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

SCOPE BBB- STABLE

Scope's credit view (summary)

The issuer rating of BBB- reflects BPS' established retail and commercial banking franchise, with solid market shares in the wealthy Italian region of Lombardy, producing a moderately stable and predictable stream of revenues and earnings.

While low by international standards, BPS' profitability track record is better than the average Italian bank. Stable revenues, good cost efficiency metrics and the lack of large restructuring one-off costs have helped the bank maintain a positive bottom line for the past decade, setting it apart from many peers which required material capital injections.

Asset quality continued to improve in 2020, thanks to sizeable disposals of non-performing exposures (NPEs) and is now more aligned with the level of other former Popolari banks. However, it still compares unfavourably with larger Italian and international peers, a factor which continues to constrain the rating. Uncertainty around the ultimate losses from the Covid-19 crisis adds to asset quality concerns.

At the end of December 2020, BPS had a CET1 ratio of 16.3% on a transitional basis, which is higher than peers and well ahead of requirements. We note that the bank could further optimise its capital structure via the issuance of capital securities, which are currently underutilised. The healthy buffers to capital requirements, alongside comfortable liquidity and funding regulatory ratios, are a key support to the rating. BPS is primarily funded by deposits, though it also uses the ECB's TLTRO lines.

Outlook

The **Outlook is Stable**, reflecting our expectation that the bank's credit profile will remain stable over the next 12-18 months. We expect the transformation of BPS into a joint stock company to positively affect long-term sustainability, but this will not lead to a higher rating in isolation. In the near term, we do not expect BPS' business model to change materially. At this stage, the key rating-change drivers are linked to the bank's financial performance.

Credit strengths

- A sound franchise in some of Lombardy's provinces
- Low but resilient profitability across the whole business cycle
- Comfortable capital and funding position

Credit weaknesses

- Limited geographic diversification
- Lagging, but improving, governance organisation and processes
- Despite improvement in recent years, weak asset quality still constrains the rating

Positive rating-change drivers

- Evidence that BPS's asset quality can remain resilient in the current stressed environment
- A continued decline in NPEs and cost of risk, leading to stronger earnings

Negative rating-change drivers

- Material credit or trading losses leading to the erosion of capital buffers
- Potential disruption from the transformation into joint stock company

Ratings & Outlook

Issuer rating	BBB-
Outlook	Stable

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Issuer profile

Founded in 1871 in Sondrio, BPS is a medium-sized cooperative bank operating primarily in the wealthy Italian region of Lombardy and Rome. The bank's branch presence in several other northern Italian regions is sparser. 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, Factorit, and BNT Banca.

The group's operations are segmented as follows:

- **Enterprises** including banking and leasing activities with non-financial companies and producer households
- **Individuals and others** encompassing banking activities with retail customers, public administrations, financial companies, and non-profit organisations
- **Securities:** the management of clients' portfolios, direct trading, and the placement of financial, insurance, and pension products; the segment also includes commissions from the distribution of third-party services.
- **Central functions** includes the results from the group's proprietary portfolio and equity stakes

Focused regional franchise in the wealthy Italian region of Lombardy

Predominantly retail banking activities, focused on individuals and SMEs

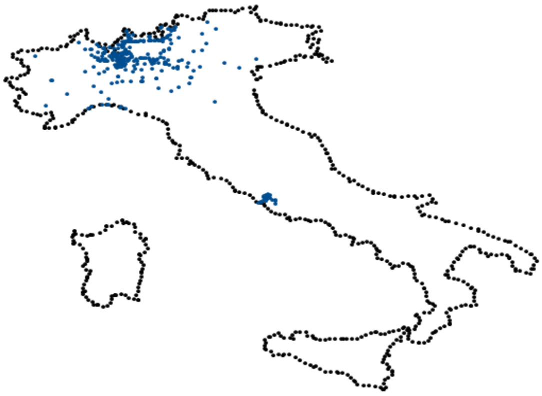
The group's business model hinges on traditional commercial banking activities mainly extended to households and local entrepreneurs (micro and small businesses). Over the years, BPS has developed solid customer relationships, especially in its home province of Sondrio.

Through its branch network, the bank also distributes leasing, life and non-life insurance products offered by the companies in which it owns stakes (Alba Leasing, 19.3%; Arca Vita, 14.8%). It also holds 34.7% of Arca Holding, which itself fully owns Arca Fondi, an asset management firm. The group entered the market of payroll/pension deducted loans by acquiring PrestiNuova in 2018. In 2019, Prestinuova was merged into BNT Banca, which previously only 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; after deducting minority interest, Factorit accounted for 6.4% of the group's consolidated net profits in 2020 (3.1% in 2019).

Regional bank with good market presence in Lombardy

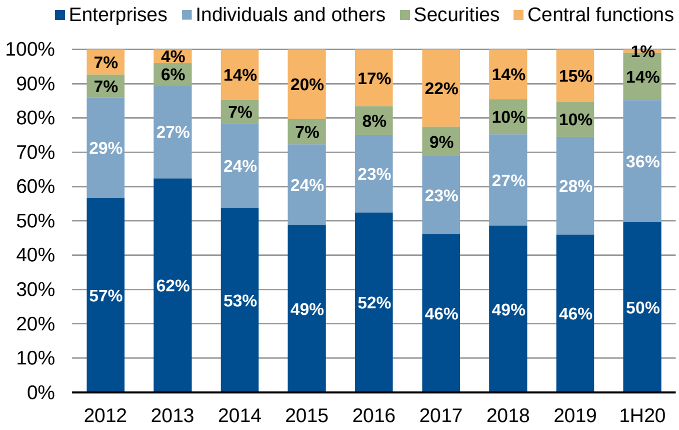
Based on YE 2019 figures, BPS has immaterial market shares in Italy (c.2% of branches), but a dominant position in its home province of Sondrio (over 40% of branches) and a relevant market presence in Lecco and Como (around 19% in both). Its branch market share in Lombardy is around 7%. Its main competitor is Credito Valtellinese in the province of Sondrio, whereas in Lombardy Intesa, Unicredit, Banco BPM and BPER are the strongest rivals.

Figure 1: Branch network



Source: SNL, Scope Ratings
Note: retail branches only

Figure 2: Revenue breakdown by segment, historical



Source: Company data, Scope Ratings

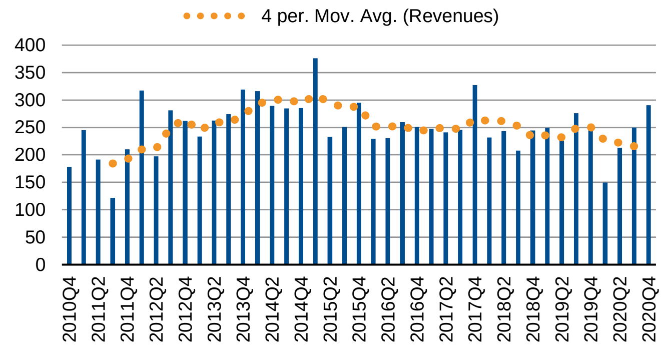
Over the past five years, decreasing interest margins have put pressure on the group's top line, a trend tempered by the resiliency of fee and commission income. Revenue volatility has been low, reflecting the well anchored customer franchise.

Proprietary portfolio is a source of earnings volatility

The main source of revenue and earnings volatility is the group's proprietary portfolio, in particular the portion held for trading. In Q1 2020, BPS reported a negative result of EUR 46m mainly ascribable to market losses. As of September 2020, the portfolio of securities amounted to EUR 10.2bn, 2.1% of which was represented by trading assets (mainly mutual funds and equities).

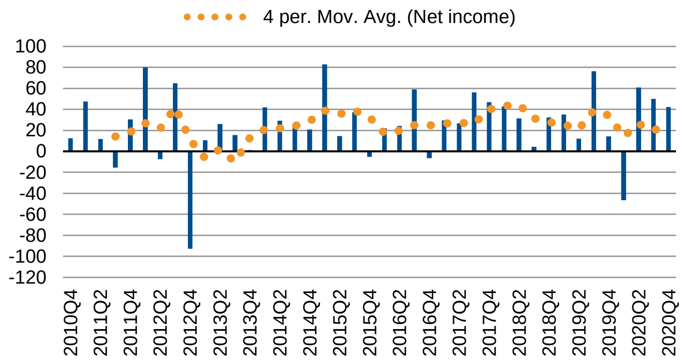
Nonetheless, we note that on an annual basis, trading income has consistently made a positive contribution to BPS' top line since 2012.

Figure 3: Quarterly revenues, historical



Source: SNL, Scope Ratings

Figure 4: Quarterly net profit, historical



Source: SNL, Scope Ratings

Focused physical branch network growth with strong efficiency metrics

As opposed to other Italian banks, BPS has not shrunk its branch network in recent years, opting instead for continued, but measured, expansion. This strategy allowed the group to extend is customer reach while maintaining good cost efficiency metrics.

BPS will face more competition as digital banking gains momentum

As a cooperative and regional player, the group values customer proximity and a physical presence in its territory. Its digital banking solution, Scrigno, is seen as an ancillary service to branch-based customer relationships, rather than a standalone banking concept. However, customer behaviour is rapidly changing in Italy as well as Europe. With basic banking products facing a process of commoditisation, BPS may need to raise investments in IT to keep up with a rapidly changing market. We believe that BPS' relatively small size constrains the budget it can deploy to develop digital solutions. Over time this could turn into a competitive challenge, especially with respect to larger peers.

Forthcoming transformation into joint stock company should accelerate improvements in corporate governance

BPS is currently registered as a cooperative stock company and regulated as a 'Banca Popolare'. From a governance perspective, the main peculiarities of this legal form consist in the granularity of shareholding and in voting limits; with the exception of institutional investors, no shareholder can own more than 1% of share capital and under no circumstances may cast more than one vote at general meetings. This system is meant to guarantee the preservation of the cooperative function.

BPS still needs to comply with the reform of cooperative banks

As part of the 2015 reform in Italy, all cooperative banks (banche popolari) with total assets of at least EUR 8bn must be transformed into joint stock companies. While all other large Popolari have complied with the reform and changed their legal form, BPS has not. This was due, according to the bank, to the legal uncertainty around the reform, which had been challenged in the Italian courts. In 2020, the European Court of Justice ruled the 2015 reform compliant with European law and the State Council revoked its order suspending the obligation to transform. The new deadline for the transformation is the end of 2021. We expect BPS to go ahead with the transformation before the end of the year. We believe the transformation into a joint stock company will accelerate the ongoing reform of the bank's corporate governance.

Supervisory pressure has led to governance improvements in recent years

The ECB has put pressure on BPS to improve the functioning of the board of directors and its organisational structure. In response, the group approved key changes to its top management, provisioning for the appointment of a chief lending officer and a chief financial officer, and to change the chief risk officer's duties. In March 2021, BPS appointed a new chief financial officer.

With respect to other ESG factors, we view positively the group's strong ties with its territory and its community as well as its stated mission to support the fabric of the local economy. We do not expect the social DNA of the group to change materially along with its legal form.

BPS has recently stepped up its efforts to manage environmental risks. However, we see considerable room for improvement with respect to disclosures and efforts to manage environmental risks.

Material improvement in asset quality in 2020, but uncertainty persists amid Covid-19 crisis

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 at 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 initially embraced a softer approach in dealing with NPEs, preferring internal management over large disposals.

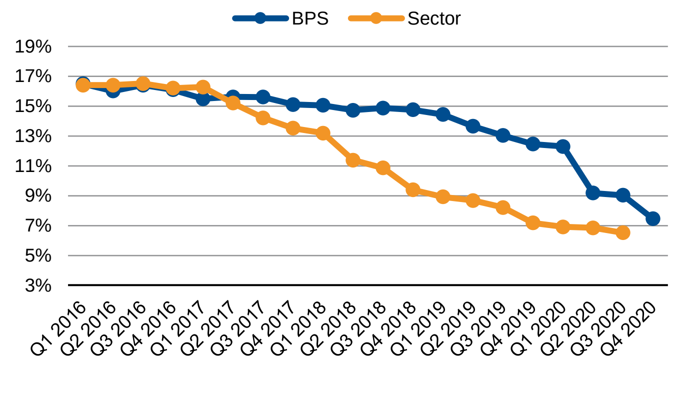
Material derisking of legacy non-performing loans in recent years

Pressured by the regulator, the group finally accelerated its NPEs disposals in 2020, when it closed two deals for a total amount of EUR 1.4bn. At the end of 2020, the NPE ratio stood at 7.4%, with coverage at 52%, in line with peers.

The delayed tackling of legacy NPEs had been a factor in BPS' frustrated attempts at inorganic growth in the recent past. The group did not receive the necessary authorisations to acquire Cassa di Risparmio di Cento (October 2019) or Farbanca (February 2020) despite a material capital excess over its requirements, with supervisors stressing the need to prioritise planned derisking and conserve the excess capital.

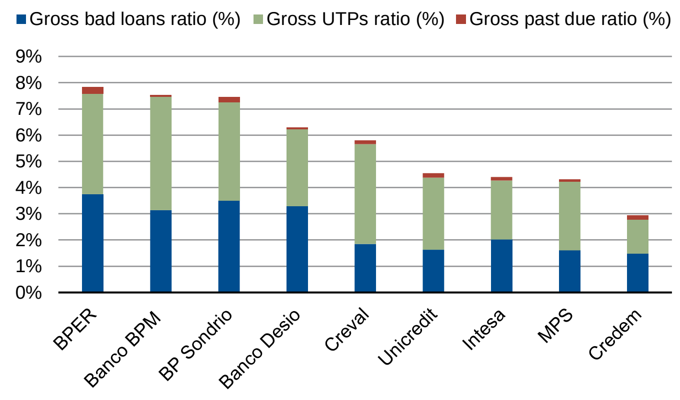
We believe that the successful execution of the planned deals should alleviate the supervisory scrutiny of the group and allow it to scout for other opportunities going forward.

Figure 5: Workout of NPEs finally accelerated in 2020 (gross NPE ratio)



Source: Company data, Bank of Italy, Scope Ratings

Figure 6: Italian banks – NPE breakdown by type as of YE 2020



Source: Company data, Scope Ratings
Note: Banco Desio as of Q3 2020

Non-performing loan formation will pick up as moratoriums expire

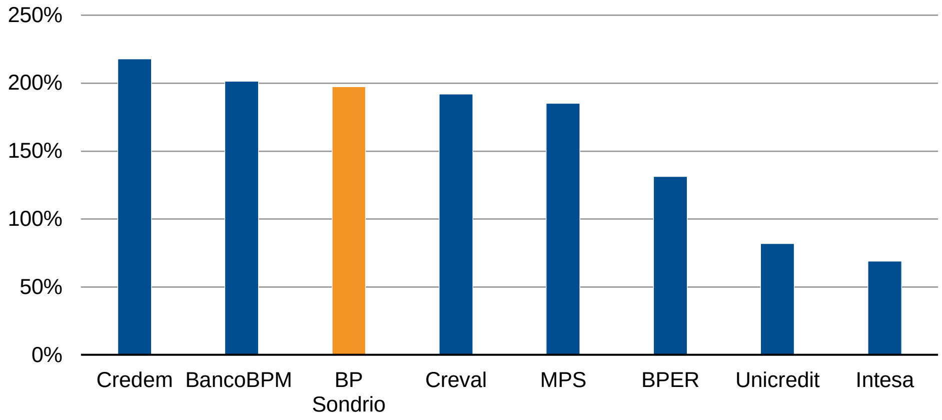
Currently, there is limited visibility on the full impacts of the Covid-19 crisis on BPS' asset quality. In 2020, the group accepted moratorium requests affecting EUR 4.5bn in customer loans, i.e. 15% of the total loan book. This proportion was roughly in line with other regional Italian banks.

Over the year, the coverage on performing loans increased by EUR 72m, from 0.48% to 0.69%. However, it is highly likely that the group will need to book further loan loss provisions, as economic restrictions remain in place while the vaccine rollout proceeded slowly in the first quarter of 2021.

High exposure to domestic sovereign risk

Among large and mid-tier Italian banks, BPS has one of the largest and most concentrated exposures to Italian sovereign bonds. As of December 2020, it held EUR 5.9bn in Italian government bonds, two times its CET1 capital base. In June 2020, 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 7: Italian sovereign bond portfolio as % of CET1 capital, YE 2020



Source: Company data, Scope Ratings

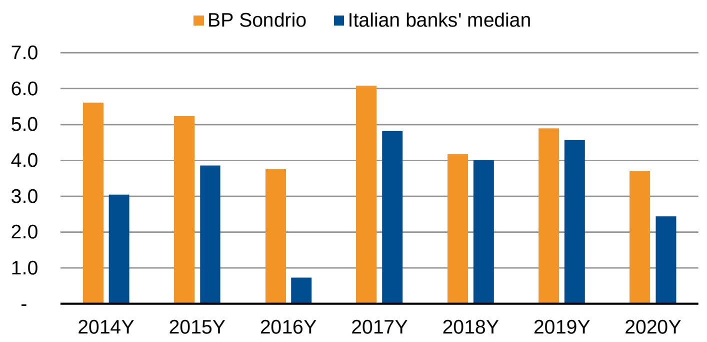
Strong track record of low but resilient profitability challenged by low interest rate environment and new asset quality cycle

In recent years, BPS has had a consistent track record of low but resilient earnings. This is all the more impressive considering that many banks in Italy have suffered heavy losses in the wake of the great financial crisis and European sovereign crisis. Several peers have gone out of business, merged (from a position of weakness) or needed large capital injections.

In our view, the key to BPS' profitability in the recent decade has been its good level of cost efficiency, relatively contained increases in the cost of risk, and the avoidance of large negative one offs.

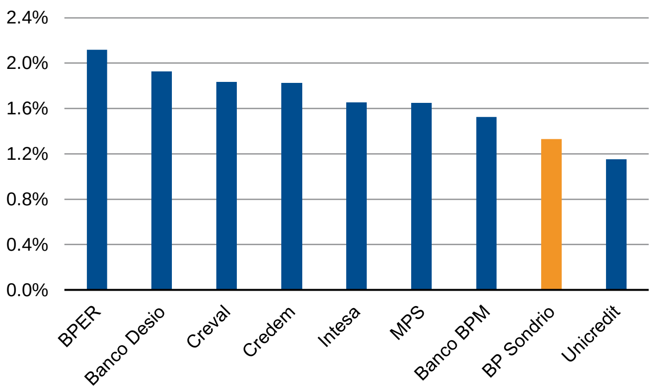
In the last two years, pre-provision profitability has again proven enough to absorb provisions related to non-performing loan sales and the impact of Covid-19. However, the pre-provision profit buffer has shrunk in recent years and may continue to do so in the current difficult interest rate scenario. The lower need to provision against legacy NPEs would have supported the bank's profitability going forward, but uncertainty around loan performance amid the economic crisis now clouds the profitability outlook. In the medium term, earnings sustainability remains a question mark. The pressure on the net interest margin is likely to persist, driven by low margins on deposits, and the carry trade on Italian sovereign bonds becoming less remunerative. Further, the need to invest in IT development could weigh on near-term pre-provision profitability.

Figure 8: BPS vs Italian banks* return on average equity (%)



Source: Company data, Scope Ratings

Figure 9: Italian banks – cost/asset ratio (2020)



Source: Company data, Scope Ratings

*Includes the Italian peers listed on page 11

Comfortable financial viability, with material headroom to minimum requirements

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

Material headroom to capital requirements, both on a CET1 and total capital basis

At the end of December 2020, BPS had a CET1 ratio of 16.3% on a transitional basis. This compares favourably with the 2020 SREP requirement of 8.69%.

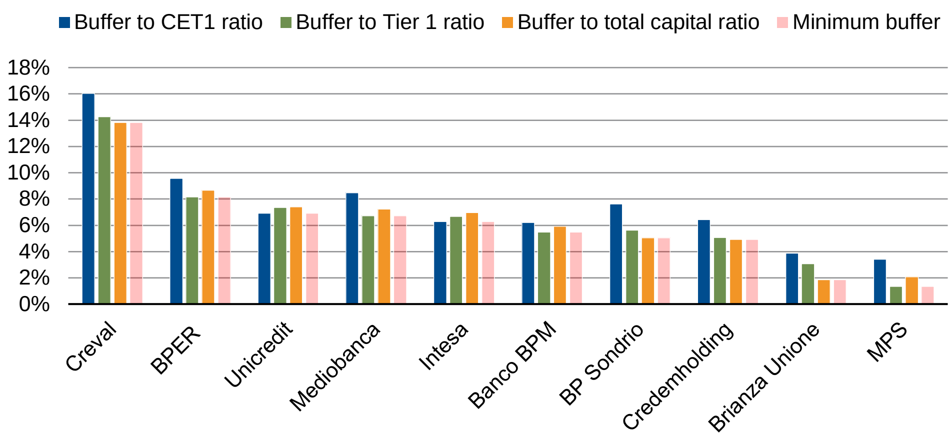
The group capital position greatly improved in May 2019, when the ECB approved the parent bank's AIRB models to assess the credit risk of corporate and retail portfolios. This headroom gave the group more strategic flexibility to accelerate de-risking.

We note that the bank could further optimise its capital structure through the issuance of AT1 securities, releasing CET1 capital that could be used for further balance sheet cleanup or growth. BPS had no outstanding CRD4-compliant AT1 notes. In July 2019 it placed a EUR 200m Tier 2 loan, which added approximately 120bps to the total capital ratio.

The minimum buffer to requirements is on total capital, at just over 500bps. This could be materially raised (further 250bps) if the group were to make full use of the AT1 and T2 buckets.

The fully leverage ratio has varied within the 5.5%-6% range over recent years, standing at 5.5% as of YE 2020.

Figure 10: Italian banks, buffers on capital requirements as of YE 2020



Source: SNL, company data, Scope Ratings estimates

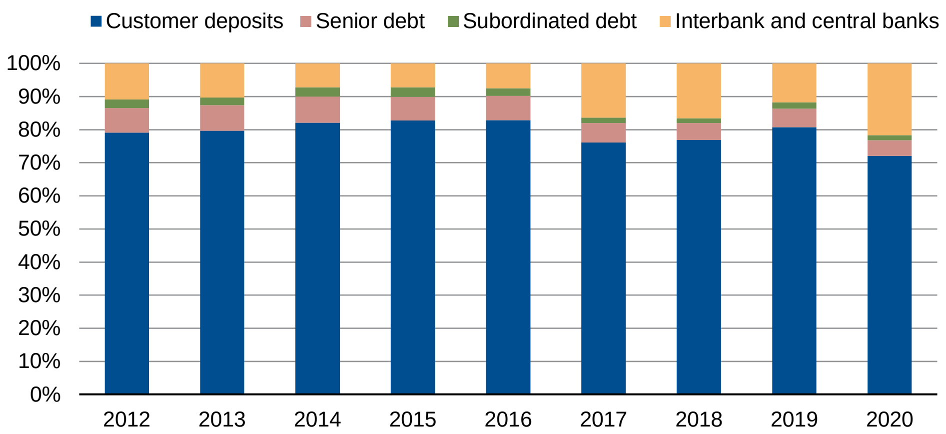
BPS' balance sheet is mostly funded by deposits and central bank lines

The group primarily funds itself via current accounts and sight deposits, which accounted for around 66% of the balance sheet as of December 2020. The growth of the deposit base has gone hand in hand with the expansion of the balance sheet over the past few years.

Historically, BPS has drawn from the TLTRO programme. In 2020, it made sizeable use of it by drawing the maximum EUR 8.1bn (18% of total funding as of year-end).

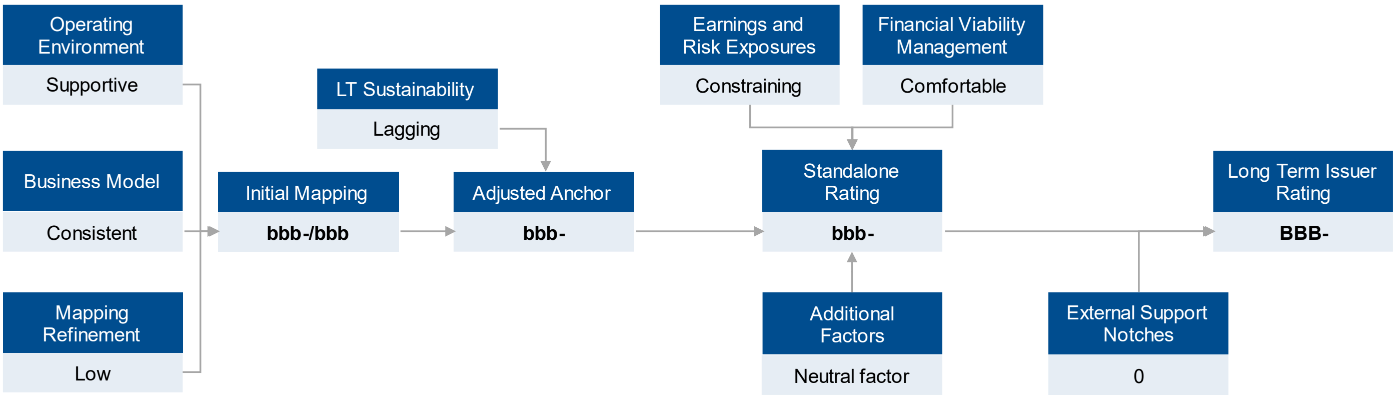
As of YE 2020, the group's liquidity coverage ratio stood at 252%, increased by around 80bps year-on-year.

Figure 11: Breakdown of funding, historical



Source: SNL, Scope Ratings.

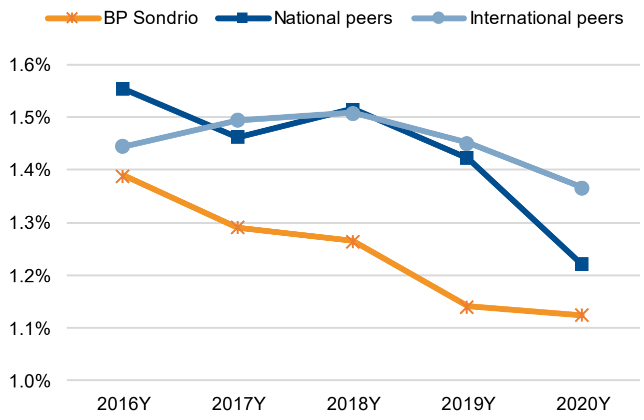
I. Appendix: Overview of the rating process



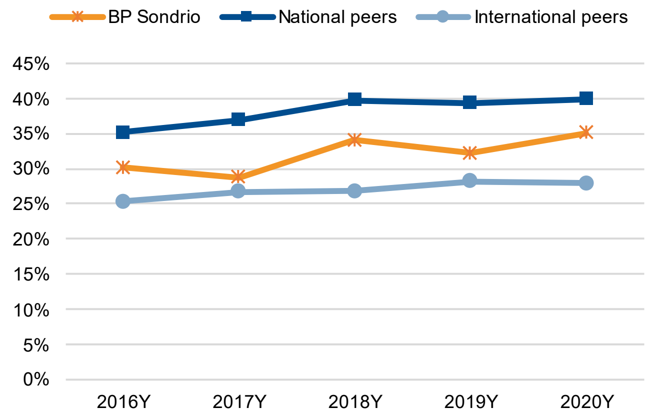
Step		Assessment	Summary rationale
STEP 1	Operating environment	Very supportive **Supportive** Moderately supportive Constraining Very constraining	• Italy is a wealthy country in the euro area, but the high level of public debt may constrain fiscal policy. • Italy is part of the European Banking Union. • The banking sector is fragmented and suffers from structurally low profitability.
	Business model	Very resilient Resilient **Consistent** Focused Narrow	• Regional bank with a sound franchise in the wealthy Lombardy region • The business model hinges on traditional commercial banking activities, with good market shares in its territories • Trading portfolio is a source of revenue and earnings volatility
	Mapping refinement	High **Low**	• Lack of diversification is a constraint to the rating
	Initial mapping	**bbb/bbb-**	
	Long-term sustainability	Best in class Advanced Developing **Lagging**	• Forthcoming transformation into joint stock company should accelerate improvements in corporate governance • BPS will face more competition as digital banking gains momentum • Strong social responsibility embedded in cooperative corporate DNA • The group is working on assessing the environmental footprint of its lending activity
	Adjusted anchor	**bbb-**	
STEP 2	Earnings capacity & risk exposures	Very supportive Supportive Adequate **Constraining** Very constraining	• Headline asset quality metrics have greatly improved and are in line with close peers, but continue to compare poorly to larger banks • Limited visibility on the full impacts of the crisis, but risks are skewed towards the downside • Strong profitability track record compared to Italian peers
	Financial viability management	Ample **Comfortable** Adequate Limited Stretched At risk	• Healthy buffers to capital requirements, both on a CET1 basis and on total capital. • Comfortable funding and liquidity positions supported by material usage of TLTRO III lines
	Additional factors	Significant support factor Material support factor **Neutral** Material downside factor Significant downside factor	• No further considerations
	Standalone	**bbb-**	
STEP 3	External support	Not applicable	
Issuer rating		**BBB-**	

II. Appendix: Peer comparison

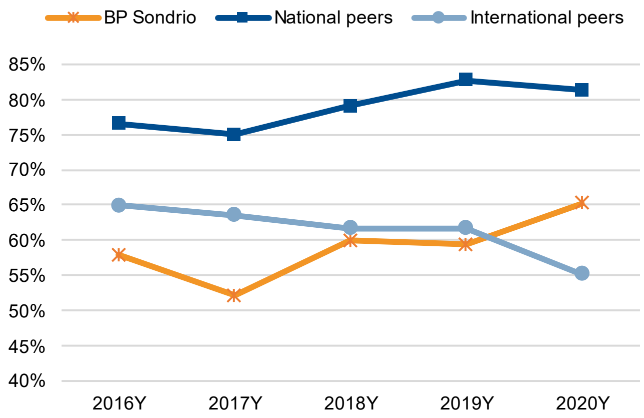
Net interest margin



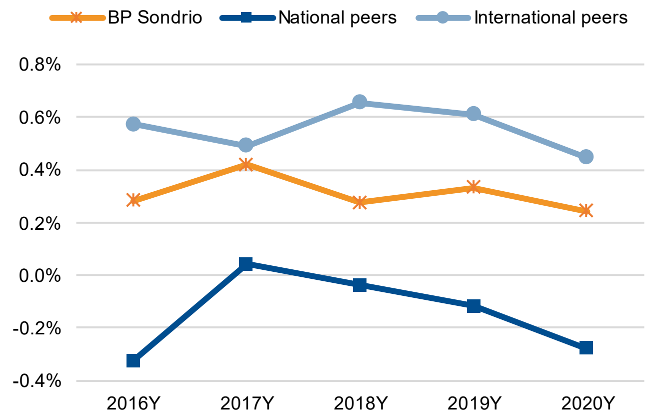
Fees & commissions, % revenues



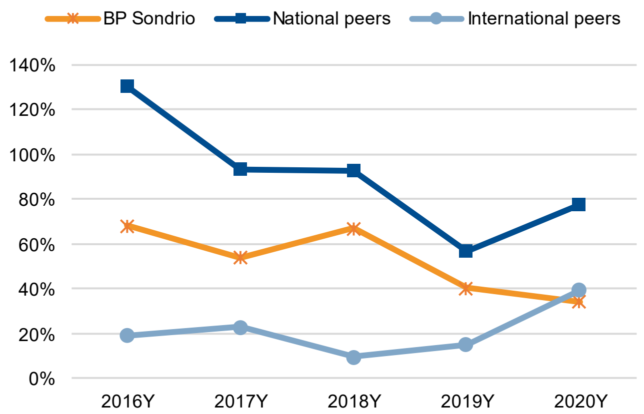
Cost/income ratio



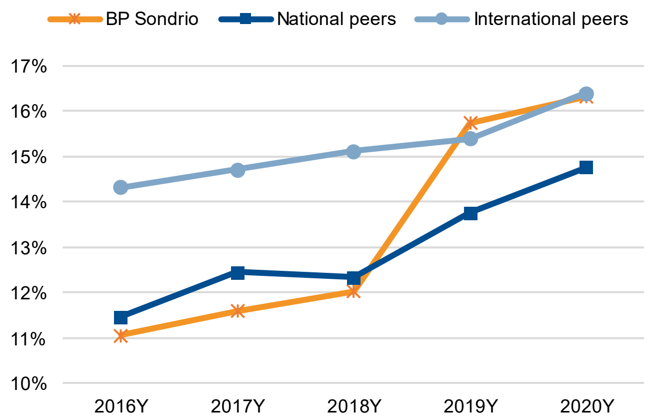
Return on average assets



Impairment on financial assets/pre-impairment profits



Common equity tier 1 ratio (%, transitional)



Source: SNL Financial, Scope Ratings
National peers: Credito Valtellinese, Banco Desio, Banco BPM, BPER, Credem, Intesa, Unicredit, Monte dei Paschi di Siena, UBI, Carige, Banca Sella, BP Bari, BP Alto Adige, CR Asti
International peers: Unicaja, Ibercaja, Liberbank, Bank Burgenland, Salzburger Landes-Hypothekenbank, Oberbank AG, Totens Sparebank

III. Appendix: Selected financial information – Banca Popolare di Sondrio S.C.p.A

	2016Y	2017Y	2018Y	2019Y	2020Y
Balance sheet summary (EUR m)					
Assets					
Cash and interbank assets	2,576	2,620	2,898	2,894	8,687
Total securities	7,877	11,893	5,076	3,237	3,849
of which, derivatives	57	98	32	32	NA
Net loans to customers	25,313	25,623	31,758	33,393	35,548
Other assets	1,434	1,488	1,396	1,623	1,724
Total assets	**37,202**	**41,625**	**41,128**	**41,146**	**49,808**
Liabilities					
Interbank liabilities	2,505	6,205	6,166	4,328	9,827
Senior debt	2,468	2,220	1,907	2,091	NA
Derivatives	112	54	74	78	40
Deposits from customers	27,702	28,801	28,630	29,817	32,728
Subordinated debt	764	613	525	714	NA
Other liabilities	994	962	1,082	1,182	NA
Total liabilities	**34,544**	**38,855**	**38,384**	**38,209**	**46,712**
Ordinary equity	2,573	2,679	2,651	2,842	2,998
Equity hybrids	0	0	0	0	0
Minority interests	85	91	93	95	98
Total liabilities and equity	**37,202**	**41,625**	**41,128**	**41,146**	**49,808**
Core tier 1/ common equity tier 1 capital	*2,568*	*NA*	*2,636*	*2,712*	*2,967*
Income statement summary (EUR m)					
Net interest income	474	490	508	460	490
Net fee & commission income	293	305	316	322	316
Net trading income	110	161	11	114	2
Other income	93	105	94	106	94
Operating income	**971**	**1,062**	**928**	**1,002**	**903**
Operating expenses	562	553	556	594	588
Pre-provision income	**409**	**508**	**372**	**408**	**314**
Credit and other financial impairments	279	274	249	165	108
Other impairments	0	0	1	3	NA
Non-recurring income	0	0	21	0	0
Non-recurring expense	0	0	0	45	49
Pre-tax profit	**130**	**234**	**143**	**195**	**157**
Income from discontinued operations	0	0	0	0	0
Income tax expense	30	68	29	56	47
Other after-tax Items	0	0	0	0	0
Net profit attributable to minority interests	1	6	3	2	3
Net profit attributable to parent	**99**	**159**	**111**	**137**	**107**

Source: SNL, Scope Ratings

IV. Appendix: Selected financial information – Banca Popolare di Sondrio S.C.p.A

	2016Y	2017Y	2018Y	2019Y	2020Y
Funding and liquidity					
Net loans/ deposits (%)	91.38	88.97	110.21	111.12	108.61
Liquidity coverage ratio (%)	107.00	NA	147.94	173.22	252.00
Net stable funding ratio (%)	124.00	NA	NA	NA	NA
Asset mix, quality and growth					
Net loans/ assets (%)	68.04	61.56	77.22	81.16	71.37
Problem loans/ gross customer loans (%)	16.10	NA	12.27	10.54	6.20
Loan loss reserves/ problem loans (%)	49.33	NA	58.46	61.14	60.90
Net loan growth (%)	5.49	1.22	23.94	5.15	6.45
Problem loans/ tangible equity & reserves (%)	91.88	NA	81.02	71.94	51.36
Asset growth (%)	4.68	11.89	-1.19	0.04	21.05
Earnings and profitability					
Net interest margin (%)	1.39	1.29	1.27	1.14	1.13
Net interest income/ average RWAs (%)	2.05	NA	NA	2.43	2.79
Net interest income/ operating income (%)	48.84	46.15	54.76	45.93	54.28
Net fees & commissions/ operating income (%)	30.19	28.74	34.02	32.15	35.05
Cost/ income ratio (%)	57.88	52.10	59.90	59.31	65.19
Operating expenses/ average RWAs (%)	2.43	NA	NA	3.14	3.35
Pre-impairment operating profit/ average RWAs (%)	1.76	NA	NA	2.16	1.79
Impairment on financial assets / pre-impairment income (%)	68.11	53.95	66.98	40.38	34.34
Loan loss provision/ average gross loans (%)	0.95	NA	NA	0.48	0.30
Pre-tax profit/ average RWAs (%)	0.56	NA	NA	1.03	0.89
Return on average assets (%)	0.28	0.42	0.27	0.33	0.24
Return on average RWAs (%)	0.43	NA	NA	0.74	0.63
Return on average equity (%)	3.76	6.09	4.18	4.89	3.70
Capital and risk protection					
Common equity tier 1 ratio (%, fully loaded)	11.06	NA	11.94	16.02	16.20
Common equity tier 1 ratio (%, transitional)	11.07	NA	12.03	16.04	16.32
Tier 1 capital ratio (%, transitional)	11.09	NA	12.07	16.09	16.36
Total capital ratio (%, transitional)	13.55	NA	13.61	18.93	18.55
Leverage ratio (%)	6.20	NA	5.78	6.12	5.45
Asset risk intensity (RWAs/ total assets, %)	62.38	NA	53.27	41.86	36.52
Market indicators					
Price/ book (x)	54.7x	51.1x	44.7x	33.4x	33.0x
Price/ tangible book (x)	55.2x	51.6x	45.2x	33.7x	33.3x
Dividend payout ratio (%)	27.27	20.00	20.83	NA	NA

Source: SNL, Scope Ratings

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