Crystallising political risk unhelpful for Italian banks

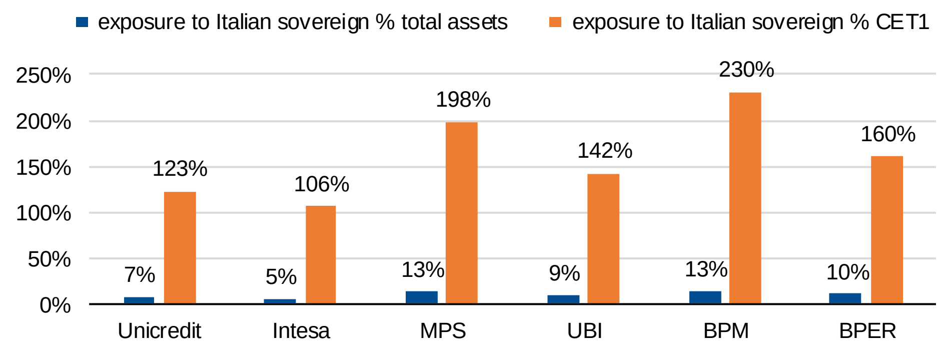
Italian shares and bonds continue to be beset by bouts of volatility as the confused situation around the formation of the new government plays out. As well as Italian government bonds, bank stock and bonds have been susceptible to the news flow.

"The formation of an anti-establishment populist government in Italy raises questions about the sovereign credit outlook, but it will also have an impact on the credit outlook for the banks," said Marco Troiano, executive director for financial institutions at Scope. "We have previously flagged Italian political risk, but it re-emerged following the March elections and is a potential rating-change driver for Intesa and UniCredit."

Scope rates Intesa and UniCredit at A with a Stable Outlook. Even though that is one notch higher that the rating on the Italian sovereign, sovereign risk exposure is seen as a critical risk factor. While both banks have more diversified sovereign portfolios than they did in the past, their respective exposures remain substantial.

"Our bank methodology does not cap bank ratings at the level of their sovereign, which is relevant in the case of strong banks such as Intesa and Unicredit, but the banks' exposures to Italian sovereign risk are greater than their entire CET1 capital bases. The risk is material," says Troiano.

Chart 1: Quantifying banks' Italian sovereign exposure



Risks to the sovereign outlook stem from the high estimated fiscal cost of some of the proposed policies as well as likely tensions with EU partners if they are acted on. More broadly, Scope is concerned that political uncertainty could reverberate through credit markets, negatively affecting the value of Italian government bonds in banks' portfolios or raising the banks' cost of funding in wholesale markets.

"Funding costs for Italian banks are still linked with yields on government debt. The sovereign spread has already widened, and this may impact funding conditions," Troiano said.

The uncertainty and volatility in the market come at a particularly bad time as some Italian banks are still trying to rid themselves of non-performing loans. "Our analysis of Italian banks' business plans shows that many, especially the mid-sized players, are planning to reduce their NPEs through asset sales. Foreign investors may be less keen to take on Italian risk given the policy uncertainty," Troiano adds.

The draft agreement between Lega and M5S includes some direct references to the banking sector, including proposals for a radical review of bail-in legislation, limitations on the ability to seize collateral without judicial authorisation, and reform of bank supervision.

"The draft agreement is light on detail but I doubt any Italian government can seriously think of rolling back the Bank Recovery and Resolution Directive, or the Banking Union. It is too early for a definitive opinion but none of this looks helpful in terms of sentiment", concludes Troiano.

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