FITCH UPGRADES BANKIA TO 'BBB'; OUTLOOK STABLE

Fitch Ratings-Barcelona/London-30 January 2019: Fitch Ratings has upgraded Bankia, S.A.'s Long-Term Issuer Default Rating (IDR) to 'BBB' from 'BBB-' and Viability Rating (VR) to 'bbb' from 'bbb-'. The Outlook on the Long-Term IDR is Stable. At the same time, Fitch has upgraded and withdrawn the ratings of BFA, Tenedora de Acciones, S.A.U. (BFA), Bankia's parent company, as the entity is no longer issuing debt. A full list of rating actions is at the end of this rating action commentary.

The upgrade of Bankia's rating follows the announced sale of a significant portfolio of non-performing loans (NPL) and foreclosed assets in December 2018, which along with continued organic reduction of problem assets in 2018, have materially reduced the bank's capital encumbrance from unreserved problem assets.

KEY RATING DRIVERS
IDRS, VR AND SENIOR DEBT
Bankia's ratings reflect its reduced, albeit still relatively high, exposure to problem assets and the challenge to rebalance its business mix and improve banking profitability. The bank's ratings also factor in its strengthened national retail franchise following its merger with the former Banco Mare Nostrum S.A. (BMN), sustained sound post-merger capitalisation, adequate funding and liquidity and management's proven record in integrations, as demonstrated with BMN's speedy and trouble-free integration.

In December 2018, Bankia announced an agreement to sell a portfolio of NPLs and foreclosed assets with a gross book value of EUR2.8 billion at end-2018 to Lone Star Fund XI (Lone Star), a private equity fund. The foreclosed assets will be transferred to two entities in which Bankia will ultimately participate through a 20% stake and Lone Star with the remaining 80%. The NPLs will be fully acquired by Lone Star. We calculate that on a pro-forma basis at end-2018 the problem asset ratio (including NPLs and foreclosed assets) will decrease to around 8% from 11.1% at end-2017 and the coverage ratio will remain at around 50%. The sale is expected to be completed in 2Q19 and we see limited execution risks.

In our assessment of asset quality, we also consider Bankia's EUR3.2 billion organic problem asset reduction achieved in 2018 and its commitment to further reduce problem assets by EUR2.9 billion in 2019 under its 2018-2020 strategic plan. We consider these targets as achievable, supported by sound prospects for Spain's economic environment and the bank's NPL work-out history.

Bankia maintains satisfactory capital buffers over the minimum regulatory requirements. Its pro-forma fully loaded CET1 ratio stood at 12.6% at end-2018, which compares well with the 9.25% Supervisory Review and Evaluation Process requirement for 2018 on a fully loaded basis. Capital exposure to unreserved problem assets will improve upon the completion of the sale. We estimate that unreserved problem assets will decline substantially to around 55% of fully loaded CET 1 at end-2018 compared with around 80% at end-2017. Our expectation is that this ratio will improve further by end-2019 if we take into account the planned organic NPL reduction.

Bankia's profitability is gradually improving, underpinned by the bank's increased commercial activity in more profitable businesses such as SME and consumer lending and in fee-based asset management businesses. However, the bank's business model and profitability remain constrained by still subdued net loan growth, large exposure to low-yielding retail mortgages and a sizeable portfolio of low-yield SAREB bonds. We expect profitability to remain challenged by the low interest rate environment and costs related to technology and regulation. However, we expect it to remain stable or moderately improve from an improving loan mix, BMN-related cost synergies, growing fee-based business and low loan impairment charges.

Bankia's funding primarily comprises a large customer deposit base, representing about 66% of total funding at end-2018. The rest is largely secured in the form of covered bonds, ECB's TLTRO or repos, which are used to fund a large stock of legacy SAREB bonds. We expect Bankia to continue financing SAREB bonds mostly with short- to medium-term sources. Liquidity reserves are adequate for scheduled long-term debt repayments and potential short-term financing risks. The bank has good access to debt capital markets as demonstrated by the issuance of AT1 and subordinated debt in 2018 and 2017, respectively.

Bankia's Short-Term IDR of 'F3' is the lower of the two possibilities for a 'BBB' Long-Term IDR under our criteria. This reflects the bank's average liquid asset portfolio and Bankia's reliance on short-term funding, which is higher than peers.

BFA

BFA is wholly owned by Spain's Fund for Orderly Bank Restructuring (FROB), and it retained a 61.4% controlling stake in Bankia at end-2018 after the merger with BMN. As part of the group's restructuring process, BFA surrendered its banking license in early 2015, but remains the group's consolidating entity and is supervised by the banking authorities on a consolidated basis, given its stake in Bankia.

BFA's IDRs and senior debt ratings are based on its VR, which is in turn driven by Bankia's VR as the latter is BFA's principal asset, representing about 64% of BFA's unconsolidated balance-sheet at end-June 2018. The other large item on BFA's balance sheet is SAREB bond holdings. BFA's VR is notched down once from Bankia's to reflect Fitch's belief that BFA's strategy is to gradually divest its ownership by end-2021. BFA's VR also reflects low double leverage of below 90% at end-2017 and manageable indebtedness given the institution's stock of unencumbered assets.

Fitch has withdrawn BFA's ratings as it no longer plans to issue debt under its debt programme and has no rated debt outstanding.

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.

SUBORDINATED DEBT

Bankia's Lower Tier 2 subordinated debt is rated one notch below the bank's VR to reflect the notes' greater expected loss severity than senior unsecured debt.

RATING SENSITIVITIES

IDRS, VR, AND SENIOR DEBT

Upside rating potential over the long term would arise from improved asset quality metrics, resulting in a reduction of its capital's vulnerability to unreserved problem assets, and further evidence of improved banking profitability. This would have to be accompanied by maintaining sound capital ratios.

Conversely, if asset quality and capital deteriorate substantially, which Fitch currently does not expect, Bankia's ratings could be downgraded. Similarly, a significant increase in risk appetite or a weakening of earnings would put pressure on the bank's ratings.

For the senior notes to achieve a one-notch uplift from the Long-Term IDR, the buffer of qualifying junior debt and non-preferred senior debt would need to exceed our estimate of a 'recapitalisation amount'. This amount is likely to be around or above the bank's minimum pillar 1 total capital requirement.

SR AND SRF
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.

SUBORDINATED DEBT
The ratings of the Lower Tier 2 subordinated debt instruments are primarily sensitive to a change in the bank's VR.

The rating actions are as follows:

Bankia:
Long-Term IDR upgraded to 'BBB' from 'BBB-'; Outlook Stable
Short-Term IDR affirmed at 'F3'
Viability Rating: upgraded to 'bbb' from 'bbb-'
Support Rating: affirmed at '5'
Support Rating Floor: affirmed at 'No Floor'
Long-term senior preferred debt and debt programme: upgraded to 'BBB' from 'BBB-'
Short-term senior preferred debt programme and commercial paper: affirmed at 'F3'
Long-term senior non-preferred debt programme: upgraded to 'BBB' from 'BBB-'
Subordinated debt: upgraded to 'BBB-' from 'BB+'

BFA:
Long-Term IDR upgraded to 'BBB-' from 'BB+' Outlook Stable and withdrawn
Short-Term IDR upgraded to 'F3' from 'B' and withdrawn
Viability Rating: upgraded to 'bbb-' from 'bb+' and withdrawn
Support Rating: affirmed at '5' and withdrawn
Support Rating Floor: affirmed at 'No Floor' and withdrawn

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Additional information is available on www.fitchratings.com

Applicable Criteria
Bank Rating Criteria (pub. 12 Oct 2018)
https://www.fitchratings.com/site/re/10044408