Intesa Sanpaolo S.p.A. Issuer Rating Report

Overview

Scope Ratings has assigned an issuer rating of A with Stable Outlook to Intesa Sanpaolo S.p.A. The rating was last affirmed on 12 July 2019, when the Outlook was changed to Stable from Negative. The short-term rating is S-1 with a Stable Outlook.

Highlights

- The ratings are driven by Intesa's strong capital position and resilient profitability despite the challenging operating environment in Italy, where 81% of the loan portfolio is based. The group has been the leading retail and commercial bank in Italy since the merger of Banca Intesa and San Paolo IMI in 2007. Group earnings and asset quality have suffered from the weak domestic economic environment in the past, but pre-provision profitability has been resilient, and the group has remained profitable if we exclude the large goodwill write-downs in 2011 and 2013.
- Despite a presence in central and eastern Europe, Intesa's operations are primarily domestic. Significant holdings in Italian sovereign debt particularly expose it to market confidence in Italian banks and in Italy in general.
- With the large disposal of bad loans in 2018, Intesa has materially derisked its balance sheet, and could even exceed its 2021 asset quality targets.
- The 2018-21 business plan targets a return on average tangible equity of 14.6%, with growth in commission income a key driver of the improved profitability. Cost savings, including a significant reduction in both the branch network and headcount, are also forecast to contribute significantly to profit growth. The ability to generate recurring earnings and capital while keeping risk under control is a key support for the ratings.

Rating drivers (summary)

The rating drivers, in decreasing order of importance in the rating assignment, are:

- Leading diversified financial services group in Italy, with revenues and profits balanced between retail, CIB and wealth management
- Likely outperformance of derisking targets
- Strong financial performance and capital generation in a challenging environment
- Ongoing diversification of the securities portfolio

Ratings & Outlook

Issuer rating	A
Outlook	Stable
Senior unsecured debt rating	A
Senior unsecured debt (MREL/TLAC eligible) rating	A-
Additional Tier 1 Instruments rating	BB+
Short-term debt rating	S-1
Short term debt rating Outlook	Stable

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Bloomberg: SCOP

Rating-change drivers

Further progress in the workout of non-performing loans. The decline in non-performing exposure (NPE) formation in recent quarters was coupled with a decline in NPEs in absolute numbers (both in gross and net terms) and an increase in coverage. We believe the reversal in asset quality trends is due to the more favourable macro environment combined with a sharper focus on the NPE management at Intesa. The recently presented 2018-21 business plan included a commitment to significant further debt recovery, by means of proactive credit portfolio management, the carve-out of the internal recovery platform, a new delinquency early-detection tool for retail exposures, and more openness towards portfolio sales.

Further material diversification away from Italy risk. With limited geographic diversification, Intesa's financial performance is linked with Italy's economic one. A more diversified footprint would be positive for the credit.

A material worsening of operating performance. Intesa's profitability and capital generation track record set the bank apart from its domestic peers. A material deterioration in Intesa's medium term earnings potential would be detrimental for the rating.

Any indication Italy's belonging to the Eurozone is at risk. While we believe that a departure from the euro remains an extremely unlikely scenario, we note that some politicians, including in governing parties, have in the past advocated for such outcome. A change in a currency regime is extremely difficult to execute, and a material risk for financial institutions who would likely see a material disruption to their activities, and likely be exposed to funding runs. We flag that such an event could result in a multiple notch downgrade for Intesa, as well as for other Italian banks

Rating drivers (details)

Leading diversified financial services group in Italy, with revenues and profits balanced between retail, CIB and wealth management

Leading financial institution with strong market shares and distribution power across Italy

Formed in 2007 through the merger of Banca Intesa and Sanpaolo IMI, Intesa is the leading provider of financial services in Italy, with strong market shares in loans (17.8%), deposits (18.1%), factoring (24.8%), life insurance (20%), mutual funds (21.4%), and pension funds (22.5%). In terms of distribution, its 4,100 branches make up 16% of the Italian bank branch network.

Revenues and profits balanced between retail, CIB and wealth management

Half of the group's operating revenues are derived from Banca dei Territori (domestic commercial banking), which offers traditional lending and deposit-collection in Italy. Banca dei Territori services households, small businesses, SMEs, and Italian mid-size corporations with a turnover of up to EUR 350m and distributes the group's asset management, insurance and private banking products. In terms of net profits, however, Banca dei Territori only accounts for 26% of the group. Private banking, insurance and asset management account for 33% of group profit, excluding distribution fees. The other main contributor to profit is corporate and investment banking, which serves large corporate clients and financial institutions as well as public finance entities.

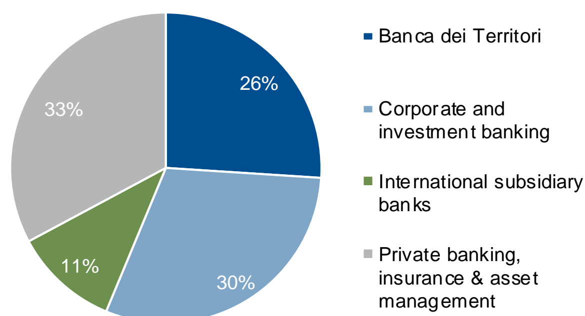
The group's international operations, which account for 11% of group net profit and 7% of the loan book, comprise approximately 1,100 branches in 12 countries, including 11 central and eastern European countries and Egypt. The largest international operations, in terms of total assets, are in Slovakia, Croatia and Hungary.

Limited diversification outside of Italy

With 81% of total loans in Italy, Intesa Sanpaolo is heavily dependent on the performance of the Italian economy. The loan book is diverse (Figure 2), and comprises residential mortgages, consumer loans, loans to SMEs and larger corporates, industrial credit as well as loans to other financial institutions.

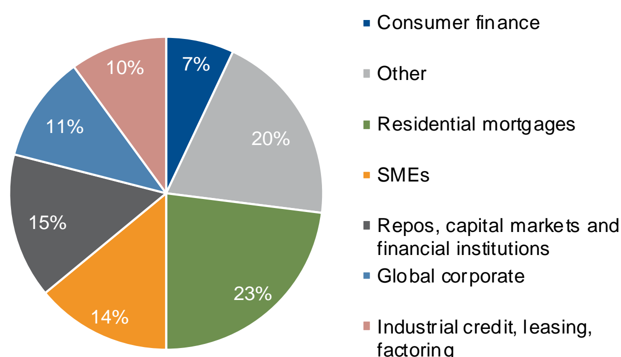
The group's lending exposure to non-financial companies is well-diversified, with no single sector accounting for more than 7% of the total. The largest sectors are services (6.1% of total loan portfolio), distribution (5.7%) and real estate (3.6%).

Figure 1: Net profit by division (2018)



Note: excluding Corporate Centre
Source: Company data, Scope Ratings.

Figure 2: Loan book composition (2018)



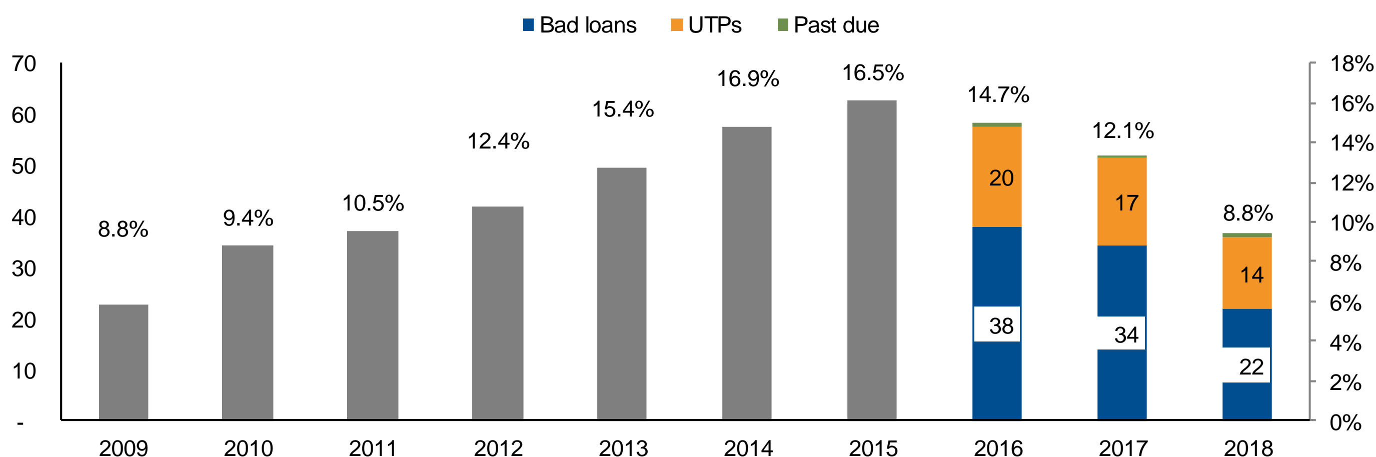
Source: Company data, Scope Ratings.

Likely outperformance of derisking targets

Material derisking already executed

The group has significantly derisked its balance sheet in recent years. From a peak of 17.2% in September 2015, Intesa's gross NPE ratio declined to 8.5% at the end of Q1 2019. The NPE coverage ratio stood at 54.1%. Unlikely-to-pay (UTP) loans make up 39% of the total exposure with a coverage of 37%, just below the Italian peer average of 40%.

Figure 3: Gross NPEs (EUR bn, LHS) and NPE ratio (%, RHS)



Source: Company data, Scope Ratings.
Note: Impaired loans = sofferenze + past due, Data excludes the contribution of the former Venetian banks

Intrum deal a key milestone in derisking

A key milestone in Intesa's derisking path was the long-term partnership agreed in Q2 2018 with Intrum, a leader in NPE management in Europe. Under the agreement, Intesa and Intrum have merged their existing Italian services into a new player, which is 51% owned and consolidated by Intrum. Intesa will retain a 49% stake, and the new entity will service Intesa's inflow of non-performing loans until 2028. The agreement also includes the sale and securitisation of EUR 10.8bn of gross NPEs, with junior and mezzanine tranches subscribed by a vehicle controlled by Intrum (51%). This allows Intesa to deconsolidate the exposure from its balance sheet, while maintaining some economic exposure (49%) to the assets.

Like other Italian banks, Intesa had come under close market scrutiny due to its high NPE ratio. The new supervisory environment has contributed to this heightened focus on NPEs: following its establishment in 2014, the European single supervisory mechanism has progressively tightened the screws on asset quality, requesting that banks review their internal policies and frameworks on bad loans and present plans to accelerate NPE reduction.

Intesa maintains exposure to deconsolidated assets' performance

We believe Intesa's management was never in a rush to sell down NPE stock, viewing them as being well-provisioned for and well-collateralised. The structure of the Intrum transaction is consistent with that view: while appeasing market observers, the transaction also allows Intesa to benefit if recoveries on sold loans eventually exceed their net transfer value.

Strategic plan envisages further derisking

The 2018-21 business plan envisages further NPE reduction and a further material derisking of the balance sheet.

Key targets include:

- A decline in gross NPEs from EUR 52.1bn to EUR 26.4bn in 2021, i.e. from 11.9% to 6% of gross loans;
- A net NPE ratio of 2.9% in 2021;
- A fall in loan-loss provisions to EUR 1.8bn by 2021 (EUR 3.3bn in 2017), with the cost of risk halving from the current 81 bps to 41 bps.

In our view, following the Intrum deal, these objectives are achievable and could even be exceeded. In March 2019, Intesa confirmed it was examining strategic options with respect to UTPs.

Strong financial performance and capital generation in a challenging environment

Intesa has emerged well from the three crises engulfing Italian banks

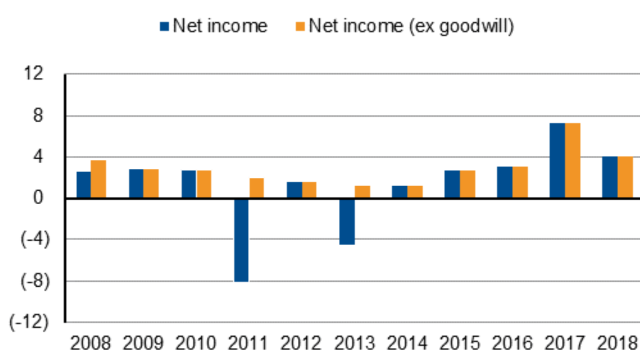
Despite the relatively difficult operating environment in Italy, Intesa has remained profitable throughout the past decade if we exclude goodwill impairments in 2011 and 2013 (Figure 4). In this decade, the Italian banking system was under extreme pressure due to the global financial crisis, the European sovereign crisis, and the long tail of the Italian asset quality crisis that followed the establishment of the single supervisory mechanism.

In 2018, Intesa posted its highest level of normalised net income in a decade (the 2017 figure benefited from a public cash contribution of EUR 3.5bn related to the takeover of two ailing Venetian banks).

High pre-provision income with low volatility is the first line of defence against losses

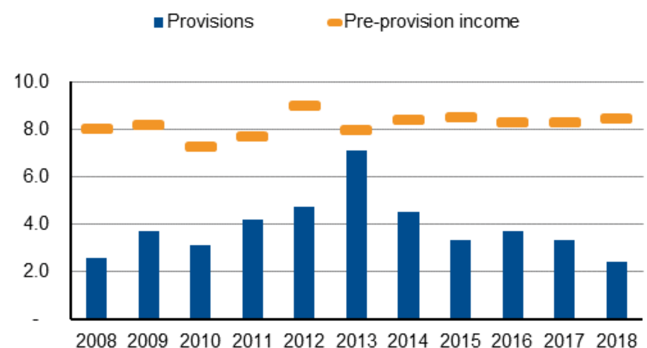
Intesa's pre-provision income has remained remarkably stable over the years, at c. EUR 8bn, affording significant buffers to absorb the provisions needed to speed up balance sheet derisking (Figure 5).

Figure 4: Intesa's losses driven entirely by goodwill impairments (EUR bn)



Source: Company data, Scope Ratings.

Figure 5: The margin between pre-provision profitability and credit impairments is increasing (EUR bn)



Source: Company data, Scope Ratings.

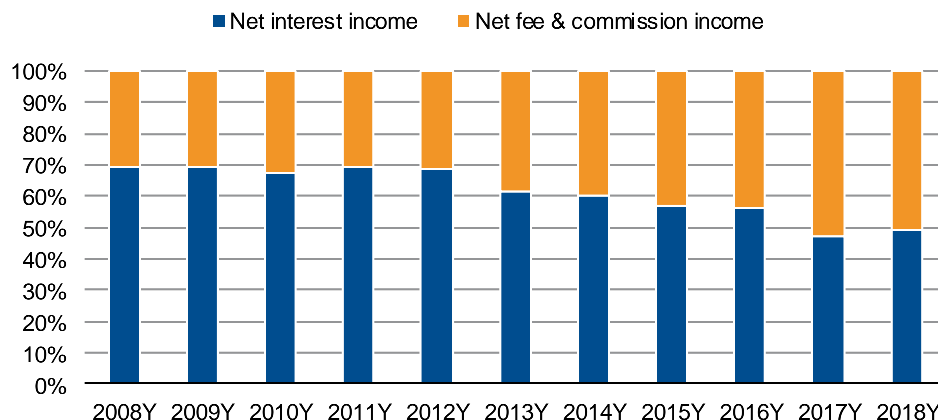
Key to the stability of pre-provision profit has been the strong growth in commission income, which has compensated for the decline in net interest income. In 2018, the contribution of NII to core revenues was c. 50%, compared to c.70% in 2012 (Figure 6).

Commission income is the main revenue growth driver

The 2018-21 strategic plan continues to emphasise business and revenue diversification, targeting 5.5% compound annual growth rate in fee income, driven by strong growth in insurance and asset management. Cost cutting also remains central to the business plan, with a very ambitious target of reducing the cost/income ratio from the current 53% to 45%. Measures include the closure of 1,100 branches; a reduction in headcount from 97,400 to 90,800; the rationalisation of the real estate portfolio; a reduction in legal entities; and tight control over administrative costs.

The business plan targets a return on average tangible equity of 14.6%, which is high in comparison to Italian and international peers. The ability to generate recurring earnings and capital while keeping risks under control is a key support for the ratings.

Figure 6: Intesa's core revenue composition, 2008-18



Source: SNL, Scope Ratings.

Strong capital supported by high organic generation

Intesa's capital position is strong. On a transitional basis, the CET1 ratio stood at 13.1% as of Q1 2019. The pro-forma fully loaded CET1 ratio stood at 13.5%. This includes the total absorption of deferred tax assets that arose through the acquisition of the two Venetian banks and the first-time adoption of IFRS 9.

The reported fully loaded leverage ratio in December 2018 was 5.7%.

More significant is Intesa's longstanding ability to generate a substantial capital excess, demonstrated by its generous dividend policy. It paid EUR 10bn in dividends in 2014-17 and has reduced its targeted dividend pay-out from 85% in 2018 to 70% in 2021.

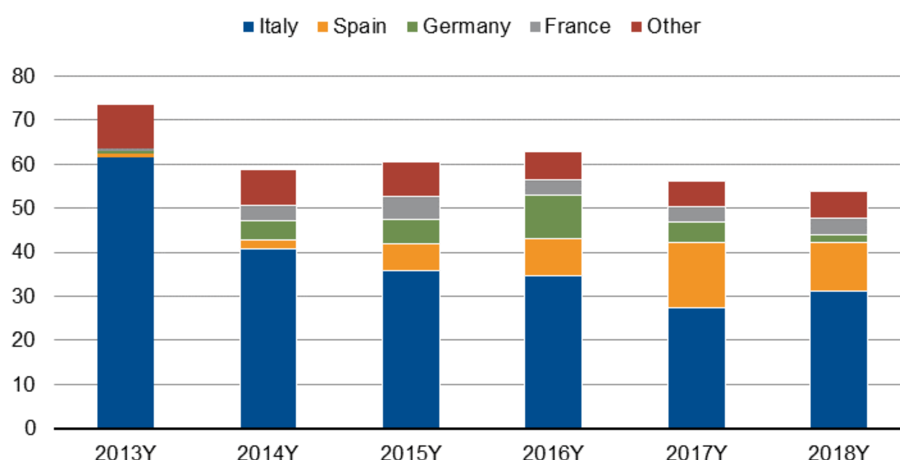
Ongoing diversification of the securities portfolio

As with most of its peers, Intesa's exposure to Italian sovereign risk is material, making it vulnerable to negative investor sentiment regarding the Italian sovereign. We currently rate Italy at BBB+ with a Stable Outlook. Italy maintains a high debt position and suffers from an elevated degree of political uncertainty compared to other eurozone countries. The recent confrontational stance of the Italian government with EU institutions further fuels uncertainties regarding the reliability of Italy's fiscal commitments for the next few years.

On the positive note, the group has diversified its sovereign bond portfolio over the last few years, adding exposures to several EU countries – notably to Germany, France and Spain. In December 2018, Intesa's exposure to Italian sovereign risk decreased to approx. EUR 30bn from approx. EUR 40bn at the end of 2014.

As of December 2018, the exposure was equivalent to 3.9% of total assets and 83.5% of transitional CET1 capital. In relative terms, the exposure is one of the lowest among Italian banks.

Figure 7: Intesa sovereign bond portfolio, by country (EUR bn)



Source: Company data, Scope Ratings.

Intesa's additional tier 1 instruments: key features and risks

We have rated the AT1 securities issued by Intesa at BB+/Stable (Figure 9).

In accordance with our rating methodology for capital instruments, the starting point for the notching-down of Intesa's capital instruments is provided by its senior non-preferred rating of A-. The minimum four notches reflect the deeply subordinated status of AT1 capital instruments in the priority of claims, their going-concern loss-absorbing features and investors' exposure to coupon-cancellation risks.

Figure 8: CRD4-compliant AT1 instruments of Intesa rated by Scope

ISIN	Currency	Issue amount	Coupon %	Issue date	Next call da	Conversion type	Trigger %	Scope rating
US46115HAU14	USD	1,000,000,000	7.7	17/09/2015	17/09/2025	Temporary w rite dow n	5.125	BB+
XS1346815787	EUR	1,250,000,000	7	19/01/2016	19/01/2021	Temporary w rite dow n	5.125	BB+
XS1548475968	EUR	1,250,000,000	7.75	11/01/2017	11/01/2027	Temporary w rite dow n	5.125	BB+
XS1614415542	EUR	750,000,000	6.25	16/05/2017	16/05/2024	Temporary w rite dow n	5.125	BB+

Source: Santander, Scope Ratings

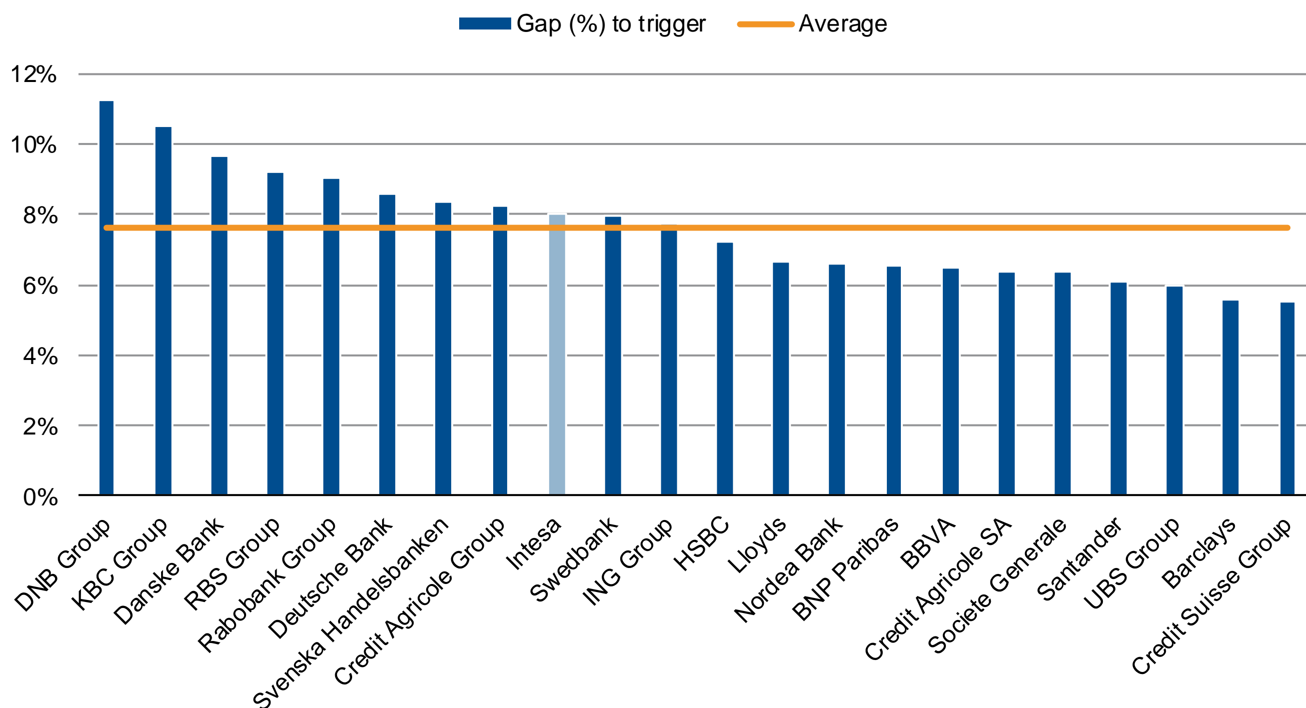
As of Q4 2018, Intesa's gap to the equity conversion trigger was 8%, slightly higher than the average of large European banks of 7.6% (Figure 8).

The distance to the MDA trigger (measured as the difference between the group's transitional CET1 ratio and its CET1 ratio requirement including the Combined Buffer Requirement) stood at a comfortable 4.2%, versus an average of 3.1% for the peer group of large European banks (Figure 9). This is based on the 2019 SREP requirement.

Management expects the fully loaded CET1 ratio to be at 13.1% in 2021 (vs 12% at YE 2018), implying a buffer of c. 400 bps to its CET1 requirement, including Combined Buffer Requirement.

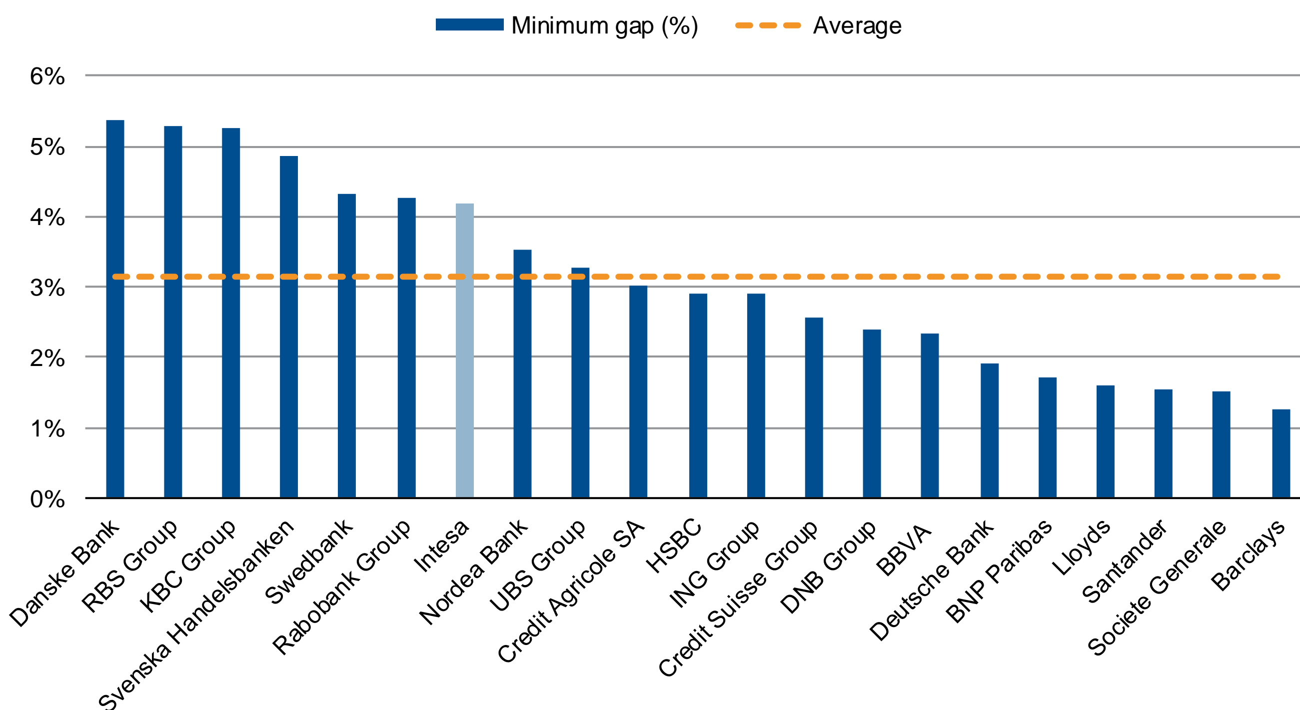
AT1 instruments are perpetual but can be called at the discretion of the issuer. So far, most issuers have exercised this option on the first call date.

Figure 9: Gap to trigger, selected European banks



Source: Banks, Scope Ratings

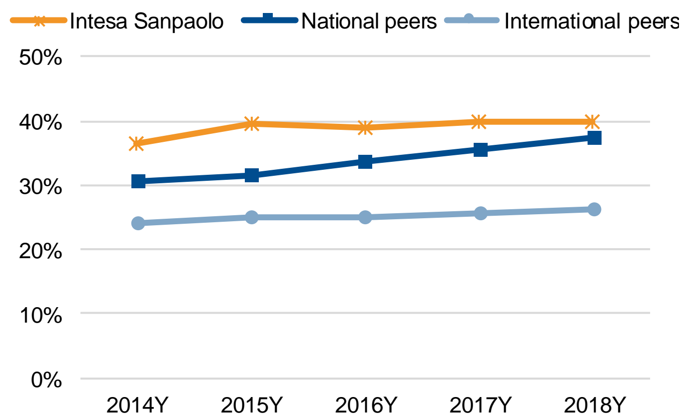
Figure 10: Distance to Combined Buffer Requirement, selected European banks



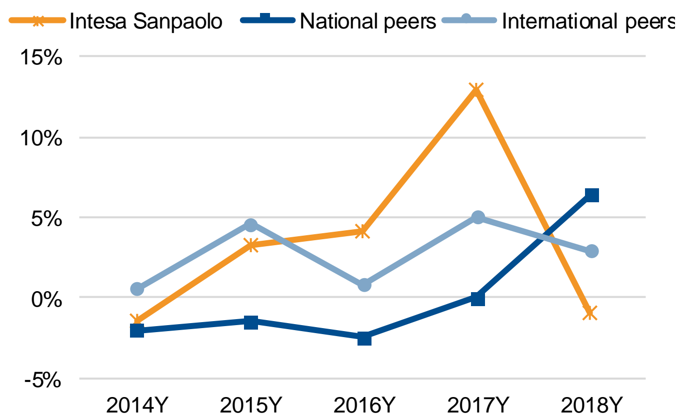
Source: Banks, Scope Ratings

I. Appendix: Peer comparison

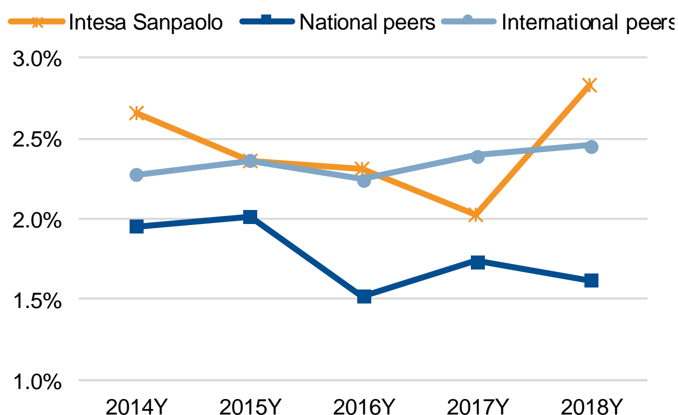
Fees & commissions % revenues



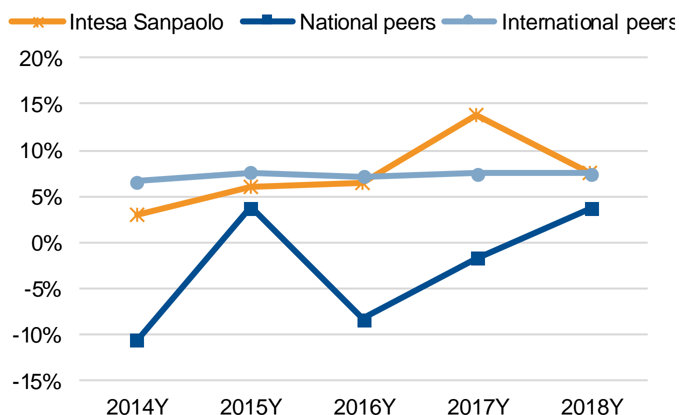
Net loan growth (%)



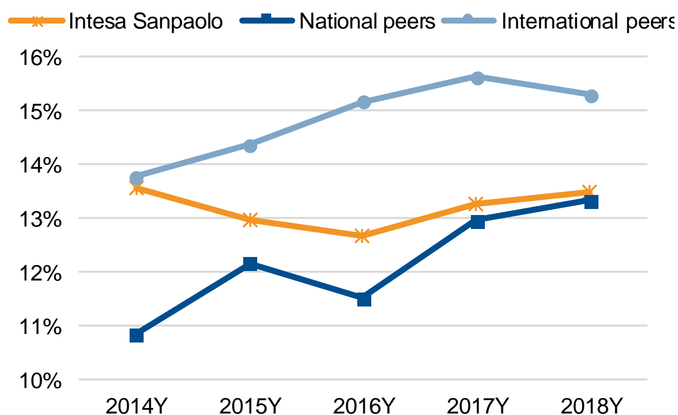
Pre-provision income/RWA (%)



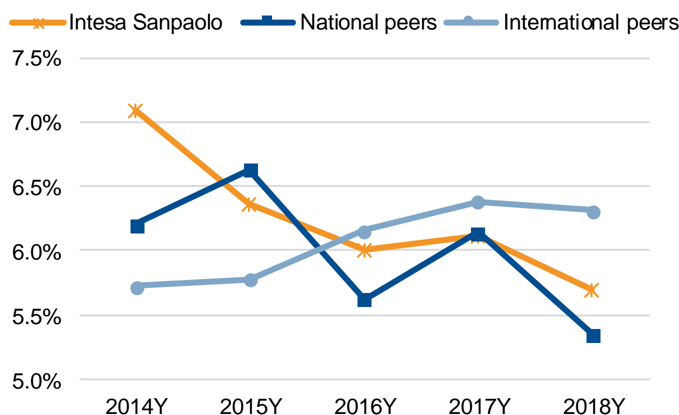
Return on average equity (%)



Common equity tier 1 ratio (transitional) (%)



Leverage ratio (%)



Source: Source

*National peers: Unicredit, Banco BPM, Banca Monte dei Paschi di Siena, UBI Banca, Banca Carige, BPER Banca, Mediobanca, Credito Emiliano, Creval.
International peers: Caixabank, Credit Mutuel, Bankia, Lloyds, Banco Sabadell, Groupe BPCE, Belfius Banque, AIB, DNB, Bank Handlowy, Commerzbank. KBC Group NV

II. Appendix: Selected financial information – Intesa Sanpaolo S.p.A.

	2014Y	2015Y	2016Y	2017Y	2018Y
Balance sheet summary (EUR m)					
Assets					
Cash and interbank assets	36,981	43,024	60,982	81,425	79,659
Total securities	232,321	244,502	261,642	108,496	105,093
of which, derivatives	45,998	38,063	36,775	28,789	29,019
Net loans to customers	339,104	350,031	364,712	411,950	407,802
Other assets	38,021	38,939	37,764	194,990	195,167
Total assets	**646,427**	**676,496**	**725,100**	**796,861**	**787,721**
Liabilities					
Interbank liabilities	53,443	62,497	76,782	108,441	110,616
Senior debt	112,629	100,620	84,845	82,790	76,816
Derivatives	51,321	43,994	45,309	36,264	38,470
Deposits from customers	230,927	255,739	291,834	323,389	326,518
Subordinated debt	15,753	14,585	15,066	14,664	10,873
Other liabilities	137,292	150,468	161,945	174,709	169,997
Total liabilities	**601,365**	**627,903**	**675,781**	**740,257**	**733,290**
Ordinary equity	44,683	46,899	46,794	52,102	49,921
Equity hybrids	0	877	2,117	4,103	4,103
Minority interests	379	817	408	399	407
Total liabilities and equity	**646,427**	**676,496**	**725,100**	**796,861**	**787,721**
Core tier 1/ common equity tier 1 capital	36,547	36,908	35,926	38,051	37,241
Income statement summary (EUR m)					
Net interest income	9,815	9,238	8,615	6,704	7,342
Net fee & commission income	6,477	6,895	6,735	7,428	7,603
Net trading income	2,107	2,399	2,534	1,137	1,178
Other income	-699	-1,066	-644	3,409	2,886
Operating income	**17,700**	**17,466**	**17,240**	**18,678**	**19,009**
Operating expenses	10,393	10,876	10,655	12,819	11,066
Pre-provision income	**7,307**	**6,590**	**6,585**	**5,859**	**7,943**
Credit and other financial impairments	4,329	2,824	3,288	3,162	2,447
Other impairments	NA	NA	22	5	39
Non-recurring items	116	NA	318	111	65
Pre-tax profit	**2,961**	**4,077**	**3,216**	**7,818**	**5,458**
Discontinued operations	0	60	987	0	0
Other after-tax Items	0	0	0	0	0
Income tax expense	1,651	1,331	1,003	464	1,386
Net profit attributable to minority interests	59	67	89	38	22
Net profit attributable to parent	**1,251**	**2,739**	**3,111**	**7,316**	**4,050**

Source: SNL

III. Appendix: Ratios – Intesa Sanpaolo S.p.A.

	2014Y	2015Y	2016Y	2017Y	2018Y
Funding and liquidity					
Net loans/ deposits (%)	147.0%	137.1%	125.0%	127.4%	125.7%
Liquidity coverage ratio (%)	NA	NA	NA	175.7%	163.2%
Net stable funding ratio (%)	NA	NA	NA	NA	NA
Asset mix, quality and growth					
Net loans/ assets (%)	52.5%	51.7%	50.3%	51.7%	51.8%
Problem loans/ gross customer loans (%)	16.9%	16.5%	14.7%	NA	8.5%
Loan loss reserves/ problem loans (%)	50.7%	50.8%	51.6%	NA	60.7%
Net loan growth (%)	-1.4%	3.2%	4.2%	13.0%	-1.0%
Problem loans/ tangible equity & reserves (%)	90.2%	85.9%	80.8%	NA	54.0%
Asset growth (%)	3.6%	4.7%	7.2%	9.9%	-1.1%
Earnings and profitability					
Net interest margin (%)	1.6%	1.5%	1.3%	1.0%	1.2%
Net interest income/ average RWAs (%)	3.6%	3.3%	3.0%	2.3%	2.6%
Net interest income/ operating income (%)	55.5%	52.9%	50.0%	35.9%	38.6%
Net fees & commissions/ operating income (%)	36.6%	39.5%	39.1%	39.8%	40.0%
Cost/ income ratio (%)	58.7%	62.3%	61.8%	68.6%	58.2%
Operating expenses/ average RWAs (%)	3.8%	3.9%	3.7%	4.4%	3.9%
Pre-impairment operating profit/ average RWAs (%)	2.7%	2.4%	2.3%	2.0%	2.8%
Impairment on financial assets / pre-impairment income (%)	0.7%	0.5%	0.5%	0.5%	0.4%
Loan loss provision/ average gross loans (%)	NA	0.7%	0.8%	NA	NA
Pre-tax profit/ average RWAs (%)	1.1%	1.5%	1.1%	2.7%	1.9%
Return on average assets (%)	0.2%	0.4%	0.5%	1.0%	0.5%
Return on average RWAs (%)	0.5%	1.0%	1.1%	2.5%	1.5%
Return on average equity (%)	2.9%	6.0%	6.5%	13.9%	7.6%
Capital and risk protection					
Common equity tier 1 ratio (%, fully loaded)	13.3%	12.5%	12.9%	14.0%	12.0%
Common equity tier 1 ratio (%, transitional)	13.5%	13.0%	12.7%	13.3%	13.5%
Tier 1 capital ratio (%, transitional)	14.2%	13.8%	13.9%	15.2%	15.2%
Total capital ratio (%, transitional)	17.2%	16.6%	17.0%	17.9%	17.7%
Leverage ratio (%)	7.1%	6.4%	6.0%	6.1%	5.7%
Asset risk intensity (RWAs/ total assets, %)	41.7%	42.0%	39.2%	36.0%	35.1%
Market indicators					
Price/ book (x)	0.9x	1.1x	0.9x	0.9x	0.7x
Price/ tangible book (x)	1.1x	1.3x	1.0x	1.0x	0.8x
Dividend payout ratio (%)	87.5%	87.5%	54.4%	46.1%	82.1%

Source: SNL

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