Italian banks' asset quality: what's in the plans?

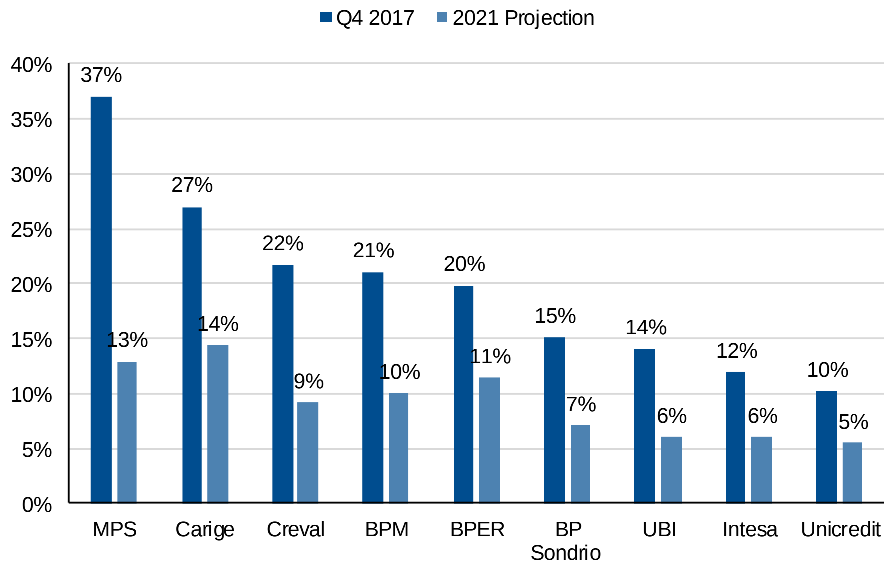
A heightened focus from supervisors has put the balance sheet clean-up plans of the major Italian banks firmly under the spotlight. Scope concludes that Intesa and Unicredit (both rated A, with stable outlook) are best positioned, among the larger groups, to achieve clean balance sheets by 2021.

Non-performing exposures (NPEs) are one key legacy from the financial and euro sovereign crises, and a factor negatively weighing on Italian bank credit in general. Over the past few years, however, trends have changed and the underlying drivers of asset quality have been improving for some time. Since their peak in 2015, Italian NPE have declined by 20%. This decline accelerated in 2017, as higher coverage and pressure from supervisors pushed banks towards more NPE sales, while a better macro backdrop limited the inflow of new NPEs.

Scope's ratings on Intesa (A, Stable) and Unicredit (A, Stable) acknowledge the better environment as well as improvements at the two banks in recent years. Moreover, the strategic plans envisage material further improvements on the asset-quality front. By 2021, Scope expects Intesa and Unicredit to achieve gross NPE ratios of 5-6% and with high coverage; levels that should make investors feel reassured. A planned decline in NPE ratios is the common denominator in the business plans Italian banks have presented in the past couple of years. Several banks (Unicredit, UBI, BPM among others) have upgraded their original targets, with NPE sales now commonly accepted as the fastest way to bring down headline ratios. Based on publicly-announced targets, we estimate that most groups should be able to bring their gross NPE ratios down to the mid to high single digit range. A handful of banks, however, will still be looking at double-digit gross NPE ratios, even assuming a successful execution of their current strategic plans.

We assume that this latter group of banks will continue to be subject to stringent supervisory focus and may have to review targets again. However, given the enhanced coverage levels, the recent experience of Creval and Carige raising equity, and the growth in demand for NPEs, we do not expect asset-quality headlines to affect the two large banking groups rated by Scope.

Figure 1: Italian banks' gross NPE ratios in 2017 and Scope's projection for 2021



Source: Banks, Scope Ratings estimates

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Asset quality: no longer a systemic risk

Scope has pointed out in the past that asset quality no longer features at the top of its list of systemic risks for Italian banks; even more so for European banks. Following the improvement of macro conditions in Italy, Scope started to observe a reversal of NPE formation trends with the first quarterly declines in NPE ratios already occurring in 2015. We continue to see the current levels of NPEs in Italy and Europe as a legacy of the crisis and a problem banking sectors are dealing with. The increased supervisory pressure coming from the ECB/SSM since 2016 has accelerated this process. Some Italian banks were forced to announce sweeping changes to their NPE strategies, often accompanied by capital increases. This has been the case for Unicredit, which today can boast one of the cleanest balance sheets in Italy, following a large sale of bad loans in the summer of 2017. However, not all banks were able to shoulder the cost of the new provisions needed to offload NPEs. Monte dei Paschi di Siena, for example, was forced to apply for a precautionary recapitalisation, and is today majority-owned by the Italian state. Veneto Banca and Banca Popolare di Vicenza were pushed into liquidation in June 2017, with part of their assets transferred to Intesa Sanpaolo. The asset quality of these banks was notably worse than the sector averages, and were somewhat reflective of idiosyncratic weaknesses, often governance-related, as shown in figure 2. These lenders had gross NPE ratios in excess of 30%, and below average coverage.

Figure 2: Gross NPE ratio and coverage as of June 2016

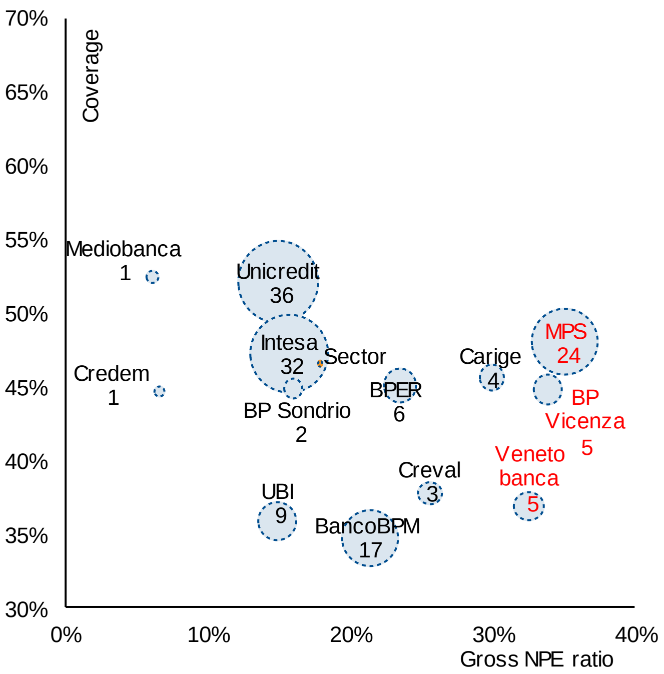
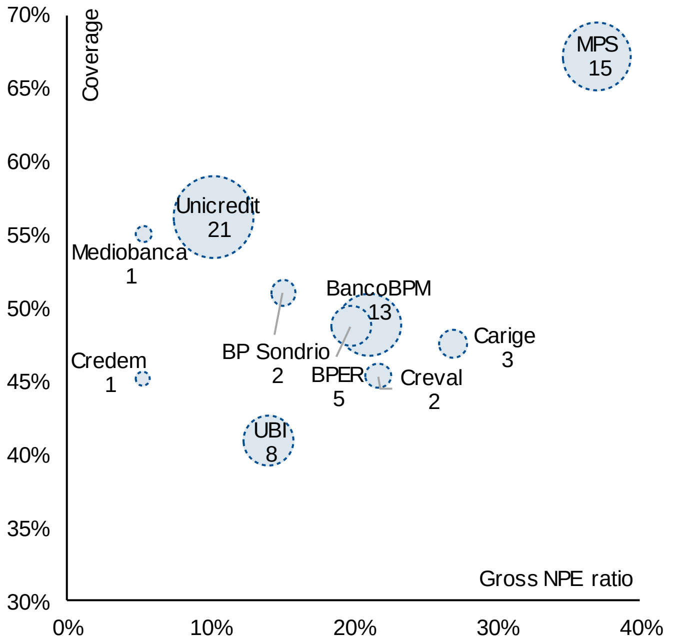


Figure 3: Gross NPE ratio and coverage as of December 2017



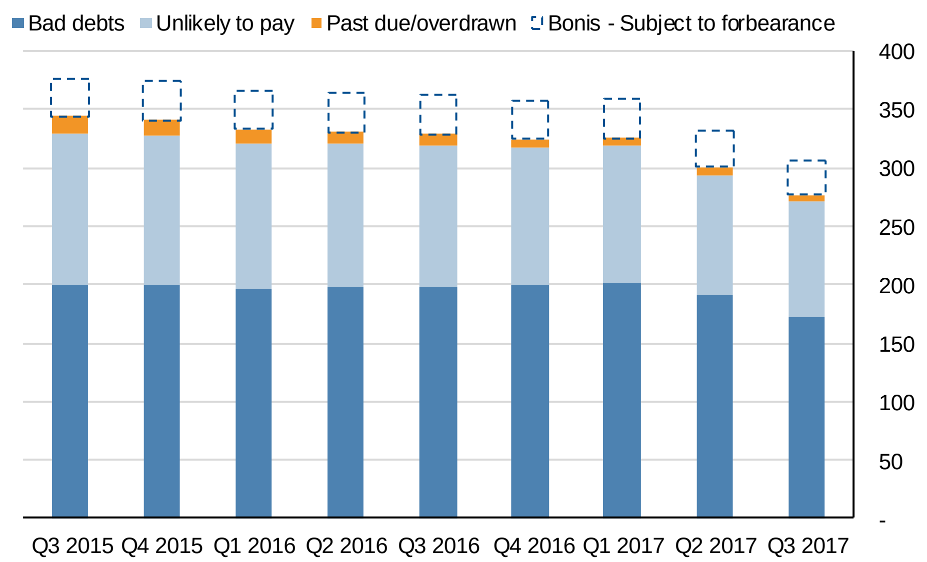
Source: Banks, Scope Ratings
Note: Bubble size=Net NPEs (EUR bn)

Even more telling, their asset quality metrics had continued to worsen long after the country had exited recession in 2014, at a time when a trend reversal was already evident in the ratios of most other Italian banks, including all the major groups.

Fast forward to 2018 (Figure 3), the picture has improved materially. With the weakest banks liquidated or in the hands of the state, sources of headline risk are much more limited. Every other bank of relevant size has increased provisions, and the vast majority have seen a decline in their gross and net NPE ratios. This evolution is also evident in industry data: gross NPEs have been declining since 2015, and the decline accelerated over the course of 2017, largely thanks to an active secondary market for bad loans.

From a peak of EUR 344bn in Q3 2015, gross NPEs have declined by 20%, and stood at EUR 274bn in Q3 2017. Four fifths of the decline are accounted for by the most recent four quarters (-16% YoY).

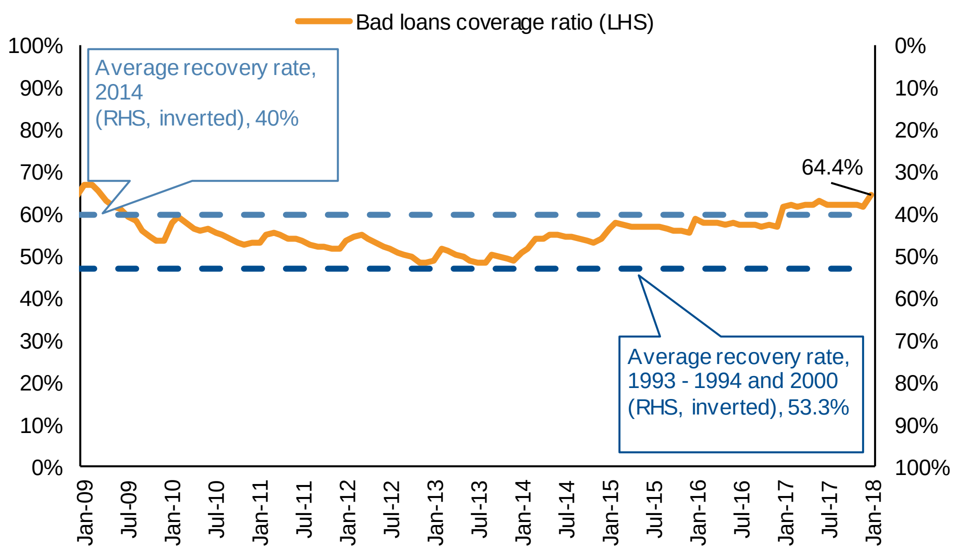
Figure 4: The NPE decline accelerated in 2017



Source: Bank of Italy, Scope Ratings

Based on industry data, and on Bank of Italy's surveys of recovery rates in the past three recessions, Scope considers that bad loans now are adequately provisioned for. The average recovery rate in the 93/94 recession and in the 2000 recession was over 53%. This went down to 40% in 2014, according to Bank of Italy surveys. The current coverage ratio (64.4%) looks adequate to cover expected losses. Barring a relapse of the economic situation, we think that provisions accruals going forward should be more contained than in the recent past. Scope expects asset quality metrics to continue to improve, supported by the favorable macro conditions.

Figure 5: Bad loans coverage is adequate



Source: Bank of Italy, Scope Ratings

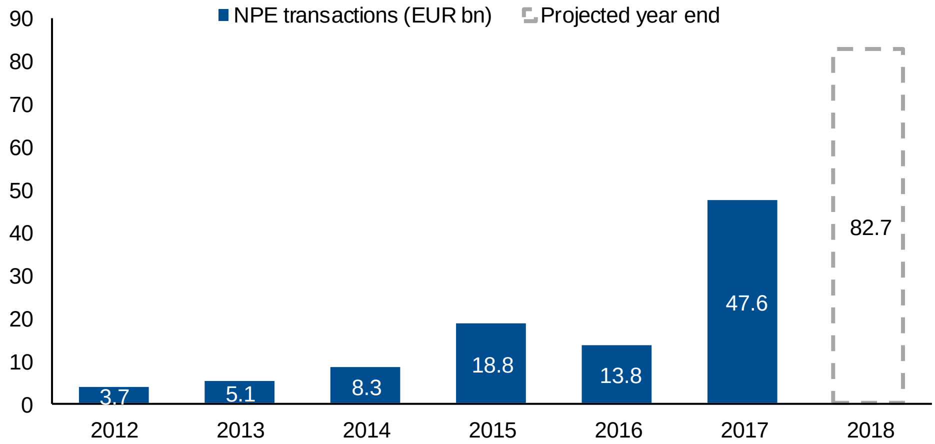
What are the main strategies banks are adopting for tackling their NPE legacy?

Strategies for dealing with NPEs have been quite varied in the past few years. Some groups favoured internal workouts and invested early on in strengthening their recovery platform (e.g. Intesa). Others opted for externalising NPE management, partnering with third-party servicers to maximise recoveries but retaining ultimate ownership of their NPEs (e.g. Creval's agreement with Cerved). Other groups opted for outright portfolio sales to specialised investors (eg BPER's sale of EUR450m in bad loans to Algebris in 2016). Others still sold their internal NPE management units alongside portfolios of NPLs and then contracted out servicing of their retained NPEs (e.g. Unicredit's sale of UCCMB to Fortress and Prelios in 2015). Bad loans securitisations and the introduction of State guarantees (GACS) helped find new investors for a relatively illiquid asset class (e.g. Banca Popolare di Bari's GACS-assisted structured securitisation in 2016).

Banks have often used more than one of the above options. More recently, NPE strategies have been converging towards markets solutions, as a consensus seems to have emerged on best practices to deal with the stock of bad loans. The ECB's publication of guidance for dealing with NPEs played a part in this, as did the increasingly intrusive SSM supervision into banks' asset quality.

Italian banks have raised cash coverage of their NPEs and have increasingly turned to market solutions to reduce on-balance sheet NPEs. Figure 6 illustrates the growth in Italian NPE transactions. As a matter of fact, the recent business plans of most Italian banks include disposals of bad loans to comply with supervisory expectations and to reduce downside risk, at the same time acknowledging that this route may not necessarily maximise value for shareholders. From a credit perspective, however, Scope sees this as a positive development. We expect 2018 to turn out to be another record year for NPE sales, as several jumbo deals (MPS, Venetian banks) will combine with smaller transactions.

Figure 6:Italian NPE market to remain buoyant



Source: PWC, Banca IFIS, E&Y, Scope Ratings Estimates

Fast forward: how clean will Italian banks' balance sheets look in 2021?

Most banks have presented explicit reduction targets in their strategic plans. However, disclosures are heterogeneous and different banks have different time horizons. To facilitate comparisons, we have combined the public targets with our own assumptions and derived expected paths of NPE reduction through 2021.

The choice of 2021 is not random: we believe that current coverage levels are consistent with expected recovery rates. This means that while economic conditions remain supportive, we do not foresee material additional losses stemming from the current NPE books. However, should the macro backdrop deteriorate again, this could put downward pressure on collateral values, recovery rates and, through these, on solvency. We feel confident, however, that the business cycle will hold through 2018 and 2019. Scope’s current forecasts are for 1.1% GDP growth in 2019, 1% in 2020 and 0.9% in 2021. But as the forecasting horizon lengthens, we believe more prudence, even scepticism is justified. In other words, sooner or later another recession will strike. Even before that, rate increases could put pressure on weaker borrowers. If banks take too long to clean up their NPEs, they risk entering the next recession still burdened by the legacy of the old crisis.

In addition, 2020/2021 is the period when ECB TLTRO loans will expire, and Italian banks will likely have to look for alternative sources of finance, possibly also facing more difficulties placing bonds with their retail customers. They may have to resort increasingly to wholesale funding in the future, hence displaying a clean balance sheet will be important.

Our analysis of bank’s business plans show material variance in what banks are targeting and where they are likely to end up in 2021.

Figure 7: Business plan targets and projected 2021 NPE ratio and coverage

	Stated Target		Q4 2017	2021 Projection
MPS	Gross NPE ratio of 12.9% in 2021	Gross NPE Ratio (%)	37%	13%
		Coverage (%)	67%	56%
Carige	Gross NPE ratio of 16.4% in 2020; Coverage of 57.8%	Gross NPE Ratio (%)	27%	14%
		Coverage (%)	48%	58%
Creval	Gross NPE ratio of of 10.6% in 2018 and 9.6% in 2020; Coverage of 50.3% and 59.1% respectively	Gross NPE Ratio (%)	22%	9%
		Coverage (%)	45%	59%
BPM	Gross NPE ratio of 17.3% in 2019; Coverage of 43.6%	Gross NPE Ratio (%)	21%	10%
		Coverage (%)	49%	45%
BPER	Gross NPE ratio of 13.5% in 2019; Coverage of 55%	Gross NPE Ratio (%)	20%	11%
		Coverage (%)	49%	55%
BP Sondrio	NA	Gross NPE Ratio (%)	15%	7%
		Coverage (%)	51%	51%
UBI	Gross NPE ratio of 10% in 2019; Coverage of 49%	Gross NPE Ratio (%)	14%	6%
		Coverage (%)*	49%	49%
Intesa	Gross NPE ratio of 6% in 2021	Gross NPE Ratio (%)	12%	6%
		Coverage (%)	51%	54%
Unicredit	Gross NPE ratio of 7.8% in 2019 (revised down from 8.4%); Coverage of >56%	Gross NPE Ratio (%)	10%	5%
		Coverage (%)	56%	56%

Source: Banks, Scope Ratings estimates
*Coverage including writeoffs

By 2021, we expect Intesa and Unicredit to achieve gross NPE ratios in the mid-single digit range along with high coverage, levels which should make investors feel reassured. UBI’s target for an NPE ratio of less than 10% in 2019 points to a similar end-point, although the higher starting level of NPEs and the somewhat lower coverage levels leave some uncertainty around execution. We don’t believe Banca Popolare di Sondrio has published explicit NPE reduction targets but its metrics (15.1% NPE ratio in 2017, with 51% cash coverage) are reassuring and we believe the bank could also reduce its NPE ratio to single digit number by 2021.

On our estimates, Creval and BPM will be looking to a gross NPE ratio of around 10%, while MPS, Carige, and BPER are likely to still have NPE ratios in the low to mid-teens in 2021.

At the end of 2017, Mediobanca and Credem already had very reassuring asset quality metrics (gross NPE ratio of c.5%), so we consider these two banks to be out of the woods already.

Unicredit: FINO transaction jump-started the clean-up

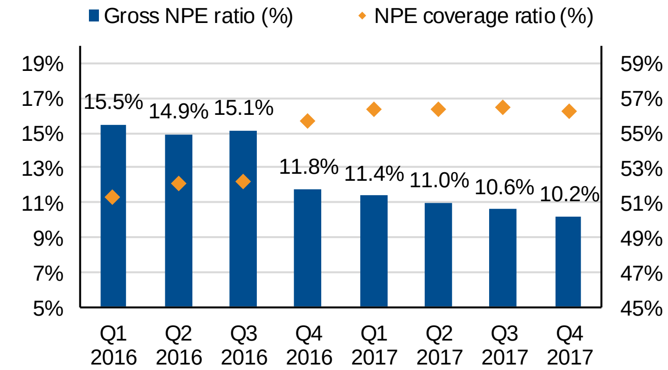
Under new management, Unicredit first announced its new strategic plan Transform 2019 in December 2016. The plan included ambitious cost restructuring targets, a sizeable capital increase (executed in 2017), and a thorough cleanup of the balance sheet.

Among other targets, Unicredit planned a material run-down of its non-core unit through 2019. This is the group's main repository for Italian non-performing assets. In Q4 2016, Unicredit booked significant extraordinary provisions, raising NPE coverage and paving the way for substantial portfolio sales. Sales include the FINO project, a EUR 17bn securitised sale undertaken in 2017.

Asset quality targets were revised in December 2017, with a further EUR 4bn reduction in gross NPEs announced and a gross NPE ratio foreseen at 7.8% for 2019 (the previous target was 8.4%).

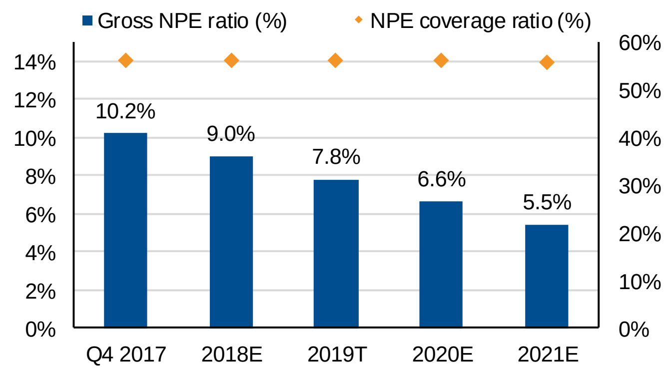
We estimate that by 2021 Unicredit's gross NPE ratio will stand at 5.5%, with the net NPE ratio just over 2%. This would be a level where asset quality would arguably no longer be a concern, although it may still be higher than international peers.

Figure 8: Unicredit's historical NPE and coverage ratio



Source: Unicredit, Scope Ratings
Note: pro-forma for the FINO deconsolidation from Q4 2016

Figure 9: Unicredit Q4 2017 NPEs and reduction targets



Source: Unicredit, Scope Ratings estimates
Note: T indicates a published target, while E signals Scope estimate

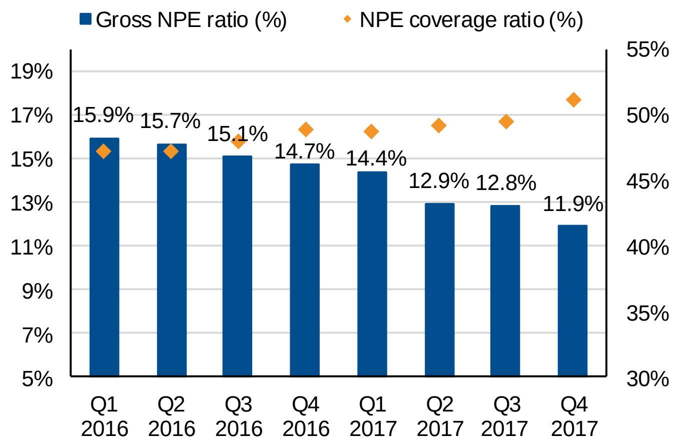
Intesa: new business plan targets accelerated balance sheet cleanup

Intesa's gross NPE ratio peaked in 2014 at around 17% and has since declined materially, standing at 11.9% at the end of 2017. The decline was largely organic, reflecting lower net inflows from performing loans into NPEs and growth in performing loans.

The acquisition of the good assets of the two Venetian banks helped increase the denominator of the ratio. Coverage stands at a reassuring 51%, or 57% including the impact of IFRS9 provisions.

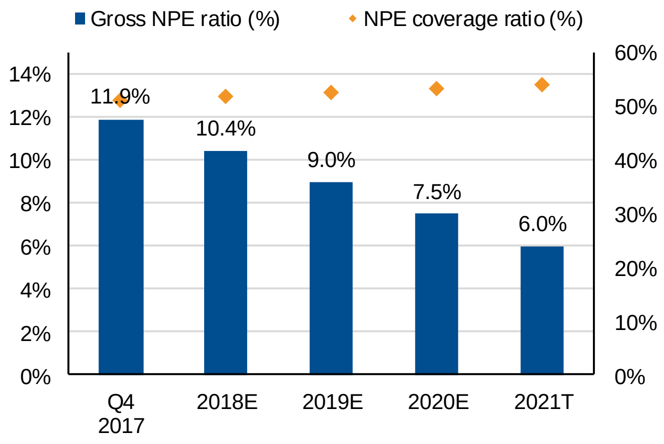
The new 2018-2021 business plan, presented in February 2018, envisages a further reduction in the NPE stock and a material de-risking of the balance sheet, supported by the more favourable macro environment. According to the plan, the gross NPE ratio in 2021 should reach 6%, while net NPE will be below 3%.

Figure 10: Intesa's historical NPE and coverage ratio



Source: Intesa, Scope Ratings

Figure 11: Intesa Q4 2017 NPEs and reduction targets



Source: Intesa, Scope Ratings

Compared to the past, Intesa seems more open to NPE portfolio sales, thanks also to higher coverage levels, which would make such sales possible without a negative impact on P&L and capital (and hence on dividend distributions).

Among the main initiatives highlighted in the plan to de-risk the balance sheet is the carve-out of Intesa's internal NPE servicer, which is the second-largest in the Italian market, and the potential search for an industrial partner to further improve servicing performance.

Intesa is also investing in the development of a new early-warning system for delinquencies in retail loans, named Pulse, and is generally moving towards a more proactive approach to managing credit quality, through the offer of rescheduling products for SMEs and scaling up the restructuring unit for mid-sized and large corporates.

Overall, in line with the organic evolution in recent years, Intesa's demonstrated ability to deliver in this area, and the improved macro backdrop in Italy, Scope believes that the targets are realistic, if not even conservative. Specifically. we believe that Intesa could achieve the 6% gross NPE target earlier than 2021, particularly if it started selling in the secondary market.

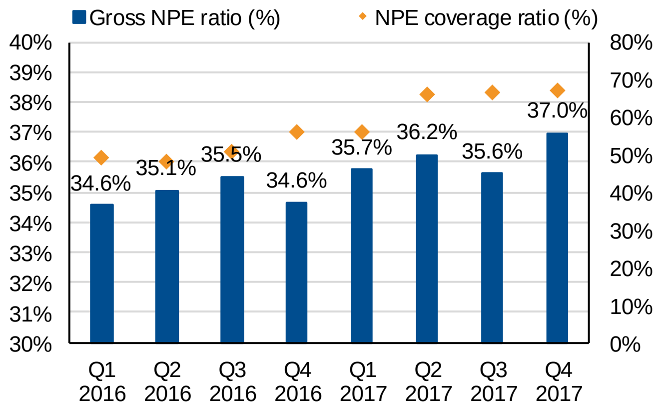
Scope's ratings remain well positioned

Scope's A issuer ratings for both groups acknowledge the more solid economic environment and the ongoing turnaround in asset quality, as well as improved operating efficiency. Intesa's ratings are supported by its strong, well tested business model and leadership position in Italy, with a material contribution from asset management, private banking and insurance. The solid performance in recent years in our view validates the solidity of the business model.

Unicredit's ratings reflect the deep restructuring under the current management team, with the ongoing de-risking and refocusing of the group, as well as a much-strengthened balance sheet since the EUR 13bn rights issue in 2017.

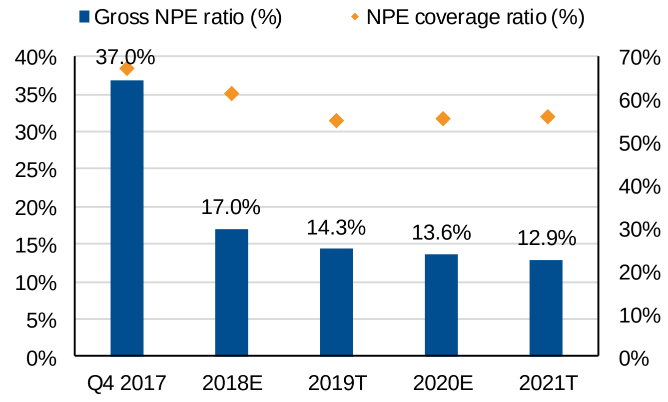
Appendix: recent asset quality metrics and business plan targets of main Italian banks

Figure 12: MPS's historical NPE and coverage ratio



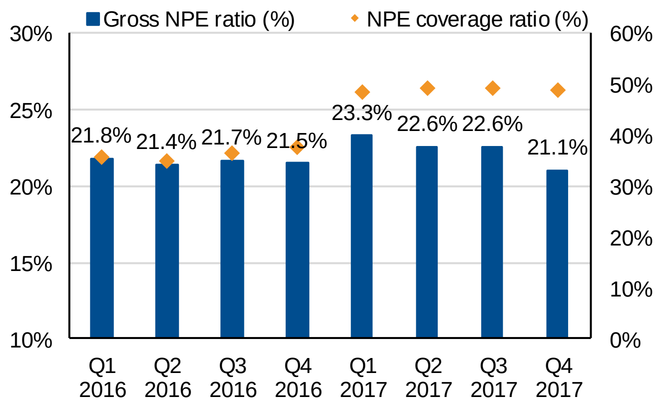
Source: MPS, Scope Ratings

Figure 13: MPS Q4 2017 NPEs and reduction targets



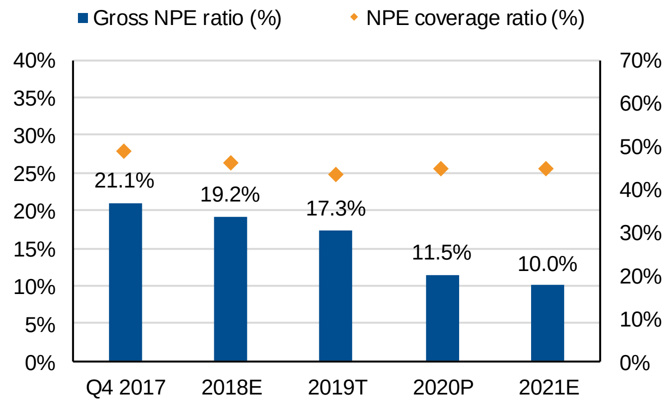
Source: MPS, Scope Ratings

Figure 14: Banco BPM's historical NPE and coverage ratio



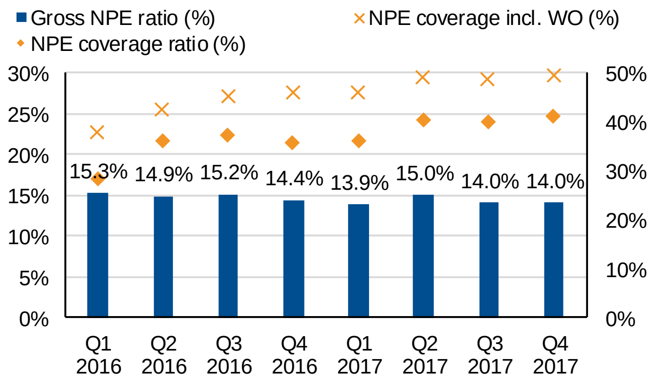
Source: Banco BPM, Scope Ratings

Figure 15: Banco BPM Q4 2017 NPEs and reduction targets



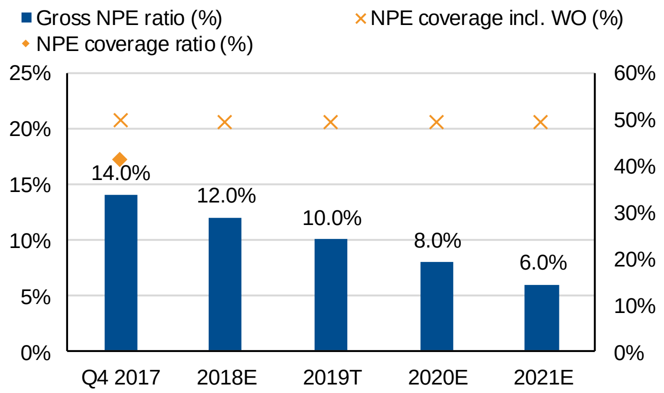
Source: Banco BPM, Scope Ratings

Figure 16: UBI's historical NPE and coverage ratio



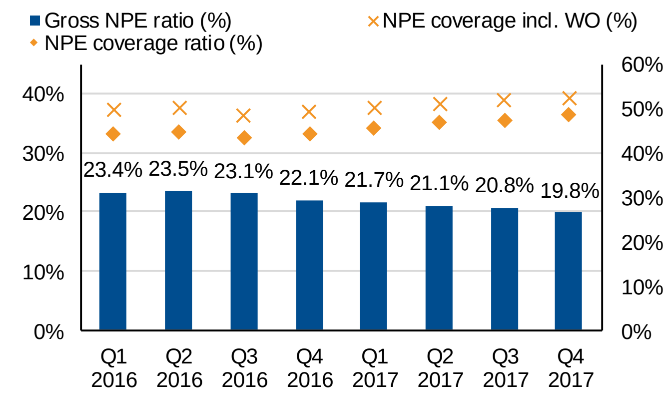
Source: UBI, Scope Ratings

Figure 17: UBI Q4 2017 NPEs and reduction targets



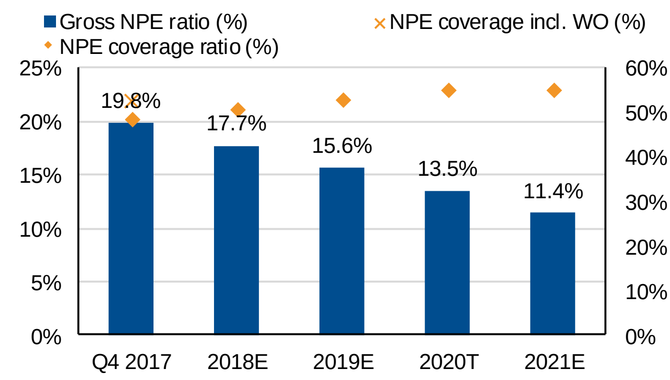
Source: UBI, Scope Ratings

Figure 18: BPER's historical NPE and coverage ratio



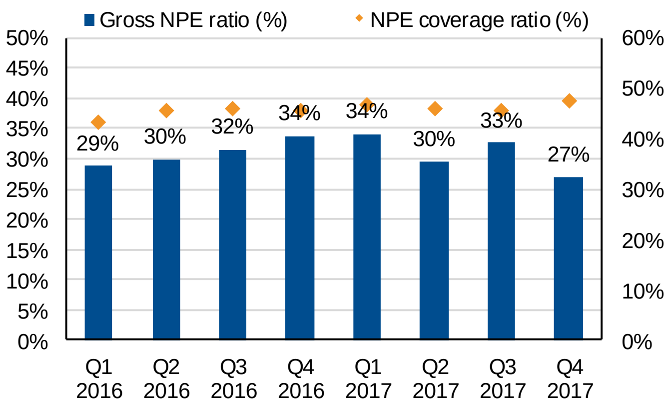
Source: BPER, Scope Ratings

Figure 19: BPER Q4 2017 NPEs and reduction targets



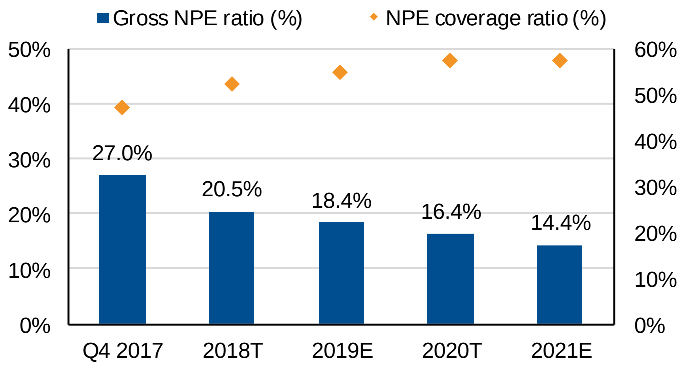
Source: BPER, Scope Ratings

Figure 20: Carige historical NPE and coverage ratio



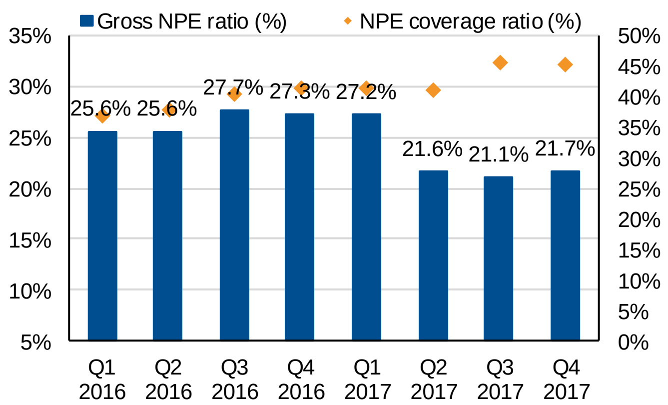
Source: Carige, Scope Ratings

Figure 21: Carige Q4 2017 NPEs and reduction targets



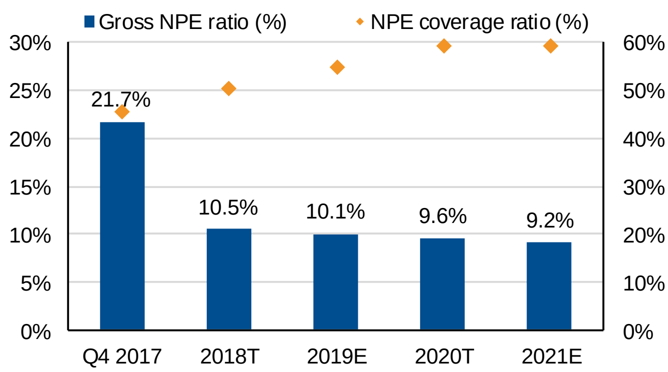
Source: Carige, Scope Ratings

Figure 22: Creval historical NPE and coverage ratio



Source: Creval, Scope Ratings
Note: The decline in Q2 2017 reflects mainly the sale of the Elrond portfolio

Figure 23: Creval Q4 2017 NPEs and reduction targets



Source: Creval, Scope Ratings

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