Italian banks: significant room to optimise capital structures

Smaller Italian banks have not optimised their capital structures. Eight out of 10 banks sampled had room to do so at the end of 2020 through issuance of capital securities. The acceleration in the pace of balance sheet de-risking at medium-sized banks in 2019 and 2020, alongside the compression of yields in credit markets, may make these deals more attractive to Italian banks going forward.

The significant improvement in banks' capital positions has mainly been driven by profit retention and lower RWAs. Combined with a softening of capital requirements in 2020, Italian banks on average exhibit comfortable buffers to their capital requirements. Buffers are biggest when calculated against the CET1 requirement but decline markedly when calculated on a total capital basis, reflecting the lack of capital securities in banks' capital stacks.

Regulatory changes in 2020, including the possibility to use Additional Tier 1 (AT1) and Tier 2 capital to meet Pillar Two requirements, have created additional room to issue capital securities with regulatory value, on top of allowances under Pillar 1.

In our view, the one-dimensional approach to regulatory capital that focuses solely on CET 1 buffers is sub-optimal as it leads banks to over-utilise common equity, the most expensive form of capital. In a perfect Modigliani-Miller world, in which the capital structure of a firm does not affect its value, this would by definition not matter. But in the highly regulated environment of European banking, we believe it does.

We believe AT1 issuance would be credit positive under most circumstances as it would reinforce capital stacks and boost subordinated MREL stacks. And, given remaining uncertainty around asset-quality trends coming out of the pandemic crisis, it would reassure creditors and supervisors about banks' ability to absorb losses.

For banks not yet taking full advantage of the ability to partially meet capital requirements (including P2R) with capital securities, such issuance would increase headroom to minimum capital requirements. Another possibility would be for banks to use part of the proceeds to increase distributions, substituting CET1 in the current capital stacks. Shareholders would likely welcome such substitution as they would benefit from increased dividends and from higher profitability on the remaining common equity base. But the credit implications would be mixed.

Substituting CET1 with lower quality capital (AT1 and Tier 2) would be marginally credit-negative, although headroom to capital requirements would remain significant for the most institutions and unlikely to turn into a credit concern. With banks trading well below book value, and the dominant view that European banking is a value-destroying business, better sentiment around equity valuation may well offset the lower quality of capital.

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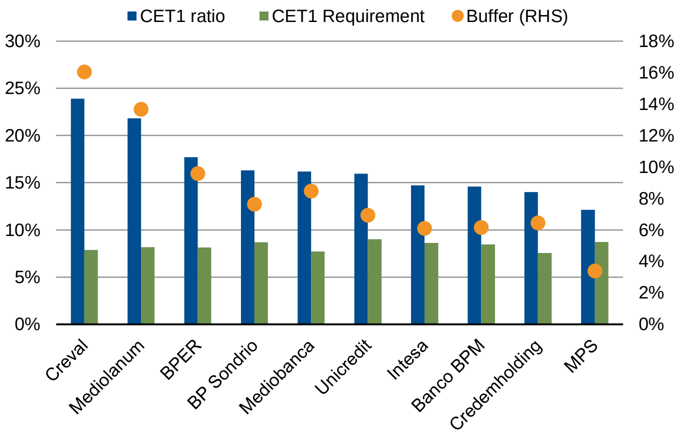
Significant buffers to requirements driven by excess CET1

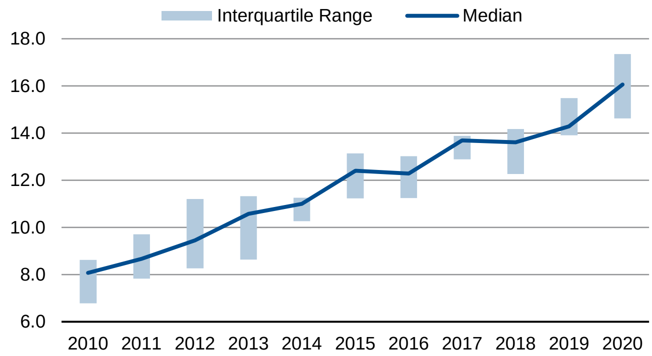
At the end of 2020, Italian banks, on average, exhibited very healthy buffers to their capital requirements. For a sample of 10 banks studied by Scope[1], the average buffer to CET1 requirements stood at 8.4% at the end of 2020. Only one bank out of 10 had a CET1 buffer of less than 500bp (Figure 1).

Figure 1: CET1 ratios vs CET1 requirements, YE 2020



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

Figure 2: Italian banks* - CET1 ratio, historical



Source: SNL, Scope Ratings
*Sample of 10 banks studied

The buffer to CET1 requirements increased from the previous year, mainly due to:

1. Earnings generation and retention, despite the difficult macro environment. The ECB dividend ban was a key driver of high organic generation.
2. Lower risk-weighted assets, which benefited from the low risk-weights of loans under public guarantee schemes as well as some other regulatory changes such as the revision of the SME supporting factor
3. A decline in CET1 requirements, due to the early application of CRD5 art.104, which allows banks to meet their Pillar 2 requirement with a mix of common equity, AT1, and Tier 2 capital.

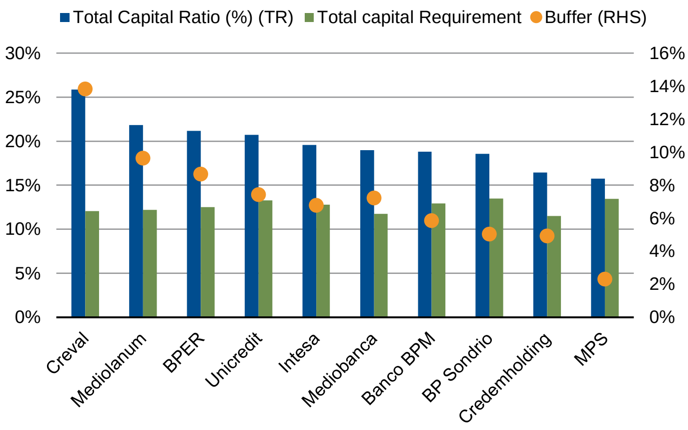
Buffers to requirements decline on a T1 and total capital basis

While reassured by the comfortable CET1 excess, we note that banks' buffers are noticeably lower on a total capital basis. For our sample, the average buffer to the total capital requirement stood at 7.2% at the end of 2020. Two banks out of 10 had a total capital buffer of less than 500bp (Figure 3).

Several issuers have not yet filled their AT1 and Tier 2 buckets, which weighs on minimum buffer calculations. We note that Italian banks have issued remarkably low volumes of AT1, hence their CET1 ratios and Tier 1 ratios are often very close (Figure 4).

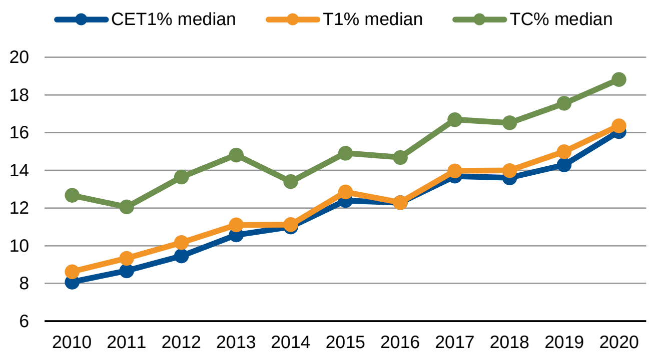
[1] The sample includes: UniCredit, Intesa, Banco BPM, MPS, BPER, Mediobanca, Credem, BP Sondrio, Credemholding (Credem's parent company and key supervisory entity), and Mediolanum.

Figure 3: Total capital ratios vs total capital requirements, YE 2020



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

Figure 4: Italian banks* -Median CET1, T1, and T2 ratios, historical



Source: SNL, Scope Ratings
*Sample of 10 banks studied

Given the lack of issued AT1s, we believe that the solvency requirement at the Tier 1 level is most often the binding constraint for Italian banks.

Not every bank fully discloses its T1 requirements, but we can estimate the size of the regulatory AT1 and T2 buckets based on current regulations and known P2R buffers.

Credit institutions are subject to a minimum requirement of 8%, of which 4.5% to be met with CET1 capital and 6% to be met with Tier 1 instruments.

While banks are obviously free to fulfil the requirement with higher quality forms of capital, they can at least issue AT1 debt for up to 1.5% of their RWAs and T2 debt for up to 2% of their RWAs and have them counted as capital. Following the supervisory decision to allow the early application of art 104 of CRD5, banks can also meet part of their P2R with capital securities (25% with Tier 2 instruments and 18.75% with AT1 instruments).

In the following table, based on disclosure by the banks, we estimate the requirements for the three levels of capital, assuming that the bank fully optimises its capital structure. Our calculations differ from the banks' own estimates as some of them include their AT1 shortfalls (or at least the P2R portion of it) in the CET1 requirement.

Figure 5: Italian banks – Breakdown of capital requirements (assuming full capital stack optimisation) as of YE 2020

Breakdown of requirements	Unicredit	Intesa	Banco BPM	MPS	BPER	Mediobanca	BP Sondrio	Credemholding	Creval	Mediolanum
Minimum CET1 Requirement	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%
Minimum AT1 Requirement	1.5%	1.5%	1.5%	1.5%	1.5%	1.5%	1.5%	1.5%	1.5%	1.5%
Minimum T2 Requirement	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%
Pillar 1 requirement	**8.0%**	**8.0%**	**8.0%**	**8.0%**	**8.0%**	**8.0%**	**8.0%**	**8.0%**	**8.0%**	**8.0%**
Pillar 2R (CET1 portion)	0.98%	0.84%	1.27%	1.55%	1.13%	0.70%	1.69%	0.56%	0.87%	0.68%
Pillar 2R (AT1 portion)	0.33%	0.28%	0.42%	0.52%	0.38%	0.23%	0.56%	0.19%	0.29%	0.22%
Pillar 2R (T2 portion)	0.44%	0.38%	0.56%	0.69%	0.50%	0.31%	0.75%	0.25%	0.39%	0.30%
Pillar 2 requirement	**1.75%**	**1.50%**	**2.25%**	**2.75%**	**2.00%**	**1.25%**	**3.00%**	**1.00%**	**1.55%**	**1.20%**
Capital conservation buffer	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%
Countercyclical buffer	0.04%	0.04%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	NA
Systemic buffer	1.00%	0.75%	0.19%	0.19%	0.00%	0.00%	0.00%	0.00%	0.00%	NA
Buffer requirements	**3.54%**	**3.29%**	**2.69%**	**2.69%**	**2.50%**	**2.50%**	**2.50%**	**2.50%**	**2.50%**	**2.50%**
Total AT1 bucket	1.83%	1.78%	1.92%	2.02%	1.88%	1.73%	2.06%	1.69%	1.8%	1.72%
Total T2 bucket	2.44%	2.38%	2.56%	2.69%	2.50%	2.31%	2.75%	2.25%	2.4%	2.30%
Total capital securities bucket	**4.27%**	**4.16%**	**4.48%**	**4.70%**	**4.38%**	**4.05%**	**4.81%**	**3.94%**	**4.2%**	**4.02%**

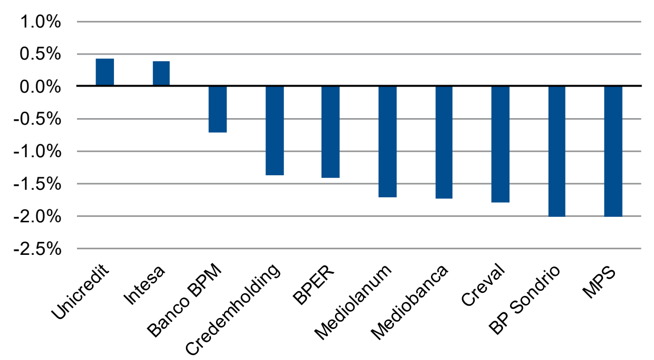
Source: Company data, Scope Ratings.

As shown, banks can fulfil a significant portion of their total requirements with capital securities, ranging from 3.94% at Credemholding (Credem's parent company and key supervised entity) to 4.81%% at Banca Popolare di Sondrio. However, only Intesa and UniCredit make full use of this. All other banks in our sample have significant room to optimise their capital structures.

Material room to optimise capital structure

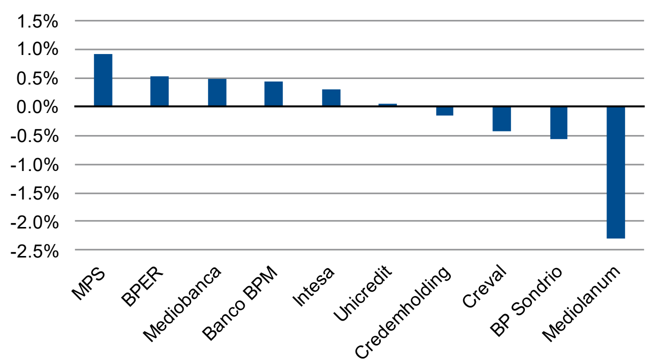
Some second-tier Italian banks have not issued AT1s at all. Others have only partially filled the AT1 bucket. For banks with weaker credit profiles, the absence from this segment of the capital markets may reflect the inability to attract demand, given the deep subordination and higher coupon risk these securities carry structurally. This is especially true for banks with insufficient distributable items, due to past losses. In other cases, bank management may also have judged the cost of issuing them as simply too high. However, we believe that the recent acceleration in the pace of balance sheet clean-up at smaller banks combined with the generalised yield compression in European fixed income markets may make AT1 deals more attractive.

Figure 6: AT1 surplus/shortfall (% or RWAs)



Source: SNL, Scope Ratings estimates
Based on December 2020 data

Figure 7: T2 surplus/shortfall (% or RWAs)



Source: SNL, Scope Ratings estimates
Based on December 2020 data

Comparing the current capital structure of the banks with our estimates of fully optimised requirements, we found significant room to issue AT1 and T2 securities at eight out of 10 banks in our sample.

Issuance of AT1s and T2 would further enhance banks' headroom to their capital requirements, which would be credit-positive. Alternatively, issuing AT1 and T2 bonds up to the regulatory recognition limit could allow for substitution of more expensive CET1, with positive implications for shareholders. We identified eight banks with an AT1 shortfall at the end of 2020 and calculate AT1 issuance could reach EUR 3.7bn. Four banks would also have room for T2 issuance, for up to EUR 380m.

Figure 8: Estimate of capital securities potential issuance

	Unicredit	Intesa	Banco BPM	MPS	BPER	Mediobanca	BP Sondrio	Credemholding	Creval	Mediolanum
AT1 surplus / shortfall (EURbn)	1.40	1.32	-0.47	-1.01	-0.48	-0.84	-0.37	-0.23	-0.15	-0.16
T2 surplus / shortfall (EUR bn)	0.20	1.06	0.29	0.47	0.18	0.24	-0.10	-0.02	-0.03	-0.22
Potential issuance (EURbn)*	**NM**	**NM**	**0.47**	**1.01**	**0.48**	**0.84**	**0.47**	**0.25**	**0.18**	**0.38**

* Estimate of issuance of capital securities that could be used to meet capital requirements

Source: Company data, SNL, Scope Ratings.

SCOPE

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