16 April 2018

Financial Institutions

Intesa Sanpaolo Spa
Issuer Rating Report

STABLE

A

Overview

Scope Ratings has assigned an Issuer Rating of A to Intesa Sanpaolo SpA. On 25 January 2018, Scope Ratings upgraded the institution's senior unsecured debt not eligible for MREL from A- to A and assigned a rating of A- to Intesa's senior unsecured debt eligible for MREL. All ratings have a Stable Outlook. The rating action followed the introduction of a new category of non-preferred senior debt by the Italian government's 2018 budget law. The short-term rating is S-1, with a Stable Outlook.

The ratings were not solicited by the issuer. Both ratings and analysis are based solely on publicly available information. The issuer has participated in the process.

Highlights

- The ratings are driven by Intesa's strong capital position and resilient profitability despite the challenging operating environment in Italy, where 81% of the loan portfolio is based. The group has been the leading retail and commercial bank in Italy since the merger of Intesa BCI and San Paolo IMI in 2007. Group earnings and asset quality have suffered from the weak domestic economic environment in the past, but pre-provision profitability has been resilient, and the group has remained profitable if we exclude large write-downs of goodwill in 2011 and 2013.

- Although it has operations in Central and Eastern Europe, Intesa's primarily domestic-based operations, combined with significant holdings in Italian sovereign debt, mean it is particularly exposed to market confidence in Italian banks and Italy in general.

Rating drivers (summary)

The rating drivers, in decreasing order of importance in the rating assignment, are:

- Largest retail and commercial bank in Italy which remained profitable during the crisis
- A balanced revenue model, with significant fee-generating activities supporting profitability
- Challenged but improving asset quality
- Strong capital position and good capital generation potential going forward
- Decreasing but still material sovereign risk exposure remains a concern

Ratings & Outlook

Issuer Rating	A
Outlook	Stable
Senior unsecured debt	A
Senior unsecured debt (MREL/TLAC eligible)	A-
Short-term rating	S-1
Additional Tier 1 instruments	BB+
Short term debt rating outlook	Stable

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Bloomberg: SCOP

Rating change drivers

Further progress in the workout of non-performing loans. The decline in non-performing exposure (NPE) formation in recent quarters, was coupled with a decline in NPEs in absolute numbers (both in gross and net terms) and an increase in coverage. We believe that the reversal in asset quality trends is partly due to the more favorable macro environment but also to a sharper focus on the management of NPEs at Intesa. The recently presented 2018-2021 business plan included a commitment to significant further debt recovery by means of a proactive credit portfolio management, the carve-out of its internal recovery platform, a new early delinquency detection tool for retail exposures and more openness towards portfolio sales.

Political risk and potential impact of Italian elections. The March general election has failed to deliver a clear winning coalition and the formation of stable government looks like a far-from-certain outcome, with the possibility of prolonged negotiations and new elections in the near future. With several Italian parties exhibiting Eurosceptic and populist tendencies, political uncertainty could reverberate through credit markets negatively impacting the price of Italian government bonds in the securities portfolio or raising Intesa's cost of funding on wholesale markets.

Event risk. As the largest and healthiest bank in Italy, Intesa may be subject to political pressure to intervene to support weaker institutions. Such risk materialised in 2017, when Intesa announced that it was acquiring the certain assets and liabilities of Veneto Banca and Banca Popolare di Vicenza. However, it only purchased performing assets, at no cost, in return for a cash contribution from the government to neutralise the impact on its capital ratios, with guarantees on the performance of high risk assets and with the government taking on the bulk of the planned restructuring costs. In our view, the very firm terms dictated are a good indication that Intesa's management is unlikely to bow to political pressure.

Rating drivers (details)

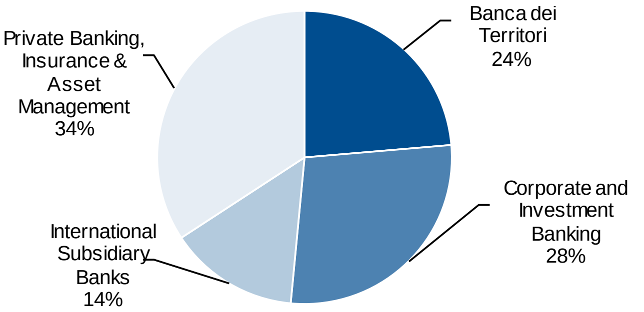
Largest retail and commercial bank in Italy which remained profitable during the crisis

Two large banks dominate the Italian banking landscape, with the residual market share split between a multitude of mid and smaller-tier players. Intesa is the leading retail and commercial bank in Italy with approximately 4700 branches in the country. Formed in 2007 through the merger of Gruppo Intesa BCI and Gruppo Sanpaolo IMI, Intesa is represented throughout the country and has a particularly strong footprint in the wealthiest regions of northern Italy. The group holds the number one position in loans (market share 18%), deposits (18%), pension funds (22%), life premiums (20%), factoring (29%) and asset management (20%).

Half of the group's operating revenues are derived from Banca dei Territori (domestic commercial banking) which offers traditional lending and deposit collection operations in Italy, servicing households, small businesses, SMEs, and Italian mid-size corporations with a turnover of up to EUR 350m, and distributing the group's asset management, insurance and private banking products. In terms of profits, however, Banca dei Territori only accounts for 24% of the group. The Private Banking, Insurance and Asset Management divisions account for 34% of group profit, excluding distribution fees. The other main contributor to profit is corporate and investment banking, which serves large corporate clients and financial institutions as well as public finance entities. In terms of international operations, the group is present in 10 countries, primarily in Central and Eastern Europe as well as in Egypt, with approximately 1,000 branches. The largest international operations are in Slovakia, Croatia and Hungary. As of year-end 2017, international subsidiary banks accounted for 11% of operating income and 7% of the total loan portfolio. Intesa's foreign presence, while material, does not contribute to significant revenue and asset diversification from the Italian market.

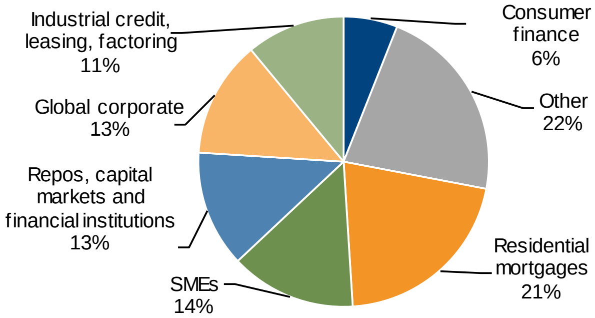
With 81% of total loans in Italy, Intesa Sanpaolo is heavily dependent on the performance of the Italian economy. The loan book is diverse (Figure 2) within its main segments: residential mortgages (22%, with an average loan-to-value ratio of 56% at year-end 2017); SMEs (14%); and repos, capital markets and financial institutions (13%). The group's loan exposure to non-financial companies is well-diversified by sector, with no single sector accounting for more than 6% of the total. The largest sectors are: services (5.8% of total loan portfolio), distribution (5.7%) and real estate (3.7%).

Figure 1: Net profit by division (2017)



Note: excluding Corporate Centre
Source: Company data, Scope Ratings.

Figure 2: Loan book composition (2017)



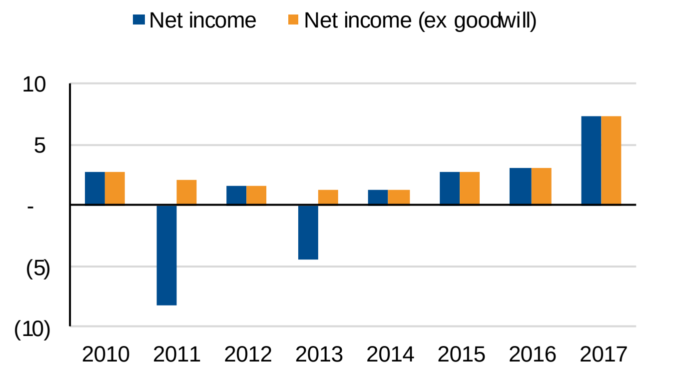
Source: Company data, Scope Ratings.

Despite the difficult operating environment in its domestic market, Intesa has remained largely profitable at the operating level, and in 2017 posted its highest level of net on record.

Indeed, while it has posted net statutory losses in 2011 and 2013 due to large write-downs of goodwill, operating performance has remained satisfactory, with pre-provision income able to absorb significant provisions, especially in 2013 (see Figure 4). The strong fee generating business, in particular strong net inflows in asset management since 2013, have kept profit in line with the preset objectives and successful execution of the expiring business plan.

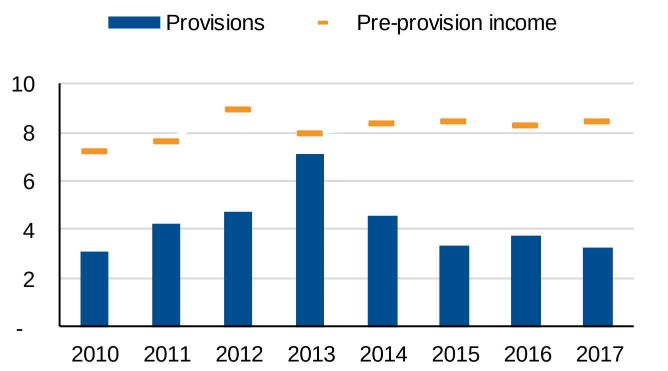
In February 2018 Intesa presented a new business plan for the 2018-2021 period. Cost cutting remains a central element in the business plan with a very ambitious target of reducing the cost/income ratio from a current 53% to 45%. Measures include the closure of 1,100 branches and cutting of the workforce from 97,400 to 90,800 employees, the rationalisation of the real estate portfolio, the reduction of legal entities, and tight control over administrative costs.

Figure 3: Intesa's losses were entirely driven by goodwill impairments (EUR bn)



Source: Company data, Scope Ratings.

Figure 4: Pre-provision profitability has been enough to absorb rising credit provisions (EUR bn)



Source: Company data, Scope Ratings.

A balanced revenue model, with significant fee-generating activities supporting profitability

In our view, one key aspect supporting Intesa's revenue-generating potential is the diversification of its revenue sources. According to our calculations, fee income in 2017 amounted to 45% of total group revenues, a percentage higher than that of Intesa's domestic and international peers. In an operating environment in which interest revenues have been and remain under pressure from slow volumes, low policy rates and low yields on securities, we consider the flexibility to generate alternative income from non-banking activities an important competitive advantage.

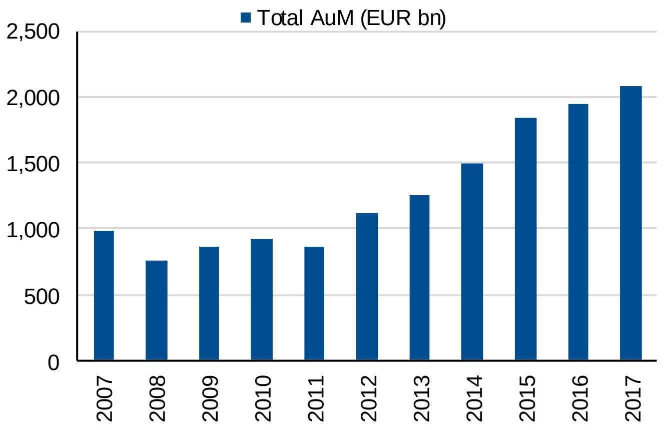
In particular, we highlight the strong performance of Intesa's asset management division Eurizon, but also of the private bank Fideuram, with net inflows of EUR 93bn since 2013, and the insurance business, contributing 11% of gross income.

Going forward, we expect these divisions to continue to drive revenue growth at Intesa. Industry data shows that the Italian asset management industry has been performing very strongly in recent years (Figure 5).

In our view, two important drivers for such solid performance remain in place:

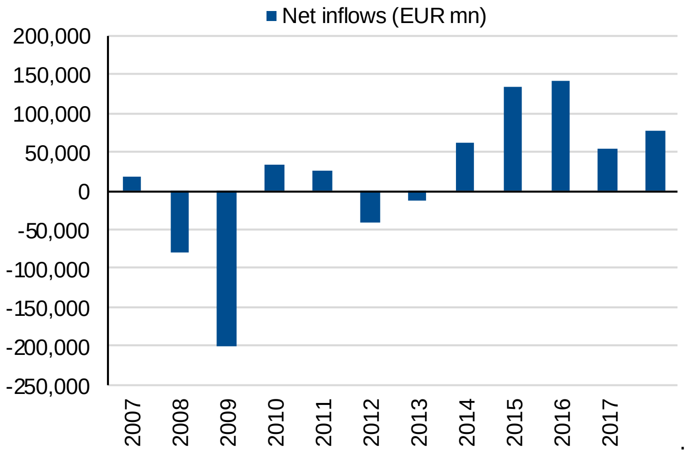
1. Savers' demand for higher returns while central bank policies keep yields low;
2. Banks' lower need for balance sheet customer funds, as limited volume growth coupled with advantageous funding allows them to focus distribution networks on higher margin products.

Figure 5: System assets under management are growing



Source: Assogestioni, Scope Ratings

Figure 6: Net Inflows into mutual funds



Source: Assogestioni, Scope Ratings

In our view, Intesa is well positioned to continue to capture the growth in the Italian asset management, supporting revenues going forward. Future revenue growth in asset management may also arise from new Wealth Management opportunities in China. With its subsidiary Yi Tsai (100% owned) and joint ventures Penghua (49% owned – EUR 75bn under management) and Bank of Qingdao (15% owned), Intesa has established another growth option in emerging markets.

In the new 2017-2021 business plan period, Intesa is targeting a 4% average annual growth in revenues, assuming moderate growth in Italian GDP and market rates still at zero in 2021. Revenue growth would mostly be fuelled by loan volume dynamics (in mortgages, personal loans, SMEs and the international division) and by fees, expected to expand at a 5.5% CAGR.

Challenged but improving asset quality

The Italian economy has been in recession since 2014 but has been growing in recent years and we expect it to continue to expand. As a result of the recession, the group's gross NPE ratio reached a peak of 17.2% in September 2015 before starting to decline, reflecting the improved operating conditions in Italy. As of December 2017, and including the provisions for IFRS 9, the group's gross NPE ratio stood at 11.9%, with coverage of 56.8%. The net NPE ratio stood at 5.5%. The group has successfully executed the accelerated deleveraging of about EUR 13bn in NPEs since September 2015. The new 2018-2021 business plan envisages a further reduction in the NPE stock and a material derisking of the balance sheet, supported by the more favourable macro environment.

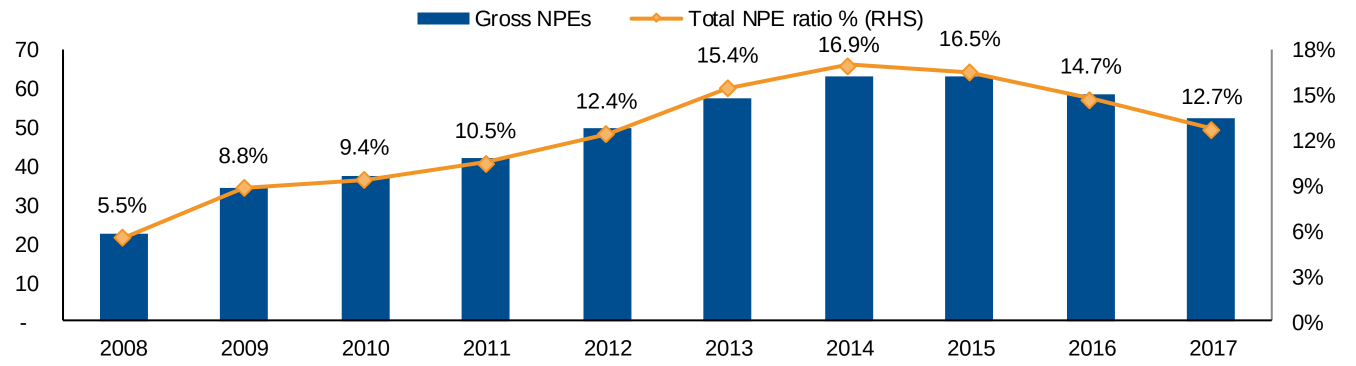
Key targets include:

- A decline in gross NPEs from EUR 52.1bn to EUR 26.4bn in 2021, i.e. from 11.9% to 6% of gross loans;
- A net NPE ratio of 2.9% in 2021;
- A fall in loan loss provisions to EUR 1.8bn by 2021 (EUR 3.3bn in 2017), with the cost of risk halving from the current 81 bps to 41 bps.

Key tools for achieving derisking include the carve-out of Intesa's recovery platform and the potential search for an industrial partner, portfolio sales, the creation of Pulse, a new early warning system for delinquencies in retail loans, and a generally more proactive approach to borrower credit quality management.

In our view, the objectives are realistic and achievable in the current environment.

Figure 7: Gross NPEs (EUR bn, LHS) and NPE ratio (%, RHS)



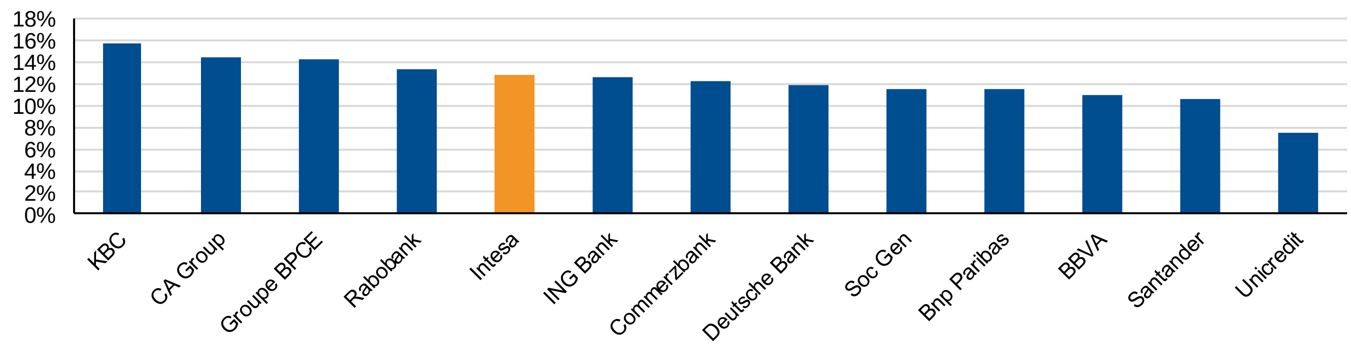
Source: Company data, Scope Ratings.
Note: Impaired loans = sofferenze + past due, Data excludes the contribution of the former Venetian banks

Strong capital position and good capital generation potential going forward

Despite the weak operating environment, Intesa has significantly improved its capital position in recent years.

As of December 2017, the group's CRD IV fully loaded CET1 ratio was 13.0%[1], at the high end of Eurozone banks (see Figure 8). On a transitional basis, the CET1 ratio stood at 13.3%. Moreover, Intesa's high profitability coupled with limited RWA growth means that the bank generates capital organically.

Figure 8: CRD IV fully loaded CET1 ratio, selected eurozone banks (2017)



Source: Company data, Scope Ratings

In terms of leverage ratio, Intesa is one of the strongest large banks in Europe. The reported fully loaded leverage ratio in December 2017 was 6.1%.

Decreasing but still material sovereign risk exposure remains a concern

As discussed in our sovereign outlook report on Italy, we consider Italy to have a low-to-medium sovereign credit strength among the large European economies. Italy maintains a high debt position and suffers from an elevated degree of political uncertainty when compared to other Eurozone countries.

[1] After IFRS9 FTA impact

In recent years, Italy has succeeded in bringing its public deficit under control (2.3% of GDP in 2016, down from 5.3% of GDP in 2009[2]) despite the decline in GDP in the recessionary period. This was mainly achieved through the introduction of new taxes, but also via measures to contain public spending, including a freeze on public sector wages and a reform of the pension system.

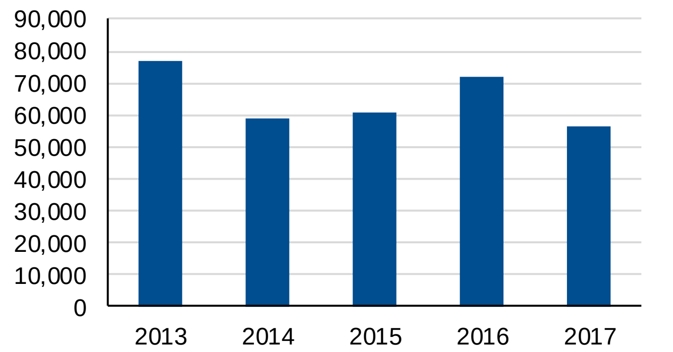
As the largest Italian bank, Intesa's exposure to Italian sovereign risk is material. As a result, the group is vulnerable to negative investor sentiment regarding the Italian sovereign.

In December 2017, Intesa's total exposure to Italian sovereign risk decreased to approx. EUR 40bn, including EUR 13bn of loans and EUR 27bn of debt securities, compared to approx. EUR 50bn at YE 2016 and over EUR 60bn at the end of 2014. Despite having fallen, this amount still represents an important concentrated exposure, close to 105% of group transitional CET1 capital.

We also note that over the past few quarters, the group has diversified its sovereign bond portfolio, adding exposures to several EU countries, especially Germany, France and Spain.

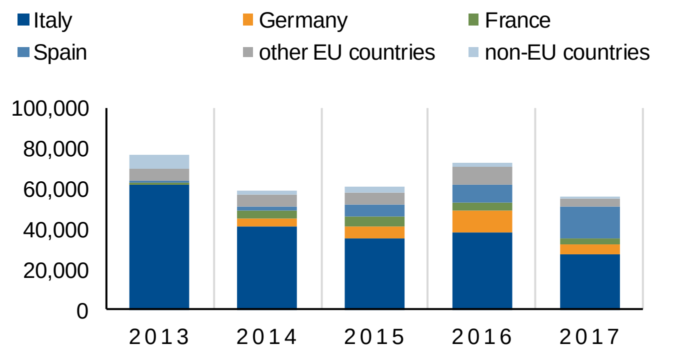
In 2013, Italian government bonds accounted for approx. 80% of the total sovereign bond portfolio, a portion that declined to around 40% in 2017. We have a favourable view of this trend, also in light of the ongoing regulatory and market debate around the capital absorption (or lack of thereof) of sovereign exposures and the potential for concentration limits.

Figure 9 Total Sovereign bond portfolio (EUR m)*



Source: Company data
*Banking business

Figure 10: Sovereign bond portfolio composition (EUR m)*

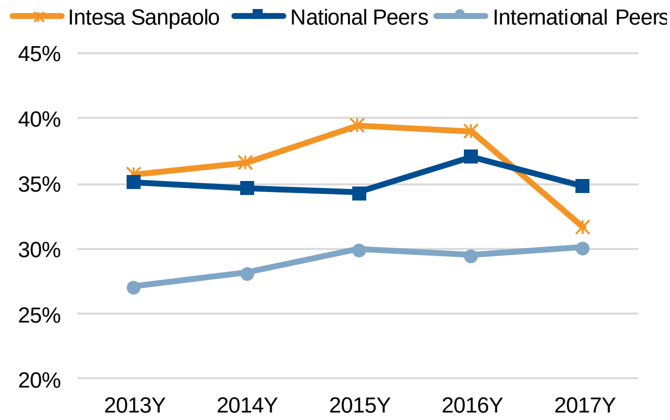


Source: Company data
*Banking business

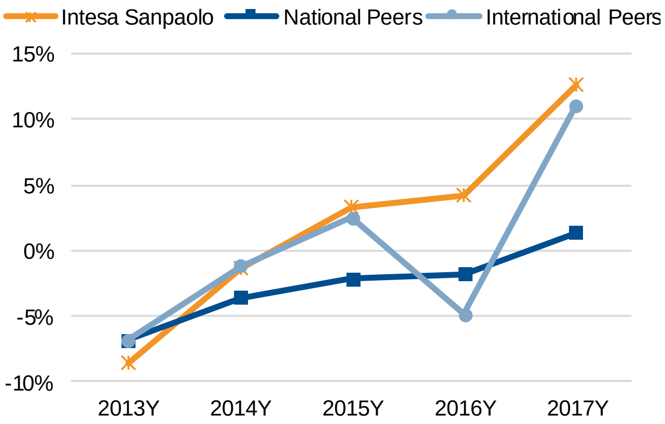
[2] Source: European Commission 2017 winter forecast, Eurostat

I. Appendix: Peer comparison

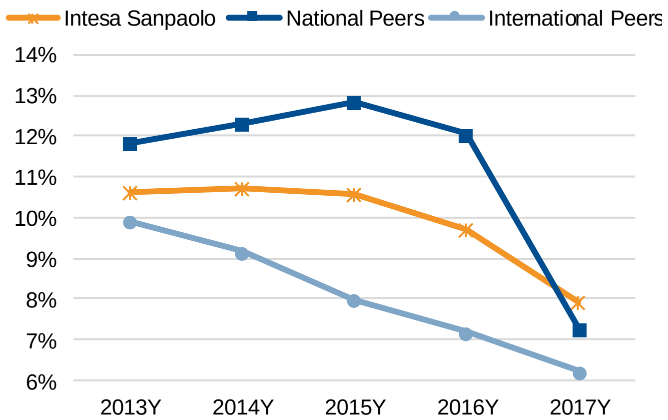
Fees & commissions % revenues



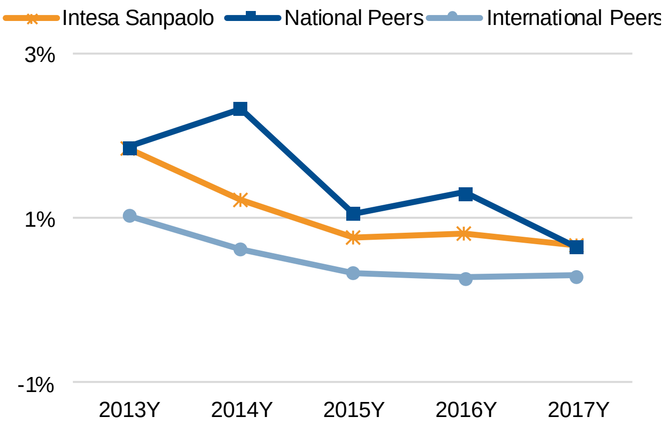
Net loan growth (%)



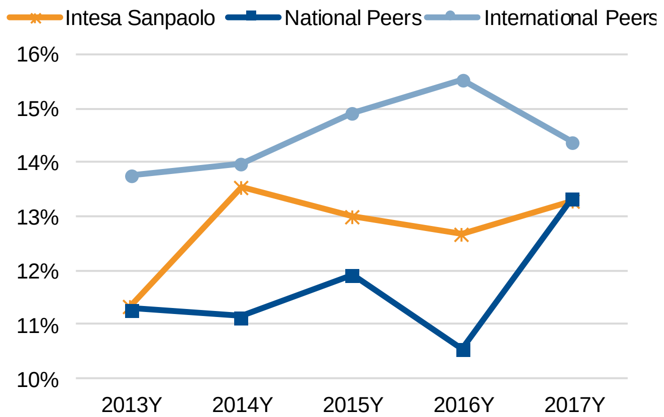
Impaired loans % gross loans (%)



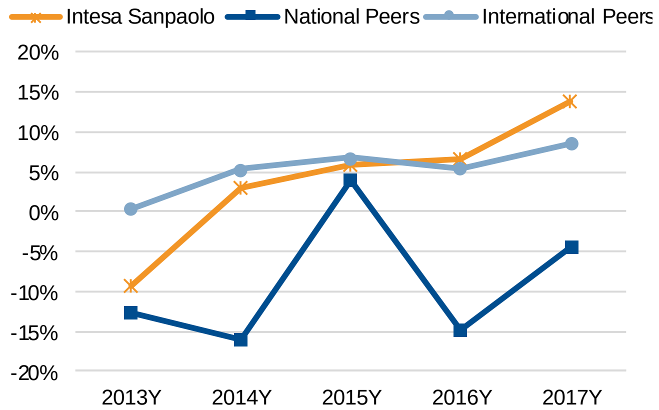
Cost of risk (LLC % gross loans)



Common equity tier 1 ratio (transitional) (%)



Return on average equity (%)



Source: SNL, Scope Ratings
National peers: Intesa, Unicredit, Monte dei Paschi di Siena, Banco BPM, UBI
International peers: Intesa, Caixa Bank,Commerzbank, Credit Agricole, KBC, Unicredit Bank, Unicredit Bank Austria

II. Appendix: Selected financial information – Intesa Sanpaolo

	2013Y	2014Y	2015Y	2016Y	2017Y
Balance sheet summary (EUR m)					
Assets					
Cash and interbank assets	32,595	36,981	43,024	60,982	81,425
Total securities	211,362	232,321	244,502	261,642	261,633
of which, derivatives	37,539	45,998	38,063	36,775	28,802
Net loans to customers	344,016	339,104	350,031	364,712	410,776
Other assets	38,310	38,021	38,939	37,764	43,027
Total assets	**626,283**	**646,427**	**676,496**	**725,100**	**796,861**
Liabilities					
Interbank liabilities	55,172	53,443	62,497	76,782	108,441
Senior debt	124,479	112,629	100,620	84,845	84,047
Derivatives	44,870	51,321	43,994	45,309	36,331
Deposits from customers	228,965	230,927	255,739	291,834	323,386
Subordinated debt	13,582	15,753	14,585	15,066	14,664
Other liabilities	114,157	137,292	150,468	161,945	173,388
Total liabilities	**581,225**	**601,365**	**627,903**	**675,781**	**740,257**
Ordinary equity	44,515	44,683	46,899	46,794	52,102
Equity hybrids	0	0	877	2,117	4,103
Minority interests	543	379	817	408	399
Total liabilities and equity	**626,283**	**646,427**	**676,496**	**725,100**	**796,861**
Core tier 1/Common equity tier 1 capital	31,295	36,547	36,908	35,926	38,051
Income statement summary (EUR m)					
Net interest income	9,885	9,815	9,238	8,615	8,527
Net fee & commission income	5,829	6,477	6,895	6,735	7,428
Net trading income	1,789	2,107	2,399	2,534	2,572
Other income	-1,161	-699	-1,066	-644	4,936
Operating income	**16,342**	**17,700**	**17,466**	**17,240**	**23,463**
Operating expense	9,928	10,393	10,876	10,655	12,819
Pre-provision income	**6,414**	**7,307**	**6,590**	**6,585**	**10,644**
Credit and other financial impairments	7,005	4,329	2,824	3,288	3,162
Other impairments	6,791	NA	NA	NA	NA
Non-recurring items	2,566	-17	NA	-59	341
Pre-tax profit	**-4,816**	**2,961**	**4,077**	**3,216**	**7,818**
Discontinued operations	0	0	60	987	0
Other after-tax Items	0	0	0	0	0
Income tax expense	-259	1,651	1,331	1,003	464
Net profit attributable to minority interests	-7	59	67	89	38
Net profit attributable to parent	**-4,550**	**1,251**	**2,739**	**3,111**	**7,316**

Source: SNL

III. Appendix: Selected financial information – Intesa Sanpaolo

	2013Y	2014Y	2015Y	2016Y	2017Y
Funding and liquidity					
Net loans/deposits (%)	150.3%	147.0%	137.1%	125.0%	127.0%
Liquidity coverage ratio (%)	NA	NA	NA	NA	175.7%
Net stable funding ratio (%)	NA	NA	NA	NA	NA
Asset mix, quality and growth					
Net loans/assets (%)	54.9%	52.5%	51.7%	50.3%	51.5%
Impaired & delinquent loans/loans (%)	10.6%	10.7%	10.6%	9.7%	7.9%
Loan-loss reserves/impaired loans (%)	77.5%	83.3%	82.0%	79.3%	81.7%
Net loan growth (%)	-8.7%	-1.4%	3.2%	4.2%	12.6%
Impaired loans/tangible equity & reserves (%)	56.1%	54.9%	53.3%	52.6%	44.5%
Asset growth (%)	-7.0%	3.6%	4.7%	7.2%	9.9%
Earnings and profitability					
Net interest margin (%)	1.6%	1.6%	1.5%	1.3%	1.2%
Net interest income/average RWAs (%)	3.4%	3.6%	3.3%	3.0%	2.9%
Net interest income/operating income (%)	60.5%	55.5%	52.9%	50.0%	36.3%
Net fees & commissions/operating income (%)	35.7%	36.6%	39.5%	39.1%	31.7%
Cost/income ratio (%)	60.8%	58.7%	62.3%	61.8%	54.6%
Operating expenses/average RWAs (%)	3.5%	3.8%	3.9%	3.7%	4.4%
Pre-impairment operating profit/average RWAs (%)	2.2%	2.7%	2.4%	2.3%	3.7%
Impairment on financial assets /pre-impairment income (%)	109.2%	59.2%	42.9%	49.9%	29.7%
Loan-loss provision charges/net loans (%)	1.9%	1.2%	0.8%	0.8%	0.7%
Pre-tax profit/average RWAs (%)	-1.7%	1.1%	1.5%	1.1%	2.7%
Return on average assets (%)	-0.7%	0.2%	0.4%	0.5%	1.0%
Return on average RWAs (%)	-1.6%	0.5%	1.0%	1.1%	2.5%
Return on average equity (%)	-9.2%	2.9%	6.0%	6.5%	13.9%
Capital and risk protection					
Common equity tier 1 ratio (%, fully loaded)	11.3%	13.3%	12.5%	12.9%	14.0%
Common equity tier 1 ratio (%, transitional)	11.3%	13.5%	13.0%	12.7%	13.3%
Tier 1 capital ratio (%, transitional)	12.2%	14.2%	13.8%	13.9%	15.2%
Total capital ratio (%, transitional)	14.8%	17.2%	16.6%	17.0%	17.9%
Leverage ratio (%)	NA	7.1%	6.4%	6.0%	6.1%
Asset risk intensity (RWAs/total assets, %)	44.1%	41.7%	42.0%	39.2%	36.0%
Market indicators					
Price/book (x)	0.7x	0.9x	1.1x	0.9x	0.9x
Price/tangible book (x)	0.8x	1.1x	1.3x	1.0x	1.0x
Dividend payout ratio (%)	NM	87.5%	87.5%	54.4%	46.1%

Source: SNL

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