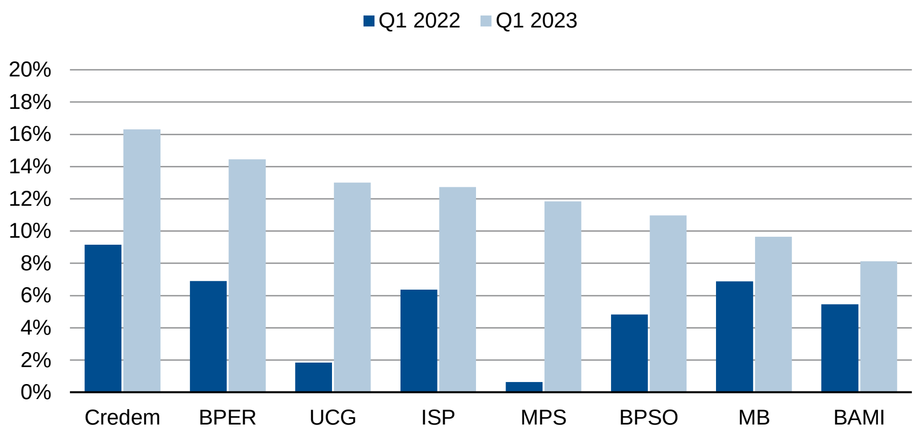
Italian banks: strong Q1 results pave the way for a promising 2023

Excellent Q1 results support our positive view on the direction of Italian banks' credit risk profiles. The combination of wider interest margins, costs savings and low loan-loss provisions will continue to support results over the next few months.

Prospects for full-year 2023 earnings have improved. The banks' latest projections point to year-on-year growth in net interest income of around 27%, higher than previously projected at 18%. At the same time, prudent guidance for cost of risk was confirmed despite record-low levels in Q1.

Figure 1: Italian banks' profitability (ROE) rises YoY



Source: SNL, Scope Ratings

However, dangers lurk. High inflation and rising borrowing costs are weighing on banks' risk tolerances as well as loan demand. Although it is too early to talk about a 'credit crunch', lending dynamics may be much weaker than projected, which would hurt banks' revenues. The higher risk of a windfall tax on banks' 'extra-profits' and further financial markets turmoil add to downside risks for the sector.

Non-performing exposure (NPE) ratios were stable, reflecting record-low default rates. Banks continued to increase coverage ahead of a potential rise in delinquencies, however, while preserving the cushion of unused general provisions.

The strong results pushed up capital ratios. Italian banks maintain healthy buffers over capital requirements and can continue their dividend distribution despite the macroeconomic uncertainties.

The decline in customer deposits from all-time highs is not of concern. Banks reported a reduction in deposits as large customers started to withdraw excess liquidity accumulated during the pandemic and retail clients look for higher yields. So far, banks' have not actively chased deposits, highlighted by minimal repricing (deposit beta).

Italian banks frontloaded their annual funding plans before the turmoil in financial markets between March and April. As a result, issuance needs in the coming months are low. At the end of June, about 45% of the outstanding TLTRO III will expire. However, banks are ready for the repayment and expect liquidity ratios to remain well above requirements.

Analyst

Alessandro Boratti, CFA
a.boratti@scoperatings.com

Team leader

Marco Troiano, CFA
m.troiano@scoperatings.com

Media

Keith Mullin
k.mullin@scopegroup.com

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Scope Ratings GmbH

Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

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Excellent quarterly results mainly thanks to higher interest margins and ultra-low credit losses

Italian banks[1] delivered an excellent Q1 performance, reaching an average ROE of 12.1% (Q1 2022: 5.3%). In a rising interest-rate environment, loan spreads widened significantly, as did interest accruals on bond reinvestments. Contained cost growth and record-low loan losses also supported quarterly earnings.

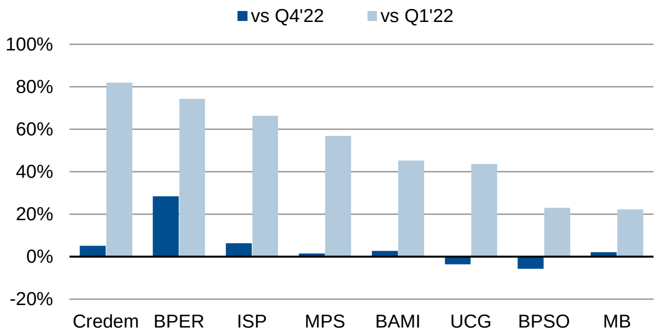
Net interest margins have significantly widened

Net interest income grew by 52% on average YoY though there were significant variations among lenders owing to differences in the speed of asset repricing, the loan mix, and usage of ECB's TLTRO III. However, growth in net interest income decelerated on a quarter-on-quarter basis. Some banks even reported minimal increases or QoQ decreases, primarily because their Q4 figure was boosted by the final TLTRO III contribution.

Fee and commission income was weak across the board due to a combination of declining loan origination, lower asset-management product sales, and lower performance fees.

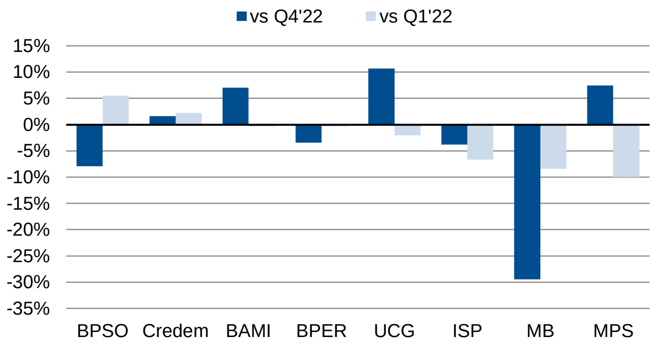
After outperforming its peers for several quarters, Mediobanca reported a decline in fees driven by weaker advisory and capital markets activity. Intesa also experienced QoQ and YoY declines mostly due to lower commercial revenues resulting from the disposal of RWAs in the previous quarter. MPS reported the steepest decline in net fee and commission income, attributed to low product placements.

Figure 2: Large YoY increase in net interest income



Source: Company data, Scope Ratings
Note: based on management data. BPER's Q1 2022 figures were restated to allow like-for-like comparison

Figure 3: Mix net fees and commissions YoY trends, while QoQ deltas were affected by Q4 seasonality



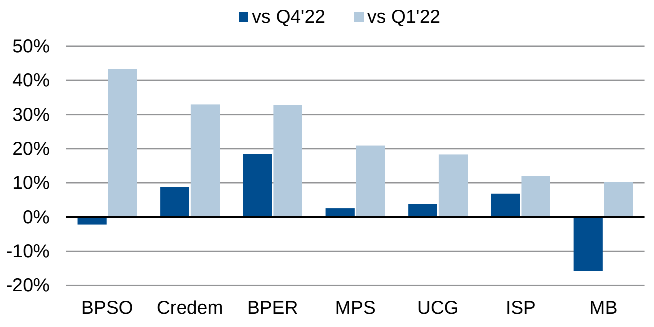
Source: Company data, Scope Ratings
Note: based on management data. BPER's Q1 2022 figures were restated to allow like-for-like comparison

Banks' operating expenses only slightly increased YoY, despite high inflation. MPS was a clear outlier, reporting around 14% YoY decline in costs due to the reduction in full-time employees. On the other hand, BP Sondrio disclosed a c.10% YoY increase in costs as result of new hirings and the impact of energy prices.

As revenues expanded at a much higher rate than costs, banks' average cost- income ratios fell sharply, from an average of 59% in Q1 2022 to 49% in Q1 2023 (Figure 5).

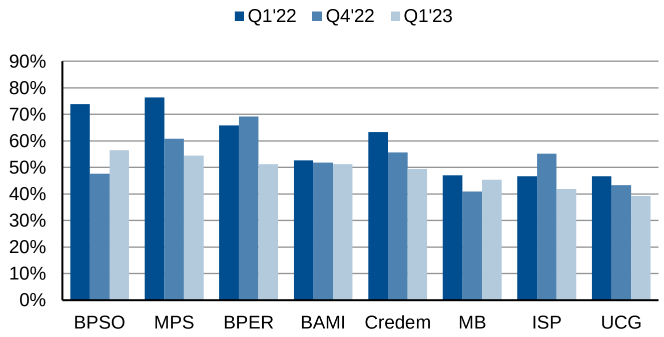
[1] Sample of eight banks: Intesa Sanpaolo (ISP), UniCredit (UCG), Banco BPM (BAMI), Banca Monte dei Paschi di Siena (MPS), BPER, Mediobanca (MB), Credem, BP Sondrio (BPSO)

Figure 4: Revenue growth in Q1 supported by net interest income



Source: Company data, Scope Ratings
Note: based on management data. BPER's Q1 2022 figures were restated to allow like-for-like comparison

Figure 5: Cost- income ratios improve despite cost inflation



Source: Company data, Scope Ratings

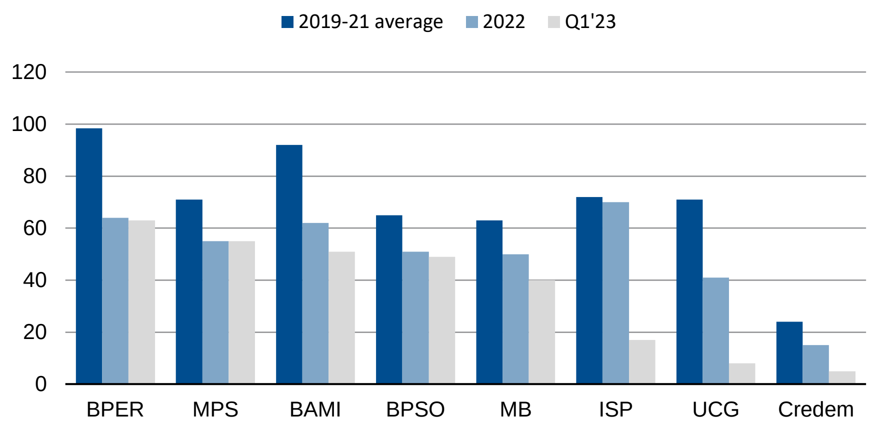
Credit losses in the first quarter were remarkably low, at 36bp (51bp in FY 2022). This reflects three main factors:

1. Banks' considerable efforts to reduce legacy non-performing loans in recent years, which reduced the need to make further provisions.
2. The improvement in origination criteria and risk management, which lowered the cost of risk for new lending.
3. Borrowers are in a better financial position, which improved their resilience against challenging economic conditions.

Variations in cost-of-risk levels can be explained by differences in loan exposure, e.g. Mediobanca's skew towards higher-risk consumer lending, and variations in NPE ratios, which impact the cost of increasing coverage.

However, despite a solid quarter, banks maintained a conservative stance and did not revise their 2023 guidance for cost of risk. This suggests a deterioration in loan quality over the course of the year.

Figure 6: Cost of risk (bp) remains at the lowest level in years



Source: Company data, Scope Ratings

2023 outlook remains positive; quarterly earnings to peak in Q2/Q3

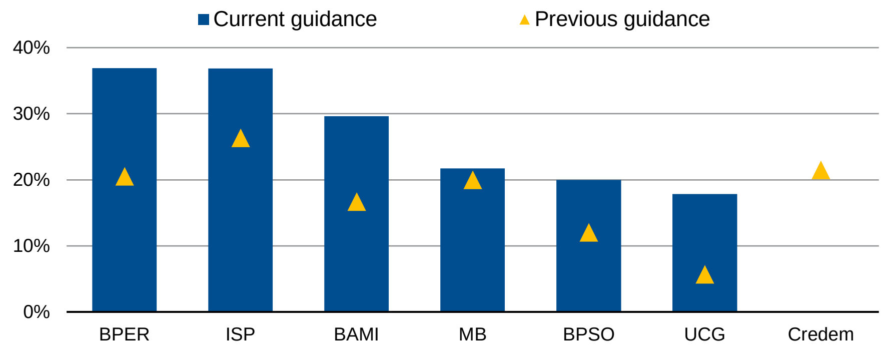
The positive earnings trend is likely to persist on the back of widening interest margins and a recovery of fee and trading income. The presence of unused management overlays[2] will partly cushion the impact of higher default rates on P&Ls.

Net interest guidance improved QoQ

In line with the momentum, banks upgraded their guidance on net interest income for 2023 to reflect higher ECB rates and a slow repricing of deposits. The latest projections point to a year-on-year growth of around 27% (previously projected at 18%), although this will depend on banks' business models and balance-sheet composition.

Based on banks' own guidance, earnings are expected to peak between Q2 and Q3, when growth in interest margins slows and cost of risk rebounds as default rates rise. On an annual basis, average ROE could surpass that of 2022.

Figure 7: Annual growth in net interest income expected for 2023



Source: Company data, Scope Ratings
Note: Mediobanca's guidance on its FY 2023 ending in June
MPS didn't provide precise guidance

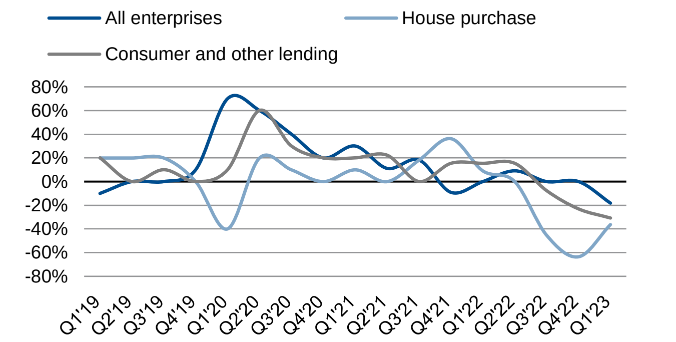
There are some risks to these rosy forecasts. Lending dynamics may prove to be significantly weaker than current estimates throughout the year. The first quarter already saw a reversal in lending growth as demand faded and banks prioritised credit quality over volumes.

The slowdown in loan origination has been particularly severe in the mortgage segment[3], due to rising borrowing costs. Lending survey data have been pointing to this trend since Q4 2022 (Figure 8). Lower loan volumes will have an adverse impact on banks' revenues.

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

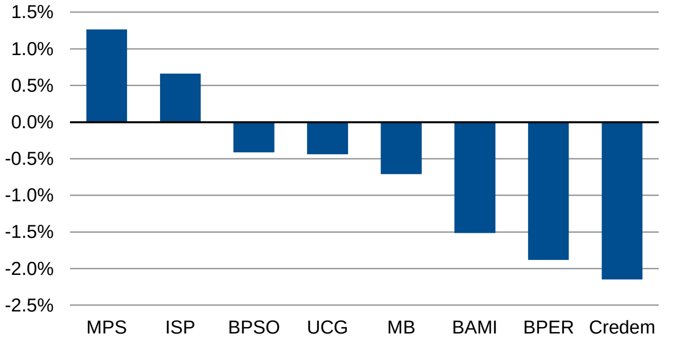
[3] In Q1, requests for residential mortgages tumbled by almost 24% on a YoY basis (source: Centrale Rischi Finanziari).

Figure 8: Banks started observing lower loan demand at the end of 2022



Source: Macrobond, Bank of Italy, Scope Ratings
Note: difference between the percentage of banks reporting an increase and a decrease in demand in the next three months

Figure 9: Customer loans declined by 0.6% on average in Q1



Source: Company data, Scope Ratings
Note: gross performing loans except for MPS (net customer loans)

A windfall tax on Italian lenders no longer off the table

The Italian Minister of Economy and Finance has hinted at the possibility of implementing a tax on banks' 'extra profits' resulting from wider spreads[4]. The main purpose of this windfall tax would not be to raise funds but to force credit institutions to increase remuneration on customer deposits. Although no concrete measures have been announced yet, the likelihood of targeted actions aimed at banks is increasing as public pressure intensifies.

Finally, further financial market turmoil either linked to a US banking crisis or heightened domestic sovereign risk could impact Italian banks' funding costs and revenues from sale of asset-management products.

NPE ratios move closer to the bottom as default rates expected to rebound

Italian banks' headline asset-quality metrics improved in Q1 2023 on the back of low default rates. While the mean gross sector NPE ratio was stable QoQ at 3.2%, coverage increased by 1.3 percentage points to 56%.

All banks' gross NPE ratio below 5% as of Q1 2023

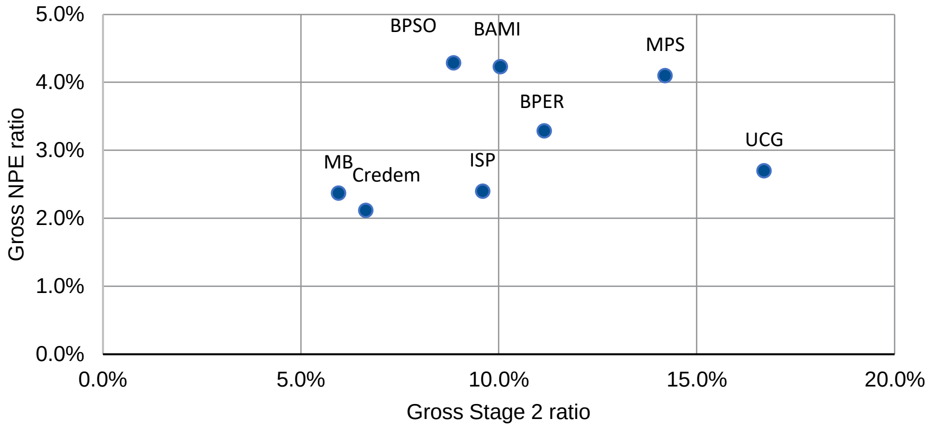
All the banks in our sample display gross NPE ratios below 5%, once considered a common key de-risking target. Yet some institutions expect further improvements in 2023. BP Sondrio sees its NPE ratio declining by 50bp by year end, while BPER sold a EUR 470m unlikely-to-pay loan portfolio in April

So far, banks have not reported signs of credit deterioration. This could be the result of the long-lasting effects of the post-Covid reopening on the Italian economy and companies' abilities to pass costs to their customers at a time of improving employment data.

However, we see the situation reversing soon, as the impacts of tighter financial conditions start to have an effect. In some European countries, bankruptcies have already started to rise in vulnerable sectors like accommodation and food, transportation, education and healthcare (see Asset Quality Review: Falling NPL ratios hide rising vulnerabilities).

4 https://www.corriere.it/economia/finanza/23_maggio_04/banche-spunta-tassa-profitti-che-arrivano-conti-senza-interessi-de715ea6-ea3f-11ed-8b0b-6cde02623b65.shtml

Figure 10: NPE ratios close to the bottom for most banks



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

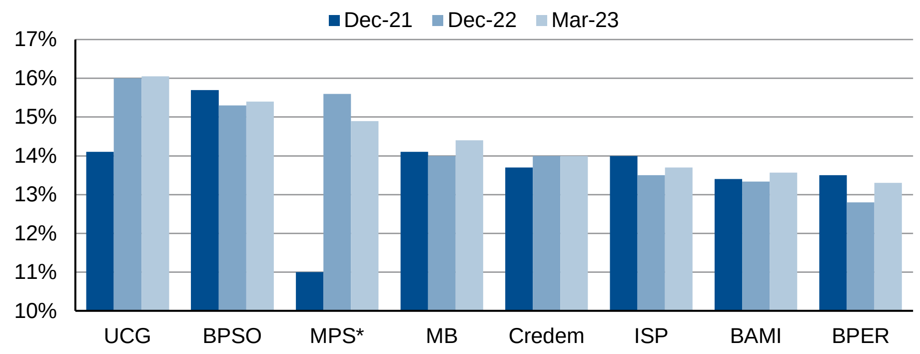
The average Stage 2 ratio is still high among Italian banks, although the difference between lenders is likely to reflect differing degrees of caution with respect to loan classification and provisioning rather than just difference in loan-book quality.

Banks maintain comfortable buffers above minimum requirements

Italian banks' capital positions are sound. As of Q1 2023, the average MDA buffer to CET1 requirements was roughly 590bp, broadly in line with YE 2022 levels, as strong capital generation offset average increases in requirements.

We expect that most excess capital will be returned to shareholders given limited growth opportunities, both organic and external. Even the most ambitious pay-out targets look sustainable and should face less supervisory attrition, at least in the short term.

Figure 11: Capital ratios improving across the board



Source: Company data, Scope Ratings

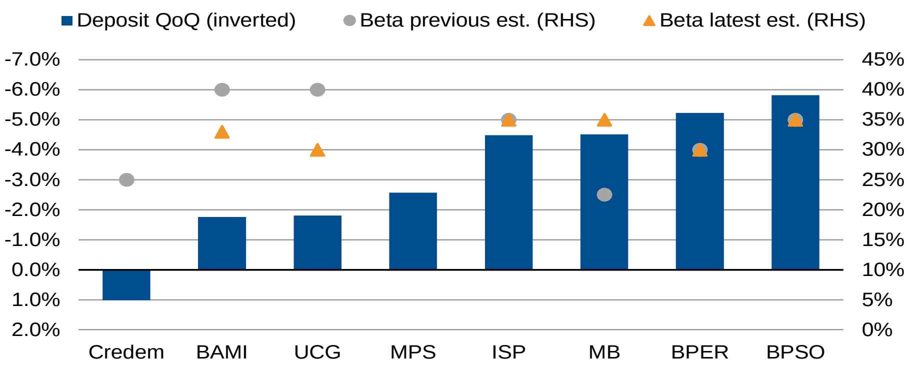
Deposits decline from all-time high while bank funding position remains sound

Large companies have withdrawn excess liquidity in Q1

So far, competition for deposits has remained limited as banks still maintain excess liquidity. As of February 2023, Italian banks' deposit beta stood at approximately 8%, which is one of the lowest in Europe. But while competition from money market funds is not a real concern, rising government bond yields pose more of a threat as these are a more direct alternative to bank deposits for retail savers. In Q1, the banks in our sample registered an average decline of 3.1% in deposits, mainly driven by large corporations withdrawing excess liquidity and retail customers shifting their money to government bonds.

Banks have forecast a deposit beta of between 20% and 40% for 2023. We consider these forecasts conservative, as they imply a significant acceleration in deposit repricing in upcoming quarters.

Figure 12: Quarterly change in customer deposits and guidance on deposit beta for 2023



Source: Company data, Scope Ratings
Note: for customer deposits, estimated figures excluding bonds, intercompany exposures, and repos (except for BPER).

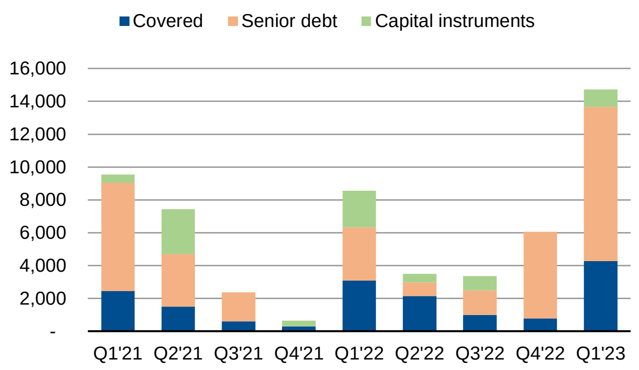
The funding position of Italian banks is sound. Between Q4 2022 and Q1 2023, banks capitalised on benign bond market conditions to frontload their annual funding plans, recording positive net issuance. Senior debt issuance for MREL purposes dominated market activity. This proactive approach limits banks' exposure to potential market turmoil in upcoming months.

A big portion of TLTRO III is due on 30 June 2023

Italian lenders still have EUR 318bn of TLTRO III funding but about 45% of that will expire in June. According to the Bank of Italy, the TLTRO III stock exceeded banks' excess liquidity deposited at the central bank by around EUR 60bn at the end of March. Consequently, to repay all the outstanding amount by YE 2024, banks will have to either raise funds in the capital market, replace it with other central bank operations, or reduce assets. We believe that banks have plenty of time to prepare for the latest deadline in 2024.

Against this backdrop, covered bond issuance represents a viable capital markets option. In this respect, we deem positive Italy's full transposition of the European Covered Bond Directive into local law as of 31 March 2023. For more details, see Italy paves the way for revived covered bond issuance.

Figure 13: Italian banks – Quarterly debt issuance, historical (USD bn)



Source: Bond Radar, Scope Ratings
Note: only large public international bon issues predominantly in EUR, USD, and GBP. It excludes domestic issuance, private placements, retained issuance, debt tranches documented and sold privately.
Issuance activity of the eight banking group in our sample

Figure 14: Selected benchmark bond issues, YTD

Issuer	Issue date	Type	Currency	Volume (m)	Coupon	First call
UniCredit	10-Jan-23	Senior preferred	EUR	1,000	4.800%	10-Jan-28
Banco BPM	11-Jan-23	Senior preferred	EUR	750	4.875%	/
UniCredit	09-Feb-23	Senior non-preferred	EUR	1,000	4.450%	09-Feb-28
Intesa	13-Feb-23	Tier 2	EUR	1,000	0.062	20-Nov-28
Intesa	27-Feb-23	Senior non-preferred	EUR	1,500	5.000%	8-Mar-26
Intesa	09-Mar-23	Senior preferred	EUR	1,500	E+ 63bp	/

Source: Bond Radar, Scope Ratings
Note: based on management data.

Selected research available on ScopeRatings.com:

Asset-quality review: falling NPL ratios hide rising vulnerabilities, May 2023

Italy paves the way for revived covered bond issuance, May 2023

European Bank Capital Quarterly: Capital remains important support for sector, April 2023

Italian banks: solid funding and liquidity against challenging backdrop, April 2023

French banks and the benefits of rising rates: the risk of slow-motion 2023, March 2023

Sound fundamentals protect Swedish banks from emerging challenges, February 2023

Spanish banks: profitability to continue strengthening in 2023, February 2023

Italian banks: promising 2023 outlook after bumper Q4, February 2023

European Bank Capital Quarterly: New year, new requirements, January 2023

2023 European Banking Outlook: strong ships in turbulent waters, January 2023

Asset quality, leveraged finance drive 2023 Pillar 2 capital updates, January 2023

Italian banks: solid Q3 performance; constructive outlook for 2023, November 2022

Issuer rating reports available to ScopeOne subscribers:

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Scope Ratings GmbH

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main
Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389 0

Paris
10 avenue de Messine
FR - 75008 Paris

Phone +33 6 6289 3512

Oslo
Karenslyst allé 53
N-0279 Oslo

Phone +47 21 09 38 35

Madrid
Paseo de la Castellana 141
E-28046 Madrid

Phone +34 91 572 67 11

Milan
Via Nino Bixio, 31
20129 Milano MI

Phone +39 02 30315 814

Scope Ratings UK Limited

London
52 Grosvenor Gardens
London SW1W 0AU

Phone +44 20 7824 5180

info@scoperatings.com
www.scoperatings.com

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