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Research Update:

Italy-Based Veneto Banca Downgraded To 'BB+/B' On Increased Economic Risk; Outlook Negative

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Overview

- We reviewed Veneto Banca's capital strengthening plans in the context of the increased economic risk we see in the Italian economy.
- In our opinion, Veneto Banca's capital strengthening actions will likely not be sufficient to maintain its risk-adjusted capital ratio sustainably above 7% over 2013-2014.
- We are therefore lowering our long- and short-term ratings on Veneto Banca to 'BB+/B' from 'BBB-/A-3' and removing them from CreditWatch negative.
- The negative outlook reflects the possibility of a downgrade if we were to lower our sovereign ratings on Italy and if we anticipated that Veneto Banca's stand-alone credit profile could weaken in the context of deteriorating domestic economic and banking industry conditions.

Rating Action

On Dec. 20, 2012, Standard & Poor's Ratings Services lowered its long- and short-term counterparty ratings on Italy-based Veneto Banca to 'BB+/B' from 'BBB-/A-3'. We also lowered our issue rating on Veneto Banca's nondeferrable subordinated debt to 'BB-' from 'BB+' and on its Tier 1 preference securities to 'B' from 'BB-'. We removed all ratings from CreditWatch where they were placed with negative implications on Aug. 5, 2012. The outlook on the long-term rating on Veneto Banca is negative.

Rationale

The downgrade reflects our view that Veneto Banca's capital strengthening actions will likely not be sufficient to fully absorb the negative impact of the increased economic risk we see in Italy on Veneto Banca's future earnings and asset quality. We no longer anticipate that Veneto Banca's risk-adjusted capital (RAC) ratio, Standard & Poor's measure of capital, would strengthen to a level comfortably above 7% over 2013-2014, from the 5.3% we calculated at year-end 2011 (pro forma for increased economic risk in Italy; see "BICRA On Italy Maintained At Group '4', Economic Risk Score Revised To '5' On Increased Credit Risk For Italian Banks," published Aug. 3, 2012). As a result, we have revised our assessment of Veneto Banca's capital and earning position to "moderate" from "adequate." We have consequently revised down our assessment

of Veneto Banca's stand-alone credit profile (SACP) to 'bb+' from 'bbb-', which in turn lead us to lower our ratings on Veneto Banca to 'BB+/B' from 'BBB-/A-3'.

Our forecast of Veneto Banca's RAC ratio incorporates our view that shareholder contributions will continue and that Veneto Banca's risk weighted assets, calculated under Standard & Poor's methodology, will likely decrease in 2013. Veneto Banca has recently issued €350 million worth of convertible bonds. According to the published terms, Veneto Banca has the option of converting them into Veneto Banca shares from March 2014. In accordance with Standard & Poor's bank capital criteria, we do not give credit to convertible bonds whose conversion is not mandatory within a given period of time in our total adjusted capital (the numerator of the RAC).

In our opinion, Veneto Banca's core earnings capacity will remain modest in the current economic environment, as a result of low interest rates, weak volume growth, a still high cost base, and potentially rising credit losses. In addition, we consider the quality of Veneto Banca's capital as modest, taking into account the high share of deferred tax assets related to goodwill and provisions, and hybrids we incorporate in our forecast total adjusted capital.

We have maintained our assessment of Veneto Banca's business position as "adequate." This reflects, among other things, our view of the track record achieved in terms of integration of the retail banks acquired in past years.

We assess Veneto Banca's risk position as "moderate" because we believe that its vulnerability to credit risk is higher than what is captured by our RAC estimates. As in the case of some other Italian banks, we believe the combined effect of mounting problem assets and reduced coverage by loan loss reserves make Veneto Banca more vulnerable to the impact of higher credit losses, particularly in the event of deterioration in the collateral values of assets. In our opinion the impact of recession, particularly on the corporate segment (which represent over 60% of Veneto Banca's loan book) will likely push Veneto Banca's stock of problem assets--which we define as the sum of bad loans ("sofferenze") and watchlist loans ("incagli")--to high levels in 2013 and 2014, after experiencing a material increase since the downturn started in 2009. We calculate Veneto Banca's gross stock of problem assets increased to 9.8% as of June 2012 compared with 5.1% in 2008. We also take into account Veneto Banca's higher exposure to the real estate and construction sectors than the Italian banking sector average. At the same time, Veneto Banca's coverage of problem assets through provisioning is low by international standards, in our view, and has decreased over the past few years to 29% in June 2012 from 33% at year-end 2008. We acknowledge that Veneto Banca's provisioning policies rely on extensive use of tangible collateral in its assessment of expected losses. Still, our assessment takes into account Veneto Banca's large stock of net nonperforming assets (including restructuring loans and loans past due), represented about 108% of Veneto Banca's Tier I capital as of June 2012.

Our SACP and ratings on Veneto Banca continue to reflect the anchor of 'bbb' we assign to commercial banks operating in Italy (the anchor is our starting point for assigning a long-term counterparty credit rating to a bank), "average" funding, and "adequate" liquidity, as our criteria define these terms.

We consider Veneto Banca's to have a "moderate" systemic importance and the Italian government to be "supportive" of its banking sector. We evaluate the likelihood of government support for Veneto Banca as "moderate" but we do not incorporate any uplift into the long-term rating from the SACP, given the 'BBB+' long-term rating on Italy.

According to our methodology, we rate nondeferrable subordinated debt issued by banks in Italy a minimum of two notches below the SACP and the hybrid preference securities four notches below the SACP when the SACP is 'bb+' or lower. As a result, we also lowered our ratings on Veneto Banca's subordinated debt to 'BB-' from 'BB+' and on its Tier 1 preference securities to 'B' from 'BB-'.

Outlook

The negative outlook on the long-term rating on Veneto Banca reflects the possibility that we could lower the ratings if we were to lower our ratings on the Republic of Italy (unsolicited BBB+/Negative/A-2), and we anticipated that deteriorating economic and banking industry conditions in Italy could affect Veneto Banca's asset quality, capital, and earnings more than we currently factor into the rating.

A deterioration of the SACP while the sovereign long-term ratings on Italy remained at 'BBB+' would not necessarily trigger a downgrade because such a deterioration might be cushioned by government support according to our criteria.

Under our baseline expectations, we still expect the RAC ratio for Veneto Banca to remain comfortably above 5% over the next two years, including shareholder contributions. We expect Veneto Banca's asset quality will continue to deteriorate in 2013, in line with its main peers, although less than in 2012. We expect Veneto Banca's credit losses to remain close to our forecast Italian domestic average, at 95-100 basis points (bps) in 2012 and 2013, while maintaining relatively stable loan loss coverage. In addition, our rating factors in our view that Veneto Banca will maintain an average funding position and adequate liquidity, including a reduction on central bank and other short-term funding sources in the medium term. We think that Veneto Banca will benefit from its deep retail customer base and continue to further reduce its 129% loan-to-retail funding ratio over the next two years, as occurred in 2011 and 2012.

We could lower the ratings if we anticipate that Veneto Banca's RAC ratio will not remain sustainably above 5% over the next 24 months, namely if the capital

strengthening actions don't materialize or as a result of worsening economic risk we see in Italy. We could also lower the ratings if we anticipate that Veneto Banca's net inflows of NPAs and credit losses will exceed our current expectations.

We could revise the outlook to stable if we anticipated an improvement in economic and operating conditions for the Italian banking system, a strengthening of Veneto Banca's capital and earning position, and a pronounced easing of asset quality deterioration.

Ratings Score Snapshot

Issuer Credit Rating	BB+/Negative/B
SACP	bb+
Anchor	bbb
Business Position	Adequate (0)
Capital and Earnings	Moderate (-1)
Risk Position	Moderate (-1)
Funding and Liquidity	Average and Adequate (0)
Support	0
GRE Support	0
Group Support	0
Sovereign Support	0
Additional Factors	0

Related Criteria And Research

- Banking Industry Country Risk Assessment: Republic of Italy, Nov. 19, 2012,
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011
- Banking Industry Country Risk Assessment Methodology And Assumptions, Nov. 9, 2011
- Group Rating Methodology And Assumptions, Nov. 9, 2011
- Bank Hybrid Capital Methodology And Assumptions, Nov. 1, 2011
- Bank Capital Methodology And Assumptions, Dec. 6, 2010

Ratings List

Downgraded; CreditWatch/Outlook Action

	To	From
Veneto Banca SCPA Counterparty Credit Rating	BB+/Negative/B	BBB-/Watch Neg/A-3

Certificate Of Deposit	BB+/B	BBB-/Watch Neg/A-3
Senior Unsecured	BB+	BBB-/Watch Neg
Subordinated	BB-	BB+/Watch Neg
Preferred Stock	B	BB-/Watch Neg

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