Spanish banks: cautious on cost of risk; valuation adjustments hit capital ratios

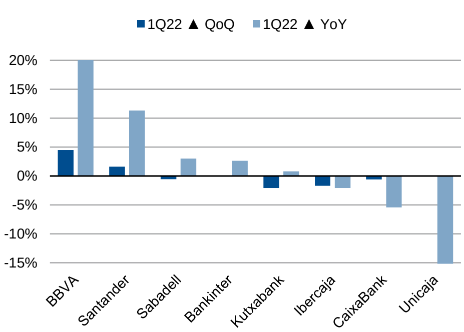
Spanish banks reported a solid set of first-quarter results. Net interest income in Spain has bottomed out, while Santander and BBVA showed a positive year-on-year trend in international lending. Domestic business diversification, especially in asset management and bancassurance, mainly benefited the former savings banks (Ibercaja, Kutxabank, Unicaja), which reported mid-single-digit growth in fees and commissions. Expenses were tightly managed against the inflationary effects of foreign operations; domestically, banks involved in in-country M&A were able to recognise cost synergies. Additional savings from efficiency initiatives will come through in 2022.

Cost of risk is generally below 2022 guidance. Lenders are still cautious about releasing provisions given uncertainties around the payment behaviour of guaranteed lending under Instituto de Crédito Oficial (ICO) public support schemes as well as altered geopolitics and related price inflation. NPL ratios were flat QoQ and lower YoY, with solid coverage across the board. Capital ratios fell slightly YoY, following dividend distributions and share buybacks. Several banks reported a material impact from fair-value adjustments on their available-for-sale (AFS) portfolios in Q1.

P&L trends

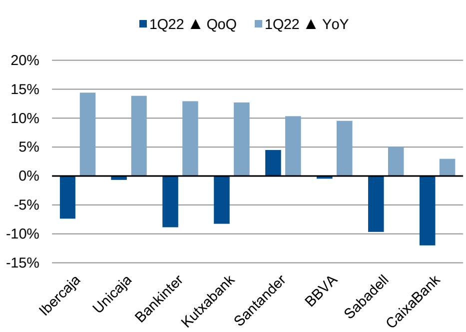
Net interest income (NII) was flat YoY for most domestic lenders, with the back book stabilising and rates increases slowly materialising in the front book. For Unicaja, the ongoing decline of recent quarters appears to have plateaued. Geographically-diversified lenders such as Santander showed solid YoY growth in the UK, Poland, Mexico and Brazil; for BBVA, in Mexico. In Spain, there is still no visible boost to margins from the steepening of the yield curve. Most banks are indicating a three-month lag before books start repricing, with the full effects coming through in 2023. Most lenders are still positive on the trajectory of core NII this year, and the potential to offset the absence of TLTRO benefits in the second half of the year.

Figure 1: Net interest income growth



Source: Company data, Scope Ratings

Figure 2: Net F&C growth



Source: Company data, Scope Ratings

Fee and commissions performance was solid across the board YoY, disregarding QoQ for seasonality effects. Bankinter's asset management arm showed solid earnings growth, as did Unicaja's mutual funds business. Kutxabank's fees and commissions revenue plus insurance now surpass intermediation as the largest combined contribution to gross income.

The gross income trajectory was also generally positive, although Unicaja and Ibercaja were penalised by weak trading income on top of declining NII.

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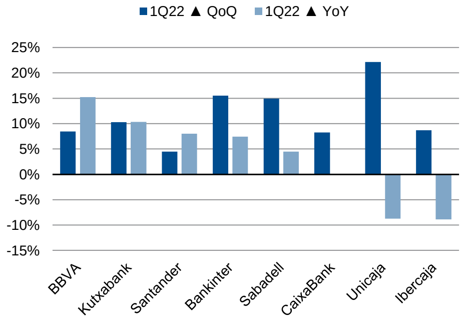
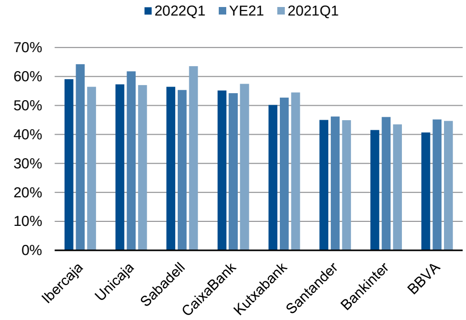
Figure 3: Gross operating income growth



Source: Company data, Scope Ratings

Figure 4: Cost-to-income ratios

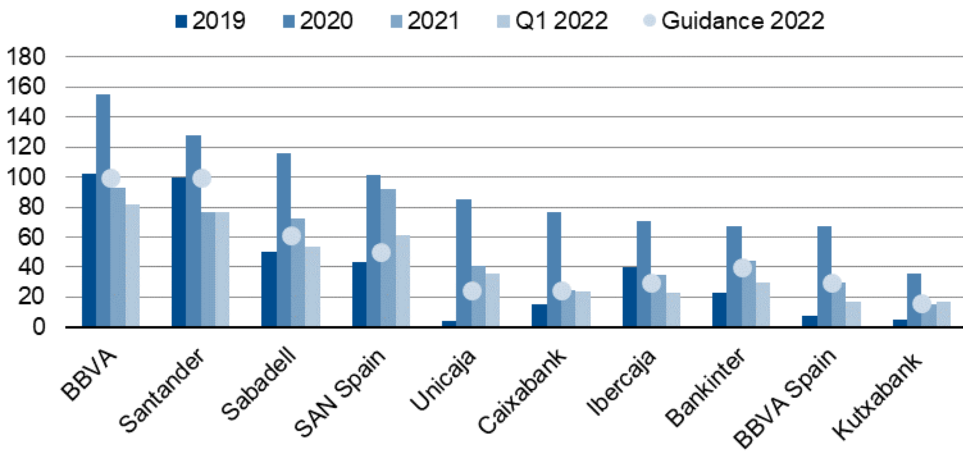


Source: Company data, Scope Ratings

Operating expenses trended down YoY in Q1. Banks were generally able to offset inflation via cost-saving measures. Cost-to-income for the sector fell from 53% on average in the first quarter of 2021 to 51% in Q1 2022. Santander, BBVA and Bankinter demonstrated the best efficiency metrics and all confirmed medium-term guidance. CaixaBank is starting to reap the benefits of M&A synergies in its operating expense line; Unicaja is expected to do so over the next few quarters.

Cost of risk at the end of the first quarter was generally below banks' 2022 guidance. Santander and BBVA are both guiding to 100bp at group level, against 77bp and 82bp respectively in Q1. Quarter-in-quarter, CoR for Santander rose, following the release of provisions in Q4 2021. In Spain, the average cost of risk of banks in a Scope sample as of Q1 2022 was 33bp, down from 44bp for 2021, albeit still above the 24bp in 2019.

Figure 5: Cost of risk



Note: for Ibercaja target CoR, for Sabadell the guidance for credit CoR (average 2019/2021) extended to total CoR
Source: Company data, Scope Ratings

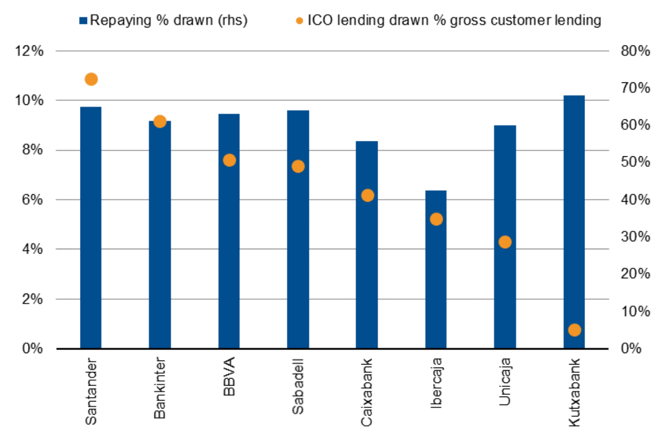
Asset quality

With no lending remaining under moratorium measures, most lenders remain cautious with respect to releasing provisions or adjusting guidance, given uncertainties about payment behaviour of credit lines guaranteed by Instituto de Crédito Oficial (and potential extensions from the new Royal Decree[1]) as well as an altered geopolitical situation affecting corporate borrowers.

As of the first quarter of 2022, around 40% of ICO drawn amounts are still in grace periods, with Ibercaja's standing at 57%. Stage 3 ratios are low, at around 2% of the total drawn. The State guarantee covers around 76% of the loans.

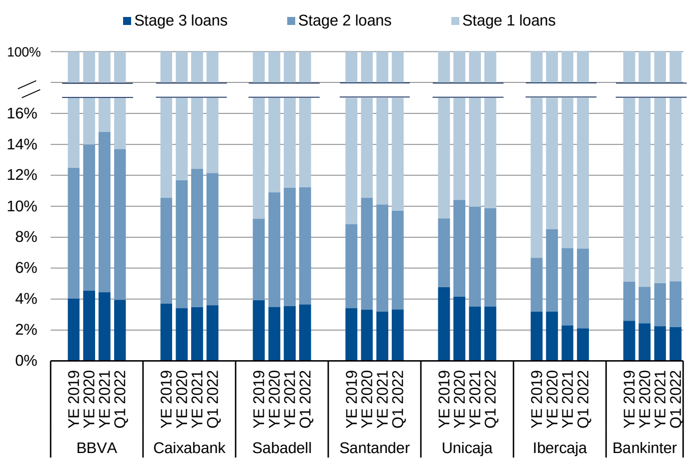
The share of gross customer lending classified as Stage 2 is flattening out after two years of increases, averaging around 7%, from 5% two years prior.

Figure 6: ICO guaranteed lending as of Q1 2022



Source: Company data, Scope Ratings

Figure 7: Customer loans by stage



Source: Company data, Scope Ratings

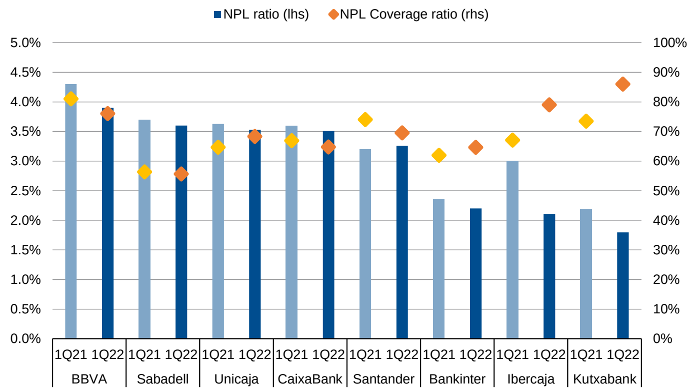
Default rates on loans under expired moratoriums have been minimal and have had no visible effect on NPL ratios. Santander is the only issuer in our sample reporting material positive quarterly NPL inflows, given the first-time application of the EBA's new definition of default. Otherwise NPL ratios are flat or declining QoQ and were lower across the board YoY.

Non-performing assets in Spain, including REO assets, are also declining except for BBVA, although these represent just 1% of BBVA group assets. The most pronounced NPA clean-up was at Ibercaja, which reported a 38% decline year-on-year in its stock of net non-performing assets, and at Kutxabank (-29%).

NPL coverage increased to 70.5% on average, from around 68%. BBVA, Ibercaja and Kutxa have the highest NPL reserves.

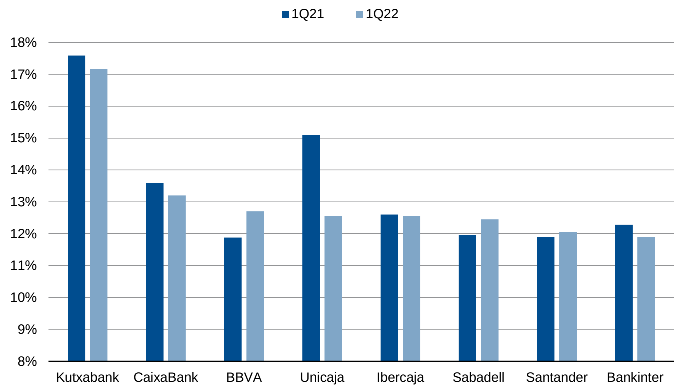
[1] https://www.boe.es/buscar/doc.php?id=BOE-A-2022-7312

Figure 8: NPL ratios and coverage



Source: Company data, Scope Ratings

Figure 9: CET1 ratios fully loaded



Source: Company data, Scope Ratings

Capital

Capital ratios are flat YoY, demonstrating solid organic generation (ex-dividends and buybacks), which offset risk-weighted asset inflation. However, several banks reported negative impacts on capital from valuation adjustments on available-for -sale portfolios. Specifically, the impact on CET1 ratios has been -9bp for Sabadell, -15bp for Bankinter (from the ALCO portfolio), -27bp for Unicaja (mostly from its stake in Portuguese utility EDP and its insurance joint venture), -29bp for Kutxabank (of which around half from its equity and fixed income portfolio) and -30bp for Ibercaja.

Spanish banks are exposed to interest-rate increases affecting the capital base through fair-value reserves, given their sizeable sovereign debt portfolios and the material share of those portfolios classified at fair value.

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