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Financial Institutions

Italian Banks: Myths and Reality about Asset Quality

Asset quality remains at the top of investor concerns with respect to Italian banks. At over EUR 360bn, the headline number of problem loans looks indeed daunting, if not unmanageable. While we appreciate market concerns, we continue to see asset quality as mainly a legacy issue for the banks we publicly rate, and believe that the size of the problem is often overstated for the overall sector.

In this thematic report, we look at the current state of Italian banks' balance sheets, and try to untangle the recent flurry of announcements. These are our main conclusions:

1) **Asset quality trends have stabilized and started improving** – meaning that, absent a relapse into a recessionary environment, Non Performing Loans (NPLs) are a legacy of the crisis to be dealt with, rather than a new problem.

2) **The actual size of the problem may be overstated**. The often cited figure of over EUR 360bn refers to a wide definition of NPL, which even includes some performing exposures. Moreover, it refers to a gross amount, which does not take into account provisions. On a stricter definition of bad loans, ie cash and non cash exposure to companies in insolvency, the gross amount shrinks to c. EUR 196bn. Net of cash provisions, the amount is EUR 83bn.

3) **The level of provisioning is generally adequate** and in line with expected recovery rates, although not sufficient for the banks to shift NPLs through sales to outside investors. Albeit there are variations amongst banking groups, the level of provisioning of bad loans is in line with historical recovery rates. The gap between book values and market values is largely attributable to the lenghty time to recover and to the high required return of outside investors.

This brings us to two possible scenarios: banks can (a) hold on to their NPLs and slowly reduce the amounts via a combination of recoveries and cures or (b) book additional provisions upfront and sell portfolios to investors. In our view the first strategy would likely maximize value for the banks, while the second would require additional provisions and transfer value to the investors – typically targeting 15%+ returns on these deals.

On the other hand, keeping large amounts of NPLs exposes the banks to downside risks around effective recovery rates, and hence may require more of a capital cushion. As one example, we believe Intesa (rated A-, stable) has enough of a capital cushion and may get more leeway from the supervisor (and the market) to adopt a flexible strategy with respect to NPL management compared to banks with a thinner capital cushion. Other stronger banks may still opt to raise capital in a bid to earn financial flexibility and strategic optionality with respect to NPL management, but also M&A. Recently, the successful capital increase of Banco Popolare has shown that it is possible to raise equity from private investors.

Substantial uncertainty remains as to the supervisors' attitude towards the problem. If the recent communication to Monte dei Paschi di Siena (MPS) is a guide, we would expect most banks to have discretion over their NPL management strategy and time frame.

Given the points above, we expect capital needs to be contained to the weakest names and manageable. However, we would see any government-funded bailout as being contrary to the spirit of the Banking Union and of BRRD and ultimately counterproductive as it could reinstate the corrosive bank-sovereign risk negative feedback loop. An increase in Atlante's firepower would in our view be the best way to backstop the system. Atlante's targeted return of 6% should also allow significant NPL transactions at prices close to the current book values.

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Italian NPLs – sizing the problem

As a first step to analysing the issue, we believe some clarity is needed as to what different reports have been referring to in recent weeks.

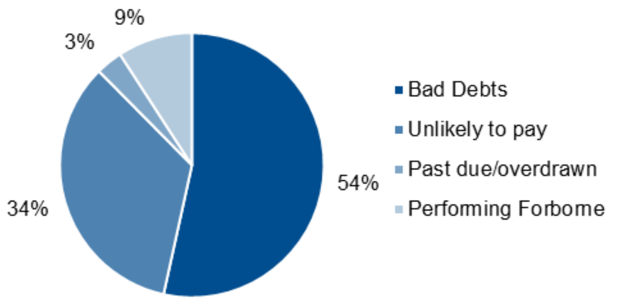
With Bank of Italy's Circular n. 272, the Italian banking system adopted the definition of non-performing exposures of the technical standards first published by the EBA in October 2013 and approved with Regulation (EU) No 680/2014.

Non-performing exposures are classified as follows:

- **Bad Loans (Sofferenze)**: On- and off- balance sheet exposures to a company in state of insolvency or in comparable situation, even if not recognized by a court of law, regardless of any guarantee or collateral posted on the exposure and irrespective of the bank's own opinion on a potential loss
- **Unlikely to pay (Inadempienze Probabili)**: when according to the bank's own judgement the debtor is assessed as unlikely to pay its obligation in full, without recourse actions or collateral realisation, regardless of any past due amount.
- **Past due and/or overdrawn exposures (Crediti scaduti e/o sconfinati)**: on-balance sheet exposures, excluding 'bad loans' and 'unlikely to pay', past due or overdrawn continuously for over 90 days. When such exposures represent more than 20% of all on-balance sheet exposures to that borrower, all off- and on-balance sheet exposures shall be considered as past due / overdrawn.

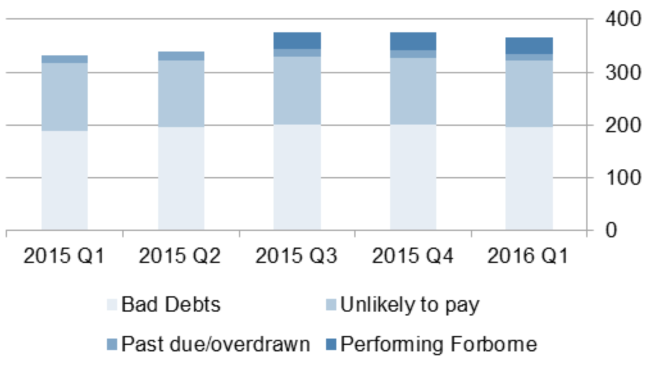
As shown by Bank of Italy's data, which reflect the new and harmonized definitions, as of March 2016 the volume of gross non-performing exposures, including towards non residents, stood at EUR 333bn, or 16.4% of total exposures. In addition, there are an additional EUR 33.6bn of forborne exposures which are currently performing. So on the widest possible definition, there were EUR 367 bn of gross potentially troubled exposures in the Italian banking system. At the same time, on a strict definition of bad loans, the figure drops to EUR 196bn, against which EUR 114bn of provisions have already been booked.

Figure 1: Total potential problem loans were EUR 367bn in Q1 2016…



Source: Bank of Italy, Scope Ratings

Figure 2: …but only half of these are actually bad loans



Source: Bank of Italy, Scope Ratings

Macro recovery should be supportive of asset quality

Going forward, we expect sector asset quality to improve as a result of the better macro environment.

Having been in a prolonged recession in 2012-2014, Italy finally posted positive GDP growth in 2015. Drivers behind the recovery are largely cyclical, including:

- QE leading to cheaper funding for all sectors of the economy,
- A weaker euro boosting net export performance
- Cheap imported fuel and a fairly neutral fiscal stance

We expect the macro recovery to firm up, with GDP growth accelerating to 1%-1.2% in 2016-2018.

However, the recovery remains fragile: unemployment remains very high, with one of the highest youth unemployment rates in the EU, and is expected to improve only gradually. Inflation remains close to zero due not only to cheap energy prices but also low demand, signalling that the output gap is negative and large (EC estimate for 2014 is 4%, expected to close by 2019).

In the medium term, growth is expected to be constrained by structural weaknesses, including a still inefficient public sector and judicial system, high taxes, rigid labour market and an undeveloped corporate financing market. These structural weaknesses were exacerbated at the time of the adoption of the euro due to the loss of adjustment mechanism through currency devaluation.

It is also worth highlighting that while the government deficit is under control at present (2.4% of GDP in 2015), the large stock of general government debt (over 130% of GDP) represents a longer term challenge as it exposes the country to changes in market sentiment, as experienced during the euro sovereign crisis in 2010-2012.

Figure 3: Main economic indicators and forecasts: Italy

	2012	2013	2014	2015	2016E	2017E	2018E
Real GDP growth, %	-2.9	-1.8	-0.3	0.6	1.0	1.2	1.2
Nominal GDP (EURbn)	1,615	1,606	1,613	1,636	1,669	1,709	1,752
Nominal GDP (USDbn)	2,074	2,132	2,141	1,801	1,795	1,867	1,946
GDP per capita (USD)	34,721	35,673	35,802	30,119	30,011	31,226	32,554
Population (year-end, m)	59.7	59.8	59.8	59.8	59.8	59.8	59.8
C/A balance, % GDP	-0.5	1.0	1.9	2.2	2.1	2.1	2.1
Inflation, annual avg, %	3.3	1.3	0.2	0.1	0.1	1.3	1.2
Govt balance, % GDP	-3.0	-3.0	-3.0	-2.4	-2.4	-1.9	-1.0
GG gross budgetary debt, % GDP	123.2%	128.8%	132.4%	132.5%	132.2%	131.1%	128.9%
Unemployment %	10.8	12.2	12.6	11.9	11.5	11.3	11.1

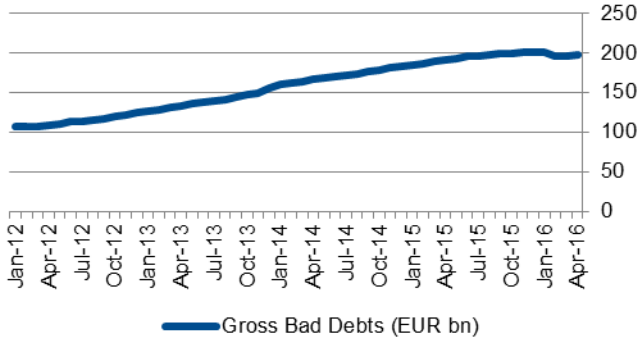
Source: Scope Ratings

The improvement in economic conditions should eventually translate in better borrower performance and more stable, if not rising, collateral values. Early signs of a turnaround in asset quality trends are already visible, both at sector level and at the level of the individual banks we rate.

Bank of Italy data shows (Figure 4) that the multi-year increase in bad loans came to an end in the second half of 2015, with the total gross bad loans figure peaking at c. EUR 200bn.

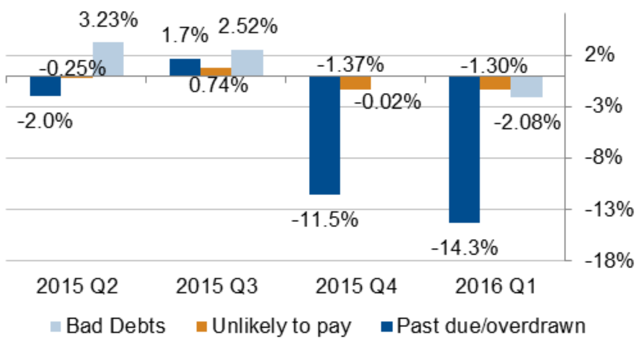
Bank of Italy data aggregates the stock of NPEs from Q1 2015 by applying the revised definitions and according to the new classification. Towards the end of 2015 the trend reversed, with bad loans essentially stable (if we exclude a large one off decline in February 2016). Past due and unlikely to pay exposures are already declining more markedly (Figure 5).

Figure 4: Gross bad loans (sofferenze) have stabilised in 2015



Source: Bank of Italy, Scope Ratings

Figure 5: Other categories of NPEs declining more markedly in Q1

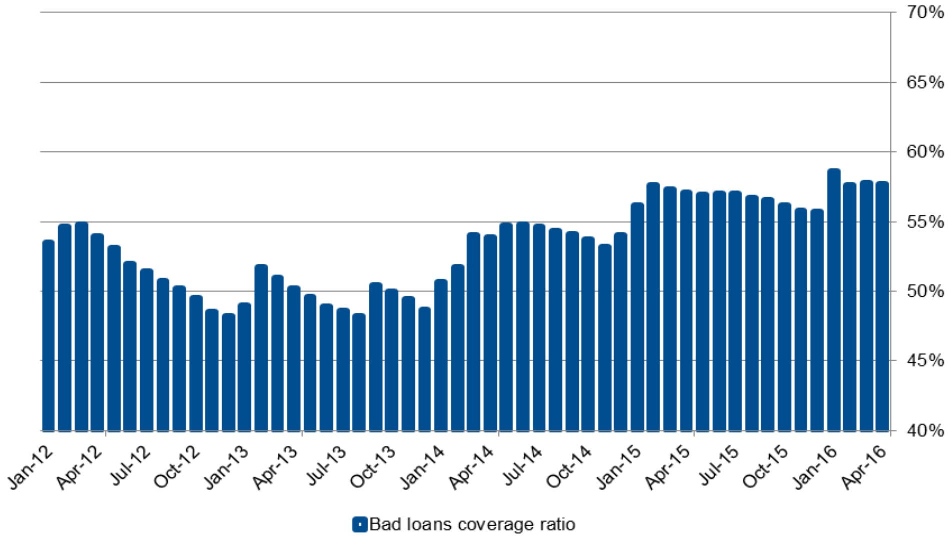


Source: Bank of Italy, Scope Ratings

Are Italian bank NPLs under provisioned?

Sector data on bad loans provisions from Bank of Italy shows that bad loans are c. 58% covered. This level has moved up significantly in recent years, from coverage of just under 50% in 2013.

Figure 6: The coverage ratio of Italian bad debts has increased significantly over the past few years



Source: Bank of Italy

The main reason for the improved coverage ratio is the active role of the Bank of Italy in the years preceding the handover of large banks to the SSM as well as the subsequent Asset Quality Review by the ECB in 2014. The intrusive supervisory work offers some comfort that provisioning is more realistic. Furthermore, a recent survey from Bank of Italy[1] has found that recovery rates for loans under liquidation have averaged 41% over the 2011-2014 period. This is in line or lower than previous surveys conducted by the central bank in 1993-1994 and 2000.

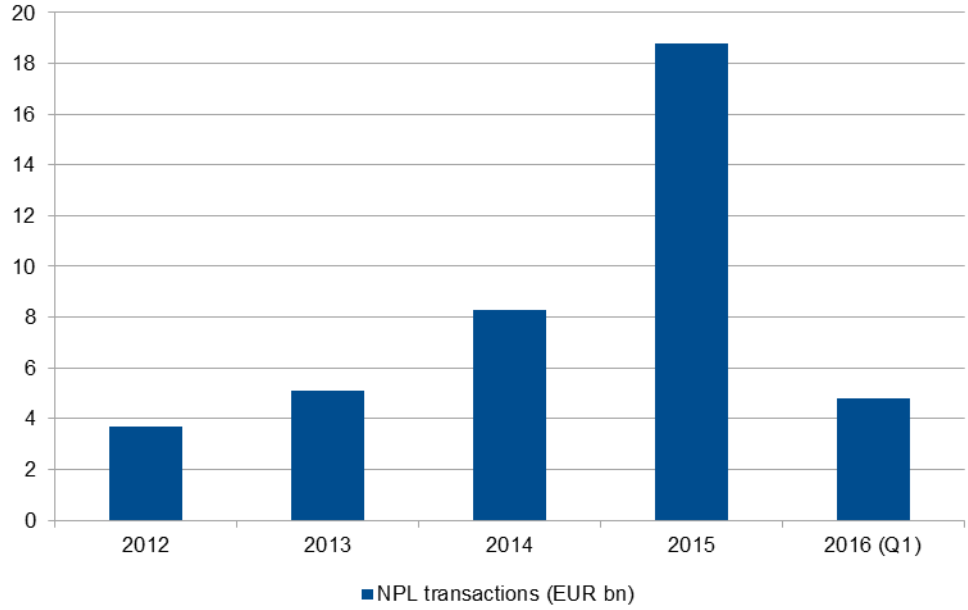
In other words, the level of provisioning is adequate given expectations of recovery on the bad loans. This does not necessarily mean that they are sufficient to quickly sell NPL portfolios to private investors.

Sales of NPLs can accelerate the cleanup, but require banks to take an upfront hit

In 2015, Italian NPL transactions more than doubled to c. EUR 19bn of gross book value (GBV) compared to the previous year, a run rate which seems to be confirmed by the data so far in 2016.

[1]Carpinelli, Cascarino, Giacomelli, Vacca *“The management of non-performing loans: a survey among the main Italian banks”.* Bank of Italy QEF311

Figure 7: Italian NPL transactions, 2012-2016



Source: Scope Ratings, PWC

Even this accelerated pace of disposals looks inadequate to swiftly clean-up balance sheets of banks. A further acceleration seems unlikely at present, as anecdotal evidence points to a still material gap between net book values and market prices:

- in November 2015 , EUR 8.5bn of NPLs were transferred from four troubled banks to a bad bank vehicle after being written down to EUR 1.5bn (17.6% of gross book value).
- In March 2016, US investor Apollo offered to buy EUR 3.5bn of gross NPL for a price close to 20% of book value, according to press reports, and contextually injecting capital into Carige. While the bid did not go through, it seems to have established a reference price in the market.

We caution that the above figures can only be read as rough estimates and that a much more granular analysis would be necessary in order to more accurately estimate the price gap between demand and supply in the Italian NPL market. In fact, the actual value would depend on several factors, including the presence of collateral and guarantees, the geographic location of the collateral and the quality of documentation, just to name a few.

For Italian banks to write down their bad loans to the 20% that outside investors are willing to offer would require material additional provisions (on our estimate, c. EUR 40bn only for the bad loans portions) and probably involve capital increases for several banks.

We stress however that this figure is not an estimate of capital shortfall. Indeed, we calculate that most Italian banks have sufficient capital resources to increase their coverage ratios and that part of the additional provisions could be capital neutral (to the extent that provisions shortfall is already deducted from banks' capital bases). Moreover, we do not expect banks to rush to increase their coverage ratio and sell as this may not necessarily maximise value for the banks, as we explain in the following pages.

Given that current cash coverage seems to be in line with historical recovery rates, we believe the price gap is instead explained by time value of money considerations, which are highly dependent on the required rate of return of the buyer. This is a particularly relevant element in Italy where excessively lengthy collateral enforcement times push out cash flows far into the future.

Assuming a recovery rate of 40% of Gross Book Value (GBV) in five years, a fund targeting 15% return would indeed calculate a purchase price, as of today, of c. 20% of GBV. Using the same assumptions, a fund targeting 20% return would only be willing to pay 16% of GBV.

A buyer with a lower return target could offer a higher bid, hence limiting the potential negative impact on the P&L and capital position of the selling bank. For example by targeting a 6% return, the Atlante fund would be able to offer 30% of GBV in the above example (see table below).

Figure 8: Discounted cash flow estimate of NPL value under different target IRR and recovery length assumptions. (% of GBV)

Years to receive cash flow	1	2	3	4	5	6	7
Investor with 20% target	33.3	27.8	23.1	19.3	**16.1**	13.4	11.2
Investor with 15% target	34.8	30.2	26.3	22.9	**19.9**	17.3	15.0
Atlante (6% target)	37.7	35.6	33.6	31.7	**29.9**	28.2	26.6
Keep on balance sheet	40.0	40.0	40.0	40.0	**40.0**	40.0	40.0

Source: Scope Ratings

The above table also highlights the importance of recovery time frames for buyers with an elevated cost of capital. We calculate that for a fund with a return target of 15%, reducing the recovery time of cash flow from 5 to 4 years would improve the bid price by c.3%.

Challenges of selling NPLs to outside investors

Having large portfolios of non-performing assets is a negative element for a bank, as it introduces an element of uncertainty which is difficult to analyse. For this reason, the legacy asset quality problems rank high on our concern list for rated Italian banks Unicredit (BBB+, Stable Outlook) and Intesa (A-. Stable Outlook). While, *ceteris paribus*, we would see positively an accelerated clean-up of their balance sheet, we also see the paradox of a banking system that is on average barely profitable to sell assets with an intrinsic return of 15%-20% to outside players. Moreover, should such a clean-up result in much weakened capital positions, this could arguably offset any positive impact from the higher visibility.

We hence assume that banks will not rush to sell NPLs at any price unless they are forced to by their supervisors.

Are the supervisors forcing the banks' hand?

On July 4, MPS announced that it has received a letter from the ECB, containing a draft decision to require the bank to reduce the amount of NPEs on its balance sheet. This communication includes a request for a plan to reduce the NPL ratio to below 20% by 2018, as well as the following table.

Figure 9: MPS required reduction in NPLs

	Actual 2015	2016	2017	2018
NPLs – Gross Exposure(EUR/bn)	46.9	Max. 43.4	Max. 38.9	Max. 32.6
NPLs – Net Exposure (EUR/bn)	24.2	Max. 21.8	Max. 18.4	Max. 14.6

Source: MPS, Scope Ratings

In our view, the communication has to be read in the context of the normal supervisory process – where the SSM continuously exchanges information with the supervised banks. In other words, it is not a sign, as some market observers have pointed out, that the ECB has lost patience with MPS.

Interestingly, the above table does not seem to indicate that the supervisors are uncomfortable with the coverage level (the requested adjustment path seems to allow for some decrease in coverage), but rather with the size of the non performing portfolio. If we take 20% as a reference point of what the supervisor sees as excessive, we note that most Italian banks are already below that level (MPS, Carige, and Banco Popolare are the only exceptions among the larger banks). This leads us to expect that stronger banks will get more leeway in their strategy to manage down NPLs.

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