SECTOR OUTLOOK

Portuguese Banking Sector Outlook 2018

Overall Outlook: Positive

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Highlights

Asset quality still the main challenge: Asset quality has been the key challenge for Portuguese banks, due to a very high ratio of non-performing loans (NPL) to total loans of 14.6% as of 3Q17, that has not been managed as proactively as in other EU countries (e.g. Spain and Ireland). A more active approach has been implemented only since the second half of 2016, mostly following the publication of the 'Guidance to banks on non-performing loans' by the ECB.

Larger write-offs and sales of NPL expected for 2018: Some of the large banks are expected to book larger sales and write-downs of NPL. We expect that NPL will reach a level closer to 13% of all loans by YE18, still well above the current EU average of 4.2%. The coverage ratio should also improve slightly and remain in line with the EU average. The improvement in the asset quality metrics has been aided also by stronger economic growth in Portugal in 2017 and we expect this to continue in 2018 as well.

Profitability still low due to high credit costs: Profitability of the banking sector was significantly affected by the large losses of Caixa Geral de Deposits (NR) and Novo Banco (CCC+) (EUR 1.9Bn and EUR 0.8Bn, resp.) recorded in 2016, due to very high loan loss provisions. However, by 3Q17, despite ongoing losses at Novo Banco, the system posted a positive, even if only slightly so, net income and return on assets (ROA) ratio of 0.4%. We expect ROA to remain positive, but below 0.5% in 2018.

Interest margins stabilising at low levels: While not their major problem, the low interest environment in Europe has also been negatively affecting profitability of Portuguese banks. Interest margins have been squeezed also in 2017, with interest rates on loans falling more than those on deposits. We expect margins to stabilise at the current levels and possibly to improve slightly towards the end of the year

Efforts to improve efficiency to start bearing fruits in 2018: During 2016 and 2017 Portuguese banks were implementing aggressive plans to reduce the number of employees, modernise their operating structures and improve efficiency. Even with the one-off costs associated with laying-off personnel and investing in technology, these measures already led to reduction in operating costs in 2017. We expect the effect to be stronger in 2018 and the cost-to-income ratio to improve and be aligned with the EU average.

Capital strengthened in 2017: We expect further improvements in capital, following both the reduction in NPL and RWA and the need to build up MREL[1]. Portuguese banks will continue building up capital levels to be more aligned with European competitors, following also the trend on CET 1 increases promoted by the regulators and the need to accommodate IFRS 9.

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[1] Minimum requirement for own funds and eligible liabilities.

1. Asset quality: NPL ratio finally improving after years on the rise

In the aftermath of the global financial crisis, banking assets and loans in Portugal decreased steeply (by 27% from 1H10 to 1H17) and the NPL ratio increased strongly, reaching a peak of 17.9%[2] of total loans in June 2016. Since then we have been observing only negligible decreases in assets and loans and some improvements in the NPL ratio. It decreased slightly, to 17.2%, by 2016 and more meaningfully, to 14.6%, in the first three quarters of 2017.

The improvement in the NPL ratio has been driven mainly by write-offs and sales of corporate loans, which account for the bulk of the NPL stock, as shown in the table below:

Portuguese Banks - Asset Quality	December 2015	December 2016	September 2017
NPL, EUR Bn (1)	49.8	46.4	39.9
NPL ratio (1)	17.5%	17.2%	14.6%
EU weighted average NPL ratio (2)	5.7%	5.1%	4.2%
NPL, non-financial corporates, EUR Bn	32.0	30.2	25.8
NPL ratio, non-financial corporates	28.3%	29.5%	26.6%
NPL coverage Portugal (1)	40.8%	45.3%	46.5%
EU weighted average NPL coverage (2)	43.7%	44.8%	44.7%

Sources: (1) Banco de Portugal Financial Stability Reports. (2) EBA Dashboard 3Q2017

Out of the total NPL of the Portuguese banking system, as of 3Q17, EUR 10.1Bn (25%) belong to Novo Banco and EUR 8.6Bn (22%) to Caixa Geral de Depositos (CGD)[3]. Approximately half of the decrease in the total amount of NPL was also attributed to these two entities, with CGD reducing NPL by EUR 2.0Bn and Novo Banco by EUR 1.2Bn in the first three quarters of 2017. Sales of NPL portfolios amounted to about EUR 2.0Bn for the system in the first nine months of 2017, a significant increase from the EUR 1.5Bn sold during the whole year 2016. We expect Novo Banco to remain particularly aggressive in writing-off non-performing assets, following the sale of the bank to Lone Star and the executed capital increase which increased the loss-absorbing capacity of the bank.

Portuguese banks have traditionally been reluctant to write-off NPL, in part due to legal and tax related concerns. Several legal reforms and regulatory initiatives have already been implemented or are underway, in order to tackle this issue. The measures are expected to lead to a better NPL management and simplified insolvency procedures.

In addition, the ECB has been providing guidance to banks to reduce the level of NPL through different tools and requesting a more active approach. The latest initiative, published in October 2017 as a consultation paper, sets minimum levels of prudential provisioning for exposures classified as NPL. The guidance requires that banks should provision new unsecured NPL in full within a period of two years of them being classified as such and secured NPL exposures within a period of seven years.

Outlook for 2018:

We expect that the aggregate level of NPL for Portuguese banks will continue to decrease, mostly from additional write-offs and some sales of NPL portfolios. We foresee a reduction of the aggregate NPL ratio to about 13% or at least 100bps lower than 2017. We expect larger banks, and especially Novo Banco, to be more aggressive in their sales and write-downs. The stable economic development expected for 2018 should be beneficial to the repayment capabilities of non-financial corporates and households. Additionally, it should be beneficial for loan demand and thus positively affecting the denominator in the NPL ratio. However, due to regulatory and legal differences and the limited room to recognize losses, we expect that NPL in the Portuguese banking sector will be at levels above the EU average for a longer period.

In terms of coverage, we expect a slight improvement to a level closer to, but below, 50%, following the sales of NPL and additional provisions recognised in anticipation of any potential implementation of stricter provisioning following the new guidance promoted by the ECB[4]. It is worth noting that Portuguese banks already have been increasing the recognition of provisions, first as it has been encouraged by the regulator and also in order to anticipate the impact of any future sale or securitisation on overall profitability.

[2] Data by the Banco de Portugal; NPL according to EBA definition; the ratios shown by EBA differ, as EBA data refers only to the six largest Portuguese banks.
[3] 3Q17 quarterly reports of Novo Banco and CGD.
[4] ECB Guidance to banks on non-performing loans, March 2017; Addendum to the ECB Guidance to banks on non-performing loans: Prudential provisioning backstop for non performing exposures, October 2017.

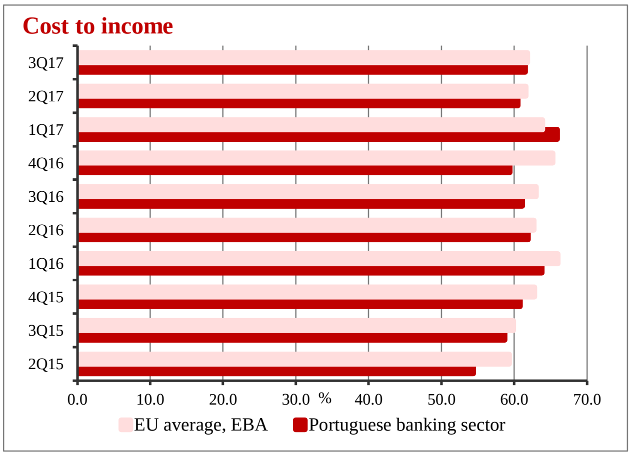
2. Profitability: sustainable return to positive bottom line results expected

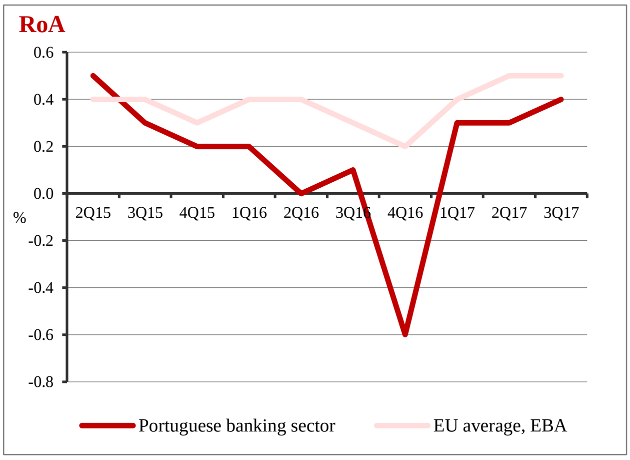
Profitability of the Portuguese banking sector was significantly affected by the large losses of CGD (EUR 1.9Bn) and Novo Banco (EUR 0.8Bn) recorded in 2016, due to very high loan loss provisions. However, by 3Q17, despite ongoing losses at Novo Banco, the sector posted a positive, even if only slightly so, net income and return on assets (ROA) ratio of 0.4%[5].

Net interest income (NII) remains the main source of income for Portuguese banks, representing 61.5% of total operating income, compared to an EU average of 56.5% based on the data provided by the EBA Dashboard 3Q17. The environment remained challenging: based on information disclosed by Banco de Portugal, the average interest rate charged by banks on new corporate loans was at a historic minimum of 2.7% as of 3Q17, down from 3.0% as of 4Q16. The rates on new mortgages fell from 1.8% to 1.6% during the same period, but there was still some minor improvement in November and December, compared to the all-time low of 1.5% as of October 2017. The average interest rate on new consumer loans was also at its historic minimum of 6.9%.

Interest rates on deposits also slid during 2017, but there was much less room for that, as they were already close to zero at the end of 2016: the rates on corporate deposits moved from 0.26% to 0.14% and those on retail deposits from 0.32% to 0.18%. It is evident, that net interest margin (NIM) has been squeezed further. However, we expect this trend to stop during 2018 and maybe even to be reversed towards the end of the year. Combined with a stable or moderately growing loan portfolio, this should lead to NII remaining stable in 2018. Negative pressure on interest expense might come from MREL issuances[6], for which the market demands higher yields, but we expect their overall impact to be low.

In terms of cost efficiency, Portuguese banks have been implementing an aggressive approach to reduce operational costs during the last years. Staff lay-offs were significant[7], despite the fact that by YE16 the number of banking sector employees per 1,000 inhabitants in Portugal was already below the median for the Euro area. Even with the one-off costs associated with laying-off personnel and investing in technology, these measures already led to reduction in operating costs in 2017, but it was not enough to offset the decreasing income. As a result, the cost-to-income ratio worsened slightly, from 59.6% as of YE16 to 63.6% as of 3Q17.





Source: EBA Risk Dashboard 3Q2017, Bank of Portugal, Dagong.

Outlook for 2018:

We expect NIM and NII to stabilise in 2018 and bottom line results to improve moderately on the back of significantly lower operating costs, in the absence of the non-recurring expenses realised in 2017. Profitability, measured as return on assets, will most likely remain at positive, albeit low, levels, following the improvements evidenced in 2017. We do not expect RoA levels above 0.5%, considering that Portuguese banks will continue cleaning up their loan portfolios to reduce NPL and, therefore, recognising additional credit losses.

[5] Data from Bank of Portugal. EBA data, referring only to the six largest banks, shows 0.0%.
[6] Portugal has not yet set the legal framework for senior non-preferred debt. Therefore, banks have been issuing more junior classes of debt, with CGD issuing a EUR 500Mn perpetual AT1 instrument paying 10.75% coupon and Millenium BCP (NR) issuing a EUR 300Mn, 10 year, Tier 2 bond paying 4.5%. Novo Banco has also announced that they plan to issue a Tier 2 bond.
[7] Novo Banco cut domestic employees from 6,571 (YE15) to 5,687 (YE16) to 5,297 (3Q17), CGD from 8,410 (YE15) to 8,113 (YE16) to 7,689 (YE17) and Millenium BCP from 7,459 (YE15) to 7,333 (YE16) to 7,189 (YE17).

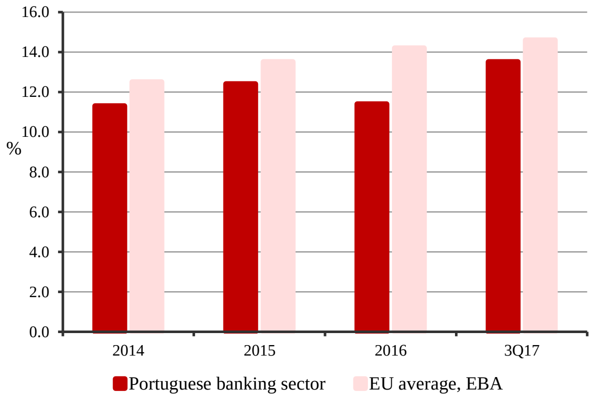
3. Capital & liquidity: building up capital to anticipate regulatory requirements

Portuguese banks' capitalisation based on CET 1 ratio has improved in 2017 following the reduction experienced in 2016, with both developments driven mostly by actions taken by the market leader, CGD[8]. For the 3Q17, the aggregate CET 1 ratio for Portuguese banks reached 13.5%,[9] compared to 11.4% for YE16, which is still below the EU weighted average of 14.6%[10].

For Portuguese banks, the improvement comes mostly from the combination of two factors: an active approach to reduce risk weighted assets on one hand and an increase of own funds on the other. The reduction of risk weighted assets has mostly been driven by continuous deleveraging and reduction of NPL. Total capital requirements for the system decreased by 8% in 2016 and by 5% in the first half of 2017. CET 1 eligible own funds increased by 9.6% in the first half of 2017, mostly due to the recapitalisation operations executed by CGD.

Funding and liquidity indicators of the system reached solid levels as of 3Q17, comparable to or even better than those for the EU average. LCR improved from 150.8% as of YE16 to 176.7%, compared to EU average of 144.6%. Loan-to-deposit ratio, a factor that we consider very important for the sustainability of a bank and the banking system, reached 94.0%, from 95.3% as of YE16, a significant reduction from the unsustainable peak of 158.8% observed in June 2010[11].

CET 1 ratio



Source: EBA Risk Dashboard 3Q2017, Bank of Portugal, Dagong.

We consider the current level as very good and expect it to remain stable. Funding from the ECB remained stable at EUR 22.7Bn (about 5.9% of total liabilities), little changed from YE16 (EUR 22.4Bn) and significantly below the peak of EUR 52.8Bn reached in 2012.

Outlook for 2018:

We expect that with the sale of NPL and securitisation transactions, capital ratios for Portuguese banks that have a large stock of NPL will improve due to the release of capital allocated to assets with a high risk weighted component (NPL are typically weighted at 150%). Additionally, banks keep divesting non-core activities, especially foreign operations.

In addition, we foresee that Portuguese banks will have to strengthen their capital to face the introduction of MREL through capital increases and eligible debt issuances, despite the higher yields demanded by the market on these securities. However, in terms of the IFRS 9 implementation we expect a moderate negative impact on capital ratios of the banks currently using the internal ratings based approach and higher impact on the banks using the standardised approach for credit risk.

Finally, capitalisation could also improve if profitability recovers faster than expected, following a change in the interest rate environment to higher levels from those expected for 2018. However, this scenario is unlikely in our view. We expect the funding and liquidity indicators to stabilise around the current solid levels.

[8] In 2016 the CET1 decreased as the bank decided to reduce NPL and recognise losses. Then, in 2017 CGD started to implement the recapitalisation plan, which included a share capital increase by the Portuguese state as CGD's sole shareholder of EUR 2.5Bn. The transaction was approved by the European Commission (EC), as the Commission decided that it was carried out on market terms. Additionally, CGD issued a EUR 500Mn AT1 instrument and started divesting non-core activities, especially abroad.
[9] Bank of Portugal.
[10] EBA Risk Dashboard Data as of Q3 2017.
[11] A reduction in the loan-to-deposit ratio of the banking sector was one of the measures in the Economic Adjustment Programme, agreed between Portugal and the EC/ECB/IMF in 2011.

Annex: Financial highlights of selected Portuguese banks

	Total Assets EUR Bn		Credit at Risk Ratio (%)		Credit at Risk Coverage (%)		CET 1 Phased-in (%)		RoAA (%)		Dagong Global Ratings
	YE16	3Q17	YE16	3Q17	YE16	3Q17	YE16	3Q17	YE16	3Q17	LTCR (1)
Caixa Geral de Depositos	94.4	94.3	10.5	9.6	78.0	76.7	7.0	13.0	-1.8	0.2	NR
Millenium BCP	71.3	73.0	10.9	9.7	66.1	69.1	12.4	13.2	0.2	0.4	NR
Novo Banco	52.3	50.5	25.6	25.2	64.5	64.7	12.0	10.9	-1.5	-1.1	CCC+/Positive
Santander Totta	45.0	48.3	5.6	5.1	89.4	82.1	15.8	16.2	0.9	1.0	NR
Banco BPI	38.3	33.3	3.7	3.3	83.0	84.0	11.4	12.5	1.2	1.5	NR
Caixa Economica Montepio Geral	21.4	19.5	15.2	15.2	51.6	55.3	10.4	13.0	-0.4	0.1	NR

(1) LTCR: Long-Term Credit Rating

Sources: Banks' annual and quarterly reports, Dagong calculations, Market Intelligence.

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