



Trading Desk Strategy

Financials Desk Commentary

Mid-sized Italian banks 3Q results: Asset quality deteriorating, coverage ratios needs to increase sooner or later

Published 14 Nov 2012 by Georgios Banos, Jorge Mayo, CFA

General Overview: Italian mid-sized banks have reported 3Q results over the last two days, and below we provide a brief summary and key takeaways. Overall, we spot common trends among the banks, with deteriorating asset quality and low coverage ratios being the most noteworthy. Gross impaired loans (NPLs, restructured, substandard and past due) keep mounting, with banks protecting earnings and capital by depleting coverage ratios, already well below European peer levels. Given the pace of asset quality deterioration, we anticipate provision charges to rise from here and remain elevated for quarters to come, potentially pushing these banks into loss-making territory. Elsewhere, we notice an improvement in core capital ratios (driven by LM exercises) and liquidity metrics (assisted by LTROs). P&L trends are as expected with pressure in net interest income (driven by low interest rate environment) and fees & commissions offset by strong trading results on the back of price appreciation on sovereign bonds and capital gains from LM exercises.

UBI: Improving liquidity and capital, but positive P&L is supported by lower coverage ratios

- **Summary and P&L trends:** UBI reported net profit of EUR 63m in 3Q 2011, after a loss of EUR 69m in the same period last year, confirming its slow but steady operating performance improvement during the year (for 9M 2012, operating revenues are up by 4% vs the same period in 2011). In 3Q 2012, ex-PPA effects, total revenues for the quarter were marginally up to EUR 850m (+1.5%), on the back of positive trading income result (+EUR 42m due to bond trading and hedging results vs a loss of EUR 23m in 3Q 11) which offset pressure on NII and slightly weaker fees and commissions; net interest income was down ~9% yoy to EUR 488m, as a result of weaker credit demand and the bank's decision to de-risk and deleverage its balance sheet. Operating expenses were broadly stable on a qoq basis (but down 4% on 9M basis), as the bank is pushing ahead with its tight cost cutting measures of staff reduction and admin expenses containment. Finally, loan loss provisions increased to EUR 160m from EUR 135m in 3Q 2011 (leading to annualised cost of risk of 70bps, on a 9M basis), reflecting macro environment deterioration.
- **B/S and Asset Quality:** Customer lending stood at EUR 95bn (-8% yoy and -0.5% qoq), reflecting lower credit volumes, bank's decision to de-risk from high risk areas and deleveraging efforts. Direct funding from customers (deposits and retail bonds) grew to EUR 81.4 bn, an increase of 4% yoy, moving the group's loan-to-deposits ratio to 117%, from 131% in September 2011. In terms of asset quality, UBI's total impaired loans (NPLs,

watchlist, restructured and past due) stand at ~EUR 10.3bn, or 10.6% of gross loans, with a coverage ratio of 25% in 3Q. This is low on a pan-European basis and we think that profitability and capital generation will be negatively affected as the bank eventually builds up coverage ratios via much higher provision charges.

- **Capital & Liquidity:** UBI reported CT1 ratio of 10.5% (Basel 2), vs 10.24% in 2Q; on the basis of EBA exercise, pro-forma Core Tier 1 stands at 9.35%. The bank disclosed its compliance with both LCR and NSFR ratios ahead of schedule (Basel III liquidity ratios). Finally, the bank's total exposure to ECB amounts to EUR 12bn, unchanged since February 2012.

Banco Popolare - Uninspiring results, affected by deteriorating asset quality

- **Summary and P&L trends:** Banco Popolare presented a weak set of results for 3Q, posting a net loss of EUR 83m slightly below market estimates of EUR 58m loss. Results were largely affected by negative EUR 116m Fair Value Option result (FVO). Operating environment remains very difficult for mid-sized Italian banks, due to increased cost of funding, lower assets spreads and increase on impaired loans. NII was relatively stable qoq (due to treasury securities portfolio stability on a quarterly basis), while fees and commissions were higher by c7% on a yearly basis (but down 2% qoq), on the back of increased fund management volumes. Trading result was very strong including gains on government bonds and an one-off on subordinated bonds buyback. Operating expenses were reduced by 4.4% on a yearly basis due to employee reduction and lower admin expenses, while loan loss provisions continue to rise.
- **B/S and Asset Quality:** On a yearly basis, total customer lending is broadly stable, but excluding Italease, loans are up ~2% yoy. Large corporate and mid-corporate lending recorded significant decreases (10% and 14% on a yoy basis), which was offset by mortgage lending and repos. Direct customer funds (deposits and bonds) are down by ~EUR 10bn yoy to EUR 97bn, due to a decrease on institutional clients placements; on the other hand, customer deposits showed some stickiness to an amount of ~EUR 40bn (up from EUR 36.5bn in FY 2011). In terms of asset quality, BP's total impaired loans (NPLs, watchlist, restructured and past due) stand at ~EUR 15.8bn (+4.5% qoq), or 16.1% of gross loans, with a coverage ratio of 34.1% in 3Q (down from 35.3% in June and 36.4% in the end of last year). Though a significant chunk of these loans are related to Italease, we view coverage ratio as low and is likely to negatively affect future profitability.
- **Capital & Liquidity:** In the end of 3Q 2012, Banco Popolare posted a Core Tier I ratio of 10.4%, up from 10.2% in June 2012. In addition, the bank disclosed that both LCR and NSFR ratios are in line with Basel III guidelines. As of beginning of November, Banco Popolare had ECB exposures amounting to EUR 13.5bn (LTRO), while it has a similar amount (EUR 13.8bn) of available assets available in case of an emergency.

BPM - Low coverage ratios support bottom-line profitability, low capital ratios

- **Summary and P&L trends:** BPM presented its 3Q results, recording net profit of EUR 25m, after a disappointing EUR 196m loss in 2Q 2012 (affected though by a EUR 360m write-down). Results benefited from positive trends on net interest income (EUR 171m, after a weak EUR 131m in 2Q), a satisfactory trading result (~EUR 40m) and improved loan loss provisions (EUR 75m, vs EUR 83m in the previous quarter). Operating costs are down yoy by 5% and stable qoq, reflecting the bank's focus on tight cost management. For 9M 2012, BPM has recorded a net loss of EUR 106m on the back of high loan loss provisions and a one-off related to goodwill write-down, but on underlying trends, revenues are up ~10% yoy, operating costs are down ~8% while annualised cost of credit lies at 80bps. Going forward, we expect a rise on loan loss provisions due to rapid

increase of gross NPLs, which is likely to hurt BPM's profitability in the short-to-medium term.

- **B/S and Asset Quality:** Lending to customers was flat qoq and 2% down since the beginning of the year on the back of reduced corporate lending. Deposits from customers stood at EUR 22.5bn in 3Q, slightly decreased from EUR 23bn in June 2012 but overall up 8% year-to-date, due to an increase on time deposits. In terms of asset quality, BPM is suffering from a rapid deterioration in its asset quality, as Gross NPLs currently stand at 10.7% of its total loans, up from 9.9% in 2Q and 8.5% in the end of 2011. At the same time, coverage ratio remains at a very low 28.5%, in line with previous quarter, supporting bottom line profitability.
- **Capital & Liquidity:** As at 3Q 2012, BPM has pledged EUR 4.7bn with ECB, down from EUR 6.2bn in 2Q; moreover, the bank's net liquidity balance stands at EUR 4.5bn. In terms of capital, its CT1 stands at 8.91% (9% in 2Q 2012), affected by sovereign ratings downgrade which led to an increase in the weight on direct exposures guaranteed by banks.

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