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Financial Institutions

Italian Bank Quarterly: record Q2 results will be hard to repeat as windfall tax looms

The positive momentum for Italian banks continued in the second quarter, thanks mainly to wider interest margins and low loan-loss provisions while asset quality and funding concerns have so far proved unfounded. However, the announced windfall tax will curtail banks' profitability in the second half.

Italian banks further increased underlying net income guidance for 2023 following stronger-than-expected second quarter results. Return on equity increased from the first quarter to 14.7% (Figure 1).

The impact of the new windfall tax on 'extra profits' could markedly reduce second half profits. A slowdown in lending and faster deposit repricing could also start eating into net interest income, although we believe there is still some upside potential above banks' projections as deposit rates could increase more slowly than expected. After bottoming in the first half at 36bp, cost of risk is likely to normalise as default rates slowly increase and banks accumulate loss reserves for 2024.

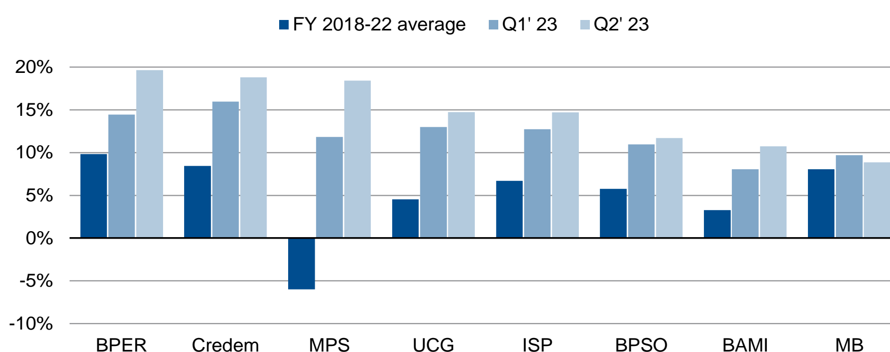
No signs of credit deterioration yet: asset quality keeps improving. In the second quarter, Italian banks' average gross NPE ratio declined by 10bp partly due to loan disposals. But while the gross Stage 2 loan ratio is decreasing, it is still high by EU standards, at around 10.4%.

Strong EBA stress test results proved Italian banks' resiliency. Under the severe scenario, the average CET1 ratio decline was at around 400bp, significantly lower than in 2021 thanks to higher earnings capacity and cleaner balances sheets.

The CET1 impact of the windfall tax will be material, ranging from 20bp to 100bp, which we estimate would decrease to 15bp-35bp if the 0.1% total asset cap is confirmed. Banks have sufficient capital buffers to absorb the hit but may have to take a more conservative stance on dividends and buybacks.

The repayment of a large portion of TLTRO III in June went well. Italian banks mostly used a mix of excess liquidity and proceeds from bond issuance to meet the deadline. Liquidity and funding ratios remain well above requirements.

Figure 1: Italian banks' return on equity increased in Q2



Source: SNL, Scope Ratings Note: data might slightly deviate from reported figures

Figure 2: Expected H2 2023 trend by key area for Italian banks	
Profitability	Supportive (net of windfall tax) ↗
Asset quality	Negligible deterioration →
Capital position	Higher capital ratios thanks to organic generation ↗
Funding and liquidity	Less supportive conditions but comfortably managed →

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Profitability may have peaked in Q2 as NII growth margins narrow and windfall tax hits bottom lines

Margin effect shadows the impact from lower loan volumes

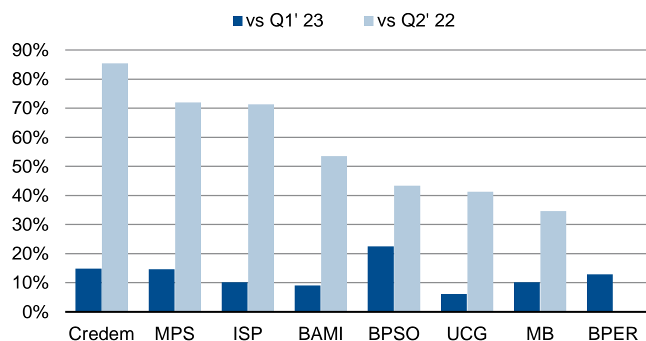
Our sample of eight Italian banks – Intesa Sanpaolo, UniCredit, Banco BPM, Banca Monte dei Paschi di Siena, BPER, Mediobanca, Credito Emiliano and Banca Popolare di Sondrio – reported excellent second-quarter results, achieving an average ROE of 14.7%, 1.6 pp higher than in the previous quarter. Net interest income continued to be the main growth driver, thanks to rising loan rates which were not matched by a corresponding pass-through to deposits. The benefitd of loan spread widening more than compensated for the drag from lower customer loan volume (-1.2% QoQ median). Net interest income accounted for 65% of banks' core revenues (net interest income plus net fees and commissions), markedly higher than a year ago (53%).

Fees and commissions declined across the board on a quarterly and annual basis. This partly reflected weaker new lending activity and the ongoing reduction in current account fees. Sales of asset management products were negatively affected by competition from the placement of Italian sovereign bonds, which attract lower remuneration for banks. Subdued investment banking turnover weighed in particular on Mediobanca's fees (-8.8% YoY).

Operating expenses rose by marginally quarter-on-quarter as investments in digitalisation, restructuring costs, and higher energy prices were mitigated by ongoing efforts to improve efficiency. Cost-income ratios fell markedly for the second consecutive quarter, from 48.6% in Q1 2023 to 45.6% in Q2 (Figure 3).

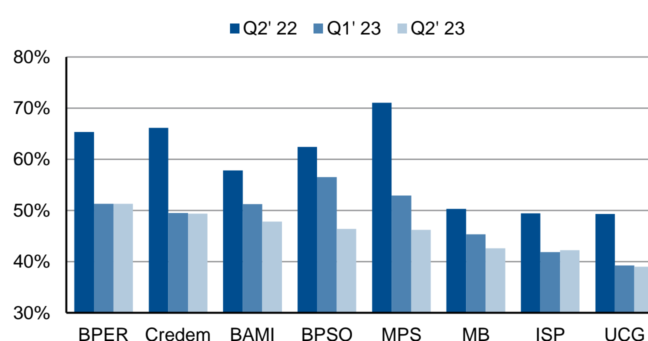
Cost of risk remained at a record low level of c. 35bp, reflecting low default rates and no changes to banks' macroeconomic forecasts.

Figure 2: Large YoY increase in net interest income



Source: Company data, Scope Ratings
Note: BPER's YoY comparison not meaningful following Carige acquisition

Figure 3: Cost-to-income ratio declined again in Q2



Source: Company data, Scope Ratings

With an excellent first half, Italian lenders have laid the ground for very strong full-year underlying results. But the room for further improvement is narrowing as interest rates approach their peak amid slowing inflation and economic growth in the euro area. Banks will also have to pay the recently announced windfall tax, which could materially reduce their 2023 annual profits.

While assets may not yet have fully repriced, pressure is mounting on banks to increase rates on deposits, particularly in Italy, where the pass-through rate is still at historically low levels (9.6% as of May).

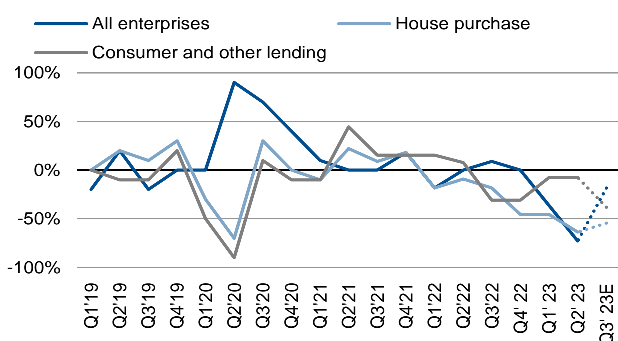
Clearer signs of loan deleveraging

At the same time, lending volumes may continue falling because of low customer demand and tighter underwriting criteria, especially for corporates. Business loans have suffered the most from the impacts of soaring rates and softer economic growth. The recent ECB

lending survey anticipates a further decline in loan demand in the third quarter, particularly in the mortgage segment (Figure 4). Deleveraging detracts not only from banks' revenue potential but is also a drag on economic growth.

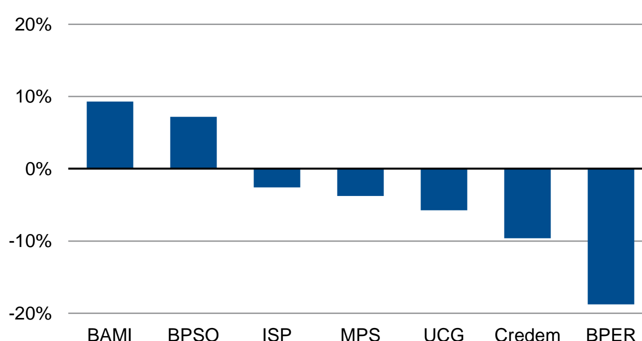
As a result, most banks have adopted a cautious approach to full-year net interest income projections. Analysing first-half results and reviewing banks' own guidance suggests net interest income will decline in the second half for most lenders (Figure 5). But we think banks may surprise to the upside because their assumptions about deposit beta (around 30%-40%) would imply a significant acceleration in repricing in upcoming quarters.

Figure 4: Loan demand to decline even further, particularly in the retail segment



Source: Macrobond, Bank of Italy, Scope Ratings
Note: difference between the percentage of banks observing an increase and a decrease in demand in the past three months, plus the three-month forward-looking view

Figure 5: Implied* net interest income growth rate in H2 vs H1 2023



Source: Company data, Scope Ratings
*Based on banks' latest guidance for full-year 2023 net interest income and H1 actual results.

Fee and commission outlook subject to growth dynamics

Italian banks are moderately optimistic about growth in fee and commission income in coming quarters but a lot will depend on macroeconomic dynamics. Scope is forecasting 1.2% growth for the Italian economy but there are risks: recent data showed a 0.3% contraction in the second quarter. Lower-than-expected growth will add pressure to lending and transaction fees.

Banks are guiding to a rebound in credit provisions in the second half. We believe their projections are conservative given the lack any of signs of credit deterioration and the banks' constructive view on asset-quality trends for 2024. This could reflect bank's inclination to accumulate generic provisions at the end of the year, especially because they have the margins to do so.

On August 7, the Italian government announced a windfall tax on 'extraordinary bank profits'. As argued in a separate comment, we deem the initial Italian government's proposal to be quite harsh on banks. The definition of extraordinary profits refers to the maximum between the growth of NII in excess of 5% per annum from 2021 to 2023 and from 2021 and 2022. The applicable tax rate of 40% will not be deductible from the corporate tax. However, the levy will be capped at 25% of banks net equity or at 0.1% of total assets.

Sound asset quality metrics and few concerns for 2024

Asset quality continues to surprise to the upside. This is reassuring, given high NPLs in the past decade have been the Achilles heel of Italian banks. In the second quarter, asset disposals drove a small decline in the gross non-performing exposure ratio to 3.1%. Since December 2022, all the banks in our sample display gross NPE ratios below 5%, which used to be a common key de-risking target for banks.

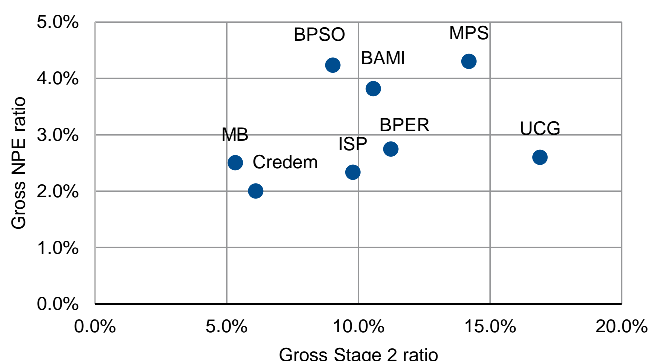
NPE coverage stood at 55.7% in the second quarter, a level that we deem comfortable. For bad loans, the most deteriorated category, coverage reaches 75%.

Gross stage 2 loan ratio still high

Despite the challenging macroeconomic backdrop, credit quality is stable. Stage 2 loans remain high by EU standards and above pre-pandemic levels, although they have declined by 4% since the beginning of the year (Figure 9). This is likely to be the result of the long-lasting effects of the post-Covid reopening on the Italian economy and the ability of companies to pass costs onto customers at a time of improving employment data.

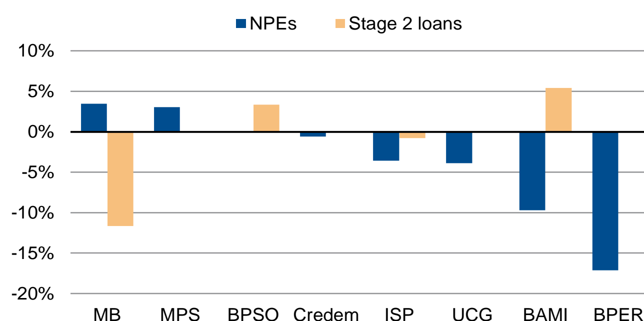
There continues to be high Stage 2 variation among banks, which reflects differing degrees of caution with respect to loan classification and provisioning rather than just differences in loan-book quality.

Figure 6: Headline asset quality metrics as of Q2 2023



Source: Company data, Scope Ratings
Note: MPS Stage 2 ratio as of YE 2022

Figure 7: QoQ improvement in stock of NPLs. Stage 2 loans remain broadly stable



Source: Company data, Scope Ratings
Note: MPS' and Credem Q1' 23 Stage 2 loans figures were NA

Trend reversal is behind the corner

We believe it is only a matter of time before the positive trend reverses, however, as the impacts of tighter financial conditions are starting to show up in GDP data. In some European countries, delinquencies are rising in the most vulnerable sectors, like accommodation and food, transportation, education and healthcare (see Asset Quality Review: Falling NPL ratios hide rising vulnerabilities).

That said, we do not expect a wave of defaults in the coming quarters. Nudged by the supervisor, Italian lenders have in recent years materially improved their management of (i) credit origination; (ii) high-risk positions and; (iii) NPLs. This will have made balance sheets more resilient to economic downturns.

EBA stress test reflected Italian banks' improvements in financial fundamentals

The results of the 2023 stress test were positive for Italian banks. Under the severe scenario, the average CET1 ratio declined by around 400bp, significantly less than in 2021. By 2025, the CET1 ratio would be above 10% for most lenders, except for BPER and Banco BPM, mainly due to lower starting points and for Mediobanca, owing to a relatively high capital drawdown (Figure 8). In the adverse scenario, only BPER hit its MDA trigger (8.3% as of YE 2022), which would imply restrictions to dividend and other capital distributions.

This outcome reflects two main factors:

Higher profitability and clean balance sheet drove positive stress test results

1) Higher pre-provision buffers thanks not only to wider interest margins but also to banks' efforts to boost income from fee-generating activities like asset management and life insurance.

   Results show that under the baseline scenario and assuming a static balance sheet from YE 2022 onwards, banks would generate 854bp of CET1 capital (pre-provision) over a three-year horizon, almost double the amount of the previous stress test.

2) Less need to book loan-loss provisions thanks to de-risked balance sheets, tighter loan origination and management, and low default rates since 2020.

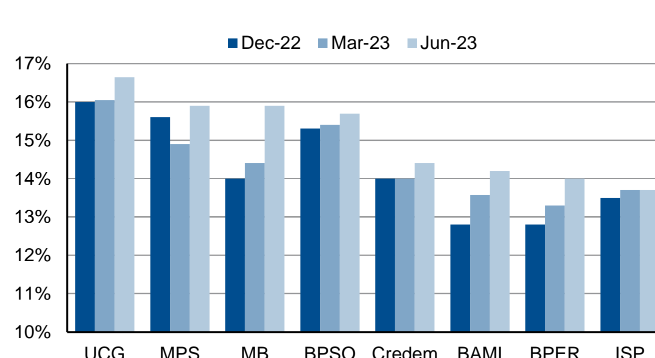
While in theory, these results are supportive of distribution plans, the windfall tax is likely to force management to reconsider generous dividend pay-out plans. We have estimated the impact of the levy in the 20bp-100bp range for the Italian banks in our sample. This estimate would decrease to 15bp-35bp if the 0.1% total assets cap is confirmed.

Figure 8: 2023 stress test results

Banks	FL CET1 YE 2022	FL CET1 YE 2025 - Adverse scenario	Drawdown
ISP	13.5%	10.8%	2.7%
UCG	16.0%	14.7%	1.3%
BAMI	12.8%	9.0%	3.8%
MPS	15.6%	10.1%	5.5%
BPER	12.0%	7.9%	4.1%
Credem	14.0%	11% to 14%	≤ 3%
BPSO	15.3%	8% to 11%	3% to 5.99%
MB	14.0%	8.7%	5.3%

Source: EBA, ECB, Scope Ratings
Note: Mediobanca's capital ratios exclude the positive effect of the permanent application of the Danish compromise (c. 100 bp)

Figure 9: Retained earnings contribute to CET1 growth



Source: Company data, Scope Ratings
Note: fully loaded CET1 ratios

Capital ratios keep rising. As of Q2 2023, the average MDA buffer to CET1 requirements reached around 660bp, 70bp higher than the first quarter thanks to earnings retention, declining risk-weighted assets, and low regulatory headwinds.

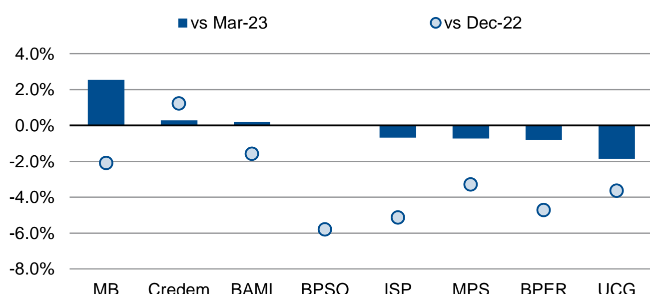
Mediobanca showed the highest quarterly increase in CET1 ratios after incorporating the benefits from the permanent application of the Danish compromise, which grants more favourable capital treatment to sizeable stakes in insurance companies. MPS followed closely (+100 bp QoQ) thanks to Q2 earnings.

Comforting trend in deposits and smooth repayment of June tranche of TLTRO III

Fears of deposit outflows in the wake of the SVB and CS crises have so far proven unfounded. Data for the second quarter show a stable trend in deposit volumes (-0.1% QoQ). UniCredit reported the largest quarterly decline (in what the group calls average commercial deposits) as it continues to prioritise pricing over volume retention.

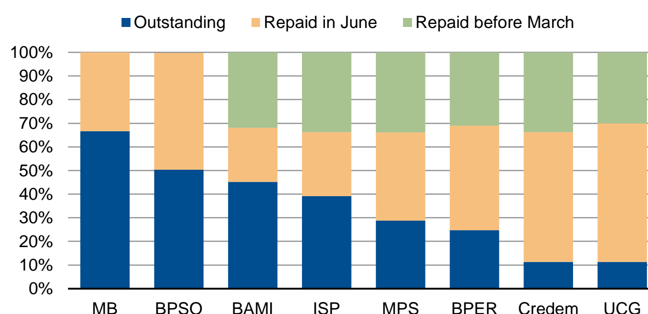
A gradual and controlled decline in deposits does not pose a threat to the sector. This trend is common during policy tightening cycles, when liquidity is drained from the system. Companies are likely to continue reducing the extra liquidity accumulated during the pandemic, partly shifting their money to government bonds together with retail customers. Italian sovereign bonds held by non-financial residents increased by about EUR 33bn in the first four months of the year, according to Bank of Italy data.

Figure 10: In Q2, Mediobanca and Banco BPM bucked the trend



Source: Company data, Scope Ratings
Note: % change in deposits volume since December 2022 and March 2023
Volumes comprise current accounts, term deposits, and certificates

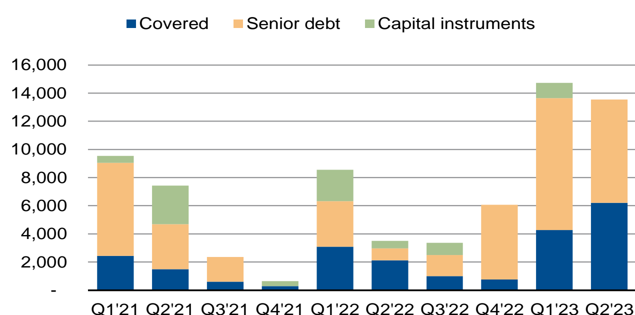
Figure 11: ECB's TLTRO III repayments in %



Source: Company data, Scope Ratings

In June, the eight banks in our sample repaid EUR 137bn of TLTRO III, 58% of the total. The repayment was carried out without any problems and with minimal impact on liquidity. To repay the expiring TLTRO III, banks used a mix of excess cash and proceeds from debt issuance (particularly senior preferred debt), which was active after markets slowed between March and May. Only MPS resorted to the ECB's MRO facilities to repay part of the expiring amount.

Figure 12: Italian banks – Quarterly debt issuance, historical (USD bn)



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

Figure 13: 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
Mediobanca	07-Mar-23	Senior preferred	EUR	750	4.750%	14-Mar-27
Intesa	09-Mar-23	Senior preferred	EUR	1,500	E+ 63bp	/
Credem	23-May-23	Senior non-preferred	EUR	400	0.056	30-May-28
Banco BPM	07-Jun-23	Senior non-preferred	EUR	750	6.000%	14-Jun-27
Intesa	12-Jun-23	Senior non-preferred	USD	1,500	7.778%	20-Jun-53

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

Selected research available on ScopeRatings.com:

European Bank Capital Quarterly: funding and liquidity under the spotlight, July 2023

UK bank stress test provides some reassurance, July 2023

French banks: sound credit profiles resilient against tighter financial conditions, June 2023

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