Spanish banks: five key credit themes for 2019

The recently reported Q4 and FY2018 results confirm that the Spanish banking sector is in very good health, with adequate profits, capital and asset quality. In this report, we identify five key themes investors should focus on in 2019 and review the results of the country's top six banks.

Profit and capital formation remain strong. Despite slowing macro momentum, results momentum remained strong. With few exceptions, banks reported solid growth in their bottom lines. Domestic volume growth in Spain was muted, with consumer credit and business loans growing but mortgages declining and margins little changed on average. However, fee income was strong for most banks, while rising loan volumes continue to drive growth in Santander and BBVA's international operations.

Cost growth was controlled and typically lower than the increase in revenues, and the cost of risk is low (so low in fact that we don't think it can last). Against this backdrop, capital formation is very strong, and banks were able not only to meet their capital targets but generally upgrade them.

Real estate sales improve capital visibility. Thanks to the very active NPA market in 2018, virtually all Spanish banks seem on track to over-deliver on their asset quality improvement targets. In 2019, we may see the long tail of the clean-up, but we think Spanish banks are ahead of the game when it comes to asset quality, a welcome development given the high supervisory pressure on this topic.

More M&A ahead. We believe there is still room for consolidation in Spain, specifically among regional banks. Aside from the talks between Unicaja and Liberbank, and the still-progressing integrations of Popular and BMN into Santander and Bankia respectively, we believe further tie-ups are possible.

Litigation risk is a nuisance but seems manageable. Following mortgage floor clauses and mortgage expense costs, 2019 may see further litigation provisions hit the banks if claims related to the IRPH mortgage index come to fruition. We see a low probability that this particular source of litigation risk will become a major credit issue, though it could become a drag on banks' profitability.

MREL requirements are coming in. Banks will issue senior non-preferred debt. BBVA, Santander and Sabadell disclosed their MREL requirements in 2018. Bankinter confirmed that it has also received its MREL and we believe that most banks should receive their MREL communications in the coming months. Over the course of the year, we expect banks to issue MREL eligible liabilities, including senior non-preferred debt.

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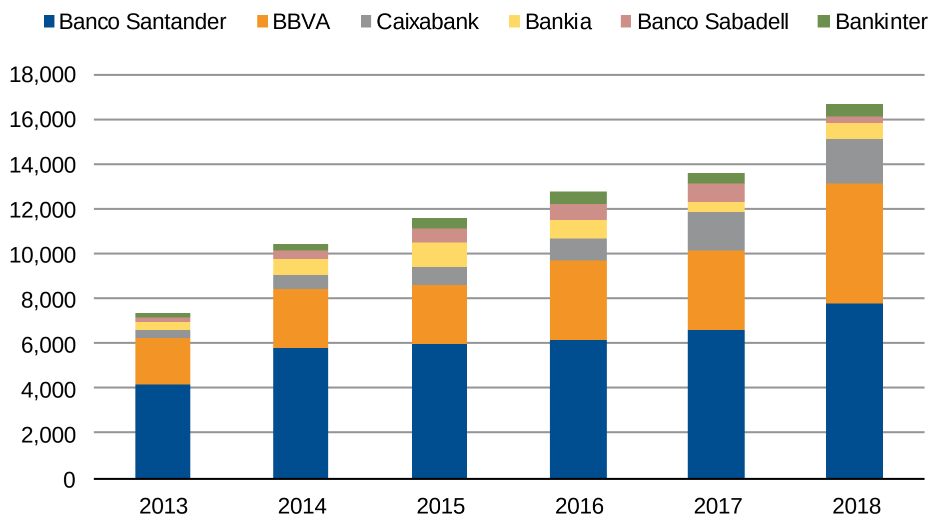
Five key credit themes

1 Profit and capital formation trends remain positive; capital targets are increasing

2018 was another year of strong profits for Spanish banks, which continue to benefit from a favourable business cycle and from the delivery of cost synergies from several ongoing integration processes. Domestic revenues remain under pressure from low interest rates, but the gradual shift in mix from mortgages to higher-margin consumer credit and business loans should help margins going forward. Mexico and South America continue to drive fast volume, revenue and profit growth for Santander and BBVA.

Figure 1: Top six banks' aggregated profit, Spain



Source: SNL, Issuers, Scope Ratings

Strong profitability against muted RWA growth in Spain is contributing to capital accumulation, with most major banks reporting fully loaded CET1 ratios between 11% and 12%; Bankia being slightly higher. Several banks recently raised their medium-term capital targets: Santander (11-12% mid-term target), BBVA (11.5%-12% range for 2019), Bankia (12% in 2020), Caixabank (12% plus 1% managerial buffer in 2021), Sabadell (12.5% in 2020).

Banks have yet to disclose their 2019 SREP letters, but based on 2018 requirements (between 8% and 9% for the above five banks), the targets imply buffers of c.300-400bp on respective CET1 requirements, on top of fully phased in CBRs. We believe this is reassuring, in the context of a degree of uncertainty regarding future regulatory headwinds possibly stemming from the ECB's targeted review of internal models (TRIM), accounting changes, and the potential for tighter supervisory guidance on NPL coverage.

2 Jumbo real estate asset sales accelerate balance sheet clean-up

The sector's NPL ratio has been declining for the past five years, the result of a benign economic environment (following a deep V-shaped recession) coupled with a very proactive regulatory approach which forced the banks to front-load provisions for real estate-related assets back in 2011 and 2012, and to raise fresh capital.

Sales of NPLs and foreclosed assets also helped the process, although it is only since 2017 that banks have started to aggressively de-consolidate non-performing assets through partnerships with large US funds (see our recent note: Spanish banks: asset quality improvements set to continue, published on 17 October 2018). During Q4 2018, BBVA closed its previously-announced transaction with Cerberus, de-consolidating EUR 13bn in gross real estate assets.

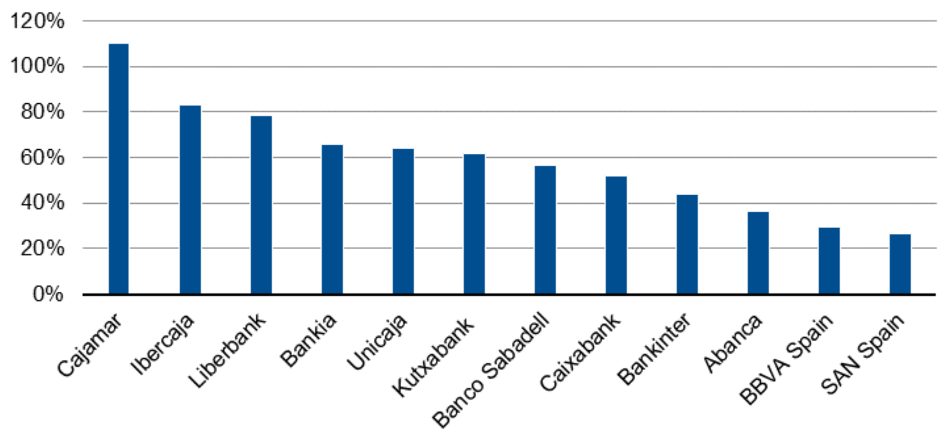
In the same quarter, Caixabank closed the transfer of EUR 12.8bn in foreclosed assets to Lone Star. Sabadell's deal with Cerberus for c. EUR 9bn is expected to close in the first half of 2019. In December 2018, Bankia announced that it had reached an agreement with Lone Star for the disposal of EUR 3bn in non-performing assets.

In addition to these jumbo-sized deals, there have been several smaller sized though still material disposals from almost every bank in the country, including SAREB (the government bad bank).

The de-consolidation deals have allowed some of the banks to hit their de-risking targets early: Sabadell's net NPA ratio of 1.6% is already lower than the 2020 target (2%), while Bankia has reduced gross NPAs by EUR 6bn in 2018, double the amount it targeted at the time of the business plan (Feb 2018).

At the end of 2018 and pro-forma for already announced disposals, it is fair to say that Spanish banks have finally cleaned up their balance sheets.

Figure 2: Texas Ratios Spanish banks, 2018



Note: Cajamar data as of June 2018, Ibercaja as of September 2018, Kutxabank as of December 2017. Bankia and Banco Sabadell: pro-forma for NPA sales

Source: Company data, Scope Ratings

3 Consolidation process continues

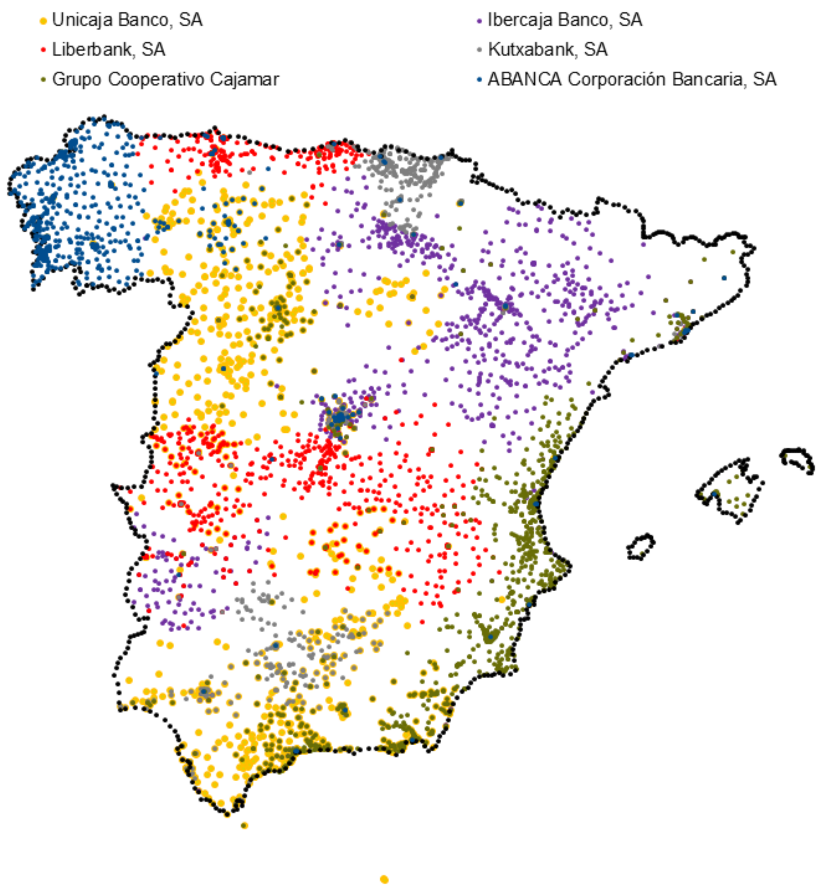
The bulk of the consolidation in Spain happened in the aftermath of the real estate boom and bust, but the process continues. Bankia has almost completed the integration of BMN; Santander is in the middle of integrating Popular; and Bankinter recently announced its acquisition of EVO Banco. Among the regional banks, Unicaja has confirmed ongoing talks with Liberbank, and we believe further combinations among the regional banks are possible.

We see in-market consolidation as positive, especially between smaller-sized regional banks, as it allows banks to scale up their digital distribution efforts and compete with larger players on a more equal footing.

If the Spanish banking crisis has a silver lining, it lies in the in-market consolidation of the sector, which has allowed a material rationalisation in cost structures and freed up budgets for much-needed investments in digital distribution.

While we acknowledge that we are reaching the tail end of the consolidation process, we still believe there are opportunities: there is very little overlap between the remaining regional bank franchises, which could seek to merge as a way to diversify and enlarge their business. We also see some of the larger banks such as Bankia and Sabadell possibly looking at M&A to round out their uneven franchises.

Figure 3: Regional banks branch franchises



Source: SNL, Scope Ratings

4 IRPH- linked mortgages and other litigation risks

IRPH-linked mortgages are the latest villain in a long series of alleged bank malpractices in Spain, following mortgage floor clauses (cláusulas suelo) and mortgage origination costs (gastos hipotecarios), particularly around mortgage lending.

In short, some variable-rate mortgages reference the IRPH index (Indice de Referencia de Prestamos Hipotecarios, Mortgage Loan Reference Index). In recent years, certain mortgage customers have claimed that IRPH indexation clauses are abusive and therefore void, on the grounds that they lacked transparency. The IRPH cases are numerous and complex, with different claims leading to different outcomes.

Some customers received favourable judgements in local and provincial courts, though in 2017 the Spanish High Court ruled in favour of the banks (and specifically of Kutxabank's appeal to a ruling in the provincial court of Alava), considering that the reference to an official index such as the IRPH does not involve any lack of transparency or abusiveness. Some other cases were deferred to the European Court of Justice (ECJ), as the judges had doubts on whether such clauses were in violation of European Consumer Protection laws (and in particular of Directive 93/13). The ECJ is expected to rule on the topic in 2019.

While we are in no position to prejudge the final outcome of the controversy, there is a risk that banks will have to book costs in 2019 to provision for a potentially adverse ruling.

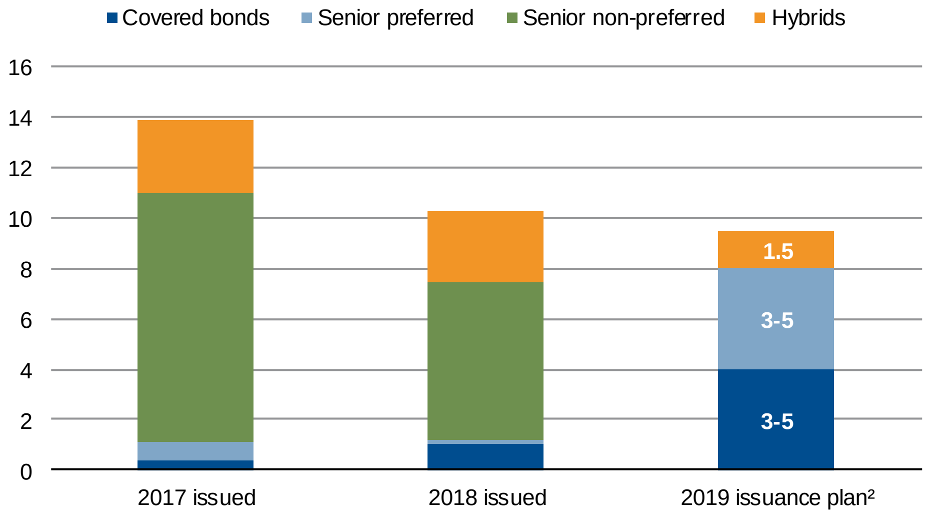
Overall, we think any impacts will be manageable for the sector, as was the case with previous litigation cases. However, we do note that while the direct financial impacts of the financial crisis (bad assets and the associated losses) seem to have been assuaged, the reputational damage on the sector will likely persist for longer, with customers more likely to enforce their redress rights if they feel they have been wronged and a well-developed litigation industry ready to assist them. If not a direct threat to their solvency, this surely represents a potential drag on their profitability.

5 MREL requirements are manageable. Banks to tap senior non-preferred in 2019

Alongside their SREP capital requirements for 2019, banks are also receiving communication on their MREL requirements. BBVA, Santander and Sabadell confirmed that they received MREL communications during 2018, at least for the requirement at the parent company level. In the latest round of results presentations, Bankinter also confirmed that it had received communication (without disclosing the actual requirement), while other banks have for now only estimated their requirement based on the SRB default formula – essentially twice the total capital requirement, including CBR, less 125bp.[1]

Santander, BBVA and Caixabank have been regularly issuing senior-non-preferred debt (SNP) in benchmark size since 2017. On the other hand, mid-size Spanish banks and smaller regional banks have been more cautious. But with the requirements now clearer and a more mature SNP market, we believe 2019 will probably see issuance of SNP from Sabadell, Bankia and Bankinter as well as the regional banks. During the fourth quarter presentation, Santander updated the market on its funding plan. Having issued over EUR 16bn in SNP in 2017 and 2018, the bank now plans to primarily issue covered bonds and senior unsecured debt for 2019.

Figure 4: Banco Santander's funding plan for 2019



Source: Santander, Scope Ratings

[1] MREL = *LAA + RCA + MCC where* LAA = P1 + P2R + CBR; RCA = P1 + P2R; and MCC = CBR - 125bp. This essentially yields: MREL =2 x Total capital requirement - 125bp

Appendix: Bank by bank

Bankinter (Not publicly rated, results published on January 24)

Bankinter closed 2018 with record-high annual profits of EUR 526m, a 6.3% y-o-y growth. The increase in the bottom line was mainly the result of volume growth, as the group keeps deploying the excess capital generated by its highly profitable operations (ROE of 13.2% in 2018). Loans grew 4% y-o-y, with all key P&L lines (NII, fees, costs, and provisions) growing by c.6%. Bankinter Portugal reported double digit loan growth, driven by progress in corporate lending.

Asset-quality trends are positive, with the NPL ratio falling to 2.9% at the end of Q4, coverage of 49% and a normalised cost of risk at 19bp in 2018 also declining. The amount of foreclosed assets is negligible, well covered and declining (EUR 348m in December). Management guided for increasing cost-of-risk in 2019 (30-35bp), due to rising impairments in the consumer finance segment.

The fully-loaded CET1 ratio stood at 11.75%, improving by 29bp in the year, with retained earnings (84bp) more than covering the need to finance higher RWAs (55bp). This does not include the impact from the acquisition of EVO Banco, announced in September 2018, and expected to close in H1 2019. At the time of the announcement the impact was estimated at 29bp.

The bank did not disclose its MREL requirement, although it confirmed that it has received a draft communication and that it currently has a EUR 450m shortfall to the requirement, which is manageable.

Bankia (BBB+, stable, results published on January 28)

For the last quarter of 2018, Bankia reported a net loss of EUR 40m vs a net profit run-rate in the previous three quarters of EUR 200-300m per quarter. The loss was driven by two elements, specifically: i) a seasonal element (the payment of deposit guarantee fund contributions in the fourth quarter); and ii) a non-recurring element (EUR 85m in net extraordinary provisions related to the sale of non-performing asset portfolios).

The key underlying trends were encouraging. The gross customer margin increased in the quarter, driven by higher asset yields, signalling a possible reversal in net interest income, which recorded a 9.6% decline in the year (Bankia + BMN pro forma). The delivery of cost synergies from the integration of BMN drove a 4.3% decline in operating expenses in the year, with larger savings materialising in the latter part of the year (8.3% y-o-y decline in expenses in Q4 18).

At the end of 2018, Bankia reported a fully loaded CET1 ratio of 12.51% ahead of both its SREP requirement for 2018 (8.563%) and its own target of 12%. We expect capital to continue to build up given the solid profitability and limited need to finance RWA growth.

A key positive development in the quarter was the acceleration in the sale of NPAs. The December pro-forma gross NPA ratio, which includes the effects of the EUR 3bn portfolio sale to Lone Star, stood at 8.2%, putting the 6% 2020 target well within reach.

Banco Santander (AA-, stable, results published on January 30)

Santander's closed the year with an annual net profit of EUR 7.8bn (growing 32% YoY at constant exchange rates) and RoTE of 11.7%. The key drivers for the increase in profitability were growth in revenues, a decline in provisions and in non-recurring items, primarily goodwill impairments and Popular integration costs.

The reported CET1 stood at 11.3%, ahead of Santander's own 11% target, although the ratio would be 27bp lower considering the full impact from IFRS 9 transition.

Having met its 2018 targets, Santander announced a mid-term target of 11%-12% for the CET1 ratio and 13%-15% for RoTE. The CET1 target range would keep Santander at the lower end of large European banking peers, but we share management's view that this is adequate given Santander's consistent track record of organic capital generation and highly diversified revenue streams. The return target looks more aggressive, especially given the challenging outlook for the UK, but the bank should provide more colour on this at its upcoming investor day on April 3.

Santander disclosed details of its funding plan for the year. At the parent company level, Santander plans to issue between EUR 7.5bn and EUR 11.5bn, subject to market condition and regulatory requirements. Interestingly, most of the issuance will be in covered bonds and senior preferred debt, as opposed to the last couple of years when new issuance was mostly in senior non-preferred debt and in capital securities.

BBVA (A+, stable, results published on February 1)

Group 2018 net profit stood at EUR 5.3bn compared with EUR 3.5bn in 2017. If exceptional items are excluded, such as the impact from the sale of BBVA Chile, 2018 net profit stood at EUR 4.6bn compared to EUR 4.3bn in 2017 (+7% y-on-y;.+22% at constant exchange rates). The corresponding underlying RoTE stood at 12.5%.

The key drivers for the improvement in underlying net profit was growth in net interest income (+10.8 y-on-y in constant euros) and in net fees and commissions (+8.9%). Expenses grew more slowly (2.5%), while provisions and impairments declined. Currency movements had a negative impact on statutory results.

Group NPLs declined to EUR 17.1bn in December 2018 from EUR 17.7bn at the end of September. The NPL ratio stood at 3.9%, down from 4.1% in September. Foreclosed assets are not material, since BBVA closed a deal with Cerberus in Q4 to de-consolidate the vast majority of its real estate portfolio. The loss in the non-core Spanish real estate division was just EUR 78m (EUR 490m in 2017). Going forward BBVA will cease reporting it separately from the Spanish banking business.

While headline asset quality metrics continue to move in the right direction, and the Spanish asset-quality crisis is water under the bridge, there has been a material increase in cost of risk in Turkey (244bp in 2018 vs 82bp in 2017) as a result of the macro volatility in the country in 2018. Management guided for 300bp cost of risk in Turkey in 2019. The deterioration in Turkish asset quality was expected and manageable in our view, in the context of Garanti's high pre-provision profitability.

BBVA's fully-loaded CET1 ratio stood at 11.34%, stable on the previous quarter and 26bp higher than a year before, with earnings (136bp) and a capital gain on the sale of BBVA Chile (50bp) more than sufficient to absorb the full IFRS 9 impact (31bp), RWA growth (24bp), market-related and other impacts (47bp) and distributions of dividends and AT1 coupons (58bp). For 2019, BBVA is targeting a CET1 ratio of 11.5%-12%.

As of December, BBVA has fully filled its AT1 and Tier 2 buckets (1.57% and 2.54%) and will complete issuance of MREL eligible debt to ensure fulfilment of MREL in 2020.

Banco Sabadell (not publicly rated, results published on February 1)

Banco Sabadell reported statutory net profit of EUR 328m at group level, a decline of 54% from the comparable figure in 2017. The group's performance in 2018 was materially affected by one-off costs connected to the IT migration of its UK subsidiary TSB (EUR 121m) and ensuing fiasco (EUR 339m) and extraordinary provisions (EUR 177m) related to the de-consolidation of a large NPA portfolio.

Positively, TSB's reported figures seem to indicate that, despite having suffered a material reputational blow, business volumes in the TSB franchise have shown some resilience. Compared to 2017, total customer loans declined 2.7%, and customer deposits declined 4.7%. However, this may reflect management actions rather than customer behaviour. Current accounts in TSB grew 3.2% in 2018.

Sabadell confirmed that 90% of the complaints related to the IT migration have been resolved so extraordinary charges should tail off in 2019.

In Spain, Sabadell's commercial dynamic was strong, with 5.1% growth in performing loans (excluding the Asset Protection Scheme-covered balance sheet) driven by corporate and SME lending.

The reported fully-loaded CET1 ratio amounted to 11.1% (+10bp q-on-q).

Pro-forma for the impact of the NPA de-consolidation deal (+19bp), the sale of real estate platform Solvia (+15bp) and IFRS 16 (-16bp), the fully loaded CET 1 ratio stands at 11.3%. With the AT1 and Tier 2 buckets completed, the fully-loaded total capital ratio (pro forma) stood at 14.9%. Banco Sabadell targets a 12% CET1 ratio by 2021.

Sabadell had already disclosed it has received an MREL requirement of 22.7% of RWAs[2], to be met by 1 January 2020.

Reported asset-quality metrics reflect the re-classification from NPAs into assets held for sale of the portfolio to be sold to Cerberus. Including the effect of this sale, which is pending execution, Sabadell will have reduced its NPAs by EUR 7.8bn in 2018.

Caixabank (not publicly rated; results published on February 1)

In 2018, Caixabank earned EUR 1,98bn net of taxes, 18% more than in 2017, for a RoTE of 9.3%. This was driven by high single-digit revenue growth, positive jaws and declining loan loss provisions.

2018 also marked the end of the strategic plan, with successful delivery of most targets; most importantly for credit investors the de-risking of the balance sheet, with the sale of real estate assets to Lone Star closed in Q4. The gross NPL ratio in December stood at 4.7%, and the underlying cost of risk in Q4 was 16bp (the reported cost of risk was 4bp, but this included an extraordinary release of provisions. For 2019, Caixabank is guiding for continued growth in revenues, though cost growth will be impacted by integration costs relating to Banco BPI in Portugal.

The fully loaded CET1 ratio stood at 11.5%, in December, growing 9 bp in Q4 but essentially flat compared to 2017 as organic generation was offset by market impacts and corporate actions, including the squeeze-out of BPI minorities.

Pro-forma for the EUR 1bn senior non-preferred notes issued in January, Caixabank reported total sub MREL of 17.7% of RWAs (17.5% FL), including 15.5% in total capital (15.2% fully loaded) with SNPs accounting for the balance.

[2] The requirement was disclosed in May 2018 and is based on RWAs as of year-end 2016

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