Spanish banks: capacity restructuring supports profitability

The Q2 results season confirmed that Spanish banks are in a cyclical sweet spot. With the latest sales of real-estate assets, legacy asset-quality problems are by and large dealt with, and the lower cost of risk is resulting in much-improved bottom lines. The delivery of synergies from in-market consolidation is keeping cost-income ratios low, despite the still-unfavourable revenue environment. Scope publicly rates Bankia (BBB+, Stable), BBVA (A+, stable) and Santander (AA-, stable).

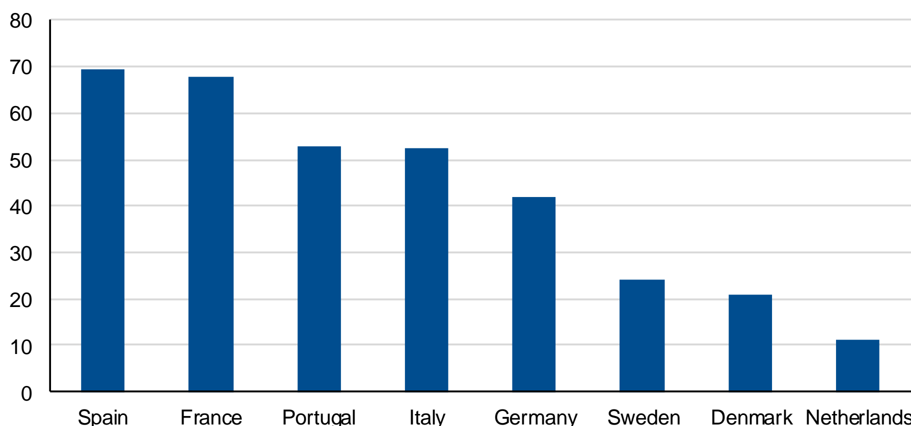
Spanish banks are now among the most profitable in Europe, according to ECB supervisory data. Their aggregate ROE stood at 9.74% in the first quarter of 2018, almost 200bps higher than a year before. On average, their returns are marginally higher than those of Italian banks, and well above their French and German counterparts. Only a handful of small countries in the euro area (EA) display stronger profitability metrics.

Scope sees the Spanish banking system's low cost-income ratio as a defining feature, which explains much of the structurally high profitability. The current low level of credit provisions reflects instead a particularly favourable moment in the credit cycle, with low NPL formation and rising collateral values. Foreign investor interest in purchasing Spanish legacy real-estate assets is an additional indication that the clean-up of banks' balance sheet is at an advanced stage.

The revenue environment remains challenging, however, with ultra-low interest rates and no volume growth. With headline inflation now running at over 2%, some inertia on costs is likely. In this environment, management actions aimed at maintaining the fine balance between revenues and costs are crucial.

Against such a backdrop, the sector continues to modify its distribution structure, by closing branches. The drivers for the reduction in branch outlets are twofold: on the one hand, the need to optimise distribution capacity following the mergers announced in 2017; on the other hand, acknowledgement that proximity is gradually losing its appeal with customers, who are increasingly shifting to digital channels, making large and cost-heavy networks a competitive burden rather than the competitive advantage they were once perceived as. Spanish branch outlets have fallen from 45,000 in 2008 to 27,480 in 2017, mirroring a marked decline in the number of banking institutions in the country during the global financial crisis. We expect this decline to continue, as Spain still has one of the highest density of bank branches in Europe.

Figure 1: No of branches per 100,000 inhabitants, selected European countries (2017)



Source: ECB, Eurostat, Scope Ratings

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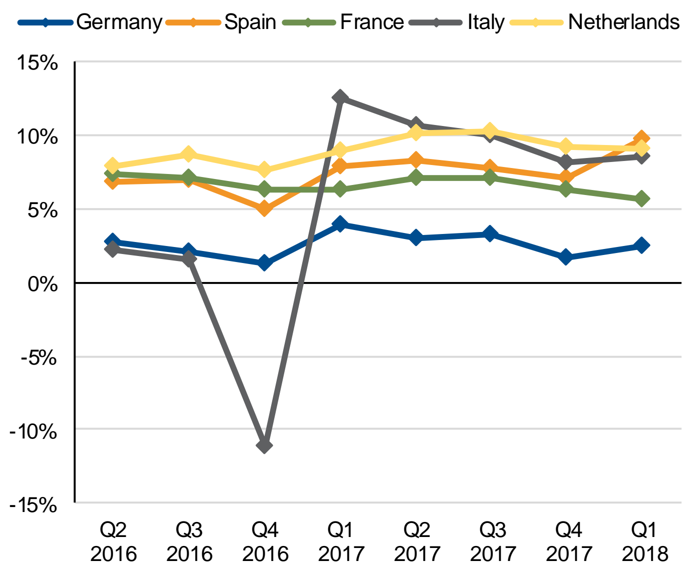
Spanish banks are among the most profitable in Europe

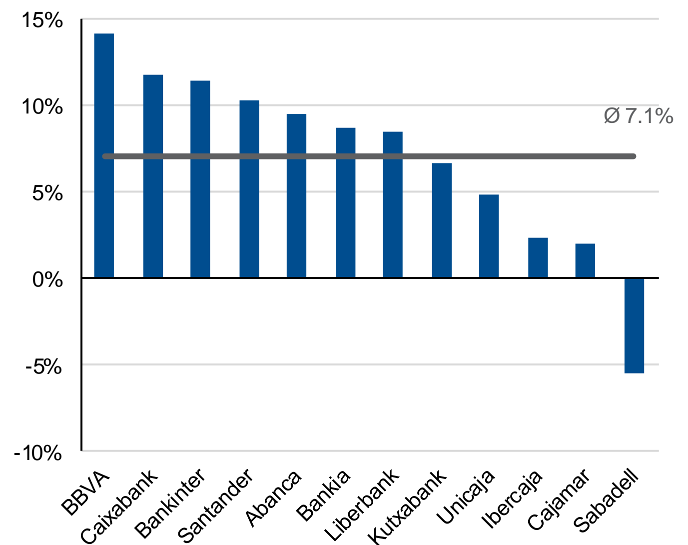
For several quarters, Spanish banks have been reporting solid earnings. In Q2 2018, aggregate net profit for the 12 banks directly supervised by the ECB stood approx.at EUR 4.2bn, essentially flat on 2017 and slightly lower than in the previous quarter. This subset of institutions had reported an average ROE of 10% in Q1 2018, the latest aggregate available data; higher than counterparties in other large European countries that are also under direct supervision by the SSM.

Figure 2: Spanish banks' ROE vs other European countries



Source: ECB, Scope Ratings

Figure 3: Q2 2018 RoTE, Spanish banks, annualised

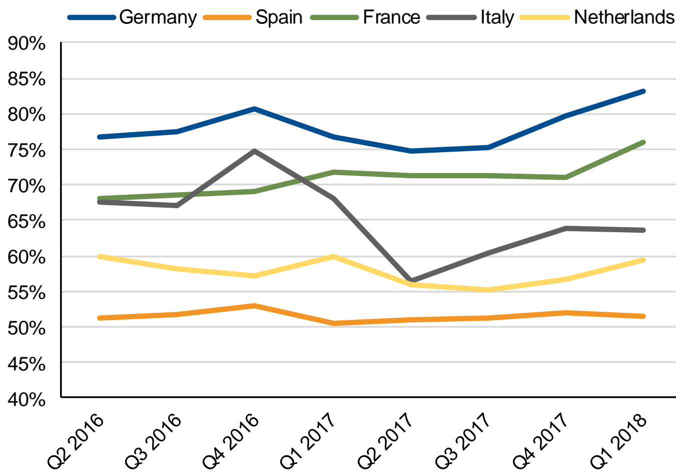


Source: SNL, Company data, Scope Ratings

The larger players are currently operating with double-digit rates of return: measured on tangible equity (i.e. disregarding goodwill and other intangibles), returns have been running at 10% or higher for BBVA, Santander, Bankinter and Caixabank. While these remain well below the returns of a decade ago (before the crisis and before the tightening of capital regulations) this is a remarkable accomplishment, considering the muted volume growth and ultra-low interest rate environment the returns have been achieved in.

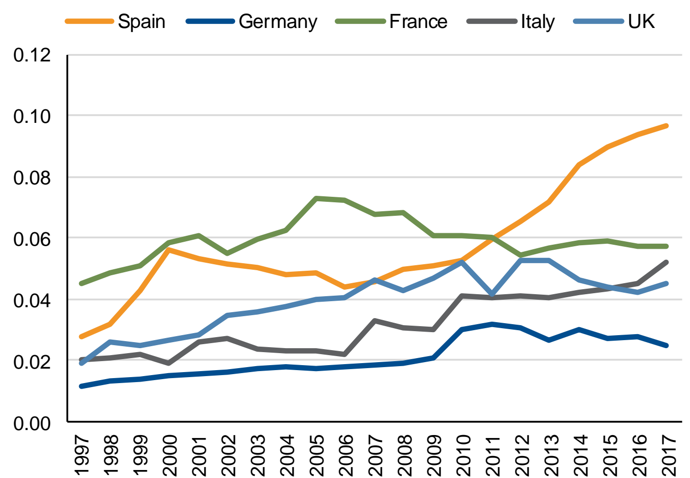
One key driver for the high profitability of Spanish banks is the good level of cost efficiency, a historical strength which continues to set Spanish banks apart from those in other countries. Despite the pressure on revenues, Spanish cost-income ratios have remained around 50% – well below those of banks in other countries, where they not only stood higher on average but have even increased in some cases, such as Germany and France. The process of forced consolidation and capacity reduction over the past 10 years has been an important factor contributing to the very positive cost evolution of Spanish banks. Scope believes this process is ongoing and expects consolidation to continue, in particular among regional banks (see our report Spanish Banks: Still Some Room for Consolidation and a Lot of Excess Capacity from December 2017).

Figure 4: Cost/Income ratios in Spain are low compared to other European countries



Source: ECB, Scope Ratings

Figure 5: Herfindal index, selected European countries



Source: ECB, Scope Ratings

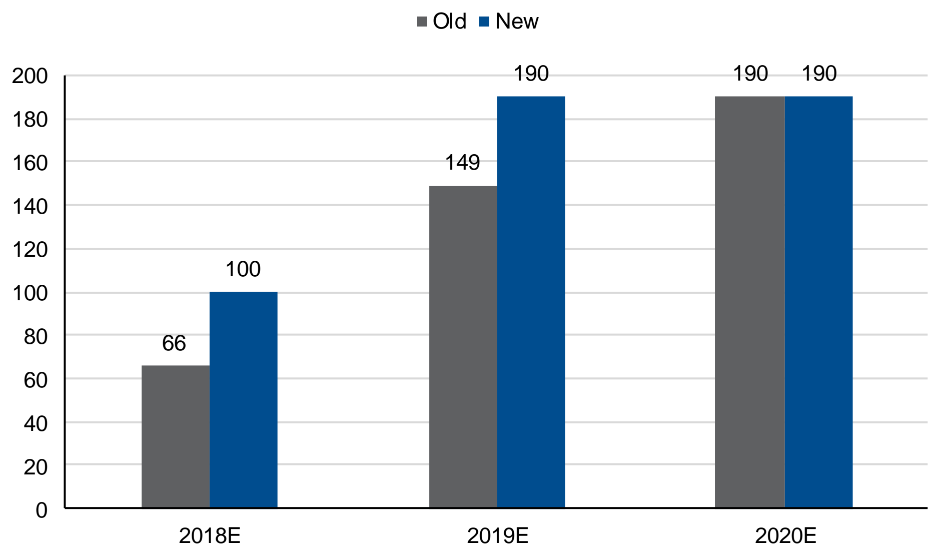
M&A and progress on integration

In Q2, both Bankia and Santander reported solid progress on the integration of BMN and Banco Popular, respectively.

Bankia announced it was merging with BMN in June 2017 and has since continued to work on reorganising the business. IT migration was completed in March 2018, while in the second quarter the commercial management system and the NPE recovery platform were integrated.

The bank has already started to harvest synergies and is now expecting the full cost benefit to materialise earlier than previously announced as the integration progresses ahead of schedule.

Figure 6: Bankia now expects to deliver 100% of the BMN synergies by 2019 rather than 2020



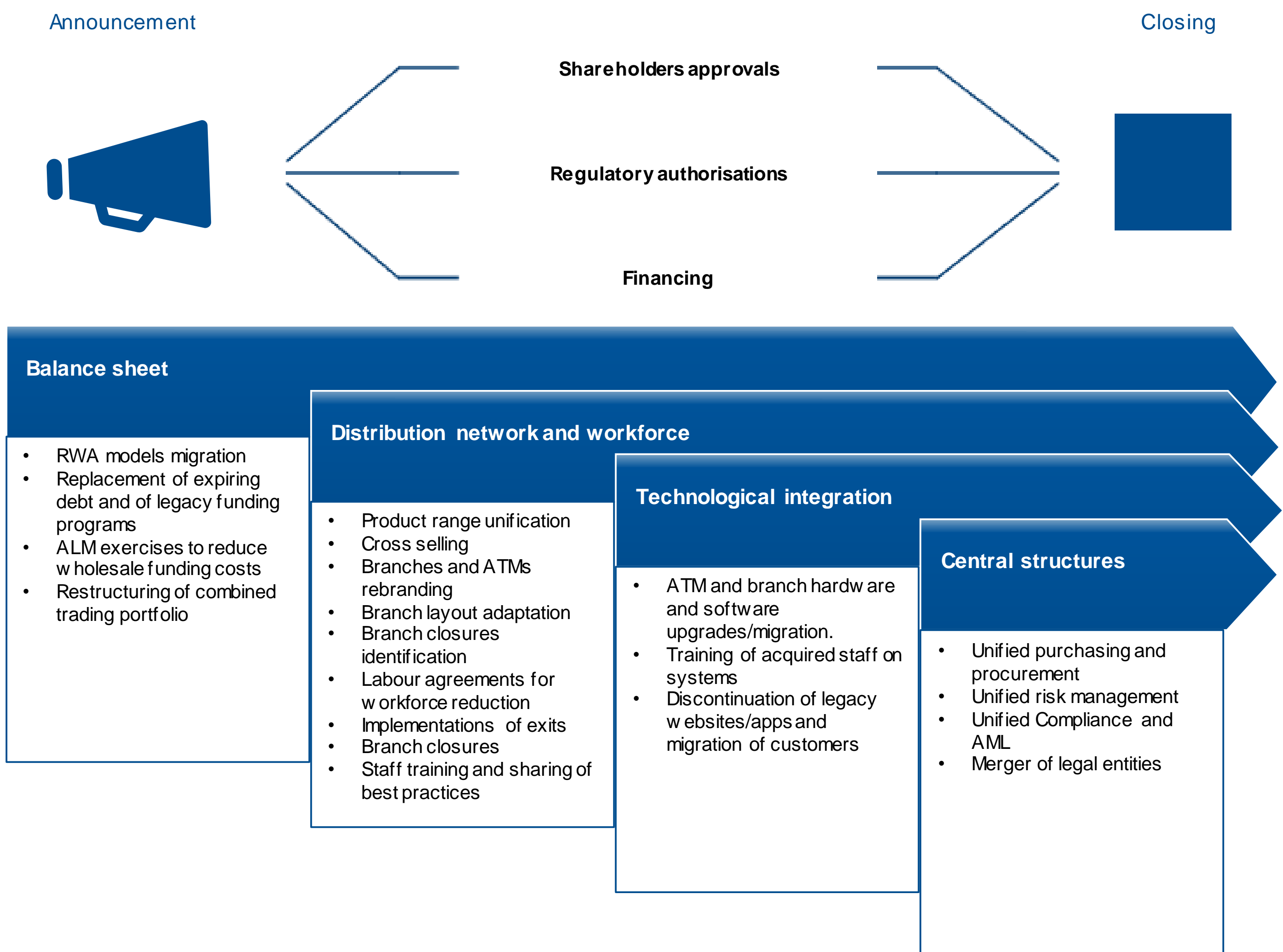
Source: Bankia, Scope Ratings

For 2018 management is now forecasting synergies of EUR 100m rather than the formerly-announced EUR 66m, with the full phase in of synergies now expected for 2019 (rather than 2020).

Like Bankia's absorption of BMN, Santander's integration of Banco Popular seems to be proceeding smoothly. The bottom line is still negatively impacted by restructuring costs, but the group is starting to converge its commercial practices in Spain, where the 1-2-3 product range was extended to Popular's former customers and with the reported initial materialisation of synergies from optimisation measures.

Management expects to receive regulatory authorisations for the legal integrations in September 2018, with the operational integration starting in Q4 and extending into the first half of 2019. While not as impressive as Bankia's integration of BMN, we think that this is also slightly ahead of the timeline initially planned. Santander is also in the process of integrating the Portuguese business of Popular into Santander Totta and of integrating all of the German operations under a single entity.

Figure 7: Stylised bank integration process, from announcement to full integration



Source: Scope Ratings

The relatively uneventful (at least so far) integrations of BMN and Popular into Bankia and Santander in Spain contrast with the very eventful IT migration of TSB, the UK subsidiary of Sabadell whose customers endured several weeks of severe disruption, eventually leading to the resignation of TSB's CEO. In the second quarter Sabadell

booked EUR 203m in costs and provisions related to the TSB crisis, including redress provisions, waivers of charges and fees, and losses from fraud. Management expects further costs to be booked in the second half of the year.

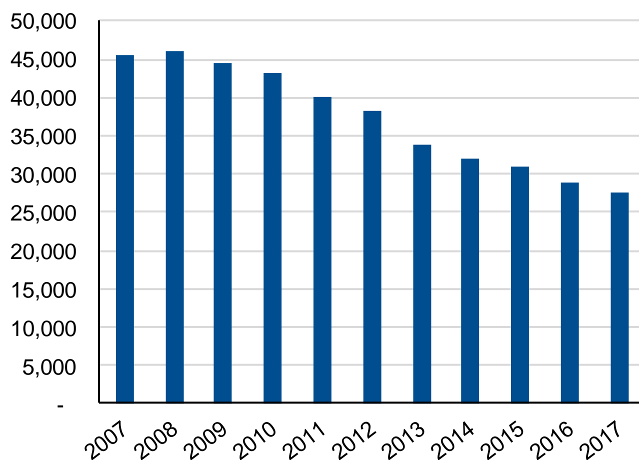
Capacity restructuring driven by consolidation and digitalisation

The reduction in physical footprints in Spain continues unabated.

From over 45,000 in 2008, the total number of branch outlets in Spain fell by over one third, to 27,480 in 2017. This process is ongoing: all of the banks publicly rated by Scope continue to report quarter-on-quarter declines in their branch footprints (once we adjust for the merger processes). For Bankia, the rationalisation of the branch network following the BMN acquisition is largely complete (87% of the planned franchise and workforce restructuring was completed as of June 2018), but this is still in the early stages when it comes to the Santander/Popular domestic integration.

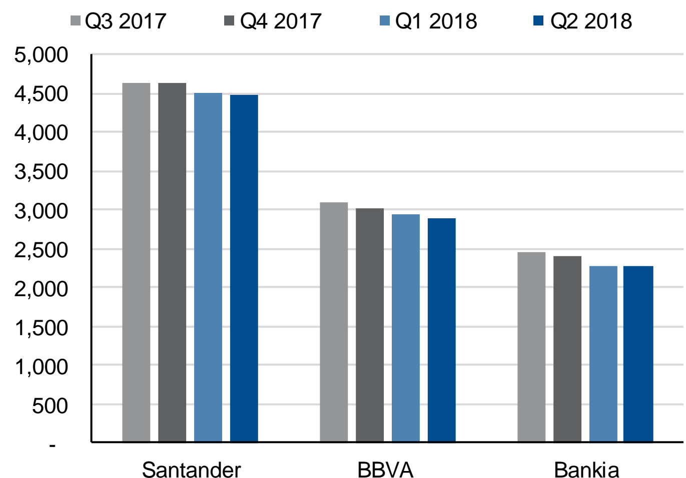
BBVA also continues to reduce its physical footprint in Spain, but this is more a result of the rapidly-changing distribution model from physical to digital channels, which accommodates customers' shifting preferences and behaviour.

Figure 8: Total Branches in Spain (2007-2017)



Source: ECB, Scope Ratings

Figure 9: Santander, BBVA and Bankia branches in Spain



Source: Company info, Scope Ratings
Note: Santander plus Popular; Bankia plus BMN

We believe the decline will continue, irrespective of M&A. We are convinced that in the medium term, branch networks will fade in importance. Digital channels are a faster, cheaper and more efficient way of delivering mass-banking services. The speed of the decline will mirror customer demographics and behavioral changes as well as their preferences. Branch numbers will eventually hit a minimum floor that will have to be maintained to service customers' more advanced banking needs. If the experience of other European countries is anything to go by, that floor remains very distant.

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