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**Covid-19 crisis and its impacts on the
economic and financial sector**

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Abstract

The World Bank data confirm that the recovery scenario will be different depending on the type of nation, the fundamentals of its economy, etc.. The Bank of Italy expects a growth of more than 4% for Italy at the end of 2021.

The Italian banking system has shown great flexibility in dealing with the coronavirus emergency, taking a completely different form from the last in 2008 recession, when credit institutions were part of the problem.

With their new social role, today in fact they are leading players. The health of the banking sector has also changed compared to 2008, with a stronger capital position, underlying the substantial resilience of the ecosystem and a more advanced expertise in NPL management.

The role of the banks operating in Italy has been and will be to support firms, households and the growth of the economy with the sound and prudent distribution of credit, the offer of modern and efficient payment services thanks also to new technologies, business advice to companies for the development and internationalization.

A clear evolution is opening up for banks in post-Covid towards digital business with a growing commitment in terms of investments in information technology.

Introduction

The Covid-19 pandemic has had extremely serious human, social and economic effects. The spread of the virus has affected the entire economy and the economic effects have appeared to different extents across sectors and geographic areas, reflecting the severity of the pandemic at local level and the economic policy responses.

The vaccination campaign and the easing of restrictions in 2021 are paving the way for economic recovery. In Italy, vaccine delivery is accelerating after a slow start hindered mainly by supply and distribution problems and uncertainty about the side effects. The goal of the Italian government was to vaccinate 80% of the population by September 2021 and it has now been achieved. Rising vaccination rates and easing restrictions in Italy will drive economic recovery.

There remains substantial uncertainty about the unfolding of the virus with the evolution of new, more contagious and lethal variants that are more resistant to existing vaccines, unless effective vaccinations become widespread everywhere. New infections would require new containment measures, with economic costs linked to lower confidence thus lower spending.

The financial sector has so far proved to be resilient to the impact of the Covid-19 crisis. Although financial risks for credit institutions have increased, they have continued to support the economy by providing new loans to businesses and households (net of the moratoriums that have been granted).

The growth prospects of banks in the European Union for 2021 are linked to credit quality problems and weakened profitability prospects. Banks entered the pandemic with huge reserves of capital and liquidity, which should help them overcome the Covid-19 crisis, at least for now. The effect of the macroeconomic shock induced by the pandemic on companies' balance sheets will force banks to accelerate their consolidation.

Given regulatory pressure and the high cost of capital of riskier assets, many banks have nowadays had to reduce the size of their market activities, or even stop those that absorbed too much capital. Regulatory changes, external conditions, modest economic growth, a low interest rate environment and a lack of cost structure optimization all raise serious questions about the business model. Many of these factors are changing for the better, which would tend to make the banking sector more attractive than it has been in the past few years.

An increasingly marked polarization will take place between large banks able to invest and more agile banks able to adapt to the digital world.

According to the new Sustainable Finance Report of the Foundation for Subsidiarity, almost 10,000 bank branches have been closed in Italy in ten years: from 34,036 at the beginning of 2010 to 24,312 at the beginning of 2020, about 30% less. Digital, competition and the challenge of sustainability are revolutionizing banks and customer relations.

This paper proposes a few reflections on the interventions implemented by the European institutions to address the economic crisis generated by the Covid 19 pandemic and on the possible implications on the banking system in the post-crisis period.

In the following paragraphs, the main aspects of the economic-financial crisis are depicted and analyzed.

1. Economic and financial situation pre-Covid crisis in Italy and in the euro area

Already in 2019, before the outbreak of the pandemic that profoundly changed the growth prospects of the economy, there had been a slight reduction in the growth of the global economy (2.9% compared to 3.6% recorded the previous year- Source: ECB) due to the slowdown in international trade, the weakness of some industrial sectors and concerns about the way the United Kingdom would leave the European Union (Brexit).

The GDP of the euro area at the end of 2019 had grown by only 1.2%, with a slowdown compared to the previous year in all the main economies (Table 1). Within the Eurozone, Italy had recorded a GDP of 0.3%, a decline compared to the previous year (0.8% recorded in 2018) and the worst figure, if compared to Germany, France and Spain.

Starting from the end of 2015, Italian banks have raised the quality of assets as a result of more prudent credit risk management policies and thanks also to the substantial reduction in the amount of non-performing loans (NPLs).

All this has led to a significant decline in impaired loans recorded in the balance sheets of banks which at the end of 2019, net of value adjustments, amounted to approximately € 70 billion (Figure 1).

¹ The thoughts and information expressed herein are solely those of the author and do not in any way bind the institution he belongs to.

Table 1 – GDP Euro area
GDP in the main euro area countries (1)
(percentage variation on previous period)

PAESI	2017	2018	2019	2019				2020
				1° trim.	2° trim.	3° trim.	4° trim.	
Area dell'euro (2)	2,5	1,9	1,2	0,5	0,1	0,3	0,1	-3,8
Francia	2,3	1,7	1,3	0,4	0,3	0,3	-0,1	-5,8
Germania	2,5	1,5	0,6	0,5	-0,2	0,3	-0,1	-2,2
Italia	1,7	0,8	0,3	0,2	0,1	0,1	-0,3	-4,7
Spagna	2,9	2,4	2,0	0,6	0,4	0,4	0,4	-5,2

Source: Bank of Italy

From top to bottom: euro area (2), France, Germany, Italy, Spain.

From left to right: 2017, 2018, 2019, 1Q2019, 2Q2019, 3Q2019, 4Q2019, 1Q2020

(1) Concatenated values. Quarterly series are seasonally adjusted and corrected for working days

(2) The euro area aggregate refers to the composition of 19 countries.

In comparison with European institutions, the Italian banking system at the end of 2019 (Figure 2) recorded a higher incidence of impaired loans on the total, equal to 6.7% (gross of adjustments) compared to a European average of 2.7%. The coverage rate of NPLs was equal to approximately 54%, significantly higher than the European average, close to 45%.

Figure 1- Non-performing loans and better-quality capital

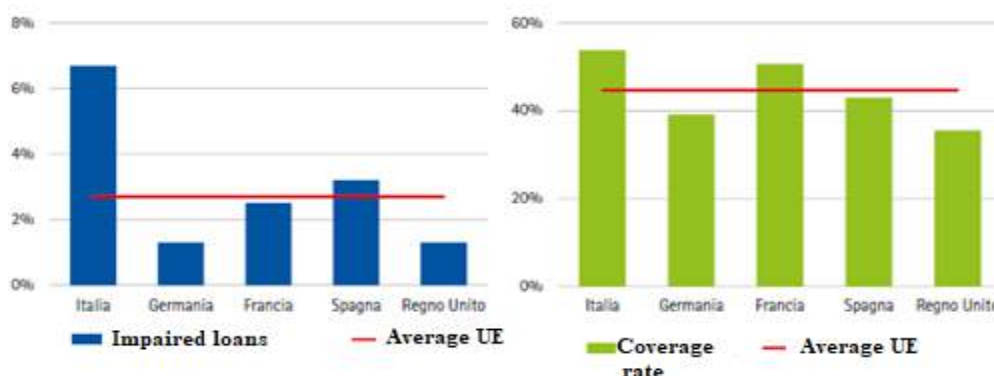


Source: Bank of Italy

Non-performing loans (right-hand scale)

Better quality capital

Figure 2 - Credit quality of the biggest European banks at the end of 2019



Source: CONSOB based on EBA data

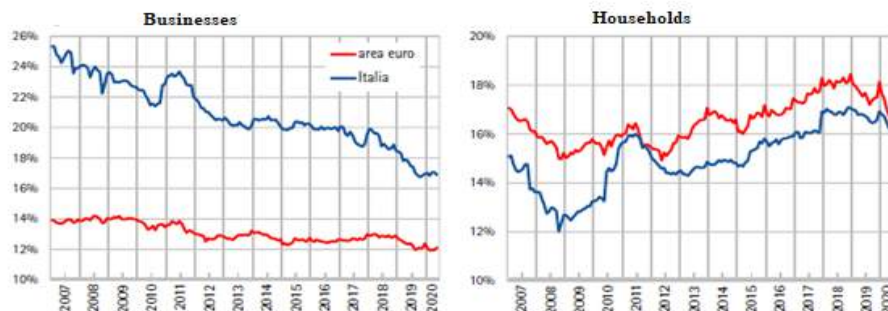
From left to right: Italy, Germany, France, Spain, UK.

Blue histograms: incidence of deteriorated loans on total loans, green histograms: coverage ratio, red line indicates the EU average

Starting from 2007 (Figure 3), Italy recorded a significant decrease in the weight of bank credit to businesses on the assets of banks. At the end of 2019, the incidence of loans to businesses on the total assets of Italian banks (about 17%) remained significantly higher than the European average (12%). On the other hand, the gap is less relevant with regard to loans to households. As evidenced from the figure below, Italian businesses are the most dependent on bank credit in Europe.

In this context, as highlighted by the ECB which has always kept encouraging Italy, it is necessary to consistently promote the use of alternative instruments to bank credit (mini bonds, crowdfunding, private debt funds, pir, elif, etc.) in order to reduce the credit risk for banks. The new rules already in force such as calendar provisioning or the new definition of default aim, in fact, to discourage traditional credit, in the same way as the new requirements for the calculation of RWA imposed by Basel III (IV).

Figure 3 - Weight of bank loans to businesses and households on total assets



Source: CONSOB based on ECB data
Businesses on the left-hand side and households on the right-hand side

In 2019, the profitability of Italian banks has continued to decline compared to the previous year, mainly due to the reduction in the interest margin. The return on equity (ROE) recorded was 5.0%, net of extraordinary components (Source Bank of Italy), compared to 5.7% recorded in 2018.

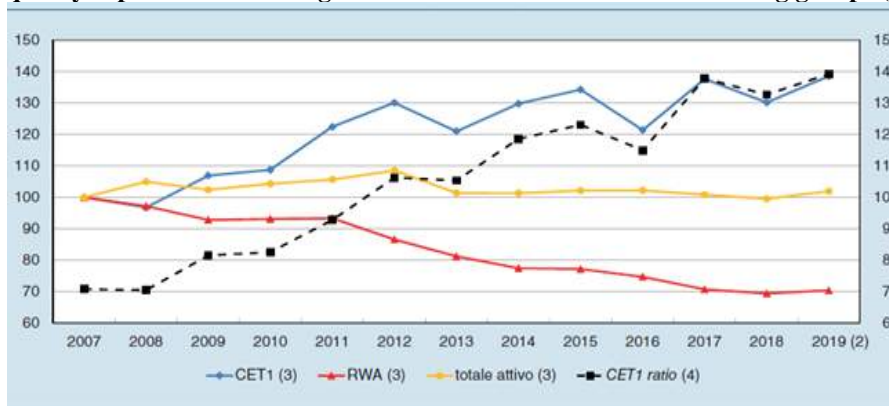
For significant banks, the ROE stood at 4.9% (5.8% on average for the main European groups). For the less significant ones, on the other hand, the ROE was equal to 6.5%. Banks that mainly carry out financing activities to households and businesses achieved a very low ROE on average, while the result of banks specialized in investment services and in particular segments of the credit market was higher.

In 2019, the capital strengthening of Italian banks resumed after it had stopped in 2018. In this context, the CET1 Ratio, the ratio between the best quality capital (common equity tier 1, CET1) and risk-weighted assets (RWA), stood at 13.9% (Figure 4), recording an increase of over 60 basis points higher than at the end of 2018.

The improvement is largely due to the increase in CET1, which benefited above all from the positive economic result of the year and the revaluation of assets measured at fair value.

Figure 4 - Evolution of CET1 ratio and RWA

Evolution of better quality capital and risk-weighted assets of Italian banks and banking groups (1)(percentage values)



Source: Bank of Italy
Blue line: CET1 (3), red line: RWA (3), yellow line: total assets (3), black dotted line: CET1 ratio (4).

(1) Better quality capital means *core tier 1* until December 2013 and, from March 2014, CET1. To define the aggregates, compare the item *Banks and banking groups: profitability and capital adequacy* in the *Methodological Notes* section of the Appendix. - (2) Provisional data. - (3) Index: 2007 = 100. - (4) Right-hand scale.

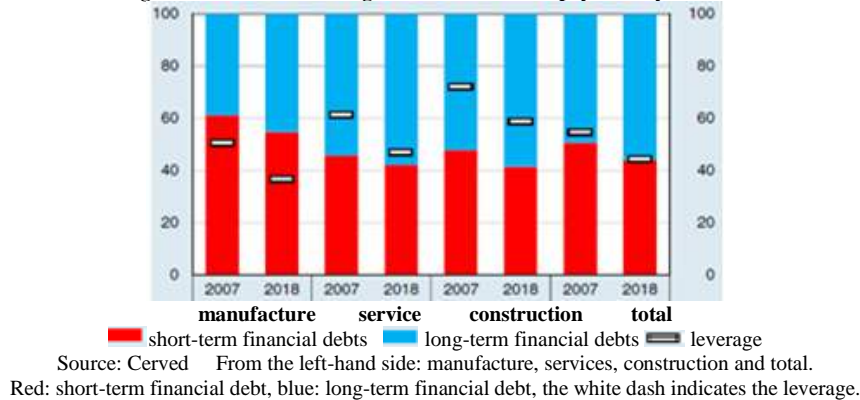
The current crisis would be more painful without the improvements in banks strength that has been ongoing since 2016.

A "pre-crisis" situation could still be observed at the end of 2020 since the effects of the economic difficulties are typically reflected on bank balance sheets with a certain delay, but above all because, in the face of the Covid crisis, governmental and sectoral measures have been adopted with the goal of preventing temporary difficulties from translating into insolvencies.

The extent of such effects will depend on the duration of the recession and on the speed of recovery. The measures adopted by the supervisory authorities aim to contain the consequences of the pandemic on banks' ability to finance the economy and to avoid pro-cyclical effects. Since February 2020, companies have faced the pandemic crisis altogether with a more balanced financial structure than they had on the eve of the double recession of 2008-2013. Financial leverage (measured as the ratio between financial payables and the sum of such payables and shareholders' equity) was found to be approximately 10% lower; the incidence of short-term debts on the total of financial debts fell by 7.00% (Source: Bank of Italy)². The decrease in overall debt and the lengthening of maturities have affected all sectors of activity (Figure 5).

² See Bank of Italy, Report on financial stability no. 1/2020

Figure 5 - Financial leverage and breakdown of payables by due date



At the end of 2019 (Source: Bank of Italy) the profitability of companies had reached high levels. The increased solidity of balance sheets and the low interest rates have favored the decline in the deterioration rate of loans to 1.9%, a level lower than the values observed in 2007 (2.6%). The debt ratio of vulnerable companies³ was estimated at 28% (compared to 44% in 2007).

2. Impacts of the crisis on the economic and financial system in Italy and in the European Union and measures adopted by Governments

The health emergency in which the world has plunged since February 2020 due to the spread of Covid has generated significant economic implications, both in terms of nature and intensity.

At the onset of the COVID-19 pandemic, rapidly evolving social restrictions have been put in place, macroeconomic uncertainty was at an all-time high as well as the pronounced deterioration in the climate of business and consumer confidence. The European Union has faced a crisis of unprecedented magnitude and contours.

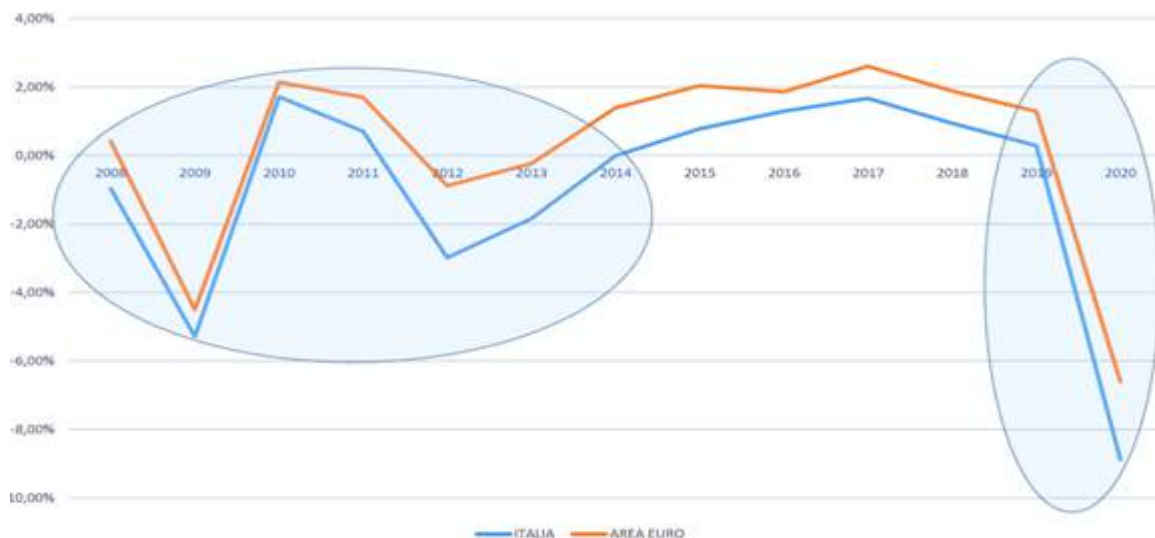
The spread of the pandemic resulted in an exogenous and symmetrical shock that hit the demand side and the supply side simultaneously, within the economies involved.

The timing and intensity of the recovery will depend on several factors: the duration of the contamination, the evolution of the global economy, the effects on business confidence and investment decisions, the effectiveness of the economic policies that were introduced and the strategies adopted.

The latest data observed in Europe in 2020 confirm that the economic effects have been significant.

In the Euro area and in the European Union, GDP in 2020 (Figure 6) revealed a contraction of -6.8% and -6.4% (Source Eurostat), while in Italy the gross domestic product shrank by -8.9% (Source Istat).

Figure 6 - Evolution of the GDP in the Euro / Italy area



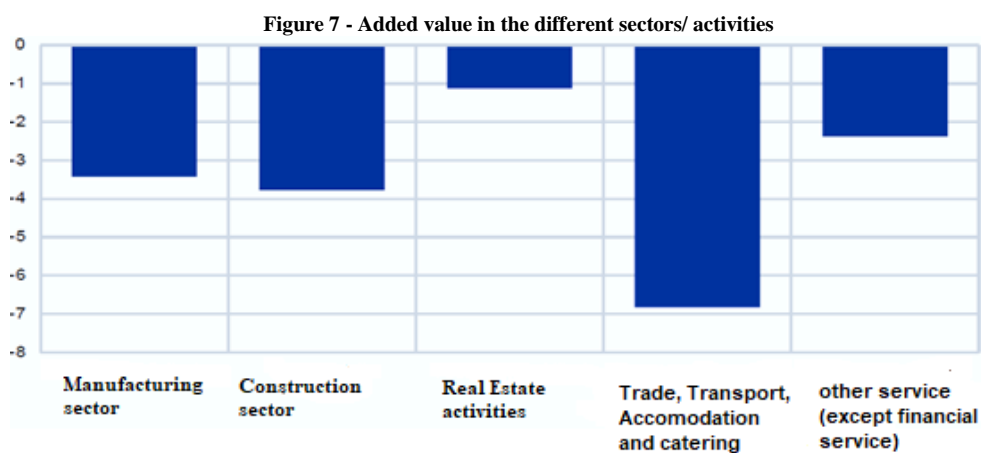
Source: based on Istat / Eurostat data.
In blue: Italian GDP, in red Euro zone GDP.

The pandemic has produced negative effects on many economic activities, but the impact of the crisis that has hit businesses has differed depending on the sector to which they belong.

In the first quarter of 2020, in the euro area, the COVID-19 pandemic caused a greater loss of added value in activities related to trade, transport, accommodation and catering compared to the manufacturing, construction and other sectors (Figure 7).

³ Vulnerable companies are defined as companies with a negative gross operating margin (EBITDA) or with a ratio between financial charges and EBITDA exceeding 50%. Companies with non-performing loans are excluded.

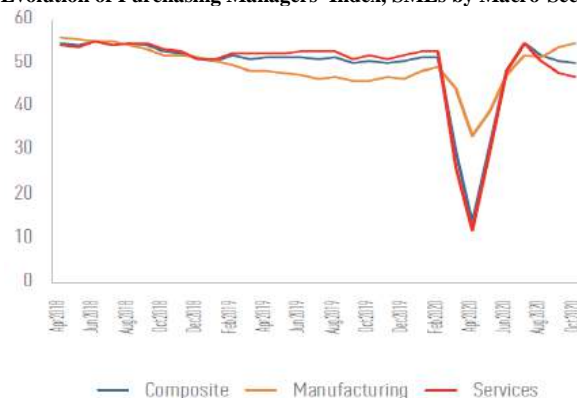
From Figure 8, it is evident that European Union companies belonging to the service sector have suffered more from the crisis than those belonging to the manufacturing sector. The PMI services index in April 2020 fell to a lower level than the manufacturing index (12 compared to 33.4) due to the pandemic. The recovery (October 2020) also highlighted a weakening of the PMI services index compared to the manufacturing sector index (48 against 53.5).



Source: ECB (Economic Bulletin 5/2020)

From left to right: manufacturing sector, construction sector, real estate, commerce-transport-accommodation-catering, other (non-financial) services

Figure 8 - Evolution of Purchasing Managers' Index, SMEs by Macro-Sectors to which they belong



Source: Eba Risk Assessment of the European Banking System, December 2020

Unlike the previous crisis of 2007-2008, this is not a banking crisis caused by a financial shock, but rather a crisis of the real economy that exposes the banking system to new risks.

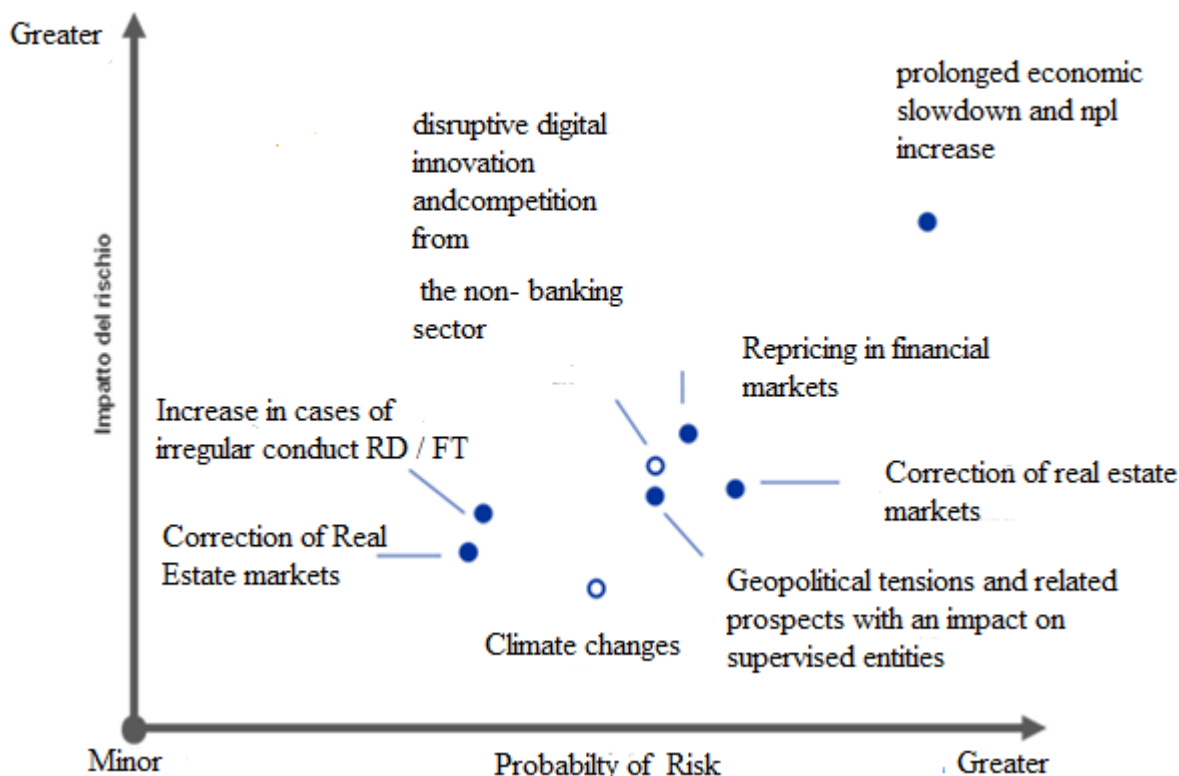
The ECB Banking Supervision has assessed the key challenges facing supervised entities over the next two to three years. The main results of the assessment are shown in the risk map of the Single Supervisory Mechanism (SSM) for 2021 (Figure 9) and in the vulnerability figure (Figure 10). These risk factors can cause an impact on banks through the most widespread internal and external vulnerabilities in the banking system itself or in the economic context in which the banks operate. Based on the current risk framework, the ECB has defined the priority areas for its supervisory activity in 2021:

- credit risk management.
 - capital solidity.
 - sustainability of the business models.
 - governance.
- As for credit risk management, the ECB Banking Supervision will focus on the adequacy of banks' management, operations, monitoring and internal information flows on credit risk. Particular attention will be placed on the ability of banks to identify any deterioration in asset quality at an early stage and to set up adequate and timely provisions, but also to continue to take the necessary measures to adequately manage late payments and non-performing loans. The Joint Supervisory Teams (JSTs) will review banks' practices in such areas and, if necessary, they will also conduct in-depth audits and targeted on-site and remote inspections.
 - As regards capital strength, it is important that banks apply sound capital planning practices based on projections that can adapt to a rapidly changing environment, particularly in a crisis situation. The JSTs will then verify the adequacy of the banks' capital plans, in the light of which they will critically examine their dividend distribution and their share repurchase policies.
 - Throughout 2021, the ECB Banking Supervision will continue to review banks' strategic plans.

Additionally, since the pandemic has accelerated the digital transformation process, supervisors will assess the progress made by banks in response to such developments. Where appropriate, the JSTs will engage in a structured supervisory dialogue with bank managers regarding the oversight of corporate strategies

- d) The suitability of risk management systems in crisis situations and the ability of banks to adapt and to use them appropriately in the current crisis will remain at the center of supervisory attention. The ECB Banking Supervision will discuss with banks on risk data aggregation capabilities and risk information presented to management bodies. The supervisory experts will also carry out checks on IT and cyber risk management practices and their governance, including the risks arising from the outsourcing of services to third party suppliers. Finally, the ECB Banking Supervision will continue its assessment of the prudential impact of the risks of money laundering and terrorism financing, particularly related to the banks' internal control systems.

Figure 9- Risk map of the Single Supervisory Mechanism (SSM)



Source: ECB (white circles represent risk factors that are expected to increase significantly in the next five years; the acronyms "RD / FT" and "NPL" refer respectively to money laundering and terrorist financing and to impaired loans).

On the ordinate axis, the Risk impact from lower to higher, on the abscissa axis, the Risk probability from lower to higher. From left to right clockwise: Decline in real estate markets, Increase in cases of misconduct/ money laundering / terrorist financing, Disrupting digital innovation and competition from non-banking sector, Redetermination of financial market prices, Prolonged economic slowdown and increase of NPLs, Cybercrime and IT system issues, Geopolitical tension impacting entities, Climate change.

Figure 10

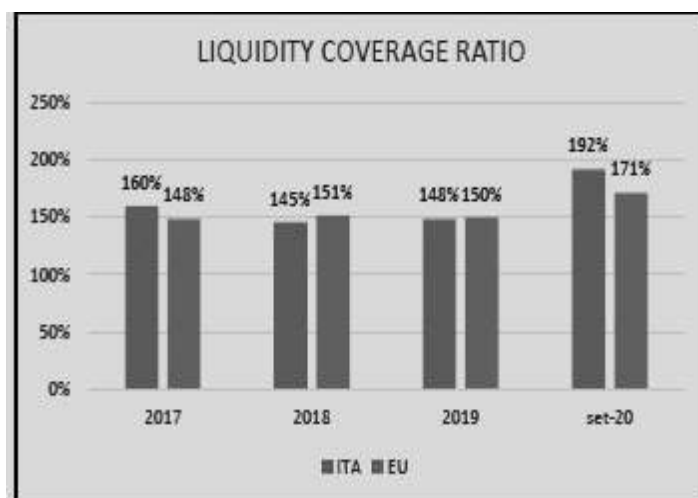
Inside the banks	weaknesses in credit risk management and hedging	structurally low levels of income and profitability	shortcomings of IT systems
	weakness of governance and strategic guidelines	persistent cost inefficiencies	
Outside the banks	high levels of public and private debt in the euro area	overcapacity in the banking sector	fragmentation of the regulatory and legal framework

Source: ECB (internal vulnerabilities can be addressed by banks themselves, while external vulnerabilities refer to the context in which banks operate).

European financial intermediaries are facing the economic crisis thanks to the availability of a good capital buffer to deal with the new credit losses that will arise. The CET1 of European banks (Source EBA⁴) was on average around 15.5% in 4Q 2020 compared to 9% recorded at the end of 2009.

In addition to broad margins of additional CET1 capital, the pandemic crisis has caught European banks (including Italian banks) with a liquidity ratio that has been growing in the past few years (Figure 11) against the minimum 100% required by the Supervisory Authorities.

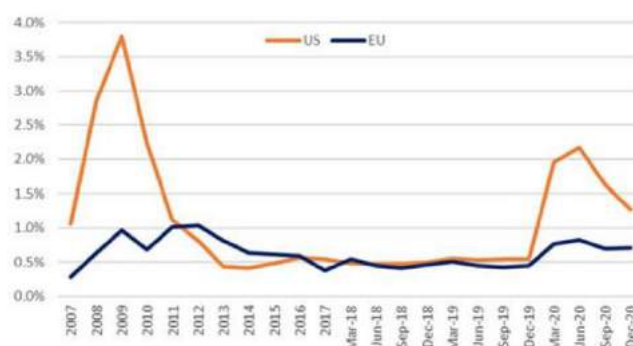
Figure 11 - LCR Italian and European Banks



Source: EBA

The COVID-19 pandemic will have a direct impact on the quality of bank assets, as further credit downgrades, an increase in distressed borrowers and a reduction in the value of collateral are likely to occur. The public support measures, including interventions by monetary, budgetary, regulatory and supervisory authorities, have produced the desired effect and thwarted a financial crisis. The great financial crisis, during which non-performing loans accumulated and saturated banks' balance sheets, taught that it is essential to identify and distinguish the purely temporary financial difficulties caused by the pandemic versus the long-lasting economic credit deterioration. Establishing adequate provisions and recognizing losses before the moratoriums and fiscal support measures expire will help avoid abrupt (cliff edge) and pro-cyclical effects that could amplify the economic cost of the pandemic. In such context, the cost of risk at the end of 2020 for European banks (higher compared to the previous year, Figure 12) stood at a value of 0.70% compared to the value of 1.27% recorded for US banks.

Figure 12 - Cost of Risk in the US and in the EU



Source: Quarterly Trends for Consolidated U.S. Banking Organizations, NY Fed; Statistical Data Warehouse (SDW), European Central Bank (ECB); and EBA supervisory reporting data

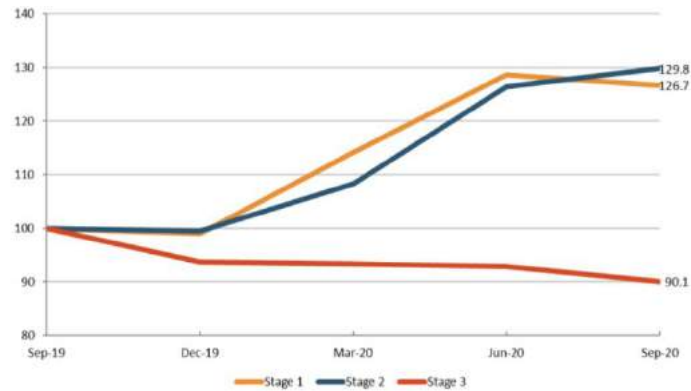
European banks (Source Dbrs Morningstar) recorded significantly lower levels of risk cost on an annual basis in the first quarter of 2021, but also in relation to all quarters of 2020 thanks to the reflection of the support provided by government measures. On a sample of 32 banks analyzed (including banks in France, Germany, Italy, the Netherlands, Spain, Sweden, Norway, Portugal, Denmark, Finland and the United Kingdom), the rating agency found an average risk cost of 31 basis points in the first quarter of 2021, far lower than that already recorded in the same period of 2020 (85 basis points) and also compared to that of the whole of 2020 (70 basis points).

In Q3 2020, European banks have increased their credit classification in stage 2 (Figure 13). In particular, in September 2020 (Source EBA⁵), EU credit institutions classified 88.6% of their credits in stage 1 (**89.5% in September 2019**), 8% in stage 2 (**6.8% in September 2019**) and 3.4% in stage 3 (3.7% in September 2019). About 20% of the loans on moratorium were classified in stage 2.

⁴ See Eba, Risk Dashboard data as of Q4

⁵ See EBA, ESMA, EIOPA, Risks and Vulnerabilities in the EU Financial System March 2021 (latest data available from EBA)

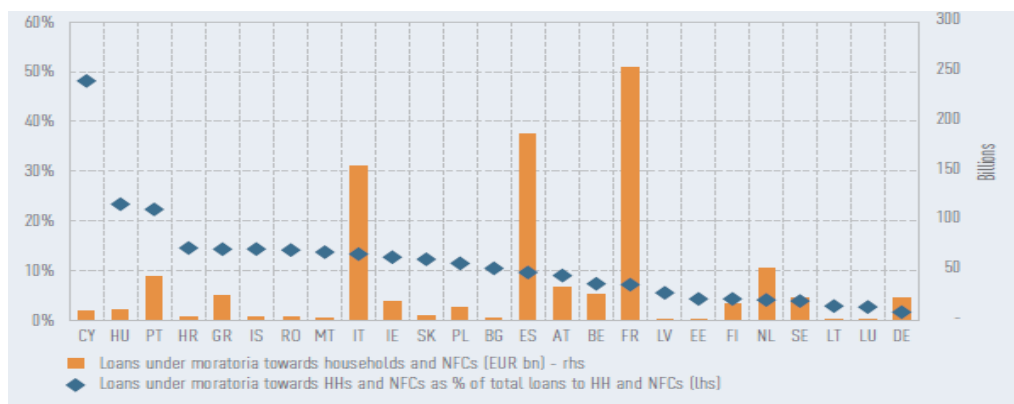
Figure 13 - Provisions for stage 1-2-3 - IFRS 9



Source: EBA supervisory reporting

With the spreading of COVID-19 in Europe and in the whole world, Member States have adopted moratoriums on loan repayments. In June 2020 (Source EBA⁶) European banks had granted a nominal volume of loans equal to € 871 billion of loan repayment moratoriums. French, Spanish and Italian banks reported the largest volumes of loans subject to a moratorium (Figure 14).

Figure 14 - Moratoriums by Country, June 2020



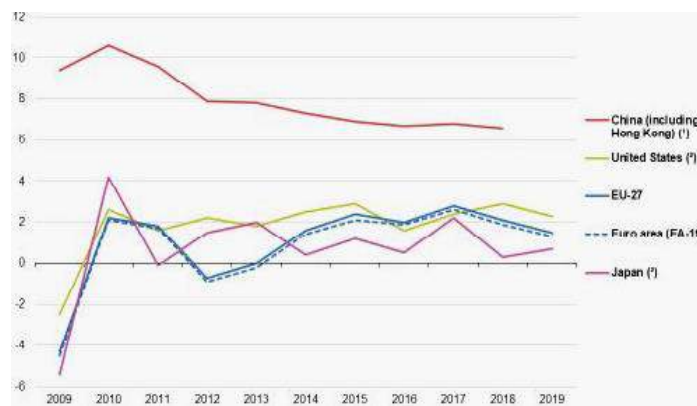
Source: Eba

In September 2020, the nominal volume of loans under moratorium was equal to 587 billion euros⁷, down from the 871 billion euros recorded in June 2020 (Source EBA).

2.1. Bank Profitability

Over the last decade, the Italian banking system has faced a series of critical issues that have significantly affected the economic results of banks. The GDP of the European Union, considerably lower than that of China, Japan and the United States, has marked a significant contraction since 2009 (Figure 15) with negative impacts on banks, both on the interest margin to be gained through financing and on credit quality. The Cost of Equity (COE) for banks in the Euro Area in the period 2008-2019 was consistently higher than the ROE (Figure 16). The low profitability prospects in recent years have resulted in a decline in bank stocks on the stock market, making it more difficult for them to raise capital, when necessary.

Figure 15- Real GDP 2009-2019

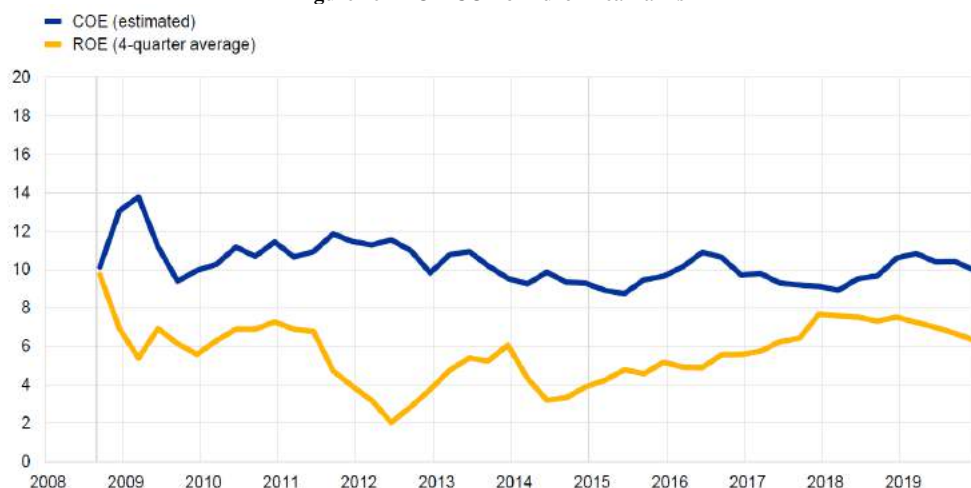


Source:Eurostat

⁶ See EBA, Risk Assessment of the European Banking System December 2020 (latest assessment)

⁷ See Risks and Vulnerabilities in the EU Financial System (March 2021 – latest available report)

Figure 16 - ROE-COE of Euro Area Banks



Source: Bloomberg, Refinitiv, Kenneth French's data library, S&P Market Intelligence and ECB calculations.

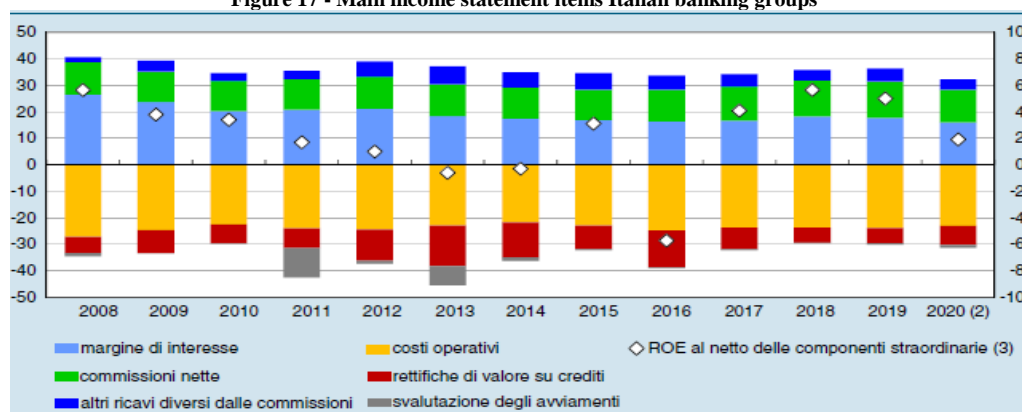
Notes: This chart shows the time-series of the cost of equity and return on equity (ROE). Latest observation: December 2019.

Starting from February 2020, the COVID-19 pandemic has further eroded the profitability of banks despite it already experiencing a decrease in 2019. European Union credit institutions (Source Eba) recorded a ROE equal to 2.0% at the end of 2020 (Source EBA⁸), a sharp decline compared to 2019 (5.7%). Italian banks also reported a sharp decline in profitability in 2020 (Figure 17).

To better understand the evolution of banks' profitability in 2019 and 2020 in the Euro Area, Table 2 and Table 3 show the profitability and solidity indicators of the biggest Italian and European banks (Rote, CET1, NPL).

For the top three Italian banks (Table 2) there was a strong decrease in profitability in 2020 compared to the previous year, greater solidity with an increase in the CET1 ratio and better credit quality with a further decrease in NPLs (in line with the ECB perspectives).

Figure 17 - Main income statement items Italian banking groups



Source: Bank of Italy (2020)

Light blue: interest margin, green: net commissions, dark blue: other revenues (excluding commissions), yellow: operating costs, red: credit risk adjustments, grey: impairment of goodwill, white shape: ROE net of extraordinary components.

Table 2 - Top Italian Banks - Financial Statements Indicators

Top Italian Banks	Rote	CET1 Ratio	Net NPL Ratio	Rote	CET1 Ratio	Net NPL Ratio
Banca Intesa Group	6,90%	14,70%	2,60%	10,40%	13,90%	3,60%
Unicredit Group	-5,40%	15,96%	1,90%	6,70%	13,22%	1,80%
Banco BPM Group	0,19%*	14,63%	3,90%	7,56*	14,76%	5,20%

Source: author, on public budget data.

NB: * the ROTE (return on tangible equity) not published on public balance sheet data was calculated by relating net profits to tangible net assets
From left to right, for 2020 and for 2019: ROTE, CET1 Ratio, effect of net NPLs on total receivables.

For the biggest European banks in the Euro Area (Table 3) there was also a drop in profitability in 2020 compared to the previous year (Credit Agricole and Santander Bank), except for Deutsche Bank. For the Deutsche Bank Group, after a sharp decline in profitability recorded in 2019 (**Rote -11.00%**), there was a slight recovery in the profitability index in 2020 (**Rote 0.20%**).

⁸ See Eba, Risk Dashboard data as of Q3 2020 and Q4 2020.

Table 3 - Top European Banks - Financial Statements Indicators

Top European Banks	Rote	CET1 Ratio	Net NPL Ratio	Rote	CET1 Ratio	Net NPL Ratio
Credit Agricole Group	9,30%	17,20%	2,40%	11,90%	15,90%	2,50%
Santander Group	1,95%	12,34%	3,21%	11,44%	11,65%	3,32%
Deutsche Bank Group	0,20%	13,60%	1,71%	-11,00%	13,60%	1,74%

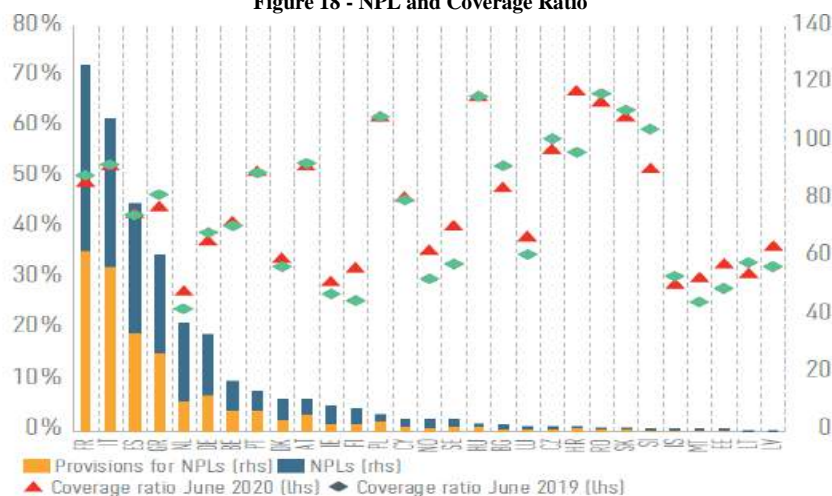
Source: author, based on public budget data

From left to right, for 2020 and for 2019: ROTE, CET1 Ratio, effect of net NPLs on total receivables.

From the above data, it is clear that the main Italian and European banks in 2020 suffered from a greater decline in profitability compared to 2019. This was mainly due to:

- the higher provisions on impaired loans made in 2020 (Figure 18).
- the high operating costs incurred. The cost-to-income ratio for Italian banks remained high within the Banking Union (Figure 19) with Italy recording a cost above the European average.
- a significant reduction in revenues (interest margin and commissions).

Figure 18 - NPL and Coverage Ratio



Source: EBA (Risk Assessment of the European Banking System, December 2020)

Figure 19 – Cost Income Ratio



Source: EBA (Risk Assessment of the European Banking System, December 2020)

The final challenge towards the recovery of profitability for Italian banks derives not only from the reduction of costs but also from the increased competition coming from outside the banking sector. Banks will need to consider very carefully how they can adjust their business models to accommodate this increased level of competition.

2.2. Measures adopted by international and national authorities

The resulting recession and the high level of uncertainty about the economic repercussions of the pandemic have been reflected in an increase in volatility and in risk aversion on the financial markets. All over the world, monetary authorities have adopted extraordinary expansionary measures to guarantee liquidity on the markets, to support lending to households and businesses and to stimulate the demand for goods, services and investments.

The effects observed on the financial markets and the prospects of a severe recession led the Monetary and Banking Supervisory Authorities to take very firm actions, the effect of which was supported by extraordinary fiscal policy measures.

The ECB reacted to the crisis by following two lines of action as indicated below:

- the first saw a return of Quantitative Easing (QE), with a strengthening of the existing Asset Purchase Program (APP) and with the launch of a new program of considerable size: the Pandemic Emergency Purchase Program (PEPP).
- the second relied on longer-term refinancing operations: the T-LTRO IIIs, which had been launched in 2019, and were then adapted in order for them to become even more convenient for banks.

With the former line of action, on 12 March 2020, the Governing Council of the ECB took the first step towards the reinforcement of the QE, in response to the escalating crisis. The APP, which had been restarted at the end of 2019 (monthly net purchases of 20 billion euros), was integrated with an additional 120 billion net purchase program, including both public and private securities, to be made within the end of 2020. In order to meet the expectations coming from the financial markets, on 18 March 2020 the ECB had established a new plan for the purchase of public and private securities called Pepp (Pandemic Emergency Purchase Program), initially amounting to 750 billion euros and then subsequently raised to 1,350 billion euros. The time horizon in which the ECB will conduct the purchases of securities for the pandemic emergency has been extended at least until the end of June 2021 and in any case the 'Pepp' will continue until the ECB assesses that the coronavirus crisis is over. Following the second wave of the pandemic, the European Central Bank on 10 December 2020 decided to expand the support package for the economy by increasing the Pepp debt by a further 500 billion, which thus reached a level of **1,850 billion euros** and will be extended by nine months, at least until March 2022 and in any case until the pandemic crisis is over.

The PEPP is the main response from the ECB to the downward revision of the expected inflation, linked to the pandemic; its goal is to further expand the orientation of monetary policy, adding to the other instruments already in use, and to provide support to the financing conditions for the real economy.

With the latter line of action, in March 2020 new longer-term refinancing operations (LTRO) were introduced, the conditions applied to the third series of targeted longer-term refinancing operations were made significantly cheaper (TLTRO3) and the Expanded Asset Purchase Program (APP) was bolstered.

In addition, in May 2020, the ECB launched a new series of long-term refinancing operations called pandemic emergency longer-term refinancing operations (PELTRO), to facilitate the maintenance of adequate levels of liquidity in the system even beyond the completion of the LTRO.

The European authorities moved promptly to deal with the negative impact of Covid-19 on banks, with the aim of giving them greater flexibility and protecting them from excessively procyclical phenomena.

The ECB has in fact allowed banks:

- to not comply, if needed, with some of the additional capital requirements imposed by Basel III (the so-called "capital conservation buffer" and "counter-cyclical buffer").
- to use their liquidity coverage buffer, a set of high-quality assets that under normal conditions can never fall below the expected cash outflows over the following 30 days (estimated assuming a moderately disrupted market scenario).
- to reduce by approximately 45% the amount of "common equity Tier 1" ("CET1") capital required (thanks to the possibility of using less expensive capital instruments, such as additional Tier 1 and Tier 2) to comply with the directives of the "Pillar 2 Requirement" ("P2R", a binding capital supplement that supervisory authorities annually impose on all institutions as part of the aforementioned SREP).
- to use, or to not establish, the additional capital buffer ("Pillar 2 Guidance", "P2G") that the supervisory authorities recommend to individual institutions on a non-binding basis, still within the SREP scope.
- a high degree of flexibility as regards the treatment of impaired loans (NPLs, Non-Performing Loans) both in terms of classification in UTP (Unlikely to Pay) and in terms of allocation to the income statement.
- new incentives to grant loans to SMEs as part of the revision of the conditions.

On January 27, 2021, the representatives of the 19 member States of the euro area officially approved the reform of the ESM (European Stability Mechanism), which follows that of the Eurogroup (the meeting of the Ministers of Economy of the euro member States) of November 2020, positively welcomed by the Euro Summit (the meeting of the Heads of State and government of the countries belonging to the euro area) of December 2020. The revision of the Treaty establishing the ESM was necessary to strengthen the functioning of the Economic and Monetary Union and favor the completion of the Banking Union. The reform will further develop the ESM toolkit and strengthen the role of the Single Mechanism in the design, negotiation and monitoring of financial assistance programs. Such changes will reinforce the resilience and problem-solving capabilities in the euro area.

The fragilities created for the effective and orderly management of banking crises made it appropriate to activate the common backstop of the Single Resolution Fund operating through the ESM.

The backstop, introduced with the ESM reform, represents a safety net in support of banks in crisis through the last resort guarantee in support of the Single Resolution Fund (SRF) which is activated only in the presence of unmanageable systemic banking crises and differs significantly from the financial support tools with which the ESM has been equipped so far.

The Backstop safety net will therefore have the following features:

- enhancement of confidence in the European banking sector through the possibility of resorting to an instrument of last resort in the event of worsened conditions.
- activation, in order to finance the resolution of one or more failing banks, in the event that the Single Resolution Fund is temporarily insufficient.
- preventing the resolution of failing banks from happening at the expense of taxpayers, by strengthening the resolution mechanism and at the same time recovering costs from the banking sector.

The Italian government also promptly approved measures to support businesses and individuals in need of liquidity. The measures introduced include those relating to the granting of state guarantees on loans (through SACE guarantees and guarantee funds for SMEs) and the partial or total moratorium measures on loans (see Legislative Decree 18 / 2020 - “Cura Italia” Decree). Through the Budget Law 2021 (L. 178/2020), the moratorium on loans for micro, small and medium-sized enterprises was extended to 30 June 2021 with the aim of better supporting businesses. With the “Sostegni Bis” Decree, the moratorium on loans to SMEs has then been extended until 31 December 2021 but only upon request from eligible companies and only in relation to the principal repayment. The 2021 Budget Law (L. 178/2020) has also introduced a new incentive to business combination processes (including for banks) carried out through mergers, demergers or company transfers. In particular, it was established that, in the event of a merger, demerger or transfer of a company, approved by the shareholders' meeting, or by the different body competent by law, between 1 January 2021 and 31 December 2021, the transformation of the deferred tax asset (DTA) into a tax credit is permitted, in favor of the subject resulting from the merger or incorporating entity, of the beneficiary and of the transferee. The maximum amount of convertible DTAs cannot exceed 2% of the combined total assets of the parties participating in the merger or demerger.

The EBA published the Guidelines for the classification of moratoriums immediately after the outbreak of the pandemic (April 2020), providing indications aimed at guiding the approach of financial institutions regarding the management of non-performing and forborne exposures.

More specifically, if the moratorium is deemed 'EBA Compliant', the automatic attribution of the status of Forborne is not mandatory.

At the end of September 2020, the EBA granted banks an extension of the credit moratoriums until 30 June 2021. Following the extensions of the national moratoriums that took place on 30 December 2020, the EBA also issued some FAQs (Frequently Asked Questions) at the end of January which provided some specific clarifications, in particular:

- moratoriums are deemed as “EBA compliant” when their duration does not exceed 9 months.
- in the event of a moratorium granted or extended before 30 September 2020 for a duration of more than 9 months, they are in any case deemed as “EBA compliant”.
- any concessions or extensions after 30 September 2020 must remain within the duration of 9 months to be EBA compliant, otherwise, the delta NPV (Net present value) has to be verified on the extension date - only after 1/1/21 - and so has the forbearance.
- any extension made on existing moratoriums is deemed as an amendment to the contract made from the moment it was activated.

2.3. Italian banking sector during the pandemic crisis

The liquidity crisis that hit Italian companies following the pandemic has found an efficient response from Italian banks. During this crisis, credit institutions have taken on a completely different role compared to the last recession of 2008, when they were part of the problem. With their new social function, today banks have in fact a leading role in providing the solution. The health condition of the banking sector has changed compared to the previous financial crisis, thanks to a more robust capital situation already recorded starting from 2019, which explains the substantial steadiness of the ecosystem and an enhanced expertise in managing non-performing loans, that have undergone a sharp decline since 2016. Loans dispensed by intermediaries have increased significantly and diffusely across sectors and among companies of different sizes, including the smallest.

The economic support measures adopted by the Government and by the European Institutions have put Italian banks in the position to grant credit to businesses at very low rates, thus playing a complementary role with respect to public sector interventions and monetary policy (Figure 20 - phase 2).

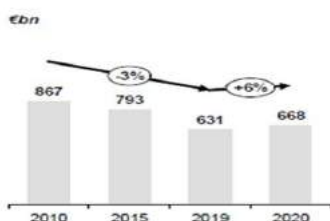
Figure 20- Number of renewals and new allocations from Italian banks in 2020 to companies and individuals



Source: Eurisc. on the ordinate axis, the index number with the 2019 average being = 100; on the abscissa axis, the week from year start, and the indication of Phase 1, Phase 2 and Phase 3. Blue dots: Individuals – 2019, Blue line: Individuals – 2020, Red dots: Companies – 2019, Red line: Companies - 2020

In 2020, the increased stock of loans to businesses (Figure 21) reflects the measures to support credit access introduced by the Government (moratoriums and guarantees on new loans), as well as the flexibility inherent in the rules of classification of loans, according to the guidelines indicated by Supervisory Authorities.

Figure 21- Stock Business loans



Source: Strategy &, based on Bank of Italy data

Italian banks are also supporting businesses and households in 2021: in April 2021, disbursements exceeded the value observed the previous year by 4.2% (Table 4).

Table 4 - Bank Lending in Italy

	Totale impieghi		settore privato *		di cui: a famiglie e società non finanziarie	
	settore privato e PA *					
	mld €	var. % a/a ⁽¹⁾	mld €	var. % a/a ⁽¹⁾	mld €	var. % a/a ⁽¹⁾
apr-16	1.810,5	0,3	1.540,3	0,4	1.402,5	0,3
apr-17	1.797,5	0,5	1.530,4	0,7	1.400,0	1,1
apr-18	1.771,8	2,4	1.506,9	2,9	1.367,7	2,5
apr-19	1.702,5	0,9	1.436,2	1,0	1.296,5	1,0
apr-20	1.687,9	1,0	1.422,1	1,2	1.282,4	1,5
mag-20	1.689,0	1,0	1.425,1	1,3	1.286,1	1,7
giu-20	1.696,9	1,5	1.436,3	2,0	1.294,0	2,8
lug-20	1.706,0	1,9	1.445,4	2,6	1.304,1	3,3
ago-20	1.703,5	2,5	1.443,7	3,4	1.305,1	4,2
set-20	1.711,5	2,5	1.453,4	3,6	1.313,8	4,7
ott-20	1.712,5	2,9	1.454,9	4,0	1.316,6	5,0
nov-20	1.721,1	3,4	1.462,1	4,4	1.324,0	5,4
dic-20	1.709,8	3,9	1.453,0	4,4	1.308,6	5,5
gen-21	1.709,9	3,8	1.449,0	4,3	1.309,5	4,9
feb-21	1.710,7	4,2	1.447,0	4,6	1.310,3	5,2
mar-21	1.718,8	3,1	1.456,7	4,0	1.316,9	4,6
apr-21	1.715,6	3,1	1.454,0	3,8	1.314,0	4,2

Source: ABI (Monthly Report May 2021)

From left to right: total loans (private sector and public administration), private sector (sub-total: households and non-financial businesses).

In recent years, the Italian banking system has fortified its credit quality with a substantial improvement in all the main asset quality performance indicators. This is due to three main factors:

- the improvement of the macroeconomic context, also following the financial and economic crises recorded between 2008 and 2012.
- important NPL deleveraging operations through the sale of non-performing loan portfolios to third parties.
- the strengthening of structures and management processes for granting, monitoring and credit recovery.

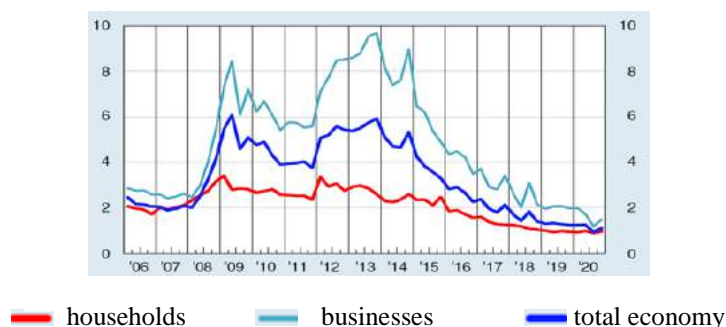
In December 2020 the stock of gross impaired loans (Source Bank of Italy) reached 103.6 billion euros (down by approximately 33%) compared to the first half of the year which had marked a stock of 133.7 billion euros, while the net stock was equal to 50.5 billion euros.

Net non-performing loans recorded in March 2021 (Source: ABI Research Department based on Bank of Italy data⁹) amounted to approximately 19.9 billion euros, down compared to the 20.9 billion euros recorded in December 2020. The net bad loans ratio on total loans decreased to 1.15% in March 2021 (it was 1.53% in March 2020, 1.84% in March 2019 and 4.89% in November 2015).

The flow of new impaired loans (Figure 22) in relation to performing loans, which remained almost stable until September 2020 (equal to 0.9%), grew in the fourth quarter of 2020 reaching 1.1%. The increase affected both loans to households (from 0.9% to 1.0%) and those to businesses (from 1.2% to 1.5%). The indicator increased mainly in sectors which had been badly exposed to the effects of the crisis such as services.

In the second half of 2020, the persistence of economic uncertainty also led to a further increase in the amount of performing loans for which the banks observed a significant increase in credit risk. The incidence of loans classified in stage 2 on the total of performing loans increased, gross of value adjustments, from 10.2% to 10.7%. In December 2020, the coverage rate of all performing loans reached 0.6% (up by 9 basis points in a year).

Figure 22 - Deterioration rate



Source: Bank of Italy (Financial Stability Report 1/2021). Red line: households, light blue: companies, bright blue: economic system.

Table 5 presents the exposures of impaired loans recorded in December 2020 which show that the greatest exposures of bad loans are concentrated in companies operating in the services sector.

⁹ See ABI Monthly Report, May 2021

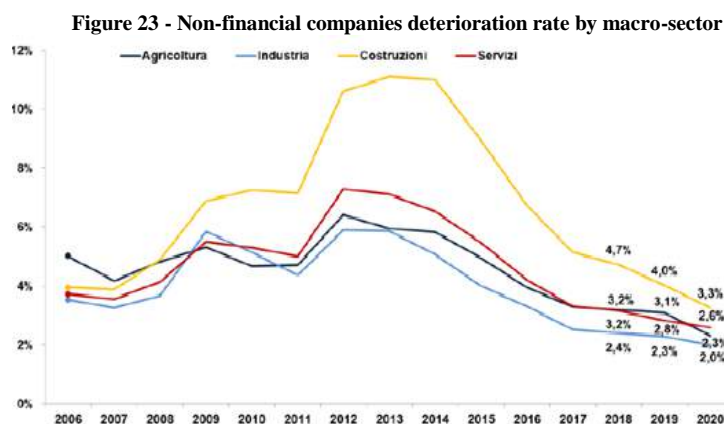
Table 5 - Exposure of impaired loans by type of customer (1)
(Billion euro and percentage values; December 2020)

ITEMS	Gross exposures	share of total gross receivables (2)	Net exposures	share of total net receivables (2)	Real guarantees (3)	Personal guarantees (3)	coverage rate for unsecured loans
Businesses (4)							
Impaired loans to customers	67	9,6	29	4,4	32	13	64,3
of which : manufacture	14	6,8	5	2,7	4	3	68,6
construction	17	24,8	7	12,4	10	3	64,3
services	33	8,7	15	4,2	16	7	61,8
of which: bad loans	33	4,6	10	1,6	15	8	76,2
of which : manufacture	6	3,2	2	1,0	2	2	77,3
construction (5)	8	12,2	3	4,8	4	2	75,6
services	16	4,2	5	1,5	7	4	75,7
Consumer households							
Impaired loans to customers	20	3,8	10	2,1	13	1	65,7
of which: bad loans	9	1,8	4	0,7	6	0	78,3
Total sectors (6)							
Impaired loans to customers	93	6,0	42	2,9	47	14	63,2
of which: bad loans	43	2,8	15	1,0	21	9	76,4

Source: Bank of Italy (Financial Stability Report 1/2021)

(1) The data are taken from unconsolidated financial statements, which do not include loans granted by financial companies belonging to banking groups and by foreign subsidiaries. "Non-current assets and groups of assets held for sale" are included, which at the end of December 2020 amounted to approximately 6 billion euro for total impaired loans before adjustments. Provisional data. - (2) The shares are calculated, gross and net of the related value adjustments, in relation to the corresponding gross and net exposure to the single sector and subsector of reference. - (3) The amount corresponds to the gross exposure amount covered by a guarantee (real or personal). - (4) The business sector, in addition to manufacturing, construction and services, also includes agriculture, forestry, fishing and other industrial activities other than manufacturing. - (5) also includes real estate activities. - (6) also includes the sectors "Public Administration", "Financial and insurance companies", "Non-profit institutions serving households" and "Non classifiable and non-classified units".

From analyzes carried out by Cerved (Figure 23), in 2020 the deterioration rates recorded for businesses have had a different intensity by counterparty macro-sector. The sectors that recorded the highest reductions in defaulted new loans are those of **agriculture** (from 3.1% in 2019 to 2.3% in 2020) and **construction** (from 4.0% to 3.3%). **Industry** remains the sector with the lowest deterioration rates, reaching 2% (from 2.3% in 2019), while **services** have fallen by 0.2% (from 2.8% in 2019 to 2.6% in 2020).



Source: ABI-Cerved

Deterioration rates by macro sector - number of credit positions that deteriorate during the year in relation to the stock of non-impaired positions at the beginning of the same year. Dark blue line: Agriculture, light blue line: Industry, yellow line: Construction, Red line: Services.

The extraordinary measures in support of businesses adopted during the pandemic have so far prevented the blocking of economic activities and the subsequent restrictions due to the health emergency from translating into a surge in corporate defaults.

The Italian banking system, together with the Spanish and French banking systems, was one of the main users of the moratorium tool (Figure 24): over 300 billion euro granted to 2.7 million entities (Source ABI). This allowed a freezing of NPLs and a strong acceleration of the dynamics of loans to non-financial companies (+ 8.5% yoy in December net of the moratoriums granted, the maximum since the end of 2008, +63 billion euro) above the average of the euro area.

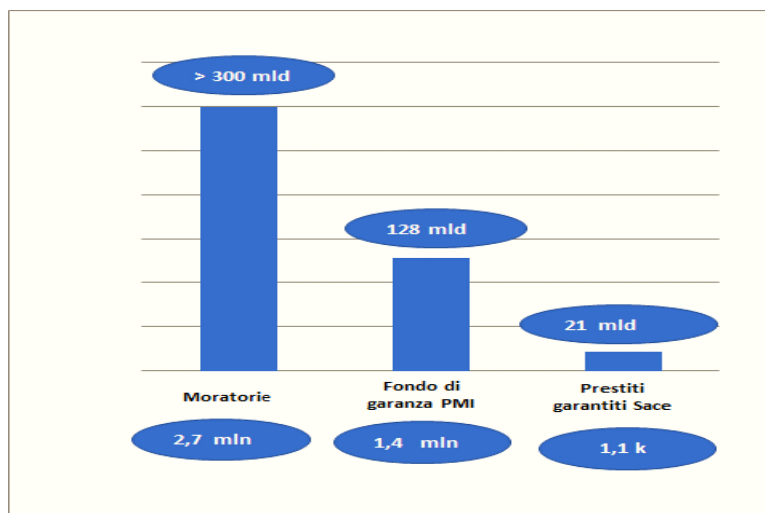
At the end of December 2020 (Source: Bank of Italy¹⁰), the CET1 ratio of the entire system was on average equal to 15.5% of risk-weighted assets (an increase compared to the 13.9% recorded at the end of 2019).

The improvement affected both significant and less significant banks (respectively 70 and 130 basis points, at 15.5% and 18.7%) and largely reflects the decrease in RWAs, which fell by 3.7% and 1.4%.

The decline was affected not only by the re-composition of assets in the portfolio towards less risky exposures by some of the main groups, but also by the effects of public guarantees granted to facilitate access to credit by households and businesses, which contributed to reducing the average weighting of risk assets.

¹⁰ See Bank of Italy, Financial Stability Report 1/2021

Figure 24 - Moratoriums and guarantees given



Source: Author, based on ABI data.

From left to right: moratoriums, SME guarantee fund, SACE guaranteed loans

3. Prospective situation of the economic and financial system in Italy after Covid

The Covid-19 pandemic has hit the Italian economy more than other European countries. In 2020, the gross domestic product fell by 8.9%, compared with a decline in the European Union of 6.4% (Source Istat / Eurostat).

In the first quarter of 2021, Italy's GDP recorded an increase of 0.1% (Source Istat) compared to the previous quarter, against a decline in the European Union which showed a quarterly decline of 0.1% (Source Eurostat). The Bank of Italy estimates a growth of Italian GDP of over 4.0% for 2021.

The crisis has hit an already fragile situation from an economic, social and environmental point of view. Between 1999 and 2019, the GDP in Italy grew by 7.9% (Source MEF). In the same period in Germany, France and Spain, the increase was respectively 30.2%, 32.4% and 43.6%.

The recession triggered by the Covid-19 epidemic in 2020 has increased the number of businesses with liquidity needs and capital deficits. The main support measures launched by the government between March and August 2020 have greatly mitigated these effects.

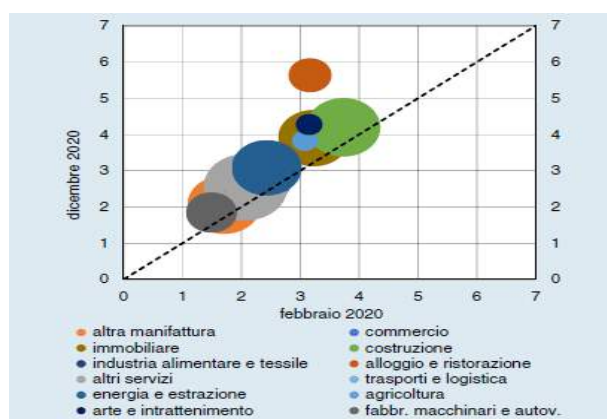
However, the use of new loans, also thanks to public guarantees, further expands debt, especially for riskier companies.

The granting of public guarantees to small and medium-sized enterprises has proved to be an effective tool to support banks that grant the loans required to cope with the crisis. However, the medium-term effects of public guarantees depend both on the duration of the guarantees and on the other policy measures that will be adopted.

At the end of 2020, many economic forecasts referred to the situation emerging from the COVID-19 pandemic. Estimates on the conditions of households and businesses when exiting the Covid crisis predict a worsening of their ability to meet debt service commitments.

According to the Bank of Italy and Cerved data (Figure 25 and Table 6), the deterioration of the creditworthiness of companies, when support measures will cease, will be significant, especially in some sectors (accommodation and catering, art and entertainment, real estate).

Figure 25 - Deterioration of creditworthiness



Source: Bank of Italy (Financial Stability Report 2/2020). Orange: manufacturing sector (other), brown: real estate, dark blue: food industry and textile, light grey: other services, medium blue: energy and extraction, black: art and entertainment, light blue: commerce, green: construction, red: accommodation and catering, pastel green: transport and logistics, pastel blue: agriculture, dark grey: machinery and vehicles.

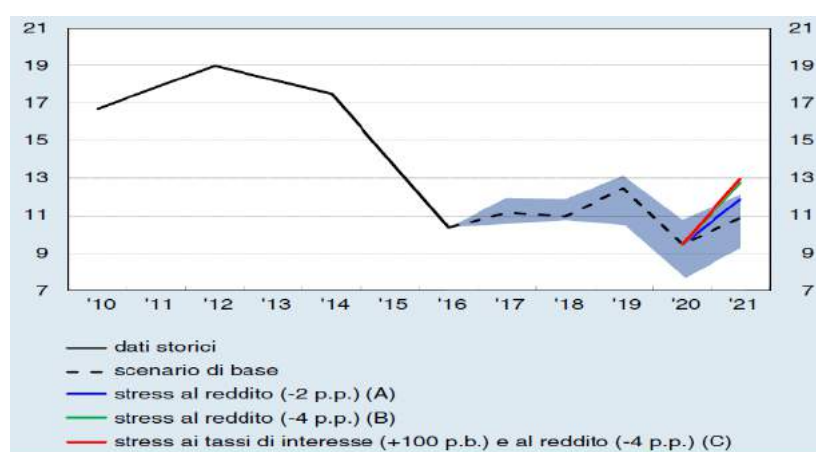
Table 6- Evolution of the probability of default (PD) by sector

Totale	4,5%	5,1%	6,0%
Manufacturing (except the specified subcategories)	3,6%	4,4%	5,7%
Manufacturing – Equipment	3,2%	4,0%	4,9%
Electricity, gas, steam and air conditioning supply	5,0%	3,7%	4,0%
Water supply, sewerage, waste management and remediation activities	4,3%	4,2%	4,5%
Constructions	7,1%	7,3%	8,7%
Wholesale and retail trade (except the specified subcategories)	3,8%	4,7%	5,6%
Transporting and storage	4,8%	5,7%	8,4%
Accommodation and food service activities	6,3%	8,7%	11,9%
Information and communication	5,0%	5,2%	4,4%
Real Estate	6,0%	5,8%	6,4%
Professional, scientific and technical activities	3,6%	3,9%	4,4%
Administrative and support service activities	5,0%	5,7%	6,5%
Tourism related supporting activities	5,8%	11,0%	14,3%
Agriculture	5,7%	6,4%	6,9%
Textile and clothing	4,2%	5,3%	6,9%
Di cui: componente manifatturiera	4,1%	5,2%	6,9%
Di cui: componente commercio e dettaglio	4,5%	4,7%	5,0%
Pharmaceutics	3,1%	2,8%	2,5%
Di cui: componente manifatturiera	2,5%	2,5%	2,3%
Di cui: componente commercio e dettaglio	3,4%	3,0%	2,5%
Automotive	3,8%	5,2%	6,0%
Di cui: componente manifatturiera	3,7%	5,0%	6,7%
Di cui: componente commercio e dettaglio	3,8%	5,3%	5,7%
Food and beverage	4,1%	4,7%	4,6%
Di cui: componente manifatturiera	3,8%	4,5%	4,1%
Di cui: componente commercio e dettaglio	4,6%	4,9%	5,3%
Fuel	3,0%	3,6%	4,7%
Di cui: componente manifatturiera	2,4%	2,9%	6,1%
Di cui: componente commercio e dettaglio	3,1%	3,6%	4,5%
Other sectors	5,0%	6,2%	7,1%

Source: Cerved Rating Agency. For sectors Textile and clothing, Pharmaceutics, Automotive, Food and beverage, Fuel, a breakdown is provided of the manufacturing component and of the trade and retail component.

The share of debt held by vulnerable firms (those with negative EBITDA or financial charges/EBITDA ratio above 50%) could increase significantly in case of adverse scenarios (Figure 26) in 2021, even if it would not reach the levels observed after the 2008 crisis and that of 2011. There is the possibility that vulnerable companies could turn into zombie¹¹ companies in the post-Covid period, contaminating the solvency of a few banks. The presence of zombie companies can be a cause but also a consequence of the presence of weak banks and as such reluctant to recognize the size and impact of non-performing loans on their balance sheets (bank forbearance, evergreening, zombie lending). Zombie companies damage the economic system by trapping productive factors that could be allocated for more profitable uses.

Figure 26 - Share of debt held by companies



Source: Bank of Italy based on Cerved data (Financial Stability Report 2/2020).

Black line: historical data, dashed line: base scenario, blue line: stress on income (-2 PP) (A), green line: stress on income (-4 PP) (B), red line: stress on interest rates (+100 bps) and on income (-4 PP) (C).

Many factors lead to fear an increase in NPLs within banks in the two-year period 2021-2022: contraction of GDP, evolution of the risk appetite of operators (of uncertain direction, but characterized by high variability); public debt situation; general institutional

¹¹Zombie is a company that operates at a loss and with very little hopes of recovering the economic equilibrium (non-viable), which would typically be forced to major reorganization or directly expelled from the market, but which nevertheless avoids bankruptcy thanks to the support it receives from lenders.

strength (legal system, efficiency of litigation processes, degree of adherence to the rule of law, predictability of rules) and specific institutional strength (quality of corporate governance); level of profitability and capitalization of the banking sector and capacity for provisions.

The factors that influence the NPL dynamics can be attributed to:

- **external factors:** GDP (main), unemployment rate, risk aversion level, inflation, interest rates, exchange rate, public debt (crowding out, bank assets quality, fiscal space), share prices (guarantees), legal system quality
- **internal factors:** bad management, bad luck, skimping (low investments in selection and monitoring), provisions, capitalization, loan growth, competition level, size, leverage, revenue diversification, profitability.

The European Union responded to the pandemic crisis with Next Generation EU (NGEU), a EU funding plan for the recovery of Europe from the economic consequences of the pandemic, which provides for a budget of 750 billion euros (of which 191.5 billion euros for Italy) put in place to oppose the effects of the coronavirus and allow the countries that will use it to restart their economy by investing in a series of sectors that constitute a priority for Europe such as green transition, innovation, education and health. The plan defined as National Relaunch and Resilience Plan (PNRR) approved at the end of April 2021 by the Italian Council of Ministers will encourage the relaunch of growth and productivity of the Italian economy.

The banking system will play an essential role in involving relevant companies in the strategic sectors of construction, technology, information, transport, manufacturing, electronics, energy. Many of these involved companies are SMEs that will need new capital to face robust investments to finance strategic dimensional growth with the needed process- and sometimes product-innovations. The credit consortia (in Italy, Confidi) will be a very effective ally for businesses to deal with the NGEU, through business consultancy which will prove to be crucial in investment choices.

On a macro scale, public spending financed by EU Next Generation funds may affect the growth expectations of businesses, and therefore their employment and investment decisions. In such context, it will be essential to direct resources towards uses that increase the productivity of the Italian system rather than towards unproductive forms which would leave the country with all the issues unsolved, once their direct impact has been exhausted. Only by embarking on a long-term growth path can the short-term effects of the pandemic be mitigated and the sustainability of public debt in the long term still be guaranteed.

The Covid-19 crisis will accelerate pre-crisis trends as subdued growth and low interest rates will persist for a long time. And this will test the resilience of the financial system and the regulatory reforms implemented after the global financial crisis.

While banks may benefit from temporary regulatory flexibility, digitalization will increase the appeal of financial services. The banking sector can move from traditional oligopoly to a system with a few dominant platforms that control access to a fragmented customer base, with a few BigTech companies and a few traditional operators transformed into platforms that control the interface with customers. Midsize banks will suffer as they are unable to handle the cost efficiencies and IT investments that are crucial in the new environment. Consolidation could be an escape route for troubled banks, but in the post-Covid-19 world, political obstacles to cross-border mergers could re-emerge as States become more protective of their domestic banking champions, with banks being considered as strategic. The current crisis will accelerate structural changes, including bank consolidation and acquisitions and mergers can be a very important factor. Consolidation of the banking sector can be an important factor in helping to address overcapacity and fragmentation potentially leading to synergies and greater efficiency. A few banks are currently proving to be too small with respect to competitiveness requirements. It is assumed that large banks have greater efficiency and resilience capabilities than small and medium-sized ones. Regulators must adapt to the digital revolution by balancing the incentive towards competition and the benefits of innovation with the protection of financial stability. To this end, they need to coordinate prudential regulation and competition policy with data-related policies, navigating amid complex trade-offs. The regulatory reforms launched following the global financial crisis and the supervisory action carried out in the past decade, in particular since the years of the sovereign debt crisis, have had significant effects both on the capitalization of banks and on the consistency of impaired loans. As a result, the ability of Italian banks to deal with adverse shocks has significantly increased. However, the scale of the current crisis could be such as to require significant action. We expect to see resilience and unstable performances among Italian banks in the coming years, as the recession will affect asset quality and overall financial profiles. In the multiplicity of new regulations and supervisory expectations, which banks have complied with in recent years or on which they are currently engaged, there are a few regulatory systems (such as the new definition of default) which effects will unfold in an economic context that makes their pro-cyclical features rather alarming. In particular, the pro-cyclical nature of such measures lies in the direct link between the difficulties of the economy and the growth of NPLs, economic difficulties which in turn are exacerbated by regulatory policies that trigger a restriction of the credit supply. This pro-cyclical nature is extremely worrying in a situation like the current one, characterized by a profound economic crisis that requires, on the contrary, counter-cyclical measures aimed at fueling the supply of credit (very appropriately implemented through the highly indulgent monetary policy of the ECB). Although banks can benefit from a certain degree of regulatory flexibility, it is necessary, however, that they use this flexibility carefully, without postponing the surfacing of highly probable losses. Faced with this situation, Banks have activated several interventions to prepare for the cliff effect deriving from the end of the accommodating measures. The available evidence suggests that the increase in credit adjustments recorded in the first half of this year is absorbed by larger intermediaries (Source: Bank of Italy), in the face of difficulties that appear to be widespread. All banks must equip themselves with suitable tools to spot the increase in the vulnerability of debtors in good time, especially those who have adhered to moratoriums, for which available information might be limited at this stage. In the coming years, it will therefore be essential to continue to manage NPLs effectively to prevent them from accumulating in balance sheets, hindering the strengthening actions and undermining market and investor confidence. The progress made so far is significant: from the collection of granular and standardized data on bad loans to the creation of organizational units specifically dedicated to recovery, from the preparation of reduction programs to the launch of a market for transactions on this type of asset. Despite the crisis, during year 2020 Italian banks seem to have overcome the severe recession without significant damages, managing to sell an amount of non-performing loans only slightly lower than what was planned before the outbreak of the pandemic.

The challenge of continuing in this direction must now be faced, ensuring full support to the economy and simultaneously maintaining suitable capital levels.

In the future (Vallino Convention Aifirm 15 December 2020) the system is moving towards the direction of fewer branches (a process strongly accelerated by the pandemic), multi-bank and outsourced low value cash services, important role of robotics and artificial intelligence, tech bank company, dichotomy between low-cost banking services (self-service, digital and "package" formulas) and high added value services (asset management, non-standardized loans), revision of human resources management system and inception of new types of contracts that provide remote services and flexibility.

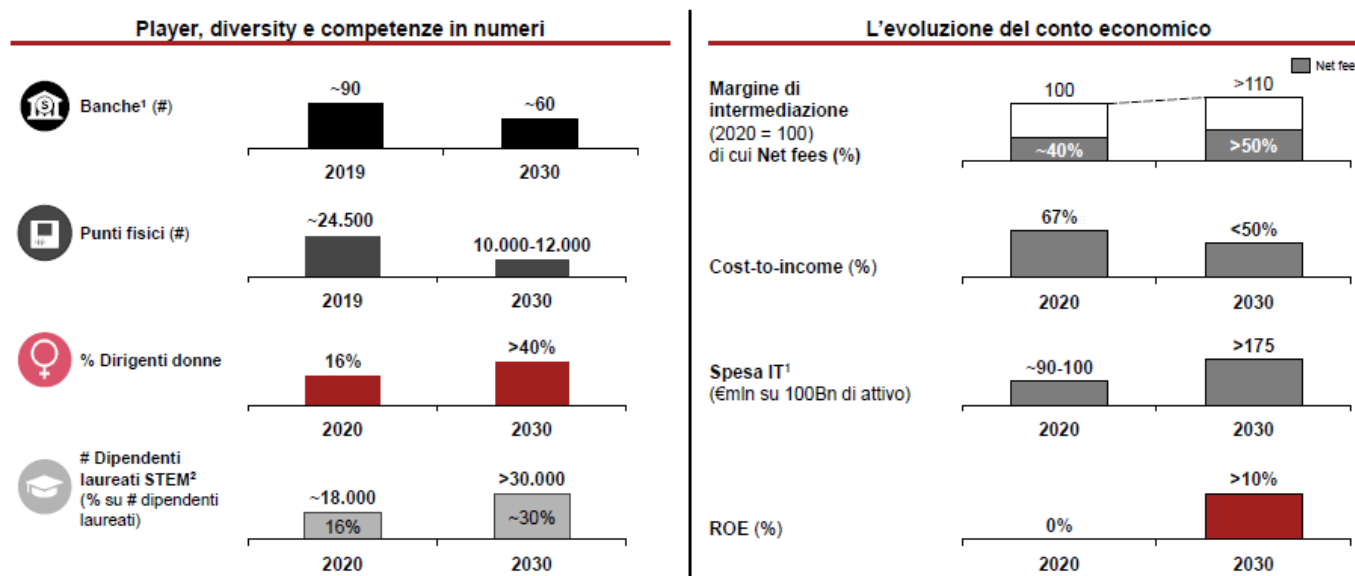
The COVID-19 pandemic will probably accelerate a few dynamics that already have begun in the banking sector (Enria, 2020):

- Digital transformation favored by widespread adoption of remote working, growth in demand for digital products and services, unbundling of traditional services.
- Need to address structurally low levels of profitability; considerable efforts to reduce costs have already been achieved: cost-to-income ratio dropped from 56.6% in 2014 to 54.4% in 2019.

In light of the new dynamics, banks (Figure 27) are therefore called upon to redesign the models, orienting them towards:

1. "remote / face-to-face" hybrid operating models.
2. "branch / digital" hybrid distribution models.
3. hybrid "in / out" sourcing models enabled by cloud, architectures and platforms.

Figure 27



Strategy&

Note: 1) Esclude Banche cooperative e filiali di banche estere 2. Discipline "STEM": Sciences, Technology, Engineering, Mathematics
 Fonti: Elaborazione Strategy& su dati pubblici, Eurostat, Centro Europeo per lo sviluppo della Formazione Professionale (Cedefop)

On the left-hand side: players, diversity and skills, in numbers. From top to bottom: Banks (#), Branches (#), % Female executives, STEM Graduate employees (# and % on graduate employees).

On the right-hand side: the evolution of the income statement. From top to bottom: Brokerage Margin (2020 = 100), of which Net Fees (%), Cost-to-income (%), IT spending (€mln on 100 bln assets), ROE (%).

Source: Strategy &

(1)excludes cooperative banks and branches of foreign banks; 2) STEM disciplines: Sciences, Technology, Engineering, Mathematics. Source: Strategy& elaboration on publicly available data, Eurostat, European Center for the Development of Professional Training (Cedefop).

The implementation of digital banking platforms will allow the automatic delivery of traditional and innovative banking products, which will reach the customer directly through websites. According to estimates by Allied Market Research, the global market for digital banking platforms in 2019 was worth 3.95 billion dollars. In 2027 it will have reached a value of 10.87 billion dollars, growing at an annual CAGR rate of 13.6%. Alongside the quantitative growth, there will be a qualitative evolution of services, made possible by the adoption of artificial intelligence and machine learning technologies.

Conclusions

The Covid-19 pandemic, which has devastated the world since the early months of 2020, suggests that there is still a long way to go. The outbreak of the pandemic hit Italy when it was already in a phase of slowing growth, which for years has remained lower than that of the most advanced economies. At European level, the response from the institutions was rapid: suffice it to think of the activation of the general safeguard clause of the Stability and Growth Pact, which for the first time allowed all member States to temporarily deviate from the medium-term budgetary goals. The ECB and other supervisory and regulatory authorities have adjusted their supervisory strategy to changing circumstances. The Central Bank intervened in a timely manner in order to stabilize the markets and create the necessary conditions to ensure the correct transmission of monetary policy impulses to the real economy. The monetary policy measures adopted by the Supervisory Authority have provided an essential contribution to support the recovery of the Eurozone economy. The nature of the current crisis makes international cooperation more essential than ever to ensure effective and timely measures to support economic activity.

Any coordination failures could jeopardize the quick economic recovery.

In the face of uncertain macroeconomic prospects, any increase in insolvencies, the more likely to happen, the longer the economic stagnation lasts, will lead to an increase in bad debts for banks and, likely, to a credit rationing which in turn would enhance the recession. The main objective is to avoid the credit crunch that occurred during the past financial crisis and also to develop the secondary market for NPLs.

The EU Commission encourages the creation of national asset management companies (AMCO) controlled by the States which could buy non-performing loans on the market from banks in crisis and it also encourages their cooperation through the establishment of a European network to create synergies. Banks, supported in getting rid of NPLs from AMCO, will be able to continue to finance healthy businesses and households.

Credit has acquired and acquires a crucial role, in the most acute phases of the crisis, to ensure the necessary liquidity for households and businesses hit by significant shocks both from the demand side and from the supply side of productive factors. The support to credit in the subsequent phase will be equally important, to sustain companies along their path towards restoring sound economic conditions to their businesses, in a context of uncertainty that is likely to linger for a long time.

The European banking regulatory framework, conceived in a completely different context from the current one, reveals a few critical issues that must absolutely be addressed in order to avoid a damaging restriction of the credit supply and social impacts on households and businesses.

However, a positive note comes from the fact that in recent years European banks have recovered their capital strength and improved the quality of their assets. In such context, both the measures aimed at mitigating the risk of debtor default and the strategies that will be put in place to support the economic recovery remain essential.

The role of European institutions in the current period of crisis has been crucial, but it is now necessary to implement regulatory simplifications and rapid and effective strategies which will allow companies to survive in the post-Covid 19 crisis. It is also necessary to implement all those European regulatory simplification initiatives aimed at helping banks to expand their lending to businesses.

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