# Italian banks' asset quality trends still positive through 2018

**Volatile politics have reignited fears around Italian banks. Some of the measures included in the government agreement between the League and the five-star movement have been directly aimed at rolling back previous reforms, including efforts to tackle the long-term structural causes of high non-performing loans. Scope believes that for the time being, asset-quality trends remain positive, thanks to a dynamic secondary market for NPEs and a supportive credit environment.**

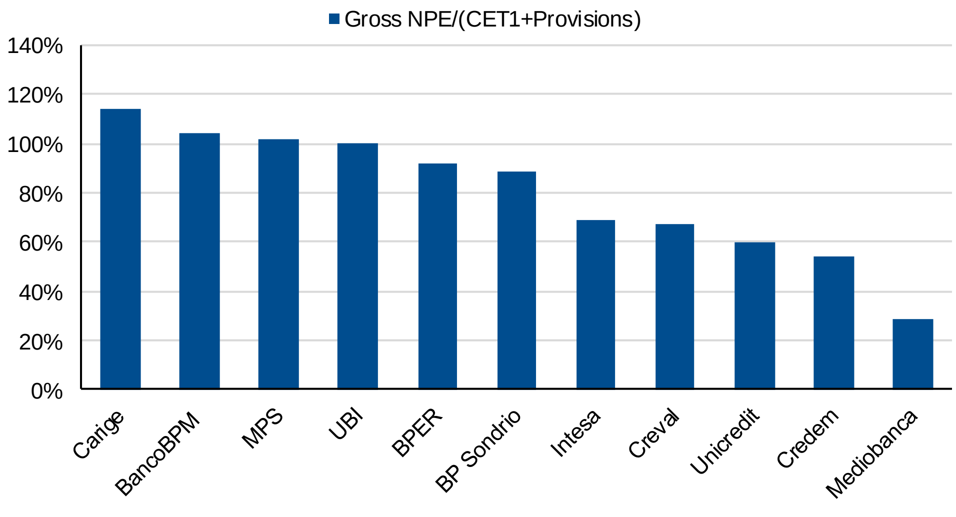
Non-performing exposures (NPEs) remain one key legacy from the financial and euro sovereign crises that continue to weigh on Italian banks, especially second and third-tier institutions. Since 2015, however, trends have inverted and Italian gross NPEs have started to decline. From their peak of EUR 345bn, they had fallen back to EUR 258bn by March 2018, with more than two thirds of the decline in the last 12 months.

The acceleration in the decline is down to the positive credit environment, with fewer borrowers entering non-performing status, and the flurry of activity in the NPE secondary market, which more than doubled in size in 2017 and will in our view double again in 2018 to top the EUR 100bn mark by the end of the year, boosted by the mega-transactions by the Venetian banks, MPS and Intesa.

Quarterly results continue to show a good underlying credit performance as well, with low NPE formation, excluding one-off impacts. There are a few clouds however, mainly related to the policy uncertainty following the outcome of the political elections in March. The agenda of the government formed by the League and the five-star movement includes measures that could derail Italy's fiscal stabilisation. Moreover, there has been a mild slowdown in projected GDP growth. This is not alarming, so long as it does not turn into a contraction which could make de-risking more difficult for the banks and lead to a new wave of problem loans.

On the bright side, both UniCredit and Intesa are rapidly progressing towards their business plan asset-quality targets and will in our view over-deliver on them. With the deal announced in April, Intesa has already delivered half-of the promised de-risking within the first six months of a four-year plan.

**Figure 1: Texas ratios have fallen back to below 100% for most Italian banks**




Source: Banks, Scope Ratings estimates

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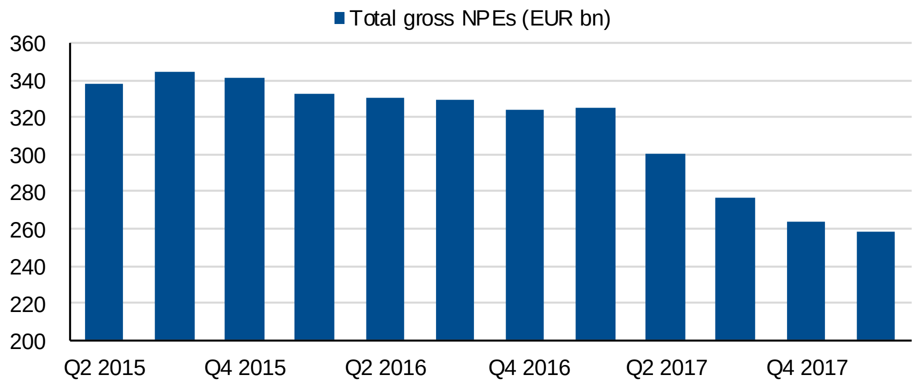
## Sector NPEs decrease at faster pace

The decline in the stock of NPEs at Italian banks is accelerating. Having reached their peak in Q3 2015 at EUR 345bn, gross NPEs stood at EUR 325bn in Q1 2017, having declined by just EUR 20bn in 18 months. Since then, the decline has gathered pace. In the 12 months to March 2018, NPEs declined by EUR 67bn, to EUR 258bn, a 20.6% annual decline. This is a welcome development, as Italian banks' asset quality has been often viewed with suspicion by investors and regulators. Scope has long indicated that it views the large stock of NPEs as a legacy issue, and a manageable one for the majority of Italian banks.

**Figure 2: The NPE decline accelerated in 2017**




Source: Bank of Italy, Scope Ratings

The rapid decline in NPE over the past year is mostly the result of two elements: a supportive credit environment, with solid economic fundamentals leading to lower formation of new non-performing loans; and a buoyant market for NPEs, supported by governmental initiatives in recent years.

Scope believes the rapid decline will continue, and that gross sector NPE will probably fall to around EUR 200bn by the end of 2018 and to below EUR 150bn in 2019.

We also believe that both rated banks Intesa (A, Stable) and UniCredit (A, Stable) will likely over-deliver on their stated de-risking objectives, at least in terms of timing.

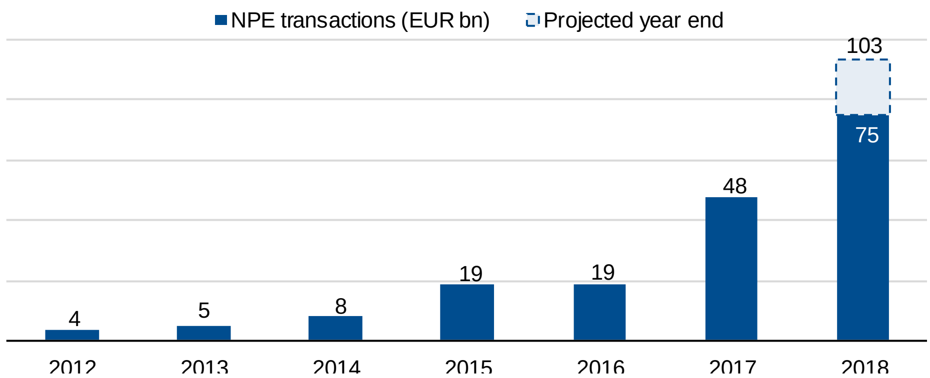
## NPE market set to hit a new record in 2018, on the back of mega deals.

Following a relatively muted pace in the years immediately following the European sovereign crisis, the market for deteriorated loans picked up in Italy from 2015 and has accelerated markedly over the past two years. In 2017, it had more than doubled (from EUR 19bn to EUR 48bn, according to Scope calculations). From this high base, we believe it could double again in 2018, to over EUR 100bn.

Just as 2017 growth was driven by UniCredit's EUR 17bn portfolio sale (FINO), 2018 has already seen the execution (or at least announcement) of several other mega-deals, from the EUR 24bn GACS-assisted securitisation of NPLs by MPS (May) to the EUR 18bn NPL sale from the Venetian banks to SGA to the EUR 10.8bn transaction between Intesa and Intrum (April).

BPM and UBI also completed sizeable transactions in the summer of 2018 (EUR5.1bn and EUR3.5bn, respectively). Several smaller banks also transacted significant levels of NPEs. Going forward, we believe activity will slow, as these mega deals are unlikely to be repeated. However, the pipeline through the end of the year remains rich and the banks' published business plan targets imply further disposals from current levels (see our report "Italian banks' asset quality: what's in the plans?" published in April 2018)

**Figure 3: NPL sales to hit €100bn**




Source: press reports, PwC, Banca IFIS, Bebeez, Scope Ratings Estimates

The reasons for the acceleration in secondary market activity are manifold. On the one hand, continued pressure from supervisors which has forced the hands of the banks into increasing their provisioning levels and looking to NPE sales as a quick way to bring down NPE ratios. On the other hand, the more supportive macro environment is attracting investors into a potentially highly remunerative, if illiquid, asset class.

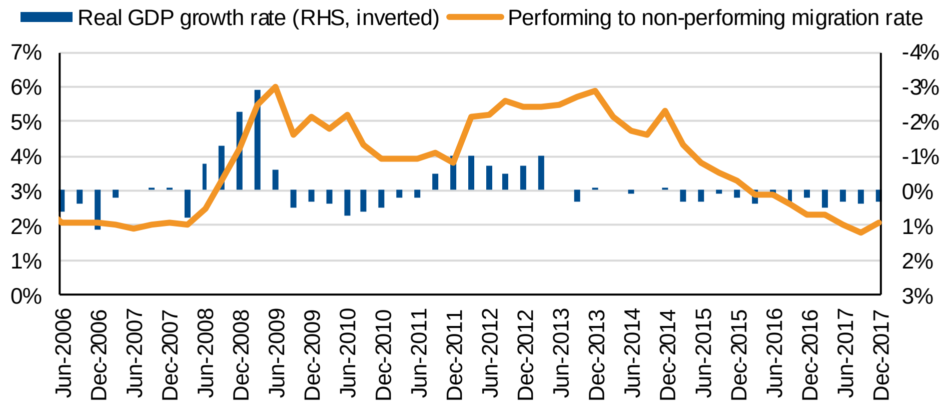
It is also important to highlight how several deals were structured as partnerships with industry specialists, whereby the selling bank retains some of the upside from the recoveries, while still de-consolidating their NPEs. In other cases, price improvements were achieved thanks to GACS-assisted securitisations, which lowered the risk and capital consumption to buyers of the senior tranches and hence supported transfer prices.

While historically transactions were mostly limited to bad loans, banks have more recently started to sell unlikely to pay (UTP) loans as well. However, Scope believe that the market for UTP loans has less potential as banks may prefer internal workouts strategies. Moreover, UTP deals are not eligible for the GACS scheme.

## Supportive macro environment leads low formation of new NPEs

Credit quality is a delayed function of economic performance. The deterioration in Italian loan quality has had two peaks in the past decade: in 2009, following the recession that stemmed from the global financial crisis and in 2013-2014 following the recession that stemmed from the European sovereign crisis (Figure 4). As Italy’s GDP stabilised and started to grow again, the formation of new NPEs started slowing and is now back to levels of around 2%, a level similar to where it was a decade ago.

**Figure 4: NPE formation is a lagged inverse function of GDP growth**



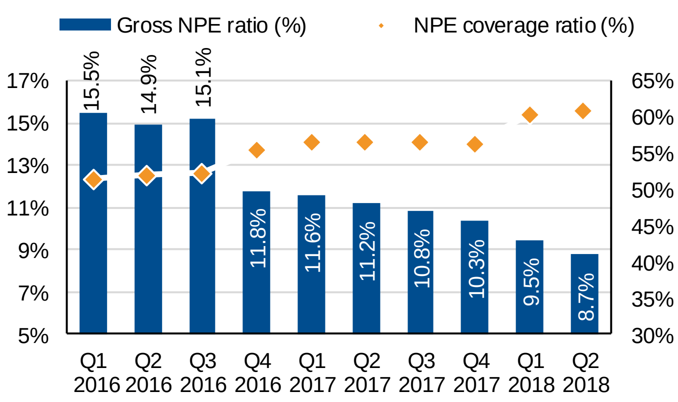

Source: Bank of Italy, Scope Ratings

## UniCredit and Intesa rapidly executing on their de-risking plans

Scope's public ratings on Intesa (A, Stable) and UniCredit (A, Stable) acknowledge the much-improved environment for asset quality and the renewed management focus on balance sheet clean-up. Both banks have published business plans which explicitly include the reduction of NPEs as a strategic priority and they have already executed significant actions aimed at such reductions.

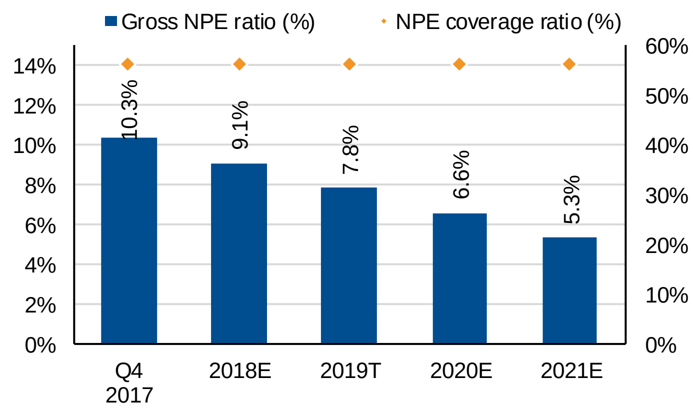
UniCredit is only midway through Transform 2019, initially presented in December 2016. Since then, it has improved on its targets twice: in December 2017 it revised down its 2019 NPE ratio target to 7.8% (from 8.4%) and in the Q2 2018 results presentation it slightly reduced the 2018 target for non-core run-down to EUR 19bn from EUR 19.2bn. The run-down of non-core should be completed by 2021.

**Figure 5: UniCredit's historical NPE and coverage ratio**




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

**Figure 6: UniCredit Q4 2017 NPEs and reduction targets**

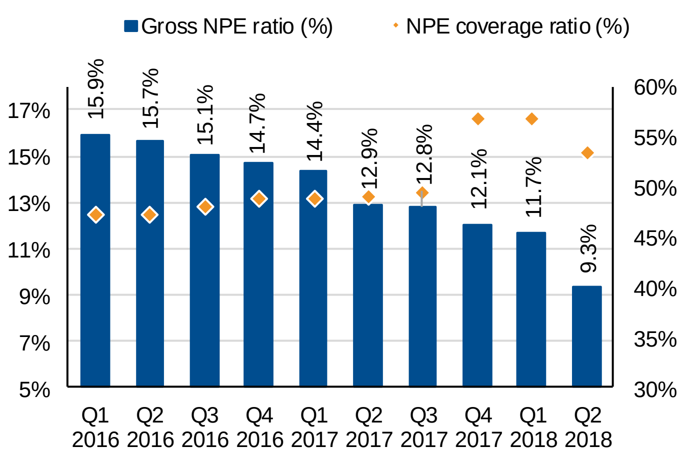



Source: UniCredit, Scope Ratings estimates
Note: T indicates a published target, while E signals Scope estimate

Intesa presented its 2018-2021 last February, targeting a 6% gross NPE ratio by 2021. In April, Intesa entered into an agreement with Intrum to sell a majority stake of a EUR 10.8bn NPE portfolio, as part of a broader strategic partnership agreement that included the creation of a new joint venture servicer to which Intesa contributes its NPL servicer and outsources its NPE books. In Q2 2018, Intesa reported a gross NPE ratio of 9.3% (net NPE ratio 4.6%) – already half way to its long-term target.

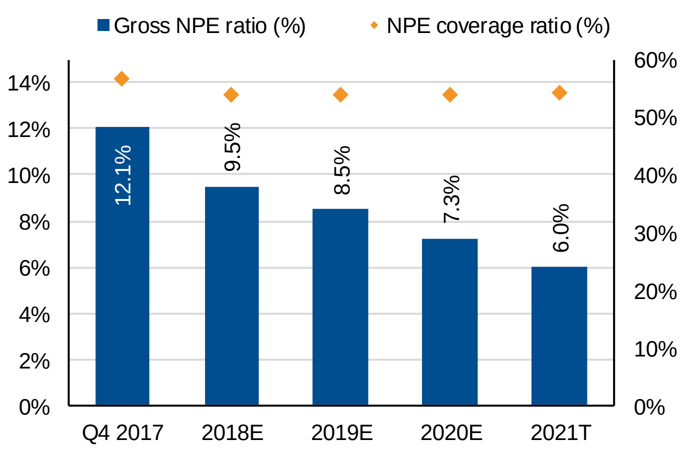
Given the most recent developments, Scope believes that both UniCredit and Intesa may actually over-deliver on their de-risking plans, at least in terms of timing.

**Figure 7: Intesa's historical NPE and coverage ratio**




Source: Intesa, Scope Ratings

**Figure 8: Intesa Q4 2017 NPEs and reduction targets**




Source: Intesa, Scope Ratings estimates
Note: E signals Scope estimate

## Political overhang over reforms, economic outlook and sovereign spreads

While the legacy stock of NPEs represents less of a concern, at least for large and well managed banks such as Intesa and UniCredit, we believe that the outcome of the March elections has somewhat clouded the outlook for Italian banks, for several reasons:

- The electorate has rewarded two anti-establishment parties, the five-star movement (M5S) and the League, which have partly built their consensus capitalising on popular resentment against European Institutions, including the euro currency.
- Both parties have proposed expensive flagship policies (flat tax and a version of universal basic income) which could negatively weigh on public finances if implemented.
- The government agreement between League and M5S seeks to undo a series of reforms that Scope deemed positive, both specific to banks and more generally regarding the fiscal framework. Specific to banks, the government agreement mentions the suppression of any regulation that allows action against debtors without court authorisation. This would lengthen the recovery time of NPEs and probably lower recovery rates for banks. The rollback of pension reform is another key point of the government agreement.
- Bond investors have noted the three points above, and sovereign spreads widened in Q2 to levels not seen since 2014. While this widening has had a manageable impact on Italian banks' capital, further widening could be more damaging, both to capital and to funding of banks.
- The macroeconomic outlook for Italy has also softened: in July, the Bank of Italy cut its forecasts for GDP growth for 2018 and 2019, from 1.5% and 1.2%, to 1.3% and 1.0% respectively. Should the uncertainty have a more prolonged impact on growth, banks could be looking at a new wave of credit deterioration while also reducing investor appetite for NPE sales.

## GACS renewal will continue to support the NPLs' secondary market

Most of the securitised transactions executed in 2018 benefited from the government guarantee (GACS) on the senior tranches. Among them, the flagship deal from MPS and the main sales from mid-sized Italian banks UBI and BPM. The guarantee scheme was due to expire in September 2018, but the EU Commission has already approved the Italian government's request to extend the scheme for a further six months, which should allow further deals to benefit from it in the coming quarters.

## Despite pick up in past-due loans in Q2, the improving trend is likely intact

Given the eventful quarter in the political arena, investors were mostly focused on the near-term impacts of the sovereign spread widening on Italian banks' capital in the second quarter. However, while the decline in NPEs was sustained, we noted a pick-up in gross inflows in past-due loans. Normally, we would view these as a potential early red flag that can signal a deterioration in the credit environment.

While we will closely monitor early asset-quality metrics in coming quarters for any indication of a change in underlying trends, we don't see reason to worry at this stage. There was no sign of deterioration in the results of other Italian banks, and both Intesa and UniCredit pointed to idiosyncratic reasons for the increase.

At Intesa, inflows into past-due loans stood at EUR 0.7bn in Q2 vs EUR 0.4bn in Q1. Intesa's management ascribes this to technical elements related to the Venetian banks' IT migration. UniCredit also reported an increase in the default rate in its Core division and gross inflows into NPEs of EUR 1.4bn from EUR 1.2bn in Q1, impacted by single name defaults in the CEE division.

Overall, despite some pick up in past-due loans and heightened uncertainty over policy direction, Scope believes that the asset quality of Italian banks will continue to improve in the coming quarters.

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