17 May 2019 Financial Institutions

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

- The ratings acknowledge the strenghtened retail franchise in Spain following the acquisition of BMN. Among the domestically oriented franchises remaining in Spain, we view Bankia as one of the best-positioned, thanks in part to significant restructuring measures over the past few years. Having successfully delivered its ambitious plan in 2012-15, the bank is in our view well placed to sustainably deliver high single-digit returns without taking on excessive risk.
- Revenues and profits remain 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, as we expect the Spanish government to gradually divest its stake in Bankia. The relative political instability in Spain in recent years adds to the uncertainty around the timing of such divestments.

Rating drivers (summary)

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

- Focused retail and commercial banking franchise in Spain
- Credible management team, with a good execution track record
- Continued revenue pressure from low interest rates
- Improving asset quality picture, with management focused on NPA reduction

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

Lead Analyst

Marco Troiano, CFA
m.troiano@scoperatings.com

Associate Analyst

Alvaro Dominguez Alcalde
a.dominguez@scoperatings.com

Team Leader

Dierk Brandenburg
d.brandenburg@scoperatings.com

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

Rating-change drivers

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

Clarification in group structure and control. The Spanish government aims to divest from Bankia and recover part of the amount spent on the bank's bailout. BFA has already sold two stakes of 7% and 7.5% in 2017 and 2014, respectively, which we expect to continue until Bankia becomes an independent entity. We see this positively overall, 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 on 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 change in fundamentals due to further M&A. The prohibition on M&A expired in June 2017. Shortly after, Bankia announced its acquisition of Banco Mare Nostrum (BMN) from Spain's Fund for Orderly Banking Restructuring (FROB). We believe further acquisitions are possible and if well executed could boost the group's geographic and product diversification; but if acquisitions result in materially weaker fundamentals this would have a negative impact on the credit instead.

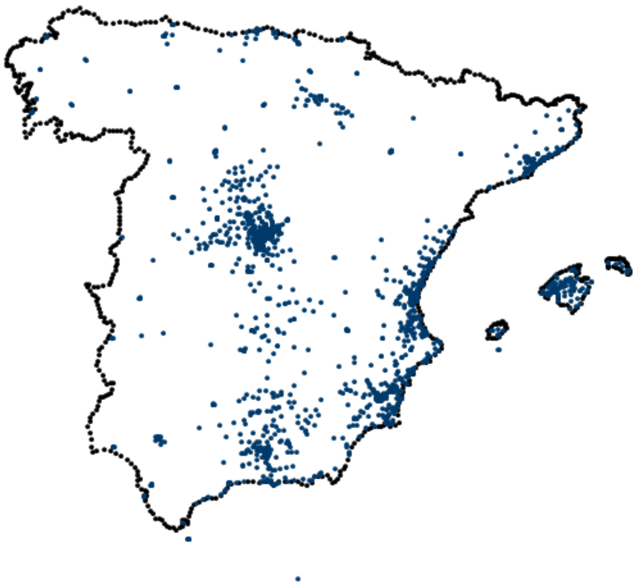
Further material cleanup of the balance sheet. While declining, the NPL ratio remains higher than national and international peers'. With a strong economy and declining unemployment, Bankia's asset quality is expected to benefit from i) an organic decline in NPLs; and ii) faster divestment from SAREB 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 on the banks' financial performance in the current low interest rate environment.

Rating drivers (details)

Focused retail and commercial banking franchise in Spain

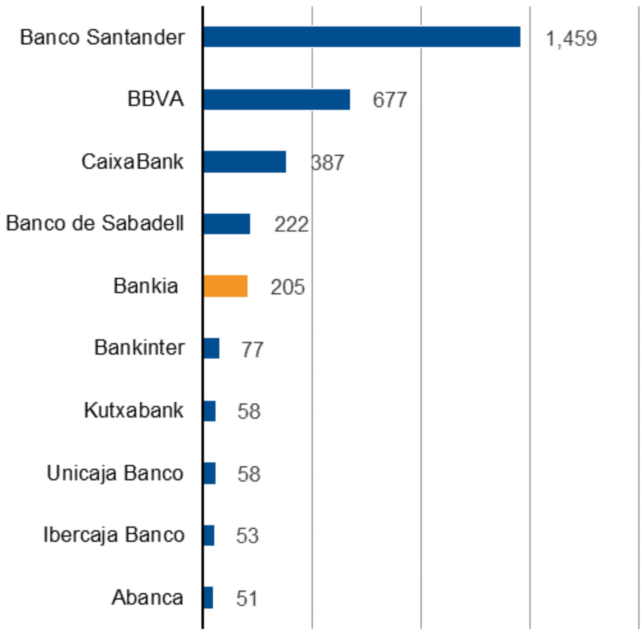
The fifth-largest Spanish bank by total assets, Bankia is a purely domestic retail and commercial lender in Spain, with very strong market shares in the regions of Madrid, the Valencian Community, La Rioja, Canary Islands and, following the acquisition of BMN in 2017, in Murcia, Andalusia and the Balearic Islands (Figure 1). Bankia also has operations in the central regions of Spain, while its presence is more marginal in northern Spanish coastal regions, which remain dominated by the regional banks.

Figure 1: Bankia's branch network



Source: Source: Bankia, SNL Financial, Scope Ratings

Figure 2: Spanish banks total assets 2018 (EUR bn)



Source: SNL Financial, Scope Ratings, banks' data

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, bancassurance products, and capital markets solutions, but these remain marginal compared to retail and commercial bank products. In 2018, Bankia agreed with Credit Agricole Consumer Finance to jointly provide consumer finance products in Spain. The new company will be 51% owned by Credit Agricole, with the remaining 49% held by Bankia, and will specialise in the provision of point-of-sale consumer finance.

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

Currently, Bankia S.A. is both the parent company of the Bankia group and the main subsidiary of the BFA group. BFA is fully owned by the FROB and owns the majority of

Bankia. While the group is supervised as one unit, Bankia issues bailinable debt such as capital instruments itself.

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

BFA has disposed of a 7.5% stake in 2014 and a further 7% stake in December 2017,but it still controls 61.42% of Bankia as of March 2019. In 2018, the Spanish government extended the original privatisation deadline (end of 2019) by 2 years to year end 2021.

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

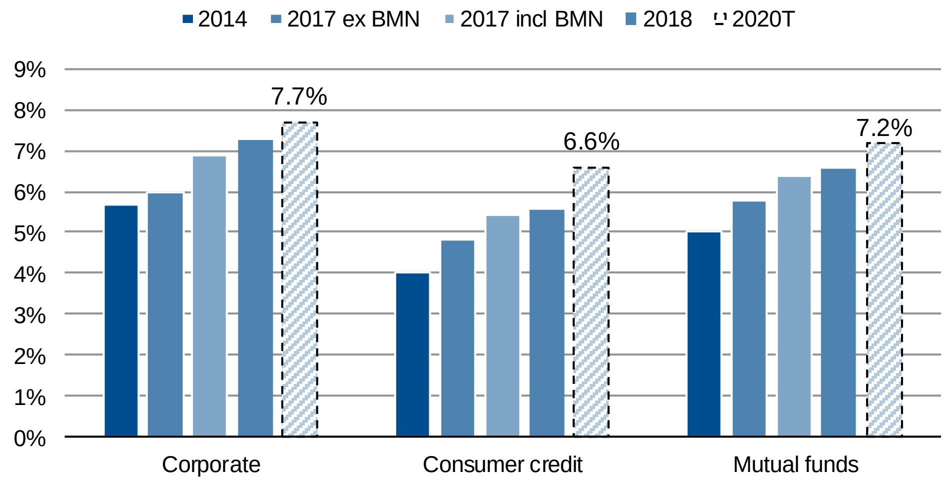
Our Issuer Rating applies to Bankia S.A. and its guaranteed subsidiaries, but not to BFA, which in any case does not issue debt.

Credible management team, with a good execution track record

Since taking the helm in 2012, the bank's current management team has completed an ambitious turnaround plan. This resulted in a significant deleveraging and derisking of the balance sheet, increased capitalisation, and improved efficiency and profitability, while market shares increased in segments where the bank was historically weak, both for consumer credit and business banking.

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

Figure 3: Bankia market shares evolution, selected products



Source: Company data, Scope Ratings

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

The 2018-20 plan is coherent with the group's current strategy. Bankia is continuing to target segments where its market shares remain below its natural distribution capacity.

Under the current strategy, mortgages are expected 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 of what they are in mortgages. Further, restrictions on Bankia in terms of lending to certain corporate sectors (such as syndicated, project and asset finance, international lending, and real estate developers) ceased to apply in 2018, opening up new opportunities for the bank to expand. Whether it can do so profitably remains to be seen.

While aware of the inherent risk of entering aggressively into areas where competitors are entrenched, Scope thinks the bank is doing this at the right point in the credit cycle – i.e. after a significant financial crisis – and the credit cycle in Spain will likely remain benign for several years. This will likely give Bankia some time to develop customer expertise before the next downturn. Bankia's management is expecting cost of risk to remain stable (24 bps) over the plan horizon and targeting a return on tangible equity of 11% in 2020. This is ambitious 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.

Continued revenue pressure from low interest rates

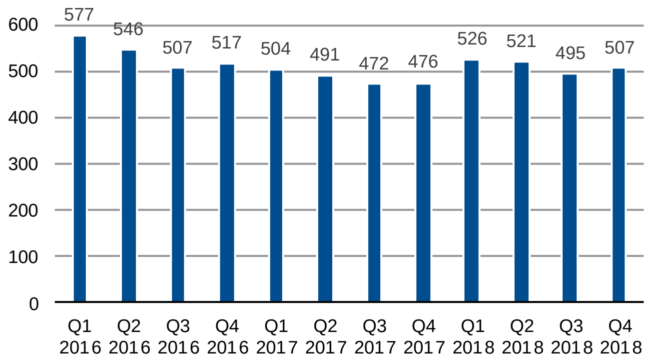
In recent years, Bankia's profitability was negatively impacted by declining net interest income (NII). In fact, we believe Bankia is more exposed to NII pressure than peers are, for three reasons:

- 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 a 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 26.8bn) that is primarily invested in Spanish sovereign debt, as well as EUR 19.2bn in SAREB bonds as of the end of 2018, obtained in exchange for real estate assets it transferred to the Spanish 'bad bank' in 2012. As SAREB bonds mature, they are automatically rolled over, with Bankia obliged to buy and hold them. Yields on SAREB and sovereign bonds have been steadily falling, which has put pressure on NII.
- Most of the balance sheet is already funded using inexpensive sources: 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.

Interest rates are likely to remain very low for the foreseeable future, with a softening of economic conditions in the eurozone likely to discourage the ECB from tightening policy.

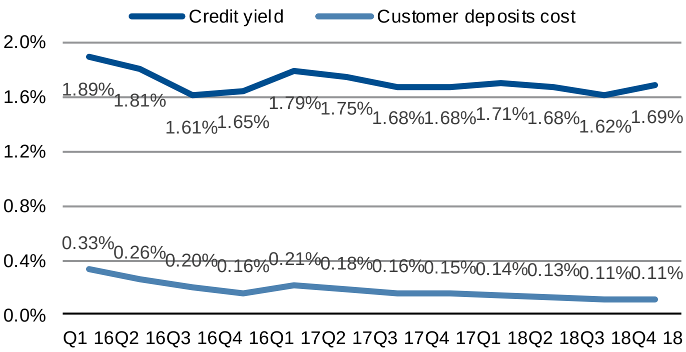
However, the ongoing shift in Bankia's business mix, from mortgages to higher-yielding products, should also support NII going forward, although it may come at the cost of higher provisions during downturns.

Figure 4: Net interest income (EUR)



Source: Bankia, Scope Ratings

Figure 5: Gross customer margin



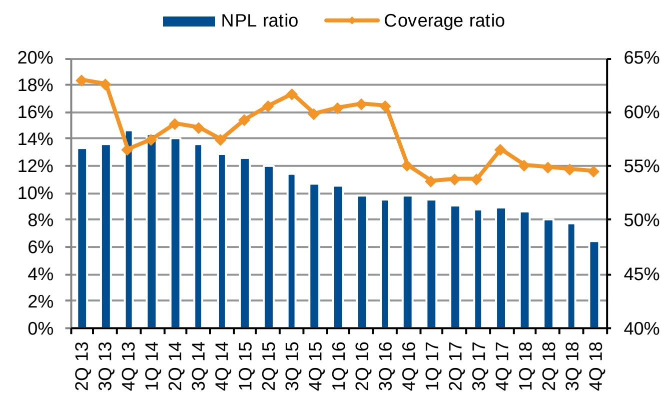
Source: Bankia, Scope Ratings

Improving asset quality picture, with management focused on NPA reduction

Scope believes that Bankia is well on track for an almost complete cleanup of its legacy NPAs by the end of 2020. Bankia's asset quality has been improving in the past few years. From EUR 20bn in Q4 2013, Bankia's gross NPLs have more than halved and stood at EUR 8.4bn at Q4 2018 at pro-forma levels, with an NPL ratio pro-forma of 6.5%. The coverage ratio was 54.6%, which we consider to be adequate, particularly given rising collateral values in Spain. Pro forma for the signed deal with Lone Star (to be closed in 2019) gross foreclosed assets stood at EUR 2.5bn. 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 assets to SAREB in 2012.

Bankia's 2018-20 strategic plan includes ambitious asset quality objectives, such as gross and net NPA ratios of lower than 6% and 3%, respectively, while maintaining a low cost of risk (23bps). Consequently, the bank aims at decreasing the volume of NPAs by EUR 2.9bn per year (EUR 8.8bn in the strategic plan period). As of December 2018, the bank has already reduced them by EUR 6bn, which makes it likely that Bankia will overdeliver on this aspect of its strategic plan. The main driver for this NPA reduction has been the signing of a EUR 3bn (GBV) deal with Lone Star consisting of foreclosed assets with a gross book value of EUR 1.65bn and EUR 1.42bn in non-performing loans.

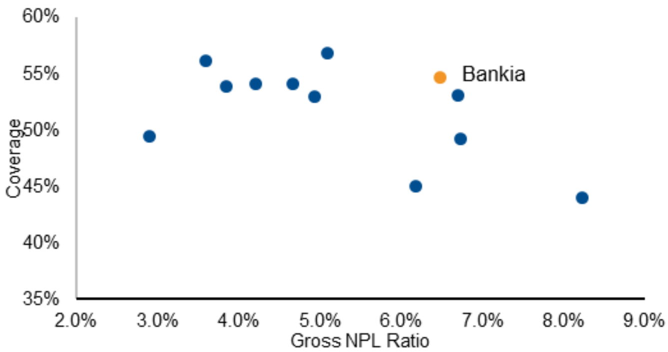
Figure 6: NPL and coverage (%)



Source: Source: Bankia, Scope Ratings

Note: Calculated on total risks, including advances and contingent exposures, Q4 2017 numbers including BMN merger

Figure 7: NPL and coverage ratios, Spanish banks



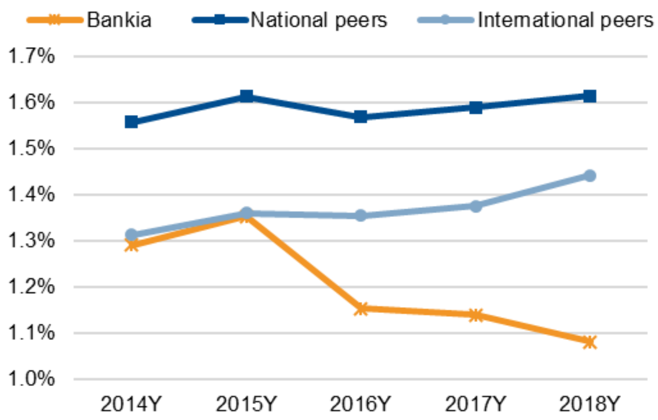
Source: SNL Financial, Scope Ratings, banks' data

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

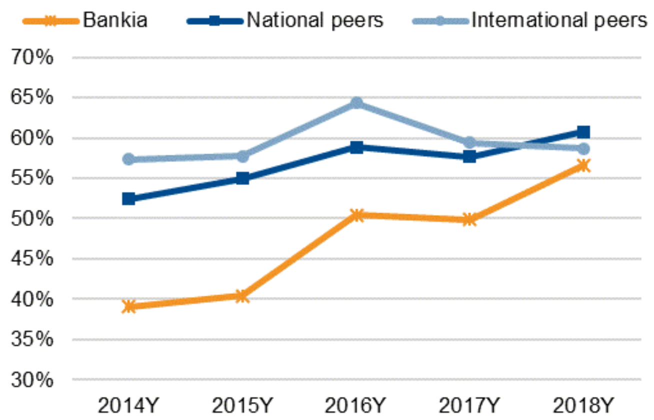
Peer data: Q4 2018, except Cajamar (Q3 2018)

I. Appendix: Peer comparison

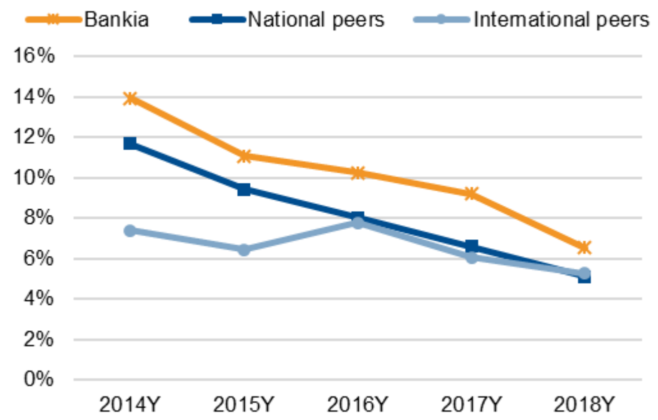
Net interest margin (%)



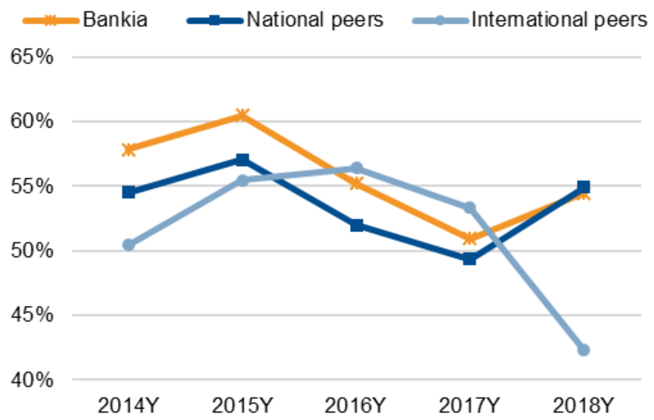
Cost-to-income ratio (%)



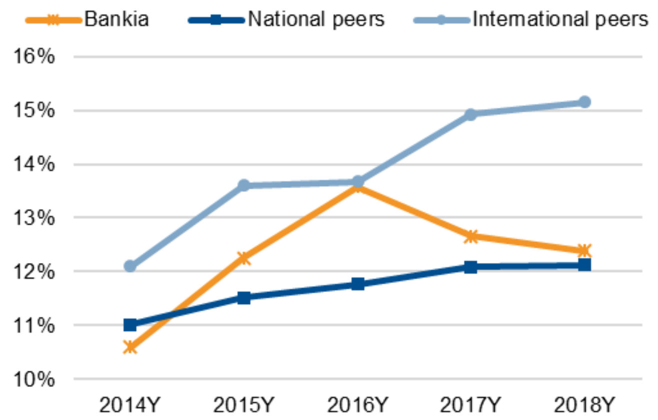
NPLs/net loans (%)



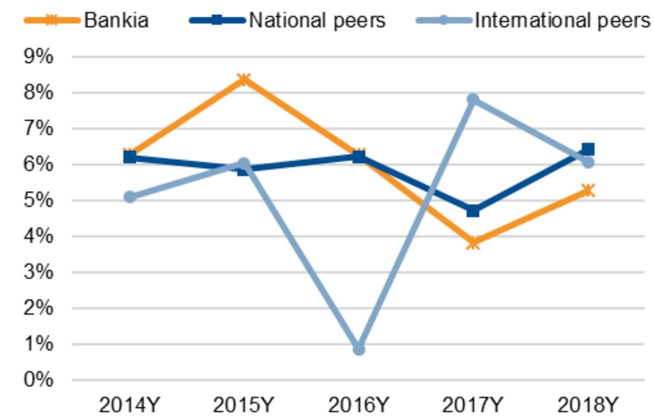
Loan-loss reserves/NPLs (%)



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, Banco BPM, UBI Banca, Sparebank 1 SMN, Sparebank 1 SR-Bank, Nationwide, Caixa Geral de Depositos, Landesbank Baden Wuttemberg, Belfius Banque, Banco Sabadell

II. Appendix: Selected Financial Information – Bankia

	2014Y	2015Y	2016Y	2017Y	2018Y
Balance sheet summary (EUR m)					
Assets					
Cash and interbank assets	13,894	9,422	6,431	7,532	9,187
Total securities	87,146	71,828	65,466	65,244	58,312
of which, derivatives	23,987	16,149	11,887	9,765	8,649
Net loans to customers	112,691	110,570	104,677	123,025	118,246
Other assets	19,917	15,150	13,594	18,132	19,478
Total assets	**233,649**	**206,970**	**190,167**	**213,932**	**205,223**
Liabilities					
Interbank liabilities	60,465	42,702	38,962	37,650	35,644
Senior debt	23,350	22,881	18,801	17,274	15,370
Derivatives	20,556	13,372	9,248	7,456	6,108
Deposits from customers	106,807	108,702	105,155	130,396	126,319
Subordinated debt	1,043	1,046	1,045	2,511	2,990
Other liabilities	NA	NA	NA	NA	NA
Total liabilities	**221,115**	**194,274**	**177,330**	**200,319**	**192,033**
Ordinary equity	12,547	12,630	12,792	13,588	13,177
Equity hybrids	0	0	0	0	0
Minority interests	-13	66	45	25	12
Total liabilities and equity	**233,649**	**206,970**	**190,167**	**213,932**	**205,223**
Core tier 1/Common equity tier 1 capital	10,874	11,289	11,606	12,173	11,367
Income statement summary (EUR m)					
Net interest income	2,927	2,740	2,148	1,968	2,049
Net fee & commission income	948	938	824	864	1,065
Net trading income	225	311	254	377	426
Other income	95	30	-150	-107	-323
Operating income	**4,195**	**4,019**	**3,076**	**3,102**	**3,217**
Operating expense	1,639	1,626	1,551	1,547	1,880
Pre-provision income	**2,557**	**2,393**	**1,524**	**1,556**	**1,337**
Credit and other financial impairments	950	583	221	329	427
Other impairments	383	174	277	157	-10
Non-recurring items	312	184	93	445	0
Pre-tax profit	**912**	**1,452**	**991**	**625**	**920**
Discontinued operations	85	0	0	0	6
Other after-tax Items	0	0	0	0	0
Income tax expense	226	391	189	131	223
Net profit attributable to minority interests	24	21	-2	-11	0
Net profit attributable to parent	**747**	**1,040**	**804**	**505**	**703**

Source: SNL data

III. Appendix: Ratios – Bankia

	2014Y	2015Y	2016Y	2017Y	2018Y
Funding and liquidity					
Net loans/deposits (%)	105.5%	101.7%	99.5%	94.3%	93.6%
Liquidity coverage ratio (%)	NA	NA	NA	172.0%	163.0%
Net stable funding ratio (%)	NA	NA	NA	NA	NA
Asset mix, quality and growth					
Net loans/assets (%)	48.2%	53.4%	55.0%	57.5%	57.6%
NPLs/net loans (%)	13.9%	11.1%	10.2%	9.2%	6.5%
Loan-loss reserves/NPLs (%)	57.8%	60.5%	55.2%	50.9%	54.6%
Net loan growth (%)	-5.4%	-1.9%	-5.3%	17.5%	-3.9%
NPLs/tangible equity and reserves (%)	73.3%	61.6%	57.8%	59.1%	45.1%
Asset growth (%)	-7.1%	-11.4%	-8.1%	12.5%	-4.1%
Earnings and profitability					
Net interest margin (%)	1.3%	1.4%	1.2%	1.1%	1.1%
Net interest income/average RWAs (%)	NA	3.2%	2.7%	2.4%	2.4%
Net interest income/operating income (%)	69.8%	68.2%	69.8%	63.4%	63.7%
Net fees & commissions/operating income (%)	22.6%	23.3%	26.8%	27.9%	33.1%
Cost/income ratio (%)	39.1%	40.5%	50.4%	49.9%	58.4%
Operating expenses/average RWAs (%)	NA	1.9%	2.0%	1.9%	2.2%
Pre-impairment operating profit/average RWAs (%)	NA	2.8%	1.9%	1.9%	1.6%
Impairment on financial assets /pre-impairment income (%)	37.2%	24.4%	14.5%	21.1%	31.9%
Loan-loss provision charges/net loans (%)	0.8%	0.6%	0.2%	0.3%	0.4%
Pre-tax profit/average RWAs (%)	NA	1.7%	1.3%	0.8%	1.1%
Return on average assets (%)	0.3%	0.5%	0.4%	0.3%	0.3%
Return on average RWAs (%)	NA	1.2%	1.0%	0.6%	0.8%
Return on average equity (%)	6.3%	8.4%	6.3%	3.8%	5.3%
Capital and risk protection					
Common equity tier 1 ratio (%, fully loaded)	10.6%	12.3%	13.6%	12.7%	12.4%
Common equity tier 1 ratio (%, transitional)	12.3%	14.0%	15.1%	14.1%	13.8%
Tier 1 capital ratio (%, transitional)	12.3%	14.0%	15.1%	14.9%	15.3%
Total capital ratio (%, transitional)	13.8%	15.2%	16.4%	16.8%	17.6%
Leverage ratio (%)	NA	5.0%	5.6%	5.5%	5.6%
Asset risk intensity (RWAs/total assets, %)	37.9%	39.1%	40.5%	40.2%	40.1%
Market indicators					
Price/book (x)	1.1x	1.0x	0.9x	0.9x	0.6x
Price/tangible book (x)	0.3x	0.3x	0.4x	0.6x	0.5x
Dividend payout ratio (%)	25.1%	29.1%	39.4%	64.8%	50.3%

Source: SNL data

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

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