FITCH WIRE

Portugal Makes Progress on Legacy Banking Problems

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Fitch Ratings-London-11 April 2017: Portugal's efforts to address the legacy problems in the country's banking sector continue to make gradual progress, Fitch Ratings says. The sale of Novo Banco would help clarify sovereign exposure to the sector if it is completed as planned, and follows the recapitalisation of Caixa Geral de Depositos (CGD).

But the outcome of current initiatives to address high non-performing loans remains unclear, and further costs to the sovereign or the banking sector cannot be ruled out.

State-owned CGD issued EUR500 million of additional Tier 1 capital notes last month, allowing for a planned EUR2.5 billion capital increase by the state. This restored capital buffers as outlined in the bank's 2017-2020 strategic plan and was factored into our affirmation of CGD's ratings on 16 March.

The government raised funds for the recapitalisation of CGD last year and this is reflected in our debt figures for 2016. Our 2017 deficit forecast of 2.9% of GDP includes 1.1% of GDP from the CGD transaction. We rate Portugal 'BB+'/Stable.

The Portuguese government also announced an agreement with US private equity firm Lone Star regarding Novo Banco, the bridge bank that took over some assets and liabilities from the collapsed Banco Espirito Santo in 2014. Lone Star will inject EUR1 billion of capital in return for a 75% stake. Portugal's Resolution Fund will retain 25%. The Fund injected EUR4.9 billion capital into Novo Banco, of which EUR3.9 billion was covered by government loans and the remainder mostly by loans from Portuguese banks.

The Lone Star deal means that sale proceeds will not be enough for the Resolution Fund to repay these loans. This is confirmed by the government's decision to extend the maturities on its loans to the Resolution Fund to 2046. We already anticipated that the gap between

the capital injected and the sale price will be covered by Portuguese banks' contributions and that these would be spread over many years to avoid damaging their profitability further.

We did not include possible positive stock-flow adjustments from planned disposals of bank assets in our sovereign debt forecasts due to uncertainty over their size and timing.

The latest developments are broadly positive. CGD is in a better position to improve profitability, and a successful sale of Novo Banco could improve investor sentiment toward the banking sector. However, the Novo Banco agreement is subject to execution risk. It requires approval by the EU authorities and the raising of EUR500 million of common equity tier 1 from a voluntary liability management exercise, the details of which are still being discussed.

Moreover, the Portuguese government has said that the Resolution Fund may need to provide additional capital if Novo Banco's capital levels drop below regulatory minimums due to the performance of designated assets held in a "side bank". The Resolution Fund's contribution would be capped at EUR850 million annually. If the Fund did not have access to sufficient funds, the government might provide it with liquidity via a new loan or guarantee, which would potentially would have an impact on fiscal accounts.

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