

**EXECUTIVE
BOARD
MEETING**

SM/21/183
Correction 1

November 12, 2021

To: Members of the Executive Board

From: The Secretary

Subject: **Republic of San Marino—Staff Report for the 2021 Article IV Consultation**

Board Action: The attached corrections to SM/21/183 (10/29/21) have been provided by the staff:

Evident Ambiguity Pages 8 (para. 10, lines 4–5), 23, 53 (footnote 2), 54 (top text figure)

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views Pages 6, 7, 8 (Box 2; para. 10, line 12; bottom left text figure), 16 (text figure data), 24, 28, 29, 48, 53 (text table), 54 (para. 4), 55

Typographical Errors Pages 16 (text figure axis) and 21

Questions: Mr. Gracia, EUR (ext. 36085)
Ms. Agrawal, EUR (sagrawal@imf.org)
Mr. Dell'Erba, EUR (ext. 35447)
Mr. Tolosa, EUR (ext. 36419)

5. A targeted policy package was put in place, but its funding was constrained by a lack of fiscal space, requiring cuts in non-essential spending. The authorities adopted measures to support the health sector and the most vulnerable population, including with direct transfers and expanding the wage supplement scheme. However, with revenues collapsing, dangerously low levels of liquidity and limited financing options, they were forced to reallocate non-priority spending and use the previous SDR allocation and reserve position at the Fund (Box 1). These measures, including a one-off levy on pensions and a public wage cut linked to reduced working hours during the lockdown, resulted in a pro-cyclical fiscal stance at the worst of the shock.

6. Large-scale external borrowing allowed a significant step-up in the policy response. After many years contemplating accessing international markets and in a challenging environment, a one-year bridge loan was secured in December 2020 from Cargill Financial Services for €150 million (11.112 percent of GDP) at a 3 percent interest. Additionally, in February 2021, San Marino successfully issued its first Eurobond, at a 3.25 percent yield and three-year maturity for €340 million (2725.1 percent of GDP, Annex VI). In addition, the Central Bank of San Marino (CBSM) secured a €100 million bilateral swap line with the ECB that was not used. With new-found liquidity, the authorities unlocked expenditure envisaged in the 2020 budget, loosening the fiscal stance from close to balance in mid-December to -3.5 percent of GDP at end 2020 (Box 1). The government adopted new targeted support measures earlier this year, including guarantees on rental property loans and grants (Decree “Ristori”) for firms that had lost at least 30 percent revenue in 2020, for a total of €18 million (about 1 percent of GDP). This will result in a supportive fiscal stance in 2021.

Box 1. Public Finances During the Pandemic

San Marino’s policy response to the pandemic was swift. On the revenue side, the authorities approved tax deferrals, allowed the rescheduling of income tax payments and utility bills, and granted tax credits and tax cuts. A temporary solidarity levy applied on pensions above €1,500 was also introduced. On the spending side, there was a freeze to all non-essential spending, while savings from the temporary reduction in public sector wages were allocated to the healthcare sector. A minimum guaranteed income was introduced to protect poorer households and the supplemental wage scheme extended to support workers affected by lockdowns. Some of these measures have been extended in 2021 although with significant lower uptake.

COVID Related Fiscal Measures

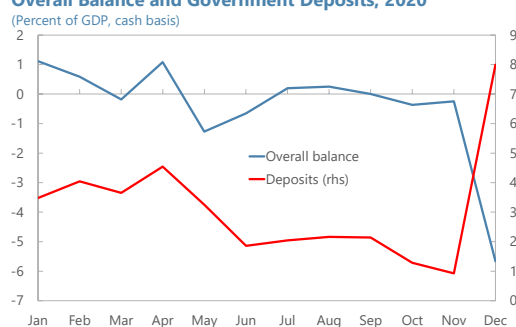
Measures	2020		2021 1/	
	EUR (Mill)	% of GDP	EUR (Mill)	% of GDP
Wage Supplement	12.6	0.9	3.1	0.2
Sick Pay	11.1	0.8	5.5	0.4
Public Wage Reduction	7.1	0.5	...	...
Reduced Social Security Contributions	9.7	0.7	0.8	0.1
Pension Solidarity Contribution	1.3	0.1	...	...
Minimum Income Tax cut	4.7	0.3	...	...
Minimum Guaranteed Income	0.3	0.0	0.1	0.0
Government Grants 2/	...	...	15.0	1.1
Guarantees	16.5	1.2	2.7	0.2
o/w to firms	16.0	1.2	2.4	0.2
o/w to families/individuals	0.5	0.0	0.3	0.0

1/ Value estimated as of June 2021.

2/ 2021 budgeted value.

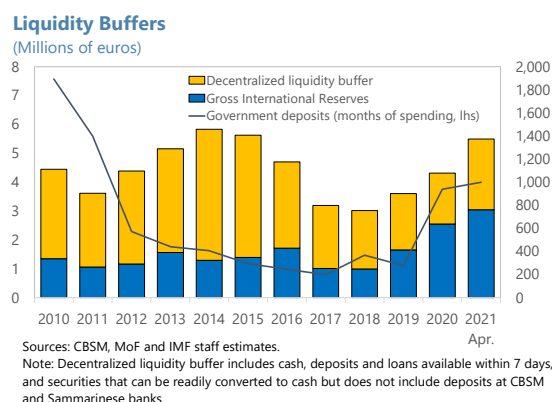
Sources: Sammarinese authorities; and IMF staff estimates.

Overall Balance and Government Deposits, 2020



7. External borrowing allowed San Marino to rebuild liquidity buffers from dangerously low levels.

The government increased deposits at CBSM and repaid an existing loan with the Central Bank (€55 million), boosting international reserves (Annex VI). They also repaid early a bond held by the state-owned bank *Cassa di Risparmio di San Marino* (CRSM) (€9485 million), which, together with a large deficit and the ensuing rotation of public sector deposits away from CBSM into commercial banks, boosted the liquidity of the banking system. Last year, low liquidity had forced CRSM to reschedule a bond, extending its maturity a few months. With credit to the private sector falling and bank deposits increasing moderately, banking sector liquidity has been stable at this new higher level.



8. Easing of supervisory and prudential measures aimed at avoiding a contraction of credit provided relief to households and corporates. The government adopted a payment moratorium generally in line with EBA guidelines for amortization of loans until March 2021. Finally, guarantees were issued on loans to households where a member lost their job, or the household lost more than 30 percent of income (up to €10,000) and firms (up to €500,000) in the tourism sector. This and other strict eligibility criteria, resulted in limited take-up at €26 million (or less than 2 percent of current loans). To boost their capital, banks were allowed to irreversibly reclassify securities from the trading to the banking book at market prices as of end-January 2020.

Moratoria and Guarantee Schemes				
	Total Loans Since 2020		Outstanding Loans (as of Aug 2021)	
	Million euros	Percent of performing loans	Million euros	Percent of performing loans
Benefiting from moratoria	150.6	16.5	77.7	8.5
Benefiting from guarantees	26.3	2.9	22.9	2.5

Source: Sammarinese authorities.

9. The capital position of the banking sector was strengthened at a high cost to taxpayers. CRSM’s capital was boosted with a sovereign perpetual bond (€455 million with a 1.752 percent interest) to cover post-GFC losses from investments largely in Italy. This is the latest in a long sequence of bailouts of the bank, now totaling €675 million, or 47 percent of 2019 GDP—the costliest banking crisis recorded.¹ After improving provisioning in line with 2017 AQR results, shareholders have taken steps to recapitalize two private banks. The banking system was further consolidated with the revocation of the license of Banca Nazionale di San Marino (BNS), a bank created after the resolution of Banca CIS in 2019 (Box 2).

¹ This is now larger than the costs of the Irish banking crisis, which at 45 percent of GDP was the costliest crisis recorded (Laeven and Valencia dataset).

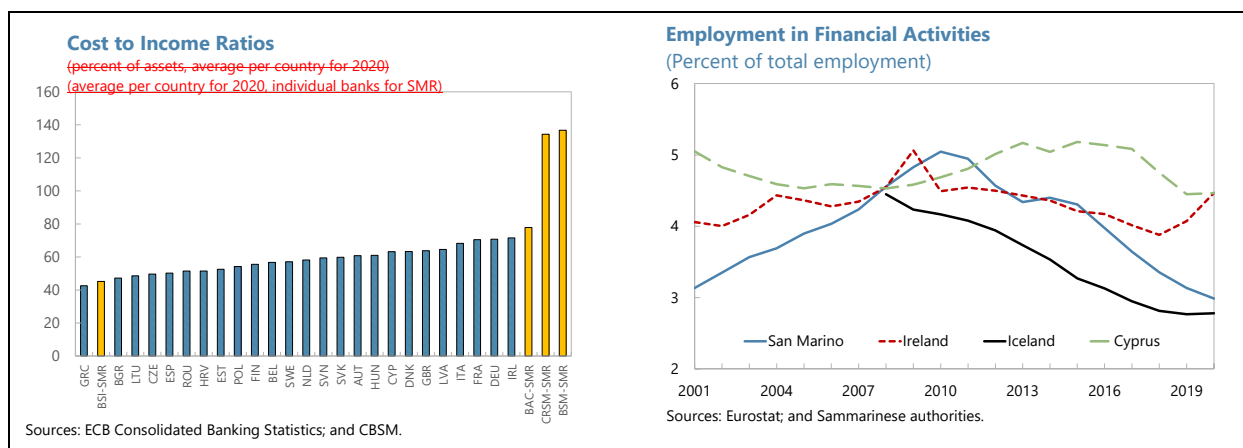
Box 2. Resolution of Banca Nazionale Sammarinese (BNS)

In July 2021 the government revoked the license of BNS, the result of Banca CIS resolution in 2019 (Box 1, IMF Country Report No. 20/93). The government purchased shares at face value (€19 million) despite the bank’s negative net equity, paying the Central Bank (former owner) with a perpetual bond that bears a symbolic 0.1 percent interest. Its assets and liabilities were transferred to a new government entity, IGRC, which will transfer most of the assets to set up an SPV for asset recovery.

The resolution of the bank was needed as it was unviable from its inception (its assets were mostly non-performing), but the delay was costly. Operating deficits were estimated at around €7.5 million as cost reduction was slow until February 2021, when most of the staff was dismissed (23 employees).

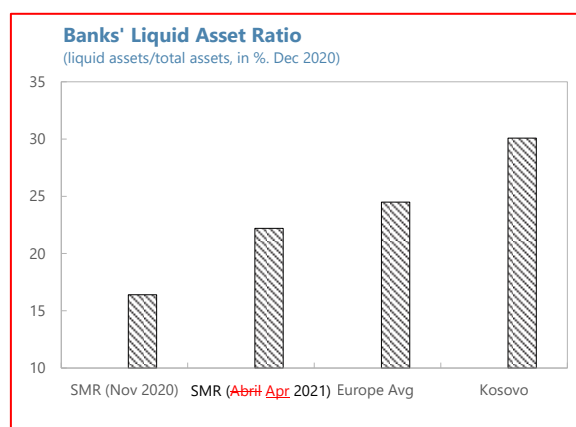
Taking over the banks’ liabilities will hit the government’s balance sheet. The government is now committed to honor BNS creditors (mostly former Banca CIS depositors that received bonds at the time of the resolution) for an amount close to €288 million. Given the poor quality of BNS assets, this commitment will increase government debt by up to 21 percent of GDP. Once proceeds from asset liquidation are exhausted, creditors are set to be compensated through certificates that can be used for tax obligations (tax credits) or public debt securities.

10. Similarly, important steps have been taken to improve the banking system’s efficiency (Annex VII). Driven by significant efforts at CRSM, costs in the banking system are now below European averages. Personnel costs fell by 30 percent in four years up to 2020 and are expected to fall further in 2021. The savings have been led by a reduction of staff (taking the share of financial activities in total employment to 3.3 percent) while wages have remained at pre-GFC levels governed by a 10-year-old expired but still binding collective agreement. During the same period, the branch network was consolidated by more than 40 percent although it remains high by regional standards. However, the cost reduction has been moderate when scaled by assets. Despite these efforts, extraordinarily high NPLs (63 percent of gross loans) and sizeable tax credits represent a large share of non-income generating assets that have hampered profitability. In August 2021, a law to create an asset management company (AMC) was approved to tackle system-wide NPLs (Box 3). With gross NPLs at around 11750 percent of GDP, this scheme could help resolve NPLs albeit not without fiscal risks.



results of 2017 AQR. In addition, they should recognize and address the likely losses associated with NPL recovery (mostly from AMC operations). Finally, while the moratoria prevented some loans from becoming delinquent, under the current supervisory framework the CBSM should proactively require banks to fully implement IFRS9 and provision based on expected rather than actual losses. In this connection, further efforts should be taken to align prudential requirements to the Basel III framework. Banks should submit credible capital management plans to deal with legacy and pandemic related losses.

34. Unilateral euroization requires healthy liquidity buffers to safeguard financial, and therefore fiscal stability. Given that CBSM cannot issue its own currency to perform the LOLR role, the liquidity buffers of the banking system need to be higher than peers. This need is particularly acute when the banking system is fully local and thus lacks contingent lines from parents and face an underdeveloped interbank market. The recent experience of low average liquidity (particularly in CRSM) should be avoided. Recent injections of liquidity should be locked-in, fully adopting Basel III liquidity standards, and taking decisive supervisory actions if breaches reappear. In addition, to reflect the challenges brought by euroization, reserve requirements should be gradually increased from the current 3.5 percent to a minimum of 10 percent, closer to prevailing levels in European countries without Central Bank backstop in euros. Current high liquidity would allow banks to meet these requirements while still being able to support the recovery through new lending.



35. Financial as well as macroeconomic and fiscal stability should be also underpinned by a healthy level of international reserves. This will restore some partial LOLR capacity which can complement banks' high liquidity buffers. San Marino is not likely to generate such capacity in a baseline scenario and over time it should be generated by strengthening the capital position of CBSM rather than through higher government deposits. Despite recent improvements due to external borrowing, reserve needs metric shows that GIR may fall below "safe" levels by end-2021 (Annex VI) even without considering LOLR needs. Increasing banks' reserve requirements, a more ambitious fiscal adjustment and preserving short-term government liquidity along the lines recommended, will support the buildup of more adequate levels of reserves, deemed essential to preserve stability.

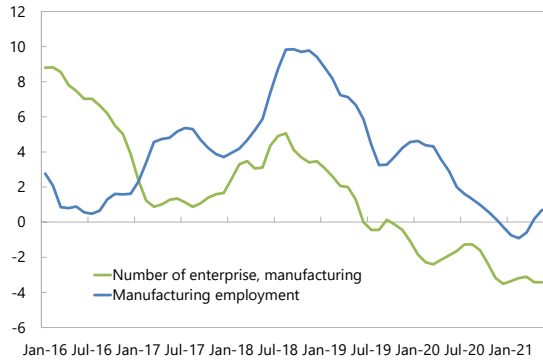
36. The authorities agreed that preserving appropriate levels of banks' liquidity is a key priority. However, they are concerned that high reserve requirements could unduly impact banks' profitability favoring complementary measures such as supervisory expectation on banks liquidity buffers. They also highlighted how more aggressive steps towards Basel III, including booking provisions based on IFRS9's forward looking approach, are constrained by the current version of the Monetary Agreement with the EU which refers to pre-IAS/IFRS. They intend to minimize fiscal risks

Figure 2. San Marino: High Frequency Indicators

Manufacturing activity has remained strong...

Manufacturing

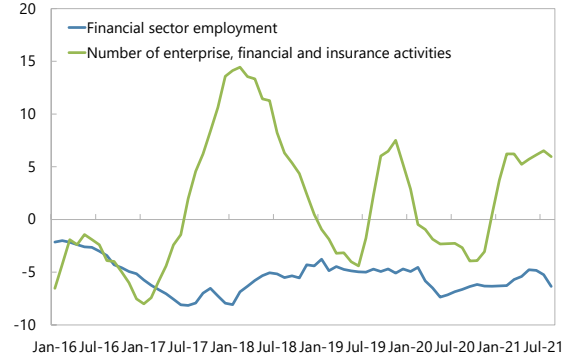
(yoy growth rate in 3-month average)



...while financial services continue to downsize.

Financial Services

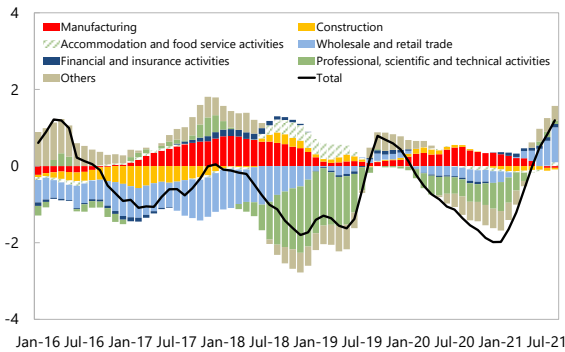
(yoy growth rate in 3-month average)



The number of active enterprises is recovering...

Number of Enterprises

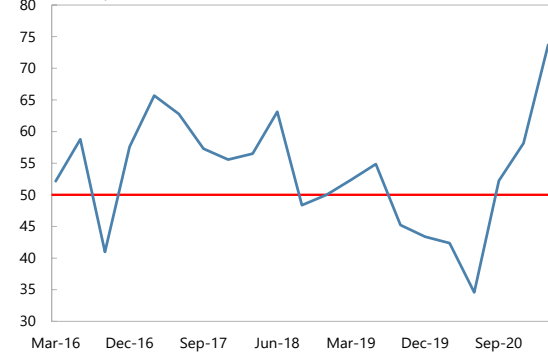
(Percent, contribution to growth in 3-month average)



...while the PMI is at a historic peak.

Purchasing Managers' Index (PMI)

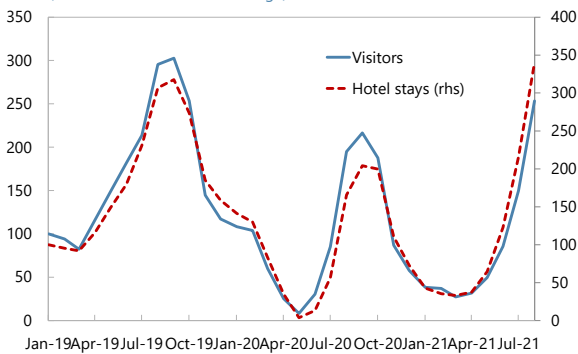
(+50; expansion)



Tourism is going back up ~~to~~ pre-covid level...

Tourism

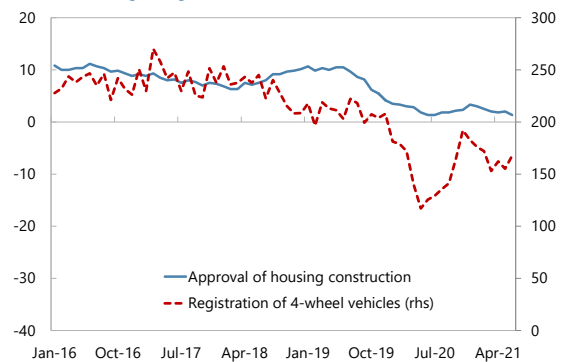
(Jan-2019=100, 3-month average)



...while durable consumption remains subdued.

Housing and Durable Consumption

(6-month rolling average)

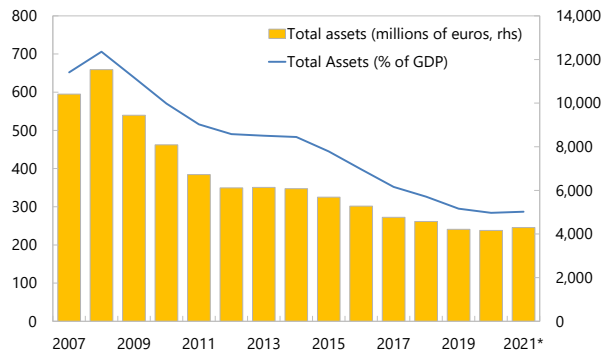


Sources: Sammarinese authorities and IMF staff.

Figure 4. San Marino: Monetary and Banking Developments

Banking system assets stabilized after decade-long contraction...

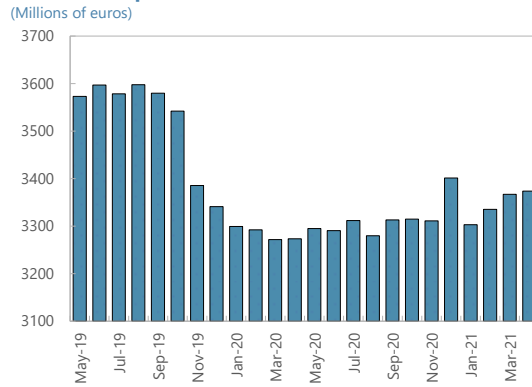
Banking System Assets



*As of June 2021. Includes assets from ex-BNS.

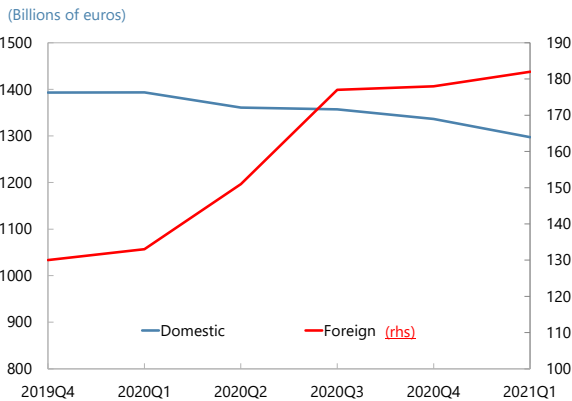
...with deposits showing signs of recovery.

Customer Deposits



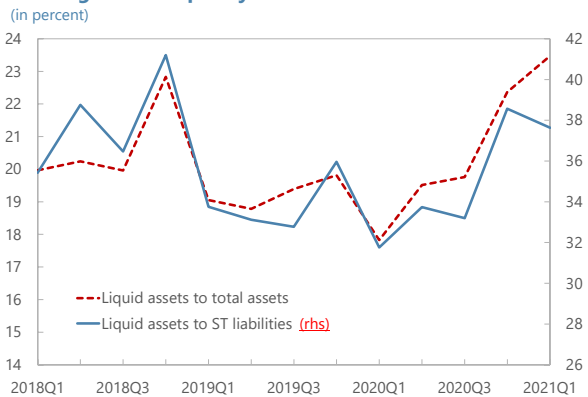
While domestic banks remain cautious to lend, cross-border lending is picking up...

Bank Credit to Firms



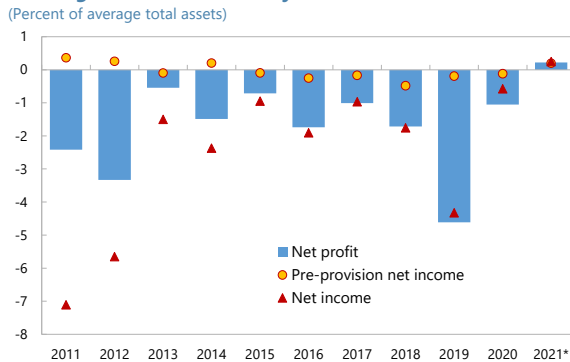
...and liquidity has recovered.

Banking Sector Liquidity



After 12 years of losses, profitability has returned...

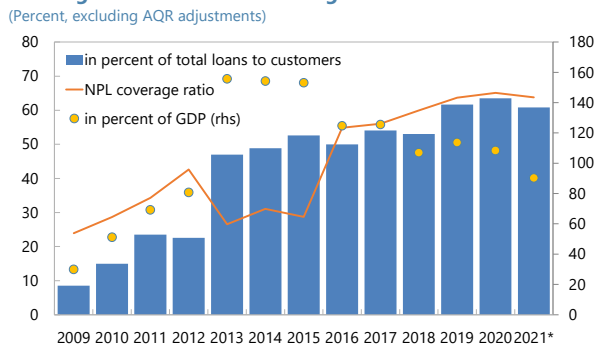
Banking Sector's Profitability



* First semester only

...however, NPL remain extraordinarily high.

Banking Sector's Non-Performing Loans



*Until June 2021

Sources: Sammarinese authorities and IMF staff.

Table 1. San Marino: Selected Economic and Social Indicators, 2018–26

GDP per capita (2019): 45,670 U.S. dollars

Life expectancy at birth (2018): 86.6 years

Population (2020): 33,574 persons

Literacy, adult (2015): 96 percent

	2018	2019	Projection						
			2020	2021	2022	2023	2024	2025	2026
Activity and Prices									
Real GDP (percent change)	1.5	2.4	-7.3	5.5	3.8	1.5	1.3	1.3	1.3
Domestic demand	1.2	6.5	-6.0	5.7	3.4	1.8	1.8	1.6	1.6
Final consumption	-0.9	1.5	-2.7	3.2	1.4	1.0	1.0	1.0	1.0
Fixed investment	2.4	18.9	-13.5	12.2	8.1	3.5	3.5	3.0	3.0
Net exports	0.6	-2.6	-2.5	1.0	1.0	0.1	-0.1	0.0	0.0
Exports	1.1	0.7	-9.1	5.2	2.6	1.9	1.9	1.7	1.8
Imports	0.8	2.6	-8.7	5.3	2.2	2.1	2.2	2.0	2.0
Contribution to GDP	1.5	2.4	-7.3	5.5	3.8	1.5	1.3	1.3	1.3
Domestic demand	0.0	5.4	-4.6	4.7	2.8	1.4	1.4	1.3	1.3
Final consumption	-0.5	0.8	-1.6	1.8	0.8	0.5	0.5	0.5	0.5
Fixed investment	0.5	4.6	-3.0	2.9	2.0	0.9	0.9	0.8	0.8
Inventories	0.9	-0.8	-0.3	-0.1	-0.1	0.0	0.0	0.0	0.0
Net exports	0.6	-2.2	-2.4	0.9	1.0	0.1	-0.1	0.0	0.0
Employment (percent change)	2.4	2.6	-0.5	1.9	1.2	0.7	0.7	0.7	0.7
Unemployment rate (average; percent)	8.0	7.7	7.3	6.1	5.9	5.7	5.6	5.6	5.6
Inflation rate (average; percent)	1.8	1.0	0.2	1.6	1.3	1.2	1.3	1.3	1.4
Nominal GDP (millions of euros)	1401.7	1443.7	1354.6	1450.7	1528.2	1570.1	1611.0	1653.7	1698.2
Public Finances (percent of GDP) 1/									
Revenues	23.0	22.9	21.6	20.5	20.5	20.6	20.5	20.5	20.4
Expenditure	24.5	22.4	59.1	39.4	22.4	22.3	22.3	22.6	22.6
Overall balance	-1.6	0.5	-37.5	-18.9	-2.0	-1.7	-1.8	-2.2	-2.2
Government debt (official)	30.1	32.0	77.9	75.0	72.8	72.2	72.3	71.9	71.6
Public debt 2/	63.5	63.5	77.9	94.3	91.7	90.6	89.6	89.0	88.2
Money and Credit 3/									
Deposits (percent change)	1.3	-5.7	8.6	...	...	...	...	...	...
Private sector credit (percent change)	-2.9	-7.1	-0.1	...	...	...	...	...	...
Net foreign assets (percent of GDP)	131.6	120.7	141.5	...	...	...	...	...	...
Commercial banks	108.6	91.6	94.5	...	...	...	...	...	...
Central bank	23.0	29.1	46.9	...	...	...	...	...	...
External Accounts (percent of GDP)									
Current Account	-1.9	6.2	2.8	1.3	1.3	1.1	1.3	0.9	0.4
Exports	161.2	163.7	161.0	158.8	157.7	157.5	156.5	156.6	156.5
Imports	153.3	148.2	149.0	147.8	147.1	146.8	146.5	146.8	146.9
Gross international reserves (millions of euros)	248.1	410.6	637.0	650.0	628.6	609.5	585.1	569.2	551.2
Financial Soundness Indicators (percent) 4/									
Regulatory capital to risk-weighted assets	12.3	9.5	10.7	...	...	...	...	...	...
NPL ratio 5/	53.0	61.7	63.5	...	...	...	...	...	...
NPL coverage ratio 5/	59.9	63.7	65.1	...	...	...	...	...	...
Return on equity (ROE)	-16.1	-70.3	-11.1	...	...	...	...	...	...
Liquid assets to total assets	22.8	19.8	22.4	...	...	...	...	...	...
Liquid assets to short-term liabilities	41.2	36.0	38.6	...	...	...	...	...	...

Sources: International Financial Statistics; IMF Financial Soundness Indicators; Sammarinese authorities; World Bank; and IMF staff.

1/ For the central government.

2/ Central government (official) debt plus Social Security Fund and BNS debt.

3/ 2019 data are as of Sept 2019.

4/ 2017-19 data do not reflect 2017 AQR results. Latest NPL ratio and NPL coverage ratio are as of Nov 2019 and the others are as of Sept 2019.

5/ CBSM supervisory data. Latest data reflect changes related to Banca CIS resolution. Supervisory data, as opposed to FSI data, reflect retrospective revisions made by banks in their annual financial statements. Loans and NPLs to banks are excluded in calculating each indicator.

Table 4. San Marino: Financial Soundness Indicators, 2012–20

	2012	2013	2014	2015	2016	2017	2018	2019	2020
Capital adequacy ratios (percent) 2/									
Regulatory capital to risk-weighted assets	8.8	13.6	11.4	12.7	11.5	13.7	12.3	9.5	10.7
Capital to assets	6.3	7.3	6.2	6.9	6.2	6.5	6.2	4.2	4.0
Asset quality ratios (percent) 2/ 3/									
Bad loans to total loans	10.6	15.4	18.2	20.8	18.3	20.5	20.4	29.7	31.1
Nonperforming loans to total loans	22.6	47.0	48.8	52.6	50.0	54.0	53.0	61.7	63.5
Bad loans net of provision to capital	58.7	54.6	70.1	79.6	73.8	78.6	90.6	166.4	151.0
Nonperforming loans net of provision to capital	164.6	289.3	332.1	340.0	224.4	250.2	249.9	360.9	334.1
NPL coverage ratio	42.6	26.5	31.1	28.7	54.8	56.0	59.9	63.7	65.1
Earning and profitability (percent) 2/									
Return on assets (ROA)	-2.2	-0.6	-1.8	-0.7	-1.0	-0.7	-1.2	-4.1	-0.6
Return on equity (ROE)	-22.5	-7.8	-21.4	-9.0	-13.2	-10.1	-16.1	-70.3	-11.1
Interest margin to gross income	58.5	46.1	32.1	37.3	39.0	42.4	50.3	35.6	39.5
Non-interest expenses to gross income	69.7	81.2	50.7	62.3	72.4	66.9	74.3	57.9	62.0
Trading income to gross income	11.7	13.3	13.9	1.9	3.0	4.1	-17.4	2.8	-1.8
Personnel expenses to non-interest expenditures	55.7	59.5	61.7	60.9	61.4	57.0	58.9	57.4	59.6
Liquidity (percent)									
Liquid assets to total assets	18.9	21.8	24.0	23.6	23.7	18.6	22.8	19.8	22.4
Liquid assets to short-term liabilities	39.6	44.7	48.4	46.5	44.8	33.3	41.2	36.0	38.6
Loans to deposits	91.8	86.7	80.0	165.0	153.8	141.4	125.6	124.1	108.4
Memo items									
Banking system assets (millions of euros) 3/	6122.1	6141.1	6081.9	5692.0	5279.8	4763.6	4576.1	4220.0	4166.8
percent of GDP	490.1	486.0	482.9	444.9	398.0	352.0	326.5	292.3	307.6

Sources: Sammarinese authorities; IMF International Financial Statistics; and IMF staff.

1/ Data beginning in June 2015 are not strictly comparable to earlier periods.

2/ 2017-18 data do not reflect 2017 AQR results, while 2019 data reflect changes related to Banca CIS resolution

3/ CBBSM supervisory data. Supervisory data, as opposed to FSI data, reflect retrospective revisions made by banks in their annual financial statements. Loans and NPLs to banks are excluded in calculating each indicator.

Table 5. San Marino: Depository Corporations Survey, 2012–20¹

	2012	2013	2014	2015	2016	2017	2018	2019	2020
(In Millions of euros, end of period)									
Net foreign assets	2600.1	2643.5	2512.2	2340.4	2136.5	1868.3	1752.2	1784.4	1916.3
Claims on nonresidents	3938.9	3864.1	3801.2	3433.9	3054.8	2612.8	2393.3	2344.9	2455.1
Central Bank	267.5	367.7	298.0	321.5	401.2	274.7	270.5	395.3	635.9
Other Depository Corporations	3671.4	3496.4	3503.2	3112.4	2653.7	2338.1	2122.7	1819.1	1819.1
Liabilities to Nonresidents	-1338.8	-1220.6	-1288.9	-1093.5	-918.4	-744.4	-641.1	-538.7	-538.7
Central Bank	0.0	0.0	0.0	0.0	-0.1	-0.2	-0.2	-0.2	-0.3
Other Depository Corporations	-1338.8	-1220.6	-1288.9	-1093.5	-918.2	-744.2	-640.9	-560.3	-538.4
Net domestic assets	1455.0	1557.5	1693.7	1323.4	1382.5	1122.4	1125.9	1008.7	885.4
Net Claims on Central Government	200.9	229.4	202.9	-8.8	-35.1	-234.8	-256.3	-209.2	134.3
Claims on State and Local Government	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Claims on Public Nonfinancial Corporations	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Claims on NBFIs	799.7	690.7	625.9	485.0	381.6	263.0	242.6	119.0	111.7
Claims on private sector	1506.3	1535.2	1656.2	1547.1	1468.6	1485.3	1381.8	1394.9	1338.5
Corporates	965.5	980.0	898.7	945.3	914.2	925.9	859.5	870.6	838.2
Households	540.8	555.1	757.5	601.8	554.3	559.4	522.3	524.3	500.3
Capital and Reserves	590.4	599.6	544.7	519.7	471.5	419.8	388.6	290.4	332.4
Other items, net	461.5	298.2	246.7	180.3	-39.0	-28.7	-146.4	5.6	366.7
Broad Money	1472.8	1539.1	1635.1	1430.0	1466.7	1441.6	1459.6	1546.5	1669.9
Currency in Circulation	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Transferable Deposits	1334.7	1385.8	1449.7	1340.5	1372.2	1370.5	1398.5	1466.5	1601.5
Other Deposits	138.2	153.4	185.4	89.4	94.5	71.1	61.1	80.0	68.4
Securities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Long-term securities excluded from Broad Money	2582.2	2661.8	2570.8	2233.8	2052.3	1549.1	1418.5	1246.6	1131.8
(Annual percentage change)									
Net foreign assets	-18.4	1.7	-5.0	-6.8	-8.7	-12.6	-6.2	1.8	7.4
Net domestic assets	42.2	7.0	8.7	-21.9	4.5	-18.8	0.3	-10.4	-12.2
Claims on private sector	-2.2	1.9	7.9	-6.6	-5.1	1.1	-7.0	1.0	-4.0
Corporates	-7.4	1.5	-8.3	5.2	-3.3	1.3	-7.2	1.3	-3.7
Households	8.7	2.6	36.4	-20.5	-7.9	0.9	-6.6	0.4	-4.6
Broad Money	-0.1	4.5	6.2	-12.5	2.6	-1.7	1.2	6.0	8.0

Sources: International Financial Statistics and IMF Staff.

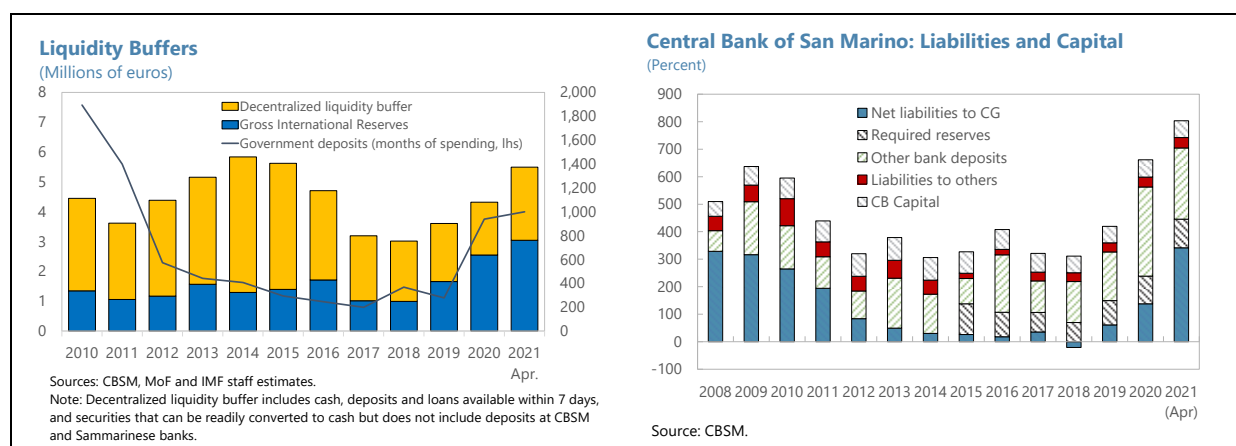
^{1/} Data beginning in June 2015 accord to the IMF's monetary and financial statistics methodology, and are not strictly comparable to earlier periods.

Annex VI. San Marino’s Systemic Liquidity Management: Developments and Policy Challenges

Large external borrowing derived in substantially improved buffers for the government, the Central Bank, and the banking system. Government buffers are well above the two months of spending target, international reserves have now raised above reserve metrics and banking system liquidity is on par with European averages. However, a large fiscal deficit and short-term loan repayments are expected to bring down significantly government (and consequently Central Bank) buffers. Meanwhile, the pandemic has exposed the need for higher reserve needs and the Eurobond rollover creates new demands for liquidity.

A. System-Wide Liquidity: Developments throughout the Pandemic

1. Fiscal buffers decreased dangerously by the end of 2020 but recovered strongly after large external borrowing. While they were at the target level of two months of spending when the pandemic struck, revenue losses caused them to fall to low levels by the end of the year (€10 million).¹ After external borrowing was secured, buffers increased dramatically despite large fiscal deficits and an early repayment of a bond held by CRSM (€8594 million).



2. San Marino’s Gross International Reserves (GIR) held up well throughout the pandemic and are close to doubling pre-pandemic levels. During 2020 international reserves were supported by a reallocation of banks’ liquidity to the Central Bank. They then benefited from the large increase in fiscal buffers following the external borrowing, reaching €768 million in April 2021 (up from €414 million in December 2019).

3. Liquidity buffers in the banking system have also recovered. Decentralized liquidity buffers held by commercial banks outside the CBSM, had fallen sharply since 2015 on the back of significant deposits outflows and reduction of government deposits. They have also recovered

¹ Pension fund buffers were significant but cannot be easily tapped by the government as they are tied up in domestic banks with limited liquidity.

Annex VII. The Reshaping of San Marino's Banking System

San Marino's banking system has gone through considerable consolidation and cost-cutting, significantly outpacing its European counterparts in the last two years. It has also made some progress in its capacity to generate income but continues to lag peers in this front as their balance sheet continues to be saddled with NPLs. Banks have been recently recapitalized (public bank CRSM most aggressively so), but there remain significant challenges as banks move to fully recognize their heavy legacy and pandemic-related losses.

1. San Marino's banking system has shrunk massively since the GFC, driven by a large drop in nonresident deposits. As deposits flew assets contracted over 60 percent, a similar magnitude of other cases with notorious banking crisis such as Cyprus or Ireland.

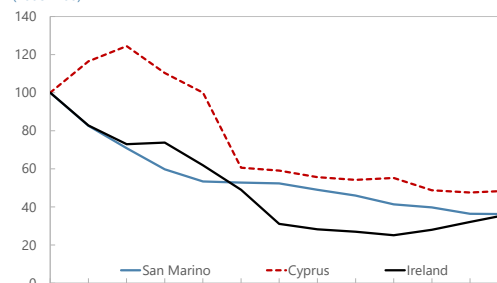
2. The banking system has gone through significant consolidation and restructuring.

Administrative costs fell by around half since their 2010 peak. Cost-cutting gathered momentum since 2018, with administrative costs down 18 percent, with proportional declines in personnel and other non-interest expenses. However, in the context of significant balance sheet contraction, cost reduction has only been 0.2 percent in terms of assets. In these two years, cost reduction has been uneven across banks, with public CRSM delivering a remarkable 30 percent reduction but from higher levels (see table below for bank-by-bank indicators).

3. Administrative costs, scaled by assets (excluding extraneous assets²), are now below European average. This is remarkable given the small market size and the ensuing incapacity of Sammarinese banks to reap economies of scale. The sector experienced significant consolidation but, given the very small population, banks are still small (€0.8–1.4 billion in assets) compared to regional averages. In Europe, small banks have had on average less profitability than

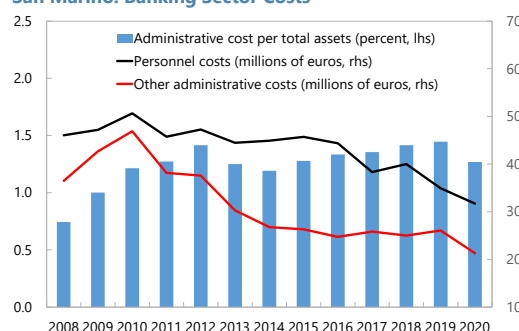
Banking System Assets

(2008=100)



Source: CBSM.

San Marino: Banking Sector Costs



Sources: CBSM; and IMF staff estimates.

San Marino Banks: Key Indicators, 2020

	CRSM	BAC	BSM
Assets	1,425	864	985
Loans to customers (net)	389	374	463
<i>Administrative costs</i>			
in mln EUR	-13.5	-13.1	-15.5
% of assets	-0.9%	-1.5%	-1.6%
Number of branches	9	8	9
Number of employees	101	115	130
<i>Operating income</i>			
in mln EUR	9.7	16.9	14.9
% of assets	0.7%	2.0%	1.5%
NIM	5.0	10.0	9.4
NPL ratio	81.9%	35.2%	54.7%
NPL coverage	76.2%	48.9%	43.7%

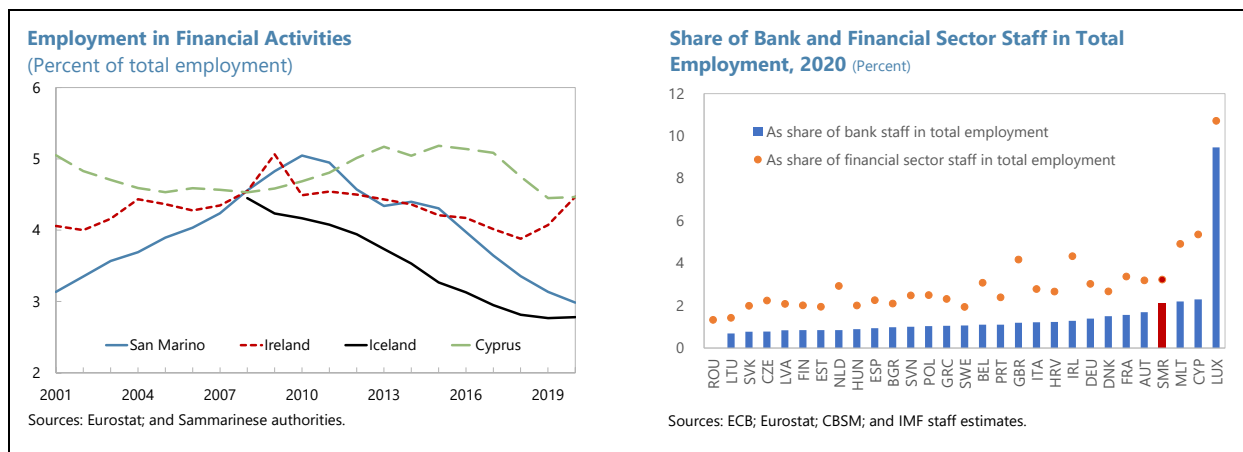
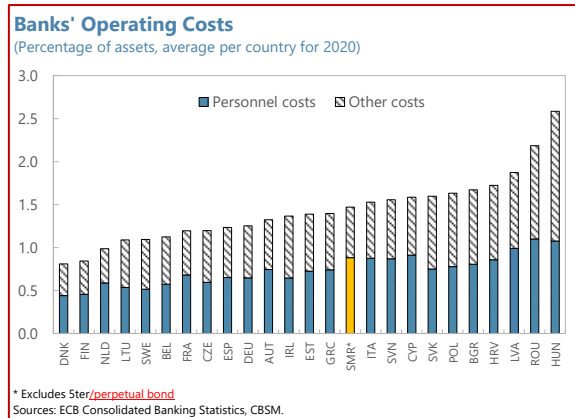
² These include CRSM legacy losses booked as asset called 5ter (converted into a perpetual bond), and tax credits.

competitors, but not significantly so. Indeed, there are a thousand viable banks in Europe that are smaller than Sammarinese banks.

4. The cost reduction has been, since 2015, led by personnel expenses.

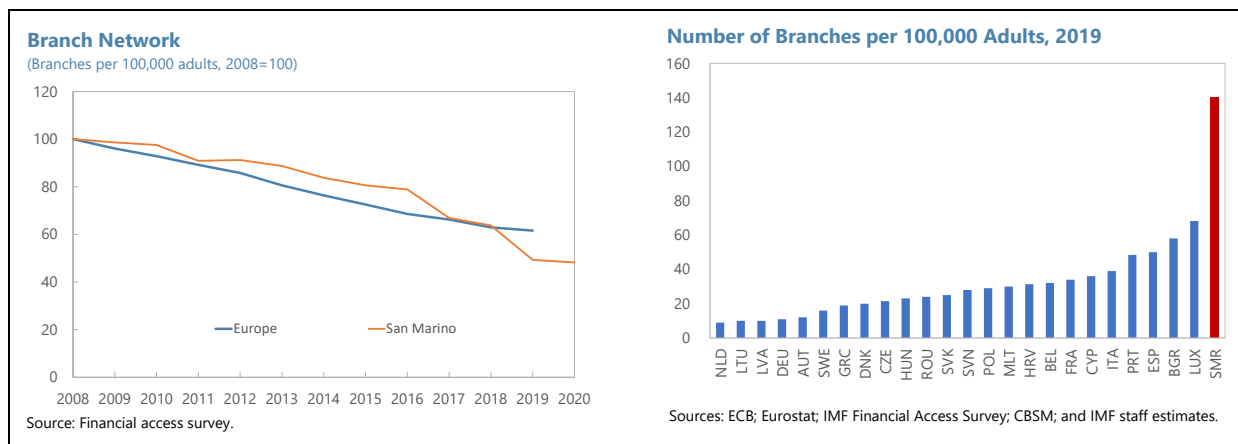
The aggressive reduction in the last two years was underpinned by a headcount reduction of approximately 70 staff (20 from CRSM), or 20 percent of total bank employees. Personnel costs as a share of assets are not grossly misaligned with EU levels, now close to the lowest in the continent.

On the back of this reduction, the share of banking sector employees in total employees in the economy have reached in 2020 a new low of 2.13 percent. This is still in the high-end of European countries but not significantly above average (1.5 percent). More broadly, finance-related workers as a share of total employment have now fallen to 3.3 percent. The share is lower than in several European countries. Compared to other countries suffering financial crisis, the overall decline is now comparable with Iceland, and far larger than those in Ireland or Cyprus.

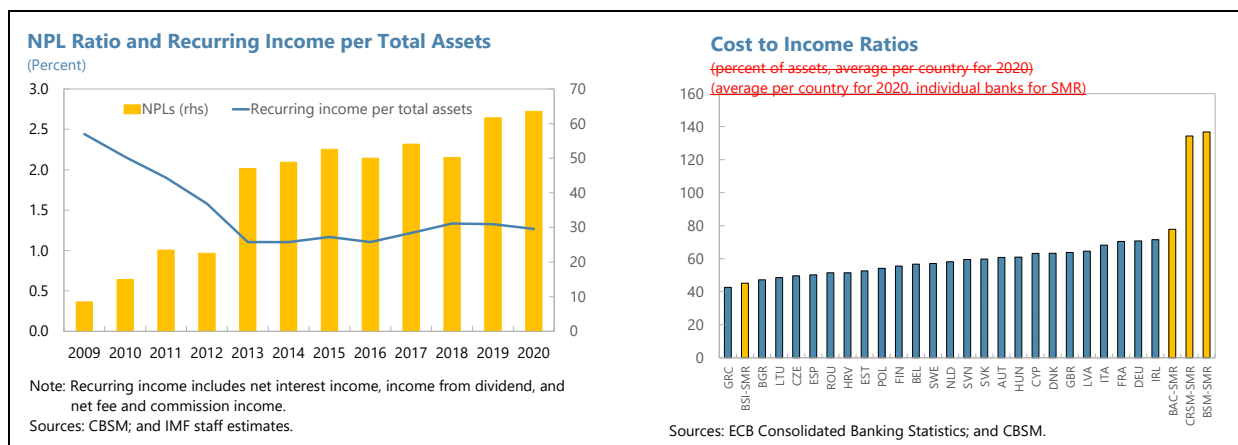


5. The reduction in administrative costs in the last two years has also been underpinned by 11 branch closures, out of 45 open branches in 2018.

Despite European banks having also pursued significant reduction in branches, San Marino has recently outpaced it. However, San Marino has still more branches per capita than any other country in the continent. To converge with European average, banks would have to cut almost 80 percent of the current branch network (26 out of 34).



6. San Marino’s banks have also made progress on propping up their income generating capacity since its 2013 lows, but it has been a slow process. Balance sheets have been continuously hampered by large and growing NPLs and tax credits (and, for CRSM until last year, legacy losses reflected as an asset). Operating income is now the lowest in Europe (or second if extraneous assets are deducted). In three private banks funding costs and interest income from performing loans are not significantly out of line with European averages. But, with deposits at CRSM six times larger than performing loans, their net interest margin is sufficiently low to bring down San Marino average to be one of the lowest in the continent.



7. Given these recent positive developments both in the cost and income side, average cost to income ratio has improved to 104 in 2020 (from 115 in 2017). It still implies, however, that banks have on average negative operating results. It is also the highest in Europe by a margin. Also, against a background of contracting assets (until last year), standard ROA indicators have not improved meaningfully. In the chart above, individual bank data for 2019 (not capturing 2020 improvements) show that CRSM’s cost to income ratio is a crucial contribution to San Marino’s banking system being significantly out of line with Europe’s. Impairment costs have also been very high post-GFC .