

FITCH DOWNGRADES BANCA POPOLARE DI SONDRIO TO 'BBB-'; OUTLOOK STABLE

Fitch Ratings-London/Milan-20 June 2017: Fitch Ratings has downgraded Banca Popolare di Sondrio's (Sondrio) Long-Term Issuer Default Rating (IDR) to 'BBB-' from 'BBB' and Viability Rating (VR) to 'bbb-' from 'bbb'. The Outlook is Stable. A full list of rating actions is available at the end of this rating action commentary.

KEY RATING DRIVERS

IDRS AND VR

The downgrade primarily reflects Fitch's view that Sondrio's strategy will ultimately fail to achieve a meaningful reduction in impaired loans over the medium term. Unreserved impaired loans will continue to weigh on its capitalisation, such that it is not fully commensurate with risks.

The IDRs and VR also reflect Sondrio's sound liquidity, resilient customer funding, and robust cost management mitigating the pressure on profitability from low interest rates.

At end-1Q17, gross impaired loans accounted for over 15% of gross loans, which is high by international standards but still compares adequately with Sondrio's domestic peers. Gross impaired loans continued to increase during 2016 (8% yoy) and 1Q17 (2% qoq) although at a slower pace than in previous years.

The bank's 2017-2021 strategic plan includes a strategy to manage impaired loans through a series of actions, which however in our view fail to reduce the stock of impaired loans in a meaningful manner. Fitch views this aspect as a weakness in the bank's strategy and expects Sondrio's asset quality to remain weak in the medium term. This means that unreserved impaired loans will continue to weigh significantly on capital. Although Sondrio's reserve coverage of impaired loans at 53% of gross impaired loans at end-1Q17 was one of the highest among rated Italian banks, unreserved impaired loans accounted for a high 72% of Fitch Core Capital (FCC), up from 65% at end-2015.

Capital ratios are acceptable with an 11.4% FCC to risk-weighted assets (RWA) ratio at end-2016 and a 10.8% end-1Q17 phased-in CET1 ratio and comfortably above regulatory requirements. However, the high level of unreserved impaired loans means that, in our opinion, the bank's capitalisation is not fully commensurate with risks.

Sondrio's profitability has been volatile and sensitive to interest rates cycles. In Fitch's view the bank's small size, which limits its pricing power outside the home province, constrains the bank's profitability. Operating profit fell 22% in 2016 as net interest income declined 11% despite tight cost management and a 35% drop in loan impairment charges.

Funding and liquidity are ample and have proven stable to date. Customer deposits have been resilient and benefit from strong client relationships, especially in its home region. Utilisation of central bank funding is reasonable and funding sources are more diversified than in the past due to increased issuance of covered bonds to institutional investors.

SUPPORT RATING (SR) AND SUPPORT RATING FLOOR (SRF)

The SR and SRF 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 and the Single Resolution Mechanism 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

IDRS AND VR

Sondrio's ratings are primarily sensitive to a further deterioration in asset quality, particularly if this puts additional pressure on capitalisation through a rise in unreserved impaired loans. The bank's ratings would also come under pressure if Sondrio is unable to generate sustainable and adequate profitability from its core businesses.

An upgrade would require a sustainable improvement in asset quality while maintaining adequate capitalisation. A material reduction in the stock of outstanding impaired loans and an improvement in operating profitability are necessary for a rating upgrade.

SUPPORT RATING AND SUPPORT RATING FLOOR

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

The rating actions are as follows:

Long-Term IDR: downgraded to 'BBB-' from 'BBB'; Outlook Stable

Short-Term IDR: affirmed at 'F3'

Viability Rating: downgraded to 'bbb-' from 'bbb'

Support Rating: affirmed at '5'

Support Rating Floor: affirmed at 'No Floor'

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