SECTOR OUTLOOK

Italian Banking Sector Outlook 2018

Overall Outlook: Stable

Contacts:
Carola Saldias
Senior Director
+39 02 7274 6011
carola.saldias@dagongeurope.com

Evgeni Petkov, CFA
Associate Director
+49 69 7805 9056
evgeni.petkov@dagongeurope.com

Highlights

Focus on asset quality: Asset quality has been the key challenge for Italian banks, due to a very large stock of non-performing loans (NPL) of EUR 324Bn as of 2Q17, that has not been managed as proactively as it has been the case in other EU countries (e.g. Spain and Ireland). A more active approach has been implemented only from the second half of 2016, mostly following the publication of the 'Guidance to banks on non-performing loans' by the ECB.

Larger sales of NPL expected for 2018: Italian banks are materialising larger sales and write-downs of NPL. We expect that NPL will reach a level closer to 15.5% of all loans, with a coverage ratio above 55% by YE18, following the more aggressive initiatives to sell deteriorated loans and to manage the portfolios more actively compared to what has been done in previous years.

Persistently low interest rate environment: We expect that for 2018 the still low interest rate environment will keep profitability close to the levels of YE17. In addition, Italian banks with heavy operational structures are struggling to significantly reduce costs to offset the reduction of net interest income coming from the low level of interest rates.

Efforts to consolidate the industry and improve efficiency: The structural weakness inherited from the very fragmented nature of the Italian banking system (around 400 consolidated banking groups by the end of 2016) has been the driver of a very low efficiency. Larger players (e.g. Banca Monte dei Paschi (NR) and Unicredit (NR)) are implementing aggressive plans to modernise their operating structures and improve efficiency going forward.

Capital has been strengthened in 2017: We expect further improvements in capital, following the need to build up MREL. Italian banks will continue to build up capital levels to be more aligned with European competitors, following also the trend on CET 1 increases promoted by the regulators.

Capitalisation ratios to be affected by IFRS 9: Based on calculations disclosed by the Bank of Italy, the introduction of IFRS 9 will have an estimated negative effect of 38bps on the average CET 1 of Italian banks, with a more moderate effect for significant banks than for less significant banks (37 and 47bps, respectively).

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1. Asset quality: reduction of NPLs as a strategic goal

The Italian banking system is showing positive signs in terms of asset quality improvements. Based on information published by the Bank of Italy, in 3Q17 the flow of new NPL as a percentage of total loans fell to 1.7%[1] (peak of around 6% in 2013), the lowest level for the period 2006-2017.

In addition, in 1H17 banks have shown a more proactive approach to reduce NPL. At an aggregate level, the stock of NPL has been decreasing mostly from portfolio sales executed by the largest Italian banks, as well as through the resolution and liquidation of the banks Banco Popolare di Vicenza (NR) and Veneto Banca (NR). Up until 2016, Italian banks had been very reluctant to sell NPL due to their expectations for recovery and also due to the potential effects of additional losses generated by a sale price that could be below book value. In 2016 a total of only EUR 11Bn of bad debt portfolios has been sold, an amount that is still very marginal compared to the total exposure, whereas in the first three quarters of 2017 banks sold or wrote down about EUR 26Bn of NPL.

Nevertheless, the stock of gross NPL accumulated by Italian banks up to 2Q17 is still significant and reached EUR 324Bn (16.3% of total loans, compared to an EU weighted average of 4.5%), mitigated to some extent by a large stock of provisions that allowed NPL coverage to reach 53.5% (EU weighted average coverage at 45.0% for 2Q17). These figures evidence the improvement compared to a peak of EUR 360Bn of NPL and coverage at 45.4% reached at YE15.

Italian Banks - Asset Quality	December 2014	December 2015	December 2016	June 2017
Total loans, EUR Bn	1,974	1,990	2,017	1,979
NPL, EUR Bn	350	360	349	324
NPL as of total loans (1)	17.7%	18.1%	17.3%	16.3%
EU weighted average NPL (2)	6.5%	5.7%	5.1%	4.5%
NPL Coverage	44.4%	45.4%	50.6%	53.5%

Sources: (1) Banca d'Italia Financial Stability Reports. (2) EBA Dashboard 2Q2017

It is also worth mentioning that after the implementation of several legal reforms of foreclosure and bankruptcy procedures, recovery times have shortened as indicated by studies of the Ministry of Justice[2]. This has helped to better manage NPL and to simplify the procedures needed in order to register foreclosures and to sell the collateral/assets.

In addition, the ECB has been providing guidance to banks to reduce the level of NPL through different tools and requesting a more active approach. The latest initiative, published in October 2017 as a consultation paper, sets minimum levels of prudential provisioning for exposures classified as NPL. The guidance requires that banks should provision new unsecured NPL in full within a period of two years of them being classified as such and secured NPL exposures within a period of seven years.

Outlook for 2018:

We expect that the aggregate level of NPL for Italian banks will continue to decrease, mostly from additional sales of NPL portfolios. We foresee a reduction of the aggregate NPL ratio to about 15.5% or at least 100bps lower than 2017, which will differ from larger to smaller banks. We expect larger banks to be more aggressive in their sales and write-downs. However, due to the regulatory and legal differences related to the bankruptcy procedures, we expect that NPL in the Italian banking industry will be at levels above the EU average for a longer period unless the legal framework changes significantly.

In terms of coverage, we expect a slight improvement to a level closer to 55%, following the sales of NPL and additional provisions recognised in anticipation of any potential implementation of tougher provisioning following the new guidance promoted by the ECB[3]. It is worth noting that Italian banks already have been increasing the recognition of provisions, first as it has been encouraged by the regulator and also in order to anticipate the impact of any future sale or securitisation on overall profitability.

[1] Banca d'Italia, Financial Stability Report November 2017.
[2] Tavolo di Studio sulle Esecuzioni Italiane.
[3] ECB Guidance to banks on non-performing loans, March 2017; Addendum to the ECB Guidance to banks on non-performing loans: Prudential provisioning backstop for non performing exposures, October 2017.

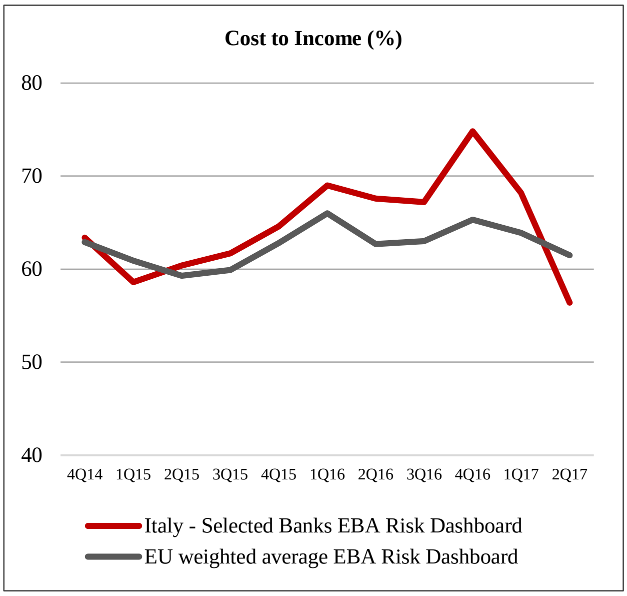
2. Profitability: persistently low interest rate environment

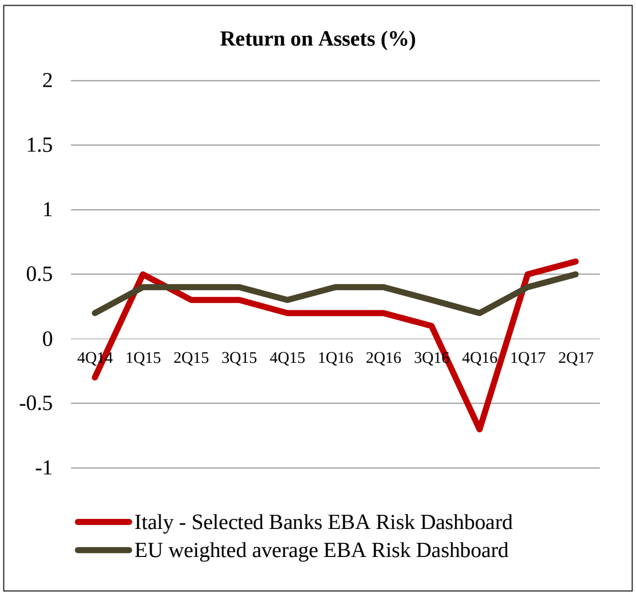
The persistently low interest rate environment is adding significant pressure to banks that have large operational structures. This has been a legacy problem of the Italian banking industry, with a very large and fragmented banking system with around 400 institutions, in which the so-called ‘significant banks’ (those directly supervised by the ECB) account for 75% of total gross customers loans as of 2Q17.

Net interest income remains the main source of income for Italian banks, representing 40.7% of total operating income based on the data provided by the EBA Dashboard 2Q17. In addition, based on information disclosed by the Association of Italian Banks (ABI), the average interest rate charged by banks on retail customer loans was at a historic minimum of 2.73%[4] as of November 2017. The average interest rate on corporate loans was also at its historic minimum at 1.45%. Despite the fact that in terms of cost of funding Italian banks are facing a favourable scenario with low funding costs, the effect of a persistent decrease in the net margin due to the low interest rate environment is negatively affecting the return of the industry to adequate levels of profitability.

In terms of cost efficiency, Italian banks are implementing a more aggressive approach to reduce operational costs compared to previous years. Consolidation among banks is also taking place at a faster pace, following the mergers between some medium sized banks and also after the resolution applied to Banca Popolare di Vicenza and Veneto Banca. As a result, in 2Q17 the cost to income ratio of Italian banks decreased to 56.4% and reached levels below the EU average of 61.5% for the same period.

Profitability of Italian banks was significantly affected by the large losses of Unicredit and Banca Monte dei Paschi recorded in 2016. However, by 2Q17 as a result of the banking consolidation and deleveraging, return on assets has finally recovered reaching 0.6%, compared to 0.5% for the EU weighted average.





Source: EBA Risk Dashboard 2Q2017, Dagong.

Outlook for 2018:

We expect that Italian banks will show an improvement in margins as well as in net interest income only by the second half of 2018, mostly based on a slight increase in interest rates that will allow banks to adjust the pricing of their loan portfolios accordingly. However, we expect this to be done slowly and to be better reflected by the results in the first quarter of 2019.

In terms of operating costs and cost to income ratio, we expect the trend observed in 2017 to continue and to show significant improvements compared to the peak of 2016. We expect cost to income to be in the lower range of 55%-65% for Italian banks, and to be more aligned to the EU average going forward, considering the additional room for further industry consolidation.

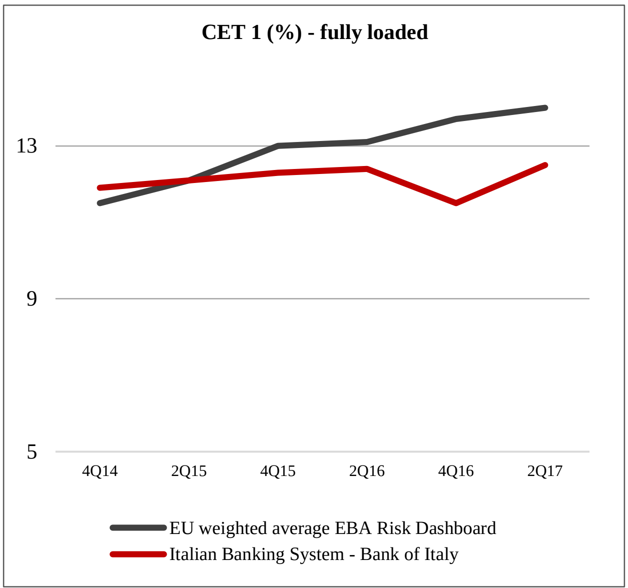
Profitability measured as return on assets should reach positive levels, following the improvements evidenced in 2017. However, we do not expect levels above 0.5%, considering that Italian banks will continue to clean-up their loan portfolios reducing NPL and, therefore, recognising additional credit losses.

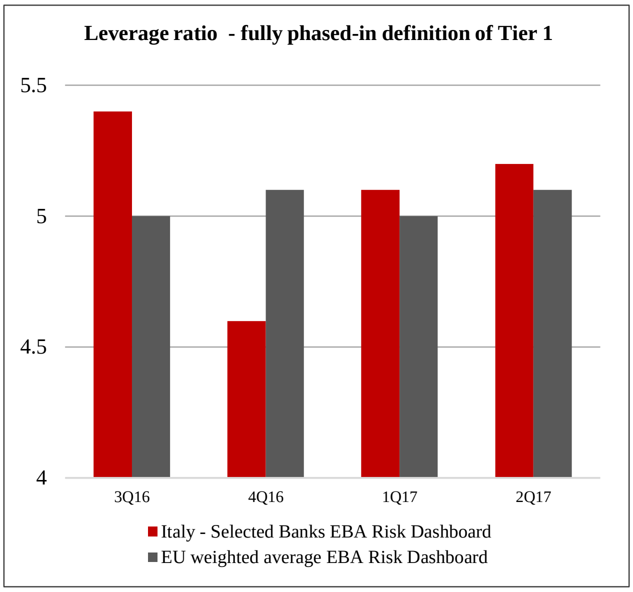
[4] ABI Monthly Outlook December 2017.

3. Capital: building up capital to anticipate MREL and IFRS 9

Italian banks' capitalisation based on CET 1 ratio has improved in 2017 following the reduction experienced in 2016, which was mostly driven by the one-off decrease of the CET 1 ratio of Unicredit. For the 2Q17, the aggregate CET 1 for Italian banks reached 12.5%,[5] compared to 11.5% for YE16, which is still below the EU weighted average of 14.0% and 13.7%[6], respectively. For Italian banks, the improvement comes mostly from the combination of two factors: an active approach to reduce risk weighted assets on one hand and an increase of own funds on the other. The reduction of risk weighted assets has mostly been driven by continuous deleveraging and reduction of NPL. The increase in own funds comes mostly from the capital increase done by Unicredit in the first half of 2017.

We observe however, ample differences between larger banks and less significant banks as highlighted also by the Bank of Italy, with larger banks reaching on average 11.8% and less significant ones 15.6%. Since the capitalisation measures of large banks like Banca Monte dei Paschi di Siena and Banca Carige (NR) only started in 2H17, the ratios above do not incorporate those new events, which should lead to an improvement in the CET 1 ratio of larger banks from 2Q17 onwards. In terms of leverage ratio, we observe that after the reduction of capitalisation generated by the significant losses of two large banks in 2016, the Italian average (5.2% as of 2Q17) has improved to levels in line with the EU weighted average of 5.1% for the same period.





Source: EBA Risk Dashboard 2Q2017, Banca d'Italia, Dagong.

Outlook for 2018:

We expect that with the sale of NPL and securitisation transactions, capital ratios for Italian banks that have a large component of NPL will improve due to the release of capital allocated to assets with a high risk weighted component (NPL are typically weighted at 150%).

In addition, we foresee that Italian banks will continue to strengthen capital to face the introduction of MREL, through capital increases and eligible debt issuances, and will be able to do so without being penalised by the market with an above average yield based on the current scenario of historically low interest rates.

However, in terms of the IFRS 9 implementation and based on calculations disclosed by the Bank of Italy, the introduction of IFRS 9 will have an estimated negative effect of 38bps on the average CET 1 ratio of Italian banks, with a more moderate effect for large banks than for less significant banks (37 and 47 bps, respectively).

Finally, capitalisation should also improve if profitability recovers faster than expected, following a change in the interest rate environment to higher levels from those expected for 2018. However, this scenario is unlikely in our view.

[5] Banca d'Italia, Financial Stability Report November 2017.
[6] EBA Risk Dashboard Data as of Q2 2017.

Annex: Financial highlights of selected Italian banks

	Total Assets EUR Bn		NPL (%)		Coverage (%)		Tier 1 (%)		RoAA (%)		Dagong Global Ratings
	YE16	2Q17	YE16	2Q17	YE16	2Q17	YE16	2Q17	YE16	2Q17	LTCR (4)
UniCredit SpA	859.5	827.1	11.8	11.0	59.5	60.2	8.2	12.9	-1.29	0.50	NR
Intesa Sanpaolo SpA	725.1	788.0	14.7	12.9	51.6	52.7	12.7	12.5	0.45	2.28	NR
Gruppo Banco BPM (1)	-	167.7	-	13.0	-	49.0	-	11.1	-	0.05	NR
Banca Monte dei Paschi di Siena SpA	153.2	143.6	34.5	37.8	57.1	67.1	8.2	1.5	-1.96	-8.41	NR
Unione di Banche Italiane SpA	112.4	134.3	14.4	14.1	38.7	43.4	11.5	11.4	-0.73	2.04	NR
BPER Banca SpA	64.9	70.5	22.1	21.1	46.2	48.7	13.8	13.4	0.04	0.59	NR
Mediobanca SpA (2)	69.8	70.4	5.5	54.8	67.4	69.9	12.1	13.3	0.86	1.03	NR
Crédit Agricole Cariparma SpA	52.9	55.7	12.4	11.7	42.2	44.2	11.4	11.1	0.40	0.50	NR
Banca Popolare di Sondrio SCpA	37.2	40.6	16.1	15.6	49.3	50.9	11.1	11.1	0.28	0.30	BBB/Stable
Credito Emiliano SpA	39.6	39.7	5.8	5.8	47.4	48.6	13.2	13.0	0.35	0.53	NR
Unipol Banca SpA (3)	12.4	11.9	36.2	35.8	31.1	70.5	9.0	15.2	0.06	-20.30	BB/Stable

(1) Gruppo BPM presented only proforma information for YE16.
(2) For Mediobanca the data for YE16 refers to 1H16.
(3) 2Q17 data for Unipol Banca is based on individual financial statements.
(4) LTCR: Long-Term Credit Rating
Sources: SNL Financials, banks' annual and semiannual reports, Dagong calculations.

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