FITCH PLACES BPM ON RWN; CHANGES POPOLARE'S OUTLOOK TO NEGATIVE

Fitch Ratings-Milan/London-21 April 2016: Fitch Ratings has placed Banca Popolare di Milano's (BPM) 'BB+' Long-term Issuer Default Rating (IDR) on Rating Watch Negative (RWN) and changed the Outlook on Banco Popolare's 'BB' Long-term IDR to Negative from Stable following a periodic review.

The review also takes into account the announcement on 23 March 2016 that the two banks intend to merge into a new parent bank to create Italy's third-largest banking group. Although the merger is still subject to shareholders' and regulatory approval, Fitch's view is that the transaction is more likely to go ahead than not. A full list of rating actions is included at the end of this commentary.

The Long-term IDRs of both banks are driven by their standalone creditworthiness as expressed by their Viability Ratings (VRs).

KEY RATING DRIVERS
VR, IDR AND SENIOR DEBT
BPM
BPM's VR of 'bb+' reflects the bank's acceptable capital ratios, moderately improved profitability and a lower level of unreserved impaired loans in relation to core capital compared with most domestic peers, despite it being high by international comparison.

The RWN reflects that the benefits to BPM of being part of a group with a stronger franchise and business model are, at least temporarily, offset by the execution challenges of integration. This includes merging with a larger bank where risk appetite, asset quality and capitalisation are comparatively weaker, including after completion of Popolare's announced capital increase.

Retail customer funding is stable at over 60% of total funding. The bank's liquidity is ample and debt maturities manageable.

BPM's impaired loans were high at over 16% of gross loans at end-2015 in comparison to the bank's history and to international peers. However, they are average among domestic peers and have decreased during 2015. The bank's comparatively large exposure to the real estate and construction sectors has reduced gradually since end-2011.

The combination of sound coverage and acceptable capitalisation resulted in unreserved impaired loans representing 75% of Fitch Core Capital (FCC) at end-2015, which is among the lowest for rated Italian banks, albeit high by international comparison.

BPM's operating profitability improved further in 2015 as lower funding costs and moderate lending growth offset margin pressure on its assets, and on the back of lower impairment charges.

Popolare
The ratings continue to reflect pressure on Popolare's capital stemming from high levels of unreserved impaired loans, which at end-2015 exceeded 200% of the bank's FCC and weak asset quality. Profitability metrics are below the industry average, despite having recovered somewhat in 2015.

The affirmation of Popolare's ratings is based on the assumption that the announced EUR1bn capital increase will be successfully executed, and that the macroeconomic environment will allow for some modest growth (we expect the economy to grow 1% in 2016 and 1.3% in 2017). We also assume the sector has sufficient momentum for the implementation of initiatives aimed at reducing the large stock of impaired loans in Italy, although a track record is required for this to be fully factored into Italian banks' ratings. We expect the merger will strengthen Popolare's already respectable franchise in wealthy Italian regions, with potentially improving competitive pricing in these areas.

The reduction in the stock of impaired loans at Popolare since end-2014 was achieved through a combination of loan disposals in the latter part of 2015, lower impaired loan formations and a persistent focus on recoveries. Popolare's gross impaired loan ratio decreased slightly to just below 26% at end-2015 (against 26.5% at end-2014 on a like-for-like basis) due to a reduction in both gross doubtful and unlikely-to-pay exposures and despite contracting gross lending during 2015. Popolare's impaired loan coverage is low, reflecting longer-term lending exposures with high collateral levels. The dip in coverage levels from end-2014 is caused by the sale of highly provisioned doubtful loan portfolios rather than a weakening of its profile.

The Negative Outlook reflects the challenge facing the new entity resulting from the merger of Popolare and BPM in managing an even larger stock of impaired loans, totalling around EUR26bn on a gross basis. Even after the planned EUR1bn capital increase, to be allocated to increase coverage levels, the new group's capital will continue to be burdened by a high level of unreserved impaired loans, close to 150% based on end-2015 figures. The set-up of a dedicated business unit in charge of reducing doubtful loans by EUR10bn in the next three years could ease some of the pressure resulting from its weak loan quality. However, it remains to be seen how quickly management can reduce the impaired loan stock.

Popolare's profitability metrics improved somewhat in 2015, particularly at pre-impairment operating level. Operating profits turned mildly positive in 2015 after the bank had been reporting operating losses since 2010. Differently to most peers, Popolare succeeded in protecting its net interest income despite loan and margin contraction, as the cost of both its customer and wholesale funding declined. Stable net interest income, increased net commission income, unchanged costs and reduced LICs all contributed to positive operating profit in 2015. However, profitability metrics remain below the sector average and the bank has yet to show that the improvement is sustainable.

The profitability of the new entity should benefit from the synergies that management will seek to realise. However, a substantial track record is necessary before this can be fully factored into the ratings.

SUBORDINATED DEBT AND OTHER HYBRID SECURITIES
Subordinated debt and other hybrid capital issued by the banks are all notched down from their respective VRs in accordance with Fitch's assessment of each instrument's respective non-performance and relative loss severity risk profiles, which vary considerably.

The upgrade of Popolare's trust preferred securities (originally issued by Banca Italease) to 'B-' from 'C' reflects the resumption of coupon payment.

SUBSIDIARY AND AFFILIATED COMPANY
The ratings of Banca Aletti reflect Fitch's view of the core function of the subsidiary within Popolare and are based on the latter's Long-term IDR.

SUPPORT RATINGS (SRs) AND SUPPORT RATING FLOORS (SRFs)

The SRs and SRFs reflect Fitch's view that senior creditors can no longer rely on receiving full extraordinary support from the sovereign in the event that a bank becomes non-viable. The EU's Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism (SRM) for eurozone banks provide a framework for resolving banks that require senior creditors participating in losses, if necessary, instead of or ahead of a bank receiving sovereign support.

RATING SENSITIVITIES
VR, IDR AND SENIOR DEBT
Fitch expects to review Popolare's ratings and resolve the RWN on BPM's ratings upon completion of the merger, expected by end-November 2016. Fitch will assess progress on the relevant factors driving the VRs as well as the merged group's strategic objectives and execution.

Upon completion of the merger, BPM's ratings will likely be aligned with those of the entity resulting from the merger and subsequently withdrawn since BPM will cease to exist as a legal entity. Fitch understands from management that BPM's rated debt will be transferred to the merged entity.

Popolare's ratings could be downgraded if upon the merger the bank does not achieve a level of unreserved impaired loans to core capital of below 150% and if Fitch anticipates that it will struggle to continue reducing this ratio thereafter. Ratings would also come under pressure if the integration with BPM encounters material execution hurdles, if overlaps in large exposures (both performing and non-performing) are not addressed swiftly or if profitability fails to improve as expected. Sudden and unexpected liquidity tensions will also put the ratings under pressure. As with most large Italian banks, Popolare is sensitive to the operating environment in Italy, particularly to the success of recent initiatives aimed at addressing Italian banks' asset quality.

SUBSIDIARY AND AFFILIATED COMPANY
Banca Aletti's ratings are sensitive to changes in Popolare's propensity to provide support and to changes in the parent's Long-term IDR.

SUBORDINATED DEBT AND OTHER HYBRID SECURITIES
The ratings of subordinated debt and hybrid securities are sensitive to a change in the respective banks' VRs. The ratings are also sensitive to a change in the notes' notching, which could arise if Fitch changes its assessment of their non-performance relative to the risk captured in the VRs.

SRs AND SRFs
An upgrade of the SR and upward revision of the SRF is contingent on a positive change in the sovereign's propensity to support BPM and Popolare. While not impossible, this is highly unlikely, in Fitch's view.

The rating actions are as follows:

BPM
Long-term IDR 'BB+' placed on RWN
Short-term IDR: affirmed at 'B'
Viability Rating 'bb+' placed on RWN
Support Rating: affirmed at '5'
Support Rating Floor: affirmed at 'No Floor'
Senior unsecured notes (including EMTN): Long-term rating 'BB+' placed on RWN, Short-term rating 'B' affirmed
Commercial paper: affirmed at 'B'
Subordinated lower tier 2 debt: Long-term rating 'BB' placed on RWN
Preferred stock and hybrid capital instrument: Long-term rating 'B+' placed on RWN

Popolare:
Long-term IDR: affirmed at 'BB'; Outlook revised to Negative from Stable
Short-term IDR: affirmed at 'B'
Viability Rating: affirmed at 'bb'
Support Rating: affirmed at '5'
Support Rating Floor: affirmed at 'No Floor'
Senior debt (including programme ratings): affirmed at 'BB'/'B'
Market-linked securities: affirmed at 'BBemr'
Commercial paper: affirmed at 'B'
Lower Tier 2 subordinated debt: affirmed at 'BB-'
Preferred stock and junior subordinated debt: affirmed at 'B-'
Trust preferred securities (ISIN: XS0255673070): upgraded to 'B-' from 'C'

Banca Aletti & C. S.p.A.:
Long-term IDR: affirmed at 'BB'; Outlook revised to Negative from Stable
Short-term IDR: affirmed at 'B'
Support Rating: affirmed at '3'

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Applicable Criteria
Global Bank Rating Criteria (pub. 20 Mar 2015)
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=863501

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