LFCIFC. The standards for evaluating applications to license establishments, and the criteria for changes in ownership and investments are adequate and strictly applied by the BdP.

Prudential Regulations and Requirements (CPs 6–15)

47. Portuguese banks comply with capital requirements established by Basel I. Risk management techniques used by credit institutions vary considerably in terms of sophistication and complexity, and different risk management tools are used by the same institution to address different risks or portfolios. While banks generally use advanced techniques, including value-at-risk models, to manage trading book risks, they apply less sophisticated tools to assess banking book risks. The BdP has recently issued a regulation that allows banks to use internal models for market risk and, to date, no bank has submitted its own model to the BdP for validation. However, it is expected that major banks will soon submit credit risk models for BdP's validation. All credit institutions will be also required to implement an internal process for overall capital adequacy assessment. Given these developments, the BdP has to further bolster its internal expertise on model validation and corporate governance evaluation.

48. Banks' loan classification and provisioning policies comply with the BCPs. However, the planned migration from the current dual system of calculating provisions (economic and regulatory provisions; the former is subject to a specific external audit review) to a more comprehensive risk based approach should be accelerated.

Methods of Ongoing Supervision (CPs 16–20)

49. The BdP carries out its supervisory function through an effective mix of off-site and on-site supervision. The information provided by credit institutions to the BdP is

comprehensive and timely so as to provide a basis for effective surveillance and early detection of financial weaknesses. Thorough off-site monitoring is conducted on a continuous basis and it is integrated with regular on-site inspections. At the time of the assessment, a comprehensive framework for assessing the risk profile of supervised institutions was still in the process of being finalized. In early 2006, a manual was completed and a pilot test was successfully carried out by applying the methodology to the assessment of a medium-sized bank. The credit risk register, which is managed by the BdP, is a complementary tool for off-site supervision. The electronic platform supporting the register could be improved and better integrated with other available tools for off-site monitoring.

Accounting Standards (CP 21)

50. Accounting rules and regulations are in line with EU Directives, and hence with the IFRS, and financial statements are prepared in accordance with those standards. Implementation of the IFRS rules has brought to the financial statements greater sensitivity to market risk, and has highlighted the relative importance of contingencies for banks' employee pension funds. The BdP is empowered to (i) require all financial information deemed necessary for supervisory purposes, (ii) demand from external auditors specific extensive assessments, and (iii) perform on-site inspections in order to assess the quality of information.

Formal Powers of Supervisors (CP 22)

51. The BdP has broad enforcement powers ranging from moral suasion to imposing penalties upon banks and their management, restricting a bank's current activities, replacing management or restricting their powers, and ultimately revoking the banking license. In the case of financially distressed institutions, the BdP may require a number of financial recovery and reorganization measures; it may also appoint one or more interim board members with veto powers over shareholders' decisions.

Cross-Border Banking (CPs 23–25)

52. The regulatory framework allows the authorities to undertake globally consolidated supervision over internationally active banking groups. Supervision over the activities abroad of Portuguese banking groups is conducted mainly through on-site inspections at the headquarters and information sharing with host-country authorities. Similarly, at the group level, the overall risk assessment of the foreign institutions operating in Portugal is left to the home supervisor.

Table 4. Portugal: Recommended Action Plan to Improve Compliance with the Basel Core Principles

Reference Principle	Recommended Action
CP - 12. Market Risk	Enhance systems to measure, monitor and control market risk.
CP - 16. On-Site and Off-Site Supervision	1) Fully implement the comprehensive framework for assessing banks' and credit institutions' risk profile. 2) Enhance access to Credit Register data and further integrate the database with other off-site supervision tools.
CP - 24. Host Country Supervision	Implement a framework with all home supervisors in order to exchange information that would improve the quality of risk assessment.

Authorities' response

53. The BdP is in broad agreement with the assessment and welcomes the overall judgment that banking supervision and regulation in Portugal are highly compliant with the Basel Core Principles for Effective Banking Supervision. The BdP acknowledges that the IMF recommendations are generally adequate and is pleased that some of these recommendations actually backup existing strands of work, such as the full implementation of a comprehensive risk rating system, which BdP considers will enhance its current approach for the risk assessment of supervised credit institutions.

II. IAIS Insurance Core Principles

54. This assessment, carried out in January-February 2006, was based on the IAIS ICP dated October 2003. Given the developed nature of the Portuguese insurance market, this assessment comments on both the essential and advanced criteria underpinning each core principle. However, in accordance with Annex 2 of the ICP, only essential criteria have been taken into account in assessing the overall level of observance of a core principle.

Institutional and macroprudential setting—overview

55. Portugal ranks as the 27th largest insurance market according to Swiss Re's insurance market report of 2004, broadly comparable to Norway and Mexico. Premiums represent 7.9 percent of GDP, or US$1,294 per capita, with substantial potential for further deepening. The Portuguese market is dominated by Personal Lines products, Life and Pension. Some 80 percent of these products are distributed through associated banks. Long-term care and full health insurance may become an additional product in future as changes in social security arrangements are on the way. The general insurance market is relatively underdeveloped, with a high concentration in motor vehicles and workers compensation. Other products, such as property and casualty business, are relatively undersold. The general lines market is

mainly distributed through personalized intermediaries, of which some 39,000 are registered in Portugal.

56. At the end of 2004, there were 69 insurance companies operating in Portugal, of which 40 are domestic insurance companies and 28 are branches of EU companies. Only two of the 40 domestic companies are registered as mutual companies, all others are limited companies. Of the 40 domestic companies 14 operate in life assurance, 21 in non-life insurance and 5 are licensed as composites. The 28 branches comprise nine operating in life, 18 in non-life and one in both lines of business. There is one branch of a company registered outside the EU. In addition to those, there are 288 licenses to provide freedom of services in force. The degree of concentration is relatively high, with approx. 60 percent of the market represented by the top five companies and a further 20 percent for the next 5 companies. The banking sector is substantially involved, including through ownership links, and represents more than 50 percent of the overall insurance market.

Main findings

57. The insurance supervisor (ISP) is very professional. The level of observance of the ICPs in Portugal is high and several planned measures and legal changes, not yet fully implemented at the time of the assessment, will likely address most of the remaining issues. In addition to recommendations in such areas (Table 4), several additional recommendations are made herein which, though not needed for ICP compliance, are nevertheless considered desirable further improvements.

Conditions for effective supervision (CP 1)

58. Good conditions for effective supervision are in place. All necessary professional resources are available and of high standards. Market infrastructure allows for an efficient management of the sector. A wide range of operational services is available to insurance undertakings and allows them to focus on technical related aspects of the business. Supervision makes extensive use of actuarial services and allows for risk-based supervision.

The supervisory system (CPs 2–5)

59. ISP needs approval for its budget from the Ministry of Finance. Although all expenses of the authority are covered by fees of the supervised entities, ISP can be subject to interventions throughout the year that could prevent it from achieving its goals. The charter should be amended to grant more formal independence in this respect, so that ISP is protected against inappropriate interference from executive branches and allowed to fully utilize its financial resources. Furthermore, ISP should reassess the staff resources required to fully implement Solvency II.

60. In addition, although not directly a matter of ICP compliance, an important issue is that, in addition to its supervisory functions, ISP manages the investment of the guarantee

fund for motor third party business (MTP)─as well as that for workers compensation─and administers the claims handling process, including loss adjustment. ISP should review its range of duties and look for alternative solutions for the guarantee funds. The management of investments is associated with potential reputational issues and represents an unnecessary risk to the supervisory organization. ISP should dispose the claims management function. The current organizational structure would allow for a smooth segregation. The objectives for ISP should be adjusted to allow for the disposal of these non-supervisory tasks related to guarantee funds and claims management.

61. The degree of cross shareholdings, the activities of banks in the insurance sector, the importance of bank-assurance for the distribution of life insurance products suggests that in time it may be desirable to review the possible advantages of a more integrated prudential supervisory authority─although this is not an urgent matter given some significant operational priorities for supervisors. Commonalities in the area of investment management, mathematical, statistical and actuarial skills may bring potential synergies in the utilization of joint resources between the central bank and ISP.

The supervised entity (CPs 6–10)

62. The Law does not currently address fit and proper requirements for senior management and other key functionaries to a sufficient extent. There are no specific requirements for insurance undertakings' external auditors and the supervisory authority does not have the power to disqualify an auditor that does not comply with fit and proper requirements. In addition, the supervisory authority is not able to require significant owners who no longer meet fit and proper requirements to dispose of their interests in the insurance undertaking. Amendments to the law are planned to address these areas.

63. On corporate governance, there is a low percentage of non-executive directors in the governing body, and the law does not expressly address some issues that relate to specific responsibilities of the governing body, such as the establishment and monitoring of compliance with standards of business conduct and ethical behavior for directors, senior management and other personnel; and the establishment and regular review of the policies that deal with conflicts of interest, fair treatment of customers and information sharing with stakeholders. Also, a significant number of insurance undertakings have not instituted audit committees and the responsible actuary is not granted direct access to the governing body as well as his independence from inappropriate orders of the insurer is not completely assured. Legal amendments are planned to address these areas.

64. Inadequacies with respect to internal controls are being addressed through a new regulation already approved and being implemented. ISP has thus ensured sufficiently that by 2007 all procedures for internal control will be in force.

Ongoing supervision (CPs 11–17)

65. The framework and implementation in these areas is effective.

Prudential requirements (CPs 18–23)

66. Although not strictly needed for compliance with the ICP, there are two areas where further consideration would be desirable. First, there is a significant amount of investments held in corporate bonds for which a rating is not available. It should be investigated why corporates avoid external rating. Also, for exposure measurement purposes, insurance companies rely on provisional ratings provided by banks. Although the write-offs reported have been immaterial, the absence of rating is a rather unusual process. Second, the law does not set specific requirements regarding the matching of assets and liabilities, and capital adequacy requirements are not adequately sensitive to the risks of the insurer's operations. In anticipation of the Solvency II project, ISP should progressively introduce the methodologies foreseen in that new solvency regime (centered on a risk-based approach).

Markets and consumers (CPs 24–27)

67. With the new legislation, which is in its final stage of approval, ISP has ensured sufficiently that adequate procedures will be in place to address current weaknesses in relation to consumer protection. Further measures are also needed in relation to insurance fraud, which is not specifically addressed in the insurance business law. Consequently, insurers and intermediaries are not required to allocate appropriate resources and implement effective procedures and controls to deter, detect, record and promptly report fraud to appropriate authorities.

68. Although not strictly needed for compliance with the ICP, two other aspects of this area should also be considered further. First, the large number of personalized intermediaries is an administrative burden to ISP. The implementation of the new directive will deliver—in contrast to other European countries—a slight release and reduction of duties. However, the amount of applications from other countries to act as an intermediary in Portugal is considerable. ISP is strongly advised to investigate the application of some form of administration fees for those applicants, in order to ensure appropriate sharing of the administrative burden. Second, the scope of information disclosed to the market could be enlarged and should be reviewed in the context of the outcome of Pillar III of Solvency II.

Anti–money laundering, and combating the financing of terrorism

69. The measures in place in this area are considered adequate for ICP purposes.

Table 5. Portugal: Recommended Action Plan to Improve Observance of IAIS Insurance Core Principles

Reference Principle	Recommended Action
CP 3 - Supervisory authority	ISP's charter should be amended to grant more formal financial independence so that ISP is more protected against inappropriate interference from executive branches and allowed to fully utilize its financial resources. Furthermore, ISP should reassess the staff resources required to fully implement Solvency II.
CP 7 - Suitability of persons	ISP should, as planned in the course of the next year, propose amendments to the law that lays down the conditions governing the carrying out of the insurance business. The amendments should set specific "fit and proper" requirements regarding external auditors and senior management; and confer to the supervisory authority the necessary powers to: • disqualify an external auditor or a senior manager that does not comply with fit and proper requirements; • require significant owners that no longer meet fit and proper requirements to dispose of their interests in the insurance undertaking.
CP 9 - Corporate Governance	Following the inquiry it conducted in 2005 to collect relevant data on insurance undertakings' governance structure and mechanisms (including internal control and risk management systems), ISP should, as planned in 2006, propose amendments to the law that lays down the conditions governing the carrying out of the insurance business, in order to establish what are the main and specific responsibilities of the insurance undertaking governing body. These should also require insurance undertakings to approve and monitor compliance with standards of business conduct and ethical behavior for directors, senior management and other personnel. Also, the Directive on statutory audit of annual accounts and consolidated accounts should be transposed into national law as intended, to address the remaining weaknesses related to the statutory audit.
CP 10 - Internal control	Complete, as planned, the implementation of the new regulation already approved, so that by 2007 all appropriate procedures for internal control will be in force.
CP 25 - Consumer protection	Implement as planned the new legislation, which is in its final stage of approval, so that adequate consumer protection procedures will be in place. Put in place, as planned, policies for insurance undertakings on how

Reference Principle	Recommended Action
	to treat consumers fairly and ensure that systems are available and training can be provided to ensure compliance with those policies by their employees and other sales collaborators.
CP 27 - Insurance fraud	Insurers and intermediaries should be required to provide counter-fraud training to management and staff and to exchange information with respect to fraud and those committing fraud.

Authorities' response

70. ISP acknowledged the fruitful discussions during the assessment process within the FSAP, and the recommendations received, which will help improve the effectiveness of insurance supervision in Portugal. ISP appreciated the appraisal of the efforts undertaken to strengthen insurance supervision according to a forward-looking and risk-based approach, and to increase the standards related with insurance undertakings' risk management and internal controls, in line with the development of the Solvency II Project. Furthermore, ISP welcomed the FSAP's recognition of the efforts made to promote and reinforce the transparency of the supervisory authority's activities and processes according to international best practices.

71. ISP has carefully considered all the FSAP recommendations and will continue to work towards their progressive implementation, both by drawing up regulatory measures and by preparing proposals for the amendment of existing laws.

III. IOSCO Objectives and Principles of Securities Regulation and Transparency of Securities Regulation

72. An assessment of the Portuguese Securities Market was conducted during December 6-20, 2005, as part of the FSAP. The Assessment was conducted based on the IOSCO Principles and Objectives of Securities Regulation and its Methodology adopted in 2003.

Market structure

73. The legal and regulatory framework provides for the participation of banks as well as other specialized entities in the Portuguese securities market. As of August 2005, there were 56 intermediaries authorized to provide investment services, including 32 credit institutions, 8 credit institution branches, 8 broker companies, 4 broker-dealer companies, and 4 investment company branches. In addition, there were 43 investment managers authorized to manage Collective Investment Schemes (CIS).

74. Two main cash markets operate in Portugal: Eurolist and MEDIP. Eurolist integrates the markets of Brussels, Paris, Amsterdam and Lisbon into a single market with the same listing requirements. MEDIP, which is the wholesale market for government debt, is fully integrated into MTS, a single market for public debt that has segments in many European countries.

75. The Portuguese securities market has a limited role as an alternative source of financing for companies. As of September 30, 2005, there were 51 companies with listed shares and 46 companies with listed bonds in Eurolist and only one Initial Public Offer was carried out in 2005. While market capitalization has shown modest growth, the market is still highly concentrated with one company, BSCH (a Spanish cross-listed issuer), representing about 52 percent of the stock market capitalization. Excluding BSCH, market capitalization amounted to around 44 percent of GDP, and the average free float for the 10 top companies amounted to almost 34 percent of their capital.

76. Liquidity of the secondary markets remains limited, except for MEDIP. For 2004, trading volume in MEDIP accounted for 72.7 percent of total trading volume in Portugal, Euronext accounted for 16.1 percent and trading in non-regulated markets and over-the-counter activity accounted for the remaining 11.2 percent.

77. The asset management industry is also modest, though it has experienced steady growth since 2000. As of August 2005, individual portfolios amounted to EUR 34.9 billion (23.7 percent of GDP), compared to EUR 11.2 billion (9.2 percent of GDP) in 2000. Over the same period, CIS increased from EUR 24.9 billion (20.4 percent of GDP) to EUR 34.2 billion (22.3 percent of GDP).

78. Derivatives markets do not play a significant role in the Portuguese securities market. Moreover, their importance has diminished: the future market has shown a downward trend, while the options market disappeared following the migration to the Liffe Connect platform.

Description of the regulatory structure

79. The Portuguese system follows a partially integrated functional approach, whereby the CMVM is responsible for market conduct and BdP for prudential regulation of market participants. The MoF retains very specific powers limited to (i) the authorization of financial intermediaries that are subsidiaries of credit institutions with their head offices in a non-euro member country, (ii) the authorization of regulated markets, and (iii) the establishment of the minimum capital requirement for financial intermediaries. Both the CMVM and the BdP are governed by an executive board, whose members are appointed for a 5-year period by the Council of Ministers, based on a proposal from the MoF. Once appointed, they can only be removed with due cause.

General preconditions for effective securities regulation

80. There are a number of preconditions necessary for the effective regulation of securities markets, and these generally appear to be in place in Portugal. However, the financial sector would benefit from speedier disposition of judicial proceedings, mainly those related to the execution of guarantees; insolvency and criminal offenses related to securities matters. The tax system appears to be complex, with different tax treatments for different sources of income, and the authorities have expressed some concern that it might be affecting the competitiveness of certain segments of the Portuguese securities market vis-à-vis other EU countries.

Main findings

81. The Portuguese regulatory framework exhibits high levels of compliance with the IOSCO Principles.

Principles related to the regulator (Principles 1–5)

82. The responsibilities of both the CMVM and the BdP are set forth by law. Both authorities have sufficient functional independence to carry out their day-to-day operations. While the BdP enjoys financial independence, permanent provisions to ensure the CMVM's financial independence are necessary. Both regulators have sufficient powers and resources to carry out their functions and both have set up organizational structures, policies, procedures and internal controls that allow them to properly discharge their duties. Both regulators are subject to a system of accountability to the public and to the Government, including financial accountability.

Principles related to compliance and enforcement (Principles 7–10)

83. Both regulators have broad regulatory and supervisory powers, including enforcement authority. Both the CMVM and the BdP have developed adequate supervisory practices for all market participants under a risk-based approach, though a comprehensive framework for risk rating financial intermediaries is yet to be implemented by the BdP. Since mid-2005, the CMVM has exhibited a more vigorous policy towards enforcement and has made more use of administrative fines. A recent reform to the Securities Code makes it mandatory for the CMVM to disclose to the public the sanctions imposed in the case of very serious infractions through its information system; however, broader disclosure might still be considered.

Principles related to information sharing and cooperation (Principles 11–13)

84. Legal provisions require the CMVM and the BdP to cooperate with each other. Formal mechanisms have been developed, including the creation of the National Council of Financial Supervisors and the signature of two MoUs. However, these MoUs need to be updated and their publication should be considered. Legal provisions allow both the CMVM

and the BdP to cooperate with foreign counterparties, although the framework for the CMVM could be clarified by amending the Securities Code. Both authorities have signed numerous MoUs, and the CMVM is a signatory of the IOSCO Multilateral MoU. In practice, within the current framework, the CMVM has answered in a reasonable time frame requests for information and assistance made by foreign counterparties.

Principles related to issuers (Principles 14–16)

85. In line with international standards, both public offerings and listings are subject to disclosure requirements at the moment of authorization and periodically thereafter. In addition, substantial and insider shareholdings are subject to disclosure requirements. There is in place (i) a set of mechanisms to ensure issuers' compliance with disclosure requirements, and (ii) a comprehensive framework for corporate governance with both mandatory regulations and a set of recommended practices implemented under a comply-or-explain regime.

Principles related to collective investment schemes (Principles 17–20)

86. Registration of CIS requires the submission of a prospectus that is in line with international standards, while proper segregation of assets is achieved through a depository. There are clear rules governing pricing of units as well as its disclosure to investors. All unit mispricings must be reported to the CMVM and published, and operators are required to compensate losses under certain circumstances. CIS operators are subject to a licensing system based on capital, and fit and proper requirements. CIS and CIS operators are subject to periodic reporting as well as on-site supervision following a risk-based approach.

Principle related to market intermediaries (Principles 21–24)

87. Licensing requirements comprise both capital requirements as well as fit and proper requirements. Market intermediaries are subject to periodic reporting to the BdP and the CMVM as well as on-site supervision by both of them. In both cases, supervision follows a risk-based approach, though BdP has yet to implement a comprehensive risk-rating system. The BdP has developed a checklist for contingency situations. However, it does not yet have a comprehensive written contingency plan to deal with the failure of a financial institution. The CMVM should coordinate with BdP to prepare detailed contingency plans that can be implemented in the event of market disruption. In addition, BdP should complete the preparation of its manual for financial crises. Portugal has also implemented an investor compensation scheme.

Principles related to self regulatory organizations and secondary markets (Principles 6–7; and 25–30)

88. The CMVM monitors all markets under its supervision in real time (on line) except for the derivatives market for which surveillance is carried out the following day. Markets

and market operators are subject to periodic reporting as well as on-site inspections. Portugal was a signatory to the MoU for the supervision of Euronext Markets and Clearnet in 2003. Joint on-site supervision of Euronext by all country regulators where Euronext operates is recommended. Provisions in place in the regulated markets provide for adequate pre-trade and post-trade transparency.

Table 6. Portugal: Recommended Plan of Action to Improve Implementation of the IOSCO Objectives and Principles of Securities Regulation

Reference Principle	Recommended Action
Principle 1	Conclude review of MoU and publish it on the website.
Principle 2	Approve permanent provisions that exclude the possibility that the Government could freeze as well appropriate CMVM's surpluses.
Principle 4	1) The BdP should adopt a more systematic approach towards public consultation. 2) The CMVM should continue its plan to set up an Internal Audit Department. 3) The CMVM could consider a more general program for investors' education.
Principle 7	The CMVM should consider joint inspections of Euronext.
Principle 10	1) The BdP should complete a risk rating system for supervision of financial intermediaries. 2) The CMVM should continue its efforts to implement a more vigorous enforcement policy. 3) The CMVM could consider the inclusion of a closing meeting with the board of the financial intermediary as part of the regular procedure for on-site inspections.
Principles 11, 13	Amend provisions of the SC to clarify authorization to exchange information and cooperate with foreign authorities.
Principle 14	Shorten the deadline for presentation of annual accounts.
Principles 17-20	Given the growth of the industry, it is important that the CMVM keeps the CIS industry under scrutiny, as commented under Principle 17.
Principle 21	Eliminate positive silence for the registration of financial intermediaries with the CMVM.
Principle 22	The BdP should complete the risk rating system.
Principle 24	The CMVM should elaborate contingency plans to deal with market disruption, and coordinate this with BdP. In addition, BdP should finish the preparation of its manual for financial crises.
Principle 26	The CMVM should consider joint inspections of Euronext.

Authorities' response

89. The authorities are broadly in agreement with the Assessment and welcome the overall judgment that the Portuguese framework is highly compliant with the IOSCO Principles.

90. The CMVM emphasized that there is already a provision in the Annual Budget for 2006 that addresses the problems that the CMVM faced in the past regarding its budget.

91. The CMVM emphasized that its Board of Directors has already changed its enforcement policies, to make more use of administrative fines. In addition, a reform to the Securities Code, which was approved during the course of the second visit, makes mandatory for the CMVM to disclose the sanctions imposed in the case of very serious infractions through its information system. In the first eight months of 2006, the CMVM imposed 19 administrative fines for a total of EUR 2.7 million.

92. The CMVM also stressed that other recommendations have been already implemented, including setting up the Internal Audit Department, and the closing meeting with the board of financial intermediaries. In addition, no financial intermediary has been registered under the rule of positive silence; however, its elimination is already included in a draft amendment to the Securities Code. Finally, the CMVM believes that it has full powers to exchange information but acknowledges that the law could be clarified.

93. The BdP acknowledges that the IMF recommendations are generally adequate and is pleased that some of them actually back up existing work, such as the full implementation of a comprehensive risk rating system, which BdP considers will enhance its current approach for risk assessment of supervised credit institutions.

APPENDIX—METHODOLOGICAL ASPECTS OF STRESS TESTING

94. This appendix describes the main assumptions and procedures underlying the stress testing exercise, which is reported in more detail in a separate Technical Note. The exercise encompassed a bottom-up and a top-down approach applied to both banking and insurance sectors (Table 7).

Table 7. Portugal: Overview of Banking and Insurance Stress Tests 1/

	Banking		Insurance	
	Bottom-up	Top-down	Bottom-up	Top-down
Coverage	1 conglomerate 5 banking groups 5 pension schemes	13 banking groups	4 life 2 nonlife 3 composite	4 non-life 2/
Relevance 3/	80 percent	87 percent	78 percent life 64 percent non-life	48 percent
Financial risks	Credit risk * Equity price risk * Interest rate risk Foreign exchange risk Volatility risk	Credit risk * Equity price risk *	Credit risk * Equity price risk * Interest rate risk * Foreign exchange risk Real estate risk	
Other risks	Actuarial risks		Life biometric risk Life lapse risk Non-life premium and reserve risk *	Non-life catastrophic
Scenario analysis	Disruptive adjustment Cyclical asynchrony	Disruptive adjustment Cyclical asynchrony	Historical correlation structure	Probable maximum loss estimation
Sensitivity analysis	yes	no	yes	no
Maximum solvency impact 4/	-1.4 percentage points of CAR	-1.1 percentage points of CAR	-101.1 percent of free surplus	-16.6 percent of free surplus

Sources: Banco de Portugal and Instituto de Seguros de Portugal.
1/ Main risks identified are starred.
2/ Including non-life companies and non-life undertakings of composite companies.
3/ For banking: relative to system assets. For insurance: relative to premiums (bottom-up) and insured capital (top-down).
4/ On an individual basis, except for top-down banking stress tests where results are reported for the system as a whole. Results are reported relative to the projected baseline for banking and relative to the pre-shock levels for insurance.

A. Banking Stress Tests

Development of Scenarios

95. Macroeconomic scenarios were developed by the BdP for the period 2005-2008. These included a baseline scenario, foreseeing a moderate economic recovery; a “disruptive adjustment” scenario, featuring an abrupt adjustment of global imbalances; and a “cyclical asynchrony” scenario, showing a strong economic upturn in the euro area that does not spill over into the Portuguese economy (Table 8).

Table 8. Portugal: Macroeconomic Aggregates

	Stress scenario 1 Disruptive adjustment			Stress scenario 2 Cyclical asynchrony		
	2006	2007	2008	2006	2007	2008
	(percentage point deviations from baseline projections)					
Real GDP growth	-1.7	-1.7	-1.4	-1.0	-1.6	-1.5
Inflation	0.0	0.2	-0.8	0.5	1.4	0.5
Unemployment rate	0.4	0.9	1.2	0.3	0.6	1.0
3-month interest rate	-1.2	-1.5	-1.5	1.4	1.9	2.5
10-year interest rate 1/	-0.3	-0.5	-0.5	0.5	0.7	1.0
Dollar/euro exchange rate /2	23.7	0.0	0.0	0.0	0.0	0.0
Stock prices	-30.0	0.0	0.0	0.0	0.0	0.0
Real Estate Prices	0.0	0.0	0.0	-0.5	-0.5	-0.5
Total credit 3/	1.4	1.1	0.2	-2.6	-5.1	-5.9
Credit to households 3/	3.3	3.5	1.8	-3.6	-6.0	-6.8
Credit to corporations 3/	-1.1	-2.1	-2.2	-1.4	-3.9	-4.8

Sources: Banco de Portugal; and IMF staff estimates.

1/ Regarding pension schemes, the actuarial rate is assumed constant for the baseline and disruptive adjustment scenarios. For the cyclical asynchrony scenario, the actuarial rate rises by a cumulative 25 basis points, distributed annually in proportion to changes in the 10-year interest rate.

2/ A positive number represents an appreciation of the euro.

3/ End-of-year figures.

96. Macroeconomic projections were translated into probabilities of default (PDs) for four types of credit on the basis of previous BdP's studies (Table 9). Loss given defaults (LGDs) were assumed constant at 10 percent for mortgages and 45 percent for the other types of credit. Given the uncertainty surrounding these estimates, a robustness test was also carried out by imposing ad hoc a 20 and 50 percent increase in derived expected losses rates.

Table 9. Portugal: Probabilities of Default Projections

	Stress scenario 1 Disruptive adjustment			Stress scenario 2 Cyclical asynchrony		
	2006	2007	2008	2006	2007	2008
	(percent increase relative to baseline)					
Corporations	29	65	111	20	71	139
Households - housing purposes	1	11	19	45	80	119
Households - other purposes	4	19	30	57	106	158
Other credits	13	35	58	38	82	136

Source: Banco de Portugal.

Bottom-Up Approach

97. The bottom-up approach examines the impact of various risk factors on individual financial institutions' balance sheet. The exercise covered one financial conglomerate and five of the largest banking groups, representing about 80 percent of total banking system assets. In addition, the stress tests considered the impact of shocks on banks' pension schemes and hence banks' potential extraordinary contributions to compensate for actuarial losses in excess of regulatory corridor. The cut-off date used was end-2005.[17]

98. The exercise featured two approaches: a scenario and a sensitivity analysis. The scenario analysis took into account the correlations amongst risk factors. Institutions projected their balance sheets, operating profits, and regulatory capital under the three scenarios and provided a qualitative assessment of their liquidity positions. The sensitivity analysis evaluates the impact of large and instantaneous shocks, other things being constant. In particular, three risk factors were examined: a non-parallel shift and a pivotal change in the yield curve; a change in equity price level and volatility; and a change in the euro-dollar exchange rate (Table 10).

Top-Down Approach

99. The top-down stress tests evaluated macroeconomic stress scenarios impact on default probabilities on banks' loan portfolio and hence on their profitability and solvency. Special attention was also given to banks' exposure to equity market risk. To map the macroeconomic scenarios into aggregate financial statements, various behavioral equations were estimated. Explicit modeling was carried out for credit and deposit aggregates. Top-down stress tests were carried out only for banking groups. Thirteen banking groups were included, representing approximately almost 90 percent of system assets.

B. Insurance Stress Tests

Bottom-Up Approach

100. The ISP coordinated a bottom-up exercise implemented by individual insurance companies. The stress tests were performed on a representative sample of life, non-life and composite insurance companies. The largest companies for each line of business were represented. The participating companies represented 78 and 64 percent of the life and non-life insurance sector, as measured by 2005 premiums, respectively. In terms of technical provisions, the sample represented 76 percent and 59 percent of the life and non-life business, respectively.

---

[17] In the case of one bank, which had a major capital increase in May 2006, the bottom-up stress tests were conducted as if the capital issue had already taken place.

Table 10. Portugal: Banking Sector: Overview of Sensitivity Shocks

Risk factor	Nature of shock	Size of shock
Interest rate risk	Joint change of 3-month and 10-year interest rates 1/ 2/	100 bps and 50 bps up 100 bps and 50 bps down 200 bps and 100 bps up 200 bps and 100 bps down
	Pivotal change of 10-year interest rate 2/	50 bps up 50 bps down
Foreign currency risk	Change in euro exchange rates 3/	15 percent up 15 percent down
Equity price risk	Change in equity prices 4/	30 percent up 30 percent down
Volatility risk	Change in implied volatility of financial market prices 5/	30 percent up 30 percent down

Source: Banco de Portugal.
1/ Shocks to interest rates with other maturities obtained by linear interpolation. Stress tests for pension schemes incorporate an increase (decrease) in the actuarial discount rate of 25 and 50 bps, respectively.
2/ Interest rate changes are equal in all currencies.
3/ Changes in euro exchange rate are applicable to all currencies. An increase indicates depreciation of the euro.
4/ Equity price shock is applied simultaneously to all equity markets.
5/ Volatility shock is applied simultaneously to all financial market prices (interest rates, exchange rates and interest rates). If initial volatility is 10 percent, a 30 percent increase implies that it rises to 13 percent.

101. The exercise consisted of two parts. First, a market-consistent value of both assets and liabilities was calculated. Second, a number of standardized sensitivity tests were carried out on the market-consistent balance sheets and the impact on insurer's capital requirements was derived. The risk factors included both financial and insurance-specific risks. The financial risks considered in the exercise were market risks (interest rate, equity, real estate and foreign exchange) and credit risk. The insurance-specific risks consisted of life underwriting risks (biometric and lapse). In addition, for the purpose of the risk-based capital adequacy formula, it was assumed that the non-life underwriting risk for premium and reserve risk corresponded to Solvency I capital requirements. The proposed shocks were calibrated with reference to earlier studies carried out within the Committee of European Insurance and Occupational Pensions (CEIOPS) (see Table 11).

Top-Down Approach

102. The ISP carried out a top-down exercise to measure the sensitivity of the non-life sector to catastrophic risk ('CAT risk'), consistent with the second quantitative impact study (QIS2) exercise within the CEIOPS. Taking into account that Portugal is exposed to a non-negligible risk of severe seismic activity, the ISP estimated the potential losses for the insurance sector in the event of a severe earthquake. The sample of institutions consisted of

103. four selected non-life insurance companies operating in the Portuguese market. For simplicity, only property insurance was considered, namely policies on buildings and contents covering the specific peril of seismic hazard.

Table 11. Portugal: Insurance Sector: Overview of Shocks Under the Bottom-Up Approach

Risk factor	Nature of shock	Size of shock
Financial risks		
Interest rate risk	Shift in the yield curve 1/	94 bps up 94 bps down
Foreign currency risk	Change in euro exchange rates	15 percent up 15 percent down
Equity price risk	Change in equity prices	35 percent up 35 percent down
Real estate risk	Change in real estate prices	5 percent up 5 percent down
Credit risk	Implementation of simplified method based on standardized approach under Basel II	0 percent for AAA to AA- 20 percent for A+ to A- 50 percent for BBB+ to BBB- 100 percent for BB+ to B- 150 percent for below B- 100 percent for unrated
Life underwriting risks		
Biometric risk	Change in mortality rates	15 percent up 15 percent down
Lapse risk	Change in lapse rate	50 percent up 50 percent down
Non-life underwriting risk		
Premium and reserve risk	Adoption of Solvency 1 capital requirement 2/	

Source: Instituto de Seguros de Portugal.
1/ This corresponds to a 30 percent movement in the 5-year rate.
2/ More advanced methodologies for estimating these risks are being tested under QIS2.

104. The earthquake scenario was applied using the "Market Loss" technique, which relies on an estimate of the expected probable maximum loss (PML) for the market as a whole due to the catastrophic event. The overall loss is then allocated to each insurance company in proportion to its share of total sum insured net of reinsurance.

105. The PML over the sum insured by the market was set at 1.11 percent. This figure corresponds to the estimate provided by an international reinsurance broker for an earthquake with a severity level higher than 8.5 points on the Richter's scale.

Combining Both Approaches

106. To estimate the simultaneous impact on the free surplus of all shocks, under both the bottom-up and top-down approaches, plausible correlation assumptions amongst individual risk factors were derived following the modular correlation approach used in QIS2.

Table 12. Portugal: Structure of the Financial System

	2000	2001	2002	2003	2004	2004 1/	2005 1/
Number							
Total deposit taking institutions	206	198	191	191	185	26	25
Total deposit taking groups	20	20	21	20	20	13	13
Of which:							
Majority state-owned groups	1	1	1	1	1	1	1
Majority foreign-owned groups	5	4	5	6	6	5	5
Insurance companies	51	51	48	44	42	…	42
Life	16	16	16	14	14	…	14
Mixed	8	8	7	7	7	…	7
Non-life	27	27	25	23	21	…	21
Collective investment institutions	260	261	221	215	224	…	242
Securities dealers	12	12	8	7	7	…	4
Real estate investment funds	23	28	34	38	51	…	66
Private closed end equity funds	17	14	11	14	15	…	35
Financial system assets							
	(in millions of euro)						
Banks	250,719	278,464	282,996	304,067	315,550	272,411	305,363
Of which:							
Foreign-majority owned	31,806	39,983	39,312	44,555	46,637	40,714	48,048
Domestic-majority owned	210,514	229,019	233,880	248,099	254,258	231,697	257,316
Foreign branches	8,399	9,463	9,804	11,413	14,655	…	…
Insurance sector	25,548	27,684	30,217	33,752	37,031	…	44,412
Life	10,806	12,861	15,249	18,053	20,512	…	25,910
Mixed	11,756	11,613	11,632	12,023	12,953	…	14,499
Non-life	2,986	3,211	3,337	3,676	3,566	…	4,004
Collective investment institutions	21,558	21,266	20,608	22,857	24,415	…	28,290
Securities dealers	45	16	1	22	34	…	5
Real estate investment funds	1,445	1,817	2,203	2,541	3,188	…	3,686
Private closed end equity funds	1,018	742	452	540	530	…	714
Assets as percent of GDP	(In percent of GDP)						
Banks	205.1	215.3	209.0	220.4	220.6	190.5	207.7
Insurance companies	20.9	21.4	22.3	24.5	25.9	…	30.1

Source: Banco de Portugal.

1/ Data for the banking sector for 2005 concerns a sample of institutions that are already complying with IAS/IFRS and that, as for December 2004, represented about 87 percent of total assets of the aggregate usually considered in regular analysis. For the sake of comparability, the figures for 2004 for this sub-sample are also reported.

Table 13. Portugal: Financial Soundness Indicators of the Banking Sector

	2000	2001	2002	2003	2004	2004 1/	2005 1/
Capital adequacy				(In percent)			
Regulatory capital to risk-weighted assets	9.2	9.5	9.8	10.0	10.4	10.2	11.3
Regulatory Tier I capital to risk-weighted assets	7.6	7.3	7.1	7.1	7.3	7.0	7.1
Capital to assets	5.8	5.5	5.6	5.8	6.1	5.8	5.1
Sectoral distribution of bank credit	(In percent of total credit to the resident non-monetary private sector)						
Households	48.2	47.7	48.4	48.3	49.3	49.3	50.7
housing purposes	36.3	36.8	38.4	38.6	39.4	39.4	41.2
other purposes	12.0	10.9	9.9	9.7	9.9	9.9	9.6
Non-financial corporations	43.0	44.9	45.3	46.9	45.2	45.2	44.1
Agriculture, hunting, forestry and fishing	0.6	0.6	0.6	0.7	0.7	0.7	0.7
Mining and quarrying	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Manufacturing	8.0	7.8	7.6	7.6	6.8	6.8	6.0
Production and distribution of electricity, gas and water	1.3	1.0	0.9	0.9	0.9	0.9	1.1
Construction	8.1	8.6	8.4	8.8	8.7	8.7	8.6
Services	24.8	26.7	27.5	28.7	27.9	27.9	27.5
Of which: Real estate activities	4.2	5.5	5.9	6.7	7.2	7.2	8.0
Other financial corporations	8.8	7.4	6.4	4.8	5.4	5.4	5.2
Foreign claims of consolidated domestic banks vis-à-vis			(In percent of end-period total assets)				
Other EMU countries	6.4	7.2	7.6	14.6	13.4	13.4	12.2
Other developed countries	5.9	7.0	7.5	3.6	3.8	7.5	7.3
Other emerging markets and developing countries	2.2	2.1	1.3	1.0	0.9	5.0	5.0
Off-shore centers	7.2	3.5	1.8	2.8	2.8	4.6	3.1
Asset quality				(In percent)			
NPLs to gross loans	2.2	2.2	2.3	2.4	2.0	1.6	1.5
Provisions to NPLs	67.7	66.8	62.8	73.0	83.4	68.0	75.0
NPL net of provisions to Tier I capital	8.8	9.8	12.4	9.5	4.6	7.7	7.0
Large exposures to regulatory capital	…	…	119.9	94.1	91.4	97.5	75.5
Earnings and profitability							
Return on Average Assets (ROAA) 2/	1.1	1.0	0.8	0.9	0.9	0.6	1.0
Return on Average Equities (ROAE) 2/	18.3	17.8	14.1	16.2	14.5	12.5	16.9
Net interest margin to interest bearing assets	2.3	2.4	2.3	2.1	2.1	…	2.2
Net interest income to gross income	62.9	65.8	65.0	60.0	58.1	57.5	53.9
Non-interest expenses to gross income	51.1	50.7	51.8	50.5	50.5	72.9	61.0
Personnel expenses to non-interest expenses	61.8	59.5	59.3	59.3	58.6	56.5	54.2
Spread between reference loan and deposit rates	4.1	4.3	3.6	3.4	3.1	3.1	3.1
Average lending rate to the non financial private sector	6.3	6.9	5.7	4.8	4.5	4.5	4.4
Average deposits rate	2.2	2.6	2.1	1.5	1.4	1.4	1.3
Liquidity							
Liquid assets to total assets	…	15.3	12.5	17.1	15.4	15.3	15.3
Liquid assets to short-term liabilities	…	89.0	85.6	108.6	115.2	109.1	99.0
Foreign currency assets to total assets	8.9	9.0	7.0	6.0	5.2	5.2	5.6
Foreign currency liabilities to total liabilities 3/	10.7	9.9	9.0	9.0	7.9	7.9	8.3
Foreign currency liabilities to total assets	9.1	9.2	7.8	6.8	5.9	5.9	6.2
Deposits to assets	55.9	53.9	53.8	51.7	51.9	52.4	48.8
Loans to deposits	114.3	121.0	127.7	126.9	126.2	136.5	143.5
Sensitivity to market risk			(In percent of regulatory capital)				
Net open position in foreign exchange	…	…	7.1	4.7	3.9	4.0	4.5
Net open position in equities	…	…	1.8	0.2	1.8	1.8	1.3

Source : Banco de Portugal.

1/ Data for the banking sector for 2005 concerns a sample of institutions that are already complying with IAS/IFRS and that, as for December 2004, represented about 87 percent of total assets of the aggregate usually considered in regular analysis. For the sake of comparability, the figures for 2004 for this sub-sample are also reported.

2/ Income before taxes and minority interests.

3/ Foreign exchange liabilities include foreign currency deposits and deposit-like instruments of resident non-monetary sector and foreign currency claims of non-resident vis-à-vis resident monetary financial institutions (excluding Banco de Portugal).

Table 14. Portugal: Financial Soundness Indicators of the Non-Banking Sectors

	2000	2001	2002	2003	2004	2005
Insurance sector						
Coverage ratio 1/	2.4	1.6	1.5	1.7	1.8	1.8
Profitability (return on average equity)						
Life	0.2	0.1	0.0	0.1	0.1	0.1
Non-life	0.1	0.0	0.0	0.2	0.2	0.2
Composite	0.6	0.0	-0.1	0.0	0.1	0.1
Corporate sector						
Total debt as a percentage of equity	95.4	113.1	127.4	112.5	106.4	108.7
Profitability (Return on equity)	8.9	8.8	8.6	…	…	…
Debt service (interest only) coverage 2/	1.7	2.0	2.5	…	…	…
Household sector						
Debt in percent of GDP	60.4	64.0	68.3	73.7	78.4	84.2
Debt in percent of Disposable Income	84.8	90.0	96.7	103.7	109.7	117.1
Interest burden in percent of total disposable income	5.2	6.2	5.4	5.0	4.9	5.0
Financial savings ratio in percent of GDP	1.2	2.8	3.2	3.4	2.9	3.4

Source: Banco de Portugal.

1/ Available solvency margin over required solvency margin.
2/ Earnings before interest and tax as a percentage of interest and principal expenses.