



RATING ACTION COMMENTARY

Fitch Affirms Sabadell at 'BBB-'; Outlook Stable

Thu 30 Jun, 2022 - 10:17 AM ET

Fitch Ratings - Barcelona - 30 Jun 2022: Fitch Ratings has affirmed Banco de Sabadell, S.A.'s Long Term Issuer Default Rating (IDR) at 'BBB-' and Viability Rating (VR) at 'bbb-'. The Outlook is Stable.

A full list of rating actions is below.

Fitch has withdrawn Sabadell's Support Rating of '5' and Support Rating Floor of 'No Floor' as they are no longer relevant to the agency's coverage following the publication of its updated Bank Rating Criteria on 12 November 2021. In line with the updated criteria, we have assigned Sabadell a Government Support Rating (GSR) of 'no support' (ns).

KEY RATING DRIVERS

Established Franchise in Spain: Sabadell's ratings are underpinned by its sound and established domestic franchise, particularly in the SME segment, and by its diversified business model by product, which provide it with a balanced revenue mix that is comparable with larger domestic peers'. The ratings are also supported by adequate capitalisation and sound funding and liquidity profiles. Asset quality remains a rating weakness, but we expect credit risks to be contained despite the uncertain operating environment.

Profitability Weakest Link: Sabadell's VR is one notch below the 'bbb' implied VR, adjusted down to reflect that in recent years the group's profitability, albeit improving, has been below historical averages. This was due to its UK subsidiary's weak

performance, restructuring costs and the impact of the pandemic. We assess the bank's profitability at 'bbb-' on our expectation that Sabadell's operating profit will exceed 1.5% of its risk weighted assets (RWAs) for the next 18 months.

Risk Diversification from TSB: Sabadell's company profile also reflects some geographic diversification from its UK business (through TSB Banking Group plc, TSB), which accounts for about 20% of group assets, and whose performance has improved. Sabadell deems TSB an integral part of the group, and expects to leverage on the UK business to support group profitability improvement, as has been in 2021 and 1Q22. However, the subsidiary's standalone profitability is likely to remain low.

Earnings Improvements: Sabadell's profitability improved in 2021 from weak levels in 2020, supported by the economic recovery in both Spain and the UK. Despite the economic impact from the Russia-Ukraine conflict, we expect Sabadell's earnings to continue to improve on higher interest rates, cost savings from restructuring in Spain and moderate loan impairment charges (LICs), provided the economic recovery in Spain remains resilient and inflation pressures subdued.

Limited Rise in Impaired Loans: Sabadell's asset quality is in line with large domestic peers', with a problem asset ratio (which includes impaired loans and net foreclosed assets) of 4% at end-March 2022, but weaker than large European peers'. Spain's economic recovery, which is underway, higher than pre-pandemic affordability rates both in the retail and corporate segments and TSB's low risk profile are likely to contain asset-quality deterioration. We expect the group's impaired loan ratio to remain broadly stable and below 4% in 2022-2023.

Satisfactory Coverage Ratio: Impaired loan coverage at 60% at end-March 2022 was higher than historical average levels, providing risk mitigation, but remains at the low end by domestic standards, and we expect coverage to trend lower in the medium term. We expect LICs to normalise on average at a low 40bp of gross loans for 2022-2023 despite current macroeconomic risks, as the bank can release pandemic-related reserves.

Adequate Capitalisation: Sabadell's fully loaded common equity Tier 1 (CET1) ratio of 12.45% at end-March 2022 was below the average of European peers but is mitigated by its improved capacity to generate earnings and by maintaining adequate buffers above regulatory requirements. We expect the bank to operate with a fully-loaded CET1 ratio at around or just above 12%, including in the event of an increase of capital distribution if the bank generates capital considerably above its target. In our view, capital remains somewhat sensitive to unreserved problem assets, which we however expect to remain within tolerable levels at around or below 30% of CET1 capital.

Sound Deposit Base and Liquidity: Sabadell fully funds its loans with customer deposits and benefits from a reasonably diversified funding profile, with frequent access to secured and unsecured wholesale markets (particularly to meet its minimum requirement for own funds and eligible liabilities (MREL)). The bank's liquidity position is sound and supported by large buffers of high-quality liquid securities.

RATING SENSITIVITIES

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

Sabadell's ratings could be downgraded on an unexpected severe setback to the economic outlook or if the financial repercussions of the current market environment are worse than Fitch currently assumes, particularly in Spain.

In particular, the ratings could be downgraded if Sabadell's CET1 ratio falls below the bank's 12% target without the prospect of recovery in the short term, capital encumbrance by unreserved problem assets rises above 50% on a sustained basis, or if the four-year average problem asset ratio increases above 5% without a clear path to reduction.

A downgrade could also be triggered by prolonged earnings weakness with operating profit trending towards 1% of RWAs with no clear visibility to reversing the trend.

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

An upgrade would require improved profitability as reflected by an operating profit/RWAs above 1.5% and trending towards 2% on a sustained basis.

A strengthening of our assessment of the bank's capitalisation will be equally important, which could come as a consequence of a higher capacity to generate capital internally. Maintaining the problem asset ratio sustainably below 4% would also be positive for the ratings.

OTHER DEBT AND ISSUER RATINGS: KEY RATING DRIVERS

Senior Debt, Deposit and Derivative Counterparty (DCR) Ratings

Sabadell's senior non-preferred notes are rated at the same level as the bank's Long-Term IDR, reflecting Fitch's view that the default risk of the notes is equivalent to that of the IDR and that senior non-preferred obligations are viewed as having average recovery prospects.

Sabadell's DCR, long-term deposit and senior preferred debt ratings are one notch above the Long-Term IDR to reflect the protection that accrues from buffers of junior and senior non-preferred debt. Fitch expects junior and senior non-preferred resolution buffers to sustainably exceed 10% of RWAs as the bank continues issuing this type of debt to comply with its MREL and subordination requirements.

The short-term deposit rating 'F2' is the higher of two options corresponding to the long-term deposit rating of 'BBB', in line with the bank's funding and liquidity score at 'bbb+'.

Subordinated Debt

Sabadell's Tier 2 subordinated debt is rated two notches below the bank's VR to reflect the notes' poor recovery prospects arising from subordination in case the bank becomes non-viable.

GSR

Sabadell's GSR of 'ns' reflects our view that although external extraordinary sovereign support is possible it cannot be relied on. This is because senior creditors can no longer expect to receive full extraordinary support from the sovereign in the event that the bank becomes non-viable.

OTHER DEBT AND ISSUER RATINGS: RATING SENSITIVITIES

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

Senior Debt, Deposit Ratings and DCR

Sabadell's DCR, senior debt and deposit ratings are primarily sensitive to downgrades of the bank's IDRs. We would also downgrade the DCR, long-term senior preferred and non-preferred debt and deposit ratings by one notch if the bank changes its strategy to meet MREL over the medium term and no longer plans to operate with a combined buffer of qualifying junior debt and senior non-preferred debt at above 10% of RWAs.

Subordinated Debt

Subordinated debt is primarily sensitive to a downgrade of Sabadell's VR.

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

Senior Debt, Deposit Ratings and DCR

Sabadell's DCR, senior debt and deposit ratings would be upgraded if the bank's Long-Term IDR is upgraded.

Subordinated Debt

Sabadell's subordinated debt ratings would be upgraded if the bank's VR is upgraded.

GSR

An upgrade of the GSR would be contingent on a positive change in the sovereign's propensity to support the bank. In Fitch's view, this is highly unlikely, although not impossible.

VR ADJUSTMENTS

The operating environment score of 'bbb+' is below the 'a' category implied score because of the following adjustment reason: economic performance (negative).

The earnings & profitability score of 'bbb-' is above the 'bb' category implied score because of the following adjustment reason: historical and future metrics (positive).

The capitalisation & leverage score of 'bbb-' is above the 'bb' category implied score because of the following adjustment reason: internal capital generation and growth (positive).

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

Unless otherwise disclosed in this section, the highest level of ESG credit relevance 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 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

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
Banco de Sabadell, S.A.	LT IDR	BBB- Rating Outlook Stable		BBB- Rating Outlook Stable
		Affirmed		
	ST IDR	F3	Affirmed	F3
	Viability	bbb-	Affirmed	bbb-
	Support	WD	Withdrawn	5
	Support Floor	WD	Withdrawn	NF
	DCR	BBB(dcr)	Affirmed	BBB(dcr)
	Government Support	ns	New Rating	
Senior preferred	LT	BBB	Affirmed	BBB

subordinated	LT	BB	Affirmed	BB
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Senior non-preferred	LT	BBB-	Affirmed	BBB-
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[VIEW ADDITIONAL RATING DETAILS](#)**FITCH RATINGS ANALYSTS****Cristina Torrella Fajas**

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APPLICABLE CRITERIA

[Bank Rating Criteria \(pub. 12 Nov 2021\) \(including rating assumption sensitivity\)](#)

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Banco de Sabadell, S.A.

EU Issued, UK Endorsed

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Banks Europe Spain
