Scope Ratings

Italian Bank Quarterly

Higher-for-longer rates support performance, credit fundamentals improve

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Italian banks are poised for strong profitability in 2024 thanks to higher-than-expected rates and resilient credit quality. Lenders have effectively managed the initial impact of declining interest rates while the outlook for fee-based activities such as wealth management looks promising after the rebound in the first half.

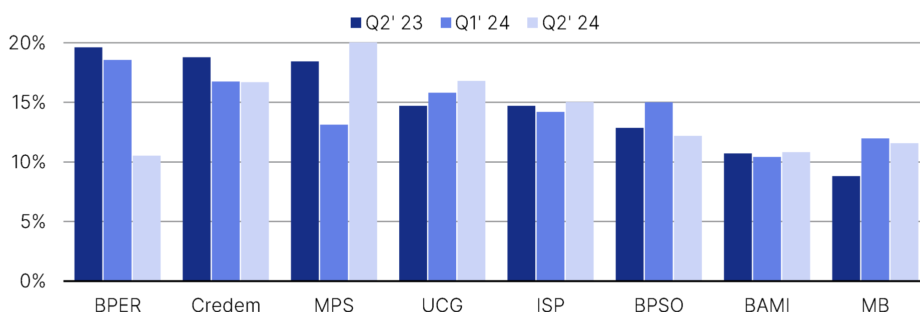
Tail risks remain. The economic backdrop remains highly uncertain, exacerbated by the worsening geopolitical crisis in the Middle East, while financial markets could see more volatility. The government, meanwhile, is mulling over a measure to force banks to raise rates on current accounts, adding a layer of uncertainty.

Asset-quality metrics remain strong although there are early signs of deterioration. We are starting to see a small pick-up in default rates but they are still within banks' FY 2024 budgets. Indeed, average cost of risk was very low at 36bp, reflecting solid loan performance and adequate levels of coverage, both on performing and non-performing loans. The Stage 2 ratio further declined in Q2.

Solid capital positions allow banks to increase distribution. Capital ratios continue to increase on the back of high earnings and optimisation of resource allocation. Due to the lack of growth opportunities, banks have committed to higher pay-out ratios (the latest being MPS and BPER).

Comfortable funding positions despite TLTRO III repayments. Our sample of Italian banks reported quarterly growth in deposits. At the same time, debt issuance for both funding and MREL purposes remains strong.

Figure 1: Italian banks' return on equity



Source: SNL, Scope Ratings. Note: based on statutory net income. Calendar years.
Note: MPS's Q2 2024 ROE was 31.3% thanks to a positive tax effect of EUR 457m

Our expectations of 2024 trend by key area for Italian banks	
Profitability	**Upgraded guidance from banks after a strong H1 →**
Asset quality	**Manageable deterioration from a strong starting point ↘**
Capital position	**Organic generation mainly offset by distributions →**
Funding and liquidity	**TLTRO III repaid without issues. Deposits volumes growing →**

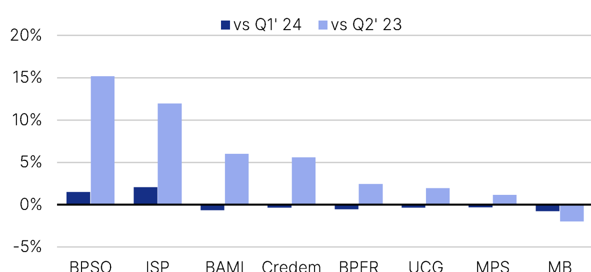
Higher-for-longer rates support banks' record results

Our sample of eight Italian banks – Intesa Sanpaolo, UniCredit, Banco BPM, Banca Monte dei Paschi di Siena, BPER Banca, Mediobanca, Credito Emiliano and Banca Popolare di Sondrio – posted strong results in the second quarter, achieving a return on average equity of 15.6%, from 14.5% in Q1 2024 and 14.8% in Q2 2023.

Net interest income close to the highs of end-2023

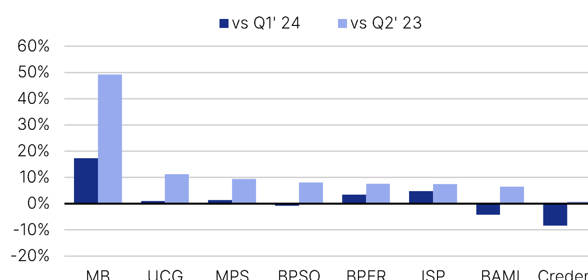
Net interest income remained close to the peak of Q4 2023 thanks mainly to banks' structural hedges, which offset the impact of the small decline in 3m Euribor (-18bp QoQ). Lending dynamics were mixed across the peer group (+0.5% QoQ), due to different commercial strategies and customer segments. Deposit pass-through plateaued at around 16% as of May 2024 benefiting loan/deposit spreads.

Figure 2: Net interest income, quarterly comparison



Source: Company data, Scope Ratings

Figure 3: Net fees and commissions, quarterly comparison



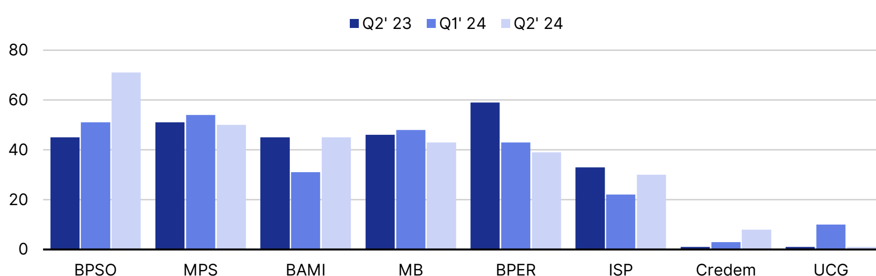
Source: Company data, Scope Ratings
Note: MB's YoY comparison is affected by the consolidation of Arma Partners from the end of 2023

Non-interest income on an upward trend after a soft 2023

Fees and commissions grew for the second consecutive quarter (+ 1.8% QoQ) despite seasonality. Sales of asset management and insurance products gained momentum against the backdrop of falling interest rates and bullish sentiment in financial markets prior to the bout of market volatility in early August. Average assets under management[1] and custody grew by 1.5% and 1.3% respectively in Q2. Commercial banking revenues also rose, reflecting higher pricing and payments revenues. Italian banks remain focused on boosting revenues from complementary financial services, one of the few growth opportunities in an otherwise mature banking market.

Operating costs continued to trend higher, driven by higher personnel costs and growing business-related expenses and investments in digital innovation. One-off charges related to workforce optimisation and provisions for tax credits impacted the total expenses of BPER and BPSO respectively. The average cost-income ratio increased to 45.8% in Q2 2024, from 44.2% in Q2 2023. Average cost of risk remained broadly stable, at 36bp, on the back of limited credit deterioration.

Figure 4: Cost of risk (bp), quarterly comparison

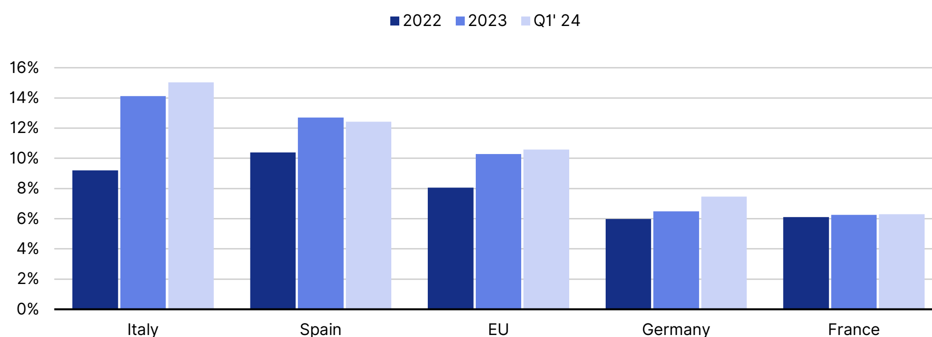


Source: Company data, Scope Ratings

[1] Including distributed third-party products.

Italian banks are performing better than we had expected. Interest rates have not rapidly declined, as doubts about persistent inflationary pressures have led the ECB to maintain a relatively tight monetary policy. And while Italian banks' assets have gradually repriced at higher rates, remuneration on customer deposits has been muted, reflecting the captive nature of most current accounts in Italy. This is a structural advantage shared by most lenders in southern Europe and has led to over-performance over the past 18 months.

Figure 5: Bank return on equity by country



Source: EBA Risk Dashboard, Scope Ratings
Note: asset-weighted average return on equity

After a strong first half, most Italian lenders are confident of matching or even beating last year's exceptional results, due to higher-than-expected rates, higher fees, controlled costs and contained provisions.

H1 strong profits achieved in a supportive environment

We remain constructive about the sector's profitability although there are downside risks. Prior to the short but sharp market downswings in early August, financial markets had rallied for over a year, supporting banks' trading income, client activity and sales of asset management products. Markets had calmed by the second week of August, but a bear market will weigh on banks' financials, particularly if spillovers affect investor perceptions of Italian sovereign risk.

Any material deterioration of the situations in Ukraine and the Middle East will impact GDP growth, putting further pressure on lending, transaction fees, and asset quality. At present, Scope expects Italian GDP to grow by 0.8% in 2024.

New political intervention cannot be ruled out

We are doubtful that the government's considerations to force banks to raise rates on current accounts will be implemented, given the legal challenges, but such a measure would clearly also negatively affect profitability.

Some signs of deterioration although Stage 2 ratio falls

Loan quality still strong, despite an uptick in defaults

Italian banks' asset quality is solid, with an average NPE ratio of 3% (stable QoQ). Credit performance is resilient, although there are now some signs of deterioration. BP Sondrio has been the most vocal among peers, citing signs of stress, particularly among retail customers due to the impact of high borrowing costs. BPER reported the highest quarterly increase in NPEs, mostly as unlikely-to-pay, although this was partly driven by a lower-than-usual cure rate due to a delay in the implementation of a new outsourcing platform for NPEs. MPS's stock of NPEs reached the highest in almost two years.

Normalisation in Stage 2 ratios

By contrast, Stage 2 loans have declined significantly for most banks since the beginning of the year. In our view, this is the result of two factors: the migration (mostly back to Stage 1) of positions that had been reclassified during the Covid pandemic, and the effects of updates to credit models[2]. Italian banks' Stage 2 loan ratios are still high by international standards, at around 9.5%, but higher Stage 2 loan ratios are associated with a greater accumulation of provisions, most of which have not yet been used.

We still expect a gradual worsening of asset quality as the impact of higher interest payments starts to affect the most vulnerable borrowers. But banks are well prepared as they have all budgeted for higher default rates compared to 2023 while projecting a stable annual cost of risk thanks to pre-emptive provisioning, high coverage, and state-guarantees on certain positions.

Figure 6: Gross NPL ratio heatmap

Country	Q4 2022	Q1 2023	Q2 2023	Q3 2023	Q4 2023	Q1 2024	Q2 2024	Quarterly change	3 months	6 months	12 months
Credem	2.1%	2.1%	2.0%	2.1%	2.0%	2.0%	1.9%		-0.1%	-0.1%	-0.2%
UCG	2.7%	2.7%	2.6%	2.7%	2.7%	2.7%	2.6%		-0.1%	0.0%	0.0%
ISP	2.3%	2.4%	2.3%	2.4%	2.3%	2.3%	2.2%		-0.1%	0.0%	-0.1%
BAMI	4.2%	4.2%	3.8%	3.5%	3.5%	3.3%	3.3%		-0.1%	-0.2%	-0.6%
MB	2.4%	2.4%	2.5%	2.6%	2.4%	2.5%	2.5%		0.0%	0.0%	0.0%
BPSO	4.3%	4.3%	4.2%	4.3%	3.7%	3.8%	3.8%		0.0%	0.1%	-0.4%
MPS	4.2%	4.1%	4.3%	4.5%	4.4%	4.5%	4.6%		0.1%	0.2%	0.3%
BPER	3.2%	3.3%	2.7%	2.8%	2.5%	2.6%	2.8%		0.2%	0.3%	0.0%

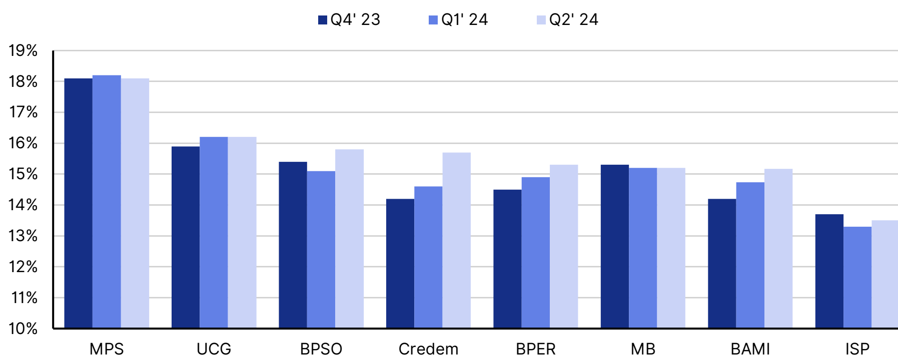
Source: Company data, Scope Ratings

Capital position continues to strengthen

Italian banks' capital positions continued to improve in Q2. As of June 2024, the average fully loaded CET1 ratio stood at 15.6%, more than 30bp higher than December 2023. This was driven by both organic generation and a reduction in RWAs (-0.9% QoQ).

We calculate that at current profitability levels, Italian banks generate around 70bp-90bp of pre-distribution capital each quarter, more than double the 2021-22 period. This supports higher shareholder remuneration. MPS announced that it will increase its dividend pay-out ratio to 75% for 2024 (the previous guidance was 50%). BPER will raise it to 60% from 50%.

Figure 7: CET1 ratio, quarterly comparison



Source: Company data, Scope Ratings

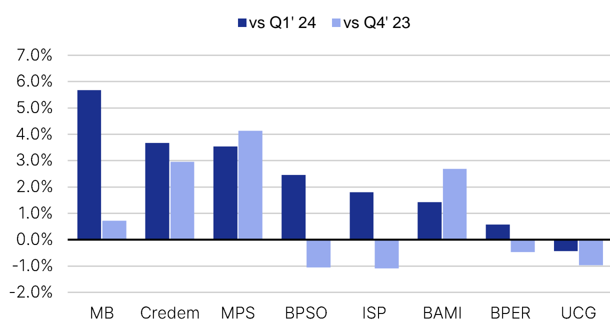
[2] The change in credit risk models (or methodologies) can have either a positive or a negative impact on loan staging. Given the very prudent approach taken by most Italian banks during the pandemic, it is not surprising to Stage 2 loans migrating to Stage 1.

Deposits outflows has stopped, easing funding pressure

Italian banks maintain sound funding positions. In Q2, they repaid a further EUR 20bn of TLTRO III to the ECB with no significant impact on liquidity ratios. The outstanding amount now stands at EUR 41bn. On the positive side for banks, deposit outflows have stopped at sector level while across our sample, banks reported an average quarterly increase of 2.3% in Q2.

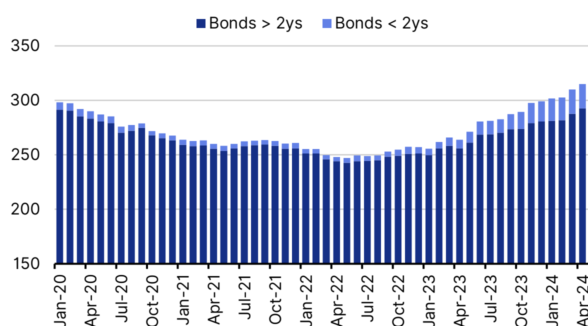
Debt issuance activity was robust in the first half. Banks found good windows to complete part or all of their annual funding plans. Issuance was only partly driven by funding purposes, as banks seek to increase their MREL capacity. At the end of May 2024, total outstanding bonds at sector level stood at EUR 316bn, the highest in six years (but still two-thirds below the pre-euro crisis peak). We expect banks to cautiously increase market funding to take advantage of tighter credit spreads. Ultimately, issuance will depend on customer loan demand, growth in the deposit base and the availability of alternative sources, such as the ECB's main refinancing operations.

Figure 8: Deposit growth, quarterly comparison



Source: Company data, Scope Ratings

Figure 9: Italian banking sector – Outstanding bonds (EUR bn)



Source: Bank of Italy, Macrobond, Scope Ratings
Note: Italian banks including CDP

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