Bankia S.A.
Issuer Rating Report

STABLE OUTLOOK
BBB+

Overview

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

- Among the domestically oriented franchises remaining in Spain, we view Bankia as one of the best positioned, thanks to significant restructuring measures over the past few years. Having successfully delivered an ambitious plan in 2012-2015, the bank is in our view well placed to sustainably deliver high single-digit returns without taking on excessive risk.
- Revenues and profits have been under pressure from a difficult interest rate environment, but asset quality continues to improve – lowering the need for new provisions going forward. Ambitious volume growth targets in business lending and consumer finance should over time shift Bankia's mix towards higher margin segments, supporting the top line.
- Despite being ultimately controlled by the Spanish government, we do not assign any additional rating notch for state support, given the Spanish government's limited flexibility to support Bankia, if needed, without external financial inputs from within the EU. In addition, we expect BFA to progressively divest its stake in Bankia, marginalising such potential support further.

Rating drivers (summary)

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

- Focused, efficient and stable franchise with strong market position in selected segments
- Credible management team, which has delivered on its restructuring business plan
- Potential easing of revenue pressure from low interest rates
- Residual uncertainty around group ownership and structure going forward
- Improving asset quality picture, with management focused on the reduction of NPAs

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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Rating change drivers

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

Clarification in group structure and control. The ultimate goal of the Spanish government is to divest from Bankia and recover part of the money it spent in the bailout, and BFA has already sold two stakes of 7% and 7.5% in 2017 and 2014, respectively. We expect BFA to continue to divest and Bankia to eventually become an independent entity, which on balance we would see as a positive, especially considering the volatile politics in Spain.

Renewed weakness in Spain's economic conditions. A relapse into recession would put new pressures on Bankia's fundamentals, including profitability and asset quality, which would be difficult to offset given the difficult outlook for revenues and the limited room for further cost efficiencies.

Material worsening of Bankia's asset quality and capital position because of further M&A activity. The prohibition on M&A activity expired in June 2017, and Bankia announced its acquisition of Banco Mare Nostrum (BMN) from Spain's Fund for Orderly Banking Restructuring, with a negative estimated impact of 190bps on Bankia's fully loaded CET1 ratio. Further acquisitions are in our view possible, as Bankia's franchise is geographically uneven; but if acquisitions result in **weaker fundamentals this would have a negative impact on the credit.**

Further material cleanup of the balance sheet. While declining, the NPL ratio remains very high in comparison to international peers'. With the economy on a strong foothold and unemployment declining, Bankia asset quality should benefit from i) an organic decline in NPLs and ii) a faster divestment from SAREB bonds to the extent that the recovery accelerates SAREB's asset disposals. While the credit risk on SAREB bonds is very limited thanks to the government guarantee, they represent a drag to the banks' financial performance in the current low rate environment.

Rating drivers (details)

Focused, efficient and stable franchise with strong market position in selected segments and regions.

Bankia originates from the forced merger of seven Spanish savings institutions, or Cajas de Ahorro, which formed an institutional protection scheme (IPS) in 2010. The two largest pre-merger entities were Caja Madrid and Bancaja, with strong presences in the Madrid and Valencia regions, together accounting for almost 90% of the Bankia group at the time of its formation. The central entity of the IPS was Banco Financiero y de Ahorros (the current BFA), which subsequently transferred most of its assets to Bankia.

Following its sale of City National Bank of Florida in October 2015, Bankia is now entirely focused on its domestic market. It has very strong market shares in the regions of Madrid, Comunidad valenciana, la Rioja, Canary Islands and, following the acquisition of BMN, in Murcia, Andalucia and the Balearic Islands. Bankia also has presence in the central regions of Spain, while its presence is more marginal in the northern coastal regions of Spain, which remain dominated by the regional banks. Due to its origins, Bankia's business model is rooted in retail and commercial banking. Its largest segment is retail, which caters to mass-market individuals and small businesses. Larger companies are served by the business banking network. Bankia also offers private banking, asset management and bancassurance products, as well as capital markets solutions, but these remain marginal compared to the retail and commercial bank products.

Bankia was listed in July 2011 on the Madrid stock exchange but was later nationalised following the emergence of larger-than-anticipated losses (partly due to the introduction of mandatory real estate provisions in early 2012) and amid significant outflows of deposits.

Despite a significant reduction in capacity since the merger, Bankia's distribution capacity remained substantial with 1,705 branches as of December 2017 (rising to 2,402 branches with the acquisition of BMN announced in 2017). Significantly, following the initial severe outflows of customer funds in 2012, the franchise stabilized, despite the reduction in branch penetration.. In fact, Bankia made a substantial effort to minimise the disruption to its retail customer base from the restructuring of the branch network, which included, for example, the introduction of the Ofibus – basically a coach acting as branch and serving several small municipalities, where branch closures would leave customers without any banking access. Over the years, Bankia has fine tuned its multi-channel distribution approach and now offers a range of interaction channels, including physical (including branches, the Ofibus, Business banking centers, ATMs) and digital (online banking, mobile banking).

Credible management team, which has delivered on its restructuring business plan

Since taking the helm of the bank in 2012, the current management team completed an ambitious turnaround plan, significantly delevering and derisking the balance sheet, increasing the bank's capitalisation, and improving efficiency and profitability, while increasing market shares in segments where the bank was historically weak, both for consumer credit and business banking.

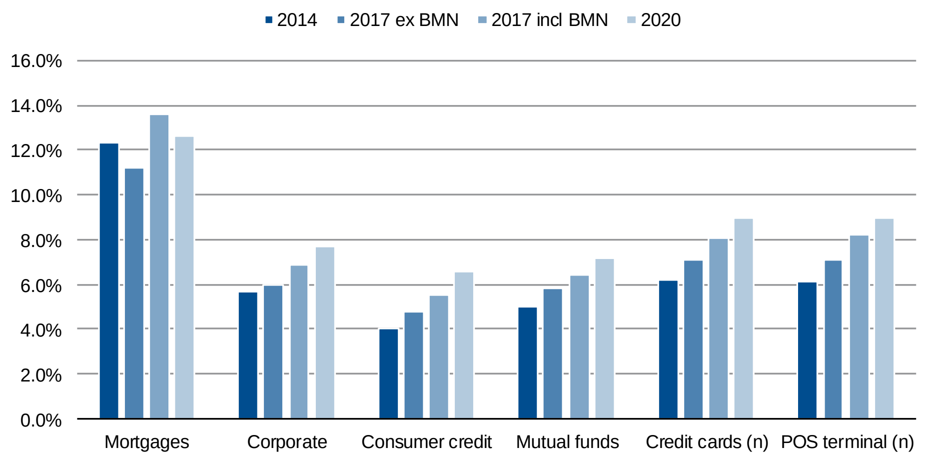
Over a three-year period, the cost-income ratio was reduced from 55.7% to 43.6%, NPLs declined from EUR 20bn to EUR 13bn, and the fully loaded CET1 ratio went from 6.82% to 12.26%. From making a loss in 2012, Bankia delivered an ROE of 10.6% in 2015. In other words, over a relatively short period of time, Bankia went from being a bank at the brink of resolution, to being a reassuringly viable one on its own merits.

In 2016 and 2017, Bankia focussed on strategic repositioning, targeting growth in high margin segments, such as asset management, SMEs and credit cards and diversifying away from mortgage lending. It also managed to improve the bank's public image (as measured by Bankia's customer satisfaction index and net promoter scores), a remarkable feat considering the tainted reputation the bank had acquired during the financial crisis.

The 2018-2020 plan is coherent with the group's recent strategy. Bankia will continue to target segments where its market shares remain below the bank's natural distribution capacity.

Under the current strategy, mortgages should come to represent 54% of the loan book by 2020. More specifically, the bank is aiming to achieve double-digit growth in consumer credit, and high single-digit growth in business loans. In our view, these growth targets are demanding, but the potential for growth is there as Bankia's market shares in these products are about half what they are in mortgages. It is also worth noting that Bankia has been restricted, in the past, from lending to certain corporate sectors (such as syndicated, project and asset finance and international lending, real estate developers), and that these restrictions have ceased to apply in 2018, opening up a whole new market for the bank to tap. Whether it has the expertise to do so profitably remains to be seen.

Figure 1: Bankia market shares evolution, selected products



Source: Company data, Scope Ratings

We are aware of the inherent risk of growing aggressively into new areas where competitors are more entrenched, but we note that the bank is doing this at the right point in the credit cycle – ie after a significant financial crisis – and that the credit cycle in Spain will remain benign for several years, allowing Bankia to build up more customer expertise in time. We note that the targeted shift in business mix, which is expected to boost net interest margins, does not lead to an increase in the cost of risk over the plan's horizon and is projected to remain stable over the plan (24 bps).

Bankia is targeting a return on tangible equity of 11% in 2020. This is an ambitious target in our view and rests on the business cycle holding up. On the other hand, the interest-rate assumptions are not particularly aggressive and Bankia is positively geared to rising interest rates. From a credit perspective, more than the numeric target, we look at the strategic direction of travel, which shows many elements of continuity with Bankia's recent history.

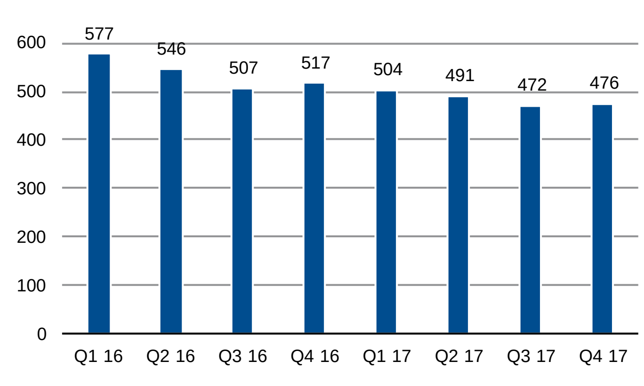
Potential easing of revenue pressure from low interest rates

In recent years, Bankia's profitability was negatively impacted by declining net interest income (NII). In fact, we believe Bankia is more exposed to NII pressure than peers are, for three reasons:

- Its loan book is tilted towards residential mortgages. Mortgages in Spain are generally variable rate with long durations, meaning banks have limited room to offset the decline in market rates (Euribor) by raising spreads. The strategy to aggressively target higher-margin business segments (credit cards, consumer lending, SMEs) partly offsets this pressure.
- Bankia holds a large ALCO portfolio (EUR 29.4bn incl. BMN), which is primarily invested in Spanish sovereign debt, as well as EUR 20.7bn (incl. BMN, EUR 15.6bn exc. BMN) in SAREB bonds at the end of 2017, obtained in exchange for the real estate assets it had transferred to the Spanish "bad bank" in 2012. As SAREB bonds mature, they are automatically rolled, and Bankia is obliged to buy and hold them. The yields on SAREB and sovereign bonds have been steadily falling, which has put pressure on NII.
- Most of the balance sheet is funded by already inexpensive sources of finance: repos, retail deposits and ECB TLTRO. While there is still room to reduce funding costs further, any reduction is unlikely to offset the lower interest income from loans and securities.

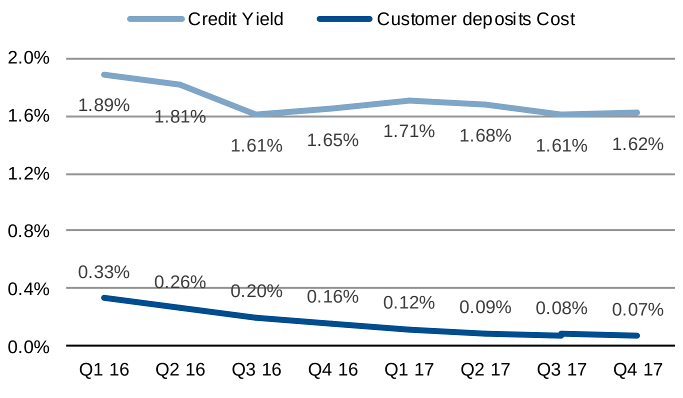
With the first signs that monetary policy in Europe may be close to a turning point, we believe the decline in net interest margins should at least partly reverse, supporting Bankia's profitability. The ongoing shift in Bankia's business mix, from mortgages to higher-yielding products, should also support NII going forward, although it may come at the cost of higher provisions during downturns (Bankia's cost of risk in 2017 was 23 bps, without the effect of the merger).

Figure 2: Net interest income (EUR m)



Source: Bankia, Scope Ratings

Figure 3: Gross customer margin



Source: Bankia, Scope Ratings

Residual uncertainty around group ownership and structure going forward

Bankia S.A. is at once the parent company of the Bankia group and the main subsidiary of the BFA group.

Fully owned by FROB, BFA owns the majority of Bankia. While the group is supervised as one, Bankia is the issuer of bailinable debt including of capital instruments.

We see Bankia as a viable standalone business, and the route to its re-privatisation seems to entail sales of the Bankia stake by BFA. BFA has already disposed of a 7%

stake in December 2017 and another 7.5% stake in 2014, leaving the FROB's indirect stake at 60.63%. This leaves uncertainty with respect to two points:

1. What will happen to BFA once it loses control of Bankia?
2. When will the regulatory focus shift from BFA to Bankia?

We expect BFA to be eventually liquidated, having fulfilled its purpose, with the regulatory focus switching to Bankia S.A. In fact, this could happen early on, given that Bankia is the deposit-taking institution of the group as well as the only issuer of traded debt.

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

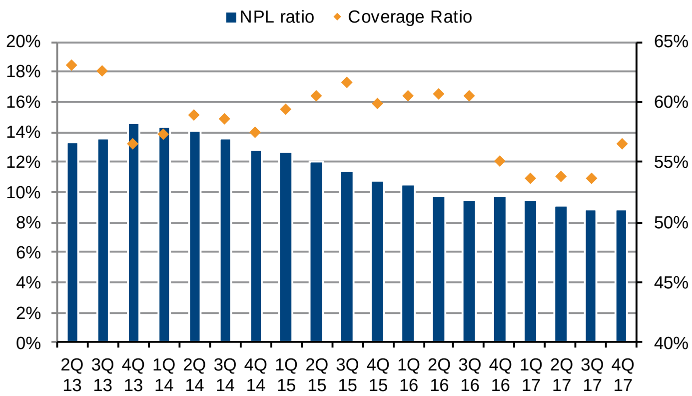
Improving asset quality picture, with management focused on the reduction of NPAs

Bankia's asset quality has been improving in past few years. From EUR 20bn in Q4 2013, Bankia's gross NPLs have halved and stood at EUR 9.7bn[1] at year end 2017, excluding the impacts from BMN; pro-forma for BMN integration gross NPL stood at EUR 12.1bn (NPL ratio of 8.9%). The coverage ratio was 56.5% (proforma for IFRS9 provision), which we consider to be adequate, particularly in the context of rising collateral values in Spain. Gross foreclosed assets amount to EUR 5.1bn (also pro forma for BMN merger). The low level of foreclosed assets compared to domestic peers' is partly explained by Bankia's transfer of a large part of its real-estate-related assets to SAREB in 2012.

The weak asset-quality metrics are still a concern, especially when compared to those of international peers. However, we see them as a legacy of the past, which we believe will become less important to the credit risk of Bankia going forward.

Bankia's 2018-2020 strategic plan includes ambitious asset quality objectives, such as reducing gross and net NPAs in half, while maintaining a low cost of risk (23bps). We believe the targets are ambitious but achievable in the current environment. In fact, Bankia could, in our view, achieve an almost completely clean balance sheet by the end of the strategic plan (2018-2020), assuming that the Spanish economy continues to perform well.

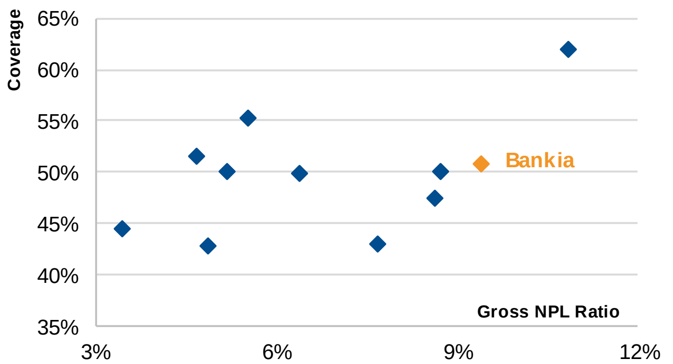
Figure 4: NPL and coverage (%)



Source: Source: Bankia, Scope Ratings

Note: calculated on total risks, including advances and contingent exposures, Q4 17 numbers including BMN merger

Figure 5: NPL and coverage ratios, Spanish banks



Source: SNL Financial, Scope Ratings, banks' data

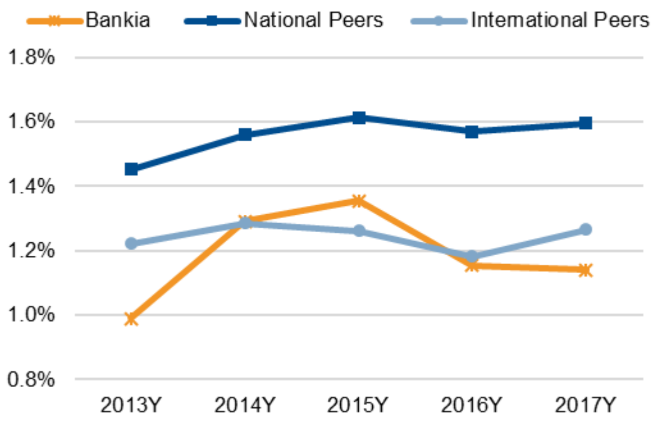
Peers include, Banco Sabadell, BBVA Spain, Santander Spain, Caixabank, Bankinter, ABANCA. Unicaja, Ibercaja, Liberbank, Kutxabank

Note: Bankia's figure as of Q4 2017,including BMN. Peer data: Q4 2017

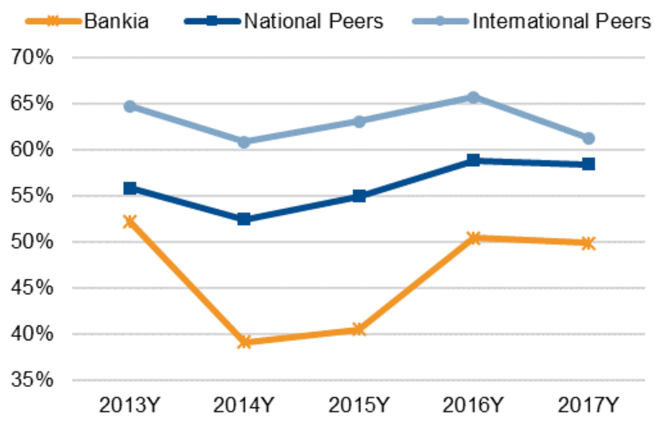
[1] Excluding BMN;

I. Appendix: Peer comparison

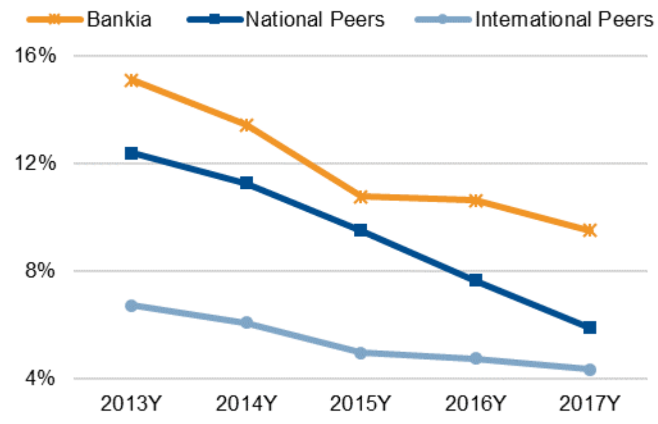
Net interest margin (%)



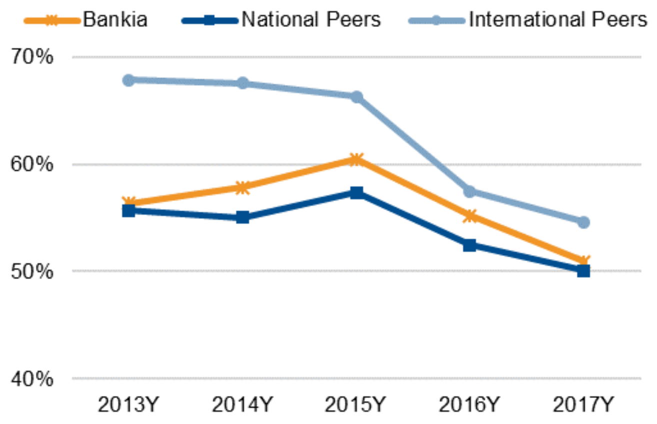
Cost-to-income ratio (%)



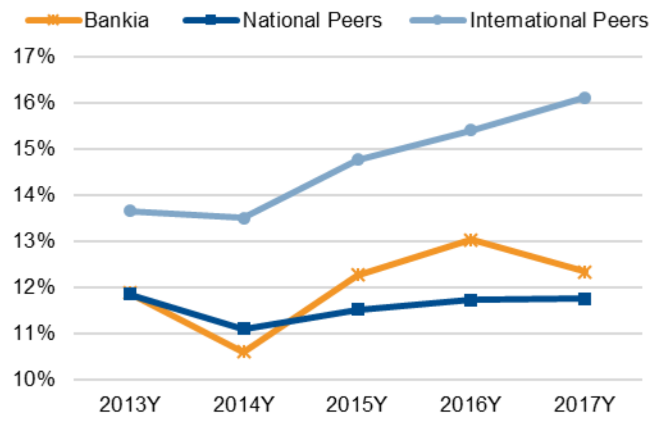
Impaired and delinquent loan ratio (%)



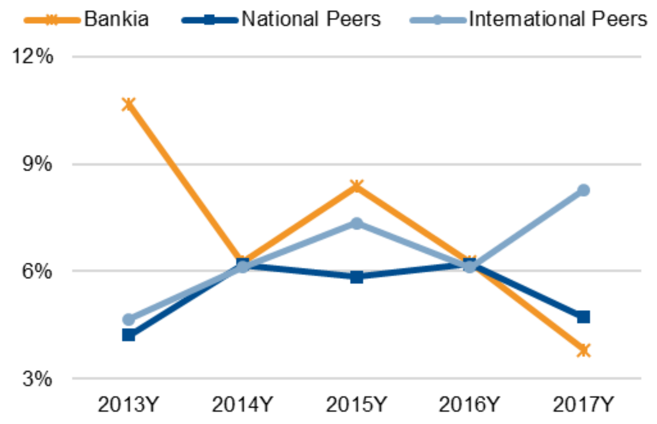
Impaired and delinquent loans coverage (%)



CET 1 fully-loaded ratio (%)



ROAE (%)



Source: SNL, Scope Ratings
*Spanish peers: Bankia,Santander, BBVA, Caixabank,Sabadell, Bankinter. Ibercaja, Unicaja, Kutxabank, Liberbank
**Cross-border peers: Bankia, Credit Agricole, RBS, BPCE, Lloyds, Rabobank, Credit Mutuel, Intesa, Commerzbank, Danske, ABN AMRO, Handelsbanken, DNB, SEB

II. Appendix: Selected Financial Information – Bankia

	2013Y	2014Y	2015Y	2016Y	2017Y
Balance sheet summary (EUR m)					
Assets					
Cash and interbank assets	12,668	13,894	9,422	6,431	7,532
Total securities	95,768	87,146	71,828	65,466	65,244
of which, derivatives	26,296	23,987	16,149	11,887	9,765
Net loans to customers	119,118	112,691	110,570	104,677	123,025
Other assets	23,918	19,917	15,150	13,594	18,132
Total assets	**251,472**	**233,649**	**206,970**	**190,167**	**213,932**
Liabilities					
Interbank liabilities	69,624	60,465	42,702	38,962	37,650
Senior debt	28,139	23,350	22,881	18,801	17,274
Derivatives	22,008	20,556	13,372	9,248	7,456
Deposits from customers	108,543	106,807	108,702	105,155	130,396
Subordinated debt	0	1,043	1,046	1,045	2,511
Other liabilities	11,573	8,894	5,571	4,119	5,033
Total liabilities	**239,887**	**221,115**	**194,274**	**177,330**	**200,319**
Ordinary equity	11,625	12,547	12,630	12,792	13,588
Equity hybrids	0	0	0	0	0
Minority interests	-40	-13	66	45	25
Total liabilities and equity	**251,472**	**233,649**	**206,970**	**190,167**	**213,932**
Core tier 1/Common equity tier 1 capital	10,556	10,874	11,289	11,606	12,173
Income statement summary (EUR m)					
Net interest income	2,425	2,927	2,740	2,148	1,968
Net fee & commission income	935	948	938	824	864
Net trading income	435	225	311	254	377
Other income	201	95	30	-150	-107
Operating income	**3,996**	**4,195**	**4,019**	**3,076**	**3,102**
Operating expense	2,085	1,639	1,626	1,551	1,547
Pre-provision income	**1,911**	**2,557**	**2,393**	**1,524**	**1,556**
Credit and other financial impairments	1,249	950	583	221	329
Other impairments	381	383	174	277	157
Non-recurring items	0	-312	-184	-35	-445
Pre-tax profit	**280**	**912**	**1,452**	**991**	**625**
Discontinued operations	117	85	0	0	0
Other after-tax Items	0	0	0	0	0
Income tax expense	-112	226	391	189	131
Net profit attributable to minority interests	-3	24	21	-2	-11
Net profit attributable to parent	**512**	**747**	**1,040**	**804**	**505**

Source: SNL data

III. Appendix: Ratios – Bankia

	2013Y	2014Y	2015Y	2016Y	2017Y
Funding and liquidity					
Net loans/deposits (%)	109.7%	105.5%	101.7%	99.5%	94.3%
Liquidity coverage ratio (%)	NA	NA	NA	NA	172.0%
Net stable funding ratio (%)	NA	NA	NA	NA	NA
Asset mix, quality and growth					
Net loans/assets (%)	47.4%	48.2%	53.4%	55.0%	57.5%
Impaired & delinquent loans/loans (%)	15.1%	13.5%	10.8%	10.6%	9.5%
Loan-loss reserves/impaired loans (%)	56.3%	57.8%	60.5%	55.2%	50.9%
Net loan growth (%)	-11.2%	-5.4%	-1.9%	-5.3%	17.5%
Impaired loans/tangible equity & reserves (%)	85.5%	73.3%	61.6%	57.8%	59.1%
Asset growth (%)	-10.9%	-7.1%	-11.4%	-8.1%	12.5%
Earnings and profitability					
Net interest margin (%)	1.0%	1.3%	1.4%	1.2%	1.1%
Net interest income/average RWAs (%)	2.5%	NA	3.2%	2.7%	2.4%
Net interest income/operating income (%)	60.7%	69.8%	68.2%	69.8%	63.4%
Net fees & commissions/operating income (%)	23.4%	22.6%	23.3%	26.8%	27.9%
Cost/income ratio (%)	52.2%	39.1%	40.5%	50.4%	49.9%
Operating expenses/average RWAs (%)	2.1%	NA	1.9%	2.0%	1.9%
Pre-impairment operating profit/average RWAs (%)	2.0%	NA	2.8%	1.9%	1.9%
Impairment on financial assets /pre-impairment income (%)	65.4%	37.2%	24.4%	14.5%	21.1%
Loan-loss provision charges/net loans (%)	1.0%	0.8%	0.6%	0.2%	0.3%
Pre-tax profit/average RWAs (%)	0.3%	NA	1.7%	1.3%	0.8%
Return on average assets (%)	0.2%	0.3%	0.5%	0.4%	0.3%
Return on average RWAs (%)	0.5%	NA	1.2%	1.0%	0.6%
Return on average equity (%)	10.6%	6.3%	8.4%	6.3%	3.8%
Capital and risk protection					
Common equity tier 1 ratio (%, fully loaded)	11.9%	10.6%	12.3%	13.0%	12.3%
Common equity tier 1 ratio (%, transitional)	11.9%	12.3%	14.0%	15.1%	14.1%
Tier 1 capital ratio (%, transitional)	11.7%	12.3%	14.0%	15.1%	14.9%
Total capital ratio (%, transitional)	12.0%	13.8%	15.2%	16.4%	16.8%
Leverage ratio (%)	NA	NA	5.0%	5.3%	5.4%
Asset risk intensity (RWAs/total assets, %)	35.3%	37.9%	39.1%	40.5%	40.2%
Market indicators					
Price/book (x)	1.2x	1.1x	1.0x	0.9x	0.8x
Price/tangible book (x)	1.2x	1.1x	1.0x	0.9x	0.9x
Dividend payout ratio (%)	NA	25.1%	29.1%	39.4%	64.8%

Source: SNL data

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