Portugal's accession and effects on the financial sector

An overview

On 1 January 1986, when Portugal joined the European Economic Community (EEC), its financial sector was almost exclusively state owned and regulated by Banco de Portugal, which set almost all the essential parameters, from the amount of credit granted to the price (interest rate) of products.

A timid liberalisation had begun not long before when, on 19 November 1983, Decree-Law 406/83 laid down that the sector was no longer legally closed to private enterprise. The first privately owned banks began to appear after the wave of nationalisations – BPI (7 March 1985), BCP (5 May 1985), BIC (1986) and BCI (27 June 1985) and some foreign banks opened subsidiaries in Portugal, such as Banco Manufacturers Hannover Trust (later Banco Chemical) in 1984 and Chase Manhattan Bank, Citibank, Barclays Bank, Banque Nationale de Paris and Générale Bank in 1985.

Accession to the EEC and the prospect of a single market speeded up the liberalisation of the sector and structural changes in ownership of banking institutions.

The central event in the transformation of the sector was its almost total privatisation, with the exception of CGD, which began in 1989 with the first, albeit minority tranche of Banco Totta & Açores.

This process lasted for about a decade and enabled the emerging financial groups to reorganise. It stabilised in 2000, and since then it has been based on five groups that represent more than 80% of the financial sector, depending on the criteria used.

Meanwhile, in the second half of the 1980s, legislation – leasing (DL 311/82), factoring (DL 56/86), investment funds (DL 1/87 and 229-C/88) and venture capital (DL 17/86), among others, opened the door for new financial asset and liability products. This allowed our system to catch up with the other EEC countries.

There were also rapid developments in administrative controls, culminating in the publication of the General Law on Credit Institutions and Financial Companies, which came into force in 1993. All the interest rates fixed by Banco de Portugal progressively disappeared, as did quantitative limits on credit. The process ended in 1994, when mandatory cash reserves were reduced from 17% to 2%.

The reaction to these changes on the part of players operating in the Portuguese financial market was exceptional. These changes occurred in a relatively short period, while in many European countries they had taken several decades.

In only 10 years after joining the EEC, we went from a crippled, shackled market with no strategic prospects to a market in which our financial system was repeatedly recognised as one of the most sophisticated and competitive in Europe. In certain areas, it was even considered exemplary, such as its electronic payment systems and different banking products like home loans.

Strategic reorientation

The progressive slowdown and then disappearance of administrative regulation of the sector created the right conditions for a real strategic revolution in the financial sector.

New credit products began to appear, such as leasing and factoring, and instruments directly aimed at each company's specific needs, such as exchange or interest rate derivatives or issues of commercial paper.

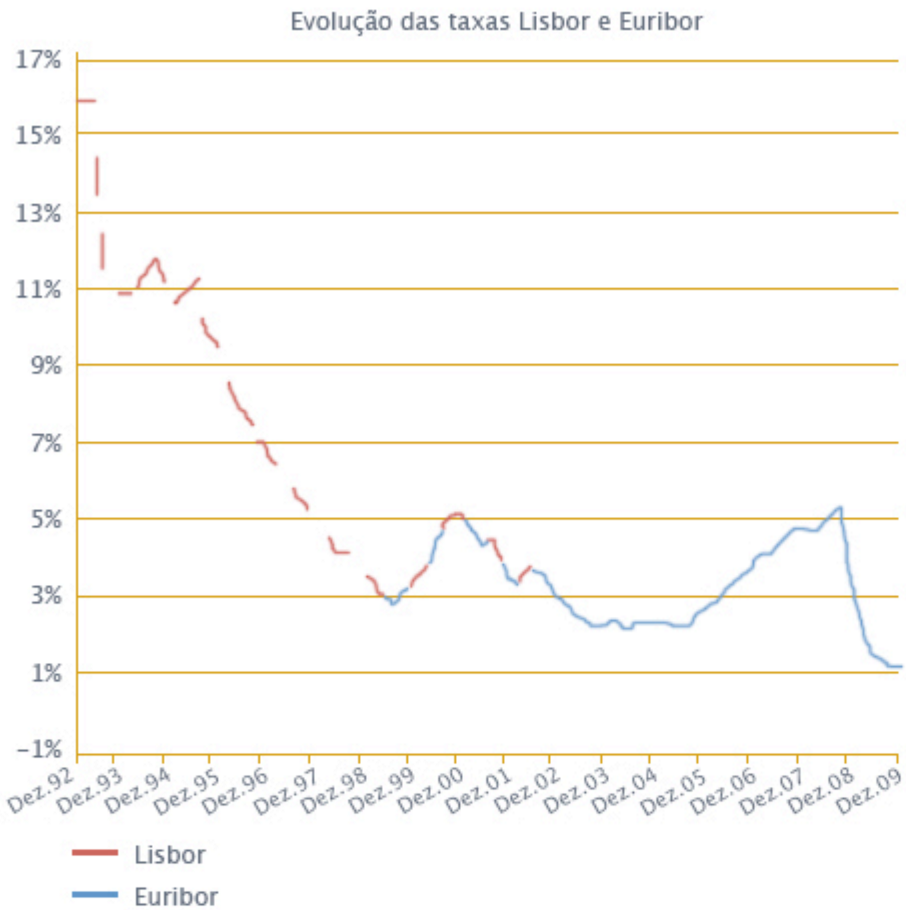
In an environment in which quantitative restrictions were gone, the banks needed to optimise the use of their capital. The Basel rules created a need for new types of risk analysis and management in order to achieve the best return on capital allocated.

While progress was quick and drastic in company loans, consumer credit and home loans simply exploded.

Consumer credit went from being almost non-existent or even illegal to a phase in which competition for new forms of contact with customers resulted not only in a rapid growth in quantity but also the appearance of new specialised institutions, such as consumer credit companies or long-term rental companies in the vehicle sector. (There were also unsuccessful stories like group purchase companies).

The development of home loans was remarkable, especially after the large drop in interest rates immediately before the creation of the euro.

Before, with nominal interest rates as high as almost 30%, the monthly repayment on home loans placed the product out of reach of most households. The fall to below 5% made it very popular indeed and Portugal was one of the European Union countries in which the highest percentage of families owned their homes and had active mortgages. This was also due to problems of high rents and the rapid expansion of credit in a relatively short time.



It was basically through home loans that the banks began the strategic orientation of getting to know their customers and trying to meet their credit and other needs, such as insurance and means of payment. This is where we find the basis for the rapid development of the *banque assurance* model that predominated from the mid-1990s to the mid-2000s. Today, the trend towards greater separation between ownership of banks and insurance companies springs basically from prudential reasons associated with own capital needs.

We have therefore gone from a situation in which the bank-household relationship was negligible in terms of credit and completely passive when it came to attracting resources to one in which this relationship is central to institutions' strategy, as it produces most of their business and is crucial to their return and financing.

Finally, there has been a huge strategic change in banks' liabilities. They are now actively seeking deposits and the competition to attract them has increased considerably. We have gone from a situation in which restrictions on credit might mean that having more deposits negatively affected return to one in which obtaining a solid, stable deposit base has become a critical success factor. This was why questions were raised in the late 1980s, when some banks started to pay interest on current accounts, which was illegal at the time, strange as it may seem.

A radical change in the structure of banks' balance sheets

The whole dynamics of change that we mentioned above and many other lesser factors that do not have time to mention here meant that bank's balance sheets had to change radically. The change was not only in size (see the growth in the late 1990s and early 2000s), but also in composition. The structural alterations appear under assets, such as credit granted, and under liabilities, in which borrowing beyond deposits becomes decisive. This need to obtain additional funding to handle the growth in assets combined with the external structural imbalance of the Portuguese economy meant that the banks progressively borrowed on a larger scale on the international financial markets.

The expansion of credit to the economy was only possible thanks to the banks' ability to intermediate international funding to meet the domestic demand for credit on the part of households and companies. Only the banks' solidity, efficiency and internationally recognised effectiveness enabled the Portuguese economy to live with the external structural imbalance that unfortunately characterised the period in question.

In short, just as an example, let's compare the figures in the table below.

Relative weight of different types of loan

Private customers

Non-financial companies

Public Sector

Total (Private customers +non-financial companies + public sector)

Private customers: homes

Private customers: consumer goods and other purposes

Source: BPstat –online statistics

It is easy to see that not only did personal loans begin to dominate, but home loans also carried a very substantial weight, as they represented 80% of loans to private customers after Portugal joined the euro.

Conclusions

The Portuguese financial system today is clearly the result of two successive events.

The first was accession to the EEC and the resulting liberalisation of the system in legislative and administrative terms and the associated re-privatisations.

The second was the creation of the Eurozone and Portugal's inclusion right from the start, as this created the right conditions for monetary stability, and the resulting reduction in nominal interest rates allowed the system to conduct a strategic reorientation in terms of business and balance sheet management.

Lisbon, 18 February 2010

Article by Professor António de Sousa - *Europa Novas Fronteiras* magazine of Centro de Informação Europeia Jacques Delors, devoted to the 25th anniversary of Portugal's accession to the EEC, June 2010