Research Update:

Spain-Based Ibercaja Banco S.A. Upgraded To 'BBB-/A-3' On Profitability Converging With Peers'; Outlook Stable

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Overview

- Ibercaja is successfully executing its business plan and has achieved most of its stated targets, including a significant reduction of its operating costs, one year ahead of schedule.
- Recent interest rate increases will significantly boost Ibercaja's earnings, and they are accelerating the convergence of its profitability with that of its peers.
- We raised our long- and short-term issuer credit ratings on Ibercaja to 'BBB-/A-3'.
- We also assigned our 'BBB/A-2' long- and short-term resolution counterparty ratings (RCRs) to the bank.
- The stable outlook reflects our expectation that Ibercaja will continue improving its operating profitability and efficiency in line with peers, and that asset quality deterioration in the now less favorable environment will be modest.

Rating Action

MADRID (S&P Global Ratings) Nov. 25, 2022--S&P Global Ratings today raised its long- and short-term issuer credit ratings on Ibercaja Banco S.A. to 'BBB-/A-3' from 'BB+/B'. The outlook is stable.

Rationale

The upgrade reflects our view that Ibercaja has delivered the execution of its business plan. We think management's efforts to restructure, streamline, and digitize its business are effective. The completion of a 15% headcount reduction over 2017-2021 was particularly pertinent in addressing the bank's high-cost base and it prepares the bank well to deal with ongoing inflationary pressures. Furthermore, Ibercaja fulfilled its business plan without impairing business generation capacity. Additionally, focus on fee income growth, leveraging on its relevant market shares in mutual and pension funds management, also supported earnings in the interest rate environment, which was negative until recently. Assets under management and insurance products grew by about 8% cumulatively between 2019 and the first nine months of 2022 and fee income represented about 43% of operating income as of end-September 2022.

Higher interest rates will strongly boost Ibercaja's net interest income (NII), causing its underlying profitability to converge with peers' more rapidly than we previously anticipated. Ibercaja's largely floating loan book and large share of loyal deposits mean it is particularly likely to benefit from the recent rise in Euribor rates, with a stronger NII complementing its already solid fee generation. At the same time, the bank's focus on residential mortgages (which account for 60% of its loan book versus 42% for the Spanish system) will also protect it against potentially significant asset quality deterioration and credit losses in the now more difficult economic environment. We now expect Ibercaja will achieve return on equity of about 6.5% in 2022, further increasing to 7.0%-7.5% by 2023 and to 7.7%-8.3% by 2024, despite having to accommodate the new windfall tax (very much aligned with our average expectation for its peers). The bank should also close the gap with peers in terms of efficiency, with its cost-to-income ratio reducing to 60% by 2023 and further to 57% in 2024, compared with 67% at end-2021.

Ibercaja's improving capitalization and our expectation of modest asset quality deterioration further support the rating. Although we anticipate some credit quality deterioration from the slowing economic growth environment and high inflation, we think this should be more manageable for Ibercaja compared with other peers that are more exposed to potentially vulnerable small and midsize enterprises and consumer lending. Under our base case, we expect cost of risk (including loans and foreclosed assets) to rise to 45 basis points (bps) in 2023 from 40 bps in 2022 (see "European Banks' Residential Mortgage Losses Should Remain Contained Even As Economies Slow," published Nov. 15, 2022). Moreover, Ibercaja's starting point is solid. Its nonperforming asset (NPA) ratio stood at 3.5% of gross loans at end-September 2022, while its loans classified as stage 2 represented 4.6% of gross loans and coverage of NPAs was 73%. We also expect its capitalization will continue to strengthen, with its risk-adjusted capital (RAC) ratio at about 9.0%-9.5% over the next 18-24 months.

Ibercaja's buffer of subordinated bail-inable debt is not large enough to protect senior debt creditors in a resolution scenario. Therefore, the ratings on the bank do not benefit from additional loss-absorbing capacity (ALAC) uplift. According to Ibercaja's funding plans to fulfil its minimum requirement for own funds and eligible liabilities (MREL), we expect its ALAC buffer will approach the 400 bp minimum threshold that we require for the bank to benefit from a one-notch ratings uplift, but it will still fall short. We forecast it will stand at about 3.7%-3.9% of S&P Global Ratings-adjusted risk-weighted assets by end-2024. We also note that the bank is not subject to issuing any subordinated MREL, and therefore it could well complete its pending MREL gap with more affordable senior preferred instruments, which we will not include in our ALAC buffer.

We assigned our RCR to Ibercaja, reflecting that we view its sale of whole business resolution strategy as likely to ensure the full and timely payment of some or all of these banks' senior liabilities. We base this view on the presence of a number of domestic players that could have the financial capacity and willingness to acquire the bank, and because Ibercaja is taking the necessary steps to be operationally prepared to ensure a sale could be executed. Recognizing the resolution strategy as effective implies that certain senior liabilities, namely those not legally bail-inable, may be protected from default during the resolution process. An RCR is a forward-looking opinion of the relative default risk of certain liabilities, notably insured deposits and secured claims. The long-term RCR generally stands one notch above the long-term issuer credit rating for investment-grade issuers.

Outlook

The stable outlook reflects that we expect Ibercaja will continue improving its earnings capacity and efficiency over the next 18-24 months, with its NII benefitting from the rising interest rate environment. It also indicates that we expect asset quality deterioration to be more modest than for other Spanish players, and capitalization to remain sound, with the RAC ratio at about 9.0%-9.5% by end-2024.

Downside scenario

We could lower the rating if Ibercaja's performance deviated from our expectations, increasing the gap with peers again. We could also lower the ratings if the bank's internal capital generation were much weaker than we expect or if asset quality deteriorated substantially.

Upside scenario

Although an upgrade is currently unlikely, we could consider it if the bank progressed in building bail-in-able buffers with subordinated instruments. An upgrade could also take place if its capital strengthened to the point that, when compared to the risks facing the bank, we thought it represented a ratings strength, provided that the bank's higher creditworthiness aligned with similarly rated peers'.

Ratings Score Snapshot

	To	From
Issuer Credit Rating	BBB-/Stable/A-3	BB+/Stable/B
Stand-alone credit profile	bbb-	bb+
Anchor	bbb	bbb
Business position	Moderate	Constrained
Capital and earnings	Adequate	Adequate
Risk position	Adequate	Adequate
Funding	Adequate	Adequate
Liquidity	Adequate	Adequate
Comparable ratings analysis	0	0
Support	0	0
Additional loss-absorbing capacity support	0	0
Government-related entity support	0	0
Group support	0	0
Sovereign support	0	0

	To	From
Additional factors	0	0
Resolution Counterparty Rating	BBB/--/A-2	NR

NR--Not rated.

ESG credit indicators: E-2, S-2, G-2

Related Criteria

- General Criteria: Hybrid Capital: Methodology And Assumptions, March 2, 2022
- Criteria | Financial Institutions | General: Financial Institutions Rating Methodology, Dec. 9, 2021
- Criteria | Financial Institutions | Banks: Banking Industry Country Risk Assessment Methodology And Assumptions, Dec. 9, 2021
- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Financial Institutions | General: Risk-Adjusted Capital Framework Methodology, July 20, 2017
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- European Banks' Residential Mortgage Losses Should Remain Contained Even As Economies Slow, Nov. 15, 2022
- Ibercaja Banco S.A., July 11, 2022
- Global Bank Country-By-Country Outlook 2023. Greater Divergence Ahead, Nov. 17, 2022
- European Banks: The Agile Will Come Out Stronger, Nov. 11, 2022

Ratings List

New Rating	
Ibercaja Banco S.A.	
Resolution Counterparty Rating	BBB/--/A-2

Upgraded

	To	From
Ibercaja Banco S.A.		
Issuer Credit Rating	BBB-/Stable/A-3	BB+/Stable/B
Senior Unsecured	BBB-	BB+
Subordinated	BB	B+
Preferred Stock	B+	B-