Italian banks: solid Q3 performance; constructive outlook for 2023

The progression of Italian bank profitability may look uninspiring but we believe third-quarter results were strong. Wider interest margins more than offset soft fees and commissions and the declining contribution of TLTRO to revenues. Operating expenses and cost of risk are under control. Positive asset-quality trends are intact and banks maintain healthy capital buffers. We believe these trends should continue into 2023.

Headline asset-quality metrics improve. Default rates remain at historically low levels despite surging inflation and worsening business and consumer confidence indicators. The average NPE ratio has declined significantly since the beginning of the year thanks to asset sales and securitisations.

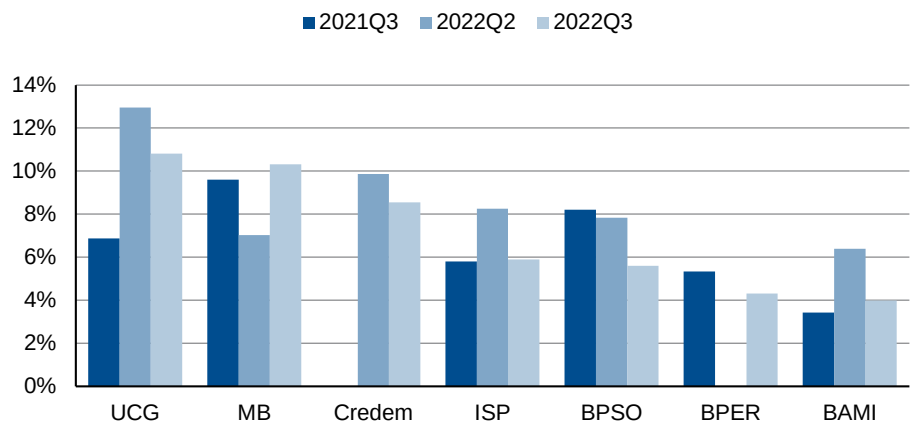
2023 outlook improving. Banks are optimistic about prospects in 2023 for two reasons: (i) a higher-than-expected increase in interest rates that could drive net interest income up by 15%-25% over 2021; (ii) borrower resiliency, thanks partially to government measures to mitigate the cost of rising energy prices.

If the economy takes a turn for the worse, banks are well capitalised. As of September 2022, the largest Italian banks held a CET1 buffer of around 590bp, a level we deem comfortable.

The year-to-date decline in capital ratios is largely driven by high dividend pay-outs, buybacks and (contained) losses on debt securities held through Other Comprehensive Income. We believe the decline of capital ratios may be coming to an end, with banks' distribution strategies turning less aggressive in the face of a more uncertain macroeconomic backdrop

TLTRO III repayment hurdle manageable. Banks can count on a large and stable deposit base, which has grown for over a decade, and reduced reliance on the bond market. Abundant liquidity, price attrition and slowing asset growth should limit competition for deposits. Banks will likely tap wholesale markets selectively and at higher cost, including for MREL purposes. However, given the low incidence of wholesale over total funding, the impact on profitability should remain limited.

Figure 1: Return on average equity – 3Q22 vs 2Q22 and 3Q21



Source: SNL, Scope Ratings
Note: Excluding figures impacted by one-offs. MPS not included.

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Rebound in net interest income drives strong Q3 results

Italian bank[1] performance was resilient in the third quarter. The third quarter return on average equity for the eight banks in our sample (Intesa Sanpaolo, UniCredit, Banco BPM, Banca Monte dei Paschi di Siena, Mediobanca, BPER Banca, Credito Emiliano, and Banca Popolare di Sondrio) was 7.1[2]% (see Figure 1 above). The key drivers for the strong performance were the rebound in net interest income, strong cost management, and low risk provisions. On the flip side, volatile financial markets continued to hurt fee and trading income.

Net interest margins have started to reflect higher rates

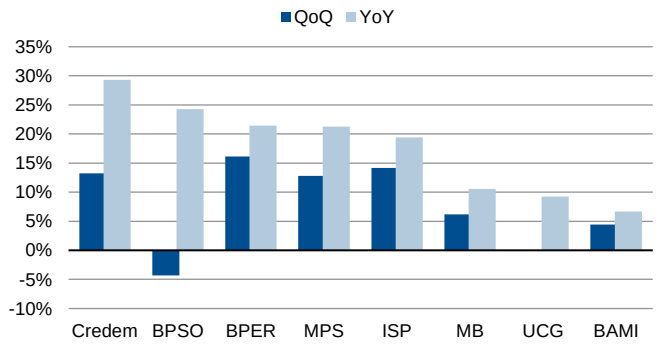
As expected, net interest income grew at a fast pace, both on a QoQ and YoY basis, reflecting the increase in Euribor. Three-month Euribor rates have risen from -0.54% at the end of the third quarter of 2021 to -0.20% on June 30 2022 to 1.17% on September 30. This has boosted asset margins on new origination and the variable-rate portion of the lending stock. Lending volumes continue to expand, especially in the business segment notwithstanding the spike in rates. These tailwinds more than compensated for the decline in TLTRO III contributions after the end of the -1% bonus period in June.

Fee and commission income trended lower for most banks, if we exclude the positive impact from the larger perimeter due to the ongoing consolidation of the sector, especially among regional banks.

The weak financial market performance continued to weigh on asset management product sales, managed volumes, and performance fees. But banking and payment fees still grew on the back of a resilient Italian economy, assisted by a tourist season that benefited from full post-pandemic re-opening.

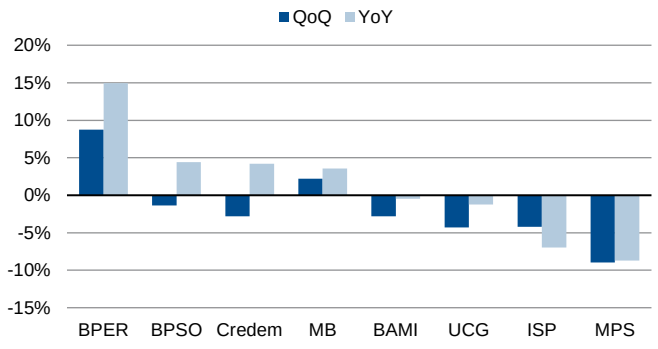
Thanks to strong activity in advisory and a resilient wealth management business, Mediobanca bucked the trend with positive QoQ fee growth.

Figure 2: Net interest income – 3Q22 vs 2Q22 and 3Q21



Source: Company data, Scope Ratings
Note: based on management data. Figures for BPER and Credem were materially affected by acquisitions

Figure 3: Net fees and commissions – 3Q22 vs 2Q22 and 3Q21



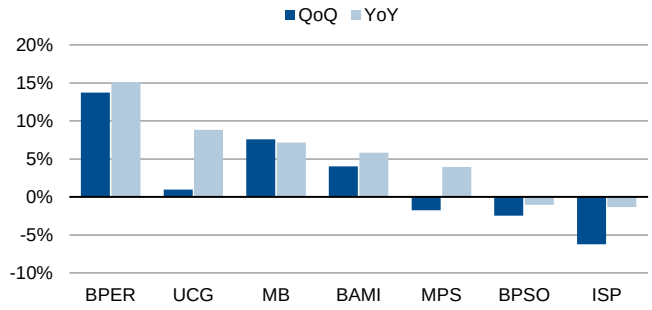
Source: Company data, Scope Ratings
Note: based on management data. Figures for BPER and Credem were materially affected by acquisitions

[1] Sample of eight banks: Intesa Sanpaolo (ISP), UniCredit (UCG), Banco BPM (BAMI), Banca Monte dei Paschi di Siena (MPS), BPER, Mediobanca (MB), Credem, BP Sondrio (BPSO)
[2] Excluding MPS, whose Q3 result included EUR 537m of restructuring costs

Cost management remains imperative for Italian banks. Banks' cost structure is less affected by energy prices relative to other sectors, so the inflation effect has been marginal so far. Upward pressure on salaries has also been contained: no bank mentioned it as a key concern on Q3 results calls. Banks that reported cost increases were those that accelerated investments, for instance in digitalisation or strategic initiatives. Mediobanca, for example, boosted the distribution network in its wealth management division.

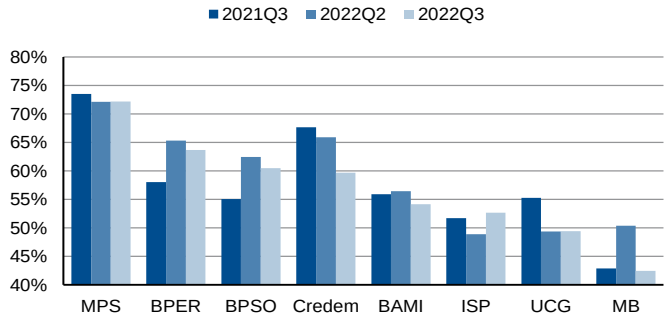
Cost-to-income for the sector fell from 57.5% on average in the third quarter of 2021 to 56.8% in Q3 2022.

Figure 4: Revenues – 3Q22 vs 2Q22 and 3Q21



Source: Company data, Scope Ratings
Note: based on management data. Figures for BPER and Credem were materially affected by acquisitions

Figure 5: Cost-to-income ratios

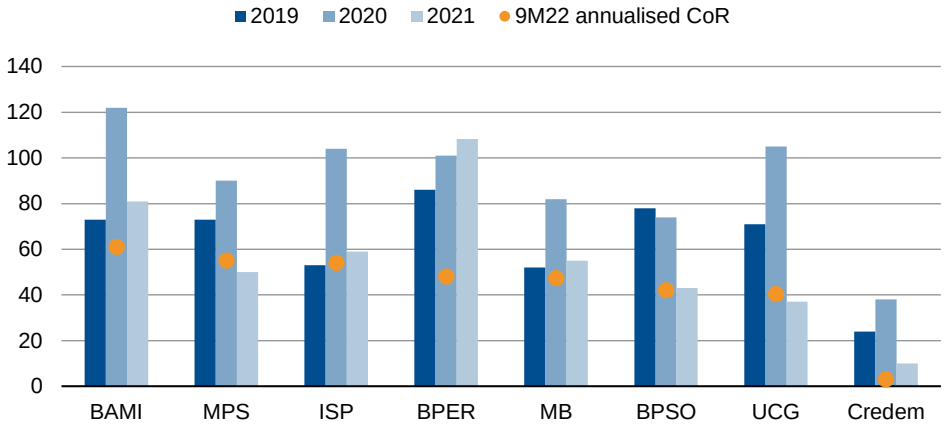


Source: Company data, Scope Ratings

Credit losses in the third quarter were modest as default rates are still at record lows. The year-to-date average cost of risk stood at 44bp for the eight banks in our sample. The average would be even lower if we had corrected the figure for the extra provisions taken by UniCredit and Intesa to cover losses on their Russian exposures (about 30bp of cost of risk for both).

Credem is a clear outlier, with its cost of risk at 3bp for the nine month period. This figure includes the benefits from impairment reversals on recently acquired assets and one favourable bad-loan disposal. Even excluding such one-offs, the underlying cost of risk stood at 10bp, which supports our view that the group's asset quality is stronger than average.

Figure 6: Cost of risk dynamics, historical



Source: Company data, Scope Ratings

2023 outlook is improving although risks are tilted to the downside.

The phase-out of TLTRO III won't prevent a steep increase in NII

Despite the deterioration in the macro environment, we are constructive on the outlook for 2023. Visibility has improved, and as market rates moved to price higher-than-expected policy rates, the revenue outlook for banks looks brighter.

Bank profitability in 2023 will be driven primarily by two factors:

1) the gradual repricing of the balance sheet to a more favourable rate environment, which will continue to boost revenues.

2) Potentially higher cost of risk, although this will largely depend on the shape and duration of the upcoming recession.

Based on banks' most recent guidance, we calculate that banks' 2023 average net interest income could be 15%-25% higher than in 2021, depending on business models and balance-sheet composition (see Figure 7). These projections already include the effect of the change in TLTRO III conditions and the rising cost of funding.

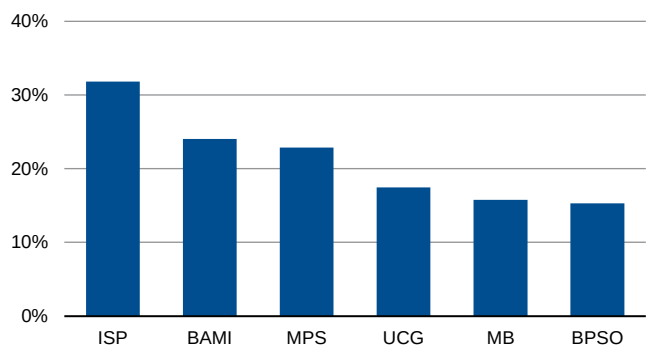
Despite worsening macroeconomic indicators, banks do not see clear signs of deterioration in credit quality. This is due both to borrowers' financial strength and government measures to contain the impact of high energy prices. For 2023, banks expect cost of risk to remain in line with 2022 levels, taking into account the cushion of unused management overlays[3] that have been accumulated this year and during the pandemic. Mediobanca stands out in this respect, with a provisions buffer equivalent to 60bp of customer loans (see Figure 8).

Recession risk still present

However, we are cautious about the risks stemming from a worsening macroeconomic outlook. A recession would hurt banks from multiple sides – lending, fees and commissions, and credit costs – leading to lower net results. Targeted fiscal measures to support households and companies at a time of high energy prices could be paramount to preventing a wave of loan defaults.

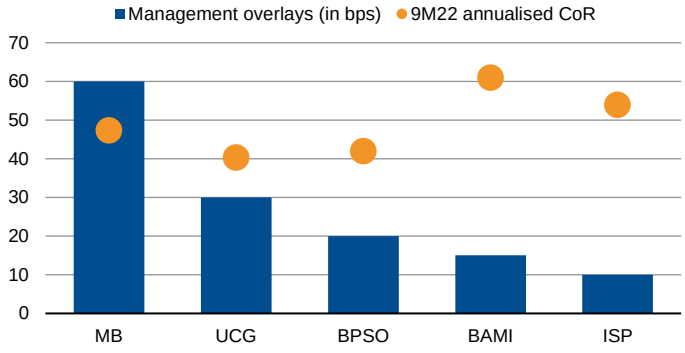
We see significantly lower political uncertainty in the short term, though, given the strong majority that the right-wing coalition has in parliament at this time. Moreover, we are confident about the continuity of economic policy and pragmatic relations between Rome and Brussels, which should prevent volatility in government bond yields.

Figure 7: Estimated NII guidance for 2023 (vs 2021)



Source: Company data, Scope Ratings
Note: based on different Euribor assumptions. Mediobanca's figures refer to the FY ending in June

Figure 8: Some banks have plenty of unused provisions to cover increasing credit losses in 2023



Source: Company data, Scope Ratings
Note: based on management data. Some banks didn't disclose their overlays

[3] Also known as 'post-model adjustments'

Disposal of legacy NPEs continues while default rate remains at record lows

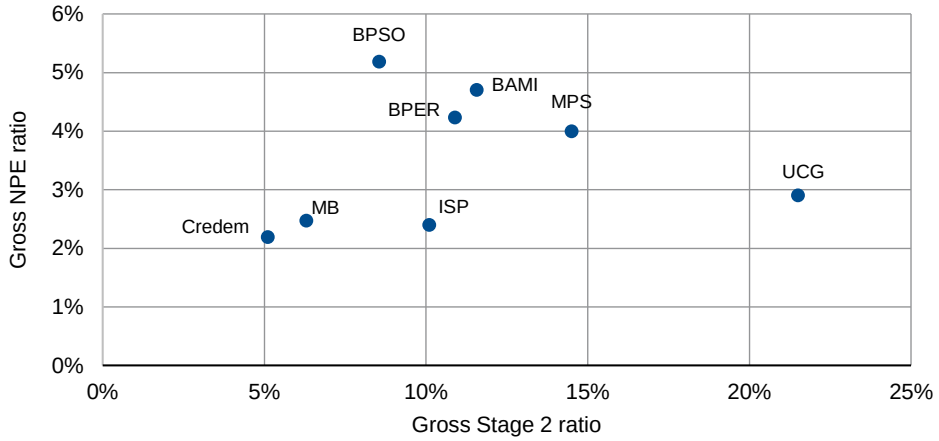
Headline NPE ratios continued to trend lower for most banks in the third quarter. The average gross NPE ratio stood at 3.5% at the end of the third quarter, down 70bp from the beginning of the year. This was mainly driven by a reduction in the NPE stock through asset sales and securitisation. Inflows of new non-performing loans remained low, with no signs of a pick-up in default rates.

Average NPL ratio set to decline even further, barring a recession

While Intesa is close to its target in terms of balance sheet de-risking, we still see some room for improvement for the other banks. As mentioned in our recent research report (Italian banks' H1 results confirm sector soundness), Intesa announced its zero-NPL ratio target in its 2022-25 business plan, raising the bar for peers to further clean up balance sheets. Achieving an NPL ratio in line with the EU average is a way not only to reduce uncertainties and earn investor confidence but also to alleviate supervisory scrutiny.

Mediobanca and Credem have long been in a league of their own, with limited legacy NPLs from the global financial crisis.

Figure 9: Asset-quality overview as of September 2022



Note: MPS and Credem's Stage 2 ratio as of June 2022
Source: Company data, Scope Ratings

The share of gross customer lending classified as Stage 2, which increased during the pandemic, remains high. There is some variation among banks, which is likely to reflect differing degrees of cautiousness with respect to loan classification and provisioning, rather than just differences in loan book quality.

In Q3, stage 2 ratios were stable for most banks, with three exceptions:

- Banco BPM moved EUR 2.5bn of loans to Stage 2 as a result of an in-depth analysis of business clients operating in energy-intensive sectors. Related NPL inflows were marginal.
- Banco Popolare di Sondrio's Stage 2 ratio increased by a third due to the worsened macroeconomic outlook, but the starting point was relatively low (6.3% in June).
- By contrast, Intesa saw its Stage 2 ratio decline by 1.5pp due to the sale of most of its cross-border Russian exposures.

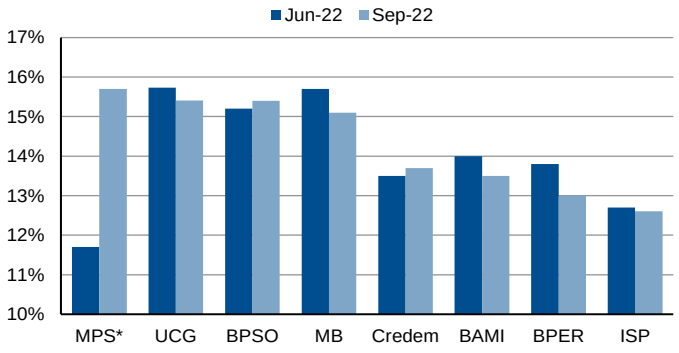
Solid capital buffers should allow banks to carry on with dividend plans but supervisors recommend prudence

As of September 2022, the capital position of Italian banks was sound, with an average MDA buffer to CET1 requirements of approximately 590bp. Excluding MPS, the average CET1 ratio declined by around 30bp in the third quarter, owing to market losses on debt securities as well as high dividend pay-outs. However, risk-weighted asset optimisation partly offset the decline.

Bond prices volatility not a concern

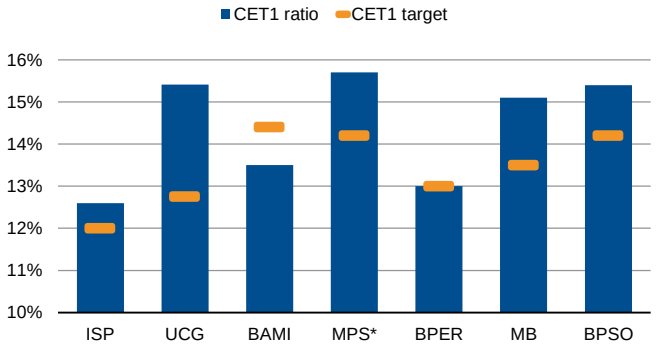
Because capital ratios remain comfortably above requirements, we are not worried about temporary impacts from falling bond valuations. It is also important to bear in mind that nowadays, the increase in Italian government bond yields barely affects banks' capital positions. Banks posted mark-to-market losses in 2018 due to BTP-Bund spread widening but since then they have rebalanced their BTP portfolios by drastically reducing the proportion held through Other Comprehensive Income (which is subject to bond price volatility).

Figure 10: Phased-in CET1 ratios, quarterly trend



Source: Company data, Scope Ratings
Note: Intesa reported its capital ratios net of the EUR 1.7bn tranche of buyback subject to board approval in 2023. MPS' figure is pro-forma the capital increase

Figure 11: Banks' Q3 phased-in CET1 ratio and targets



Source: Company data, Scope Ratings
Note: Credem does not have a public CET1 target. For ISP, UCG and MB, these are minimum thresholds

UniCredit, Mediobanca and Banca Popolare di Sondrio have significant buffers to their capital requirements and to their own internal targets. Therefore, they may continue and indeed seem committed to pursue distribution plans and even one-off dividends or share buybacks.

Supervisors have shown some unease about the souring economic outlook, though, urging banks to be prudent about macroeconomic assumptions and cautious about distribution plans.

Supervisors object to aggressive payout plans

We do not expect a repeat of Covid-style blanket bans on distributions but we side with the supervisors' view that in the face of increased macro uncertainty aggressive payout commitments may lower the banks' room for manoeuvre. In particular, the ECB seems concerned about banks committing to absolute amounts. This is understandable. If earnings disappoint, banks would have to meet their commitments by reducing their capital cushions.

Moreover, stronger banks may also want to keep some powder dry for potential acquisition bargains subject to valuations.

Comfortable buffers to requirements are a factor supporting our ratings in Italy. A significant run-down of capital buffers would have negative implication for the banks' credit profiles.

Change in TLTRO III terms accelerates normalisation in funding conditions

Italian banks have drawn hundreds of billions of euros at TLTRO III auctions over the past two and half years, with indisputable income and funding benefits. Around half of the facility will mature in June 2023, while the balance will be repaid between September 2023 and 2024.

TLTRO III will be repaid early only if unnecessary for funding

The upcoming change in TLTRO III terms will eliminate the ability for banks to profit from re-depositing liquidity with the ECB, and reduce the profitability of the carry trade on government bonds, likely pushing some banks to accelerate repayments if they hold excess liquidity. However, TLTRO III remains a cheap source of funding compared to wholesale issuance and we expect Italian banks will not fully repay early if they are using it to back lending activity, only to have to replace it with more expensive wholesale funding.

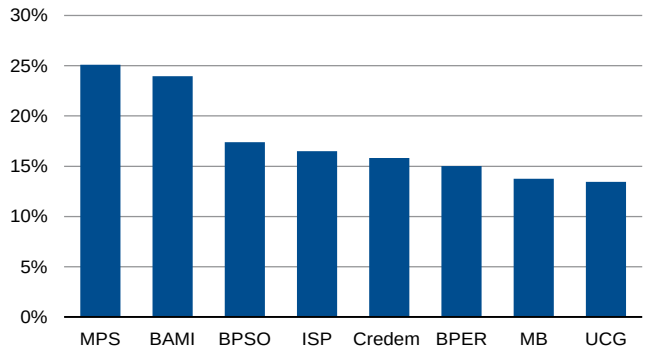
Large and stable customer deposit base the main source of funding

The end of TLTRO was always going to bring new challenges to Italian banks. Over the course of 2023, Italian banks will have to find alternative funding for part of the expiring lines. This will reignite their capital market funding activities – and come at a cost. However, the need for wholesale finance should be limited. After the global financial crisis, lenders progressively reduced their reliance on the bond market for funding, increasing their customer deposit base. This trend accelerated during the pandemic when deposits were boosted by high household savings rates and the increased liquidity available to non-financial companies. Given the dynamic growth in customer deposits in recent years, we believe pressure on revenues from higher funding costs should be manageable for most banks.

Given the current abundance of deposits, we do not expect the rapid growth in interest rates to trigger price competition among the largest Italian banks. As of September 2022, average deposit rates had barely moved from historical lows (Figure 13).

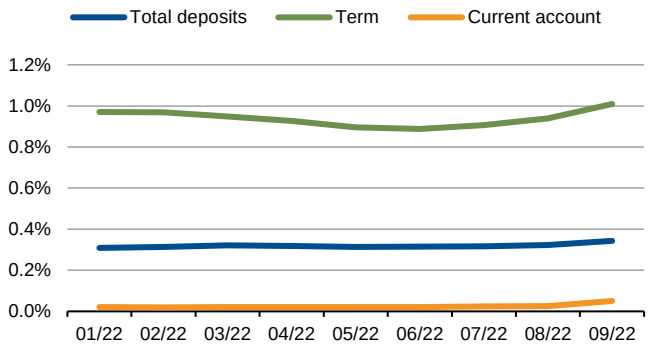
As of September 2022, MPS was most exposed to TLTRO III in relative terms (around 25% of total funding).

Figure 12: TLTRO III as % of total cash funding (customer deposits, wholesale debt, bank funding)*, Q3 2022



*Excluding AT1 debt
Source: Company data, Scope Ratings

Figure 13: Italian banking sector – Deposit rates trend (stock)



Source: Bank of Italy, Macrobond, Scope Ratings
Note: deposits from retail and non-financial companies

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