Bankia S.A.
Issuer Rating Report

STABLE OUTLOOK
BBB+

Overview

Scope Ratings assigns an issuer rating of BBB+ to Bankia S.A., with a Stable Outlook, and a short-term rating of S-2 with a Stable Outlook.

The ratings are not applicable to the unguaranteed subsidiaries of the rated parent, nor to BFA, Tenedora de Acciones, S.A.U. (BFA) – the holding company of the group which includes Bankia – although the analysis of Bankia's credit strength takes into account the group's specific corporate structure.

Highlights

- The ratings acknowledge Bankia's domestically oriented retail and commercial banking business model, with a focus on low-risk mortgages. The franchise was strengthened through the merger with BMN in 2017. In September 2020, Bankia communicated that it has entered merger talks with Caixabank. A combination between the two entities would create an unrivalled market leader in several segments, from bancassurance to wealth management.
- The operating environment has deteriorated materially, and we expect the Spanish economy to contract by 12.5% in 2020, before rebounding next year. We expect the recession to drive an increase in Spanish banks' cost of risk, which was at cyclical lows in 2019.
- Profitability remains the main shortcoming in an otherwise impressive turnaround for an institution that has undergone a profound transformation over the past decade. A business combination with another large Spanish bank such as Caiabank could catalyse further cost cutting and support pre-provision profitability for both entities.
- When it comes to the derisking of legacy non-performing assets (NPAs), Bankia looks set to overdeliver on its strategic targets, although the Covid-19 recession will lead to an increase in non-performing loan (NPL) formation that will have to be dealt with over time.
- The Outlook is Stable, reflecting our expectation that Covid-19 impacts will be manageable for the bank.

Rating drivers (summary)

The rating drivers, in decreasing order of importance in the rating assignment, are:

- Focused retail and commercial banking franchise in Spain
- Rapidly deteriorating economic environment, which could affect the bank's performance going forward
- Strong management track record of strategic delivery, though profitability remains the bank's Achilles heel
- Effective derisking of legacy bad assets, but Covid-19 recession will pose new challenges

Ratings & Outlook

Issuer rating	BBB+
Outlook	Stable
Senior unsecured debt	BBB+
Senior unsecured debt (MREL/TLAC eligible)	BBB
Short-term debt rating	S-2
Short-term debt rating outlook	Stable
Covered bonds ratings	AAA
Covered bonds outlook	Stable

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Bloomberg: SCOP

Rating-change drivers

Worse than expected decline in credit quality. The Covid-19 recession is likely to represent a turning point in asset quality and cost of risk trends. So far, the bank expects the cost of risk for the full year to be around 70-80bps. This cost of risk level can be absorbed by ordinary profitability but could lead to capital erosion should losses prove to be higher.

Clarification in group structure and control. The Spanish government aims to divest from Bankia and recover part of the amount spent on the bank's bailout. BFA already sold two stakes of 7% and 7.5% in 2017 and 2014, respectively, and we expect these divestitures to continue until Bankia becomes an independent entity. We view this development positively overall, especially considering the volatile political situation in Spain.

Significant deterioration in Spain's sovereign credit strength. Given the material exposure to Spanish sovereign risk, a significant deterioration in Spain's credit strength would be negative for Bankia.

Material change in fundamentals due to further M&A. The prohibition on M&A expired in June 2017. Shortly after, Bankia announced its acquisition of Banco Mare Nostrum (BMN) from Spain's Fund for Orderly Banking Restructuring. We believe further acquisitions are possible. If they are well executed, acquisitions could boost the group's geographic and product diversification; however if acquisitions result in materially weaker fundamentals, the impact on credit would be negative. In September 2020, Bankia announced, in response to media reports, being in contact with Caixabank over a potential merger of the two entities, stating that a proposal to initiate a study and an analysis has been submitted to Bankia's governing bodies.

Rating drivers (details)

Focused retail and commercial banking franchise in Spain

Bankia is the fifth largest banking group in Spain by total assets

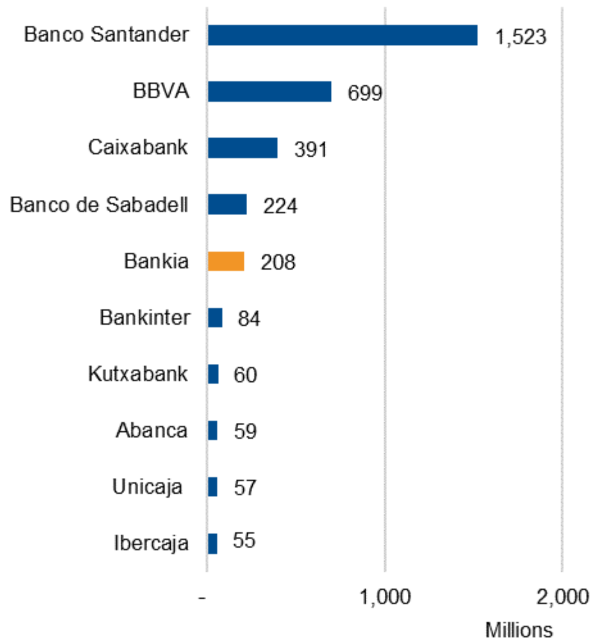
Bankia is a purely domestic retail and commercial lender in Spain, with strong market shares in the regions of Madrid, Valencia, La Rioja, the Canary Islands and, following the acquisition of BMN in 2017, in Murcia, Andalusia and the Balearic Islands. Bankia also has operations in the central regions of Spain, while its presence is more marginal in northern Spanish coastal regions, which remain dominated by regional banks.

Bankia is the fifth-largest Spanish bank in terms of assets with EUR 208.4bn as of December 2019 and an approx. 10% national market share in 2019. This 2019 national market share stood at 12.5% in mortgages, 11.8% in card turnover, 11% in household deposits and 10.9% in loans to households.

Figure 1: Bankia's branch network

Source: Bankia, SNL Financial, Scope Ratings

Figure 2: Spanish banks total assets 2019 (EUR bn)



Source: SNL Financial, Scope Ratings, banks' data

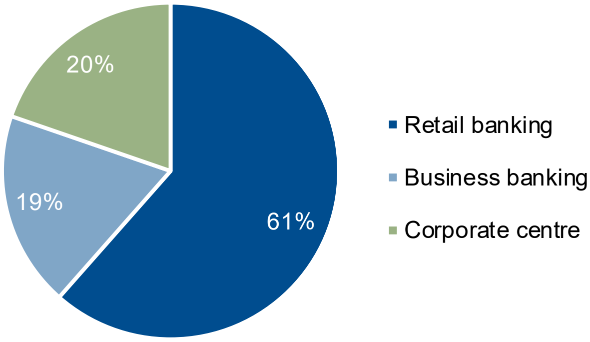
Bankia's business model revolves around retail banking

Bankia's largest division is retail banking, which caters to individuals and small businesses (turnover of up to EUR 6m) and contributed 61% of gross income in 2019. The retail product range comprises mortgages, consumer loans, the direct deposit of salary and pension payments, credit cards, the payments of bills, insurance, investment and pension funds. In 2018, Bankia agreed to jointly provide consumer finance products in Spain together with Credit Agricole Consumer Finance. The new company will be 51% owned by Credit Agricole, with the remaining 49% held by Bankia, and will specialise in the provision of point-of-sale consumer finance.

Larger companies with turnover exceeding EUR 6m are served by the business banking segment (19% of 2019 gross income), which also comprises the group's activity in capital markets (financial advisory services, derivatives, fixed income trading and origination).

The corporate centre (20% of gross income) includes group functions and assets held for sale, as well as investments in associates and joint ventures accounted for using the equity method. For reporting purposes, it also includes asset management activities in the retail segment.

Figure 3: Bankia's gross income split by segment (2019)



Source: Company data, Scope Ratings

Bankia originated from the forced merger of seven Spanish savings institutions, or cajas de ahorro, which formed an institutional protection scheme (IPS) in 2010. The central entity of the IPS was Banco Financiero y de Ahorros (the current BFA), which subsequently transferred most of its assets to Bankia. Bankia was listed on the Madrid stock exchange in July 2011 but was later nationalised after suffering larger-than-anticipated losses (partly due to mandatory real estate provisions introduced in early 2012) and a significant outflow of deposits.

Bankia is controlled, via BFA, by the Spanish resolution fund FROB

Currently, Bankia S.A. is both the parent company of the Bankia group and the main subsidiary of the BFA group. BFA is fully owned by Spain's Fund for Orderly Banking Restructuring and owns the majority of Bankia. While the group is supervised as one unit, Bankia issues bail-inable debt, such as capital instruments, itself.

We see Bankia as a viable standalone business, although its re-privatisation is taking longer than originally planned.

BFA disposed of a 7.5% stake in 2014 and a further 7% stake in December 2017, but it still controls 62% of Bankia as of December 2019. The Spanish government extended the original privatisation deadline (originally end of 2017) twice to year-end 2021.

In September 2020, Bankia and Caixabank announced that they have entered merger negotiations. A merger of the two entities would create an unrivalled national champion in Spain.

Our issuer rating applies to Bankia S.A. and its guaranteed subsidiaries, but not to BFA, which, in any case, does not issue debt.

Rapidly deteriorating economic environment, which could affect the bank's performance going forward

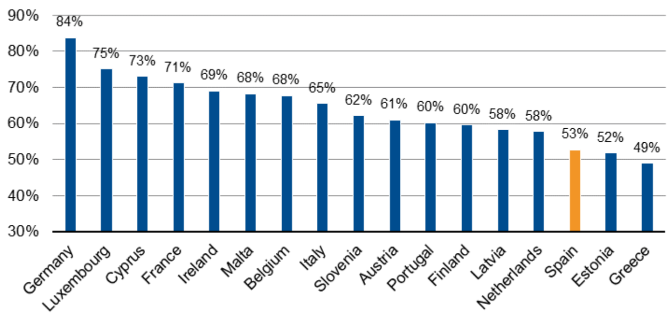
Spain is a wealthy economy within the eurozone. Its financial system is well developed, with several large banks, including important international players such as BBVA and Santander.

The Spanish banking system has consolidated during the great financial crisis

The Spanish banking sector underwent a wave of consolidation during the financial crisis, which brought down the number of banks (of relevant size) to about a dozen. Currently, there are a couple of global diversified financial groups (Banco Santander and BBVA), a few national players (Caixabank, Bankinter, Bankia and Sabadell, alongside Santander and BBVA) and a few regional banks (Kutxabank, Ibercaja, Unicaja, Abanca). Branches are currently the prevalent distribution channel, but we expect this to reverse in the medium term. Several banks also provide wealth management (Santander, BBVA, Caixabank, Ibercaja) and insurance products (Caixabank, Ibercaja).

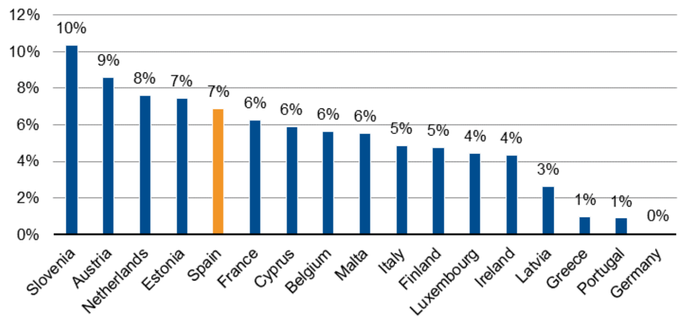
The system is characterised by a good level of cost efficiency (by international standards), which supports profitability. The latter has recently been under pressure from declining rates as a large proportion of loan books is comprised of variable-rate mortgages.

Figure 4: Cost-income ratios, key European countries (Q4 2019)



Source: ECB Supervisory returns, Scope Ratings.

Figure 5: Banks' return on equity by country (Q4 2019)



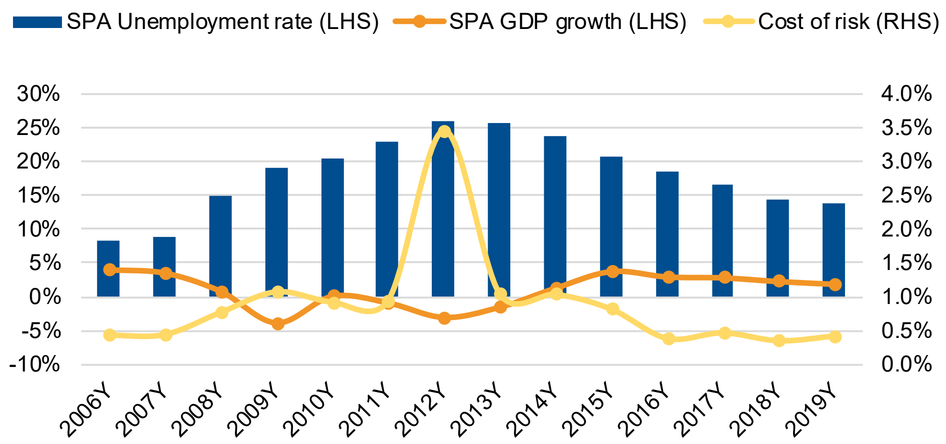
Source: ECB Supervisory returns, Scope Ratings.

Following two consecutive shocks, namely the Great Financial Crisis and the euro area crisis, during which Spain requested financial assistance to recapitalise financial institutions in July 2012, the Spanish economy has undergone significant structural adjustment. Since Spain exited the European Stability Mechanism programme in January 2014, its economy has averaged growth of around 2.8%. This is a full percentage point above the euro-area average and was driven by the government's structural reforms (mostly implemented in 2010-2015), wage moderation and resulting cost competitiveness gains, low oil prices, the European Central Bank's accommodative monetary policy and favourable external conditions, particularly in the euro area.

Spanish banks' cost of risk is at cyclical lows

The sector's cost of risk was at cyclical lows in 2019, having reached its peak in 2012 when mandated real estate-related provisions caused a massive spike.

Figure 6: Spanish banks' historical cost of risk (2006-2019) vs cyclical indicators



Source: SNL, Scope Ratings

The Covid-19 outbreak will drive a deep recession and an increase in cost of risk

The sudden outbreak of coronavirus in March 2020 will most likely represent a turning point in the economic cycle. In mid-March, Spain announced a national lockdown in order to slow the spread of Covid-19, leaving only essential shops, pharmacies, bank branches and urgent public services open.

Initially planned to last for two weeks, the lockdown was extended until 4 May, when a gradual lifting of restrictions began over an eight-week period.

Even once the gradual return to a 'new normal' is complete, we believe human and economic activity will continue to be impacted. A deep recession in 2020 is pretty much consensus, as is the expectation of some rebound next year.

We currently expect the Spanish economy to contract by 12.5% in 2020 and rebound by 7% in 2021.

Strong management track record of strategic delivery, though profitability remains the bank's Achilles heel

The management team has delivered a material derisking of the balance sheet

The current management team, which took the helm in 2012, has transformed a bailed out, deeply troubled financial institution into a viable banking operation, delivering on most of its strategic targets over the past decade. The first, ambitious turnaround plan focused on significantly deleveraging and derisking the balance sheet, increasing capitalisation, and improving efficiency and profitability, while growing market shares in segments where the bank was historically weak, both for consumer credit and business banking.

Since 2016, Bankia has focused on strategic repositioning, targeting growth in high-margin segments such as asset management, SMEs and credit cards and diversifying away from mortgage lending. It has also managed to improve its public image (as measured by Bankia's customer satisfaction index and net promoter scores), a remarkable feat considering the reputational blow it suffered during the financial crisis.

In addition, management has overdelivered on the integration of BMN, acquired in 2017. Synergy targets were achieved ahead of planned deadlines and materially upgraded compared to original expectations at the time of announcement.

The current strategy targets a progressive mix shift towards higher-margin segments

The current 2018-20 plan continues to follow the group's recent strategic trajectory. Bankia is continuing to target segments where its market shares remain below its natural distribution capacity.

Under the presented strategy, mortgages are expected to account for 58% of the loan book by 2020 (61% in 2019). The group counted on fast growth in consumer credit (target CAGR of 16.2% for 2017-2020) and business banking (target CAGR of 7.9%) to dilute the weight of mortgages in the book, as it saw the potential to increase penetration in these segments, where its market share was well below the mortgage market share.

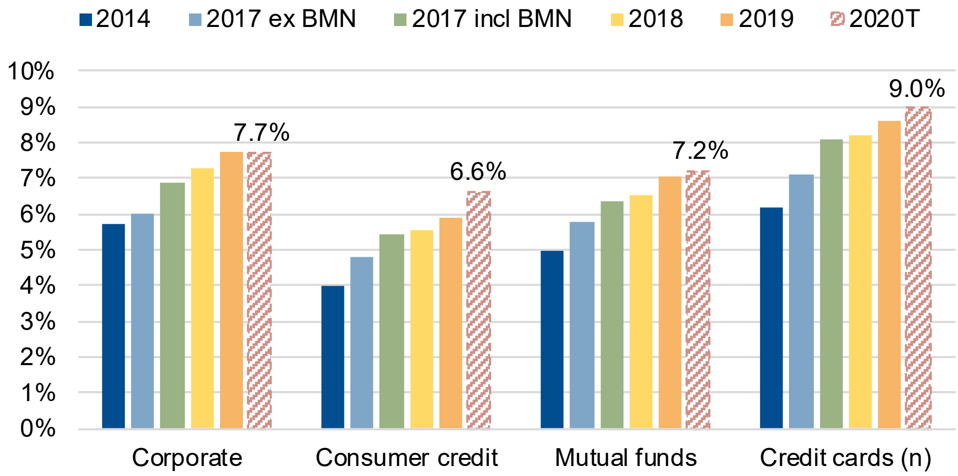
Further, restrictions on Bankia in terms of lending to certain corporate sectors (such as syndicated, project and asset finance, international lending, and real estate developers) ceased to apply in 2018, opening up new opportunities for the bank to expand.

So far, the bank has managed to increase its market share in target segments, and commercial goals for 2020 looked within reach at the end 2019.

Bankia is still on track to meet most commercial targets in 2020

Bankia also reported good progress on customer satisfaction and on the digitalisation of sales, where it already met its initial 2020 target of 35% at the end of 2019. The percentage of digital customers (which Bankia defines as customers that perform at least one transaction digitally over 12 months) stood at 57.1% as of Q2 2020 (vs a strategic target of 65%). Based on this metric, Bankia is still behind its own strategic target, as well as other major Spanish banks. We note, however, that the Covid-19 related lockdown may have accelerated customers' transition to digital channels, possibly boosting the bank's likelihood of also hitting this target by the end of the year.

Figure 7: Bankia market shares evolution, selected products



Note: 2019 market shares for credit cards are as of September 2019 as this is the latest available data. 2019 market shares for corporate (companies) and consumer credit are as of November 2019.

Source: Company data, Scope Ratings

Bankia will miss financial targets due to low interest rate environment and Covid-19 related asset quality stress

While most commercial targets still look achievable, the Covid-19 recession will most likely drive strategic failures to meet financial targets.

The original return on tangible equity target of 11% was always ambitious in our view, and was dropped in 2019, as it became clear that interest rates would remain at ultra-low levels for a prolonged period.

Bankia is also likely to overshoot its original 24bps cost of risk target, as a result of Covid-19 related model provisions in H1 and higher specific provisions in H2. In Q2, Bankia's management guided for a 70-80bps cost of risk in 2020.

Given the extraordinary circumstances, we do not see this as a material driver of credit risk in itself, although we do believe that Bankia will have to manage costs tightly to absorb rising provisioning in the face of a stagnant revenue outlook.

Effective derisking of legacy bad assets, but Covid-19 recession will pose new challenges

When it comes to the derisking of legacy NPAs, Bankia was well on track to overdeliver on its strategic targets at the end of 2019. Bankia's 2018-20 strategic plan included ambitious asset quality objectives, such as gross and net NPA ratios of lower than 6% and 3%, respectively, while maintaining a low cost of risk (24bps). In euro terms, the bank aimed at decreasing the volume of NPAs by EUR 2.9bn per year (EUR 8.8bn in the strategic plan period).

Bankia will likely overdeliver on tis 2020 derisking targets

As of December 2019, the bank had already reduced NPAs by EUR 8.4bn, which makes it likely that Bankia will overdeliver on this aspect of its strategic plan. The main driver for this NPA reduction has been the signing of a EUR 3bn (gross book value) deal with Lone Star consisting of foreclosed assets with a gross book value of EUR 1.65bn and EUR 1.42bn in NPLs.

Figure 8: Bankia's main asset quality metrics

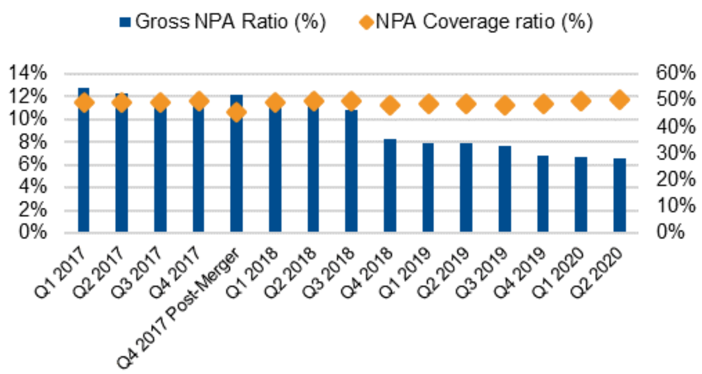
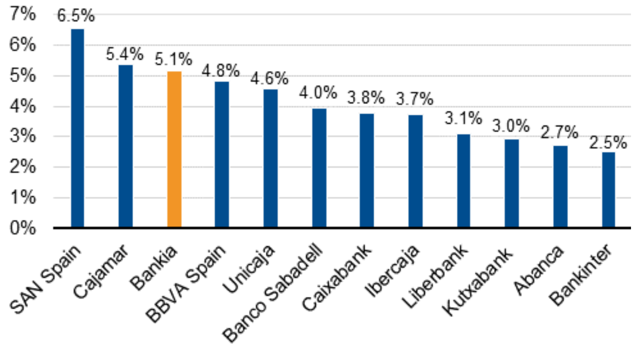


Figure 9: Spanish banks' NPE ratios – Q2 2020



Asset quality will likely worsen going forward as a result of the Covid-19 recession

We expect the asset quality picture to worsen over the coming quarters as a result of the Covid-19 induced recession. Despite strong public sector support to the economy, as well as measures to help borrowers stay current, we see the risk that a proportion of customers will struggle to return to full performance once some of the temporary measures are lifted.

Due to its business model as a retail bank, Bankia is less exposed to some of the hardest hit sectors, such as oil and airlines, but parts of the loan book (tourism, catering) may nonetheless suffer deterioration.

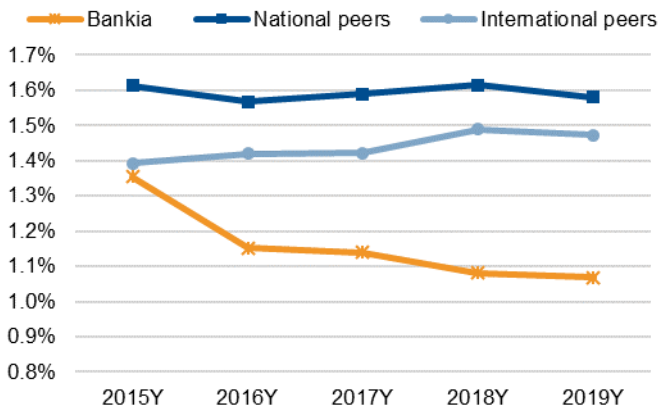
As of end of June 2020, the bank had approved over 40,000 customer requests to defer mortgage payments, for an amount corresponding to 6.4% of Bankia's total mortgage lending.

In Q2 2020, Bankia booked an extraordinary provision of EUR 185m for Covid-19. Total H1 2020 extraordinary covid19 provisions amounted to EUR 310m, representing approx. 57% of total H1 2020 provisions (EUR 547m). In H1 2020 cost of risk increased to 73bps (+51bps YoY) while the underlying cost of risk stood at 27bps (not far from the bank's medium-term strategic targets). The bank pointed out that 2020 cost of risk could amount to approx. 70-80bps.

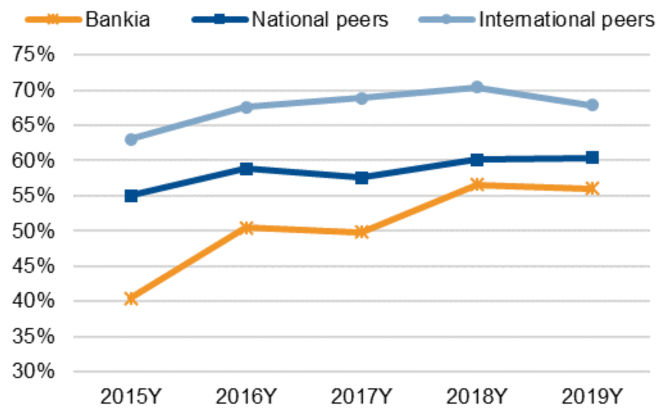
Interestingly, the bank also provided an insight into the cost of risk in its different businesses in Q1 2020, with mortgages' cost of risk at 10bps and consumer loans' cost of risk at 200bps.

I. Appendix: Peer comparison

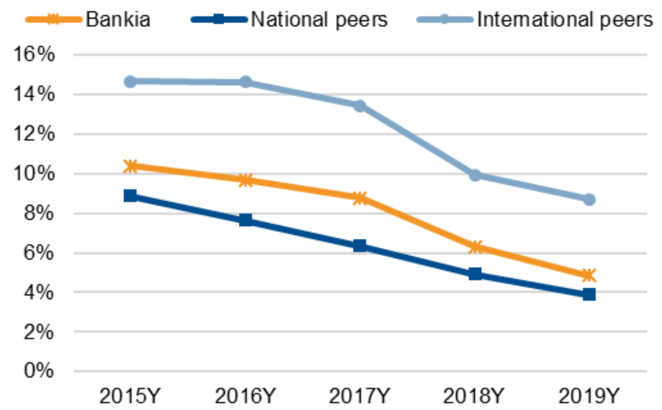
Net interest margin (%)



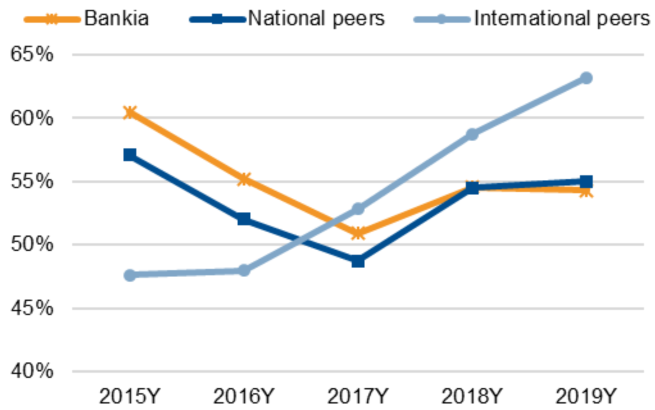
Cost-to-income ratio (%)



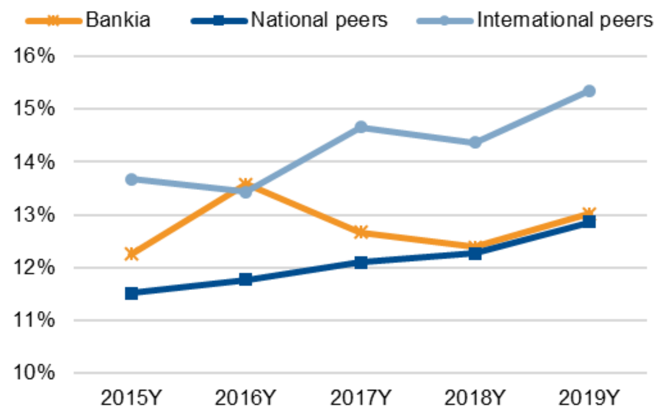
NPLs/net loans (%)



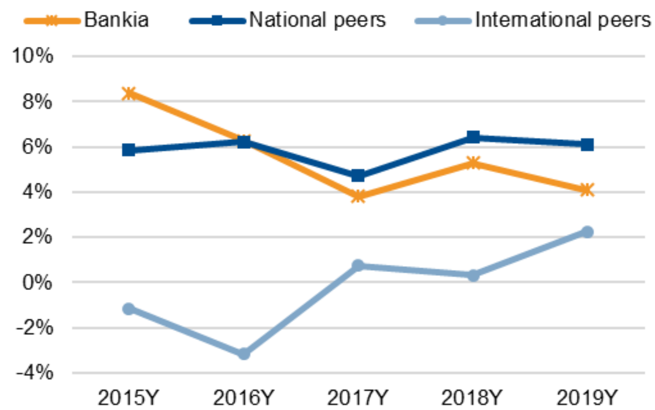
Loan-loss reserves/NPLs (%)



CET 1 fully loaded ratio (%)



Return on average equity (%)



Source: SNL, Scope Ratings
*Spanish peers: Bankia,Santander, BBVA, Caixabank,Sabadell, Bankinter. Ibercaja, Unicaja, Kutxabank, Liberbank
**Cross-border peers: Bankia, Banco BPM, UBI Banca, Novo Banco, Piraeus Bank, Nationwide, Caixa Geral de Depositos, Landesbank Baden Wuttemberg, Belfius Banque, Banco Sabadell

II. Appendix: Selected Financial Information – Bankia

	2015Y	2016Y	2017Y	2018Y	2019Y
Balance sheet summary (EUR m)					
Assets					
Cash and interbank assets	9,422	6,431	7,532	9,187	18,694
Total securities	71,828	65,466	65,244	58,313	54,240
of which, derivatives	16,149	11,887	9,765	8,649	9,018
Net loans to customers	110,570	104,677	123,025	118,295	117,444
Other assets	15,150	13,594	18,132	19,428	18,091
Total assets	**206,970**	**190,167**	**213,932**	**205,223**	**208,468**
Liabilities					
Interbank liabilities	42,702	38,962	37,650	35,644	40,269
Senior debt	22,881	18,801	17,274	15,370	16,209
Derivatives	13,372	9,248	7,456	6,108	6,566
Deposits from customers	108,702	105,155	130,396	126,319	124,785
Subordinated debt	1,046	1,045	2,511	2,990	2,983
Other liabilities	5,571	4,119	5,033	5,602	4,321
Total liabilities	**194,274**	**177,330**	**200,319**	**192,033**	**195,133**
Ordinary equity	12,630	12,792	13,588	13,177	13,322
Equity hybrids	-	-	-	-	-
Minority interests	66	45	25	12	13
Total liabilities and equity	**206,970**	**190,167**	**213,932**	**205,223**	**208,468**
Core tier 1/ common equity tier 1 capital	*11,289*	*11,606*	*12,173*	*11,367*	*11,120*
Income statement summary (EUR m)					
Net interest income	2,740	2,148	1,968	2,049	2,023
Net fee & commission income	938	824	864	1,065	1,081
Net trading income	311	254	377	425	313
Other income	30	(150)	(107)	(218)	(147)
Operating income	**4,019**	**3,076**	**3,102**	**3,321**	**3,270**
Operating expenses	1,626	1,551	1,547	1,880	1,831
Pre-provision income	**2,393**	**1,524**	**1,556**	**1,441**	**1,439**
Credit and other financial impairments	583	221	329	427	463
Other impairments	174	277	157	94	220
Non-recurring income	-	58	-	-	-
Non-recurring expense	184	93	445	-	-
Pre-tax profit	**1,452**	**991**	**625**	**920**	**756**
Income from discontinued operations	-	-	-	6	-
Income tax expense	391	189	131	223	213
Other after-tax Items	-	-	-	-	-
Net profit attributable to minority interests	21	(2)	(11)	0	1
Net profit attributable to parent	1,040	804	505	703	541

Source: SNL data

III. Appendix: Ratios – Bankia

	2015Y	2016Y	2017Y	2018Y	2019Y
Funding and liquidity					
Net loans/ deposits (%)	101.7%	99.5%	94.3%	93.6%	94.1%
Liquidity coverage ratio (%)	NA	NA	172.0%	163.0%	204.0%
Net stable funding ratio (%)	NA	NA	NA	120.0%	124.0%
Asset mix, quality and growth					
Net loans/ assets (%)	53.4%	55.0%	57.5%	57.6%	56.3%
Problem loans/ gross customer loans (%)	10.4%	9.7%	8.8%	6.3%	4.9%
Loan loss reserves/ problem loans (%)	60.5%	55.2%	50.9%	54.6%	54.3%
Net loan growth (%)	-1.9%	-5.3%	17.5%	-3.8%	-0.7%
Problem loans/ tangible equity & reserves (%)	61.6%	57.8%	59.1%	45.1%	36.3%
Asset growth (%)	-11.4%	-8.1%	12.5%	-4.1%	1.6%
Earnings and profitability					
Net interest margin (%)	1.4%	1.2%	1.1%	1.1%	1.1%
Net interest income/ average RWAs (%)	3.2%	2.7%	2.4%	2.4%	2.5%
Net interest income/ operating income (%)	68.2%	69.8%	63.4%	61.7%	61.9%
Net fees & commissions/ operating income (%)	23.3%	26.8%	27.9%	32.1%	33.0%
Cost/ income ratio (%)	40.5%	50.4%	49.9%	56.6%	56.0%
Operating expenses/ average RWAs (%)	1.9%	2.0%	1.9%	2.2%	2.3%
Pre-impairment operating profit/ average RWAs (%)	2.8%	1.9%	1.9%	1.7%	1.8%
Impairment on financial assets / pre-impairment income (%)	24.4%	14.5%	21.1%	29.6%	32.2%
Loan loss provision/ average gross loans (%)	0.5%	0.2%	0.3%	0.3%	0.4%
Pre-tax profit/ average RWAs (%)	1.7%	1.3%	0.8%	1.1%	0.9%
Return on average assets (%)	0.5%	0.4%	0.3%	0.3%	0.3%
Return on average RWAs (%)	1.2%	1.0%	0.6%	0.8%	0.7%
Return on average equity (%)	8.4%	6.3%	3.8%	5.3%	4.1%
Capital and risk protection					
Common equity tier 1 ratio (%, fully loaded)	12.3%	13.6%	12.7%	12.4%	13.0%
Common equity tier 1 ratio (%, transitional)	14.0%	15.1%	14.1%	13.8%	14.3%
Tier 1 capital ratio (%, transitional)	14.0%	15.1%	14.9%	15.3%	15.9%
Total capital ratio (%, transitional)	15.2%	16.4%	16.8%	17.6%	18.1%
Leverage ratio (%)	5.0%	5.6%	5.5%	5.6%	5.4%
Asset risk intensity (RWAs/ total assets, %)	39.1%	40.5%	40.2%	40.1%	37.2%
Market indicators					
Price/ book (x)	1.0x	0.9x	0.9x	0.6x	0.4x
Price/ tangible book (x)	0.3x	0.4x	0.6x	0.5x	0.7x
Dividend payout ratio (%)	29.1%	39.4%	64.8%	52.6%	72.4%

Source: SNL data

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