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Lisbon, 14 July 2016

Mr. Moisés Schwartz
Director
Independent Evaluation Office
of the International Monetary Fund
700 19th Street, N.W.
Washington D.C. 20431
U.S.A.

Dear Mr. Schwartz,

Dear Sir,

Banco de Portugal takes note of "The IMF and the Crises in Greece, Ireland and Portugal – an evaluation by the Independent Evaluation Office" and welcomes the opportunity it provides to reflect on the Fund's engagement with the euro area during these crises.

While this assessment is relevant to draw lessons, it is of paramount importance to recall that six years have passed since the first of the programs under review was negotiated and that the economic, financial and institutional conditions were particularly challenging at the time. A fair assessment should thus take into consideration the widespread uncertainty, the market volatility and, most importantly, the absence of a European crisis management framework at the time.

Overcoming such instability was indeed one of the key achievements over this period. In the case of Portugal, the EU-IMF program provided the conditions to launch an economic adjustment process in the face of severely constrained market access. The measures undertaken allowed for significant fiscal consolidation, effective external adjustment and the implementation of structural reforms, while safeguarding financial stability. The resilience of bank deposits in this period attests to the maintenance of financial stability. Although important challenges remain, calling for continued efforts, the progress achieved paved the way for economic recovery and restored regular market access. The IMF's contribution to these results was particularly relevant in what regards its expertise in program design and management.

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Nonetheless, lessons should be drawn from the Fund's first-time engagement with highly integrated advanced economies in the context of a monetary union.

Recalling the relevance of the IEO's exercise, Banco de Portugal considers, however, that the approach to the financial sector must be understood in context. Thus, the assessment carried out in the report requires substantial clarification, especially in what refers to the rationale behind the strategy for the banking sector. This concern has been conveyed to Carlo Cottarelli, Executive Director for Portugal, in preparation of the Executive Board meeting.

Furthermore, notwithstanding the relevant disclaimers, the assessment presented in Supplement 10 ("The IMF's Role in the Euro Area Crisis—Financial Sector Aspects") lacks rigor and seems highly speculative, which is not fully compatible with an IEO assessment. It should also be highlighted that Banco de Portugal's institutional view was not sought beforehand in the context of this Supplement.

The Supplement distributed to the IMF Executive Board contained serious factual mistakes, which we had the opportunity to flag. In addition, newspaper articles are frequently used as background for critical remarks. This is clearly inappropriate and resulted in severe and biased allegations by the author, namely in what regards Banco de Portugal's conduct as national supervisor for the banking sector.

Firstly, it is stated that the Portuguese crisis was perceived to be "mostly fiscal" instead of directly linked to the financial sector, which justified reluctance in nationalizing commercial banks despite their "incentives for related-party lending, awkward governance structures and high leverage". The author's remark suggests that a decision to nationalize the banking sector could be motivated by these specific features, which wouldn't be appropriate.

Secondly, the stated disapproval of the Special on-site Inspection Program model adopted in Portugal does not seem to be backed by clear and strong arguments.

It should be highlighted that this model was agreed amongst the parties – it was not imposed by Banco de Portugal. Stating something along those lines is highly depreciative to the role of the *troika* institutions in the whole process. Banco de Portugal considered the initiative was a success, as it provided point-in-time assessments of the credit portfolios of the largest banking groups and to what extent impairments were adequately registered in the balance sheets. This program also included a work stream under which the calculation of RWAs were verified and another that evaluated the methodologies and parameters used in the stress test exercises. The

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whole process was carried out under the supervision of an independent steering committee (that, along with the *troika* institutions, included external experts and members from other central banks). Following the first exercise in 2011, several exercises were conducted throughout the next years. While the first exercise was conducted towards the credit portfolios in general, the following exercises were conducted with a clear focus in market segments that were strongly hit in the context of the adverse macroeconomic conditions (e.g., the real estate and construction sector). In this sense, it is difficult to understand the remark that the reviews were conducted on "limited parts of the banks' portfolios". It should be further highlighted that the model adopted in the Special Inspections Program was the predecessor of the 2014 Comprehensive Assessment which prepared the creation of the Single Supervisory Mechanism. The methodology and governance structure of the Comprehensive Assessment is clearly coincidental with the one adopted in the Special Inspections Program, which attests to the success of the latter.

Moreover, it is referred that the program's approach to the financial sector in Portugal was a missed opportunity to clean up the financial sector, in contrast to other cases. However, considering the present situation of the European banking systems, it is not absolutely clear that adopting a "system-wide external review of the asset quality" of banks would have led to a situation whereby Portuguese banks' balance sheets would carry much less NPLs than at the present. In fact, the "BlackRock type" approach was followed in other banking systems which shared a similar starting point with Portugal in terms of NPL ratio, but now record a higher average ratio than Portuguese banks. This indicates that the "BlackRock type" approach did not prove to be a way to fix banking problems that arise from a prolonged period of very low growth.

Finally, in the specific case of BES, grave accusations of misleading assurances and untimely supervisory action from Banco de Portugal are made without substantiation.

The fact that the BES Group had a significant exposure to the non-financial part of the Espírito Santo Group (GES) had always been present in the supervisory assessment of the bank and originated a set of supervisory measures that included higher capital ratios and the reinforcement of governance and internal control procedures. It was following the special inspection program that focused on the largest non-financial exposures of the main banking groups that accounting irregularities were found in GES (the non-financial arm) and which led to a set of measures designed to ring fence the bank from GES, prohibiting the increased exposure to the non-financial part of the group. The resolution measure applied to BES followed the highly

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detrimental actions to the bank taken by its management, which violated the specific determinations from Banco de Portugal. It is widely accepted that the resolution of BES reflects the adoption of fraudulent actions by its management and, as such, could never had been identified by the IMF staff in 2011 or following a "BlackRock type" of asset review.

While fully acknowledging the central and independent role of the IEO, the concerns raised in this letter should prompt careful consideration.

Yours sincerely,

Carlos da Silva Costa

Copies to:
Executive Director for Portugal, Carlo Cottarelli;
European Department Director, Poul Mathias Thomsen.

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