Italian banks: moratorium extension delays loss recognition, raising uncertainties

Payment holidays implemented at the beginning of the spring lockdown were essential to support borrowers' viability at a time when incomes collapsed. However, as some losses seem unavoidable, extending the schemes for too long may simply delay loss recognition and lower earnings and balance-sheet visibility in the short term.

Moratorium requests in Italy since March amount to EUR 301bn, 92% of which have been granted. Partly thanks to a pragmatic supervisory approach, most of these loans are currently classified as performing, although there was some migration from Stage 1 to Stage 2 in Q2 2020. Once moratoriums expire, we believe some borrowers will be unable to resume regular payments (so will move to Stage 3).

We have previously highlighted that we expect the credit cycle to remain relatively benign, with Italian cost of risk peaking between 100bp and 150bp i.e. lower than in the previous crisis. We expected specific provisions to start creeping in towards the end of 2020 after the expiry of legal moratoriums, initially set for September.

The recent extension to January 2021 has pushed back the day of reckoning. We believe that a gradual pick-up in specific provisions is still on the cards for H2, but that most banks' cost of risk will be at the lower end of that range. The relative stabilisation in macroeconomic forecasts will translate into lower macro-driven provisions in the second half of the year, coupled with only a modest rise in specific impairments. In other words, we now see a less turbulent end to this year but a worsened outlook for 2021 profitability.

We flag the lower visibility on loan quality. Our analysis of Q2 disclosures highlights significant differences in the classification of loans under moratorium, especially with respect to corporates. In some cases (e.g. MPS), up to 50% of business loans under moratorium have been classified as Stage 2, while other banks continue to report them as Stage 1, implying no significant increase in credit risk (SICR) of the loans.

From disclosures alone, it is tough for investors to gauge how much of these variations can be put down to differences in loan-book quality and how much is representative of a more cautious approach to loan classification and provisioning. For example, highly-rated exposures can benefit from more beneficial accounting treatment under IFRS 9 (low-risk exposure exemption), under which financial exposures that are determined to have low credit risk at the date of reporting are automatically deemed not to have suffered a significant increase in credit risk.

Until the moratoriums are resolved, it will be challenging to assess the real extent of losses, and while the postponement of the end-date of legal moratoriums (which primarily affects SME loans) could reassure investors in the short term, it also prolongs the period for which they are left in the dark about ultimate losses from the Covid-19 crisis.

Just like in Schrodinger's famous thought dilemma, external investors will have a hard time judging the extent of balance-sheet decay until loans exit moratoriums and an outcome is observed. The extension to the beginning of 2021 extends this uncertainty, which is negative from a credit standpoint.

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

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Scope Ratings GmbH

3rd Floor
111 Buckingham Palace Road
UK-London SW1W 0SR

Headquarters

Lennéstraße 5
10785 Berlin

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

info@scoperatings.com
www.scoperatings.com

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With the August extension, legal moratoriums only expire in January 2021

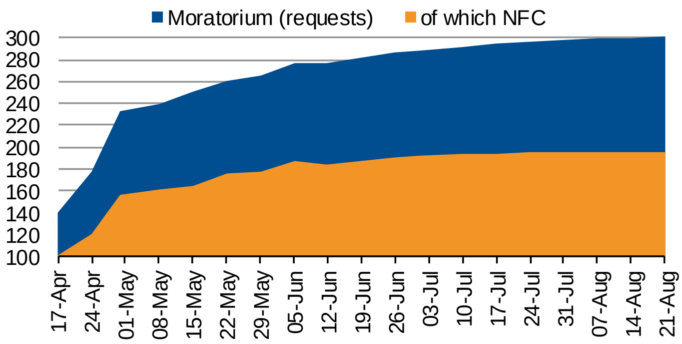
Widespread payment holidays, first introduced with the *Cura Italia* decree (D.L. 18/2020) in March, were originally planned to expire at the end of September. Under art. 56.2 of the decree, payment suspensions apply to a large portion of performing business loans for SMEs and micro businesses impacted by Covid-19. Eligibility was broad, encompassing the most common technical forms of business finance in Italy; including, among other things, mortgages, leasing contracts, bullet loans and credit lines. The main requirement for the request was a self-certified status of temporary liquidity shortage because of Covid-19. Non-performing loans were excluded.

Residential mortgage borrowers (employees and self-employed) in temporary financial difficulties could suspend mortgage payments for up to 18 months.

Financial intermediaries also promoted further programmes for customers not eligible for legal moratoriums, through the Italian Banking Association (ABI), the Consumer Finance Association (Assofin) and independently.

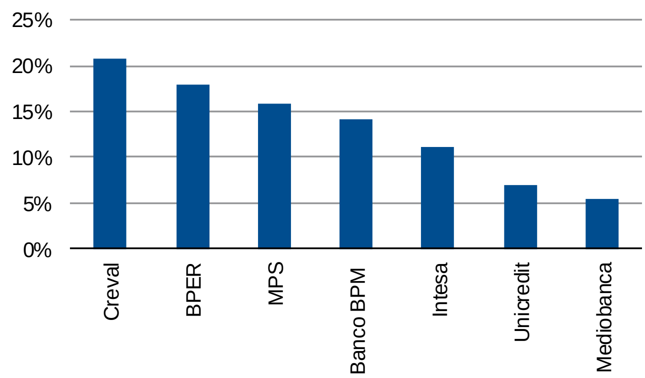
Many bank customers requested and were granted moratoriums, with requests exceeding EUR 200bn by the end of April. After a fast pick-up during lockdown, requests slowed and currently stand at roughly EUR 301bn. Of those, 92% were accepted.

Figure 1: Italian banking sector – cumulative moratorium requests as of 21 August



Source: Bank of Italy, ABI, Scope Ratings

Figure 2: Italian banks – Approved moratoriums as % of total book



Source: Banks, Scope Ratings.
Note: Banco BPM, Mediobanca's moratoriums as of 31 July, Intesa's as of 24 July. UniCredit's as of 3 July, BPER's, Creval's and MPS's as of 30 June

At this stage, it remains difficult to estimate how many of these loans will go back to be fully performing and when. Disclosure from banks on the performance of borrowers under moratoriums during the summer reporting season was mixed, but there are indications that not all is well among borrowers. Mediobanca, for example, reported 'just' EUR 2.6bn of loans under moratorium (5% of total group loans). But incidence is higher in the leasing segment (35%) and consumer finance (9%). The bank also reported that 85% of consumers under moratorium had already resumed regular payments.

While reassuring on the one hand, that data point raises legitimate questions about the remaining 15%. While this may be less of a credit issue for Mediobanca, given the lower exposure to credit risk of its business model and solid profitability buffers, it is a relevant question for other Italian banks, some of which have reported that over 20% of their loan book was under moratorium (Figure 2).

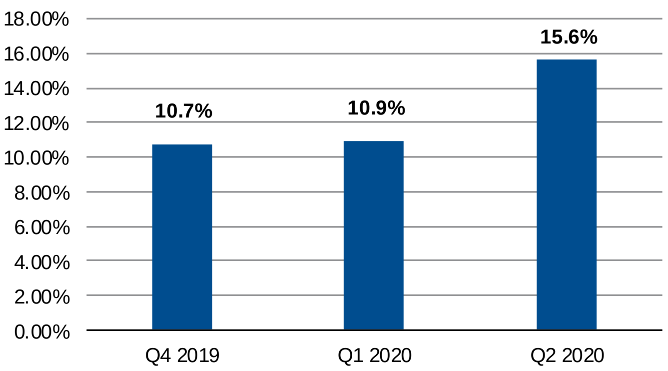
For this reason, we had expected a moderate pick-up in loan non-performance (with the associated loan-loss provisioning needs) towards the end of 2020 and extending into 2021. The so called "August decree" (D.L. 104/2020), further extends legal moratoriums until the end of January, pushing into next year the need for specific provisions.

It is important to note that for loans subject to moratorium, lenders can apply to receive a public guarantee covering 33% of delayed payments (instalments or principal repayments) or increased drawings of committed lines.

Moratoriums push Stage 2 ratio higher

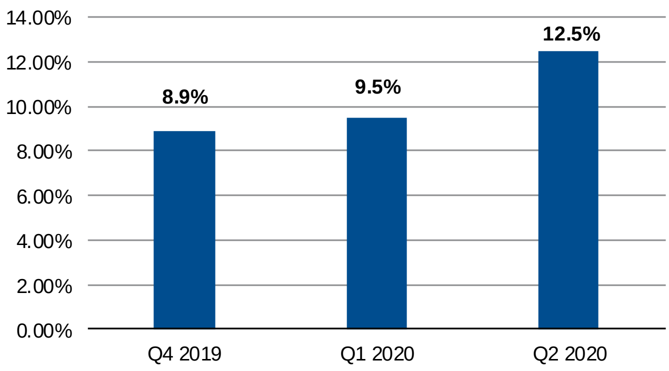
While headline NPE ratios continued to trend lower for most banks, there was a material increase in Stage 2 loans for several banks. Figures 3 and 4 show this for the two largest players in Italy: The Stage 2 ratio increased by three percentage points for UniCredit and five percentage points for Intesa.

Figure 3: Intesa Sanpaolo – Stage 2 Ratio evolution



Source: Company data, Scope Ratings

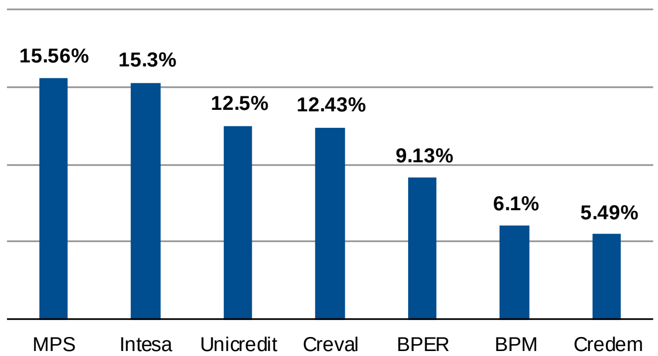
Figure 4: UniCredit – Stage 2 Ratio evolution



Source: Company data, Scope Ratings

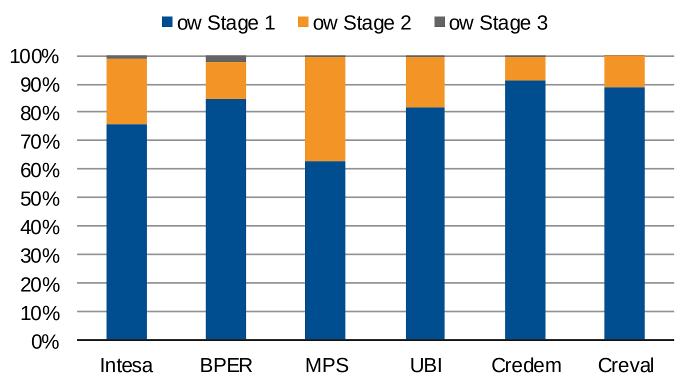
Other Italian banks showed more limited increases. Credem, Banco BPM and Creval, for example, showed increases in the Stage 2 ratio of less than one percentage point. While European bank supervisors were clear that moratoriums should not in themselves be considered as signs of worsening credit quality and therefore not automatically trigger a migration from one stage to another (with the associated move to lifetime expected losses and front-loading of provisioning), we note that a non-negligible portion of loans under moratorium were classified as Stage 2.

Figure 5: Italian banks: Stage 2 Ratio comparison as of June 2020



Source: Company data, Scope Ratings

Figure 6: Total loans under moratorium: staging classification as of June 2020.



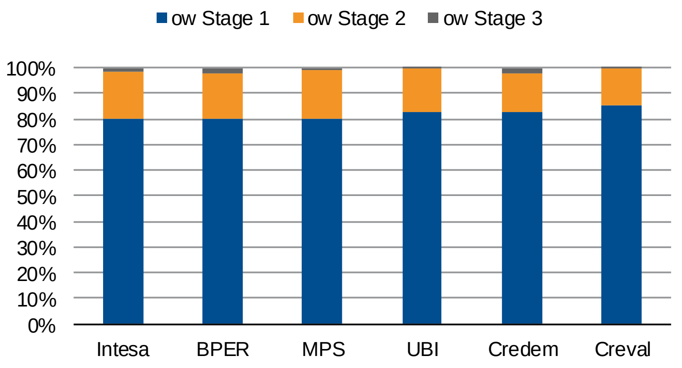
Source: Banks, Scope Ratings.

The extent of Stage 2 classification varies among banks and portfolios. In household loans, the proportion of loans classified as Stage 2 was typically lower than 20%, with limited variability among banks. For business loans, we note a broader range, representing up to 50% of loans under moratorium at MPS and only 6% at Credem.

These variations can reflect two elements: on the one hand, a difference in the credit quality of the underlying customer franchises. On the other hand, they could reflect faster recognition by banks of heightened credit risk among certain customers .

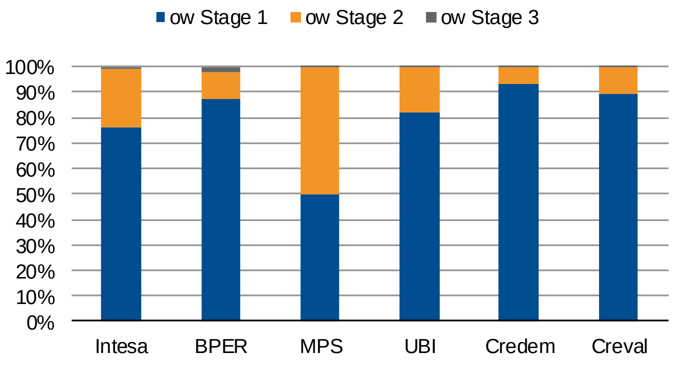
Under IFRS 9, reclassification from Stage 1 to Stage 2 results from a significant increase in credit risk (SICR) since initial recognition. In practice, banks can use a number of criteria to test for SICR, ranging from statistical (e.g. increases in probability of default or rating-class migrations) to analytical (e.g. negative EBITDA or the existence of forbearance measures). Highly-rated exposures can benefit from the so-called low credit risk exemption, under which banks can disregard a deterioration in credit risk as long as the credit is considered "low risk" at the time of the assessment, effectively preventing credit deterioration within the low risk segments from resulting in heightened provisioning needs.

Figure 7: Loans to households under moratorium: staging classification as of June 2020.



Source: Company data, Scope Ratings

Figure 8: Loans to non-financial corporations under moratorium: staging classification as of June 2020.



Source: Banks, Scope Ratings.

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

London

3rd Floor
111 Buckingham Palace Road
London SW1W 0SR

Madrid

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

Phone +34 914 186 973

Milan

Regus Porta Venezia
Via Nino Bixio, 31
20129 Milano MI

Phone +39 02 30315 814

Oslo

Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com

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Scope Ratings GmbH, Lennéstraße 5, 10785 Berlin, District Court for Berlin (Charlottenburg) HRB 192993 B, Managing Director: Guillaume Jolivet.