Daiwa Capital Markets

Spain – Banking Sector Review

- Years of consolidation have streamlined Spain's banking sector into 10 groups, with the top five controlling 84% of domestic assets.
- Higher rates have boosted earnings however, near-term rate cuts shift the focus to lending growth, deposit beta management, and revenue diversification.
- Strong capital buffers, better underwriting, and years of NPL reductions have positioned banks well to withstand potential deterioration of the operating environment.
- The windfall tax extension and new capital requirements are manageable, especially for larger banks with diverse income streams and solid capital generation.

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Overview

The overall operating environment for Spanish banks remains positive, supported by favourable macro-economic developments as well as strong bank earnings and credit fundamentals. Spain's banking sector has undergone considerable consolidation over the past 15 years, reducing the number of banking groups from over 60 to just 10 major groups today. The five largest banks (i.e. CaixaBank, Santander, BBVA, Sabadell and Bankinter) account for some 84% of total domestic sector assets. This transformation of the banking landscape has generated larger banking groups, and also raised Spanish banks' relative competitiveness against international peers, by increasing operational efficiencies, enhancing pricing power and improving overall transparency. In recent years, as elsewhere in Europe, Spanish banks have enjoyed a prolonged period of elevated earnings generation supported by the higher-for-longer rates environment. Interest-generating assets have been the key profit drivers, especially in Spain, where they contribute a large proportion to total revenues and the adoption of variable-rate lending products is traditionally higher than in other European countries. ECB rate cuts since June 2024 haven't materially affected bank profitability so far, however the prospect of further cuts in 2025 presents a potential headwind and in part has shifted the earnings focus to non-interest yielding assets.

Major Spanish banks - Peer table

Issuers Groups	Total Assets (EURm)	Total Revenues (EURm)	Net Income (EURm)	RoTE (%)	NIM (%)	Cost-Income Ratio (%)	NPL Ratio (%)	NPL Coverage Ratio (%)	CET1 (%)	LCR (%)
Santander	1,837,081	61,876	12,574	16.3	2.9	41.8	3.1	65.0	12.8	168
BBVA	772,402	35,481	10,054	19.7	3.4	40.0	3.0	80.0	12.9	134
CaixaBank	631,003	15,873	5,787	18.1	1.8	38.5	2.6	69.0	12.2	207
Sabadell	239,598	6,337	1,827	14.9	2.4	48.7	2.8	62.0	13.0	210
Bankinter	113,012	2,901	953	19.0	1.9	36.2	2.1	69.0	12.4	193

Source: Company reports; Bloomberg, Daiwa Capital Markets Europe

While informative, we caution that comparisons of the various banking groups on key metrics alone, such as in the table above, can be somewhat misleading. Santander and BBVA have large international operations (i.e. Latam, Turkey, UK, Poland, and US), whereas most other Spanish banks are primarily focused on their home market and to a lesser extent Portugal or the UK. Some of these overseas operating environments are inherently riskier and therefore group-wide measures on non-performing loans (NPL), loan loss provisions (LLP) or the cost of risk (CoR) are understandably higher.

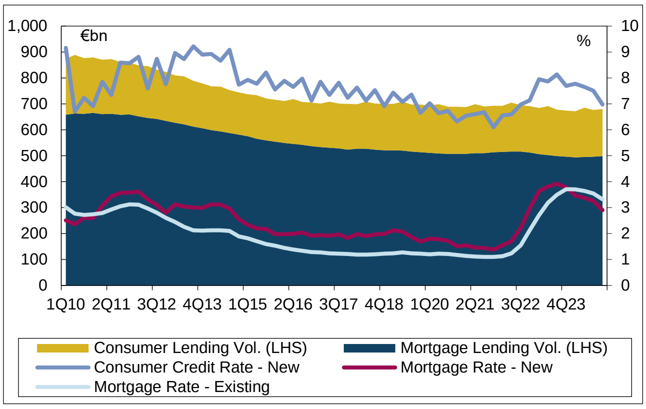
Banking sector consolidation

The 2021 merger of CaixaBank and Bankia established Spain's largest domestic bank, significantly enhancing operational efficiency and market share. This consolidation not only bolstered CaixaBank's competitive position but also contributed to the overall stability and resilience of the Spanish banking sector. In a similar vein, BBVA's proposal in May 2024 to acquire Banco Sabadell aims to create a more robust financial institution, capable of offering enhanced lending capacity and improved services to customers. It would provide BBVA with some welcome geographical profit diversification, alongside its highly successful Mexican operations that currently account for 50% of net attributable profits. Some concerns have been raised regarding the potential impact of such a merger on small and medium-sized enterprises (SMEs) and market competition, as this would further consolidate an already concentrated banking sector. BBVA has sought to address these by proposing commitments to the National Commission on Markets and Competition (CNMC) consistent with financial inclusion and competitive practices. If successful, this merger would further streamline the banking landscape, which could drive economic growth and innovation within Spain's financial services industry.

Earnings composition and lending growth

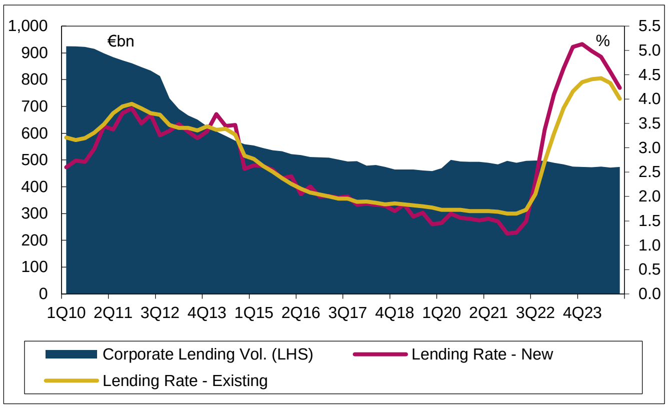
In 2025 and 2026, interest rates are likely to remain well above pre-pandemic lows, which we deem supportive of overall profitability over the medium-term. However, strong domestic competition in retail lending, in particular in the mortgage space, may put a squeeze on margins. Spanish banks will likely look to offset downward pressure on net interest margins (NIM) through a combination of higher lending volumes, well managed deposit betas and a greater focus on net fee and commission incomes. During the rate-hike cycle, asset lending rates were swiftly repriced, leading to strong earnings growth, despite retail and corporate client asset volumes remaining broadly flat since 2020.

Retail asset volumes and average rates, by type



Source: Bloomberg; Daiwa Capital Markets Europe

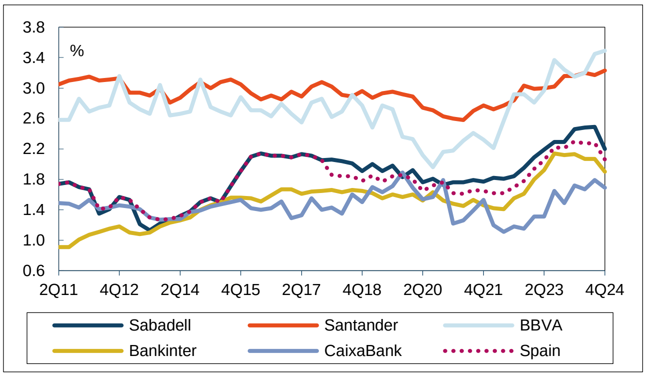
Corporate asset volumes and average rates by type



Source: Bloomberg; Daiwa Capital Markets Europe

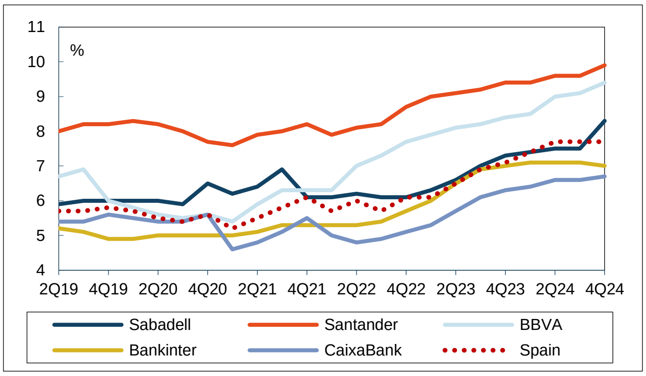
Recent ECB rate cuts have curtailed tailwinds to net interest income (NII), which makes up between 60% - 80% of total revenues generated in Spain in FY24, depending on the banking group. In recent quarters, banks have lowered fixed-rate mortgage margins and eased certain affordability thresholds to bolster lending volumes. Reported loan growth in the domestic Spanish market remained robust for all banks, underscoring the solid operating environment that has underpinned the positive earnings trajectory. As of FY24, Bankinter reported the highest growth rate (+3.9% yoy), albeit from the lowest nominal base in our list of banks. This was followed by BBVA (+3.8% yoy), Sabadell (+3.7% yoy), Santander (+3.2% yoy) and CaixaBank (+1.9% yoy). Since 2019, risk weighted assets (RWAs) on Spanish banks' balance sheets increased from EUR1.26tr to EUR1.41tr (+12%) however, net revenues as a percentage of RWA only started noticeably rising from 2022 onwards, as interest rates increased. We expect this positive momentum to be carried forward at least until 2026, supported by the expansion of alternative revenue streams.

Group net interest margin (NIM)



Source: Company reports; Bloomberg; Daiwa Capital Markets Europe

Net revenues as % of average RWA

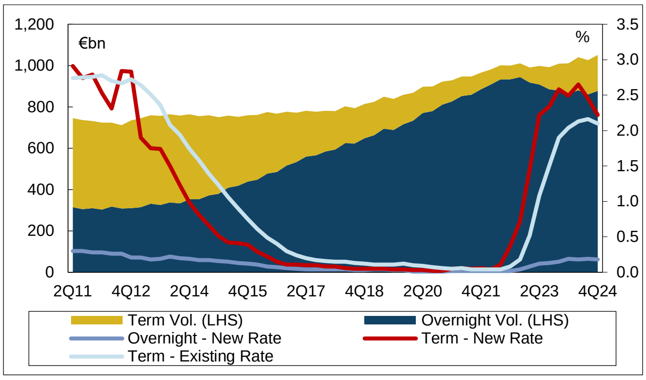


Source: Bloomberg; Daiwa Capital Markets Europe

Deposit margin management

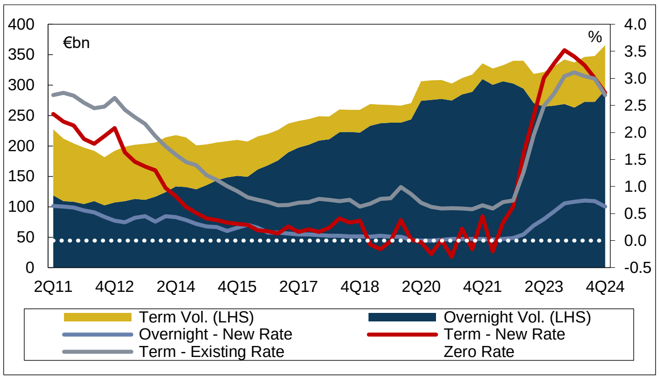
Careful management of deposit betas has helped offset some of the headwinds to interest income, while banks have been bolstering their asset and wealth management offerings to diversify their revenue streams. Currently net fee and commission income contributes some 25% of total revenues and, based on latest earnings presentations, banks have guided for net fee and commission income growth in the low-to-mid single digits in 2025. Lower rates on deposit accounts will likely incentivise more customers to transfer some of their holdings to managed products that will be fee and commission generating. Banks in Spain have also swiftly adjusted deposit rates offered to clients, thus partially mitigating the impact of margin compression. Repricing of term deposits for both retail and corporate clients occurred almost in tandem, while the adjustment to overnight rates has been more pronounced for corporate clients. Ultimately, Spanish banks are navigating a delicate balancing act between driving volume growth and safeguarding profitability in a highly competitive environment. Their ability to maintain NIMs, diversify revenue streams, and capitalise on the growing demand for fixed-rate mortgages will be critical to achieving sustainable growth.

Retail deposit volumes and average rates by type



Source: Bloomberg; Daiwa Capital Markets Europe

Corporate deposit volumes and average rates by type

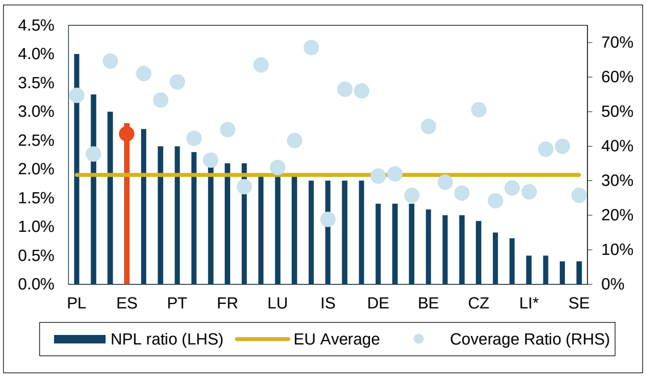


Source: Bloomberg; Daiwa Capital Markets Europe

Asset quality

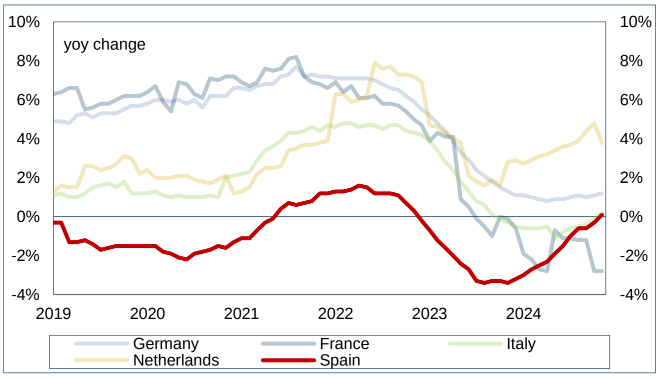
Asset quality has remained remarkably resilient in the Spanish banking sector, despite the spike in interest rates in recent years. This is due to rising real disposable incomes of the borrower base, improved underwriting standards and over a decade of non-performing loan portfolio disposals. The average NPL ratio among Spanish banks has fallen to 2.8%, gradually converging with the European average, which currently stands at 1.9%, according to data from the European Banking Authority (EBA). The sector is well placed to face any potential deterioration in balance sheet asset quality due to strong capitalisation levels and elevated provisioning (44% coverage ratio), which are above the European average. Loan loss provisions (LLP) are at moderate levels from a historical point of view and paired with the stable macroeconomic outlook and improved borrower base this is reflected in current cost of risk metrics (see appendix).

European NPL and coverage ratios



Source: EBA Risk Dashboard; Daiwa Capital Markets Europe

New mortgage volume growth; Quarterly yoy growth



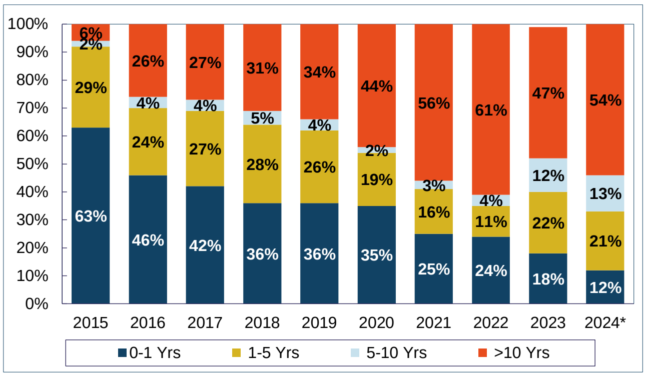
Source: Bloomberg; Daiwa Capital Markets Europe

Lending dynamics and mortgage market

The domestic mortgage market is very important to the banking sector as it represents the single largest lending component on bank balance sheets. The market is highly competitive and has seen significant change of customer behaviour in recent years. Despite the steady increase in house prices since 2014, they have not yet returned to their pre-crisis peak and affordability, as measured by the ratio of house prices to real disposable income, has remained broadly stable over the same period. These circumstances have been positive for bank lending volumes, which have benefitted from a robust labour market, strong economic activity relative to other euro area countries and competitive mortgage pricing. Most major banks have recently conceded some of their mortgage margins and increased maximum loan-to-values (LTV) to 80% to remain competitive and grow market share.

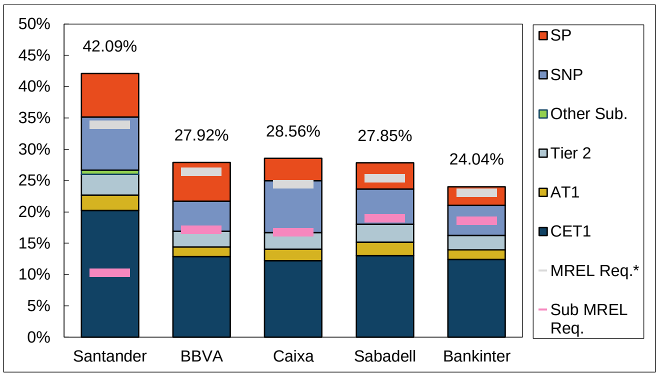
Over the near term, we do not anticipate this to have an adverse impact on asset quality given the broadly benign macroeconomic backdrop, however we have observed a noticeable shift in the popularity of certain mortgage products. Given the trajectory of policy rates, demand has shifted towards longer-term fixed rate products and away from variable rate mortgages. Expectations of a normalised interest rate environment have sharply reduced the attractiveness of variable rate products, which now only make up 13% of new originations, compared with 63% in 2015, when interest rates were very low. While this makes earnings trajectories more predictable over the medium term, it also somewhat constrains the upside potential that comes with variable-rate loan repricing, a distinguishing factor of Spanish banks compared with other core European markets.

Mortgage rates by type and duration



*Source: *Data until end-Nov 2024; AHE; Daiwa Capital Markets Europe*

Spanish banks MREL composition and requirements



*Source: *Incl. CBR; Company reports; Daiwa Capital Markets Europe*

Impact of temporary banking levy

In November 2024, the Spanish government finalised a three-year extension to the existing windfall tax that was applicable to the domestic banking sector. The new tax replaces the temporary levy from 2022, which was aimed at domestic activities of banks. It was charged as a fixed rate of 4.8% and was applicable to banks' net interest and net fee and commission income for 2022 and 2023. It targeted credit institutions with those income items in excess of EUR800m in 2019. While this approach was aimed at financially more potent entities, it also presents less of a drag for large banking groups with international footprints, capable of offsetting the additional expenses with diversified income streams. This is even more relevant considering that the levy is not deductible from corporate tax, and banks are not allowed to pass on the additional costs to their clients. However, despite not being permitted to offset or pass on the additional costs, the annual nominal impact on bottom line profitability has been fairly manageable, ranging between EUR100 – EUR500m.

The extension and modification of the existing levy by three more years, to the 2025-2027 period, replaces the flat rate with a progressive tax structure. This approach is expected to ensure that larger banks contribute more towards the government's fiscal strategy. It is structured as follows:

- 1% on NII and net fee and commission income up to EUR750m;
- 3.5% on NII and net fee and commission income between EUR750m and EUR1.5bn;
- 4.8% on NII and net fee and commission income between EUR1.5bn and EUR3bn;
- 6% on NII and net fee and commission income between EUR3bn and EUR5bn;
- 7% on NII and net fee and commission income exceeding EUR5bn

The November change in the windfall tax means that banks making more than EUR5bn in the above-mentioned revenue lines incur the highest levy. This applies to Santander, BBVA, and CaixaBank based on FY24 earnings

Funding, liquidity & capitalisation

The large share of customer deposits, in particular overnight deposits, as a proportion of total liabilities, provides lenders with a cost-effective funding source and reduces reliance on capital markets. Nevertheless, Spanish banks have demonstrated good and regular access to wholesale funding when needed and completed their 2024 funding programmes without any issues. Their 2025 funding plans are largely focused on replacing maturing debt issuances. Due to its size and systemic importance, Santander is the only Spanish bank that is classified as a G-SIB by the Financial Stability Board (FSB), and is therefore subject to TLAC and MREL requirements. The other banks are only subject to MREL requirements and have been fully compliant with their respective subordination and total MREL requirements, with no shortfalls registered.

In terms of capitalisation, reported regulatory ratios such as CET1 are adequate and well above minimum requirements. However, we note that while buffer amounts are adequate they are also below the European average as Spanish banks tend to actively manage their excess capital in order to fund RWA expansion and engage in shareholder remuneration. Capital ratios tend to be maintained in close proximity to management targets (generally within 100bps) and the average fully-loaded CET1 ratio for our observed group of banks was 12.7% at FY24, largely unchanged against last year (+9bps yoy). Looking ahead, the Bank of Spain has opted to introduce the countercyclical buffer requirement (CCyB) on domestic private sector exposures from October 2026, with an interim requirement of 0.5% in 2025. Santander and BBVA will be less affected by this, due to their large international footprints, compared to the other more domestically focused lenders. However, given the lengthy phase-in period and strong internal capital generation across the board, we expect all lenders to easily comply with the higher requirement.

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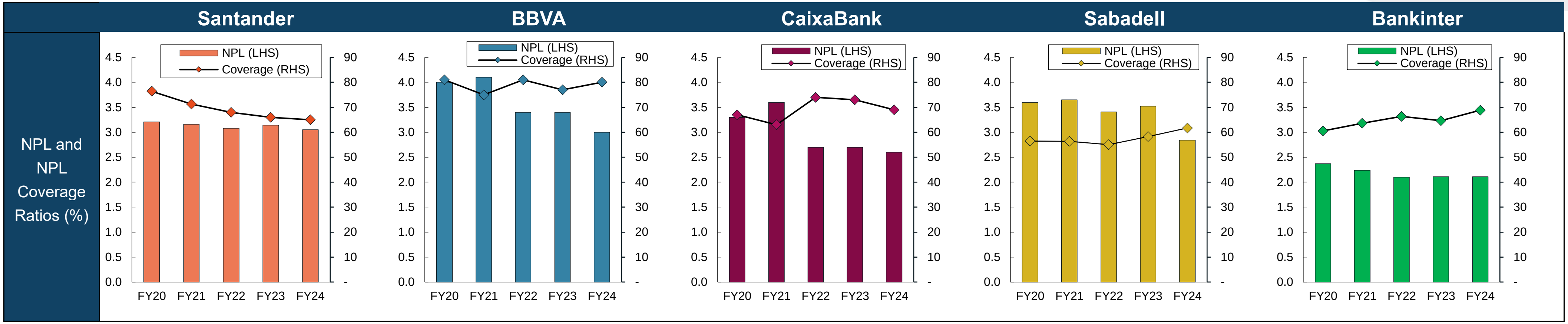
Appendix: Peer Comparables



Source: 'Estimate' refers to analyst estimates compiled in Bloomberg; Company reports, Bloomberg; Daiwa Capital Markets Europe

Credit Ratings

		Santander	BBVA	CaixaBank	Sabadell	Bankinter
Moody's	Rating	A2	A3	A3	Baa2	Baa1
	Outlook	Positive	Positive	Stable	Positive	Stable
	Last Rating Action	Affirm	Affirm	Upgrade	Affirm	Affirm
	Effective Date	26-Sep-2024	19-Mar-24	19-Mar-24	08-Oct-24	19-Mar-24
Fitch	Rating	A	BBB+	A-	BBB+	WD
	Outlook	Stable	Positive	Stable	Stable	-
	Last Rating Action	Upgrade	Upgrade	Upgrade	Upgrade	-
	Effective Date	11-Feb-25	11-Feb-25	04-Dec-24	10-Jan-25	-
S&P	Rating	A+	A	A	BBB+	A-
	Outlook	Stable	Stable	Positive	Positive	Stable
	Last Rating Action	Affirm	Affirm	Upgrade	Upgrade	Affirm
	Effective Date	22-Nov-24	29-Apr-24	14-Nov-24	29-Apr-24	29-Apr-24
JCR	Rating	AA-	WD	NR	NR	NR
	Outlook	Stable	-	-	-	-
	Last Rating Action	Upgrade	-	-	-	-
	Effective Date	23-Jan-25	-	-	-	-

Source: Arrows indicate direction of recent rating action; Moody's, Fitch, S&P and Japan Credit Rating Agency

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* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.
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