Capital Markets Day 2017

CRO Speech

Introduction / cover

Good morning Ladies and Gentlemen

My presentation will focus on further explaining, what has already been done in terms of asset quality over the past twelve months, and what we plan to do over the next two years to achieve 2019 targets.

Slide 3 – Decisive actions to improve Group asset quality

First of all, as you have heard throughout the morning, we are fully on track with Transform 2019, having taken decisive actions to improve our asset quality and continue to de-risk our balance sheet.

All relevant Group asset quality metrics have materially improved in the last twelve months, thanks to our ongoing disposals, disciplined origination and strict risk management.

Tangible evidence of this is our Group cost of risk, which is at 54 basis points year-to-date, and confirmed the guidance to be significantly lower than last year, within the range of 55 to 60 basis for 2017, with expectation to be closer to 60 basis points.

The FINO transaction is proceeding in line with plan. We successfully closed phase 1 in July, with all objectives achieved. Phase 2 binding agreements have been signed, to sell down our stakes below 20 per cent, with closing expected in the first quarter of 2018.

As you know, our key focus is the proactive management of NPE stock and, by the end of 2019, we will reduce gross NPEs by a further 4 billion compared to the original Transform 2019 target.

In addition, we target the complete run down of our Non Core division by 2025, entirely self-funded.

Slide 4 – Proactively providing transparency and clarity on regulatory headwinds

During this presentation, we will also provide more transparency and clarity on expected regulatory headwinds, both within the Transform 2019 time horizon and beyond.

As already mentioned by Jean Pierre, assumptions on regulation, models and pro-cyclicality within Transform 2019 are confirmed.

Thanks to our solid capital position, we have decided to anticipate part of EBA guidelines already during Transform 2019, mainly within Italian models.

Our organic capital generation will more than compensate the expected annual regulatory capital headwinds post 2019. This will be explained in detail by Mirko.

And even with the impact from this additional regulation and model changes, we are confirming our 2019 Group cost of risk target of 55 bps.

Slide 5 – 2017 asset quality improved thanks to proactive actions on stock and disciplined origination

Let's start by having a look at Group asset quality, one year after the launch of Transform 2019.

Firstly, we have delivered solid results with our gross NPE ratio, improving by 4.5 percentage points from 15.2 to 10.6 per cent. The Group ratio for Core is at 5.0 per cent, close to the EBA average.

This de-risking has been achieved whilst we have also been strengthening our NPE coverage ratio, which was at 56.5 per cent in September 2017, up 4.3 per cent year-on-year.

As already mentioned by Giovanni, due to seasonal effects, we expect gross NPEs and cost of risk to increase slightly in CBK Italy in Q4, due to proactive management of legacy files. However, our overall asset quality remains solid and confirmed by our cost of risk, while still within the expected range of 55 to 60 basis points, it will be closer to 60 basis points at the end of 2017, in line with seasonality effects and conservative approach. This is significantly lower than last year.

Slide 6 – Significant improvement across all Group asset quality metrics

We are taking proactive actions to upgrade our asset quality, and as a result all relevant metrics have materially improved in the last twelve months.

We have enhanced our credit processes. In particular, we proceeded with the automation of credit underwriting with a focus on Individuals and Small Business. Andrea and Giovanni gave you some tangible examples earlier.

The managerial KPIs introduced, such as expected loss on new business, further strengthen our focus on asset quality and disciplined origination in close cooperation with the business.

As a result, default rates have decreased from 1.6 per cent in the first nine months of 2016 to 1.3 per cent in September 2017.

Our effective management of restructuring is positively impacting both the

- cure rate - with back to performing flows increasing from 7.3 per cent to 9.2 per cent
- and migration rate - with flows from UTP to bad loans dropping from 20.7 per cent to 15.4 per cent in the first nine months of 2017.

Slide 7 – Expected Loss evolution confirming strong underwriting discipline

Improved asset quality of our portfolio is also confirmed by the evolution of expected loss, on both stock and new business.
This is a direct consequence of making new business expected loss, one of the key managerial KPIs as part of Transform 2019.

In underwriting, the focus is on clients with good ratings, resulting in an expected loss for new business lower than the one on existing stock at Group level.

In particular, Commercial Banking Italy and CEE are good examples, with expected loss on new business significantly below expected loss on stock.

As a result of business growth dynamics, the expected loss on new business in Germany, Austria and CIB is a touch higher than the one on stock, but still at low levels.

Overall, our high quality origination has resulted in expected loss on stock at 35 basis points, for the Group Core, 3 basis points lower than last year.

Let's now move to slide 8, to complete the overview of Group Core.

Slide 8 – Low Group Core Cost of Risk thanks to disciplined risk management and write-backs

As we have already seen, cost of risk has improved in the last twelve months.
For example, in Commercial Banking Italy and CEE, cost of risk reduced from 70 to 66 basis points, and from 109 to 94 basis points, respectively.

We have exceptionally low cost of risk in Commercial Banking Germany, Austria and CIB thanks to a better macro environment and write-backs.

Slide 9 – NPEs deleveraging plan on track thanks to decisive actions in Non Core

Let’s now move to Non Core to complete the overview of our performance in the last twelve months.

As part of our NPE deleveraging plan, we have taken decisive actions, resulting in a reduction of €23.8 billion of gross NPEs in the last twelve months, taking the Non Core NPE stock down to €32.5 billion in September 2017.

As you can see, the €23.8 billion reduction was driven by disposals amounting to €19.2 billion including FINO, confirming the Group solid track record in this activity.

We had recoveries for €1.1 billion and on top of that, about €1.9 billion gross loans have been brought back to Core, mainly driven by corporate files.

Finally, the strong coverage ratio is confirmed also for Non Core, with an increase from 53.5 per cent to 57.1 per cent.

Slide 10 – FINO phase 1 closed, all objectives achieved; phase 2 binding agreements signed to sell down to below 20%

A quick reminder of what project FINO is. FINO stands for “Failure Is Not an Option.” At the last Capital Markets Day, we announced the sale of €17.7 billion of gross NPE to securitisation vehicles, with majority interest of these vehicles then sold to Fortress and PIMCO. The transaction was a landmark deal, as it was the largest ever bilateral NPL transaction in Europe, and was executed with precision, speed and high impact.

We structured the transaction in two main phases.

In phase 1, framework agreements with Fortress and PIMCO were signed in December 2016. Closing and the transfer of the portfolio occurred in July 2017. Pricing was confirmed and no additional provisions were needed.

Immediately thereafter, phase 2 was launched with the aim of further reducing the risk profile of the Group, and optimising the capital structure of the vehicles.

We are pleased to announce that we have entered into binding agreements, to sell down our interests to below 20 per cent. Closing for one of the vehicles has already occurred on 7 December, while closing for the other two vehicles is expected by the end of Q1 2018.

As part of the deal, we have obtained ratings from DBRS and Moody's for a €650 million bond offering of FINO, and have applied for GaCS for the most senior tranche.

At the same time, "Significant Risk Transfer" with the ECB to achieve regulatory deconsolidation is in progress.

Slide 11 – Transparency on sector-wide regulatory headwinds up to end 2019 and beyond

Let me take this opportunity to provide full transparency on the impacts we expect from regulatory headwinds.

During the timeline of Transform 2019, there are only two main topics.

First, the impacts stemming from model changes, pro-cyclicality and IFRS 9 are confirmed.

Second, thanks to our solid capital position, we have decided to partially anticipate EBA guidelines on credit risk models, in particular for Italy.

Notwithstanding this anticipation, we confirm our 2019 fully loaded CET1 ratio target above 12.5 per cent.

Beyond 2019, there are four areas of new regulation that we will comment on.

First, the remaining EBA guidelines will be fully implemented.

Second, calendar provisioning means full prudential provisioning of bad loans, with different time horizons for secured and unsecured exposures. There is still an ongoing discussion between ECB and the European Commission on this topic.

Third, the Fundamental Review of the Trading Book changes the capital framework for market risks. Since last year, the timeline for FRTB has shifted and first implementation has been postponed to 2022.

Finally, Basel IV has just been published on 7 December, introducing constraints for use of internal models for credit and operational risks.

As Mirko will explain, our organic capital generation will more than compensate for expected annual regulatory capital headwinds post 2019.

Let me now focus on the key elements of the EBA guidelines and Basel IV, which are the two regulatory changes with the highest expected impact.

Slide 12 – EBA guidelines defining European standards for credit risk regulatory models

The EBA guidelines, issued in final form on 20 November this year, define common standards for credit risk regulatory models. They will apply to all European banks and will affect particularly the ones with high NPE ratios as well as countries with long judicial procedures.

The EBA guidelines will affect mainly loss given default models (so-called "LGD"), by imposing more conservative computation of risk parameters.

One of the most relevant changes is a higher discount rate to be applied to recoveries, using the historical risk free rate with a fixed spread of 5 per cent.

For example, the current discount rate for Italian models is on average 5 per cent, versus a future EBA requirement of around 8.5 per cent, which means an increase of 3.5 percentage points. And this discrepancy could be higher in low interest-rate jurisdiction.

Another relevant change requires banks to include ALL the defaults in the LGD computation, also the ones for which the collection activities are still ongoing, the so-called "incomplete workout".

In addition, a key requirement is to quantify and foresee an explicit prudential factor, namely the "margin of conservatism", to compensate for models' estimation errors.

Considering the characteristics of our portfolio, the elements that are expected to have the most impact are related to the introduction of the higher discount rate on recoveries, and the inclusion of the incomplete workouts in LGD models.

It is also worth mentioning that in the final guidelines, EBA left the door open to review the discount rates to be applied for recoveries before the final implementation.

Lastly, there is a possibility of a specific treatment of extraordinary disposals in the LGD computation. Once technical guidance is issued, we will be able to better understand how to factor this development into our models.

Let me now move to Basel IV on slide 13**.**

Slide 13 – Basel IV introducing constraints for use of internal models for capital

Basel IV aims to reduce the variability of capital consumption in the sector, by limiting the application scope of internal models for credit and operational risks.

The final document on Basel IV issued on 7 December, is somewhat more favourable than was expected. As I will elaborate shortly, the impact on our capital ratios is well manageable. Let me now briefly touch the key areas affected by Basel IV.

Regarding LGD models for credit risk, the use of internal models for low default portfolios such as banks and large corporate clients will no longer be permitted, and will be substituted by parameters defined by the regulator.

A key change in the final regulation is that the threshold to identify the large corporate segment, is now set at 500 million turnover versus the previous more penalising hypothesis of 200 million. In addition, the regulatory parameters for LGDs are somewhat improved.

Regarding the new standardised framework, the final regulation introduces lower risk weights versus the original proposal for some asset classes, such as residential mortgages and unsecured SME exposures.

As widely expected, Basel IV also foresees capital absorption for ALL the off balance sheet exposures.

For the remaining asset classes that are treated with the advanced IRB approach, there were some changes that overall are neutral to positive compared to industry expectations, such as reduced LGD input floors for some portfolios, and the removal of the scaling factor of 1.06 for all portfolios.
On operational risk, Basel IV disallows the use of internal models and moves to a revised Standardised Approach. The revised standardised measurement approach will consider financial statement information, through the so-called Business Indicator, adjusted by a factor based on the last 10 years of recorded operational losses.

The capital requirements from the new rules defined by Basel IV will then be compared to a so-called output floor, calculated as a percentage of the capital requirements under the full Standardised Approach. The output floor is set at 72.5 per cent. At that level, it will not affect our capital ratio.

The final document sets the implementation date at 1 January 2022, with a five-years phase-in period for the output floor only. As the reform goes through the process of being transposed into European laws, we expect similar phase-in periods to be introduced for the other elements of the package as well.

Slide 14 – 2019 CET1 ratio target confirmed whilst anticipating additional regulatory headwinds

Let’s now move to the capital impact from regulation, models and pro-cyclicality during the Transform 2019 time frame.

As already said, for the period from Q4 2016 to the end of 2019 we confirm our estimate of an impact of 1.5 per cent on our CET1 ratio.

Out of this 1.5 per cent, 0.3 per cent had already occurred by end of Q317.

With regard to the partial anticipation of EBA guidelines and related effects, we will mainly revise selected Italian models by including all bad loans in credit losses estimation, introducing a prudential margin of conservatism, and reviewing macro economic downturn factors.

The resulting impact will be an additional 0.9 per cent mostly in 2018, which includes other minor adjustments.

Our solid capital position has allowed us to make this choice, and Mirko will give you more details shortly.

Slide 15 – Providing transparency and clarity on regulatory headwinds post 2019

You have seen this slide before but let me talk you through it in more detail.

Full implementation of the EBA guidelines is expected to start from the end of 2020, with an additional estimated impact of around 0.9 per cent on top of what we have already planned to anticipate during Transform 2019.

This includes the full extension to all Group credit risk regulatory models, in the period between 2020 and 2021.

We believe this estimate is a conservative one. For example, we have assumed that the discount rate fixed spread of 5 per cent will be confirmed. Should the fixed spread be lower by one percentage point, the impact on the CET1 ratio would be lower by 7-9 basis points.

For calendar provisioning, as we said before, discussion is still ongoing between ECB and the European Commission.

In October this year, the ECB issued an addendum to their NPE Guidance, asking for 100 per cent provisioning of NEW NPEs from January 2018, after two years for unsecured, and after seven years for secured loans. The European Commission drafted its version of calendar provisioning in November 2017, which is much more lenient on the banks.

The key difference is that the European Commission calls for provisioning on newly originated loans, while secured loans provisioning only after eight years with some recognition on the value of collaterals.

Our estimated impact of 0.4 per cent for calendar provisioning is based on our understanding of the more conservative ECB proposal, and already reflects the combined effect with EBA guidelines.

The Fundamental Review of the Trading Book, previously included within the Transform 2019 period, has now been postponed and would have an expected impact of 0.1 per cent.

Finally, for Basel IV the current estimated impact on CET1 ratio is around 0.9 per cent, lower than our initial estimate of 1.5 per cent. The change in estimate reflects the more favourable framework set by the final regulation issued on 7 December, as well as business and risk mitigation actions, such as portfolio mix optimisation and reduction of operational losses.

I know that this is a lot of information to digest on regulatory headwinds, but we feel we should aim to provide our investors with full transparency and clarity on this important topic. The key takeaway is that our organic capital generation will more than compensate for these expected annual regulatory headwinds post 2019, as Mirko will show later.

Slide 16 – EBA guidelines impact on KPIs through model changes, mainly Loss Given Default

Let’s now move back to the Transform 2019 horizon and how the EBA guidelines work in practice.

First of all, let me emphasise how the model changes have an impact on our reported KPIs, even if the underlying business remains unchanged or improving.

This is because the historically realised losses are now taking into account more conservative EBA guidelines requirements, thus increasing LGD parameters. The increase of LGD directly translates into higher expected loss and, to a smaller extent, into higher cost of risk through generic and statistical provisions.

The resulting increase in KPIs is therefore driven by model changes, which are triggered by regulation and are backward-looking, incorporating legacy positions, while the quality of underlying business is stable or improving.

Slide 17 – 2019 Group CoR confirmed even with impact of regulation and model changes

As pointed out in previous slide let me now highlight the impact of model changes on our cost of risk.

First, we confirm our cost of risk Group 2019 target of 55 basis points, fully absorbing the impact from model changes and the partial anticipation of the EBA guidelines.

Model changes impact cost of risk with 4 basis points in 2019, but we are able to fully offset that by our improved underwriting and asset quality.

In 2018, the impact on cost of risk is higher at 15 basis points, mainly due to the one-off effect from the partial anticipation of EBA guidelines mostly in Italy, significantly affecting both stock and new business.

In 2019 the expected impact is lower because the model changes are less relevant and the additional impact from 2018 model changes will affect only the new flows.

The impact will be unevenly felt across our business divisions. The main effect will be in Commercial Banking Italy, with 17 basis points in 2018 and 5 basis points in 2019, mostly because of the partial anticipation of EBA guidelines and the effect of long judicial procedures and high NPE ratios in Italy.

Similarly due to model changes, expected loss on performing stock will increase in 2018 and 2019, as detailed in the Annex on page 30. What is worth mentioning is that, net of model changes, the organic evolution of asset quality is in line with 2019 targets.

Slide 18 – Gross NPEs down by a further 4.0bn by 2019 thanks to decisive de-risking

Reduction of NPEs and improvement of their management is a key priority of Transform 2019.

Transform 2019 already envisaged decisive and proactive actions on legacy issues and targeted gross NPEs of €44.3 billion at Group level.

We are now lowering that ambitious target by a further €4 billion by the end of 2019, bringing the NPE target down to €40.3 billion.

€2 billion of that will come from the Group Core, thanks to sound origination, tight monitoring and active recovery strategy, including disposals in CEE.

The other €2 billion will come from an accelerated rundown of Non Core, mainly thanks to a new

Leasing NPE strategy which I will comment on shortly.

In order to achieve our NPEs targets, we have put in place a comprehensive set of initiatives and we have a clear operational plan, also taking into account the ECB guidance on NPE management, and lessons learnt from FINO.

Slide 19 – 2019 NPEs ratio target for Group Core down to 4.7%

For the asset quality of the Group Core, we had communicated two key KPIs last year: gross NPE ratio at 5.0 per cent and cost of risk at 45 basis points in 2019.

We now improve target NPEs ratio from 5 per cent to 4.7 per cent, thanks to €2.0 billion lower NPEs stock target, and lower by 2 basis points our cost of risk target for 2019 to 43 basis points.

We also confirm our strong NPE coverage above 51 per cent communicated last year.

Please refer to the Annex for details, by divisions.

Slide 20 – Further reduced 2019 Gross NPEs target thanks to proactive actions on Non Core

Let's move now to Non Core.

During last year's presentation, we communicated a target for 2019 net loans at €8.1 billion, a significant de-risking compared to €22.3 billion net book value as of September 2016.

Now our expectation is to close 2019 with net loans at €7.4 billion, €0.7 billion lower than previous target.

We will reach this target with €2 billion lower Gross Loans, now €17.2 billion instead of €19.2.

The various actions to further run-down the remaining part of the Non Core are listed on the right side of the slide.

First, proactive focus on performing clients, will allow us to bring back to the core portfolio, €3.3 billion of exposure.

Second, repayments and recoveries will contribute with €4.2 billion.

Third, our solid track record on disposals will be confirmed with additional €4.6 billion disposals.

Last but not least, we expect a further write-off for €3.2 billion.

Taken together, this will result in a further reduction of €15.3 billion in the gross loans of Non Core by end of 2019.

Slide 21 – Non Core reduction of 2.0bn thanks to clear leasing rundown strategy

As you can see in this slide, €2 billion lower target for Non Core 2019 are driven by the new NPE Leasing strategy.

Specifically, we can identify three main types of actions.

First, an increase in asset sales, thanks to intensification of the remarketing process. This includes new sales channels, with specialised partners in real estate, and improvement in the efficiency of the sale process.

Second, the disposal of the residual claims portfolio generated by asset sales, will be managed through an industrialised and competitive process.

Third, fully provisioned non-performing exposures and with high vintage, will be written off.

This new plan is expected to bring down the Non Core NPE Leasing portfolio from €4.5 billion as at September 2017 to €3.1 billion by 2019.

Slide 22 – Active disposals and recovery drive the rundown strategy

Our rundown strategy uses active disposals and recovery strategies, as key levers to further speed up and to optimise the Non Core portfolio rundown.

Disposals have been planned for 2017, and over the next two years. In the first three quarters of 2017, €1.2 billion out of the €2.2 billion disposals planned this year for Non Core, have been completed. By the end of 2019, we intend to reach a cumulative €5.8 billion, including Leasing.

In addition to disposals, our recovery strategies include two securitisation vehicles, with Sandokan involving real estate exposures, and Pillarstone loans to industrial companies.

Those strategies are based on the implementation of turnaround plans, with dedicated specialists, enhancing restructuring capabilities and performance.

These securitisation vehicles are currently on the balance sheet, but we will explore rundown acceleration and deconsolidation.

Slide 23 – Self funded full rundown of Non Core by 2025

Looking beyond Transform 2019, we continue to accelerate the Non Core run down, and plan to finalise it by the end of 2025. This will bring to a close this Italian legacy issue.

In particular, we confirm that from 2019 onwards, the Non Core portfolio will be composed of NPEs only, since the residual performing component will be reduced to zero by end of 2018, mainly thanks to back to Core and repayments.

Therefore, there will be no new flows to NPE from 2019 onwards, making Non Core a closed legacy portfolio to be fully run down.

Decisive de-risking of NPEs portfolio will then continue, bringing gross NPEs stock to around €7 billion by 2022, equalling around €3 billion Net NPEs. Contribution will come especially from mortgages, corporate and leasing asset classes.

The full rundown by 2025 will continue, through effective internal workout and restructuring activities, also leveraging on disposals and write-offs. This will be entirely self-funded, as the Non Core capital allocation is enough to absorb any future cost.

Slide 24 – Closing remarks

Finally, let me quickly recap the key points we discussed today.

First, we are fully on track with Transform 2019, with improved asset quality in 2017, thanks to proactive actions on the stock and disciplined origination.

Second, we proactively anticipate regulatory changes which harmonise with European standards.

Third, the FINO transaction is proceeding in line with the defined timeline. We successfully closed phase 1 in July. Phase 2 binding agreements have been signed to sell down below 20 per cent, with closing expected by first quarter 2018.

Fourth, 2019 cost of risk target is confirmed thanks to our disciplined risk management.

Fifth, we are lowering our gross NPE target for 2019 by an additional €4 billion gross NPEs.

Last, we commit to fully rundown the Non Core Division by 2025, the rundown will be entirely self-funded.

Thank you for your attention, and I will turn over to Mirko.