



RATING ACTION REPORT

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

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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, 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. 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 43.1% as of August 2018, 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 53.6% of operating income.

#### Stable funding structure and liquidity

BPS's funding consists mainly of deposits (73% of total liabilities as of 1H18) which is a common strength of local traditional banks and in particular of co-operative banks in Italy. The remainder comes from interbank funding (16%, of which ECB TLTRO<sup>1</sup> is about 72%), market funds (7%) and other liabilities.

Liquidity, in our opinion, is ample and comes from a sizeable portfolio of ECB eligible assets that amounts to EUR 12.8Bn, with usage of EUR 6.0Bn as of 1H18. 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 MREL<sup>2</sup> in the medium term.

<sup>1</sup> Targeted Longer-Term Refinancing Operations

<sup>2</sup> Minimum Requirement for own funds and Eligible Liabilities

### Strong capitalisation

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 SREP<sup>3</sup>, the bank has been able to improve its capitalisation through internal capital generation and to reach a Tier 1 ratio of 11.75% by 3Q18 (11.6% at YE17), which we expect to increase further in the medium term. We view this level as adequate, considering the 8.375% 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.

### Improving, but still weak asset quality

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 83bps as of 3Q18 (from the peak of 194bps in 2013). For YE17 and 1H18 the bank is showing further improvements in asset quality, with NPL<sup>4</sup> at 14.7% of gross loans based on Dagong calculations for 1H18, compared to 15.1% as of YE17 and 16.1% by YE16. We expect this trend to persist following the more active approach to reduce NPL implemented by the bank last year. The coverage ratio is also adequate and above average at 56.4%.

### Moderate geographic diversification and strong 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 54.4%, Lazio 10.9% and Switzerland 13.6% as of 1H18, 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 agreed acquisition of Cassa di Risparmio di Cento in the region of Emilia-Romagna will be achieved in 2019. The competitive position of the bank in its home region is strong.

### 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.

<sup>3</sup> Supervisory Review and Evaluation Process

<sup>4</sup> 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’<sup>5</sup>. 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 28.4Bn in consolidated gross loans and EUR 41.6Bn in consolidated assets as of 1H18. In terms of market share, the bank is relatively small for the Italian market (1.2% market share in terms of loans in August 2018), but benefits from a significant market share in the province of Sondrio (43.1%).

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 13.6% of BPS’s total loans as of 1H18.
- (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 (07 February 2018)
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 (25 July 2018)  
General Rating Framework (14 August 2018)

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<sup>5</sup> 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.

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