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ISSUER COMMENT
24 March 2016

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RATINGS

Banco Popolare Società Cooperativa

Baseline Credit Assessment	b2
Bank Deposits	Ba2 Stable/NP
Senior Unsecured	Ba3 Stable
Counterparty Risk Assessment	Ba2(cr)/NP(cr)

Banca Popolare di Milano S.C.a r.l

Baseline Credit Assessment	b2
Bank Deposits	Ba2 Stable/NP
Senior Unsecured	Ba3 Negative
Counterparty Risk Assessment	Ba2(cr)/NP(cr)

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Banco Popolare Società Cooperativa, Banca Popolare di Milano S.C.a.r.l.

Merger Between Banco Popolare and BPM Has Long-Term Positive Credit Implications

Summary

On March 23, 2016, the boards of Banco Popolare Società Cooperativa (Banco, Ba2/Ba3 stable, b2[1]) and Banca Popolare di Milano S.C.a.r.l. (BPM, Ba2 stable/Ba3 negative, b2) published a joint press release indicating the two banks agreed to merge by the end of 2016.

We believe that the merger, which is still subject to several approvals, will have long-term positive implications for the banks and for the Italian banking system. A combined Banco-BPM – which will become the third largest player in Italy – will be able to weather a more competitive banking environment at a time when banks face profitability challenges, tougher regulatory constraints and also have to cope with the challenges of digital banking that will require substantial investment. The merger will include an equity capital increase of €1 billion, the proceeds of which will be used to increase the coverage of problem loans up to 49% from 44%; this is credit positive for the senior debt and deposit ratings on both institutions, in our view.

Furthermore, this merger will put pressure on the main competitors of Banco and BPM, potentially prompting other banks to participate in a much-needed consolidation of the sector.

In the meantime, the proposed combination brings challenges: (1) the merger is still subject to final approvals by relevant authorities and by the banks' shareholders; (2) in the short-term there will be execution risks; and (3) the combined entity will start operating from a relatively weak base in a challenging operating environment.

In the long-term, there will be improvements in revenues and operating costs

The merger between Banco and BPM should lead to cost savings and better revenue diversification.

Both Banco and BPM operate mostly in the relatively wealthy northern Italy, an overlap which offers the opportunity to rationalise their branch networks. At the same time, cost reduction is likely to takes several years, as it is common in these cases.

A larger group has also the potential to offer a wider offer of products, which would in turn improve revenue diversification. Italian banks' profitability is being challenged by a low interest rate environment, limited growth opportunities, and high loan loss charges. The ability to offer a wider range of products and services, in particular high fee-generating wealth management products, will be key to offsetting the reduction in profits derived from the traditional commercial banking activities of deposit taking and loan granting.

Banco and BPM estimate that they will reach pre-tax synergies of €365 million by 2018, a 52% improvement from the aggregate €698 million pre-tax profit reported in 2015 by the two banks. These estimated synergies are mostly derived from cost savings of €290 million (8.5% of 2015 combined costs), while the targeted revenues synergies are a modest €75 million (1.4% of combined revenues). In the short-term, the banks will incur in one-off integration costs of €435 million, or more than 60% of the combined entities' 2015 pre-tax profit.

The merger is supported by improved capital, governance could improve

As part of the merger plan, Banco agreed on a €1 billion capital increase, which is credit positive. Banco has reached an underwriting agreement with Mediobanca (unrated) and with Bank of America (rated Baa1 stable at holding level), which will guarantee its execution. The aggregate Common Equity Tier 1 ratio (CET1), currently at 12.4%, will mechanically increase to 13.7% after the €1 billion capital injection; however given that the new entity will increase the level of coverage of problem loans, the CET1 ratio will in practice remain close to its current level at 12.5%.

Capital ratios could slightly increase following the adoption of internal models for the computation of risk-weighted assets (RWA) on BPM's loans, which will reduce the RWA.

The merger, together with the forthcoming conversion of the banks into joint-liability companies, will also contribute to improving governance, which has thus far been a weakness for BPM. Currently, as both Banco and BPM are chartered as cooperative banks, each shareholder has one vote irrespective of the shares that he owns. This structure, which provides a relatively high level of influence to minority shareholders, has curbed BPM's ability to take critical measures, which in turn weighed on BPM's ratings. The new Banco-BPM group will be a joint-stock company, in which the balance of power will be better distributed according to the number of shares owned by each shareholder.

The proposed governance structure has some complex features, however.

For the first three years, the board of directors of the new group will have be relatively large, with 19 members, at least nine of which will be independent; this is nonetheless a significant reduction compared with the combined boards, which today comprise of 47 members. Subsequently, board members will be reduced to 15, of which at least seven independent.

After the merger, all the branches of Banco and BPM located in the core areas where BPM currently operates will be regrouped under a new subsidiary; this new legal entity will be then merged into the main bank after three years.

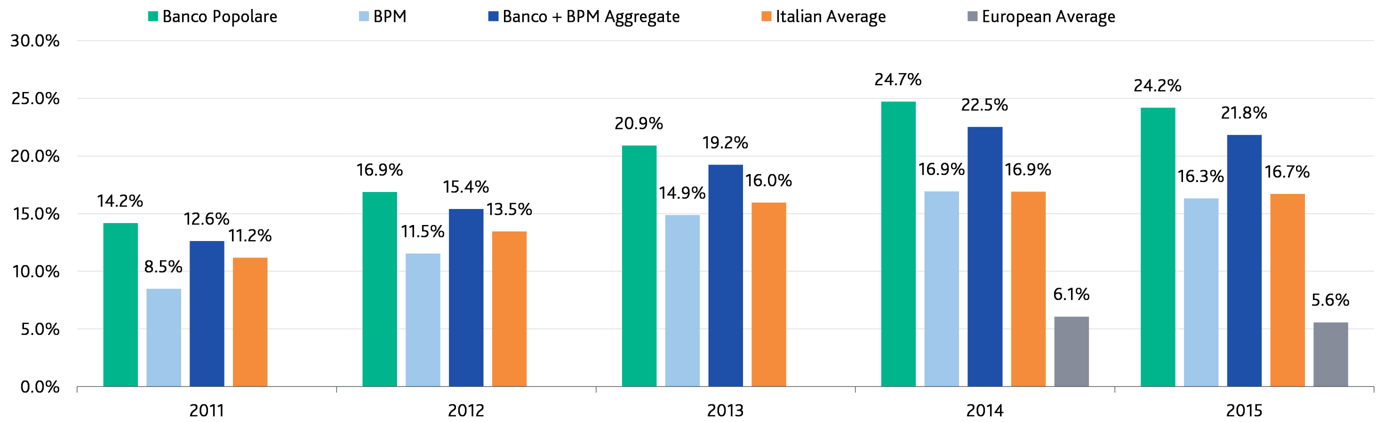
Several risks remain in the short-term

As with most mergers of this nature, there will be execution risks in the short- and even medium-term: IT integration, discussions with the unions on redundancies, appointment of management that properly represents shareholders and the two legacy banks, and so on. Banco's past experience, including the successful integration in the 2000s of Banca Popolare di Novara and Banca Popolare Italiana, should help in this regard.

Nevertheless, despite the forthcoming capital measures, the Banco-BPM group will be burdened by significant challenges in terms of asset risk and profitability.

In particular, the stock of problem loans is very high, mostly coming from legacy issues at Banco and its subsidiary Banca Italease (now merged into Banco).

Exhibit 1
Stock of problem loans is very high

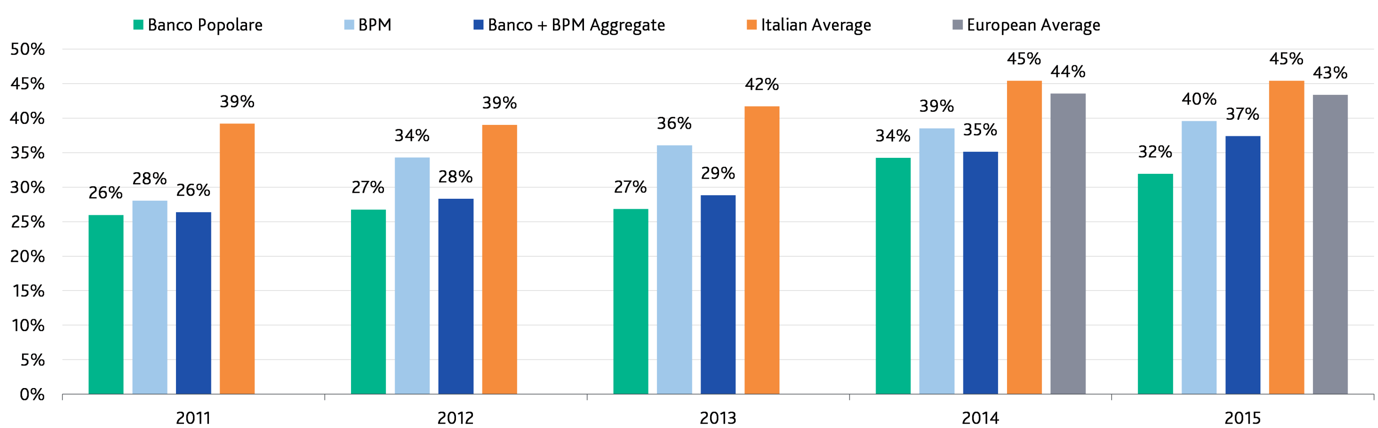


Banco's write-off policy is material; including the portion of loans that were written-off, in 2015 Banco's problem loan ratio would be 27.8%.
Source: For Banco and BPM, banks' reports and Moody's calculations. Italy system averages 2011-2013 Bank of Italy, 2014-2015 European Banking Association. European system averages European Banking Association. 2015 system average are as of June 2015.

The pro-forma 37% coverage of problem loans of the new group will be below the Italian and European average (around 43% and 45% respectively), while it the 12.5% CET1 ratio will be more or less in line with system averages (around 13% and 11.5% for Italian and European banks respectively). That said, Banco's portion of written-off loans is material; including these loans, the aggregate coverage would be 49%. The increased coverage will help the bank to dispose of problem loans in time; at present, there is no clear indication if the combined entity will take advantage of the new "bad bank" guarantee in the near future[2]. This will mostly depend on market conditions; the banks' management stated that there is no pressure to immediately reduce the stock of problem loans via disposals.

At the same time, given the aforementioned very large stock of problem loans, the new group's capital is not as resilient as its European peers to a stressed environment. A new recession, which would have an impact on the value of collateral, or a more prudent valuation of collateral would have a more material impact on Banco-BPM's capital compared with its European peers.

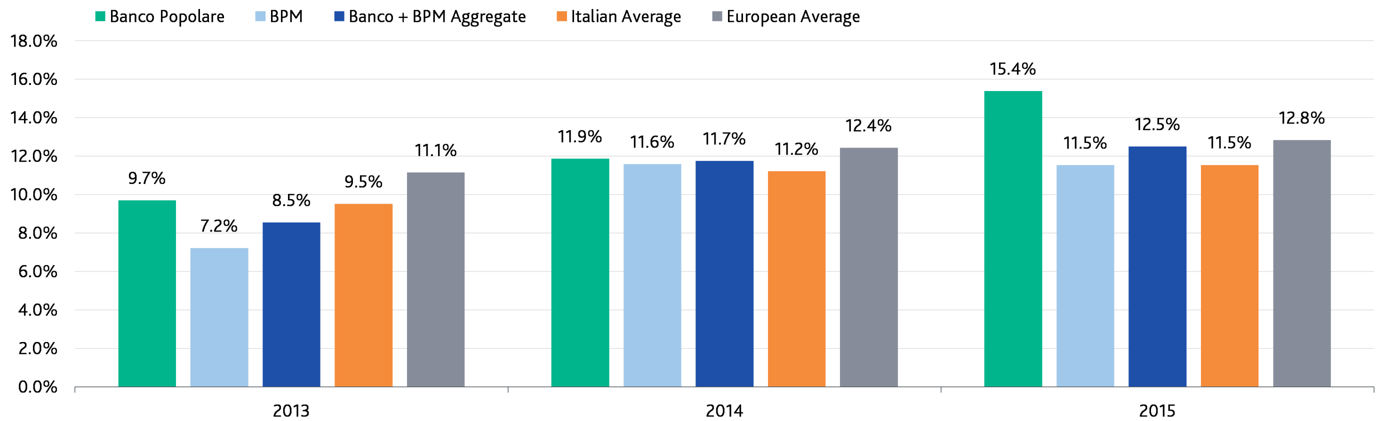
Exhibit 2
Coverage of problem loans



The aggregate coverage include the planned increase of reserves. Banco's write-off policy is material; including the portion of loans that were written-off, in 2015 Banco's coverage would be 44%, and the aggregate coverage 49%.
Source: For Banco and BPM, banks' reports and Moody's calculations. Italy system averages 2011-2013 Bank of Italy, 2014-2015 European Banking Association. European system averages European Banking Association. 2015 system average are as of June 2015.

Exhibit 3

Core capitalisation is in line with European average



Data for Banco in 2015 and the aggregate CET1 ratio includes the planned €1 billion capital increase; the aggregate CET1 ratio also includes the planned increase of coverage of problem loans. 2013 data refer to Basel 2's core Tier 1 ratio.
Source: For Banco and BPM, banks' reports and Moody's calculations. System averages are from the European Banking Association.

Profitability of the new entity is likely to be weak and remain so due to:

» Weak net interest income resulting from the low interest rate environment and low loan growth

» High reliance on gains on securities, which are volatile in nature

» High level of operating costs, which represent more than two-thirds of the banks' revenues, excluding gains on securities and the contribution to the resolution fund and deposit guarantee scheme

» High cost of risk, with loan loss charges representing 0.9% of the banks' loans in 2015, although we expect this to reduce given the reduced inflow of problem loans

Exhibit 4

Combined profitability is weak

Income Statement 2015, data in €/million	Banco	BPM	Banco+BPM
Net Interest Income	1,545	807	2,352
Net Fee and Commission Income	1,426	606	2,032
Result from financial assets	441	181	622
Other	251	73	324
Total revenues	**3,663**	**1,667**	**5,330**
Operating Expenses	**-2,405**	**-1,020**	**-3,425**
- o/w extraordinary contribution to resolution fund	*114*	*40*	*154*
Pre Provision Income	**1,258**	**647**	**1,905**
Loan loss charges	-804	-342	-1,146
Other provisions	-105	10	-95
Other non operating items	-4	38	34
Pre-tax profit	**345**	**353**	**698**
Taxes	71	-63	8
Other	14	-1	13
Net profit	**430**	**289**	**719**
Cost of risk, bp	*90*	*93*	*91*

Cost of risk is calculated on loans gross of reserves. Cost of risk for Banco excludes write-offs, as its write-off policy is material.
Source: Banks' reports and Moody's calculations.

Exhibit 5
Main balance sheet information

Balance Sheet 2015, data in €/million	Banco	BPM	Banco+BPM
Cash and Securities	28,118	11,717	39,836
Net Interbank	-13,517	-3,615	-17,132
Net Loans	78,422	34,187	112,608
Total Assets	120,510	50,203	170,713
Deposits	53,470	28,623	82,093
Debt Securities in Issue	16,568	8,849	25,418
Equity	8,494	4,338	12,832

Source: Banks' reports and Moody's calculations.

The merger still requires several approvals

The merger has been approved by the banks' boards yet still requires further approvals, most notably by the banks' shareholders, the European Central Bank (ECB), and the antitrust authority.

We believe that this merger will be eventually approved by the ECB, which according to press reports set a number of requirements for the merger, in particular with respect to the calibration of the capital and coverage increase.

The Banco-BPM merger should not create significant antitrust issues. In northern Italy the new group will be the third largest player, with a market share of around 11%; the combined Banco-BPM will be the largest bank in Lombardy (15.5% market share), and the third largest in Veneto and Piedmont (9.5% and 12.5% market share respectively).

Shareholder support for the transaction is not completely certain. Both Banco and BPM are currently cooperative banks, in which each shareholder has one vote irrespective of the number of shares that he has. This structure, which the new entity will not adopt, creates uncertainties on the outcome. The final vote will depend on the number of shareholders that will participate in the shareholders' meeting, and their large number makes predictions difficult. We believe that, prior to the boards' approvals, the structure of the transaction has been discussed with the banks' main stakeholders, including the influential employees of BPM; this suggests that the deal will most likely be approved.

Further consolidation could occur in the Italian market

We believe that the Banco-BPM merger was influenced by several factors.

With the currently low interest rate environment and low loan growth, Italian banks' profitability is very much challenged. After being loss-making for four years between 2011 and 2014 in aggregate, the European Banking Association reported that in June 2015 Italian banks' return on Tier 1 capital was 5.2%, which compares with a 9.1% for European banks, and with 12.9% and 9.3% respectively for Italy's main peers, Spain and France. Against this background, the prospect of cost savings and revenue diversification are important drivers for banks to merge. These factors are common across the entire system, and we expect the Banco-BPM could herald a deeper consolidation.

In the 2000s we saw a series of important mergers, such as those that led to the creation of the current UniCredit SpA group (Baa1/Baa1 stable, ba1), Intesa Sanpaolo SpA (A3/Baa1 stable, baa3), and Unione di Banche Italiane SpA (Baa1/Baa2 stable, ba1). Not all mergers have been positive for the banks involved, nor for the Italian system; for example, Banca Monte dei Paschi di Siena SpA's (B2/B2 negative, caa2) acquisition of the weak Banca Antonveneta in 2008 has led to considerable difficulties. After 2009, most consolidation was linked to the rescue of weak banks; for example, the acquisition of Banca Monte Parma by Intesa Sanpaolo in 2010, the acquisition of Banca Popolare di Spoleto by Banco Desio (unrated) in 2014, and the acquisition of Banca Tercas by Banca Popolare di Bari (unrated) in 2014. The Italian banking system is still less concentrated than other European systems. After the merger between Banco and BPM, and considering the mutual banking network as one group, the five largest Italian banks will have a market share of deposits of around 50%. In France and in the UK, the five largest group have a combined market share of more than 80%; in Spain the situation is closer to the forthcoming structure for Italy, with the five largest group having a combined market share of around 60%.

All-in-all we believe there is still some room for further consolidation in the banking industry in view of the numerous challenges Italian banks have to deal with.

Endnotes

1 The bank ratings shown in this report are the bank's deposit rating, senior unsecured debt rating and baseline credit assessment.

2 For further information, please refer to our Sector Comment entitled Italy's Bad-Bank Scheme Will Require the Recognition of Loan Losses, published in February 2016.

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