Ten Reasons Why Italian Asset Quality Jitters May Be Excessive

The asset quality debate has kept the Italian banking sector hostage for the past year. Scope's view throughout has been that the high levels on non-performing exposures are primarily the consequence of the prolonged double-dip recession in 2008-2014, and that despite the large headline number of non-performing loans (NPLs), trends have been improving for some time.

More recently, with the orderly liquidation of two troubled Venetian banks in June and the approval of Monte Dei Paschi di Siena's (MPS) application for a precautionary recapitalisation in July, headline risk has further receded.

In this report, we update and summarise our view of Italian asset quality trends.

1. **NPLs are decreasing, not increasing.** Gross NPLs in the sector are falling, and both gross and net NPLs are declining at most major banks.
2. **New NPL formation is at a pre-crisis level, while recovery rates are rising**. The migration of loans from performing to non-performing status is at levels not seen since 2008.
3. **The NPL market has revived.** After slowing down materially from the second quarter of 2016, sales of NPLs picked up significantly in 2017 which is set to be a record year for NPL sales.
4. **Coverage ratios are adequate.** Coverage for bad loans is in line with historical recovery rates for the past three recessions.
5. **The economy is on a more solid footing.** The IMF forecasts GDP growth of 1.3% in 2017.The stronger macro environment is supportive of credit quality.
6. **Critical situations are gradually being dealt with.** With the precautionary recapitalisation of MPS and the orderly liquidation of Banca Popolare di Vicenza and Veneto Banca, headline risk has become more limited.
7. **The larger banks have credible strategies for dealing with NPLs.** Intesa (rated A, Stable) has set up an effective framework for dealing with legacy NPLs. Quarter after quarter, it has been reducing troubled exposures through internal workouts – a strategy which the management deems most appropriate for maximising value to the bank. Unicredit (rated A, Stable) has completed a large capital increase and taken its coverage of NPLs to a level that should support its deconsolidation efforts.
8. **Classification and measurement are in line with European standards.** Over the past two years, supervisors have turned the heat up on NPLs. This increased level of scrutiny has acted as a catalyst for banks to focus on a balance sheet clean-up.
9. **Post-crisis origination reflects much stricter lending criteria.** A large portion of NPLs was originated before the crisis. Since then, banks have materially tightened their lending criteria – which should keep future default rates contained.
10. **Structural reforms should start to bear fruit.** In 2015, insolvency law was reformed, allowing faster out-of-court settlements to be reached.

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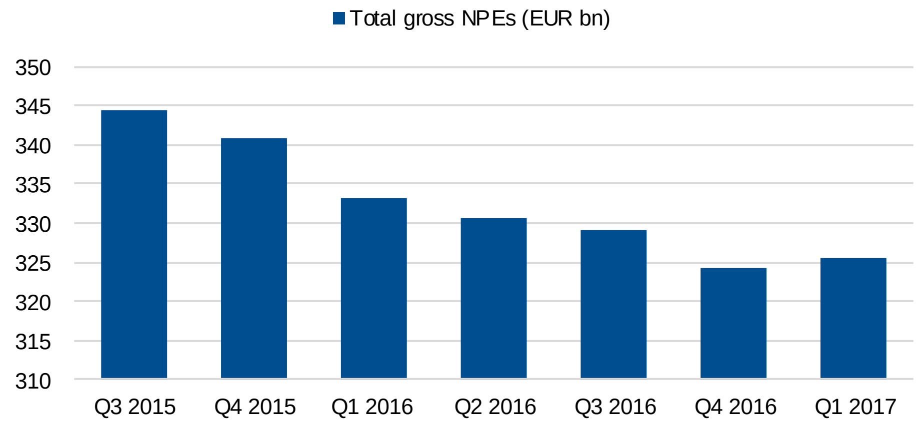
1. NPLs are decreasing, not increasing

Sector gross non-performing exposures, including both the most problematic category of bad loans (sofferenze) as well as slightly better-quality unlikely-to-pay (inadempienze probabili) and past-due loans, continue to decline. Since this new classification was introduced in Italy in 2015, aggregate sector NPLs have gone from EUR 345bn to EUR 325bn (16% of total gross loans), gross of provisions. The decrease reflects lower inflows, higher recovery rates and some secondary market transactions. The fall in NPE will become more evident when H2 2017 data becomes available as a result of large portfolio sales which are being completed.

Figure 1: Gross NPLs have already been falling for several quarters

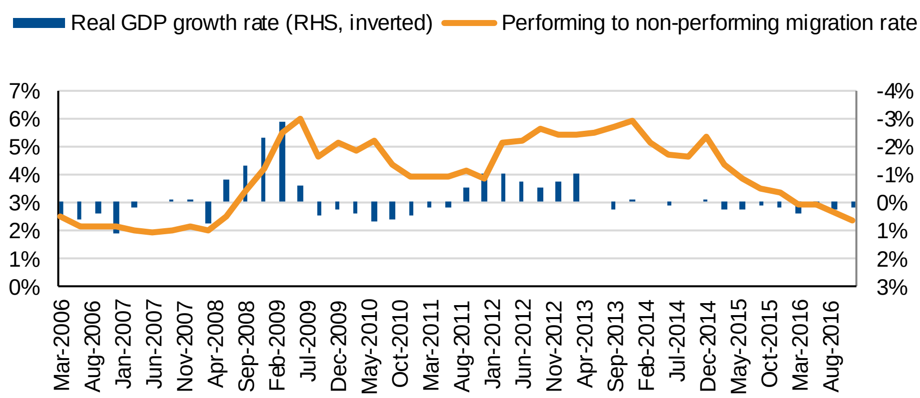


Source: Bank of Italy, Scope Ratings

2. New NPL formation is at a pre-crisis level, while recovery rates are rising.

The rate of deterioration for performing loans slowed materially in 2016, and is now at the level it was before 2008. This comes as no surprise, given the improvement in the operating environment.

Figure 2: GDP growth and NPL formation in Italy

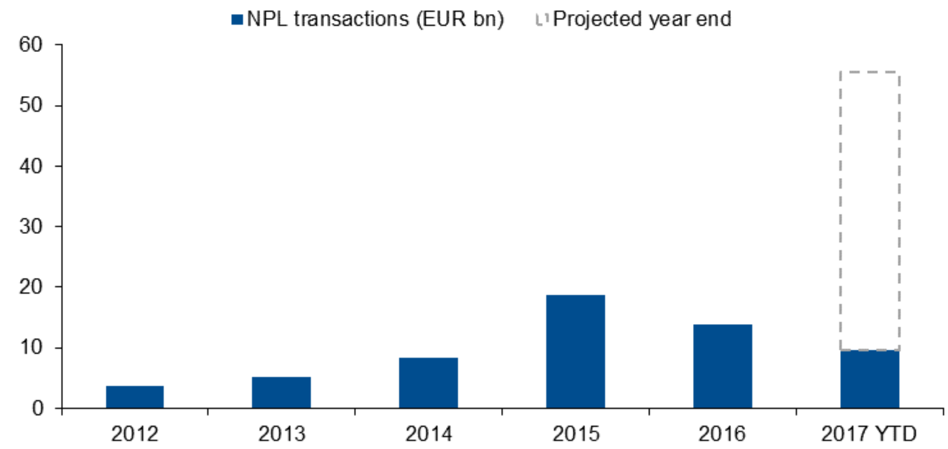


Source: Bank of Italy, Scope Ratings

3. The NPL market has come back to life.

The secondary market in Italian NPLs slowed materially in 2016. In our view this is due to the political uncertainty related to the constitutional referendum and to buyers tactically waiting for better prices amid supervisory-induced fire sales. In 2017, the NPL market is set to grow materially, driven especially by some extraordinarily large sales by Unicredit and MPS. The price for NPLs in the secondary market remains quite low, despite initiatives (GACS, Atlante funds) to stimulate demand. We believe that the main driver for the low prices is the high return targets of potential buyers, coupled with the lengthy recovery times.

Figure 3: Italian NPL transactions

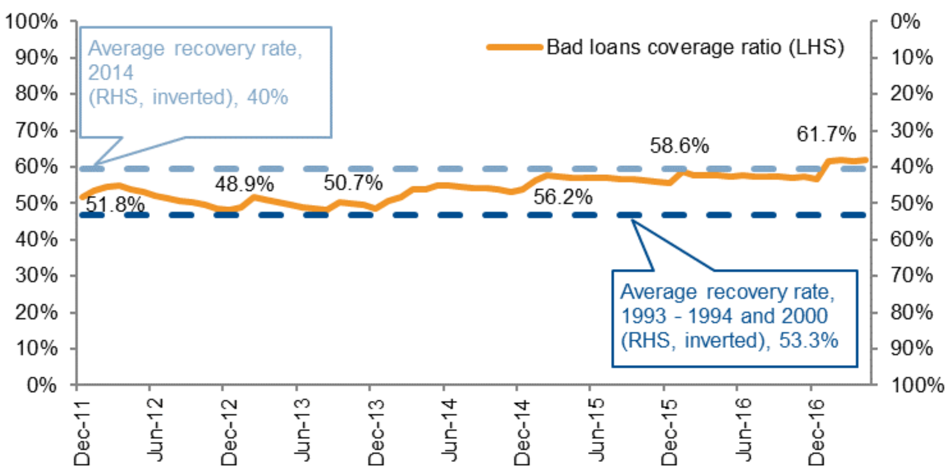


Source: IFIS, PWC, EY, Scope Ratings

4. Coverage ratios are now at a level consistent with historical recoveries

While the accumulation of bad loans came to a halt in 2015, banks have continued to book substantial provisions, pushed by supervisors. In five years, the cash coverage ratio on bad loans has increased from just under 50% to a healthier 61.7%. The current level of provisions is ahead of historical loss rates, both using the most recent recession (Bank of Italy 2014 survey) and previous cycles as reference points.

Figure 4: Italian bank sector aggregate bad loans coverage ratio



Source: Scope Ratings, Bank of Italy

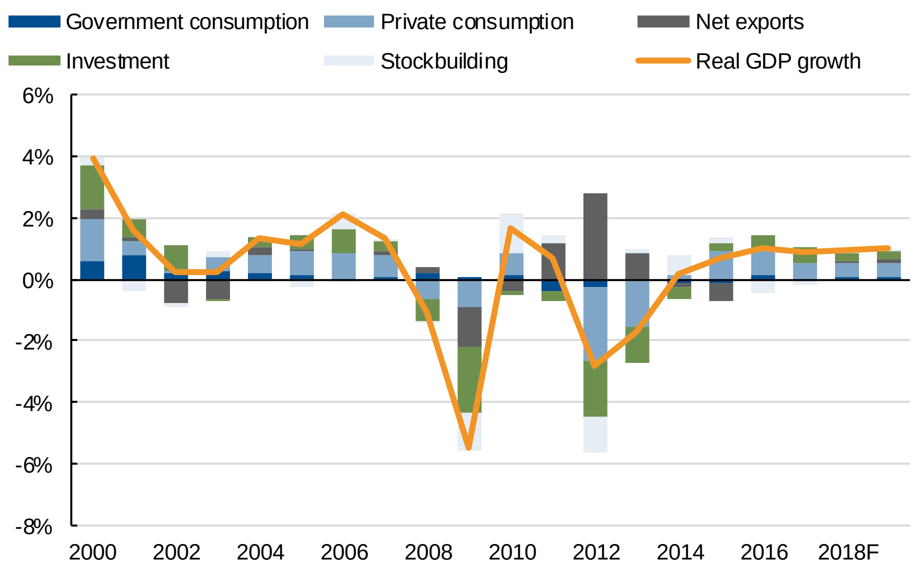
Across banks, coverage rates are more homogeneous than in the past. Differences do, however, remain, reflecting varying levels of collateral and guarantees, and, occasionally, different write-off policies.

5. The Italian economy is on a solid footing.

Following the double-dip recession (2008-2010 and 2012-2014) Italian real GDP growth turned positive in 2014. GDP accelerated moderately in 2016, with a yearly growth rate of 1% compared to 0.7% in 2015. Recent indicators point to an ongoing, if gradual, recovery.

Scope expects moderate economic expansion of around 1% to continue in both 2017 and 2018, driven by investment and private consumption.

Figure 5: Italian GDP growth drivers

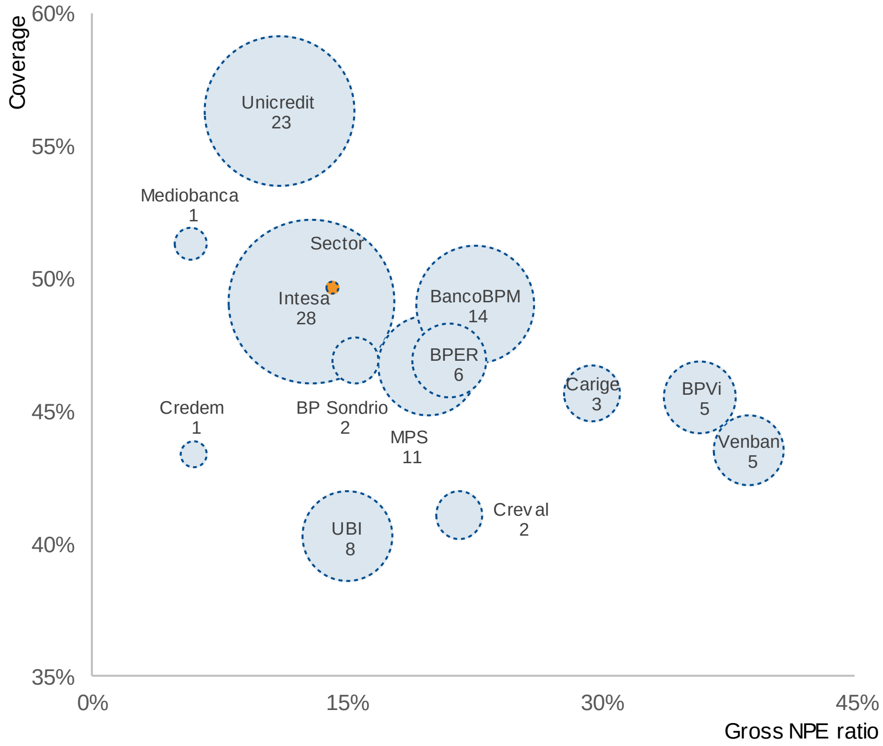


Source: National Statistics Accounts, Scope Ratings

6. Critical situations are gradually being dealt with

The orderly liquidation of Veneto Banca and Banca Popolare di Vicenza in June, coupled with the approval of the precautionary recapitalisation of MPS, have removed material headline risk from the sector. While the sector remains qualitatively heterogeneous, most lenders are on course to cleaning up their balance sheets and, barring a relapse of the Italian economy into recession, should manage to do so without major hitches.

Figure 6: Gross NPE ratio



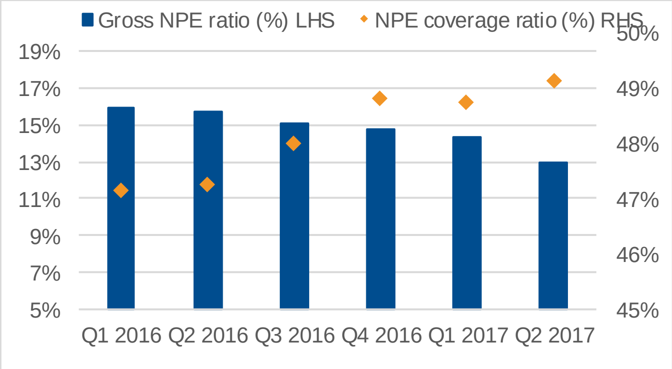
Source: Banks, Scope Ratings
Note: bubble size = total gross NPEs

7. The larger banks have credible strategies for dealing with NPLs.

UniCredit's new strategy presented at the end of 2016 aimed at a rapid de-risking of the balance sheet, which was already partly achieved with the deconsolidation of the FINO portfolio in 2017. The approach required a large provisioning effort and a capital increase, but UniCredit now has one of the best set of asset quality metrics in the sector. The 2019 targets are, in our view, conservative, with a targeted 5% NPL ratio in the core divisions and a decline in non-core NPLs of approx. EUR 37bn (of which EUR 17.7bn have already been deconsolidated via the FINO transaction).

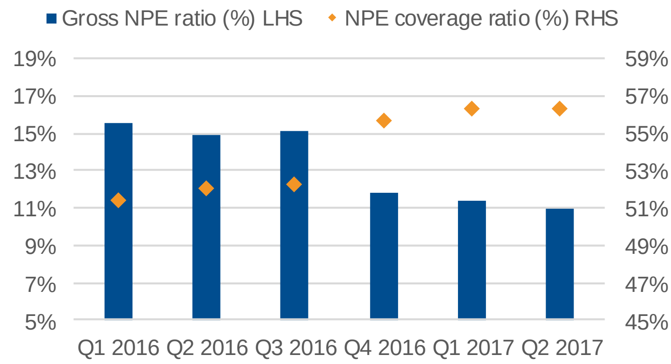
Intesa has taken a different approach, relying mainly on internal workouts to maximise value and, more selectively, on the secondary market. This strategy has also been bearing fruit for several quarters.

Figure 7: Intesa NPEs and reduction targets



Source: Intesa, Scope Ratings

Figure 8: Unicredit NPEs and reduction targets



Source: UniCredit, Scope Ratings

8. Classification and measurement are in line with European standards.

The reporting of non-performing exposure by Italian banks fully conforms with the EBA's Implementing Technical Standard from 2013 (approved by the EC in regulation 680/2014).

Asset quality was one of the most scrutinized areas in banks' business in 2016. In September 2016, the ECB published a stocktake of national supervisory practices and legal frameworks related to NPLs which provides an interesting angle on the way the Bank of Italy operates as a supervisor.

On average, the Italian supervisory framework is in line with other countries with respect to NPLs, with a stronger-than-average information framework (public register, data protection) and a weaker-than-average legal and judicial framework. Very detailed supervisory reporting of NPLs and on and offsite supervisory powers offset the relative lack of explicit guidelines with regard to NPL provisioning and write-offs.

The availability of detailed borrower-level information allows the Bank of Italy to identify discrepancies between banks in borrower classification, while the extensive data collected by the Central Credit Register (Centrale Rischi) allows the benchmarking of coverage ratios between similar exposures. Discrepancies are then addressed with bank representatives or further investigated by means of on-site inspections.

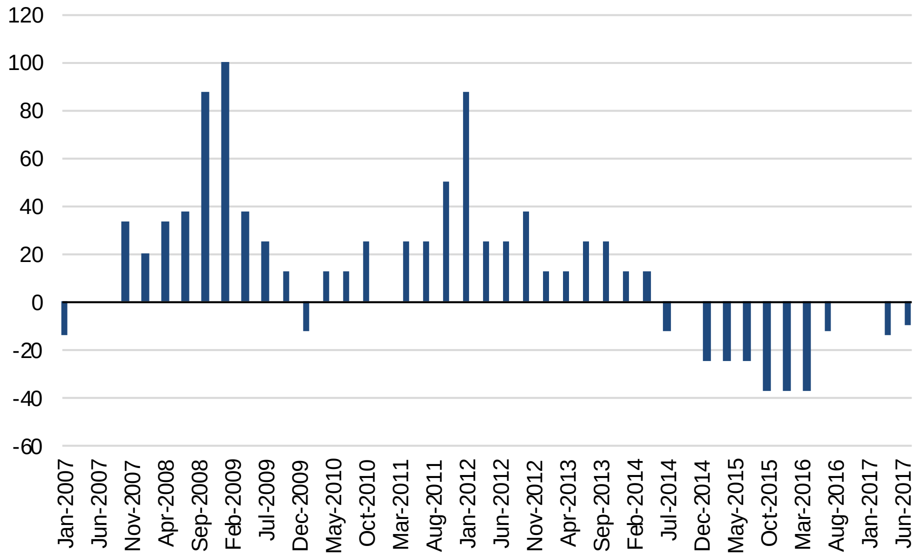
9. Post-crisis origination reflects much lower appetite for risk

Playing catch-up with the increasing capital requirements of Basel III whilst failing to organically generate material capital has much reduced Italian banks' appetite for risk in the post-crisis years.

The ECB bank lending survey shows that bank credit officers in Italy have reported tightening standards for lending to enterprises almost uninterruptedly between 2008 and 2014. This tightening has been fuelled by the cost and availability of capital and liquidity, but also by a lack of creditworthy borrowers. From 2015, some of these factors were reversed, and banks started reporting, on average, looser standards.

Despite the perils of drawing hard conclusions from survey data, we are confident that the average quality of loans originated in recent years has improved.

Figure 9: Changes in banks' credit standards for approving loans or credit lines to enterprises (net percentage)



Source: ECB bank lending survey, Scope Ratings
Note: net percentage of banks reporting tightening standards

10. Structural reforms should start to bear fruit.

In the past, Scope has highlighted the importance of looking beyond the immediate problem of the legacy stock of NPLs and at the underlying causes of its persistence.

Back in 2015 (Tackling the Structural Causes of the Italian NPL Problem), we identified two key drivers for this persistence: the fiscal disincentives to provisioning against NPLs and writing off bad debts; and the lengthy and expensive process to resolve insolvency and enforce on collateral.

In the past two years reforms have been introduced to remove such tax disincentives and shorten recovery times (among several other reforms of the governance of banking foundations, Popolari and cooperative banks).

The more advantageous tax treatment of provisions, allowing banks to fully deduct provisions in the year they are booked (compared to 18 years' staggered allowance before 2012 and five years from 2012-2014) has helped banks to raise their coverage ratios in recent years.

Decree law 83/2015 and decree law 59/2016 contained several measures aimed at raising recovery values, including the possibility for debtors to pledge assets as collateral without ceding control or the option to include clauses for the out-of-court enforcement of real estate guarantees in loan agreements (Patto Marciano).

While these measures may do little to help clear the stock of seasoned bad loans, we believe that they will contribute to faster workouts on future cohorts of NPLs.

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