Italian banks: result season confirms sector soundness

The credit fundamentals of the large Italian banks remain solid. First-half results were reassuring, as is guidance for the rest of the year. The banks posted increases in revenues and profits across the board.

Economic growth, increasing loan balances, rising market rates and low credit losses were all key drivers of the strong performance. Cost are under control and positive asset-quality trends remain intact, for now. On average, Italian banks are well capitalised despite generous distribution policies.

Full year outlook robust. Core net interest income will increasingly benefit from interest-rate hikes and will more than offset expiry of the TLTRO bonus rate. Outlook for net fees and commissions is less visible but inflation and economic growth should be supportive. Cost of risk will remain low thanks to low expected default rates and the presence of management overlays.

UniCredit and Intesa keep Russian exposure under control but exit strategies are still unclear. In Q2, UniCredit materially reduced its cross-border exposure to Russia, while the decline for Intesa was marginal.

After initial provisions taken in Q1, the impact on profit and capital should be contained, considering the financial strength of Russian clients and the resiliency of local operations. The two groups have been looking for solutions to leave the market at limited cost, without providing a clear strategy.

2023 outlook more uncertain. We are more cautious about 2023. As base effects and boosts to economic growth from pent-up demand fade, Italy's growth is likely to converge to its long term, uninspiring norm. While core NII expands on the back of higher rates, loan quality may start to deteriorate.

Downside risks linked to general economic environment and political instability. The energy crisis inevitably carries downside risks, as does the global slowdown – partly an engineered policy response to the inflationary threat. In addition, snap elections in September may trigger a new round of volatility around confidence-sensitive Italian assets, which could harm Italian banks' market-driven revenues, funding costs, and, under more severe scenarios, ability to tap the markets for wholesale funds.

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Solid H1 results mainly reflect revenue growth and low credit losses

Italian bank performance was strong in H1 2022, despite surging inflation, volatile markets, and worsening business and consumer confidence indicators. Revenue resilience was not a surprise given the strong growth of the Italian economy and sector data indicating an increase in both lending volumes and loan interest rates. Banks were able to offset inflationary pressures through long-planned cost reduction actions, while credit losses stayed at historical low levels. For the eight Italian banks in our sample, H1 2022 return on average equity was c. 6.5[1]%.

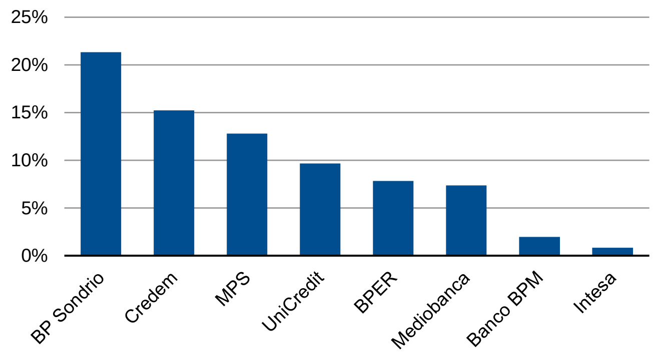
Average H1 NII increase of 9.6% YoY

On a year-on-year basis (YoY), net interest income grew for most domestic lenders. Banks continued to benefit from the -1% bonus rate on the ECB's TLTRO. At the same time, the commercial component of NII increased thanks to higher lending volumes and partly to the rebound in loan rates, especially for new mortgages. Finally, NII was boosted by higher bond yields and coupon appreciation in inflation-linked securities (particularly in the case of BP Sondrio).

Average H1 fee and commission income increase of 6% YoY

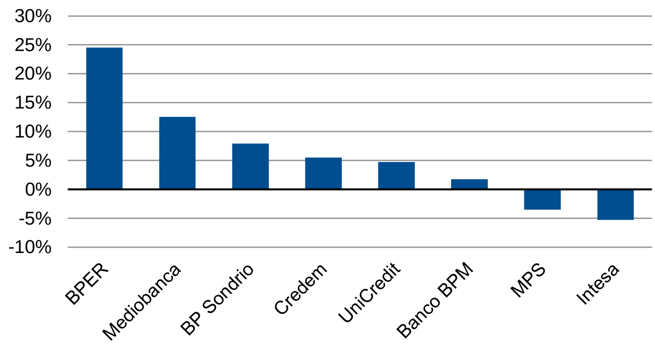
Italian economic growth continued to support banks' net fee and commission income, although performance was not homogeneous. In particular, banks with a higher reliance on asset management were hit by bearish markets (e.g. Intesa), which curbed new-money inflows and reduced performance fees.

Figure 1: Net interest income – H1 2022 vs H1 2021



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

Figure 2: Net fees and commissions – H1 2022 vs H1 2021



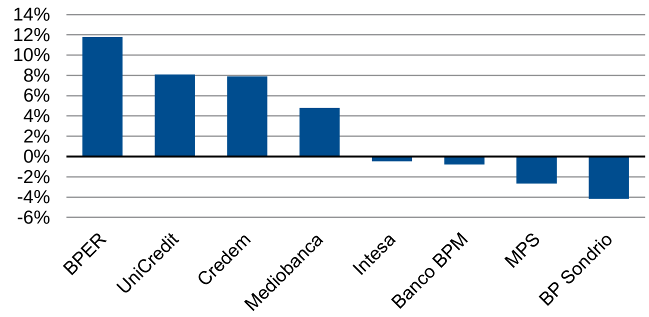
Source: Company data, Scope Ratings
Note: based on management data. Figures for BPER and Credem were materially affected by acquisitions

Operating expenses trended down YoY in H1. Although the banks' cost structure is less affected by energy prices compared to other sectors, inflation did hit administrative costs. However, Italian lenders were generally able to offset such pressures via cost-saving measures. Banks that displayed a cost increase were those that accelerated investments, for instance in digitalisation or strategic initiatives (e.g. Mediobanca boosted the distribution network in its wealth management division).

Cost-to-income for the sector fell from above 58% on average in the first quarter of 2021 to 56.5% in H1 2022.

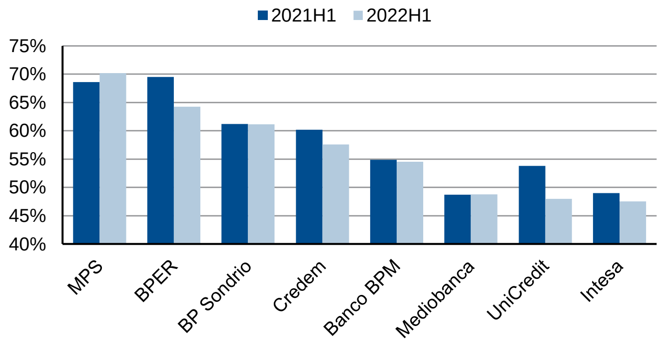
[1] Excluding BPER, whose H1 net result included a large badwill linked to the Carige acquisition.

Figure 3: Revenues – H1 2022 vs H1 2021



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

Figure 4: Cost-to-income ratios



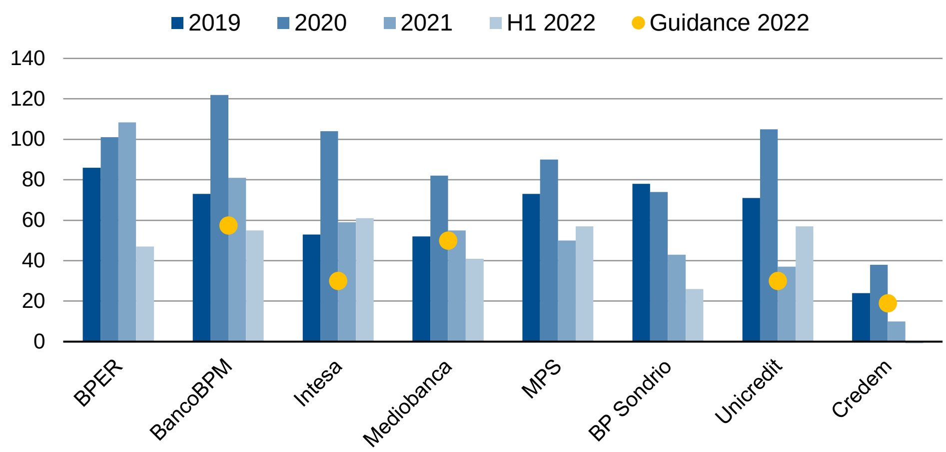
Source: Company data, Scope Ratings

During the first six months of 2022, Italian banks' cost of risk fell from 55bp in 2021 to an average of 43bp. This was the result of four main factors:

- Default rates are still at record lows despite the gradual lifting of borrower support measures, such as loan moratoriums.
- The partial reversal of pandemic-related overlays, which are extra provisions taken by management in 2020, on top of those driven by macroeconomic models. UniCredit, for example, released EUR 400m, Intesa EUR 300m.
- Low direct or indirect exposure to Russia, Ukraine, and Belarus, except for UniCredit and Intesa.
- Limited exposure to energy-intensive sectors, which represented 8.5% of performing business loans as of YE 2021 according to the Bank of Italy. The one-year probability of default in the energy-intensive sectors was also lower than the average for the other sectors, 1.2% vs 1.9%, according to AnaCredit data.

Management offered comforting guidance for the rest of the year, with full year cost of risk expected to settle around 40bp, on average.

Figure 5: Cost of risk (bp) – Historical data and 2022 guidance



Note: for Mediobanca guidance refers to FY 2023 started in July 2022. Credem's H1 Cost of risk was -1bp. BPER, BP Sondrio and MPS did not provide guidance for 2022 cost of risk
Source: Company data, Scope Ratings

We do not expect profitability to swing considerably in the second half of 2022 despite a more challenging macroeconomic scenario.

The revenue boost from higher policy rates, now expected at around 0.50%/0.75% at the end of the year, will more than offset the decline caused by the end of TLTRO bonus rate. Benefits to NII will be sizeable, in the order of about 8%-20% of 2021 levels, depending on the characteristics of the banks' business model and balance-sheet composition. However, the full impact on margins will only come to fruition in 2023, as loans only gradually reprice.

There is less visibility on the other components of operating income, although a strong tourist season, resilient corporate activity and inflation should support banking fees (e.g. from payments) especially in Q3. In contrast, income from asset management and trading activities is more uncertain and will largely depend on financial market dynamics.

The bottom line will continue to benefit from a low cost of risk. As mentioned above, banks remain well provisioned, with a cushion of management overlays. In H2, default rates should start to pick up from an all-time low but with no visible effects on the P&L.

Energy crisis and general elections are two H2 catalysts

Downside risk factors comprise primarily (i) a cold winter due to a shortage of energy supply, causing a recession; (ii) market turmoil in the wake of the general elections to be held in September, impacting banks' trading income and asset management-related revenues, and potentially hindering access to the bond market.

Disposal of legacy NPEs continue while default rate remains at record low level

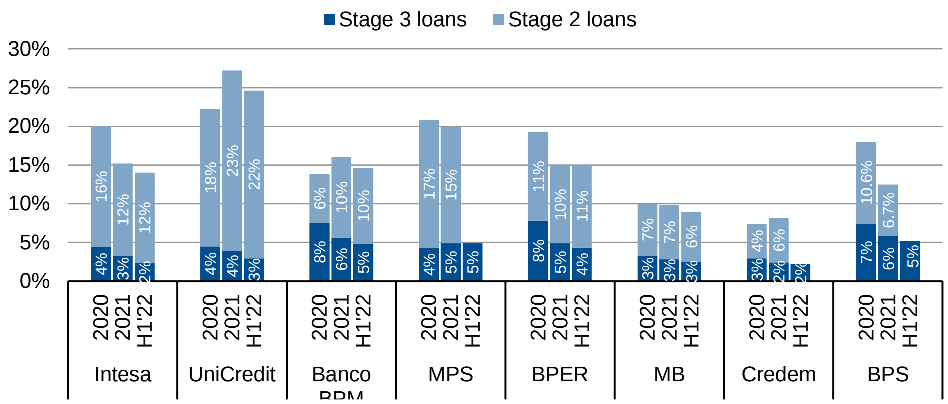
In H1 2022, headline NPE ratios continued to trend lower for most banks. This was mainly driven by a reduction in the NPE stock through asset sales and securitisation. Inflows of new non-performing loans remained low, with no signs of a pick-up in default rates on loans formerly under moratorium.

As of June-end, the average gross NPL ratio stood at 3.7%, down 50bp from the beginning of the year. Italian banks' asset quality is as strong as ever. Legacy non-performing loans accumulated in the wake of the GFC are a non-issue from a credit perspective.

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

We do not expect banks to stop there. Intesa has paved the way towards the zero-NPL ratio target in its 2022-25 business plan; a strategy that other competitors are mirroring. Achieving a NPL ratio in line with EU average is a way not only to reduce uncertainties and earn investor confidence but also to alleviate supervisory scrutiny.

Figure 6: Stage 2 and Stage 3 loans ratios of the largest Italian banks



Source: Company data, Scope Ratings
Note: MPS, Credem and BPER's Stage 2 ratios not available yet

However, we note that the share of gross customer lending classified as Stage 2, which increased during the Covid pandemic, is still high. There is some variation among banks, which is likely to be based on how cautious approaches have been to loan classification and provisioning, rather than on differences in loan book quality.

Very solid capital buffers allow banks to carry on with dividend plans

As of June 2022, the capital position of Italian banks was sound, with an average MDA buffer on CET1 requirements of approximately 560bp. On average, the CET1 ratio declined by more than 40bp in the first six months of the year, owing to market losses on debt securities, as well as to high dividend pay-outs and acquisitions in some circumstances.

Banks' capital ratios shielded

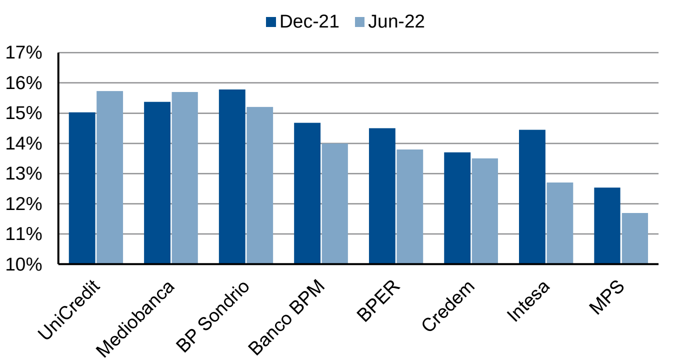
Capital impacts from falling bond valuations were contained and mainly derived from foreign bond holdings. Following mark-to-market losses in 2018 due to the BTP-Bund spread increase, banks have rebalanced their Italian BTP portfolios by drastically reducing the proportion held through other comprehensive income (which is subject to bond price volatility).

Given their comfortable positions, most of the banks have confirmed their distribution plans for the year. In recent months, a few lenders have even hinted at potential one-off dividend or share buybacks.

Most banks still have significant room not only above their capital requirements, but also to their own internal capital targets, although we believe management may adopt a more conservative approach, especially if the business cycle takes a turn for the worse. Excess capital may instead be used to accelerate the restructuring and consolidation process. Stronger banks may also want to keep some powder dry for potential bargains if valuations allow.

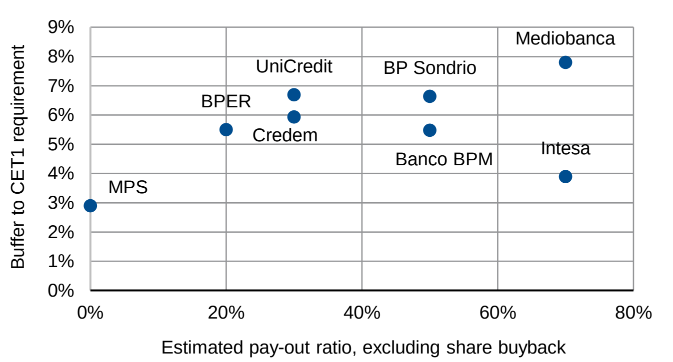
With respect to capital distributions, we believe the ECB will not reinstate blanket restrictions on dividend payments, but it could apply soft pressures to banks to retain capital. The EU supervisor recently advised banks to "review their capital trajectories to include sufficiently conservative and updated adverse macroeconomic scenarios"[2]. While acknowledging the resilience of Italian banks to the Covid shock, such caution was echoed by the IMF in its latest article IV consultation paper[3].

Figure 7: CET1 ratio



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

Figure 8: Bank's projected 2022 pay-out ratios vs capital buffer as of Q2 2022



Source: Company data, Scope Ratings
Note: Credem's buffer to requirement refers to the holding's capital ratios

[2] https://www.bankingsupervision.europa.eu/press/speeches/date/2022/html/ssm.sp220707~2c4f24a6b2.en.html
[3] https://www.imf.org/en/Publications/CR/Issues/2022/07/28/Italy-2022-Article-IV-Consultation-Press-Release-Staff-Report-and-Statement-by-the-521484

Intesa and UniCredit keep Russian exposure under control, but uncertainty remains

Since the beginning of the war in Ukraine, UniCredit and Intesa have worked to reduce cross-border exposure to Russia and find exit strategies for their local subsidiaries at limited cost.

UniCredit: In recent months, the group has reduced its exposure to Russia by more than EUR 2.7bn, from EUR 5.5bn to EUR 3.8bn, excluding its local subsidiary. Net cross-border exposure of EUR 2.8bn will decline over time, also through negotiations with clients and asset swaps with third parties. Coverage on cross-border assets was 30%.

Meanwhile, the group has yet to find a solution to divest from its Russian subsidiary. In Q2, the reduction in local assets combined with the appreciation of the Rouble drove up the group's CET1 ratio by 52bp. This partly offset the impact of its initial actions, i.e. the write-off of the Russian subsidiary and provisions against cross border exposures, which cost 92bp in Q1.

UniCredit is trying to avoid selling the Russian unit at a deep discount. Lately, there has been an increasing interest from countries that have not sanctioned Russia. In any case, as of July, UniCredit's CET1 ratio would remain above 14.9% even in an extreme loss scenario, which management deems unlikely.

Intesa: The decrease in exposure to Russia was less marked than for UniCredit. At constant FX rates, Russian assets have declined by EUR 400m since the beginning of the war.

The group's cross-border exposure to Russia is represented by medium-term loans to leading Russian players, which are expected to perform well in the years to come. As of Q2, these assets amounted to EUR 3.85bn, net of Export Credit Agency guarantees of EUR 900m and provisions taken in Q1.

Like UniCredit, Intesa has not found a way to exit the Russian market. However, the group has a smaller local presence, which holds EUR 700m of customer loans (less than 0.2% of the group's total).

Although a slow run-down of exposures looks operationally and economically manageable, a prompter exit from the Russian market or at least a clearer forward strategy would reduce uncertainty, allowing the banks to move forward from what has already turned to a legacy issue for European banks.

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