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Are Italian banks part of the crisis or its solution this time?

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1. The recent legacy

The shock due to the coronavirus pandemic is likely to cause serious difficulties for the Italian banking sector, which has already been affected severely by the impact that the long European crisis of 2011-13 had on Italy's productive and financial systems.

As is known (see Figure 1; see also Messori, 2011), in the second half of the 1990s and in the first decade of the new century, Italian banks recorded rates of increase in loans granted that were much higher than the growth rates of the national GDP. This was accompanied by a slackening of the criteria for selecting borrowers and an increase in the balance sheet gaps between loans and deposits ('funding gap'), bridged by huge issues of bank bonds.[3] In addition to reaching a higher weight on total bank liabilities than in other euro area (EA) member states (see Bank of Italy, various years; ECB, various years), in Italy these bonds manifested further peculiarities: they were massively allocated in the retail investors' portfolios (see Figure 2), in tiny and captive market segments largely illiquid, and at unjustifiably low interest rates (see Grasso et al., 2010).[4]

The result of the excess credit granted was that, when the international financial crisis turned into a 'real' crisis (2008-09) and fueled the macroeconomic imbalances (2010-11) then at the base of the second

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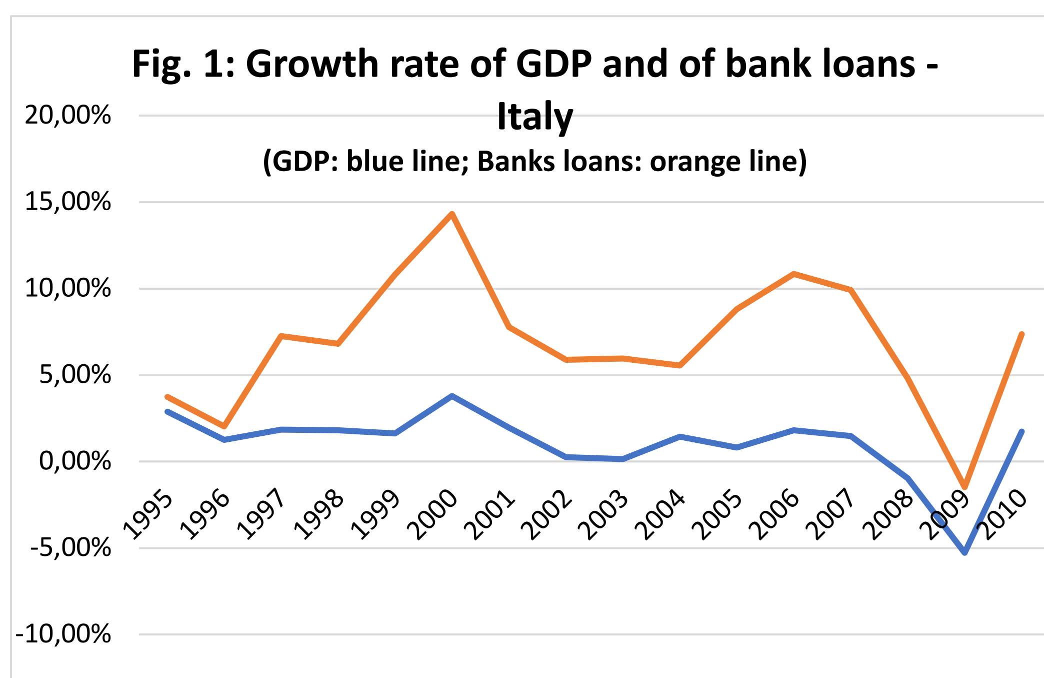
[3] Schivardi *et al.* (2017) and Bugamelli *et al.* (2018) carry out empirical exercises that do not confirm the thesis of an inefficient allocation of credit in Italy in the years indicated. The descriptive and unsystematic evidence offered by the balance sheets of many mutual banks (*banche popolari*) and former savings banks between 1999 and 2006 suggests a different picture. Not being at the center of the analysis, the possible link between the selection of borrowers and the allocation of credit is not further explored herein. It would actually be useful to resume the discussion on this issue. A related issue would be the analysis of the possible impact exerted on banks' credit allocation by the organizational inefficiencies that big and small Italian banking groups experienced in the 1990s and in the first decade of the current century due to the dominant role played by former banking foundations in their ownership structure and in their governance (see for example: Messori 2002).

[4] The term "unjustified" is used because the rates on various structured and illiquid bank bonds were not higher than those on government bonds with the same duration. Note that, in those years, government bonds were considered almost risk-free and were already exchanged in very liquid markets. In addition, interest rates on the same bank bond often underwent a significant increase when the purchaser was a professional investor instead of a retail investor.

EA recession (2011-13), the insolvency rates of Italian non-financial firms showed a surge not attributable only to the heavy Italian economic recession. As the trends in Non-Performing Loans (NPL) compared to total bank loans in Italy (see Figure 3) show, from 2011-12 the relative curve had an exponential growth that reached its peak around the end of 2015. It should be noted that, also in 2011-12, the incidence of NPLs in Italy was much higher than that of the Spanish banking sector.[5] The excess of bank bonds issued in Italy instead made the liability side of Italian bank balance sheets vulnerable to the evolution of European regulation. The second pillar of the Banking Union implies that public interest banks on the verge of bankruptcy involve in their resolution or liquidation processes also the private holders - first - of subordinated bonds ('burden sharing': since early 2015) and - then - of all unsecured bonds ('bail-in': since early 2016).[6] Thus, the implementation of the Banking Union increased the risk also of the previous stock of bank bonds in the hands of retail investors and withered low-cost banking funding.

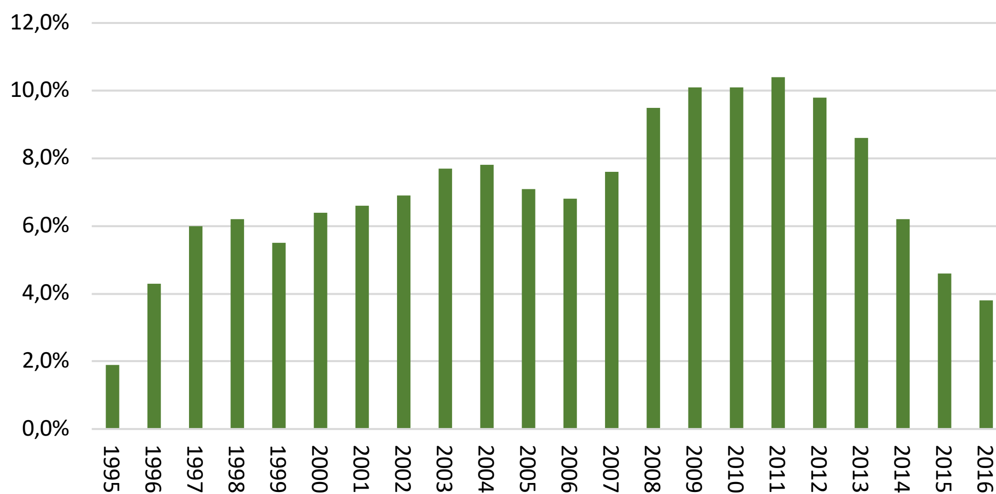


Source: Euro Area Statistics: Italy

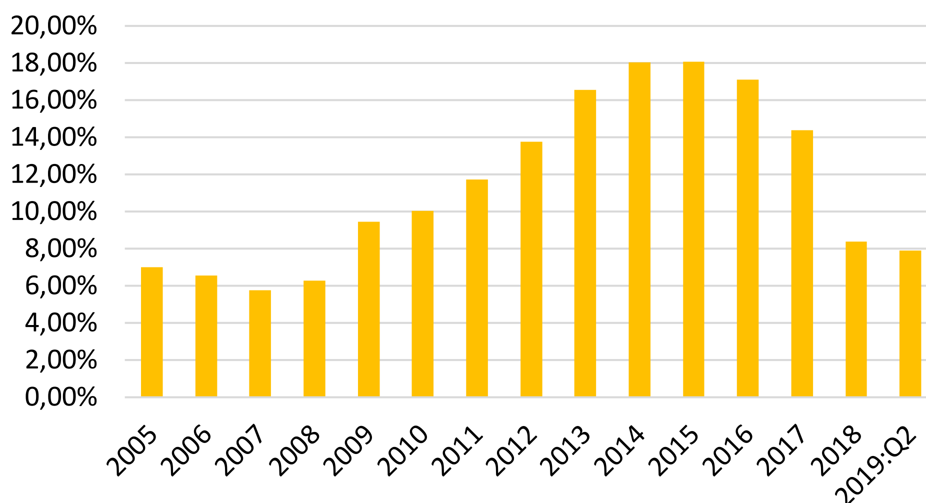
[5] In this regard, it should be remembered that, using the agreement reached by the European Council and the Eurosummit of June 2012, in the summer of that same year the Spanish government decided to refinance and recapitalize its banking sector through the new form of 'light' European aid program financed by the temporary EFSF mechanism (which later merged into the European Stability Mechanism: ESM). After signing a 'Memorandum of Understanding', the Spanish government was thus able to allocate approximately 40 billion euro, provided by the EFSF, to mainly fund medium and small-medium-sized national banks, which consequently strengthened their activity. The Italian government decided not to resort to this European aid program because it would have made the already abnormal Italian government debt even higher. As we will see, this choice had a negative impact on Italy's subsequent banking events.

[6] The introduction of bail-in in the management of banking crises actually dates back to the spring of 2013 with the launch of the European aid program carried out by the ESM for Cyprus. A few months later (June 2013), the Council of the European Union approved the BRRD, which reformulated two directives from 2010 and 2012 that were never passed and which provided for the cases of application of burden sharing and bail-in (for public interest banks); in addition (end of July of the same year), the European Commission issued a Communication which took for granted the adoption of burden sharing in the EA banking crises. The Court of Justice of the European Union legitimized this point (see C-526/14; see also Tosato 2016), stating that burden sharing was lawful and retroactively enforceable even if not compulsory. As also shown in Figure 2 above, these repeated European signals did not push Italian banks to drastically decrease the issue of bonds (including subordinated bonds). A truly significant fall occurred only from the end of 2013 onwards.

The situation in which Italian banks found themselves during the European crisis (2011-13), following the choices they made during the previous fifteen years, produced at least two consequences: sharp increases in their (perceived and actual) riskiness and a drop in their profitability (see Figure 4).[7]



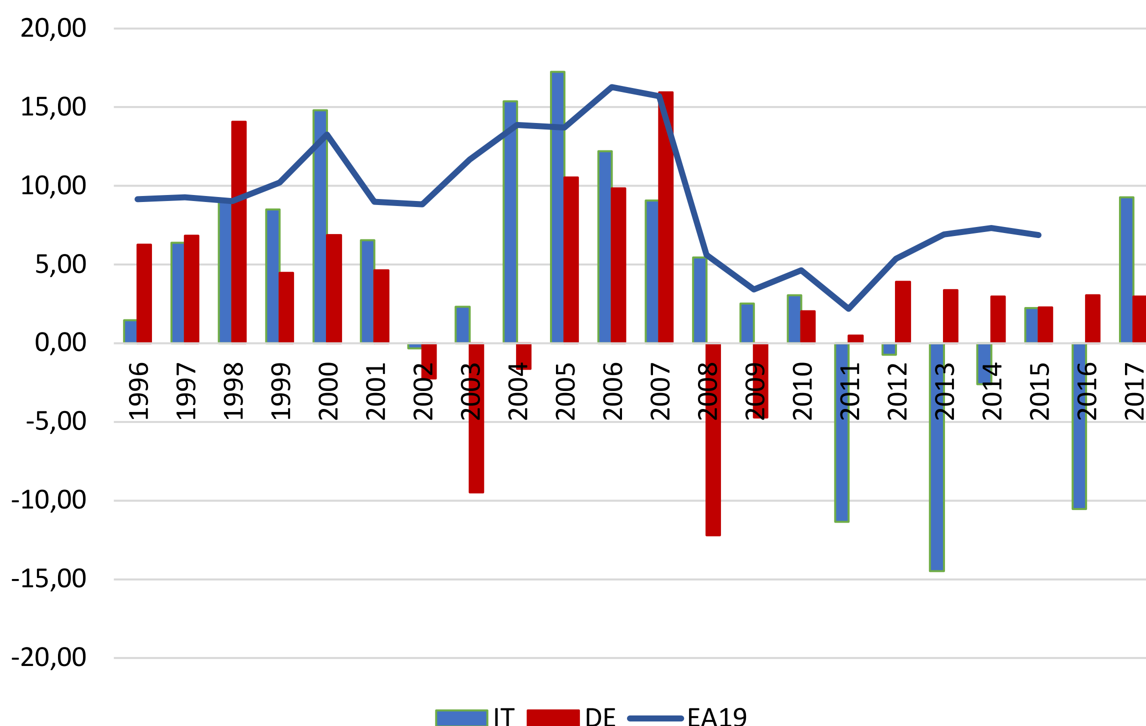
Source: Bank of Italy



Source: European Banking Authority Reports

[7] A comparison was made with the German banking sector because, leaving aside the cases of the countries under the traditional European aid program, it was the sector that - together with the Italian one - recorded the worst performances in the EA.

Note that the second consequence occurred despite the positive contribution to bank profits provided by low-cost re-financing of the European Central Bank (ECB), and by the related 'carry trade' on national government bonds which was then strengthened by the announcement of the complete quantitative easing program (winter 2014), by its approval (January 2015) and by its implementation (from March 2015). The fact is that the increased risk and low profitability negatively affected the stock or market values of Italian banks and their capitalization rates, which, although adequate to meet European capital requirements, were already below the average of the EA banking sectors before the crises. Thus, the 'Comprehensive Assessment' of the ECB and of the European Banking Authority (EBA) (October 2014) highlighted the systemic crisis risks threatening the Italian banking sector. This crisis was then actually triggered by the failure of four small or small-medium banks in Central Italy (November 2015), whose amount of deposits was just around 1% of the national total; and it reached its peak with the events that led to the precautionary recapitalization of MontePaschi di Siena by the Italian State and to the forced administrative liquidation of two major banks from the Veneto Region based on national procedures (summer 2017). Due to the large presence of small retail investors among the holders of various forms of bonds or - even – equities of the banks involved, these events had a vast social impact.



Source: Bank Scope

2. The fragilities before the pandemic

After limiting the negative drift of MontePaschi di Siena through the State acquisition of the absolute majority of its shares and after absorbing the bankruptcy of the two banks from the Veneto Region through massive public aid and the intervention of a major national banking group (Intesa-San Paolo), the Italian banking sector seemed to have surmounted the peak of its crisis despite a succession of problematic cases (various former savings banks and mutual banks, including Carige and Popolare di Bari). Since 2017, although achieving results below the EA average, the Italian banking sector had in fact recovered its positive profit margins (see again Figure 4). Furthermore, at the end of 2019, all Italian banks and especially the two major banking groups (Intesa-San Paolo and Unicredit) had liquidated more than half of their NPLs compared to the peak reached at the end of 2015, and had strengthened their capitalization rates (see Figure 3; see also Bank of Italy 2020, pp. 33-6). It is true that before the pandemic shock, in the Italian banking sector average, profitability rates remained below those in the EA average, the incidence of NPLs on total loans remained above that of the EA average and the trend in the 'unlikely to pay' loans (UTP) was not reassuring because it amounted to almost 50% of total problem loans. Yet, thanks to the progress made, the stability of the Italian banking sector seemed to be a shared fact. However, such a conclusion must be made with caution in light of the negative interaction between the residual fragility characterizing many Italian banking groups at the end of 2019 and the pandemic's economic-financial impact.

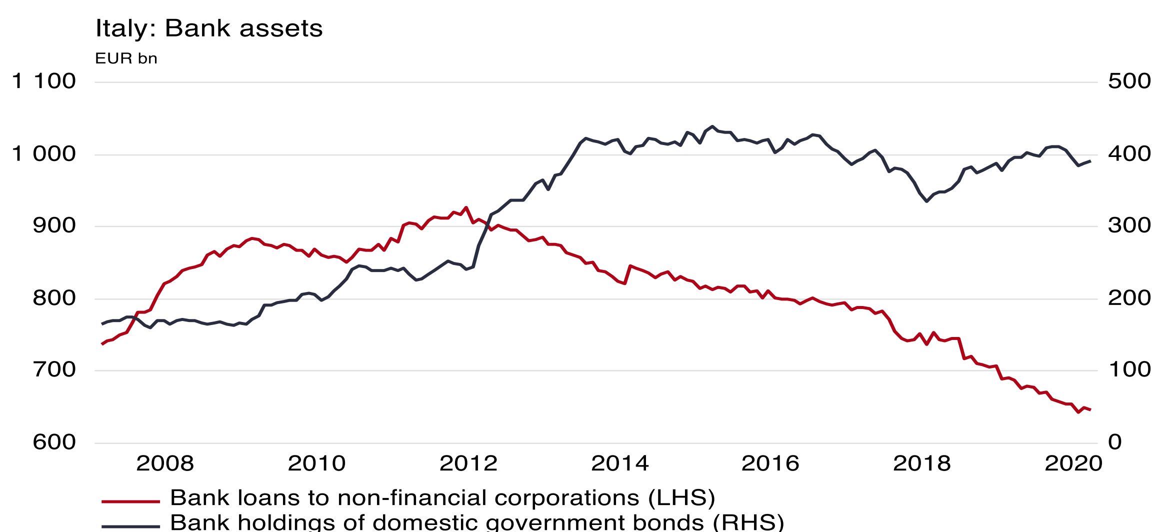
In this regard, it is important to qualify two quantitative aspects examined in the previous section. First, in the most recent years, the recoveries in the average profitability of the Italian banking sector have been concentrated in the two largest banking groups and in some small and medium-small banks; unfortunately, various medium banking groups and certain small banks still have very low profit margins.[8] Second, as also shown in Figure 5, the Italian banking sector continues to hold an excessive amount of national government bonds. In particular, after reducing this amount in the phase of overcoming the peak of systemic difficulties, since the beginning of 2019 Italian banks have again focused on Italian government bonds. In addition to creating a 'doom loop' that increases the joint probability of a sovereign debt crisis and a banking crisis, in Italy the banks' choice to increase their holdings of these bonds was related to the reduction of loans to the "real" economy.[9]

[8] The statement does not conflict with empirical evidence, according to which in several years (for instance, in 2019) the profitability of so-called significant banks has been lower than that of less significant banks. According to European supervisory rules, many medium-size Italian banks are classified as significant. It should also be noted that, in recent years, one of the two major banking groups has faced serious difficulties.

[9] The opposite trend between bank loans to non-financial firms and bank holdings of national government bonds is also important for underlining that the criticisms of the doom-loop cogency do not grasp the complexity of the problem (see, for example, Nielsen 2016). It is true that a country's banking sector, hit by a sovereign debt crisis, would suffer a serious shock even if it did not hold an excessive amount of that country's debt bonds; it is also true that a significant downsizing of that same stock would tend, on the contrary, to trigger or aggravate the crisis. However, if the extreme case of a systemic 'bankruptcy' is excluded, the crisis could have a differentiated impact on various banks depending on their exposure to that government bond. Furthermore, the inverse correlation examined here shows that the doom loop has pro-cyclical effects. The exposure to sovereign bonds tends, in fact, to increase and the supply of credit to decrease precisely in the phases in which the productive sector would need greater banking support.

This inverse correlation, which emerged between the end of 2011 and 2016 and which then resumed from the beginning of 2019, reveals the obsolescence of the prevalent business model of Italian banks. At least until the outbreak of the pandemic, especially medium and medium-small-sized banking groups and small banks did not offer borrowers a range of financial services (traditional loans included) aimed at supporting their potential expansion, but rather tended to defend bank profit margins by exploiting non-conventional ECB monetary policy and the related carry-trade opportunities. In fact, on the asset side, the business model of most Italian banks focused on limited and selective loans to firms located in the reference markets of each specific bank, on slightly more generous loans to households, on the distribution to retail investors of basic financial services produced by external 'factories', and on a large holding of national government bonds and deposits at the ECB; on the liability side, this same business model adapted passively to households increasing 'flight to liquidity', thus accentuating the weight of more traditional funding (deposits), and drew on ECB re-financing.

Fig. 5: The correlation among bank assets components



Source: Euro Area Statistics: Italy; Bank of Italy.

This business model has maximized the vulnerability of Italian banks, especially the small and medium-sized ones, both with respect to the very low - if not negative - interest rates that have characterized the EA for several years (since the summer of 2014) and with respect to the fall in net revenues deriving from the mere distribution of financial products. On the other hand, it maximized the impact of the high cost of ECB reserves on Italian banks.[10] In short, the business model of Italian banks was unable to cope with the compression of unit net interests and, with the exception of the carry trade on national government bonds and some initiatives by larger banks, to offset it through a significant increase in the other components of banking income.

[10] Note that the cost of these reserves is also the effect of excess savings (compared to investments) and excess bank deposits.

To avoid these consequences, it would have been useless to dismiss the traditional banking model centered on corporate and retail loans, since this model has an essential role in financing specifically the small and medium-size non-financial firms. Conversely, each of the small and medium-sized Italian banks would have had to reorganize itself to acquire larger shares of - at least – the national loans market so as to compensate the fall in unit net interests by means of a 'volume effect' strengthened by economies of scale. However, this possibility was precluded precisely by the inability of these banks to overcome their limited size. Furthermore, the moderate capitalization of these banks and the low profitability of a significant part of them impeded the overcoming or mitigation of the excessive fragmentation of the Italian banking market and of the lack of a corresponding European single market through the implementation of national or transnational merging processes. As already mentioned, in principle, small and medium-sized Italian banks would have had another chance to compensate for the fall in unit net interests: by increasing their revenues from financial services. To successfully pursue such an alternative without an excessive holding of national government bonds, each of them would have had to internalize the 'factories' of financial assets in its business model; however, the efficient management of these 'factories' was incompatible precisely with the overly small size. Therefore, small and medium-sized Italian banks remained trapped in a vicious circle and ended up concentrating their efforts on a compression of costs that was, in any case, insufficient to guarantee adequate profit margins, especially for medium-sized groups.

Before the outbreak of the pandemic shock, only one large banking group in Italy pursued the traditional business model effectively and with high profitability. At the beginning of 2020, this group had, in fact, very high shares in the loans markets of the most advanced areas of the country; and, in order to further strengthen its pre-eminent position, it has launched the process for the acquisition of one of the most important medium-sized Italian banks. In addition, and above all, it focused on the production and supply of services in the insurance sector and of asset management funds. The other major Italian banking group pursued an opposite strategy. Despite having an adequate size for expanding and strengthening its numerous and profitable financial 'factories', it proceeded with their complete disposal and focused on a drastic compression of costs and on an equally drastic containment of its budgetary risks. The process affected all the geographical areas of the group, which has a strong position in many European countries; however, this process was particularly intense in Italy, which is why the banking activities' center of gravity moved abroad. At least in the short term, this strategy has produced significant profit margins.

The picture described therefore confirms that the Italian banking sector as a whole has tried to recover short-term profitability through two initiatives: the increase in its already abnormal holding of national government bonds and the reduction of its costs. The first initiative was examined above. It was a decisive factor in limiting losses or in supporting bank profits from the end of 2014 to 2019. During this period, Italian banks were able to refinance with the ECB at rates that in the beginning were close to zero and then negative, and they profited from positive interest rates on medium/long-term national government bonds. In doing so, however, these banks exposed themselves to the risks of instability in the Italian government balance sheet and strengthened the doom loop between the potential Italian sovereign debt crisis and the potential banking insolvency crisis; moreover, they practiced a sort of

'crowding out' with respect to corporate and retail financing and thus created negative externalities for the 'real' economy. With regard to the second initiative, empirical evidence shows that it was an apparent success: today the cost/income ratio of Italian banks is on average in line with European best practice. However, the compression of costs entailed the reduction of human resources with higher training and skills and the reduction of investments for digital adaptation and reorganization. Italian banks thus deprived themselves of the fundamental tools necessary to modify their obsolete business models.

The conclusion is that, when the pandemic shock hit the national economy and began to threaten the international economy at the end of February 2020, the Italian banking sector had overcome the peak of its previous crisis but had not yet completed the necessary adjustments to adapt to the new financial structures or - even worse - had moved in ineffective directions for long-term solutions. Therefore, banks were undermined by at least three interconnected fragilities. First, there were too many of them in Italy: apart from the two largest groups, the remaining banks had an inadequate size and competed on market segments that were too small and with too narrow margins. Secondly, Italian banks were still very vulnerable to the problem of NPLs and UTP loans; therefore, they tended to react to past credit excesses by concentrating their supply of financing in favor of high liquid firms rather than firms that really needed bank loans. Finally, and as a consequence of the first two weaknesses, on average the Italian banking sector had business models with inadequate profitability,[11] despite their excessive - and, in the short term, profitable - holding of national government bonds. As a result, especially the small and medium-sized banks were unable to use their own resources or to implement sufficient market re-capitalizations to carry out the necessary consolidation processes and the related processes for expanding their market shares.

The two largest Italian banking groups had overcome the first and third fragility. However, they suffered the negative impacts of the excessive number of suppliers and the related segmentation of the national loans market in various local markets. Furthermore, the pursuit of short-term profitability had prevented the achievement of efficient medium-long term business models. More specifically, the group with the most articulated offer of financial services had an excessive dependence on the national market and therefore was too exposed to the Italian macroeconomic evolution and to the decreasing degree of confidence born by the wealth holders in the future of the country. The group with the largest European presence had a defensive business model because it was too concentrated on risk reduction in traditional activities and on cost compression as the dominant short-term profitability tool. Having uncertain medium-long term strategies, it became ideal prey for acquisitions by international competitors.

[11] Although in different forms and measures among the banking sectors of the various member states, the inadequacy of the bank business models and the associated low profitability concern the entire EA. In this regard, the comparison proposed by Bini Smaghi (2019) of the European and US banking sectors is emblematic.

3. Banks at the time of the pandemic

The consequences of the pandemic shock will likely worsen the fragility of the Italian banking sector. Raising the average risk of borrowing firms and households, they will in fact lead to increases in the expected amount of NPLs and to further burdens on the already problematic situation of UTP loans. Given that there will be a drop in GDP of just under 10 percentage points in 2020, Bank of Italy (2020)'s estimates imply that the problem loans in the Italian banking sector will record an annual growth of more than 2 percentage points of all loans. Furthermore, at least for the 2020-21 period, there will be a sharp decrease in net interest margins and an even more pronounced drop in the other components of net banking income. In the absence of corrective measures, all this would lead to a reduction in bank capital ratios and to a drop in banking profitability, which would be especially heavy for medium and medium-small Italian banks. Given that low and decreasing profitability increases the difficulties of recapitalization on the market, these banks would tend to react by reducing the riskiness of their assets; and, given the increase in the riskiness of borrowers and the traditional business model, any attempt to reduce the riskiness of the assets would result in a fall in the supply of loans. Bank deleveraging would thus trigger a vicious cycle as the credit restriction would worsen borrowers' future insolvencies and the consequent losses in the sector.

This trend is reinforced by the de-risking choices made for some time by one of the two major Italian banking groups (see section 2) and confirmed by the recent decision to make additional provisions for 900 million euro. The other major Italian banking group's focus on the domestic market cannot offset the sector's inertia towards a credit crunch. As is also shown by the fall in the market prices of financial equities, it follows that the Italian banking sector will be part of the new crisis rather than part of its solution.

If banking behavior became an aggravating factor for Italy's crisis, there would be particularly worrying macroeconomic effects. Compared to the main competing area (the United States), the EA is characterized by specific forms of bank-centrism which have limited the weight of the equity and corporate bond markets as firms' financing instruments. Note that, even in recent years, this weight has been between four and five times lower than that in the United States (see Messori 2019). Moreover, among the major member states of the EA, Italy has characterized itself as the country with the lowest incidence of non-banking segments in the national financial market (see Messori 2018). Under normal conditions, the majority of Italian firms which are limited by their small size receive their liquidity from self-financing or bank credit. The pandemic shock is, however, wiping out the profits and liquidity of most companies. Consequently, even if the block in the productive activities is now weakening the aggregate demand for financial services, the demand for bank loans by the Italian productive sector could become substantial in the unlocking and economic recovery phase (see section 4).[12] In light of the above, the risk is that this latter demand will remain largely unsatisfied. The conclusion is therefore that, in order to stem - in the short term - the collapse of the Italian economy and to relaunch - in the medium

[12] Indirect evidence of this is that the month of March marked a spike in the demand for bank loans in the EA.

term - the recovery of Italy's businesses, adequate banking support to the 'real' economy will be needed; such support would, however, be incompatible with a banking sector that is part of the crisis.

The initiatives approved by the ECB in March and April 2000 are of crucial importance for getting out of this trap.

The first program (PE-LTRO) composed of seven operations to be launched between May and December 2020 and to be closed by September 2021, renews the LTRO expired in March 2020 and is characterized by fixed-rate refinancing supplies for an amount only limited by the corresponding demands from banks. Each of these ECB loans, whose maturity is between sixteen and eight months (i.e. in September 2021 for the first loans and in July 2021 for the last), has an interest rate equal to the average interest rate on the ECB's main refinancing operations (today equal to 0%) coinciding with the duration of the specific loan, decreased by 25 basis points; therefore, the first operation of the PE-LTRO program will result in a negative interest rate of -0.25%.

The second program, which will be implemented from June 2020 to June 2021 and which provides for three-year refinancing, represents a strengthening of the T-LTROIII decided between March and June 2019 and launched in September of the same year.[13] It offers refinancing for a maximum amount equal to 50% of the eligible loan stock accounted for in the balance sheet of each bank at the end of February 2019, at different conditions for three different bank types. The most virtuous banks, that is, those that will be able to meet their reference threshold (benchmark plus a possible add-on, now set at 0) relating to the net loans granted to the productive sector in the period between the beginning of March 2020 and the end of March 2021,[14] get an interest rate equal to the average rate on the excess of bank reserves at the ECB (today equal to -0.50%) during that period, decreased by 50 basis points. Furthermore, their current interest rate of -1% is also the maximum rate for their refinancing between the end of June 2020 and the end of June 2021; instead, for the T-LTROIII refinancing that precedes or follows the period just indicated the interest rates are equal to the average rates on the excess of bank reserves at the ECB in force for the duration of this refinancing. Median virtuous banks, which will not be able to meet their reference threshold between the beginning of March 2020 and the end of March 2021, but which will meet the benchmark increased by 1.15% in the longer April 1, 2019 - March 31, 2021 period, obtain

[13] In the original formulation (June 2019), the refinancing of the T-LTROIII had a two-year duration. This refinancing was extended to a three-year duration in September 2019.

[14] In the original formulation (June 2019), the benchmark of each bank was defined by referring to the amount of eligible loans disbursed in previous periods. To belong to the most virtuous group and thus to obtain the best refinancing conditions (equal, at that date, to 10 basis points above the average rate on bank reserves at the ECB in the period), a bank had to fulfill one of the following conditions: the reproduction of the benchmark, if the bank in question had achieved a positive rate of change in its net loans in the April 1, 2018 - March 31, 2019 period; or the benchmark plus an add-on of at least 2.5% of this benchmark on March 31, 2021 (and, from September 2019, on March 31, 2022: see note 12), if the bank in question had recorded zero rates of change in its net loans in the April 1, 2018 - March 31, 2019 period. The banks belonging to this second group and unable to meet that reference threshold (benchmark + 2.5%) are defined herein as median virtuous banks. They had to pay increasing interest rates, compared to those paid by the most virtuous banks, according to the size of their negative gap. Finally, the third type of banks (the less virtuous ones), with negative rates of change in their net loans in the said period, obtained interest rates equal to 10 basis points above the average rate on the main ECB refinancing operations in force for the duration of these loans. In March 2020, the add-on on the benchmark was brought to 0 for the period from April 1, 2020 to end of March 2021. As just stated, the latter period was brought forward by one month in the ECB meeting of April 2020.

interest rates on refinancing equal to those in force on average in that period; in any case, for the end of June 2020 - end of June 2021 period, the rate on refinancing of this second type of banks is not higher than the average rate on the main refinancing operations of the ECB (today equal to 0%), coinciding with the duration of their loan, decreased by 50 basis points. Finally, the less virtuous banks obtain, in the same period, an interest rate (-0.50%) equal to the maximum rate to be paid by the second type of banks.

The incentives designed by the ECB to push EA banks to finance the economic system were simultaneously strengthened by the temporary easing of various prudential and accounting rules by both European regulatory and supervisory authorities (respectively, EBA and SSM), the Basel Committee, and the European Commission. Without any claim to exhaustiveness, it is enough to recall that - for the current year and for 2021 - EA banks are allowed to have a capitalization below the second pillar capital requirements (guidelines and reserves) and liquidity buffers; banks are also allowed to use as prudential capital the reserves aimed at hedging against risky but not insolvent credits; supervisory groups are encouraged to use flexibility in the annual supervisory checks on individual banks (SREP); a long-term assessment of loan adjustments is encouraged; the new and more severe accounting of losses (including expected losses) on problem loans is suspended, and the maturity for the absorption of these same losses is softened; the constraint on leverage has been eased; it has become clear that the borrowers' utilization of general moratoriums or public guarantees does not lead to the accounting of greater risks or to mechanical increases in unlikely to pay (UTP) loans. Furthermore, the European Commission has accepted the indication from the Basel Committee to postpone the adoption of the new and more binding capital standards for larger banks by 2023, and has anticipated the preferential treatment for loans to small and medium-sized firms in terms of capital coverage expected in mid-2021. Finally, the SSM has softened the requests for the provision of bail-in-able liabilities (the so-called MREL) aimed at facing bank resolution processes.[15]

It is believed that, thanks to the ECB's PE-LTRO and T-LTROIII programs, there may be an injection of more than three trillion euro into the economic system of the EA before the end of 2021; and the loosening of prudential and accounting rules promoted by the European Commission, EBA and SSM is expected to lead to additional liquidity of more than 500 billion euro. The problem is that these, albeit important, initiatives are temporary and are limited to the short-medium term. At most, according to the previous analysis, the T-LTROIII will incentivize the financing of the most virtuous banks in favor of the 'real' economy until March 2022; and the other interventions will finish at the end of 2021.[16] Conversely, the pandemic's effects on the equilibrium of the Italian banking sector that have been

[15] The SSM has, however, placed new constraints on the allocation of actual profits. In fact, it invited European banks not to distribute dividends and not to buy back their own shares at least until autumn 2020. In principle, these are wise decisions because they are aimed at strengthening bank capital. However, it should be considered that both constraints have a negative impact on the market price of listed banks and, therefore, are a further obstacle to market recapitalizations.

[16] It is reasonable to forecast that T-LTROIII will be followed by T-LTROIV. However, the ECB does not have any formal commitment to reproduce its ultra-expansionary policy over time and through the banking channels. Moreover, as suggested by some reactions to the recent initiative of the German Constitutional Court (May 5, 2020), there will possibly be growing pressure to gradually reduce the size of the ECB's balance sheet. This implies that the ECB's future refinancing policy will be characterized by strong uncertainty.

examined above and that affect - albeit with different intensity - also the banking sectors of the other EA countries tend to be long term. Therefore, as the "European Temporary Framework" itself suggests and as it was immediately noticed by Germany and France, EA banks are ready to use the generous refinancing of the T-LTROIII and PE-LTRO and to exploit the loosening of prudential and accounting rules to support firms' loans only if the member states are willing to absorb a large part of the possible defaults deriving from troubled borrowers in the long term. For the reasons mentioned above, this is even more true in the Italian case.

The decree law issued by the Italian government on April 8 (the so-called Liquidity Decree) provides - in principle - a satisfactory response to this problem, since it envisages public guarantees on bank loans potentially equal to 400 billion euro. As already mentioned in an article in the *Il Sole 24 Ore* newspaper written in collaboration with Franco Bassanini and Claudio De Vincenti (April 12, 2020), this decree strengthens guarantees on bank loans up to 800,000 euro and up to a borrower yearly income not exceeding 3.2 million euro through the Central Guarantee Fund (CGF), reaching 100% coverage - direct or indirect (that is, through the so-called Confidi – associations of guarantee providers); in addition, it authorizes lending without creditworthiness checks for the part of loans not exceeding 25,000 euro. Although through a somewhat cumbersome procedure, it then sets an ad hoc maximum threshold for interest rates on loans thus guaranteed. The Liquidity Decree also offers, through SACE,[17] public guarantees ranging between 70% and 90% on larger bank loans that do not fall within the management of the CGF. The granting of these latter guarantees requires, however, often complex procedures which can be distorted by the need to exempt lenders from excessive legal responsibilities and which can be delayed by inefficiencies concerning Italy's public administration and bank bureaucracy. In addition, it pushes banks to set excessive financial burdens. Finally, in the case of SACE but also in that of CGF, the rules do not protect borrowing firms from Italian banks' opportunistic behavior. The latter are not effectively prohibited from replacing pre-existing unsecured loans with new guaranteed loans.

The Liquidity Decree has been criticized because it does not earmark sufficient public funds to grant, even by means of a generous leverage effect, guarantees of 400 billion euro. However, the Italian government has undertaken to resolve the problem with the so-called Relaunch Decree by means of a significant provision. Furthermore, as outlined in the previous analysis, there is a number of significant short-term weaknesses in the Liquidity Decree's implementation. However, here the focus is on two medium-long term shortcomings of the Liquidity Decree that have hitherto been underestimated. First, given the constraints imposed by the "European Temporary Framework", public guarantees concern loans with a maximum duration of six years (or, with some expedients, eight years); however, if the previous description of the dynamics of the NPLs in the 2011-2016 period is correct (see section 1 above), the explosion of borrowers' defaults will mature in a longer time (around fifteen years) and Italian banks will subsequently be driven by very prudent choices in lending during the potential recovery phase (from 2022). Secondly, at least so far and despite the growing liquidity problems, the recourse of Italian

[17] SACE is an Italian company belonging to the "Cassa Depositi e Prestiti" (CDP) group. The Italian government holds the absolute majority of shares of CDP.

small and medium-sized firms to guaranteed loans has been much lower than expected; therefore, it is questionable whether the exit from the pandemic crisis does not require other forms of financing.

4. Possible solutions

These two medium-long term shortcomings are important for addressing a crucial policy problem: how is it possible to prevent the inclusion of the banking sector among the components of the current crisis from translating into a decisive negative factor that will hinder the recovery of the Italian economy? Apparently, both shortcomings become significant only if, thanks to appropriate simplifications and corrections, during 2020 and 2021 the Liquidity Decree will have been able to overcome its short-term weaknesses and thus incentivize Italian banks to supply an amount of loans sufficient to make a significant part of Italian small and medium-sized firms survive. In such a case, bank financing would have contributed to overcoming the pandemic peak and would have paved the way for the starting of Italy's economic recovery. In fact, as will be said shortly, the links between the effective disbursement of loans guaranteed in the short term and the two medium-long term shortcomings of the Liquidity Decree are more complex because they are conditioned by uncertainty and negative expectations.

The question raised by the first of the two medium-long term shortcomings of the Liquidity Decree is whether the Italian banking sector will be able to finance the innovative reorganization of the production processes, which will be essential ingredients for the recovery of the Italian economy and the European one after 2022. The regulatory, fiscal and economic framework will not be favorable. In the EA, banking supervisors and regulators will aim at reabsorbing the temporary derogations from the capital requirements and accounting rules introduced in 2020, as they will be under strong pressure to control outbreaks of financial instability. Furthermore, even without reversing the expansionary sign of its monetary policy, the ECB will be forced to limit the increases in liquidity introduced into the economic system to slow down the growth in the size of its balance sheet and not to exacerbate the institutional conflict between the European Court of Justice and the German Constitutional Court, which is creating difficulties for the German Central Bank as part of the European System of Central Banks (see also note 15, above). On the other hand, Italy's severe fiscal capacity constraints, resulting from the dramatic increase of its already abnormal government debt/GDP ratio, will limit those public investments and that public support for private investments which will instead be at the heart of the innovative economic recovery in competing countries. Therefore, in order to be part of the recovery processes, small and medium-sized Italian firms that will no longer be able to receive new loans with guarantees will have to request and obtain new and more substantial bank loans without guarantees and new financial services.

The previous analysis indicates that the Italian banking sector, unable to overcome its pre-existing underlying fragility during the crisis of 2020 and 2021 (see section 2) and deprived of refinancing at the significantly negative rates of the T-LTROIII program after March 2022, will not be able to meet the demands from Italy's productive sector from 2022 onwards. If, at the start of the recovery, they set the objective of compensating for the lack of public support for investments and satisfying the growing

demand for loans (at this point no longer guaranteed) from private firms, Italian banks would have to assume the task of selecting and generously financing borrowers with positive potential but weighed down by the dramatic recession that will have just ended. Moreover, they would have to increase their lending in an economic phase of extreme uncertainty and without a stable national economic policy framework. Thus, they would assume the risk of being called to manage a future surge in NPLs and UTP loans in their balance sheets between the late 2020s and the mid-2030s, when the temporary relaxation of regulatory and accounting rules and the effect of public guarantees on loans will have long since terminated.[18]

One of the two major Italian banking groups will probably try to take up this difficult challenge, compensating the growing risks of credit and financial activity with its adequate capitalization and with the persistently good profitability of its financial product 'factories'; however, it will record a growing vulnerability due to excessive concentration on the increasingly fragile national market. The other large Italian banking group could, in part, make up for this last problem thanks to its stronger presence in European markets. The strategy pursued to date, however, makes it difficult to conceive a U-turn leading to growing credit and financial risks for Italy's economic recovery. The remaining small and medium Italian banks will continue to be constrained by their modest capitalization and insufficient size, which will make it very difficult for them to modify their obsolete business and governance models and which will thus inhibit effective aggregation processes. Therefore, they will not be able to grant a greater and riskier amount of credit and to offer adequate financial services. The recently formed poles of cooperative credit banks, in addition to being already partly engaged in delicate rescue operations preceding the pandemic and made worse by the heavy economic recession, will remain absorbed for a long time by problems of reorganization and internal restructuring.

Although based on medium-term future forecasts, the previous considerations seem to have already been incorporated into the decision-making functions of the main Italian economic actors. The latter tend to believe, in fact, that the Italian government's economic policy strategies and Italy's consequent potential for the recovery phase are undermined by such high uncertainty that discourages any initiative. Adding to the short-term weaknesses of the Liquidity Decree, this explains the apparent paradox that negatively differentiates the Italian situation from that of other European countries (see also note 11 above) and that lies at the foundation of the Liquidity Decree's second medium-long term shortcoming examined above (see section 3): the limited demand for loans with State guarantee, to date carried out both by small firms for amounts not exceeding 25,000 or 800,000 euro and by medium-sized firms for larger amounts. Even if condemned to remain in a stalemate due to the ever heavier liquidity constraints, these firms prefer to rely on current public donations to minimize costs and protect the income of their employees rather than take the risk of weighing down their debt positions (even if

[18] This clarifies why the ventilated extension from six to ten years in the duration of loans covered by public guarantees could mitigate the problem without solving it. To solve the problem, the Italian government would have to illustrate the reasons that work in favor of a more substantial extension of this type of bank loans by referring to the past dynamics of the NPLs and UTP loans in the Italian banking sector. However, a significant extension in the duration of loans with public guarantees would also have the effect of strengthening the 'moral hazard' risk in banking behavior. To make its request credible, the Italian government must therefore elaborate more incisive systems for controlling opportunistic behaviors than those contained in the Liquidity Decree.

guaranteed by the State) and thus find themselves in irreversible conditions of weakness without renewed support from the national banking sector precisely at a time when the economic recovery and European and international competition will be restarting.[19]

These choices, made by a significant part of the Italian productive system, mark the impending arrival of yet another dangerous vicious circle in the Italian macroeconomic context. The worsening of the short-term stalemate, induced by excessive uncertainty about the medium-long term prospects, undermines the recovery capacity of the Italian productive sector and jeopardizes the country's future economic growth rates. As is well illustrated by the 2010-2014 period, a lower growth rate, however, makes the constraints of the Italian public balance sheet more binding, therefore weakening the space for possible public interventions in support of investments and firms. As a result, the growth outlook worsens further and relations between banks and non-financial firms also deteriorate.

If the Italian banking sector were less fragile than it is today, it could play an important role in preventing the arrival of such a vicious circle. Italian banks should undertake to stimulate loans covered by State guarantees and to fully use the stimuli offered by the ECB until the beginning of 2022 through the introduction of a large amount of liquidity in the banking channel. In performing this function, Italian banks should pursue long-term systemic benefits without taking advantage of regulatory stretch marks to obtain myopic short-term benefits (increases of financial burdens and replacement of previous unsecured loans with new loans covered by State guarantees). Furthermore, in the medium term, a less fragile Italian banking sector could play an active and positive role in providing financial support to firms with growth potential during the recovery phase of the Italian and European economy; that is, it would have the ability to strike a balance between effective borrower selection and the credit crunch risk. Even in such a more favorable situation, it would however be unrealistic to expect Italian banks to act as the sole pivot to address and resolve the structural weaknesses of the Italian economy and to push non-financial firms onto a path of growth. To this end, it is at least necessary to design complementary forms of business financing.

The analysis of the possible non-banking forms of financing for Italian firms must start from a point mentioned above (see section 3), the one relating to the organization of national financial markets and the wealth held by households. Among the major EA countries, Italy has the lowest weight of non-bank financial segments and one of the highest incidences of household financial wealth on GDP.[20] Together with the peculiar weakness of Italian institutional investors (pension funds and life insurance), this helps to explain why the country is also characterized by a very pronounced quality gap between the composition of household financial portfolios and the composition of non-bank financing potentially

[19] The recent Relaunch Decree, centered on a short-term and muddled response to the various needs of Italy's economic players, strengthens uncertainty about the future and endorses the 'wait and see' strategy.

[20] In section 3, it was emphasized that, in Italy, the corporate bond markets and the stock markets are even less important than in the other large EA countries. Let us add here that, in the Italian financial markets, the segment of non-banking loans to the productive sector is also underdeveloped. During the international financial crisis of 2007-09, there emerged an area of "shadow banking" that performed a large number of non-regulated activities including lending. Improvement in international regulation has settled the issue of non-banking lending, which does not belong to "shadow banking" anymore and involves institutional and professional investors. Despite some initiatives, in Italy this process is still at an early stage.

demanded by firms. A few data are sufficient to illustrate this point. Towards the end of 2019, the financial wealth of Italian households amounted to around 4,350 billion euro, if calculated as the total value of the gross financial assets held; if cleared of the debts of the same households, this financial wealth decreased to around 3,400 billion euro. Also towards the end of 2019, as much as 160 billion euro of the total value of these gross financial assets (that is, 3.7%) was held in cash and a remaining amount of more than 1,250 billion euro was held in the form of bank deposits (that is, almost 29%). This is equivalent to stating that around a third of the gross financial assets of Italian households (just under 1.5 trillion euro) was allocated in liquid form. Moreover, at the beginning of the pandemic crisis, the Italian banking sector held more than 2,710 billion euro in the form of deposits; and this amount has further increased in the last two months.

It would be sufficient to move a third of the liquid wealth held today by Italian households towards less liquid and riskier financial assets (equities and corporate bonds) in order to make available a very high flow of non-bank loans (about 500 billion euro) for the national productive sector. However, without the use of distorting and dangerous processes of "financial repression"[21] such a move would be impracticable; moreover, without forced and unconceivable constraints on the financial choices of small and medium-sized firms, the issues of corporate bonds and equities would not reach an amount high enough to revolutionize the capital and financial structure of productive activities.[22] It is therefore a matter of pursuing much less ambitious and more concrete objectives: to make attractive to Italian households a partial and gradual reallocation of their portfolios towards less liquid financial assets than cash and deposits but less risky than the direct holding of equities and corporate bonds; to avoid having small and medium-sized Italian firms pursue direct access to financial markets.

These results can be achieved only if one preliminary condition is met: Italian households must have the power to decide the allocation of their financial portfolios in a political-institutional setting which is not as uncertain as it is today. It would then be necessary to create funds which are managed by non-bank financial intermediaries (that is, by professional investors) and which can benefit from State support. Professional investors would have the task of selecting and deciding on the purchases of bond and equity issues by homogeneous groups of medium and small firms, which could thus diversify their financing sources without direct and expensive access to financial markets. The professional investors themselves should then finance these purchases by placing the bonds issued by their funds on the market.[23] State support would absorb part of the risks of the bonds offered by funds in the financial

[21] The expression "financial repression" indicates the introduction of - more or less explicit – forced constraints on the allocation of financial wealth. These constraints are hardly compatible with free capital movement within the European single market. In fact, in accordance with this indispensable principle, Italian households would avoid the national forced constraints by reallocating their financial wealth to other parts of the European market.

[22] Specifically, the very small and small Italian firms have a governance that does not provide for the separation between ownership and management. In order not to lose management control, many Italian entrepreneurs refuse to open the financial structure of their firms to the market. This helps to explain the inadequate size of a large part of Italian firms. In any case, it is a constraint that should not be neglected.

[23] For more details on the possible organization of the processes, see: Messori (2018) and (2019).

markets, thus making them attractive for the portfolios of Italian households.[24] These funds would take the form of public-private intermediaries and, if successful, would produce at least four positive effects: they would enrich the financing sources of Italian small and medium-sized firms during the delicate recovery phase after the pandemic recession; they would ease the pressure on the Italian banking sector and allow for its strengthening; they would open the capital and financial structure of that part of the Italian firms which, even if efficient, are unable to increase their size (size jumps) due to their difficulties in having direct access to the debt and stock markets; they would reduce the qualitative gap between the composition of the financial portfolios of Italian households and the financial needs of Italian firms.

5. Conclusions

The foregoing analysis implies that, to get out of the very serious economic recession of 2020 and begin a growth phase, the Italian productive system cannot limit itself to using the credit and financial services offered by the national banking sector.

As indeed happened before the pandemic shock, Italy's large and medium-large innovative companies, which had successfully inserted themselves in the old international value chains (which today should be renewed and simplified), will continue to use the financial services of international banking and non-banking groups to obtain more sophisticated equity and security services and insurance services to cover their export risks. Furthermore, based on their strategic choices, they will be able to turn directly to international markets to differentiate their financing sources. Even small and medium-sized Italian firms will not be able to overcome the block in economic activities and to become part of the European recovery processes by relying exclusively on financing from the Italian banking sector. They will also have to access market funding sources (stocks and bonds), even if indirectly, that is, through the mediation of public-private funds.

These considerations do not lead to the marginalization of the Italian banking sector. Even if there were a positive expansion in the non-banking sources of finance, Italian banks would continue to play a crucial role in lending to firms. In this case, they could preserve a predominant, even if no longer exclusive, role in an economy that will get back on track rather than be condemned to marginalization. However, to make positive contributions to the Italian economy rather than being part of the negative legacies of the crisis, the Italian banking sector must overcome the fragility that existed before the pandemic shock and that has now worsened.

In this regard, it is enough to refer to two points. First, the critical cases already developing at the end of 2019 and the new critical outbreaks which could emerge as a result of the recession should be addressed and resolved through market acquisition processes carried out by healthy banks. In the

[24] Although in different contexts, similar public-private initiatives were carried out by the Obama administration in the spring of 2009. They were one of the driving factors of the US economy's rapid exit from the 2007-09 crisis (see in this regard: Messori 2009, chapter 3).

absence of market acquisitions, it would be possible either to apply the European or national procedures for an orderly bank resolution, or to entrust the rescue of the banks in crisis to the direct intervention of the State. The latter possibility would exploit the temporary tolerance of the European institutions and would have to respect the severe fiscal constraints of the Italian public balance sheet. This set of solutions is more effective than resorting to the national Interbank Deposit Protection Fund. The latter should return to its original task of setting aside funds for depositor guarantees rather than acting as an informal clearinghouse for redistributing resources within the Italian banking sector.[25] Second, particularly small and medium-sized banks should innovate their business model, focusing their efforts on capital strengthening and related consolidation processes.

[25] Lacking market solutions, the best alternative would be recourse to a European or national equivalent of the Federal Deposit Insurance Corporation (FDIC), which plays different and distinct roles, including the possible restructuring of specific types of the US banks in difficulties. This possibility would require institutional changes; hence, it is here neglected.

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