MOODY'S INVESTORS SERVICE

Credit Opinion: Banco Popolare Società Cooperativa

Global Credit Research - 15 Apr 2016

Verona, Italy

Ratings

Category	**Moody's Rating**
Outlook	Rating(s) Under Review
Bank Deposits	*Ba2/NP
Baseline Credit Assessment	**b2
Adjusted Baseline Credit Assessment	**b2
Counterparty Risk Assessment	*Ba2(cr)/NP(cr)
Issuer Rating	**Ba3
Senior Unsecured -Dom Curr	**Ba3
Subordinate -Dom Curr	**B3
Pref. Stock Non-cumulative -Dom Curr	**Caa2 (hyb)
Banca Italease S.p.A.	
Outlook	Rating(s) Under Review
Bkd Senior Unsecured -Dom Curr	**Ba3
Bkd Subordinate -Dom Curr	**B3
Banca Italease Capital Trust	
Outlook	Rating(s) Under Review
BACKED Pref. Stock Non-cumulative	**Caa2 (hyb)

* Rating(s) within this class was/were placed on review on April 13, 2016
** Placed under review for possible upgrade on April 13, 2016

Contacts

Analyst	**Phone**
Edoardo Calandro/London	44.20.7772.5454
Maria Jose Mori/Madrid	34.91.768.8200
Nicholas Hill/Paris	33.1.53.30.10.20
Aleksander Blacha/London	44.20.7772.5454

Key Indicators

Banco Popolare Societa Cooperativa (Consolidated Financials) [1]

	[2]**12-15**	[2]**12-14**	[3]**12-13**	[3]**12-12**	[3]**12-11**	**Avg.**
Total Assets (EUR million)	**117,240.7**	**119,784.0**	**122,049.4**	**131,921.4**	**134,126.6**	[4]**-3.3**
Total Assets (USD million)	**127,358.0**	**144,945.0**	**168,177.0**	**173,924.0**	**174,115.8**	[4]**-7.5**
Tangible Common Equity (EUR million)	**6,250.0**	**5,808.9**	**5,710.3**	**3,743.3**	**3,770.3**	[4]**13.5**
Tangible Common Equity (USD million)	**6,789.3**	**7,029.0**	**7,868.5**	**4,935.1**	**4,894.5**	[4]**8.5**
Problem Loans / Gross Loans (%)	**24.2**	**17.4**	**14.7**	**12.7**	**10.7**	[5]**16.0**
Tangible Common Equity / Risk Weighted Assets	**11.5**	**10.3**	**10.0**	**6.1**	**4.1**	[6]**10.9**

(%)						
Problem Loans / (Tangible Common Equity + Loan Loss Reserve) (%)	**156.8**	**112.0**	**120.6**	**144.4**	**132.7**	[5]**133.3**
Net Interest Margin (%)	**1.3**	**1.3**	**1.3**	**1.4**	**1.4**	[5]**1.3**
PPI / Average RWA (%)	**1.7**	**1.7**	**2.2**	**1.8**	**1.0**	[6]**1.7**
Net Income / Tangible Assets (%)	**0.2**	**-1.5**	**-0.4**	**-0.5**	**0.2**	[5]**-0.4**
Cost / Income Ratio (%)	**73.9**	**72.7**	**64.7**	**63.4**	**72.9**	[5]**69.5**
Market Funds / Tangible Banking Assets (%)	**30.3**	**28.8**	**28.6**	**33.5**	**52.8**	[5]**34.8**
Liquid Banking Assets / Tangible Banking Assets (%)	**24.3**	**24.0**	**20.5**	**17.6**	**17.5**	[5]**20.8**
Gross loans / Due to customers (%)	**127.2**	**122.3**	**126.7**	**128.0**	**209.2**	[5]**142.7**

Source: Moody's

[1] All figures and ratios are adjusted using Moody's standard adjustments [2] Basel III - fully-loaded or transitional phase-in; IFRS [3] Basel II; IFRS [4] Compound Annual Growth Rate based on IFRS reporting periods [5] IFRS reporting periods have been used for average calculation [6] Basel III - fully-loaded or transitional phase-in & IFRS reporting periods have been used for average calculation

Opinion

SUMMARY RATING RATIONALE

On 13 April 2016 we placed the Banco Popolare Societa Cooperativa's (Banco Popolare) b2 standalone baseline credit assessment (BCA), Ba2 deposit rating, and Ba3 senior debt rating on review for upgrade. This decision follows the 23 March's announcement made by Banco Popolare and Banca Popolare di Milano (BPM, Ba2/Ba3) that their respective boards had reached an agreement on a merger that will be completed before year-end 2016.

Banco Popolare's Ba2 deposit rating is underpinned by the bank's b2 standalone BCA, extremely low loss-given-failure under our Loss Given Failure (LGF) analysis, and our assessment of low probability of government support. Banco Popolare's Ba3 senior debt rating is underpinned by the bank's b2 BCA, very low loss-given-failure, and low probability of government support.

Banco Popolare's b2 BCA reflects the bank's weak asset quality, improved capital, and modest profitability.

Rating Drivers

- Merger with BPM, including a EUR1 billion capital increase

- Weak asset quality

- Improved capital adequacy, with adequate buffer in a stressed environment

- Modest profitability

Rating Outlook

Banco Popolare's ratings are on review for upgrade , reflecting our view that the combined Banco-BPM group will display stronger credit fundamentals relative to those currently displayed by the two individual banks based on (1) improved coverage of problem loans thanks to the EUR1 billion capital increase approved by Banco Popolare, which will be fully earmarked to reinforce provisions; (2) long-term benefits of cost synergies and rationalisation as well as expectations of better revenue diversification; and (3) improvements in corporate governance (a key rating constraint for BPM) after both banks have converted into joint-stock companies prior to the merger.

What Could Change the Rating - Up

Upward pressure on Banco Popolare's ratings could arise once the merger comes into effect and the new group has a greater risk absorption capacity and a more effective and efficient corporate governance when compared to Banco and BPM individually.

What Could Change the Rating - Down

A downgrade of the banks' ratings is unlikely given the current review for upgrade. However, downward pressure could develop if Banco and BPM decided to not merge and the banks displayed a material deterioration in their asset risk or profitability metrics.

DETAILED RATING CONSIDERATIONS

WEAK ASSET QUALITY

We view Banco Popolare's asset quality as very weak, as reflected in our score for asset risk of caa3, one notch below the macro-adjusted score of caa2.

The bank's gross problem loans (see notes 1 and 2 at the end of this report) were around 24% of gross loans at December 2015. Following a recessionary year in Italy, and some reclassification required by the ECB Asset Quality Review, in 2014 the stock of gross problem loans increased by more than 10%, mostly due to a high increase in restructured loans (+30%) and bad loans (+18%), while past-due substantially decreased by 50%. In 2015 gross problem loans decreased by almost 5%, or EUR1 billion, thanks to a significant reduction in the inflow of problem loans (EUR2.2 billion, which compares with EUR4.9 billion in 2014), and substantial sales in the market. We note however that the outflow of problem loans is still slow (less than EUR0.9 billion in both 2014 and 2015) due to the difficulties involved with the workout of problem loans in Italy.

Coverage of problem loans is 43.7% (including write-offs), and in line with system average. Banco Popolare has planned a EUR1 billion capital increase, the proceeds of which will be used to increase the level of coverage. The bank estimates that the combined Banco-BPM will have a level of coverage of problem loans of around 49% (the write-offs being take into account in the calculation of coverage).

IMPROVED CAPITAL

Banco Popolare's improved capital adequacy, which we score baa3, is a relative strength for the bank.

In December 2015 Banco Popolare reported a phased-in CET1 ratio of 13.2% (fully-phased: 12.4%); in November 2015 the ECB imposed a specific prudential CET1 requirement of 9.55% on the bank.

Following the merger with BPM, Banco Popolare expects its CET1 ratio to be around 12.5%.

MODEST PROFITABILITY

Banco Popolare's profitability is a key weakness for the bank, and we score this caa2.

In 2015 Banco Popolare reported a 13% improvement in pre-provision profit, to EUR 1,258 million from EUR 1,113 million; the improvement was driven by one-off sales of equity stakes, which has been partly offset by contributions to the Italian Resolution Fund and the Deposit Guarantee Scheme.

Revenues improved by 8.5%, to EUR 3.7 billion from EUR 3.4 million, mostly owing to the disposal of non-core equity stakes. Operating costs increased by 6%, to EUR 2,405 million from EUR 2,263 million, the bulk of it pertaining to a EUR 162 million contribution to the Italian Resolution fund and the Deposit Guarantee Scheme. Cost-income ratio remained stable, at 66% from 67% in 2014.

Banco Popolare reported EUR 804 million loan loss charges, a 77% reduction from the EUR 3.6 billion reported in 2014; this is the main driver of Banco Popolare's improved profitability. Credit cost reduced significantly to 94bp, a sharp decline from the 406bp reported in 2014, which was negatively impacted by the result of the European Central Bank's Comprehensive Assessment. We note that this level is below the 116bp average in years 2008-2013, but it is still significantly higher than the 40bp pre-crisis level of 2003-2007.

Looking forward, we expect some bottom-line improvements mostly deriving from further reduction in loan loss charges. Revenues will be challenged, due to a combination of little growth, a low interest rate environment, and stability in fees and commissions; operating costs should reduce, absent any extraordinary costs, while loan loss charges should reduce further.

The merger with BPM will bring long-term revenues and cost synergies; in the short-term, the merger will imply high one-off integration costs, and extraordinary EUR1.5 billion loan loss charges to improve coverage of problem loans, which will be achieved with the proceeds of the capital injection.

BANCO POPOLARE'S BCA IS CONSTRAINED BY ITALY'S MACRO PROFILE OF MODERATE+

As a domestic bank, Banco Popolare's operating environment is heavily influenced by the performance of the Italian economyy, and its Macro Profile is thus aligned with that of Italy, at Moderate+. The merger with BPM will not change Banco Popolare's macro profile, as both banks operate only in Italy. The macro environment for Italian banks is characterised by lower economic growth and greater event risk than in core European countries. In addition, credit conditions are weakened by high leverage of the corporate sector, which is highly reliant on short-term debt and bank funding. Bank funding has stabilised but conditions remain fragile. Institutional strength is assessed as high +, which is partly supported by commonly agreed EU political, economic, fiscal and legal standards.

Notching Considerations

LOSS GIVEN FAILURE AND ADDITIONAL NOTCHING

Banco Popolare is subject to the EU Bank Resolution and Recovery Directive (BRRD), which we consider to be an Operational Resolution Regime. Our analysis assumes residual tangible common equity of 3% and losses post-failure of 8% of tangible banking assets, a 25% run-off in "junior" wholesale deposits, a 5% run-off in preferred deposits and 26% of junior deposits over total deposits. These are in line with our standard assumptions. Furthermore, we take into account the full `depositor preference' whereby junior deposits are preferred over senior debt creditors in accordance with a law decree introducing full depositor preference in Italy starting from 2019. We exclude from our at-failure balance sheet deposits and assets of foreign subsidiaries.

We believe that Banco Popolare's deposits are likely to face extremely low loss-given-failure, due to the loss absorption provided by the residual equity that we expect in resolution, subordinated debt and senior unsecured debt, as well as the volume of deposits themselves. This is supported by the combination of deposit volume and subordination. This results in an uplift of three notches from the bank's BCA.

We believe that Banco Popolare's senior unsecured debt is likely to face very low loss-given-failure, due to the loss absorption provided by the residual equity that we expect in resolution, subordinated debt, as well as the volume of senior unsecured debt itself. This is supported by the combination of senior unsecured debt volume and subordination. This results in an uplift of two notches from the bank's BCA.

For junior securities issued by Banco Popolare and its fully-guaranteed vehicles, our LGF analysis confirms high loss-given-failure, given the small volume of debt and limited protection from more subordinated instruments and the residual equity that we expect in resolution. We also incorporate additional notching for preference share instruments reflecting the coupon features. The resulting Preliminary Rating Assessment (PRA) are set out in the table at the bottom of this document.

We do not expect the merger with BPM to materially change our assumptions.

GOVERNMENT SUPPORT

We believe that there is a low likelihood of government support for Banco Popolare's debt and rated wholesale deposits in the event of its failure, which does not result in any uplift; this probability reflects the bank's position in the Italian market, with Banco Popolare being significantly smaller than the country's two largest banks. As such, we do not believe Banco Popolare to be a sufficiently systemically important bank to give any uplift to the ratings.

We do not expect the merger with BPM to change our government support assumptions, and the combined Banco-BPM will still be significantly smaller than Italy's two largest banks.

COUNTERPARTY RISK ASSESSMENT

Banco Popolare's Ba2(cr)/Not Prime(cr) Counterparty Risk Assessment (CR Assessment) is three notches above the bank's BCA. Banco Popolare's CR Assessment is driven by the bank's b2 BCA, and by substantial bail-in-able debt and deposits likely to support the operating obligations; low probability of government support does not result in any uplift.

The CR Assessment, which is not a rating, reflects an issuer's probability of defaulting on certain bank operating liabilities, such as covered bonds, derivatives, letters of credit and other contractual commitments. In assigning the CR Assessment, we evaluate the issuer's standalone strength and the likelihood, should the need arise, of affiliate and government support, as well as the anticipated seniority of counterparty obligations under our advanced Loss Given Failure framework. The CR Assessment also assumes that authorities will likely take steps to preserve the continuity of a bank's key operations, maintain payment flows, and avoid contagion should the bank enter a resolution.

Note 1: Unless noted otherwise, data in this report is sourced from company reports and Moody's Banking Financial Metrics.

Note 2: Note 2: For data starting from 2015, problem loans include bad loans, unlikely to pay exposures, and past due. For further details please refer to our Sector In-Depth entitled "Italian Banks Implement New Problem Loan Definition; Our View on Asset Risk Is Unchanged", published in October 2015.

About Moody's Bank Scorecard

Our Scorecard is designed to capture, express and explain in summary form our Rating Committee's judgment. When read in conjunction with our research, a fulsome presentation of our judgment is expressed. As a result, the output of our Scorecard may materially differ from that suggested by raw data alone (though it has been calibrated to avoid the frequent need for strong divergence). The Scorecard output and the individual scores are discussed in rating committees and may be adjusted up or down to reflect conditions specific to each rated entity.

Rating Factors

Banco Popolare Società Cooperativa

Macro Factors	
Weighted Macro Profile	**Moderate +**

Financial Profile						
Factor	**Historic Ratio**	**Macro Adjusted Score**	**Credit Trend**	**Assigned Score**	**Key driver #1**	**Key driver #2**
Solvency						
Asset Risk						
Problem Loans / Gross Loans	24.2%	caa2	↓	caa3	Quality of assets	Expected trend
Capital						
TCE / RWA	11.5%	baa3	←→	baa3	Risk-weighted capitalisation	
Profitability						
Net Income / Tangible Assets	-0.6%	caa2	↑↑	caa2	Return on assets	
Combined Solvency Score		b2		b2		
Liquidity						
Funding Structure						
Market Funds / Tangible Banking Assets	30.3%	ba3	←→	ba3	Extent of market funding reliance	
Liquid Resources						
Liquid Banking Assets / Tangible Banking Assets	24.3%	baa3	←→	baa3	Stock of liquid assets	
Combined Liquidity Score		ba2		ba2		

Financial Profile	b1

Qualitative Adjustments	Adjustment
Business Diversification	0
Opacity and Complexity	0
Corporate Behavior	0
Total Qualitative Adjustments	**0**

Sovereign or Affiliate constraint	Baa2

Scorecard Calculated BCA range	**ba3 - b2**

Assigned BCA	**b2 Possible Upgrade**

Affiliate Support notching	**--**

Adjusted BCA	**b2 Possible Upgrade**

Instrument Class	Loss Given Failure notching	Additional notching	Preliminary Rating Assessment	Government Support notching	Local Currency rating	Foreign Currency rating
Deposits	--	--	--	--	Ba2 RUR Possible Upgrade	Ba2 RUR Possible Upgrade
Senior unsecured bank debt	--	--	--	--	Ba3 RUR Possible Upgrade	
Dated subordinated bank debt	--	--	--	--	B3 RUR Possible Upgrade	
Non-cumulative bank preference shares	--	--	--	--	Caa2(hyb) RUR Possible Upgrade	

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on http://www.moodys.com for the most updated credit rating action information and rating history.

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