FITCH RATES BANCA POPOLARE DELL'ALTO ADIGE - VOLKSBANK 'BB+'; OUTLOOK STABLE

Fitch Ratings-Milan/London-11 July 2017: Fitch Ratings has assigned Banca Popolare dell'Alto Adige S.p.A. (Volksbank) a Long-Term Issuer Default Rating (IDR) of 'BB+' with a Stable Outlook and a Viability Rating (VR) of 'bb+'. A full list of rating actions is at the end of this rating action commentary.

Volksbank is a second-tier bank in Italy, headquartered in Bolzano, the northern province of Trentino Alto Adige. The bank provides a range of traditional banking services to its core clientele of individuals and SMEs. In 2015, the bank expanded in neighbouring Veneto through the acquisition of a small cooperative bank, Banca Popolare di Marostica (Marostica). In late 2016 the bank transformed into a limited company from its previous status as a cooperative.

KEY RATING DRIVERS
IDRS AND VR
Volksbank's Long- and Short-term IDRs are driven by standalone intrinsic strength as captured in the VR. The VR reflects the bank's moderate local franchise and a less diversified business model compared with larger domestic players, as well as the stability and experience of the bank's management. The ratings also factor in Volksbank's acceptable risk appetite and capitalisation. While the latter is generally maintained with adequate buffers over regulatory minimums it may not always be fully commensurate with the bank's risks. The VR further reflects weakened asset quality, following the acquisition of Marostica, and undiversified funding sources.

Volksbank has maintained an adequate capacity to attract and retain customers, with some pricing power capabilities in its reference territories, and particularly in its home wealthy Province of Bolzano. However, its competitive positioning at the national level is modest, given Volksbank's lack of size and depth compared with higher-rated domestic banks. In more recently entered geographies the bank generally has limited pricing power. We believe that its undiversified business model, revenue sources and geographical presence render the bank more sensitive to changes in the interest rates cycle.

The management of Volksbank benefits from depth, stability and experience and its corporate culture is sound. While transparency is solid and the bank's governance has not to date presented significant risk to creditors, overall governance is less developed than higher-rated peers, for example, in respect of board oversight. The bank's strategy is adequately articulated although this may be subject to change based on market opportunities, as evidenced in the Marostica acquisition in 2015. The acquisition has weakened a number of Volksbank's key financial metrics, making execution of financial objectives more vulnerable to changes in the economic cycle.

The bank's CET1 and total capital ratios, both at 11.7% at end-2016, are maintained with satisfactory buffers over regulatory minimums. However, Fitch believes that capitalisation may not be fully commensurate with the bank's risks, in particular those stemming from unreserved impaired loans, which accounted for over 80% of Fitch Core Capital (FCC) at end-2016. The absence of non-core capital in its capital structure means total capital levels and buffers over Pillar II requirements are moderate, compared with other second-tier banks with similar capital ratios.

Asset quality is a rating weakness for Volksbank. Prior to Marostica's acquisition, the bank's asset quality metrics reflected generally sound underwriting standards and processes, which helped maintain credit risk at manageable levels, particularly in the credit exposure originated in the

Province of Bolzano. However, impaired loan levels increased significantly after the acquisition of Marostica to around 16% of gross loans at end-2016, bringing them more in line with domestic averages but worse than our global universe of rated banks. Fitch expects Volksbank to achieve a gradual reduction in its impaired loan ratio. However, since the bank's approach is biased towards gradual workout to protect collateral values, meaningful reductions in the stock of impaired loans will take time to materialise

In our opinion profitability is also a rating weakness, having deteriorated since 2015 due to a significant increase in loan impairment charges (LICs). Revenue sources and margins reflect the bank's ability to reduce funding costs so far by accessing cheaper ECB funding, reducing deposit costs of Marostica customers and switching from deposits to current accounts. The bank also has a good track record of keeping operating costs under reasonable control. Fitch believes that the profitability prospects of Volksbank are sensitive to interest rate cycles and might suffer from its limited ability to re-price its liabilities in the coming quarters. Fitch expects LICs to continue to weigh on profitability, albeit to a lesser extent than in 2016.

Although customer funding has generally been stable so far, a bias towards current accounts renders it potentially more volatile during periods of market stress. Volksbank's funding structure is heavily reliant on customer deposits, which accounted for about 70% of total non-equity funding at end-2016. The deposit base is rather granular and has a track record of stability, reflecting the strength of Volksbank's relationship with local territories. The diversification of its funding sources is in line with other second-tier domestic peers but less so than larger and higher-rated banks in Italy.

Volksbank's liquidity coverage and net stable funding ratios are maintained above 100%. Overall liquidity, however, is weaker than at higher-rated banks, which have more developed contingency plans and broader access to funding.

The 'B' Short-Term IDR corresponds to a 'BB+' Long-Term IDR, in line with our criteria.

SUPPORT RATING (SR) AND SUPPORT RATING FLOOR (SRF)
The bank's SR and SRF reflect Fitch's view that although external sovereign support is possible it cannot be relied upon, given Volksbank's small size and the adoption into Italian law of the EU's Bank Recovery and Resolution Directive.

RATING SENSITIVITIES
IDRS AND VR
Volksbank's VR and thus Long-Term IDR are sensitive to a further weakening of asset quality and deterioration of capitalisation. The ratings would be downgraded if the bank's impaired loan ratio proves stubbornly high or increases, especially if this weakens the level of capital encumbrance by unreserved impaired loans. The ratings would also be downgraded if Volksbank fails to recover profitability to sustainable levels, after the operating losses reported in 2016. Negative rating pressure could also arise if the bank's funding and liquidity deteriorate or from a change in risk appetite (eg. excessive growth not accompanied by the necessary internal capital generation or evolution in controls).

Volksbank's company profile, notably the bank's moderate franchise, means upside for the VR and IDRs is limited. Over time the ratings could be upgraded if the bank shows a consistent record in reducing its impaired loans and the share of unreserved impaired loans in relation to capital. Evidence of stronger and more stable profitability and a more diversified funding profile, for example through more regular access to secured and unsecured institutional markets, would also benefit the ratings.

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 Volksbank. While not impossible, Volksbank's small size and bank resolution tools available in Italy mean a change in the bank's SR and SRF is highly unlikely, in Fitch's view.

The rating actions are as follows:

Long-Term IDR assigned at 'BB+', Outlook Stable
Short-Term IDR assigned at 'B'
Viability Rating assigned at 'bb+'
Support Rating assigned at '5'
Support Rating Floor assigned at 'No Floor'

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Additional information is available on www.fitchratings.com

Applicable Criteria
Global Bank Rating Criteria (pub. 25 Nov 2016)
https://www.fitchratings.com/site/re/891051