2. Portuguese banks in melancholy mood

Liquidity heavily dependent on the decision of DBRS

Since the beginning of the Economic Assistance Programme in June 2012, when recourse to the ECB reached its peak of €60 billion, Portuguese banks have reduced their reliance to around €25 billion in the first few months of 2017. This level (3.0% of the total of the Eurosystem) is way above the Portuguese central bank's capital key of 1.7%, but has improved appreciably since the worst moments of the crisis (10% of the total of the Eurosystem). In Portugal, short-term transactions (MROs) account for nearly 6% of ECB financing (almost negligible in Spain), and the banks used the last TLTRO II auction to replace this short-term financing with longer-term and cheaper funding.

With this measure the uncertainty about the sovereign debt rating is partly dispelled: **DBRS is the only rating agency to maintain Portugal's long-term sovereign debt at investment grade**, a decision which it confirmed on 21 April. If the rating had been downgraded, the liquidity obtained with Portuguese sovereign debt as collateral would have had to be replaced by ELA, (emergency liquidity assistance), which would have increased financing costs and impaired the banks' reputations. A rating downgrade by DBRS would also have affected purchases of public debt under the Public Sector Purchase Programme (PSPP), since the ECB would have stopped buying Portuguese public debt. In the past few months the rate of purchases of Portuguese debt has slowed due to their being close to the ECB's 33% limit on holdings of a single issuer.

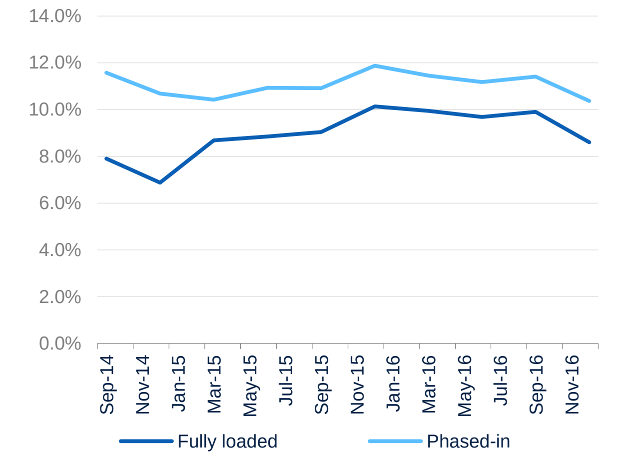
Additionally, the banking system in aggregate has had a loan-to-deposits ratio of less than 90% since the end of 2016, due to substantial deleveraging (since mid-2012 credit has declined at 5.3% year-on-year) and the increase in deposits since the end of 2015. Lastly, according to EBA data[2], the Liquidity Coverage Ratio (LCR) of Portugal's banking system in December 2016, at 146.4%, was similar to that of Spain (147.9%) or the UK (146.5%) and above the average for the European Union (141.1%).

Solvency

According to the EBA, the Portuguese and Italian financial systems are those with the lowest CET1 phase-in ratios (10.4% at the end of 2016), and Portugal's fully-loaded CET1 is the lowest (8.6%). Both ratios fell significantly during 2016: by 151 and 153 bps respectively. Much of this adjustment was concentrated in the last quarter of 2016, due to a number of corporate transactions and very adverse results, affected by low interest rates and higher provisioning. During the first quarter of 2017 there were some corporate movements which increased the amount of capital in banks' balance sheets. This weak solvency situation is partly caused by a higher density of risk-weighted assets than that of other countries in the region. Thus solvency measured by the fully-loaded leverage ratio is similar to Spain's and better than the European average.

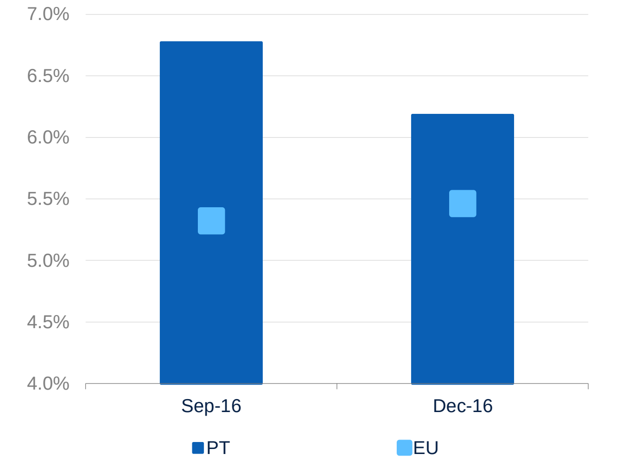
2: All EBA data used in this report are from the latest publication of the Risk Dashboard (4Q2016).

Figure 1 Common Equity Tier 1, CET1 (%)



Source: BBVA Research and EBA

Figure 2 Fully-loaded leverage ratio (%)



Source: BBVA Research and EBA

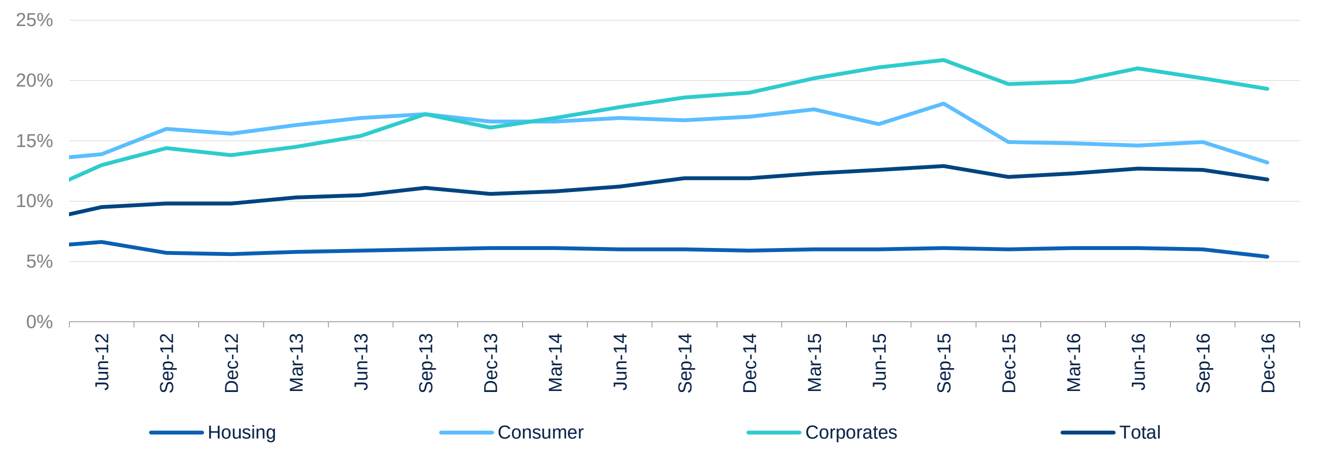
Lending and credit quality

Since 2012 lending to the resident private sector has fallen at an average year-on-year rate of more than 5%, and shows no signs of recovery. Deleveraging is concentrated in lending to businesses and loans to households for home purchase, whereas lending to households for other purposes (consumer and other) has shown year-on-year growth of more than 10% since October of last year. The decline in lending for home purchase and the adjustment in interest rates have notably lightened Portuguese households' financial burden, from an aggregate peak of 14.4% of gross disposable income (GDI) in 2009 to 8.8% in December 2016.

Since 2011 all the credit quality indicators[3] of Portuguese banks have deteriorated. For example "credit at risk" (*crédito em risco*) increased in the first two quarters of 2016, holding steady in the third and falling in the fourth quarter to 11.8%, in line with the levels of one year earlier. The fall in the last quarter of last year was generalised across all portfolios (Figure 3). Coverage has improved since mid-2012, going from 50.5% in June 2012 to 69.0% at the end of 2016, following a fourth quarter (+320 bps) heavily influenced by the restructuring of Caixa Geral. According to the latest data published by the EBA, among EU countries Portugal has the third biggest accumulated impaired exposure in its banks' balance sheets (16.4%), just ahead of Italy with 12.6%, and far ahead of Spain with 4.9%. Despite this, it still has a comparable coverage ratio (43.6%), similar to Spain's (43.7%) and slightly below the European average of 44.6%.

3: Portugal's central bank replaced the past-due credit metric with "credit at risk", which is a broader concept and includes a stricter definition of refinanced assets. Furthermore, the EBA publishes the NPL ratio with the comparable supervisory definition at consolidated level.

Figure 3 NPL ratio by portfolios (*crédito em risco*, %)



Source: BBVA Research and Banco de Portugal

Profitability

Portuguese banks' profitability remains badly impaired as a combined result of a number of factors which have persisted for several years: 1) a depressed level of lending activity; 2) an environment of low interest rates; 3) badly impaired credit quality and 4) heavy provisioning. The deterioration in profitability is confirmed by Banco de Portugal data: ROE for 2016 turned negative again (-8.0%), following what had seemed like a recovery in 2015.

Part of the deterioration seen in profitability on the domestic front is offset by the consolidated groups' international activity. Since 2007 international activity has contributed on average 24% of net interest revenue and total revenues.

In the next few quarters, part of the improvement in profitability will have to come from further adjustment of installed capacity. Taking the Spanish case as an example, efforts must concentrate on personnel expenses, where there should be a margin for reducing the number of employees by a further 13%, compared with the 16% achieved in the past eight years, which will lead to improved efficiency of the system.

All in all, the Portuguese banking systems has not recovered yet from the crisis and faces a gloomy future. In this sense, banks must make additional efforts to clean-up and restructure in order to be prepared to support economic growth.

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Este informe ha sido elaborado por la unidad de Sistemas Financieros

Economista Jefe de Sistemas Financieros y Regulación
Santiago Fernández de Lis
sfernandezdelis@bbva.com

Con la colaboración de:

Ana Rubio
arubiog@bbva.com

Jaime Zurita
jaime.zurita@bbva.com

Cristina Deblas
cristina.deblas@bbva.com

Macarena Ruesta
esperanza.ruesta@bbva.com

Cristina Plata
cristinateresa.plata@bbva.com

José Félix Izquierdo
jfelix.izquierd@bbva.com

Javier Villar
javier.villar@bbva.com

BBVA Research

Economista Jefe Grupo BBVA
Jorge Sicilia Serrano

Análisis Macroeconómico
Rafael Doménech
r.domenech@bbva.com

Escenarios Económicos Globales
Miguel Jiménez
mjimenezg@bbva.com

Mercados Financieros Globales
Sonsoles Castillo
s.castillo@bbva.com

Modelización y Análisis de Largo Plazo Global
Julián Cubero
juan.cubero@bbva.com

Innovación y Procesos
Oscar de las Peñas
oscar.delaspenas@bbva.com

Sistemas Financieros y Regulación
Santiago Fernández de Lis
sfernandezdelis@bbva.com

Coordinación entre Países
Olga Cerqueira
olga.gouveia@bbva.com

Regulación Digital
Álvaro Martín
alvaro.martin@bbva.com

Regulación
María Abascal
maria.abascal@bbva.com

Sistemas Financieros
Ana Rubio
arubiog@bbva.com

Inclusión Financiera
David Tuesta
david.tuesta@bbva.com

España y Portugal
Miguel Cardoso
miguel.cardoso@bbva.com

Estados Unidos
Nathaniel Karp
Nathaniel.Karp@bbva.com

México
Carlos Serrano
carlos.serranoh@bbva.com

Oriente Medio, Asia y Geopolítica
Álvaro Ortiz
alvaro.ortiz@bbva.com

Turquía
Álvaro Ortiz
alvaro.ortiz@bbva.com

Asia
Le Xia
le.xia@bbva.com

América del Sur
Juan Manuel Ruiz
juan.ruiz@bbva.com

Argentina
Gloria Sorensen
gsorensen@bbva.com

Chile
Jorge Selaive
jselaive@bbva.com

Colombia
Juana Téllez
juana.tellez@bbva.com

Perú
Hugo Perea
hperea@bbva.com

Venezuela
Julio Pineda
juliocesar.pineda@bbva.com

INTERESADOS DIRIGIRSE A: BBVA Research: Calle Azul, 4. Edificio de la Vela - 4ª y 5ª plantas. 28050 Madrid (España). Tel.:+34 91 374 60 00 y +34 91 537 70 00 / Fax:+34 91 374 30 25 - bbvaresearch@bbva.com www.bbvaresearch.com