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Clarity on Novo Banco Capital Injections Could Help Portuguese Banks

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Fitch Ratings-Paris / London-07 January 2021: Clarity on the timing of any fresh capital injection for Novo Banco S.A. could improve the backdrop for Portuguese banks' funding and capital raising plans in 2021, Fitch Ratings says. We expect a capital injection if one is required, but prolonged uncertainty would damage investor sentiment towards the sector.

Novo Banco is the 'good bank' which took over some assets and liabilities from Banco Espirito Santo, S.A. after its 2014 collapse. In 2017, US private equity firm Lone Star acquired a 75% stake in Novo Banco, while Portugal's Resolution Fund retained 25%. The Resolution Fund provides additional capital if Novo Banco's drops below minimum levels, set with reference to the performance of certain designated assets, and other conditions are met under a Contingent Capital Agreement (CCA) approved by the European Commission.

Whether a capital injection under the CCA is needed in 2021 depends on Novo Banco's 2020 results, which have yet to be published. The CCA allows capital injections totalling EUR3.89 billion, of which nearly EUR3 billion has already been provided, most recently in May 2020 when the Resolution Fund injected EUR1.035 billion (about 0.5% of GDP). But in late November, opposition parties blocked the inclusion of a further potential EUR476.6 million capital injection in the 2021 state budget.

The Finance Minister and Prime Minister have said that the Portuguese authorities will meet their commitments under the CCA, underpinning our assumption that additional capital would be provided if needed. However, opposition parties have become more vocal in questioning the cost of Novo Banco support and a perceived lack of parliamentary scrutiny.

The minority government's failure to secure parliamentary approval for the potential capital injection in the state budget, and parliament's request that the Court of Audit review Novo Banco's losses that necessitated capital injections under the CCA since 2018, could lead to significant political and legal uncertainty. Rui Rio of the opposition Social Democrats has said his party would support an injection, subject to the outcome of Court of Audit's review. Novo Banco's management and Lone Star strongly dispute claims by some politicians that non-performing asset sales may have been structured to benefit Lone Star.

Uncertainty could persist for some months, at least until the Court of Audit reports and parliament examines its conclusions. The government could try and inject capital without parliamentary approval, using funds set aside in the 2021 state budget for unexpected expenses, but this would be politically controversial. It could include a capital transfer in a supplementary budget, but this would require parliamentary approval. It is unclear if Lone Star would take legal action if it believed the authorities were in breach of the CCA.

Persistent uncertainty around such issues could weaken investor sentiment towards Portuguese banks, especially if investors questioned the authorities' ability to abide by the CCA. Any increase in funding costs would erode the sector's profitability, which is already weak through lack of business diversification, high reliance on interest income, and strong domestic competition. We expect operating profit/risk-weighted assets for Fitch-rated Portuguese banks to drop from about 1.2% in 2020 to 0.9% in 2021, with the weakest banks being loss-making in both years.

Operating Profitability

%

Op. ROAE 1H20 (LHS) Op. profit/RWAs 1H20 (RHS) Op. ROAE avg. 2015-2019 (LHS)
Op. profit/RWAs avg. 2015-2019 (RHS)

Note: ROAE = return on average equity. RWAs = risk-weighted assets. BCP = Banco Commercial Portugues, CGD = Caixa Geral de D
Source: Fitch Ratings, banks

The sector also faces potentially costly issuance of minimum requirements for own funds and eligible liabilities (MREL) resuming in 2021-2022 ahead of intermediary compliance dates. The Single Resolution Board recently estimated that Portuguese banks had an MREL shortfall of EUR10.7 billion at end-1H20, or 9.1% of their total risk exposure. EUR2.4 billion of this was in subordinated liabilities, which would be costlier to issue. Some banks have limited access to unsecured wholesale funding markets.

Extra funding for regulatory purposes will exacerbate profitability challenges, although banks may get extra time to meet MREL targets.

Capitalisation and Leverage

% at end-September 2020*

CET1 ratio (LHS) Total capital ratio (LHS) CET1 SREP requirement (LHS) Leverage ratio (RHS)

Note: BCP = Banco Commercial Portugues, CGD = Caixa Geral de Depositos. CET1 SREP includes the Capital Conservation Buffer
Source: Fitch Ratings, banks

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