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

POSITIVE
BBB-

Ratings & Outlook

Issuer rating	BBB-
Outlook	POSITIVE

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Overview

Scope Ratings has assigned an issuer rating of BBB- to Banca Popolare di Sondrio S.C.p.A. (BPS), with a Positive 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, which specialises in agricultural business loans and payroll deductible loans.
- Like other Italian banks, BPS saw a material deterioration in asset quality during the crisis, though ratios have more recently started to improve. Nevertheless, BPS' progress on asset quality has been slow compared to peers: at c. 13%, the non-performing exposure (NPE) ratio is significantly higher than the average for Italian banks, while coverage of c. 56% is roughly in line with the sector's average. We see positively the recent announcement of a disposal of c. EUR1bn of NPLs, indicating a possible acceleration in the pace of de-risking of the balance sheet. BPS also holds a significant exposure to Italian government bonds.
- On the other hand, BPS remained profitable throughout the crisis. It has one of the lowest cost/income ratios in Italy, which allows it to take 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, to be repaid in 2020/2021.

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
- Asset quality has improved very slowly compared to the sector but accelerated in 2019
- Low but resilient profitability track record
- Solid capital position, with sufficient room to manoeuvre following AIRB adoption

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Rating-change drivers

A further material reduction in NPEs. The NPE ratio has been declining slowly in recent quarters and remains high compared to both national and international standards. In August 2019, BPS announced it has deliberated the sale of a EUR 1bn portfolio of NPEs. We see this as an indication that the bank has the willingness to accelerate the derisking of its balance sheet.

A material worsening of operating performance. Thanks to a dominant competitive position in its home province and strong relationships with local clients, a low cost/income ratio and a relatively contained increase in the cost of risk, BPS has managed to remain profitable in recent years while many local peers reported losses, sometimes large enough to threaten their survival. However, the bank's pre-provision profitability has eroded in recent years, limiting the room to absorb losses in the future should the need arise.

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. It has a sparser branch presence in several other northern Italian regions (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.

BPS has immaterial market shares in Italy (1.9% of branches), but a dominant position in its home province of Sondrio (over 49% of branches) and relevant market positions in Lecco and Como (c. 20% in both). Its branch market share in Lombardy is 7.7%.

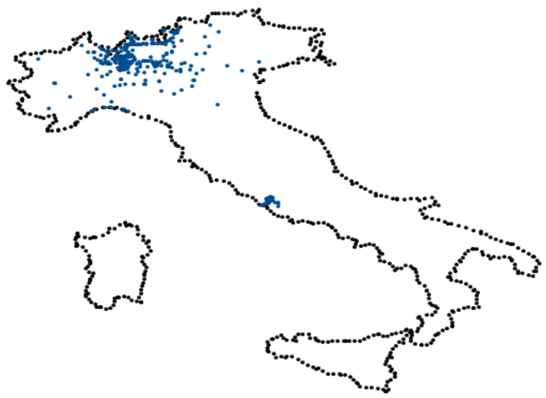
A commercial bank catering to local businesses and households

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 it has stakes in (Alba Leasing, 19.26%; Arca Vita, 14.8%). After the acquisition of PrestiNuova in 2018, BPS entered the market of payroll/pension deducted loans as well. In 2019, Prestinuova was merged into Banca della Nuova Terra, which previously specialised in agricultural loans.

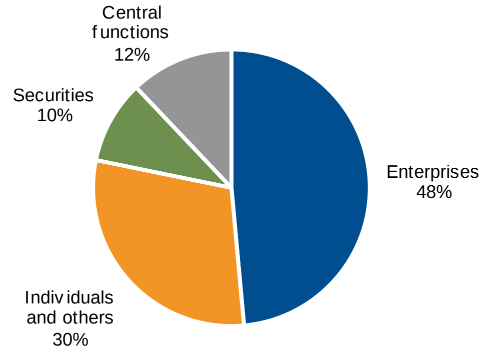
Finally, BPS is active in factoring through its subsidiary Factorit (of which it owns 60.5%), one of the largest players in Italy; Factorit accounted for 4.3% of the group's consolidated net profits in 2018.

Figure 1: Branch network



Source: SNL, Scope Ratings

Figure 2: H1 2019 revenues breakdown, by segment



Source: Company data, Scope Ratings

In H1 2019, almost 80% of BPS' revenues is derived from typical commercial banking activities, which span across the Enterprises (48%) and the Individuals and Others (30%) segments (Figure 2). The former comprises traditional commercial banking, leasing, and factoring services to non-financial companies and family businesses, whereas 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.

Non-negligible contributions to the group's income stem 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 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%.

BPS must transform into joint stock company by 2020

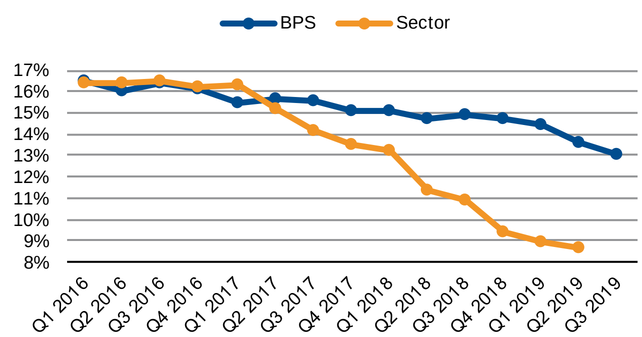
As part of the 2015 reform in Italy, all cooperative banks (*banche popolari*) with total assets of EUR 8bn or more must transform into joint stock companies. BPS has not yet complied with the requirement due to the legal uncertainty arising from the reform being challenged in Italian courts. The deadline for the transformation into a joint stock company, which has been postponed several times, currently stands at the end of 2020.

Asset quality has improved very slowly compared to the sector but accelerated in 2019

High level of NPE's is credit weakness

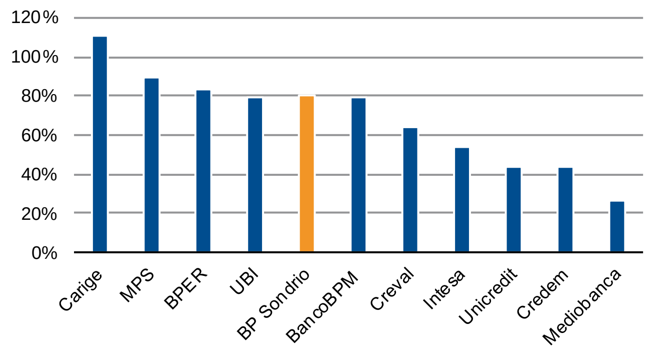
In the aftermath of the financial crisis, BPS accumulated a high stock of gross non-performing loans, which reached a peak of EUR 4.3bn in the beginning of 2016, equivalent to 16.5% of customer loans. Since then, NPEs have started declining, partly as a result of an improved economic environment. Unlike most Italian banks, the group has embraced a softer approach in dealing with NPEs, preferring internal management over large disposals. As a result, while gross NPE ratios of peers have declined materially, BPS' only fell marginally (Figure 3), leaving it towards the bottom of its peer group: at the end of September 2019, the NPE ratio stood at 13.03% (vs 8.7% for the Italian sector in June), with a coverage at 55.5% (in line with peers'). In August 2019 however, the group announced it is looking to sell one billion worth of non-performing loans, as part of a de-risking strategy that aims to bring the gross NPE ratio down to 8% by 2022. Pro forma for such sale, we estimate that the NPE ratio of BPS would still be close to 10%, which is higher than the average for Italian banks though more in line with former popolari banks.

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



Source: Company data, Bank of Italy, Scope Ratings

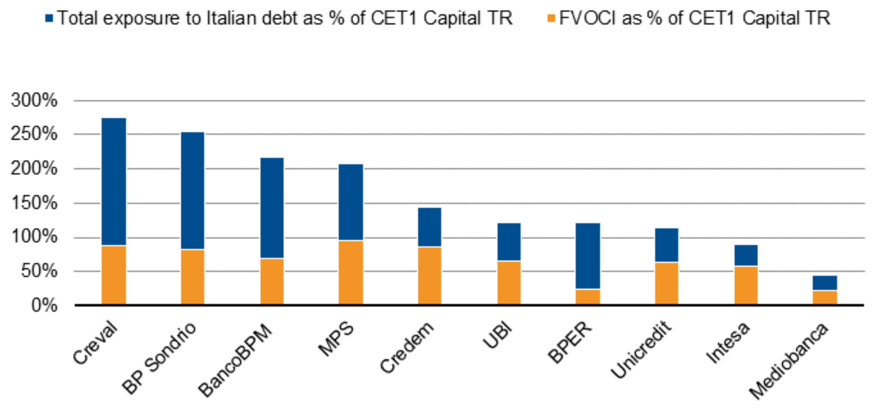
Figure 4: Gross NPEs/provisions+CET1 capital, Italian banks, Q3 2019



Source: Company data, Scope Ratings Notes: Carige's and Banco BPM's figures as of YE 2018 and H1 2019, respectively

BPS also has one of the largest and most concentrated exposures to Italian sovereign bonds (Figure 5). As of June 2019, it held EUR 6.6bn in Italian government bonds, roughly two and a half times its CET1 capital base. 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.

Low but resilient profitability track record

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

In 2018, BPS recorded a net profit of EUR 111m, equating to a return on average equity of c. 4%. Profitability improved in 2019, with the bank recording net income of EUR 123m in the first nine months of the year, with a return on average equity of c. 6%. This result was helped by a good contribution from the securities portfolio, as well as by a decline in the cost of risk.

BPS has been one of the few Italian banks to remain profitable during the crisis.

BPS has a solid earnings track record, and it remained profitable during the most recent crisis, which led to many banks in Italy needing 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 2018, BPS' cost/asset ratio was one of the best among Italian banks, at c. 1.4% (Figure 7).

The 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 the recognition of c. EUR 45m in negative value adjustments, which were fully absorbed by the bank's operating profitability. However, the pre-provision profit buffer has shrunk in recent years and may continue to do so in the current difficult interest rate scenario. This, coupled with the need to reduce NPEs further, will likely continue to pressure the bottom line.

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

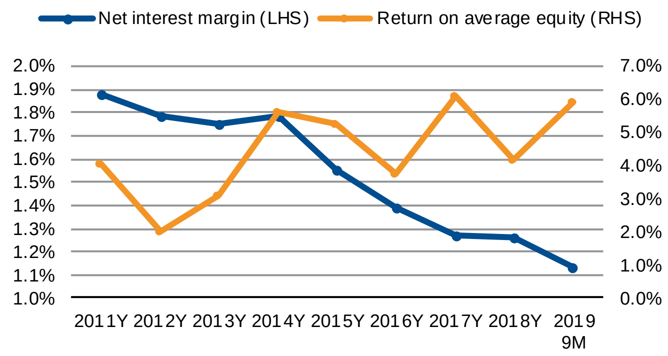
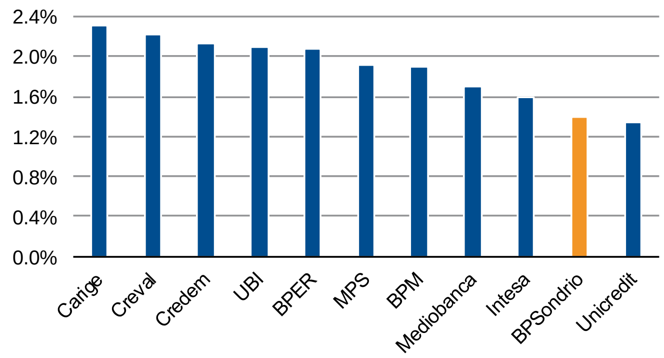


Figure 7: Cost/asset ratio vs peers (2018)



Source: SNL, Scope Ratings

Source: SNL, Scope Ratings

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

BPS is directly supervised by the ECB and is ahead of its prudential capital and liquidity requirements.

Increased headroom to the total capital SREP requirement

At the end of September 2019, BPS had a CET1 ratio of 15.9% on a transitional basis. This compares favourably with the 2019 SREP requirement of 9.25%. The Tier 1 ratio stood at 15.9% and the total capital ratio stood at 18.7% (against a SREP requirement of 12.75%). The group capital position greatly improved in May 2019, when the ECB approved the parent bank's AIRB models to assess credit risk of corporate and retail portfolios. The current headroom should give the group more strategic flexibility to accelerate derisking if needed. BPS has no outstanding CRD4-compliant AT1 notes and EUR 324m of CRD4-compliant Tier 2 notes as at the end of 2018. In July 2019 it placed a EUR200m Tier 2 loan, which added approximately 120bps to the total capital ratio.

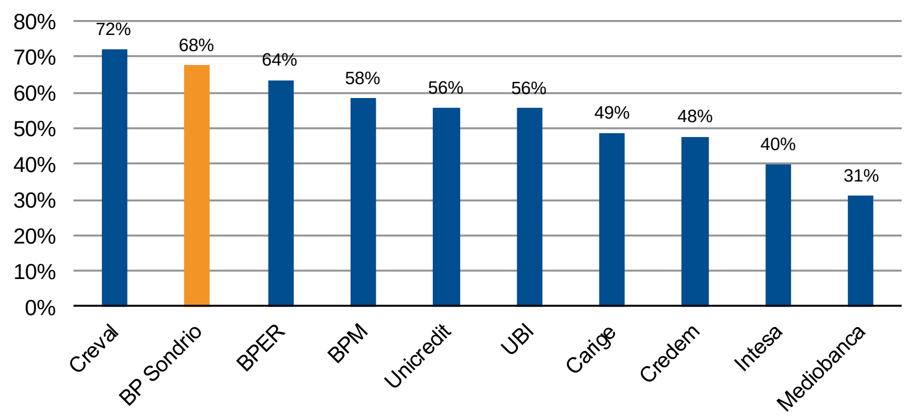
Approval of AIRB models may lead to RWA decline

The fully loaded leverage ratio of 5.68% at the end of September 2019 is strong, in our view.

As of September 2019, BPS reported that its LCR was ahead of requirements.

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). It also has EUR 4.6bn (10.9%) of outstanding TLTRO lines from the ECB, which will have to be repaid in 2020 and 2021.

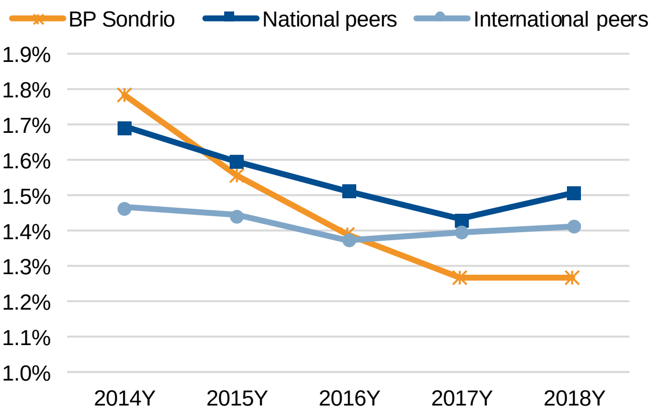
Figure 8: Customer deposits as % of total liabilities, as of June 2019



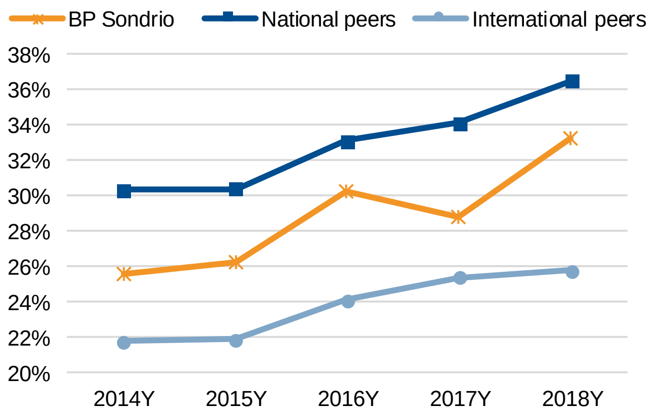
Source: SNL, Scope Ratings.

I. Appendix: Peer comparison

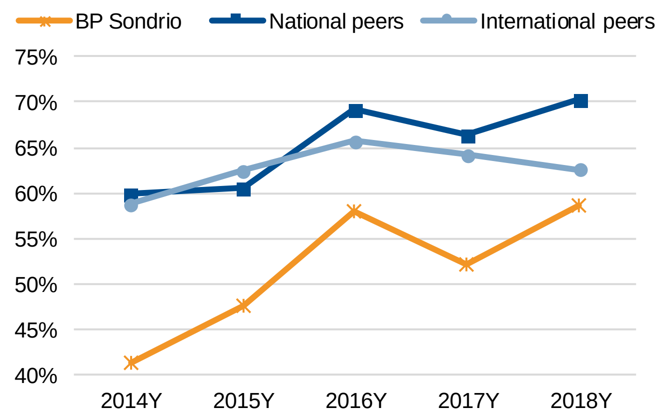
Net interest margin



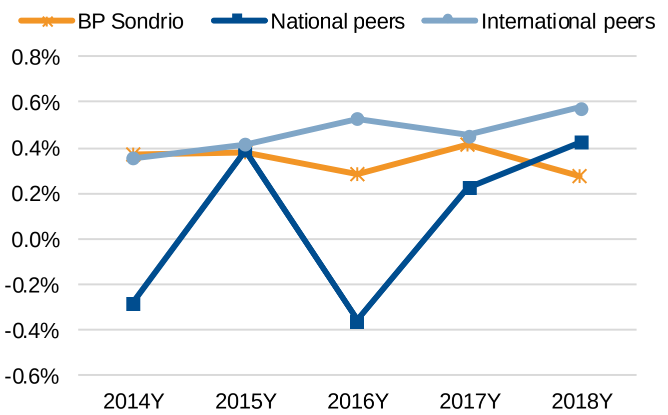
Fees & commissions % revenues



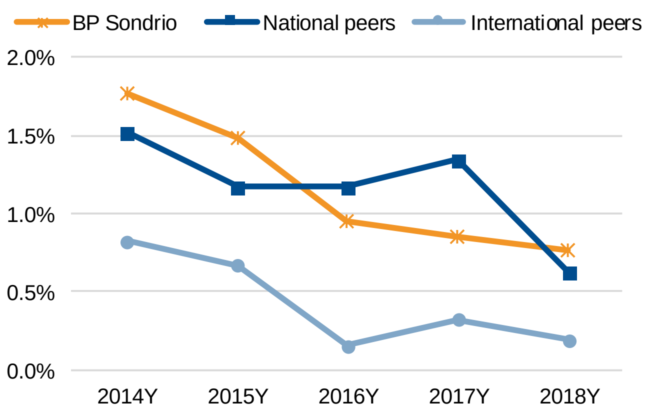
Cost/income ratio



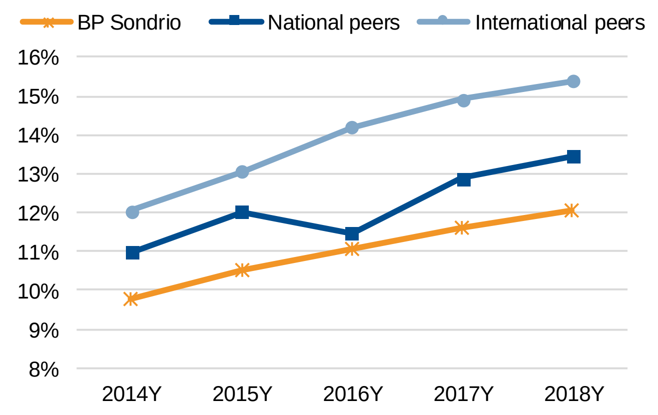
Return on average assets



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,
International peers: Credito Valtellinese Unicaja, Ibercaja, Liberbank, Bank Burgenland, Salzburger Landes-Hypothekenbank, Oberbank
Hypo Niederösterreich, Sandnes Sparebank, Totens Sparebank

II. Appendix: Selected Financial Information – Banca Popolare di Sondrio S.C.p.A.

	2015Y	2016Y	2017Y	2018Y	2019H1
Balance sheet summary (EUR m)					
Assets					
Cash and interbank assets	1,746	2,576	2,620	2,898	4,263
Total securities*	8,401	7,877	11,893	5,076	3,913
of which, derivatives	64	57	98	32	36
Net loans to customers**	23,997	25,313	25,756	31,758	32,337
Other assets	1,394	1,434	1,356	1,396	1,587
Total assets	**35,538**	**37,202**	**41,625**	**41,128**	**42,100**
Liabilities					
Interbank liabilities	2,302	2,505	6,205	6,166	6,358
Senior debt	2,263	2,468	2,220	1,907	2,631
Derivatives	102	112	54	74	80
Deposits from customers	26,347	27,702	28,801	28,630	28,459
Subordinated debt	918	764	613	525	527
Other liabilities	955	994	962	1,082	1,230
Total liabilities	**32,888**	**34,544**	**38,855**	**38,384**	**39,285**
Ordinary equity	2,563	2,573	2,679	2,651	2,721
Equity hybrids	0	0	0	0	0
Minority interests	87	85	91	93	93
Total liabilities and equity	**35,538**	**37,202**	**41,625**	**41,128**	**42,100**
Core tier 1/ common equity tier 1 capital	2,441	2,568	2,638	2,636	2,597
Income statement summary (EUR m)					
Net interest income	543	474	490	508	230
Net fee & commission income	303	293	305	316	153
Net trading income	212	110	161	11	42
Other income	97	93	105	113	51
Operating income	**1,156**	**970**	**1,062**	**948**	**475**
Operating expenses	549	562	553	556	307
Pre-provision income	**607**	**409**	**508**	**392**	**168**
Credit and other financial impairments	409	279	274	249	55
Other impairments	1	0	0	0	0
Non-recurring items	0	0	0	0	45
Pre-tax profit	**196**	**130**	**234**	**143**	**68**
Discontinued operations	0	0	0	0	0
Other after-tax Items	0	0	0	0	0
Income tax expense	59	30	68	29	21
Net profit attributable to minority interests	8	1	6	3	0
Net profit attributable to parent	**129**	**99**	**159**	**111**	**47**

Source: SNL, Scope Ratings
“Since 1 January 2018, loans and receivables at amortised cost
**Since 1 January 2018, financial assets at fair value (through profit and loss and through other comprehensive income).

III. Appendix: Selected Financial Information – Banca Popolare di Sondrio S.C.p.A.

	2015Y	2016Y	2017Y	2018Y	2019H1
Funding and liquidity					
Net loans/ deposits (%)	91.1%	91.4%	89.4%	110.2%	113.6%
Liquidity coverage ratio (%)	129.0%	107.0%	NA	147.9%	158.8%
Net stable funding ratio (%)	125.0%	124.0%	NA	NA	NA
Asset mix, quality and growth					
Net loans/ assets (%)	67.5%	68.0%	61.9%	77.2%	76.8%
Problem loans/ gross customer loans (%)	16.3%	16.1%	15.1%	12.3%	11.4%
Loan loss reserves/ problem loans (%)	48.2%	49.3%	53.9%	58.5%	57.3%
Net loan growth (%)	-0.1%	5.5%	1.7%	23.3%	3.6%
Problem loans/ tangible equity & reserves (%)	90.9%	91.9%	84.1%	81.0%	78.1%
Asset growth (%)	-0.2%	4.7%	11.9%	-1.2%	4.7%
Earnings and profitability					
Net interest margin (%)	1.6%	1.4%	1.3%	1.3%	1.2%
Net interest income/ average RWAs (%)	2.3%	2.0%	2.1%	2.3%	2.2%
Net interest income/ operating income (%)	47.0%	48.9%	46.2%	53.6%	48.4%
Net fees & commissions/ operating income (%)	26.3%	30.2%	28.7%	33.3%	32.1%
Cost/ income ratio (%)	47.5%	57.9%	52.1%	58.6%	64.7%
Operating expenses/ average RWAs (%)	2.3%	2.4%	2.4%	2.5%	3.0%
Pre-impairment operating profit/ average RWAs (%)	2.5%	1.8%	2.2%	1.8%	1.6%
Impairment on financial assets / pre-impairment income (%)	67.4%	68.2%	54.0%	63.6%	32.5%
Loan loss provision/ average gross loans (%)	1.5%	1.0%	0.9%	0.8%	0.3%
Pre-tax profit/ average RWAs (%)	0.8%	0.6%	1.0%	0.6%	0.7%
Return on average assets (%)	0.4%	0.3%	0.4%	0.3%	0.2%
Return on average RWAs (%)	0.6%	0.4%	0.7%	0.5%	0.5%
Return on average equity (%)	5.2%	3.8%	6.1%	4.2%	3.4%
Capital and risk protection					
Common equity tier 1 ratio (%, fully loaded)	10.3%	11.1%	11.5%	11.9%	15.5%
Common equity tier 1 ratio (%, transitional)	10.5%	11.1%	11.6%	12.0%	15.5%
Tier 1 capital ratio (%, transitional)	10.5%	11.1%	11.6%	12.1%	15.6%
Total capital ratio (%, transitional)	13.4%	13.6%	13.7%	13.6%	17.3%
Leverage ratio (%)	6.1%	6.2%	5.7%	5.8%	5.6%
Asset risk intensity (RWAs/ total assets, %)	65.5%	62.4%	54.6%	53.3%	39.8%
Market indicators					
Price/ book (x)	0.7x	0.6x	0.5x	0.5x	0.3x
Price/ tangible book (x)	0.2x	0.3x	0.2x	0.2x	NA
Dividend payout ratio (%)	24.1%	27.3%	20.0%	20.8%	NA

Source: SNL, Scope Ratings

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