Spanish Bank Quarterly

Trade uncertainty weighs on asset quality; fee and commission remain key to profitability

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Spanish banks' margins are compressing rapidly yet profitability continues to improve. Net interest margins reached their lowest level since Q1 2024 following the steady reduction in interest rates and the downward repricing of loan portfolios. Profitability is largely driven by higher loan volumes, sustained growth in fees and commissions and strict cost discipline.

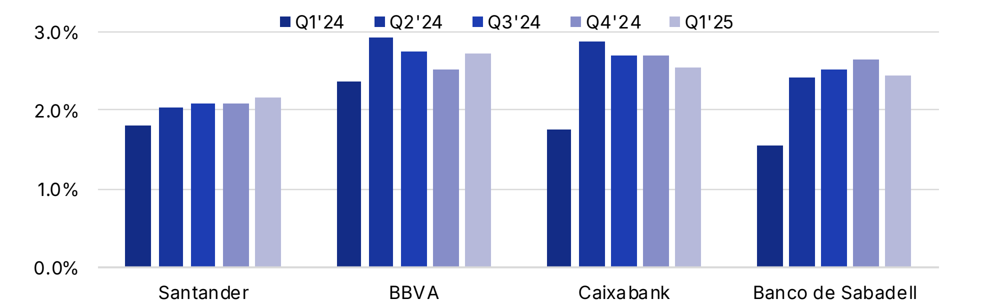
Competitive dynamics intensify, further weighing on profitability. The potential merger between BBVA and Banco de Sabadell is adding complexity to market dynamics, as smaller banks pursue consolidation opportunities, further compressing margins.

Asset quality remains strong amid early signs of potential deterioration. NPL ratios continued to trend downwards across our sample of banks, marking new historic lows for Spanish portfolios for Q1 2025. But we expect signs of deterioration to emerge by Q3 2025, due to strong growth in consumer lending in 2024 and some negative impacts from commercial loan portfolios related to export-oriented SMEs, following the increased global trade volatility.

Capital remains adequate and aligned with targets. CET1 ratios remain stable. After a decade of high levels of shareholder remuneration, capitalisation remains tightly aligned to management targets. Supported by strong profitability, organic capital generation remains strong, allowing for further balance-sheet growth.

Rating Outlook. The Stable outlooks assigned to our public ratings on BBVA (A+/Stable) and Banco Santander (AA-/Stable) indicate that risks are broadly balanced in 2025.

Figure 1: Spanish banks' annualised return on risk weighted assets*



* Proxy for capital generation before distribution, annualised net profit to average. RWA (QoQ). Source: Banks' financial data, Scope Ratings.

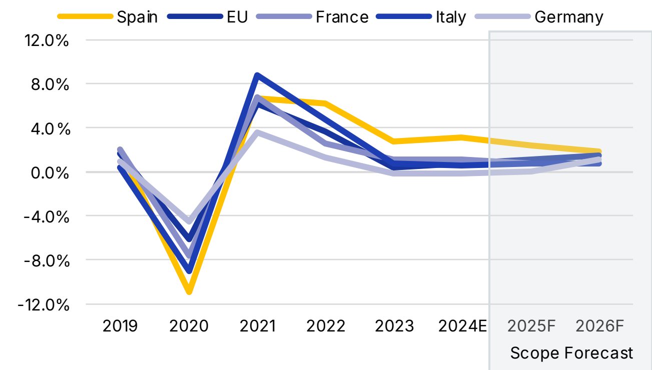
Our expectations of 2025 trends by key area for Spanish banks		
Profitability	↘	Mildly negative. Decreasing compared to 2024
Asset quality	↘	Mildly negative. NPLs and cost of risk likely to increase
Capital position	→	Stable. Increase in RWAs and payouts offsetting organic generation
Funding and liquidity	↗	Midly positive. Shift from sight to time deposits finally over

1. Spain's growth to outperform EU peers despite external headwinds

Despite continuing uncertainty around the global economy from the effects of US tariffs, our economic forecast for Spain (A/Stable) remains unchanged, with GDP growth at 2.5% in 2025. Compared to Spain's largest European peers, higher tariffs are expected to have less impact given the economy's lower exposure to US trade than the EU average. However, Spain is still exposed to spillover effects from more exposed EU trading partners.

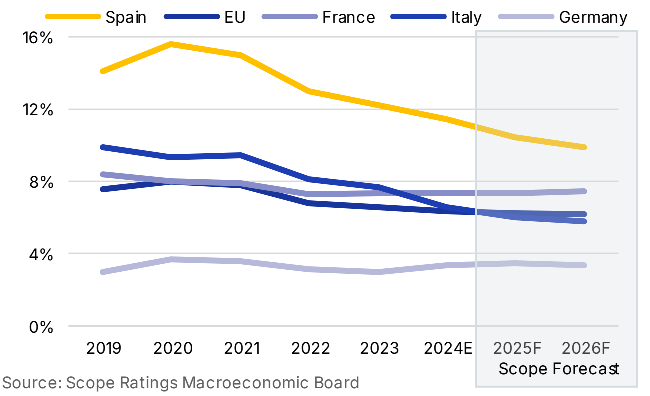
Growth is underpinned by an expanding labour market supported by immigration, strong household spending, and stable investment. These fundamentals should support loan volumes in 2025. Key risks stem from geopolitical and global trade issues. SMEs and corporate loans are the most sensitive to any downward revisions to the growth outlook.

Figure 2: GDP growth



Source: Scope Ratings Macroeconomic Board

Figure 3: Unemployment rate



Source: Scope Ratings Macroeconomic Board

Thanks to the steady reduction of private sector debt in Spain since the global financial crisis, Spain has renewed capacity to grow. The aggregate loan-to-deposit ratio for the Spanish banking sector declined to 73% at YE 2024 from a peak of 150% in 2007. Based on preliminary data from the Bank of Spain, credit growth was 1.5% in Q1 2025, confirming the positive trend started in H2 2024.

Resilient profitability despite declining rates

RoRWAs still above 2.0% for all four banks

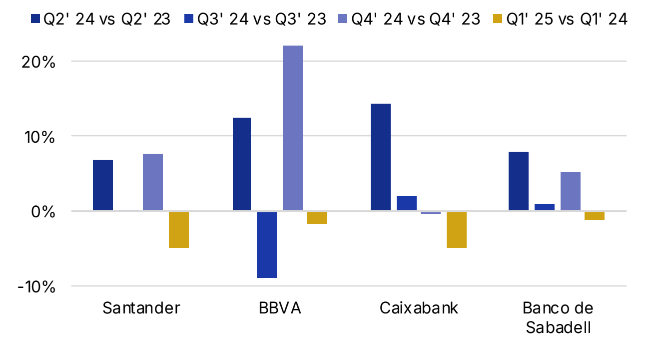
The first quarter of 2025 was characterised by double-digit YoY growth in net profits for our sample of banks (BBVA, Santander, Banco de Sabadell and CaixaBank), resulting in an average RoE of approximately 16%, up from around 13% in Q1 2024, and an average RoRWA of 2.47%, compared to 1.87% in Q1 2024.

The positive results were driven by still-resilient net interest income, higher fee and commission income, and benefits from changes in the structure of banking tax payments from a one-time payment previously disbursed in Q1 to quarterly instalments.

Following the reduction in interest rates, net interest income (NII) decreased YoY and QoQ as margins shrank, despite higher business volumes, mostly from consumer loans. Interest-rate hedging continues to be a key strategy to manage the downward pressure, amid expectations of additional interest-rate cuts.

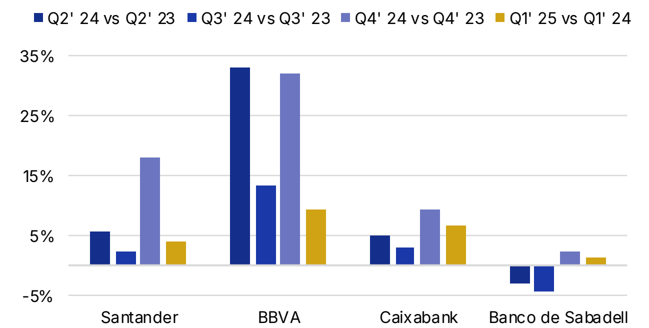
Fee and commission income continues to grow YoY, notably for Santander and CaixaBank as they benefit from rising fee income from wealth management and insurance activities. We expect this to stabilise in H2 2025 as AuM has plateaued, although there is still some upside from payments and credit card transactions.

Figure 4: Net interest income, YoY



Source: Banks' financial data, Scope Ratings

Figure 5: Net fees and commissions, YoY

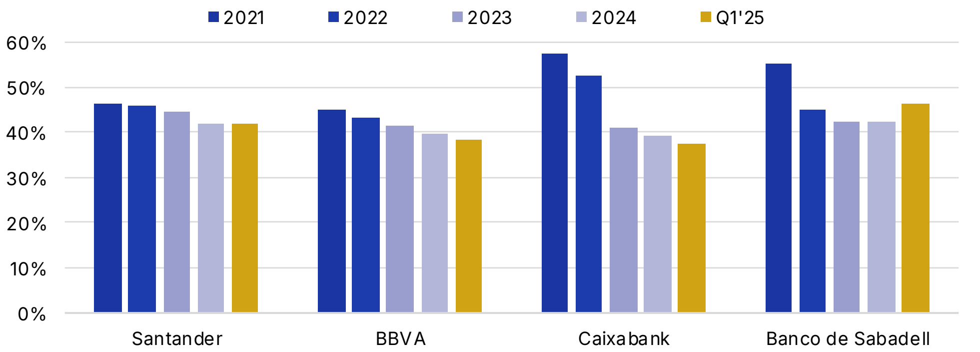


Source: Banks' financial data, Scope Ratings

Efficiency levels stable around 40% for most banks

Cost-income ratios remain strong and were in a range of 36%-46% in Q1 2025, although they have deteriorated since FY2024. The effect of salary increases and inflationary pressures on suppliers continues to be absorbed by strong revenue generation. We expect banks to maintain strong cost discipline in 2025 and cost-income ratios to stabilise between 40%-42%, as most banks have fully optimised their branch networks, while the revenue base decreases slightly compared to 2024.

Figure 6: Efficiency, cost-to-income ratio

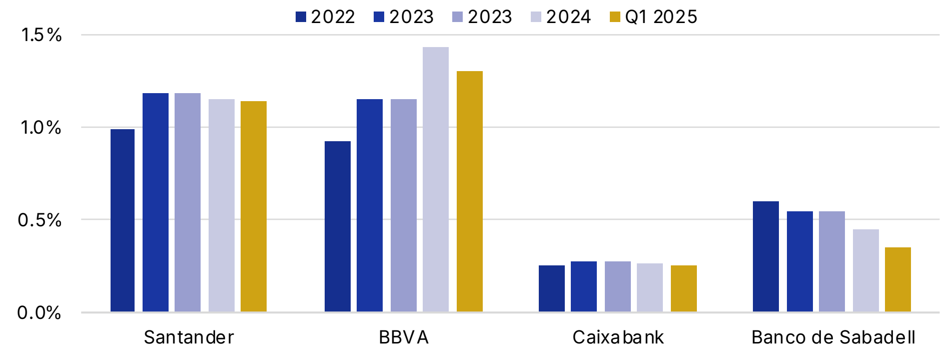


Source: Banks' financial data, Scope Ratings.

Cost of risk decreased for all four Spanish bank in our sample, both YoY and QoQ. While BBVA, Sabadell and CaixaBank strongly reduced loan-loss provisions YoY due to positive impacts from portfolio sales, Santander showed almost no change QoQ due to a large component of provisions in its payments business. With loan-loss provisions stable or declining, cost of risk was supported by loan growth on the denominator.

However, we do expect cost of risk to increase in 2025 for all banks in our sample as loan quality deteriorates, in particular in consumer lending and from commercial loans exposed to sensitive sectors like trade and wholesale.

Figure 7: Cost of Risk (CoR)



Source: Banks' financial data, Scope Ratings.

Asset quality stable though risks are increasing

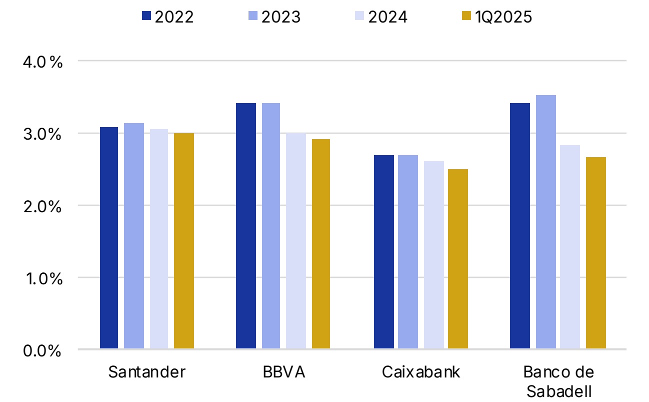
Asset quality remains strong, with better-than-expected NPL and stage 2 ratios

NPL ratios decreased QoQ for all four banks in our sample. Santander's NPLs remain the highest among the banks in our sample due to the negative effects from its payments business in Brazil, which has been impacted by higher interest rates and inflation. By contrast, the NPL ratio exclusively related to Santander's Spanish exposures (2.56% as of Q1 2025) remains contained and is better aligned with our sample.

Strict underwriting standards and prudent risk management, supported by a stable macroeconomic environment and employment, continue to underpin asset quality in Spain. However, trade volatility related to export uncertainty is weighing on the outlook for asset quality in the medium term.

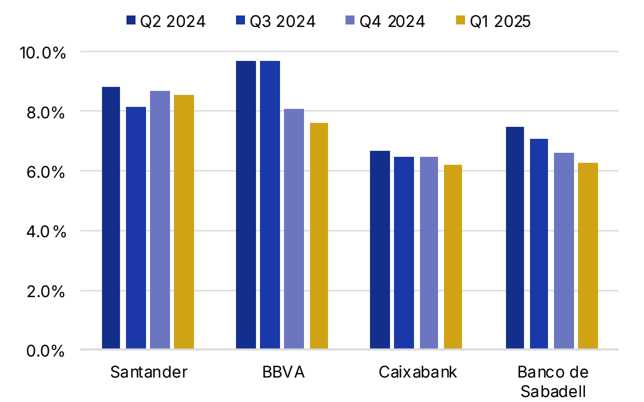
The stock of stage 2 loans fell for all banks YoY and QoQ, supporting better-than-expected asset quality.

Figure 8: NPL ratio



Source: Banks' financial data, Scope Ratings

Figure 9: Stage 2 ratio



Source: Banks' financial data, Scope Ratings

Organic capital generation supports strong shareholders distributions

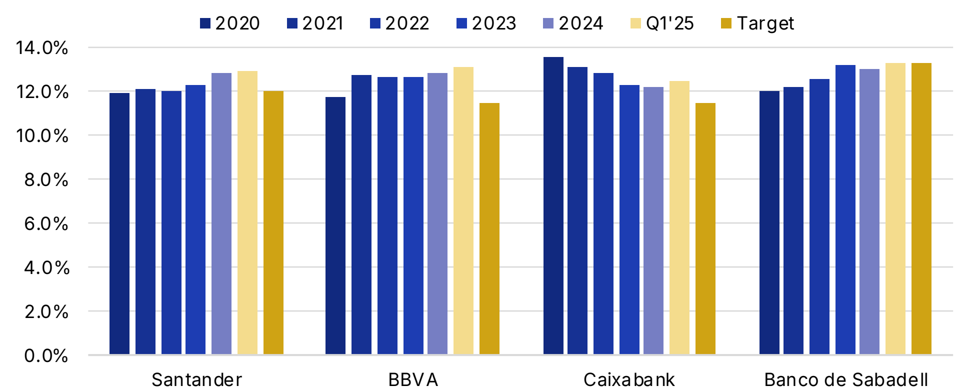
Capital levels aligned with management target, following optimisation strategies

The average CET 1 ratio of our sample was 12.94% in Q1, slightly higher than Q4 2024 because of organic capital generation. After the positive results of 2024, total distributions to shareholders for the whole of the Spanish banking sector (including dividends and share buybacks) were the highest for a decade. Provided that results remain strong, we do not expect major changes to the 50%-60% distribution strategies of the four banks in coming quarters.

Most banks in our sample reported CET 1 broadly aligned with targets, although the buffer above regulatory requirements remains below the EU average. We consider capital levels to be reasonable in our view considering the sector's ability to generate capital organically.

As of Q1 2025, all four banks in our sample maintained a net surplus of organic capital generation after dividend accruals and AT1 coupon payments. BBVA's stood at +31bp, followed by Sabadell at +24bp, CaixaBank +11bp, and Santander +6bp.

Figure 10: CET 1 ratio, evolution vs target



Source: Banks' financial data, Scope Ratings.

Competition and growth prospects challenge domestic players

Competition to squeeze margins, and uncertain effects on asset quality could erode profitability

BBVA's acquisition of Sabadell is at the final approval stage, having received the green light from almost all relevant authorities. The decision now rests with the government, which has until the end of June to grant final approval, with or without additional conditions. The key risk to the transaction is if approval comes with harsh conditions that change the economic and financial rationale of the deal and causes BBVA to reassess its value and eventually withdraw the offer.

In parallel to M&A activities, and in the context of strong capital generation and liquidity, our expectation is for heightened competition in lending to attractive customer segments (consumer, SMEs), as banks look at ways to deploy capital organically to boost their market positioning. This has the potential to squeeze sector margins, contributing to softer profitability in the second half of the year, alongside some deterioration in asset quality if exports suffer from a slowdown in global trade. Nevertheless, the Spanish banking sector continues to provide a supportive environment for banking activities, confirming our view of the sector's robustness of its operating performance (European bank operating environments 2025).

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