3. The Portuguese banking system: relief at the DBRS rating

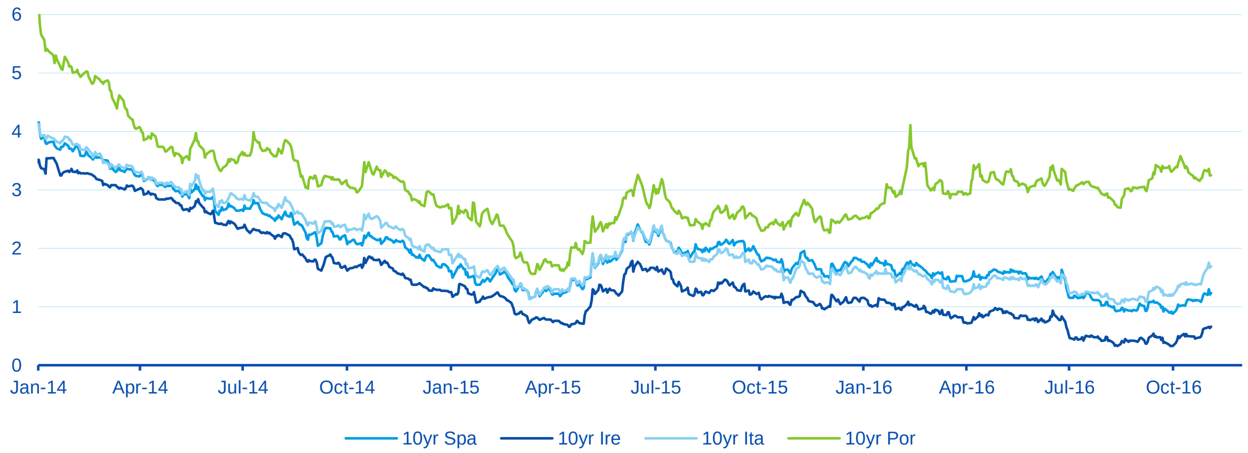
DBRS has confirmed that Portuguese debt has not been downgraded to junk bond status

On 21 October, DBRS announced that it would not be reducing the rating of Portuguese debt to "speculative grade", the only major agency not to do so. This is of great importance, as the state of Portuguese banking depends to a large extent on its sovereign debt not simultaneously being rated as speculative grade by the four leading rating agencies – DBRS, Fitch, Moody's and S&P.

This is essential if Portuguese banks are to continue to use their sovereign debt as collateral in ECB refinancing operations, allowing them to remain in the Public Sector Purchase Programme and ensure there is no significant upward pressure on the yield offered by Portuguese debt. As can be seen in Figure 1, over recent months the performance of 10-year sovereign debt has been worse in Portugal in comparison to Spain, Italy and Ireland. There are no signs of contagion, which may suggest that markets can distinguish more easily between the situation in countries in episodes that occurred before the financial crisis.

Figure 1

Yield on 10-year sovereign bonds (%) (%)



Source: BBVA Research based on Bloomberg

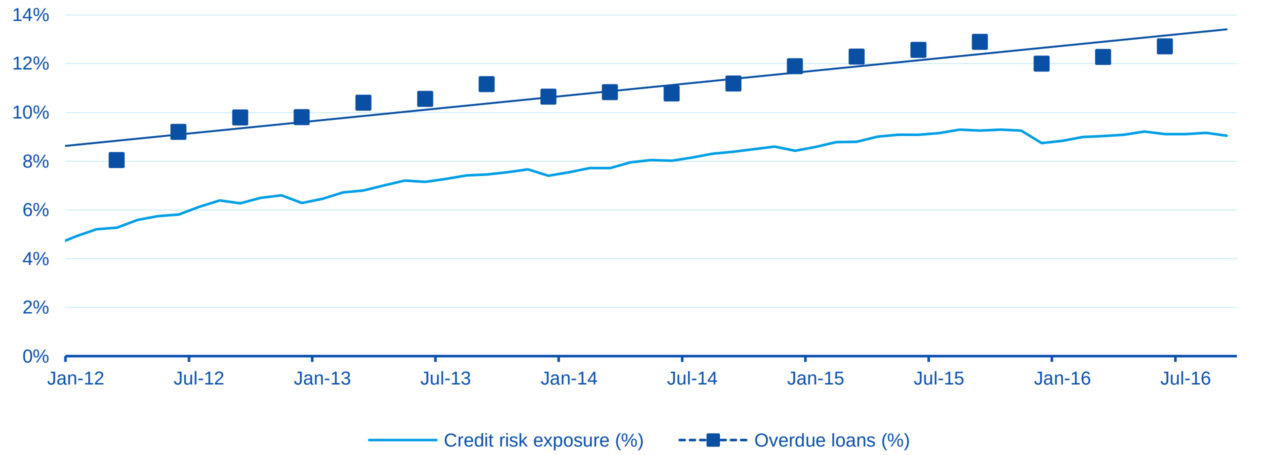
The situation in which Portuguese banks find themselves is yet to stabilise and is dependent on how the country's economy performs

Confidence in institutions and the implementation of new structural reforms are essential in order to strengthen a banking system:

- **One of the most concentrated in the Eurozone.** At the end of 2015, Portugal's banking system was still very concentrated in comparison to other major European systems. The market quota of the five largest banks is 69.6% (vs. 60.2% in Spain). There are areas of uncertainty inherited from the financial crisis, such as the consolidation of the banking system which has yet to be resolved, the state-rescued Novo Banco is looking for a buyer, there has been a takeover bid from BPI and Banif has just been sold.
- **This may go further than just capacity adjustments.** According to the ECB, between 2012 and 2015, the number of employees shrank by 8% (compared to shrinkage of 16% in Spain and 19% in Greece), while the number of branches dropped by 11% (-18% in Spain and -30% in Greece). Adjustment is not therefore particularly intense.
- **The private credit sector continues to contract** (down 3% YoY, Oct 16), **although private sector deposits are recovering slowly** (up 3% YoY, Oct 16). Eurosystem financing stands at €23.5 billion (down 1% YoY, Oct 16), a figure which is much lower than the more than €50 billion in 2012 during the implementation of the measures agreed upon with the rescue programme.
- **Worsening efficiency.** The cost-to-income ratio has increased since its low point in early 2015 (51%) to 63% the second quarter of 2016. Despite the reduction in operating costs, the fall has been greater on the revenue side. This contrasts with the figures for banks in Spain (51%) and Greece (52%), although it is better than in Italian and French banks (68%) or banks in Germany (71%).
- **Low yield.** According to the Bank of Portugal, the domestic ROE for the first six months of 2016 stood at 0.3% YoY (compared to 6.3% in the first half of 2015). Similar, the ROA was 0% YoY (compared to 0.5% for the same period the previous year). This lower yield is due in part to poorer financial transaction results and the exceptional figures for the first six months of 2015. Portuguese banks also have ongoing foreign operations, above all in Angola, which have improved their profitability.
- **The lower quality of assets is also yet to be resolved.** Since early 2012 there has been a progressive deterioration in credit quality (see Figure 2), something which is evident in the monthly delinquent loan rate, calculated based on the definition of due loans (9.1% in 2Q 2016) and the quarterly ratio based on credit risk exposure (12.7% in 2Q 2016), with a stricter classification, although one which is more comparable with other European figures.
- **Concerns over solvency.** The consolidated CET1 ratio continues to fall to 11.6% (2Q 2016). Its institutions have not been subject to the European stress test made public in late July, leading to speculation. Caixa Geral, Portugal's biggest deposit-taking institution, has just had a further recapitalisation approved.

Figure 2

Non-performing loans – (overdue loans and credit risk exposure) / total gross credit (%)



Source: BBVA Research based on Banco de Portugal

In short, although it is good news that DBRS has not downgraded Portugal's credit rating, the situation its banks are experiencing is some way off being described as sound and new measures will be required in the future.

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