

DBRS Morningstar Upgrades Novo Banco's LT Issuer Rating to BB (low), Stable Trend

BANKING ORGANIZATIONS

DBRS Ratings GmbH (DBRS Morningstar) has upgraded the ratings of Novo Banco, S.A. (novobanco or the Bank), including the Long-Term Issuer ratings to BB (low) from B (high). The Short-Term Issuer Rating has been confirmed at R-4. The Trend on all ratings remains at Stable. The Bank's Intrinsic Assessment (IA) has also been upgraded to BB (low) while the Support Assessment has been maintained at SA3.

The Bank's Long-Term Deposit rating was upgraded to BB from BB (low), which is one notch above the IA, reflecting the legal framework in place in Portugal which provides full depositor preference in bank insolvency and resolution proceedings.

At the same time, novobanco's Long-Term Critical Obligations Rating was confirmed at BB (high), which is two notches above the IA, in line with the standard notching approach outlined in our banking methodology. The Critical Obligations Ratings reflect DBRS Morningstar's expectation that, in the event of a resolution of the Bank, certain liabilities (such as payment and collection services, obligations under a covered bond program, payment and collection services, etc.) have a greater probability of avoiding being bailed-in and are likely to be included in a going-concern entity.

A full list of rating actions is included at the end of this press release.

KEY RATING CONSIDERATIONS

The upgrade reflects novobanco's progress in implementing its restructuring plan, including the improvement in the Bank's profitability, capital, and asset quality. In 2022, the Bank completed its restructuring programme started in 2017, throughout which novobanco has significantly reduced its stock of legacy assets. Whilst improving, however, novobanco's asset quality metrics continue to compare unfavorably to the EU average.

Net attributable income more than doubled compared to 2021 mainly on the back of higher revenues, lower provisions and impairments, as well as one-off gains from the sale of some real-estate assets. The Bank also saw an increase in its regulatory capital levels, supported by organic capital generation, and RWA reduction.

The Stable trend reflects our view that risks are broadly balanced. The improvements achieved to date put the Bank in a stronger position to cope with a more demanding operating environment due to rising interest rates and economic slowdown.

The Bank's IA is positioned below the Intrinsic Assessment Range (IAR). This in part reflects the incorporation of some one-off items, including profits from asset sales and some impairment reversals within the bank's financial statements that are incorporated within the scorecard results. However, the ratings also take into account one-off items within the scorecard. However, the ratings consider a more challenging economic environment for the Bank.

RATING DRIVERS

Positive rating pressure would require novobanco to demonstrate a further improvement in asset quality and capitalisation.

A downgrade could result from a material weakening of the Bank's capital levels and liquidity position, or a significant worsening in asset quality.

RATING RATIONALE

Franchise Combined Building Block (BB) Assessment: Moderate

The Bank has a relatively stable franchise as the fourth largest bank in Portugal, and a leading franchise in SME and Corporate banking with a market share of around 14.5% for corporate loans at end-2022. In February 2023, novobanco received notification from the Directorate General for Competition (DG Comp) that the restructuring plan is now considered concluded. In line with this plan, in 2022, the Bank continued to make progress in de-risking its balance sheet and simplifying its operational structure .

At end-2022, novobanco had 4,090 employees versus 4,193 at end-2021 while the number of branches fell to 292, down by 19 units YoY. At the same time, the Bank has continued to invest in digitalisation and branding. As part of its strategic refocus on the core business in Portugal, novobanco completed the sale of its Spanish operations in H2 2021

Earnings Combined Building Block (BB) Assessment: Weak/Very Weak

In 2022 novobanco recorded positive results for a second consecutive year. Net profit increased to EUR 560.8 million, up EUR 376.3 million in 2021 on the back of higher revenues and lower cost of risk. Net interest income grew by 9.1% YOY to EUR 625.5 million, benefitting from higher interest rates and asset repricing, especially in Q4. Credit provisions fell 77% YOY in 2022 to EUR 34.5 million, reflecting a more benign operating environment in 2022. As a result, the Bank reported a cost of risk of 45 bps, down from 70 bps in 2021, and below the medium-term target of under 50 bps announced in October 2021. The Bank's profitability was also supported by one-off gains from the sale of some real-estate assets, including its headquarters.

DBRS Morningstar expects the Bank to remain profitable going forward, supported by the repricing of its loan book. However, we expect an increase in cost of funding and a slight deterioration in asset quality as a result of the persistent inflationary pressures, as well as renewed market volatility and uncertainty.

Risk Combined Building Block (BB) Assessment: Moderate/Weak

Since 2017, novobanco has made significant progress in de-risking its balance sheet, with the provision of capital support through the Contingent Capital Agreement (CCA) from the Portuguese Resolution Fund playing a key role in this process. novobanco's gross NPL stock decreased by 21% YOY in 2022 to EUR 1.4 billion. This was mainly supported by cures and recoveries and write-offs. The Bank's gross NPL ratio fell to 4.3% from 5.7% at FY 2021. Nonetheless, this ratio remains higher than the European average.

Credit quality risks from both the pandemic and market stress resulting from the Russia/Ukraine conflict have been managed, and thus far we have not noted significant asset quality deterioration. In the medium term, however, DBRS Morningstar expects potential asset quality risks arising from higher interest rates and economic slowdown. As the Bank's loan book gradually reprices to reflect increased rates, some stress is anticipated on the Bank's customer loan asset quality as debt affordability reduces.

The Bank's asset base also shows a large exposure to debt securities, of which the majority is held at amortised cost. The increase in interest rates has led to the formation of unrealised losses. The potential capital impact however appears contained.

Funding and Liquidity Combined Building Block (BB) Assessment: Good/Moderate

The Bank's current funding structure depends largely on deposits and ECB funding. Total deposits amounted to EUR 28.4 billion, up 4% YOY, and accounted for 61% of total assets at end-2022. Around 73% of the Bank's deposit base is made of retail deposits. The increase in rates has not yet affected the pricing of novobanco's customer deposits, whose average rate decreased marginally YOY to 17 bps in 2022 from 19 bps in 2021, although this was up from 15 basis points at end-June 2022. The Bank also has exposure to the ECB, with EUR 6.3 billion in total funds at end-2022. This has reduced significantly YOY, following the phase out of TLTRO and a prepayment made in December 2022.

The Bank has a liquidity buffer of around EUR 13.7 billion, corresponding to around 48% of its deposit base, and a significant portion is cash held at the ECB. The Bank's regulatory liquidity ratios remain adequate, with the liquidity coverage ratio (LCR) reported at 210% at end-2022, up from 182% in 2021, whilst the net stable funding ratio (NSFR) declined slightly to 113% from 117%, and is lower compared to peers. The decline in the NSFR in part relates to the roll-off of TLTRO funds.

Capitalisation Combined Building Block (BB) Assessment: Weak/Very Weak

At end-2022 the Bank reported phased-in CET1 and total capital ratios of 13.7% and 16.0%, respectively, against the SREP regulatory minima of 8.7%, and 13.5%, including a Pillar 2 Requirement of 3%. This represents a significant improvement in capital ratios against those reported at end-2021 (11.1% and 13.1% respectively). The increase results from both strong profitability benefitting organic capital generation, alongside a reduction in RWAs, also as a result of improved PDs following the exit of loan moratoria. In 2021, the Bank had been operating below its 13.5% total capital required under SREP, on the back of the extraordinary measures granted by the ECB to counter the COVID-19 emergency.

DBRS Morningstar notes that novobanco's capital ratios at FY 2022 do not include the potential capital payment under the CCA scheme. Up until 2020, the support from the CCA had been timely and aligned to novobanco's requests. However, the capital paid to novobanco in 2021 was lower than the amount initially requested. This led to an arbitration process with the Resolution Fund, and the outcome of this still remains unclear. Against this backdrop, similar disputes could occur in the future, notwithstanding the EUR 485 million of capital support potentially still available for novobanco. novobanco did not make an additional call in 2022.

Further details on the Scorecard Indicators and Building Block Assessments can be found at <https://www.dbrsmorningstar.com/research/412041>

ENVIRONMENTAL, SOCIAL, GOVERNANCE CONSIDERATIONS

The G factors have changed from the prior credit rating disclosure. The Corporate Governance subfactor is no longer considered as relevant to the ratings and trends of novobanco, as reputational issues related to past management and the failure of its predecessor bank Banco Espirito Santo (BES) are now considered legacy issues.

Political risk is still considered as relevant, reflecting the current disputes between the Bank and the Resolution Fund.

There were no Environmental or Social factors that had a significant or relevant effect on the credit analysis.

A description of how DBRS Morningstar considers ESG factors within the DBRS Morningstar analytical framework can be found in the DBRS Morningstar Criteria: Approach to Environmental, Social, and Governance Risk Factors in Credit Ratings at <https://www.dbrsmorningstar.com/research/396929/dbrs-morningstar-criteria-approach-to-environmental-social-and-governance-risk-factors-in-credit-ratings> (17 May 2022)

Notes:

All figures are in EUR unless otherwise noted.

The principal methodology is the Global Methodology for Rating Banks and Banking Organisations <https://www.dbrsmorningstar.com/research/398692> (23 June 2022). In addition DBRS Morningstar uses the DBRS Morningstar Criteria: Approach to Environmental, Social, and Governance Risk Factors in Credit Ratings <https://www.dbrsmorningstar.com/research/396929> <https://www.dbrsmorningstar.com/research/373262> (17 May 2022) in its consideration of ESG factors and the DBRS Morningstar Criteria: Guarantees and Other Forms of Support <https://www.dbrsmorningstar.com/research/394683/dbrs-morningstar-criteria-guarantees-and-other-forms-of-support> (4 April 2022)

DBRS Morningstar does not audit the information it receives in connection with the rating process, and it does not and cannot independently verify that information in every instance.

The sources of information used for this rating include Morningstar Inc. and Company Documents, novobanco Press Release Q4 2022 Results, novobanco 2016-2022 Annual Reports. DBRS Morningstar considers the information available to it for the purposes of providing this rating to be of satisfactory quality.

The conditions that lead to the assignment of a Negative or Positive trend are generally resolved within a 12-month period. DBRS Morningstar's outlooks and ratings are under regular surveillance

For further information on DBRS Morningstar historical default rates published by the European Securities and Markets Authority (ESMA) in a central repository, see: <https://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml>. DBRS Morningstar understands further information on DBRS Morningstar historical default rates may be published by the Financial Conduct Authority (FCA) on its webpage: <https://www.fca.org.uk/firms/credit-rating-agencies>.

The sensitivity analysis of the relevant key rating assumptions can be found at: <https://www.dbrsmorningstar.com/research/412042>

This rating is endorsed by DBRS Ratings Limited for use in the United Kingdom.

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Initial Rating Date: August 5, 2014

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For more information on this credit or on this industry, visit www.dbrsmorningstar.com.

Ratings

NB Finance Ltd.

Date Issued	Debt Rated	Action	Rating	Trend	Attributes
29-Mar-23	Senior Notes Guaranteed by NB	Upgraded	BB (low)	Stb	EU U

Novo Banco Luxembourg Branch

Date Issued	Debt Rated	Action	Rating	Trend	Attributes
29-Mar-23	Long-Term Deposits	Upgraded	BB	Stb	EU U
29-Mar-23	Long-Term Senior Debt	Upgraded	BB (low)	Stb	EU U
29-Mar-23	Short-Term Debt	Confirmed	R-4	Stb	EU U
29-Mar-23	Short-Term Deposits	Confirmed	R-4	Stb	EU U

Novo Banco, S.A.

Date Issued	Debt Rated	Action	Rating	Trend	Attributes
29-Mar-23	Long-Term Issuer Rating	Upgraded	BB (low)	Stb	EU U
29-Mar-23	Short-Term Issuer Rating	Confirmed	R-4	Stb	EU U
29-Mar-23	Long-Term Deposits	Upgraded	BB	Stb	EU U
29-Mar-23	Long-Term Senior Debt	Upgraded	BB (low)	Stb	EU U
29-Mar-23	Short-Term Debt	Confirmed	R-4	Stb	EU U
29-Mar-23	Short-Term Deposits	Confirmed	R-4	Stb	EU U
29-Mar-23	Long Term Critical Obligations Rating	Confirmed	BB (high)	Stb	EU U
29-Mar-23	Short Term Critical Obligations Rating	Confirmed	R-3	Stb	EU U
29-Mar-23	Subordinated Debt	Upgraded	B	Stb	EU U
29-Mar-23	Long-Term Senior Debt - EUR 5 billion EMTN Programme	Upgraded	BB (low)	Stb	EU U
29-Mar-23	Senior Non-Preferred Debt - EUR 5 billion EMTN Programme	Upgraded	B (high)	Stb	EU U
29-Mar-23	Subordinated Debt - EUR 5 billion EMTN Programme	Upgraded	B	Stb	EU U

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