# Spanish banks: cost of risk manageable in 2020 but watch the shape of any recovery

**Spanish banks' reassuring Q1 results showed that they should be able to withstand rising cost of risk in 2020, thanks to strong pre-provision profits. But uncertainties abound, and the risk of a longer-than-anticipated economic contraction remains.**

Spanish banks reported a solid set of Q1 results, mostly on account of a very strong showing in January and February before the Covid-19 lockdown. Pre-provision profitability for several banks increased though reported net profits were down, driven by higher cost of risk in anticipation of the lockdown.

**Mild capital erosion, but comfortable buffers.** Some banks suffered some erosion in their capital ratios, mostly from the market rout in March and ensuing markdowns of equity and debt securities. However, they remain comfortably above requirements, especially so after accounting for flexibility in P2R composition.

**Asset-quality trends intact, for now.** Asset-quality trends remained positive, with sequential declines in NPL ratios and reported coverage ratios boosted by provisioning efforts. We believe this will change. Asset-quality indicators tend to lag economic reality by a few quarters. Due to the payment moratoriums and associated supervisory flexibility, the lag may be amplified, with borrowers' credit problems not surfacing until the end of the year.

**Banks prudently front-loading provisions.** Even so, banks took large extraordinary provisions, ranging from 35bp of loans at Unicaja to 141bp of loans at BBVA, to anticipate credit losses which are likely to materialise later. They also communicated their expectations for 2020 cost of risk – in the 50bp-100bp range for most banks.

**Pre-provision profits should be able to absorb losses this year.** We anticipate banks will be able to absorb these provisions out of ordinary profitability, maintaining positive bottom lines for the rest of the year. Spanish banks enter the crisis from a position of strength, with pre-provision profitability exceeding 1% of loans, with few exceptions.

**Downside risks stem from second lockdown and shape of recovery.** We do see some downside to our expectations. Banks' cost of risk estimates/guidance are based on a sharp but short recession. A second lockdown in the second half of 2020 would deepen and lengthen the recession and would likely lead to more than proportional increases in cost of risk.

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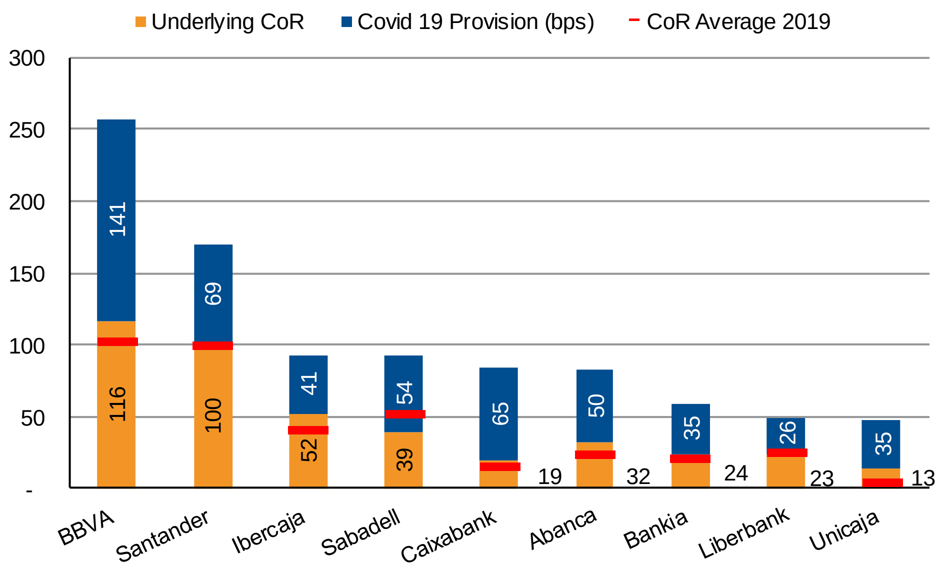
## Extraordinary Covid-19 provisions range from 35bp to 141bp in Q1

**Extraordinary provisions lead to doubling in cost of risk**

Even though there is no sign yet of asset-quality deterioration in the reported numbers (Q1 only reflected a couple of weeks of lockdown), banks started booking provisions in anticipation of worsening trends later in the year, reflecting higher loss-expectations under IFRS 9. These provisions were clearly flagged as exceptional, and disclosed separately from the underlying cost of risk, which remained under control.

As Figure 1 shows, underlying cost of risk was not materially different from 2019 levels. Including extraordinary provisions, however, cost of risk more than doubled for some lenders.

**Figure 1: Q1 provisioning reflects Covid-19 prudential provisions**




Source: Company data, Scope Ratings

In line with recent supervisory recommendations, banks made use of available accounting flexibility; loans falling under debt moratoriums were not automatically reclassified as Stage 2 or Stage 3

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**Provisioning efforts anticipates future loan losses**

The extraordinary provisions largely reflected the front-loading of future loan losses, based on worse macro assumptions and in some cases, such as BBVA, an additional provisioning overlay for most vulnerable sectors and clients (e.g. oil & gas exposures). They also included the effect of mitigating guarantee measures from the Spanish government.

The amount of extraordinary provisions primarily reflected each bank's business model: those with a focus on residential mortgages typically provisioned less than SME and corporate lenders.

Several banks pointed out that the key driver for mortgage defaults is the direction of house prices, alongside unemployment. A sharp but short recession that does not result in lasting house-price deflation should prove to be a more benign environment for mortgage lenders than the most recent Spanish crisis, where GDP contracted over several years and house prices fell. Banks with large emerging market franchises, also took sizeable extraordinary provisions.

## Extraordinary provisions in Q1 reflect incomplete V-shaped recovery in 2021, with no second lockdown

**Spain's lockdown lasted two months**

On 13 March, Spain announced a national lockdown in order to suppress the spread of Covid-19, leaving only essential shops, pharmacies, bank branches and urgent public services open.

Initially planned to last for two weeks, the lockdown was extended until 4 May, when a gradual lifting of restrictions began, over an eight-week period. According to the current phasing plan, the Spanish authorities will allow some activities to re-open from 11 May, subject to capacity constraints and safety measures. The plan envisages a transition to a 'new normal' by mid-June.

Even once the phasing in to 'new normal' is complete, we believe human and economic activity will continue to be impacted. A deep recession in 2020 is pretty much consensus, as is the expectation of some rebound next year.

The recently published Bank of Spain's reference macro scenarios for the Spanish economy (Figure 2) offer a glimpse of what to expect. GDP declines under Scenario 1 and 2 are comparable, in terms of magnitude, with our baseline economic outlook. Under more severe but far from impossible assumptions, the Spanish economy could contract by over 10%, with an incomplete recovery in 2021.

**Figure 2: GDP forecasts under Bank of Spain's simulations**

| | 2020 | 2021 | Confinement duration (weeks) | Other key assumptions |
|---|---|---|---|---|
| Supply side approach | | | | |
| Scenario 1 | -6.60% | | 8 | Almost Complete normalisation after confinement |
| Scenario 2 | -8.70% | NA | 8 | Almost Complete normalisation in Q4 |
| Scenario 3 | -13.60% | | 12 | Incomplete normalisation at year end |
| Demand side - Simulations with Bank of Spain quarterly model (MTBE) | | | | |
| Scenario 1 | -6.80% | 5.50% | 8 | Offsetting measures prevent lasting job losses and company closures |
| Scenario 2 | -9.50% | 6.10% | 8 | A certain proprotion of firms do not manage to prevent liquidity problems from becoming solvency ones |
| Scenario 3 | -12.40% | 8.50% | 12 | A larger proprotion of firms do not manage to prevent liquidity problems from becoming solvency ones |
| Scope 's economic outlook for Spain | | | | |
| Baseline | -8.00% | 4.50% | | Gradual lifting of containment measures by end Q2. Gradual economic recovery from Q3 |
| Alternative Scenario 1 | -13.00% | NA | NA | Lockdowns and quarantine policies are extended significantly to the end of Q3 2020 |
| Alternative Scenario 2 | -18.00% | | | Combination of a period of extended containment measures and a more pronounced recession in the US of 10% in 2020 |

Source: Bank of Spain, Scope Ratings

**Spanish banks' scenarios clustered around Bank of Spain's**

For Q1 provisioning purposes and for setting full-year cost-of-risk guidance, most banks either used Bank of Spain scenarios (Unicaja, Sabadell) or their own projections (Bankia, Caixabank, BBVA). When disclosed, these point to economic contractions of a magnitude comparable to Bank of Spain's scenarios. BBVA, for example, is forecasting a GDP decline in Spain of between 5.5% and 10.5% in 2020, with a rebound of 4.2% to 7.2% in 2021.

**Shape of recovery crucial for NPL and collateral values**

In its analyst call following the results, Banco Santander (which did not publish explicit forecasts or give a country-by-country split for the overlay of extraordinary provisions) highlighted that the shape of any economic rebound would be a key factor determining both NPL evolution and provisioning needs in coming years.

Our understanding is that neither the Bank of Spain nor the banks are expecting a second lockdown later in the year. In our view, this will prove a crucial assumption determining whether banks will stay profitable for the year.

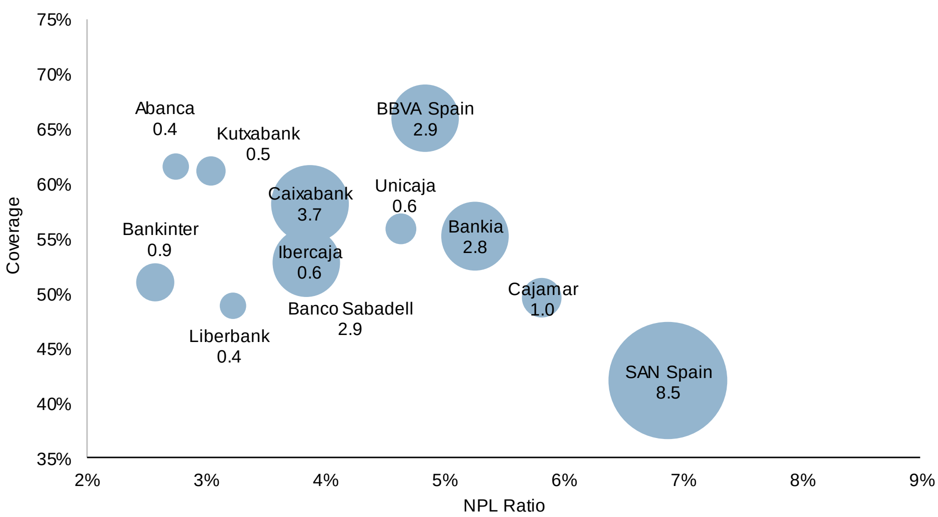
## Banks enter recession from a position of strength

Having materially de-risked their balance sheets, and with capital bases built up over the past decade, Spanish banks entered the new crisis from a position of strength. The significant sector consolidation in the aftermath of the real estate boom-and-bust cycle flushed the weakest players out of the system, and the Spanish banking sector today comprises a handful of players with nationwide franchises alongside several regional or multi-regional banks.

**Legacy NPLs no longer a credit threat**

The decline in legacy NPL has been steady over recent years. Most banks have gross NPL ratios of under 5%, with good coverage. For a sample of 12 banks we track, we calculate that net NPLs have declined from EUR 36bn in March 2018 to EUR 25bn in March 2020 (Figure 3). Half of this exposure sits with Santander and BBVA, the two banks best placed to absorb credit impacts thanks to their strong profitability.

**Figure 3: Key asset-quality metrics, Spanish banks (March 2020)**




Source: Company data, Scope Ratings

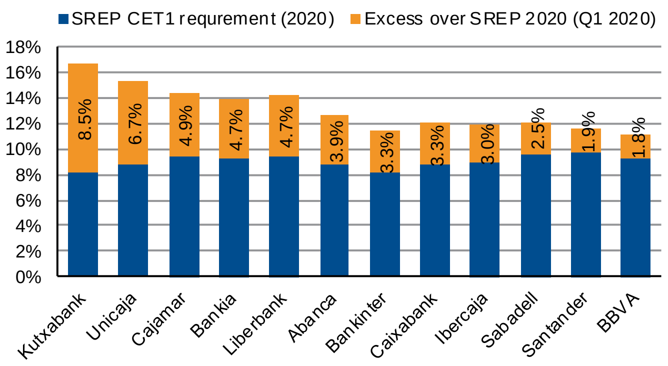
Despite having built up their capital bases over the past decade, Spanish banks' RWA-based capital ratios continue to compare unfavourably with international peers – though Spanish banks rank strongly on a leverage ratio basis.

**Supervisory measures support capital buffers**

While generally lower than international levels, the capital position of Spanish banks is soundly above requirements (Figure 4), with the latest supervisory announcements further improving the margin over the minimum SREP requirements. In our report "Spanish banks: less profit, more dividends, M&A on hold for now", published in February 2020, we calculated that art. 104 relief alone was worth over 50bp and up to 109bp (Figure 5).

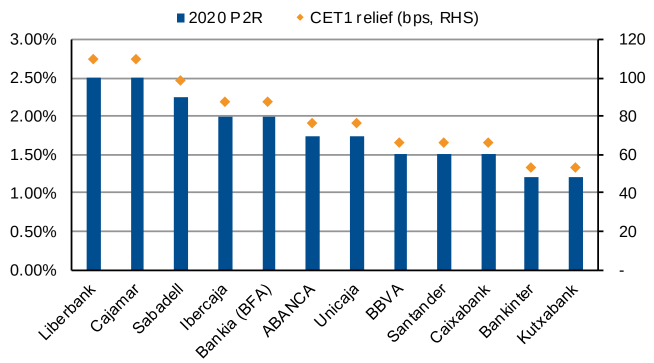
Before the Covid-19 pandemic took hold in Spain, we were expecting Spanish banks to increase shareholders' returns. With dividends and buybacks now very unpopular with supervisors, our expectation is for the banks to use profits to protect their capital levels.

**Figure 4: Excess capital over SREP requirement: Spanish banks**




Source: SNL, Spanish banks, ECB, Scope Ratings

**Figure 5: 2020 Pillar 2 requirements and estimated 2021 CET1 capital relief from art 104 implementation.**




Source: ECB, Scope Ratings

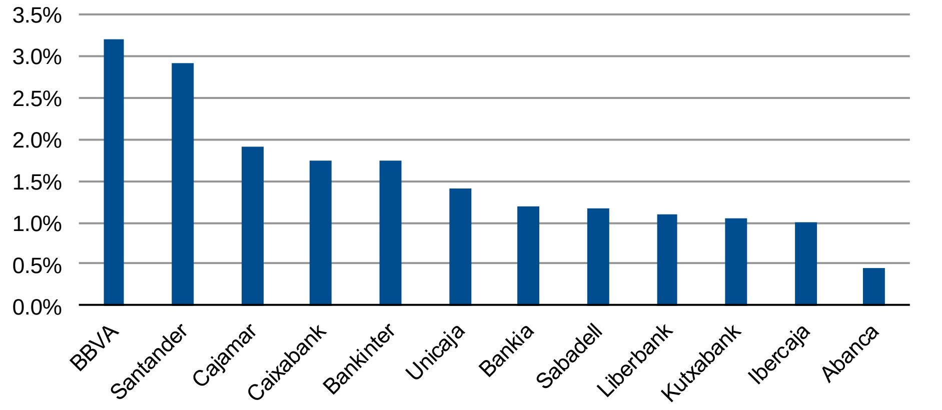
As we have pointed out before (see our report "COVID-19 impacts on European banks: pre-existing financial health condition matters", published in March 2020), we look at pre-provision profitability as banks' first line of defence in the face of heightened credit risk, before they have to dip into their capital buffers. Domestic Spanish banks' pre-provision profitability in 2019 typically ranged from 1% of loans to 2% of loans (Figure 6), while Santander and BBVA's profitability was higher, on account of their higher-margin emerging markets franchises.

**Solid pre-provision profit provides first line of defence**

In Q1, most banks reported stable or growing pre-provision profit, on account of a very strong start to the year, especially in fee and commission income. Looking ahead, the outlook for pre-provision profitability is more uncertain, although some banks mentioned that they expect relative resilience in core revenues, especially in net interest income (NII).

Some factors are likely to boost NII, including higher volumes as clients' need for liquidity and payment holidays boosts loan balances, while cheap TLTRO borrowing lowers funding costs. On the other hand, we believe new liquidity injections from the ECB could lead to more declines in market rates and ultimately to adverse repricing effects on mortgage books. Fee income from placement of savings products and asset management is also likely to suffer from the market turbulence in March.

**Figure 6: Spanish banks' pre-provision profitability*, 2019Y**




Source: SNL, Scope Ratings
*Pre-provisions profits/net loans

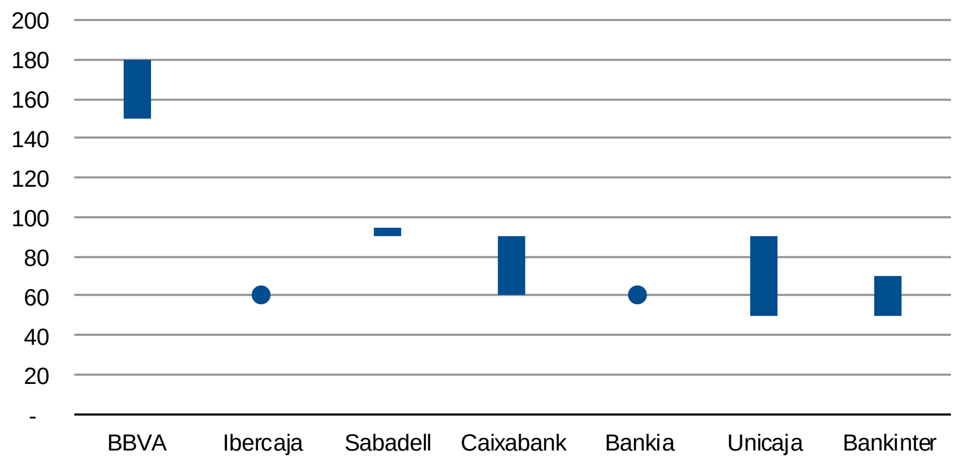
## Banks' expectations point to manageable cost of risk for the year

**Management cautious on providing guidance, but indicating ranges for cost of risk**

Several banks provided their expectations for cost of risk in the year. Obviously cautious about over-committing given the still-significant uncertainty, they added several caveats to their stated expectations, and often preferred offering ranges rather than point estimates (Figure 7). Banks typically see their full-year cost of risk between 50bp and 100bp of loans i.e. generally lower than their provisioning effort in Q1.

BBVA's cost of risk guidance of 150bp-180bp is significantly lower than the 257bp reported in Q1.

**Figure 7: Cost of risk "soft" guidance for 2020 (Spanish banks)**




Source: Company data, Scope Ratings

**Positive net profits for the year, but second lockdown could put capital into play**

Under the soft guidance provided, banks should be able to absorb credit impacts out of ordinary profitability. The obvious downside to this relatively benign outlook (at least for credit) lies in the possibility of a second lockdown later in the year, which would see provisioning needs increase beyond the guided ranges and possibly putting banks' capital bases into play.

## Appendix: summary of key crisis-offsetting measures for Spanish banks

- Spanish government:
  - Fiscal measures worth EUR 18bn (1.6% of GDP)
  - Mortgage and consumer loan moratorium for vulnerable individuals (RDL 11/20) for three months
  - Instituto de Crédito Oficial guarantees for self-employed, SMEs and corporates for up to EUR 100bn)
- Monetary authority:
  - New and expanded asset purchase programmes worth EUR 870bn
  - New LTROs
  - Improved TLTRO 3 conditions, with new borrowing rate as low as negative 100bp
- Regulatory/Supervisory relief:
  - Capital relief via lower countercyclical capital buffers and P2R mix
  - Leeway to draw into liquidity buffers
  - Recommendation on dividends and capital conservation measures.
  - Flexibility on NPL recognition and phasing in of IFRS 9.

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