16 Sep 2020 | Affirmation

Fitch Affirms Bankia at 'BBB'; Outlook Negative

Fitch Ratings-Barcelona-16 September 2020:

Fitch Ratings has affirmed Bankia S.A.'s Long-Term Issuer Default Rating (IDR) at 'BBB', Viability Rating (VR) at 'bbb' and Short-Term IDR at 'F2' and removed them from Rating Watch Negative. The Outlook is Negative.

A full list of rating actions is below.

The affirmation primarily reflects our view that Bankia's ratings are not immediately at risk from the impact of the economic downturn from the pandemic, thanks to its sufficient capital buffers which provide it with headroom to absorb the likely reduction in profitability and higher credit risks.

However, the Negative Outlook reflects our view that risks remain tilted to the downside in the medium term, especially if the recession proves deeper or the recovery weaker than our forecasts. In this case, Bankia's ratings might come under pressure from higher-than-anticipated inflows of new impaired loans, weaker revenue generation and larger credit losses, ultimately resulting in greater-than-expected capital erosion.

The rating actions do not consider any impact of a potential merger with Caixabank, S.A. On 3 September, Bankia and Caixabank announced that they had initiated merger talks. The discussions so far cover the structure of the potential deal as an equity swap, and a non-disclosure agreement for the exchange of information for due diligence purposes. Fitch will wait until the full terms of any merger deal are known before assessing whether to take any rating action on Bankia.

Key Rating Drivers

IDRs, VR AND SENIOR DEBT

Bankia's ratings are underpinned by its capitalisation, owing to adequate buffers over regulatory requirements and reduced capital encumbrance by unreserved problem assets. Bankia's well-established national retail franchise supports a large customer deposit base, which provides funding stability. Asset quality and profitability are relative rating weaknesses and are expected to deteriorate during the economic downturn.

Fitch expects GDP to contract by a sizeable 13.2% in 2020 followed by a recovery in 2021. Furthermore, there are downside risks to these economic forecasts, including the risk that further containment measures or lockdowns are implemented, causing further shocks to the economy. While the Spanish authorities have taken several fiscal support measures for the private sector that should be positive for Bankia as for other Spanish banks, these measures are due to be lifted over time. The implications for the financial sector will therefore likely only become more apparent in 2021.

Bankia's capitalisation is maintained with satisfactory buffers over regulatory minimum requirements and ratios are above domestic peers. At end-June 2020, the regulatory common equity Tier 1 (CET1) ratio was 14.3% (13.3% on a fully loaded basis). The latter benefits from the Board of Directors' decision in March 2020 to suspend its plans to distribute EUR2.5 billion excess capital to the bank's shareholders, as originally envisaged in the 2018-2020 Strategic Plan, and to suspend dividend payments in 2020. In addition to other expected positive regulatory impacts, the bank received regulatory approval to use IRB models for the calculation of risk-weighted assets on its mortgage loan portfolio, which should add 160bp to the fully loaded CET1 capital ratio. Capital encumbrance from unreserved problem assets significantly reduced to 41% at end-June 2020 from 55% at end-2018.

Bankia enters the economic downturn with a problem assets ratio (including impaired loans and net foreclosed assets) of 6.1% at end-1H20, which is well below the bank's peak of over 16.0% at end-2013 but weaker than domestic peers and still high by international standards. The reserve coverage ratio for problem assets was 50% at end-June 2020. We expect inflows of new impaired loans to increase towards end-2020 and more significantly in 2021 as borrower support measures are lifted and asset quality pressures arise as the effect of the crisis becomes more apparent. However, our asset quality assessment considers Bankia's share of retail mortgages (53% of total loans at end-June 2020),which is above the peer average and that performed better during previous crises. We expect this to partially shield the bank from asset quality deterioration. Nonetheless, Bankia remains sensitive to the unemployment level, which we expect to rise to 19.3% in 2021 from an already high 14.1%.

Bankia's profitability is modest by international standards, weighed down by large low-risk and low-yielding residential mortgage lending and a sizeable portfolio of zero-yielding SAREB bonds. We expect earning pressure to further intensify over the next two years as a result of high loan impairment charges (LICs) and subdued business volumes. In 1H20 Bankia booked an additional EUR310 million impairment charges (largely LICs) related to the coronavirus crisis, bringing the annualised LICs/gross loans ratio to around 70bp. Our assessment of profitability assumes that earnings will recover, albeit remaining at structurally low levels once the crisis abates, as a result of Bankia's strategy to further diversify its business mix, expand fee-based business and further cost-cutting efforts. However, our negative view on this factor reflects the downside risk to this assumption in case of persistent economic pressure.

Bankia's funding profile has improved in the past few years following loan deleveraging and steady deposit growth. Its large, stable and granular retail deposit base almost fully covered gross loans and accounted for 64% of total funding at end-June 2020. ECB funding utilisation accounted for 12% of total funding and the use of ECB's targeted longer-term refinancing operations (TLTRO) largely funds SAREB bonds. Bankia's liquidity position is comfortable, supported by large investments in high quality liquid securities, and given its manageable wholesale funding maturities. The bank has good access to the debt capital markets and the capacity to generate additional liquidity in a short period, if necessary.

Bankia's Short-Term IDR of 'F2' is the higher of the two possibilities for a 'BBB' Long-Term IDR under our criteria and is based on our assessment of the group's funding and liquidity, which largely reflects ample liquidity buffers against the bank's short-term maturities.

Bankia's long-term senior preferred notes are rated in line with the bank's Long-Term IDR. This reflects Fitch's view that the likelihood of default on the senior preferred notes is in line with that of the bank and that recoveries are average.

Long-term senior non-preferred notes are rated one notch below the bank's Long-Term IDR. This reflects the prospects of below-average recoveries arising from the possible use of senior preferred debt to meet resolution buffer requirements, and the combined buffer of Additional Tier 1, Tier 2 and senior non-preferred debt being unlikely to exceed 10% of risk-weighted assets.

SUPPORT RATING AND SUPPORT RATING FLOOR

Bankia's Support Rating (SR) of '5' and Support Rating Floor (SRF) of 'No Floor' reflect Fitch's belief that senior creditors of the bank can no longer rely on receiving full extraordinary support from the sovereign in the event that the bank becomes non-viable. The EU's Bank Recovery and Resolution Directive and the Single Resolution Mechanism for eurozone banks provide a framework for resolving banks that is likely to require senior creditors to participate in losses, instead of, or ahead of a bank receiving sovereign support.

SUBORDINATED DEBT

Subordinated lower Tier 2 debt is rated two notches below the VR for loss severity, reflecting poor recoveries arising from its subordinated status.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to negative rating action/downgrade:

The Negative Outlook on Bankia reflects medium-term risks to its ratings from the coronavirus outbreak.

The most immediate downside sensitivity for Bankia's ratings relates to the economic and financial market fallout arising from the coronavirus crisis. The bank's ratings could be downgraded if there is a more substantial and prolonged deterioration in profitability than we currently envisage, ultimately eroding the fully-loaded CET1 ratio below the 12% target or capital encumbrance to unreserved problem assets raises to above 50%, without credible prospects to be restored. These circumstances could stem, for example, from a further downward revision of Fitch's expectations for the Spanish economy, triggering higher-than-expected asset quality deterioration

Factors that could, individually or collectively, lead to positive rating action/upgrade:

The Outlook could be revised to Stable if the bank's operating environment stabilises and the bank successfully manages the challenges arising from the economic downturn, limiting downside risks to its asset quality and profitability, while maintaining current capital levels.

Rating upside is currently limited. In the long-term, an upgrade would require improved prospects for the operating environment and a meaningful and sustained improvement of core profitability, combined with a relevant improvement in asset quality while maintaining capital ratios at current levels.

In addition to these sensitivities, if a merger agreement between Bankia and Caixabank is reached, upon the disclosure of the details of the agreement, and subject to our assessment of execution risks, including receipt of regulatory approvals, we will take rating action based on the combined entity's financial metrics and Fitch's medium-term expectations. The combined entity would have total assets of about EUR665 billion, with Caixabank accounting for two-thirds and Bankia one-third and would become the largest domestic bank by scale and market share by some margin.

SENIOR NON-PREFERRED AND SENIOR PREFERRED DEBT

Senior debt ratings are primarily sensitive to changes in Bankia's IDRs. In addition, we would upgrade long-term senior preferred and non-preferred debt by one notch if the size of the combined buffer of junior and senior non-preferred debt is expected to sustainably exceed 10% of RWAs or if resolution buffers are expected to be met with senior non-preferred debt and more junior instruments.

SUBORDINATED DEBT

Subordinated debt is primarily sensitive to a change in Bankia's VR.

SUPPORT RATING AND SUPPORT RATING FLOOR

An upgrade of the SR and upward revision of the SRF would be contingent on a positive change in the sovereign's propensity to support Bankia. While not impossible, this is highly unlikely, in Fitch's view.

Best/Worst Case Rating Scenario

International scale credit ratings of Financial Institutions and Covered Bond issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of four notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [https://www.fitchratings.com/site/re/10111579]

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING
The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG Considerations

The highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or to the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

Bankia S.A.; Long Term Issuer Default Rating; Affirmed; BBB; RO:Neg
; Short Term Issuer Default Rating; Affirmed; F2; RW: Off
; Viability Rating; Affirmed; bbb; RW: Off
; Support Rating; Affirmed; 5
; Support Rating Floor; Affirmed; NF

----subordinated; Long Term Rating; Affirmed; BB+; RW: Off
----Senior preferred; Long Term Rating; Affirmed; BBB; RW: Off
----Senior non-preferred; Long Term Rating; Affirmed; BBB-; RW: Off
----Senior preferred; Short Term Rating; Affirmed; F2; RW: Off

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Additional information is available on www.fitchratings.com

Applicable Criteria
Bank Rating Criteria (pub. 28 Feb 2020) (including rating assumption sensitivity)

Additional Disclosures
Dodd-Frank Rating Information Disclosure Form
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