Credit Opinion: Banca Tercas

Banca Tercas

Teramo, Italy

Ratings

Category	Moody's Rating
Outlook	Stable
Bank Deposits	A3/P-1
Bank Financial Strength	C-

Contacts

Analyst	Phone
Carlo Gori/Milan	39.02.9148.1100
Henry MacNevin/Milan	
Antonio Carballo/London	44.20.7772.5454

Key Indicators

Banca Tercas

	[1]2006	2005	2004	2003	2002	5-Year Avg.
Total assets (EUR billion)	3.06	2.74	2.31	2.21	2.14	[2]9.44
Total capital (EUR billion)	0.30	0.28	0.27	0.25	0.24	[2]5.89
Return on average assets	0.91	0.70	0.75	0.47	0.46	0.66
Recurring earnings power [3]	2.19	1.62	1.82	1.64	1.39	1.73
Net interest margin	3.59	3.26	3.40	3.64	3.80	3.54
Cost/income ratio (%)	56.75	67.18	64.56	66.69	70.43	65.12
Problem loans % gross loans	2.11	3.92	5.21	3.24	3.10	3.52
Tier 1 ratio (%)	11.54	12.79	14.98	15.28	17.39	14.40

[1] As of December 31. [2] Compound annual growth rate. [3] Preprovision income % average assets.

Opinion

SUMMARY RATING RATIONALE

Moody's assigns a bank financial strength rating (BFSR) of C- to Banca Tercas (Tercas), which translates to a Baseline Credit Assessment (BCA) of Baa1. The rating reflects the bank's sound local franchise, capitalisation and liquidity, but also its significant borrower concentration, lack of independent board members, small size and ambitious growth strategy.

Tercas's deposit rating of A3 receives a one-notch uplift from the bank's BCA based on Moody's assessment of a moderate probability of systemic support in the event of need.

Credit Strengths

- Prudent, although declining, level of capitalisation

- Strong liquidity, albeit reducing, and retail funding

- Satisfactory and improving profitability

- Good market position in the Abruzzo region and in the home province of Teramo

Credit Challenges

- Meaningful borrower and geographical concentration

- Credit risk management could benefit from some strengthening

- Still relatively small size and ambitious independent growth strategy

- All board members are currently designated by the controlling shareholder, the charitable foundation Fondazione Cassa di Risparmio di Teramo

Rating Outlook

The outlook on all ratings is stable.

What Could Change the Rating - Up

A substantial improvement in risk positioning and efficiency could prompt an upgrade of the BFSR to C, which would in turn lead to an upgrade of the deposit ratings to A2.

What Could Change the Rating - Down

An aggressive growth, resulting in deteriorating asset quality or profitability, could prompt a downgrade of the BCA to Baa2 and of the deposit ratings to Baa1.

Recent Results and Developments

Net income grew 49% to EUR 26 million in 2006. The Tier 1 capital ratio was 12%.

DETAILED RATING CONSIDERATIONS

Detailed considerations for Tercas's currently assigned ratings are as follows:

Bank Financial Strength Rating

Moody's assigns a bank financial strength rating (BFSR) of C- to Banca Tercas, which translates to a Baseline Credit Assessment (BCA) of Baa1. The rating reflects the bank's sound local franchise, capitalisation and liquidity, but also its significant borrower concentration, lack of independent board members, small size and ambitiuos growth strategy.

As a point of reference, the assigned BFSR is one notch below the C outcome generated by Moody's bank financial strength scorecard, to account for the bank's relatively small size.

Qualitative Rating Factors (50%)

Factor 1: Franchise Value

Trend: Neutral

Tercas is a regional savings bank mainly operating in the region of Abruzzo (rated A2), where it is the second largest banking group with a 15% market share of deposits. It is dominant in its home province of Teramo, where it enjoys a 57% market share of deposits. This appears sustainable given that it increased from an already very high 55% in 2003. Although it has been diversifying into neighbouring regions, Tercas maintains significant operations in the local market of Abruzzo (which accounts for 76 out of its total 103 branches) and therefore it scores poorly for geographical diversification. The bank operates mainly with retail clients and small businesses, offering reasonable earnings stability.

Tercas's score of C- reflects Moody's view on its franchise value.

Factor 2: Risk Positioning

Trend: Neutral

Tercas's corporate governance and risk positioning are constrained by the lack of independent board members, as these are currently all appointed by the controlling charitable foundation Fondazione Cassa di Risparmio di Teramo. The foundation controls 65% of Tercas, with the remainder controlled by private shareholders. Credito Valtellinese is in the process of acquiring 15% of the bank and signing a strategic agreement, which may involve the appointment of some board members. Tercas also plans to list on the stock exchange in 2008, with the foundation retaining at least 51%.

Although credit risk management is in need of some improvement, this is mitigated by the bank's deep knowledge of its local client base. Tercas's loan portfolio exhibits significant borrower concentration, though this is not unusual for Italian banks, and some concentration towards the real estate sector.

Liquidity management is sound, with the bank being self-funded for the next 18 months. As expected for a relatively small savings bank, management has little market risk appetite, with low VAR of the trading book and shift sensitivity of the banking book.

The bank has a strategy of independent growth involving the integration of weaker players and new branch openings with a view to ultimately reaching 350 branches in central Italy (which is ambitious, from the current level of 103) and EUR 500 million of equity (from around EUR 300 million). It aims to increase its geographical diversification away from Abruzzo to neighbouring regions such as Marche, Lazio and Emilia Romagna, although competition in these areas is intense and Tercas still has insignificant market shares.

Tercas's overall score for risk positioning is E.

Factor 3: Regulatory Environment

Please refer to the forthcoming Banking System Outlook for a description of Italy's regulatory environment.

Factor 4: Operating Environment

Trend: Neutral

This factor is common to all Italian banks. While the more difficult operating environment experienced in recent years affected the profitability of Italian banks, this showed some signs of improvement in 2005 and 2006. Moody's assigns a C- score for the overall operating environment.

Quantitative Rating Factors (50%)

Factor 5: Profitability

Trend: Improving

Tercas's revenues are not well diversified, being 68% reliant on net interest income. Commissions from asset management are, in particular, relatively under-developed. Nevertheless, the bank's profitability appears satisfactory, with an above-average pre-provision income in 2004-2006 (2.5% of risk-weighted assets) and, after meaningful loan loss provisions (21% of PPI in 2006), an average net return on risk-weighted assets of 1.1%.

Until 2004 the bank was not focused on commercial initiatives and had a low cross-selling of products. Since then, Tercas has been refining its customer segmentation and enhancing its product offering, for example with the introduction of package accounts in 2006, although it embarked on this later than competitors.

The strengthening profitability trend started in 2006, supported also by (1) an increased contribution and cross-selling of small businesses, for which competition from national groups is less intense; and (2) the substitution of marginal clients with more active ones. This improvement in profitability is expected to continue this year and next, as evidenced by a strong first half of 2007, with net income increasing around 88%.

Tercas's score of C+, with an improving trend, reflects Moody's view on its profitability.

Factor 6: Liquidity

Trend: Weakening

Tercas has traditionally enjoyed a strong and sticky retail deposit base, resulting in considerable liquidity. Over the past few years, however, loans have grown at a faster rate than deposits, going from 72% of deposits in 2004 to 100% in June 2007, whilst liquid assets have fallen from 36% of assets in 2004 to 27% in 2006. Also in 2006 the bank started tapping the Eurobond market, having previously relied entirely on retail bonds.

Going forward, we expect loan growth to be financed by (a) a further reduction in liquidity, although it is expected to remain sound; and (b) an increase in wholesale funding from current moderate levels (EUR 210 million). To further diversify its sources, the bank has two securitisations of performing mortgages totalling up to EUR 450 million (of which EUR 90 million was done in August) to be completed by June 2008. Given its comfortable funding position, Tercas is able to wait for favourable market conditions before proceeding with these plans.

The bank's score of B+, with a weakening trend, reflects Moody's view on Tercas's liquidity.

Factor 7: Capital Adequacy

Trend: Weakening

Capitalisation was excellent, with a core Tier 1 ratio of 11.5% in 2006 thanks also to a prudent dividend payout, although this is small in absolute terms (EUR 300 million in 2006). However, as for liquidity, the actual and anticipated loan growth is translating into a decline in capitalisation. In addition, a possible acquisition could reduce capitalisation further. Moody's expects Tercas to maintain its Tier 1 ratio above 8% going forward.

Tercas's score of A, with a weakening trend, reflects Moody's view on the bank's capitalisation.

Factor 8: Efficiency

Trend: Improving

Tercas's cost-to-income ratio was acceptable in 2006 (57%) and continued to improve in June 2007. The bank is implementing a number of actions to reduce its cost structure, such as increasing the variable part of staff compensation, renegotiating all supply contracts and investing in IT systems. By the year end, however, the bulk of the improvement should be achieved and little scope remains for further cost-cutting. This is because the bank generally applies a policy of in-house production even in product areas where it may lack critical mass, such as asset management. In addition, new branch openings and a number of new projects, such as the creation of a merchant bank, may limit efficiency improvements.

The C score, with an improving trend, reflects Moody's view of the bank's efficiency.

Factor 9: Asset Quality

Trend: Neutral

Loans continued their high historical growth, rising 25% in 2006 thanks to increases in the home province of Teramo and expansion in Rome. Low-risk residential mortgages accounted for 20% of the portfolio, a lower percentage than at other retail banks of similar size.

Asset quality was still average, with problem loans representing 3.75% of loans in 2004-2006 despite the securitisation and sale of non-performing loans in 2000 and 2006. The bank continued to experience meaningful flows of new non-performing loans, as a result of the rapid loan growth and the weaker economy in Abruzzo (rated A2) than the Italian average. The coverage of problem loans (71% in 2006) was lower than high historical levels but should be enough to continue the sale of NPLs broadly at book value. Moody's will closely monitor Tercas's asset quality evolution, as this is a key rating driver for the bank.

The bank's score of C+ reflects Moody's view on its asset quality.

Global Local Currency Deposit Rating (Joint Default Analysis)

Moody's assigns global local currency deposit ratings of A3/Prime-1 to Tercas. The long-term rating receives a one-notch uplift from Tercas's BCA of Baa1 based on Moody's assessment of a moderate probability of systemic support for the bank in the case of need. This is based on the bank's importance in its home region. Italy (local currency deposit ceiling of Aaa) is considered a medium support country.

ABOUT MOODY'S BANK RATINGS

Bank Financial Strength Rating

Moody's Bank Financial Strength Ratings (BFSRs) represent Moody's opinion of a bank's intrinsic safety and soundness and, as such, exclude certain external credit risks and credit support elements that are addressed by Moody's Bank Deposit Ratings. BFSRs do not take into account the probability that the bank will receive such external support, nor do they address risks arising from sovereign actions that may interfere with a bank's ability to honor its domestic or foreign currency obligations. Factors considered in the assignment of BFSRs include bank-specific elements such as financial fundamentals, franchise value, and business and asset diversification. Although BFSRs exclude the external factors specified above, they do take into account other risk factors in the bank's operating environment, including the strength and prospective performance of the economy, as well as the structure and relative fragility of the financial system, and the quality of banking regulation and supervision.

Global Local Currency Deposit Rating

A deposit rating, as an opinion of relative credit risk, incorporates the BFSR as well as Moody's opinion of any external support. Specifically, Moody's Bank Deposit Ratings are opinions of a bank's ability to repay punctually its deposit obligations. As such, they are intended to incorporate those aspects of credit risk relevant to the prospective payment performance of rated banks with respect to deposit obligations, which includes: intrinsic financial strength, sovereign transfer risk (in the case of foreign currency deposit ratings), and both implicit and explicit external support elements. Moody's Bank Deposit Ratings do not take into account the benefit of deposit insurance schemes which make payments to depositors, but they do recognize the potential support from schemes that may provide assistance to banks directly.

According to Moody's joint default analysis (JDA) methodology, the global local currency deposit rating of a bank is determined by the incorporation of external elements of support into the bank's Baseline Credit Assessment. In calculating the Global Local Currency Deposit rating for a bank, the JDA methodology also factors in the rating of the support provider, in the form of the local currency deposit ceiling for a country, Moody's assessment of the probability of systemic support for the bank in the event of a stress situation and the degree of dependence between the issuer rating and the Local Currency Deposit Ceiling.

National Scale Rating

National scale ratings are intended primarily for use by domestic investors and are not comparable to Moody's globally applicable ratings; rather they address relative credit risk within a given country. A Aaa rating on Moody's National Scale indicates an issuer or issue with the strongest creditworthiness and the lowest likelihood of credit loss relative to other domestic issuers. National Scale Ratings, therefore, rank domestic issuers relative to each other and not relative to absolute default risks. National ratings isolate systemic risks; they do not address loss expectation associated with systemic events that could affect all issuers, even those that receive the highest ratings on the National Scale.

Foreign Currency Deposit Ratings

Moody's ratings on foreign currency bank obligations derive from the bank's local currency rating for the same class of obligation. The implementation of JDA for banks can lead to high local currency ratings for certain banks, which could also produce high foreign currency ratings. Nevertheless, it should be noted that foreign currency deposit ratings are in all cases constrained by the country ceiling for foreign currency bank deposits. This may result in the assignment of a different, and typically lower, rating for the foreign currency deposits relative to the bank's rating for local currency obligations.

Foreign Currency Debt Ratings

Foreign currency debt ratings are derived from the bank's local currency debt rating. In a similar way to foreign currency deposit ratings, foreign currency debt ratings may also be constrained by the country ceiling for foreign currency bonds and notes; however, in some cases the ratings on foreign currency debt obligations may be allowed to pierce the foreign currency ceiling. A particular mix of rating factors are taken into consideration in order to assess whether a foreign currency bond rating pierces the country ceiling. They include the issuer's global local currency rating, the foreign currency government bond rating, the country ceiling for bonds and the debt's eligibility to pierce that ceiling.

About Moody's Bank Financial Strength Scorecard

Moody's bank financial strength model (see scorecard below) is a strategic input in the assessment of the financial strength of a bank, used as a key tool by Moody's analysts to ensure consistency of approach across banks and regions. The model output and the individual scores are discussed in rating committees and may be adjusted up or down to reflect conditions specific to each rated entity.

Rating Factors

Banca Tercas

Rating Factors [1]	A	B	C	D	E	Total Score	Trend
Qualitative Factors (50%)						D+	
Factor 1: Franchise Value (20%)						C	0
Market Share and Sustainability			x				

Geographical Diversification				**x**			
Earnings Stability		**x**					
Earnings Diversification [2]							
Factor 2: Risk Positioning (20%)						**E**	**0**
Corporate Governance [2]					**x**		
- Ownership and Organizational Complexity				x			
- Key Man Risk							
- Insider and Related-Party Risks				--	--		
Controls and Risk Management			**x**				
- Risk Management				x			
- Controls		x					
Financial Reporting Transparency			x				
- Global Comparability	x						
- Frequency and Timeliness					x		
- Quality of Financial Information			x				
Credit Risk Concentration	**--**	**--**	**--**	**--**	**--**		
- Borrower Concentration	--	--	--	--	--		
- Industry Concentration	--	--	--	--	--		
Liquidity Management		**x**					
Market Risk Appetite	**x**						
Factor 4: Operating Environment (5%)						**C-**	**0**
Economic Stability		**x**					
Integrity and Corruption				**x**			
Legal System				**x**			
Financial Factors (50%)						**B-**	
Factor 5: Profitability (7.9%)						**C+**	**0**
PPP % Avg RWA		2.51%					
Net Income % Avg RWA			1.05%				
Factor 6: Liquidity (7.9%)						**B+**	**0**
(Mkt funds-Liquid Assets) % Total Assets	-13.76%						
Liquidity Management		x					
Factor 7: Capital Adequacy (7.9%)						**A**	**0**
Tier 1 ratio (%)	13.10%						
Tangible Common Equity % RWA	13.10%						
Factor 8: Efficiency (3.5%)						**C**	**0**
Cost/income ratio			62.83%				
Factor 9: Asset Quality (7.9%)						**C+**	**0**
Problem Loans % Gross Loans			3.75%				
Problem Loans % (Equity + LLR)		19.75%					
Lowest Combined Score (15%)						**C+**	
Economic Insolvency Override						**Neutral**	
Total Scorecard Implied BFSR						**C**	
Assigned BFSR						**C-**	

[1] - Where dashes are shown for a particular factor (or sub-factor), the score is based on non public information
[2] - A blank score under Earnings diversification or Corporate Governance indicates the risk is neutral