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Portugal: Reaping the rewards

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Reaping the rewards

Moody's rewarded Portugal's economic recovery with a return to investment grade in mid-October. In the wake of the positive news, *Bank+Insurance Hybrid Capital* sought issuer, investor and rating agency views alongside insights from Crédit Agricole CIB on the story behind the upgrade and how it could affect Portuguese banks' issuance in challenging markets.

Neil Day, Bank+Insurance Hybrid Capital (BIHC): Moody's upgraded Portugal to Baa3 on 12 October, citing a broadening of Portugal's growth drivers as a key factor alongside an improvement in the trajectory of government debt. How is Portugal's better economic outlook playing through in the banking sector, which Moody's said shows greater stability?

Bruno Costa, Caixa Geral de Depósitos: The economic performance of Portugal has certainly contributed favourably to the banking system in several ways. On the one hand, new credit concession has increased over the last three years, although in net terms credit growth as a whole is still negative. This is a consequence of the overall deleveraging that has taken place in the Portuguese economy since the Assistance Programme led by the Troika from 2011 to 2014. This also causes banks to be very comfortable in terms of liquidity, which is a positive aspect. The pace of deleveraging is decreasing, so I believe we are close to seeing a turning point in terms of credit growth becoming net positive. Another positive aspect is that the recovery in the real estate market has helped banks dispose of non-performing assets in their balance sheets.

Christine Passieux, BNP Paribas AM: Whilst witnessing positive developments in 2017 — i.e. an increase in profitability and operational efficiency as well as a significant reduction of the stock of non-performing loans — the Portuguese banking system still exhibits some vulnerabilities, with high exposure to the sovereign and the real estate sector, as well as a significant level of non-performing assets. In that context, an upgrade of the Portuguese sovereign to investment grade combined with an improved economic outlook are positive factors which mitigate some of these weaknesses.

Firstly, a sustainable, albeit moderating GDP growth trajectory (BNP Paribas economists expect Portuguese GDP to grow 2.2% in 2018 and 1.8% in 2019) and lower unemployment rate are likely to fuel the demand for new loans, which is still fragile. The October lending survey carried out with five Portuguese banks has showed that whilst the demand for loans to corporates remained broadly unchanged in Q3, the demand for residential mortgage loans has increased, driven by greater consumer confidence, housing market prospects and the low level of interest rates. At the same time, most institutions reported tighter credit standards following the recommendation issued by the Bank of Portugal applicable for July 2018 when assessing the creditworthiness of borrowers. While limiting the risks incurred by the banks, this is also likely to constraint lending volume growth.

Secondly, after declining between 2010 and 2013, house prices in Portugal have recovered since then, helped by the increase in household disposable income, declining unemployment, the boost in tourism, and the rise in investment by non-residents taking advantage of attractive residential properties. This recovery in the real estate market has clearly helped banks decrease their NPL stock and sell-off non-performing assets.

Participants:

- Rui Coimbra, head of investor relations division, Millennium bcp
- Rui Constantino, investor relations, Banco Santander Portugal
- Bruno Costa, head of funding and investor relations, Caixa Geral de Depósitos (CGD)
- Doncho Donchev, capital solutions, DCM, Crédit Agricole CIB (CACIB)
- Joana Guerreiro, head of funding, Banco Santander Portugal
- Vincent Hoarau, head of FI syndicate, CACIB
- Tristan Lagarrigue, head of credit sales – FraBeLux, CACIB
- Christine Passieux, senior financial analyst, BNP Paribas Asset Management
- Rodrigo Torres, country head Portugal, CACIB
- María Vinuela, analyst, financial institutions group, Moody's
- Neil Day, managing editor, Bank+Insurance Hybrid Capital (BIHC), and moderator

Rui Coimbra, Millennium bcp: The Portuguese economy went through a successful fiscal consolidation: the state budget deficit at the end of 2017 stood at 0.9% (excluding the impact of the CGD recapitalisation) and the target included in the 2019 budget points to a 0.2% deficit in 2019, with a surplus forecast for as early as 2021. Also, public debt has been decreasing and moves towards a situation of sustainability, approaching, gradually, 100% of GDP (currently at 124% versus a peak of 130% of GDP in 2014).

Following the 2011-2013 recession, economic activity is now strong, with GDP up by 2.8% in 2017 and projections for GDP growth in 2018 are above 2%. Unemployment has decreased significantly from its peak, and now stands at 7.4% (8.9% full year 2017 figures). The current account has turned positive (0.6% surplus in 2017), following deficits of around 10% for most of the decade up to 2010. The real estate market has also recovered.

The Portuguese banking system is concentrated, with the top five banks accounting for circa 80% of the total market, has a comfortable liquidity and capital position, together with a lower, although still elevated, weight of NPLs. NPL coverage by loan loss reserves is also increasing.

Owing to the continued economic recovery, Moody's upgraded the Portuguese Republic and six Portuguese banks, recognising the improvement in operating conditions for banks in Portugal, notably asset quality and capital.

Banco Santander Portugal: The better economic conditions, manifested in the form of growing exports and investment, are clearly positive for the banking sector. On the one hand, because companies have evolved positively, in terms of activity and profitability, with improving economic and financial indicators and lower delinquencies. On the other hand, because it is being reflected in a recovery of credit demand by the most dynamic industries, which are beginning to show a positive evolution despite the overall decline in the stock of credit.

Rodrigo Torres, Crédit Agricole CIB: The positive momentum of the Portu-

Rodrigo Torres, CACIB

guese economy is indisputable. Even if growth is still below the Eurozone average, the socialist government has kept a focus on reducing the public deficit and bringing public debt to a sustainable downward trajectory. And we cannot forget that when this socialist minority government took office in late 2015, with the support in parliament of left-wing parties, many were sceptical on the outcome of this new political coalition never tested in Portugal before.

Exports, which stood at 25% of GDP before the crisis, are expected to represent 45% of GDP this year. This somehow reflects the structural reforms done by the private sector that is being the motor of the economy. Foreign investment is playing a very important role, with the associated recovery in real estate prices that is helping banks reduce their stock of NPEs faster than expected in their own initial projections.

María Vinuela, Moody's: As a consequence of our decision to upgrade Portugal's government bond rating to Baa3, we also changed Portugal's Macro Profile to Moderate from Moderate- to reflect the more favourable operating conditions for banks in Portugal owing to the continued economic recovery. This assessment of a more favourable operating environment for banks, in combination with ongoing improvements in other credit fundamentals, notably asset quality and capital, resulted in rating upgrades by one to two notches, rating affirmations or rating placements on review for upgrade on 16 October for the six Portuguese banks we rate.

Day, BIHC: What are the key recent developments in your individual business outlook and credit story? How are you dealing with the stock of NPAs?

Costa, CGD: Caixa is now almost two years into the implementation of the strategic plan agreed between the Portuguese authorities and the European Commission. The results have been very positive, in many cases beyond the milestones that had been agreed in terms of capital generation, reduction of structural costs, rationalisation of Caixa's presence abroad, and reduction of non-performing assets. On this topic, Caixa's NPL ratio decreased from 15.8% to 10.5% between December 2016 and June 2018 through a combination of sales, cures, write-offs and cash collections. We just completed the sale of a large portfolio of corporate loans which will bring the ratio below 10%. The target agreed with DG Comp is to reach an NPL ratio below 7% by the end of 2020, but in fact our management has an even more ambitious target to reach below 5% in the same period. We believe these targets are very much achievable and the objective is to bring CGD in line with the average of other European banks by the end of the strategic plan.

'The positive momentum is indisputable'

Banco Santander Portugal: Santander Portugal has a lower stock of NPAs vis-a-vis its peers, in view of its conservative risk profile, which allowed it to have a better performance during the economic recession and adjustment period. Currently, we are managing the NPAs received in the acquisition of Banco Popular Portugal in exactly the same manner as we did with the NPAs acquired from Banif, with timely sales in the market of specific portfolios.

Excluding those sales, Santander Portugal's loan book would be registering a mild increase, especially in terms of loans to non-financial corporates, as we have maintained markets shares of around 20% for new loan origination (both in terms of corporate and mortgage loans).

Coimbra, Millennium bcp: BCP is a reference private sector bank in Portugal, well positioned to benefit from the recovery of the Portuguese economy. It's the largest private sector bank in Portugal in terms of business volumes and generates 34% of the system's core net income (NII + fees and commissions — operating costs that include staff, other administrative costs and depreciation).

Millennium bcp has successfully executed an operational turnaround, reinforcing its financial and capital position despite the adverse setting of the banking sector in the core Portuguese market. This position reflects its relentless efforts and the cumulative effect of multiple achievements, such as a 44% cost reduction in Portugal since 2011. BCP has significantly improved its operational efficiency and is now one of the most efficient banks in Europe, with cost to core income ratio at 49% in the first half of 2018.

Over the last five years there was a continued improvement in domestic NII and NIM, supported by the reduction in cost of funding. NIM stands at 1.8% in Portugal and 2.2% for the group in 1H 18.

BCP has significantly strengthened its deposit base, which now represents 88% of total funding. The loan to deposit ratio stands at 88% as of 1H 18 and sets the conditions for loan growth recovery. BCP presents solid liquidity and funding metrics: 176% LCR ratio, 129% NSFR ratio; and significantly reduced ECB net funding to EUR3.1bn as of 1H 18.

Regarding the stock of NPAs, one should highlight the 57% reduction in group NPEs since 2013 through focused NPE management with a dedicated recovery strategy in Portugal: a EUR6.9bn reduction in NPEs, from EUR12.8bn in

2013 to EUR5.9bn in 1H 18. Simultaneously, there was a significant increase in domestic NPE coverage ratios towards circa 50% (106% including collateral) in 1H 18. BCP is reducing on average EUR1.5bn of NPEs per year through sales, recoveries and write-offs — each accounting for one-third of the reduction. The target is to reach EUR3bn of NPEs by 2021. BCP is also reducing foreclosed assets (-11% in June 2018 y-o-y) through sales, consistently (quarter after quarter) above the book value.

Doncho Donchev, CACIB: As reflected in the comments from the banks, the turnaround achieved by the Portuguese banking system as a whole in the space of 2014 versus now in terms of static indicators — such as CET1 and overall capital ratios, NPL/NPE ratios and coverage, Texas ratios, but also in terms of profitability and operating cost optimisation — is remarkable. It clearly reflects the successful performance of the Portuguese economy over this period — Portugal, together with Ireland and Spain are successful examples showcasing that structural reforms work.

What stands out in this context is in particular is the development of CET1 ratios over this period, with some of the banks included here moving from the lower end of the EU banking community in terms of this ratio to comfortably towards the middle, particularly when adjusted for higher RWA densities relative to, for example, northern Europe.

Day, BIHC: How has your capital position evolved and what are your targets?

Coimbra, Millennium bcp: Over the last years, BCP has been able to strengthen its capital base mainly through continued deleveraging, while selectively tapping the markets to raise capital. In January 2017, BCP increased capital by EUR1.33bn through a successful rights issue. This transaction enabled the bank to repay the remaining EUR700m in contingent convertible securities (CoCos) subscribed by the Portuguese government before the mid-2017 deadline, as well as to boost its solvency levels. More recently, through organic capital generation, BCP has enhanced its CET1 phased-in ratio to 11.7% (1H 18), which compares to a SREP requirement of 8.81%, and its Total Capital phased-in ratio to 13.4%, which compares to a SREP requirement of 12.31%. The revised target according to the bank's strategic plan 2018-2021 consists in achieving and maintaining a CET1 ratio of around 12%.

Joana Guerreiro and Rui Constantino, Banco Santander Portugal

'The system still exhibits some vulnerabilities'

Banco Santander Portugal: We are optimising our capital structure, considering the improved economic outlook, maintaining capital ratios that preserve a comfortable buffer versus the regulatory requirements. Our sound capital position, achieved through organic capital generation, has allowed us to acquire Banco Popular Portugal and maintain an elevated CET1 capital ratio. While we aim to maintain core capital around current levels, total capital will be managed in order to comply with the subordinated MREL requirements.

Costa, CGD: Caixa's capital position has evolved very favourably over the last 18 months. As of June 2018, Caixa's CET1 was 14%, Tier 1 was 15.1%, and Total capital 16.6%, well above the minimum requirements even taking into account the phasing-in of capital buffers over the next years. This compares with 12.1% CET1 and 14.1% total capital in the beginning of 2017, just after the first phases of the recapitalisation. Capital ratios have increased due to the reduction of RWAs as well as due to the organic generation of CET1 via profits. We can expect this trend to continue for the future. Caixa does not have absolute targets for its capital ratios, but given its nature as a public company and the difficulties in allowing states to inject capital in companies due to EU State Aid rules, it is Caixa management's intention to have substantial buffers of capital at all times that will allow it to endure less favourable economic cycles without the need to go back to its shareholder to ask for more capital.

Day, BIHC: Bruno, how did CGD's Tier 2 transaction go and how did it fit into your plans?

Costa, CGD: The Tier 2 transaction was the third and last phase of the recapitalisation plan, after agreeing with DG Comp that we could complete the requirement to access private investors by issuing Tier 2 instead of AT1. The deadline to complete the recapitalisation was September 2018 (18 months after the capital injection by the state, which took place in March 2017), but given the


Rui Coimbra, Millennium bcp

volatility in the market caused by the political situation in Italy, we thought it would be wiser to anticipate the issue. We found a window in late June which, despite not being ideal, still allowed for a successful transaction very well received by the investor community.

Vincent Hoarau, CACIB: Caixa Geral's Tier 2 was a landmark trade printed in choppy markets. We were very happy to contribute to resolving the situation and reinvigorating the funding franchise in primary. The funding team and dealers demonstrated that the signature is a very credible alternative for international bonds investors.

Back in June, a level of 5.75% for the quality distribution we enjoyed was definitely an excellent result for Caixa Geral. This Tier 2 was in the pipeline for quite some time and the market window imposed was quite challenging at the end of June when we proceeded. You could still feel the scars of the violent mark to market moves and negative returns investors suffered throughout H1. Generally speaking, the volatile markets of 2018 have made the sale of subordinated debt much harder, with a lot of execution risks associated with any subordinated trade.

CGD Tier 2 is now trading well above par in early November, just shy of a 104% cash price. It has tightened by more than 75bp versus swaps since it was launched in June. Everyone should really be very happy.

Day, BIHC: What can you tell us about your issuance plans going forward, particulary with regard to any capital/subordinated activity?

Coimbra, Millennium bcp: BCP currently holds a very strong liquidity position, not having any relevant wholesale funding needs to support its core operating requirements, given that it has a loan to deposit ratio below 100%.

Recently, the bank has been notified by the Bank of Portugal of the Single Resolution Board's decision regarding the MREL for the resolution group headed by BCP, at a sub-consolidated level, which includes the operations based in Portugal, Switzerland and Cayman, and excludes the ones based in Mozambique and Poland. The MREL requirement has been set at 14.46% of the total liabilities and own funds of the Resolution Group, as of 30 June 2017 (with the prudential requirements as of 1 January 2017), which is equivalent to 26.61% of such Resolution Group´s risk-weighted assets. Moreover, the bank has been informed that the MREL requirement needs to be met by 1 July 2022.

> **'You could still feel the scars of the violent moves'**

Additionally, in the same medium term horizon, BCP will continue to manage the composition of its capital buffers, issuing subordinated instruments to fill the applicable regulatory buckets to optimise the cost efficiency of its total buffer of own funds.

Costa, CGD: Given Caixa's very comfortable liquidity situation at the moment, any plans for future issuance will be driven exclusively by regulatory requirements. Having completed the recapitalisation, the next regulatory requirement will be MREL. We still need to hear from the SRB what will be the specific requirements for Caixa and how much time we will have to implement it. On the other hand, we also need the government in Portugal to prepare the necessary legislation that will allow us to issue senior non-preferred bonds. We don't expect to have a very significant shortfall to cover, given that the bank's RWAs will decrease further and our capital ratios will rise accordingly. In any case, we are ready to adjust our funding and capital plan in order to accommodate all the requirements we are asked to comply with over the next few years.

Donchev, CACIB: Portugal is part of the Banking Union within the EU and as such Portuguese banks are subject to the standard SRB MREL-setting methodology, which is now well understood by markets. We at CACIB expect that all Portuguese banks will receive their MREL requirements in the course of 2019 — as mentioned by Miguel, BCP recently disclosed that the SRB has determined a MREL target at the sub-consolidated level.

One particular point to note is that in our view, Portuguese banks' funding over the next one to two years is likely to be driven exclusively by prudential and MREL requirements as the banks have excess liquidity and funding via predominantly deposits and as such do not need to tap wholesale funding markets (not even for TLTRO refinancing). Hence, the public appearance of Portuguese banks in the market should benefit to some degree from rarity value.

Regarding the adoption of the Portuguese senior non-preferred law, we ex-

Christine Passieux, BNPP AM

pect Portugal to adhere to the deadline set by the EU Bank Creditor Hierarchy Directive, which mandates that all EU member states must have senior non-preferred debt introduced in national legislation by the end of 2018.

Day, BIHC: The improvement in the Portuguese situation comes while there are increasing political risks in some parts of Europe and greater episodes of volatility in financial markets. What arguments can Portuguese banks make to be positively differentiated in this more adverse environment?

Vinuela, Moody's: The funding and liquidity position of Portuguese banks stabilised in 2017 and 2018, aided by balance sheet deleveraging, while their deposit funding remained stable. As a consequence, banks have been able to reduce their loan-to-deposit ratios from the very high levels seen in 2012. We do not see funding as a constraint at the moment. Portugal's large banks have been able to raise debt in the capital markets, and their refinancing needs are limited.

Portuguese banks have around EUR20bn of exposure to the ECB's Targeted Longer Term Refinancing Operations (TLTROs), which we expect them to gradually repay between June 2020 and March 2021. The sector's TLTRO funding has declined considerably from its 2012 peak of EUR61bn. It now accounts for around 5% of Portuguese banks' assets, below the level of other European systems such as Italy and Spain.

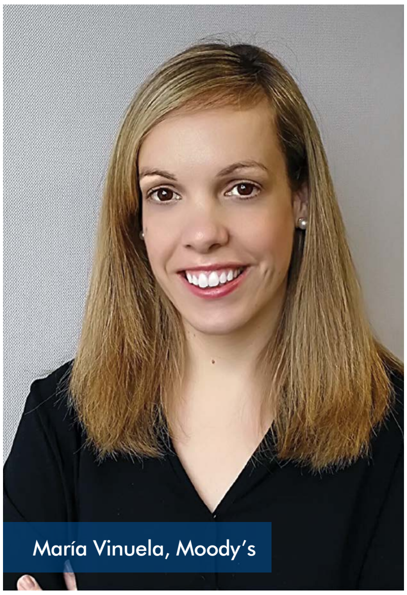
However, we note that Portugal is more susceptible than larger European banking systems to a market shock, as yields on Portuguese banking debt are more sensitive to changes in market sentiment. In addition, the introduction of the EU's Minimum Requirement for Own Funds and Eligible Liabilities (MREL) rule, under which banks must hold minimum volumes of loss-absorbing capital, will force Portuguese banks to issue eligible financial instruments. A continued improvement of Portuguese banks' financial fundamentals will be key to ensuring that they retain affordable access to the capital markets.

Banco Santander Portugal: The Portuguese financial system is well advanced in its restructuring process, even though there are differences between entities. The gains obtained in terms of sounder capital and lower NPL ratios, within the context of a more balanced economy, clearly should contribute to a better risk perception by outside observers.

'They are far better positioned than 5 years ago'

Passieux, BNP Paribas AM: On the political front, the ruling socialist party, in power since the end of 2015, does not have a majority in parliament, and relies on the support of several smaller left-leaning parties. The government has nevertheless successfully pursued a consolidation policy, which, coupled with the gearing effects of growth, has helped improve public finances to the satisfaction of the European Commission. Despite political challenges, over the past two years, the government has successfully retained the broad support of its parliamentary alliance.

While Portuguese banks do have substantial exposure to government bonds (in line with most EU banks) the largest part is domestic and their exposure outside Portugal is largely focused in international markets where Portuguese banks have been present historically (Angola, Mozambique, Macau). Exposure to Italy is not significant and, in contrast to 2011, the spillover effect from the crisis in Italy has, so far, been limited. Investors are clearly more confident about the economic trajectory of the country and the improvement in its public finances. As a result, Portuguese sovereign bonds have outperformed in 2018. Looking back to 2011, one of the key concerns that investors had about Portugal was the deadly loop between the sovereign and the banking system, each requiring the other to bail it out, resulting in a rescue package from the EU. Today, Portuguese banks, with restored capital and lower reliance on central bank funding, are benefitting from a stronger Portuguese economy and while risks remain, they are far better positioned than five years ago.



María Vinuela, Moody's

Costa, CGD: Portuguese banks went through periods of great volatility and uncertainty during the years of the Assistance Programme and learned valuable lessons. These days, Portuguese banks are better capitalised, have plenty of access to liquidity, and are taking advantage of the favourable economic environment to reduce non-performing exposures and clean up their balance sheets. Profitability may still be a challenge given the very low levels of in-


Bruno Costa, CGD

terest rates, but I'm confident the Portuguese banking system will continue to show great resilience even if market conditions worsen in the near future.

Tristan Lagarrigue, CACIB: French investors are extremely diligent and sensitive to timing, and unfortunately the ongoing noise and fluid geopolitical situations that were influencing global markets when CGD surfaced discouraged some French investors from investing in Portuguese assets. This is what everyone could read anyway when looking at the distribution statistics. Nevertheless, the overall sentiment towards the jurisdiction has been very positive for quite some time now. Our domestic investor base likes the credit story and appreciates the positive rating trajectories and evolution of the capital metrics over the last 15 months. And most of our clients have already reopened lines on Portuguese credits. I am very optimistic with regards to the expansion of Portuguese banks towards the French investor base, but also in other regions on the continent. They offer strong RV, and investors find in Portuguese assets valuable instruments to play the convergence and compression trade.

CGD's outperformance in Tier 2 proved many around us wrong. CGD's funding management made this transaction a success in spite of the mixed record in the country, with some resolution processes in the past, and paves the way for a return in force of Portuguese issuers in primary in 2019. Needless to say, what is valid for Portuguese financial borrowers — also including Santander Portugal and Millennium bcp — is also valid for corporate issuers. And in that respect, EDP's recent successes also delivered evidence of the very good shape of the jurisdiction. EDP is another credit that is very well received by French investors.

Coimbra, Millennium bcp: The increase in sovereign risk, which has escalated in the last three months, is related, more recently, to the issue of the Italian Budget for 2019 and has resulted in Moody's recent downgrade of the sovereign and Italian banks' ratings. This generates volatility in financial markets and has also some side effects on BCP shares given Portugal's dependence on the European project.

What differentiates Portugal from some other European countries is a stable overall political environment, with no significant social unrest. Portugal is ruled by a centre left-wing coalition government that is entering the last year of its term of office. During this time the political mood was relatively calm. There was not much difficulty in approving the annual budgets in the Parliament and the social and labour environment was smooth, without signs of major protest movements. All the rating agencies recognise the enormous progress in fiscal consolidation and the reduction of the public debt burden. Portuguese public debt spreads have also moved in the right direction.

> **'The political mood has been relatively calm'**

Portuguese banks are set to benefit from the economic recovery, volume growth in the coming years, decreases in loan delinquencies, and future increases in interest rates in Europe.

Meanwhile, BCP is improving its asset-risk indicators and steadily increasing its organic capital generation, as lower cost of risk levels are reflected in an improving domestic bottom line. One should also highlight the lower reliance on wholesale funding and its modest refinancing requirements as a result of its recent and successful balance sheet restructuring and deleveraging effort.


Tristan Lagarrigue, CACIB

Hoarau, CACIB: In early November credit and equities have shown more resilience, but investors continue to sell into any strength, willing to offload positions and reduce balance sheet with year-end looming. In the secondary market, high beta names are being marked better — but you still need to be aggressive to hit the bid if you are trying to sell. There is no structural appetite for higher beta risk assets at present and liquidity in the subordinated space is very limited, regardless of the jurisdiction and risk profile of the signature you consider.

However, Portuguese names are doing relatively well. High beta southern European credits are more exposed to spikes in volatility, but Portuguese names have in general outperformed their peers. The rating trajectory of the Portuguese sovereign and the ongoing improvement in the banking sector continue to deliver elements of comfort to opportunistic credit investors, even if the high level picture shows a very nervous market. ●

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