Spanish banks: net interest income boost more than compensates for bank levy

Spanish banks reported another strong set of results in the first quarter of 2023, driven by strong growth in net interest income that more than compensated for the impact of the temporary bank tax. With most lending extended at floating rates and with little deposit sensitivity, we expect net interest income to be the main tailwind for stronger earnings in 2023.

Credit costs should remain in line or slightly above 2022 levels, supported by provisions accumulated during the pandemic but also by a resilient labour market. Stronger pre-provision profitability supports the banks' ability to sustain higher cost of risk in 2023 and potentially 2024.

Despite significant TLTRO repayments, funding pressure should remain low, especially given the marginal lending growth expected in 2023. A solid, mostly retail, deposit base coupled with limited needs to tap the markets for MREL funding will keep net stable funding ratios and liquidity coverage ratios adequately above requirements. Capital ratios should improve as retained earnings more than offset distributions, and risk weighted asset growth remains low.

Spanish bank performance continues to be driven by solid net interest revenue growth, as asset repricing outpaces higher funding costs. Operating jaws remain positive, with cost-income ratios hitting new lows at most banks.

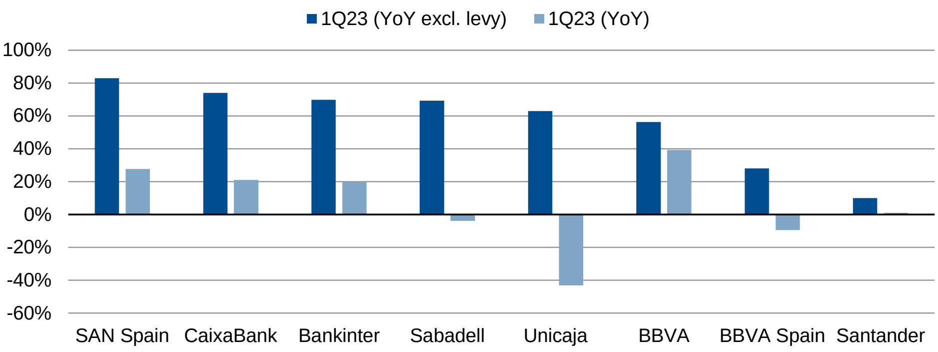
While funding costs have increased, liquidity metrics remain comfortably above minimum requirements, even after Spanish banks repaid a substantial share of their TLTRO borrowings; some ahead of schedule.

Funding comes mainly from deposits from retail and SME customers and close to 70% of eligible deposits are covered by the deposit guarantee fund. While Q1 showed some deposit outflows, this was matched by a broadly symmetric reduction in gross lending. Capital market access proved resilient in the first quarter: issuance was the highest in three years and across the capital structure.

Strong retained earnings, valuation effects and flat to declining RWAs support capital ratios. We expect that further reductions in mortgage lending will lead to flat or slightly declining loan books in 2023.

The latest lending survey for Q1 2023 points to a broad tightening of credit standards across residential mortgages, corporate and consumer lending. Loan demand in the quarter declined across all segments and banks expect further decreases in the second quarter, albeit to a lesser extent.

Figure 1: Profits rise despite temporary bank levy



Source: Company data, Scope Ratings

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Links to related research

See page 6 for links to related commentary and research.

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Solid recurring results, driven by widening margins

NII significantly strengthens YoY

Q1 was a strong quarter for net interest income in Spain, with YoY growth of around 40%, significantly exceeding 2023 guidance at most banks. Widening customer margins driven by asset repricing, and low deposit betas on a mostly flat loan book drove very strong results. Fees and commissions showed modest growth, mostly from operations outside Spain, for example at BBVA as domestic asset management fees remain under pressure.

Santander's revenue performance in Europe and Mexico offset the more challenging environment in the US, South America and at the Digital Consumer Bank. Higher trading gains were strong contributors in the quarter. By contrast BBVA's solid performance in all geographies was marred by lower trading income, mostly affecting revenues in Spain.

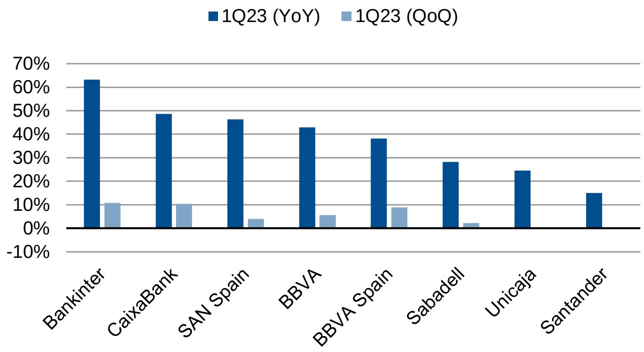
Solid operating leverage, despite temporary levy dimming revenues

For predominantly domestic lenders, operating expenses were flat YoY. For Santander, the increase in costs was contained at around 11% (below composite inflation). BBVA saw OpEx increase by 25% YoY (in constant euros). This was driven by inflation outside Spain. In Q1, Spanish banks bore the full brunt of the temporary levy on 2022 domestic core revenues. Except for Unicaja and BBVA Spain, though, all banks offset the impact of the levy on net results.

Efficiency metrics were flat to slightly better, driven by better top-line performance. Bankinter's cost-income ratio improved to 36% from 44% in 2022, as the 25% increase in revenues YoY dwarfed single-digit costs increases.

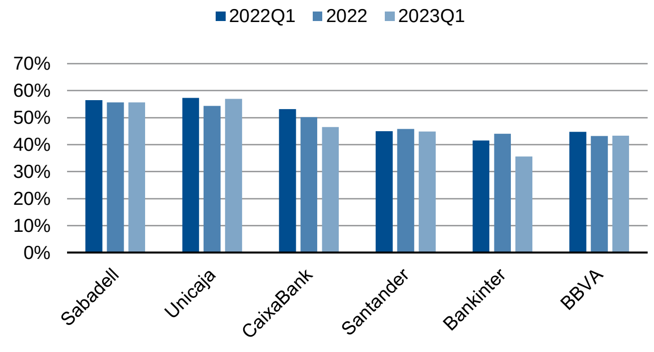
Domestic cost of risk fell in Q1 and remained well within banks' full-year guidance. BBVA and Santander reported some QoQ increases in loan-loss provisions: in the Digital Consumer Bank and in Portugal for Santander; in Mexico for BBVA. In both cases overall cost of risk of around 105bp was in line with their respective full-year guidance.

Figure 2: Net interest income picks up



Source: Company data, Scope Ratings

Figure 3: Strong revenues drive cost income benefits



Note: incl. temporary levy in gross income. Source: Company data, Scope Ratings

Funding and liquidity remain strong despite marginal deposit outflows

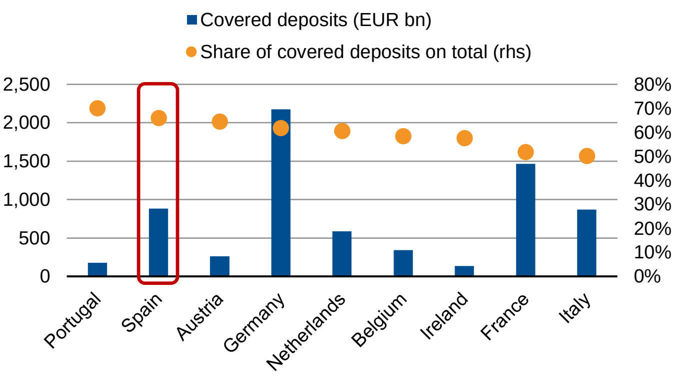
While all banks closed Q1 with deposits in line or above one year prior, they also reported net deposit outflows in the quarter; most banks also recorded an increase in off-balance sheet savings products.

Spanish bank funding relies predominantly on a solid retail deposit base. As of end-2022, 66% of household and corporate deposits were covered by deposit insurance; a coverage ratio second only (in Europe) to Portugal (70%).

The former savings banks have the highest share of retail stable deposits, followed by Sabadell, with around 80%. Bankinter, owing to its business model, holds a significant share of wholesale deposits related to clearing, custody and cash management activities, which are regarded as less vulnerable in periods of market stress. Santander and BBVA have more diversified deposit bases but retail deposits still represent over 60%.

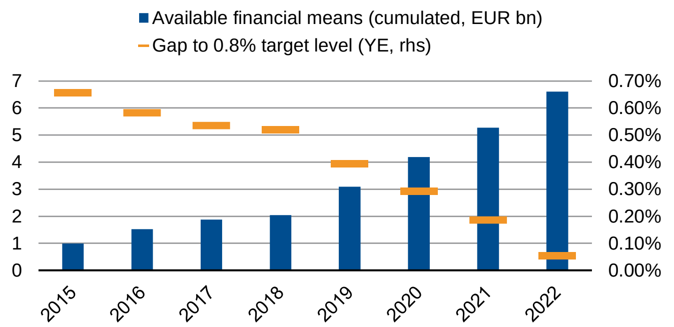
Domestic lenders have reached 0.75% of the 0.8% target level of contributions to their Deposit Guarantee Scheme (DGS), which must be fully met by July 2024. Assuming no changes to the current scheme, 2023 will be the last year of material contributions (EUR 1.5bn in 2022).

Figure 4: High share of deposits covered by the DGS



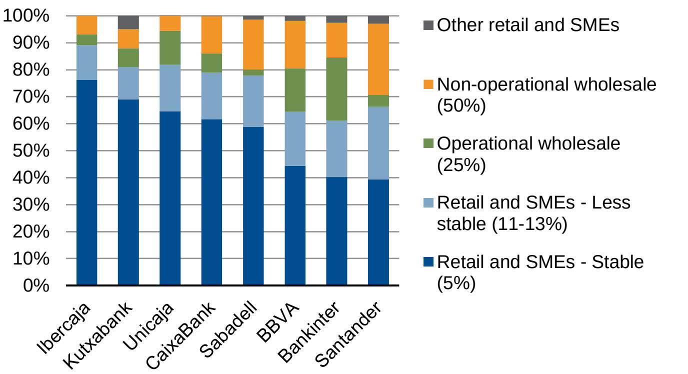
Source: EBA, Fondo de Garantía de Depósitos de Entidades de Crédito, ECB, Scope Ratings

Figure 5: DGS almost fully funded



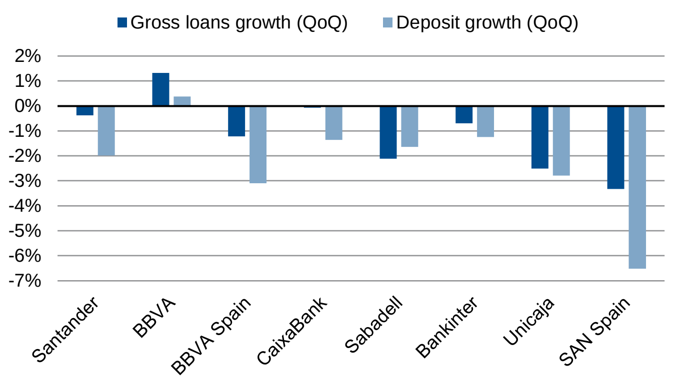
Source: Fondo de Garantía de Depósitos de Entidades de Crédito, Scope Ratings

Figure 6: Retail funding above 60% of total



Note: for Kutxabank Q3 2022, otherwise FY2022.
* Regulatory weighting for LCR purposes in parenthesis
Source: Company data, Scope Ratings

Figure 7: Deposits outflows within mid-single digit



Source: Company data, Scope Ratings

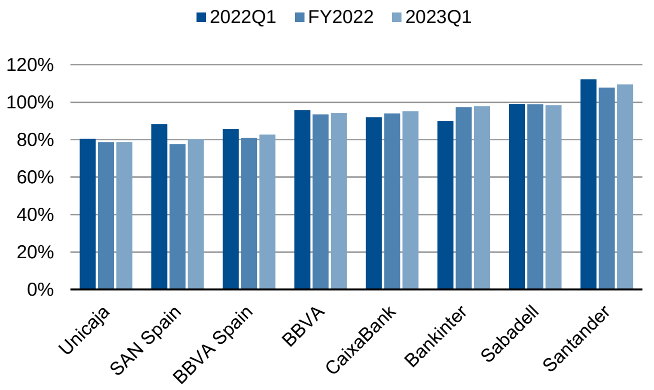
Spanish banks have repaid a material share of their TLTRO funding (or all of it in the case of Ibercaja), ahead of euro area peers. Liquidity coverage ratios remain comfortably above requirements, nevertheless.

Pressure on deposit remuneration remains limited and while expectations about deposit betas remain unchanged, a slower-than-expected pass-through of higher rates resulted in an upward revision of 2023 NII guidance at Bankinter, BBVA and CaixaBank.

With lending growth in negative territory (often driven by mortgage deleveraging), there is no evidence of material pressure on loan-to-deposit ratios, which in Spain remain below the 100% mark, in some cases significantly so.

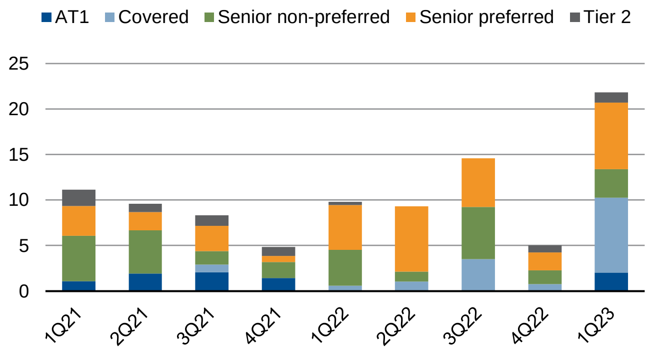
Capital markets issuance in the first quarter was driven by covered and senior preferred bonds. Monthly volumes show peak issuance in January, and with 30 tranches issued across all seniorities in the period. In March, issuance slowed significantly driven by market turmoil following the events in the US and the Credit Suisse debacle.

Figure 8: Loan-to-deposit ratios mostly below 100%



Note: excl. repos and reverse repos Source: Company data, Scope Ratings

Figure 9: Good market access, especially in senior debt (USD equivalent)



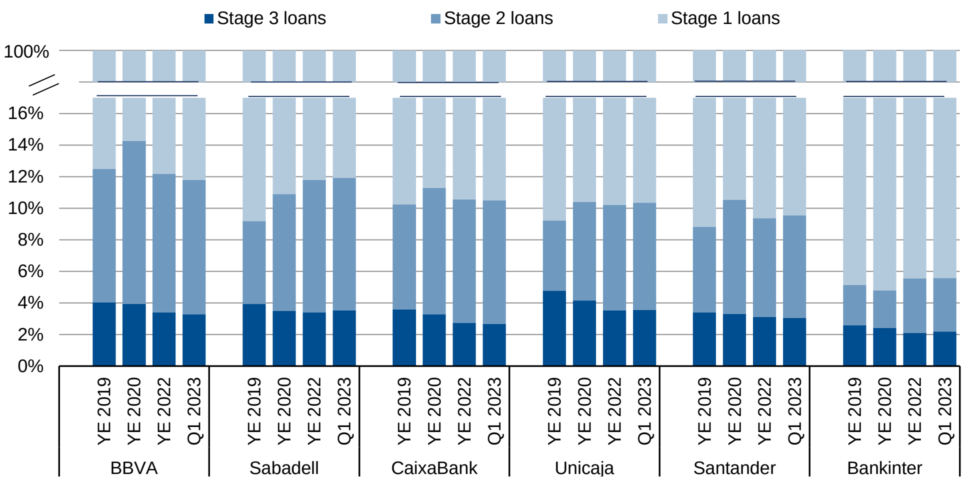
Source: Bond Radar, Scope Ratings

No visible deterioration in headline asset quality metrics (yet)

Spanish banks reported flat Stage 3 and coverage ratios in Q1. These have been continuously improving since 2019 and coverage levels have strengthened. Public and sector-wide Covid-related measures such as moratoriums and guarantee facilities have shielded Spanish banks' balance sheet from material NPE inflows; an active market for disposals have supported outflows.

However, lending classified as Stage 2 stands at around 7% of gross exposures for our sample, roughly 150bp above the figure at YE2019 but stable versus YE2020. This figure comprises positions weakened by the Covid crisis together with some early recognition of exposures with increased credit risk given the higher financing costs the private sector is experiencing in the current economic and monetary environment.

Figure 10: Since 2019, lending classified as Stage 2 has increased



Source: Company data, Scope Ratings

Spain is less exposed than other large EU economies to the energy crisis. The Spanish government allocated around 3.4% of GDP to shield households and companies between September 2021 and January 2023, mostly in the form of tax breaks. Two additional measures were put in place to soften the debt burden deriving from the weak economic backdrop following Russia's invasion of Ukraine and from higher interest rates.

First in March 2022, a EUR 10bn guarantee facility managed by Instituto de Crédito Oficial (ICO) was established to cover lending to companies and self-employed workers. Second, in November 2022, the Code of Good Practices for mortgages on principle residences (CGP) was amended and new temporary provisions were established for vulnerable borrowers.

In a scenario of mortgage reference rates increases of 400bp, the Bank of Spain estimates that the outstanding principle eligible under both measures at around EUR 65bn, almost three times the amount eligible under the previous code.

While this represents a material portion of outstanding mortgage debt, not all eligible borrowers will sign up to the CGP measures, so even though maturity extension qualifies as forbearance, it will not automatically trigger migration to Stage 2 or Stage 3. We do not therefore expect a material increase in risk provisions from these measures, but they should at the same time alleviate the pressure on borrowers. This potentially supports the performance of mortgage debt.

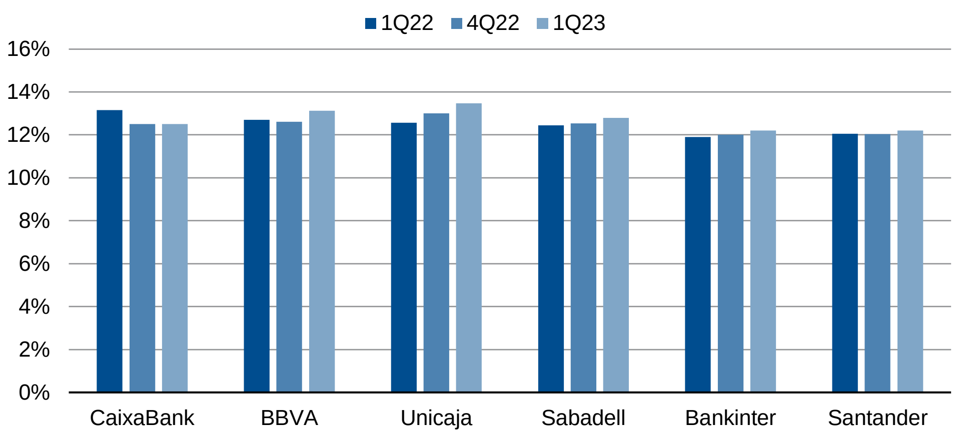
On the ICO facility, contrary to the scheme put in the place during the pandemic, the amounts disbursed from the EUR 5bn tranche activated in May 2022 have been low. We believe this was driven by the productive sector in Spain being less exposed to the energy shock, alongside lower demand for credit as a result of higher interest rates.

It is worth noting that the credit quality of the ICO loans is deteriorating: the NPL ratio stood at 7.1% at the end of 2022 and the Stage 2 ratio was almost 20%. The State guarantee covers around 76% of drawn amounts, easing the burden on the banks. So far only 1.7% of loans are in default.

Capital reflects good organic generation

With no regulatory headwinds impacting capital ratios this year, solvency ratios in the first quarter were supported by solid organic capital formation (ex-banking tax and distributions), timid to negative RWA growth and positive valuation effects.

Figure 11: Fully-loaded CET1 ratio improving YoY



Source: Company data, Scope Ratings

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