Covid-19: no immediate Italian NPL wave but defaults set to rise from 2021

Official responses to the Covid-19 outbreak will delay a sharp increase in defaults in Italy. Government measures will relieve borrowers' financial burdens and cushion the impact of asset-quality deterioration on banks' balance sheets. Vulnerable obligors, however, may not avoid default.

We expect new defaults to start materialising from 2021, once the extraordinary systemic aid programmes are over, and as economic contraction translates into higher unemployment and borrower distress. We expect a gradual increase in households defaults, but a sharper increase in company defaults.

Moratoriums (payment suspensions) mainly cover mortgages on primary homes and SME loans. Individuals are typically less leveraged than SMEs, therefore it is likely that they will not extensively apply for moratoriums and rely instead on available liquidity and continue servicing their debt. We thus expect a gradual increase in defaults by individuals over time.

Corporates and SMEs will benefit from State-guaranteed financings at low rates. These financings have a grace period of two years, during which capital is not repaid. Since companies are typically leveraged, we expect a wider use of financial aid but a cliff effect of defaults, after grace periods have expired, by companies unable to re-start servicing their debt or obtain new financing.

Since corporate and SME financing will be mostly covered by State guarantees, credit risk will partially migrate from banks' balance sheets to State accounts. Therefore, it is possible that the Italian government will create a bad bank to manage State-guaranteed corporate and SME non-performing loans. Under this scenario, we do not expect NPL securitisation activity to reach the levels of 2018-2019.

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1. New defaults to rise from 2021

In response to the Covid-19 outbreak, Italian authorities introduced several measures. Among the most recent and relevant ones are: the introduction of national guarantee schemes on new financings to SMEs and corporates[1], moratoriums for individuals and SMEs, and general liquidity injections by the ECB.

Despite all these measures, we expect that new defaults will eventually emerge, especially among more vulnerable borrowers.

We do not expect an immediate spike of defaults in 2020, but they will increase from 2021. We expect that the timing of defaults in Italy will be driven by several factors:

1. A time-lag effect, which is typical of each period of crisis (see Section 2)
2. National moratoriums (see Section 3.1) that will delay the transition of economic contraction into defaults
3. A two year grace period for State-guaranteed financings (see Section 3.2) that will delay companies' timelines for paying off their debts
4. Regulatory guidelines that prevent the automatic recognition of defaults caused by Covid-19, in relation to moratoriums (see Section 4)
5. The speed of the country's recovery (shape and durability) in case of baseline scenarios[2].

2. NPL inflows in a crisis show a lag effect

Defaults from the 2011 sovereign crisis peaked two years later

There is usually a lag between a systemic crisis and the build-up of NPLs in the banking system. Figure 1 shows that NPL inflows i.e. new defaults, peaked about two years after the 2011 euro sovereign debt crisis, while the stock of outstanding NPLs peaked even later, in around 2015.

The double-dip recession that struck Italy between 2008 and 2014 severely impaired Italian banks' balance sheets and loan quality. The Italian banking system was impacted by the 2008-09 recession (phase 1 of the financial crisis), but even more during the 2011 sovereign debt crisis (phase 2 of the financial crisis), where borrowers' ability to repay debt further diminished.

Figure 1 shows that NPL inflows from individuals increased in phase 1, more or less at the time of the crisis. By contrast, SME defaults saw a lag: SME NPLs saw a strong jump[3] in around 2013, two years after the 2011 crisis. The lag of SME defaults occurred in the context of a credit-crunch as phase 2 of the crisis undermined access to credit by SMEs.

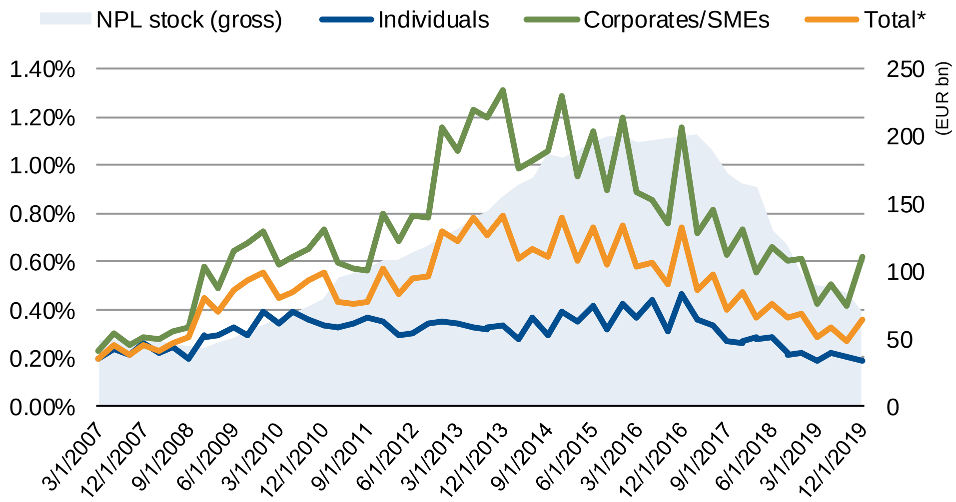
Figure 1 also shows that Individuals were less impacted in the 2011 crisis than corporates. Default rates for individuals doubled between 2010 and 2016 compared to the pre-crisis period, while SMEs default rates increased six-fold.

Default timing: 2011 lag versus 2020 lag

Even if the nature of the 2011 crisis was completely different to the current one, we expect to see a similar behaviour of lagged defaults as a result of Covid-19. We expect a shorter lag for the current crisis, particularly as many more aid measures have been put in place to mitigate or avoid defaults (as further described in Sections 3, 4 and 5 below).

[1] With up to 100% cover via insurance credit agency SACE (owned by the state development credit agency Cassa Depositi e Prestiti (CDP)). and via the state guarantee fund "Fondo centrale di garanzia"
[2] Please refer to Scope article Q2 Sovereign Update.
[3] A first jump occurred immediately after the crises in 2008.

Figure 1. Non-performing loan (NPL) inflows (2007-2020)*



*Total refers to all borrowers except financial monetary institutions. NPL inflows are computed as new NPL inflows over performing stock at inception, with a quarterly basis.

Source: Bank of Italy (Banca Dati Statistica or BDS)

3. Moratoriums and State-guaranteed financings push back unavoidable defaults

The Italian government introduced[4] several measures to alleviate borrowers' financial difficulties; including moratoriums and State-guaranteed financings. The former are mainly addressed to individuals (mortgages on primary homes) and SMEs; the latter to SMEs and corporates.

Defaults by individuals: gradual increase

Even though moratoriums will relieve the financial burdens on all borrowers, they will mainly reach their goal on healthier borrowers. We expect that once the moratorium is over, vulnerable obligors will default. Since individuals are not highly leveraged, we expect they will only partially rely on moratoriums; they will probably exhaust all their financial resources and any family aid before defaulting. We therefore expect they will show a gradual increase in defaults.

Company defaults: cliff effect once grace periods are over

With regard to companies, we expect that the weakest will default with a cliff effect in two years, once the grace period of their financings is over.

Companies can benefit from extensive State-guaranteed financings with a grace period of two years, during which there are no capital payments. Financings are also capped at 25% of company turnover. This means that lost revenues are basically transformed into new debt that has to be repaid after the grace period. If companies lose more than 25% and they are not able to fully recover, they will default. At the same time, if companies do not recover during the grace period, they will by definition not be able to repay their debt[5]. Therefore, we expect that vulnerable companies will default with a cliff effect in two years, once the grace period of their financings is over.

SME loans, especially those 100% guaranteed by the State, will not be screened by banks in terms of credit analysis. Therefore, compared to household loans (for which the moratorium is for existing loans so already credit-screened by the banks) SME loans might be riskier than a typical SME/corporate bank loan.

[4] As per "Cura Italia Decree", law decree 17 March 2020, n.18, along with all other relevant decrees.
[5] Which is any case covered for 70%-90% by the State, in case of corporates. For SMEs the State can cover up to 100% if certain criteria are met.

3.1. Moratorium measures

Moratoriums envisage the suspension of financings or instalments up to different maturities (12-18 months), based on borrower type and on the severity of Covid-19 impacts.

Consumer loans are expected to be covered by new moratoriums

Currently, national moratoriums do not cover consumer loans, though we expect new measures will be introduced soon.

National moratoriums

1. **SME financings**: One-off financings (i.e. with no instalments) expiring before the end of September are postponed to September with the same conditions, while instalments for amortising financings (including leasing), are suspended until the end of September and rescheduled, at no additional cost. SMEs are required to declare a temporary lack of liquidity. *Fondo centrale di garanzia* facilities could cover up to 33% of suspended instalments or financings.

   Additionally, for banks adhering to the *Addendum del Credito 2019*[6], medium and long-SME term financings and leasing outstanding as of 31 January 2020 and impacted by Covid-19 can be suspended by up to 12 months. The suspension entails only capital payments, while interest will be paid as originally scheduled. Besides, the maturity of medium and long-term financings can be extended by up to 100% of the residual amortisation period, with certain caps. Short-term financings can be extended up to 270 days from the original maturities. This measure is applicable only until year-end.

Job suspension and reduction of working hours trigger moratoriums, not only job-loss events

2. **Residential mortgages**: Residential borrowers had prior access to so-called Gasparrini Fund benefits. The Fund, established in 2007, allows for moratoriums of up to 18 months on residential mortgages (on primary residences) below EUR 250,000 that have been amortising for at least one year.

   The Fund covers job losses and events of death for low-income borrowers (ISEE below EUR 30,000). Due to the extraordinary circumstances brought by Covid-19, the government has expanded the application of these benefits. The Fund is accessible without an income statement, and borrowers can access it in case of job suspension or reduction of working hours.

   Previous moratoriums do not count for the computation of the 18 months suspension if the mortgage was regularly amortising in the previous three months. Beyond job loss or death, payment suspension can last up to 18 months based on the severity of the job suspension or reduction of working hours. Moratoriums can be repeated in non-consecutive periods, as long as they last for 18 months in total and based on available Fund resources.

   A 12-month moratorium, triggered by reduced working-hours or job suspension registered for five up to 10 months, might be a realistic scenario for most obligors[7]. Plus, the potential repeat of moratoriums up to a total of 18 months could contribute to shifting these periods of payment suspensions.

[6] "Addendum for accordo del credito 2019", ABI, 6 March 2020.
[7] As per Art.1 of the MEF Decree, 25 March 2020. Obligors are entitled to a payment suspension up to 6 (respectively 12, or 18) months, in case of job suspensions or reduced working-hours ranging between 30 and 150 consecutive business days (respectively 151-302, or higher than 303). Reduced working-hours refer to a reduction of at least 20% on the original working schedule.

3. **Freelancers and autonomous workers**: The government has expanded the applicability of moratoriums to autonomous workers and freelancers to December 2020. In case of a significant decrease of their turnover from 21 February 2020 (i.e. a 33% decrease relative to 4Q 2019), they are entitled to Fondo Gasparrini benefits, namely a moratorium of up to 18 months.

   50% of accruing interest to be paid by borrowers

   In the case of items (2) and (3), 50% of the interest accruing on residual debt during the suspension period will be paid by the Fund. This means that borrowers will have to make some payments, albeit they should be relatively low.

4. **Consumer loans**: We expect consumer loans will be soon covered by moratoriums, to make the segment less exposed to downturns

3.2. State-guaranteed financings

April's government decree introduced new measures to improve access to credit and liquidity support. Among the most relevant and valid until year-end are:

i) a EUR 200bn guarantee scheme (run by government export credit agency SACE) for corporate financing, with a 70%-90% coverage (based on the size and turnover of companies); and EUR 30bn targeted to SMEs that had already exhausted financings under the government's *Fondo-Centrale-Garanzia* scheme. Financings have a maximum maturity of six years. Companies can apply for a pre-amortisation period of 24 months, during which they have to pay interest but not capital. The maximum financing amount is capped at the higher of i) 25% of companies' 2019 turnover and ii) doubled personnel costs. Financing rates are concessional; the guarantee is on a first call and covers both capital and interests components.

ii) 100% guarantee (granted under the Fondo Centrale di Garanzia and Confidi schemes) on new SMEs financings up to EUR 800,000, without pre-requisites. The guarantee is applicable in case of financings with a 24-month grace period and a maturity up to six years.

4. Regulatory directives will prevent automatic default classification

Moratoriums will not lead to automatic default or forborne classifications

As recently stated by European Banking Authority (EBA)[8], "the moratoria being introduced as a response to Covid-19 pandemic aim to address systemic risks and alleviate potential risks that may occur in the wider EU economy in the future". For this reason, exposures benefiting from moratoriums will not be automatically classified as forborne or defaulted for regulatory and accounting rules (IFRS 9). However, financial institutions should still assess borrowers' likelihood to pay through risk measurement and credit risk assessments.

Moratoriums will not lead to automatic negative credit scores

Furthermore, the EBA required[9] banks to adopt appropriate measures for consumer protection across Europe: temporary measures should not automatically lead to negative implications for the consumer's credit rating.

[8] EBA's Statement on the application of the prudential framework regarding Default, Forbearance and IFRS 9 in light of COVID-19 measures, 25 March 2020.
[9] EBA's Statement on consumer protection and payment issues in the light of the Covid-19 exceptional circumstances, 25 March 2020.

Moratorium impacts on borrowers' classification, according to the EBA

Forborne classification: The forborne classification is meant to capture ad-hoc measures offered by banks to borrowers experiencing (or likely to experience) financial difficulties[10].

Prudential default definition: Restructurings where the net present value of the loan from the lender's view is unaffected and where the restructuring is granted to borrowers who are likely to meet their obligations, are not classified as defaulted. Regarding the definition of default, past-due days are counted based on the post-moratorium schedules (i.e. the suspension or delays in payments permitted by moratoriums impacts the 90 days past-due criterion, as the delays are counted based on the modified schedule of payments).

Accounting rules (IFRS 9): accounting rules should not consider an increased credit risk as automatically driven by moratoriums. Banks have to evaluate whether borrowers will be significantly affected by the current situation in the long term or not as this will mitigate any potential cliff effect of transfers between IFRS 9 stages.

Moratoriums can be legislative or non-legislative. If they meet general requirements, they do not lead to forbearance

The EBA clarified[11] that "general moratorium" in the form of legislative and non-legislative measures should not trigger a forbearance classification. This widens the applicability of the EBA's directives beyond national measures.

General criteria for moratoriums, according to the EBA:

i) launched before 30 June 2020,

ii) broadly applied and similar in economic substance, regardless of whether they are legislative or non-legislative,

iii) based on broad initiatives. In the case of changes to payment schedules, the initiative shall not be carried out by a single institution,

iv) applied to a broad range of obligors, regardless of their perceived creditworthiness,

v) changes to payment schedules with a limited period of time (i.e. suspension, postponement or reduction of payments). Other conditions should not be changed, nor, in general, should interest rates.

5. Will new NPLs be securitised?

As depicted in Section 3, State guarantees will cover corporates and SMEs defaults on new financings. Coverage varies from 70% to 100% of loan amounts; therefore, the State will take the largest share of credit risk. The State is already covering some NPL risk through the GACS guarantee. However, in this case, the State is providing a direct guarantee. Therefore, it is possible that the Italian government will create a bad bank to manage State-guaranteed corporate and SMEs non-performing loans. Under this scenario, we do not expect NPL securitisation activity to reach the levels of 2018-2019.

[10] "Forbearance" means that credit institutions grant a concession (i.e. temporarily postpone capital and/or interest payments of a loan) when they identify that a borrower is experiencing or is likely to experience financial difficulty in repaying a loan(s).
[11] EBA's Guidelines on legislative and non-legislative moratoria on loan repayments applied in the light of the COVID-19 crisis, 2 April 2020.

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