Spanish banks: less profit, more dividends, M&A on hold for now

Having reviewed the full year results of Spanish banks, we consider the sector's credit quality to be solid, despite a lull in profitability improvements, which is likely to be temporary. As solvency ratios sit comfortably above minimum requirements, Spanish banks have more regulatory leeway to define their capital distribution policies, which in our view will result in higher capital returns – particularly for lenders with limited opportunities for profitable growth. Creditors should see the improved capital generation capacity of Spanish banks as a sign of strength even if capital ratios have peaked for this cycle.

Spanish banks' full-year results were solid, despite headline declines in net profits for the major groups. Against a backdrop of heightened challenges for net interest income, results showed good progress on commissions, costs and asset quality. Stable or growing dividend payouts are testament to managements' optimism with respect to underlying P&L trends, as well as comfort with respect to capital positions.

One-off items explain profit decline. Reported profitability was held down by sizeable goodwill impairments, lower trading gains on ALCO portfolios and integration-related restructuring charges. The restructuring of branch networks is ongoing, in parallel with customers migrating to digital channels, particularly mobile banking.

Higher shareholder returns signal supervisors' ease. Stable or growing dividend payouts, and buybacks, are rarely good news for credit. However, in a highly-regulated sector such as European banking, this at least signals that supervisors are increasingly at ease with banks' stability. We see this as a strength – not a weakness.

Capital formation to remain strong. Aside from profits, 2020 capital formation will likely benefit from one-off items such as the sale of Spanish insurance company CASER (owned by multiple Spanish banks) to Helvetia. The regional banks will also benefit from the renewal of distribution agreements with CASER, for which they will receive upfront payments.

Regional banks cooling down on M&A. Following unsuccessful attempts in 2019, the regional banks seem to be less interested in consolidation. In the short run, increased dividend payouts and buybacks coupled with shareholders' desire to retain control will likely counter the supervisor's gentle pressure for more deals.

Distribution agreements a poison pill for consolidation. The signing of new long-dated insurance distribution agreements could discourage potential suitors because their resolution would add to integration costs in case of a deal. Between 2019 and 2020, several agreements were signed among regional banks, making a deal more difficult.

Stand-alone strategies are riskier. A strategy of splendid regional isolation may be effective in the short term because dense branch networks and strong brand recognition protect the regional banks' dominant market shares. However, we believe this is risky. In a consolidated market where larger competitors are taking full advantage of their scale to invest in digital capacity, regional banks could gradually lose their appeal.

Strategy risk unlikely to turn into an immediate credit threat. While we believe the regional banks could suffer from being sub-scale in a consolidated domestic market, we do not see this as an immediate risk to creditors. Any market share erosion would play out over several years, with management having to continuously adjust the cost base against a declining balance sheet and top line. We continue to see consolidation between regional banks, or into larger players, as the most likely outcome.

Analysts

Marco Troiano, CFA (author)
m.troiano@scoperatings.com

Alvaro Dominguez
a.dominguez@scoperatings.com

Team Leader

Dierk Brandenburg
d.brandenburg@scoperatings.com

Media

Keith Mullin
k.mullin@scopegroup.com

Related Research

European banks' financial fundamentals: as good as it gets?, Dec 2019

Spanish banks: five key themes for 2019, Feb 2019

Scope Ratings GmbH

Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 20 3457 0444

Headquarters

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

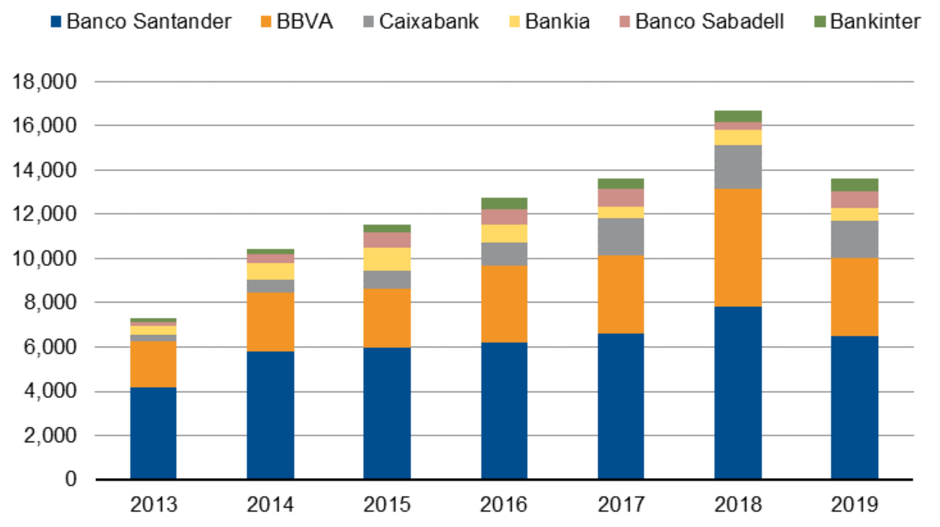
info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

Large banks report lower profits, but underlying trends are solid

In 2019, reported profits for the top six banks fell to EUR 13.5bn, an 18% decline from the 2018 peak of EUR 16.5bn. Of the six banks, only Sabadell and Bankinter reported growth in statutory net profit.

Figure 1: Top 6 Spanish banks profits, 2013-2019



Source: SNL, Spanish banks, Scope Ratings

However, on closer inspection results were solid, as is the outlook for next year:

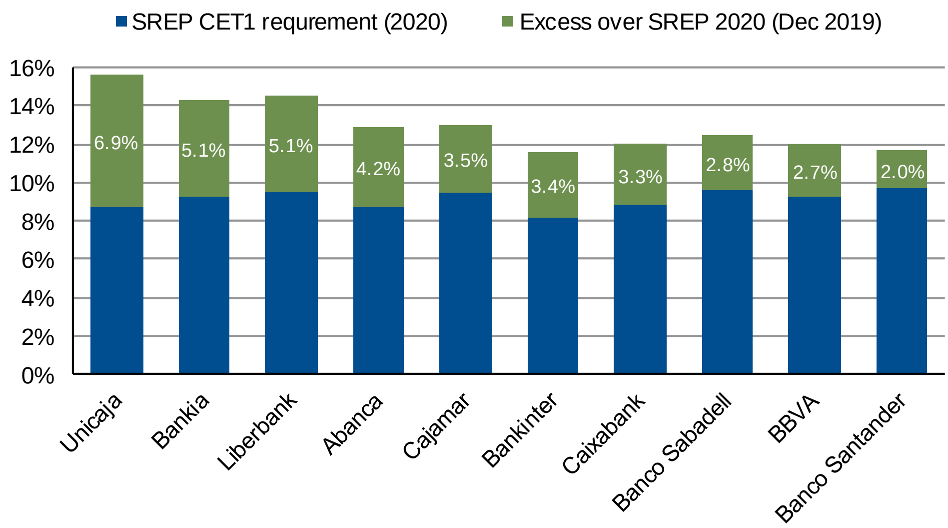
- BBVA's 35% headline decline in statutory net profit was driven by US goodwill impairment in Q4 and by the results of BBVA Chile in 2018 (and the capital gain on its sale in the third quarter). Adjusting for these two items underlying net profit grew 2.7% (2% at constant FX).
- Santander's net income of EUR 6.5bn was also lower than in the previous year. It included several positive and negative one-off items, including UK goodwill impairment and restructuring charges related to the Popular integration. Underlying net profit grew 2.3% (3.2% at constant FX).
- Caixabank's 14% drop in statutory net profit was driven by the large restructuring charge booked in Q2 (c. EUR 1bn) related to the BPI integration.
- Bankia's net attributable profit declined by 23% due to a 27% decline in trading gains and a 9.4% increase in provisions. The more stable elements of the P&L showed better trends, however, with 1.5% growth in fee income and especially very tight cost management (-4.8% yoy) more than offsetting the 1.3% decline in NII.

P&L trends for the larger Spanish banks still look robust despite a challenging revenue environment. This is reflected in stable dividends after capital targets have largely been reached.

- Bankia is maintaining its dividend of EUR 11.6c per share, raising the pay-out from 50% to 65%, while reiterating that excess capital over the 12% CET1 ratio target will be distributed (the current ratio is 13.02%); a share buyback is not off the cards.
- Caixabank's proposed dividend per share (DPS) of EUR 0.15 represents a 53% payout, slightly higher than last year's 51%.
- Bankinter's proposed DPS is EUR29c, 49% of EPS and stable compared to the previous year.
- BBVA's pay-out policy of 35%-40% (2019 proposed cash DPS of EUR 0.26c, 36% pay-out) is less aggressive, reflecting the broader growth optionality the bank has in its emerging market franchises. Management expects to be around the capital target (CET 12%) by end-2020, after which the bank may look to up shareholder remuneration (via higher dividends or buybacks) in case it cannot profitably deploy capital.
- Santander's DPS of EUR23c represents close to 50% of underlying EPS, a stable pay-out compared to the previous year. Like BBVA, the lower pay-out is consistent with better (more profitable) growth options than purely domestic peers. Santander's CET1 ratio of 11.65% is within the target range.
- Sabadell's pay-out ratio of 40% (DPS of EUR 4c proposed for 2019) is lower than most domestic peers, reflecting the effort to rebuild capital in the year, at 12.1% pro forma for the sale of the asset management business.

Among the regional banks, Unicaja, Liberbank and Abanca have significant excess capital. Of the three, Abanca is the more likely to deploy it for growth, given its recent more acquisitive track record and its aspiration to be an Iberian bank. Unicaja and Liberbank are instead going to increase capital returns to shareholders – the former through higher dividends and the latter via a share buyback.

Figure 2: Excess capital over SREP requirement, Spanish banks



Source: SNL, Spanish banks, Scope Ratings

Strong progress towards MREL compliance in 2019; banks well placed to meet requirements going forward

In line with our expectations (see **Spanish banks: five key themes for 2019**), large and second-tier Spanish banks were very active in the senior non preferred segment in 2019, as they built up their MREL stacks. For 2020, we think activity in the senior non preferred space may be more opportunistic, as banks' MREL needs look manageable.

Santander, BBVA and Sabadell already MREL-compliant

Santander, BBVA and Sabadell (banks with resolution colleges) had already received binding MREL targets in 2018, including subordination requirements and were early issuers of senior non preferred debt in 2018 and 2019. The published requirements included explicit subordination requirements.

The MREL requirements, first received in May 2018, became effective on January 1, 2020. With full-year 2019 results, the three banks reported compliance with both the MREL requirement and applicable subordination requirements.

MREL requirements announced in May 2019

For banks without resolution colleges (Bankia, Caixabank, Bankinter, Abanca, Unicaja, Ibercaja, Liberbank) the first binding requirements were announced in May 2019. For the time being, no subordination requirement has been announced for this group of banks, although this may change in future years. Subordination requirements are set based on a combination of a general level, applicable buffer requirements and a bank-specific metric, which considers no-creditor-worse-off (NCWO) risk in the senior layer. A floor for the subordination requirement is set at 14% plus the combined buffer requirement. (16% plus combined buffer requirement for G-SIBs). For Spanish domestic banks, this calculation would put the subordination requirement floor in the 16%-17% range, which looks achievable, especially considering the still-distant deadlines.

The requirements, calculated based on 2017 FY balance sheets, will come into force at different dates through January 2023. It is important to point out that the MREL targets will have to be met based on the RWAs at the time the requirements come into force.

Bankinter requirement kicks in in July; bank already compliant

Bankinter's requirement of 18.9% of RWAs (8.52% of Total Liabilities and Own Funds – TLOF) will be the first to become effective, from July 2020. At the time of the announcement, Bankinter disclosed it had an MREL ratio of 17.2% (of RWAs) and that the requirements were in line with its expectations and funding plans – envisaging no trouble achieving compliance. It subsequently issued EUR 750m in SNP in June 2019 – worth c. 220bp of RWAs by our calculations, effectively taking the bank above the requirement. A further senior non preferred bond of EUR 750m was issued in January 2020, increasing both the MREL buffer and the proportion of subordinated instruments in Bankinter's capital structure.

Caixabank meeting MREL requirement a year in advance

Caixabank's requirement of 22.5% of RWAs (10.6% of TLOF) will become effective from January 2021. With Q4 2019 results, the bank reported an MREL ratio of 21.9%, which will increase to 22.5% with the EUR 1bn senior preferred bond issued in January 2020, effectively matching the requirement one year in advance. Nevertheless, we expect the bank to continue to be a net issuer in 2020, to build some buffer over the requirement.

Bankia well placed to meet its requirement

For Bankia and Kutxabank, requirements only kick in in July 2021. Bankia's target is 23.7% of RWAs (10.02% of TLOF), which compares with an MREL ratio of 21.93% at the end of 2019. Bankia was very active in 2019 in issuing MREL-eligible debt, including EUR 1bn in Tier 2 debt, EUR 1.25bn in senior non preferred and EUR 1.25bn in senior preferred debt (over 450bp of 2019 RWAs, although the Tier 2 issue was a replacement). We expect Bankia to continue to be a net issuer of MREL-eligible debt in 2020, in the forms of senior debt. With the AT1 and T2 buckets full, and no near-term binding subordination requirement, the bank may hold off senior non preferred issuance while its subordination requirement is not set in stone.

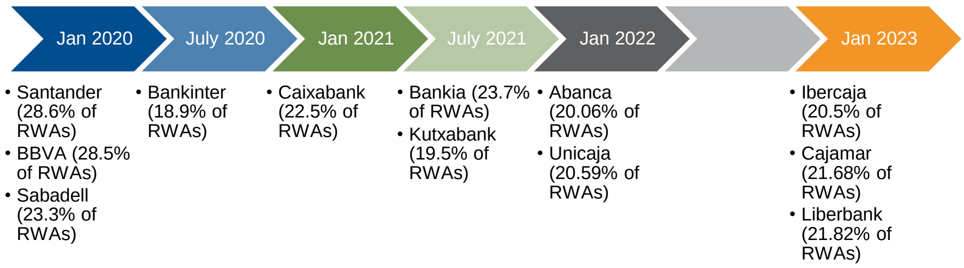
Kutxabank's target undemanding

Kutxabank target of 19.54% of RWAs (10.51% of TLOF) is one of the lowest in Spain, and especially undemanding considering the Basque group's strong starting point. As of September 2019, Kutxabank's total capital ratio stood at 16.84%, and the bank issued its inaugural EUR 500m senior non preferred bond in September 2019, worth 163bp of RWAs. We estimate that the remaining shortfall to the MREL requirement is just over 1%, or EUR 300m, which looks very manageable before July 2021. We would expect another SNP issue of similar size in 2020, which would allow the bank to build a buffer over its MREL requirement.

Regional banks could hold off issuance given lack of urgency

The other regional banks also received their requirements in 2019 but these requirements will only apply from January 2022 for Unicaja and Abanca and January 2023 for Ibercaja, Liberbank and Cajamar. The ample timelines will in our view drive an opportunistic approach where banks delay issuance to avoid unnecessarily paying the cost of MREL compliance years in advance (also considering the cheap and abundant funding available).

Figure 3: Timeline of Spanish banks MREL requirement effectiveness



Source: SNL, Spanish banks, Scope Ratings

Regional banks cooling down on M&A (for now), distributing capital excess

For all the talk about M&A between regional banks, remarkably little actually happened in 2019. The Unicaja-Liberbank tie-up did not materialise, while Abanca, Kutxabank and Ibercaja sat on the sidelines.

The law on banking foundations (26/2013) mandates that banking foundations relinquish control over banks (i.e. dilute themselves to below 50% and do not exercise effective control). If they don't achieve this, they have to prepare contingency plans to tackle potential capital, including a dedicated reserve fund to be made available should the bank need equity.

Unicaja likely to distribute its excess capital to its controlling foundation

Malaga-based Unicaja successfully opened up capital in June 2017, when the controlling foundation diluted itself to c.50% through an IPO. A merger with Liberbank would have allowed the Fundacion Unicaja to dilute itself further and, over time, relinquish control.

Instead, the foundation announced in November 2019[1] that it would maintain control of the bank and proceed to set up the mandatory reserve fund by 2024.

The fund must[2] be at least 0.6% of RWAs, though it may be higher depending on whether the bank is listed, the percentage ownership of the controlling foundation and the impact of the investment in the bank on the foundation's equity base. The deadline for compliance is 2023.

As a minimum, we calculate – based on FY 2019 RWAs of EUR 23bn – that the reserve fund will have to amount to EUR 138m.

The foundation will direct at least 30% of incoming dividends from Unicaja banco to the fund. For FY2019, Unicaja will distribute EUR 76.6m in dividends – close to half of which will go to the foundation. At the current rate of profits and dividends, and assuming a 30% allocation would translate to c EUR 11.5m contribution annually, which appears insufficient to meet the 2023 deadline.

We believe the need for the foundation to build up the reserve fund (while also continuing its social work (*Obra Social*) will drive capital distribution choices at Unicaja for the next few years.

In its Q4 result call, Unicaja's management already pointed to its intention to distribute excess capital. Unicaja is targeting a 13% CET1 ratio (currently 14% on a fully-loaded basis). While management remains open to the consolidation option, M&A seems to have lost its appeal, for now.

Liberbank recently launched a share buyback

Similarly, Liberbank's CEO stated during the Q4 2019 results call that the bank remains open to value-creating consolidation deals. However, we note that the announcement of a EUR 20m buyback on December 30 is a strong pointer to a stand-alone strategy. Liberbank has significant excess capital and may generate more next year, due to decent organic generation alongside potential positive one-offs, such as the sale of its stake in Caser (see below).

At the end of 2019, Liberbank had a regulatory CET1 ratio of 14.6% (13% fully loaded) – well above the 2020 SREP requirement of 9.5%. The buyback will take the cash payout to shareholders to 38%, from 20% a year before.

[1] Protocolo de Gestión de la participación financiera de la fundación bancaria Unicaja en Unicaja Banco S.A.
[2] RD 877/2015 (as amended by RD 536/2017

Ibercaja focused on IPO this year

Zaragoza-based Ibercaja also seems to remain set on a stand-alone plan, entailing an IPO by end 2020. The IPO will allow the controlling Ibercaja foundation (currently owning a 87.8% stake) to dilute its stake as per latest management protocol[3].

Kutxabank capital is controlled by three separate banking foundation: BBK (57%), Kutxa (32%) and Vital (11%), with BBK exerting control. BBK has long opted to maintain control over the bank[4], and started to build up the reserve fund in 2015.

Abanca most active in M&A in recent years

Abanca, which had shown interest in buying Liberbank in 2019, remains in our view a candidate for further consolidation. The Galician entity is still integrating Banco Caixa Geral in Spain and Deutsche Bank's Portuguese private and commercial banking operations, acquired in 2019. On February 10, 2020, it announced the acquisition of 95% of the shares of Portuguese EuroBic. While noting that the transaction remains subject to due diligence and regulatory approvals, we see the announcement as a confirmation of the bank's acquisitive attitude and ambition to transcend its regional roots.

While momentum seems to have been lost, possibly due to the frustration linked to the inability to seal deals last year, we believe the case for consolidation among regional banks remains strong.

Revenues and profits will remain under pressure, due to the unfavourable interest-rate environment. With medium-term profitability (and profitability targets) stuck in the low-to mid-single digit range, Spanish regional banks are currently destroying value for their owners. While in the short term this could be an acceptable state of affairs, as shareholders prefer to maintain control, it is not conducive to investment (or re-investment of earnings).

As customer interactions naturally migrate from branches to online and mobile channels, some of the regional banks' historical competitive advantages (proximity and relationships) become eroded and competition intensifies. In order to defend their market shares, regional banks will have to invest significantly in the development of their digital offerings. With more limited budgets, regional banks run the risk of becoming digital laggards and lose customers to larger competitors.

[3] Protocolo de gestión de la participación financiera de la Fundación Bancaria Ibercaja un Ibercaja Banco, S.A.
[4] Protocolo de gestión de la participacion financiera de Fundación Bancaria Kutxa - Kutxa Banku Fundazioa en Kutxabank, S.A.

Art.104 relief is worth 50-100bp of CET1 capital for Spanish banks

In the last month of 2019, an orientation emerged towards Pillar 2 requirements possibly being fulfilled in the future with a mix of common equity and capital instruments.

Change in mix of Pillar 2 will result in looser CET1 requirement

CRD5's art.104a.4 establishes that banks are allowed to do so, aligning the approach in the Banking Union to other European jurisdictions where this is already the case, including the UK and Sweden. This represents a departure from the previous supervisory approach of the SSM, which required banks to meet Pillar 2 requirements exclusively through CET1 capital.

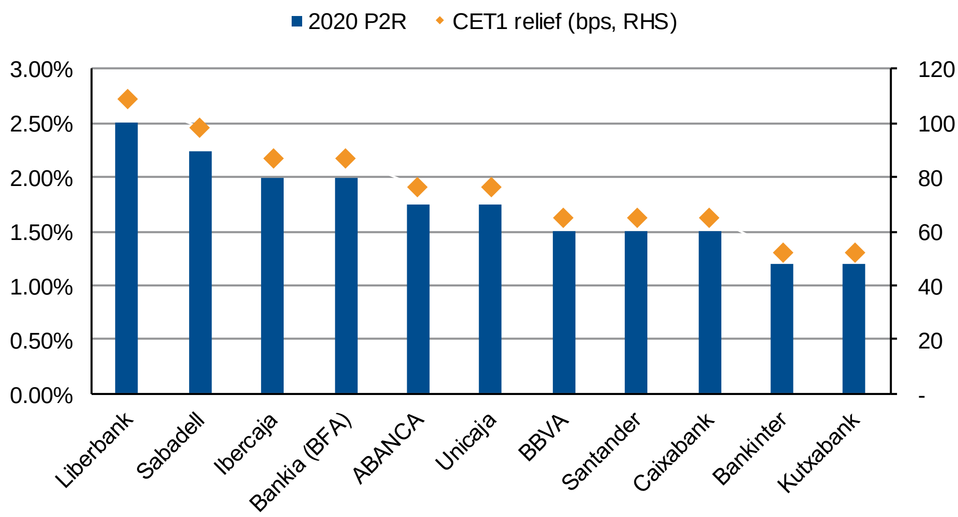
During the Q4 results season, banks started disclosing the expected impact of such change on their CET1 requirement. Bankia disclosed they expect c.90bp benefit from moving to a mix of CET1, AT1 and T2s to fulfil Pillar 2 requirements. This squares with our calculations, based on the same mix of capital instruments as in Pillar 1.

Liberbank, Sabadell will benefit the most

Based on 2019 SREP results and P2R requirements for 2020, we estimate that for Spanish banks under the SSM the change will be worth between 53bp and 109bp of the CET1 requirement. The biggest beneficiaries in term of capital relief will be the banks with the highest Pillar 2 requirements, Liberbank and Sabadell, while the impact will be most contained for Bankinter and Kutxabank.

One important caveat here is that national legislation implementing CRD5 will have to be passed by the end of 2020, and hence the new rule on Pillar 2 mix will only apply from 2021, when Pillar 2 requirements may actually be different at that stage.

Figure 4: 2020 Pillar 2 requirements and estimated 2021 CET1 capital relief from art 104 implementation.



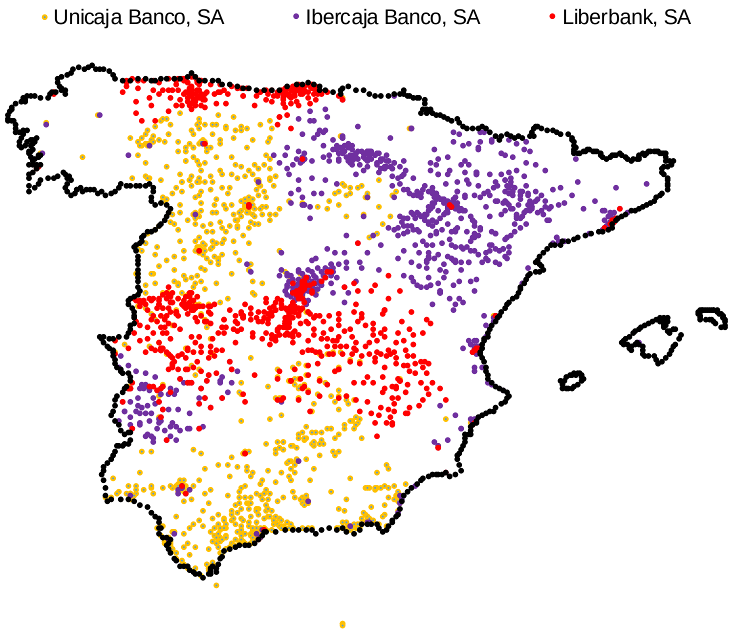
Source: ECB, Scope Ratings

CASER sale to support capital formation in 2020

Helvetia will control CASER

In January 2020, Swiss insurer Helvetia's announced the acquisition of a majority stake in Spanish insurer CASER, with several Spanish banks selling their stakes. Following the transaction, Helvetia will control 70% of CASER, with Unicaja, Liberbank and Ibercaja retaining minority shares of just under 10% each. These three banks also renewed their strategic distribution agreements with CASER, facilitated by the fact that these banks operate in separate regions with essentially no overlap.

Figure 5: CASER distribution through Ibercaja, Unicaja and Liberbank shows limited overlap



Source: ECB, Scope Ratings

Unicaja, Liberbanca and Ibercaja will distribute CASER products

Unicaja had recently reviewed its insurance distribution in 2017, entering into a JV with the Santa Lucia group for life insurance, and conferring to it its life insurance businesses Unicorp Vida and CajaEspana Vida. Subsequently, the partnership had started to expand into non-life products – something that will have to be reviewed in light of the CASER agreement. Liberbank and Ibercaja have their own life insurers and were already distributing CASER policies in non-life.

For the other selling shareholders (Caixabank, Abanca and Bankia), CASER was more of a financial stake – often a legacy of the post-crisis consolidation in the savings banks sector. Caixabank has long been operating a successful bancassurance model; Bankia reshaped its insurance distribution agreements in 2017, entering into a JV and distribution agreement with Mapfre; Abanca, had already signed a bancassurance agreement in 2019 with Credit Agricole Assurance.

Deal brings capital benefit to regional banks

In 2020, subject to completion, the CASER deals will contribute positively to banks' capital build. Several of the banks have disclosed the direct impacts, which includes capital gains on the sold stakes, revaluation effects and lower capital consumption of the remaining stakes (under 10%), and cash contributions related to the renewal of distribution agreements. The impact is likely to be relatively small for Bankia (+12bp) and Caixabank (+2-3bp). However, it will be more material for regional banks (for example, 35bps for Unicaja and 42bps for Liberbank), due to their smaller size and to the extra upfront payout from the renewal of distribution agreements.

Spanish banks: less profit, more dividends, M&A on hold for now

Scope Ratings GmbH

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main
Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris
1 Cour du Havre
F-75008 Paris

Phone +33 1 8288 5557

London
Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 20 3457 0444

Madrid
Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan
Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo
Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com