

Italian Banks' Asset Quality: Still a Problem but on an Improving Path



In this report we again deep-dive into the issue of Italian asset quality, building on our previous research and reviewing the situation in light of the most recent data and developments.

In our view, bad debts and other non-performing exposures (NPEs) are largely a legacy of the past and are unlikely, as some have claimed, to lead to widespread bank failures or to weigh heavily on public finances. We believe asset quality is currently under control at most banks, especially at large systemic ones. A few banks face more challenging situations, but these are largely a legacy of the past and are gradually being dealt with.

Italian asset quality has listed higher on our concern list in the past than it does today, despite heightened market attention following high-profile, negative news that hit the wires in 2016.

Scope expects NPEs in the Italian banking system to decline, albeit slowly, even in the absence of further action from the Italian government, as the domestic economic recovery eventually feeds through to troubled borrowers' finances and collateral values. Further government initiatives may speed up such process.

In fact, we believe Italian banks' problems have been exacerbated partly by the very proactive approach of supervisors in 2016 with regards to asset quality. This helped to undermine confidence in asset valuations, and in the sector more generally, even before the Renzi government's demise in December added to the reluctance to invest in Italian NPEs.

Growth in NPE transactions, which picked up in 2015, came to a halt in H2 2016. In our view, this is because funds started to anticipate a wall of NPE supply as a result of supervisory pressure on banks. Supply concerns, combined with increased political uncertainty in Italy, has to some extent derailed the efforts of Banca Monte dei Paschi di Siena (MPS) to raise capital independently, while pushing UniCredit to raise substantial levels of new capital and aggressively mark down loans. Scope expects a more dynamic market for NPEs in 2017.

For Unicredit (A-, under review for possible upgrade) and Intesa (A, Stable), asset quality remains a legacy weakness, although both banks are better placed than in the past. Unicredit, following a recent capital increase and the significant provisioning in Q4 2016, now displays more reassuring metrics, with total gross NPEs at 11.8% of loans and coverage above peers' across all NPE categories. Intesa's asset quality metrics, while less favourable, still compare well with Italian peers'. Both banks have seen positive trends for several quarters.

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Related Research

[Italian Banks: Myths and Reality about Asset Quality](#)
July 2016

[Public Securitisations of Italian NPLs Make an Unsteady Comeback in 2017](#)
January 2017

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Some clarity on definitions

In this report, we mostly refer to total **non-performing exposures (NPEs)** as defined by the EBA's 'Implementing Technical Standards' from October 2013, and as approved by the European Commission on 9 January 2015 (Regulation 680/2014). Circular 272 of the Bank of Italy also adopts these definitions.

The definition provides further sub-classifications for NPEs: i) bad loans, ii) unlikely to pay, and iii) past due or overdrawn.

In line with the EBA guidelines, Italian banks also disclose **performing forborne** exposures. While these borrowers are currently performing, some market participants consider them potentially problematic.

Figure 1: Different definitions apply to different aggregates

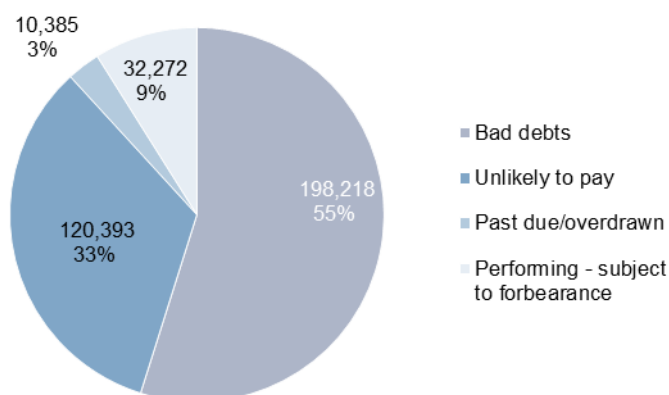
Non Performing Exposures (NPEs)		
Bad Loans	Unlikely to Pay	Past Due
On- and off- balance sheet exposures to a company in state of insolvency or in comparable situation, even if not recognized by a court of law, regardless of any guarantee or collateral posted on the exposure and irrespective of the bank's own opinion on a potential loss	Exposures where the debtor is assessed (by the bank) as unlikely to pay its obligation in full, without recourse actions or collateral realisation, regardless of any past due amount.	On-balance sheet exposures, excluding 'bad loans' and 'unlikely to pay', past due or overdrawn continuously for over 90 days. When such exposures represent more than 20% of all on-balance sheet exposures to that borrower, all off- and on-balance sheet exposures shall be considered as past due / overdrawn.
(Performing) Forborne		
Performing exposures towards a debtor facing or about to face financial difficulties where concessions (e.g. modification of contractual clauses, rolling over of exposure) have been made.		

Source: Scope Ratings

At the end of September 2016, total gross NPEs for the Italian banking system stood at EUR 329bn. This included EUR 198bn classified as bad debt, EUR 120bn as unlikely to pay, and EUR 10bn as past due or overdrawn. In addition, banks reported EUR 32bn of performing forborne loans.

Using the widest-possible definition of problem loans, EUR 361bn of exposures in the Italian banking system are considered potentially troubled, with the most severe classification comprising just over half of this total.

Figure 2: Potential problem loans, Italian banks (gross amounts, EUR bn)



Source: Bank of Italy
Note: as of September 2016

It is important to stress that NPEs do not automatically result in losses: The above-mentioned exposures are indeed covered by accumulated loan-loss provisions, collateral or personal guarantees. Aggregate data on NPE coverage is scarce; bottom-up data from the main banking groups in Italy show that coverage of total NPEs stands at around 50%, which includes only balance sheet provisions, thus disregarding collateral and guarantees.

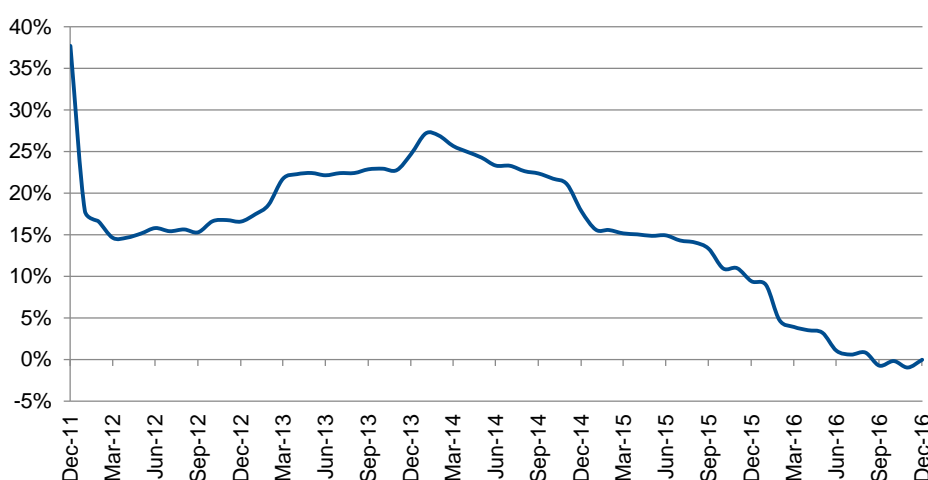
For the rest of this report, we will focus on NPEs (including bad loans, unlikely to pay and past due) and will leave forbore performing exposures out of our analysis.

Asset quality in Italy is under control

Although NPE levels remain a justified concern, asset quality trends have been improving for several years. We consider asset quality to be less of a problem today than it was a few years back.

Figure 3 shows the year-on-year change in gross bad loans for the system. Growth in bad loans has decelerated markedly since 2014 and is now practically nil.

Figure 3: Growth in gross bad loans (% YoY)

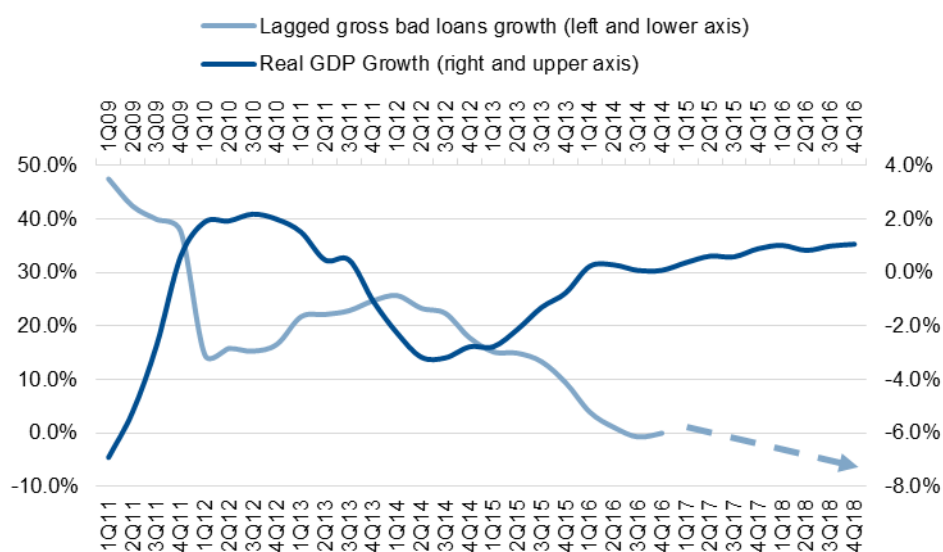


Source: Bank of Italy

In our view, this is not surprising: credit quality lags behind economic growth. The improvement in economic conditions (helped by quantitative easing, a weaker euro and cheap oil) has translated into marginal improvements in borrower performance.

After Italy's recession ended in 2014, asset quality trends started to stabilise in 2015, and are now exhibiting positive dynamics (Figure 4). We believe that, absent a relapse into recession, Italian bank NPEs will continue to decline in coming years, although slowly.

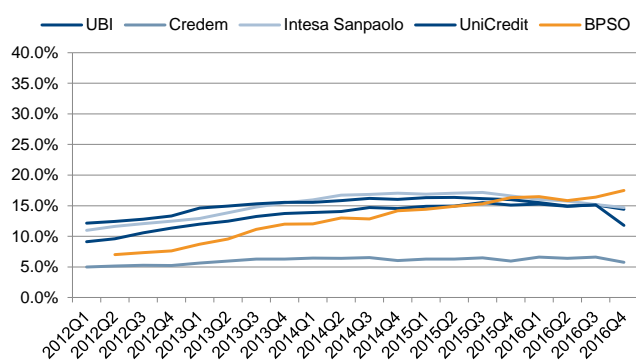
Figure 4: Growth in gross bad loans (two-year lag) and Italy GDP (% YoY)



Source: Bank of Italy, Eurostat, Scope Ratings

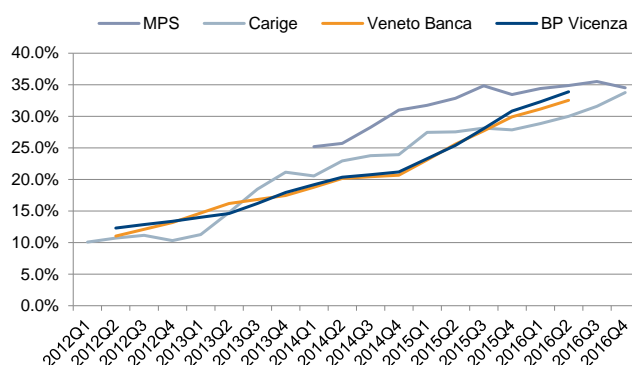
The timing of such a decline may vary from bank to bank. Even today, painting the whole sector's asset quality with a broad brush is misleading. Several banks, including national champions Intesa and Unicredit, have reported for several quarters a decline in new NPE formation and a rise in recoveries, and most banks of systemic importance are reporting stable or declining net NPE ratios.

Figure 5: Gross NPE ratios have stabilised at most banks...



Source: SNL, Scope Ratings

Figure 6: ...albeit with exceptions



Source: SNL, Scope Ratings

Weak spots undoubtedly remain, and are often more visible than the good stories. Nevertheless, to assume that the situation faced by MPS could extend to the rest of the

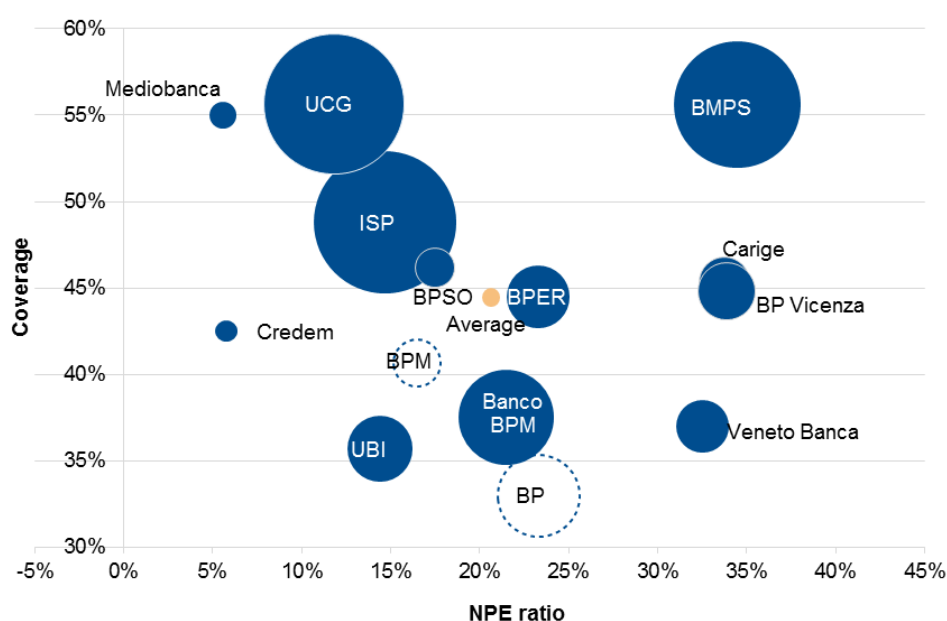
sector would be wrong. In fact, we believe most banks of systemic importance are in a good shape with respect to asset quality.

Coverage in line with expected recovery rates but not with bid prices

As we wrote in the past ([Italian Banks: Myths and Reality about Asset Quality, July 2016](#)), we do not believe Italian NPEs are significantly under-provisioned. Coverage levels vary, partly reflecting the differing compositions of NPE stocks at the different banks.

Figure 7 plots the NPE ratios and coverage of the major Italian banking groups (we estimate our sample accounts for 75% of total system NPEs).

Figure 7: NPE and coverage ratios, sample of Italian banks



Source: SNL, Company data, Scope Ratings
 Note: As of Dec 2016. For BPV and Veneto Banca, as of June 2016
 Size of the bubble indicates gross size of NPE portfolio

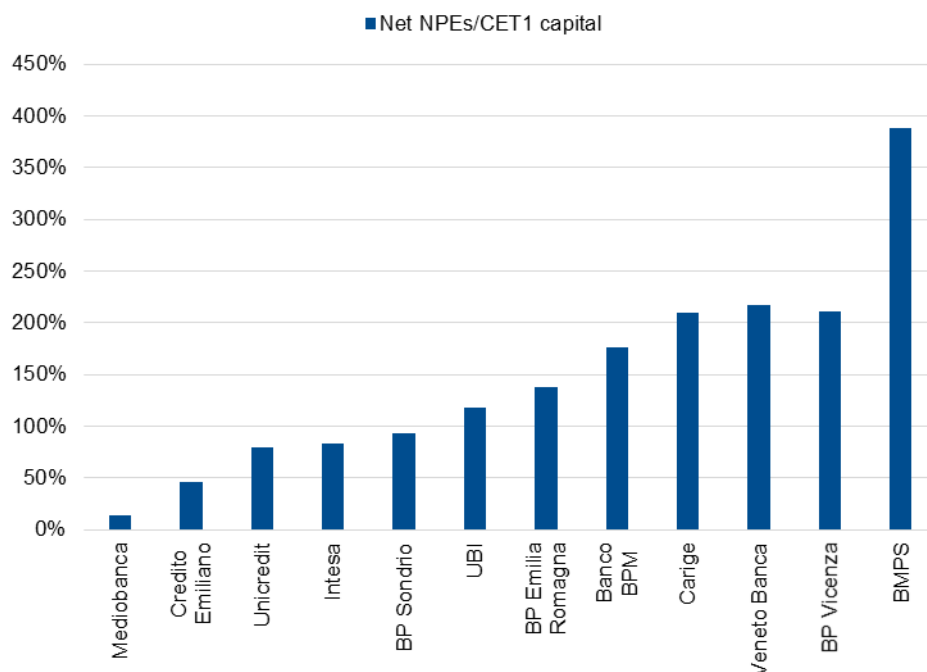
We identify three major groups:

- 1) The two rated banks, Intesa and Unicredit, have stable or declining gross and net NPE ratios, as well as declining Texas ratios¹. Combined, their NPEs account for 34% of the system's total. Other smaller banks also display fairly reassuring metrics.
- 2) Institutions with more troubling situations – namely, higher-than-average NPE levels and low coverage, and NPEs net of provisions amounting to a multiple of equity (MPS, Carige, Veneto Banca and BPV are examples) – contribute about 21% of the system's NPEs. We believe the recent precautionary recapitalisation of MPS, along with the government's decision to provide up to EUR 20bn to deal with banking sector recapitalisations, has materially removed headline risk around NPEs in this group.
- 3) Between the above two groups are a number of other institutions, mostly banche popolari or former popolari, which display either above-average NPE levels, or below average (but growing) coverage. Our analysis is mostly focused on the largest

¹ Calculated as the ratio of net NPEs over CET1 capital

popolari groups, all of which have reported improvements in asset quality, in some cases thanks to disposals.

Figure 8: Italian banks Texas ratios %



Source: SNL, Company data, Scope Ratings
Note: As of Dec 2016. For BPV and Veneto Banca, as of June 2016.

To be sure, differing metrics often reflect differing strategies and asset compositions. For example, bad loans generally require more provisions than past-due loans which are not impaired. Similarly, NPEs backed by real estate collateral would require lower provisioning than say, credit cards. Moreover, different write-off policies can distort comparisons (banks writing off debt more aggressively tend to report lower coverage).

While perfect granularity is difficult to achieve, banks typically report separate coverage ratios for the different types of NPEs.

Coverage of bad loans ranges between 45% and 65% (sector average is 57% according to data from Bank of Italy).

The average coverage of bad loans is in line with historical recovery rates (41% during 2011-2014, according to a recent survey by the Bank of Italy). This would allow banks to work out their bad-loan stocks without major further losses, if they chose to do so. However, this would take many years, and banks are under pressure from regulators to accelerate the de-risking of balance sheets.

Coverage of unlikely-to-pay and past-due loans is lower, reflecting the lower severity of their non-performance. Sector data relating to the coverage of these loans is not available, but coverage for unlikely-to-pay loans typically ranges between 15% and 45%, while coverage of past-due loans ranges between 5% and 35%. Should these exposures migrate to bad loans, they would require further provisioning.

Figure 9: Key asset-quality metrics, Italian banks

	Mediobanca	Credito Emiliano	Unicredit	Intesa	BP Sondrio	UBI	BP Emilia Romagna	Banco BPM	Carige	Veneto Banca	BP Vicenza	BMPS
Gross NPEs (EUR m)	2,082	1,403	56,342	58,137	4,426	12,521	11,174	25,914	7,333	7,891	9,394	45,785
Coverage	55.0%	42.5%	55.6%	48.8%	46.2%	35.7%	44.5%	37.5%	45.4%	36.9%	44.8%	55.6%
Bad loans (EUR m)	542	856	31,799	37,834	2,100	7,261	7,039	14,413	3,726	3,867	4,612	29,424
Coverage	69.0%	59.6%	65.6%	60.6%	63.4%	45.1%	57.3%	45.7%	63.0%	52.9%	59.2%	64.8%
Unlikely to pay (EUR m)	Na	504	23,165	19,745	Na	5,119	3,977	11,349	3,487	3,731	4,646	15,247
Coverage	Na	15.6%	43.3%	26.9%	Na	23.1%	23.5%	27.2%	27.5%	22.4%	31.4%	40.3%
Past-due loans (EUR m)	Na	43	1,379	558	Na	141	158	153	120	293	137	1,114
Coverage	Na	16.9%	34.3%	21.7%	Na	5.7%	7.8%	18.2%	16.4%	10.6%	11.1%	23.3%
Gross NPE ratio	5.6%	5.8%	11.8%	14.7%	17.5%	14.4%	23.3%	21.5%	33.8%	32.6%	33.9%	34.5%
Net NPE ratio	2.5%	3.4%	5.6%	8.2%	9.4%	9.8%	14.6%	14.7%	22.1%	23.5%	22.2%	19.0%
Net NPEs (EUR m)	937	807	24,995	29,767	2,382	8,056	6,197	16,204	4,077	4,979	5,187	20,320
Net NPEs/CET1 capital	14.2%	45.7%	79.3%	82.9%	92.9%	118.0%	137.8%	176.6%	210.1%	216.7%	210.9%	387.8%
Gross NPEs/Sector NPEs	0.6%	0.4%	17.1%	17.7%	1.3%	3.8%	3.4%	7.9%	2.2%	2.4%	2.9%	13.9%

Source: SNL, Company data, Scope Ratings
Note: As of Dec 2016. For BPV and Veneto Banca, as of June 2016.

Overall, while poor asset quality remains a credit weakness for the sector, Scope does not believe there is an emergency, or the potential for the crisis to escalate at a level where it could pose systemic risk. As a matter of fact, asset quality listed higher on our list of concerns in 2014 (when our ratings activity started), during which non-performance was mounting and the economy was still in the doldrums.

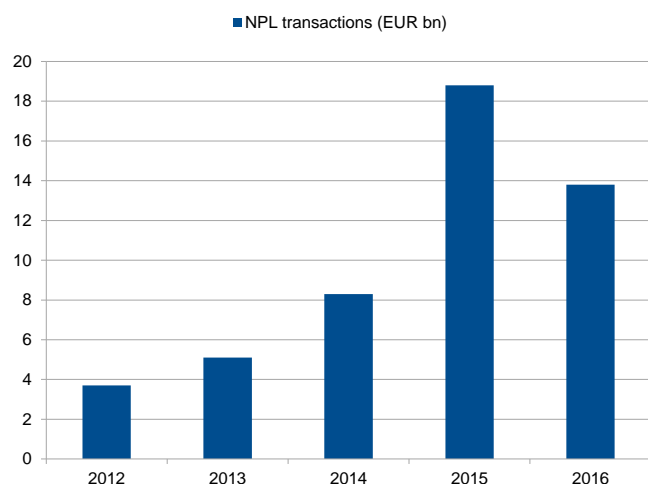
Many observers indicate that NPE sales are a key avenue to de-risking balance sheets.

From a shareholder's perspective, however, this avenue has always been unpalatable. Indeed, buyers of NPEs typically require a 15-20% return on such an investment, which is higher than banks' own current, projected or hoped-for profitability. Hence, selling asset portfolios with such internal rates of return is, from a bank shareholder's perspective, undesirable (however reassuring this may be for supervisors or credit investors). Moreover, to mark down NPEs to a level that would attract investors' demand (c. 20% of face value, if recent deals are any indication), banks would have to recognise further losses upfront, and sometimes raise further capital. This would dilute current shareholders, again an unattractive proposition.

Despite this challenge, the market for NPEs picked up some steam in 2014 and 2015, and there were high hopes of further acceleration in 2016 based on first-quarter trends. It turned out that such early hopes were misplaced, and Italian NPE deals slowed to a trickle from Q2 2016.

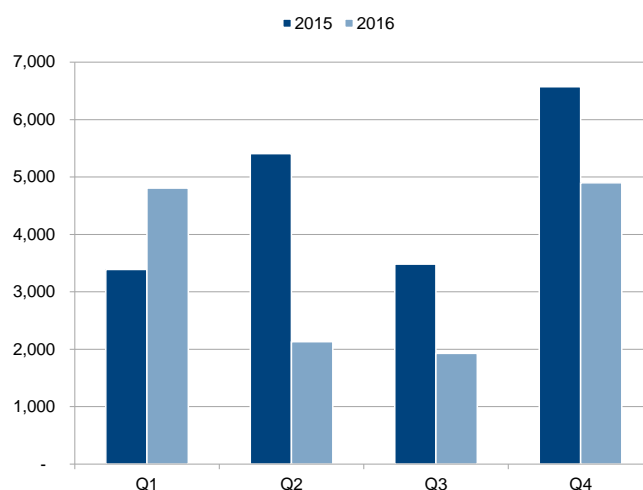
Selling NPEs remains unpalatable, due to high upfront cost

Figure 10: NPE transactions were showing a positive trend...



Source: PwC, Scope Ratings

Figure 11:which halted from Q2 2016



Source: PwC, Scope Ratings

In our view, the reasons for the slowdown were twofold:

- 1) In Q2 2016, supervisors were clearly upping the pressure on some banks to reduce NPE levels, to the point of sending letters with explicit reduction targets. In our view, this led to expectations of higher forced supply and of lower prices, and some buyers may have opted to tactically sit out of the market.
- 2) Later in the year, political uncertainty connected to the referendum on constitutional reform further dampened investors' appetite for Italian assets.

We believe that the market will see a revival in 2017. Both Unicredit and MPS plan to sell tens of billions of NPEs, with other banks also considering disposals.

We also expect some recovery of the NPE ABS market, which has been dormant for several years. This should be supported in 2017 by recent government initiatives, including the NPE securitisation guarantee scheme (Garanzia Cartolarizzazione Sofferenze), the creation of the Atlante funds, and reforms to address legacy legal issues related to credit recovery. In 2016, only Banca Popolare di Bari issued a securitisation (EUR 150m); while 2017 has already seen a large securitisation project launched by Unicredit (project FINO) to help deconsolidate EUR 17bn of loans.

I. Appendix: Recent initiatives to improve systemic asset quality

Despite much criticism about government inertia, Scope finds that, in the realm of banks and asset quality, Italy has been quite active over the past few years. In 2015, reforms of popolari banks and banking foundations were passed (a reform of cooperative banks was passed in 2016), as well as a more favourable tax treatment of loan-loss provisions to incentivise the provisioning of bad loans.

In 2016, additional initiatives were taken to support the sector:

Garanzia Cartolarizzazione Crediti (GACS)

In February 2016 a law decree (converted to law in April) introduced the possibility of a state guarantee on securitisations of non-performing loans. Subject to certain conditions, and for a fee, the state can issue a guarantee on the senior tranches.

New measure to reduce recovery time

Law decree 59/2016, converted to law in June, includes additional measures to reduce NPE recovery times, including:

- The possibility for debtors to pledge assets without transferring control
- The option to include clauses in loan agreements for the out-of-court enforcement of real property guarantees (Patto Marciano)
- Changes in rules and procedures for the execution of enforcement proceedings

Atlante funds

While technically a private-sector initiative, Atlante 1 (EUR 4.25bn) and Atlante 2 (undisclosed) funds were also launched with the aim to support some of the most difficult recapitalisations and balance sheet clean-ups, and buying junior tranches of NPE securitisations to help deconsolidate bad assets.

Salva Risparmio-earmarked funds

In the middle of the MPS crisis in December 2016, the Italian government launched Decree 237/2016 (so-called Salva Risparmio), which earmarks EUR 20bn to support recapitalisations of troubled banks. EUR 6.6bn are needed to support MPS's recapitalisation plan, with the rest available to support other ailing institutions.



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