Financial Institutions Ratings
Intesa – AT1 Rating Report

Security ratings

Outlook	Stable
7.7% USD 1.0bn perpetual AT 1 notes (September 2015) temporary write-down on 5.125% trigger	BB+
7% EUR 1.25bn perpetual AT 1 notes (January 2016) temporary write-down on 5.125% trigger	BB+
7.75% EUR 1.25bn perpetual AT 1 notes (January 2017) temporary write-down on 5.125% trigger	BB+
6.25% EUR 750m perpetual AT 1 notes (May 2017) temporary write-down on 5.125% trigger	BB+

The ratings have not been solicited by the issuer; the analysis is based solely on public information.

Rating rationale

Scope rates at BB+ Intesa's four Additional Tier 1 (AT1) notes listed in the table above. Details on the rated instruments are contained on the next page. The ratings are based on the following considerations:

- Senior unsecured debt rating: A-, Stable Outlook
- Minimum notches down from senior unsecured debt rating: 4
- Additional notches: 0

In accordance with our rating methodology, the starting point for notching down a capital instrument rating is the senior unsecured debt rating, and no longer the issuer rating. Refer to Scope's Bank Capital Instruments Rating Methodology, published in May 2017, for more details.

The minimum four notches reflect the deeply subordinated status of AT1 capital instruments in the priority of claims, their going-concern loss-absorbing features and investors' exposure to coupon-cancellation risks.

The lack of additional notching for these securities reflects the following considerations:

1) Intesa has a very strong capital position, and on our estimates will have a buffer of over EUR 20.8bn to the trigger at group level at the end of Q1 2017. Despite the notes carrying a separate trigger on the parent company's CET1 ratio, we deem it irrelevant given the parent company is very well capitalised.

2) We deem it unnecessary to add further notches for coupon-cancellation risk. There are significant buffers to both the Pillar 1 CBR and the total SREP requirements, and we estimate that Intesa has ample distributable items, which should not represent a constraint to coupon payments. The recent separation of Pillar 2 requirements and guidance has further reduced the coupon-cancellation risk for Intesa's AT1 securities.

The release of this rating report does not constitute a rating action. Last rating action was assigned on 15 June 2017. For further information on the last rating action and regulatory information please click here.

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Issuer credit profile

In February 2017 Scope upgraded the Issuer Rating of Intesa Sanpaolo SpA to A with a Stable Outlook. The short-term rating is S-2, with Stable Outlook.

The ratings are driven by Intesa's strong capital position and resilient profitability despite the challenging operating environment in Italy, where 82% of the bank's loan portfolio is based. The group has led the retail and commercial banking sector in Italy since Intesa BCI and San Paolo IMI merged in 2007.

Although the bank has operations in central and Eastern Europe, its primarily domestic-based operations, combined with significant holdings in Italian sovereign debt, expose it to market confidence in Italian banks in particular and Italy in general.

Issuer	Intesa
Issue date	**17 September 2015**
Amount	USD 1bn
Coupon	• 7.70% from 17 September 2015 to 17 September 2025, then 5y USD mid-swap + 5.462% • Paid semi-annually (March 2017 and September 2017)
Format	• Non-cumulative temporary write-down deeply subordinated fixed-rate resettable notes (perpetual) • Redeemable at the option of the bank, subject to regulatory consent, in case of change in capital treatment or tax treatment • Redeemable at the sole option of the bank, subject to regulatory consent, from first call date (17 September 2025)
ISIN	US46115HAU14/ US46115HAV96/ IT0005136251/ IT0005136269
Capital treatment	Additional Tier 1

Issue date	19 January 2016
Amount	EUR 1.25bn
Coupon	• 7.0% from 19 January 2016 to 19 January 2021, then 5y EUR mid-swap + 6.884% • Paid semi-annually (January 2019 and July 2019)
Format	• Non-cumulative temporary write-down deeply subordinated fixed-rate resettable notes (perpetual) • Redeemable at the option of the bank, subject to regulatory consent, in case of regulatory event (change in classification) or change in tax treatment; • Redeemable at the sole option of the bank, subject to regulatory consent, from first reset date (19 January 2021)
ISIN	XS1346815787
Capital treatment	Additional Tier 1

Issue date	11 January 2017
Amount	EUR 1.25bn
Coupon	• 7.75% from 11 January 2017 to 11 January 2027, then 5y EUR mid-swap + 7.192% • Paid semi-annually (January 2011 and July 2011)
Format	• Non-cumulative temporary write-down deeply subordinated fixed-rate resettable notes (perpetual) • Redeemable at the option of the bank, subject to regulatory consent, in case of regulatory event (change in classification) or change in tax treatment • Redeemable at the sole option of the bank, subject to regulatory consent, from first reset date (11 January 2027)
ISIN	XS1548475968
Capital treatment	Additional Tier 1

Issue date	16 May 2017
Amount	EUR 750m
Coupon	• 6.25% from 16 May 2017 to 16 May 2024, then 5y EUR mid-swap + 5856% • Paid semi-annually (May 2016 and November 2016)
Format	• Non-cumulative temporary write-down deeply subordinated fixed-rate resettable notes (perpetual) • Redeemable at the option of the bank, subject to regulatory consent, in case of regulatory event (change in classification) or change in tax treatment (upon occurrence of a tax event) • Redeemable at the sole option of the bank, subject to regulatory consent, from first reset date (16 May 2024)
ISIN	XS1614415542
Capital treatment	Additional Tier 1

Main risks	
Coupon cancellation	• Fully discretionary • Mandatory if Available Distributable Items are insufficient • Mandatory if distributions exceed the Maximum Distributable Amount • Mandatory if relevant authority orders the issuer to cancel relevant interest payments
Principal loss absorption	• Temporary write-down upon trigger event: reduce the current principal amount of each note by the relevant write-down amount (pro rata with other notes and equal loss-absorbing instruments). • Permanent write-down or conversion to equity at the point of non-viability
Trigger for principal loss absorption	• CRD4 transitional CET1 ratio (group) < 5.125% or • CRD4 transitional CET1 ratio (Intesa Sanpaolo Spa) < 5.125%

Source: Prospectus. Scope Ratings

Key risk: coupon cancellation

Coupon payments on the securities are fully discretionary and subject to distribution restrictions.

We see no need for further notching for coupon-cancellation risk due to the comfortable distance to both CBR and SREP requirements, the sufficiency of Available Distributable Items (ADIs), and significant managerial flexibility to adjust dividend policy if needed.

Available Distributable Items (ADIs)

The concept of ADI is defined in the Capital Requirements Regulation (CRR; article 4.1-128) as "the amount of the profits at the end of the last financial year plus any profits brought forward and reserves available for that purpose before distributions to holders of own funds instruments less any losses brought forward, profits which are non-distributable pursuant to provisions in legislation or the institution's by-laws and sums placed to non-distributable reserves in accordance with applicable national law or the statuses of the institution, those losses and reserves being determined on the basis of the individual accounts of the institution and not on the basis of the consolidated accounts".

Intesa has only disclosed ADIs as of YE 2014 of EUR24bn, and we estimate this number has not changed much since, given the bank has been distributing most of its profit to shareholders. For a more detailed calculation of Intesa's ADIs, refer to our research report "Identifying and Calculating Available Distributable Items (ADI): The Example of Italian Banks".

Combined Buffer Requirement (CBR)

The CRD4-CRR restrictions on discretionary distributions, effective from 1 January 2016, are based on transitional CET1 requirements. The restrictions apply when CET1 capital falls below the CBR, defined as the sum of the capital conservation buffer, the countercyclical buffer and systemic risk buffers as applicable.

These buffers are in addition to Pillar 1 and Pillar 2 requirements; while the Pillar 2 guidance does not affect the level at which the Maximum Distributable Amount needs to be calculated.

Helpfully for investors, banks disclose their capital requirements stemming from the Supervisory Review and Evaluation Process (SREP). The SREP capital requirement comprises the minimum Pillar 1 CET1 requirement and an institution-specific Pillar 2 CET1 requirement for risks not covered explicitly under CRD IV.

For 2017, Intesa has disclosed a CET1 requirement of 7.25%. This is lower than the CET1 requirement in 2016, largely due to two factors:

(i) the ECB has separated a guidance component from the Pillar 2 requirement, which as a result has dropped to 1.5% from 2.5% last year.

(ii) In the 18th update to Circular 285 (4 October 2016) the Bank of Italy reversed a previous decision to apply the capital conservation buffer without a transitional period, realigning its practice to the majority of other national competent authorities in Europe[1].

The new CET1 requirement for Intesa hence comprises a minimum 4.5%, a 1.25% capital conservation buffer and an additional Pillar 2 requirement of 1.5%. Not being a global systemically important bank, the bank is not subject to a global systemic buffer

[1] https://www.bancaditalia.it/compiti/vigilanza/normativa/archivio-norme/circolari/c285/Aggiornamento-18-041016.pdf

requirement; however, given its systemic importance in Italy, it is identified as domestically systemically important by the Bank of Italy, the country's competent authority. Intesa's 'other systemically important institutions' buffer, currently at 0%, will rise to 0.75% by 2021. Currently, the countercyclical buffer rate for Italy is also set at 0%.

Table 1: Estimated capital requirements

	2016	Q1 2017	2018	2019
Required CET1 associated with distribution restrictions:	9.50%	7.25%	8.06%	8.88%
Combined Buffer Requirement (CBR)				
- Capital conservation	2.50%	1.25%	1.88%	2.50%
- Systemic	0.00%	0.00%	0.19%	0.38%
- Countercyclical	0.00%	0.00%	0.00%	0.00%
Pillar 2 CET1 requirement	2.50%	1.50%	1.50%	1.50%
Pillar 1 CET1 requirement	4.50%	4.50%	4.50%	4.50%
Intesa SanPaolo Group CET1, transitional (%)	12.7%	12.5%		
Distance to CET1 requirement incl. CBR (%)	**3.2%**	**5.3%**		
Distance to CET1 requirement incl. CBR (EUR bn)	**9.0**	**14.8**		
Intesa SanPaolo Group Tier 1, transitional (%)	13.9%	14.1%		
Required Tier 1 incl. CBR (%)	11.0%	8.8%		
Distance to Tier 1 requirement incl. CBR (%)	**2.9%**	**5.4%**		
Intesa SanPaolo Group total capital, transitional (%)	17.0%	17.3%		
Required total capital, incl. CBR (%)	13.0%	10.8%		
Distance to total capital requirement incl. CBR (%)	**4.0%**	**6.6%**		
RWAs (EUR bn)	284	282		

Source: SNL, Company data, Scope Ratings

Intesa's solvency position is very strong: its transitional CET1 ratio in March 2017 stood at 12.5%, giving Intesa ample distance to the CBR, including the Pillar 2 requirement for 2017, of 5.3% – which is reassuring. While this distance is, in our view, set to decline over time as buffer requirements are phased in, we note that management has significant flexibility to adjust if needed, as the current business plan includes a generous dividend policy, which is also factored into our estimates of capital build-up.

It is worth noting that, while investors mostly focused on CET1 requirements in the past, banks must comply with all capital requirements at all times before CET1 capital can be allocated in accordance with CBR buffers. In other words, if a bank does not have sufficient AT1 or Tier 2 capital (or MREL, once the requirements are in force), CET1 instruments can be used to fill the shortfall instead, provided the same capital has not been used twice.

Hence monitoring of coupon-cancellation risk has to take into account any weakness in the bank's capital structure, as this could lead to the CBR not being met and the MDA calculation to be activated.

As shown in table 1, all of Intesa's capital ratios are strong and the distance to CBR is even larger for the total capital ratio than it is for the CET1 ratio.

Key risk: principal loss absorption

We see no need for further notching for principal-loss-absorption risk due to the comfortable distance to triggers as well as the significant managerial flexibility to adjust dividend policy.

The mechanism for loss absorption is temporary write-down. The securities have a 5.125% CET1 trigger, where CET1 capital is based on transitional rules. The trigger applies both to the Intesa Sanpaolo group and Intesa as parent company. However, the parent company had an even stronger CET1 ratio of 18.2% at the end of 2016 and we believe the risk of the two reference entities diverging materially in capital evolution is insignificant. Also, as Intesa's operations are almost entirely based in the EU, the risk of regulatory ringfencing of capital is very remote.

Distance to trigger

Distance to trigger for the group stands at 7.4% in 2017. We believe this distance is set to decline slightly, both in percentage of risk-weighted assets and in absolute terms. Intesa targets a CET1 ratio of 12.2% in 2017 and has, in the past few years, returned excess capital to shareholders through a generous dividend policy.

Table 2: Distance to trigger – Intesa Group

	2016	Q1 2017	2018	2019
Trigger level	5.125%	5.125%	5.125%	5.125%
Intesa SanPaolo Group CET1, transitional (%)	12.7%	12.5%		
Distance to trigger (%)	**7.5%**	**7.4%**		
Distance to trigger (EUR bn)	**21.4**	**20.8**		

Source: SNL, Company data, Scope Ratings

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