Banca Popolare di Sondrio S.C.p.A. Issuer Rating Report

SCOPE BBB- STABLE

Overview

Scope Ratings has assigned an issuer rating of BBB- to Banca Popolare di Sondrio S.C.p.A. (BPS), with a Stable Outlook.

Highlights

- The ratings are based on BPS' focused regional franchise in Lombardy, one of the wealthiest regions in Europe. BPS is a medium-sized cooperative bank primarily operating in Milan and other provinces in Lombardy, as well as in Rome and with a more marginal presence in several other northern Italian regions. BPS is also the parent company of the BPS group, which includes a small bank in Switzerland (BPS Suisse), and Factorit, a factoring joint venture with Banco BPM and Banca della Nuova Terra that specialises in agricultural business loans and payroll deductible loans.
- Like other Italian banks, BPS saw a material deterioration in asset quality during the crisis, which it has tackled more slowly compared to peers. Derisking is a key managerial priority and asset quality metrics should improve in 2020 thanks to sizeable NPL disposals.
- The sudden deterioration in the operating environment following the Covid-19 outbreak in Q1 2020 and the ensuing lockdown is likely to drive Italy into a recession, which could put pressure on BPS' asset quality and profitability. It is worth noting, however, that BPS remained profitable throughout the previous crisis. It has one of the lowest cost/income ratios in Italy, which allows it to book significant provisions while maintaining a positive bottom line. BPS is well capitalised, significantly exceeding SREP requirements, and has low leverage.
- BPS is primarily funded by deposits, though it also uses the ECB's TLTRO lines.

Rating drivers (summary)

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

- Focused regional franchise in the wealthy Italian region of Lombardy
- A rapidly deteriorating operating environment, which is likely to impact the bank's financial performance going forward
- Improvements in asset quality much slower than the sector but accelerated in 2019
- Track record of low but resilient profitability
- Solid capital position, with sufficient room to manoeuvre following AIRB adoption

Ratings & Outlook

Issuer rating	BBB-
Outlook	Stable

Lead Analyst

Marco Troiano, CFA
m.troiano@scoperatings.com

Team Leader

Dierk Brandenburg
d.brandenburg@scoperatings.com

Scope Ratings GmbH

3rd Floor
111 Buckingham Palace Road
UK-London SW1W OSR
Phone +44 20 3457 0444

Headquarters

Lennéstraße 5
10785 Berlin
Phone +49 30 27891-0
Fax +49 30 27891-100

info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

Rating-change drivers

A material worsening of the BPS' credit fundamentals due to the looming recession. The sudden deterioration in the operating environment following the Covid-19 outbreak in Q1 2020 and the ensuing lockdown is likely to drive Italy into a recession. If mitigating measures by the government prove insufficient to prevent a wave of defaults, BPS' profitability and asset quality metrics could suffer. We flag that a material worsening in BPS' operating performance in the medium term would be negative for the rating.

A further material reduction in legacy NPEs. The NPE ratio has been declining slowly in recent quarters and remains high by both national and international standards. In August 2019, BPS announced it is planning the sale of a EUR 1bn portfolio of NPEs, for which completion would be targeted for 2020. In our view, this indicates the bank's willingness to accelerate balance sheet derisking, which would be critical given the challenging operating environment we envisage for 2020.

Any indication that Italy's membership of the eurozone is at risk. While we believe a departure from the euro remains extremely unlikely, we note that some politicians, including in governing parties, have advocated for it in the past. A change in currency regime is extremely difficult to implement and would pose a material risk for financial institutions, which are likely to see a serious disruption in their activities and be exposed to funding runs. Such an event could result in a multiple-notch downgrade for BPS, as well as for other Italian banks.

Rating drivers (details)

Focused regional franchise in the wealthy Italian region of Lombardy

Medium-sized cooperative bank with good market position in Lombardy

Founded in 1871 in Sondrio, BPS is a medium-sized retail cooperative bank operating primarily in the wealthy Italian region of Lombardy and Rome. The bank's branch presence in several other northern Italian regions is more sparse (Figure 1). It is also the parent company of the BPS group, which includes BPS Suisse, with about 20 branches in Switzerland as a result of organic growth.

The Italian banking system is moderately fragmented, with a handful of banks competing at national level beside regional and cooperative banks. Branches are still the predominant distribution channel. BPS has immaterial market shares in Italy (2% of branches), but a dominant position in its home province of Sondrio (over 48.5% of branches) and relevant market positions in Lecco and Como (c. 19% in both). Its branch market share in Lombardy is 7.9%.

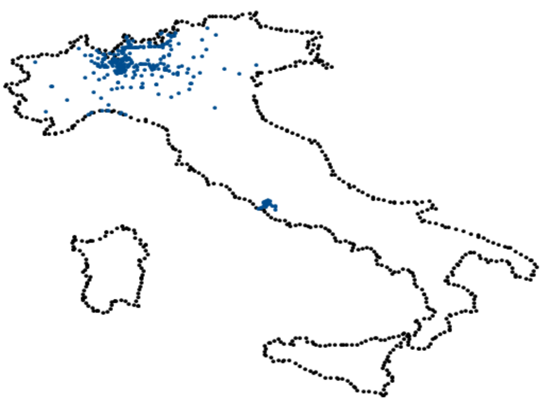
Commercial bank catering to local businesses and households

The group business model hinges on traditional commercial banking activities (loans, deposits and payment services) mainly extended to households and local SMEs. Over the years, the BPS group has developed solid and longstanding relations with customers, especially in its home province of Sondrio.

Through its branch network, the bank also distributes leasing, life and non-life insurance products of the companies in which has a stake (Alba Leasing, 19.3%; Arca Vita, 14.8%). It also holds 36.8% of Arca Holding, which itself fully owns Arca Fondi, an asset management firm, After the acquisition of PrestiNuova in 2018, BPS entered the market of payroll/pension deducted loans. In 2019, Prestinuova was merged into Banca della Nuova Terra, which previously specialised in agricultural loans.

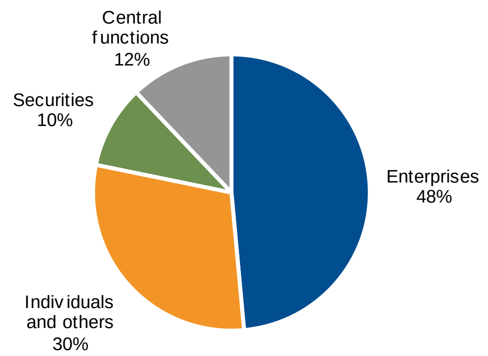
Finally, BPS is active in factoring through its subsidiary Factorit (of which it owns 60.5%), one of the largest players in Italy; Factorit accounted for 4.3% of the group's consolidated net profits in 2018.

Figure 1: Branch network



Source: SNL, Scope Ratings

Figure 2: H1 2019 revenues breakdown, by segment



Source: Company data, Scope Ratings

Close to 80% of BPS' revenues is derived from typical commercial banking activities, which span across the Enterprises (48%) and Individuals and Others (30%) segments (Figure 2). The former comprises traditional commercial banking, leasing, and factoring services to non-financial companies and family businesses, while the latter relates to activities with households, public administrations, financial companies and other customers.

The Securities segment includes commission income from the distribution of third-party financial instruments, insurance and pensions products, and portfolio management.

Smaller contributions to the group's income come from the management of its own bond portfolio (see page 5) and from equity investments (notably Alba Leasing, Arca and Unione Fiduciaria), both accounted under the Central Functions segment.

As opposed to other Italian banks, BPS group has not shrunk its branch network in recent years, opting instead for continued, though measured, expansion. At the same time, BPS has embraced multichannel banking, offering smart ATMs, online banking and payment apps on top of traditional forms of interaction via physical branches.

BPS' share capital is held by roughly 170,000 shareholders, most of which are also clients. No shareholder can own more than 1% of the share capital except for institutional investors, which collectively account for slightly more than 20%.

Transformation into joint stock company still pending

As part of the 2015 reform in Italy, all cooperative banks (*banche popolari*) with total assets of at least EUR 8bn must transform into joint stock companies. BPS has not yet complied with the requirement due to the legal uncertainty arising from the reform being challenged in Italian courts. The final judgements on the legitimacy of the reform are still pending both at the European and at the national level and therefore a further extension of the current deadline for the transformation, which currently stands at the end of 2020, cannot be excluded.

A rapidly deteriorating operating environment, which is likely to impact the bank's financial performance going forward

Covid-19 lockdown in Italy adds uncertainty to economic outlook

The Covid-19-related lockdown, in force since the beginning of March, is likely to push annual GDP growth estimates well into the red, at least for this year. At this stage, it is difficult to estimate the full economic blow from the health crisis. This will depend, among other things, on the degree of reduction in human and economic activity, the time it takes to bring the contagion under control and to rebuild supply chains and inventories, as well as the policy response of fiscal and monetary authorities.

At present, we forecast negative GDP growth of 7.5% under our baseline scenario, which includes a return to broad normality in the summer, but double-digit declines under more negative scenarios in which normality returns at a later point in the year.

Worsened macro scenario likely to impact revenues and asset quality

The deterioration of operating conditions is likely to impact the group's financial performance. We see heightened risk for revenues, especially for fee income deriving from investment and insurance-related products and new lending. Moreover, some customers will default, triggering an initial increased need for credit provisions.

Asset quality may also suffer, though the full recognition of new NPEs may only come at a later stage. Eventually, the magnitude of the virus' impacts will depend how well the government can support the economy both during and after the lockdown.

The Italian government's response to the crisis has been strong: it envisages the injection of hundreds of billions of euros in the Italian economy. Among other measures, business loans will be eligible for government guarantees – reaching up to 100% for small firms.

Heightened risk to domestic sovereign credit

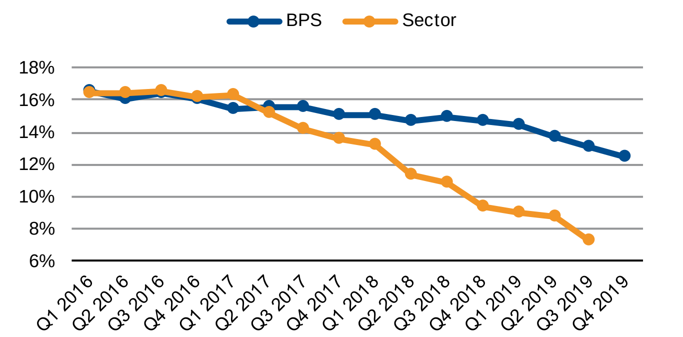
As of April 2020, the Republic of Italy is rated BBB+ by Scope, with Stable Outlook. The debt/GDP ratio is very high at 132%; the ratio's long-run sustainability is the main constraint in the medium run. The 2020 budget had estimated a deficit of 2.2% of GDP before declining to 1.4% in 2022, but now expects to break 7% of GDP in 2020, with public debt easily rising past 145% of GDP. At the same time, the crisis demonstrates a core rationale underpinning our investment-grade rating for Italy compared to the more pessimistic view of market participants: Italy's systemic importance in the euro area and the extraordinary support European institutions would provide under worst-case scenarios.

Improvements in asset quality much slower than the sector but accelerated in 2019

High level of NPEs is credit weakness

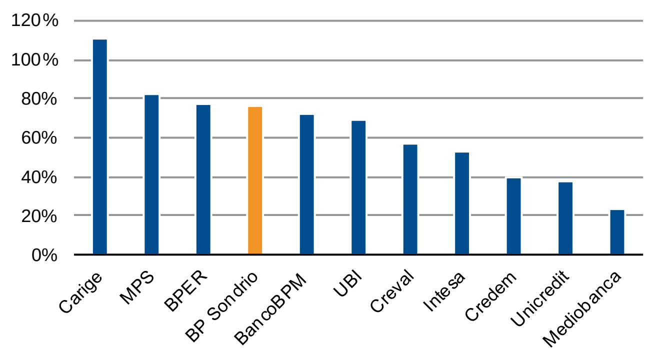
In the aftermath of the financial crisis, BPS accumulated a high stock of gross NPLs, peaking at EUR 4.3bn in the beginning of 2016, equivalent to 16.5% of customer loans. Since then, NPEs have started declining, partly as a result of an improved economic environment. At the end of 2019, the NPE ratio stood at 12.58% (vs 8.7% for the Italian sector in June), with a coverage at 57.8% (in line with peers').

Figure 3: BPS has fallen behind the Italian sector on asset quality (gross NPE ratio)



Source: Company data, Bank of Italy, Scope Ratings

Figure 4: Gross NPEs/provisions+CET1 capital, Italian banks, Q4 2019



Source: Company data, Scope Ratings Notes: Carige's as of YE 2018

The relative delay in the decline of BPS' NPE ratio compared to that of other Italian banks reflects the group's historical preference for internal workouts versus large disposals.

NPE disposals planned for 2020

In August 2019, however, the group announced it is looking to sell around EUR 1bn of NPEs as part of a de-risking strategy to reduce the gross NPE ratio to 8% by 2022. Pro forma for such a sale, we estimate that the NPE ratio of BPS would still be close to 10%, which remains higher than the average for Italian banks – though more in line with that of former popolari banks.

The late tackling of legacy NPEs has been a factor in BPS' frustrated attempts at inorganic growth in recent quarters. Indeed, the group did not receive the necessary authorisations to acquire Cassa di Risparmio di Cento (October 2019) and Farbanca (February 2020) despite a material capital excess cushion over its requirements, with supervisors stressing the need to prioritise planned derisking and conserve the capital excess. Balance sheet derisking is a current priority for the management team.

Covid-19 lockdown could lead to increased NPE inflows

As Italy enters a new recession in 2020, we see the risk of the derisking efforts being at least partly offset by an increase in NPE inflows. The Covid-19 related lockdown is bound to cause financial distress to clients, despite public sector's measures to keep the liquidity taps going.

Offsetting measures will limit and delay – financial impacts

Residential mortgage borrowers (employees and self-employed) in temporary economic difficulty can suspend mortgage payments for up to 18 months. A public solidarity fund (Fondo Gasparrini) would pay 50% of the interest portion, while the borrower would remain liable for the remaining 50%.

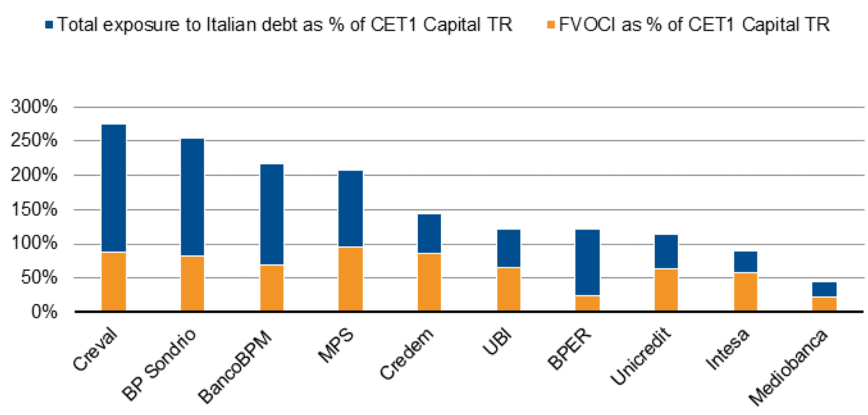
For SMEs, a moratorium has been placed on the existing stock of loans (EUR 220bn) until 30 September 2020. New SME loans can benefit from a public guarantee for six years (100% for balances up to EUR 800,000).

Larger companies (500 employees and over) can also benefit from public guarantees (ranging between 70% and 90% depending on the size of the company) provided by Italian export credit agency SACE.

We believe the above-mentioned measures will limit not only the number of defaults, but also the bank's exposure to customers who default after having renegotiated their loans. However, we still expect new flows of NPEs, as some businesses may decide to fold rather than rack up additional debt – to be repaid later in an environment that remains highly uncertain.

BPS also has one of the largest and most concentrated exposures to Italian sovereign bonds (Figure 5), holding EUR 5.9bn worth as of December 2019, more than two times its CET1 capital base. As of June 2019, the majority of the Italian bonds were held at amortised cost, thereby limiting the sensitivity of the group's regulatory capital ratios to volatility in sovereign spread.

Figure 5: Total exposure to Italian debt as % of transitional CET1 (June 2019)



Source: Company data, Scope Ratings.

Track record of low but resilient profitability

For the past five years, BPS' profitability has been low but resilient, in the mid-single digit range.

In 2019, BPS recorded a net profit of EUR 137m, equating to a return on average equity of c. 5%. This result was helped by a good contribution from the securities portfolio, as well as by a decline in the cost of risk.

BPS was one of the few Italian banks to remain profitable during the crisis

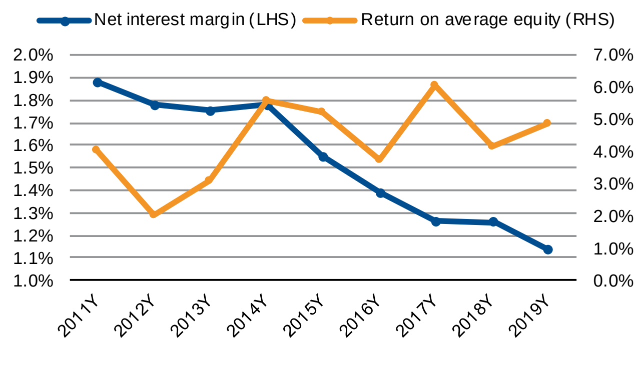
BPS has a solid earnings track record, and was even profitable during the most recent crisis, a period in which many banks in Italy needed to be recapitalised. In the past few years, the group achieved such a result thanks to a mix of factors, including:

- a relatively resilient net interest income despite the declining interest rate environment; however, net interest income includes potentially volatile components, such as interest on government bonds and NPEs.
- stable or mildly increasing net commission income;
- avoidance of NPE disposals, which for other peers have necessitated a large frontloading of provisions;
- above-average operating efficiency; as of YE 2019, BPS' cost/asset ratio was one of the best among Italian banks, at c. 1.5% (Figure 7).

Need to deal with legacy NPEs still challenges the profit outlook

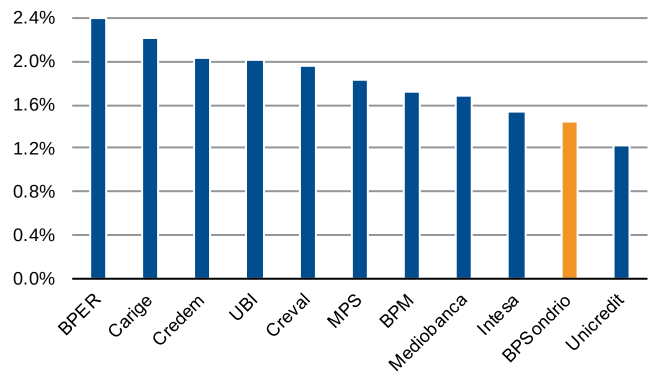
So far, the bank has managed to absorb provisions through operating income. For example, the sale of EUR 1bn in NPEs announced in August 2019 led to c. EUR 45m in negative value adjustments, which could be fully absorbed by operating profitability. However, the pre-provision profit buffer has shrunk in recent years, a trend that is unlikely to reverse given the challenged macroeconomic environment. This, coupled with the need to reduce NPEs further, is likely to continue to pressure the bottom line.

Figure 6: BPS' ROE held on while net interest margin kept decreasing



Source: SNL, Scope Ratings

Figure 7: Cost/asset ratio vs peers (2019)



Source: SNL, Scope Ratings Note: Carige's figures as of 2018Y

Solid capital position, with sufficient room to manoeuvre following AIRB adoption

Italy is part of the European Banking Union, which consists of the single rulebook, a single supervisory mechanism and a single resolution mechanism. A common deposit insurance scheme is yet to be implemented in Europe.

A number of significant Italian banks are directly supervised by the ECB, while less significant institutions are supervised by the Bank of Italy, which is the designated national competent authority (NCA) for Italy under the single supervisory mechanism. BPS is directly supervised by the ECB.

Increased headroom to the total capital SREP requirement

At the end of 2019, BPS had a CET1 ratio of 16.04% on a transitional basis. This compares favourably with the 2019 SREP requirement of 10%. The Tier 1 ratio stood at 16.09% and the total capital ratio stood at 18.93% (against a SREP requirement of 13.5%). The group capital position greatly improved in May 2019, when the ECB approved the parent bank's AIRB models to assess the credit risk of corporate and retail portfolios. These numbers include the decision not to distribute any dividend for financial year 2019, in line with the ECB's recent recommendation.

The current headroom should give the group more strategic flexibility to accelerate derisking if needed. BPS has no outstanding CRD4-compliant AT1 notes and about EUR 550m of CRD4-compliant Tier 2 notes as at the end of 2019. In July 2019 it placed a EUR 200m Tier 2 loan, which added c. 120bps to the total capital ratio.

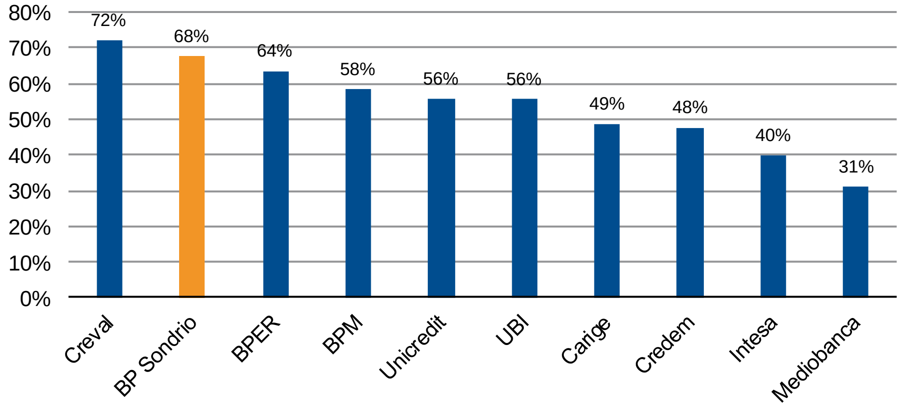
The fully loaded leverage ratio of 6.03% at the end of December 2019 is strong, in our view.

As of YE 2019, BPS reported that its liquidity coverage ratio is ahead of requirements.

BPS' balance sheet is mostly funded by deposits and central bank lines

The group funds itself primarily via current accounts and sight deposits, which accounted for c. 68% of the balance sheet as of June 2019 (Figure 8). Historically, BPS has also used TLTRO funding (EUR 4.6bn in June 2019, or 10.9% of the balance sheet), and we expect the bank to benefit from improved terms on the TLTRO3 lines in coming quarters.

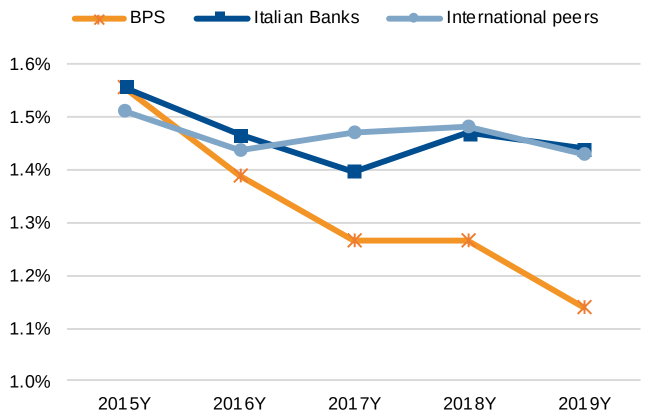
Figure 8: Customer deposits as % of total liabilities, as of June 2019



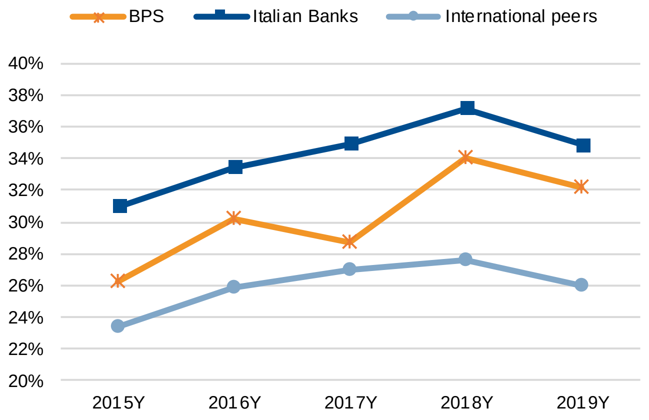
Source: SNL, Scope Ratings.

I. Appendix: Peer comparison

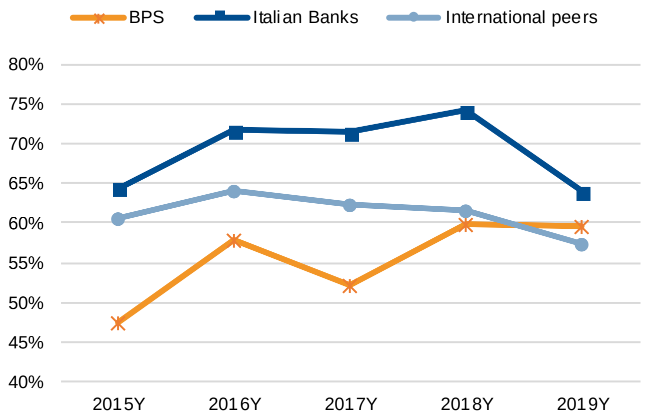
Net interest margin



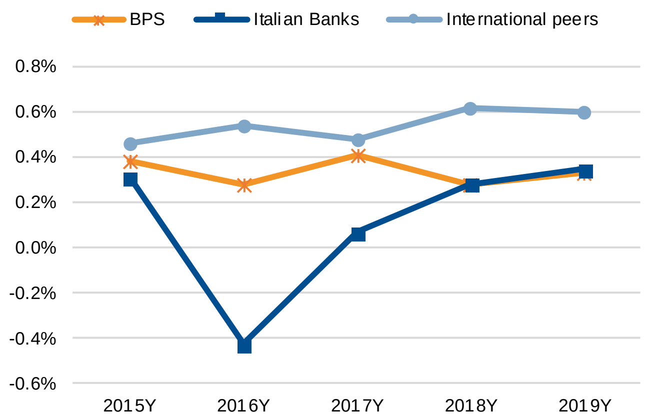
Fees & commissions % revenues



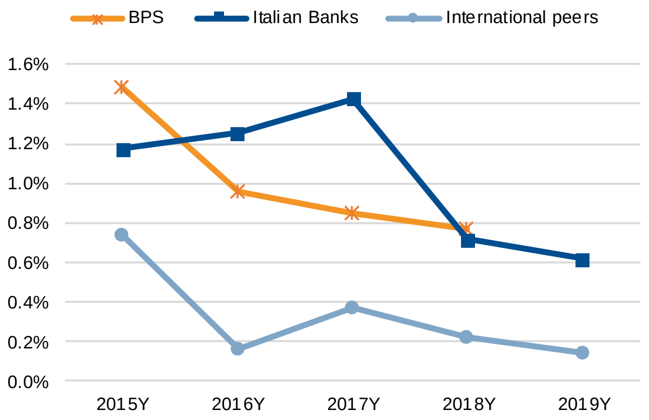
Cost/income ratio



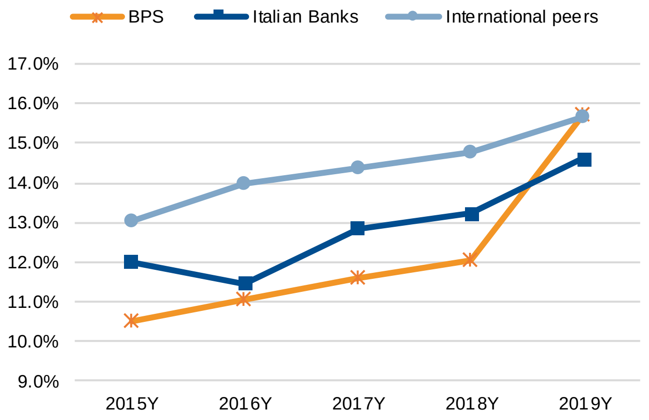
Return on average assets



Cost of risk (%)



Common equity tier 1 ratio (%, transitional)



Source: SNL Financial, Scope Ratings
National peers: Credito Valtellinese, Intesa, Unicredit, Monte dei Paschi di Siena, Banco BPM, UBI, Banca Popolare di Sondrio, Credem, Mediobanca, BPER, Carige
International peers: Unicaja, Ibercaja, Liberbank, Bank Burgenland, Salzburger Landes-Hypothekenbank, Oberbank AG, Toens Sparebank
\

II. Appendix: Selected financial information – Banca Popolare di Sondrio S.C.p.A.

	2015Y	2016Y	2017Y	2018Y	2019Y
Balance sheet summary (EUR m)					
Assets					
Cash and interbank assets	1,746	2,576	2,620	2,898	2,894
Total securities	8,401	7,877	11,893	5,076	3,497
of which, derivatives	64	57	98	32	NA
Net loans to customers	23,997	25,313	25,756	31,758	33,133
Other assets	1,394	1,434	1,356	1,396	1,623
Total assets	**35,538**	**37,202**	**41,625**	**41,128**	**41,146**
Liabilities					
Interbank liabilities	2,302	2,505	6,205	6,166	4,328
Senior debt	2,263	2,468	2,220	1,907	NA
Derivatives	102	112	54	74	78
Deposits from customers	26,347	27,702	28,801	28,630	29,817
Subordinated debt	918	764	613	525	NA
Other liabilities	955	994	962	1,082	NA
Total liabilities	**32,888**	**34,544**	**38,855**	**38,384**	**38,209**
Ordinary equity	2,563	2,573	2,679	2,651	2,842
Equity hybrids	0	0	0	0	0
Minority interests	87	85	91	93	95
Total liabilities and equity	**35,538**	**37,202**	**41,625**	**41,128**	**41,146**
Core tier 1/ common equity tier 1 capital	*2,441*	*2,568*	*2,638*	*2,636*	*2,713*
Income statement summary (EUR m)					
Net interest income	543	474	490	508	460
Net fee & commission income	303	293	305	316	322
Net trading income	212	110	161	11	114
Other income	97	93	105	93	105
Operating income	**1,156**	**970**	**1,062**	**927**	**1,001**
Operating expenses	549	562	553	556	597
Pre-provision income	**607**	**409**	**508**	**371**	**405**
Credit and other financial impairments	409	279	274	249	165
Other impairments	1	0	0	0	0
Non-recurring items	0	0	0	0	45
Pre-tax profit	**196**	**130**	**234**	**143**	**195**
Discontinued operations	0	0	0	0	0
Other after-tax Items	0	0	0	0	0
Income tax expense	59	30	68	29	56
Net profit attributable to minority interests	8	1	6	3	2
Net profit attributable to parent	**129**	**99**	**159**	**111**	**137**

Source: SNL, Scope Ratings

III. Appendix: Selected financial information – Banca Popolare di Sondrio S.C.p.A.

	2015Y	2016Y	2017Y	2018Y	2019Y
Funding and liquidity					
Net loans/ deposits (%)	91%	91%	89%	110%	111%
Liquidity coverage ratio (%)	129%	107%	NA	148%	NA
Net stable funding ratio (%)	125%	124%	NA	NA	NA
Asset mix, quality and growth					
Net loans/ assets (%)	67.5%	68.0%	61.9%	77.2%	80.5%
Problem loans/ gross customer loans (%)	16.3%	16.1%	15.1%	12.3%	NA
Loan loss reserves/ problem loans (%)	48.2%	49.3%	53.9%	58.5%	NA
Net loan growth (%)	-0.1%	5.5%	1.7%	23.3%	4.3%
Problem loans/ tangible equity & reserves (%)	90.9%	91.9%	84.1%	81.0%	NA
Asset growth (%)	-0.2%	4.7%	11.9%	-1.2%	0.0%
Earnings and profitability					
Net interest margin (%)	1.6%	1.4%	1.3%	1.3%	1.1%
Net interest income/ average RWAs (%)	2.3%	2.0%	2.1%	2.3%	2.4%
Net interest income/ operating income (%)	47.0%	48.9%	46.2%	54.8%	46.0%
Net fees & commissions/ operating income (%)	26.3%	30.2%	28.7%	34.1%	32.2%
Cost/ income ratio (%)	47.5%	57.9%	52.1%	60.0%	59.6%
Operating expenses/ average RWAs (%)	2.3%	2.4%	2.4%	2.5%	3.2%
Pre-impairment operating profit/ average RWAs (%)	2.5%	1.8%	2.2%	1.7%	2.1%
Impairment on financial assets / pre-impairment income (%)	67.4%	68.2%	54.0%	67.2%	40.7%
Loan loss provision/ average gross loans (%)	1.5%	1.0%	0.9%	0.8%	NA
Pre-tax profit/ average RWAs (%)	0.8%	0.6%	1.0%	0.6%	1.0%
Return on average assets (%)	0.4%	0.3%	0.4%	0.3%	0.3%
Return on average RWAs (%)	0.6%	0.4%	0.7%	0.5%	0.7%
Return on average equity (%)	5.2%	3.8%	6.1%	4.2%	4.9%
Capital and risk protection					
Common equity tier 1 ratio (%, fully loaded)	10.3%	11.1%	11.5%	11.9%	15.7%
Common equity tier 1 ratio (%, transitional)	10.5%	11.1%	11.6%	12.0%	15.7%
Tier 1 capital ratio (%, transitional)	10.5%	11.1%	11.6%	12.1%	15.8%
Total capital ratio (%, transitional)	13.4%	13.6%	13.7%	13.6%	18.6%
Leverage ratio (%)	6.1%	6.2%	5.7%	5.8%	6.0%
Asset risk intensity (RWAs/ total assets, %)	65.5%	62.4%	54.6%	53.3%	41.9%
Market indicators					
Price/ book (x)	0.7x	0.5x	0.5x	0.4x	0.3x
Price/ tangible book (x)	0.7x	0.6x	0.5x	0.5x	0.3x
Dividend payout ratio (%)	24.1%	27.3%	20.0%	20.8%	NA

Source: SNL, Scope Ratings
Note: Capital and leverage ratios do not include the effects of the decision not to pay dividends on 2019 earnings.

Scope Ratings GmbH

Headquarters Berlin

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891-0

Frankfurt am Main

Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389-0

Paris

1 Cour du Havre
F-75008 Paris

Phone +33 1 8288 5557

London

3rd Floor
111 Buckingham Palace Road
UK-London SW1W OSR

Phone +44 20 3457 0444

Madrid

Edificio Torre Europa
Paseo de la Castellana 95
E-28046 Madrid

Phone +34 914 186 973

Milan

Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo

Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 623142

info@scoperatings.com
www.scoperatings.com

Disclaimer