Intesa Sanpaolo SpA Issuer Rating Report

A STABLE OUTLOOK

Overview

On 2 February 2017, Scope Ratings upgraded the Issuer Credit-Strength Rating (ICSR) of Intesa Sanpaolo SpA to A from A-, maintaining the Stable Outlook. The rating upgrade was related to forthcoming adjustments in creditor hierarchy related to the introductions of MREL-eligible debt and are in line with the most current version of Scope's bank rating methodology (May 2016). The short-term rating is S-2, with Stable Outlook.

The ratings were not solicited by the issuer. Both ratings and analysis are based solely on publicly available information. The issuer has participated in the process. For the full list of ratings see the **Ratings** section at the end of this report.

Highlights

The ratings are driven by Intesa's strong capital position and resilient profitability despite the challenging operating environment in Italy, where 82% of the loan portfolio is based. The group has been the leading retail and commercial bank in Italy since the merger of Intesa BCI and San Paolo IMI in 2007. Group earnings and asset quality have suffered from the weak domestic economic environment, but pre-provision profitability has been resilient and the group has remained profitable if we exclude large write-downs of goodwill in 2011 and 2013.

Although it has operations in Central and Eastern Europe, Intesa's primarily domestic-based operations, combined with significant holdings in Italian sovereign debt, mean it is particularly exposed to market confidence in Italian banks and Italy in general.

Rating drivers (Summary)

The rating drivers, in decreasing order of importance in the rating assignment, are:
1. Largest retail and commercial bank in Italy, which remained profitable during the crisis
2. A balanced revenue model, with significant fee-generating activities supporting profitability
3. Weak but improving asset quality
4. Strong capital position and potential capital generation going forward
5. Declining but still material sovereign risk exposure, which remains a concern

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Bloomberg: SCOP

Rating-change drivers

Further progress in the workout of non-performing loans. The decline in NPE formation in recent quarters was coupled with a decline in NPEs' absolute numbers (both in gross and net terms) and an increase in coverage. We believe the inversion in asset quality trends is due not only to the more favourable macro environment but also to an increased focus on the management of NPEs at Intesa. The business plan presented in March 2014 included initiatives for a more proactive management of impaired loans, including the creation of a dedicated team for the management of high-value substandard and restructured and a business unit dedicated to deleverage the NPE stock.

Renewed tension on Italian bank and sovereign debt. Tensions surrounding peripheral European assets were sedated, for the past few years, by a strongly accommodative monetary policy. As economic recovery takes hold in Europe, the European Central Bank will gradually remove its support, starting with a termination of its asset purchase programme in December 2017. Despite not directly affecting the P&L, rising yields on the bank's Italian sovereign bond holdings would raise questions on the bank's capital levels.

Event risk. Due to its ownership structure (four Fondazioni control c. 21% of Intesa's capital) and relatively sound financial position, there remains a risk the group could be subject to political pressure or asked to support weaker domestic banks or companies deemed to be of national interest. During the 2014-2017 business plan presentation, CEO Carlo Messina stated that Intesa had no interest in taking part in any consolidation within Italy and expressed instead a preference for increased distribution of excess capital to shareholders rather than M&A.

Rating drivers (Details)

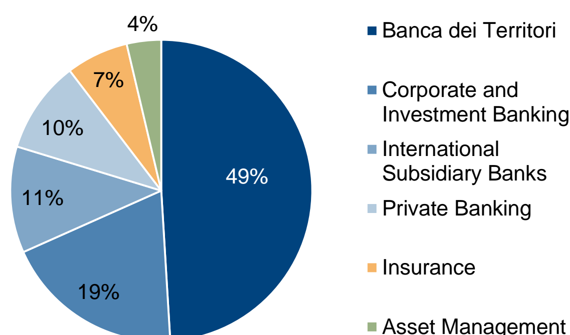
1. Largest retail and commercial bank in Italy, which remained profitable during the crisis

Two large banks dominate the Italian banking landscape, with the residual market share split between a multitude of mid- and smaller-tier players. Intesa is the leading retail and commercial bank in Italy with approximately 4,000 branches in the country. Formed in 2007 through the merger of Gruppo Intesa BCI and Gruppo Sanpaolo IMI, Intesa is present throughout the country and has a particularly strong footprint in the wealthiest regions of northern Italy. The group holds the number-one position in loans (market share 16%), deposits (17%), pension funds (22%) and asset management (20%).

More than half of the group operating income is derived from Banca dei Territori (domestic commercial banking), which offers traditional lending and deposit collection operations in Italy, servicing households, small businesses, SMEs, and Italian mid-size corporations with a turnover of up to EUR 350m, as well as the group's product companies. The other main contributor to operating income is corporate and investment banking, which serves large corporate clients and financial institutions as well as public finance entities. In terms of international operations, the group is present in 11 countries, primarily in Central and Eastern Europe as well as in Egypt, with approximately 1,100 branches. The largest international operations are in Slovakia, Croatia and Hungary. As of year-end 2016, international subsidiary banks accounted for 11% of operating income and 7% of the total loan portfolio. Intesa's foreign presence, while material, does not contribute to significant revenue and asset diversification from the Italian market. This differentiates Intesa's business model from Unicredit's.

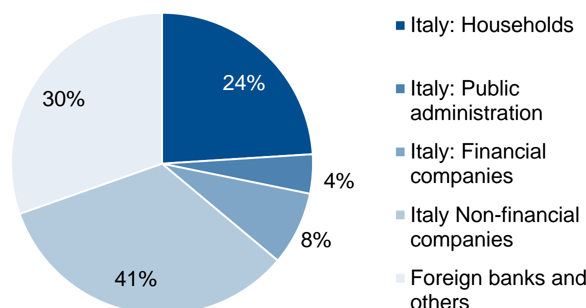
With 82% of total loans in Italy, Intesa Sanpaolo is heavily dependent on the performance of the Italian economy. The loan book is diverse within its main segments: households comprising 24% (mostly residential mortgages with an average LTV ratio of 55% at year-end 2016); mid-sized corporates and public finance (9%); SMEs (15%); and industrial credit, leasing and factoring (12%). The group's loan exposure to non-financial companies is well diversified by sector, with no single sector accounting for more than 6% of the total. The largest sectors are: services (5.8% of total loan portfolio), distribution (5.3%) and real estate (4.1%).

Figure 1: Revenues by division (2016)



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

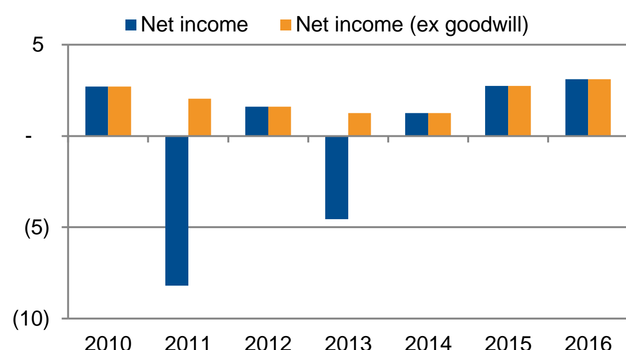
Figure 2: Loan book composition (2016)



Source: Company data, Scope Ratings.

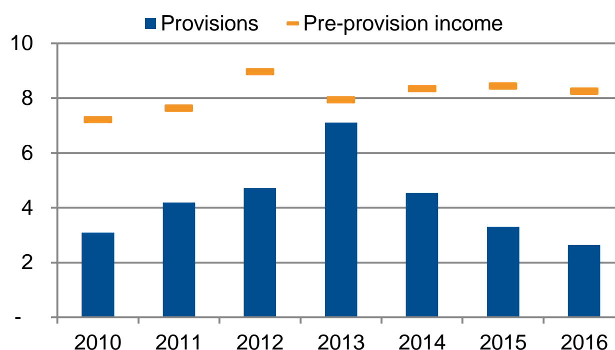
Despite the difficult operating environment in its domestic market, Intesa has remained largely profitable at the operating level. Indeed, while it has posted net statutory losses in 2011 and 2013 due to large write-downs of goodwill, the operating performance has remained satisfactory, with pre-provision income able to absorb significant provisions, especially in 2013 (see Figure 4).

Figure 3: Intesa's losses were entirely driven by goodwill impairments (EUR bn)



Source: Company data, Scope Ratings.

Figure 4: Pre-provision profitability has been enough to absorb rising credit provisions (EUR bn)



Source: Company data, Scope Ratings.

2. A balanced revenue model, with significant fee-generating activities supporting profitability

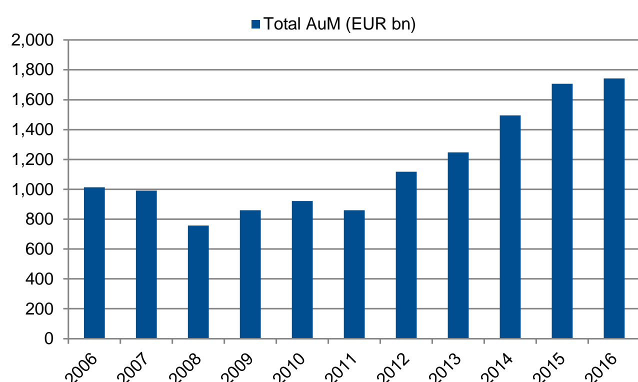
One key aspect supporting the revenue-generating potential of Intesa is in our view the diversification in its revenue sources. We calculate that in 2016 fee income amounted to 43% of total group revenues, a percentage higher than its domestic peers. In an operating environment where interest revenues are under pressure from slow volumes and declining yields on securities, we deem it an important competitive advantage to have the flexibility to generate alternative income from non-banking activities.

In particular, we highlight the strong performance not only of Intesa's asset management division, Eurizon, but also of the private bank, Fideuram, and of the insurance business.

Going forward, we expect these divisions to continue to drive revenue growth at Intesa. Industry data shows that the Italian asset management industry has been performing very strongly in recent years. In our view the recent growth of the industry can be ascribed to two elements:

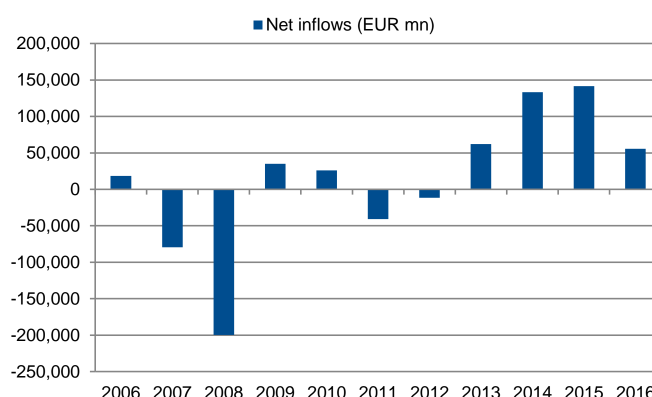
1. Savers' demand for higher returns while central bank policies compress yields
2. Banks' lower need for balance sheet customer funds, as limited volume growth coupled with advantageous TLTRO funding allows them to focus distribution networks on higher-margin products.

Figure 5: System assets under management are growing



Source: Assogestioni, Scope Ratings.

Figure 6: Net inflows into mutual funds



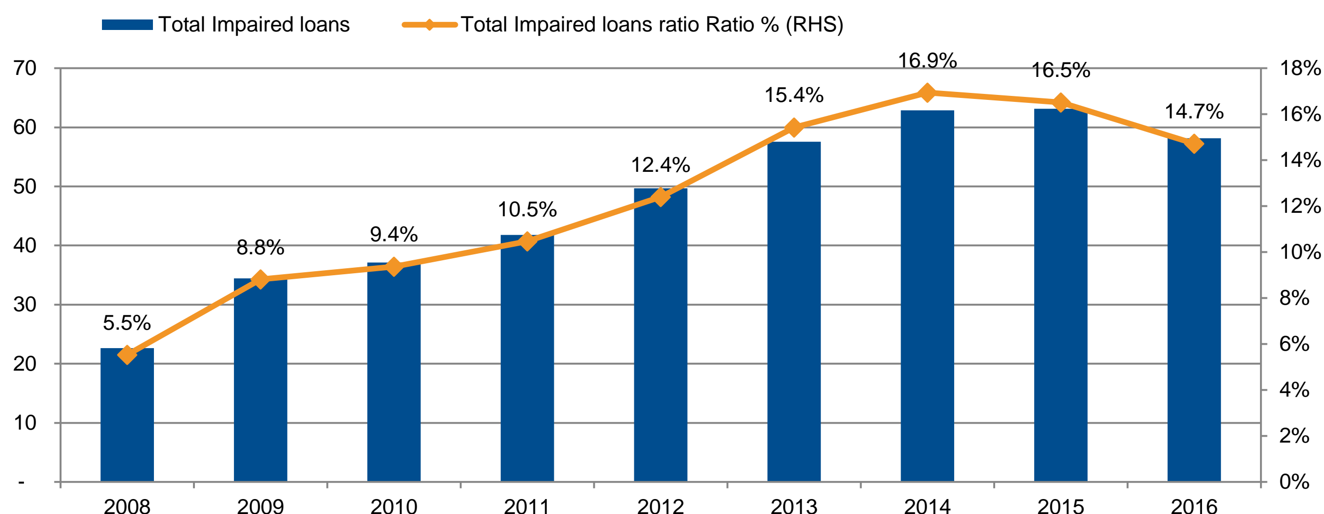
Source: Assogestioni, Scope Ratings.

Intesa is in our view well positioned to continue to capture the growth in Italian asset management, hence supporting revenues going forward.

3. Weak but improving asset quality

The Italian economy was in recession until 2014, but has been growing in recent years and we expect it to continue to expand. As a result of the recession in Italy, the group's gross NPE ratio increased to 16.9% in 2014 from 4.8% in 2007 but is now declining (14.7% in December 2016). This remains a very high level compared to international peers, although we expect it to continue to decline in the coming years, supported by the more favourable macro environment.

Figure 7: Gross NPEs and NPE ratio (2008-2016)



Source: Company data, Scope Ratings.

Note: Impaired loans = sofferenze + watchlist + restructured + past due

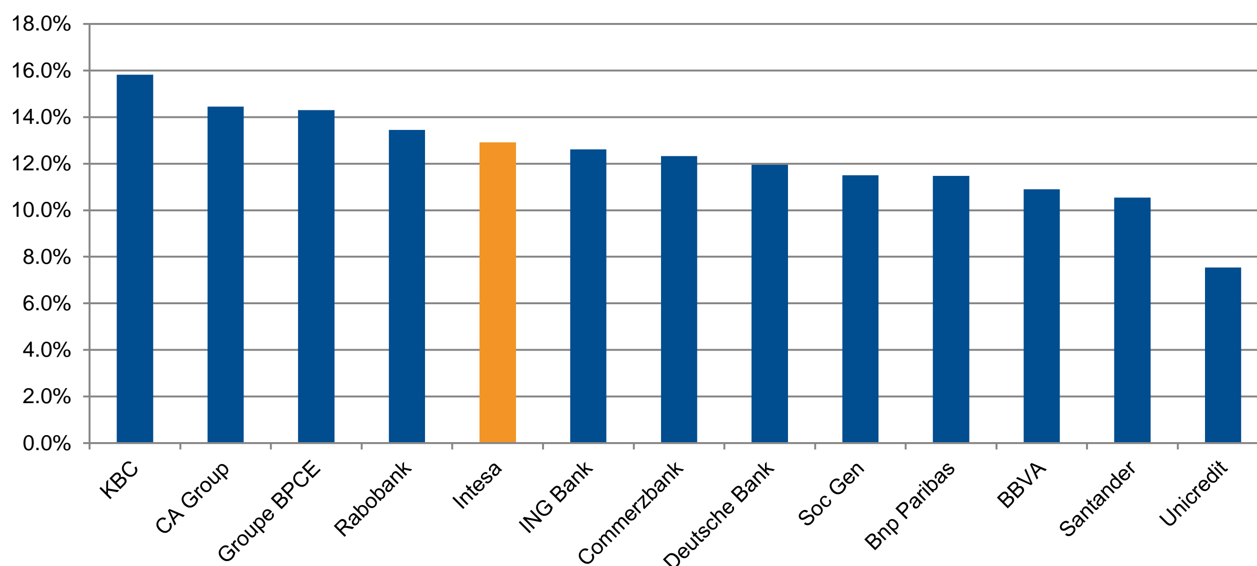
As of December 2016, coverage of NPEs was 48.8%, or 149% including collateral and financial guarantees (157% including personal guarantees).

4. Strong capital position and capital generation

Despite the weak operating environment, Intesa has significantly improved its capital position in recent years.

As of December 2016, the group's CRD IV fully loaded CET1 ratio was 12.9%, at the high end of eurozone banks (see Figure 8). On a transitional basis, the CET1 ratio stood at 12.7%. Moreover, Intesa's high profitability coupled with limited RWA growth means that the bank generates capital organically.

Figure 8: CRD IV fully CET1 ratio, eurozone banks FY 2016



Source: Company data, Scope Ratings

In terms of leverage ratio, Intesa is one of the strongest large banks in Europe. The reported leverage ratio in December 2016 was 6.3%.

5. Declining but still material sovereign risk exposure, which remains a concern

As the largest Italian bank with only limited international diversification, Intesa has a large exposure to Italian government debt.

As we discuss in our sovereign outlook report on Italy, we consider Italy to have a low to medium sovereign credit strength among the large European economies. Italy maintains a high debt position and suffers from a heightened degree of political uncertainty when compared to other eurozone countries. As a result, the group is vulnerable to investor sentiment, which can affect Italian sovereign risk.

In recent years, Italy has been successful in bringing its public deficit under control (-2.3% of GDP in 2016; 3% in 2014 from 5.3% of GDP in 2009[1]) despite the decline in GDP in the period. This has been achieved mainly through the introduction of new taxes, but also via measures to contain public spending, including a freeze on public-sector wages and a reform of the pension system.

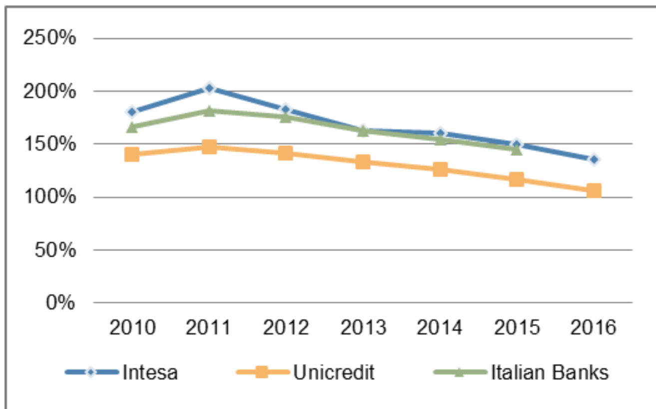
In December 2016, total exposure to Italian sovereign risk had declined to c. EUR 50bn, including EUR 15bn of loans and EUR 35bn of debt securities, compared to c. 53bn at YE2015 and over EUR 60bn at the end of 2014. While lower than in the past, such an amount still represents an important concentrated exposure, close to 140% of group transitional CET1 capital. The duration of the government bond portfolio is 5.2 years, although the portfolio is almost completely hedged.

We also note that over the past few quarters the group has, diversified its sovereign bond portfolio, adding exposures to several EU countries, especially Germany, France and Spain. While the banking sovereign bond exposure to EU countries of EUR 61.5bn is slightly above both the 2014 and 2015 numbers, it has markedly declined when compared to December 2013 (EUR 69.4bn); moreover Italy now only accounts for around 56% of it, compared to 61% in 2015 and 71% in December 2014.

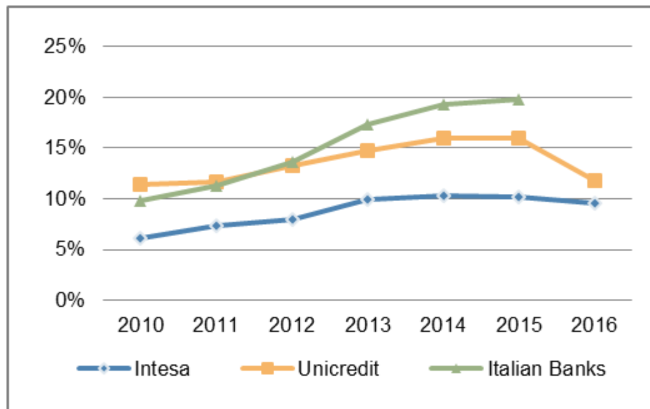
[1] Source: European Commission 2017 winter forecast, Eurostat.

Appendix A: Peer comparison

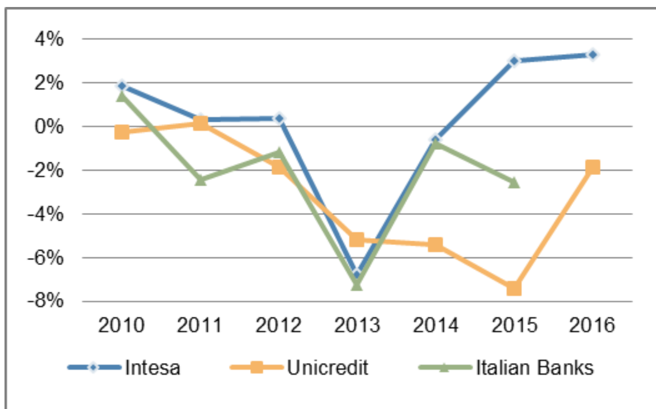
Gross loans % total deposits



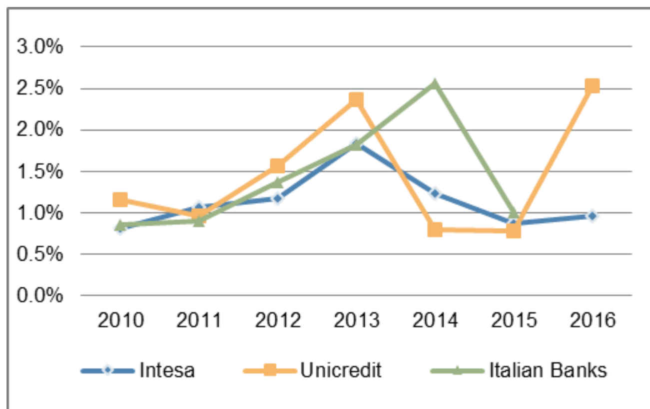
Impaired loans % gross loans



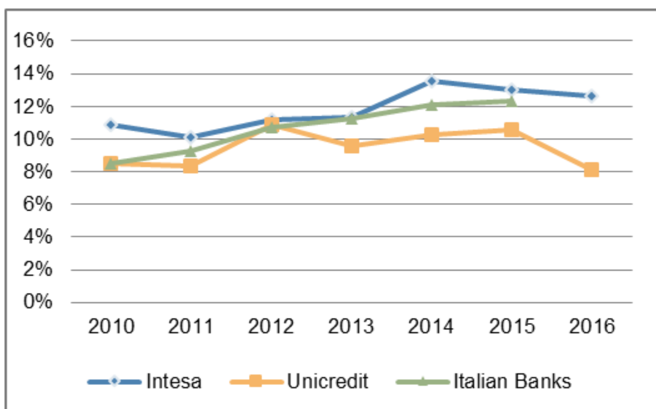
Total gross loan growth (%)



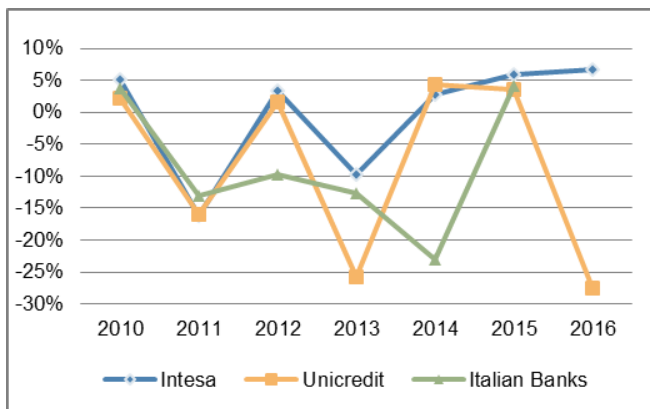
Cost of risk (LLC % average loans)



Common equity tier 1 ratio (transitional) (%)



Return on average equity (%)



Source: SNL, Scope Ratings
National peers: Intesa, Unicredit, Monte dei Paschi di Siena, Banco Popolare, UBI

Appendix B: Selected financial information – Intesa Sanpaolo

	2012	2013	2014	2015	2016
Balance sheet summary (EUR bn)					
Assets					
Cash and interbank assets	41.3	32.6	37.0	43.0	61.0
Total securities	154.6	172.0	186.3	206.4	224.9
Derivatives	56.7	37.5	46.0	38.1	36.8
Net loans to customers	376.6	344.0	339.1	350.0	364.7
Other assets	44.4	38.0	38.0	38.9	37.8
Total assets	**673.6**	**624.2**	**646.4**	**676.5**	**725.1**
Liabilities					
Interbank liabilities	75.9	55.2	53.4	62.5	76.8
Senior debt	145.9	128.7	112.6	100.6	84.8
Derivatives	61.7	40.7	51.3	44.0	45.3
Deposits from customers	218.5	229.1	230.9	255.7	291.8
Subordinated debt + non-equity hybrids	13.4	13.6	15.8	14.6	15.1
Other liabilities	108.3	111.8	137.3	150.5	161.9
Total liabilities	**623.7**	**579.1**	**601.4**	**627.9**	**675.8**
Ordinary equity	49.3	44.5	44.7	46.9	46.8
Equity hybrids	0.0	0.0	0.0	0.9	2.1
Minority interests	0.6	0.5	0.4	0.8	0.4
Total liabilities and equity	**673.6**	**624.2**	**646.4**	**676.5**	**725.1**
Core tier 1 / common equity tier 1 capital	33.5	31.3	36.6	36.9	35.9
Income statement summary (EUR bn)					
Net interest income	9.4	8.1	8.4	7.7	7.3
Net fee & commission income	5.5	6.1	6.8	7.3	7.3
Net trading income	2.2	1.2	0.7	1.0	1.2
Other income	0.8	0.8	1.0	1.1	1.2
Operating income	**17.9**	**16.2**	**16.8**	**17.2**	**16.9**
Operating expense	8.9	8.3	8.6	8.7	8.7
Pre-provision income	**9.0**	**8.0**	**8.2**	**8.5**	**8.3**
Loan-loss provision charges	4.7	7.1	4.6	3.3	3.7
Other impairments	0.0	0.0	0.0	0.0	0.0
Non-recurring items	-0.4	2.1	-0.2	0.0	0.2
Pre-tax profit	**3.6**	**2.5**	**3.3**	**4.9**	**4.5**
Discontinued operations	-0.4	-6.2	0.0	-0.5	0.1
Income tax expense	1.5	0.9	1.8	1.7	1.4
Net profit attributable to minority interests	0.0	0.0	0.2	0.0	0.1
Net profit attributable to parent	**1.6**	**-4.6**	**1.3**	**2.7**	**3.1**

Source: SNL, Scope Ratings

Appendix C: Ratios – Intesa Sanpaolo

	2012	2013	2014	2015	2016
Funding/Liquidity					
Gross loans % total deposits	183.3%	162.9%	160.6%	149.4%	135.3%
Total deposits % total funds	48.2%	53.7%	55.9%	58.9%	62.0%
Wholesale funds % total funds	51.8%	46.3%	44.1%	41.1%	38.0%
Liquidity coverage ratio (%)			>100%	>100%	>100%
Net stable funding ratio (%)			>100%	>100%	>100%
Asset mix, quality and growth					
Gross loans % funded assets	65.4%	64.0%	62.3%	60.4%	58.1%
Impaired loans % gross loans	8.0%	10.0%	10.3%	10.2%	9.6%
Loan-loss reserves % impaired loans	74.5%	78.4%	83.3%	82.0%	79.3%
Gross loan growth (%)	0.4%	-6.8%	-0.6%	3.0%	3.3%
Impaired loan growth (%)	9.6%	16.2%	2.9%	2.5%	-3.4%
Funded assets growth (%)	5.0%	-4.6%	2.0%	6.3%	7.5%
Earnings					
Net interest income % revenues	52.7%	49.9%	49.7%	44.9%	43.1%
Fees & commissions % revenues	30.5%	37.7%	40.2%	42.7%	43.0%
Trading income % revenues	12.2%	7.1%	4.4%	6.0%	7.0%
Other income % revenues	4.6%	5.2%	5.8%	6.4%	6.8%
Net interest margin (%)	1.8%	1.5%	1.6%	1.5%	1.3%
Pre-provision income % risk-weighted assets (RWAs)	2.9%	2.8%	3.0%	3.1%	2.9%
Loan-loss provision charges % pre-provision income	52.6%	89.4%	55.6%	39.1%	44.9%
Loan-loss provision charges % gross loans (cost of risk)	1.2%	1.8%	1.2%	0.9%	1.0%
Cost income ratio (%)	49.8%	51.1%	51.1%	50.8%	51.2%
Net interest income / loan-loss charges (x)	2.0	1.1	1.8	2.3	2.0
Return on average equity (ROAE) (%)	3.3%	-9.7%	2.8%	6.0%	6.6%
Return on average funded assets (%)	0.3%	-0.8%	0.2%	0.4%	0.5%
Retained earnings % prior year's book equity	1.6%	-10.9%	0.0%	0.8%	-2.2%
Pre-tax return on common equity tier 1 capital	10.9%	7.8%	9.6%	13.4%	12.3%
Capital and risk protection					
Common equity tier 1 ratio (%, fully loaded)			13.3%	12.6%	12.9%
Common equity tier 1 ratio (%, transitional)	11.2%	11.3%	13.6%	13.0%	12.7%
Tier 1 capital ratio (%, transitional)	12.1%	12.2%	14.2%	13.8%	13.9%
Total capital ratio (%, transitional)	13.6%	14.8%	17.2%	16.6%	17.0%
Tier 1 leverage ratio (%)			7.1%	6.8%	6.3%
Total loss coverage (CET1 + loan-loss provisions) % RWAs	19.2%	21.9%	25.4%	24.3%	23.2%
Asset risk intensity (RWAs % total assets)	44.3%	44.3%	41.7%	42.0%	39.2%

Source: SNL, Scope Ratings

Intesa Sanpaolo SpA
Issuer Rating Report

Ratings *

Issuer Credit-Strength Rating	**A**
Outlook	Stable
Senior unsecured debt	A-
Additional Tier 1 instruments	BB+
Short-term debt rating	S-2
Short-term debt rating outlook	Stable

* The ratings are not applicable to debt issued by unguaranteed subsidiaries of the rated parent.

Regulatory Disclosures

Information pursuant to Regulation (EC) No 1060/2009 on credit rating agencies, as amended by Regulations (EU) No. 513/2011 and (EU) No. 462/2013

Responsibility

The party responsible for the dissemination of the financial analysis is Scope Ratings AG, Berlin, District Court for Berlin (Charlottenburg) HRB 161306 B, Executive Board: Torsten Hinrichs (CEO), Dr. Stefan Bund.

The rating analysis has been prepared by Marco Troiano, Director

Responsible for approving the rating: Sam Theodore, Managing Director

Rating history:

Date	Rating action	Rating
11.06.2014	First Assignment	BBB+
10.09.2015	Review (upgrade)	BBB+
20.10.2015	Upgrade	A-
02.02.2017	Upgrade	A

The rating outlook indicates the most likely direction of the rating if the rating were to change within the next 12 to 18 months. A rating change is, however, not automatically ensured.

Information on interests and conflicts of interest

The rating was prepared independently by Scope Ratings and without a mandate (unsolicited rating) but with participation of the issuer

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Key sources of Information for the rating

Website of the rated entity/issuer, Annual reports/quarterly reports of the rated entity/issuer, Current performance record, Detailed information provided on request, Data provided by external data providers, Interview with the rated entity, External market reports, Press reports / other public information.

Scope Ratings considers the quality of the available information on the evaluated company to be satisfactory. Scope ensured as far as possible that the sources are reliable before drawing upon them, but did not verify each item of information specified in the sources independently.

Examination of the rating by the rated entity prior to publication

Prior to publication, the rated entity was given the opportunity to examine the rating and the rating drivers, including the principal grounds on which the credit rating or rating outlook is based. The rated entity was subsequently provided with at least one full working day, to point out any factual errors, or to appeal the rating decision and deliver additional material information. Following that examination, the rating was not modified.

Methodology

The methodologies applicable for this rating "Bank Rating Methodology" (May 2015) & "Bank Capital Instruments Rating Methodology" (July 2015) are available on www.scoperatings.com. The historical default rates of Scope Ratings can be viewed on the central platform (CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml. A comprehensive clarification of Scope's credit rating, definitions of rating symbols and further information on the analysis components of a rating can be found in the documents on methodologies on the rating agency's website.

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