Portugal
Special Report

Major Portuguese Banks: Semi-Annual Review and Outlook

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Related Research

Applicable Criteria

- *Global Financial Institutions Rating Criteria (December 2009)*

Other Research

- *Fitch Downgrades Portugal to 'AA-'; Outlook Negative (March 2010)*
- *Portugal (March 2010)*

Summary

2009 was a challenging year for Portuguese banks, due to the economic recession across most of Europe. The Portuguese economy has not been immune to this economic downturn and for most of 2009 Portugal reported a contraction in GDP, reaching −2.7% by the year-end.

The five leading Portuguese banks[1] suffered a general decline in profitability and asset quality, from both their domestic and international activities, although they proved to be more resilient than many of their international peers. Indeed, in terms of net income, BES, Santander Totta and Banco BPI reported higher net income for 2009 than for 2008, although this did include large capital gains from financial operations and the sale of different assets. CGD's net income declined significantly in 2009 (down by nearly 40%), due to the impact of lower interest rates on net interest revenue, while Millennium bcp's net income remained flat — mostly attributable to lower revenues from its international operations, particularly from Poland. Asset quality for the major Portuguese banks remained healthy in 2009, unlike the position in some other countries, although it did weaken somewhat, reflecting the economic environment. Capital ratios improved in 2009 and the Portuguese banks continued to tap the capital markets for funding, although at higher costs and generally shorter maturities.

Outlook

Fitch Ratings expects the leading Portuguese banks to be able to cope reasonably well with the challenging 2010 and maintain at least the same levels of profitability as in 2009. Fitch believes that margins for the larger Portuguese banks are expected to remain relatively stable compared to those of 2009, as they will benefit from increasing lending spreads, although this will also depend on interest rates remaining unchanged. Although domestic business growth is expected to be modest, due to low economic growth in Portugal, this is likely to be partially offset by improving contributions from the Portuguese banks' international operations, which should benefit from those countries' economic expansion, from Angola in particular. Costs are expected to remain under control and levels of commission income and revenues from insurance operations should also benefit from improved financial market stability and a focus on cross-selling.

However, the agency thinks that the banks' performance in 2010 will be highly dependent on the extent of any economic recovery in Portugal. Performance will also be affected by any adverse reaction in the capital markets reflecting concerns over the Portuguese government's fiscal position. This would increase wholesale funding costs for the Portuguese banks and make access to the capital markets to obtain funding more difficult. The banks' profitability in 2010 will also depend on any deterioration in the economies of the other main countries in which they operate, such as Poland, Angola and Brazil, although this seems less likely. The leading Portuguese banks have some reliance on gains from financial operations and therefore the performance of the financial markets will be key in determining the banks' profits. While Fitch expects asset quality to deteriorate in 2010, as economic

[1] Caixa Geral de Depósitos (CGD; rated 'AA-; Negative Outlook'), Banco Comercial Português (Millennium bcp; rated 'A+; Negative Outlook'), Banco Espírito Santo (BES; rated 'A+; Negative Outlook'), Santander Totta SGPS (Santander Totta; rated 'AA; Stable Outlook') and Banco BPI (rated 'A+; Negative Outlook')

conditions in Portugal are likely to remain subdued, it also believes that the deterioration should be manageable and that loan impairment charges will remain at a similar level to 2009.

The Portuguese Economy

Fitch's current projections for the Portuguese economy in 2010 suggest slight growth in GDP of 0.5%, and unemployment rising slightly to 10%.

On 24 March 2010, Fitch downgraded the Republic of Portugal's Sovereign Long-Term Foreign- and Local-Currency IDRs to 'AA−' from 'AA', and maintained the Negative Outlook (for further information see the Rating Action Commentary, via the link in the *Related Research* section on page 1). The rating action reflected Fitch's concerns about the potential impact of the global economic crisis on Portugal's public finances over the medium term, given the country's existing structural weaknesses, significant budgetary underperformance in 2009, high indebtedness across all sectors of the economy and short track record of fiscal consolidation.

Millennium bcp's, CGD's, BES's and Banco BPI's Individual Ratings were downgraded to 'B/C' from 'B' between 2008 and 2009, reflecting concerns over the banks' performance amid the deteriorating operating environment. In August 2009, the Outlook on Banco BPI's Long-Term IDR was changed to Negative from Stable to reflect concerns regarding the bank's deteriorating profitability in Portugal and high reliance on earnings from its Angolan subsidiary. Following the downgrade of the Republic of Portugal on 24 March 2010, CGD's Long-Term IDR was downgraded to 'A+' from 'AA−', with Negative Outlook, and its Short-Term IDR to 'F1' from 'F1+'. On 29 March 2010, Fitch maintained Banco BPI's Long-Term IDR on Negative Outlook and revised the Outlook on both Millennium bcp and BES to Negative from Stable to reflect Fitch's concerns about the Portuguese government's fiscal position, which is likely to mean that the operating environment in Portugal will remain challenging in the medium term.

Profitability

The major Portuguese banks' operating profitability remained under pressure in 2009 mainly due to loan impairment charges and a narrowing — in most cases a significant one — of the net interest margin (NIM). Contributions from international operations suffered from lower revenues, reflecting the difficult global economic environment. The decline at operating level was more noticeable for Millennium bcp and CGD. The only large Portuguese bank to report a significant improvement in operating profitability was BES, although operating profit benefited from an increased contribution from its trading and derivatives portfolio (EUR285m).

Unlike many of their international peers, in 2009, the Portuguese banks (except Santander Totta) continued to expand their lending (albeit at lower levels than in the past), and management made greater efforts to widen corporate spreads. However, overall margins narrowed, as this was not sufficient to compensate for the negative impact of the repricing of loans at lower interest rates and for the higher funding costs, particularly from increased competition for deposits and from wholesale funding, as the banks continued to access the capital markets but typically at higher spreads. Of the five largest banks, CGD was by far the most affected by narrowing margins, as it is also the one with the largest proportion of mortgages to individuals in its loan book, where spreads cannot easily be increased. Banco BPI's margins also narrowed, affected by the increased proportion of marketable securities on its balance sheet in H209, as the bank focused on enhancing its liquidity; these marketable securities inflates the average earning assets and reduces returns. BES and Santander Totta were the only large Portuguese banks to report stable NIMs in 2009, mainly owing to the widening of corporate loan spreads, helped by having a large proportion of corporate loans in their lending portfolio. Millennium bcp's NIM also narrowed, despite the widening of spreads on around a third of its corporate loan book, which nevertheless was not sufficient to compensate for the increasing cost of customer funds in its Polish subsidiary.

NIR should benefit from lending growth in 2010, particularly from banks' international operations, which, together with the constant widening of lending spreads should help to maintain or even improve margins. While in some other countries the repricing of loans at lower interest rates is likely to take place in full in 2010, for the Portuguese banks this has already happened (in 2009) and therefore banks are less likely to suffer further on this front in 2010. However, competition for deposits will remain strong in Portugal and wholesale funding costs will remain relatively high in 2010, which could add further pressure on the banks' NIMs.

Traditionally Portuguese banks have reported strong levels of commission income. In 2009, despite slower growth in business volumes and lower customer risk appetite for investment and pension funds, most banks reported increasing commission income. Commissions accounted for an average of 0.7% of average earning assets in 2009 and Fitch expects this source to continue to be a good contributor to operating profit. Historically, CGD's commission income has been lower than its peers' and in 2009 only represented 0.4% of average earning assets. Net insurance revenue for most banks also increased, helped by the positive impact that the partial recovery of stock markets had on insurance investment portfolios.

Cost control was an important part of the banks' strategies in 2009, not only in Portugal but also in their main international subsidiaries. Although at some banks non-interest expenses fell substantially (such as Millennium bcp (down by 11%), BES (down 7%) and Banco BPI (down 6%)), in others (eg CGD and Santander Totta), non-interest expenses remained flat. However, cost-cutting measures were not generally sufficient to compensate for the decline in operating revenues and the cost/income ratios (as calculated by Fitch) deteriorated in general, appearing relatively high by international standards. The only exception to this was Santander Totta, whose cost/income ratio (as calculated by Fitch) improved in 2009, remaining below 50%.

Loan impairment charges in 2009 remained in line with those reported in 2008, although these were high. Loan impairment charges at BES increased significantly to EUR539m, nearly doubling from levels in 2008, although these did include around EUR106m of anticipated provisions. Loan impairment charges also rose at Santander Totta (EUR94m), although this total compares favourably with the other banks'.

Over the last decade, the Portuguese banks have expanded their activities internationally, diversifying revenue sources. 2009 was marked by much lower contributions from international activities, which, although still yielding positive results, declined dramatically from very strong levels in the previous year. Contributions from international business areas declined sharply in 2009 for Millennium bcp, while growth rates were positive for BES and BPI. Millennium bcp saw the contributions from its subsidiaries in Poland decline to EUR0.3m in 2009 from EUR117.9m in 2008 and in Greece to EUR9.0m from EUR15.1m. However, the contribution from its Mozambican operation remained stable at EUR52m. For Banco BPI, international operations, largely in Angola, continued to provide a large proportion of the group's net income before minority interests (66%) growing by 20% in 2009. BES's international operations seemed to be less affected by the global economic downturn and grew by 25% in 2009, with Angola and the UK the major performers, while Brazil's contribution remained flat. While there is uncertainty regarding the performance of all banks domestically, as this will depend on the performance of the Portuguese economy in 2010, Fitch expects international operations at all banks to recover in 2010 and gradually increase their contributions as most emerging-market economies expand. However, domestic activities will continue to be the main contributor to the banks' profitability, except for Banco BPI, and therefore the banks' 2010 performance will largely depend on Portugal's economic recovery.

For analytical purposes, Fitch has reclassified as non-recurrent, and therefore below operating profit, the major capital gains from the sale of certain equity stakes held by Portuguese banks and any significant impairments of investments in 2009: Millennium bcp obtained EUR21m of capital gains with the sale of a minority stake in Millennium Bank in Angola, plus EUR57.2m from the sale of other assets and some gains from the buy-back of Upper Tier 2 subordinated debt. BES sold a 24% stake in BES Angola, obtaining EUR191m of capital gains and Santander Totta also sold part of its stake in Santander Totta de Angola in H109, raising EUR28m. In 2009, Millennium bcp and Banco BPI also managed to sell the stakes they held in each other (following Millennium bcp's attempted acquisition of BPI) and therefore their net income did not suffer further large impairments from the decline in value of these stakes. CGD's net income, however, was negatively affected by large impairments related to the decline in market value of the equity investment portfolio of its insurance company, and a large impairment related to its exposure to a US bank.

Asset Quality and Loan Growth

Impaired loans (loans overdue by more than 90 days) and loan impairment charges have increased gradually in 2009, reflecting the recession in Portugal and the rise in unemployment. However, despite the difficult global and domestic economic conditions, asset quality for the larger Portuguese banks remained healthy in 2009. The stock of impaired loans can be influenced by, for example, different write-off or foreclosed assets policies; the ratio of loan impairment charges to gross loans is therefore a more useful measure of the banks' asset quality. In general terms, this ratio has remained relatively stable in 2009 for all banks, partly helped by the increased affordability of mortgage payments for households following the decline in interest rates in late 2008. Loan loss coverage remained at above 100% for CGD, Millennium bcp, BES and Santander Totta whereas it declined to 89% for Banco BPI, which traditionally has had weaker loan loss coverage. By geography, the majority of impaired loans were located in Portugal, reflecting the banks' domestic focus. During 2009 the proportion of impaired loans relating to international activities also increased, although they remain low as a proportion of total impaired loans.

Foreclosed assets (mostly relating to residential mortgages) and write-offs remain at reasonable levels, although they could potentially rise in 2010. Portugal has not experienced a property boom in the last decade and prices have only declined modestly since the beginning of the financial crisis.

Funding and Liquidity

The five Portuguese banks included in this review have large retail domestic franchises, which provide them with a relatively stable customer deposit base. BES and Santander Totta, nevertheless, have relatively high loans (including securitisations)/customer deposits ratios when compared with their Portuguese peers'. CGD benefits the most from customer deposits, reflecting its state ownership, strong market share and large retail franchise in Portugal (see Table 2).

Table 1: Asset Quality

	CGD		Millennium bcp		BES		Santander Totta		Banco BPI	
(%)	2009	2008	2009	2008	2009	2008	2009	2008	2009	2008
Gross lending growth (domestic and international activities)	2.8	12.9	4.7	10.4	4.8	11.7	(0.8)	7.8	2.4	7.7
Overdue loans>90 days	1,966.8[c]	1,548.7[c]	1,813.0	700.0	810.6	524.2	414.6[c]	271.9[c]	559.9	357.1
Overdue loans>90 days/ total loans	2.47	2.00	2.30	0.90	1.60	1.09	1.26	0.82	1.80	1.20
Loan impairment reserves/ overdue loans >90 days	122.4	137.3	119.0	211.6	191.5	219.0	136.0	191.4	88.9	116.9
Loan impairment charges / total loans	0.52	0.58	0.80	0.86	1.07[a]	0.57	0.29	0.07	0.46[b]	0.40

[a] 0.86% excluding EUR106m of extraordinary provisions
[b] 0.37% excluding EUR33.2m of extraordinary provisions
[c] As calculated by Fitch from CGD's and Santander Totta's 2009 results presentation
Source: The banks' financial data as per 2009 results presentations

However, the loans (including securitisations)/customer deposits ratio does not take into account the fact that the larger Portuguese banks tend to have placed debt issues with retail customers.

In recent years, the banks have funded their business expansion with funding from the capital markets, given its availability and relatively narrow spreads. Access to the capital markets has been mainly through issues of senior and subordinated debt, securitisations, covered bonds and commercial paper, which helped to diversify funding sources by maturity and investor.

Since the beginning of the global financial crisis in 2008, the leading Portuguese banks have also accessed funds from the European Central Bank (ECB), like most European peers, although, to date, the use of this source of funding has been limited. The use of ECB funds has been mostly an alternative to commercial paper with the added attraction of its low cost. The Portuguese banks have also been building up portfolios of eligible assets, in case access to the capital markets becomes more difficult again. These portfolios mainly comprise own securitisations retained on-balance-sheet and government bonds. For CGD this amounted to EUR4.5bn (at end-September 2009); Millennium bcp EUR10.6bn, BES EUR4.4bn plus EUR4.8bn to be used at other central banks; Santander Totta EUR9.8m and Banco BPI EUR3bn at end-2009.

The financial and liquidity crisis has resulted in a general increase in the cost of funding for all banks across Europe and, in some cases, the banks have faced difficulties placing certain debt issues in the market. However, in contrast with many of their European peers, the leading Portuguese banks have continued to tap the capital markets without any major problems in 2009, although issuance during 2009 was normally of shorter maturities (three to five years, on average), including covered bonds. In addition, the Portuguese banks have also placed large debt issues via private placements to refinance funding maturities. As seen in Table 3, they will need to refinance fairly large wholesale funding maturities in the next three years. BES and Millennium bcp already pre-financed part of their 2010 wholesale funding maturities in 2009, and Banco BPI has issued EUR1bn of covered bonds and EUR0.5bn of senior debt in January 2010.

Since late 2008, the Portuguese government has made available a government guaranteed funding scheme totalling EUR20bn, to be used for medium-term unsubordinated issuance by banks until end-2009. In comparison with many other European banks, the leading Portuguese banks have made only limited use of the Portuguese scheme: CGD issued EUR1.25bn, BES EUR1.5bn and Millennium bcp EUR1.5bn in late 2008/ early 2009. None of the leading Portuguese banks has made use of the full amount available under this scheme.

Fitch views this as an indication that the major Portuguese banks' access to capital markets for funding worked relatively well in 2009, including placing issues of covered bonds with investors. The agency understands that the government proposes to

Table 2: Funding

	CGD		Millennium bcp		BES		Santander Totta		Banco BPI	
(%)	2009	2008	2009	2008	2009	2008	2009	2008	2009	2008
Customer deposits (EURm) [a]	64,265.5	60,106.4	46,307.0[a]	44,561.0	25,446.5	23,972.8	15,052.0	15,655.0	22,617.9	23,084.0
Gross loans (including securitisations) (EURm)	79,627.2	79,050.4	77,348.1	73,849.3	50,531.1	48,197.63	32,905.8	33,154.8	30,431.0	29,723.8
Loans (including securitisations) /customer deposits (%)	123.9	128.8	167.0	165.2	198.6	201.1	218.2	211.8	132.4	128.8
Deposits from central banks (EURbn)	1.5[c]	0.6	3.4	3.3	4.8[b]	3.8[b]	3.0	2.9[c]	2.8	0.0

[a] including repos to customers
[b] including EUR1.4bn of ECB funds at end-2009 (EUR2bn at end-2008)
[c] As at end-H109
Source: The banks' financial data as per 2009 results presentations

extend the scheme for a reduced amount until mid-2010, though it is unlikely that there will be further utilisation unless the capital markets become much more difficult to access and/or more expensive, reflecting concerns over the Portuguese government's fiscal position.

Table 3: Wholesale Funding Maturities for the Leading Portuguese Banks

EUR bn	CGD	Millennium bcp	BES	Santander Totta	Banco BPI
2010	4.1	4.6	5.1	0.7	2.4
2011	n.a.	3.3	4.7	2.9	0.8
2012	n.a.	3.5	3.8	0.0	2.4

Source: The banks' published data, including amounts already pre-financed

Capital

By end-September 2009, all five of the leading Portuguese banks in this review achieved the minimum Tier 1 capital ratio of 8% recommended by the Bank of Portugal (BoP). Fitch welcomes the strengthening of capital levels in 2009, but notes that they are needed to face the challenging economic environment.

Table 4: Capital Ratios

	CGD		Millennium bcp		BES		Santander Totta		Banco BPI	
(%)	2009[a]	2008[a]	2009[a]	2008[a]	2009[b]	2008[b]	2009[b]	2008[a]	2009[a]	2008[a]
Core Tier 1	8.3	6.8	6.4	5.8	8.0	6.1	9.2	8.1	7.8	8.0
Tier 1	8.5	7.0	9.3	7.1	8.3	7.1	11.0	10.1	8.6	8.8
Total Capital	12.6	10.7	11.5	10.5	11.1	11.3	11.9	11.2	11.8	12.4

[a] Under the Standardised approach of Basel II
[b] Under the IRB approach of Basel II
Source: The banks' published data

However, improved capital ratios were achieved in different ways at each bank (see Table 4). BES successfully launched a EUR1.2bn rights issue in May 2009. CGD received a EUR1bn capital injection from its shareholder, the Portuguese Government, in June 2009. Millennium bcp issued EUR1bn of perpetual subordinated debt with conditional coupons, which the BoP has qualified as Tier 1. Given slower loan growth and active balance sheet management at most banks, risk-weighted assets also declined, boosting the capital ratios at most banks.

In all cases the banks' pension funds performed well, which, together with lower actuarial deviations, helped to reduce the banks' obligations. During 2009 BES and Santander Totta obtained authorisation from the BoP to use the IRB approach under Basel II for credit risk, which helped their capital ratios in late 2009. Millennium bcp has recently received approval to use the IRB approach on its retail portfolio collateralised by commercial and residential real estate and on its domestic corporate portfolio. On this basis, the Core Tier 1 ratio rises to 7.1% for end-2009.

Highlights: Major Portuguese Banks

	CGD		Millennium bcp		BES		Santander Totta		Banco BPI	
(EURm)	**2009 [b]**	**2008**	**2009 [b]**	**2008**	**2009 [b]**	**2008**	**2009 [b]**	**2008**	**2009 [b]**	**2008**
Total assets	120,984.8	111,060.0	95,550.4	94,423.7	82,297.2	75,186.7	48,590.4	44,084.9	47,455.8	43,003.4
Total equity [a]	6,556.8	4,883.7	5,220.8	5,248.2	6,338.9	3,895.6	2,663.1	2,414.6	2,302.7	1,698.1
Net interest revenue	1,641.3	2,201.4	1,337.5	1,757.9	1,290.2	1,178.1	806.0	762.2	617.2	676.2
Net commission income and insurance income	939.0	933.8	731.7	740.4	680.1	599.2	372.2	376.0	323.2	241.2
Results from financial operations	199.5	51.7	225.3	206.3	137.8	(147.5)	59.1	47.1	218.9	10.0
Other operating income	219.6	203.4	36.2	138.8	154.4	121.7	16.5	49.8	9.4	112.8
Equity accounted profit	(4.4)	30.4	66.3	19.1	30.0	(20.3)	(0.1)	0.0	18.3	9.7
Non-interest operating expenses	1,936.3	1,934.1	1,540.2	1,734.6	1,055.7	1,131.3	551.4	564.1	675.0	716.1
Loan impairment charge and other credit impairment and provisions	629.0	552.9	630.5	574.6	611.8	331.8	97.8	27.5	145.2	127.9
Operating profit	429.7	933.7	226.3	553.3	625.0	268.1	604.5	643.5	366.8	205.9
Non-operating income and expenses	(55.3)	(271.8)	69.2	(211.3)	59.9	242.5	31.4	(9.0)	(47.5)	23.6
Pre-tax profit	374.4	661.9	295.5	342.0	684.9	510.6	635.9	634.5	319.3	229.5
Taxes and discontinued operations	70.2	156.7	46.2	84.0	109.8	83.5	105.3	116.2	45.4	51.4
Net income (before minority interests)	304.2	505.2	249.3	258.0	575.1	427.1	530.6	518.3	273.9	178.1
Net interest margin (%)	1.53	2.20	1.48	1.72	1.77	1.76	1.82	1.82	1.48	1.72
Pre-tax profit/ Average Assets	0.33	0.62	0.31	0.37	0.86	0.72	1.36	1.46	0.72	0.55
Pre-tax profit7 Average equity	6.63	14.30	5.54	7.24	13.12	11.74	23.58	27.66	16.06	13.32
Ratings										
Long-term IDR	A+		A+		A+		AA		A+	
Short-term IDR	F1		F1		F1		F1+		F1	
Individual	B/C		B/C		B/C		B		B/C	
Support	1		2		2		1		2	
Support rating floor	A+		BBB		BBB-				BBB-	
Outlook	Negative		Negative		Negative		Stable		Negative	

[a] Equity includes minority interests and fair value reserves and does not take hybrid instruments into account
[b] Unaudited figures
Source: The banks' financial data adapted by Fitch Ratings as at the date of this review