Italian Bank Quarterly: Growing resilience despite uncertainties

Italian bank profitability has settled at a high level thanks to wide interest margins and low loan-loss provisions. Thanks to robust financial fundamentals, banks are well placed to face a softer economic outlook and any uncertainties, particularly surrounding lending and deposit dynamics.

Italian banks are confident about 2024. As expected, third-quarter profitability plateaued after peaking in Q2. But Italian lenders are confident they can repeat or even beat 2023 results next year, thanks to continued high rates, a rebound in fees, cost efficiencies and expected low credit losses.

However, significant risks remain. Competition for deposits may increase more than expected in 2024 among the banks, also because the government is targeting retail investors with sovereign bonds (BTP Valore). And the lending outlook is weakening as demand for credit continues to decline. This could have an adverse impact on the Italian economy, which is unlikely to grow above 1% in coming years. Heightened tension in the sovereign bond market and the possibility of a new windfall tax are other downside risks.

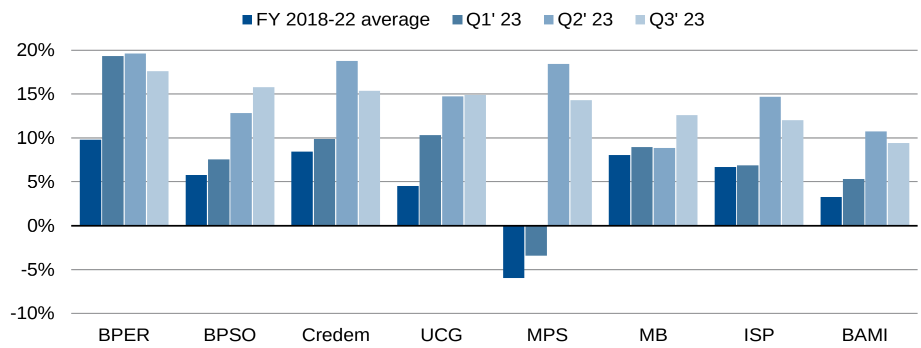
Stable trend in asset quality (for now). The improvement in headline credit quality metrics is ending but there are no clear signs of deterioration yet. This is likely down to the resiliency of businesses and households, combined with time-lag between a slowdown in the real economy and defaults.

Capital positions are strengthening thanks to earnings retention and a reduction in risk-weighted assets. Law 136/2023 allowed banks to convert the windfall tax on 'extra-profits' into non-distributable reserves (2.5 times the tax amount), therefore with no impacts on profits and capital.

Stability in deposits in the past two quarters may indicate that savvier customers have already moved their money out of current accounts. That said, we expect more deposit attrition in 2024, especially if the ECB maintains its rates policy.

UniCredit and Intesa expand operations in Eastern Europe. Recent M&A activity is in line with the two banks' ambitions and is credit neutral due to limited acquisition volumes.

Figure 1: Italian banks' return on equity remained at a high level in Q3



Source: SNL, Scope Ratings Note: data might slightly deviate from reported figures

Expected 2024 trend by key area for Italian banks	
Profitability	Even in the case of a decline, still supportive for credit ↗
Asset quality	Manageable deterioration ↘
Capital position	Higher capital ratios thanks to organic generation ↗
Funding and liquidity	Less supportive conditions but comfortably managed ↘

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Profitability is plateauing. Upbeat 2024 guidance.

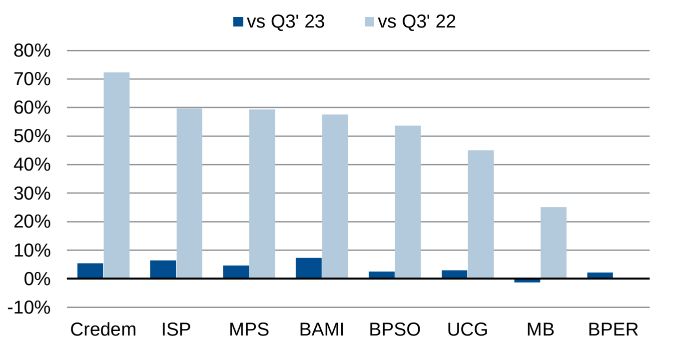
Our sample of eight Italian banks – Intesa Sanpaolo, UniCredit, Banco BPM, Banca Monte dei Paschi di Siena, BPER, Mediobanca, Credito Emiliano and Banca Popolare di Sondrio – reported another strong set of quarterly results, achieving an average ROE of 14%, around 1pp lower than in the previous quarter. The difference between the two quarters was down to equity growth.

Trend in NII could reverse in Q4

Q3 trends were similar to those observed in Q2. Average growth in net interest income slowed (+3.8% QoQ against +12.5% in Q2) due to the combination of reduced commercial spread widening and declining customer volumes (Figure 2). Fees and commissions continued to slide because of seasonality impacts, low sales of asset management products, and weak investment banking markets. With expenses decreasing on the back of tight cost discipline, the average cost-income ratio fell for the third consecutive quarter, from 45.8% in Q2 to 43.9% in Q3 (Figure 3).

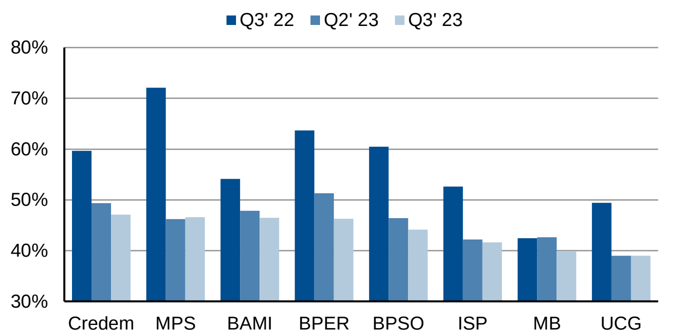
Cost of risk declined to c.33 bp (-2bp), reflecting low default rates and no changes to banks' macroeconomic forecasts.

Figure 2: Net interest income is decelerating



Source: Company data, Scope Ratings
Note: BPER's YoY comparison not meaningful following Carige acquisition

Figure 3: Cost-to-income ratios improved again in Q3



Source: Company data, Scope Ratings

Banks continue to be upbeat for next year, despite growing uncertainty around the growth of the Italian economy amid a complex geo-political situation and tight monetary conditions (Figure 4).

NII still a growth driver

Banks have guided to moderate average growth in annual net interest income, on the back of higher commercial spreads: most lenders are forecasting higher Euribor levels in 2024 than in 2023. Lenders are also confident that deposits will reprice at a lower rate than previously thought. UniCredit is the outlier here, citing an increase in deposit pass-throughs, declining volumes, and lower contributions from Russia as the main causes for a decrease in net interest income in 2024.

Overall, banks are projecting that revenues will increase thanks also to the rebound in fees driven by higher inflows of managed assets and insurance products.

Cost of risk in line with 2023, therefore at low levels

The fact that no bank has guided to higher loan loss provisions next year is unsurprising. That said, default rates are at record lows and there are still few signs of any credit deterioration. But banks could contain the impact of a modest deterioration in credit quality because they hold a cushion of unused management overlays accumulated over the past few years. These amount on average to 20bp-60bp of customer loans.

Figure 4: Italian banks' provisional guidance* on 2024 P&L items vs 2023

2024 guidance vs 2023E	ISP	UCG	MB	BAMI	BPER	MPS	BPSO
Net interest income	↗	↘	↗	↗	→	→/↘	→
Fees & commissions	↗	↗	↗	/	/	↗	/
Revenues	↗	/	↗	/	/	↗	/
Loan loss provisions	→	→	→	/	→	/	→
Net income	↗	→/↗	/	↗	/	/	/

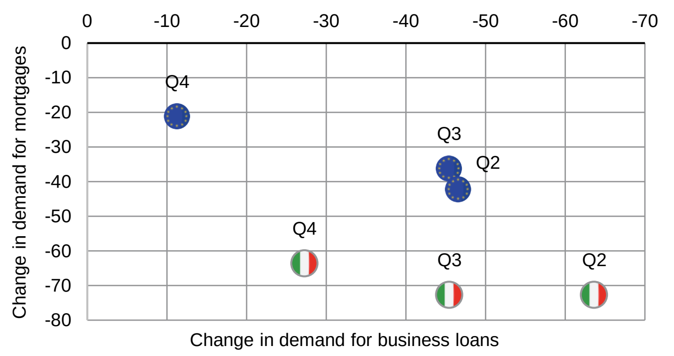
Source: Management guidance, Scope Ratings
Notes: Mediobanca refers to FY 2023/24 ending next June. *BPER and BPSO based on management's opinion

We have identified five main downside risks to these positive forecasts:

Clearer signs of loan deleveraging

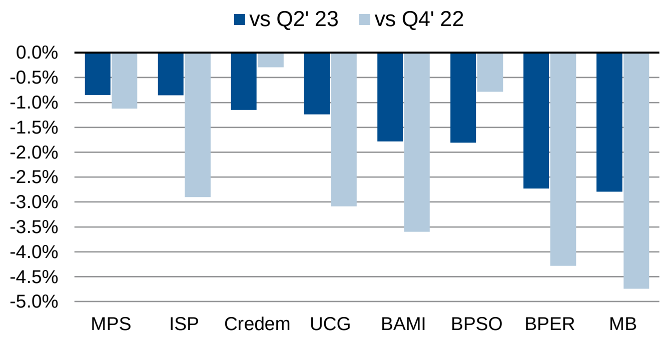
1) A steeper decline in customer loans. Loan demand in Italy is falling more rapidly than elsewhere in the EU, as suggested by lending surveys and banks' own data. We believe this trend reflects softer economic growth and a greater erosion in net disposable income in Italy. Deeper-than-expected deleveraging in coming quarters would detract not only from banks' revenue potential but could also drag on economic growth and asset quality.

Figure 5: Loan demand expected to be weak also in Q4



Source: Macrobond, ECB, Scope Ratings
Note: difference between the percentage of banks observing an increase and a decrease in demand in the past three months (Q2 and Q3), plus the three-month forward-looking view (Q4)

Figure 6: Decline in customer loans* accelerated in Q3



Source: Company data, Scope Ratings.
*Reported performing customer loans.
For ISP, BPSO and MB, gross performing customer loans.

2) Acceleration in deposit repricing. So far, banks have preferred to boost short-term profitability and have not chased deposits, especially at a time of lower loan demand. Some have not yet launched campaigns to attract term savings, like Banco BPM. A pass-through rate at historically low levels (10.7% as of August) reflects this situation. However, pressure to increase deposit remuneration may mount if the ECB does not switch its monetary policy soon.

3) Economic recession: while Scope is forecasting 0.8% growth for the Italian economy for 2024, downside risks linger. Lower-than-expected growth will add pressure to lending and transaction fees.

4) Adverse financial markets sentiment. Lower-than-forecast GDP growth, ballooning re-financing costs and reclassification of the accounting treatment of recent years' tax credits have renewed pressure on Italy's public finances. In October, the BTP-Bund spread spiked above 200bp (now down to around 180bp) following the release of the draft budget law, which anticipates an additional EUR 23.5bn deficit over a three-year period. Heightened domestic sovereign risk, with the 10-year government bond yield at around 4.5% could impact Italian banks' funding costs and sales of asset-management products in 2024.

5) Introduction of a new windfall tax. Italian banks decided to exercise the option provided by the law on the windfall tax and set aside 2.5x tax due as non-distributable reserves. While this is positive for the sector, the government might want to compensate for missed inflows with a new measure next year.

Stable asset-quality metrics reflect resiliency in the economy and potential time-lag in credit deterioration

Credit quality remains stable despite a challenging macroeconomic backdrop. As of September 2023, Italian banks' average gross non-performing exposure (NPE) ratios stood at 3.1%, flat QoQ. All the banks in our sample display gross NPE ratios below 5%, which used to be a common key de-risking target for banks.

NPE coverage stood at around 56% in the third quarter, a level we deem comfortable. For bad loans, the worst category, coverage reaches 75%.

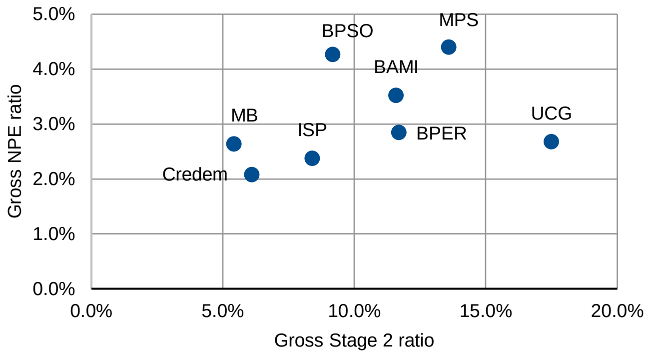
MPS was the only bank explicitly talking about signs of credit deterioration, mostly in the retail segment. Its stock of NPEs increased by more than 5% in the quarter. All the other lenders reiterated what has been said over the course of the year: default rates still at record low levels and no signals of a change in trends.

The NPE ratio is a lagging macro indicator

In our view, the current situation reflects on one hand the resiliency of the Italian economy, underpinned by solid business results and strong employment data, on the other the time lag between real-economy slowdown and credit deterioration.

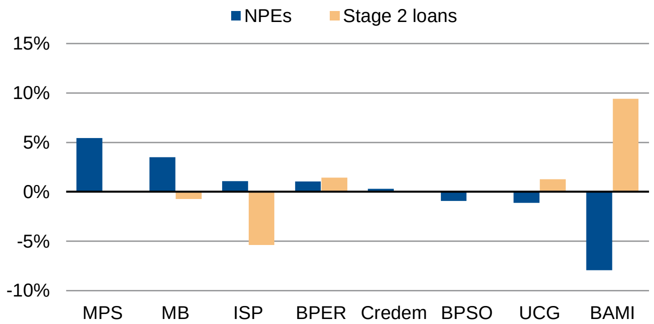
Even when the positive trend reverses, we do not expect a wave of defaults in coming quarters. In recent years, Italian lenders materially improved their management of credit origination, high-risk positions, and NPLs. This has made balance sheets more resilient to economic downturns.

Figure 7: Headline asset quality metrics as of Q3 2023



Source: Company data, Scope Ratings
Note: MPS' and Credem's Stage 2 ratio as of June 2023

Figure 8: Mixed asset quality trends* in Q3



Source: Company data, Scope Ratings
Note: MPS' and Credem Q1' 23 Stage 2 loans figures were NA
*Based on gross stock

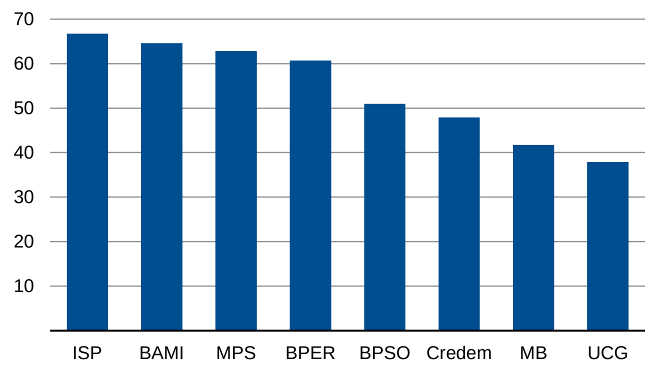
Capital ratios increase further after windfall tax scare[1]

In our August report, we said the windfall tax would be likely to force management to reconsider generous dividend pay-out plans. However, the government's amendments to the initial proposal, ratified in law no. 136/2023, largely neutralised the impacts for banks, which, as mentioned above, opted to convert the levy into non-distributable reserves.

We believe the law will have no impact on banks' distribution plans. On average, the reserve accounts for 54bp of CET1 capital, much lower than excess capital. Lenders will continue distribution plans, potentially even increasing pay-outs: Intesa decided to offer extraordinary dividends in light of its outstanding results and healthy capital position.

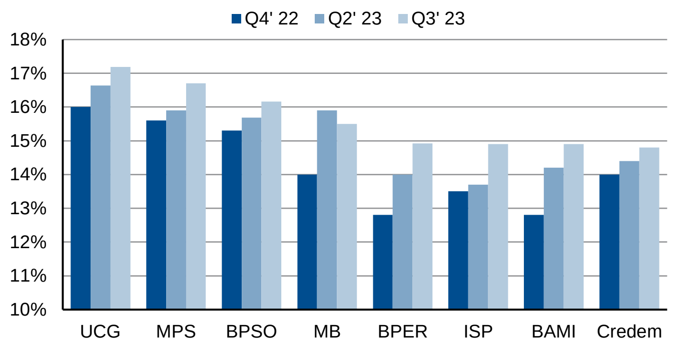
In Q3, the banks' capital ratios rose again. The average buffer to CET1 requirements reached around 710bp, 60bp higher than the second quarter thanks to earnings retention and declining risk-weighted assets due to lower lending activity.

Figure 9: non-distributable reserves related to law no. 136/2023 as % of Q3 RWAs (bp)



Source: Company data, Scope ratings
Note: estimates

Figure 10: Retained earnings contribute to CET1 growth in the past two quarters



Source: Company data, Scope Ratings
Note: fully loaded CET1 ratios

Solid funding position, but there are headwinds ahead

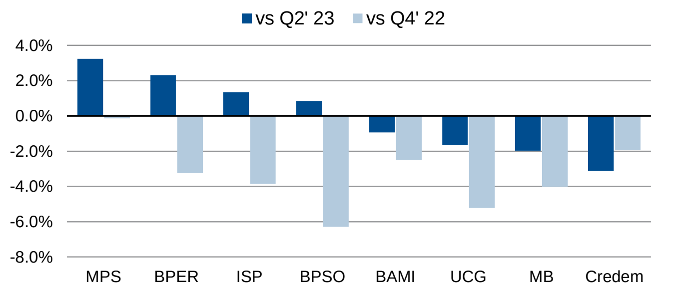
Competition for customer deposits remains muted in Italy. Data for the third quarter show a stable trend in deposit volumes, with no QoQ variation. Since the beginning of the year, average volumes have declined by 3.1% but with variations among banks. Since lenders have not actively chased volumes so far, the differences are mostly down to the greater or lesser extent of more rate-aware customer groups, such as larger corporates for Intesa and UniCredit or pension schemes for BPSO.

As of August, system-level deposits were down 6% from the peak reached 13 months earlier. We reiterate that a gradual and controlled decline in deposits does not pose a threat to the sector. This trend is common during policy-tightening cycles when liquidity is drained from the system: within the euro area, growth in M3 turned negative for the first time since the GFC. Companies are likely to continue reducing the extra liquidity accumulated during the pandemic, partly shifting their money to government bonds, alongside retail customers.

After a busy H1, in which banks were able to frontload most of their annual funding plans, market issuance declined in Q3, particularly for covered bonds. Intesa, the most active in Q3, reopened the market for subordinated debt in Italy after the CS crisis with a EUR 1.25bn AT1 bond.

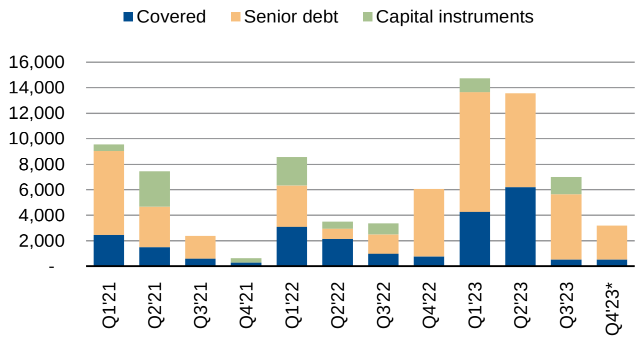
[1] This equity reserve can't be distributed, but it can absorb losses and can be computed in the CET1 capital

Figure 11: Mixed deposit trends in Q3



Source: Company data, Scope Ratings
Note: % change in deposits volume since December 2022 and March 2023
Volumes comprise current accounts, term deposits, and certificates, except for BPSO

Figure 12: Italian banks – Quarterly debt issuance, historical (USD bn)



Note: Issuance activity of the eight banking group in our sample. Only large public international bond issues predominantly in EUR, USD and GBP. Excludes domestic issuance, private placements, retained issuance, debt tranches sold under MTN programmes. Q4 2023 issuance refers to the period until 9 November.
Source: Bond Radar, Scope Ratings

UniCredit and Intesa look East for growth opportunities

The two leading Italian banks recently announced acquisitions in Romania and new partnerships in Greece. UniCredit and Athens-based Alpha Bank agreed to merge their Romanian subsidiaries to create the country's third largest banking group with a combined market share of 12% of total assets (see Appendix 2). UniCredit will hold 90.1% of the new entity. The capital impact for UniCredit is marginal (around 15bp).

Intesa followed suit by announcing the purchase of First Bank, a Romanian financial institution with total assets of around EUR 1.5bn. Thanks to this acquisition, Intesa's presence in Romania will double in size.

Romania can offer a good investment case for banks seeking growth and diversification. The country has strong medium-term growth potential (around 4%), bolstered by a sizeable allocation of EU funds. The banking sector enjoys high profitability, well in excess of the cost of equity, according to the central bank. Asset quality and capital are sound. The prospect of medium-term entry into the euro area adds to the appeal.

UniCredit is also entering the Greek market by establishing a commercial partnership with Alpha to distribute its asset management and unit-linked products and create a JV in pension-saving products (AlphaLife, with UniCredit holding 51% of shares). The Italian group also submitted an offer to purchase the Hellenic Financial Stability Fund's 9% stake in Alpha. The latter transaction closed on 10 November.

UniCredit's bet on Greece follows years of structural reforms in the local banking system that have led to a drastic reduction in the NPL ratio and higher financial stability. The Greek economy is expected to grow above potential in the years to come, in particular thanks to the implementation of the National Recovery and Resilience Plan in the years to come. In August, Scope upgraded Greece's sovereign credit rating to BBB-/Stable.

Limited growth options in Italy, especially in traditional segments

We believe a key driver for these investments lies in UniCredit and Intesa's substantial excess capital coupled with limited growth options within their core market. UniCredit is carrying on with its new strategy centred around growth, after years of retrenchment and asset disposals, while Intesa is seeking to increase its geographic diversification.

Given the marginal impacts on capital ratios, these developments are credit neutral in both cases. In fact we deem the banks' bolt-ons as a positive as they have the potential either to consolidate banks' market positions or to enter new sector niches.

Appendix 1 - Selected benchmark bond issues, YTD

Issuer	Issue date	Type	Currency	Volume (m)	Coupon	First call
UniCredit	10-Jan-23	Senior preferred	EUR	1,000	4.800%	10-Jan-28
Banco BPM	11-Jan-23	Senior preferred	EUR	750	4.875%	/
UniCredit	09-Feb-23	Senior non-preferred	EUR	1,000	4.450%	09-Feb-28
Intesa	13-Feb-23	Tier 2	EUR	1,000	6.184%	20-Nov-28
Intesa	27-Feb-23	Senior non-preferred	EUR	1,500	5.000%	8-Mar-26
Mediobanca	07-Mar-23	Senior preferred	EUR	750	4.750%	14-Mar-27
Intesa	09-Mar-23	Senior preferred	EUR	1,500	E+ 63bp	/
Banco BPM	07-Jun-23	Senior non-preferred	EUR	750	6.000%	14-Jun-27
Intesa	12-Jun-23	Senior non-preferred	USD	1,500	7.778%	20-Jun-53
Intesa	22-Aug-23	Senior preferred	EUR	1,500	5.125%	/
Intesa	31-Aug-23	AT1	EUR	1,250	9.125%	07-Mar-30
Intesa	09-Nov-23	Senior preferred	EUR	1,750	E+80bp	/

Source: Bond Radar, Scope Ratings

Appendix 2 – Romanian banking sector – Top banks by total assets as YE 2022

#	Bank	Total assets (EUR m)
1	Banca Transilvania S.A.	28,399
2	Banca Comerciala Romana S.A.	19,979
3	UniCredit + Alpha (pro forma)	17,652
4	BRD - Groupe Société Générale S.A.	14,924
ex 4	UniCredit Bank SA	13,381
5	Raiffeisen Bank S.A.	12,650
6	CEC Bank S.A.	12,480
7	Banca de Export Import a României - EximBank SA	4,658
ex 8	Alpha Bank Romania SA	4,271
8	OTP Bank Romania S.A.	4,018
9	Intesa + First Bank (pro forma)	3,112
10	Garanti Bank SA	2,699
11	Libra Internet Bank S.A.	1,964
12	Vista Bank (România) S.A.	1,639
ex 13	First Bank S.A.	1,562
ex 14	Banca Comerciala Intesa Sanpaolo Romania S.A.	1,550

Source: SNL, Scope Ratings

Selected research available on ScopeRatings.com:

European banks face disruptive retail funding dynamics, November 2023

European Bank Capital Quarterly, October 2023

French banks quarterly: sobering times, September 2023

SG strategy update: it doesn't have to be fancy, September 2023

Spanish Bank Quarterly: earnings solid but limited room for growth from here, August 2023

Italian Bank Quarterly: record Q2 results will be hard to repeat as windfall tax looms, August 2023

European Bank Capital Quarterly: funding and liquidity under the spotlight, July 2023

Asset-quality review: falling NPL ratios hide rising vulnerabilities, May 2023

Italian banks: strong Q1 results pave the way for a promising 2023, May 2023

Italy paves the way for revived covered bond issuance, May 2023

European Bank Capital Quarterly: Capital remains important support for sector, April 2023

Italian banks: solid funding and liquidity against challenging backdrop, April 2023

Sound fundamentals protect Swedish banks from emerging challenges, February 2023

Italian banks: promising 2023 outlook after bumper Q4, February 2023

European Bank Capital Quarterly: New year, new requirements, January 2023

2023 European Banking Outlook: strong ships in turbulent waters, January 2023

Issuer rating reports available to ScopeOne subscribers:

Intesa Sanpaolo SpA

UniCredit SpA

Banco BPM SpA

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