Scope Ratings

# Banca Popolare di Sondrio SpA

## Issuer Rating Report

Issuer rating

BBB

Outlook

Stable

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### Summary and Outlook

Banca Popolare di Sondrio's (BPS) issuer rating of BBB is based on the following assessments:

- **Operating environment assessment: Supportive (low).** Italy has a large and diversified economy but is constrained by high debt levels and limited fiscal flexibility. Being part of the European banking union, the regulatory and supervisory environment is considered highly supportive for the financial stability of banks. The assessment also considers the high fragmentation and low efficiency of the Italian banking system.
- **Business model assessment: Consistent (low).** BPS has an established retail and commercial banking franchise, with solid market shares in the wealthy Italian region of Lombardy. Although its national market share is low, BPS enjoys a dominant position in Sondrio and has a significant market presence in the provinces of Lecco and Como. This supports moderately stable and predictable revenues and earnings over the cycle.
- **Long term sustainability assessment: Developing.** Governance has improved thanks to the transformation into a joint stock company and the reorganisation of the management structure. BPS' cooperative roots and its attention to the territories where it operates, indicates strong social responsibility and responsiveness to the interests of various stakeholders. However, we believe there is material room for improvement in the bank's preparedness for digital competition.
- **Earnings capacity and risk exposures assessment: Neutral.** BPS has demonstrated the ability to generate earnings throughout the cycle. And in a higher rate environment, the group's results have significantly increased.

  We expect BPS' return on average equity to remain in the low double digits in 2024 and 2025. While the default rate is assumed to increase from record lows, the group has a cushion of EUR 200m in overlays (approximately 50 bps of customer loans) that could be used to absorb higher credit losses. Management has guided to a cost of risk of 50-60 bp, in line with Southern European peers.
- **Financial viability management assessment: Comfortable.** BPS holds comfortable buffers against regulatory solvency requirements. We expect these to be maintained over the strategic plan horizon, as strong organic capital generation (around 90 bp per annum net of dividends) should be able to accommodate business growth and regulatory headwinds.

#### Outlook

The Stable Outlook reflects our view that BPS' credit profile will remain unchanged over the next 12-18 months.

**What could move the rating up**

- We currently see limited upside to the rating given the group's lower business diversification compared to peers. The rating already incorporates the group's greatly improved asset quality profile as well as the comfortable capital and funding positions.

**What could move the rating down**

- A significant reduction in the buffer to capital requirements, currently a key support for the rating.
- A material increase in non-performing loans linked to weaker operating conditions.

## Rating drivers overview table

| Step | | Assessment | | | Summary rationale |
|---|---|---|---|---|---|
| STEP 1 | Operating environment | Very supportive | H | L | • Italy is a core euro area member with a large and diversified economy<br>• The government has provided sizeable support in recent years. However, high debt levels may constrain fiscal flexibility in the future<br>• Strong supervisory framework within the European Banking Union<br>• The banking sector is highly fragmented although financial fundamentals have been improving |
| | | Supportive | H | L | |
| | | Moderately supportive | H | L | |
| | | Constraining | H | L | |
| | | Very constraining | H | L | |
| | Business model | Very resilient | H | L | • Regional bank with an established franchise in the wealthy Lombardy region<br>• Traditional commercial banking business model, with good market shares in its territories<br>• Solid track record of results over the cycle |
| | | Resilient | H | L | |
| | | Consistent | H | L | |
| | | Focused | H | L | |
| | | Narrow | H | L | |
| | **Initial mapping** | **bbb-** | | | • |
| | Long-term sustainability | Best in class | | | • Transformation into joint stock company and continuous improvements in corporate governance<br>• BPS will face more competition as digital banking gains momentum<br>• Strong social responsibility embedded in cooperative roots<br>• Greater commitment to manage environmental risks |
| | | Advanced | | | |
| | | Developing | | | |
| | | Constrained | | | |
| | | Lagging | | | |
| | **Adjusted anchor** | **bbb-** | | | • |
| STEP 2 | Earnings capacity & risk exposures | Very supportive | | | • Stronger earnings record than Italian peer average over the cycle<br>• Headline asset quality metrics have significantly improved to be in line with close peers, but they still compare unfavourably to larger banks<br>• Sizeable domestic sovereign bond portfolio, mainly held at amortised cost and with contained sensitivity to changes in yields |
| | | Supportive | | | |
| | | Neutral | | | |
| | | Constraining | | | |
| | | Very constraining | | | |
| | Financial viability management | Ample | | | • Healthy buffers to capital requirements<br>• Comfortable funding and liquidity positions supported by a large deposit base<br>• Smooth repayment of TLTRO III, partly due to abundant excess reserves<br>• Liquidity ratios well above minimum requirements |
| | | Comfortable | | | |
| | | Adequate | | | |
| | | Limited | | | |
| | | Stretched | | | |
| | | At risk | | | |
| | Additional factors | Significant upside factor | | | ♦ No further considerations |
| | | Material upside factor | | | |
| | | Neutral | | | |
| | | Material downside factor | | | |
| | | Significant downside factor | | | |
| | **Standalone** | **bbb** | | | |
| STEP 3 | External support | Not applicable | | | |
| **Issuer rating** | | **BBB** | | | |

**Issuer profile**

Founded in Sondrio in 1871, Banca Popolare di Sondrio (BPS) is a medium-sized bank operating primarily in the wealthy Italian region of Lombardy. The bank's branch presence in other northern Italian regions is more limited. The group also comprises BPS Suisse (with 20 branches in Switzerland), Factorit and BNT Banca. Activities are focused on traditional commercial banking (loans, deposits and payment services) mainly for households and local SMEs. Over the years, the BPS group has developed solid, longstanding relations with customers, especially in its home province of Sondrio.

Once a cooperative bank, BPS transformed to a joint-stock company in December 2021. This opened up the bank's share capital to institutional investors. Currently, the largest shareholder is Unipol Gruppo Spa, with a 19.7% stake.

The group's operations are segmented as follows:

- Enterprises: including banking and leasing services for non-financial companies and producer households
- Individuals and others: encompassing banking activities with retail customers, public administrations, financial companies and nonprofit organisations
- Securities: comprising the management of client 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: including results from the group's proprietary portfolio and equity stakes

## Recent events

- In **March 2024**, BPS successfully issued a EUR 300m subordinated Tier 2 bond. This is above the EUR 200m the group had originally planned for the 2022-25 period. Demand from institutional investors was around EUR 1.8bn.
- In **February 2024**, the group reported record annual results. Widening interest margins boosted the group's revenues, while fee and commission income remained solid. The cost of risk increased YoY due to management's decision to build up generic provisions in case the macroeconomic environment deteriorates. The group's return on equity was at 13.8%.
- In **January 2024**, the group joined the UN Principles for Responsible Banking and the Net-zero Banking Alliance initiatives, as committed to in its 2022-25 strategic plan.
- In **December 2023**, BPS sold EUR 174m of bad loans through the multi-originator securitisation 'Luttazzi Pop Npls 2023'. This led to a decline in the gross NPE ratio to 3.7%.
- In **December 2023**, BPS announced that the group's Pillar 2 requirement had increased by 13 bp to 2.79%. The new requirement took effect on 1 January 2024.
- In **November 2023**, the group announced that from 1 January 2024, its binding MREL requirement was 23.10% of RWAs, excluding the combined buffer requirement. This is slightly higher than the interim requirement of 22.82%. The requirement based on leverage exposure remained at 5.90%.

## Rating drivers

***Focused regional franchise in the wealthy Italian region of Lombardy***

*BPS operates primarily in Italy. The 'supportive low' operating environment assessment is anchored to Italy's large and diversified economy constrained by high debt levels and limited fiscal flexibility. Being part of the European banking union, the regulatory and supervisory environment is considered highly supportive for the financial stability of banks. The assessment also considers the high fragmentation and low efficiency of the Italian banking system (see Box A).*

*The 'consistent low' business model assessment is based on BPS' deep-rooted retail and commercial banking franchise in a few provinces in Lombardy, Italy's wealthiest region. The soundness of BPS' business model is evidenced by its record of positive earnings. The assessment is limited by the group's sub-national profile and low business diversification compared to peers.*

Established local franchise

The group's business model is based on traditional commercial banking activities mainly for local entrepreneurs (i.e., micro and small firms) and households. Over the years, BPS has developed solid customer relationships, especially in its home province of Sondrio.

BPS owns one of the country's largest players in the factoring market, Factorit, which has contributed significantly to loan growth since 2022. The group enriches its offer with leasing, asset management, life and non-life insurance products developed by companies in which it holds stakes (Alba Leasing 19.3%, Arca Vita 14.8%, Arca Holding 34.7%). Finally, it is also active in the field of payroll/pension-deducted loans through its subsidiary BNT Banca.

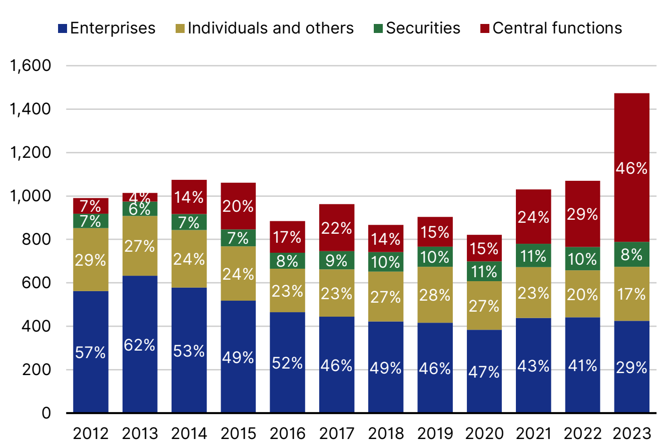
Regional bank with good market presence in Lombardy

BPS is a small player in the fragmented Italian banking market but has a dominant position in its home province of Sondrio (57% of branches) and relevant shares in Lecco and Como (around 24% in both). Its branch market share in Lombardy is close to 10%. Its main competitor in the province of Sondrio is Credit Agricole Italia, whereas Intesa, UniCredit and Banco BPM are its strongest rivals in Lombardy.

The group operates in Switzerland through BPS Suisse, which focuses on residential mortgages and private banking. Swiss activities account for approximately 10% of the group's revenue and assets and have a low risk profile.

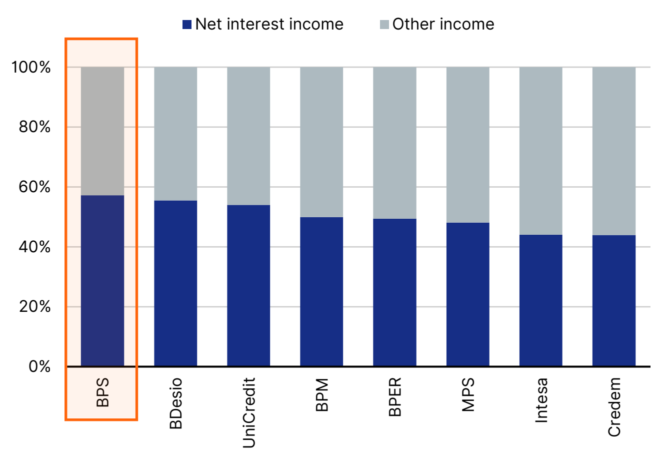
On average, BPS generates more than half of its revenues from net interest income, a percentage that has increased to over 60% since 2021 thanks to rising policy rates. This is above the domestic peer average, reflecting the group's gearing towards lending activities (Figure 2).

**Figure 1: Revenue breakdown by segment (EUR m)**




Source: SNL, Scope Ratings
Note: Segment results are affected by funding cost allocation

**Figure 2: Revenue breakdown – Italian peer comparison**

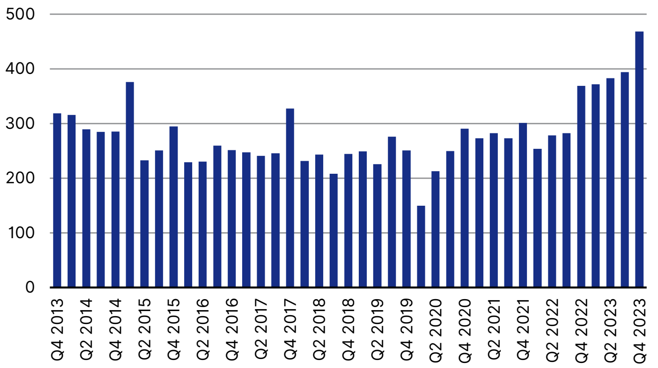



Source: Management data, Scope ratings
Note: Based on five-year average for 2019-2023

Proprietary portfolio has been a source of earnings volatility

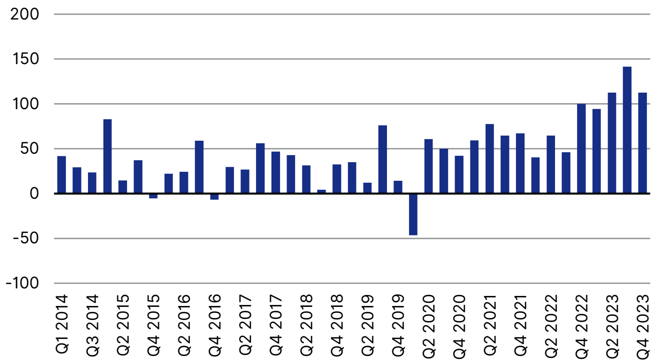
The group has a solid record of operating performance over the cycle, which we believe reflects the strength of its business model and more prudent underwriting standards than other regional banks in Italy. The main source of revenue and profit volatility has often been the group's proprietary portfolio, particularly the portion held for trading. In the past five years, the only quarterly loss was due to market losses at the beginning of the pandemic (Figure 4). To reduce volatility, BPS has cut the exposure to mutual funds, which are accounted for as financial assets held for trading.

**Figure 3: BPS – quarterly revenues (EUR m)**




Source: SNL, Scope Ratings

**Figure 4: BPS - quarterly net profit (EUR m)**




Source Company data, Scope ratings

In contrast to other Italian banks, BPS has not shrunk its branch network in recent years, opting instead for continued, measured expansion. This approach has enabled the group to extend its customer reach while maintaining good cost efficiency metrics.

In June 2022, following the transformation to a joint-stock company, BPS released its first public business plan. The group's strategy is based on three main guidelines:

i. Focus on 'distinctive areas', which are either the most profitable for the group or where it has a competitive edge. These include banking activities with SMEs and institutional entities (e.g. universities and private pension schemes) and the group's Swiss business. The group also envisages further cross-selling opportunities (e.g. insurance products).

ii. 'Qualified growth in high-value areas', such as the distribution of third-party asset management and insurance products, and the payment business.

iii. 'Digital evolution of customer relationships' to achieve multi-channel interactions. The plan entails sizeable investments in IT to strengthen the group's technological infrastructure and data management. BPS also aims to expand its digital product offer with products like instant lending.

The strategic targets were set in a lower interest rate environment. Consequently, barring a material economic downturn, we expect the group to comfortably exceed its 2025 earnings goals, which entail a return on average equity of 9.2%.

## Box A: Focus on BPS' main operating environment: Italy

### Economic assessment

- Italy is the world's eighth largest economy and the EU's third largest economy after Germany and France. It is the second largest manufacturer in the EU, with a significant trade surplus that has increased over the past decade.
- The economy is diversified, although one of its defining traits is the prevalence of small and micro enterprises, which are often family-owned. This is mirrored in banks' loan books, where SME loans often account for the lion's share.
- As of YE 2023, the country's real GDP per capita was in line with the EU average. However, wealth is concentrated in the north, while southern regions are behind in many social and economic aspects, such as growth, employment, infrastructure development and education.
- Historically, the country has suffered from low GDP growth, low growth potential, an ageing population and a lack of investment and structural reform.
- Scope expects growth to converge towards the long-term potential of 1%. But there is upside potential from an efficient implementation of public investments and reforms related to Next Generation EU funds (Italy will receive EUR 191.5bn by 2026).
- The government debt-to-GDP ratio is the second highest in Europe. High indebtedness, in the context of the rigid European fiscal framework, has constrained the government's ability to deploy countercyclical measures in past recessions.
- Italy is renowned for its chronic political instability (the country has had 68 governments in 77 years). Political turmoil can weigh on investor confidence and influence the spread between 10-year Italian bond yields and their German equivalent.

| Key economic indicators | 2021 | 2022 | 2023 | 2024E | 2025F |
|---|---|---|---|---|---|
| Real GDP growth, % | 8.3 | 4.1 | 1.0 | 0.6 | 1.2 |
| Inflation (HICP), % change | 1.9 | 8.8 | 5.9 | 1.5 | 2.3 |
| Unemployment rate, % | 9.5 | 8.1 | 7.7 | 7.5 | 7.3 |
| Pocily rate, % | -0.5 | 2.0 | 4.0 | 3.3 | 2.5 |
| Public debt, % of GDP | 147 | 142 | 137 | 138 | 137 |
| General government balance, % of GDP | -8.8 | -8.0 | -7.2 | -4.5 | -3.9 |

Scope macroeconomic forecast
Source: Scope Ratings

### Soundness of the banking sector

- Significant important banks, like BPS, are directly supervised by the ECB within the Single Supervisory Mechanism. Banking regulations in the country are largely aligned to the most recently agreed international standards, as set by the Basel Committee.
- The Italian banking system is highly fragmented, with a handful of banks competing at the national level beside regional and cooperative banks. Physical branches are still the predominant distribution channel, albeit declining at rapid pace (-38% since 2009, as of YE 2022).
- Over the past ten years, Intesa has absorbed weaker competitors and outgrown competitors such as UniCredit to become Italy's largest bank. In 2020, Intesa acquired UBI, cementing its market leadership. We believe Intesa's growth increases the pressure on other Italian banks.
- Consolidation is ongoing among medium-sized former popolari banks, with BPER emerging as an active consolidator. French group Crédit Agricole has also been expanding, taking over Creval and showing interest in further inorganic growth.
- The sector has long been characterised by low margins, high provisions (due to Global Financial Crisis-related non-performing loans) and lacklustre profitability. However, after cleaning up their balance sheets, banks are now enjoying a period of elevated profitability on the back of widening interest margins and very low credit costs.
- Customer deposits are the main source of funding for the system, while reliance on wholesale issuance has greatly diminished since the Global Financial Crisis. During the pandemic, Italian banks had access to hundreds of billions of euros of the ECB's targeted longer-term refinancing operations (TLTRO III).

| Banking system indicators | 2018 | 2019 | 2020 | 2021 | 2022 |
|---|---|---|---|---|---|
| ROAA, % | 0.5 | 0.4 | 0.1 | 0.4 | 0.6 |
| ROAE, % | 6.3 | 5.9 | 1.6 | 6.1 | 9.0 |
| Net interest margin, % | 1.4 | 1.4 | 1.3 | 1.2 | 1.4 |
| CET1 ratio, % | 13.2 | 14.2 | 15.5 | 16.7 | 16.8 |
| Problem loans/gross customer loans, % | 8.2 | 6.3 | 4.4 | 3.4 | 2.6 |
| Loan-to-deposit ratio, % | 120.1 | 120.1 | 113.2 | 108.8 | 106.7 |

Source: SNL, Scope Ratings

***Improved corporate governance and strong social commitment to its territory***

*The 'developing' long-term sustainability assessment reflects the group's progress on improving its corporate governance, including the transformation to a joint stock company and the reorganisation of the management structure. The assessment also considers the group's cooperative roots and the attention to the territories where it operates, indicating a strong sense of social responsibility and responsiveness to different stakeholder interests. However, we believe there is material room for improvement in terms of preparedness for digital competition.*

**Figure 5: Long-term sustainability overview table**[1]

| | Industry level | | | Issuer level | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Materiality | | | Exposure | | | Management | | | |
| | Low | Medium | High | Low | Neutral | High | Weak | Needs attention | Adequate | Strong |
| **E Factor** | | ◇ | | | ◇ | | | | ◇ | |
| **S Factor** | ◇ | | | | ◇ | | | | ◇ | |
| **G Factor** | | | ◇ | | ◇ | | | | ◇ | |
| **D Factor** | | | ◇ | | ◇ | | | ◇ | | |

Source: Scope Ratings

**Digitalization: BPS will face more competition as digital banking gains momentum**

Customer behaviour is rapidly changing in Italy as in Europe. With basic banking products becoming commoditised, BPS will need to increase investments in IT to keep up with a rapidly changing market. The group's relatively small size limits the resources available for digital investments and solutions. Over time this could become a competitive challenge, especially with respect to larger peers.

Hybrid approach to serving clients

As a former cooperative and regional player, BPS still values customer proximity and a physical presence in its territory. Rather than closing branches, the group has decided to modernise them to accommodate to changing customer needs. For instance, branch employees are increasingly spending more time on commercial and advisory activities, whereas traditional services are provided digitally.

**Governance: sizeable improvements in recent years**

In December 2021, the group approved the transformation to a joint stock company. This ended the one person, one vote principle that had governed the members' meeting, thus allowing for greater participation by institutional investors.

Strong governance record

Nudged by supervisors, BPS has recently reorganised its management team, aligning it with market norms for listed companies. Senior management now comprises a chief financial officer, a chief risk officer and a chief lending officer. We believe there is room for further improvement, for instance with respect to the staggered election of the members of the board directors and the number of independent directors (currently one third of the board). Nevertheless, BPS is on a gradual and steady path of improving governance.

[1] The ESG-D heatmap is not a scorecard but illustrates how each factor informs our overall assessment. The Materiality table shows how we assess the credit relevance of each factor for the entire European banking industry. The Exposure table shows to what extent the bank is exposed to risks or benefits from opportunities compared to peers, given its business model and countries of operation. The Management table shows how we view the bank's navigation through transitions.

While the group's previous governance structure was not aligned with market best practice, BPS has a strong governance record and has not been involved in mis-selling conduct like some peers. We consider this to be evidence of the group's conservative risk culture.

**Social: strong external profile, while there is room for improvement in relation to gender diversity and pay gap**

With respect to the 'social' factor, we view positively the group's strong ties to 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 despite the change in its legal form.

However, we believe the group has more to do with respect to gender diversity in top management and the gender pay gap.

**Environment: greater commitment in the current 2022-25 plan**

BPS has increased its efforts to manage environmental risks and keep up with the sector developments. We highlight actions such as the approval in 2021 of a climate policy to reduce direct impact and to manage the impact from lending/investing and in 2022 defining a path towards carbon neutrality and portfolio alignment. In 2024, the group joined the UN Principles for Responsible Banking and the Net-zero Banking Alliance initiatives, as committed to its 2022-25 strategic plan.

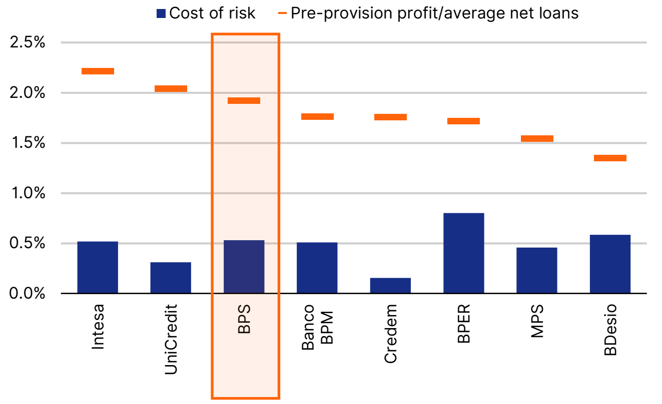
Based on EBA Pillar III climate risk disclosures, the group's corporate exposures contributing to climate change accounted for about 28% of total assets as of end-2023, higher than for Italian commercial banks and the international peer average. However, only 2% of corporate exposures were from sectors excluded from EU Paris Benchmarks. So far, BPS has set group-wide emission reduction targets (by 2030) in relation to proprietary lending exposure to four sectors: power, oil & gas, agriculture, and transportation.

| Box B: Overview of BPS' Pillar 3 disclosures on climate risk (data as of December 2023) | |
|---|---|
| **Sectors that contribute to climate change (banking book, exposure to non-financial corporations)** | Carrying amount: EUR 16.1bn (out of EUR 19.5bn) |
| | Of which exposures to companies excluded from EU Paris Benchmarks: EUR 0.3bn, 1.8% of total exposures to non-financial corporations |
| **Climate change transition risk**<br>**Exposures to top 20 carbon-intensive firms (banking book)** | None |

***Strong track record of low but resilient profitability coupled with greatly improved asset quality***

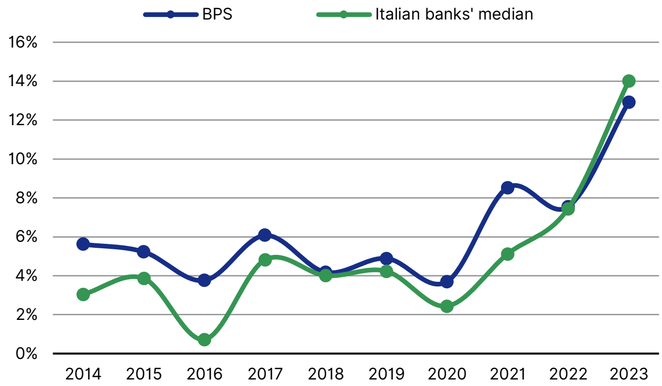
*The 'neutral' assessment of earning capacity and risk exposures is based on BPS' demonstrated ability to generate earnings throughout the cycle. It also acknowledges a material improvement in asset quality since 2017, with headline metrics now close to domestic and European peers.*

**Figure 6: Pre-provision income and impairments – peer comparison**




Source: SNL, Scope Ratings
Notes: Three-year averages based on 2021-2023. P&L data based on SNL reclassification

**Figure 7: Return on average equity – peer comparison**




Source: SNL, Scope Ratings
Note: Italian bank median includes the Italian peers listed on page 13

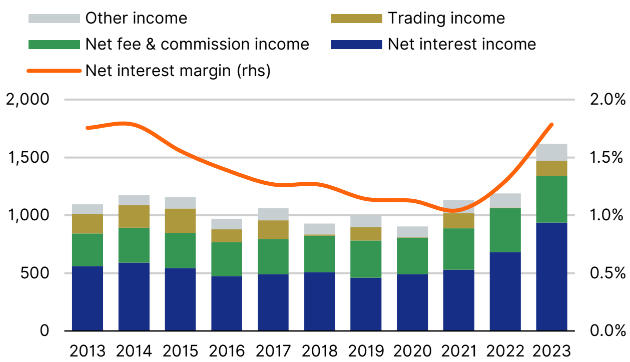
BPS has a solid earnings record. In the wake of the Global Financial Crisis, the group remained profitable while several domestic and international peers failed and needed recapitalisation. We believe that this was due to a mix of factors, including (i) a less opportunistic approach to lending, as reflected in a controlled cost of risk, (ii) resilient income from fees and commissions, which partly offset the decline in interest margins and, (iii) the absence of restructuring and legal costs.

Since 2021, the group's earnings have materially increased. The rise in policy rates has boosted margins on lending and the returns from the proprietary portfolio (primarily inflation-linked and floating rate notes). At the same time, fee and commission income has continued to rise. Revenue growth has outpaced the increase in costs, which was mostly inflation-driven. Credit losses have remained under control, with a low default rate while the impact from NPL disposals has been marginal.

In 2023, BPS reported a return on average equity of 13.8%, well above the target for 2025. Although we expect rates to start declining from the second half of the 2024, they are likely to remain above the level assumed by the group over the plan horizon. In addition, net fee and commission income will be supported by the group's strategic initiatives. For these reasons, we think that the group is well positioned to continue overperforming.

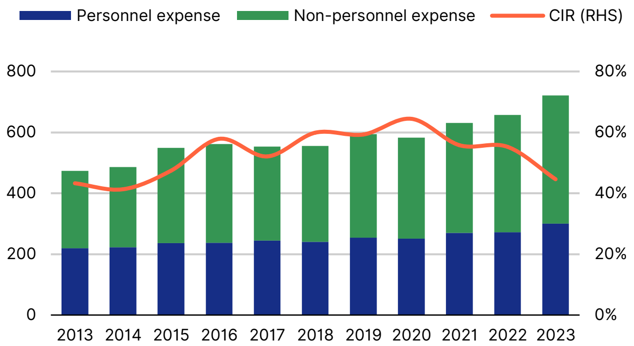
However, we also see risks. Lending activity may be strained by higher borrowing costs and sluggish economic growth. Likewise, credit losses may rise as default rates normalize. Management has guided to a cost of risk of around 50-60 bps, which is in line with Southern European peers.

**Figure 8: BPS - revenue profile (EUR m) and net interest margin**




Source: SNL, Scope Ratings
Note: P&L data based on SNL reclassification

**Figure 9: BPS – expense profile (EUR m) and cost-income ratio**



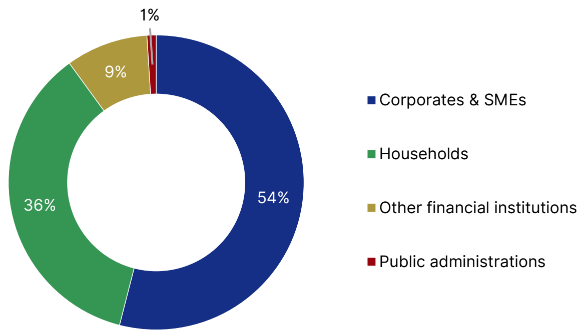

Source: SNL, Scope Ratings
Note: P&L data based on SNL reclassification

BPS' customer loan book is skewed towards business customers, particularly small companies, like for most Italian peers. However, short term factoring loans and Swiss mortgages, which are relatively low risk, make up around 30% of lending.

We note that business loan book is adequately diversified across economic sectors. Over the years, the group has developed expertise in serving specific customer groups, such as export-oriented companies and private pension schemes.

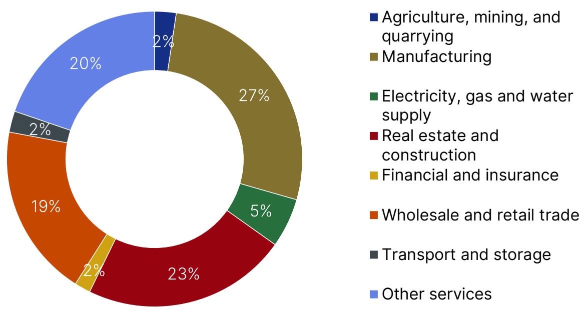
**Figure 10: Composition of loan book**

10.1 Breakdown of by customer type, YE 2023




Total net amount as of YE 2023: EUR 34.5bn.
Source: Company data, Scope Ratings

10.2 Focus on business loans, YE 2023




Total net amount as of YE 2023: EUR 19bn
Source: Company data, Scope Ratings

Asset quality continues to improve thanks to asset disposals and the low inflow of new non-performing exposures. As of YE 2023, the group's gross NPE ratio stood at 3.7%, close to the domestic average, and already below the 2025 target of 3.8%.

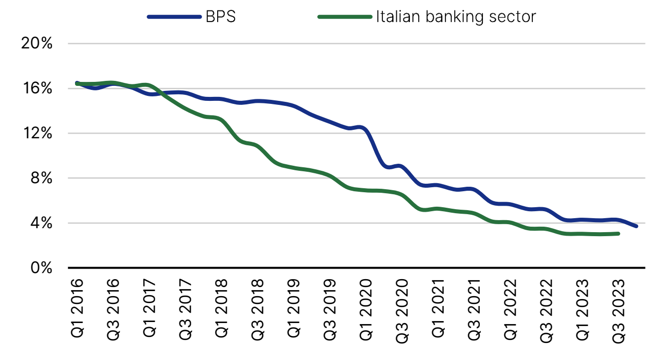
De-risking activity is not over

While the group was slower than Italian peers to dispose of legacy NPLs, its approach is now aligned with that of the sector. Hence, we do not exclude further NPL disposals in the coming years.

Loan book performance has been resilient

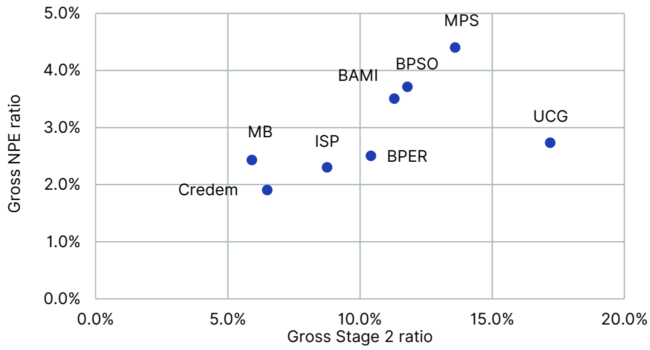
Loan performance has been resilient under a challenging macroeconomic backdrop characterized by high borrowing costs and slowing economic growth. In 2023, the group's default ratio was very low at 1.1%. In this context, we view positively management's Q4 decision to increase the coverage on performing loans to align it with the domestic peer average. The cushion of post-model adjustments (overlays) now amount to EUR 200m, equivalent to more than 50 bp of customer loans.

**Figure 11: Decline in gross NPE ratio has accelerated since 2020**




Source: Company data, Bank of Italy, Scope Ratings

**Figure 12: Gross NPE and Stage 2 ratios as of YE 2023, Italian peer comparison**




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

High exposure to domestic sovereign risk

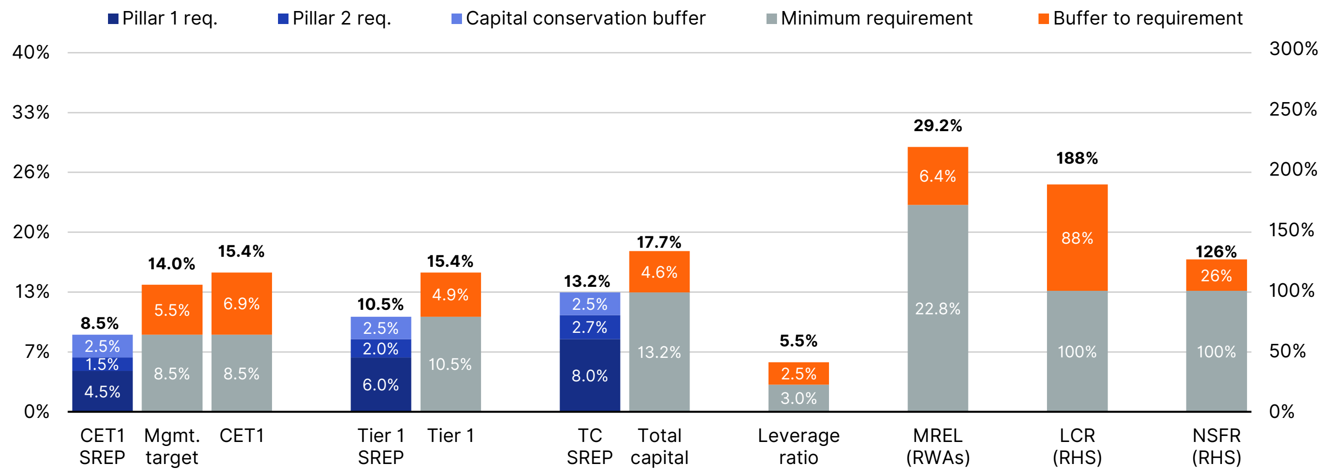
Among large and mid-tier Italian banks, BPS has the largest exposure to Italian sovereign bonds. As of December 2023, the group held EUR 6.8bn in Italian government bonds, accounting for 50% of the total bond portfolio and equivalent to about 194% of Tier 1 capital. Most of the Italian government bonds are held at amortised cost, limiting the sensitivity of the group's regulatory capital ratios to sovereign spread volatility. Moreover, the modified duration of the sovereign bond portfolio is contained as most of the exposure is floating notes.

We do not consider the credit exposure to sovereign risk as a constraint for the assessment of BPS' earnings capacity and risk exposures. We estimate that the group could withstand significant losses on its sovereign bond portfolio in the unlikely event of a sovereign default while retaining its regulatory viability. Further, the Italian sovereign rating of BBB+ is one notch above BPS' rating.

***Comfortable financial viability, with material headroom to minimum requirements***

*The 'comfortable' financial viability management assessment reflects not only BPS' current high buffers over regulatory requirements but also our view that the group will continue to maintain them. The assessment also considers the group's solid funding position underpinned by a stable deposit base.*

**Figure 13: Overview of distance to requirements, as of end-December 2023**




Source: SNL, company data, Scope Ratings
Note: phased-in capital ratios and requirements as of YE 2023

Following the ECB's approval of the bank's AIRB models for retail and corporate exposures in 2019, BPS has maintained large buffers to minimum capital requirements. This has also given the group more flexibility to accelerate balance sheet de-risking and to pursue business growth.

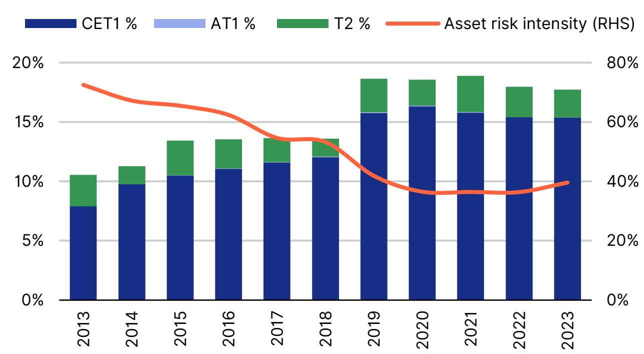
CET1 ratio expected to remain above 15% over next two years

The group has set a minimum threshold for its CET1 ratio of 14%, reflecting its prudent approach to capital management. Over the next two years, we expect the group's solvency position to remain robust as organic capital generation offsets the impact of RWA inflation and regulatory headwinds (mainly related to Basel IV). In June 2022, BPS committed to a 50% pay-out ratio, which was increased to 55% for 2024 given the recent strong operating performance. This level is in line with the average for Italian regional banks.

Given strong organic capital generation and unfavorable pricing, the group has not issued AT1 securities. Instead, the group uses CET1 capital and Tier 2 bonds to fulfill its requirements.

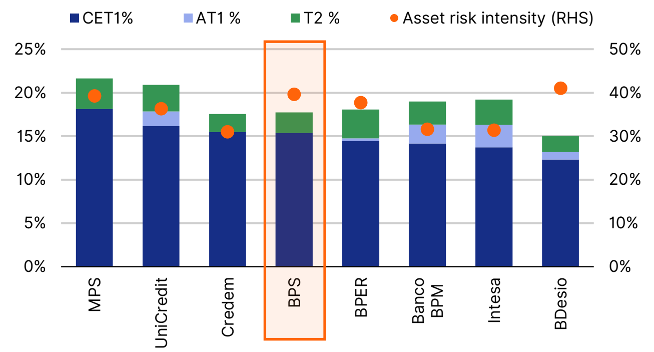
**Figure 14: Key capital metrics**

14.1 Historical evolution




Source: SNL, Scope Ratings

14.2 Italian peer comparison at YE 2023




Source: SNL, Scope Ratings
Note: Data for BDesio and Credem refer to their respective financial holdings

BPS' balance sheet is mostly funded by deposits

The group funds itself primarily via current accounts and sight deposits, a common feature among Italian commercial banks. Deposits accounted for more than two-thirds of total funding as of December 2023. Over the past decade, the growth of the deposit base has gone hand in hand with the expansion of the balance sheet, and the loan/deposit ratio has remained stable at around 90%.

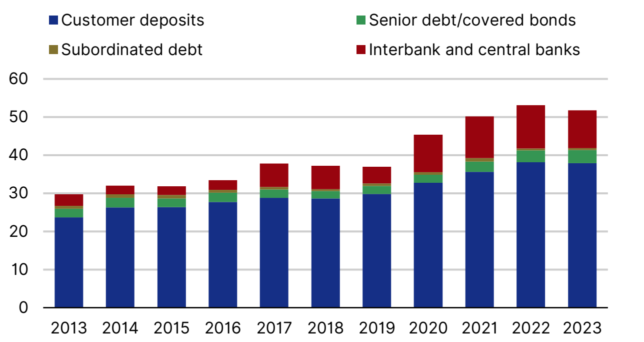
In the first half of 2023, the rapid rise in interest rates induced some customers, notably private pension schemes, to withdraw their deposits. But after an initial decline, volumes grew again in the second half, partly thanks to the group's marketing of term products. Recent trends highlight the stickiness of the group's deposits. If competition for deposits intensifies and liquidity in the system shrinks, the group will need to manage the trade-off between higher funding costs and lower deposit volumes.

BPS made full use of the ECB's TLTRO III programme during the Covid pandemic. Take-up reached EUR 8.9bn, i.e., more than 15% of total balance sheet. As of April 2024, the group has repaid more than half of the outstanding amount. The group plans to use both excess liquidity and the proceeds from the sale of bonds to cover the remaining maturity of EUR 3.7bn due in September 2024.

Outstanding debt (retail + wholesale) stands at EUR 4.4bn, making up about 8.7% of the group's total funding. BPS aims to become a regular issuer in the institutional market in the coming years, as it needs to increase bond funding for MREL purposes.

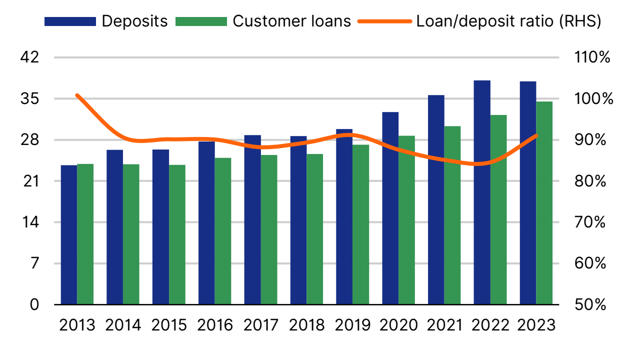
From 1 January 2024, the group must meet an MREL requirement of 22.82% of risk-weighted assets (excluding the combined buffer requirement) and 5.90% of leverage exposure on a consolidated basis. As of YE 2023, the group's MREL ratios comfortably exceeded both requirements. The group has not received a subordination requirement.

**Figure 15: BPS - Funding breakdown (EUR bn)**




Source: SNL, Scope Ratings

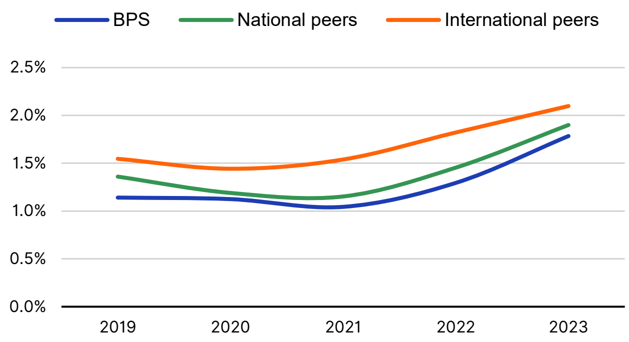
**Figure 16: BPS - Loan and deposit volumes (EUR bn)**



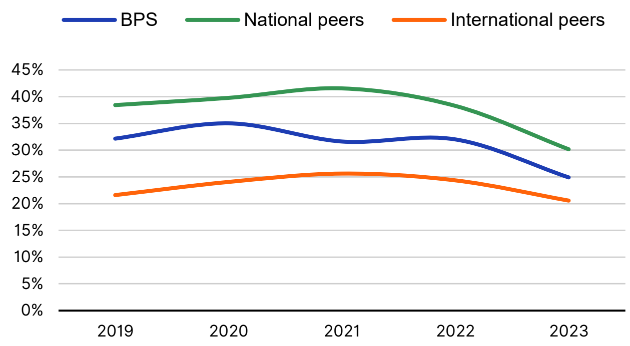

Source: SNL, Company data, Scope Ratings

## I. Appendix: Peer comparison

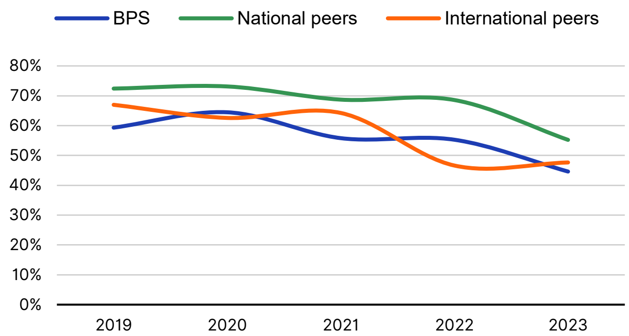
Net interest margin



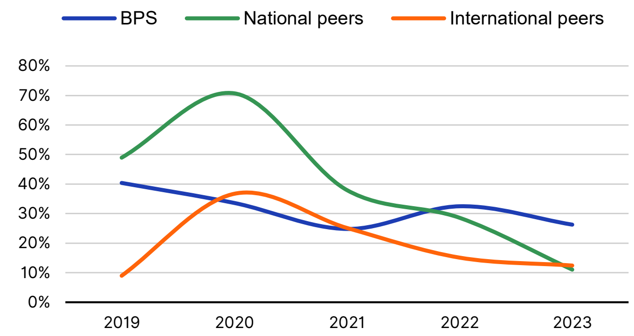

Fees & commissions/revenues



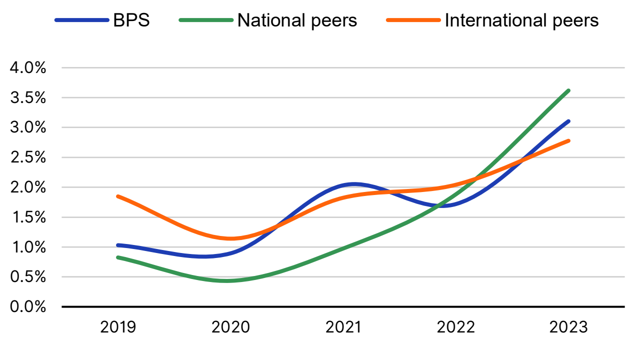

Cost/income ratio



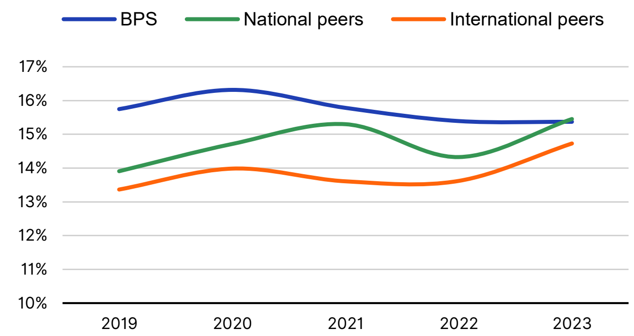

Impairment on financial assets/pre-impairment profit




Pre-tax return on RWAs




Phased-in CET1 ratio




National peers: Intesa Sanpaolo, UniCredit, Banco BPM, Banca Monte dei Paschi di Siena, BPER Banca, Credito Emiliano, Banco di Desio e della Brianza, Banca Sella Holding, Banca Popolare di Bari, Banca Popolare dell'alto Adige, Cassa di Risparmio di Asti
International peers: SpareBank 1 Nordmore, Unicaja Banco, Ibercaja Banco, Oldenburgische Landesbank, BAWAG Group
Source: SNL, Scope Ratings

### II. Appendix: Selected financial information* – Banca Popolare di Sondrio SpA

| | 2019 | 2020 | 2021 | 2022 | 2023 |
|---|---|---|---|---|---|
| **Balance sheet summary (EUR m)** | | | | | |
| **Assets** | | | | | |
| Cash and interbank assets | 2,894 | 8,687 | 8,929 | 8,856 | 6,669 |
| Total securities | 3,237 | 3,496 | 4,130 | 3,447 | 3,905 |
| of which, derivatives | 32 | 60 | 29 | 63 | NA |
| Net loans to customers | 33,393 | 35,900 | 39,845 | 42,368 | 43,409 |
| Other assets | 1,623 | 1,724 | 2,111 | 3,183 | 3,739 |
| **Total assets** | **41,146** | **49,808** | **55,016** | **57,854** | **57,722** |
| **Liabilities** | | | | | |
| Interbank liabilities | 4,328 | 9,827 | 10,875 | 11,382 | 9,918 |
| Senior debt | 2,091 | 2,132 | NA | NA | NA |
| Derivatives | 78 | 40 | 107 | 116 | 72 |
| Deposits from customers | 29,817 | 32,728 | 35,603 | 38,122 | 37,916 |
| Subordinated debt | 714 | 699 | NA | NA | NA |
| Other liabilities | 1,182 | 1,286 | NA | NA | NA |
| **Total liabilities** | **38,209** | **46,712** | **51,641** | **54,467** | **53,912** |
| Ordinary equity | 2,842 | 2,998 | 3,270 | 3,387 | 3,809 |
| Equity hybrids | 0 | 0 | 0 | 0 | 0 |
| Minority interests | 95 | 98 | 105 | 0 | 0 |
| **Total liabilities and equity** | **41,146** | **49,808** | **55,016** | **57,854** | **57,722** |
| *Core tier 1/ common equity tier 1 capital* | *2,712* | *2,967* | *3,163* | *3,240* | *3,513* |
| **Income statement summary (EUR m)** | | | | | |
| Net interest income | 460 | 490 | 529 | 681 | 937 |
| Net fee & commission income | 322 | 316 | 358 | 381 | 403 |
| Net trading income | 114 | 2 | 131 | 5 | 131 |
| Other income | 106 | 95 | 113 | 122 | 146 |
| **Operating income** | **1,002** | **904** | **1,131** | **1,189** | **1,617** |
| Operating expenses | 594 | 583 | 631 | 657 | 721 |
| **Pre-provision income** | **408** | **321** | **500** | **532** | **896** |
| Credit and other financial impairments | 165 | 108 | 124 | 173 | 235 |
| Other impairments | 3 | 7 | 2 | 5 | NA |
| Non-recurring income | 0 | 0 | 0 | 0 | 0 |
| Non-recurring expense | 45 | 49 | 0 | 0 | 0 |
| **Pre-tax profit** | **195** | **157** | **375** | **354** | **660** |
| Income from discontinued operations | 0 | 0 | 0 | 0 | 0 |
| Income tax expense | 56 | 47 | 100 | 103 | 199 |
| Other after-tax Items | 0 | 0 | 0 | 0 | 0 |
| Net profit attributable to minority interests | 2 | 3 | 6 | 0 | 0 |
| **Net profit attributable to parent** | **137** | **107** | **269** | **251** | **461** |

Source: SNL, Scope Ratings
Note: Reclassified financial information could differ from "reported financials"

**III. Appendix: Selected financial information* – Banca Popolare di Sondrio SpA**

| | 2019 | 2020 | 2021 | 2022 | 2023 |
|---|---|---|---|---|---|
| **Funding and liquidity** | | | | | |
| Net loans/ deposits (%) | 111% | 109% | 111% | 110% | 114% |
| Liquidity coverage ratio (%) | NA | 252% | 164% | 161% | 188% |
| Net stable funding ratio (%) | NA | 128% | 132% | 129% | 126% |
| **Asset mix, quality and growth** | | | | | |
| Net loans/ assets (%) | 81.2% | 72.1% | 72.4% | 73.2% | 75.2% |
| Problem loans/ gross customer loans (%) | 10.5% | 5.5% | 4.0% | 3.0% | 3.0% |
| Loan loss reserves/ problem loans (%) | 61.1% | 67.3% | 70.1% | 75.4% | 76.3% |
| Net loan growth (%) | 5.1% | 7.5% | 11.0% | 6.3% | 2.5% |
| Problem loans/ tangible equity & reserves (%) | 71.9% | 46.0% | 36.7% | 30.4% | 27.6% |
| Asset growth (%) | 0.0% | 21.1% | 10.5% | 5.2% | -0.2% |
| **Earnings and profitability** | | | | | |
| Net interest margin (%) | 1.1% | 1.1% | 1.0% | 1.3% | 1.8% |
| Net interest income/ average RWAs (%) | 2.4% | 2.8% | 2.9% | 3.3% | 4.4% |
| Net interest income/ operating income (%) | 45.9% | 54.2% | 46.8% | 57.3% | 58.0% |
| Net fees & commissions/ operating income (%) | 32.2% | 35.0% | 31.6% | 32.0% | 24.9% |
| Cost/ income ratio (%) | 59.3% | 64.5% | 55.8% | 55.3% | 44.6% |
| Operating expenses/ average RWAs (%) | 3.1% | 3.3% | 3.4% | 3.2% | 3.4% |
| Pre-impairment operating profit/ average RWAs (%) | 2.2% | 1.8% | 2.7% | 2.6% | 4.2% |
| Impairment on financial assets / pre-impairment income (%) | 40.4% | 33.6% | 24.8% | 32.5% | 26.3% |
| Loan loss provision/ average gross loans (%) | 0.5% | 0.3% | 0.3% | 0.4% | 0.5% |
| Pre-tax profit/ average RWAs (%) | 1.0% | 0.9% | 2.0% | 1.7% | 3.1% |
| Return on average assets (%) | 0.3% | 0.2% | 0.5% | 0.5% | 0.8% |
| Return on average RWAs (%) | 0.7% | 0.6% | 1.5% | 1.2% | 2.2% |
| Return on average equity (%) | 4.9% | 3.7% | 8.5% | 7.6% | 12.9% |
| **Capital and risk protection** | | | | | |
| Common equity tier 1 ratio (%, fully loaded) | 15.7% | 16.2% | 15.7% | 15.3% | 15.1% |
| Common equity tier 1 ratio (%, transitional) | 15.7% | 16.3% | 15.8% | 15.4% | 15.4% |
| Tier 1 capital ratio (%, transitional) | 15.8% | 16.4% | 15.8% | 15.4% | 15.4% |
| Total capital ratio (%, transitional) | 18.6% | 18.5% | 18.9% | 18.0% | 17.7% |
| Leverage ratio (%) | 6.1% | 5.5% | 5.3% | 5.1% | 5.5% |
| Asset risk intensity (RWAs/ total assets, %) | 41.9% | 36.5% | 36.4% | 36.4% | 39.6% |
| **Market indicators** | | | | | |
| Price/ book (x) | 0.3x | 0.3x | 0.5x | 0.5x | 0.7x |
| Price/ tangible book (x) | 0.3x | 0.3x | 0.5x | 0.5x | 0.7x |
| Dividend payout ratio (%) | NA | 25.0% | 33.9% | 50.9% | 54.9% |

Source: SNL, Scope Ratings
Note: Reclassified financial information could differ from "reported financials"

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## Related research

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## Applied Methodology

Financial Institutions Rating Methodology, February 2024


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