Italian banks resilient in 2020 but not out of the woods

Full-year results confirmed that Italian banks have sailed through the pandemic-induced recession with limited damage to their credit profiles, and obvious pressure on their P&Ls largely balanced by improved solvency and continued progress in dealing with legacy NPEs. The expiry of moratorium programmes in 2021 represents a key near-term challenge for the sector, though early guidance is encouraging. Longer term, we continue to stress the need for banks to boost underlying profitability, which has been uninspiring through the cycle.

The multi-year trend of improving asset quality is intact for now, as banks continue to shed legacy NPE portfolios and new defaults remain very low. Reported asset-quality numbers are increasingly at odds with the deepest annual contraction in GDP since World War 2.

Generous public-sector support to the stranded population, temporary payment holidays and a pragmatic approach by bank supervisors to loan classifications have contributed to the apparent calm in bank credit portfolios. But it is too early for banks to declare victory over the pandemic cycle. Most moratoriums are set to expire in June 2021, and we expect asset-quality trends to be less benign in 2021 than they were last year.

Following the material provisioning effort in 2020, we expect cost of risk to remain elevated this year, pressuring profitability. As we have highlighted in previous research, bank profitability in Italy and abroad suffers first and foremost from structural factors that are beyond the control of bank management teams.

These include post GFC re-regulation, which has led banks to shun high-risk (but also high-margin) business and carry more capital. Challenges also include the low level of interest rates and flat yield curve, which renders bread and butter maturity transformation an unprofitable business.

Positively for credit, Italian banks have comfortable buffers against capital requirements, following a material improvement of capital ratios in 2020. Ratios benefited from retained profits but also from a significant reduction in RWAs, a handy side effect of public sector guarantees on new loans.

We believe 2021 will see a continuation of the trend towards greater bank consolidation in Italy, given appealing industry and financial drivers for in-country deals, including the recent encouraging clarifications from supervisors.

The unravelling of the ruling government coalition in January reinforced our view, in the context of unprecedented central bank intervention in financial markets, that risks arising from the banks' large holdings of domestic government bonds are limited. As the political crisis unfolded, there were no signs of investor panic in closely watched gauges of country risk, such as the Bund/BTP spread.

Near term, we see no risk of a sovereign crisis becoming a negative driver for bank credit. Longer term, however, we note that Italian banks will come out of the crisis with greater exposure to Italian sovereign debt because of the guaranteed lending programmes.

Analysts

Marco Troiano, CFA
m.troiano@scoperatings.com

Alessandro Boratti
a.boratti@scoperatings.com

Team leader

Dierk Brandenburg
d.brandenburg@scoperatings.com

Media

Keith Mullin
k.mullin@scopegroup.com

Related Research

2021 European Banking Outlook
December 2020

Italian Banks: moratorium extension delays loss recognition, raising uncertainties
September 2020

Italian banks: positive trend in asset quality could be about to go into reverse
May 2020

Scope Ratings UK

111 Buckingham Palace Road
London SW1W 0SR

Scope Ratings GmbH

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

Bloomberg: RESP SCOP

Asset-quality metrics improving, loss recognition delayed

In 2020, Italian banks' headline asset-quality metrics improved. We calculate that net non-performing exposures (NPEs) declined by more than 33%[1] for our sample of nine large Italian banking groups, with NPE coverage broadly stable year-on-year at 53%.

Italian banks sold about EUR 38bn of NPEs in 2020

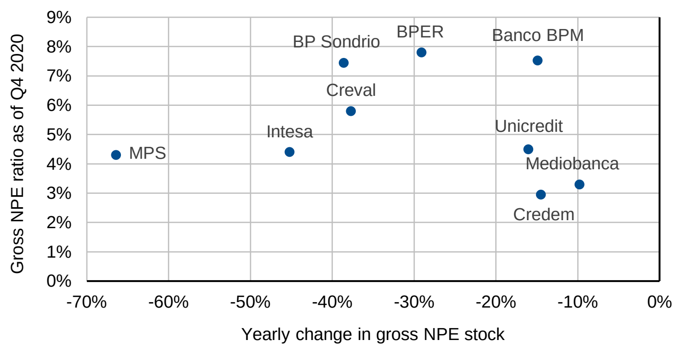
A resilient NPE primary market enabled banks to reduce legacy exposures despite the Covid crisis, which halted market operations during the first lockdown. Italian banks sold around EUR 38bn of non-performing loans in 2020[2]. MPS, Intesa, and UniCredit contributed around half of the value of all transactions. MPS completed a jumbo-deal with State-owned AMCO for about EUR 8bn of gross NPEs (Project Hydra), Intesa sold EUR 6.6bn in NPLs, while UniCredit closed a handful of deals for around EUR 5.3bn in total. The GACS scheme boosted bank de-risking through public securitisations.

MPS made the biggest progress by reducing its NPE stock by 66% in one year thanks to the deal with AMCO (Figure 1). Following Intesa's merger with UBI, the bank moved swiftly to accelerate the clean-up of the combined balance sheet, also deploying badwill from the merger. Its pro forma gross NPE ratio now stands at 4.4%, below the EBA's 5% guidance. After many years, BP Sondrio, BPER, and Creval were finally able to bring their gross NPE ratios into single digits, partly closing the gap to the national average. UniCredit, Banco BPM, Credem, and Mediobanca also reduced their stock, albeit by a lower amount (10%-20%).

Low inflows from performing to NPE

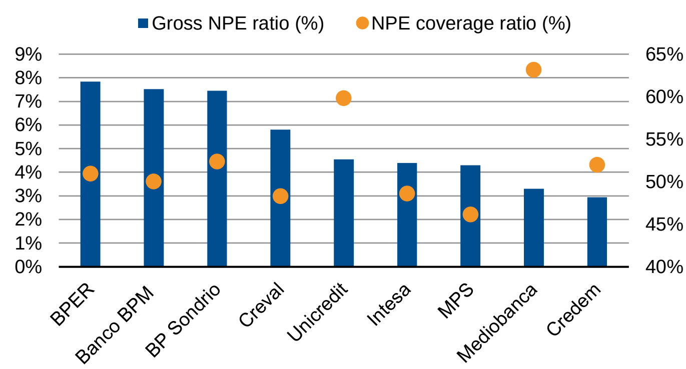
At the same time, the default rate, which measures migration from performing loans to NPE continued to decline for most banks. At BPER and BPM, it stood at 1% (from 1.7% and 1.2% a year ago). Intesa also reported a 36% year on year decline in the default rate.

Figure 1: Italian banks – Change in gross NPE stock in 2020 v gross NPE ratio as of Q4 2020



Source: Company data, Scope Ratings
Note: Intesa's yearly change was estimated by including UBI's figures in the 2019Q4 data. Intesa' gross NPE ratios is pro forma the announced disposals

Figure 2: Italian banks – Gross NPE ratio and NPE coverage as of Q4 2020



Source: Company data, Scope Ratings

But headline asset-quality measures only provide a rearview mirror image of banks' balance sheets. The NPE deals concluded in 2020 related only to NPE exposures from previous crises, well before the pandemic started to bite. There is little evidence so far of any credit deterioration, which is in large part due to the combination of moratoriums, continued access to government-guaranteed funding and a relaxation of NPE classification rules. In addition, fiscal measures such as income support, subsidies and tax deferrals have helped avoid a cliff-edge scenario in loan delinquencies.

1 When considering Intesa's YE 2020 figures pro forma the sale of NPLs (currently accounted as discontinued operations).
2 Source: Banca IFIS' Marketwatch

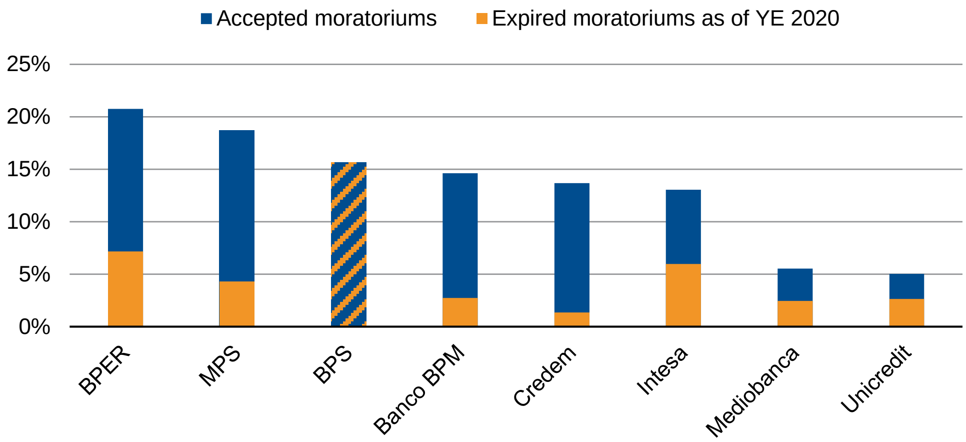
Performance of loans under moratorium a key factor to watch

A key factor to watch in 2021 will be the performance of loans exiting moratorium: end-of-January data shows that Italian banks received 2.7m moratorium requests for roughly EUR 300bn in value (c 17% of total loans), of which 95% were accepted. Of these, EUR 189bn were still outstanding, including EUR 137bn in loans to non-financial corporations, in large part SMEs under art. 56 of the *Cura Italia* decree.

While sector data shows that moratorium requests have clearly tailed off, the original duration of the legal moratorium programme was extended twice and now runs until 30 June 2021, with payment suspensions automatically extended unless the borrower opted out before 31 January or 31 March for companies operating in the tourism sector.

The percentage of outstanding loans under moratorium was higher among regional banks than at some of the larger groups (Figure 3). We believe the moratorium regime will delay full loss recognition until at least the second half of 2021.

Figure 3: Accepted and expired moratoriums as % of net loans as of YE 2020



Source: ECB, Scope Ratings
Note: BPS' detail on expired moratoriums is not available

Banco BPM: 0.5% default rate on expired moratoriums

Disclosure on the credit performance of expired moratoriums has been mixed. In general, banks are optimistic, highlighting the fact that there are few or no clear signs of deterioration. For instance, the default rate on Banco BPM's expired moratoriums stood at 0.5%, whereas BPER stated that its delinquency rate was 'negligible'.

However, the performance of expired moratoriums provides a biased view of the overall picture. Except for consumer loans, whose backstop expired on 30 September, exits from moratoriums were voluntary and we expect performance to worsen over time.

Another important factor to watch will be the timing of any change in the supervisory stance towards NPE classification. The EBA ruled that loans under moratorium do not need to be classified as forborne under article 47b of Regulation (EU) No 575/2013. This proved crucial to avoid an automatic migration from IFRS stage 1 loans to stage 2 and stage 3 NPEs. Thus, the visibility of asset quality is low. We expect credit costs to remain elevated in 2021 and beyond, though the outcome depends on the speed of economic recovery and additional fiscal support measures.

Covid recession compounds structural profitability challenges

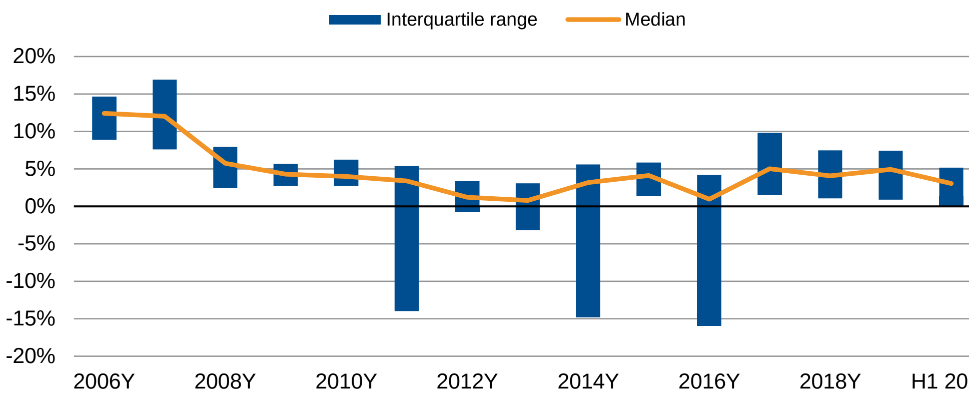
Even before the Covid-19 crisis, many Italian banks had been struggling to deliver adequate profitability. We estimate that on average Italian banks have been value-destroying businesses for more than 10 years once the cost of capital is taken into account for (Figure 4).

Profitability suffering from both structural and cyclical factors

The causes for the lacklustre profitability are shared by banks in other parts of Europe: higher capital requirements, a rising cost of regulation and low interest rates due to the ECB's monetary policy stance. Italian banks have also been plagued by the accumulation of NPEs in the wake of the great financial and sovereign crises against which they had to book large provisions.

In such a context, the few banks reporting above-average returns have been those with diversified business models embracing fee-driven activities, such as Intesa and Mediobanca, or niche players.

Figure 4: Italian banks – Return on average equity, historical



Source: SNL, Scope Ratings
Note: the sample includes the top 20 commercial banks in Italy as of YE 2020 and a handful of defunct institutions, such as Veneto Banca SpA

In 2020, Italian banks' revenues suffered a further blow from subdued customer activity, low trading income, and curtailed dividends from equity investments (Figure 5). The most resilient component of revenues was interest income. The decline here was softened by the support from attractively priced TLTROs and high lending volumes.

Continued cost discipline partly compensated for the decline in the top line. Banks reduced personnel costs by cutting bonuses and travel-related expenses, and delaying non-essential hiring.

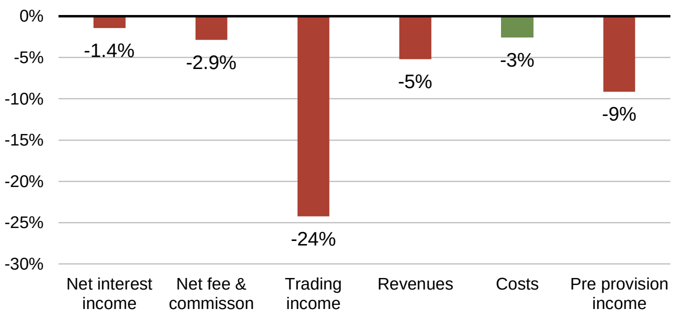
Cost of risk manageable, but drags on profitability outlook

Despite the spike in the first half of 2020, cost of risk remained at a manageable level, rising by just 20bp. It is worth bearing in mind, though, that 2019 incorporated significant provisions for NPE disposals. In fact, some banks even reported a year-on-year a decline in credit losses, due to the inflated base of 2019 (Figure 6).

The bulk of extra provisions taken in 2020 were attributable to revised macroeconomic scenarios and, to a lesser extent, loan reclassification from Stage 1 to Stage 2. We expect further migration towards Stage 2 and Stage 3 loans to require additional provisions in 2021.

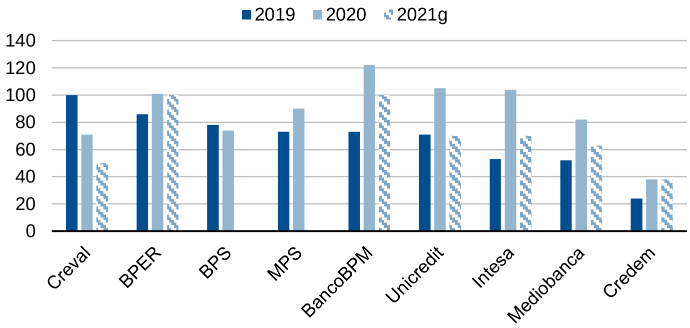
For 2021, Italian banks have guided for a decrease in cost of risk, counting on a slow but gradual return to normality by mid-year. We expect pre-provision profitability to be resilient in 2021 thanks to a rebound in fee and commission income and further cost-containment efforts, but high cost of risk will likely continue to weigh on the bottom line.

Figure 5: P&L components, 2020-2019 change % - Sector average



Source: Company data, Scope Ratings
Note: the sample includes UniCredit, Intesa (ex. UBI), Banco BPM, MPS, Credem, Mediobanca, Creval, and BP Sondrio

Figure 6: Cost of risk – 2019 vs 2020 vs 2021 guidance



Source: Company data, Scope Ratings
Note: Mediobanca's figures refer to fiscal periods ending in June. Upper bound of the ranges provided for the 2021 CoR guidance

Significant capital build in 2020; comfortable room to requirements.

Profit, dividend ban and RWA decline drive capital accumulation

Italian banks' capital ratios reached new highs in 2020 (Figure 7). Their CET1 ratios increased on average by 130bp, which adds another layer of protection to shoulder credit losses beyond what is currently anticipated.

The three main factors supporting capital ratios were:

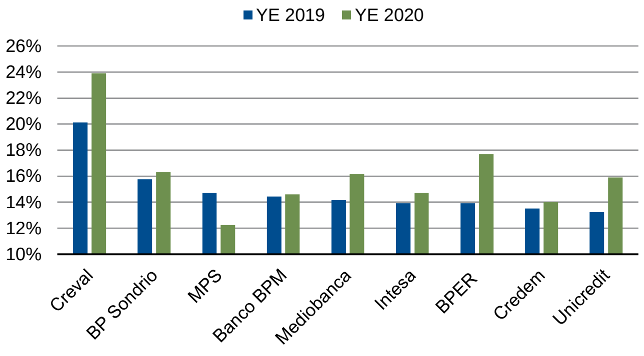
1) Low but positive internal capital generation.
2) The ECB's recommendation not to pay dividends in 2020 and to limit earnings distribution in 2021.
3) On average, a decrease in risk-weighted assets thanks to:
   a. The low risk weights of loans under the public guarantee scheme, which represented an important slice of total lending in 2020.
   b. The regulatory response to the crisis through the anticipation of some CRR II measures, such as the revised SME supporting factor and the possibility not to deduct 'prudently valued software assets' from CET1.

Banks' headroom to regulatory requirements materially improved in 2020

As of YE 2020, Italian banks' capital ratios were comfortably above their SREP requirements; MPS being the most notable exception, as the bank's capital base was eroded by losses in 2020. For the major banks, the minimum distance to capital requirements stood at over 500bp.

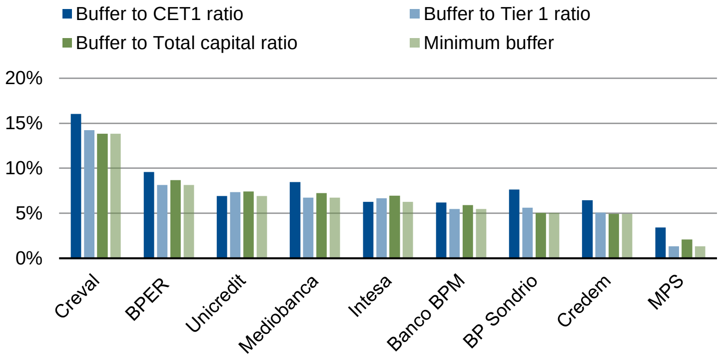
The comfortable buffers reflect the increase in capital ratios but also the average decline in SREP requirements as supervisors moved to expand banks' room for manoeuvre as the pandemic hit in March. Given their predominantly domestic nature, Italian banks did not materially benefit from the reduction in countercyclical risk buffers across Europe (it had already been set at 0% by the Bank of Italy before 2020). Instead, bringing forward CRD 5 art.104, which allows banks to meet their Pillar 2 requirement with a mix of common equity, AT1s, and Tier 2 capital, decreased the CET1 requirement by 84bp on average for our sample of banks.

Figure 7: Italian banks – Phased in CET1 ratio, 2019 vs 2020



Source: SNL, Scope Ratings
Note: Credem's buffers to SREP requirement refer to the holding perimeter (Credemholding)

Figure 8: Italian banks, buffers to SREP requirements as of YE 2020

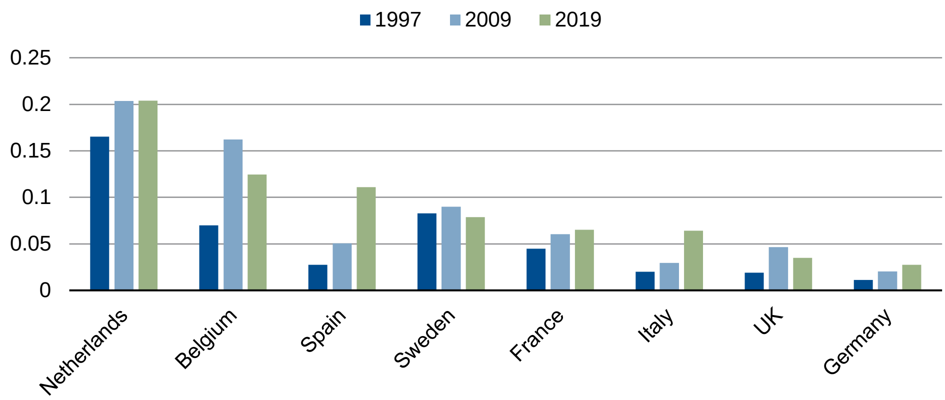


Source: Company data, SNL, Scope Ratings.
Note: Credem's buffers to SREP requirement refer to the holding perimeter (Credemholding)

Solid drivers for domestic M&A; consolidation will continue

Even though the trend towards larger (and fewer) banks has accelerated since the great financial crisis, the Italian banking sector remains one of the most fragmented in the European Union (Figure 9). At the end of 2019, there were still 485 different banks operating across the country, according to Bank of Italy data.

Figure 9: Herfindahl-Hirschman bank concentration index, selected EU countries



Source: ECB, Scope Ratings

The current environment encourages M&A

Recessions can often accelerate sector consolidation as weaker entities suffer asset-quality deterioration and capital erosion, and are forced to combine with stronger players that have more financial muscle to withstand losses. But in the current environment, we believe there can be further drivers for sector consolidation, including between banks with solid fundamentals, like Intesa-UBI. Against a backdrop of structurally challenged profitability, combinations can bring significant benefits, including:

a) Revenue synergies from enhanced cross-selling of services and products and from increases in pricing power stemming from gains in market share.
b) Cost synergies from economies of scale with respect to central costs and densely overlapping branch networks.
c) Scaling-up of digital investments, which is paramount for the sustainability of the banking business and can give a competitive edge to early adopters.

Aside from these industry drivers, there are financial considerations that in our view materially boost the odds of more deals in Italy.

a) The supervisory approach to consolidation is seen as more supportive than in the past. In January 2021, the ECB published its guide on the supervisory approach to consolidation[3], assuaging concerns around the potential for increased capital requirements on banks undergoing M&A, and clarifying that acquisition badwill could be recognised as regulatory capital. Given depressed valuations, deals that generate badwill can facilitate the clean-up of balance sheets from legacy NPEs without hurting the P&L. The ECB also confirmed it would accept temporary use of existing internal models.

b) Italy's 2021 budget law introduced a fiscal incentive that allows companies involved in M&A in 2021 to convert DTAs (on and off-balance sheet) into tax credits for up to 2% of the accounting value of the assets involved.

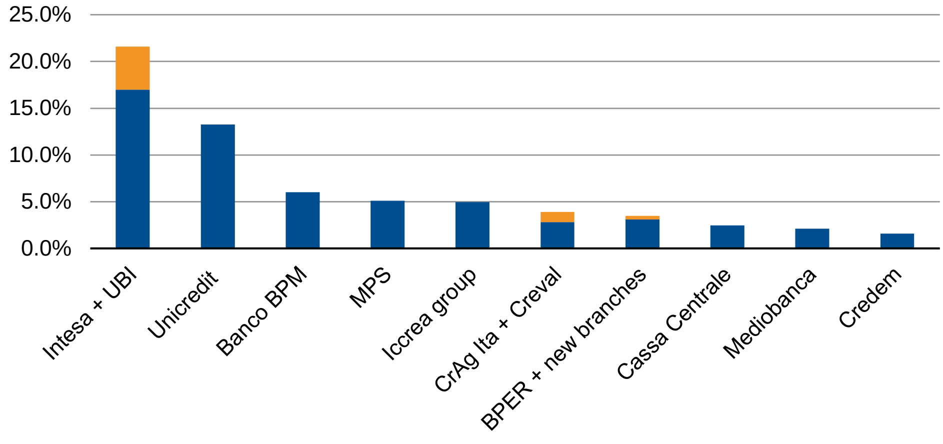
c) Finally, following the limitations in dividend payments in 2020 and 2021, stronger banks have accumulated excess capital that could be deployed in mergers. In this context, low bank equity valuations help make acquisitions financially viable.

Intesa's takeover of UBI has raised the pressure on other Italian banks to consolidate

The Intesa-UBI merger further strengthened Intesa as the leading financial institution in Italy (Figure 10), while taking a potential consolidator off the market.

In a side deal, BPER acquired 486 branches and 134 operational units as well as the related assets and liabilities from Intesa, expanding its operations in the North-West of Italy. In 2019, the BPER had already enlarged its balance sheet and operations through the acquisition of Unipol Banca. In Q4 2020, Credit Agricole Italia announced an offer to acquire Creval to bolster its presence in Lombardy and Sicily.

Figure 10: Top Italian banks – Market shares on customer loans as of YE 2019



Note: customer loans net of repos. UniCredit's figure was estimated. CDP and BNL were not included
Source: Company data, Bank of Italy, Scope Ratings

3 https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.guideconsolidation2101~fb6f871dc2.en.pdf

More deals to come in 2021

So far, UniCredit and Banco BPM, the second and third largest domestic banking groups, have stayed out of the fray, though both were linked with a possible takeover of troubled MPS. MPS has been on the market for some time, as the economy and the finance ministry seeks an exit strategy. As agreed with the EU Commission, the Italian government must reprivatise MPS by the end of 2021.

With EUR 83bn in loans and EUR 77bn in deposits, MPS is seen as an opportunity for UniCredit to close the domestic gap with Intesa, or alternatively for Banco BPM to establish itself as a third large banking pole with a double-digit market share.

Banco BPM has been open to M&A for quite some time; in the past, it had been associated with UBI, but the two groups never went beyond preliminary talks.

Banco BPM is reportedly working on a combination with BPER. Together, the two would form the third Italian banking group, with a market share in customer loans of around 10% and a strong presence in the wealthiest Italian regions.

If any of the above deals go through, around 50% of the market will be concentrated in the hands of three banking groups, with State-controlled CDP accounting for around 15%. The two French subsidiaries, BNL and Credit Agricole Italy, together with the two cooperative groups, Iccrea and Cassa Centrale, will account for another 15% of the market. The remainder will remain split among smaller banks, operating mostly on a regional or sub-regional scale.

Political risk unlikely to add to investor concerns in the near term

This started with a new political crisis triggered by Italia Viva, a small centre-left party led by former prime minister Matteo Renzi, who pulled support from the Conte government on 13 January. To avoid holding snap elections in the middle of a health crisis, the president recruited former ECB president Mario Draghi to form a government (A Draghi government would have longer-term implications not only for Italy but Europe at large). Mr. Draghi was sworn in as prime minster on 13 February and his government won a confidence vote by both arms of parliament the following week, with a broad majority.

Draghi’s cabinet includes politicians from major parties and a number of highly regarded experts. Draghi’s primary focus is on managing the health and economic crises and using EU funds to reignite growth. Whether he can push through significant structural reforms remains to be seen, however, given the heterogeneity of his government.

The new political crisis did not stress financial markets

Political crises are hardly a novelty in Italy: the country has had 66 governments in the 74 years since 1946. Remarkably, this time around the crisis was reflected in hardly any financial market volatility. BTP investors watched the unfolding events with relative calm, especially after Draghi’s name started to circulate as potential PM. BTP/Bund spreads remained close to historical lows.

This reflects confidence in the stabilising role of the ECB and the positive stance of the different parties towards the EU. Near term, these factors outweigh fears over budgetary confrontations. Political risk seems unlikely to represent a major threat to Italian bank credit. The next elections are scheduled for 2023, assuming the Draghi government can maintain support among MPs.

Political instability will remain a potential risk factor for Italian banks in the medium term, however, as the economic consequences of the Covid-19 crisis could re-inflame anti-establishment sentiment among voters. Banks’ exposure to sovereign debt remains significant – a factor that continues to generate unease among credit investors.

In this context, TLTRO III revamped Italian bonds as low hanging fruit for carry trades, fostering a short-lived increase in sovereign exposure by last summer. As of YE 2020, Italian banks' exposure to BTPs was still high, especially among mid-sized groups, but roughly in line with 2019 levels (Figure 11). This is not a concern as long as market volatility remains low and is repressed by central bank asset purchases. But things could change when monetary policy normalises and especially if the political tide turns in favour of Eurosceptic forces.

In case of spiking BTPs yields, capital would be marginally hit

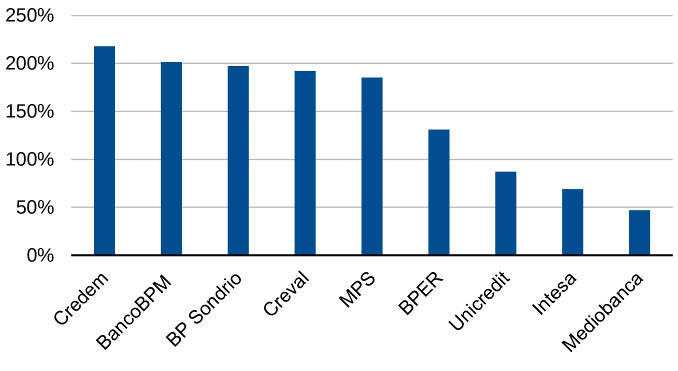
If BTP spreads increase, banks' cost of funding would likely increase due to higher country-risk premiums and higher valuation haircuts applied to BTPs posted as collateral in the repo market.

With respect to capital, the effects could be milder than in the past: since 2018, Italian banks have drastically reduced the proportion of BTPs marked to market, shielding their regulatory capital from spikes in bond yields.

Besides this direct exposure through government bonds, Italian banks have granted over EUR 150bn in loans to corporates and SMEs with significant State guarantees since April 2020, further tightening the credit links with the domestic sovereign (Figure 12). Among our sample of Italian banks, we calculate that on average, State-guaranteed loans accounted for around 7% of their total customer loan book as of YE 2020.

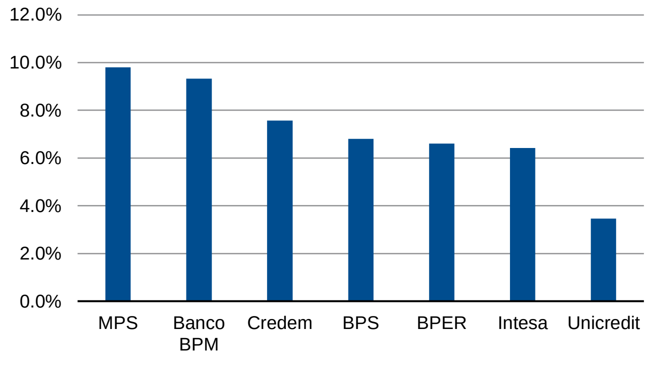
As of February 2021, Scope rates the Italian Republic BBB+ with a negative outlook. As per our methodology, our bank ratings are not mechanistically correlated to our sovereign ratings but reflect our assessment of each individual bank's exposure to sovereign risk. Several of our bank ratings, including in Italy, are indeed higher than Scope's ratings on the home sovereigns.

Figure 11: Italian banks – Exposure to sovereign debt as % Cet1 capital, YE 2020



Source: Company data, Scope Ratings
Note: UniCredit as of Q3 2020

Figure 12: Granted Italian state-guaranteed loans as % of total loan book as YE 2020



Source: Company data, Scope Ratings
Note: Intesa' s figure includes a small portion of guaranteed loans granted in CEE.

Italian banks resilient in 2020 but not out of the woods

Scope Ratings GmbH

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main
Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris
23 Boulevard des Capucines
F-75002 Paris

Phone +33 1 8288 5557

Oslo
Karenslyst allé 53
N-0279 Oslo

Phone +47 21 62 31 42

Madrid
Edificio Torre Europa
Paseo de la Castellana 95
E-28046 Madrid

Phone +34 914 186 973

Milan
Via Nino Bixio, 31
20129 Milano MI

Phone +39 02 30315 814

Scope Ratings UK Limited

111 Buckingham Palace Road
London SW1W 0SR

Phone +44 (0)20 7340 6347

info@scoperatings.com
www.scoperatings.com

Disclaimer