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Ratings

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MedioCredito Centrale SpA

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MedioCredito Centrale SpA

SACP	bb	+	Support	+2	+	Additional Factors	0

Anchor	bbb-	
Business Position	Moderate	-1
Capital and Earnings	Strong	+1
Risk Position	Moderate	-1
Funding	Below Average	-1
Liquidity	Adequate	

ALAC Support	0
GRE Support	0
Group Support	+2
Sovereign Support	0

Issuer Credit Rating
BBB-/Stable/A-3

Major Rating Factors

Strengths:	Weaknesses:
• Support from the Italian government. • Strong capitalization. • Sole manager of the public fund to support small and midsize enterprises (SMEs).	• Highly concentrated portfolio. • Maturity mismatch between assets and liabilities. • Contained franchise, compared with domestic banks.

Outlook: Stable

S&P Global Ratings' stable outlook on Italy-based bank MedioCredito (MC) reflects our expectation that the Italian government will provide MC with extraordinary support, if needed, and that the bank's capitalization will remain sound.

Specifically, we expect that internal capital generation will be sufficient to maintain the bank's risk-adjusted capital (RAC) ratio above 10% in the next 12-24 months from a pro forma 15.9% at end-2016, despite the capital reduction of €160 million embedded in the acquisition agreement between Poste Italiane and Invitalia.

We could lower the ratings if we lowered our rating on Italy, if we anticipated that MC would not be able to preserve its current capitalization, or if we perceived that the expected alignment between government mission and the bank's strategy would not materialize.

Although unlikely at this stage, we could raise the rating on MC if we raised our rating on Italy and we saw significant reduction of concentration of the bank's loan book.

Rationale

On Feb. 9, 2017, Poste Italiane SpA announced the disposal of MC's entire equity package to Invitalia, the national agency for inward investments and economic development, with a particular focus on Southern Italian regions. The Italian Ministry of Economy and Finance 100% owns and controls Invitalia.

We now see a stricter interconnection between the bank and the Italian government, and, consequently, a high probability that the latter would intervene to provide MC with a certain extent of extraordinary support, in times of need. This is incorporated in the two additional notches above MC's stand-alone creditworthiness.

This reflects the bank's strong capitalization, with projected RAC likely to remain comfortably above 10% by end-2019, on the back of contained lending growth and positive--although modest--profitability.

In this regard, we anticipate that the bank's engagement in the management of the public "Fondo Centrale di Garanzia" (Central Guarantee Fund) will continue to support MC's revenue stability, generating approximately 50% of the revenue base.

Nevertheless, MC's limited franchise--especially in the direct lending business--is likely to remain a risk for its revenue generation capacity and overall creditworthiness.

In addition, MC's material single-name concentration may continue to affect its asset quality evolution in the next couple of years. At end-2016, the top 20 performing corporate exposures stood at 1.5x the bank's capital. Although we believe that the bank will gradually increase its portfolio granularity by targeting small SMEs in the south of Italy, we consider that this process will take a few years.

Furthermore, the bank's weaker-than-average funding profile could cause a mismatch between assets' and liabilities' respective maturities.

Anchor: 'bbb-' for a bank operating in Italy

Our bank criteria use our Banking Industry Country Risk Analysis economic risk and industry risk scores to determine a bank's anchor, the starting point in assigning an issuer credit rating. Our anchor for a bank operating in Italy is 'bbb-'.

We expect the economic recovery in Italy, which started in 2015, will gather momentum, with average annual GDP growth of 1.3% in 2017-2019. Rising investment, steady employment growth, and an expansionary monetary policy will support the recovery. This will also reinforce the recovery of private sector creditworthiness in the coming quarters, particularly that of domestic corporations, in our view.

More favorable economic conditions will also support Italian banks' ongoing efforts to reduce their large stock of NPEs (defined as the sum of bad loans, unlikely to pay, and past due loans over 90 days), accumulated during the recession that occurred between 2008 and 2015. We expect that the amount of NPEs will gradually decrease to about 13%-14% in 2019 versus the 18.7% we estimate as of June 2017, also benefiting from the banks' plans to sell a portion of those problematic assets.

Despite the above-mentioned improvements, we think Italian banks still face higher economic risks than most peers.

This is because the high NPE stock will weigh on banks' balance sheets and profitability for a few years. It could also represent a tail risk for banks if economic conditions were to deteriorate again. Moreover, the substantial amount of time needed for creditors in Italy to recover collateral and settle lawsuits--due to the less effective insolvency and foreclosure procedures and judicial system--is likely to remain an obstacle to a more material reduction of the stock than we currently envisage.

Industry risks for Italian banks are likely to remain higher than for banks in peer countries. The Italian government's decision to fund the bail-out of troubled institutions such as Banca Monte dei Paschi di Siena SpA, and the liquidation of Veneto Banca SpA and Banca Popolare di Vicenza ScpA in June 2016, restored market confidence. While this provided some relief to the Italian banking sector, it did not solve its basic problems. This is because low interest rates and still-high credit losses lower banks' profitability prospects over the next two years, in our view. Moreover, structural problems such as high cost bases and fragmentation constrain profitability, in our opinion. In this context, many banks' access to markets is likely to remain limited and the cost of financing could remain higher than in other European Economic and Monetary Union (eurozone) banking sectors, despite the ample liquidity in the market.

Supportive factors for the Italian banking system are Italy's traditional focus on retail and commercial lending, and our view that its regulatory standards are aligned with international best practices, mainly thanks to the European Central Bank directly supervising more than 80% of the banking sector.

Table 1

MedioCredito Centrale SpA Key Figures

		--Year-ended Dec. 31--			
(Mil. €)	**YTD-June 2017**	**2016**	**2015**	**2014**	**2013**
Adjusted assets	2,574	2,724	2,553	2,296	1,331
Customer loans (gross)	1,689	1,770	1,584	1,366	785
Adjusted common equity	431	397	398	390	153
Operating revenues	46	96	102	102	65
Noninterest expenses	24	45	45	41	41
Core earnings	6	29	33	38	12

YTD--Year to date.

Business position: Small public bank, with renewed focus on Southern Italian economies

After the acquisition, we expect MC to direct its activities to promoting investments in the economically depressed Southern Italian areas, thus reverting to the public utility role for which it was founded back in 2011. Our expectations reflect the stricter interconnection we now see with the government, as well as the strong strategic alignment with its new owner, Invitalia.

In order to pursue the group's strategic objectives, we believe that MC will primarily focus on the promotion of lending-facilitating tools--chiefly, the public "Fondo di Garanzia". At end-2016, the total amount of requests received reached about 117,000, much higher than the 60,000 in 2011. We expect this number to continue rising in the future, therefore supporting the bank's operating revenues. As of June 2017, the fees stemming from this activity were €27 million (59% of the operating revenues).

In parallel with the management of such funds, the bank will continue to exercise its direct lending business. In particular, we expect MC to predominantly address SMEs operating in the south of Italy. In this regard, MC has already dismantled the network of agents through which it used to develop its retail lending business.

Furthermore, we understand that MC's lending strategy will follow a more project-based approach, in line with Invitalia's guidelines.

In our view, the bank will pursue balanced growth. As a result, we consider that the overall customer loans portfolio is likely to remain stable at current levels--€1.6 billion as of June 2017--while gradually rebalancing toward a prevailing proportion of loans to SMEs based in the south. As of June 2017, roughly 32% of corporate loans were toward corporations based in these areas (22% of the overall customer loans portfolio).

Although we recognize improved business prospects stemming from a clearer strategic direction, we still consider the bank's limited franchise--with negligible presence at national level--as a potential risk in terms of business development and revenue stability, especially if compared with other domestic regional banks.

Table 2

MedioCredito Centrale SpA Business Position

		--Year-ended Dec. 31--			
(%)	**YTD-June 2017**	**2016**	**2015**	**2014**	**2013**
Loan market share in country of domicile	0.11	0.11	0.10	0.09	0.05
Deposit market share in country of domicile	0.03	0.03	0.02	0.02	0.02
Total revenues from business line (currency in millions)	45.94	97.22	101.93	101.69	65.36
Commercial banking/total revenues from business line	100.00	100.00	100.00	100.00	100.00
Commercial & retail banking/total revenues from business line	100.00	100.00	100.00	100.00	100.00
Return on equity	2.49	6.85	7.61	12.85	7.64

YTD--Year to date.

Capital and earnings: Robust capitalization, despite capital reduction

We anticipate that MC's capitalization will remain strong in 2018-2019. Specifically, we predict that MC's RAC ratio will remain steadily above 10% at year-end 2019, although declining from a pro forma RAC ratio of 15.9% at end-2016.

The main driver behind the decline in the ratio is the potential overall €200 million capital reduction embedded in the acquisition transaction agreement between Poste Italiane and Invitalia. Bank of Italy has so far only approved €160 million of the total amount. In addition, the transaction implies a €30 million extra dividend to be paid to Poste on 2016 net profit.

On the other hand, negligible lending expansion and positive--although modest--profitability will continue to support the bank's internal capital generation capacity. In addition, we do not envisage any dividend payment to Invitalia until 2019.

We expect MC to generate about €75 million profit over 2017-2019. In our view, MC will generate about €90 million-€100 million operating revenues per year, sustained by the proceeds mainly coming from the management of the "Fondo di Garanzia". Furthermore, we believe that the bank will continue to benefit from a lighter-than-system-average cost base, reporting a stable cost-to-income ratio of 50%, compared with 60% at system level. This stems from the absence of a network of branches outstanding. We understand it is Invitalia's intention to find agreements with other Italian commercial banks, in order to use their network as distribution channels for the group's products and services. Finally, we consider that credit losses will continue to constrain MC's profitability, although with a projected cost-of-risk declining to 80 basis points (bps) at end-2019, in line with the Italian system average.

Table 3

MedioCredito Centrale SpA Capital And Earnings					
		--Year-ended Dec. 31--			
(%)	**YTD-June 2017**	**2016**	**2015**	**2014**	**2013**
Criteria reflected in RAC ratios	N/A	2017 RAC Criteria	2010 RAC Criteria	2010 RAC Criteria	2010 RAC Criteria
Tier 1 capital ratio	28.13	25.37	28.38	32.71	21.23
S&P RAC ratio before diversification	N/A	13.19	14.78	16.24	11.29
S&P RAC ratio after diversification	N/A	9.75	12.28	13.68	9.38
Adjusted common equity/total adjusted capital	100.00	100.00	100.00	100.00	100.00
Net interest income/operating revenues	41.18	43.26	46.83	42.97	32.32
Fee income/operating revenues	59.31	51.47	43.23	40.39	54.36
Market-sensitive income/operating revenues	0.01	4.54	9.31	15.52	11.82
Noninterest expenses/operating revenues	52.02	47.08	44.32	40.03	62.16
Preprovision operating income/average assets	1.65	1.93	2.34	3.36	2.17
Core earnings/average managed assets	0.49	1.08	1.37	2.09	1.02

YTD--Year to date. N/A--not applicable. RAC--Risk-adjusted capital.

Risk position: Highly sensitive to single-name defaults

With the top 20 performing exposures estimated to stand at about 1.5x MC's capital as of December 2016, the bank's single-name concentration will remain one of the major risks in terms of asset quality, in our view. This is because it may expose the bank to potentially significant inflows of nonperforming assets (NPAs) and credit losses.

In June 2017, the bank's NPA stock jumped to €117 million, from €80 million as of year-end 2016, following the deterioration of only two positions, then classified as "unlikely to pay". Because of this, the bank had to proceed with additional provisions, leading the bank's cost-of-risk to rise to 140 bps on the same date.

As a result, we see MC's comparatively low NPA ratio--standing at 6.96% versus 18.7% at system level in June 2017--as potentially underestimating the real risk embedded in the bank's unseasoned portfolio. This is reflected in the relatively quick asset quality deterioration experienced by the bank, which saw its NPA ratio almost double in just a few years (0.94% at end-2013)

Although we expect the bank to increase the granularity of its customer loans portfolio by lending to SMEs based in the south of Italy, we believe that this process will take some time.

However, despite the bank's new strategic focus, we do not expect material nonperforming inflows coming from MC's focus on this particular sector, following the more supportive economic conditions and a more targeted lending approach--along with Invitalia's historical expertise in financing start-up companies and SMEs.

Table 4

MedioCredito Centrale SpA Risk Position

		--Year-ended Dec. 31--			
(%)	**YTD-June 2017**	**2016**	**2015**	**2014**	**2013**
Growth in customer loans	(9.20)	11.74	15.94	74.11	334.08
Total diversification adjustment / S&P RWA before diversification	N/A	35.31	20.40	18.69	20.41
Total managed assets/adjusted common equity (x)	5.97	6.87	6.42	5.89	8.72
New loan loss provisions/average customer loans	1.41	0.76	0.81	0.66	0.72
Gross nonperforming assets/customer loans + other real estate owned	6.96	4.54	2.71	1.31	0.94
Loan loss reserves/gross nonperforming assets	50.54	58.14	77.81	118.37	189.53

YTD--Year to date. N/A--not applicable. RWA--Risk-weighted assets.

Table 5

MedioCredito Centrale SpA Risk-Adjusted Capital Framework Data

(Mil. €)	**Exposure***	**Basel III RWA**	**Average Basel III RW (%)**	**S&P Global RWA**	**Average S&P Global RW (%)**
Credit risk					
Government and central banks	942	1	0	421	45
Institutions and CCPs	96	20	21	65	68
Corporate	1,136	1,085	96	1,757	155
Retail	502	190	38	400	80
Of which mortgage	465	163	35	348	75
Securitization§	0	0	0	0	0
Other assets†	77	69	90	171	222
Total credit risk	2,753	1,364	50	2,814	102
Credit valuation adjustment					
Total credit valuation adjustment	--	13	--	0	--
Market risk					
Equity in the banking book	0	0	0	0	0
Trading book market risk	--	0	--	0	--
Total market risk	--	0	--	0	--
Operational risk					
Total operational risk	--	171	--	191	--
(Mil. €)		**Basel III RWA**		**S&P Global RWA**	**% of S&P Global RWA**
Diversification adjustments					
RWA before diversification		1,561		3,005	100
Total Diversification/Concentration Adjustments		--		1,061	35
RWA after diversification		1,561		4,067	135

Table 5

MedioCredito Centrale SpA Risk-Adjusted Capital Framework Data (cont.)

(Mil. €)	Tier 1 capital	Tier 1 ratio (%)	Total adjusted capital	S&P Global RAC ratio (%)
Capital ratio				
Capital ratio before adjustments	395	25.3	397	13.2
Capital ratio after adjustments‡	395	25.4	397	9.8

*Exposure at default. §Securitization exposure includes the securitization tranches deducted from capital in the regulatory framework. †Other assets includes deferred tax assets (DTAs) not deducted from ACE. ‡Adjustments to Tier 1 ratio are additional regulatory requirements (e.g. transitional floor or Pillar 2 add-ons). RWA--Risk-weighted assets. RW--Risk weight. RAC--Risk-adjusted capital. RAC 2016 is based on parameters as of December 2016. By taking into account the improved economic risk in Italy, the pro forma 2016 RAC would have been 15.9%. Sources: Company data as of Dec. 31, 2016, S&P Global.

Funding and liquidity: Potential risk stemming from maturities mismatch

We see MC's funding to be constrained by the bank's reliance on sources of funding with relatively short maturities, especially compared with its assets side.

As such, this may be the cause of a maturity mismatch between the bank's funding mix and its customer loans portfolio, with an average maturity of more than four years.

We estimate that the weight of short-term interbank funding on the overall funding mix in June 2017 was approximately 25%. The remaining part of the bank's funding structure is based on other sources of nonstable funding, including corporate deposits. Our stable funding ratio was about 80% as of June 2017.

However, we think the bank's liquidity adequately covers the bank's short-term wholesale funding. Our broad liquid assets/short-term wholesale funding—excluding TLTRO II—was about 1x as of June 2017.

Table 6

MedioCredito Centrale SpA Funding And Liquidity

		--Year-ended Dec. 31--			
(%)	**YTD-June 2017**	**2016**	**2015**	**2014**	**2013**
Core deposits/funding base	25.48	27.78	19.54	18.58	29.22
Customer loans (net)/customer deposits	314.23	284.65	395.77	418.58	243.71
Long term funding ratio	53.98	54.01	49.47	52.00	67.47
Stable funding ratio	80.04	79.48	75.90	81.45	104.74
Short-term wholesale funding/funding base	55.72	54.92	61.21	59.77	37.15
Broad liquid assets/short-term wholesale funding (x)	0.71	0.70	0.69	0.77	1.12
Net broad liquid assets/short-term customer deposits	(194.33)	(183.22)	(428.33)	(1,014.40)	219.77
Short-term wholesale funding/total wholesale funding	74.76	76.05	76.08	73.42	52.49
Narrow liquid assets/three-month wholesale funding (x)	N/A	4,150.22	4,201.92	7.36	6.68

YTD--Year to date. N/A--not applicable.

Support: High likelihood of government's extraordinary support.

In accordance with our criteria for government-related entities, we base our view of a high likelihood of extraordinary government support on MC's:

- Importance for Italy. MC is a profit-seeking bank whose activity--supporting south of Italy regions' economic

recovery--fits well into its owner's public mandate; and
- Very strong link with the Italian government. The government now fully owns MC through Invitalia. Further to this, we do not envisage any privatization of the bank's new owner in the medium term. As a result, we believe that the Italian government will exercise stable control on the bank's business plan through Invitalia. Finally, we believe that a failure of MC could directly damage the government's reputation.

Additional rating factors: None

No additional factors affect this rating.

Related Criteria

- Methodology for Linking Long-Term and Short-Term Ratings, April 7, 2017
- Risk Adjusted Capital Framework Methodology, July 20, 2017
- Quantitative Metrics For Rating Banks Globally: Methodology And Assumptions, July 17, 2013
- Banks: Rating Methodology and Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Rating GREs: Methodology And Assumptions, March 25, 2015
- Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Banking Industry Country Risk Assessment: Italy, Nov. 16, 2017
- Positive Actions Taken On Italian Banks On Reduced Economic Risks and Sovereign Upgrade, Oct. 31, 2017
- Italy Upgraded To 'BBB/A-2' On Firming Economic Recovery; Outlook Stable, Oct. 27, 2017

Anchor Matrix

Industry Risk	Economic Risk									
	1	2	3	4	5	**6**	7	8	9	10
1	a	a	a-	bbb+	bbb+	bbb	-	-	-	-
2	a	a-	a-	bbb+	bbb	bbb	bbb-	-	-	-
3	a-	a-	bbb+	bbb+	bbb	bbb-	bbb-	bb+	-	-
4	bbb+	bbb+	bbb+	bbb	bbb	bbb-	bb+	bb	bb	-
5	bbb+	bbb	bbb	bbb	bbb-	**bbb-**	bb+	bb	bb-	b+
6	bbb	bbb	bbb-	bbb-	bbb-	bb+	bb	bb	bb-	b+
7	-	bbb-	bbb-	bb+	bb+	bb	bb	bb-	b+	b+
8	-	-	bb+	bb	bb	bb	bb-	bb-	b+	b
9	-	-	-	bb	bb-	bb-	b+	b+	b+	b
10	-	-	-	-	b+	b+	b+	b	b	b-

Ratings Detail (As Of January 30, 2018)	
MedioCredito Centrale SpA	
Counterparty Credit Rating	BBB-/Stable/A-3

Ratings Detail (As Of January 30, 2018) (cont.)	
Counterparty Credit Ratings History	
31-Oct-2017	BBB-/Stable/A-3
15-Feb-2017	BB/Watch Dev/B
30-Jul-2015	BB/Negative/B
18-Dec-2014	BB/Watch Neg/B
24-Jul-2013	BB+/Negative/B
12-Jul-2013	BBB-/Watch Neg/A-3
Sovereign Rating	
Italy	BBB/Stable/A-2
Related Entities	
Poste Italiane Group	
Issuer Credit Rating	BBB/Stable/A-2
Senior Unsecured	BBB
Short-Term Debt	A-2

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

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