Just in Time

COVID-19

Some Thoughts on Public-Guarantee Loans and Banks in Italy

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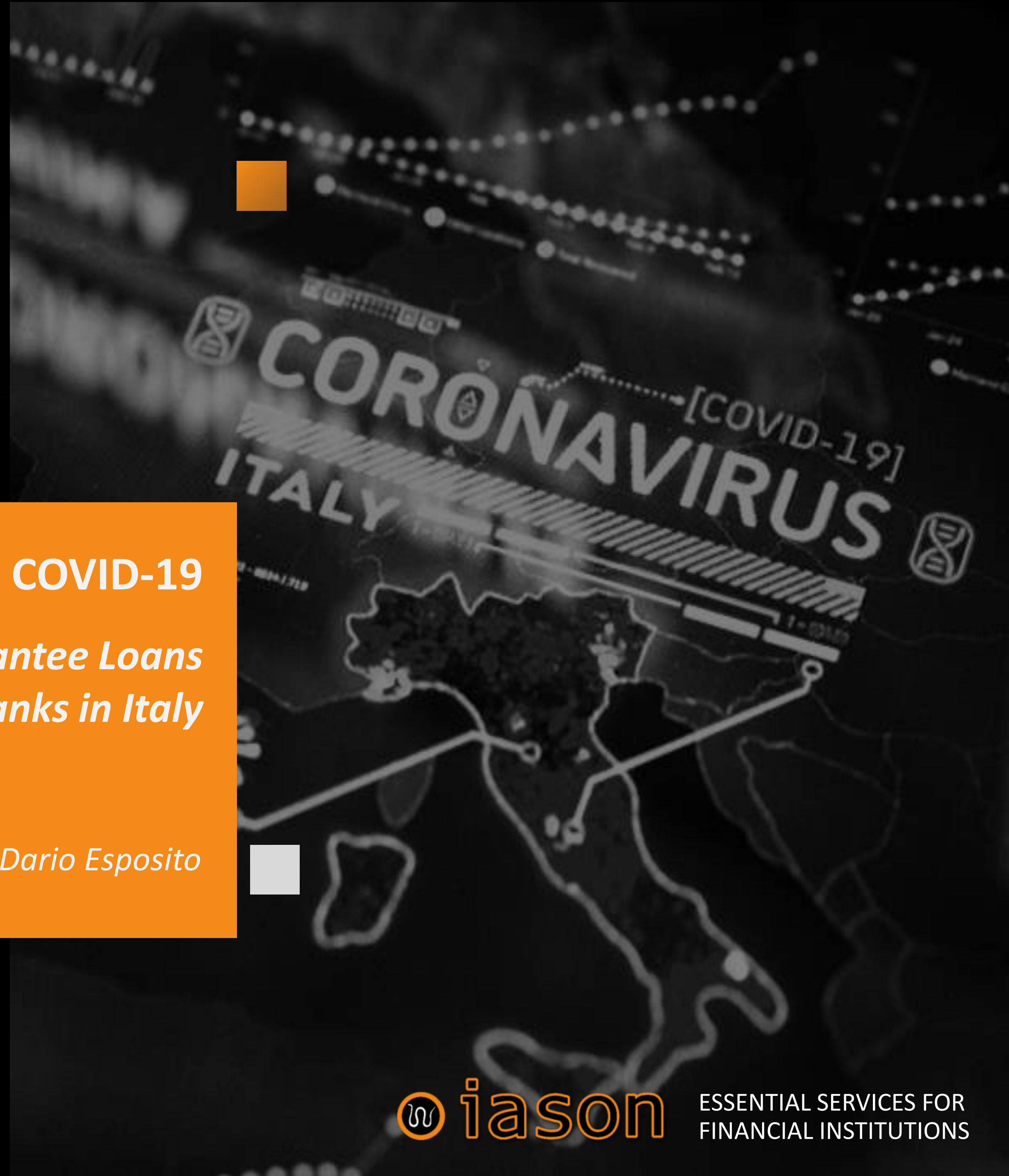

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ESSENTIAL SERVICES FOR FINANCIAL INSTITUTIONS

At a Glance

01

Introduction

Introduction

- **Mr. Draghi** (Financial Times, "Draghi: we face a war against coronavirus and must mobilize accordingly", 25 March 2020) advocates that "**banks must rapidly lend funds….to companies**….and the capital they need to perform this task must be provided by the government **in the form of state guarantees**".
- **In Italy, unprecedented fiscal measures – in the form of large-scale government guarantees on loans** – have aimed at softening the impact of the Covid-19 fallout on firms, thus limiting the destruction of productive capacity and reducing the recovery time.
- In the continuation of this short note, and after **a review of the legislative framework**, we will focus on **some possible short and medium-term impacts on the banking system.**
- Finally, unlike a traditional shock to firms' liquidity, the current stoppage of companies' activities is accompanied by a significant loss of revenues which in the future will only be partially recovered.

It is of paramount importance, also for the purpose of mitigating the impacts on the banking system, to activate other economic measures and sources of financing aimed at facilitating a rapid return **to better sustainability of firms' financial structure.**

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Legislative Framework

Legislative Framework 1/3

Firms support measures were introduced with the DL 18/2020 ("Cura Italia") of 17 March 2020 and the DL 23/2020 ("Liquidità") of 8 April 2020.

- The main measures contained in **Legislative Decree 18/2020** include the **blocking of the revocation of certain types of financing, the extension of the loans and the suspension of the repayment of the debts of small and medium-sized enterprises** - SMEs (Recommendation CE / 2003/361: SMEs with fewer than 250 employees and annual turnover or assets not exceeding 50 and 43 million Euros respectively, are considered SMEs).
- **With Legislative Decree 23/2020**, on the other hand, **the State guarantees firms debt for around 200 billion Euros** (of which at least 30 billion Euros are destined to support SMEs, including among these self-employed workers and self-employed VAT holders) **through the company SACE**. **The beneficiary company as of February 29, 2020, must not have non-performing exposures to the banking sector, according to the current definitions of Supervision** (see slide 5 for a summarize information on SACE guarantees).
- **Legislative Decree 23/2020**, fully replacing Article 49 of Legislative Decree 17/2020, then **provides that firms with up to 499 employees can obtain the SACE guarantee, but must first have exhausted the maximum available plafond of the Fondo Centrale di Garanzia for SMEs, managed by Mediocredito Centrale.** The Fondo is allocated an additional endowment for 2020 of just over 1.7 billion Euros. Of particular importance is the possibility provided by the Liquidity Decree - unlike the Cura Italia Decree - **to grant the guarantee of the Fund also in favor of final beneficiaries who, at the date of the request, present exposures classified as Unlikely to Pay or Past Due as long as the aforementioned classification is not earlier than 31 January 2020.** The guarantee is also granted to companies that, after 31 December 2019, have been admitted to the "concordato con continuità aziendale", have entered into agreements restructuring or have presented a recovery plan to the exclusion of companies with exposures classified as Bad Loans – Sofferenze (see slide 6 for a summarize information on Fondo Centrale di Garanzia guarantees).
- **Legislative Decree 23/2020 has also introduced 200 billion Euros of guarantees measures in order to strengthen the export and internationalization activities of firms** and modifies the functioning of SACE's intervention by introducing a co-insurance system with 90% of the non-market risks assumed by the State and 10% by SACE itself.

Legislative Framework 2/3

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SACE: loan guarantees' scheme

		Firm Category		
		Up to 250 employees and revenues up to 50 million Euros	Up to 5,000 employees and revenues up to 1.5 billion Euros	More than 5000 employees or revenues larger than 1,5 billion Euros
Gov.t Guarantees (% of Loan)		90%	90%	80% (if Revenue ≤5 billion Euros)
				70% (if Revenue > 5 billion Euros)
Maximum Guarantee Amount		Up to 25% of 2019 revenue or double the Italy-based payroll expenses		
Limitations		The loan must be fully allocated to sustain labor, investment and capital costs pertaining to firm activities located in Italy.		
		Firms cannot distribute dividends or engage in stock repurchasing activities (share buyback) throughout 2020		
		Firms must manage employment levels through agreements with Unions		
Costs (% of Loan Guarantee)	***Year***			
	1	0.25%	0.50%	0.50%
	2-3	0.50%	1%	1%
	4-6	1%	2%	2%
Application Procedure		The firm applies directly through the bank, which oversees the credit and underwriting process. If the application is positive, it passes on to SACE. In the case of guarantees of 80% and 70%, there will be a guarantee and unique code subordinated to the MEF, after hearing the MISE, based on the role that the company plays.		
Repayment period		Up to 6 years		
		Available pre-amortization periods: 12,18 or 24 months.		

Legislative Framework 3/3

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FONDO CENTRALE di GARANZIA SMEs: loan guarantees' scheme

	Firm Category		
	SMEs and individuals engaged in business, arts and professions	**Firms with up to 499 employees and revenues up to 3.2 million Euros**	**Other firms with up to 499 employees**
Gov.t Guarantees (% of Loan)	100%	90% + 10% guarantee "confidi"	90%
Maximum Guarantee Amount	25% of revenues , up to 25k Euros	25% of revenues, up to 0,8 million Euros	Double the 2019 payroll expenses or 25% of last revenues or Required 18-month Operating and Investment Capital Up to 5 million Euros
Costs	Free (charges limited to the bank's operating and administrative costs)		
Application Procedure	Affidavit on Covid-19 losses No evaluation of creditworthiness	Evaluation of the firm's financials, excluding the last few months	
Repayment period	Up to 6 years Pre-amortization period: min. 24 months.	Up to 6 years	Up to 6 years

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03

Some Impacts on Banks

Some Impacts on Banks 1/4

- The different public guarantees of the loans granted to firms and analyzed in the previous slides certainly have impacts on the bank's risk profiles. **Some risk profiles have already been highlighted in a previous article by Iason** (see Iason Originals, "COVID-19, Measures to mitigate Credit Risk") and include, among others, Credit risks, Operational risks, Legal risks, Outsourcing risk, ICT and Security risks, Money Laundering and Terrorist Financing risks, Liquidity risks, Interest Rate risk on Banking Book, Strategic risks and Reputational risks.

- **In the following slides we will focus on the effects**, in the short and medium term, **on credit RWA and on Sovereign risks for banks**.

- Regarding the first issue of **credit RWA** , the public guarantee, being at first request, allows banks to cancel the capital absorption on the loan portion covered by SACE and/or by the Fondo Centrale di Garanzia.

- **An analysis on RWA was therefore implemented on available data from the EBA 2019 EU-Wide Transparency Exercise.**

Considering the current credit risk exposures of the 11 major Italian banks and considering an average of 85% in SACE guarantees on a total amount of € 200 billion Euros, **the impact in terms of Credit RWA at the Italian banking system, rebus sic stantibus, is not-significant even when considering a dramatic increase in the Probability of Default** (see Iason Originals, "COVID 19, Impact Analysis on the Probability of Default of Non-Financial Companies in Italy") **and of Loss Given Default**.

Some Impacts on Banks 2/4

- **In the short-term, the impact on banking system has been substantially neutralized** by recent regulatory interpretation of RWA, definition of default, and forbearance (see Iason Originals, "COVID-19, Measures to mitigate Credit Risk"). Moreover, an important dynamic is the leniency being given to banks in the regulatory interpretation of the new accounting treatments of provision (IFRS9), which otherwise could cause increased expected losses to flow more rapidly into the P&L through the provisions line (see Iason Originals, "COVID-19, Measures to mitigate Credit Risk").

- On the other hand **the banking sector, in the medium term, will face severe effects**, **including an unprecedented wave of distressed and defaulted obligors leading to a sharp increase in loan loss provisions**: there will be an asset quality issue. All this on top of the pre-existing challenges for banks brought about by low interest rates and increased market disruption from newer competitors. Credit markets are already pricing in a significant increase in expected credit losses in the corporate bond and loan markets.

The introduction of public guarantees on loans constitutes the existence of a trade-off between the immediate availability of credit for businesses and the future incentive of banks to stop lending: this incentive is more relevant in the case of the riskiest and least profitable firms for the bank**.** Moreover, **the possible difficulties in the redemption of public guarantee, or the no-redemption at all, may be a disincentive for public-guarantee loans granted by the banking system. In the medium-term the impact on banks (profitability and capital ratios) will depend on the extent to which short term cashflow issues lead to long term structural issues for firms.**

Some Impacts on Banks 3/4

- If the impact on credit RWA, rebus sic stantibus, has been almost neutralized in short term there will be to consider **a second issue: the increase in Sovereign risks on the banks' banking books**.
- Changes to collateral **monetary policy**, short-term repos, additional quantitative easing programs as well as longer-term lending guaranteed instruments for banks **have a short-term benefit for sovereign spreads and hence bank capital ratios.**
- **The Italian banks' consolidated financial statement** published by the Bank of Italy, on its April 2020 Economic Bulletin, **shows an already large Sovereign risk exposure** (in terms of sovereign debt and debt to the Public Administration) based on the current amount of capital.

The poor forecasts of economic growth and public finance stability of Italy (see Iason Originals, "COVID 19 Impact Analysis on Italy's Sovereign Risk") **and an additional several hundred billion in government guarantees, when redeemed, will further boost in the medium-term, Italian banks' Sovereign risk.**

Some Impacts on Banks 4/4

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Main assets and liabilities of Italian banks (1)
(billions of euros and percentage changes)

	End-of-month stocks		12-month percentage changes (2)	
	November 2019	February 2020	November 2019	February 2020
Assets				
Loans to Italian residents (3)	1,682	1,665	-1.8	-1.9
of which: firms (4)	643	635	-1.8	-1.3
households (5)	632	631	2.4	2.5
Claims on central counterparties (6)	103	81	39.8	-1.1
Debt securities excluding bonds of resident MFIs (7)	540	535	0.8	-1.5
of which: securities of Italian general government entities	395	390	-3.7	-5.4
Claims on the Eurosystem (8)	139	125	57.0	72.0
External assets (9)	436	446	7.3	8.7
Other assets (10)	912	917	7.7	7.7
Total assets	**3,813**	**3,770**	**4.1**	**3.1**
Liabilities				
Deposits of Italian residents (3) (11) (12)	1,628	1,626	7.7	6.5
Deposits of non-residents (9)	335	341	5.7	3.6
Liabilities towards central counterparties (6)	136	122	-5.2	-12.1
Bonds (12)	241	236	2.1	-1.6
Liabilities towards the Eurosystem (8)	234	215	-3.9	-11.3
Liabilities connected with transfers of claims	130	127	13.5	9.0
Capital and reserves	370	358	-4.1	-4.6
Other liabilities (13)	737	744	4.0	8.3
Total liabilities	**3,813**	**3,770**	**4.1**	**3.1**

Source: Supervisory reports.
(1) The data for February 2020 are provisional. – (2) Adjusted for reclassifications, value adjustments and exchange rate movements. Changes in loans to firms and households are adjusted for securitizations. – (3) Excludes transactions with central counterparties. – (4) Harmonized definition, excludes producer households. – (5) Harmonized definition, includes producer households, non-profit institutions serving households, and households not classified elsewhere. – (6) Only repos. – (7) Excludes bonds of resident MFIs, i.e. banks and money market funds. – (8) Includes the accounts with the Eurosystem for monetary policy operations; see Tables 3.3a e 3.3b in 'Banks and Money: National Data', Banca d'Italia, Statistics Series. – (9) In the period considered these refer mainly to interbank transactions. – (10) Includes bonds held by resident MFIs; loans to resident MFIs; shares and other equity of resident companies; cash; money market fund units; derivatives; movable and immovable goods; and some minor items. – (11) Excludes liabilities connected with transfers of claims. – (12) Excludes liabilities towards resident MFIs. – (13) Includes bonds held by resident MFIs; resident MFI deposits; derivatives; and some minor items.

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04

Some Impacts on Firms

Some Impacts on Firms 1/2

- **Measures such as the issuing of public guarantees on loans** do not alleviate the losses suffered by some sectors, but instead aim to facilitate the granting of liquidity on favorable terms by the banking system: therefore the **firms' financial leverage and their vulnerability increases**.
- **SMEs remain the heart of the Italian business system and as such must act in the medium term regarding both the definition of strategies in financial and business terms**. Firms are required to have a greater ability to evaluate changes in business models and above all a strategic planning capacity in order to be able to equip themselves with an adequate capital structure to overcome the current economic crisis.

There is an urgent need to take further measures that will allow firms to quickly return to more sustainable debt levels and the possibility of diversifying sources of financing.

Some Impacts on Firms 2/2

- **One possible measure could be the creation of a special vehicle with public capital to purchase guaranteed loans granted from banks.** The vehicle would be financed through public financing and with long-term debt placed on the market: long-term debt securities issued by the vehicle must be eligible for ECB's securities purchase programs. **Other solutions could be that of public participation in the capitalization of private equity funds focused on SMEs and/or public guarantee on company equity issues.**

- As regards tax solutions, the **introduction of favorable tax treatments for recapitalization and aggregation of firms** should be considered. **Tax incentives for the issuance of hybrid capital instruments**, the use of which could prevent the massive introduction of new debt into the company.

- **Alternative lending, such as Fintech Platforms (factoring, inventory financing) or Private Debt, supports the capital structure of companies** through a wide range of instruments provided by non-bank entities. These instruments can support both short and medium-term financial and liquidity needs.

05

Final Remarks

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- **Loan guarantees provide substantial incentives for the banks to grant new loans** (or roll over existing ones). But as the pandemic evolves, banks need to be prepared for the significant spike in obligor's financial difficulty, which is likely to materialize in the next months.

- **Despite government guarantees on firms' loans, many businesses will fail as a result of the COVID 19 crisis**, and many that survive will be financially damaged. **The banks that lend to them are sure to suffer** not only credit losses but forgone revenues from the collapse in business activity.

- As analyzed before, **the government's guarantees boost**, among other things, **the Sovereign risk** and this could be a blow up for the entire banking system.

- **In order to mitigate Systemic risk, firms must be able to take advantage of current and future economic and fiscal measures that should make their debt sustainable.**

Company Profile

Iason is an international firm that consults
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Iason integrates deep industry knowledge
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and in Strategic Planning

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This document was prepared in collaboration with Simone Manca, who at the time were working for Iason Consulting.

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