Spanish banks: asset-quality improvements set to continue

The asset quality of Spanish banks has been improving for several years. Once the recently announced portfolio sales have been executed, Santander (AA-, stable), BBVA (A+, stable), Caixabank (not publicly rated) and Sabadell (not publicly rated) will have de-consolidated almost all of their real estate assets in a final step to move on from the real estate boom-and-bust cycle.

The improving trends in Spanish asset quality are not new. The sector's NPL ratio has been declining since 2013; partly the result of a sharp rebound following a deep V-shaped recession but also due to a very proactive regulatory approach which forced the banks to front-load provisions for real estate-related assets back in 2011 and 2012, and to raise fresh capital (in some cases via public injections).

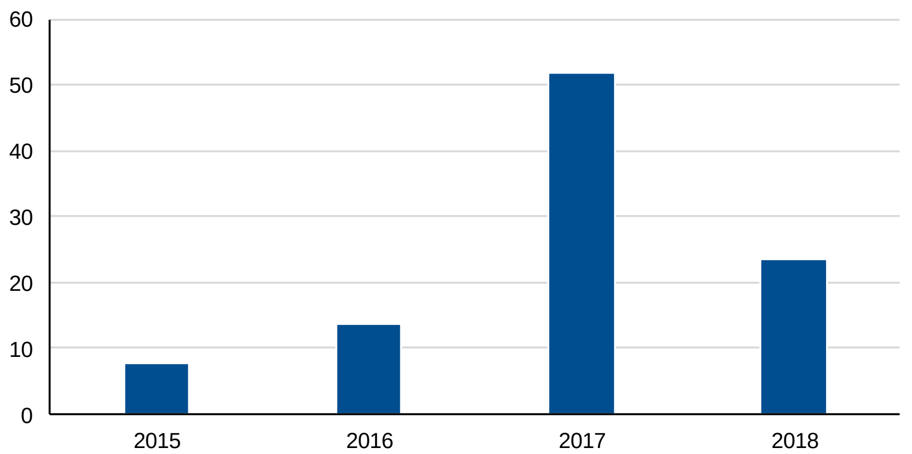
This resulted in a decimation of the number of banks in the country, but the surviving players stand on a much stronger footing. Compared to other countries in Europe, the fast decline in NPLs also reflects speedier and less expensive corporate insolvency procedures, which allowed banks to foreclose on collateral relatively early. However, so long as uncertainty remained on the outlook for real estate prices, seized real-estate assets sat on banks' balance sheets, still absorbing capital, operational resources, management time and sometimes requiring additional provisions.

More recently, as the economic recovery has firmed up, these assets have become less of a concern for most banks, which had ring-fenced real-estate assets and NPLs into non-core run-off divisions.

Over the past year, four of the five largest Spanish banks have announced deals to de-consolidate real estate assets, through joint ventures with US investors Cerberus, Lone Star and Blackstone. The Santander/Blackstone transaction, announced in 2017, is already closed. Sales by BBVA (EUR 13bn), Caixabank (EUR 12.8bn) and Sabadell (EUR 9.1bn) – which have been announced in the past 12 months and are expected to close by H1 2019 at the latest (provided that there are no hiccups with the regulatory approvals) – account on Scope estimates for over half of the remaining real-estate assets (and 64% of the real-estate assets owned by the top 12 banks in Spain).

At the same time, NPLs have accelerated their decline. In this area as well, there have been some relevant transactions (Santander/Blackstone being the main one); others are in the pipeline.

Figure 1: NPA sales announcements, Spain, 2015-2018



Source: Banks, Scope Ratings

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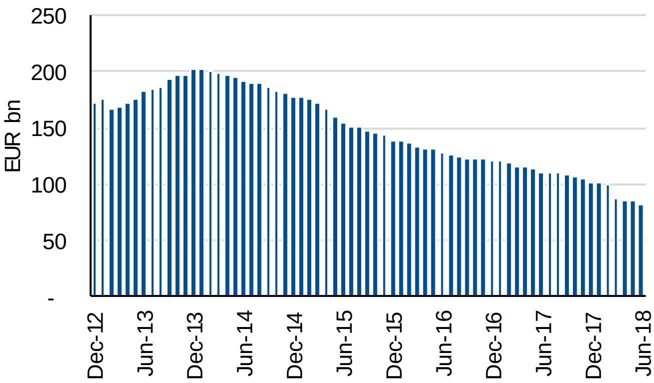
NPLs continue their decline, supported by a growing economy

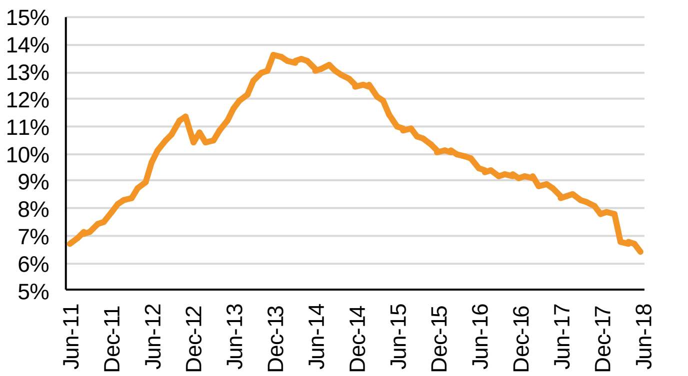
Supported by the favourable macro environment, asset-quality trends have been very positive for Spanish banks, which saw the sector NPL ratio peak in December 2013. Since then NPLs have declined by almost 60%, from over EUR 200bn to EUR 82bn in June 2018, as banks gradually run down their non-core real-estate divisions, a feat made easier by the recovering housing market.

Figure 2: Spanish Banking Sector gross NPL stock (EURbn)



Source: Bank of Spain, Scope Ratings

Figure 3: Sector NPL ratio is rapidly declining

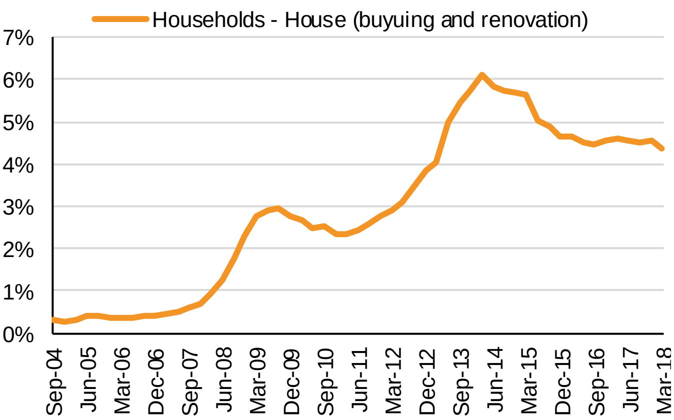


Source: Company data, Scope Ratings
Note: Data refers to resident private sector

In recent quarters, banks have accelerated their clean-up through portfolio sales. As of Q2 2018 Scope considers residual NPLs to be at manageable levels for rated banks and a legacy from the crisis rather than a real credit concern. Bank of Spain data shows that the sector NPL ratio stood at 6.4% as of June 2018.

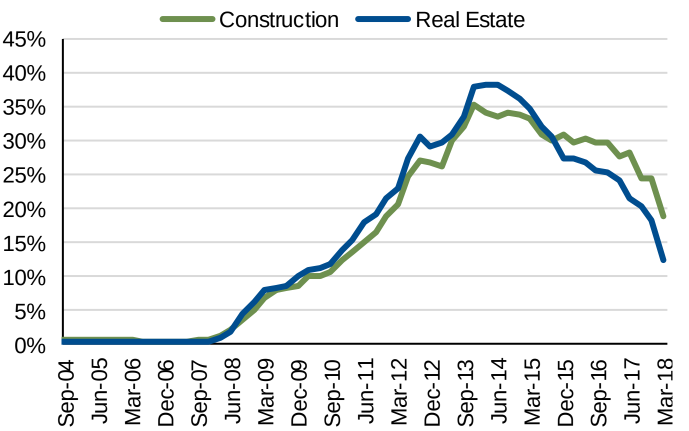
The steep decline in the NPL ratio at the beginning of 2018 is due to the execution of a large portfolio sale (c. EUR 30bn in gross assets including NPLs but also real-estate assets) by Banco Santander to Blackstone. The loans disposed of were mostly non-performing commercial real-estate related inherited through the Banco Popular acquisition. Data from the Bank of Spain show that while the decline in real estate-related NPLs has been accelerating in recent quarters, the NPL ratio for the household segment remains stable at just under 5%. Scope expects the decline in NPLs to continue in a positive economic environment, with recoveries exceeding NPL formation. We also note that the NPL market in Spain continues to be active.

Figure 4: NPL ratio, households



Source: Bank of Spain, Scope Ratings

Figure 5: NPL ratio, construction and real estate

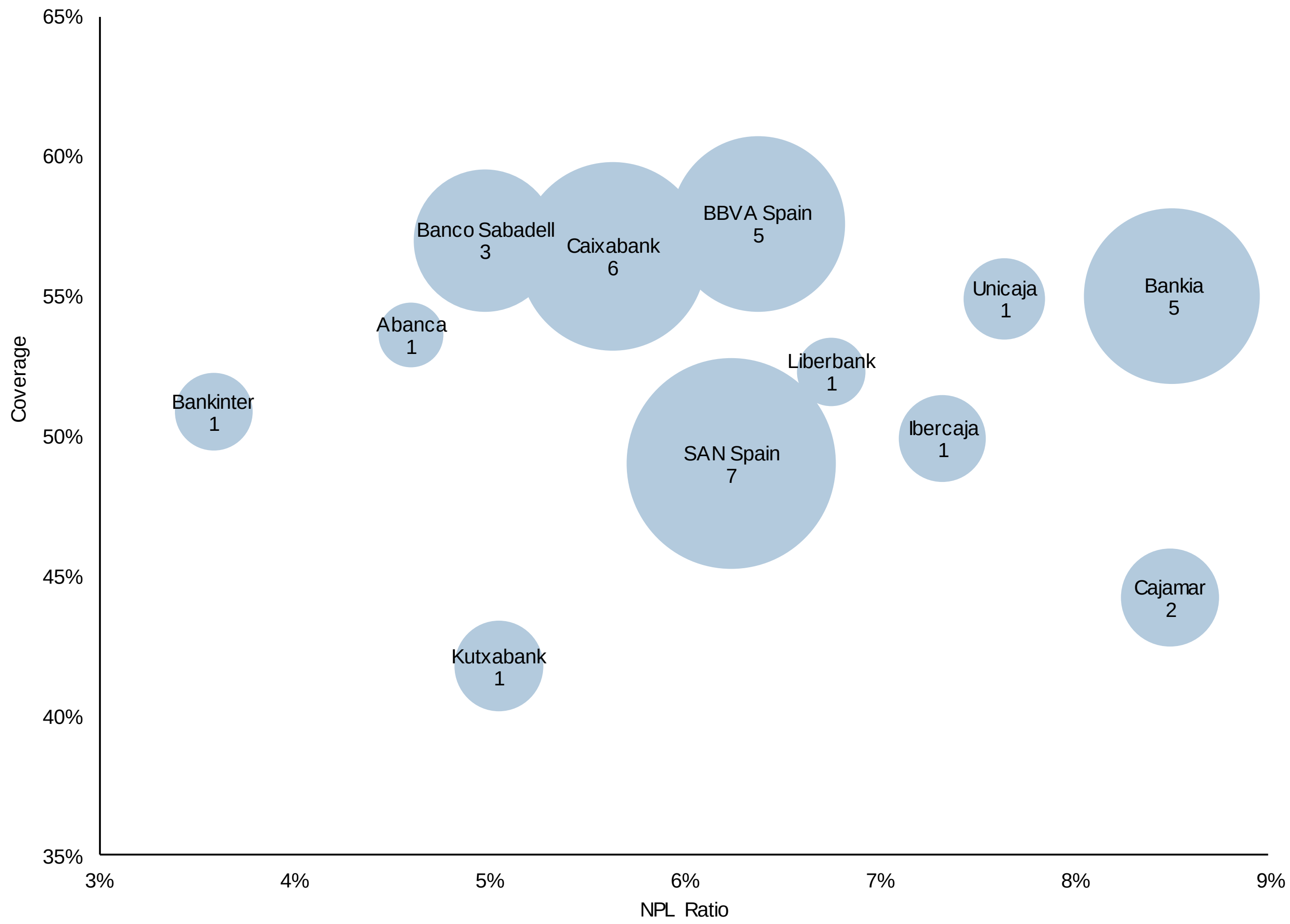


Source: Company data, Scope Ratings

While the trends are undoubtedly positive, our bottom-up analysis shows significant dispersion around averages: as of Q2 2018, we calculate that the 12 Spanish banks directly supervised by the ECB held c. EUR 61.2bn of gross NPLs (EUR 28.6bn net of provisions), for an average gross NPL ratio of 5.8% and an average coverage ratio of 52%. However, NPL ratios range between 3.6% at Bankinter and 8.5% at Bankia, with coverage between 42% (Kutxabank) and 58% (BBVA).

Figure 6 offers a summary view of the NPL ratios and coverage at the 12 banks directly supervised by the ECB.

Figure 6: NPL and coverage ratios, Spanish banks

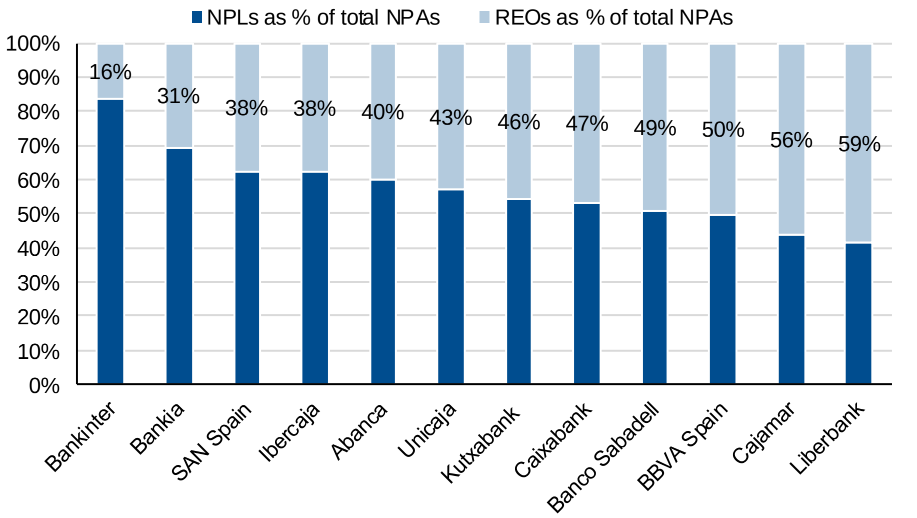


Notes: Data as of Q2 2018. For Kutxabank, data is as of year-end 2017.
Source: Company data, Scope Ratings

Banks move real estate assets off balance sheet through partnerships

However, simply looking at NPLs offers an incomplete picture of the sector's asset quality. Over the years, in fact, banks have been foreclosing on their NPLs, and in some cases still hold large portfolios of real-estate collateral. For the banks in Figure 7, we estimate that these amounted to close to EUR 55bn as of June 2018. For some banks, the gross book value of foreclosed assets is higher than the gross value of NPLs

Figure 7: NPLs and real estate owned asset, split



Source: Banks, Scope Ratings Estimates

The NPA ratio, which includes both NPLs and foreclosed assets, is in the high single-digit range for most Spanish banks, with only Cajamar above 10% according to Scope calculations.

These ratios look set to decline further in the coming quarters, as several lenders are in the process of completing sizeable portfolio sales of foreclosed properties (on top of NPL sales).

In Q4 2017, BBVA announced it was transferring EUR13bn in real-estate assets, alongside operational assets and employees to manage them (essentially the Spanish non-core real estate division) to a new vehicle and would transfer control to Cerberus, while retaining a 20% stake. The operation, expected to close by the end of 2018, should not have any material impact on profit and be marginally positive for BBVA's CET1 ratio.

In June 2018, Caixabank announced that it would transfer its real-estate operations, including EUR12.8bn in real-estate assets alongside its real-estate servicer Servihavitat, to a vehicle to be controlled by US fund Lone Star, and retain a 20% stake.

In July 2018, Sabadell announced it had reached an agreement to sell real-estate assets to Cerberus for a gross book value of EUR 9.1bn. Sabadell will also retain a 20% economic interest in the transferred portfolio, through a joint venture structure. However, Sabadell real estate company Solvia does not form part of the deal and will remain consolidated into Sabadell. Solvia will continue servicing the properties.

We estimate that these three deals alone will lead to the de-consolidation of more than half of the foreclosed assets currently on the balance sheet of Spanish banks in our sample. Figure 8 offers an overview of the recently announced deals, including their expected financial impact.

Figure 8: Key features of the main deals between Spanish banks and US funds

Seller	Partner	Asset type	% of JV retained	Servicer included	Gross Book Value	Announce-ment date	Expected completion	Expected impact on capital	Transfer price /GBV
Banco Santander	Blackstone	NPLs and RE assets	49%	Yes	EUR 30bn	08/08/2017	Q1 2018	+10 bps on Santander's CET1 FL.	33.3%
BBVA	Cerberus	Real estate assets	20%	Yes	EUR 13bn	29/11/2017	H2 2018	Slightly positive impacts	38.5%
Banco Sabadell	Cerberus	Real estate assets	20%	No	EUR 9.1bn	19/07/2018	H1 2019	+13 bps on Sabadell's CET1 FL.	42.9%
Caixabank	Lone Star	Foreclosed assets	20%	Yes	EUR 12.8bn	28/06/2018	Q4 2018/Q1 2019	+30 bps on Caixabank's CET1 FL.	52.9%

Source: Banks, Scope Ratings

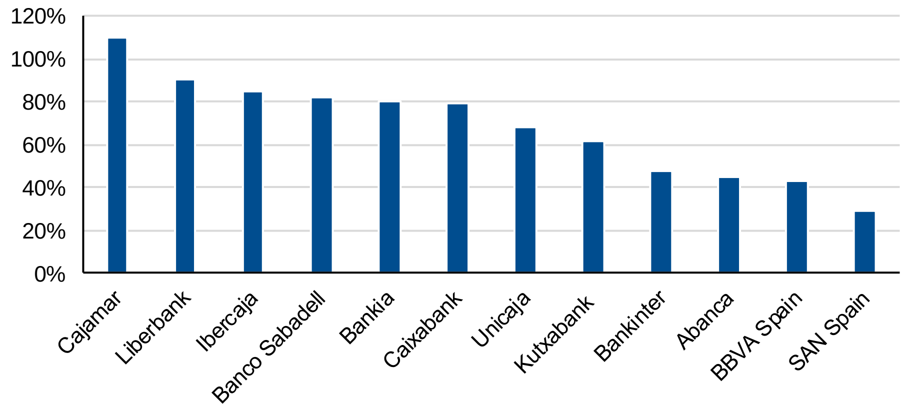
The transactions share several characteristics but perhaps more interesting are the differences. For example, while Santander will retain a 49% stake in the joint venture with Blackstone, the other deals are structured around an 80%/20% partnership. While it is customary for sellers to retain a minority stake in such ventures (to guarantee a smoother handover, better aligned incentives, and operational linkages etc.), Santander's stake seems to indicate that the bank preferred to maximise economic exposure to the assets while still achieving deconsolidation. Notably, the transfer price in the Santander/Blackstone transaction was materially lower (as a percentage of the gross book value) compared with other transactions.

Similarly, we note that Sabadell did not transfer its real-estate servicer (Solvia) as part of the deal, a key difference with the other transactions. Sabadell's Solvia will continue to service the transferred portfolio, hence continuing to generate fee income from it while still achieving de-consolidation and allowing the bank to show better asset quality ratios..

We note that the above-mentioned transactions will not only lead to a material improvement in the reported asset quality of the banks but will do so with limited impacts on profits and marginally positive impacts on capital ratios.

We believe other deals are likely, as the US funds may look to scale up and capitalise on their newly-acquired platforms and as other Spanish banks potentially look at further reducing their reported NPA ratios through portfolio sales. For one, an accelerated clean-up of the balance sheet is one of the stated objective of Bankia's (BBB+, stable) recently announced strategic plan.

Figure 9: Texas ratios, Spanish banks



Source: Banks, Scope Ratings Estimates
Note: Data as of Q2 2018, Q4 2017 for Kutxabank. Texas ratio is calculated as Gross NPA over Provisions+CET1 Capital)

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