

Rating Action: Moody's affirms Banca del Mezzogiorno's Baa3/P-3 deposit ratings and ba3 standalone BCA, assigns Baa3 issuer rating

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Stable outlook on deposit rating, negative outlook on issuer rating

London, 28 March 2018 -- Moody's Investors Service (Moody's) today affirmed the ba3 standalone baseline credit assessment (BCA) of Banca del Mezzogiorno -- MCC S.p.A. (Banca del Mezzogiorno), its Baa3/Prime-3 deposit ratings, and the Baa3(cr)/Prime-3(cr) Counterparty Risk Assessments (CR Assessment); the outlook on Banca del Mezzogiorno's long-term deposit rating remains stable. At the same time, the rating agency assigned a Baa3 long-term issuer rating, with negative outlook.

A full list of affected rating is available at the end of this press release.

RATINGS RATIONALE

-- AFFIRMED STANDALONE BCA

Moody's affirmation of the ba3 standalone BCA of Banca del Mezzogiorno reflects the bank's plan to focus its activity on lending to corporates in the weaker south of Italy through rapid loan growth, resulting in lower capitalisation and returns, and with increased reliance on wholesale funding. These risks are mitigated by government guarantees on the majority of the loans that the bank will grant, still good capital ratios, and ample liquidity resources that could be potentially provided in case of need by Banca del Mezzogiorno's public shareholders.

Banca del Mezzogiorno reported a stock of EUR1.6 billion loans as of end-2017; 29% were residential mortgages granted throughout Italy, whilst the remaining were loans towards large corporate (46%) and small and medium enterprises (SMEs, 25%) operating in southern Italy. In its new 2018-2020 business plan, the bank is planning to focus its new activity on lending to corporate and SMEs in southern Italy, while the residential mortgage portfolio will slowly run off in several years; Banca del Mezzogiorno plans on growing its portfolio of corporate and SME lending by 6% in 2018, and 18% in both 2019 and 2020. Moody's considers this growth to be rapid, increasing the risk already associated with the weaker operating environment in the region.

As a mitigating factor, most of new loans granted by Banca del Mezzogiorno will partially benefit from government guarantees, which will reduce credit losses; furthermore, the legacy low-risk residential mortgage portfolio, which according to the bank's plan will represent 21% of total loans in 2020, will continue to provide some diversification.

Banca del Mezzogiorno's new strategy will lead to a gradual reduction in capital, but which in Moody's view will remain good. The bank's Common Equity Tier 1 (CET1) ratio declined to 16.2% at end-2017 compared to 28.1% at end-June 2017. The bank has not disclosed its CET1 targets for the new business plan, but its capitalisation will fall further given it plans to grow its equity by almost 20% in three years through earnings retention, while loans will grow by almost a third in the same timeframe.

Moody's believes that the bank's strategy will lead to lower returns on tangible assets, as the high and stable commissions derived from the management of government guarantee funds will be diluted by the returns on the new lending activity, which Moody's expects to be low in the context of low interest rates.

The rapid loan growth will be largely financed through the issuance of bonds in wholesale market (+118% in three years). Overall, reliance on inherently less stable wholesale funding is an additional risk; furthermore, the percentage of liquid assets will likely reduce as the bank's loan book grows, reducing buffers in case of lack of market access. These additional risks are however partially mitigated by ample liquidity potentially available from the public sector in case of need.

-- UNCHANGED EXTREMELY LOW LOSS-GIVEN-FAILURE FOR DEPOSITS

Banca del Mezzogiorno is subject to the EU's Bank Recovery and Resolution Directive (BRRD), which Moody's

considers to be an Operational Resolution Regime.

According to Moody's advanced Loss Given Failure (LGF) analysis, Banca del Mezzogiorno's deposits remain likely to face extremely low loss-given-failure, due to the loss absorption provided by the residual equity that the rating agency expects in a resolution scenario, as well as the volume of senior debt issued by the bank. This results in an uplift of three notches for the deposit rating from the bank's BCA. This also takes into account Moody's expectation that deposits will in practice rank above senior debt in a resolution given the introduction of full deposit preference in 2019.

-- MODERATE GOVERNMENT SUPPORT

Moody's said it continues to assume a moderate likelihood of government support for Banca del Mezzogiorno's rated wholesale deposits in the event of its failure, but this does not result in any further uplift given the proximity of their unsupported creditworthiness to the rating of the government of Italy (Baa2 negative). This probability reflects the balance between on the one hand, the bank's government ownership, and its role in supporting economic development in southern Italy; on the other hand, the limitations for government intervention on banks in distress according to the BRRD.

ISSUER RATING ASSIGNED

Moody's today also assigned a first-time Baa3 issuer rating to Banca del Mezzogiorno. The rating reflects (1) the bank's standalone BCA of ba3; (2) Moody's expectation that senior debt will likely face very low loss-given-failure in a resolution scenario, which provides an uplift of two notches; (3) Moody's assumption of a moderate probability of government support, which results in an additional one-notch uplift.

Given the one notch of government support uplift, the long-term issuer rating is aligned with that of the long-term deposit rating. While Moody's assessment of the probability of support is moderate for both instruments, the lower unsupported creditworthiness of senior unsecured liabilities means that the issuer rating benefits more from the potential support of the government.

RATING OUTLOOK

The outlook on Banca del Mezzogiorno's long-term deposit rating is stable, reflecting the moderate economic recovery in Italy. Moody's expect Italy's GDP to grow by around 1.5% in 2018.

The bank's issuer rating has instead a negative outlook, mirroring the negative outlook on Italy's Baa2 sovereign debt rating.

FACTORS THAT COULD LEAD TO AN UPGRADE

Moody's said that Banca del Mezzogiorno's BCA could be upgraded following a track record of a low cost of risk, and greater diversification of funding sources.

The bank's deposit rating could be upgraded following an upgrade of the BCA. An upgrade of Italy's sovereign debt rating could also lead to an upgrade of Banca del Mezzogiorno's deposit rating, but this is unlikely given the negative outlook on Italy's sovereign debt rating.

Banca del Mezzogiorno's issuer rating could be upgraded following an upgrade of the BCA, provided that the loan growth is financed through bail-in-able unsecured debt as stated in the bank's business plan.

FACTORS THAT COULD LEAD TO A DOWNGRADE

Conversely, Banca del Mezzogiorno's BCA could be downgraded following a considerable deterioration of the bank's loan book, or a material reduction of capital.

The bank's deposit and issuer ratings could be downgraded following a downgrade of the BCA, or if the asset growth is funded through non bail-in-able debt such as deposits or secured funding. Furthermore, Banca del Mezzogiorno's issuer rating could be downgraded following a downgrade of Italy's sovereign debt rating, which has had a negative outlook since December 2016.

LIST OF AFFECTED RATINGS

Issuer: Banca del Mezzogiorno - MCC S.p.A.

..Assignments:

...Long-term Issuer Ratings, assigned Baa3 Negative

..Affirmations:

...Long-term Counterparty Risk Assessment, affirmed Baa3(cr)

...Short-term Counterparty Risk Assessment, affirmed P-3(cr)

...Long-term Bank Deposits, affirmed Baa3 Stable

...Short-term Bank Deposits, affirmed P-3

...Adjusted Baseline Credit Assessment, affirmed ba3

...Baseline Credit Assessment, affirmed ba3

..Outlook Action:

...Outlook changed to Stable(m) from Stable

PRINCIPAL METHODOLOGY

The principal methodology used in these ratings was Banks published in September 2017. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

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