Italian banks: policy uncertainty unlikely to derail credit recovery

A widening of Italian banks' credit spreads in 2018 in parallel with the sovereign, and subdued issuance of bank paper stand in stark contrast with fast-improving sector fundamentals, including better capital and asset quality and, with few exceptions, better earnings visibility.

Over the last year, investor scepticism towards Italian bank debt has been caused by the increase in policy uncertainty in Italy. This arose from the discontinuity vote during the March 2018 general election, in which the Italian democratic process favoured two 'outsider parties', the League and the Five Star Movement, which went on to form a coalition government. Markets were quick to reprice Italian bank and sovereign risk: both parties had previously seemed ambivalent, at best, over Italy's euro area membership whilst challenging the EU's fiscal framework.

Despite a material weakening in the Italian macro picture and rising yields, large and medium-sized Italian banks have shown remarkable resilience, continuing to work towards strategic objectives, achieving material de-risking quarter after quarter, thus, laying the foundation for profitability improvement.

With few exceptions, banks' capital ratios are well ahead of regulatory requirements and generally increasing. We expect fully-loaded common equity tier 1 (CET1) ratios to converge towards the 12%-14% range, against all-in requirements of 7%-10%. Asset-quality trends also remain supportive, with non-performing exposure (NPE) stocks falling and asset-quality ratios moving out of the danger zone.

Low profitability remains the sector's weak spot. Indeed, while the fall in credit provisions has brought bottom lines back into positive territory, the value proposition of several institutions remains dubious at best. Faced with high capital requirements, low interest rates and a fragmented market, banks will have to work hard to boost ROEs. Revenue diversification into areas with little or no capital absorption will be key. This is already apparent in the strategic direction indicated by Intesa and Credito Valtellinese. We believe that Banco BPM and UniCredit will announce similar strategic plans later this year.

We therefore expect continued improvement in Italian banks' credit profiles, with further declines in NPEs and a declining cost of risk leading to better capital formation, especially among the former popolari banks. Another Italian confrontation with the European Commission over fiscal matters seems likely in the coming months, though the government has committed to meeting 2020 structural fiscal targets. This could nonetheless lead to a re-escalation in sovereign risk in the autumn, but based in recent performance and barring doomsday scenarios, banks should be able to cope with BTP-Bund spread volatility.

A key risk to our base case and bank ratings lies in the off-chance that Italy's euro area membership is called into question or there is a sovereign debt restructuring. We deem such a scenario to be extremely unlikely, but also acknowledge the rise of Euroscepticism in Italy and the presence of some Eurosceptics in government. A change in the currency regime would yield unpredictable consequences and almost surely disrupt bank funding, most likely before it is even executed.

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Stable Outlook on Italian bank ratings reflects more balanced risk profile

We have held a Negative Outlook on publicly-rated Italian banks since November 2018. This was driven by our expectations of:

- A worsening operating environment on the back of higher sovereign spreads translating into higher rates throughout the economy, possibly undoing the impact of fiscal loosening.
- Downside risks to capital in case of a marked decline in government bond values.
- Potentially more challenging conditions for reducing remaining NPEs on bank balance sheets.
- Potential medium-term impacts on funding costs, including the cost of deposits, if spreads were to stay elevated for a long period of time.

In July 2019, we moved to a Stable Outlook, acknowledging that:

- Despite a slowdown in GDP at the end of 2018, banks' performance has remained satisfactory and on an improving path.
- The BTP/Bund spread has tightened materially following news that the European Commission would not open an excessive deficit procedure against Italy in July. Moreover, banks have generally reduced the sensitivity of their capital base to volatility in BTP yields.
- With the ECB's latest dovish turn, including the introduction of TLTRO3 lines in September and the yield compression across credit markets following ECB President Mario Draghi's speech in Sintra, the pressure on wholesale funding issuance cost has reduced.

Risks to the bank ratings are broadly balanced

Overall, we believe a base-case marginal improvement in the sector's credit profile is balanced by downside risks to the operating environment if negotiations over fiscal policy were to turn sour and result in long-lasting market dislocations.

We also note that, as per our methodology, our bank ratings are not mechanistically correlated to our sovereign rating on Italy. Instead, they reflect our assessment of each individual bank's exposure to sovereign risk.

Bank ratings are not mechanistically correlated with Sovereign ratings

Our base case excludes any credit event on the Republic of Italy, as well as its exit from the euro currency area, which we consider a tail risk. Such scenarios would result in a multiple-notch rating downgrade for Italian banks.

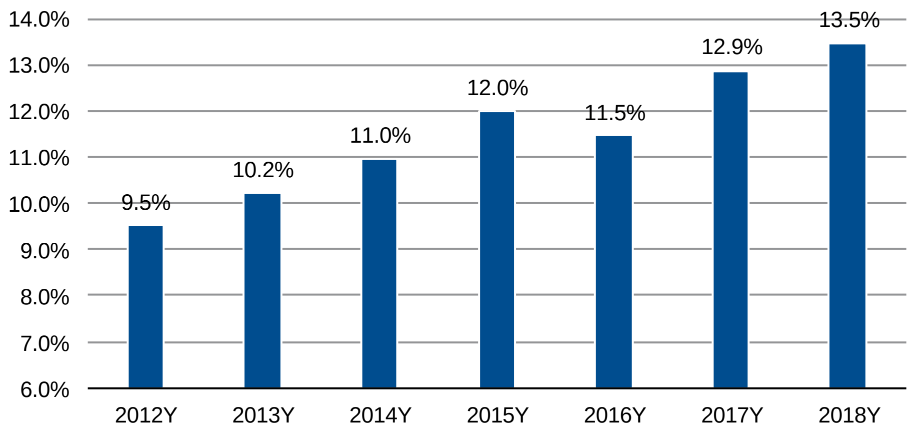
Continuous improvement in capital ratios, driven by higher requirements

We track Italian banks' financial fundamentals from a top-down and bottom-up perspective; from both viewpoints, we believe fundamentals have been improving over the past couple of years.

Despite the headwinds, sector solvency has continued to improve

We calculate that the average CET1 ratio for the largest 10 independent banks stood at 13.5% at the end of 2018, 60bp higher than a year before.

Figure 1: Italian banks' average CET1 ratio has been improving

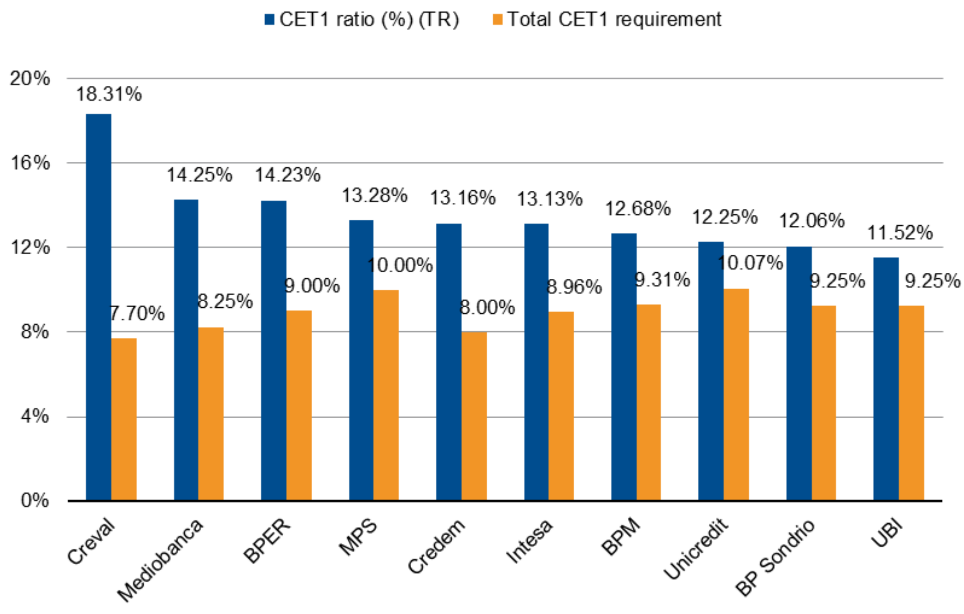


Source: SNL, Scope Ratings
Note: Transitional basis; sample includes Intesa, UniCredit, Banco BPM, UBI, MPS, BPER, Credem, Creval, Mediobanca BP Sondrio.

Reported CET1 ratios are well above regulatory requirements

Notably, reported capital is comfortably ahead of SREP requirements, which range between 7.7% and around 10% for Italian banks. Fully-loaded ratios are lower, largely due to the full impact from the first-time adoption of IFRS 9, but still well ahead of requirements. Noticeably, there is a broad dispersion between the CET1 ratios of the different banks. In our opinion, this is due to the uncertainty in recent years regarding steady state requirements as well as anticipated accounting and regulatory impacts (such as TRIM and IFRS 9). Assuming capital requirements stabilise at current levels, we see Italian banks' CET1 ratios converging towards the 12-14% range in the medium term, with weaker business models towards the higher end of this range.

Figure 2: CET1 ratios (Q1 2019) vs 2019 SREP requirements



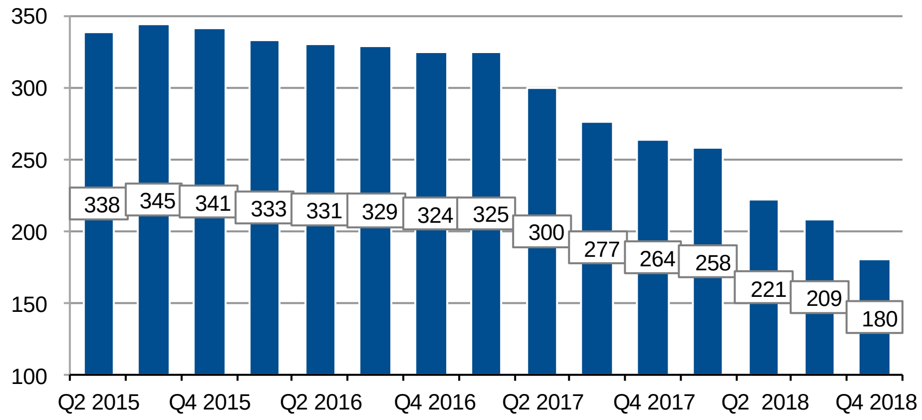
Source: SNL, Scope Ratings.

Asset quality continues to improve, steadied by NPE disposals

Gross NPEs on banks' balance sheets have almost halved in three years

As one of the few remaining pockets of weak asset quality in Europe, Italy has been uppermost in the minds of credit investors and bank supervisors in the last few years. Since 2015, however, trends have inverted with Italian gross NPEs in decline. From a peak of EUR 345bn, the level fell to EUR 180bn by December 2018, with a marked acceleration in the pace of decline between 2017 and 2018 (Figure 3).

Figure 3: Italian banks' NPE stock



Source: Bank of Italy, Scope Ratings

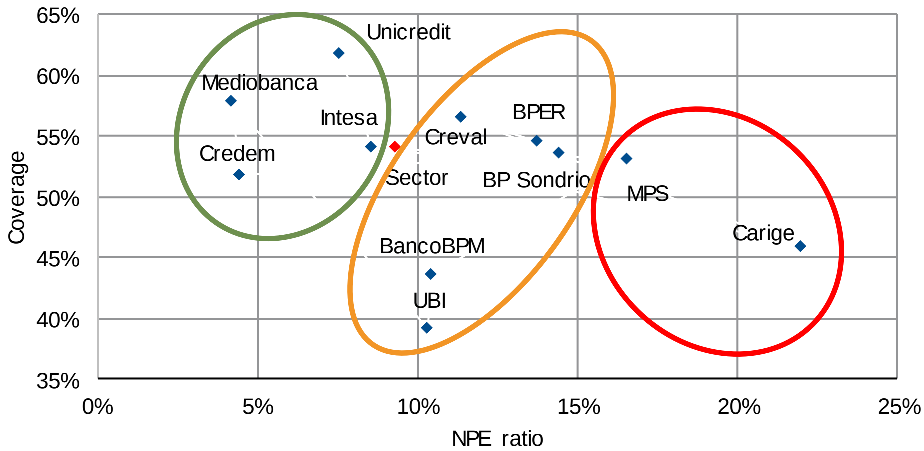
The improvement was driven by:

- Better macro conditions: with some delay following the country's exit from recession in 2014, credit conditions improved, the flow of new NPEs slowed, and recoveries started to improve.
- Regulatory pressure: pressure on banks to quickly reduce NPEs intensified after the creation of the single supervisory mechanism (SSM). Asset quality was quickly identified as a supervisory priority and regulators started to demand that banks reduce problematic exposures.
- Active secondary market boosted by public guarantees on securitisations of bad loans (GACS).
- Heightened managerial focus on fast NPE declines: Virtually every business plan presented in the past three years has prioritised asset-quality improvement (also the result of supervisory and market pressures).

The pace of asset-quality improvement could slow down

We expect NPEs to continue to fall, albeit possibly at a slower pace as most large banks have already achieved material de-risking (Figure 4).

Figure 4: Most large Italian banks are out of the woods



Source: Bank of Italy, Scope Ratings

Note: data as of Q1 2019

Large banks have brought their asset quality under control

Mediobanca and Credem have always had reassuring asset quality metrics and currently have gross NPE ratios of below 5%. UniCredit and Intesa have gross NPE ratios of under 10%, and levels are likely to move towards 5% over the next couple of years.

Among co-operative and former co-operative banks, the larger players have gross NPE ratios of between 10-15%, often having reduced their NPE stock thanks to GACS-assisted securitisations. These banks have typically finalised flagship deals already but remain active in selling smaller NPE portfolios to the market, with marginal improvements on a quarterly basis. We believe that, barring a material deterioration in the operating environment, these banks can reduce their NPEs without material capital injections.

Few outliers remain but they are unlikely to pose a systemic risk

Alongside the Venetian banks that were liquidated in 2017, Banca MPS and Carige were always the sector's outliers, showing particularly high NPE ratios. For these banks, gross NPEs remain above 15% of loans. However, these banks no longer pose a systemic risk. Following a precautionary recapitalisation in 2017, Banca MPS is now majority owned by the Italian state, while Carige is already under special administration. Regulators are working towards a recapitalisation and a potential sale to a stronger bank.

Profitability of traditional banking to remain low

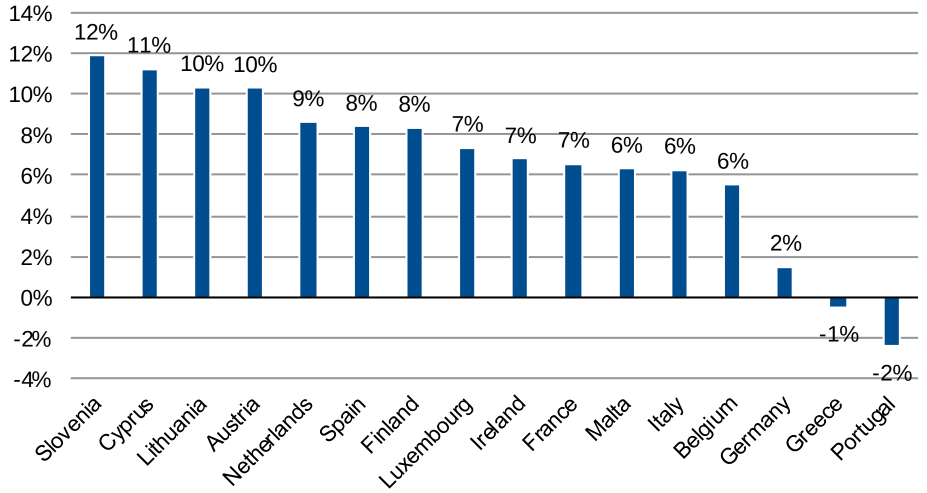
The structural decline in profitability is due to factors largely beyond banks' control

Inadequate profitability among European banks is a well-known and widespread problem. This is a combination of lower leverage (due to higher capital requirements) and lower net interest margins (largely due to zero or negative interest-rate policies). For Italian banks, however, the above factors have been compounded by the need to provision for NPLs.

From a creditor's standpoint, the lack of profitability is not an immediate concern. However, the capacity to generate earnings is important in two respects: i) recurring earnings are the first line of defence against unexpected losses before capital is called upon; and ii) a business model without a convincing record of earnings generation would struggle to raise new equity at a time of need.

Admittedly, Italian and many other European banks report returns below their market-implied cost of equity. However, based to the latest data from the SSM, Italian banks' ROE stood at 6% at the end of 2018, which is in line with other major banking markets such as France

Figure 5: Banks profitability (ROE) by country, Q4 2018



Source: ECB, Scope Ratings

Like in the case of capital, the average masks a heterogeneous picture: bank-level data shows ROEs ranging from negative 13% at Carige to 9.3% at Mediobanca, largely reflecting large differences in cost of risk. This is due to the large NPE clean-up at many banks in 2018, and levels should normalise in 2019 and 2020.

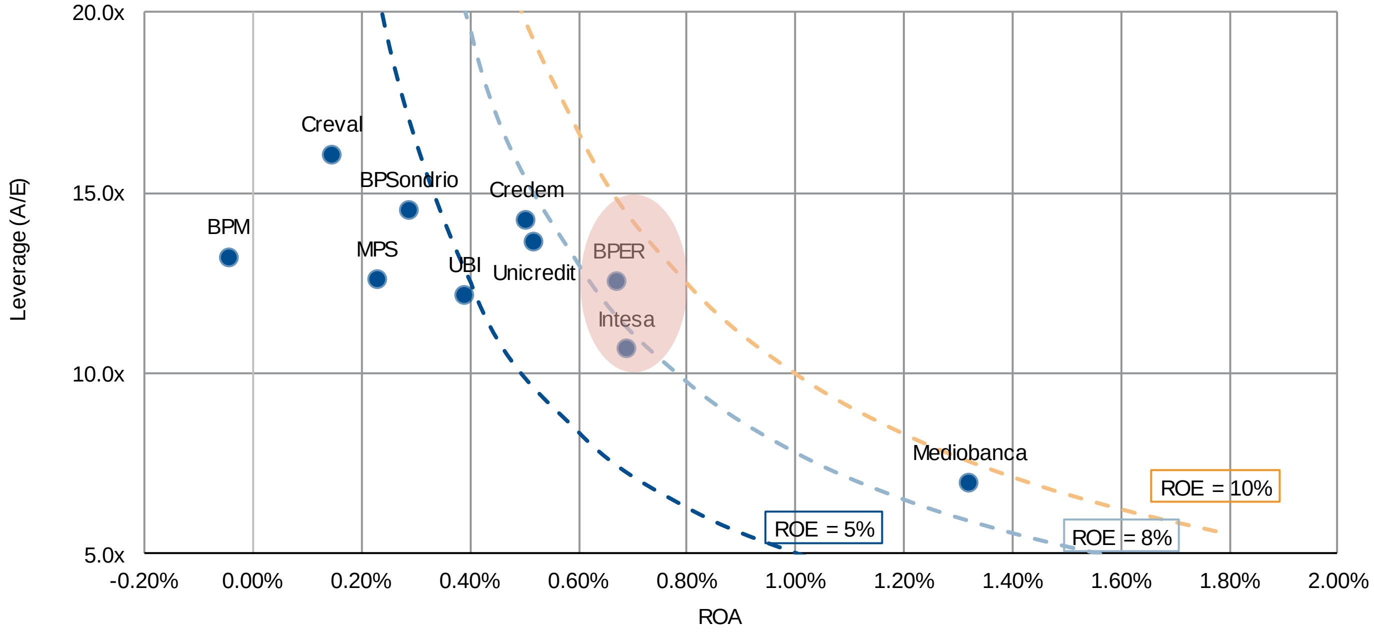
Profitability will likely improve with further declines in sector cost of risk

Even when it normalises, Italian banks' cost of risk will likely settle between 50-100bp of loans – higher than in most European countries. This reflects the riskier structure of Italian loan books, which are skewed more towards business loans and less towards retail mortgages compared with other European countries.

On a normalised basis, we believe sector ROE will likely settle between 8% and 10%, with ROA between 60bp and 80bp and leverage between 10x and 15x (Figure 6).

Double-digit ROEs will be rare, and (excluding one-off gains) either confined to cyclically strong macroeconomic conditions or reserved to certain product niches or structurally better-diversified business models. The ability to generate risk-adjusted profits through activities with relatively low capital consumption sets business models apart, in our view; in the new regulatory environment, off-balance-sheet, fee-generating services are more profitable than on-balance-sheet, interest-spread-driven savings intermediation.

Figure 6: RoE equation key components, Italian banks, 2018



Source: SNL, Scope Ratings
Note: dotted lines represent different ROA/leverage combinations yielding equivalent ROEs.

Targeting better cost and capital structure efficiency for higher returns

In Figure 6, we highlight where we expect the ROE equation of Italian commercial banks to converge over the next few years, i.e. an ROA of 60-80bp and leverage between 10x and 15x. Mediobanca is the obvious outlier: the bank's asset risk/return relation provides a similar level of profitability but with a different leverage/asset profitability combination.

Cost-cutting, cheaper funding and cross selling are the main managerial levers to structurally boost profitability

We anticipate that several commercial banks will move right on the chart in 2019 and 2020 as their cost of risk declines. Beyond a declining cost of risk, banks have several levers to structurally improve their ROA, but none are easy to manoeuvre:

- Cost-cutting is always an option, especially considering the large branch networks and the shift to online, and especially mobile, banking. However, cost-cutting faces political resistance and can lead to losses on self-occupied real estate.
- Reduction in funding costs, taking advantage of continued abundant liquidity in wholesale markets. This could entail an increased use of cheap secured funding, while abandoning more expensive term deposits or retail bonds.
- Seeking additional fee income from non-balance-sheet activities, for example, recycling savings of the yield-hungry clients into investment products.

Vertical moves on the chart are constrained by solvency requirements and are unlikely barring either a complete overhaul of the current capital framework or a material shift in the asset mix..

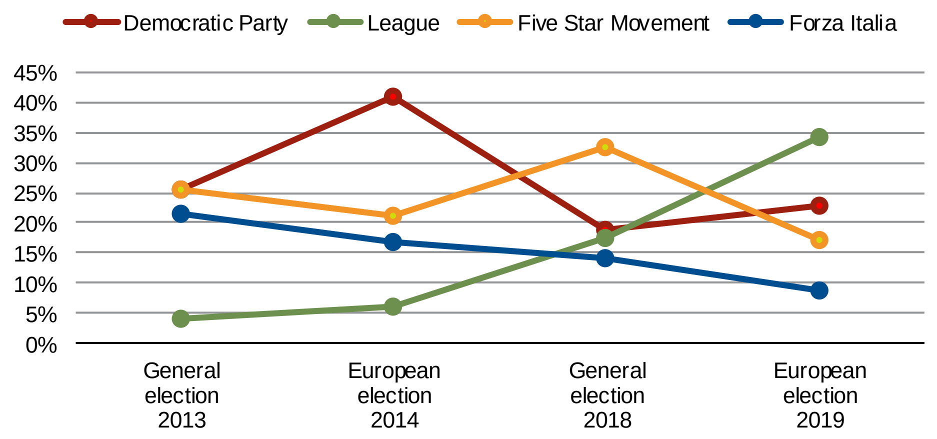
At the margin, banks could probably get away with limited increases in leverage as long as they substitute capital securities for equity in their capital base. However, the cost of such capital securities would weigh on profitability.

Political risk: four manageable scenarios and the off-chance of disaster

The policy outlook remains a risk

We believe the outlook for Italian policy remains uncertain, mainly due to two factors: i) the reversal of the power equilibrium within the current government following the League's triumph at European elections, and chance of early parliamentary elections; and ii) the challenging fiscal outlook, with a likelihood of confrontation with European authorities over 2020 budget negotiations.

Figure 7: Recent elections have seen the League ascend



Source: Scope Ratings

We believe the following four outcomes are possible in the near-term:

1) The current government finds a compromise with the newly installed European Commission over the 2020 budget; this is likely to be helped by better-than-anticipated 2019 budgetary outturns and a commitment made by the government to sterilise any removal of scheduled 2020 VAT increases. However, a moderation in Italian ambitions for tax cuts, perhaps in exchange for some leeway on investments, will be necessary.

2) The current government offers insufficient concessions and the European Commission opens an Excessive Deficit Procedure. This does not come with immediate sanctions but rather starts a more prolonged process of negotiations. The scale of the sell-off in Italian debt in this scenario is however capped by accommodative ECB policies.

3) The government coalition unravels before or during budget negotiations, with a new government formed without the need for elections. Scope considers this scenario as unlikely.

4) The government coalition unravels before or during budget negotiations, leading to new elections and allowing the League to capitalise on the current favourable polls. A caretaker government could be charged with passing the 2020 budget.

Banks should fare adequately under these scenarios

While we believe that market sentiment will be a source of volatility, the impact on banks will be manageable, both in terms of capital and funding. The ECB's announcement of TLTRO 3 loans and Draghi's hints on continuing his ultra-loose monetary policy have made a prolonged funding drought less likely and banks will continue to tap markets.

Italexit: very low probability, but not to be ignored

We believe an Italexit is extremely unlikely

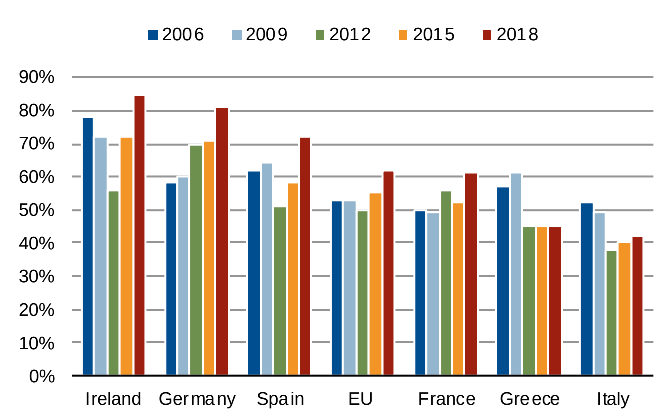
There remains the off-chance of a less benign end-game should a compact and uncompromising Italian government meet an unforgiving European Commission over the autumn. Beyond some posturing on both sides, there lurks the possibility that the debate around Italexit may gather pace.

Before being sworn in, both the League and the Five Star Movement had been openly critical of the EU institutional framework and hesitant about continued euro area membership. Once in power, however, their stances softened, though rekindled briefly in 2019 by the League during its campaign for European Parliament. The strategy paid off, giving the League a significant boost on election day.

Euroscepticism is on the rise in Italy

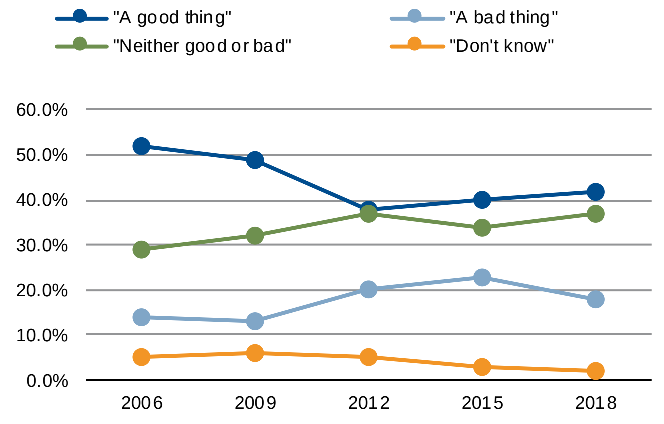
The success of anti-EU rhetoric is not surprising. According to the latest Eurobarometer survey, Italians are among the least satisfied with EU membership, and Italy is one of the few countries where EU approval is lower today than it was before the crisis.

Figure 8: Share of respondents holding a positive view of EU membership, Italy vs other EU countries



Source: European Parliament, Scope Ratings

Figure 9: The euro sovereign crisis took a toll on Italian Europhilia



Source: European Parliament, Scope Ratings

Over the past year, the government has moved in the direction of measures that could be steps to prepare the country for a possible currency break-up. These include a form of citizenship income alongside a citizenship-registered prepaid card; small-ticket, transferable government IOUs; a clarification on the ownership of Bank of Italy gold reserves; and a proposal to reform central-bank governance, including a provision to allow parliament to change the central bank's statute and increase the political role in the appointment of central bank directors.

Recent government initiatives raise doubts about the government's commitment to the euro

We do not believe the government is actively pursuing a unilateral currency break-up, and we consider the likelihood of an Italian exit from the euro as being very low over the foreseeable horizon – especially as the euro area architecture still lacks a legal mechanism facilitating any *orderly* euro exit However, Italy is executing elements of a playbook that could make an exit less painful, perhaps as a negotiating tactic or simply as prudent management of a worst-case outcome.

A change in the currency regime would yield unpredictable consequences and almost surely disrupt bank funding, most likely before it is even executed.

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