



Moody's Investors Service

Credit Opinion: Banca Tercas

Global Credit Research - 08 Jul 2009

Teramo, Italy

Ratings

Category	Moody's Rating
Outlook	Stable
Bank Deposits	A3/P-2
Bank Financial Strength	C

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Key Indicators

Banca Tercas

	[1]2008	2007	2006	2005	2004	Avg.
Total assets (EUR billion)	3.50	3.51	3.06	2.74	2.31	[2]9.62
Total capital (EUR billion)	0.44	0.37	0.31	0.28	0.27	[2]11.77
Return on average assets	0.89	1.27	0.91	0.70	0.75	0.90
Recurring earnings power [3]	1.75	2.24	2.19	1.62	1.82	1.92
Net interest margin	3.83	3.98	3.60	3.26	3.40	3.61
Cost/income ratio (%)	61.53	55.63	56.75	67.18	64.56	61.13
Problem loans % gross loans	2.04	1.18	2.11	3.92	5.21	2.89
Tier 1 ratio (%)	11.53	10.47	11.86	12.79	14.98	12.33

[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 and capitalisation and solid liquidity profile, but also its significant borrower concentration, lack of independent board members, as well as relative small size.

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 level of capitalisation
- Solid liquidity profile with significant retail funding, a key strength in current market conditions
- 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 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

At year-end 2008, Tercas reported a net income of Eur31 million, down from Eur42 million in 2007. Trading losses of Eur16 million, increased operating costs and meaningful loan loss provisions (26% of pre-provision income) were only partly offset by non-operating items, worth Eur5.2 million, and slightly increased net interest income and increased other operating income items. Thanks to cheap retail funding, net interest margins remained strong at 3.83%. Tier 1 stood at 11.53% under Basel II, up from 10.47% at year-end 2007 under Basel I, mainly due to better risk-weighting under the new framework.

Moody's affirmed, with a stable outlook, the long-term debt and deposit ratings and the BFSR of Tercas on 18 June 2009, believing that the bank can absorb a level of stress beyond Moody's expected loss assumptions and remain appropriately capitalised at their current rating level. At the same time, Moody's placed on review for possible downgrade the Prime-1 short-term deposit rating of the bank.

On 1 July 2009, the Prime-1 short-term deposit rating was downgraded to Prime-2. The rating action reflects the fact that, in current market and funding conditions, a Prime-1 short-term deposit rating is no longer compatible with the bank's risks and funding profile, as reflected in their A3 long-term deposit ratings.

Please also refer to Moody's press release of June 18th and July 1st 2009 for further details.

DETAILED RATING CONSIDERATIONS

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

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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 southern region of Abruzzo, 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.

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 good, thanks also to the solid retail funding base. 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 and no sub-prime exposure.

The bank has a strategy of independent growth involving the integration of weaker players and new branch openings in central Italy. 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. We caution that the need to acquire market share in areas where the bank's franchise is less developed might potentially increase risk in the credit portfolio.

Tercas's overall score for risk positioning is E.

Factor 3: Regulatory Environment

Please refer to the most recent Banking System Outlook on Italy for a discussion of Italy's regulatory environment.

Factor 4: Operating Environment

Trend: Neutral

This factor is common to all Italian banks. For a discussion of the operating environment please refer to Moody's latest Banking System Outlook on Italy. Moody's assigns a C- score for the overall operating environment.

Quantitative Rating Factors (50%)

Factor 5: Profitability

Trend: Neutral

Tercas's revenues are not well diversified, being 80% 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 the past years (2.22% of risk-weighted assets in 2008) and an average net return on risk-weighted assets of 1.12%.

Profitability indicators weakened slightly in the past year, impacted by the trading loss of Eur4.7 million, increased costs and meaningful loan loss provisions. The trading loss derives mainly from mark-to-market adjustments of the bank's trading portfolio, as well as foreign exchange losses of Eur0.4 million and write-downs on the Eur3 million Lehman Brothers senior bond, following the bank's file for bankruptcy in September 2008.

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.

Tercas's score of C reflects Moody's view on its profitability.

Factor 6: Liquidity

Trend: Neutral

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 147% in 2008, whilst liquid assets have fallen from 36% of assets in 2004 to 16% in 2008. 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. Nevertheless, taking into account also bonds placed with retail clients, around 70% is funded through the stable and cheaper retail channel. This figure compares well with other small- and medium-retail- and commercial banks in Italy. Especially in a crisis such as this, we reiterate the importance of a solid retail franchise, such as that enjoyed by Tercas.

To further diversify its sources, the bank has three securitisations of performing mortgages and leasing contract totalling up to EUR473 million, completed in 2007 and 2008.

The bank's score of B reflects Moody's view on Tercas's liquidity.

Factor 7: Capital Adequacy

Trend: Neutral

Capitalisation is strong, with a core Tier 1 ratio under Basel II of 11.53% at year-end 2008 thanks also to a prudent dividend payout, although it is relatively small in absolute terms (EUR318 million). The Tier1 ratio improved compared to year-end 2007 (10.47%) benefiting mainly from more favorable risk-weighting under the new Basel II framework. 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 reflects Moody's view on the bank's capitalisation.

Factor 8: Efficiency

Trend: Neutral

Tercas's cost-to-income ratio weakened in 2008 (62%), but remains satisfactory. 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 end 2007, however, the bulk of the improvement was achieved, so that 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, reflects Moody's view of the bank's efficiency.

Factor 9: Asset Quality

Trend: Weakening

Loans continued their high historical growth, rising 8% during 2008, and 19% in 2007 thanks to increases in the home province of Teramo, but also expansion outside the bank's traditional territory, such as Rome. Low-risk residential mortgages accounted for about 28% of the portfolio.

At 2.04% at year-end 2008 problem loans* as percentage of gross loans still compares well with Italian retail- and commercial peers, also thanks to the securitisation and sale of non-performing loans in 2000, 2006 and 2007. The bank continues to experience meaningful flows of new non-performing loans, as a result of the rapid loan growth and the weaker economy in the southern region of Abruzzo than the Italian average. Gross non-performing loans increased from Eur10 million to Eur33 million at year-end of 2008. The coverage of problem loans (75% at year-end 2008) was lower than high historical levels, but should be enough to continue the sale of NFLs broadly at book value. Moody's will closely monitor Tercas's asset quality evolution, as this is a key rating driver for the bank.

Problem loans include: non-performing loans (sofferenze), watchlist (incagli - including only those over 90 days overdue), restructured (ristrutturati) and past due loans (scaduti).

The bank's score of B, with a weakening trend, 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 is considered a medium support country.

ABOUT MOODY'S BANK RATINGS

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. AAaa 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: Franchise Value						C-	Neutral
Market Share and Sustainability			x				
Geographical Diversification					x		
Earnings Stability		x					
Earnings Diversification [2]							
Factor: Risk Positioning						E	Neutral
Corporate Governance [2]					x		
- Ownership and Organizational Complexity	--	--	--	--	--		
- 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: Operating Environment						C-	Neutral
Economic Stability		x					
Integrity and Corruption				x			
Legal System				x			
Financial Factors (50%)						B-	
Factor: Profitability						C	Neutral
PPP %Avg RWA - Basel II			2.25%				
Net Income %Avg RWA - Basel II			1.12%				
Factor: Liquidity						C+	Neutral
(Mkt funds-Liquid Assets) % Total Assets				11.38%			
Liquidity Management		x					
Factor: Capital Adequacy						A	Neutral
Tier 1 ratio (%) - Basel II	11.53%						
Tangible Common Equity / RWA - Basel II	11.53%						
Factor: Efficiency						C	Neutral
Cost/income ratio			57.97%				
Factor: Asset Quality						B	Neutral
Problem Loans % Gross Loans		1.78%					
Problem Loans % (Equity + LLR)		13.12%					
Lowest Combined Score (15%)						C	
Economic Insolvency Override						Neutral	

Aggregate Score		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



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