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The Italian economic and institutional system in a pandemic situation

Abstract

This paper provides a first assessment of the effect of the COVID-19 emergency on the Italian economy. The impact of the pandemic is analyzed from three points of view: the institutional settings and the differences in power between the central and local governments; the impact on the real economy and sectoral differences; the role of the banking sector in supporting the real economy during and after the crisis. The paper highlights how the pandemic affected Italian regions and sectors differently, and presents policy consideration regarding the European banking sector.

Key words: bank, banking system, COVID-19, Italian economy, regions, sectoral differences

JEL: E01, E58, G01, G17, G21, H12, H51, H72, I15, I18

Włoski system gospodarczy i instytucjonalny w sytuacji pandemii

Streszczenie

Artykuł zawiera wstępną ocenę wpływu pandemii COVID-19 na włoską gospodarkę. Wpływ pandemii analizowany jest z trzech punktów widzenia: otoczenia instytucjonalnego i różnic między władzami centralnymi oraz lokalnymi; wpływu na realną gospodarkę i różnic sekto-

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rowych; roli sektora bankowego we wspieraniu realnej gospodarki podczas kryzysu i po nim. Podkreślono w jaki sposób pandemia wpłynęła na włoskie regiony i sektory gospodarki, oraz rozważono kwestie polityki europejskiego sektora bankowego.

Słowa kluczowe: bank, COVID-19, gospodarka Włoch, regiony, różnice sektorowe, system bankowy

Introduction

Italy was the first European country to be severely hit by what is nowadays acknowledged as the COVID-19 pandemic, started in. The first cases of the COVID-19 emergency were registered on January, 31, 2020, when a couple of Chinese tourists resulted positive to the test in Rome, while the first case of a positive Italian citizen was announced on February, 6, 2020, a man repatriated from Wuhan.

Since then Italy was the first western country to experience massive intensive care unit (ICU) admissions in specific regions of the country and a generalized lockdown of social and economic activities that lasted for three whole months and is nowadays seeing some forms of relaxation.

This study aims at providing the first assessments about the Italian institutional, economic and financial situation in the midst of this pandemic while analyzing how Italy is coping with the ongoing medical and economic crisis. This is one of the first academic studies specifically addressing the issue of the pandemic from the point of view of a single, most affected country, embracing a 360 degree vision, i.e. not limited to a specific economic sector[1] or to a review and comparison of other pandemics of the past[2].

1. The numbers of the emergency

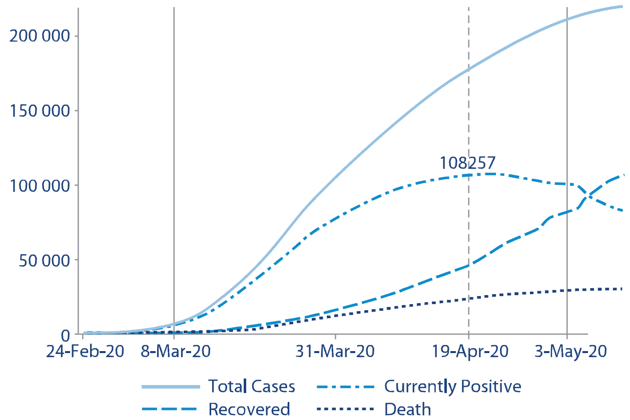
After the first cases of the COVID-19 emergency in Italy were registered the number of sick people accelerated exponentially until the end of April.

In particular, starting from the beginning of February, two important clusters were registered in Lombardy and Veneto: in order to contrast this outbreak, on February 23, when the number of cases exceeded 100, the government imposed the quarantine on eleven municipalities. By the end of the month, the total number of registered cases surpassed 1,000 (with nearly half of them being in Lombardy) and 14 regions out of 20 have registered at least 1 case of COVID-19, signalling that the diffusion of the virus represented a national problem. Therefore, on March 8, the Italian government intervened more harshly to restrain and contrast the diffusion of the virus, extending the quarantine on the whole region of Lombardy and other

1 T. Laing, *The economic impact of the Coronavirus 2019: implications for the mining industry*, The Extractive Industries and Society, 2020.
2 J.W. Goodell, *COVID-19 and finance: agendas for future research*, Finance Research Letters, 2020.

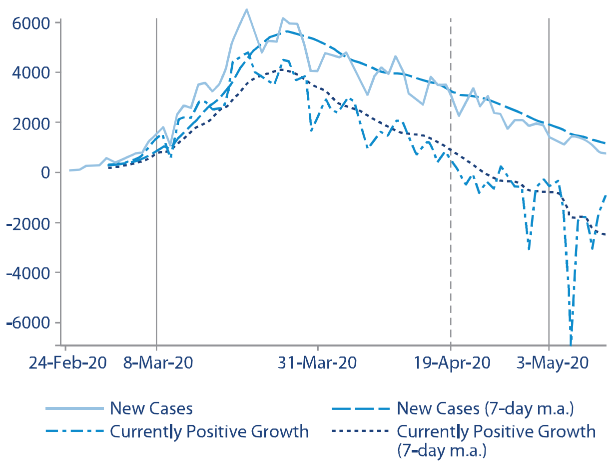
14 provinces. In the following days, the containment measures have been extended to the whole national territory, and, on March, 21, the Prime Minister announced the closure of any production activity that was not strictly necessary, crucial, indispensable for essential goods and services until April 3, 2020. Afterwards, the government extended the period of restrictions in force until May 3, 2020. On May 4, 2020, the so-called “phase 2” began, that is a gradual easing of the previous containment measures. At the beginning of phase 2, there were still 100,179 positive cases, over 210,717 total cases confirmed.

Figure 1. The numbers of the emergency



Reference lines on March, 8, 2020, and on May, 3, 2020 (the end of the so-called “phase-1”).
Source: Italian Ministry of Health.

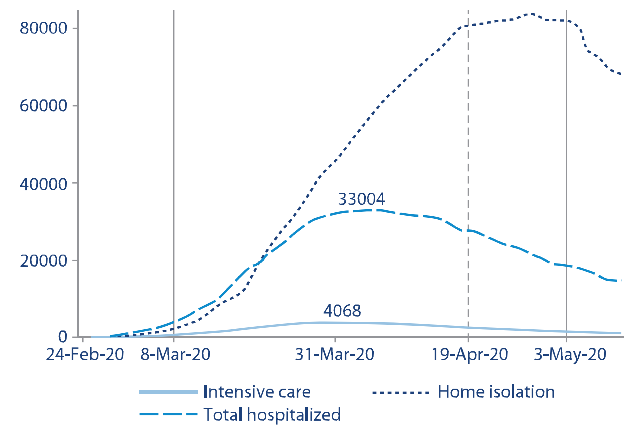
Figure 2. The number of the emergency (daily change and moving averages)



Reference lines on March, 8, 2020, and on May, 3, 2020 (the end of the so-called “phase-1”).
Source: Italian Ministry of Health.

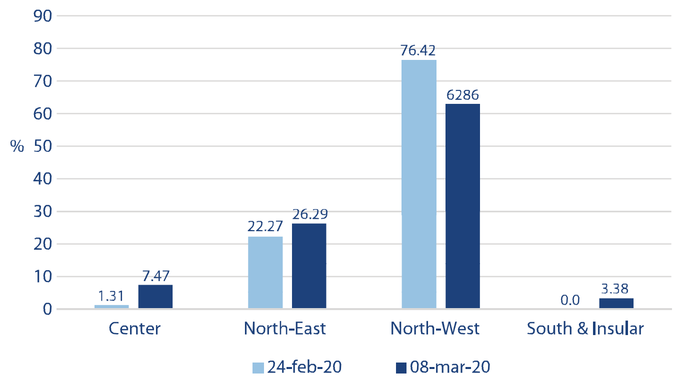
The maximum number of currently positive cases was reached in late April, two months after the outbreak of the disease, as happened in China. However, on a day-by-day distribution, the peak was reached much earlier, in late March (Figure 2). With these trends, it is by no means difficult to understand why the national health system was overwhelmed as if a tsunami was raging. In a number of regions, the directive was to stop and delay non-urgent visits, focusing only on COVID-19 restraint, containment and recovery. A huge effort was done in order to create new intensive care rooms and to create ad-hoc sites (in the hospitals or even in the close outside) in order to check potential cases and manage the positives.

Figure 3. The burden on the national health system



Reference lines on March, 8, 2020, and on May, 3, 2020 (the end of the so-called "phase-1").
Source: Italian Ministry of Health.

Figure 4. The differences in the diffusion of COVID-19 between macro-areas in Italy



Source: Italian Ministry of Health.

The diffusion of COVID-19 was not homogeneous across regions, since the very beginning of the emergency. It is quite clear that the diffusion of the virus followed different patterns in regions. What it is still missing is the answer to the question "Why did this happen?".

Overall, between March and May 2020, three peaks of the diffusion of COVID-19 in Italy can be identified. The first one is the maximum of the currently positive cases, which was registered on April, 19, 2020. The second one is the peak of new cases and of new positive cases, on a daily basis, that was reached in late March. The last one, that is connected to the burden on the national health system, was reached in early April. Moreover, at the beginning of the crisis, the diffusion of the COVID-19 was homogeneous across regions and the recovery is following a different pace as well, which makes more difficult for the Government to decide if and when to "open borders" across Italian regions.

2. The emergency from an institutional point of view

From an institutional point of view, the COVID-19 emergency was addressed under the constitutional framework, which allows decisions in exceptional situations without alteration of the ordinary division of powers while recognizing a specific role to the Italian Regions. Therefore, it is interesting to analyze the system of public responsibilities in order to focus on what powers are held by the different levels of government and how the health crisis has been dealt with. From 1970 Italian Republic is a pluralistic system, based on the presence of Municipalities and Regions, exercising relevant public functions, which should receive a central coordination. Regions have the same capacity of the State to adopt legislative acts, whereas Municipalities have only administrative functions. Therefore, administration is by and large carried out at a level of proximity to the citizen: this is a very valuable choice, yet the good functioning of services deeply depends on a high degree of coordination, as already stated. This coordination has not often worked properly in the past: we can argue that the (historical) difficult relationship between the central power and the local governments caused very serious effects in the present situation of emergency, as the adoption of not coherent decisions at all levels was the reason of an evident ineffective management of the crisis itself.

In a situation of crisis, the first step undertaken by the Italian Council of Ministers on January 31, 2020 was the declaration of "the state of emergency", following the WHO's declaration of a 'Public Health Emergency of International Concern' on January 30, 2020. After this declaration, the Italian Government adopted a series of decrees, whose initial purpose was to establish a wide range of limitation of civil rights, so as to force citizens to respect a period of quarantine. On May 13, 2020 the Government adopted a new decree containing a wide range of economic measures aimed at providing financial support to businesses, workers and families.

The extraordinary situation has raised some problems with regard to the measures concerning civil rights, as it was clear – exactly as anywhere else – that there was the necessity to limit the circulation of people – citizens and also foreigners – and their ordinary life. The decrees that put a halt to economic and leisure activities, transfers, schooling and religious services were not always accepted passively by municipalities and Regions: the local institutions repeatedly adopted decisions in opposition to the national rules, in some cases further restricting citizens' freedom, in other cases allowing behaviors prohibited by the State. The result was a great sense of unease for the citizens, who followed this confusing production of rules with discomfort having difficulties with their accomplishment. As a matter of fact, the health emergency offered the Regions an amazing occasion to affirm their role and to distance themselves from the approach of the national institutions. Loyal cooperation failed in many cases[3] whereas it should be the ordinary way to manage the relationship between local and central government. Such a situation was not totally unexpected, as the loyal cooperation between decentralized and central powers has always been practiced with difficulty: the present phase would have required a special effort to develop a dialogue among the different levels of government, but this failed to take place, and the most serious consequences appeared in the perspective of the healthcare system.

Indeed, the main challenge was faced by the health authorities, who had to adopt extraordinary solutions so as to treat a huge number of very serious cases[4]. The Italian Constitution provides that the right to health protection is guaranteed through a regional organization, although the State maintains significant functions for the correct working of the National Health Service. The Regions have the task to organize the healthcare whereas the State has the duty to determine the financial resources necessary to the 21 regional systems and to define the so called "essential levels" of the healthcare system, whose purpose is to assure the principle of equality. The aim is to guarantee a homogeneous standard of protection all over the country, even though each Region has the possibility to offer a higher level of healthcare if it has the economic resources to deliver it.

In this regard, the different models of organization of each regional health systems played a particular role. The Regions did not offer the same solutions to COVID-19 infection, which caused little damage in Southern Regions whereas it provoked a high number of deaths and infected people in the Northern part of Italy. In some Regions, the healthcare is assured through a complex system of home-care services, which requires a wide network of health facilities that offer assistance on the territory. Other Regions have developed hospitals and structures aimed at treating people far from home: in these Regions, the structures of hospitalization appeared

[3] C. Buzzacchi, *Rifinanziamento della sanità pubblica e Mes: un caso di liaisons non così tanto dangereuses*, http://www.lacostituzione.info/ (access 24.04.2020).

[4] C. Buzzacchi, *Coronavirus e territori: il regionalismo differenziato coincide con la zona "gialla"*, http://www.lacostituzione.info/ (access 02.03.2020).

not sufficient, and therefore there was a great effort to provide, in very short time, the buildings – sometimes military tents – and the services needed.

When the most acute phase was over, the great issues which continued to cause troubled relationships between the State and the local institutions concerned how to manage the restart of all activities. In a country where the infection had had an uneven diffusion on the one hand; and the distribution of masks, viral and antibody testing, which seemed to be lacking, on the other side, the great need was to govern the recovery with clear and reasonable rules. Many Regions appeared to rush into the restart, especially to let the sectors of industry and tourism resume: their decisions, adopted in opposition to the national decrees, were followed by litigation before the judges, and once more the evidence was of an institutional system with great difficulties to manage the emergency. In addition, everywhere the supply of masks and tests seemed not to be enough, and it was not clear who should take responsibility, if the State or Regions. Such a state of confusion and disorganization had obviously serious effects on prevention and on the orderly return to everyday life, although at the same time people had great expectations towards the Government, trusting that it would allocate a proper amount of resources in order to overcome the situation of hardship.

In order to collect the huge amount of resources necessary for this task the Italian Government had to ask the Parliament twice to deliberate the budget variation[5]: this was deemed necessary to comply with the European fiscal rules and art. 81 of the Italian Constitution, which provide the "balanced budget rule". Deficit spending can occur only in "exceptional circumstances", which refer to the "case of an unusual event outside the control" of the State concerned "which has a major impact on the financial position of the general government or to periods of severe economic downturn", according to art. 3 of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union of 2012. After the authorization granted by the Parliament, the Government planned to access to several sources of liquid assets: the Pandemic Emergency Purchase Program (PEPP) launched by the ECB, the new temporary asset purchase program of private and public sector securities to counter the serious risks to the monetary policy transmission mechanism; the delivery of European guarantee by EIB, whose goal is to support the real economy up to 200 billion €, following the Eurogroup's recommendation and the European Council's endorsement to include the EIB's proposal into the joint EU response package; and the financial assistance which became available with the European Mechanism of Stability after the removal of the conditionality criteria. All the resources are expected to limit the consequences of the severe economic crisis following the pandemic; yet the economic effects were not the only damage felt, as there are some critical issues whose solution is not merely financial.

[5] C. Buzzacchi, *Scostamento di bilancio da Coronavirus*, http://www.lacostituzione.info/ (access 13.03.2020).

Among these issues the most critical is probably that concerning schooling. The decision to keep only distance activities, with great sacrifice of learning and socialization, is expected to have serious effects on the future prospects of the country. The cultural urgency is going to be not less dangerous than the risks of unemployment and poorness: it will generate further poorness if young people cannot receive the right level of education. The challenge to face concerns a new model of education, and the hope is that institutions and private actors of the society will dedicate the correct amount of attention and efforts to this goal.

3. COVID-19 and the real sector

In the fourth quarter of 2019, the euro-area economy observed a general slowdown[6]. On average, the real EU GDP growth was almost unchanged: the contractions in the manufacturing sectors and in net-exports was counterbalanced by a positive contribution by domestic demand. On a different path stood Italy, which in the same period observed a reduction in GDP growth. Table 1 shows that, after three quarters of positive (though mild) increment, the GDP decreased by -0.3%, also implying a growth of 0.3% on a yearly basis. In particular, unlike the average euro-area performance, Italy observed a reduction in the domestic demand, partially mitigated by foreign trade. In fact, total imports observed a reduction of 1.74%, which was not enough to cover the reduction in domestic demand.

Table 1. Contribution to GDP growth in 2019

	2019Q1	2019Q2	2019Q3	2019Q4
GDP growth[a]	0.23%	0.11%	0.06%	-0.30%
National Consumption	-0.10%	0.00%	0.23%	-0.19%
Households Consumption	-0.07%	0.01%	0.32%	-0.21%
Government spending	-0.18%	0.00%	-0.07%	-0.11%
Gross fixed investments	1.99%	-0.15%	0.00%	-0.14%
Total imports	-2.68%	0.70%	1.05%	-1.74%
Total Exports	-0.48%	0.76%	-0.24%	0.33%

[a] growth rates are expressed as a percentage change with the previous period. The growth rate of GDP refers to chain-lined volumes adjusted for seasonal and calendar effects.
Source: Istat.

[6] ECB Economic Bulletin 2020, 2.

Although the fourth quarter of 2019 was not positive, forecasts for the next three years were more encouraging. In particular, in January 2020, the GDP growth projections[7] were 0.5% in 2020, 0.9% in 2021 and 1.1% in 2022. Those forecasts were mainly due to an expected support from the domestic demand and from an expected recover in the world trade. Investments were expected to rise, although with lower rates than in previous years: on one hand, low interest rates and favourable lending conditions were supposed to increase investments; on the other hand, uncertainty on trade policies were supposed to reduce firms' incentive to invest.

In sum, even though the Italian economy registered a stop in the last months of 2019, it was expected to recover and gradually strengthen in the next three years.

Impact of the emergency on the whole economy

Table 2 shows projections for the output growth and world-trade volumes growth by the International Monetary Fund (IMF) as published in the World Economic Outlook of April 2020. The projections reveal a 3% drop in world GDP, heavily unbalanced towards advanced economies that will not be recovered by 2021. According to those forecasts, Italy will observe a contraction of 9.1% of its GDP in 2020, much higher than the average loss in the euro-area, while a recover in 2021, in which it is expected a GDP growth of 4.8%, in line with the euro-area. The contraction of 2020 is due to the result of the first two quarters, while in the second part of the year a small recovery is expected, if and only if there is a relax in the containment measures (already started at the beginning of May.

The firms started to face slowdowns since late February, when the two clusters in the North of Italy were discovered and containments measures started. In particular, a survey conducted by Confindustria between February and March 2020, i.e. at the beginning of the emergency[8], on nearly 4.3 thousand firms, highlighted that two thirds of the respondents claimed that the spread of COVID-19 had an impact on their activity, with regional and sectoral differences[9].

Survey signalled two main problems: input acquisition and the slowdown on the demand side. In particular, the 21.7% of firms reported both problems, while 5.7% just the first one, and 28.7% only the second one. A second wave of the survey (Confindustria, 2020b) was run in April, after the strict containment measures adopted at the end of March: results were much more shattering. Almost the totality of respondents reported an impact on their activity (97.2%), with almost half of them delineating bad scenarios, i.e. they cannot reach yearly objectives and/or they will need to restructure/downsize the firm (in the previous wave less than 15% reported those scenarios). After the closure of non-essential activities, more

7 Bank of Italy, Forecasts are based on data available at 13 January 2020.
8 Confindustria, *Risultati relativi all'indagine sugli effetti del COVID-19 per le imprese italiane*, 2020.
9 Sectoral differences are depicted in the next sub-section.

than 70% of the firms interviewed reported that they had to close or partially close their activity. Micro and Small firms are the ones suffering the most: with respect to normal activity. Other important problems that firms faced were the difficulty to find sanitary material and, more importantly, the shortage of financial liquidity.

Table 2. IMF economic projections on real GDP growth and world trade volumes

		Projections	
Output	**2019**	**2020**	**2021**
World output	2.9%	-3.0%	5.8%
USA	2.3%	-5.9%	4.7%
Euro-Area	1.2%	-7.5%	4.7%
Germany	0.6%	-7.0%	5.2%
France	1.3%	-7.2%	4.5%
Italy	0.3%	-9.1%	4.8%
Spain	2.0%	-8.0%	4.3%
UK	1.4%	-6.5%	4.0%
Advanced Economies	1.7%	-6.1%	4.5%
Emerging markets and developing economies	3.7%	-1.0%	6.0%
World trade volumes – Imports			
Advanced Economies	1.5%	11.5%	7.5%
Emerging markets and developing economies	-0.8%	-8.2%	9.1%
World trade volumes – Exports			
Advanced Economies	1.2%	12.8%	7.4%
Emerging markets and developing economies	0.8%	-9.6%	11.0%

Source: International Monetary Fund (2020). "World Economic Outlook, April 2020: The Great Lockdown".

The emergency had a strong impact on the organization of work. First of all, the closure of non-essential activities and the associated stop in the production resulted in a large reduction in working hours (quantified by the Confindustria survey in approximately -32.5% with respect to March 2019). In parallel, income support measures were adopted in order to strengthen social safety nets. Second, the use of the so-called smart-working, i.e. work from home, has been encouraged. Instead, for those jobs that cannot be performed outside the company, new health measures to prevent the spread of the virus have been adopted. Finally, events such as exhibitions, conferences and sporting events were prohibited.

The contraction in the production activity is not only a short-term problem. The return to pre-COVID-19 levels depends on how Italy will face the reduction in the domestic demand, in production, the connected loss of job and, more importantly on the stop of the spread of the pandemic. As highlighted by Bank of Italy[10], a return to growth depends on the success of economic policies to assess company bankruptcies, on the capacity of the economy to recover and how financial markets will be able to support such a recovery. From this perspective, Italy has already defined a number of measures to contrast the economic contraction: among all, income support for workers and households, measures to support firms' liquidity (mainly through the banking sector) and credit support for firms in the form of public guarantee for loans.

Sector differences

The economic impact of the spread of COVID-19 has not been (and will not be) homogeneous across sectors. The very first slowdown of economic activity is connected to the Italian sectors like tourism and the automotive industry, which have strong connections with that part of the world. In particular, tourism suffered from slowdowns since the very beginning of the emergency, when flight bans and constraints affected the flow of people between China and Italy. Other sectors, like automotive, textile and luxury goods had difficulties in both finding inputs for the production and selling their good to the Chinese market. It is clear that in the first part of the emergency, the sectors that suffered the most were those most relying on world trade (flows of goods) and travel (flows of people).

After the two clusters in the north of Italy were discovered, the pandemic has started to affect all sectors of the economy. Containment measures started to control flows of people and goods, up to the closures of all non-essential activities from the second part of March to early May. Sectoral projections on economic performance for years 2020–2021 were laid down by Cerved[11].

Data in Table 3 include only broad macro-sectors. Digging deeper in the analysis, the report shows that the most suffering sector will be Cinema and projections of Film, with a loss of 65% of sales in the soft scenario, followed by air transportation of passengers, airports management, tourism sector and restaurants. On the contrary, the best forecasted performances are associated to on-line commerce and firms which produce materials connected to the health emergency.

[10] Bank of Italy, Economic Bulletin 2020, Issue 2 (April, 17).

[11] https://know.cerved.com/imprese-mercati/limpatto-del-covid-19-sui-settori-il-cerved-industry-forecast-reloaded/ (access 13.03.2020).

Table 3. Sales growth projections in different scenarios

	Soft scenario[a]			Hard scenario[b]		
	2020/2019	**2021/2020**	**2021/2019**	**2020/2019**	**2021/2020**	**2021/2019**
Best performing macro-sectors						
Chemical and pharmaceutical	0.4%	5.7%	6.1%	-0.2%	7.3%	7.0%
Farms/ agricultural companies	-1.4%	2.2%	0.8%	-2.7%	2.6%	-0.2%
Electrical engineering and IT	-10.2%	11.7%	0.3%	-15.2%	18.3%	0.3%
Least performing macro-sectors						
Means of transport	-19.5%	14.8%	-7.6%	-27.9%	27.2%	-8.2%
Logistic	-24.0%	23.2%	-6.4%	-33.3	30.9%	-12.7%
Non-financial services	-15.6%	11.4%	-6.0%	-21.1	16.1%	-8.4%
Average	-12.7%	11.2%	-2.9%	-18.0%	16.6%	-4.3%

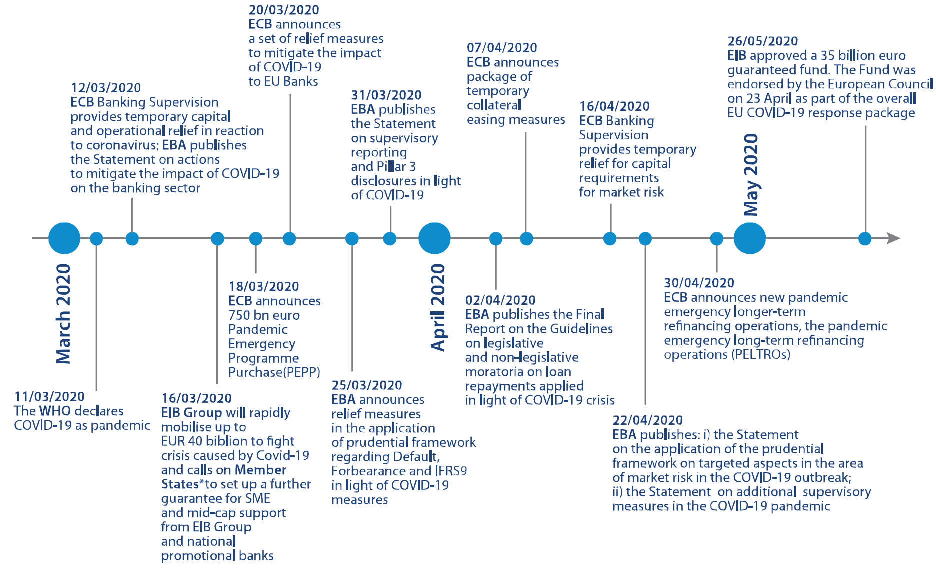
[a] the soft scenario does not consider future lockdowns;
[b] the hard scenario considers the emergency state to be persistent up to the end of 2020, with also the possibilities of future lockdowns.
Source: Cerved, "L'impatto del COVID-19 sui settori: il Cerved Industry Forecast", May 2020.

Considering the distribution of sectors within the whole Italian economy, where tourism makes an important part of GDP (5%) and of employment (6%), it is quite clear why the Italian economy will be one of the most severely hit within the Eurozone.

4. COVID-19 and the Italian banking sector

The current crisis does not see the banking system as the source of the problem; as a matter of fact, it is considered a part of the solution and it is expected to carry out the role of conductor of the support measures implemented by the European Central Bank (ECB) and the European and National Banking Authorities to deliver funding to the real economy (Figure 5). However, the ability of the Italian banking systems to deliver such task will depend on the health before the outbreak of the COVID-19 emergency.

Figure 5. Regulators and Supervisors measures to support the banking system



* European Member States set up guarantee schemes to support SME, Mid-cap and Large-cap companies

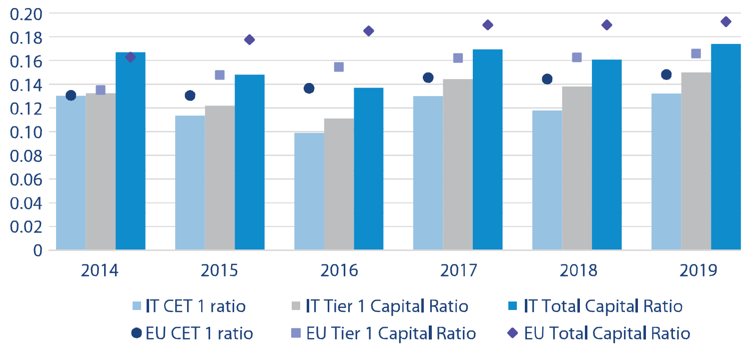
Source: Authors' elaboration.

In this view, Italian banks find themselves facing the crisis from a stronger position than the one they were in before the double-dip recession of 2008-13. The ratio of the highest loss-absorbing capital to risk-weighted assets rose from 7.1 per cent in 2007 to 13.9 in 2019[12]. The improvement is particularly important given that it was carried out without resorting to state recapitalizations: in the last ten years Italian banks have in fact built up capital buffers by raising funds from private investors. The decision not to distribute dividends in this year of emergency, in accordance with the recommendation of the supervisory authorities, will help to further improve the banking system's capital position, which is in any case still below the average value registered at EU level (Figure 6).

Similarly, the asset quality of Italian banks has improved enormously: their balance sheets were cleared of most non-performing loans, whose ratio over total loans have fallen by 10 per cent over the last five years (2015 – 16.69%; 2019 – 6,67%) while the coverage ratio has increased and it is now higher than the EU average (Figure 7). As before, no state interventions in the form of a national bad bank were put in place and banks disposed their non-performing assets through market sales and securitizations, thanks to a government-backed scheme (GACS, "*garanzia sulla cartolarizzazione delle sofferenze*") that helped by making securitization deals easier.

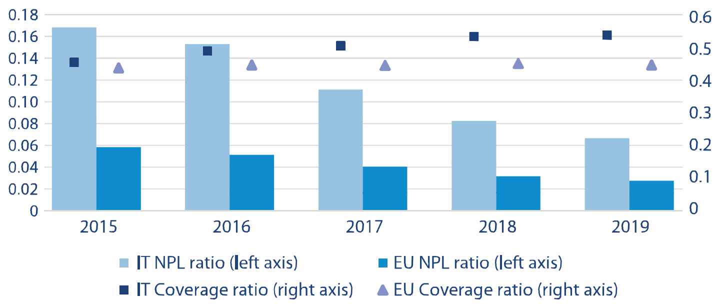
[12] Bank of Italy Governor's speech, May 2020.

Figure 6. Bank capitalization



Source: Authors' elaboration on EBA Risk Dash Board data.

Figure 7. Bank asset quality in Italy and EU

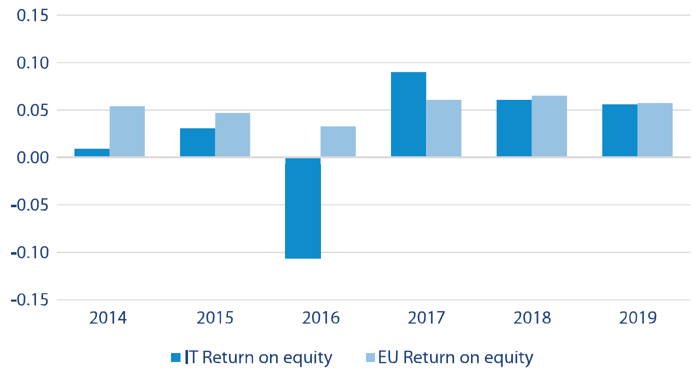


Source: Authors' elaboration on EBA Risk Dash Board data.

Thanks to this important bad asset disposal, profitability has improved from the very low levels registered in 2016 and now is in line with (low) EU averages (Figure 8). The revenue composition of Italian banks characterize the Italian banking system on average, i.e. banks with an asset mix balanced between interest bearing activities and activities that generates fees and commissions, mainly from trading activities with customers (Figure 9). Although the merits of revenue diversification are still a matter of debate in the academic literature[13], the evidence is that Italian banks benefited from being almost equally exposed to an environment of low interest rates and to market trends.

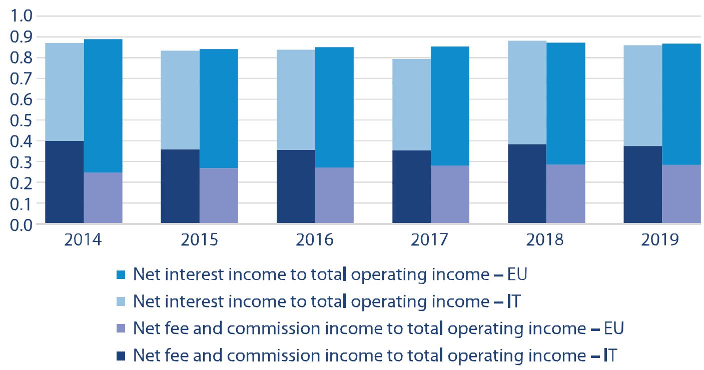
[13] C. Staikouras, G. Wood, & R. Denney, *Bank Non-Interest Income: A Source of Stability?*, Cass Business School Research Paper 2000.

Figure 8. The bank profitability in Italy and EU



Source: Authors' elaboration on EBA Risk Dash Board data.

Figure 9. The composition of bank revenues



Source: Authors' elaboration on EBA Risk Dash Board data.

So far, the impact of the pandemic recession created some difficulties in accessing the bond market, an issue widespread across banks in Europe, and in a moderate increase in loan loss provisions attributable to those banks that have incorporated the unfavorable economic outlook into the models used to compute expected losses[14]).

Notwithstanding the progress of the last few years, it is quite clear that the depth of the upcoming recession due to this unexpected sanitary emergency will inevitably affect banks' balance sheets in the medium term. The fall in productive output estimated by the Bank of Italy is expected to reach 9 per cent in 2020 in the baseline scenario, a level greater than that suffered at two different crises faced in the last 12 years (2008 and 2013). The financial crisis which started in 2007 and exploded as

[14] Bank of Italy Governor's speech, 2020.

a Sovereign debt crisis in 2012 in Europe, plus more recent defaults of Italian banks[15], are events which stressed the importance of high standards in credit risk management and in the quality of bank loan portfolios. It is nowadays widely recognized that a high level of non-performing loans (NPLs) affects bank lending capacity and lowers bank profitability, as well as its ability to raise new capital. Moreover, the high level of NPLs "*can pose risks of cross-border spill-overs in terms of the overall economy and financial system of the EU and alter market perceptions of the European banking sector as a whole*"[16]. NPLs reflect the credit quality of the loan portfolio of a bank and in aggregate terms the quality of the credit supply in a given country.

In the last years, an increasing number of researchers have studied the determinants and the evolution of NPLs and of the coverage rate (the loans reserve over non-performing loans), underlining the importance of both macroeconomic and bank specific variables in affecting the level of non-performing assets. Many authors underlined the close relationship between the economic cycle and the credit portfolio quality of banks[17]. In general, their results show that changes in macroeconomic conditions (such as a decrease in GDP) play a crucial role in the worsening of the quality of the loan portfolio, in the increase of loan loss provisions and in an upsurge of the level of NPL ratio.

In light of these evidences, the COVID-19 crisis is inevitably expected to negatively affect the credit quality of bank loan portfolio. The average effect will be different depending on the condition of each country. In fact, although during the last years throughout the Eurozone the NPL ratio decreased from 6.68% in 2015 to 2.75% in the last quarter of 2019, some differences across countries still exist (Figure 10).

The COVID-19 crisis has all the characteristics to imply a strong negative impact on bank asset quality. In fact, this crisis, that started as a health crisis and has spread as a global economic crisis, halted the economy activity of many countries. The lockdown has impacted several economic sectors and, in many countries, the unemployment rate is rapidly rising. The forecasts would be even worse should the activity restrictions extend to the third quarter of the year and should the governmental measures to support the real economy eventually fail.

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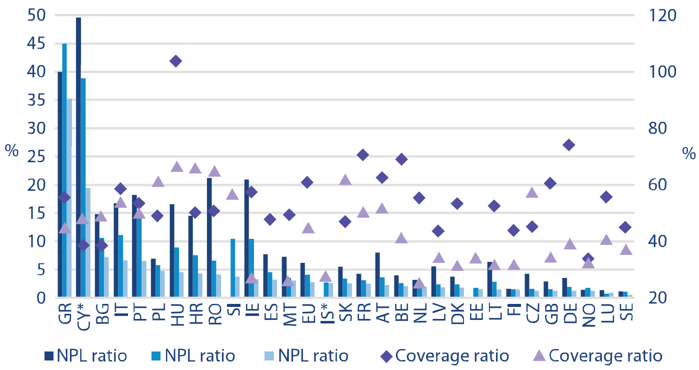
15 Banca Etruria, Carichieti, Cassa di Risparmio di Ferrara, Banca Marche, Banca popolare di Vicenza, Veneto Banca, Monte dei Paschi di Siena, Carige are the most recent cases of distressed Italian banks.

16 European Council, 2017.

17 J.A. Bikker, P.A.J. Metzemakers, *Bank provisioning behaviour and procyclicality*, Journal of International Financial Markets, Institutions and Money 2005, Vol. 15; A. Boudriga, N. Boulila, S. Jellouli*, Does bank supervision impact nonperforming loans: cross-country determinants using aggregate data?* MPRA Paper No. 18068/2009; M. Bofondi, T. Ropele, *Macroeconomic determinants of bad loans: evidence from Italian banks* Occasional Paper, Questioni di Economia e Finanza, Banca d'Italia, 2011; *Castro Macroeconomic determinants of the credit risk in the banking system: the case of the GIPSI*, Economic Modelling 2013, Vol. 31; R. Beck, P. Jakubik, A. Piloiu, *Key determinants of Non-performing loans: new evidence from a Global sample,* Open Economic Review 2015, Vol. 26; D. Cucinelli, M.L. Di Battista, M. Marchese, & L. Nieri, *Credit risk in European banks: The bright side of the internal ratings based approach*, Journal of Banking & Finance 2018, nr 93.

In this context, the idea of a European bad bank returns to the limelight. Already in 2017, Andrea Enria, at that time EBA Chairman and today the Chair of the ECB Supervisory Board, proposed the creation of a EU's bad bank to buy billions of euro of toxic loans. This proposal becomes even more reasonable in light of the possible consequences that this crisis may have on balance-sheet of European banks. In 2020 A. Enria returned to bring the proposal of a European bad bank to the attention of European Commission: a government backed centralized agency to deal with the expected upsurge of NPLs in the Eurozone.

Figure 10. The NPL ratio and Coverage ratio across European Union



Source: Authors' elaboration on EBA Risk Dash Board data. Note: NPL ratio % on the left, Coverage ratio % on the right.

5. Is the creation of a European bad bank the solution?

In the last 20 years, the number of banking crises that have affected the banking systems of both advanced and emerging economies has grown strongly. The resolution programs for these crises, adopted by individual countries, entailed one or more of the following options: regulatory forbearance, direct financial assistance, acquisition of NPLs, financial assistance to debtors, establishment of a bridge bank, bank liquidation or bank nationalization.

In the majority of the most recent crises (from Swedish crisis of early 2000 to the subprime crisis of 2007–2009), Governments addressed the problem of accumulating NPLs in the banking system through the establishment of an Asset Management Company (the so called "bad bank"), which is assigned the task of recovering the (bad) assets sold by ailing banks.

Ayadi[18] report several examples of European and non-European bad banks, specifically created to manage both the bank non-performing loans and the failed or likely to

[18] R. Ayadi, G. Ferri, & R.M. Lastra, *Systemic solutions to systemic crises. dealing with NPLs in the Eurozone*, European Economy 2017, No 1, pp. 173–198.

fail banks. Among the most important examples of centralized agency to dispose the assets of the failed institutions we can find (in the Eurozone and elsewhere):

- the Resolution Trust Corporation (RTC) in US, created in 1989 to manage the assets of the failed Savings and Loan associations;
- The *Fondo de reestructuración ordenada bancaria* (FROB), a government funded program adopted by the Spanish government in June 2009 to manage the restructuring and resolution of troubled credit institutions;
- The Troubled Asset Relief Program (TARP), a US government program to deal with the toxic assets that were burdening large US financial institutions after the burst of the subprime crisis;
- the Industrial Revitalization Corporation of Japan (IRCJ) set up in April 2003 to promote the restructuring of relatively large and troubled banks;
- the National Asset Management Agency (NAMA) set up in Ireland in December 2009 to manage bad assets of ailing Irish banks;
- FMS Wertmanagement set up in Germany in 2010 up to manage the impaired assets of the banking group Hypo Real Estate Holding AG;
- The Spanish Sareb, set up in 2012, to reduce the impact of the real estate crisis on Spanish banks' balance sheets.

However, in the case of EU bad banks, the regulatory context in which they were created was different from today and the Banking Recovery and resolution Directive (BRRD) was still in the making. Since 2016 this directive is in force and any further bad bank needs to take into account the BRRD resolution tools and requirements plus the Banking Union legislation. The bail-in is the most famous tool of BRRD which provides that no State aid can be granted before losses are charged to shareholders, subordinated bondholders up to plain vanilla bondholders and depositors. However, the positive experiences of "bad banking" cannot be ignored.

During the recent years, supervisors and regulators have published several guidelines and rules on how banks should manage their NPLs. The most important are: i) the new definition of default[19]; ii) the ECB guidelines[20] in which ECB stresses the importance of timely provisioning and write-off practices related to NPLs and the Addendum[21] in which ECB delaines the expectations when assessing a bank's levels of prudential provisions for NPLs; iii) the guidelines on management of non-performing and forborne exposures[22] with the aim of achieving a sustainable reduction of NPLs of banks to strengthen the resilience of their balance-sheets; iv) finally, the European Parliament[23] issues the calendar provisioning with the indications on the time within which a position classified as NPLs must be fully covered.

19 European Banking Authority, *Final Report on the Application of the definition of default under Article 178 of Regulation (EU) No 575/2013*. EBA/GL/2016/07, 29 September 2016.

20 European Central Bank, *Guidance to banks on non-performing loans*, 2017.

21 European Central Bank, *Addendum to the ECB guidance to banks on non-performing loans: prudential provisioning backstop for non-performing exposures*, 2018.

22 European Banking Authority, *Final Report. Guidelines on management of non-performing and forborne exposures*, EBA/GL/2018/06, 31 October 2018.

23 European Parliament, *Regulation (EU) 2019/630 of the European Parliament and of the Council of*

However, although it is widely recognized the importance of the supervisory pressure on banks to proactively manage their NPL, to improve the provisioning coverage and their management system, these measures are not sufficient to permanently manage NPLs. At least two other activities must be put in place:

- a reform of the legal systems and judiciary procedures that in some countries are too much slow and overburdened (as in Italy), to ensure faster and more efficiency recovery processes;
- a creation of a more efficient secondary market for impaired assets in order to reduce information asymmetry and inter-temporal pricing problems that can derive from the illiquidity of the market.

Historical examples demonstrated that state support is crucial to successfully deal with legacy assets carved out from banks under restructuring[24,25,26]. As suggested by Ayadi, introducing a European bad bank would provide a number of benefits, from a clearer view on the magnitude of the legacy assets problem in the Eurozone to a maximization of the recovery rate on such assets with positive spillover effects on the procyclicality in banking and the credit supply to the economy up to the promotion of transparency in a market segment – that of NPL disposal – that tends to suffer extreme opaqueness; and finally, the stimulation of accountability, since its profits (that are likely to be quite high based on past historical records of similar experiences throughout the world) would be channeled back to possibly helping sustain the Single Resolution Fund, thus avoiding relying on taxpayers' money, should a major shock occur.

Conclusions

The sanitary and economic crisis we are living has no precedents, at least in recent times. It is an asymmetric crisis: it hit EU countries, Italian regions and economic sectors differently.

The pandemic and the recession have opened up extremely uncertain scenarios that make it very difficult to outline future equilibriums. What is generally acknowledged is an overall uncertainty in the forecasts for at least the next two years.

There had been unprecedented interventions to ensure financial liquidity to families and firms and support the supply of credit, at the Italian and EU level. These interventions, in the domain of monetary policy, fiscal policy and regulatory

17 April 2019 amending Regulation (EU) No 575/2013 as regards minimum loss coverage for non-performing exposures, Official Journal of the European Union, 25 April 2019.

24 D. Cooke, & J. Foley, *The role of the asset management entity: an East Asian perspective*. *Rising to the Challenge in Asia*, A Study of Financial Markets 1999, Vol. 2, Special Issues.

25 P. Bongini, G. Ferri, A. Patarnello, *La crisi giapponese: scenari macroeconomici e ruolo del sistema bancario*, Credito popolare 2002, n. 4.

26 R. Ayadi, G. Ferri, & R.M. Lastra, *Systemic solutions to systemic crises. dealing with NPLs in the Eurozone*, European Economy 2017, 1, pp. 173–198.

revisions (relaxation), have been devised to help banks to play their central role in the smooth overcoming of the crisis phase. Italian banks arrived to this appointment well equipped with capital and liquidity and a credit portfolio with higher asset quality thanks to a strengthened process of valuation of credit risk and to a process of NPLs disposal made in recent years.

However, a new wave of bad loans in the next two years is highly expected. EU and among them Italian banks will most likely suffer material losses as a result of the COVID-19 outbreak and the confinement measures. Although the macroeconomic forecasts for the EU anticipate an extraordinary downturn, it is still very difficult to predict the pace of the economic recovery and too early to conclude on the mitigating impact of government support measures. As said, any quantification of losses is surrounded by significant uncertainty. The increase in non-performing loans will have to be dealt with in a timely manner, using all available instruments, including those for their restructuring and sale on the market, through a temporary EU-wide support. The debate on the creation of an EU-wide bad bank should start since now.

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