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SECTOR REVIEW

NPL and elections: main topics in early 2018

After the derating in December due to EBA guidelines uncertainties and the slightly increasing SREP requirements, Italian banks had a good start in 2018. Some good news on the NPL side and expectations of manageable outcome from the Italian election are driving Italian banks rerating.

- **Europe and debt the big absents from the political debate so far** - Italian politicians do not seem to consider how to cope with the reduction of the public debt and the commitments with EU. However the coalitions' detailed programs are still missing and the campaign has just started. Whatever the election's outcome, a grand coalition (new normal in Europe) could take over limiting risks of a populists' government.
- **2018 SREP: slightly up** - At system level, we flag an average increase of the P2R by +6bps yoy (from 2.11% to 2.17%), while the total fully loaded overall capital requirement (OCR) rose by +12bps from 9.45% to 9.57%. The ECB is carefully looking at the NPL plans of the banks and is more lenient with banks setting ambitious and aggressive NPL reduction targets.
- **NPL reduction main catalyst for Italian banks: strategic option ahead for ISP** - The main theme for Italian banks in 2018 is asset quality again. The start of the year was good, with ISP is currently in talks with Intrum for a potential €10bn NPL disposal which could help the banks to achieve 11.4% gross NPE ratio, anticipating the achievement of the 2019 target, and the disposal of the Capital Light Bank (or part of it).
- **Regulatory headwinds "diluted" in the long run** – EBA guidelines and Basel 4 are expected to deploy their negative impacts in the long run. The calendar provisioning needs final approval, but we tend to believe that the main risk may come from a potential clean-up action on the NPE stock imposed by the ECB. Banks are already taking spontaneous actions to speed up the process. Focus on ISP, top pick among Italian banks (OP, €3.2TP) ahead of the plan announcement (expected in February).

Figure 1: Current NPL plans and potential adjustments

(€m, %)	2016	9M17	2019	2016-19	9M17-2019	YtD	Additional NPE reduction
UCG	11.8%	10.6%	7.8% (8.4%)	(-18,400)	-12,600	5,800	-4,000
ISP	14.7%	13.7%	10.5%	-16,000	-11,500	4,500	-10,000*
MPS	34.5%	35.6%	14.3%	-27,500	-26,714	786	
UBI	14.4%	14.0%	12.8%	-1,100	-733	367	
BAMI	24.7%	22.6%	16.1%	-6,300	-5,500	800	-3,000*
BPE	22.1%	20.8%	13.5%	-4,321	-4,000	321	
Total	**20.4%**	**19.6%**	**12.5%**	**-73,621**	**-61,047**	**12,574**	**-17,000***

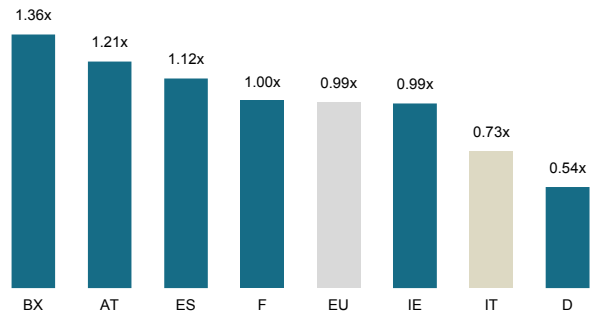
Source: Company data, Credit Suisse estimates, IlSole24ore, Bloomberg - *Potential reduction

Valuation and performance

Small premium, selective approach

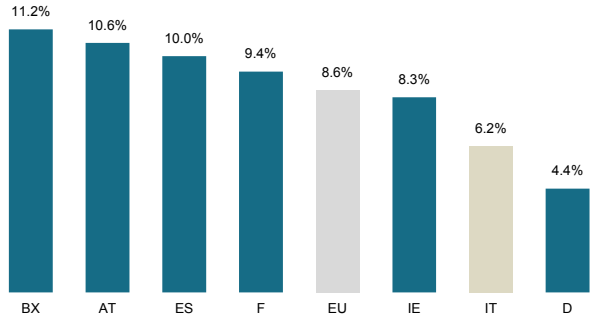
Italian banks valuations have moved from 0.75x 1y forward consensus PTBV in November to the current 0.73x PTBV. The PTBV discount to Eurozone peers currently stands at 26%, while the consensus RoTE gap at ~28%.

Figure 2: PTBV18E by country



Source: Credit Suisse estimates, Thomson Reuters

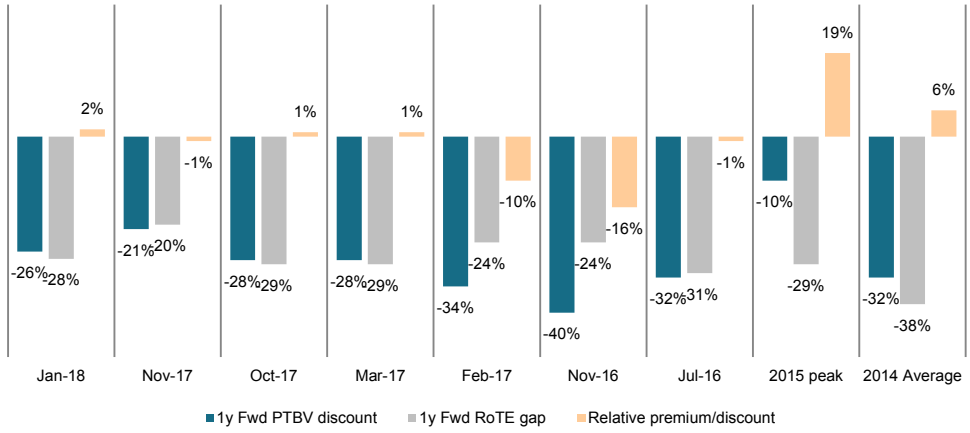
Figure 3: RoTE18E by country



Source: Credit Suisse estimates, Thomson Reuters

The relative valuation has moved from a 1% relative discount in November to a 2% relative premium currently (slightly above the October 2017 level). While on the PTBV side Italian banks offer good value, we stress the profitability and the capital angles. In our view, banks with low RoTE and tin capital trade at justified discount. We are selectively constructive on Italian banks.

Figure 4: Italian banks' current and historical relative valuation trends



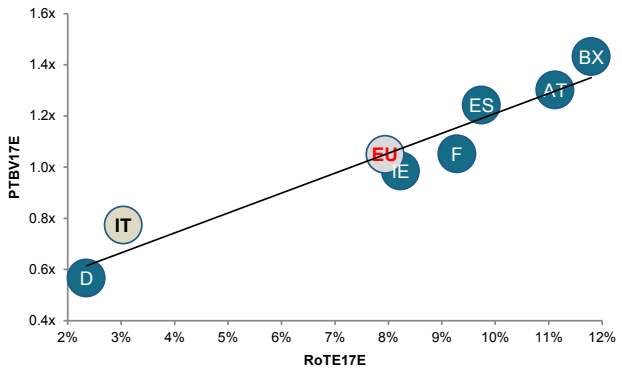
Source: Credit Suisse estimates

Our value maps (based on consensus RoTE vs PTBV) for 2017E and 2018E are backed by the following dynamics and implied drivers:

- Our 2017E value map indicates that Italian banks are expensive and trading at a premium to their Eurozone peers. The RoTE17E gap stands at 62% owing to the fall in profitability to 3.1% on additional asset quality clean-up. At 0.77x PTBV17E, the valuation may look demanding, but it is justified by NPE stock reduction (due to asset quality improvement and to a lot of deals executed/announced). Asset quality improvement should drive lower CoR and higher the RoTE. For Italian banks, the normalization of the CoR is one of the main supports to future profitability.

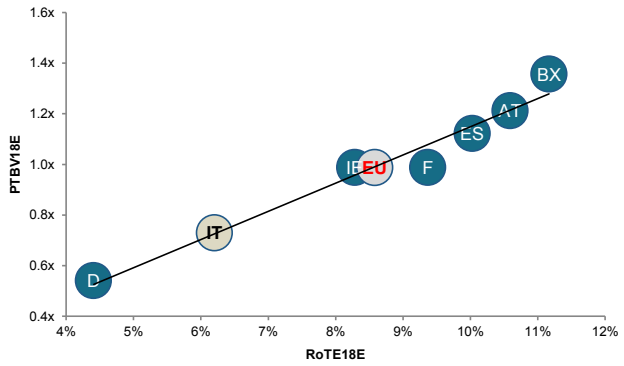
- The 2018E value map shows the RoTE "normalizing" because of a lower CoR (down -43% yoy based on consensus data): as a result, the average consensus RoTE18E would touch ~6%, narrowing the gap to -28%. The relative valuation shows a slight premium of 2%. With restructuring actions, asset quality trends are the main potential sources of earnings momentum and future profitability.

Figure 5: RoTE17E vs PTBV17E



Source: Credit Suisse estimates, Thomson Reuters

Figure 6: RoTE18E vs PTBV18E

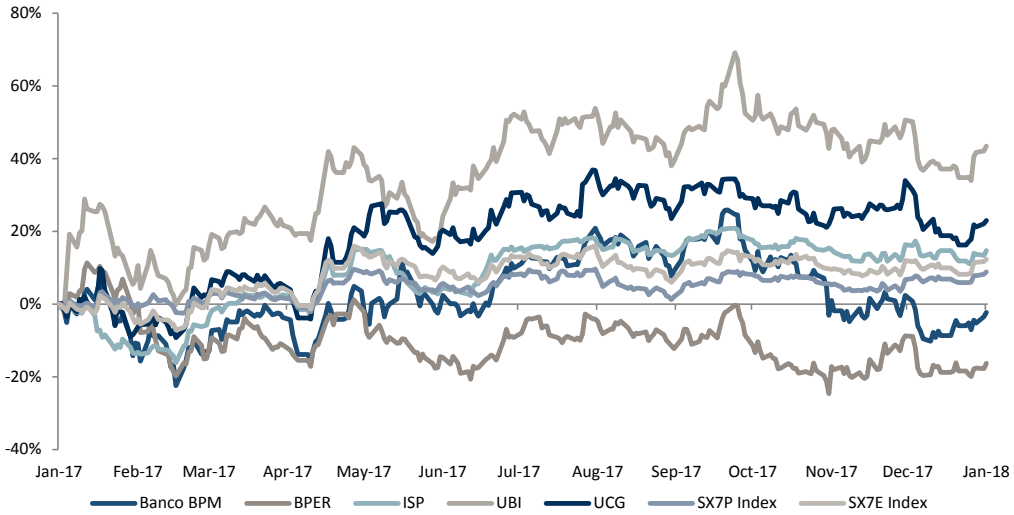


Source: Credit Suisse estimates, Thomson Reuters

Performance: a good start of the year

After the derating in December due to EBA guidelines uncertainties and the slightly increasing SREP requirements, Italian banks had a good start of 2018, despite the elections ahead. President Mattarella gave a reassuring message while dismissing the Parliament on December 28th: Prime Minister Gentiloni will remain in charge until the appointment of a new government after the elections in order to guarantee as much stability as possible. The rerating has been further supported by the initial execution of the MPS' €26bn NPE deconsolidation (with the disposal of the Mezzanine tranche to Quaestio) and talks of a potential deal between ISP and Swedish Intrum Justitiam, which seems to be interested in the purchase of €10bn NPL and of the Capital Light Bank.

Figure 7: Italian banks: Market performance YoY vs SX7P/E vs MIB30



Source: Thomson Reuters Datastream

NPL theme: strategic options for ISP?

As mentioned in our note Italian banks – NPLs and the ECB still the focus in 2018, the main theme for Italian banks is continuing to be asset quality. The start of the year was good, with MPS selling to Quaestio Capital Management the mezzanine tranche of the €26bn jumbo securitization announced last year. This sets the initial step of the NPE deconsolidation execution: the junior tranche allocation and the placement of the senior tranche will be executed later once the GACS will be assigned (see Italian banks-Discerning asset quality for more details). ISP confirmed to be in talks with Intrum Justitia AB to sell its credit-servicing platform (the Capital Light Bank unit - CLB) along with a €10bn portfolio of bad loans to accelerate its disposal of bad loans. According to BBG, the CLB may be valued at about €500m, though ISP might consider selling a portion. As part of the deal, Intrum could manage some of ISP's existing and future non-performing loans. ISP is seeking to accelerate the disposal of bad loans and said in November that it planned to cut a gross €16bn of bad debt by the end of 2019, including €4.5bn it slashed in the first nine months of 2017. The 2019 gross NPE target is currently set at 10.5% from 13.7% in Q317. Based on Q317 data the Gross NPE ratio would fall to 11.4%, while the Net NPE ratio from 7.4% to 6.7%. If confirmed the deal could help ISP to improve the NPE target.

Figure 8: Potential impact of the NPL disposal

(€m, %)	ISP	ISP PF
Total gross loans	392,074	382,074
Total net loans	363,878	360,878
Gross NPE	**53,607**	**43,607**
Provisions	-26,541	-19,541
NPE coverage	*49.5%*	*44.8%*
Net NPE	**27,066**	**24,066**
Gross NPL	34,855	24,855
Provisions	-21,204	-14,204
NPL Coverage	*60.8%*	*57.1%*
Net NPL	13,651	10,651
Gross UTP	18,320	18,320
Provisions	-5,253	-5,253
UTP Coverage	*28.7%*	*28.7%*
Net UTP	13,067	13,067
Gross Past Dues	432	432
Provisions	-84	-84
Past Dues Coverage	*19.4%*	*19.4%*
Net Past Dues	348	348
Gross NPE ratio	**13.7%**	**11.4%**
Net NPE ratio	**7.4%**	**6.7%**
Gross NPL ratio	8.9%	6.5%
Net NPL ratio	3.8%	3.0%
Texas ratio - (Gross NPE/TE+Provisions) - %	**78.0%**	**70.7%**
Texas ratio stated - (Net NPE/TE) - %	**64.2%**	**57.1%**

Source: Company data, Credit Suisse estimates

ISP could sell the NPL at a price no lower than 30% of the GBV (in line with the NBV) thanks to the use of the IFRS9 to increase coverage and to limit the following capital impact stemming from the increasing LGD. ISP is expected to announce the new plan 2018-2021 in February (day TBA). The NPL deal could be part of the plan, as well as: (i) increasing focus on asset management business; (ii) new focus on P&C business (via organic growth); (iii) cost control (the recent agreement with the unions is expected to take relevant cost savings in 2021 (€675m savings at regime, or 12% of the staff cost).

SREP 2018: slight increase yoy

On December 29th the ECB released the SREP update for UBI, which was the last Italian bank receiving the regulatory requirement. At system level, we flag an average increase of the P2R by +6bps yoy (from 2.11% to 2.17%), while the total fully loaded overall capital requirement (OCR) rose by +12bps from 9.45% to 9.57%.

Figure 9: 2018 SREP requirements and CS total capital requirements

(%)		ISP	UCG	MPS	UBI	BAMI	BPER	Italy (CSe)
a	P1 Requirements (P1R)	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%	4.50%
b	P2R	1.50%	2.00%	3.00%	2.25%	2.50%	1.75%	2.17%
c = a + b	**P1R + P2R = TSCR (Total SREP Capital Requirement)**	**6.00%**	**6.50%**	**7.50%**	**6.75%**	**7.00%**	**6.25%**	**6.67%**
d	Capital Conservation Buffer CCB	1.88%	1.88%	1.88%	1.88%	1.88%	1.88%	1.88%
e	G-SIFI	0.00%	0.75%	0.00%	0.00%	0.00%	0.00%	0.13%
f	O-SII Buffer	0.19%	0.25%	0.06%	0.00%	0.00%	0.00%	0.08%
g	CCyB	0.00%	0.07%	0.00%	0.00%	0.00%	0.00%	0.01%
h = d + e + f + g	*Transitional combined capital buffer required*	*2.07%*	*2.95%*	*1.94%*	*1.88%*	*1.88%*	*1.88%*	*2.10%*
i = c + h	**Overall Capital Requirements (OCR)**	**8.07%**	**9.45%**	**9.44%**	**8.63%**	**8.88%**	**8.13%**	**8.76%**
j	Capital Conservation Buffer CCB (2019)	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%
k	G-SIFI (2019)	0.00%	1.00%	0.00%	0.00%	0.00%	0.00%	0.17%
l	O-SII Buffer (2021)	0.75%	1.00%	0.25%	0.00%	0.25%	0.00%	0.38%
m	CCyB (2019)	0.08%	0.07%	0.00%	0.00%	0.00%	0.00%	0.03%
n = j + k + l + m	*Fully loaded combined capital buffer required*	*3.33%*	*3.57%*	*2.75%*	*2.50%*	*2.75%*	*2.50%*	*2.90%*
o = c + n	**FL OCR**	**9.33%**	**10.07%**	**10.25%**	**9.25%**	**9.75%**	**8.75%**	**9.57%**
r	P2G (actual/CSe)	1.25%	1.50%	1.25%	1.05%	1.00%	1.00%	1.18%
s = o + r	FL OCR including P2G	10.58%	11.57%	11.50%	10.30%	10.75%	9.75%	10.74%
t	Management buffer (CSe)	1.00%	1.00%	1.00%	1.00%	1.00%	1.00%	1.00%
u = s + t	**Total CS Capital Requirements**	**11.58%**	**12.57%**	**12.50%**	**11.30%**	**11.75%**	**10.75%**	**11.74%**
v	FL CET1 Q317	13.40%	13.81%	14.50%	11.54%	12.49%	13.81%	13.26%
w = v - o	**MDA buffer**	**4.07%**	**3.74%**	**4.25%**	**2.29%**	**2.74%**	**5.06%**	**3.69%**

Source: Company data, Credit Suisse estimates

At company level, UCG benefited from an improvement in the SREP requirement, while the rest of peers posted a worsening with the exception of ISP (for which SREP was flattish) and MPS (as the SREP issued in July was already for 2018).

Figure 10: Main changes 2018-2017

(%)	ISP	UCG	MPS	UBI	BAMI	BPER	Italy (CSe)
FL OCR 2017 (i)	9.26%	10.52%	10.25%	8.75%	9.40%	8.50%	9.45%
Gap FL OCR 2018-2017	**0.07%**	**-0.45%**	**0.00%**	**0.50%**	**0.35%**	**0.25%**	**0.12%**
Gap P2R 2018-2017	**0.00%**	**-0.50%**	**0.00%**	**0.50%**	**0.10%**	**0.25%**	**0.06%**
MDA buffer 2017	4.14%	3.29%	4.25%	2.79%	3.09%	5.31%	3.81%
MDA buffer 2018	4.07%	3.74%	4.25%	2.29%	2.74%	5.06%	3.69%

Source: Company data, Credit Suisse estimates

The small banks suffered from an increase of the capital requirements, with UBI impacted most (+50bps in terms of P2R), while BAMI was slightly affected by the P2R increase (+10bps only) but it was affected by the +25bps O-SII charge added in 2018 for the first time.

The SREP requirement seems not only function of the actual dynamics occurred during 2017 but also of the future prospects: UCG decline reflects the actions implemented at end 2016 (FINO and the jumbo rights issue), UBI increase reflected the integration of the Three banks and the slow reduction, BAMI limited increase factors in a new NPL 2019 target, as well as BPER.

The ECB is carefully looking at the NPL plans of the banks and is more lenient with banks setting ambitious and aggressive NPL reduction targets.

Many banks have been improving their NPL plans: (i) on December 12, UCG lowered the NPE ratio 2019 target from 8.4% to 7.8%, increasing the NPE reduction by additional €4bn; (ii) BAMI's CEO said in an interview (Ilsole24ore, December 27th) that the IFRS9 first time adoption (FTA) could help to increase the NPE coverage allowing the bank to improve the NPE 2019 reduction target from €8bn to €11bn.

ISP's SREP is flat, but the bank has not announced the new strategic update yet: it is very likely that the new NPE reduction target will be ambitious and with limited impact on the P&L, as the bank could take advantage of the FTA.

UBI looks the most penalized bank in terms of SREP requirement due to the slow NPE reduction, but we tend to believe that the bank will easily beat the targets well ahead of schedule and will also be able to improve the NPE internal recovery target thanks to its internal unit (consisting of 400 HC).

The short & long term regulatory headwinds

IFRS9

In the short term we flag the IFRS9 which has come in force as of January 1 2018. The impact is already broadly factored in the estimates and the stock prices. For Italian banks we have anticipated the impact in our note on November 2 (Italian Banks - Discerning asset quality): 2.32% on Q217 tangible equity and -32bps of Q217 CET1 ratio. The IFRS9 could turn into a positive which may help banks to increase NPE coverage without impacting the P&L (only the equity with the First Time Adoption).

The calendar provisioning

By H118 at latest (but we do not rule out an outcome by Q118), the ECB is expected to release the final document on the "calendar provisioning", which provides for the full coverage of new NPEs after 2 years if unsecured or after 7/8 years if collateralized. According to the "addendum" (the ECB consultation document issued in October), banks may use all tools available of the provisioning backstop (existing and new provisions, shortfall to expected loss and other deductions according to the article 3 CRR). Our analysis in our note published on November 2 (Italian Banks - Discerning asset quality) points to an average cumulated 2018-2022 impact for CS banks universe of 58bps.

The EBA guidelines

The EBA guidelines (GL) provide a definition of common standards for credit risk regulatory models. The GL are one of the initiatives of the EBA to reduce unjustified variability of risk parameters and own funds requirements as part of a broader review of the Internal Rating-Based (IRB) approach and to provide rules that will lead to increased comparability of the model outcomes. The GL provide clarification on the estimation of Probability Default (PD) and Loss Given Default (LGD) parameters for both defaulted and non-defaulted exposures.

The GL differentiate between model development and calibration: **model development** is understood as part of the process of estimation of risk parameters that leads to appropriate risk differentiation, whereas **calibration** is the part of the estimation that leads to appropriate risk quantification.

The GL put more focus on calibration, leaving significantly greater flexibility for institutions in model development. If a bias in risk quantification is identified, it has to be addressed through an appropriate adjustment and **margin of conservatism (MoC)**. The appropriate "adjustments" come from the following requirements: (i) LGD discount rate on recoveries; (ii) LGD incomplete workout treatment; (iii) MoC; and (iv) other requirements (like higher weight of stressed macro-economic scenarios, revised treatment of temporary cured cases).

(i) - **Discount rate**. The EBA has considered various possibilities and analyzed various practices in that regard. Approaches used by institutions include the use of discount factors based on effective interest rates of the underlying loans, various add-ons in the range of 0 to 10% and even higher in some cases, and various underlying internal and external interest rate benchmarks. As significantly different approaches are currently used by institutions, the discount factor was recognized as one of the main drivers of non-risk-based variability of the LGD estimates. The proposed solution of using interbank funding rates and a 5% add-on has the advantage of being simple and contributing to increased comparability of LGD estimates. It is considered appropriate that the discount rate should not depend on the credit standing of the institution, so the discount rate does not reflect funding costs but rather is focused on the uncertainty inherent in the recovery processes and the time value of money. The discount rate specified in the GL is expected to reflect the average economic conditions that are adequate for the purpose of the long-run average LGD. It is not considered to be associated with downturn conditions (separately

set). Note that the adequacy of the 5% add-on will be further analyzed and potentially reviewed before the date of application of the GL.

(ii) - Treatment of incomplete recovery processes - All observed defaults have to be taken into account in the calculation of long-run average LGD: incomplete recovery processes should also be included. These incomplete processes carry valuable information, in particular about the most recent observations, and cases that are particularly difficult and therefore require longer recovery processes. Exclusion of this information would not only lead to loss of relevant, up-to-date information, but could also lead to underestimation of LGD, and this was therefore considered inappropriate.

However, to obtain a realistic value of long-run average LGD, the incomplete recovery processes should be included with future recoveries that are expected to be realized. **The value of future recoveries is not an objective, observed measure but has to be estimated based on the recoveries factually observed on those cases that are already closed.** *As a result, the 'long-run average LGD' will also be a measure that is not fully objective, as it contains components that are estimated*.

To obtain a fully objective intermediate measure, it is proposed that institutions should also calculate the 'observed average LGD' taking into account realized LGDs only on those defaults that are related to closed recovery processes, including those that are treated as closed because they have reached a certain threshold in terms of the time in default, i.e. a maximum length of the recovery process during which additional recoveries can be reasonably expected. Although this objective measure will not include any elements of estimation, it has to be kept in mind that it may not accurately reflect the real experience, as the cure and high-recovery cases may be over-represented.

More difficult cases usually stay longer in recovery processes, and therefore they are likely not to be included in the 'observed average LGD'. This has to be adjusted to account for the most recent experience based on the incomplete recovery processes, to obtain an adequate long-run average LGD. For this purpose, institutions should estimate the most likely future recoveries on cases where the processes are not yet complete. As such estimates can be provided only where sufficient data exists to support them, it is proposed that institutions should estimate future recoveries only until a certain point in time, i.e. the maximum length of the recovery process during which a sufficient number of recoveries were actually observed in similar cases. The assumptions underlying the expected future costs and recoveries should be adequately justified and back-tested.

The EBA GL will come into force as of Q420 and will be completed by 2021. It is reasonable to expect higher impact for banks with high NPE ratios and countries with long judicial procedures.

In general for Italian banks the incomplete recovery processes is factored in the model change impact, which is in turn already partly factored in the targeted CET1 ratios (some final adjustments could also be positive) according to some recent business plans. The partial internal workout may overlap with IFRS9. A dynamic estimate could lead to a lower negative impact compared to a static approach. In addition, a positive cycle expectation could improve the evolution and the impact, while if a bank with strong capital "forces" the underlying assumptions adopting a more pessimistic cycle scenario the LGD could get worse. A stronger capital situation could lead to forcing the internal workout with negative impact on the LGD and on the Expected Loss (EL).

The largest impact of the EBA GL could be in terms of discount rate applied to calculate the LGD. This broadly depends on the model vintage, the granularity and efficiency of the model, the segmentation and the type of exposures. For example a vintage too backward looking could sharply lift the discount rate (close to the max 10%) as the 3M Euribor stood at 3-400bps in 2008 like in the case of UCG, which at the Capital Market Day the company guided for a -180bps impact between 2018 and 2020 (of which -

90bps by the plan horizon in 2019). As mentioned in our report Unicredit – Capital buffer behind regulation?, we cannot rule out that UCG is deliberately anticipating the impact of the EBA guidelines as the implementation is starting 2020 (completed in 2021). For the plan 2019, the company is limiting the application of the new model to the Italian portfolio only, with an impact of -90bps. The new models provide for a recalibration of PD and LGD which impacts mainly banks with high NPE stock and long judicial procedures. The main impact for UCG comes from the high discount rate applied due to the vintage, lifting LGD and impacting the DCF (as well as the time value if recovery procedures are too long).

The additional -90bps impact after 2019 comes from the extension of the models to the rest of the loan portfolio. High default portfolios are clearly more impacted. As a pioneer in using the advanced internal models among Italian banks, we cannot rule out that UCG is now applying a tightened resetting of the models after years.

Basel IV

On December 7th the GHOS published the long awaited detailed Basel IV reform package/ The set of final proposals are better than expected (see European Banks Strategy (#26) – First read Bal4: better than expected – flexibility to water down further) thanks to: (i) a long phase-in (9 years) to 2027; (ii) a change to the Standard Approach (loan splitting and potential national discretion); (iii) more favorable treatment of mortgage loans and of CRE exposures (by LTV buckets); (iv) relevant mitigation in terms of revised scope of IRB approaches for large and mid-corporate (consolidated revenue threshold increased from €200m initially proposed to €500m); (v) further mitigation in terms of operational risk calculation (introducing national discretion in the determination of the Internal Loss Multiplier – ILM).

In our first read we flagged that among European banks relative winners are, mortgage heavy banks with manageable impact and/or sizeable buffers (ABN, Danske, and LLOY), banks with historically high litigation (BNP, and LLOY), as operational risks are significantly watered down.

The final reform proposal put Italian banks (already not expected to be heavily hit by Basel IV) in a further better position with potential more limited negative bill for the following reasons: (i) average low LTV mortgage (between 50%-60%); (ii) low CRE exposure; (iii) limited use of A-IRB models; (iv) limited exposure to corporates with €500m turnover.

The calculation methodology of the operational risk charge, based on a revenue multiplier, is penalizing for Italian banks relative to European peers, being less exposed to litigations. In conclusion we may argue that Basel IV could hit Italian banks in terms of operational risk impact relative to the impact in terms of credit risk.

In conclusion, based on the above mentioned reasons, we expect a much lower impact for Italian banks relative to other European banks: the view is corroborated by 90bps impact disclosed by UCG during the recent Capital Market Day (from 150bps previously mainly for the different revised IRB scope for large and mid-corporate). For UCG 60% of the impact comes from credit risk, while the rest from operational risk. For ISP we expect the operational risk to be more relevant impact in terms of credit risk, for which we expected very limited impact. Retail wise, the real estate exposure has a low LTV (less than 60% on average) while on the corporate side, the revision to F-IRB has a limited impact while input floors are not relevant too. ISP's starting point is already overweight in terms of RWA density.

The GHOS was unable to find an agreement on the Sovereign exposures risk weights, but future might change. For Italian banks, the sovereign exposure could be a relevant issue, mainly in terms of low rating bonds (like the Italian) and concentration ratio, however a long phase-in would not harm. According to different proposals there are a few options: among them the most "politically correct" includes 10% RWA floor + an add-on based on ratings (bearing in mind that the concentration ratio should be consistent with the LCR).

Election Day on March 4: Europe and debt the big absents

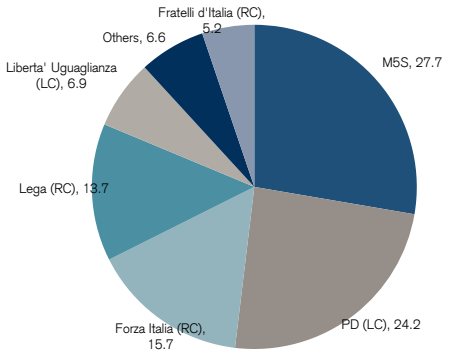
On December 28th, President Mattarella dismissed the Parliament as expected: the Election Day has been called on March 4th.

Prime Minister Gentiloni will remain in charge until the appointment of a new government after the elections in order to guarantee as much stability as possible

In the absence of a clear majority after the vote another round of new election shortly after cannot be ruled out. The new electoral law (so called "Rosatellum") should help to mitigate the risk of hung parliament being based on the following rules: one third of the lower and upper house elected with majority premium and the remainder elected proportionally

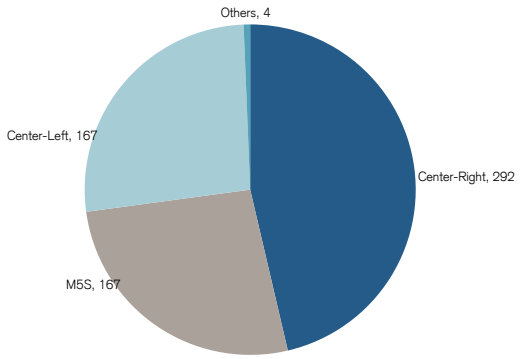
This system should also help coalitions and penalize parties running "solo" (read 5stars). M5S is leading the most recent polls, but the right coalition would take over the lower house. PD (Renzi's Democratic Party) looks like losing momentum.

Figure 11: Most recent polls (%)



Source: Ixe', Credit Suisse

Figure 12: Lower house composition based on polls



Source: Ixe', Credit Suisse

For the European Union the main priority of the new Italian government should be the reduction of the huge public debt. However, according to the press (Il Sole, January 2), the political coalitions are making expensive promises during the campaign.

The Center Right (Lega and Forza Italia) campaign looks like the most expensive and is based on: (i) the reduction of the income taxes (flat tax introduction, €30-40bn cost); (ii) the introduction of a minimum "dignity income" for low or no income households (€15-17bn cost); (iii) increase of the pensions to €1,000 floor (€18bn cost); (iv) the cancellation of IRAP (€13bn cost); (v) the reduction of the pension age eligibility by two-three years (€140bn cost over 2017-2035, or an annual cost in the region of €18bn); and (vi) more flexibility in terms of Fiscal Compact (returning to ~3% deficit to GDP target, €24bn). The total bill of the Center Right promises is between €104bn and €130bn including the reduction of the pension age, equivalent to 7%-8% of GDP assuming the annual cost of the pension age reduction (€86-112bn excluding it, equivalent to a more realistic but still high 5-7%). Lega and Forza Italia are confident to gather the funds to finance the mentioned promises from the emersion of the black economy as a result of the reduction of taxes, adjustments of tax expenditures, reduction of public spending and more flexibility.

M5S campaign looks expensive too and is based on: (i) the reduction of taxes and the change of tax expenditures (€12-15bn cost); and (ii) a minimum "citizenship income" for low income households (€15-17bn cost). The total bill of the M5S promises is between €53bn and €59bn, equivalent to 3-4% of the GDP. M5S aims to fund the proposals by

reducing the tax expenditures for high income (above €90k) and increasing taxes for banks and insurance.

The Left Coalition looks the one with the most reasonable program from a financial perspective. It is based on: (i) the change of the IRPEF (households' income tax reduction, €12-15bn cost); and (ii) €80 bonus for low income households (€5.7bn cost). The total bill of the promises would be between €18bn and €21bn, equivalent to 1% of the GDP.

Figure 13: Cost of the political programs

€bn	Right Coalition Best Case	Right Coalition Worst Case	M5S Best Case	M5S Worst Case	Left Coalition Best Case	Left Coalition Worst Case
Flat tax (20%-15%)	30	40				
IRPEF Reduction			12	15	12	15
Dignity/Citizenship income	15	17	15	17		
Minimum pensions	4	18	2	3	1	2
80 Euros Bonus					6	6
Fiscal compact	24	24	24	24		
IRAP cancellation	13	13				
Total cost	**86**	**112**	**53**	**59**	**19**	**23**
As a % pf GDP	5.4%	7.0%	3.3%	3.7%	1.2%	1.4%
Reduction of pension age	18	18	0	0	0	0
Total cost	**104**	**130**	**53**	**59**	**19**	**23**
As a % pf GDP	6.5%	8.1%	3.3%	3.7%	1.2%	1.4%

Source: IlSole24ore, Credit Suisse estimates

The Right Coalition seems to targeting ageing range of people and could likely be successful with such a campaign also in view of the current polls.

Clearly the programs should be consistent with the financial commitments sets with the European Union, mainly because the QE will be over soon. So far Italy has benefited from a low funding cost thanks to the ECB, which has kept under control the sovereign spread so far.

The detailed programs of the coalitions are still missing and the campaign has just started: the political parties do not seem to consider this and how to cope with the tapering and the reduction of the public debt, which is one of the main concerns of the European Authorities. Europe and public debt are the big absents in the current Italian political debate.

In the lack of financial conditions improvement (both in terms of GDP growth and public debt reduction) and of help by the ECB, Italy could face another difficult season for its funding cost, for which the only solution could be represented by the OMT (Outright Monetary Transactions) with the implications in terms of reduction of sovereignty.

In the next few weeks, approaching March 4th the polls outcome could drive some volatility in the Italian market. A victory of the populist parties could widen the sovereign spread potentially affecting Italian banks however we cannot rule out whatever the election's outcome, that a grand coalition (new normal in Europe) could take over limiting risks of a populists' government.

Companies Mentioned *(Price as of 10-Jan-2018)*
BPER Banca (EMII.MI, €4.492)
Banco BPM S.p.A. (BAMI.MI, €2.852)
Intesa-Sanpaolo (ISP.MI, €2.97)
Intrum Justitia (IJ.ST, Skr281.6)
Monte dei Paschi di Siena (BMPS.MI, €3.968)
UBI Banca (UBI.MI, €3.98)
Unicredit (CRDI.MI, €17.0)

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