SCOPE Scope Ratings

Italian bank quarterly

Upbeat guidance to even better earnings in 2024 should be treated with caution

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Italian banks had a record year in 2023, thanks to high commercial spreads and low loan-loss provisions. Operating conditions look less favourable now, with rate cuts expected from the second half and default rates set to rise gradually.

Banks have issued strong earnings guidance for 2024, but downside risks remain. Resilient net interest income and rebounding fees will support revenues, while operating costs and loan-loss provisions will remain under control. This is in line with the Q3 guidance, since banks' assumptions on the rate trajectory, economic growth and default rates have not changed materially.

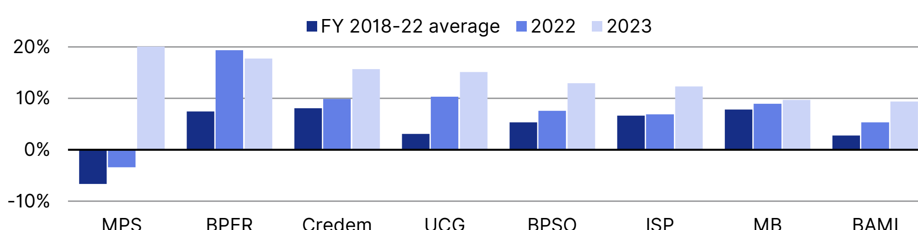
We are more cautious given the highly uncertain macro scenario in 2024 with Italy's GDP growth expected to remain weak at 0.6% in 2024. Weaker economic growth, which could be undermined by adverse geopolitical developments, could hurt banks' revenues and put pressure on their cost of risk. We also flag that the combination of high nominal yields, the government's elevated debt issuance needs, and the ECB's balance-sheet shrinkage might re-ignite domestic sovereign risk in a worst-case scenario, with repercussions on banks' funding costs. The potential for a new windfall tax or higher minimum reserve requirements are other risks.

We finally expect default rates to rise moderately this year. But the impacts should be manageable as banks entered 2024 with strengthened balance sheets (average gross non-performing exposure ratio of 2.9%) and following years of improvements in credit management. Banks also hold a cushion of unused management overlays that could be used to absorb emerging losses and contain the cost of risk.

Banks are increasing their pay-out ratios while maintaining a comfortable capital position. With limited opportunities for both organic and inorganic growth, banks are increasing shareholder remuneration with a combination of higher dividend pay-outs and extraordinary share buybacks. However, capital ratios remain well above requirements and, in most cases, management targets.

Solid funding positions remain despite changing market conditions. The repayment of TLTRO III continues smoothly, partly thanks to low funding needs to meet loan demand as deposit outflows have slowed significantly.

Figure 1: Italian banks' return on equity



Source: SNL, Scope Ratings. Note: based on statutory net income. Calendar years.

Our expectations of 2024 trend by key area for Italian banks	
Profitability	Slightly declining but still supportive for credit →
Asset quality	Manageable deterioration from a strong starting point ↘
Capital position	Organic generation offset by distribution →
Funding and liquidity	Less supportive conditions but comfortably managed ↘

Profitability will remain strong in 2024 but earnings growth likely to end

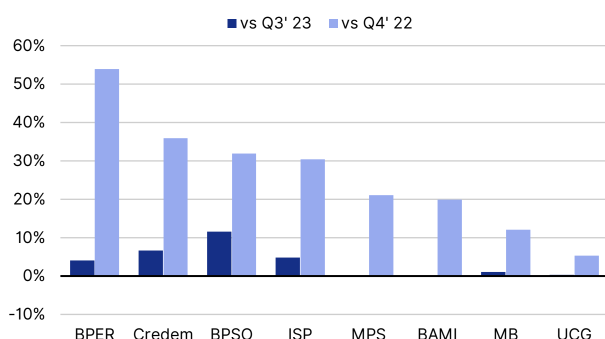
Our sample of eight Italian banks – Intesa Sanpaolo, UniCredit, Banco BPM, Banca Monte dei Paschi di Siena, BPER Banca, Mediobanca, Credito Emiliano and Banca Popolare di Sondrio – reported record results in 2023, achieving an average return on equity (ROE) of 14.6%, almost double that of the previous year.

Q4 results were mixed, however, mainly owing to seasonal costs and loan losses. Average growth in net interest income was only slightly positive as the effect of rate hikes is fading and lending activity remained subdued (Figure 2). Revenues were nonetheless supported by higher fees and commissions, which benefited from seasonal effects.

Operating costs increased due to the accrual of variable expenses and the impact of the renegotiation of the national labour contract. Therefore, after falling for three consecutive quarters, the average cost-income ratio rose to 48.3% in Q4, from 43.9% in Q3 (Figure 3).

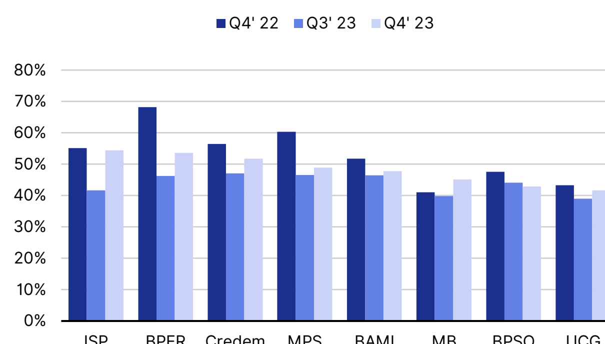
Cost of risk increased significantly to approximately 63bp in Q4 (35bp up to Q3), reflecting conservative management decisions to accumulate provisions rather than an actual deterioration in credit quality.

Figure 2: Net interest income, quarterly comparison



Source: Company data, Scope Ratings

Figure 3: Cost-to-income ratios



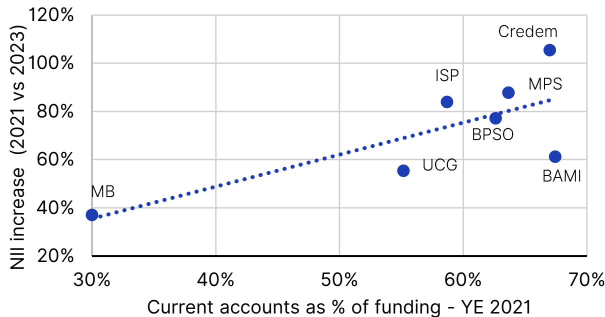
Source: Company data, Scope Ratings

Performance driven by spectacular NII results and low cost of risk

Growth in net interest income (NII) has led to excellent results for Italian banks over the past 18 months. In a higher interest-rate environment, maturity transformation has become a highly profitable activity again after more than a decade, although with variations among banks depending on their funding and asset mix. Lenders reporting the highest increases in net interest income are those funded by a higher proportion of cheap, sticky current accounts. Banks like Mediobanca have faced a faster repricing of liabilities, given the higher proportion of funding deriving from term deposits and bonds (Figure 4).

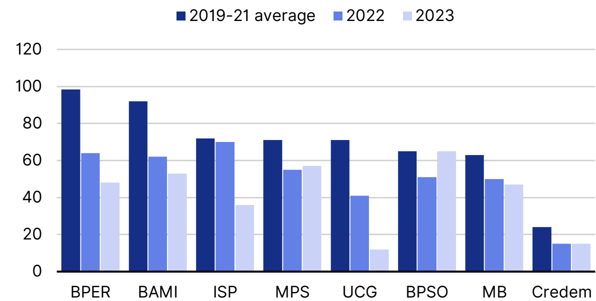
The second key driver of performance was the marked reduction in credit losses, at 42bp in 2023, compared to 51bp in 2022, and 70bp between 2019 and 2021. This primarily reflected low borrower defaults and the accumulation of unused provisions during the pandemic. In addition, much cleaner balance sheets and improved underwriting criteria/risk management have led to a structural reduction in the need to provision.

Figure 4: Correlation between 'cheap' funding base and increase in net interest income since 2021



Source: Company data, Scope Ratings
Note: BPER excluded due to Carige acquisition affecting the comparison
Credem's 2021 NII was restated to include CariCento's H1 estimated contribution and allow a like-for-like comparison with 2023 figures

Figure 5: Low credit risk backed banks' strong performance



Source: Company data, Scope Ratings
Note: cost of risk expressed in bps

Despite the potential for policy rate cuts by the second half of the year, the repricing of liabilities and rising default rates, Italian lenders remain confident that 2024 will yield similar, if not better, results. Their upbeat guidance is based on three main assumptions:

1) Stable or higher margins. Although most assets have now repriced, Euribor is likely to be higher than the 2023 average, which is positive for commercial margins. In addition, most lenders have positioned themselves to mitigate the initial impact of a decline in interest rates with hedges (through the so-called replicating portfolios).

2) Fee and commission income is expected to rebound on the back of higher inflows of managed assets and insurance products, as well of continuing investments in capital-light activities.

3) Cost of risk will remain under control, despite a pick-up in defaults. Banks should be able to limit the impact of a modest deterioration in credit quality because they have a cushion of unused management overlays accumulated over the past few years.

Figure 6: Italian banks' guidance on 2024 P&L items vs 2023

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

Source: Management guidance, Scope Ratings
Note: Only explicit guidance was considered. Mediobanca's guidance refers to its fiscal period ending on 30 June 2024.

Downside risks linger in a highly uncertain macro scenario

We reiterate that there are several downside risks that could weigh on banks' results in 2024. The outlook for lending remains poor, reflecting weak economic growth and an erosion in net disposable income in Italy.

The Italian economy, which we expect to grow by 0.6%, could be impacted by adverse geopolitical developments, for instance prolonged trade disruptions to the Red Sea trade route. Lower-than-expected GDP growth would put pressure on lending, transaction fees, and cost of risk.

While we remain constructive about domestic sovereign risk, the combination of high nominal yields, elevated sovereign issuance needs (EUR 480bn to EUR 520bn of bills and bonds in 2024) and the roll-back of the ECB's Pandemic Emergency Purchase Programme could raise volatility in sovereign spreads. Our base case is that the ECB will adopt quantitative tightening gradually and adjust or halt such measures should there be sign(s) of meaningful market disruption. Turmoil in domestic financial markets impacting Italian banks' funding costs and sales of asset-management products represents a downside risk.

Other potential negative factors could come from new extraordinary government measures targeting banks 'extra profits'. Or the ECB's decision to increase banks' minimum reserve requirements (now at 1% and remunerated at 0%).

Muted signs of credit deterioration as banks' asset quality further improves

Loan quality continues to surprise to the upside. In the fourth quarter, gross non-performing exposures (NPE) declined by around 6% across our sample partly thanks to asset disposals. The average gross NPE ratio was 2.9%, down 40bp despite an unfavourable denominator effect (lower loan volumes). All banks in our sample display gross NPE ratios below 5%, once a common key de-risking target for banks.

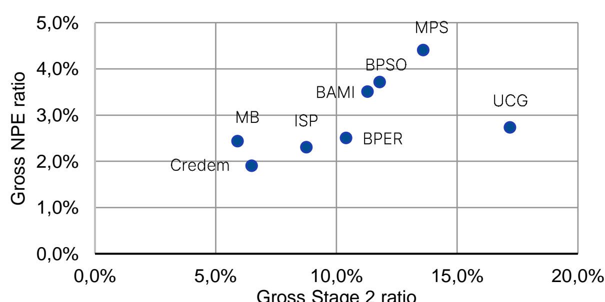
Higher Stage 2 loan ratio comes with relatively high performing loan coverage

The Stage 2 loan ratio is still high by international standards, at 10.7%. However, this has not been accompanied by an acceleration in default rates, which are close to their historic lows (Figure 8). Higher stage 2 loan ratios came with a greater accumulation of provisions, most of which haven't been used yet.

The current situation primarily reflects the resilience of the Italian economy, underpinned by solid corporate results and strong employment data. According to the latest available Bank of Italy data[1], the share of debt owed by households and firms at risk is at the lowest level in a decade, at around 9% and 28% respectively. That said, we believe it also reflects a longer-than-usual time lag between real-economy slowdown and credit deterioration. Moreover, the impacts of rising borrowing costs have been mitigated by the high percentage of fixed-rate mortgages and companies' low financing needs after taking up state-guaranteed loans during the pandemic.

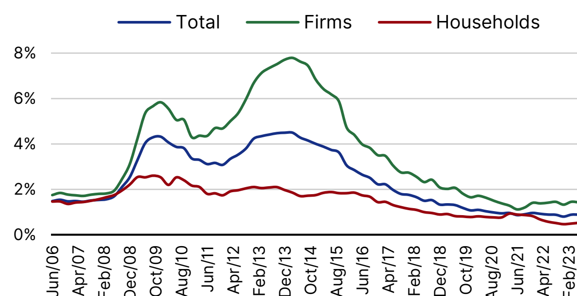
We do not expect a wave of defaults in 2024, but rather a gradual worsening of asset quality with a moderate impact on headline metrics. In recent years, Italian lenders have materially improved their management of credit origination, high-risk positions, and NPLs. This has made balance sheets more resilient to adverse operating conditions.

Figure 7: Headline asset quality metrics as of Q4 2023



Source: Company data, Scope Ratings.
Note: MPS' stage 2 ratio as of Q2 2023.

Figure 8: Annualised quarterly flows of NPLs in relation to the stock of performing loans



Source: Bank of Italy, Central Credit Register, Scope Ratings
Note: Firms exclude producer households.

[1] Bank of Italy, based on the Survey on Household Income and Wealth for households and Cerved data for firms.

Strong earnings foster higher shareholder remuneration

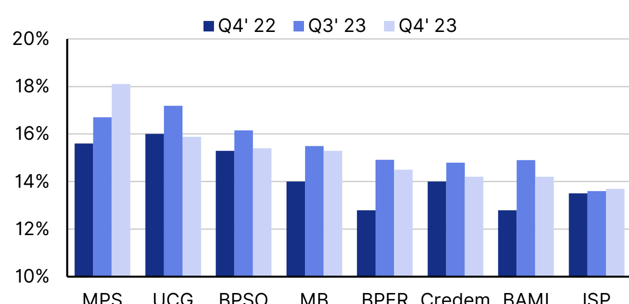
With record profits supporting internal capital generation, Italian banks can sustain higher payouts while maintaining healthy buffers above requirements. As of the fourth quarter of 2023, the average CET1 buffer, including the pay-out provision, stood at around 640bp.

Record-high distributions after 2023

After Intesa (which announced an extraordinary share buyback in its Q3 earnings call), other banks have followed suit. BP Sondrio announced a small pay-out hike of around 5pp, while MPS brought forward its return to paying a dividend by two years, pledging a EUR 0.25 cent/share cash dividend (25% payout, excluding Q4 one-offs). Banco BPM increased its pay-out to 67%, from 50%. We calculate an average payout of 62% for 2023, versus 50% in 2022.

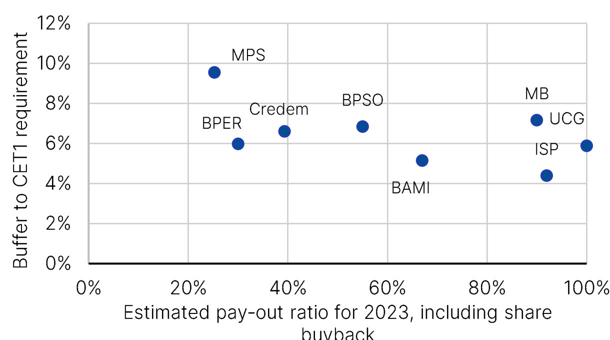
Given current profitability and strong solvency positions, we believe that increasing distributions can improve banks' equity stories. However, high pay-out ratios also reflect the lack of organic growth opportunities in Italy, as well as the reduced scope for M&A due to higher equity valuations.

Figure 9: CET1 ratio, quarterly comparison



Source: Company data, Scope Ratings

Figure 10: CET1 buffer vs estimated pay-out for 2023



Source: Company data, Scope Ratings
Note: For MPS, the pay-out was calculated excluding Q4 2023 one-offs. Mediobanca's pay-out refers to its FY 2024 ending next June.

Since 1 January 2024, banks have had to comply with the minimum requirement for own funds and eligible liabilities (MREL). Disclosure is not comprehensive yet and, in our sample, we do not have data for MPS and BPER. All other banks report a comfortable buffer above minimum requirements, which is the result of a combination of strong capitalisation and targeted issuance of loss-absorption instruments in recent years.

We are confident that all banks are meeting their MREL targets, which is a binding condition for paying dividends. We expect more complete disclosures from banks along with the publication of Pillar 3 documents in the coming months.

Normalisation of bank funding mix has been well managed so far

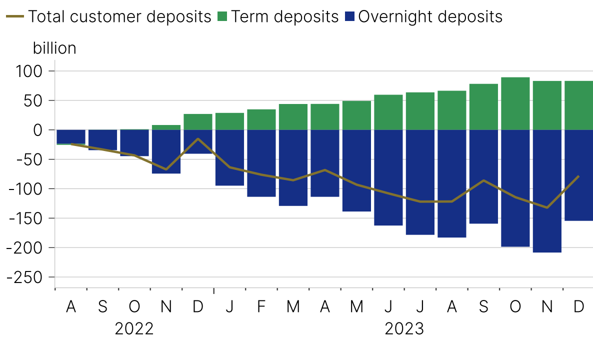
Over the past two years, the normalisation of interest rates and the unwinding of the TLTRO III have led to a reshaping of Italian banks' funding profiles. This has not jeopardised banks' solvency metrics though.

The rise in interest rates prompted more rate-aware retail customers to shift their money from current accounts to higher-yielding options, such as Italian bonds and term deposits. This was mirrored by companies reducing excess liquidity accumulated during the pandemic. At sector level, customer deposits have fallen by EUR 78bn, albeit from an all-time high (Figure 11).

Given the large deposit base and subdued loan demand, banks have not aggressively chased customer money. This has led to muted competition for deposits in Italy, which is reflected in the low beta of 14bp as of December 2023. According to latest figures, interest-sensitive time deposits account for 7% of banks' funding[2] (3% as of YE 2021).

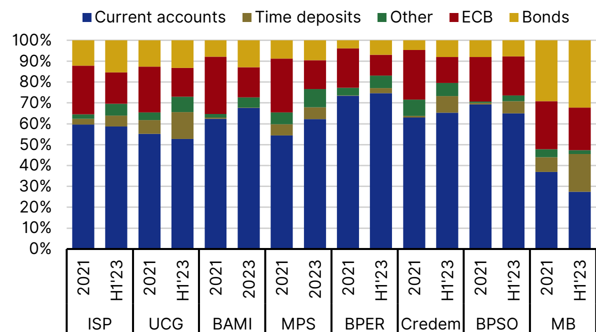
Sector-wide data show that the banking turmoil of spring 2023 had no spillover effects on the Italian banking market. Although Italian lenders are not invulnerable to a sudden loss of customer confidence, we believe that high liquidity ratios and a high proportion of customer funds covered by the deposit guarantee scheme make them relatively less exposed to this type of shock.

Figure 11: Cumulative flows of Italian bank deposits since July 2022 (first rate-hike)



Source: Bank of Italy, Macrobond, Scope Ratings

Figure 12: Breakdown of funding by sources, comparison between YE 2021 and YE 2023/H1 2023

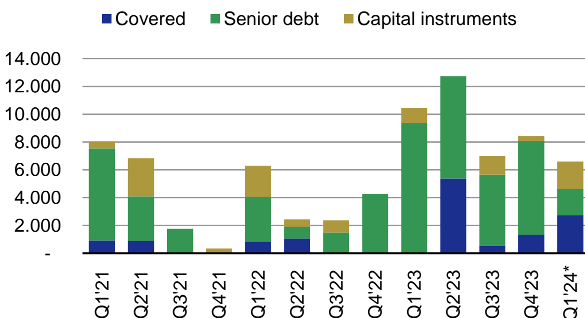


Source: Company data, Scope Ratings
Note: Liabilities held at amortised cost. 'Other' includes repos.

TLTRO III repayments continue smoothly. Banks have used a mix of excess cash and proceeds from debt issuance (particularly senior preferred debt) to repay the ECB facility. MPS was the only financial institution resorting to the ECB's main refinancing operation to replace part of its expiring TLTRO III lines.

Compared to the pre-tightening cycle, banks have increased reliance on wholesale debt issuance, mainly for MREL purposes. After Italy's full transposition of the European Covered Bond Directive into local law on 31 March 2023), covered bond issuance has resumed too (Figure 13).

Figure 13: Quarterly debt issuance, historical (USD bn)



Source: Bond Radar, Scope Ratings
Note: Issuance activity of the eight banks in our sample, excluding international subidiaries. 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. Q1 2024 issuance refers to the period until 8 February.

Figure 14: Selected benchmark bond issues, YTD

Issuer	Issue date	Type	Currency	Volume (m)	Coupon %	First call
UniCredit	9-Jan-24	Tier 2	EUR	1,000	5.375	16-Apr-29
BPER	9-Jan-24	AT1	EUR	500	8.375	16-Jul-29
Banco BPM	10-Jan-24	Senior non-preferred	EUR	750	4.875	17-Jan-29
UniCredit	16-Jan-24	Senior non-preferred	EUR	1,000	4.300	23-Jan-30

Source: Bond Radar, Scope Ratings

[2] Referred to our sample of eight Italian banks.

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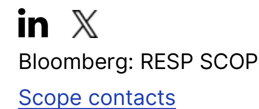
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