BANCA D'ITALIA
EUROSISTEMA

Financial Stability Report

1 | 2014

May 2014

BANCA D'ITALIA
EUROSISTEMA

Financial Stability Report

Number 1 / 2014
May

Other economic publications of the Bank of Italy:

Annual Report
Account of the main developments in the Italian and world economy during the year

Economic Bulletin
A quarterly report on developments in the Italian and world economy

Economic developments in the Italian regions
A series of reports on the regional economies

Working Papers (*Temi di discussione*)
A series of empirical and theoretical papers

Occasional Papers (*Questioni di economia e finanza*)
Miscellaneous studies of issues of special relevance to the Bank of Italy

New research at the Bank of Italy
A newsletter on recent research work and conferences

Economic History Working Papers (*Quaderni di Storia Economica*)
A series of papers on Italian economic history

These publications are available online at www.bancaditalia.it
and in hard copy from the Bank of Italy's library (Biblioteca, Via Nazionale 91, 00184 Rome, Italy)
and at the branches of the Bank.

© Banca d'Italia, 2014
For the hard copy version: registration with the Court of Rome No. 209, 13 May 2010
For the electronic version: registration with the Court of Rome No. 212, 13 May 2010

Director
Paolo Angelini

Editorial committee
Giorgio Gobbi (coordinator), Giorgio Albareto, Paolo Angelini, Martina Bignami, Pietro Catte, Alessio De Vincenzo, Paolo Finaldi Russo, Antonella Foglia, Andrea Generale, Giuseppe Grande, Aviram Levy, Gaetano Marseglia, Fausto Parente (Ivass), Matteo Piazza, Silvia Vori, Francesco Zollino

Boxes
Pierluigi Bologna, Emilia Bonaccorsi di Patti, Marianna Caccavaio, Wanda Cornacchia, Vincenzo Cuciniello, Alessandra De Aldisio, Carla Desideri (Ivass), Paolo Garofalo, Giovanni Guazzarotti, Eleonora Iachini, Costanza Iacomini, Marcello Miccoli, Arianna Miglietta, Stefano Nobili, Marcello Pericoli, Antonio Renzi, Luca Serafini, Andrea Zaghini

Rita Anselmi, Valentina Memoli and Rosanna Visca (editorial assistants for the Italian version)
Giuseppe Casubolo and Roberto Marano (charts and figures)

The English edition has been translated from the Italian by the Secretariat to the Governing Board.

Address
Via Nazionale 91, 00184 Rome - Italy

Telephone
+39 0647921

Website
http://www.bancaditalia.it

All rights reserved. Reproduction for scholarly and non-commercial use permitted,
on condition that the source is cited.

ISSN 2280-7616 (stampa)
ISSN 2280-7624 (online)

Based on data available on 28 April 2014, unless otherwise indicated.
Printed by the Printing and Publishing Division of the Bank of Italy, Rome, May 2014.

CONTENTS

OVERVIEW 5

1 MACROECONOMIC RISKS AND INTERNATIONAL MARKETS 7

1.1 The macroeconomic and financial context 7

1.2 The main risks for financial stability 11

1.3 The real-estate markets 15

2 THE FINANCIAL CONDITION OF HOUSEHOLDS AND FIRMS 18

2.1 Households 18

2.2 Firms 19

3 THE BANKING AND FINANCIAL SYSTEM 23

3.1 The comprehensive assessment 23

3.2 The market's assessment of Italian banks 24

3.3 Credit 25

3.4 Banks' funding, liquidity risk, refinancing risk 30

3.5 Banks' capital and profitability 31

3.6 Insurance companies 35

4 THE MARKETS AND EUROSYSTEM REFINANCING 40

4.1 The liquidity market 40

4.2 Eurosystem refinancing 43

4.3 The government securities market 45

BOXES

The transmission of US interest rate rises to euro-area interest rates 11

The fragmentation of euro-area financial markets 13

Bond issues by Italian firms in the last decade 21

The road to Banking Union 23

Definition of non-performing exposures and forbearance in the EBA rules and the asset quality review 27

Italian banks' deleveraging in the European context 33

Recent developments in banks' branch networks in Italy 34

Insurance companies' investments in bonds issued by SMEs 37

An indicator of systemic liquidity risk in the Italian financial markets 41

The diffusion and risks of virtual currencies: the case of Bitcoin 42

SYMBOLS AND CONVENTIONS

Unless indicated otherwise, figures have been computed by the Bank of Italy.

In the following tables:

- – the phenomenon in question does not occur
- .... the phenomenon occurs but its value is not known
- .. the value is known but is nil or less than half the final digit shown
- :: the value is not statistically significant
- () provisional

OVERVIEW

The global expansion proceeds at moderate and regionally uneven rates

The world economy continues to expand moderately with differing regional performances. In Europe the recovery has also involved the countries hit by the sovereign debt crisis. In some of the emerging economies with structural imbalances, growth has slowed and capital outflows have been recorded.

In Europe financial conditions improve in the countries worst hit by the sovereign debt crisis …

Financial conditions in the euro area have improved in the last few months. The reduction in the spread on government securities, which has been more pronounced since last autumn, mainly reflects the subsidence of fears of a break-up of the single currency, thanks to signs of economic recovery, the effects of fiscal consolidation and the introduction of reforms in a number of countries, the Eurosystem's initiatives and the progress made towards Banking Union.

… but the risks are still considerable

Significant risks remain, especially as regards the evolution of the macroeconomic situation. Negative consequences for growth and financial stability in the euro area could come from a worse than expected slowdown in the emerging economies or an unexpectedly protracted period of low inflation. Uncertainties also stem from the geopolitical tensions in various parts of the world, in particular the crisis between Russia and Ukraine. On the other hand, the risk that the less accommodative monetary policy stance in the United States might cause an increase in medium- and long-term interest rates in the euro area as well has lessened, although it has not disappeared.

In Italy the slow improvement in the macroeconomic situation continues

In Italy the economic recovery is spreading, but it remains fragile. The real-estate market is still weak. House prices are still declining, although the fall in non-residential property prices has come to a halt. Foreign portfolio investment in Italy has increased, both in government securities and private-sector securities. Interest rates have declined on all maturities.

The financial conditions of households are sound …

In 2013 households suffered a smaller decline in disposable income than in 2012; there was a reduction in debt and a recovery in investment in financial assets. Low interest rates and measures to support borrowers helped to contain the vulnerability of indebted households. It is estimated that the proportion of financially fragile households would increase by only a modest margin even under adverse macroeconomic scenarios.

… but those of firms are still difficult

Although some positive signs are emerging, the financial conditions of firms remain weak. Several large companies have substituted bonds for part of their bank debt; for smaller firms, difficulties in accessing credit, low liquidity and the uncertainties still surrounding the cyclical upswing will remain the main sources of risk in the coming months.

The Comprehensive Assessment is under way

The Comprehensive Assessment of the largest euro-area banks is now in progress. The exercise, in which 15 Italian banks are taking part, will permit uniform comparison of bank balance sheets in different countries, helping to reduce the segmentation of European financial markets still further.

Market assessments of Italian banks improve

In the first few months of the year the markets' evaluations of Italian banks improved considerably, bringing them nearer to those of banks in the other main euro-area countries.

The contraction in credit eases

The contraction in bank lending abated somewhat at the start of 2014. Qualitative surveys of banks found more favourable conditions for credit to households; the conditions of credit access for firms, though slightly better, remain restrictive.

The deterioration in loan quality slows

The deterioration in banks' loan asset quality has eased. The flow of new bad debts as a ratio to outstanding loans stabilized in the fourth quarter of 2013, and preliminary data indicate that in the first quarter of 2014 it declined. However, the volume of non-performing loans is still growing.

Loan loss provisions hit profitability but significantly raise coverage ratios

The massive loan loss provisions entered in the banks' accounts at the end of 2013 completely absorbed operating profits, but at the same time they resulted in a significant rise in coverage ratios. This development was welcomed by the markets and may help to revive the market for non-performing loans. Some large banks have announced initiatives to optimize the management of these exposures. The lowering of banks' operating costs continued, thanks in part to the rationalization of branch networks.

Banks reduce their sovereign exposure

Beginning in the second half of last year, Italian banks have reduced the volume of their government securities portfolio.

The funding gap narrows and repayment of Eurosystem financing proceeds

The funding gap has been brought back down to the levels registered in the middle of the last decade, and the repayment of Eurosystem financing has continued, albeit unevenly across banks. The largest have stepped up their bond issuance on the international markets, returning to positive net issues.

A number of banks announce capital increases

Italian banks' capital position deteriorated as a result of the massive loan loss provisions made at the end of 2013. A number of banks have undertaken capital increases for a total of €10 billion. Italian banks' leverage remains lower than that of other European banks.

Risks in the insurance sector are modest

For insurance companies the risks deriving from the protracted phase of low interest rates are modest, thanks in part to insurers' prudent policies on guaranteed-yield policies. The main risks for the sector stem from the tenuous economic recovery. The soundness of the leading companies is now being assessed by the European insurance authority.

Liquidity conditions in the financial markets are easier

The liquidity of the Italian financial markets has improved further. The systemic liquidity risk indicator is now at its lowest level ever, reflecting heavier trading on the secondary market in government securities.

1 MACROECONOMIC RISKS AND INTERNATIONAL MARKETS

1.1 THE MACROECONOMIC AND FINANCIAL CONTEXT

The global economic recovery remains moderate

Global economic recovery continues at a moderate pace overall, and still at different speeds in the main areas (Figure 1.1). The upswing is gaining strength in the United States and the United Kingdom, and in the euro area it is now spreading also to the countries worst hit by the sovereign debt crisis. By contrast, in Japan and in the emerging economies there are signs of a slowdown.

Figure 1.1

Source: Based on Consensus Economics data.
(1) Forecasts made in the months shown on the horizontal axis. – (2) Right-hand scale; average of the forecasts for Brazil, Russia, India and China, weighted on the basis of each country's GDP in 2012, at purchasing power parity.

The Fed's tapering has not affected the advanced countries …

The US Federal Reserve is tapering its purchases of securities. Furthermore, it has announced that the rise in the federal funds rate, which is expected to start in mid-2015, will be gradual and dependent on an actual improvement of economic conditions overall. These indications have helped allay uncertainties about the consequences of the tapering. In the advanced countries the financial market volatility indicators fell back to the levels seen at the beginning of last year (Figure 1.2.a); long-term yields on US and German securities stabilized (Figure 1.2.b).

Figure 1.2

Sources: Based on Bloomberg and Thomson Reuters Datastream data.
(1) Daily data. Indices (31 December 2012=100) derived from the volatility implied in option prices. – (2) Daily data; per cent.

… but is causing tensions in the emerging economies

Among the emerging countries there have been tensions and capital outflows, chiefly in some of the economies characterized by fiscal imbalances, high inflation and heavy dependence on external funding. The effects on the markets of the political crisis in Ukraine and Russia's subsequent annexation of Crimea have so far been limited almost entirely to the countries directly involved.

In Italy the economic recovery is slow

In Italy the modest recovery in economic activity continues, helped by good export performance, which has favoured the return to a current account surplus (see *Economic Bulletin*, No. 2, 2014). Last year the budget deficit remained stable at 3 per cent of GDP, while the primary surplus, at 2.2 per cent, was the largest in any euro-area country, along with Germany's (Table 1.1). Public debt rose from 127.0 to 132.6 per cent of GDP. More than a third of the increase was due to an acceleration of the payment of general government's commercial debts and to financial assistance to other euro-area countries. In a climate of renewed confidence in the monetary union, foreign investors increased their investment in Italy, both in government securities and in private-sector bonds and shares (Figure 1.3.a). This has benefited financial asset prices; the fall in interest rates has involved all maturities (Figures 1.3.b and 1.3.c).

Figure 1.3

Capital flows and yields on government debt securities in Italy

Source: Based on Bloomberg data for sovereign spreads with Germany.
(1) Monthly data in billions of euros. Bank of Italy balance vis-à-vis the ECB in TARGET2 recorded at the end of the month; for the other variables, non-residents' cumulative capital flows from July 2011 onwards. – (2) Deposits and loans, including funding intermediated by resident central counterparties. – (3) The figure for March 2014 was estimated on the basis of the TARGET2 balance, net of the interest paid to non-residents on any Italian government securities they hold.– (4) Daily data; per cent. Interest rates implied by the zero-coupon curve of Italian government securities, spot rate at the 3-year maturity and forward rates at the 2-year and 5-year maturities starting, respectively, 3 and 5 years forward.– (5) Basis points. No data are available for the 3-, 15- and 30-year maturities for Ireland or the 15- and 30-year maturities for Portugal.

Budgetary policy remains prudent

The government's *2014 Economic and Financial Document*, approved on 8 April, updated the forecasts for the public finances for this and the next four years. The 2014 deficit target was revised from 2.5 to 2.6 per cent of GDP. On the basis of the Government's programmes, in 2015 the budget will be practically balanced in structural terms and the debt-to-GDP ratio will start to come down. The debt sustainability indicators, which also take account of the costs deriving from population ageing, and the other macroeconomic indicators confirm that Italy's public finances are broadly balanced in the long term and its level of private sector debt is relatively low (Table 1.1).

Table 1.1

Financial sustainability indicators
(per cent of GDP, unless otherwise specified)

	Budget deficit (1)			Primary surplus (1)			Public debt (1)			GDP *(annual growth rate)* (2)		
	2013	2014	2015	2013	2014	2015	2013	2014	2015	2013	2014	2015
Italy	3.0	2.7	1.8	2.2	2.3	3.3	132.6	134.5	133.1	-1.9	0.6	1.1
Germany	0.0	0.0	0.1	2.2	1.6	1.4	78.4	74.6	70.8	0.5	1.7	1.6
France	4.3	3.7	3.0	-2.0	-1.7	-1.0	93.5	95.8	96.1	0.3	1.0	1.5
Spain	7.1	5.9	4.9	-3.7	-2.8	-1.7	93.9	98.8	102.0	-1.2	0.9	1.0
Netherlands	2.5	3.0	2.0	-0.7	-1.8	-0.8	73.5	75.0	74.4	-0.8	0.8	1.6
Belgium	2.6	2.4	2.1	0.6	0.6	0.8	101.5	99.8	99.6	0.2	1.2	1.2
Austria	1.5	3.0	1.5	1.0	-1.0	0.6	74.5	79.1	78.2	0.4	1.7	1.7
Finland	2.1	2.6	1.9	-1.2	-2.7	-2.1	57.0	60.2	62.1	-1.4	0.3	1.1
Greece	12.7	2.7	1.9	-8.7	1.5	3.0	175.1	174.7	171.3	-3.9	0.6	2.9
Portugal	4.9	4.0	2.5	-0.6	0.3	1.9	129.0	126.7	124.8	-1.4	1.2	1.5
Ireland	7.2	5.1	3.0	-2.5	-0.7	1.6	123.7	123.7	122.7	-0.3	1.7	2.5
Euro area (3)	3.0	2.6	2.0	-0.1	-0.1	0.5	92.6	95.6	94.5	-0.5	1.2	1.5
United Kingdom	5.8	5.3	4.1	-2.8	-3.5	-1.9	90.6	91.5	92.7	1.8	2.9	2.5
United States	7.3	6.4	5.6	-4.1	-3.2	-2.4	104.5	105.7	105.7	1.9	2.8	3.0
Japan	8.4	7.2	6.4	-7.6	-6.4	-5.5	243.2	243.5	245.1	1.5	1.4	1.0
Canada	3.0	2.5	2.0	-2.6	-2.2	-1.6	89.1	87.4	86.6	2.0	2.3	2.4

	Characteristics of public debt (4)			Sustainability indicators		Private sector financial debt at end Q3 2013		External positions	
	Share maturing plus deficit in 2014	Average residual life of govt. securities in 2014 (*years*)	Non-residents' share in 2013 (*% of public debt*)	S2 indicator (5)	IMF indicator (6)	Households	Non-financial firms	Current account balance in 2013	Net international investment position at end-2013 (7)
Italy	28.4	6.3	36.7	-2.3	2.8	44.9	81.9	1.0	-30.0
Germany	6.8	6.5	61.1	1.4	0.9	57.6	57.0	7.5	48.3
France	16.9	6.7	63.8	1.6	4.4	57.0	104.3	-1.3	-21.1
Spain	20.7	5.7	40.0	4.8	6.6	78.1	130.7	0.8	-98.2
Netherlands	14.3	6.7	55.9	5.9	6.1	126.9	93.6	10.4	53.0
Belgium	15.2	7.5	62.6	7.4	8.4	56.8	192.3	-1.6	44.1
Austria	11.5	7.8	87.4	4.1	6.0	53.8	108.4	2.7	3.4
Finland	8.0	6.1	83.5	5.8	3.8	66.6	115.8	-1.1	15.8
Greece	15.8	8.2	85.9	....	....	64.3	64.9	0.7	-119.0
Portugal	20.7	5.2	63.6	....	5.2	88.8	166.2	0.5	-118.7
Ireland	8.7	12.4	65.3	....	6.3	102.5	212.8	6.6	-107.8
Euro area (3)	....	....	....	2.1	....	64.5	100.6	2.3	-13.4
United Kingdom	11.6	14.6	29.7	5.2	6.2	92.2	92.1	-4.4	-1.3
United States	24.4	5.5	32.4	....	11.7	78.5	80.5	-2.3	-27.2
Japan	57.9	6.5	7.9	....	13.4	63.4	104.4	0.7	68.4
Canada	16.0	6.0	22.4	....	5.4	94.7	98.7	-3.2	1.4

Sources: IMF, Eurostat, ECB, European Commission, Istat, national financial accounts and balance-of-payments data.
(1) Final data for 2013 for European and euro-area countries from Eurostat, *Newsrelease Euroindicators*, 23 April 2014. Final data for 2013 for non-European countries and forecasts for 2014 and 2015 for all countries from IMF, *Fiscal Monitor*, April 2014. – (2) IMF, *World Economic Outlook*, April 2014. – (3) Data refer to 18 countries for the budget deficit, the primary surplus and the public debt; to 17 countries for GDP, the S2 indicator, private sector financial debt and external positions. – (4) IMF, *Fiscal Monitor*, April 2014. For Greece, the figure for the residual maturity of government bonds in 2014 is calculated on the basis of Bloomberg data. – (5) European Commission, *Fiscal Sustainability Report 2012*, December 2012. Increase in the primary surplus/GDP ratio (with respect to 2011) needed to satisfy the general government intertemporal budget constraint, given demographic and macroeconomic projections. The estimate takes account of the level of the debt, the outlook for economic growth, changes in interest rates and future primary surpluses, which are affected by the trend of age-related expenditure. – (6) IMF, *Fiscal Monitor*, April 2014. Increase in the primary surplus/GDP ratio that would need to be achieved by 2020 (and maintained for a further decade) in order to bring the debt/GDP ratio down to 60 per cent by 2030. The value includes the projected increase in health and pension expenditure between 2014 and 2030. – (7) For France, end-2012 data; for Ireland and the euro area, data at the end of the third quarter of 2013.

For the euro-area banks funding conditions are improving but not credit quality

Conditions are improving for the euro-area banks to access the wholesale funding markets; credit risk premiums have decreased and bond issues have expanded (Figures 1.4.a and 1.4.b). Nevertheless, credit quality remains low on average and varies from country to country (Figure 1.4.c). Lending to firms contracted in almost all euro-area economies, with interest rates remaining more or less constant relative to 2013 (Figure 1.4.d); lending to households declined in the countries most exposed to sovereign debt tensions, and stagnated or grew only slightly in the others. Financial analysts have revised their earnings forecasts further downwards both for this year and next (Figure 1.4.e).

Figure 1.4

Euro-area banks: main indicators

Sources: Based on Bank of Italy, ECB, Bloomberg, Dealogic, I/B/E/S and Thomson Reuters Datastream data.
(1) Basis points. Basket of sovereign CDS: simple average of Germany, France, Italy and Spain; basket of bank CDS: simple average of the 10 banks listed for those four countries in the note to Figure 3.1. – (2) Monthly data; billions of euros. Bonds not backed by collateral or by a government guarantee. – (3) Quarterly data. Four-quarter moving sum of provisions expressed as a percentage of total loans. The different shades of red correspond to differences between the percentiles shown in the legend. Sample of major euro-area banks that engage in various kinds of banking activity, including at international level: Banco Santander, BBVA, BNP Paribas, Crédit Agricole, Commerzbank, Deutsche Bank, ING, Intesa Sanpaolo, Société Générale and UniCredit. – (4) Monthly data; per cent. Loans to non-financial firms resident in the euro area. – (5) The data on interest rates refer to transactions in euros and are gathered and processed using the Eurosystem's harmonized method. – (6) Loans are adjusted for the accounting effect of securitizations. – (7) Weekly data. Indices, last forecast for 2013=100.

1.2 THE MAIN RISKS FOR FINANCIAL STABILITY

Although diminishing, the risks for financial stability remain substantial

In the euro area the financial system has continued to gather strength thanks to the measures taken by the European Central Bank, the economic recovery, the advance towards Banking Union, and progress with fiscal consolidation and structural reform in several countries. Nonetheless, significant risks remain, particularly in relation to macroeconomic developments.

The economic recovery is still fragile …

The cyclical recovery in the euro area continues to depend on the growth of world demand. The risks for the global economy have changed somewhat in recent months: those originating in the advanced economies have diminished, but the slowdown in the emerging economies could last longer than expected owing to the structural obstacles to growth and the prospect of less accommodative monetary conditions in the United States. The most vulnerable of the emerging countries are those with large payments imbalances or heavily indebted households and firms. In China risks may stem from the difficult transition towards financial intermediaries operating fully according to market principles and the increasingly large shadow banking system. The thus far limited economic repercussions of the tensions between Russia and Ukraine would become significant in the unlikely event (at this stage) of a lengthy stoppage of Russian gas and oil supplies to Europe, about half of which pass through Ukraine.

Finally, the danger of the normalization of monetary policy in the United States pushing up medium- and long-term interest rates also in the euro area has faded but not vanished entirely (see box).

THE TRANSMISSION OF US INTEREST RATE RISES TO EURO-AREA INTEREST RATES

The rise in long-term interest rates in the United States since the spring of 2013 has been accompanied by a smaller increase in those in Germany and initially also in the euro-area countries worst affected by tensions in the government securities market, among them Italy. There is the possibility that further increases in US interest rates will be transmitted to euro interest rates, with adverse repercussions on productive activity.

The co-movements in US and German interest rates are due mainly to term premiums, which have decreased sharply since the beginning of the millennium (see panel (a) of the figure). The decline began in the US and was then transmitted to the euro area. It was caused by strong demand for US government securities on the part of emerging countries to accumulate foreign-exchange reserves and more recently by the Fed's purchases of Treasury securities as part of its quantitative easing programme. According to our estimates, between November 2008 and April 2013, quantitative easing reduced the term premium on ten-year securities by about 1.6 percentage points in the US and by about 1.0 points on average for German and French rates.

The trend in interest rates on Italian government securities in the last decade can be broken down into three phases (see panel (b) of the figure). The first goes from the launch of EMU to the collapse of Lehman Brothers in September 2008. During this period, in which sovereign risk premiums in the European countries were generally aligned, a strong positive correlation existed between the yields on Italian and German securities and to a lesser extent between Italian and US yields. In the second phase, going from September 2008 to the summer of 2012, the correlations slowly diminished before turning extremely negative: real or financial exogenous shocks prompted investors to cut back their exposures to the euro-area countries most vulnerable in the event of a break-up of the monetary union, and seek shelter in safe-haven assets, such as German and US government securities. In the third phase, beginning in the summer of 2012 with the ECB's announcement of its Outright Monetary Transactions programme, the correlations increased again, progressively returning to positive values, though still below pre-2008 levels.

Since May 2013, expectations of a gradual tapering of quantitative easing in the United States have brought upward pressure to bear on US and European interest rates, which central bank forward guidance has sought to counter. In the European countries worst hit by the sovereign debt crisis the pressure has been more than offset by heavy demand from investors in flight from the emerging countries in search of safer and relatively profitable investments (see the box "The narrowing of Italy's sovereign spreads since the summer of 2012", *Economic Bulletin*, No. 2, 2014). Going forward, once the favourable effect of capital inflows has worn off, yields on the securities of the most vulnerable European countries will be newly exposed to the risk of further rises in US interest rates. This would be more likely if rate rises were not transmitted via expectations regarding short-term interest rates, which are directly influenced by the ECB's forward guidance, but via term premiums. By contrast, there appears to be less likelihood that interest rates will rise as a result of portfolio shifts towards low-risk assets as happened at the height of the sovereign debt crisis.

Interest rates on 10-year government debt securities in the US and the euro area: levels, term premiums and correlations with Italian rates

Source: Based on Thomson Reuters Datastream data.
(1) Average monthly data; percentage points. – (2) Zero-coupon rates calculated on the basis of French and German government securities. – (3) Term premiums are estimated using an interest rate factor model from M. Pericoli, "Expected inflation and inflation risk premium in the euro area and in the United States", Banca d'Italia, *Working Papers*, No. 842, 2012. – (4) Daily data. Correlation between daily changes in 10-year zero-coupon interest rates calculated by means of an exponentially weighted moving average. The two vertical lines indicate, respectively, the collapse of Lehman Brothers on 14 September 2008 and the speech given by ECB President Mario Draghi in London on 26 July 2012.

… and inflation is very low

Inflation in the euro area could remain very low for an extended period, generating risks for financial stability through several channels (Figure 1.5). To begin with, given the lower bound on nominal interest rates, real interest rates could rise beyond the level needed to support economic recovery. Moreover, adjustment would become more costly for indebted sectors. Last, given nominal rigidities, the adjustment of competitive imbalances between the euro-area countries could become more drawn out.

The macroeconomic risks could heighten those for the banking industry

Despite signs that credit quality is stabilizing, the large proportion of non-performing loans,

Figure 1.5

Forward inflation rates in the euro area (1)
(daily data; per cent)

Source: Based on Bloomberg data.
(1) One-year, 2-year, 4-year and 6-year forward one-year inflation rates.

Figure 1.6

Banks' exposure to emerging economies and offshore centres (1)
(quarterly data; billions of euros)

Source: Based on BIS data.
(1) Data at Q4 2013. Total exposures of banks of the countries on the horizontal axis to borrowers in the economic areas or countries in the legend. Data on ultimate debtor basis. The aggregate "Central and Eastern European countries" includes countries from the former USSR.

particularly in the countries hardest hit by the recession, is eating into banks' profitability and making them less willing to lend. The fragmentation of the funding and lending markets has diminished but not disappeared (see box). Other possible sources of vulnerability for banks are the risks originating in the emerging countries. Exposures to them differ markedly among the banking systems of the main European countries, in terms of both overall size and geographical composition (Figure 1.6). Italian banks have fairly limited exposures, mainly to the countries of Central and Eastern Europe (see Chapter 3).

THE FRAGMENTATION OF EURO-AREA FINANCIAL MARKETS

The prolonged phase of global financial instability that began in the summer of 2007 has caused financial markets in the euro area to become fragmented along national lines (see *Financial Stability Report*, No. 4, 2012). The phenomenon has become less marked lately, but it has not ceased completely.

A simple indicator of fragmentation is the dispersion of interest rates on loans to banks and firms among the various countries, which increased considerably from 2010 to the summer of 2012 and remains significant despite lessening recently (see figure, panel (a) below and Figure 1.4.d). The dispersion reflects diverging trends between the countries most vulnerable to sovereign debt tensions and the other euro-area countries. In the first group, the spreads on bank and corporate bonds began to narrow again in the second half of 2012 after the ECB introduced Outright Monetary Transactions, but in most cases they continue to be higher than before the sovereign debt crisis (see panels (b) and (c) of the figure).

Part of the interest rate dispersion can be attributed to differences in fundamentals, starting with credit risk. However, econometric estimates that take account of issuer characteristics and other features of the securities indicate that, even adjusting for these factors, the cost of borrowing for private bond issuers in Italy was on average still some 40 basis points higher than for German issuers in the period following the introduction of OMT (see table).

Indicators of banking and bond market fragmentation in the euro area

Sources: Based on ECB, Dealogic and Thomson Reuters Datastream data.
(1) Percentage points. Standard deviation between countries of the bank lending rates in the legend applied to firms and average asset swap spreads at issue on bank and corporate bonds. Monthly data for bank interest rates and annual data for bond spreads. – (2) Average annual asset swap spreads at issue, in basis points, on bonds (placed on the international market) of banks or of firms whose parent company is located in the country indicated on the horizontal axis. The periods of time are: financial crisis, from 2007 Q4 to 2010 Q2; sovereign debt crisis, from 2010 Q3 to 2012 Q2; post OMT, from 2012 Q3 to 2013 Q4. – (3) Legend: BE=Belgium; DE=Germany; ES=Spain; FR=France; IE=Ireland; IT=Italy; NL=Netherlands; PT=Portugal. – (4) Monthly data. National government securities held by banks of the country in the legend, as a percentage of banks' total assets. See P. Angelini, G. Grande and F. Panetta, "The negative feedback loop between banks and sovereigns", Banca d'Italia, *Occasional Papers*, No. 213, 2014.

Another indicator of financial market fragmentation along national lines in the euro area is the increase in the share of assets that financial institutions invest in national government securities. This shift first became apparent in September 2008 in the wake of the collapse of Lehman Brothers. It has involved the banks of almost all the euro-area countries, including those least affected by the sovereign debt crisis (see panel (d) of the figure), as well as other financial intermediaries such as insurance companies. Here again, there are signs that the trend is reversing as the sovereign debt crisis gradually fades. Italian banks have progressively reduced their investments in national government securities since July last year (see Chapter 3).

Yield spread between bonds issued by Italian and German banks and firms
(basis points)

		ascribable to	
		type of issuer or type of security	country of residence (2)
	(1)	(2)	(3)
Financial crisis (4)	59	59	0
Sovereign debt crisis (5)	139	37	102
Post OMT (6)	187	146	41

Source: Based on Dealogic, Bloomberg and Thomson Reuters Datastream data.
(1) Differential between the average value, in the period indicated, of asset swap spreads at issue of Italian banks' and firms' bonds and the average value of those of German banks' and firms' bonds. – (2) Estimate of the part of the differential with respect to Germany (first column) due to the features of securities (rating, volume, duration, currency) and issuers (rating, size, sector), calculated as the difference between the first and the third column. – (3) Estimate of the part of the differential with respect to Germany (first column) due to the fact that the issuer's parent company is located in Italy, not in Germany. The estimates, which take account of the characteristics of the securities and issuers in note (2), are based on over 7,000 issues by euro-area firms in 2006-2013. – (4) From 2007 Q4 to 2010 Q2. – (5) From 2010 Q3 to 2012 Q2. – (6) From 2012 Q3 to 2013 Q4.

1.3 THE REAL-ESTATE MARKETS

The real-estate market loses momentum in the US, but is beginning to stabilize in the euro area …

The US property market recovery has levelled off for the time being, partly owing to the rise in mortgage rates since last summer. However, futures prices indicate that house prices should begin to increase again in the second half of 2014. In the euro area, house prices stabilized between the first and second half of 2013 (Figure 1.7). There are still large differences between countries, though, with prices falling again in Spain and the Netherlands, generally stable in France, but continuing to rise in Germany and Ireland.

Figure 1.7

House prices in Europe (1)
(quarterly data; indices, 2000=100)

Sources: Based on national sources and ECB data.
(1) Nominal prices.

… while the Italian property market remains weak

House prices in Italy have been declining since the end of 2011. In the fourth quarter of 2013 they were down by 1.3 per cent on the previous quarter and by 4.8 per cent on a year earlier (Figure 1.8). Instead, prices were virtually stationary in all the main categories of non-residential property and increased slightly for industrial premises (production sheds and warehouses) in the second half of the year. The number of house sales began to contract again in the last quarter of 2013, presumably owing to the postponement of purchases to the beginning of this year to take advantage of the reduction in stamp duty (from 3 to 2 per cent for main residences) and in mortgage and land registry taxes (now set as a fixed amount and no longer as a proportion of the value of the property).

Figure 1.8

The property market in Italy: transactions and prices
(quarterly data, adjusted for seasonal and calendar effects)

Sources: Based on data from Bank of Italy, Istat, OMI, Nomisma and Scenari Immobiliari.
(1) Right-hand scale. – (2) Deflated using the change in consumer prices; right-hand scale. – (3) Total market. – (4) Right-hand scale. This experimental prices indicator uses data from actual market transactions. The tertiary segment comprises office buildings and credit institutions; commercial property comprises shops, shopping centres and accommodation; industrial property consists of buildings for industrial use.

The risk of house price overvaluation is still low

The risk of house prices being overvalued in Italy is limited. The housing affordability index and the price-rent ratio have fallen to fairly low values by historical standards (Figure 1.9).

The outlook for the real-estate market in Italy remains uncertain

The weakness of the real-estate market is expected to persist in the coming months, despite some signs that the situation is easing. Estate agents expect a further drop in house prices in the current quarter. The decline in the confidence indicator for

Figure 1.9

Housing affordability index and ratio of house prices to rents in Italy
(semi-annual data; indices, 1992-2013 average=100)

Sources: Based on Bank of Italy, Istat, OMI and *Consulente immobiliare* data.
(1) With respect to new rental contracts. – (2) Right-hand scale. The indicator is given by the ratio of debt service on new mortage loans – proxied by the product of house prices and interest rates – to household disposable income; a decrease indicates that housing is more affordable.

Figure 1.10

Estate agents' expectations in Italy (1)
(percentage points; balance of responses)

Sources: Based on Bank of Italy, OMI and Tecnoborsa data.
(1) Quarterly data from the survey conducted by the Bank of Italy, Tecnoborsa and OMI. Balances between the percentages of responses indicating a situation that is improving or worsening. Short-term expectations refer to the quarter following the one indicated; expectations for the national market refer to a 2-year horizon.

construction firms since the beginning of this year has wiped out most of the gain recorded in the second half of 2013. The number of building permits for residential property rose slightly, however. Activity in the sectors supplying intermediate inputs to the construction industry shows signs of stabilizing, while estate agents' pessimism for the short term has eased and expectations for the medium term remain strongly positive (Figure 1.10).

Prices of non-residential property may be negatively affected when sixteen retail real-estate investment funds maturing before December 2016 are cashed out within a short space of time. Foreign investors have shown a growing interest, through tender offers, in acquiring stakes in some of the maturing funds that are more attractive because the value of their net assets exceeds their market capitalization. To minimize the risk of property prices being driven down, the Government is now examining a bill allowing the funds to sell off their assets more slowly. In view of its counter-cyclical function, this measure would play a macro-prudential role.

2 THE FINANCIAL CONDITION OF HOUSEHOLDS AND FIRMS

2.1 HOUSEHOLDS

The decline in Italian households' disposable income slows

In 2013 the decline in households' disposable income under way since 2011 slowed in real terms, recording a contraction of 1.2 per cent for the year as a whole. Nominal income was basically unchanged; while consumption fell, savings increased substantially (11.1 per cent).

Together with the rise in the price of financial assets, this contributed to the increase in financial wealth (0.5 per cent) in the first nine months of 2013. Total wealth, however, continued to decline as a result of the drop in house prices.

Mortgage loan disbursements underscore early signs of recovery

Households' financial debt contracted again, by 1.6 per cent in 2013, but there were signs of a recovery in loans for house purchase. Compared with the same period in 2013, mortgage loan disbursements rose by 9.3 per cent in the first quarter of 2014 (Figure 2.1). Bank surveys suggest that the improvement reflects an easing of the terms of supply and a recovery of demand, mainly owing to the less negative outlook for economic activity.

Figure 2.1

Loans for house purchase: demand and supply conditions and new loans
(diffusion indices and millions of euros; quarterly data)

Sources: Euro-Area Bank Lending Survey and supervisory reports.
(1) Right-hand scale. Includes subrogations and substitutions. – (2) For the demand index, values above (below) zero indicate expansion (contraction); for the supply index, values above (below) zero indicate tightening (easing).

Interest rates remain at historically low levels …

In the early months of 2014, the average cost of bank credit for households was unchanged at a record low of 4.0 per cent, above all due to the very low Euribor rates, to which most mortgages are index-linked (72 per cent).

… helping to limit the vulnerability of indebted households

In the two years 2012-13 low interest rates and measures to support mortgage holders in difficulty helped mitigate the effect of the sharp drop in disposable income on the finances of indebted households. The latest Survey on Household Income and Wealth indicates that in 2012 the share of vulnerable households (those with disposable income below the median and debt service higher than 30 per cent of income) represented 2.9 per cent of the total. In the second half of 2013 non-performing loans as a share of total lending to households rose by three decimal points, to 10.3 per cent. The biggest deterioration was in the category that includes loans to fund professional activities (Table 2.1; *Other loans*).

The main risk comes from weak income growth

Our forecasts indicate that assuming gradual economic recovery (see *Economic Bulletin*, No. 1, 2014) the share of vulnerable households will remain basically unchanged in 2015 at 2.8 per cent of the total. The main risk for indebted

households comes from weak growth in disposable income: if this were to remain unchanged from 2013, the share of vulnerable households would rise to 3.3 per cent in 2015. An increase of 100 basis points in the three-month Euribor rate during the same period would have a more moderate effect, bringing the share of vulnerable households to 3.0 per cent.

2.2 FIRMS

Profitability is still low but firms' expectations improve

Despite a modest improvement in the last part of the year, in 2013 firms' profitability stayed at a very low level. According to national accounts data, gross operating profit as a percentage of value added held stable at 33 per cent, with interest expense absorbing more than 21 per cent. Weak investment activity held down firms' external funding requirement.

The latest business surveys signal an improvement in expectations for demand in the months to come, especially among exporters and the largest firms; investment conditions are deemed more favourable than in recent months and a majority of firms predict an increase in investment expenditure in 2014.

Faint signs emerge of an easing of financial conditions

The financial conditions of firms remain weak overall. Production halts and the number of bankruptcy procedures initiated in 2013 reached a new peak (Figure 2.2.a); while the balance between new registrations and closures of firms (around 12,700) is still positive, it is more than two-thirds below that observed in the previous five years. In the final months of 2013, however, there were signs of a slight improvement. The growth in bad debts eased (see Section 3.3); Cerved data indicate a modest reduction both in the proportion of unpaid invoices as a share of the total amount falling due, and in the share of companies paying late.

Table 2.1

Loans to consumer households (1)
(millions of euros and percentage composition)

	June 2013		December 2013	
	House purchase loans			
Total	**341,970**	**100.0**	**339,865**	**100.0**
of which:				
Performing	322,078	94.2	318,865	93.8
Non-performing	19,891	5.8	21,000	6.2
Past-due (2)	*3,148*	*0.9*	*3,053*	*0.9*
Substandard	*6,110*	*1.8*	*6,558*	*1.9*
Bad debts	*10,633*	*3.1*	*11,388*	*3.4*
	Consumer credit			
Total	**116,511**	**100.0**	**113,203**	**100.0**
of which:				
Performing	103,555	88.9	101,117	89.3
Non-performing	12,956	11.1	12,085	10.7
Past-due (2)	*1,876*	*1.6*	*1,714*	*1.5*
Substandard	*3,233*	*2.8*	*3,353*	*3.0*
Bad debts	*7,847*	*6.7*	*7,018*	*6.2*
	Other loans (3)			
Total	**100,331**	**100.0**	**100,304**	**100.0**
of which:				
Performing	77,560	77.3	76,233	76.0
Non-performing	22,770	22.7	24,072	24.0
Past-due (2)	*1,879*	*1.9*	*1,689*	*1.7*
Substandard	*4,547*	*4.5*	*4,789*	*4.8*
Bad debts	*16,344*	*16.3*	*17,594*	*17.5*
	Total loans			
Total	**558,811**	**100.0**	**553,372**	**100.0**
of which:				
Performing	503,194	90.0	496,215	89.7
Non-performing	55,617	10.0	57,157	10.3
Past-due (2)	*6,903*	*1.2*	*6,457*	*1.2*
Substandard	*13,890*	*2.5*	*14,701*	*2.7*
Bad debts	*34,824*	*6.2*	*36,000*	*6.5*

Source: Supervisory reports.
(1) Loans include repos but not securitized loans cancelled from the balance sheets. – (2) Past-due loans include restructured loans. – (3) Other loans mainly comprise current account overdraft facilities and mortgages to build or buy non-residential properties, to consolidate other loans or for other non-specific purposes.

Credit continues to contract …

In 2013 the decline in financial debt that began in mid-2011 continued, with a fall of 2.7 per cent on an annual basis (Figure 2.2.b). The debt-to-GDP ratio shed two percentage points, bringing it to 81 per cent. The decline was basically attributable to bank loans, which continued to contract in the early months of this year (down 4.2 per cent on an annual basis in March 2014). The Italian banks interviewed in the euro-area bank lending survey reported an easing of lending conditions, which nonetheless remain restrictive. The survey of manufacturing firms conducted by Istat in the early months of 2014 indicates that the share of firms reporting difficulty in accessing credit

Figure 2.2

Firms' financial conditions

Sources: Bank of Italy, Istat and Cerved Group.
(1) Data for companies that filed at least one financial statement in the three years prior to the reference date. – (2) Right-hand scale. – (3) Data for the non-financial corporate sector. The figures for the fourth quarter of 2013 are provisional. – (4) The loans include bad debts. The data refer to a sample of some 420,000 firms, divided according to a score assigned by Cerved on the basis of several balance-sheet indicators. Firms are defined as "sound" with scores of 1 (high safety), 2 (safety), 3 (high solvency) and 4 (solvency); "vulnerable" with scores of 5 (vulnerability) and 6 (high vulnerability); "risky" with scores of 7 (risk), 8 (high risk) and 9 (very high risk) . – (5) The data exclude companies that issued bonds between 2009 and 2013.

remained high – around 18 per cent among firms with fewer than 50 employees and 12 per cent among the largest firms (Figure 2.3).

… in part owing to the reimbursement of general government debts

In addition to weak investment growth, the decline in credit was partly due to the acceleration in the repayment of general government arrears, which many firms used to reduce their exposure to banks. At end-March 2014, about half the amount allocated for the two years 2013-14 had been reimbursed (€23.5 billion). Surveys conducted by business associations indicate a slight improvement in general government payment times with respect to the past, although they are still far off the 30-60 days prescribed by European law (see the box "General government commercial debts", *Economic Bulletin*, No. 2, 2014).

Figure 2.3

Difficulty in accessing credit
(per cent and diffusion indices)

Sources: Bank of Italy and Istat.
(1) Monthly averages; share of manufacturing firms reporting that they had applied for but not obtained credit as a percentage of the total that had contacted banks or finance companies in the last three months. – (2) Right-hand scale. Quarterly data for Italian banks; positive values indicate a tightening of supply. The diffusion indices are built based on the following weighting scheme of the qualitative responses of banks: 1=substantial tightening, 0.5=moderate tightening, 0=basically stable, -0.5=moderate easing, -1=substantial easing.

Some large firms adopt alternative financing channels …

As in 2012, the decline in credit among the largest and financially soundest companies was mostly due to the substitution of bank debts with bonds (see the box "Bond issues by Italian firms in the last decade"). Among the firms that did not issue bonds, bank lending to those with healthy balance sheets slowed less (Figure 2.2.c). The increase in firms' liquidity (cash and

bank deposits expanded by around €15 billion in 2012 and in 2013) also appears to have been partly due to bond issues.

… and measures are adopted to support SMEs' access to credit

For small and medium-sized firms, the main measure to support access to credit remains the Central Guarantee Fund, which last year accepted a record number of applications (77,000) in relation to guarantees for loans amounting to €10.8 billion. A further expansion of the Fund's activity could come from the increase in its endowment and the recent changes to its modus operandi (see *Financial Stability Report*, No. 6, 2013). In July 2013, the Italian Banking Association together with the main business associations signed a new moratorium, the third since 2009, allowing SMEs to request the suspension or extension of loan repayments; as under the previous agreement, the eligibility criteria exclude firms with poor debt repayment records. Fewer firms applied than in the past: in 2013 some 55,000 applications were granted in relation to total suspended repayments of principal amounting to €3.3 billion. An improvement in firms' ability to access credit in the medium term could derive from the capital-building incentives introduced by Decree Law No. 201/2011 (the Allowance for Corporate Equity), reinforced by the 2014 Budget Law No. 147/2013: the scant contribution of equity capital is, in fact, one of the factors that have most limited firms' ability to secure new funding during the crisis.

The principle risks are still the weakness of the recovery and the difficulty in obtaining funding

The weakness of the recovery and the difficulty of accessing credit will continue to be the main risk factors for firms in the months to come. Despite positive expectations for the demand for goods and services, small firms still routinely struggle with liquidity and funding problems. Delay in recovering profitability will have the biggest impact on the most financially fragile firms: according to the latest available data on the balance sheets of around 650,000 mostly micro-enterprises, in 2012 the proportion of vulnerable firms (i.e. with net interest expense of more than 50 per cent of their gross operating profit) was close to 33 per cent and their loans were 46 per cent of the total credit to firms; the smallest firms and those in the construction sector were the most vulnerable.

BOND ISSUES BY ITALIAN FIRMS IN THE LAST DECADE

Between 2009 and 2013 gross bond issues by non-financial Italian corporations increased significantly, averaging €32 billion a year, compared with €23 billion between 2002 and 2007. The placements were particularly high – in excess of €35 billion – in the years when firms experienced the greatest difficulties in accessing bank credit (2009, 2012 and 2013). The increase was confined to large firms, which have access to international markets (see the figure). Among SMEs, whose placements are mostly aimed at the domestic market, there was a decline in both the value of the securities issued and the number of issuers.

During the crisis the number of first-time issuers was substantially lower than in the preceding period, averaging 69 and 122 firms a year, respectively. Only in 2013 did the number of new issuers pick up again, especially among large companies, several of which benefited from the new law on unlisted corporate securities (mini-bonds). (1)

Since the first placement in November 2012, there have been 24 issuers of mini-bonds (including two non-Italian issuers) for a total amount of close to €6 billion. Smaller firms' recourse to this instrument continues to be hindered by various factors. On the one hand, with their characteristic

(1) Decree Law 83/2012, ratified by Law 134/2012, updated the rules for debt security issues (financial bills and bonds) by unlisted companies other than banks and micro-enterprises as defined in Commission Recommendation (2003/361/EC). For securities listed in regulated markets or held by professional investors, the law removes the limit on the tax deductibility of interest payments and the maximum value of the securities that can be placed (Article 2412 of the Civil Code) and exempts some categories of investor (including banks, companies and non-residents) from the 20 per cent withholding tax.

Bond issues by firm size
(millions of euros and units)

Sources: Bank of Italy and Dealogic.

low liquidity and high risk, mini-bonds may be unappealing to institutional investors; on the other, many businesses might be reluctant to bear the costs connected with the greater level of transparency required by the market.

Bond issues have largely replaced bank debt. An analysis conducted on a sample of around 260 Italian industrial groups shows that between 2009 and 2013 those that turned to the bond market reduced their indebtedness to banks operating in Italy by around 42 per cent, while bank lending to other groups remained basically unchanged. The placements of securities by the groups in the sample came to around €68 billion net of redemptions, while bank loans fell by €33 billion.

3 THE BANKING AND FINANCIAL SYSTEM

3.1 THE COMPREHENSIVE ASSESSMENT

The comprehensive assessment of the soundness of the main euro-area banks preliminary to the initiation of the Single Supervisory Mechanism on 4 November is under way (see box).

THE ROAD TO BANKING UNION

The Single Supervisory Mechanism (SSM) is at an advanced stage of realization. Approved last October, it will be fully operational this November, after the conclusion of the comprehensive assessment by the ECB and the national supervisory authorities of the 128 largest banking groups in the euro area (15 of which are Italian).[1] The exercise, which comprises a supervisory risk assessment, an asset quality review and a stress test, has three main purposes: to assess the actual soundness of the banks by harmonized standards; to quantify any corrective measures that may prove necessary; and to provide clear and comparable information on banks' conditions. The assessment is intended to help restore confidence in the European banking system and foster the flow of finance to the economy.

The asset quality review is now under way, based on data as at 31 December 2013. This will be followed by the stress test, whose methodology has just been published by the European Banking Authority.[2] The review covers all exposures, including market exposures (in particular also the hard to value or "level 3" exposures)[3] and applies the harmonized definitions of performing and non-performing exposures (see the box "Definition of non-performing exposures and forbearance in the EBA rules and the asset quality review"). To this end, banks' capital adequacy is assessed against the benchmark of a common equity tier 1 ratio (CET1) of 8 per cent of risk-weighted assets. The capital requirement is calculated on the banks' balance sheets at the end of 2013, using the definition of capital in effect on 1 January 2014 and considering the scope for national discretion, usually transitory, under the new capital regulations (Capital Requirements Directive IV and the Capital Requirements Regulation). The minimum CET1 ratios to pass the stress test are 8.0 per cent in the baseline scenario and 5.5 per cent in the adverse scenario.[4] The results of the comprehensive assessment will be disclosed at the conclusion of the exercise. Banks are expected to cover capital shortfalls arising from the asset quality review or stress test baseline scenario within six months and those stemming from the adverse scenario within nine months. The shortfalls will have to be made good above all by avoiding dividend distributions, disposing of non-strategic assets, reducing costs, and carrying out equity issues on the market; reductions in risk-weighted assets associated with the validation of internal models will be taken into consideration subject to certain conditions.[5]

[1] The Italian groups in the exercise are Banca Carige, Banca Monte dei Paschi di Siena, Credito Valtellinese, Banca Popolare dell'Emilia-Romagna, Banca Popolare di Milano, Banca Popolare di Sondrio, Banca Popolare di Vicenza, Banco Popolare, Credito Emiliano, ICCREA Holding, Intesa Sanpaolo, Mediobanca, UniCredit, Unione Di Banche Italiane, and Veneto Banca.

[2] See https://www.eba.europa.eu/-/eba-publishes-common-methodology-and-scenario-for-2014-eu-banks-stress-test.

[3] Level 3 assets are over-the-counter instruments valued by banks' complex internal models (see the box "The weight of level 3 assets in the total assets of European banks", *Financial Stability Report*, No. 6, 2013).

[4] For the definition of capital used in the stress test, see the EBA documentation cited in note 2.

[5] See the ECB's press release of 29 April (http://www.ecb.europa.eu/press/pr/date/2014/html/pr140429_1.it.html) and its note on the Comprehensive Assessment (http://www.ecb.europa.eu/pub/pdf/other/notecomprehensiveassessment201404en.pdf?f76543999bdb25be25521bd9728f41d8).

In March the Commission, the Council and the European Parliament reached agreement on the single resolution mechanism for banking crises, which comes fully into force on 1 January 2016. The resolution mechanism supplements the Single Supervisory Mechanism. A Single Resolution Board is to be instituted (consisting of five permanent members plus the national resolution authorities and, as observers, representatives of the ECB and the Commission), and a Single Resolution Fund created with an endowment, when fully phased in, of about €55 billion (corresponding to 1 per cent of the deposits covered by guarantee schemes), financed by contributions from the banks. The Board will decide on initiation of the resolution process, unless the Commission objects. The Council can intervene in the decision at the request of the Commission. The Fund's full endowment will be provided within eight years. Annual contributions will be divided equally over the period, and the mutualization of national resources will be gradual (60 per cent will be pooled in the first two years). The Fund can raise resources on the market. The design of a financial backstop, which could prove necessary in the event of extraordinary losses, remains to be finalized.

The single supervisory and resolution mechanisms are supplemented by the Bank Recovery and Resolution Directive and the Deposit Guarantee Scheme Directive. The latter provides for substantial harmonization of national schemes, but discussion of a single deposit insurance scheme has been postponed.

3.2 THE MARKET'S ASSESSMENT OF ITALIAN BANKS

Market indicators improve and volatility diminishes

The assessment of the major Italian banks as measured by market indicators has improved markedly since the end of 2013, consequent on the narrowing of sovereign spreads and the capital strengthening plans. Between November and mid-April, Italian banks' CDS spreads came down by 127 basis points on average and their share prices gained 20 per cent (Figure 3.1). Over the same period, the average CDS spreads of the main European banks diminished by 47 basis points and their shares rose by 11 per cent. The improvement in the indices was accompanied by a drop in volatility. The steep rise in share prices brought the Italian banks' average price-to-book ratio up to 74 per cent, further narrowing the gap with their European competitors (the average for the major German, French, Spanish and Dutch banks was 84 per cent).

Figure 3.1

Listed Italian banks: international comparison (1)

Sources: Based on data from Bloomberg, Moody's KMV and SNL Financial.
(1) Panel (a) refers to the following banks: for Italy, UniCredit, Intesa Sanpaolo and Banca Monte dei Paschi di Siena; for France, BNP Paribas, Société Générale and Crédit Agricole; for Germany, Deutsche Bank and Commerzbank; for the United Kingdom, Barclays, Royal Bank of Scotland, HSBC and Lloyds; for Spain, Banco Santander and Banco Bilbao Vizcaya Argentaria. Panels (b) and (c) refer to the following sample of banks: for Italy, UniCredit, Intesa Sanpaolo and Banca Monte dei Paschi di Siena; for Europe, UniCredit, Intesa Sanpaolo, Banca Monte dei Paschi di Siena, BNP Paribas, Société Générale, Crédit Agricole, Deutsche Bank, Commerzbank, ING, Banco Santander, Banco Bilbao Vizcaya Argentaria, HSBC, Barclays, Royal Bank of Scotland, Lloyds, UBS and Credit Suisse; for the United States, Citigroup, JPMorgan Chase, Bank of America, Goldman Sachs, Morgan Stanley and Wells Fargo.– (2) Simple average of daily data, basis points. Five-year senior debt. – (3) Daily data, percentage points. The expected default frequencies (EDFs), calculated on the basis of the price and volatility of the stock of the banks to which they refer, measure the likelihood of assets having a lower market value than liabilities over a period of 1 year.– (4) Average share prices are calculated with reference to price indices; closing price at 29 August 2008=100.

3.3 CREDIT

Lending to the economy and the quality of credit

The contraction in credit slows …

Bank lending to the private non-financial sector continued to decline, albeit at a slightly slower pace than in the second half of 2013 (Figure 3.2.a). The surveys of banks and firms show a small improvement in loan supply conditions (see Chapter 2); banks expect lending policies to remain unchanged in the current quarter.

Figure 3.2

Changes in loans and interest rates

Sources: Based on Bank of Italy and ECB data.
(1) The percentage changes are calculated net of reclassifications, exchange rate variations, value adjustments and other variations not due to transactions. Lending includes loans not recorded in banks' balance sheets because they have been securitized. Where necessary the data have been seasonally adjusted. – (2) The data refer to transactions in euros and are collected and processed using the Eurosystem's harmonized method.

… and loan interest rates remain basically unchanged

Loan interest rates diminished a little for households and remained stable for firms (Figure 3.2.b). In February they were higher than the euro-area average, by 80 basis points for firms (at 3.5 per cent) and by 40 basis points for loans to households for house purchase (at 3.4 per cent).

The fall in loan quality eases

The ratio of new bad debts to outstanding loans stabilized at around 3 per cent (Figure 3.3). In the last quarter of 2013 the indicator fell from 4.8 to 4.5 per cent for loans to firms and remained stable at around 1.3 per cent for those to households. Preliminary information indicates that the flow of new bad debts slowed in the early months of 2014.

Figure 3.3

Ratio of new bad debts to outstanding loans (1)
(per cent)

Sources: Supervisory reports and Central Credit Register.
(1) Quarterly flow of adjusted bad debts in relation to the stock of loans, net of adjusted bad debts, at the end of the previous quarter; annual data up to the fourth quarter of 1995. Data seasonally adjusted, where necessary, and annualized. All sectors comprise all resident counterparties except MFIs.

In December 2013 non-performing loans (marked by repayment anomalies) amounted to 15.9 per cent of total customer loans, up from 14.4 per cent in June (Table 3.1); net of loan loss provisions, the ratio was 10.0 per cent, up from 9.6 per cent in June. For bad debts alone, the gross and net ratios were 8.7 and 4.0 per cent respectively, up from 7.8 and 3.8 per cent in June. Net bad debts came to 33.6 per cent of regulatory capital. In the first two months of 2014 there was a small increase in the ratio of bad debts to outstanding loans.

Coverage ratios improve for the banking system as a whole …

The ratio of loan loss provisions to non-performing exposures (the coverage ratio), which also reflects the degree of asset impairment, rose to 41.8 per cent in December 2013 from 39.9 per cent in June; for bad debts alone the ratio rose from 55.2 to 56.9 per cent (Table 3.1). In the last two years the prudent valuation of assets by banks, encouraged by the supervisory authority,[1] led to more than €60 billion of loan loss provisions, which absorbed almost all their operating profits.

… and for the banks participating in the comprehensive assessment

Coverage ratios have increased for small and minor banks and for the banks participating in the comprehensive assessment. For the five largest groups the ratio was 44.6 per cent, in line with the values of the leading European banks, which on average were equal to 44.8 per cent in September 2013. Minor banks' below-average coverage ratios are accompanied by a larger proportion of non-performing loans backed by collateral.

Table 3.1

Loan quality: shares of non-performing and collateralized loans and coverage ratios (1)
(per cent; millions of euros; December 2013)

	Top 5 groups			Large banks			Small banks			Minor banks			Total system		
	% composition	Share of collateralized loans	Coverage ratio	% composition	Share of collateralized loans	Coverage ratio	% composition	Share of collateralized loans	Coverage ratio	% composition	Share of collateralized loans	Coverage ratio	% composition	Share of collateralized loans	Coverage ratio
Customer loans	**100**	**60.0**	**8.0**	**100**	**56.4**	**5.6**	**100**	**54.4**	**7.1**	**100**	**74.5**	**5.4**	**100**	**60.2**	**7.2**
of which:															
Performing	83.4	59.1	0.7	86.4	56.1	0.6	83.5	53.6	0.6	84.1	73.6	0.5	84.1	59.5	0.7
Non-performing	16.6	64.4	44.6	13.7	58.7	37.3	16.6	58.5	39.9	15.9	79.3	31.5	15.9	64.2	41.8
Bad debts	*9.4*	*63.3*	*58.6*	*6.9*	*55.3*	*55.0*	*9.1*	*52.7*	*54.7*	*7.7*	*76.2*	*48.5*	*8.7*	*62.0*	*56.9*
Substandard	*5.2*	*68.5*	*27.8*	*4.8*	*62.3*	*22.0*	*5.4*	*64.7*	*24.3*	*6.5*	*83.0*	*18.1*	*5.3*	*68.5*	*25.3*
Restructured	*1.1*	*39.9*	*29.1*	*0.8*	*42.5*	*14.0*	*0.6*	*47.3*	*25.3*	*0.4*	*63.0*	*17.0*	*1.0*	*42.1*	*25.6*
Past-due	*0.8*	*76.8*	*12.8*	*1.1*	*78.4*	*9.7*	*1.5*	*75.4*	*11.7*	*1.4*	*83.5*	*4.4*	*1.0*	*78.0*	*10.9*
Memorandum item:															
Customer loans	1,253,855			445,249			130,646			177,072			2,006,828		

Source: Supervisory reports.
(1) The coverage ratio is the amount of loan loss provisions as a share of the corresponding gross exposure. For performing loans, it is calculated as the ratio of generic provisions to performing loans. The division into size classes is based on the composition of banking groups in December 2013 and total non-consolidated assets as of December 2008. The top 5 groups comprise the banks belonging to the UniCredit, Intesa Sanpaolo, Banca Monte dei Paschi di Siena, UBI Banca and Banco Popolare groups. The size classes "large", "small" and "minor" refer to banks belonging to groups or independent banks with total assets, respectively, greater than €21.5 billion, between €3.6 billion and €21.5 billion, and below €3.6 billion. Foreign bank branches are not included.

The Italian market for non-performing loans shows signs of reviving

In the first quarter of 2014 there were signs of a narrowing of the gap between the book value of non-performing loans and the prices investors interested in buying them were prepared to pay. The contraction was due to several factors: the increase in coverage ratios following the very substantial loan loss provisions banks made

[1] See Banca d'Italia, "The recent asset quality review on non-performing loans conducted by the Bank of Italy: main features and results", 2013.

at the end of 2013; the reduction in uncertainty about asset values owing to the improvement in economic conditions; the decline in the spread on government securities; and an increase in foreign residents' propensity to invest in Italy, including in risky assets. In the first three months of 2014 Italian banks sold or securitized bad debts amounting to about €2 billion, as against €3 billion in the whole of 2013, of which more than €1 billion in December. The two main banking groups recently stipulated a non-binding memorandum of understanding with specialized foreign firms in order to maximize the value of a portfolio of restructured loans through proactive management and the provision of new financial resources to the debtor firms. The injection of new capital and the strengthening of management skills may be decisive in overcoming client companies' difficulties.

DEFINITION OF NON-PERFORMING EXPOSURES AND FORBEARANCE IN THE EBA RULES AND THE ASSET QUALITY REVIEW

Last year the EBA published harmonized definitions of non-performing exposures and exposures on which concessions have been granted (forbearance) to be used for harmonized supervisory financial reporting across Europe.[1] The new definitions, which will enter into force for the exposures existing at 30 September 2014, are basically in line with those currently used in Italy.

According to the EBA, banks must classify exposures as non-performing, whether or not they are backed by collateral or guarantees, when they deem the debtors unable to repay them in full (the unlikely to pay criterion), regardless of whether there are unpaid past-due amounts, or when they are more than 90 days past-due and their amount is significant according to the criteria established at national level, which are now being harmonized.[2]

For past-due exposures to retail customers (households and SMEs) it is possible to use the transaction approach (classifying only specific loans as non-performing exposures) or the debtor approach (all the exposures to the same debtor are classified as non-performing exposures). The debtor approach is always used for exposures to other categories of non-bank customer. When the transaction approach has been used, it must be replaced by the debtor approach when the past-due exposure is more than 20 per cent of the total on-balance-sheet exposure to the debtor (pulling effect). This rule is different from the basically less restrictive one currently in force in Italy, which includes only the past-due exposure in the numerator of the ratio and uses a 10 per cent threshold.

When a debtor's financial difficulties lead to a revision of the contractual conditions of an exposure in the customer's favour, the exposure is considered to have benefited from forbearance. Only a part of forborne exposures is to be included in non-performing forbearance.[3] Exit from the latter category normally occurs in accordance with less restrictive criteria than those provided for under the rules currently in force in Italy (see the box "The EBA's definition of forbearance and non-performing exposures", *Financial Stability Report*, No. 6, 2013).

The differences between the countries of the Single Supervisory Mechanism as regards the definitions of non-performing exposures and the related statistics have made it impossible to adopt the EBA's notion immediately. For the purposes of the Asset Quality Review, to prevent these differences from prejudicing the comparability of the results, the ECB has referred to a

[1] See https://www.eba.europa.eu/-/eba-publishes-final-draft-technical-standards-on-npls-and-forbearance-reporting-requirements.

[2] Non-performing exposures always include exposures classified as impaired under accounting rules (IAS 39) or defaulted under prudential rules (CRR). In Italy (but not always elsewhere) alignment in the actual application of these classifications is ensured by the definition of non-performing assets contained in the Bank of Italy's regulations.

[3] If forborne exposures do not satisfy the criteria for classification as non-performing, they are classified as performing forbearance.

version that always adopts the transaction approach for retail exposures, without considering the pulling effect. Furthermore, this definition does not explicitly consider forbearance; the existence of concessions will nonetheless be taken into account in the Asset Quality Review, while checking that debtors' situations have not deteriorated (assessment of the impairment criteria adopted by banks pursuant to IAS 39).

The new tax regime and legal reforms may contribute to a reduction in non-performing loans

The development of the market for non-performing loans may also benefit from the changes to the taxation of loan loss provisions introduced with effect from 2013. In fact the tax disincentives to making loan loss provisions have been partly removed by reducing (from 18 to 4 years) the period over which losses may be deducted for income tax purposes and providing, in contrast with the past, for their deduction for the purposes of the regional tax on productive activities (IRAP). These changes make it less costly for banks to adopt more prudent loan valuation policies and reduce the implicit cost of the compulsory loan to the tax authorities associated with the division of the deduction into instalments. By permitting the deduction of larger provisions in adverse cyclical phases, such as the present one, the new tax regime attenuates the procyclicality of the tax system.[2]

The disposal of non-performing assets is also hindered by the long time needed to recover loans, which depresses the price that investors are willing to pay and increases the proportion of non-performing loans in banks' portfolios. Since 2005 important legislative measures have been adopted to increase the efficiency of bankruptcy and crisis procedures. Some of these reforms, enacted in 2010, have not yet produced their full results.

Exposure to euro-area sovereign risk and foreign assets

Italian banks' exposure to Italian general government diminishes

Banks' exposure to Italian general government is decreasing. Between July 2013 and March 2014 they made net sales of government securities amounting to €22 billion, most of which was accounted for by the five largest banking groups and other large banks (Figure 3.4.a). At the end of March banks' holdings of general government securities amounted to €382 billion and 10.2 per cent of their total assets (Figure 3.4.b). It is estimated that since July the value of the portfolio has risen by about €13 billion as a consequence of the sharp fall in yields.

The exposure to Central and Eastern Europe holds stable

At the end of 2013 Italian banks' exposure to residents in Central and Eastern Europe amounted to €171 billion, equal to just over a quarter of their total exposure to non-residents. The ratio of non-performing assets was just under 10 per cent of the total. The exposure to Russia amounted to €21 billion or 12 per cent of total balance-sheet lending to the area and the ratio of non-performing loans was low overall and fell from 4.3 per cent at the end of 2012 to 3.2 per cent at the end of 2013. The exposure to Ukraine amounted to €4.6 billion or 2.7 per cent of total lending to the area and the ratio of non-performing loans rose from 33.5 per cent at the end of 2012 to 47.2 per cent at the end of 2013. The exposure to other developing countries outside Central and Eastern Europe was small (Table 3.2).

[2] See A. De Vincenzo and G. Ricotti, "The use of tax law from a macroprudential perspective: the impact of some recent tax measures on procyclicality and banks' stability" in Banca d'Italia, *Notes on Financial Stability and Supervision*, No. 1.

Figure 3.4

Banks' investments in general government securities (1)

Source: Supervisory reports.
(1) Amounts of purchases are net of fluctuations in market prices. Holdings are shown at market values. All general government securities are counted, including those issued by local authorities. The Cassa Depositi e Prestiti is excluded. – (2) Right-hand scale.

Table 3.2

Exposures of Italian groups and banks to residents of countries in the euro area, Central and Eastern Europe and other developing countries by sector of counterparty (1)
(billions of euros at December 2013)

	General government		Banks	Financial corporations	Households and non-financial firms	Total	As a percentage of total exposures (2)
	Total	*of which*: securities					
Italy	434.1	379.0	103.4	128.0	1,342.6	2,008.1	78.9 (3)
Germany	37.3	…	29.1	17.0	85.1	168.5	15.3
Austria	13.3	…	6.8	1.6	50.8	72.5	38.8
France	2.4	…	13.1	3.3	7.5	26.3	3.0
Luxembourg	0.4	…	3.1	10.0	4.6	18.1	4.5
Spain	3.6	…	5.2	2.2	3.9	15.0	3.8
Netherlands	0.2	…	3.8	4.9	4.2	13.1	2.3
Ireland	0.2	…	0.7	5.6	0.4	6.9	2.4
Portugal	0.5	…	0.1	0.3	0.4	1.3	1.3
Greece	0.0	…	0.6	0.0	0.4	1.1	3.1
Cyprus	0.0	…	0.0	0.1	0.8	1.0	4.1
Other (4)	5.0	…	2.1	1.1	16.8	24.9	4.1
Total euro area	**497.1**	**…**	**168.1**	**174.2**	**1,517.6**	**2,357.0**	
Russia	1.9	…	1.7	1.1	16.5	21.2	11.8
Ukraine	0.4	…	0.1	0.0	4.1	4.6	24.9
Central and Eastern Europe	**43.0**	**…**	**9.4**	**3.7**	**114.8**	**170.9**	**15.4**
Other developing countries	**2.8**	**…**	**7.5**	**0.3**	**7.6**	**18.2**	**0.9**

Sources: Consolidated supervisory reports for banking groups and individual supervisory reports for banks not belonging to a group.
(1) Exposures to "ultimate borrowers", gross of bad debts and net of provisions. BancoPosta and Cassa Depositi e Prestiti are not included. Rounding may cause discrepancies in totals. – (2) As a percentage of the total exposures to residents in each country in September 2013 reported to the BIS by a large group of international intermediaries. – (3) Since the BIS data for Italy do not include exposures to residents, the ratio is obtained by including the exposure shown in the previous column (Total) in the denominator. – (4) Belgium, Finland, Malta, Estonia, Slovakia and Slovenia. The last three countries, with exposures amounting to about €20 billion, are also included in the total for Central and Eastern Europe.

3.4 BANKS' FUNDING, LIQUIDITY RISK, REFINANCING RISK

The contraction in assets reduces funding needs and the funding gap

Italian banks' total funding is diminishing, mainly as a consequence of the reduction in liabilities towards the Eurosystem and in short-term wholesale funding (Figure 3.5). Retail deposits have continued to expand, growing by 1.5 per cent. The stock of bank bonds held by households has continued to shrink rapidly owing to the increase in the tax rate on bond interest at the start of 2012 and to nearly €10 billion of buy-backs by the largest banks in the context of asset liability management operations. In addition, banks have given the sale of insurance products (see Section 3.6) and investment funds priority over retail bond funding in order to augment their fee income. The funding gap narrowed to 10.6 per cent of lending in March (Figure 3.6).

Figure 3.5

Growth in bank funding: contributions of the various components (1)

(percentage points and 12-month percentage changes)

Source: Supervisory reports.
(1) The sum of the contributions is equal to the percentage change over 12 months in the total funds raised. The percentage changes in the single components are calculated net of reclassifications, exchange-rate variations, value adjustments and other variations not due to transactions. Liabilities towards resident monetary financial institutions are excluded. Net liabilities towards central counterparties are the funds raised by way of repos with non-residents via central counterparties.

The liquidity position strengthens …

The one-month liquidity position improved (Figure 3.7), thanks to the fall in government security yields, which boosted the value of the assets eligible as collateral for Eurosystem refinancing. Banks reduced their foreign funding in the form of repos (see Section 4.1) and stepped up their wholesale bond placements on international markets, where net funding has been positive since the last quarter of 2013 thanks in part to revived issuance of unsecured bonds (Figure 3.8).

Figure 3.6

Italian banks' funding gap (1)

(billions of euros and per cent)

Source: Supervisory reports.
(1) Share of loans not financed by retail funding. For the calculation methodology, see the box "The funding gap of Italian banks" in *Financial Stability Report*, No. 4, April 2012.

Figure 3.7

Banks' net liquidity position (1)

(averages; per cent of total assets)

Source: Data for a sample of 31 banking groups subject to periodic monitoring of their liquidity position by the Bank of Italy.
(1) The net liquidity position is calculated as the (positive or negative) difference between holdings of assets eligible for use as collateral for Eurosystem refinancing operations and cumulative expected cash flow. The time frame is 1 month; on prudential grounds it is assumed that there is no roll-over of maturing obligations vis-à-vis institutional counterparties.

Figure 3.8

Source: Dealogic.
(1) The data refer to Italian banks' issues of secured and unsecured bonds on international markets with issue amounts of more than €200 million. Issues retained on issuers' balance sheets, those addressed to the retail market and those of Italian banks' foreign subsidiaries are not included.

Figure 3.9

Source: Data for a sample of 31 banking groups subject to periodic monitoring of their liquidity position by the Bank of Italy.
(1) Excludes government-guaranteed bonds pursuant to Decree Law 201/2011. For data referring to the remaining months of 2014 and to 2015, right-hand scale.

… and funding costs fall

The differential between the yield on bank bonds and the swap rate continued to diminish in the first quarter of 2014, falling to around 170 basis points. The cost of issues is still higher for Italian banks than for German banks in respect of bonds having the same rating and overall characteristics, because of the persistence of market fragmentation (see the box "The fragmentation of euro-area financial markets").

The improvement in funding conditions is facilitating the gradual repayment of the longer-term refinancing operations (see Section 4.2) and making it easier to roll over wholesale bonds falling due; the latter amount to about €31 billion for the period May-December 2014, compared with €52 billion in May-December 2013 (Figure 3.9).

Alignment with the new rules on liquidity is virtually complete

In June 2013 the 13 Italian banks included by the Basel Committee on Banking Supervision in the observation sample for convergence towards the new prudential rules on liquidity were already in compliance with the 60 per cent liquidity coverage ratio set for 2015. As of the same date 11 groups had net stable funding ratios above 100 per cent and the other two groups were close to 90 per cent.[3]

3.5 BANKS' CAPITAL AND PROFITABILITY

Capital ratios fall as a result of massive provisions

In December 2013 the Italian banking system's core tier 1 and tier 1 capital ratios were about 30 basis points lower than in June owing to the large volume of write-downs by the main banking groups, a development common to many euro-area banks (see Figure 1.4c). Risk-weighted assets continued to shrink, albeit more slowly than in the last two years. The core tier 1 ratio of the five largest banking groups was 10.4 per cent, down by 80 basis points from 11.2 per cent in June 2013 (Figure 3.10); the tier 1 ratio was 11.1

[3] The Basel Committee recently modified its definition of both the numerator (available stable funding) and the denominator (required stable funding) of the net stable funding ratio. In particular, the weightings of loans to SMEs were reduced for the calculation of required stable funding, a decision that should lead to an improvement in the indicator for Italian banks.

Figure 3.10

Banking groups' core tier 1 ratios
(per cent; end-of-period data)

Source: Consolidated supervisory reports.

per cent and the total capital ratio 14.5 per cent, down from 11.9 and 15.0 per cent in June. The capital ratios of the other groups subject to the Comprehensive Assessment improved slightly.

In the first few months of this year 9 banking groups (8 of which are involved in the Comprehensive Assessment) completed or announced capital increases totalling some €10 billion; for the banks subject to the assessment, these equity injections will boost capital ratios by an average of about 1 percentage point.

Alignment with Basel III proceeds

The new rules on banks' capital (Basel III) as defined at European level by the Capital Requirements Directive IV/Capital Requirements Regulation entered into force on 1 January of this year; in Italy their phase-in will be completed by 2018. On the basis of the national transitional rules, it can be estimated that the average common equity tier 1 (CET1) ratio of the 15 banks subject to the Comprehensive Assessment was 9.9 per cent on 1 January 2014 (against an actual core tier 1 ratio of 10.0 per cent on 31 December 2013).

Italian banks' financial leverage is low by international standards

Italian banks' leverage ratio, calculated as tier 1 capital over total on- and off-balance-sheet exposures in accordance with the Basel III definitions, averaged 4.1 per cent on 30 June 2013, above the regulatory minimum of 3 per cent scheduled to go into effect in 2018. Italian banks' financial leverage is low by international standards (see the box "Italian banks' deleveraging in the European context"). The leverage ratio will provide additional information for evaluating the outcomes of the Comprehensive Assessment.

ITALIAN BANKS' DELEVERAGING IN THE EUROPEAN CONTEXT

The financial crisis and the sovereign debt crisis put pressure on banks to reduce their financial leverage.[1] For a sample of large European banks comprising the 15 Italian banks subject to the Comprehensive Assessment and the 38 European banks involved in the EBA's 2013 EU-wide Transparency Exercise,[2] the leverage declined from 28.3 in December 2012 to 24.8 in June 2013 (see panel (a) of the figure). At the latter date the German banks' had the highest figure (32.2), followed by the French (30.2); the lowest was that of the Italian banks, whose leverage fell from 19.9 in December 2011 to 18.0 in June 2013.

Deleveraging was achieved mainly through capital strengthening (see panel (b) of the figure). The contribution of asset reductions, recorded for nearly all the sample banks, mainly reflected declines in securities and derivatives issued by the private sector and a contraction in customer loans that in most cases involved the performing component. By contrast, exposures to sovereign issuers pushed leverage up in all the countries.

European banks' financial leverage and determinants of its changes

Sources: Based on EBA, SNL Financial and supervisory report data.
(1) Financial leverage is calculated as total balance-sheet assets over the sum of capital, reserves, profit for the period and issue premiums, net of the negative elements of core capital. In calculating the sample average, leverage is weighted by capital. The list of sample banks is as follows: Austria: Erste Group Bank and Raiffeisen Zentralbank; Belgium: KBC Bank; Germany: Deutsche Bank, Commerzbank, Landesbank Baden-Württemberg, DZ Bank, Bayerische Landesbank, Norddeutsche Landesbank, HSH Nordbank Hamburg, Landesbank Hessen-Thüringen Frankfurt, Landesbank Berlin, DekaBank Deutsche Frankfurt, and WGZ Bank; Denmark: Danske Bank, Jyske Bank, Sydbank, and Nykredit; Spain: Banco Santander, Banco Bilbao Vizcaya Argentaria, Caja de Ahorros y Pensiones de Barcelona, and Banco Popular Espanõl; France: BNP Paribas, Crédit Agricole, BPCE, and Société Générale; United Kingdom: Royal Bank of Scotland, HSBC, Barclays, and Lloyds; Italy: Intesa Sanpaolo, UniCredit, Banca Monte dei Paschi di Siena, Banco Popolare, UBI Banca, Credito Emiliano, Veneto Banca, Credito Valtellinese, Banca Popolare dell'Emilia Romagna, Banca Popolare di Milano, Banca Popolare di Sondrio, Banca Popolare di Vicenza, Banca Carige, Mediobanca, and ICCREA Holding; Netherlands: ING, Rabobank Nederland, and ABN Amro Bank; Sweden: SNS Bank, Nordea Bank AB, SEB AB, Svenska Handelsbanken AB, and Swedbank AB. – (2) The change in financial leverage, $assets_t/capital_t$ - $assets_{t-1}/capital_{t-1}$, can be broken down into "capital effect" $assets_t$*(1/$capital_t$ - 1/$capital_{t-1}$); "loans and government securities effect" (sovereign $exposure_t$ - sovereign $exposure_{t-1}$)/ $capital_{t-1}$; "customer loans effect" ($loans_t$ - $loans_{t-1}$)/ $capital_{t-1}$; "other assets effect" (other $assets_t$ – other $assets_{t-1}$)/$capital_{t-1}$. The residual effect resulting from the breakdown ($assets_t$ – $assets_{t-1}$)*1/($assets_t$ – $assets_{t-1}$) is not shown in the chart.

[1] Financial leverage is calculated as total balance-sheet assets over the sum of capital, reserves, profit for the period and issue premiums, net of the negative elements of core capital.

[2] At the end of December 2012 the sample banks accounted for about 80 per cent of the total assets of the banking systems of the countries considered.

Profitability is negative, owing to substantial loan losses

The profitability of the largest Italian banking groups deteriorated in 2013, mainly as a result of substantial loan loss provisions. Net of non-recurring items such as goodwill impairments, ROE was negative by 1.3 per cent, as against a positive return of about 1 per cent in 2012.

Loan loss provisions increase again

Loan loss provisions exceeded operating profits (Figure 3.11). The increase in provisions involved both the banks subject to the Comprehensive Assessment and, to a lesser extent, the remaining banks, whose provisions absorbed 80 per cent of operating profits. Operating profits diminished by 2.4 per cent owing to the sharp fall in net interest income (down by 10 per cent), only partially offset by the increase in other income.

Figure 3.11

Banking groups: loan loss provisions as a percentage of operating profits (1)
(per cent)

Source: Supervisory reports.
(1) Up to 2012, the data refer to the aggregate of banking groups; for 2013, to the 32 largest groups.

The cost-income ratio remains stable thanks to measures to improve efficiency

Operating costs came down by 3 per cent, while staff expenses fell by 5 per cent, partly as consequence of the rationalization of branch networks by the largest banks (see box). The ratio of operating costs to gross income remained stable at 62 per cent. The strategic plans recently presented by the main banking groups project a significant reduction in the ratio over the next four years.

RECENT DEVELOPMENTS IN BANKS' BRANCH NETWORKS IN ITALY

Between 2008 and 2013 the total number of bank branches in Italy shrank by 7 per cent, from more than 34,100 to about 31,700. The five largest banking groups accounted for the decline, shedding 3,500 branches, whereas the branch networks of the remaining banks (including branches of foreign banks) expanded up to 2012, in keeping with their gains in market share. In the period considered, the number of bank employees fell by 9.6 per cent (from 337,000 to 306,000 full-time equivalent

Change in branches, employees and volume of business per branch

(a) *Change in branches and employees* (1)
(percentage changes 2013 on 2008)

(b) *Change in the volume of business per branch by category of bank* (2)
(percentage changes 2013 on 2008; constant prices)

Source: Supervisory reports.
(1) Groups and banks not belonging to groups. Excludes mutual banks and branches of foreign banks. The size of the circle is proportional to the banks' total assets. For banking groups with establishments abroad, only the Italian components are counted. – (2) Excludes branches of foreign banks. The percentage change in the volume of loans and deposits per branch is calculated on the 5 years from 2008 to 2013 for each category of bank. It is divided between the contribution of the percentage change in loans and deposits (numerator) and the contribution of the change in the number of branches (denominator). The components whose sign is positive increased the ratio of the volume of loans and deposits to the number of branches, those whose sign is negative reduced it. Weighted averages. Changes at constant prices adjusted for the GDP deflator.

workers); the share of bank employees assigned to branch networks remained stable at around 65 per cent. The reduction in total staff was sharper among banks that downsized their branch networks (see panel (a) of the figure).

The reorganization of the banking industry's branch networks has brought an increase in efficiency for every category of bank. For the first five groups, average funds per branch – a measure, albeit partial, of the productivity of retail intermediation – grew by more than 4 per cent between 2008 and 2013 (valued at constant prices); the improvement was entirely due to the reduction in the number of branches (see panel (b) of the figure). The remaining banks recorded an increase in average funds per branch of more than 5 per cent, as loans and deposits expanded more rapidly than branch networks. An analysis of the changes in branch networks at provincial level shows that banks closed branches where average funds per branch were lowest.

Between 2008 and 2012 banks that shed branches saw their ratio of costs to assets fall from 2.2 to 1.9 per cent, largely reflecting the reduction in staff costs; the ratio fell less (from 1.9 to 1.7 per cent) for the other banks, in this case as a result of assets growing faster than costs. The cost-income ratio fell for both categories even though the groups and banks that pared their networks recorded a steep drop in income over the same period.

3.6 INSURANCE COMPANIES

The market's assessment

Market indicators improve further

The market indicators confirm the improving assessment of the main Italian insurance companies (Figure 3.12). The recovery in expected earnings per share continued in the early months of 2014. Share prices and the expected default rates implicit in them returned to the levels of the first half of 2011. The credit ratings assigned to the leading companies by the main agencies were unchanged.

Figure 3.12

Insurance companies in Italy and the euro area

Sources: Based on Thomson Reuters Datastream and Moody's KMV data.
(1) Daily data. Insurance company share indices.– (2) Weighted average (by the number of shares in circulation) of expected earnings per share in the 12 months following the reference date. Monthly data. For Italy the data refer to the following companies: Assicurazioni Generali, Mediolanum Assicurazioni, Società Cattolica Assicurazioni, UGF Assicurazioni, Vittoria Assicurazioni; for the euro area the data refer to the companies included in the Datastream insurance sector index. – (3) Thirty-day averages of daily data in per cent. The expected default frequencies, calculated on the basis of the price and volatility of the shares of the companies to which they refer, measure the likelihood of the market value of assets being lower than that of liabilities over a period of 1 year. The graph shows the median values of the expected default frequencies of the Italian insurance companies considered (see note 2) and of the companies included in Moody's KMV European insurance sector index.

Premium income and liquidity

Premium income rises in the life sector while continuing to fall in non-life insurance

Life-insurance premium income rose again in the first quarter of 2014, with an increase of 35 per cent from the year-earlier quarter (Figure 3.13.a). The sharpest gain was in premiums on policies distributed through the banking channel. Non-life premiums remained slack (down 5 per cent in the fourth quarter of 2013 from a year earlier), particularly in motor liability insurance (Figure 3.13.b).

Figure 3.13

Premium income of Italian insurance companies
(quarterly data; billions of euros)

Source: IVASS.
(1) Mostly with-profits policies. – (2) Mostly unit-linked and index-linked policies.

Figure 3.14

Ratio of surrenders and benefit payments to premiums in the life insurance sector (1)
(quarterly data; per cent)

Source: IVASS.
(1) The indicators are calculated as the sum of policy surrenders and benefit payments at policy maturity (principal and annuities) in proportion to premium income during the period. An amount higher (lower) than 100 indicates a net outflow (inflow) of funds.

Figure 3.15

Investments and unrealized capital gains and losses of Italian insurance companies

Sources: IVASS and Bloomberg.
(1) Balance-sheet values. The composition of government securities is partially estimated. – (2) Unrealized capital gains and losses are the difference between market value and balance-sheet value of the securities held.

Liquidity risk is modest

Liquidity risk in the life sector continued to diminish. Surrenders plus benefit payments continued to be much lower as a ratio to premiums than in the previous two years, and there was a further decline in surrenders (Figure 3.14).

Investments

Investment in Italian government securities remains high

Insurance companies' investment was again concentrated on Italian government securities. The portion of these securities with residual maturity of over five years increased (Figure 3.15.a). Net unrealized capital gains (i.e. the difference between market value and book value), already strongly positive at the end of 2013, increased in the early months of the new year (Figure 3.15.b).

The recent regulatory measures to support financing of the economy could encourage a progressive diversification of bond investments (see box).

INSURANCE COMPANIES' INVESTMENTS IN BONDS ISSUED BY SMEs

Some of the measures enacted with Decree Law 145 of 23 December 2013 to support lending to businesses and the economy are designed to foster investment by insurance companies in financial instruments issued by small and medium-sized enterprises. In particular, the decree requires IVASS to extend the list of assets eligible to cover reserves.

The previous legislation allowed insurers to invest in bonds and similar securities not traded in regulated markets only if they had residual maturity of less than a year or were issued by companies whose financial statements had been audited for at least three years. Issues deriving from securitizations had to be of investment grade.

Assets covering technical reserves
(ratio to technical reserves; per cent and billions of euros)

	2011	2012	2013
Debt securities (1)	85.3	85.8	87.7
of which:			
securitizations (2)	*0.5*	*0.5*	*0.4*
securities issued by infrastructure concessionaires (since 2012, 3 per cent ceiling in place) (3)	–	*0.0*	*0.0*
unlisted securities (cap of 10 per cent for total unlisted securities) (4)	*2.2*	*2.6*	*1.5*
Equity securities (5)	5.5	4.6	3.7
of which:			
unlisted securities (cap of 10 per cent for total unlisted securities)	*1.2*	*1.1*	*0.8*
Real estate (6)	3.9	4.0	3.6
Alternative investments (5 per cent ceiling) (7)	0.4	0.4	0.3
Other assets (8)	5.4	5.9	5.1
Total	**100.5**	**100.7**	**100.4**
Memorandum item:			
Technical reserves (9)	383	395	424

Source: IVASS.
(1) Mostly government securities. Includes units of harmonized bond-based UCITS. – (2) Senior, investment grade securitization issues. – (3) Securities issued pursuant to Legislative Decree 163/2006. – (4) The 10 per cent cap refers to total securities not traded in a regulated market, units of closed-end real-estate funds not traded on regulated markets, units of investment funds reserved to professional investors and units of hedge funds. – (5) Includes units of harmonized equity-based UCITS. – (6) Includes units of closed-end real-estate UCITS established in an EU member state. – (7) Units of open-end non-harmonized UCITS, units of closed-end securities investment funds not traded on regulated markets, funds reserved to professional investors, hedge funds. – (8) Credits (mainly claims on reinsurers, policyholders and brokers and tax credits), sight deposits with banks, and other assets not included in the preceding items. – (9) Total life and non-life technical reserves.

Under the new rules, insurance companies can also invest in mini-bonds that do not meet the requirements concerning the firm's age, the auditing of financial statements, and residual maturity. In addition, they can invest in securitization bonds not of investment grade as long as they comply with the characteristics specified in the decree. For each of the two new categories of eligible bonds, there is a limit of 3 per cent of the technical reserves to cover. According to the companies' balance-sheet data for 2013, if fully exploited these new margins would permit additional investment of about €25 billion.

As regards investment funds specializing in the new types of securities, the limit on investment concentration in a single fund has been raised from 1 to 3 per cent of total coverage assets.

The effects of the new rules on the investment strategy of insurance companies are highly uncertain. In fact, regulatory constraints may not constitute the main barrier to this kind of investment, inasmuch as their investment in private-sector securities in general is still well below the regulatory ceiling (see table). And investment in corporate bonds, which are riskier on average, could be affected by the imminent passage of the new prudential rules (Solvency II), which will institute risk-based capital requirements. To mitigate the impact on the insurance companies' investment policies, the European Commission is considering more favourable rules for certain types of asset, such as securities issued in connection with high-quality securitizations.

Profitability and capital adequacy

Profitability is satisfactory and the capital base remains sound

Profitability in the non-life sector continued to improve, with ROE gaining more than 6 percentage points in 2013 (Figure 3.16.a), thanks chiefly to the positive trend in the technical account (Figure 3.16.b). In the life sector ROE, though still comfortably positive, fell by 7 percentage points, owing above all to a decline in investment income. Solvency ratios remained well above the minimum regulatory requirements (Figure 3.16.c).

Figure 3.16

Main indicators for Italian insurance companies
(per cent)

Source: IVASS.
(1) Ratio of earnings to shareholders' equity. – (2) Ratio of incurred losses plus operating expenses to premium income for the period. – (3) Ratio of actual regulatory capital to the capital requirement, calculated individually for the Italian market. The high mean values reflect the presence of companies (mostly parent companies of conglomerates, including international conglomerates) with individual solvency ratios well above the minimum requirement.

The risks are connected with economic uncertainty

The main risks for the Italian insurance industry continue to stem from the tenuous nature of the economic recovery. By contrast, the possible repercussions of the protracted phase of low interest rates on the companies' capacity to honour their liabilities represents only a limited risk. An IVASS survey on life insurance policies with guaranteed minimum yield indicates that the volume of additional reserves needed to cope with the risk of defaulting on obligations to policyholders remains very modest (scarcely 0.5 per cent of the companies' mathematical provisions at the end of 2013). This reflects both investment policies, which have continued to focus on Italian government securities with their relatively high yields, and prudent policies on guaranteed yields. Over 92 per cent of the mathematical provisions relate to policies with guaranteed yields of less than 3 per cent, and new products offer guarantees of less than 2 per cent.

The potential risks in connection with interest rate dynamics will be assessed as part of the stress test conducted between April and July 2014 by the European Insurance and Occupational Pensions Authority.

4 THE MARKETS AND EUROSYSTEM REFINANCING

4.1 THE LIQUIDITY MARKET

Liquidity conditions on the Italian financial markets improve

In the early part of 2014 liquidity conditions on Italy's financial markets improved. The indicator that measures systemic liquidity risk was close to the lowest level on record (Figure 4.1), mainly reflecting increased trading on the secondary market for government securities (see the box "An indicator of systemic liquidity risk in the Italian financial markets").

Repo trading grows …

The volume of repos traded on the MTS platform increased (Figure 4.2), most notably in the special repo segment (see Section 4.3). More than half of the trades are concluded between Italian and foreign intermediaries that use the interoperability link between the two central counterparties active on the market – LCH.Clearnet SA (LCH) and Cassa di Compensazione e Garanzia (CC&G). Uncollateralized trading remains very thin, however, both on the e-MID electronic market and over the counter.

… while recourse to the repo market for funding abroad declines

At the end of March, Italian banks' net foreign position on the MTS repo market fell below €50 billion (Figure 4.3.a), reflecting the decline in the number of Italian banking groups with significant net debtor positions (Figure 4.3.b). Refinancing risk remains limited, in view among other things of the long average residual life of outstanding contracts (47 days in 2014, down from 53 in 2013).

Interest rates remain in line with those in the euro area

In a phase of reduction of excess liquidity and heightened volatility of short-term interest rates,

Figure 4.1

Indicator of systemic liquidity risk in the Italian financial markets (1)

(daily data; index range: 0 to 1)

Sources: Based on Thomson Reuters Datastream, Bloomberg and Bank of Italy data.
(1) The indicator measures the joint risk in the money market, the secondary market for government securities, and the equity and corporate bond markets. The index range is between 0 (minimum risk) and 1 (maximum risk). The graph also shows the contributions of the individual markets to the composite indicator and the correlations between them.

Figure 4.2

Trading on Italy's electronic and OTC liquidity markets

(monthly averages of daily data; billions of euros)

Sources: Based on e-MID SIM S.p.A., MTS S.p.A. and TARGET2-Banca d'Italia data.
(1) Estimates of uncollateralized money market trading with maturity up to one week by Italian banks with extra-group counterparties, based on TARGET2 data.

Figure 4.3

Italian banks' net position on the MTS repo market (1)

Source: Based on MTS S.p.A. data.
(1) The total net position is calculated on the cash value of the outstanding contracts.

AN INDICATOR OF SYSTEMIC LIQUIDITY RISK IN THE ITALIAN FINANCIAL MARKETS

In the wake of the financial crisis numerous indicators have been developed to identify situations of stress in the markets. The indicator shown in Figure 4.1 is an example, providing a coincident measure of systemic liquidity risk in the Italian financial markets.[1] It is obtained by aggregating ten elementary series characterizing three market segments of particular importance for Italian intermediaries: equity and corporate bond markets, Italian government bonds, and the money market.

The aggregation of the series is based on correlations, which are variable over time, between the indicators of liquidity risk of the various market segments: increases in the degree of correlation increase the system's overall exposure to liquidity risk, reductions decrease it.

The indicator is standardized in such a way that the range is between 0 (no stress and high levels of liquidity) and 1(maximum stress).

The indicator accurately charts the phases of the recent financial crisis, with peaks corresponding to the collapse of Lehman Brothers in September 2008, the aggravation of the Greek debt crisis in April and December 2010, and the tensions in other European countries, including Italy and Spain in the second half of 2011.

Data on trends in the individual markets and on how the correlations interact, amplifying or attenuating situations of stress, are obtained by analysing the indicator's components. The sum of the contributions of the various markets is equal to the value of the composite indicator calculated assuming constant perfect correlation across the three segments. The difference between the indicator and the sum of the contributions accordingly reflects the impact of the time-varying cross-correlations between the markets.

[1] The indicator is calculated using the standard methodologies adopted for the calculation of systemic risk based on the portfolio choice theory. For more details, see E. Iachini and S. Nobili, "An indicator of systemic liquidity risk in the Italian financial markets", Bank of Italy, *Occasional Papers*, No. 217, 2014.

the average cost of funding on Italian money markets remains close to that in the euro area (Figure 4.4); the dispersion of borrowing rates among intermediaries declined in both the repo and uncollateralized segments.

The diffusion of virtual currencies in Italy is limited

In the past year interest in virtual currencies has grown, but their diffusion in Italy has been limited. As with other forms of financial innovation, together with its Eurosystem partners the Bank of Italy is monitoring the evolution of the phenomenon to evaluate benefits and risks. Virtual currencies, however, are not equivalent to legal tender, and their users are not safeguarded against risks (see the box "The diffusion and risks of virtual currencies: the case of Bitcoin").

Figure 4.4

Money market rate spreads (1)
(monthly averages of daily data; basis points)

Sources: Based on e-MID SIM S.p.A., MTS S.p.A. and RepoFunds Rate data.
(1) e-MID and Eonia: overnight; Repo Italy and Repo Germany: contracts on government securities with maturity of one business day concluded on electronic trading platforms operated by MTS S.p.A. and ICAP, and guaranteed by a central counterparty; MTS-general collateral and Eurepo: tomorrow-next.

THE DIFFUSION AND RISKS OF VIRTUAL CURRENCIES: THE CASE OF BITCOIN

A virtual currency is a form of unregulated, digital money, issued and controlled on the basis of computer algorithms that can be accepted on a voluntary basis by the parties to a transaction as a means of payment alternative to legal tender.[1] The virtual currency scheme that has acquired most importance in the past year, although its diffusion in Italy is limited, is Bitcoin. Units of Bitcoin can be acquired by participating via one's own computer hardware in the creation of new money ("mining") or using legal tender on generally unregulated electronic markets. There are currently around 12.5 million Bitcoins in circulation, for an exchange value of around €6 billion (at the average exchange rate in March 2014).

Like other virtual currencies, Bitcoins have a purely fiduciary value that is not controlled or guaranteed by any central bank of issue, which partly explains why it is highly volatile and carries significant risks for holders. Based on the available data, at end-March 2014 the value in euros of one Bitcoin had fallen by half from the peak reached in early December 2013. Over this period the currency recorded average daily fluctuations of around 4 per cent, with peaks of more than 10 per cent.

International studies have found that most Bitcoins are held for speculative purposes. The anonymity of the transactions, by facilitating the avoidance of legal constraints on the transfer of funds, means that this virtual currency can serve illegal purposes. There are no known cases of Bitcoin having been used to any significant extent by regulated financial intermediaries; accordingly, to date there have been no consequences for the stability of the financial system or for the monetary policy transmission mechanism.

At the time of writing the most serious risks linked to the use of Bitcoin – aside from its serving illegal purposes – relate to consumer protection. A large Japanese platform for the deposit and exchange of Bitcoins recently collapsed, triggering heavy losses for users. At European level there is broad agreement on the need for harmonized rules on virtual currencies. In the event of losses (for example, following theft by hackers or the closure of platforms), users now have no protection

[1] See ECB, "Virtual currency schemes", 2012, http://www.ecb.europa.eu/pub/pdf/other/virtualcurrencyschemes201210en.pdf.

whatsoever. Last December the European Banking Authority warned consumers of the risks involved in the use of virtual currencies.[2]

[2] See EBA, "Warning to consumers on virtual currencies", 2013, http://www.eba.europa.eu/documents/10180/598344/EBA+Warning+on+Virtual+Currencies.pdf.

4.2 EUROSYSTEM REFINANCING

Recourse to Eurosystem refinancing is reduced

Since November the Bank of Italy's counterparties have cut their resort to Eurosystem credit from €231 billion to €203 billion (the maximum of €284 billion was in July 2012) through early repayment of their three-year refinancing operations (Figure 4.5.a). After peaking at €10.1 billion in February, fixed-term deposits with the Bank of Italy subsided to their November level of about €1.3 billion (Figure 4.5.b), while reserve deposits in excess of the requirement and use of the deposit facility also decreased from €11 billion to €7 billion.

Figure 4.5

Recourse to refinancing and to deposits with the Bank of Italy (1)
(average daily data in the maintenance period; billions of euros and per cent)

Sources: Based on ECB and Bank of Italy data.
(1) The dates on the horizontal axis refer to the month in which each maintenance period ends; for the last period, average to 23 April.

Available eligible assets remain substantial …

In conjunction with the reduction in refinancing, the collateral pool diminished from €353 billion to €325 billion (Figure 4.6.a), but the portion of uncommitted assets (overcollateralization) rose to 34 per cent.[1] Within the pool the proportion of Italian government securities has increased and that of all other assets decreased (Figure 4.6.b). The volume of freely available eligible securities outside the pool remains large (€224 billion), equal to 104 per cent of refinancing operations outstanding, compared with 92 per cent in September 2013.

[1] Comparison of overcollateralization of the pool deposited by counterparties of the Bank of Italy with that of other euro-area central banks is affected by the existence in other countries of triparty collateral management, which enables banks to use securities at a central depository both for operations with the central bank and for transactions with other counterparties (e.g., repos). In Italy, Monte Titoli plans to expand the scope of its triparty service by the end of the year.

Figure 4.6

Eligible assets of Bank of Italy counterparties (1)
(end-of-period data)

Sources: Based on ECB data and supervisory reports.
(1) The amount of assets committed to the Eurosystem includes the portion covering interest accrued and dollar refinancing. – (2) Pool assets at 1 October 2013. – (3) Main monetary policy counterparties by volume of assets of the groups to which they belong.

… permitting a gradual withdrawal from Eurosystem financing

At 23 April, 38 of the 112 Italian counterparties that had taken part in the three-year refinancing operations had repaid €79 billion, or 31 per cent of the initial borrowing, compared with 62 per cent in the other euro-area countries. The ECB's decision to extend the full allotment procedure at least to July 2015 enables banks to plan gradual repayment. By our estimates, if the recent favourable conditions in the funding and government securities markets persist, Italian banks will have a sufficient buffer of liquid assets to bring their debt with the Eurosystem back down to the levels prevailing before the acute phase of the sovereign debt crisis. A very few small banks – accounting for less than 1 per cent of banking system assets – would have to accompany the disposal of liquid assets with strategies to increase funding. In a more prudent scenario – on the hypothesis of funding and government bond market conditions about the same as their 2013 averages – the portion of total assets held by banks that would have to expand their funding would come to slightly under 9 per cent.

Figure 4.7

Italian government-guaranteed bank bonds
(data at 31 March 2014; per cent of stock at 30 June 2012)

Source: Based on ECB and Bank of Italy data.

The volume of government-guaranteed bank bonds decreases further

The face value of outstanding bank bonds guaranteed by the Italian government now stands at €61 billion, compared with €86 billion in June 2012.[2] Of this reduction, €10 billion stemmed from maturing securities and €15 billion from bonds cancelled prior to maturity to avoid paying commissions to the State (Figure 4.7). Own securities pledged as collateral for refinancing operations make up 58.7 per cent of the amount originally issued. Securities traded amount to 12 per cent, of which more than half was deposited in the collateral pool by other banks (in particular, central credit institutions). The rest had either been sold or committed on the collateralized secondary market.

4.3 THE GOVERNMENT SECURITIES MARKET

The cost of new issues decreases and their average maturity lengthens

From November 2013 to April 2014 placements of Italian government securities amounted to €257 billion (€52 billion net of redemptions). The average yield at issue fell to 1.4 per cent (Figure 4.8), the lowest value recorded since the introduction of the euro. The weighted average cost of outstanding government securities is now 3.7 per cent. The lengthening of the average life at issue, which rose to 4.5 years, has not yet halted the reduction in the average residual life of outstanding government securities, now 6.4 years (Figure 4.9.a).

Figure 4.8

Issues of government securities: average yield at issue and average cost of the securities in circulation (1)
(monthly data; per cent)

(1) Unindexed government securities placed on the domestic market. The data are updated to 30 April 2014. – (2) Weighted average of the interest rates at issue of government securities outstanding at the end of the month. – (3) Weighted average of the interest rates on the government securities placed during the month, by settlement date.

Figure 4.9

Average maturity and redemption schedule of government securities

(a) *Maturity of government securities at issue and average residual life of outstanding government securities* (1)
(annual data; years)

(b) *Redemption schedule of medium- and long-term government securities* (4)
(monthly data; billions of euros)

Sources: Based on Ministry for the Economy and Finance and Bank of Italy data.
(1) Government securities placed on the domestic market. The figures for 2014 refer to the end of April. The two series differ in level mainly due to the quantity of BOTs, which account for a larger share of the life-at-issue series than of the residual-life series. – (2) End-of-period data, weighted by the stock of outstanding securities. – (3) Average maturity of issues in the period by settlement date, weighted by the quantity issued. – (4) Government securities (including those placed on international markets) with original maturity of more than one year. The redemptions of index-linked BTPs are not revalued for inflation. – (5) Right-hand scale.

[2] The date when the Ministry for the Economy and Finance stopped granting guarantees was 30 June 2012; see the box "Measures to expand collateral in Eurosystem operations", *Financial Stability Report*, No. 3, 2012.

In 2015 the volume of government securities maturing will be substantial

Next year €210 billion of medium- and long-term government securities will mature, a large quantity compared with the last few years (Figure 4.9.b). To reduce the bunching of redemptions during the year, since November the Treasury has engaged in buy-backs and conversions of securities maturing in 2015 for a total of €8 billion.

Secondary market liquidity improves considerably

The liquidity of Italian government securities on the MTS secondary market continued to improve: trading volumes increased, including for the longer maturities, as did the quantities posted by market makers; bid-ask spreads narrowed (Figure 4.10). The increase in trading volumes boosted activity in the MTS special-repo market, where market makers were normally able to borrow securities at a very low cost (specialness). The liquidity of the BTP futures market also increased (Figure 4.11.a). The net notional volume of credit default swaps on Italian government debt remained stable (Figure 4.11.b).

Figure 4.10

Bid-ask spread and trading volumes on MTS (1)

(monthly averages of daily data; billions of euros and basis points)

Source: Based on MTS S.p.A. data.
(1) The spread is measured as the simple average of the bid-ask spreads observed during the trading day for the BTPs listed on MTS. – (2) Volumes traded on MTS. – (3) Bid-ask spread; right-hand scale.

Figure 4.11

Derivatives markets on Italian sovereign debt

(a) *Futures on 10-year BTPs; trading volumes and open interest* (1) *(daily data; thousands of contracts)*

(b) *Sovereign CDS: net notional volumes (weekly data; billions of dollars)*

Sources: Based on Thomson Reuters Datastream and Dealogic data.
(1) Open interest is the sum of all open futures contracts on the date indicated.

The proportion of Italian government securities held by non-residents increases

In December 2013 the share of Italian government securities held by non-residents was 27 per cent, up by 0.9 percentage points on June (Figure 4.12); in the same period the share held by Italian banks declined from 23 to 21.7 per cent (see Section 3.3). Balance of payments data show that in the first two months of 2014 non-residents' confidence in Italian government securities increased and led to very large net purchases with a consequent further rise in the proportion held by non-residents. On the basis of TARGET2 balances, in March the proportion remained virtually unchanged (see Figure 1.3.a).

Figure 4.12

Italian general government securities: distribution by holder (1)

Source: Financial accounts data.
(1) Percentage shares calculated at market prices net of securities held by Italian general government entities. The shares of non-resident holders are shown separately. The data used for this figure have undergone a statistical revision so that they are not comparable with those included in the previous issues of this publication. – (2) Estimate, based on market sources, of Italian government securities held by the Eurosystem (net of those held by the Bank of Italy) in the framework of the Securities Markets Programme (SMP). – (3) Individually managed portfolios and investment funds managed by foreign institutions but attributable to Italian investors. Partially estimated data. – (4) Net of securities held by foreign individually managed portfolios and investment funds but attributable to Italian investors and by the Eurosystem (excluding the Bank of Italy) in the framework of the SMP. – (5) Non-financial corporations, pension funds, and other types of investor.