



RATING ACTION REPORT

07 February 2018

Dagong Global Affirms the Long-Term Credit Rating of Banca Popolare di Sondrio S.c.p.A. at 'BBB', Outlook 'Stable'

Primary analyst

Carola Saldias
Senior Director
Via dei Bossi 2a
20121 Milan, Italy
+39 02 7274 6029
carola.saldias@dagongeuropa.com

Back-up analyst

Evgeni Petkov
Associate Director
+49 69 7805 9056
evgeni.petkov@dagongeuropa.com

Committee chairperson

Gerald Dorsch
Senior Director
+49 69 8304 7547
gerald.dorsch@dagongeuropa.com

Dagong Global has affirmed the Long-Term Credit Rating of Banca Popolare di Sondrio S.c.p.A. (BPS) at 'BBB', with Outlook 'Stable'. The Short-Term Credit Rating is affirmed at 'A-3'.

RATING RATIONALE

The Long-Term Credit Rating takes into account the Individual Financial Strength Assessment (IFSA) at 'bbb', and our External Support Assessment (ESA) of 'Low', reflecting a low potential to receive National Systemic Support. The level of support considers the fact that the bank is under the Banking Recovery and Resolution Directive (BRRD), which does not allow any form of government support.

The IFSA reflects BPS's stable franchise in terms of loans and deposits in its home market of Lombardy in Northern Italy. It also reflects the bank's profitable and stable traditional banking model, retail-based funding, strong liquidity, very strong capitalisation and adequate non-performing loans coverage. The IFSA is constrained by the bank's still large stock of non-performing loans (NPL) and relatively small size, which limits any material improvement in its geographic scope and competitive positioning. The main considerations for the IFSA are laid out below.

Sustainable franchise

BPS has kept a traditional banking business model with focus on lending and deposit-taking in Northern Italy, which historically has shown better economic growth than the rest of Italy. At local level in the province of Sondrio, the bank enjoys a stable and large market share in terms of loans of about 43% as of 3Q17, while in the overall region of Lombardy its market share is 3.7% and in Italy it is 1.2%. In our view, the bank keeps a balanced composition of earnings from core banking activities, with net interest representing 48.9% of operating income.

Stable funding structure and liquidity

BPS's funding consists mainly of deposits (78% of average total funding for 3Q17) which is a common strength of local traditional banks and in particular of co-operative banks in Italy. The remainder comes from market funds (13%) and net interbank funding (9%, of which ECB TLTRO¹ is about 74%).

Liquidity, in our opinion, is ample and comes from a sizeable portfolio of ECB eligible assets that amounts to EUR 12.3Bn, with current usage at EUR 5.3Bn. We expect that the funding structure will remain mostly based on customers' deposits, however, market funds could increase their relative importance following the need of MREL² in the medium term.

¹ Targeted Longer-Term Refinancing Operations

² Minimum Requirement for own funds and Eligible Liabilities

Capital

BPS had successfully raised capital in the past, in anticipation of the Comprehensive Assessment conducted by the ECB (European Central Bank) and the EBA (European Banking Authority). In addition, following the requirements after the implementation of the BRRD and the SREP³, the bank has been able to improve its capitalisation through internal capital generation and to reach a Tier 1 ratio of 11.6% by 3Q17 (11.1% at YE16), which we expect to increase further in the medium term. We view this level as adequate, considering the 7.25% minimum required by the ECB. In our opinion, BPS has a sufficient capital buffer to support lending growth and to weather off potential unlikely increases in credit risk.

Credit Risk

Asset quality remains the main challenge for BPS. Loan loss provision expenditure (LLP) increased substantially in the period 2012-2014, affecting profitability and hence the bank's internal capital generation. In 2015, the bank was able to change the trend and improve asset quality, which allowed it to reduce the cost of risk and reach a level of 101bps as of YE16 (from the peak of 194bps in 2013). For YE16 and 3Q17 the bank is showing further improvements in asset quality, with NPL⁴ at 15.6% of gross loans based on Dagong calculations for 3Q17, compared to 16.1% by YE16. We expect this trend to persist following the more active approach to reduce NPL implemented by the bank last year.

Geographic Diversification and Competitive Position

BPS's geographic diversification is in our view moderate, given its presence mostly in selected Italian regions and Switzerland through its fully owned subsidiary Banca Popolare di Sondrio (SUISSE) SA. The current portfolio composition in terms of gross loans with Lombardy 56.5%, Lazio 10.5% and Switzerland 13.4% as of 3Q17, does not contribute enough diversification to mitigate the still relatively weak growth prospects of the Italian economy, in our opinion. However, some additional diversification coming from the potential acquisition of Cassa di Risparmio di Cento in the region of Emilia-Romagna will likely be materialised during 2018.

External Support Assessment

We assess the possibility of national systemic support as 'Low' for BPS. Our view takes into account the application of the BRRD since January 2016. This directive gives the Single Resolution Committee (at EU level) the power to decide on resolution plans, and identify the most appropriate actions to preserve the financial stability of the Euro area in the need of implementing a resolution procedure for any bank. We recognise that for BPS – now under the direct supervision of the ECB and the BRRD – any forthcoming direct support is to be structured through the Banking Resolution Mechanism, using the approved tools including the centralised Single Resolution Fund.

RATING OUTLOOK

The 'Stable' outlook reflects our view on the bank's stable financial performance, with internal capital generation growing in the next two years and sufficient to cover additional potential losses from current and expected problematic assets, without material effects on capital ratios. In addition, the stable outlook incorporates the expected cautious organic growth strategy within the bank's current geographic scope and a smooth reduction of NPL. We also expect a slow recovery of profitability during 2018-2019 following a stabilisation of net interest margins and a reduction of loan loss provisions, and a stable and ample liquidity buffer supported by a large pool of ECB eligible assets.

RATING SENSITIVITIES

We would consider a positive rating action if we see a material and sustainable improvement in core profitability levels in a more resilient and growing economic context, further strengthened capital, or a material reduction of problematic assets.

We would consider a negative rating action if we see a deterioration of capital ratios, most likely triggered by a worse-than-expected evolution of the bank's asset quality and hence weaker profitability. A downgrade could also be triggered by a reduction of coverage levels for the NPL portfolio.

³ Supervisory Review and Evaluation Process

⁴ NPL definition used by EBA that includes 'sofferenze', 'inadempienze probabili' and 'esposizioni scadute'.

COMPANY PROFILE

BPS was established in 1871 in Sondrio and incorporated as a ‘banca popolare’⁵. The bank focuses on traditional banking services, providing plain vanilla banking products mainly to households and local small and medium-sized corporates in its home region, Lombardy. The bank has a network of 350 branches, located in 8 regions and 31 provinces, mainly in Northern Italy and Rome. The bank is grouped within the medium-sized banks in Italy, with EUR 27.6Bn in consolidated gross loans and EUR 40.0Bn in consolidated assets as of 3Q17. In terms of market share, the bank is relatively small for the Italian market (1.2% market share in terms of loans in September 2017), but benefits from a significant market share in the province of Sondrio (42.8%).

BPS has two important subsidiaries that help to diversify geographically and business-wise:

(1) Banca Popolare di Sondrio (SUISSE) SA, established in 1995 and headquartered in Lugano, Switzerland. 100% controlled by BPS, it is incorporated under Swiss law and supervised by the Swiss National Bank. It provides lending to individuals and corporates, as well as private banking and asset management services, through its 20 branches in Switzerland and one branch in Monaco. On a consolidated basis, it accounts for 13% of BPS’s total loans as of 3Q17.

(2) Factorit, a factoring company which operates mainly in Italy and of which BPS holds 60.5%.

FULL LIST OF SOLICITED RATINGS**Banca Popolare di Sondrio S.c.p.A.**

Long-Term Credit Rating (FC&LC)	BBB
Short-Term Credit Rating (FC&LC)	A-3
Outlook	Stable
IFSA	bbb
ESA	Low, National Systemic

FC&LC: Foreign Currency and Local Currency

RATING HISTORY

Banca Popolare di Sondrio S.c.p.A.	BBB/A-3/Stable (16 February 2017)
Banca Popolare di Sondrio S.c.p.A.	BBB/A-3/Stable (22 February 2016)
Banca Popolare di Sondrio S.c.p.A.	BBB/A-3/Stable (26 February 2015)

CRITERIA APPLIED

Criteria for Rating Financial Institutions (10 July 2017)

OTHER REGULATORY DISCLOSURES

- The ratings above are solicited and Dagong has received compensation for providing these ratings.
- In determining the ratings, Dagong uses public and non-public information provided by the issuer, public information from reliable third-party sources and internally developed models and analytical tools. Dagong’s analytical team does not take into consideration sources of information deemed not reliable.
- This Rating Action Report was disclosed to the rated entity before being published. Dagong had provided the rated entity a draft ahead of the publication to review for any factual errors and unintentional disclosure of confidential information. Dagong maintains full editorial control over the Rating Action Report, which represents its independent opinion.

For any further information on rating criteria and procedures, please refer to the following links:

<http://www.dagongeuropa.com/procedures.php>

http://www.dagongeuropa.com/rating_criteria.php

Media contact:

Fei Chen

+49 69 8304 4421

fei.chen@dagongeuropa.com

⁵ Movement of co-operative banks developed in Italy since 1864 with the foundation of several banking institutions that follow the cooperative model (one stakeholder, one vote) with the objective of promoting the economic development of a specific region or territory.

DISCLAIMERS

NO CONTENT (INCLUDING RATINGS, CREDIT-RELATED ANALYSES AND DATA, VALUATIONS, MODEL, SOFTWARE OR OTHER APPLICATION OR OUTPUT THEREFROM) OR ANY PART THEREOF ("CONTENT") MAY BE MODIFIED, REVERSE ENGINEERED, REPRODUCED OR DISTRIBUTED IN ANY FORM BY ANY MEANS, OR STORED IN A DATABASE OR RETRIEVAL SYSTEM, WITHOUT THE PRIOR WRITTEN PERMISSION OF DAGONG GLOBAL. DAGONG GLOBAL DOES NOT INTEND TO ASSUME, AND IS NOT ASSUMING, ANY RESPONSIBILITY OR LIABILITY TO ANY PARTY ARISING OUT OF, OR WITH RESPECT TO, THIS CONTENT. THIS CONTENT IS NOT INTENDED TO, AND DOES NOT, FORM A PART OF ANY CONTRACT WITH ANYONE, EITHER DIRECTLY OR INDIRECTLY. THE CONTENT SHALL NOT BE USED FOR ANY UNLAWFUL OR UNAUTHORIZED PURPOSES. DAGONG GLOBAL DOES NOT GUARANTEE THE ACCURACY, COMPLETENESS, TIMELINESS OR AVAILABILITY OF THE CONTENT AND IS NOT RESPONSIBLE FOR ANY ERRORS OR OMISSIONS (NEGLIGENT OR OTHERWISE), REGARDLESS OF THE CAUSE, FOR THE RESULTS OBTAINED FROM THE USE OF THE CONTENT.

USERS OF RATINGS

USERS OF RATINGS SHOULD BE AWARE THAT DAGONG GLOBAL'S RATINGS ARE OPINIONS REFLECTING THE ABILITY OF AN ENTITY OR A SECURITIES ISSUE TO MEET FINANCIAL COMMITMENTS SUCH AS INTEREST, PREFERRED DIVIDENDS AND REPAYMENT OF PRINCIPAL, IN ACCORDANCE WITH THEIR TERMS. IN PARTICULAR, THE USERS OF RATINGS SHOULD BE AWARE THAT A CREDIT-RELATED AND OTHER ANALYSES, INCLUDING RATINGS, AND STATEMENTS IN THE CONTENT ARE STATEMENTS OF OPINION AS OF THE DATE THEY ARE EXPRESSED AND NOT STATEMENTS OF FACT. DAGONG GLOBAL'S OPINIONS, ANALYSES AND RATING ACKNOWLEDGEMENT DECISIONS (DESCRIBED BELOW) ARE NOT RECOMMENDATIONS TO PURCHASE, HOLD OR SELL ANY SECURITIES OR TO MAKE ANY INVESTMENT DECISIONS, AND DO NOT ADDRESS THE SUITABILITY OF ANY SECURITY.

THE CONTENT SHOULD NOT BE RELIED ON AND IS NOT A SUBSTITUTE FOR THE SKILL, JUDGMENT AND EXPERIENCE OF THE USER, ITS MANAGEMENT, EMPLOYEES, ADVISORS AND/OR CLIENTS WHEN MAKING INVESTMENT AND OTHER BUSINESS DECISIONS. DAGONG GLOBAL ASSUMES NO OBLIGATION TO UPDATE THE CONTENT FOLLOWING PUBLICATION IN ANY FORM OR FORMAT.

ISSUING RATINGS

CREDIT RATINGS DO NOT DIRECTLY ADDRESS ANY RISK OTHER THAN CREDIT RISK. IN PARTICULAR, RATINGS DO NOT DEAL WITH THE RISK OF LOSS DUE TO CHANGES IN INTEREST RATES AND OTHER MARKET CONSIDERATIONS. DAGONG GLOBAL CANNOT GUARANTEE THE FULL ACCURACY OF ALL INFORMATION PROVIDED BY AN ENTITY FOR THE RATING PROCESS.

IN ISSUING AND MAINTAINING ITS RATINGS, DAGONG GLOBAL RELIES ON FACTUAL INFORMATION IT RECEIVES FROM ISSUERS AND UNDERWRITERS AND FROM OTHER SOURCES DAGONG GLOBAL BELIEVES TO BE CREDIBLE. DAGONG GLOBAL DOES NOT PERFORM AN AUDIT AND UNDERTAKES NO DUTY OF DUE DILIGENCE OR INDEPENDENT VERIFICATION OF ANY INFORMATION IT RECEIVES. WHERE DAGONG GLOBAL DECIDES, AT ITS OWN DISCRETION, TO PERFORM AN ENHANCED FACTUAL INVESTIGATION OR AN INDEPENDENT VERIFICATION ON THE INFORMATION RECEIVED, THE USERS SHOULD BE AWARE THAT NEITHER AN ENHANCED FACTUAL INVESTIGATION NOR ANY THIRD-PARTY VERIFICATION CAN ENSURE THAT ALL OF THE INFORMATION DAGONG GLOBAL RELIES ON IN CONNECTION WITH A RATING WILL BE ACCURATE AND COMPLETE. ULTIMATELY, THE ISSUER AND ITS ADVISERS ARE RESPONSIBLE FOR THE ACCURACY OF THE INFORMATION THEY PROVIDE TO DAGONG GLOBAL AND TO THE MARKET IN OFFERING DOCUMENTS AND OTHER REPORTS.

RELATIONSHIP WITH ANY ISSUER

DAGONG GLOBAL DOES NOT HAVE A FIDUCIARY RELATIONSHIP WITH ANY ISSUER, SUBSCRIBER OR OTHER INDIVIDUAL. NOTHING IS INTENDED TO OR SHOULD BE CONSTRUED AS CREATING A FIDUCIARY RELATIONSHIP BETWEEN DAGONG GLOBAL AND ANY ISSUER OR BETWEEN DAGONG GLOBAL AND ANY USER OF ITS RATINGS. RATINGS MAY BE CHANGED, QUALIFIED, PLACED ON RATING WATCH OR WITHDRAWN AS A RESULT OF CHANGES IN, ADDITIONS TO, CORRECTNESS OF, UNAVAILABILITY OF OR INADEQUACY OF INFORMATION OR FOR ANY REASON DAGONG GLOBAL DEEMS SUFFICIENT.

DAGONG GLOBAL DOES NOT PROVIDE TO ANY PARTY ANY CONSULTANCY SERVICE, FINANCIAL ADVICE OR LEGAL, AUDITING, ACCOUNTING, APPRAISAL, VALUATION OR ACTUARIAL SERVICES. A RATING SHOULD NOT BE VIEWED AS A REPLACEMENT FOR SUCH ADVICE OR SERVICES. THE ASSIGNMENT OF A RATING BY DAGONG GLOBAL SHALL NOT CONSTITUTE CONSENT BY DAGONG GLOBAL TO USE ITS NAME AS AN EXPERT IN CONNECTION WITH ANY REGISTRATION STATEMENT, OFFERING DOCUMENT OR OTHER FILINGS UNDER ANY RELEVANT SECURITIES LAWS.

© 2018 DAGONG GLOBAL. ALL RIGHTS RESERVED.