Bankia S.A.
Issuer Rating Report

STABLE OUTLOOK
BBB+

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.

For the full list of ratings see the **ratings list** section at the end of this report.

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. With the recent upticks in longer-term rates, Bankia's revenues may be at a turning point.

Despite being ultimately controlled by the Spanish government, we do not assign any additional 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:
1. Focused, efficient and stable franchise with strong market position in selected segments
2. Credible management team, which has delivered on its restructuring business plan
3. Potential easing of revenue pressure from low interest rates
4. Residual uncertainty around group ownership and structure going forward
5. High levels of legacy NPLs in an international context, but with high coverage

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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 a stake (7.5%) in 2014. 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

Bankia originates from the merger under duress 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.

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. In this context, the Spanish government injected EUR 18bn of capital into BFA/Bankia group via the Fondo de Restructuracion Ordenada Bancaria (Fund for Orderly Banking Restructuring, or FROB).

Despite a significant reduction in capacity since the merger, Bankia's distribution capacity remained substantial with 1,886 branches as of December 2016 (bound to rise to over 2,500 branches with the acquisition of BMN announced in 2017). Significantly, the reduction in this network did not result in a loss of customer deposits (Bankia suffered severe deposit outflows in 2012). 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.

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, Valencia, la Rioja, Canary Islands and, following the acquisition of BMN, in Murcia, Granada and the Balearic Islands. Bankia also has presence in Andalucia and 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.

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 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 perception (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. Going forward, we believe Bankia will continue to target segments where its market shares remain below the bank's natural distribution capacity. 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.

From 2018, Bankia will gain even more strategic flexibility, thanks to the expiry of business restrictions imposed as part of the 2011 rescue of the group. As a result, it will be able to re-enter certain product lines, such as syndicated, project and asset finance and international lending. It will also be able to lend to real estate developers, though given the group's history we expect management to be extremely cautious in this area.

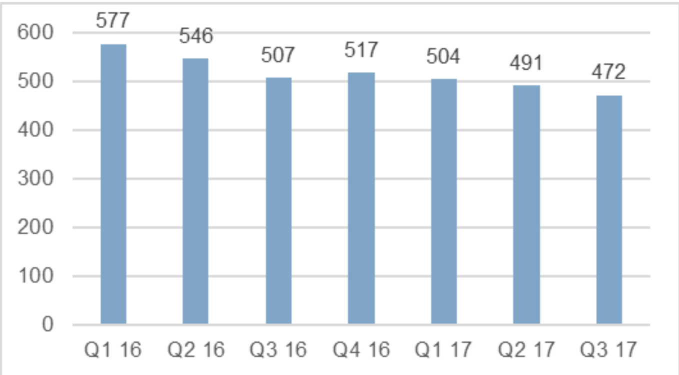
Potential easing of revenue pressure from low interest rates

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, which is primarily invested in Spanish sovereign debt, as well as EUR 16.4bn in SAREB bonds at the end of 2016, 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.

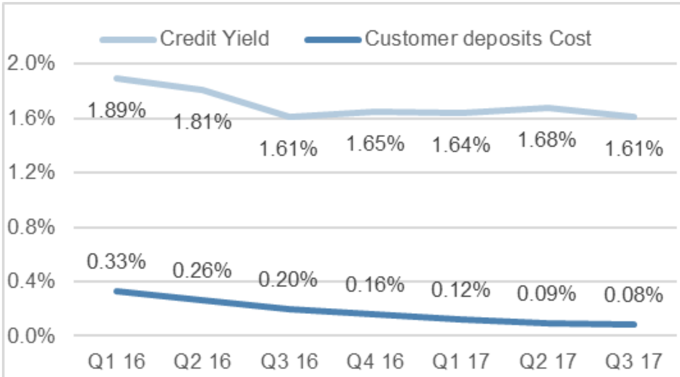
With the first signs that monetary policy in Europe may be close to a turning point, we believe the decline in net interest margins should at least partly reverse, supporting Bankia's profitability. The ongoing shift in Bankia's business mix, from mortgages to higher-yielding products, should also support NII going forward, although it may come at the cost of higher provisions during downturns (Bankia's cost of risk in the first nine months of 2017 was 24 bps).

Figure 1: Net interest income (EUR m)



Source: Bankia, Scope Ratings

Figure 2: 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 7.5% stake in 2014 and in September 2017 the Spanish finance minister announced that the FROB was studying a further stake sale of between 7 and 9% of Bankia. 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.

High levels of legacy NPLs in an international context, but with high coverage

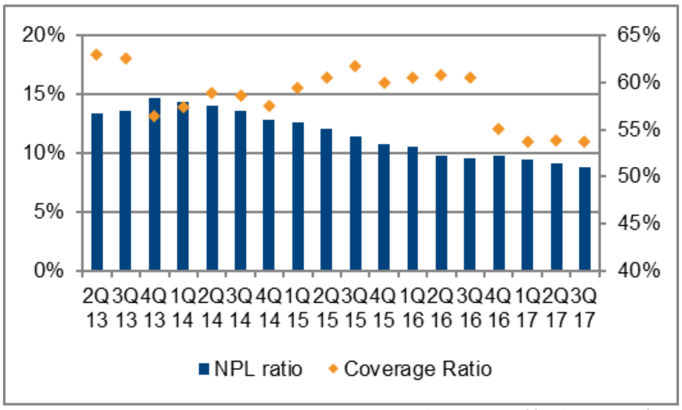
Bankia's asset quality has been improving in past few years. From EUR 20bn in Q4 2013, gross NPLs have halved and stood at EUR 10.1bn in Q3 2017, for an NPL ratio of 8.8%. At 54%, the coverage ratio is higher than those of peers. Gross foreclosed assets amount to EUR 3.15bn, with a coverage of 34%.

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 certainly 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.

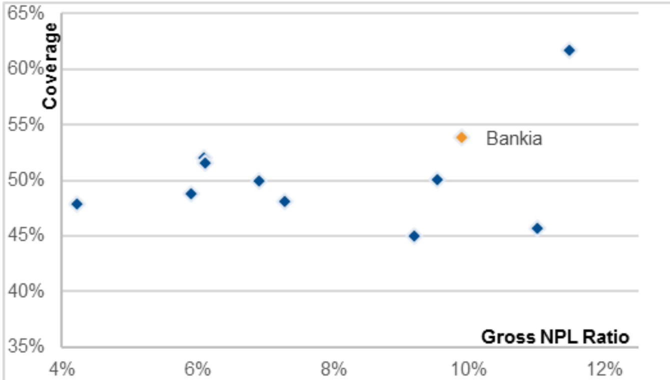
Indeed, we note that the high coverage, together with the improving macroeconomic environment, is likely to facilitate the process of selling down bad assets and completing the cleanup process initiated by the SAREB transfers.

Figure 3: NPL and coverage (%)



Source: Bankia, Scope Ratings
Note: calculated on total risks, including advances and contingent exposures

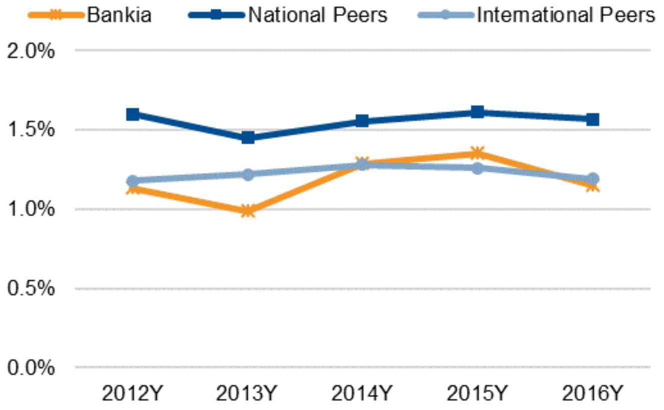
Figure 4: NPL and coverage ratios, Spanish banks



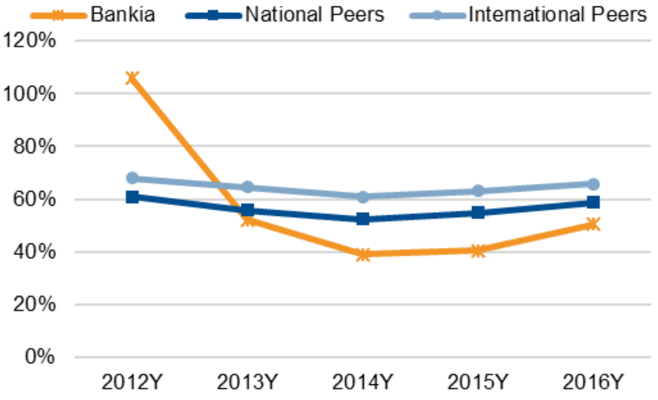
Source: SNL Financial, Scope Ratings, banks' data
Peers include Banco Popular, Banco Sabadell, BBVA Spain, Santander Spain, Caixabank, Bankinter, ABANCA. Unicaja, Ibercaja, Liberbank, Kutxabank

Appendix A: Peer comparison

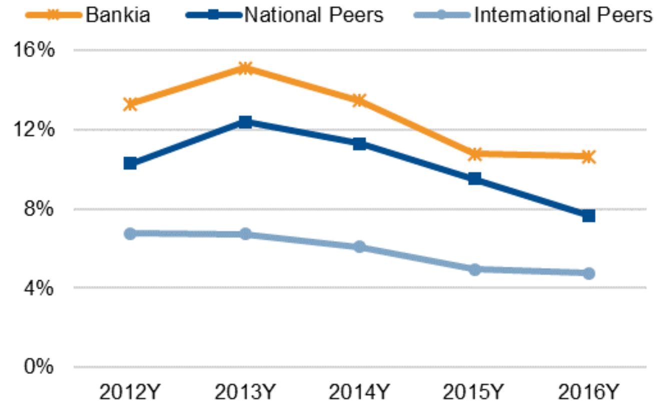
Net interest margin (%)



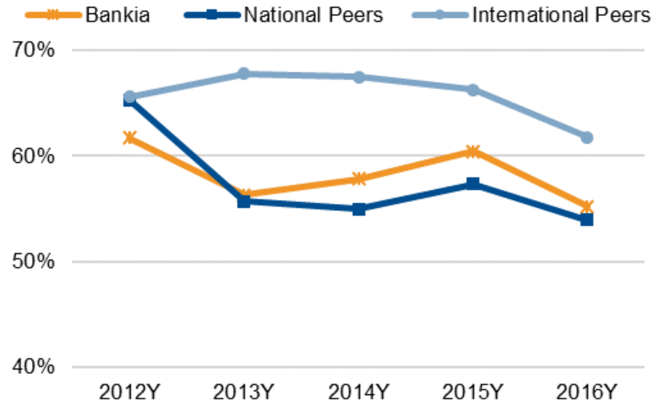
Cost-to-income ratio (%)



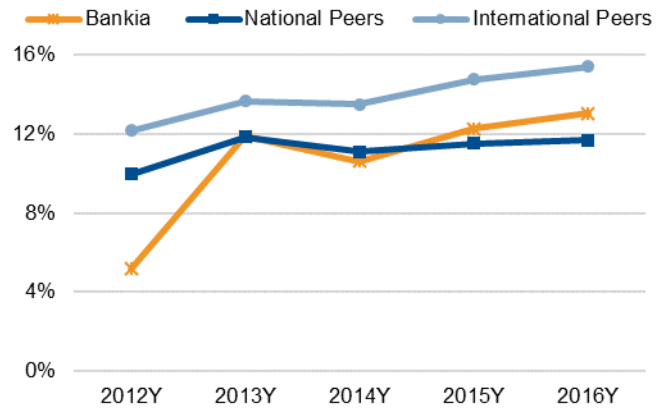
Impaired and delinquent loan ratio (%)



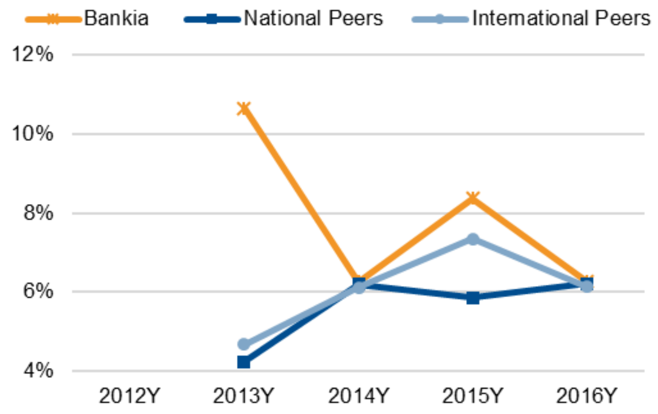
Impaired and delinquent loans coverage (%)



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

Appendix B: Selected Financial Information – Bankia

	2012Y	2013Y	2014Y	2015Y	2016Y	2017- 9M
Balance sheet summary (EUR m)						
Assets						
Cash and interbank assets	12,558	12,668	13,894	9,422	6,431	5,472
Total securities	112,984	95,768	87,146	71,828	65,466	57,361
of which, derivatives	41,560	26,296	23,987	16,149	11,887	9,763
Net loans to customers	134,177	119,118	112,691	110,570	104,677	103,479
Other assets	22,591	23,918	19,917	15,150	13,594	12,935
Total assets	**282,310**	**251,472**	**233,649**	**206,970**	**190,167**	**179,247**
Liabilities						
Interbank liabilities	78,035	69,624	60,465	42,702	38,962	34,852
Senior debt	37,335	28,139	23,350	22,881	18,801	17,103
Derivatives	36,445	22,008	20,556	13,372	9,248	7,540
Deposits from customers	110,904	108,543	106,807	108,702	105,155	100,637
Subordinated debt	15,641	0	1,043	1,046	1,045	2,278
Other liabilities	10,006	11,573	8,894	5,571	4,119	3,780
Total liabilities	**288,366**	**239,887**	**221,115**	**194,274**	**177,330**	**166,190**
Ordinary equity	-6,008	11,625	12,547	12,630	12,792	13,011
Equity hybrids	0	0	0	0	0	0
Minority interests	-48	-40	-13	66	45	46
Total liabilities and equity	**282,310**	**251,472**	**233,649**	**206,970**	**190,167**	**179,247**
Core tier 1/ common equity tier 1 capital	5,382	10,556	10,874	11,289	11,606	NA
Income statement summary (EUR m)						
Net interest income	3,089	2,425	2,927	2,740	2,148	1,467
Net fee & commission income	992	935	948	938	824	636
Net trading income	387	435	225	311	254	321
Other income	-575	201	95	30	-150	-64
Operating income	**3,893**	**3,996**	**4,195**	**4,019**	**3,076**	**2,360**
Operating expense	4,125	2,085	1,639	1,626	1,551	1,155
Pre-provision income	**-232**	**1,911**	**2,557**	**2,393**	**1,524**	**1,205**
Credit and other financial impairments	18,932	1,249	950	583	221	241
Other impairments	3,026	381	383	174	277	12
Non-recurring items	0	0	-312	-184	-35	0
Pre-tax profit	**-22,189**	**280**	**912**	**1,452**	**991**	**953**
Discontinued operations	0	117	85	0	0	0
Other after-tax Items	0	0	0	0	0	0
Income tax expense	-2,997	-112	226	391	189	213
Net profit attributable to minority interests	-136	-3	24	21	-2	1
Net profit attributable to parent	**-19,056**	**512**	**747**	**1,040**	**804**	**739**

Source: SNL data

Appendix C: Ratios – Bankia

	2012Y	2013Y	2014Y	2015Y	2016Y	2017 - 9M
Funding and liquidity						
Loans/deposits (%)	120.9%	109.7%	105.5%	101.7%	99.5%	102.8%
Liquidity coverage ratio (%)	NA	NA	NA	NA	NA	160.0%
Asset mix, quality and growth						
Loans/assets (%)	47.5%	47.4%	48.2%	53.4%	55.0%	57.7%
Impaired & delinquent loans/loans (%)	13.3%	15.1%	13.5%	10.8%	10.6%	NA
Loan-loss reserves/impaired loans (%)	61.7%	56.3%	57.8%	60.5%	55.2%	53.9%
Net loan growth (%)	-27.1%	-11.2%	-5.4%	-1.9%	-5.3%	-1.5%
Impaired loans/tangible equity & reserves (%)	NA	85.5%	73.3%	61.6%	57.8%	52.8%
Asset growth (%)	-6.8%	-10.9%	-7.1%	-11.4%	-8.1%	-7.7%
Earnings and profitability						
Net interest margin (%)	1.1%	1.0%	1.3%	1.4%	1.2%	1.2%
Net interest income/RWAs (%)	2.4%	2.5%	NA	3.2%	2.7%	NA
Net interest income/revenues (%)	79.4%	60.7%	69.8%	68.2%	69.8%	62.2%
Fees & commissions/revenues (%)	25.5%	23.4%	22.6%	23.3%	26.8%	26.9%
Cost/income ratio (%)	106.0%	52.2%	39.1%	40.5%	50.4%	48.9%
Operating expenses/RWAs (%)	3.2%	2.1%	NA	1.9%	2.0%	NA
Pre-provision income/RWAs (%)	-0.2%	2.0%	NA	2.8%	1.9%	NA
Loan-loss provision charges/pre-provision income (%)	NA	65.4%	37.2%	24.4%	14.5%	20.0%
Loan-loss provision charges/gross loans (%)	11.4%	1.0%	0.8%	0.6%	0.2%	0.3%
Pre-tax profit/RWAs (%)	-17.1%	0.3%	NA	1.7%	1.3%	NA
Return on average assets (%)	-6.4%	0.2%	0.3%	0.5%	0.4%	0.5%
Return on average RWAs (%)	-14.8%	0.5%	NA	1.2%	1.0%	NA
Return on average equity (%)	-596.3%	10.6%	6.3%	8.4%	6.3%	7.7%
Capital and risk protection						
Common equity tier 1 ratio (%, fully loaded)	5.2%	11.9%	10.6%	12.3%	13.0%	14.2%
Common equity tier 1 ratio (%, transitional)	5.2%	11.9%	12.3%	14.0%	15.1%	16.1%
Tier 1 capital ratio (%, transitional)	5.0%	11.7%	12.3%	14.0%	15.1%	NA
Total capital ratio (%, transitional)	9.8%	12.0%	13.8%	15.2%	16.4%	19.1%
Tier 1 leverage ratio (%)	2.2%	4.6%	5.1%	5.8%	6.4%	NA
Asset risk intensity (RWAs/total assets, %)	36.9%	35.3%	37.9%	39.1%	40.5%	NA
Market indicators						
Price/book (x)	NA	1.2x	1.1x	1.0x	0.9x	0.9x
Price/tangible book (x)	NA	1.2x	1.1x	1.0x	0.9x	0.9x
Dividend payout ratio (%)	NA	NA	25.1%	29.1%	39.4%	NA

Source: SNL data

Bankia S.A.
Issuer Rating Report

Ratings *

Issuer Rating	**BBB+**
Outlook	Stable
Senior unsecured debt rating (non - MREL)	BBB+
Senior unsecured debt rating (MREL)	BBB
Short-term debt rating	S-2
Short-term debt rating outlook	Stable

* The ratings are not applicable to debt issued by unguaranteed subsidiaries of the rated parent.

Regulatory disclosures

This credit rating and/or rating outlook is issued by Scope Ratings AG.
The rating analysis has been prepared by Marco Troiano, Executive Director. Responsible for approving the rating: Sam Theodore, Managing Director
The rating was first assigned by Scope on 30.11.2017. / The rating was last updated on 30.11.2017.

Methodology

The methodology used for this rating(s) and/or rating outlook(s) Bank Rating Methodology - May 2017 is available on www.scoperatings.com.
Historical default rates of Scope Ratings can be viewed in the rating performance report on https://www.scoperatings.com/#governance-and-policies/regulatory-ESMA Please also refer to the central platform (CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml. A comprehensive clarification of Scope's definition of default as well as definitions of rating notations can be found in Scope's public credit rating methodologies on www.scoperatings.com.
The rating outlook indicates the most likely direction of the rating if the rating were to change within the next 12 to 18 months.

Stress testing & cash flow analysis

No stress testing was performed. No cash flow analysis was performed.

Solicitation, key sources and quality of information

The rated entity and/or its agents participated in the rating process.
The following substantially material sources of information were used to prepare the credit rating: public domain, the rated entity and third parties. Scope considers the quality of information available to Scope on the rated entity or instrument to be satisfactory. The information and data supporting Scope's ratings originate from sources Scope considers to be reliable and accurate. Scope does not, however, independently verify the reliability and accuracy of the information and data.
Prior to publication, the rated entity was given the opportunity to review the rating and/or outlook and the principal grounds on which the credit rating and/or outlook is based. Following that review, the rating was not amended before being issued.

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