



BANCA D'ITALIA
EUROSISTEMA

Financial Stability Report

November 2013

Number

6



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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

World growth remains moderate

The growth of the world economy is still moderate and regionally uneven. The emerging economies are weighed down by financial conditions that are less favourable than in the past, and in some cases by macroeconomic imbalances that built up during the period of rapid growth. Uncertainty about the future stance of budgetary policy in some major advanced countries persists.

In Europe the risks to financial stability diminish but are still significant

In the euro area, where the signs point to cyclical recovery, the main risk remains that of a new downward spiral between economic fragility, sovereign debt crises and the vulnerability of banks. The segmentation of financial markets persists. Banks' access to wholesale funding markets has improved but is still intermittent. Credit quality is worsening, not only in the countries hardest hit by the crisis.

In Italy there are qualitative signals of an economic improvement

Italian business surveys indicate that the contraction of industrial activity has come to a halt, but the dispersion of opinions is broad and the outlook remains uncertain. The improvement of the external account is proceeding, thanks in part to the continuing moderate growth of exports. The number of real-estate transactions has stabilized, but house prices are still declining, albeit at a slower pace.

The liquidity of the Italian government securities market has improved and yields have declined. Non-residents have continued to make net purchases. The fiscal adjustment must be implemented in order to curb risk premiums on Italian government paper and ensure credit conditions that can foster the economic recovery.

Households' financial conditions remain sound

Despite a decline in disposable income, indebted households' financial con-

ditions are still sound overall. Low interest rates and measures in favour of borrowers help to limit the burden of debt service. The proportion of financially vulnerable households has not increased and should remain stable next year as well.

Firms' profitability diminishes further

The profitability of businesses is declining, owing to the protracted recession. The proportion of financially fragile firms (those with high ratios of interest expense to gross operating profit) has risen. The considerable uncertainty concerning the strength and timing of the recovery, together with the difficult terms of access to credit (especially for small and medium-sized enterprises) are still significant sources of risk.

Credit continues to contract

Lending continues to contract, owing both to weak demand and to the banks' restrictive stance on supply, which stems above all from the increasing riskiness of firms. With the cyclical upturn the decline in credit is expected to moderate in the course of 2014. Large corporations have increased their recourse to the bond market.

Work on the first stage of the European Banking Union has begun

The comprehensive assessment of the state of the main euro-area banks in the framework of the European Single Supervisory Mechanism is getting under way. The exercise, which will cover 15 large and medium-sized banks in Italy, can bring significant benefits to the country's banking system. It will make banks' balance sheets more transparent and internationally comparable, thus helping to attenuate the fragmentation of financial markets and improve funding conditions.

Credit quality is affected by the recession ...

Italian banks' chief problem is the rapid increase in non-performing loans, prin-

cipally to businesses, as a result of the protracted recession. According to preliminary data, the new bad debt ratio stopped rising in the third quarter of this year; next year, while remaining high, it is expected to fall gradually. In the future it will be necessary to reduce the volume of non-performing loans. The comprehensive assessment, by dispelling the uncertainty about the quality of bank balance sheets, should foster the revival of the loan securitization market.

... and cuts into banks' profitability; coverage ratios are stable

Banks' operating profits are largely absorbed by loan losses; for the system as a whole, they should be sufficient to cover loan losses both this year and next. Coverage ratios (measured by the ratio of loan loss provisions to non-performing loans) have held stable. The Bank of Italy's checks on the adequacy of banks' provisioning continue.

The banks reduce their exposure to government securities in the third quarter

Italian banks' purchases of domestic general government securities accelerated from late 2011 onwards; one contributing factor was the widening differential between the risk-adjusted yields on government securities and loans. In the third quarter of 2013 there were net disposals of securities, in conjunction with the signs of economic recovery and the easing of strains in the wholesale funding markets.

Bank funding diminishes; the funding gap reaches a low level

Banks' funding has been contracting since the spring, reflecting the gradual repayment of Euro-system refinancing and, more recently, a slight decrease in retail funding,

in part as a result of the banks' marketing policies. Net funding on wholesale markets has also remained negative, but there has been an upturn in bond placements, facilitated by the fall in the risk premium on Italian government securities. The funding gap has narrowed to historically low levels.

The banks continue to strengthen their capital base

The strengthening of the banks' capital base has proceeded without recourse to public funds. Since the onset of the crisis government support to the banks – granted exclusively in the form of loans – has been very limited in Italy, both in absolute terms and relative to other countries. The assessments conducted by the Bank of Italy and the IMF have confirmed that overall the Italian banking system does not need substantial recapitalization, even assuming conditions of stress. Financial leverage is low by comparison with other European banks.

The insurance industry is sound

The capital position of Italian insurance companies remains solid. Premium income has continued to rise and liquidity risk to diminish. Profitability is satisfactory. Given their large portfolios of government securities, the companies remain sensitive to the possible resurgence of sovereign debt tensions.

The summer's money market tensions have subsided

The liquidity conditions of the Italian financial markets have come back into line with those prevailing prior to the crisis. The tensions on very-short-term interest rates observed in June and July had subsided by the beginning of August.

1 MACROECONOMIC RISKS AND INTERNATIONAL MARKETS

1.1 THE MACROECONOMIC AND FINANCIAL CONTEXT

Global growth remains moderate; the recovery in the euro area is still uncertain

The world economy shows signs of picking up after the slowdown recorded in the second half of 2012 and the early part of this year. However, the expansion remains moderate, with different regional trends. While growth expectations have gradually solidified for the United States and Japan and have been revised slightly upwards for China, the forecasts for most of the emerging countries have been revised downwards (Figure 1.1). In Europe, where economic activity continues to be slack, GDP is expected to grow by about 1 per cent next year.

The financial tensions connected with the Fed's tapering subsidy

In recent months the tensions engendered on US financial markets first by expectations of a tapering of bond purchases by the Federal Reserve and then by fears of a technical federal government default gave rise to pronounced fluctuations of volatility indices and interest rates on international markets (Figure 1.2) and massive capital outflows from emerging economies. To counter the rise in money market rates in the euro area, in July the Governing

Figure 1.1

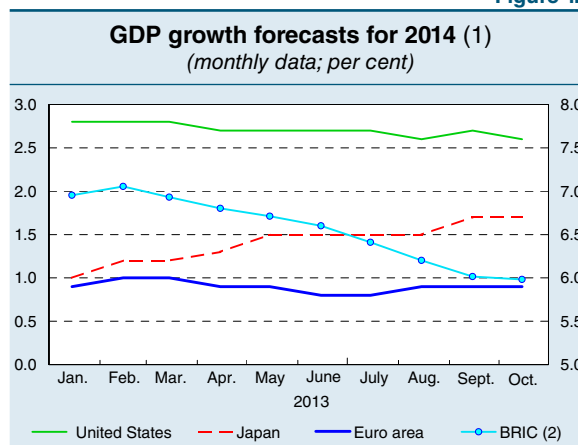
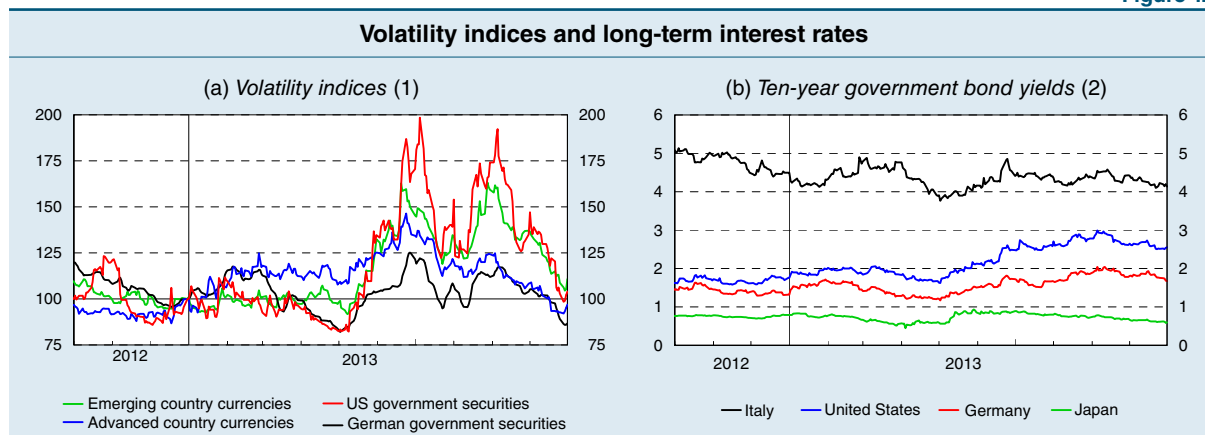


Figure 1.2

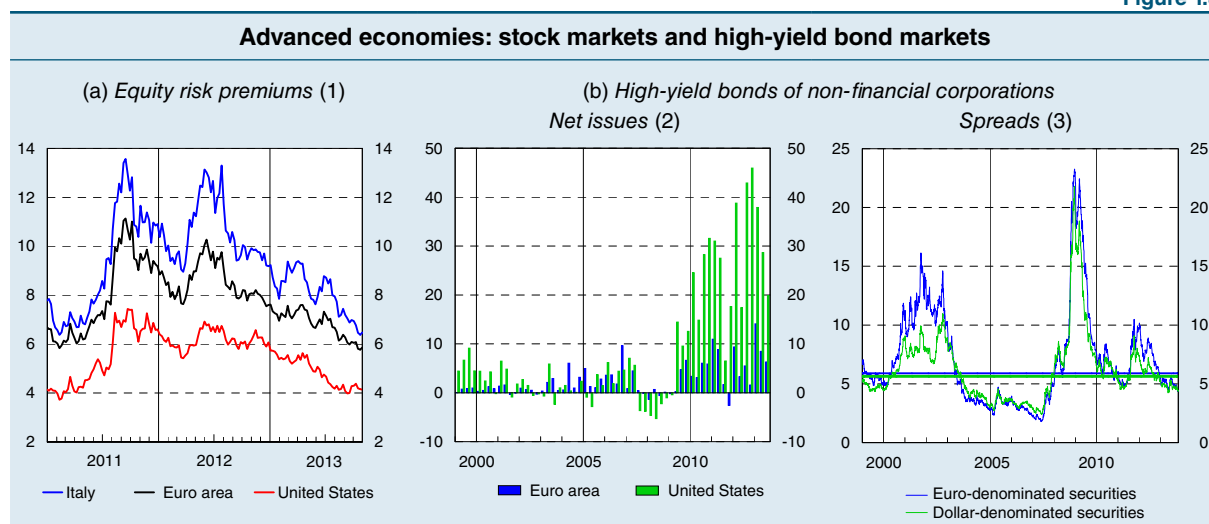


Council of the ECB decided to provide forward guidance on its key interest rates. In early November, with underlying price pressures diminishing further and credit dynamics remaining subdued, it cut the rate on main refinancing operations by a quarter of a percentage point, to 0.25 per cent.

Demand for high-risk assets remains strong

Portfolio adjustments on global financial markets have mainly involved emerging market assets, but there has been no broadly based decline in the demand for high-risk assets. In the advanced countries, equity risk premiums have fallen further (Figure 1.3.a), while high-yield bonds have continued to register substantial albeit recently diminishing net issues and spreads below the long-term levels (Figure 1.3.b). At the same time, long-term interest rates in countries deemed to be at low credit risk have remained low by historical standards.

Figure 1.3



Sources: Based on data from Bloomberg, Dealogic, I/B/E/S, Merrill Lynch and Thomson Reuters Datastream.

(1) End-of-week data; per cent. The risk premium is calculated as the difference between expected earnings for the next 12 months, as a percentage of current stock market capitalization, and the nominal yield on ten-year government bonds (proxied, for Italy and the euro area, by German government bonds). – (2) Quarterly data; billions of euros. Redemptions are estimated. – (3) For securities denominated in euros the spreads are calculated with reference to French and German government securities, for those denominated in dollars with reference to US government securities. Daily data; percentage points. The horizontal lines indicate the median values calculated from 1999 onwards.

Italy continues with structural fiscal adjustment ...

In Italy, the contraction of the economy appears to have halted (see *Economic Bulletin*, October 2013). Both spot and forward yields on government securities have remained relatively stable across the maturity spectrum since the summer (Figure 1.4.a), while yield spreads with Germany have narrowed (to about 240 basis points for the ten-year maturity; Figure 1.4.b). During the summer the European Council closed the excessive-deficit procedure opened against Italy at the end of 2009. According to the forecasts of the Government and the European Commission, net borrowing will stay below the threshold of 3 per cent of GDP in 2013. The ratio of public debt to GDP is expected to increase sharply this year owing to the recession, the payment of general government commercial debt arrears and financial support to EU countries. The debt/GDP ratio will begin to come down in 2014 according to the Government's estimates, whereas the Commission forecasts that it will increase again, primarily as a consequence of a less favourable projection for nominal GDP growth.

Italy's long-term financial situation is in equilibrium according to the public debt sustainability indicators, which take account of a series of structural factors (including healthcare and pension expenditure, linked to demographic trends; Table 1.1). Other macroeconomic indicators, such as the economy's overall debtor position (comprising public and private sector debt) and the net international investment position are also in line with the average values for the euro area.

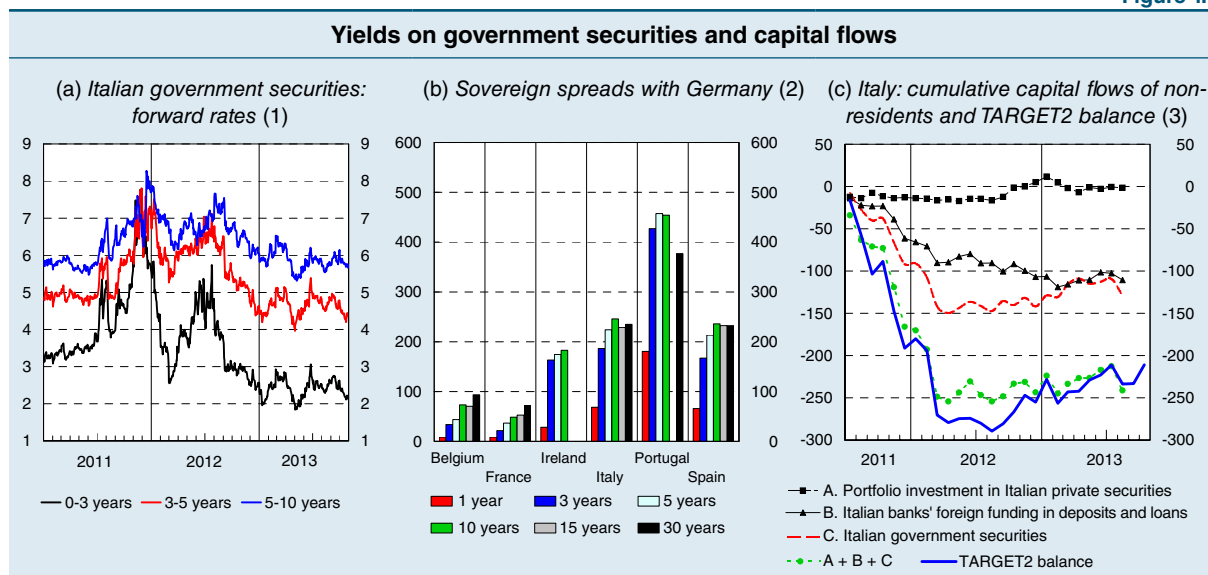
Table 1.1

Financial sustainability indicators (per cent of GDP, unless otherwise specified)												
	Budget deficit (1)			Primary surplus (1)			Public debt (1)			GDP (annual growth rate) (2)		
	2012	2013	2014	2012	2013	2014	2012	2013	2014	2012	2013	2014
Italy	3.0	3.0	2.7	2.5	2.3	2.8	127.0	133.0	134.0	-2.5	-1.8	0.7
Germany	-0.1	0.0	-0.1	2.5	2.3	2.2	81.0	79.6	77.1	0.7	0.5	1.7
France	4.8	4.1	3.8	-2.3	-1.8	-1.4	90.2	93.5	95.3	0.0	0.2	0.9
Spain	10.6	6.8	5.9	-7.6	-3.3	-2.4	86.0	94.8	99.9	-1.6	-1.3	0.5
Netherlands	4.1	3.3	3.3	-2.2	-1.4	-1.5	71.3	74.8	76.4	-1.2	-1.0	0.2
Belgium	4.0	2.8	2.6	-0.6	0.3	0.5	99.8	100.4	101.3	-0.1	0.1	1.1
Austria	2.5	2.5	1.9	0.1	0.2	0.7	74.0	74.8	74.5	0.9	0.4	1.6
Finland	1.8	2.2	2.3	-0.7	-1.2	-1.3	53.6	58.4	61.0	-0.8	-0.6	0.6
Greece	9.0	13.5	2.0	-4.0	-9.4	2.8	156.9	176.2	175.9	-6.4	-4.0	0.6
Portugal	6.4	5.9	4.0	-2.1	-1.6	0.3	124.1	127.8	126.7	-3.2	-1.8	0.8
Ireland	8.2	7.4	5.0	-4.5	-2.8	-0.2	117.4	124.4	120.8	0.2	0.3	1.7
Euro area	3.7	3.1	2.5	-0.6	-0.1	0.5	92.6	95.5	95.9	-0.7	-0.4	1.1
United Kingdom	6.1	6.4	5.3	-3.1	-3.4	-2.4	88.7	94.3	96.9	0.1	1.3	2.2
United States	8.3	5.8	4.6	-6.1	-3.6	-2.6	102.7	106.0	107.3	2.8	1.6	2.6
Japan	10.1	9.5	6.8	-9.3	-8.8	-6.1	238.0	243.5	242.3	2.0	2.0	1.2
Canada	3.4	3.4	2.9	-2.8	-2.8	-2.4	85.3	87.1	85.6	1.7	1.6	2.2
	Characteristics of public debt (3)			Sustainability indicators		Private sector financial debt at end-2012		External positions				
	Share maturing plus deficit in 2013	Avg residual life of govt securities in 2013 (yrs)	Non-residents' share in 2013 (% public debt)	S2 indicator (4)	IMF indicator (5)	Households	Non-financial firms	Current account balance in 2012	Net international investment position at end-2012			
Italy	28.4	6.4	35.8	-2.3	2.2	45.2	83.1	-0.4	-26.4			
Germany	8.3	6.4	59.9	1.4	1.1	58.0	57.8	7.0	41.5			
France	17.4	6.7	61.3	1.6	4.7	56.7	105.1	-2.2	-21.1			
Spain	20.2	5.5	37.5	4.8	7.5	80.3	130.1	-1.1	-93.2			
Netherlands	11.6	6.7	56.0	5.9	6.2	127.8	94.5	9.4	46.8			
Belgium	18.7	7.3	59.9	7.4	9.3	56.0	191.7	-2.0	47.6			
Austria	9.0	7.5	83.5	4.1	4.9	53.9	110.0	1.6	0.4			
Finland	8.8	6.2	91.6	5.8	3.9	66.0	119.2	-1.7	18.4			
Greece	21.1	8.2	79.8	....	3.3	63.8	64.8	-2.4	-108.8			
Portugal	23.3	4.8	65.2	....	6.1	91.0	164.2	-2.0	-115.4			
Ireland	12.4	12.1	65.7	....	7.7	105.4	223.7	4.4	-112.0			
Euro area	....	....	....	2.1	....	65.0	99.8	1.3	-13.3			
United Kingdom	12.1	14.4	32.7	5.2	7.0	93.2	96.3	-3.8	-9.1			
United States	23.9	5.5	33.8	....	11.7	79.0	78.6	-2.7	-23.8			
Japan	58.4	6.4	8.4	....	16.8	65.5	103.3	1.0	62.3			
Canada	16.6	5.6	24.7	....	6.5	93.4	88.6	-3.4	-16.6			

Sources: IMF, Eurostat, ECB, European Commission, Istat, national financial accounts and balance-of-payments data.

(1) Data for European countries and the euro area are from European Commission, *European Economic Forecast Autumn 2013*, November 2013. The data for non-European countries are from IMF, *Fiscal Monitor*, October 2013. – (2) The data for European countries and the euro area are from European Commission, *European Economic Forecast Autumn 2013*, November 2013. The data for non-European countries are from IMF, *World Economic Outlook*, October 2013. – (3) Data from IMF, *Fiscal Monitor*, October 2013. – (4) 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. Data from European Commission, *Fiscal Sustainability Report 2012*. – (5) Increase in the primary surplus/GDP ratio (with respect to 2012) 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 2013 and 2030.

Figure 1.4



Source: Based on Bloomberg data for sovereign spreads with Germany.

(1) 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. – (2) Data recorded on 31 October 2013; basis points. No data are available for the 15- and 30-year maturities for Ireland or for the 15-year maturity for Portugal. (3) 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.

... and records a further improvement in the external accounts

Italy's external accounts have continued to improve. The balance of payments on current account, positive since the final months of 2012, has registered a growing surplus as a result of the reduction in imports and the good performance of exports. Foreign investors made substantial net purchases of government securities in the first seven months of the year, followed by disposals in August (Figure 1.4.c); subsequently they appear to have resumed making purchases (see Figure 4.13.a).

The banks are still under pressure, and not only in the countries hit hardest by the crisis

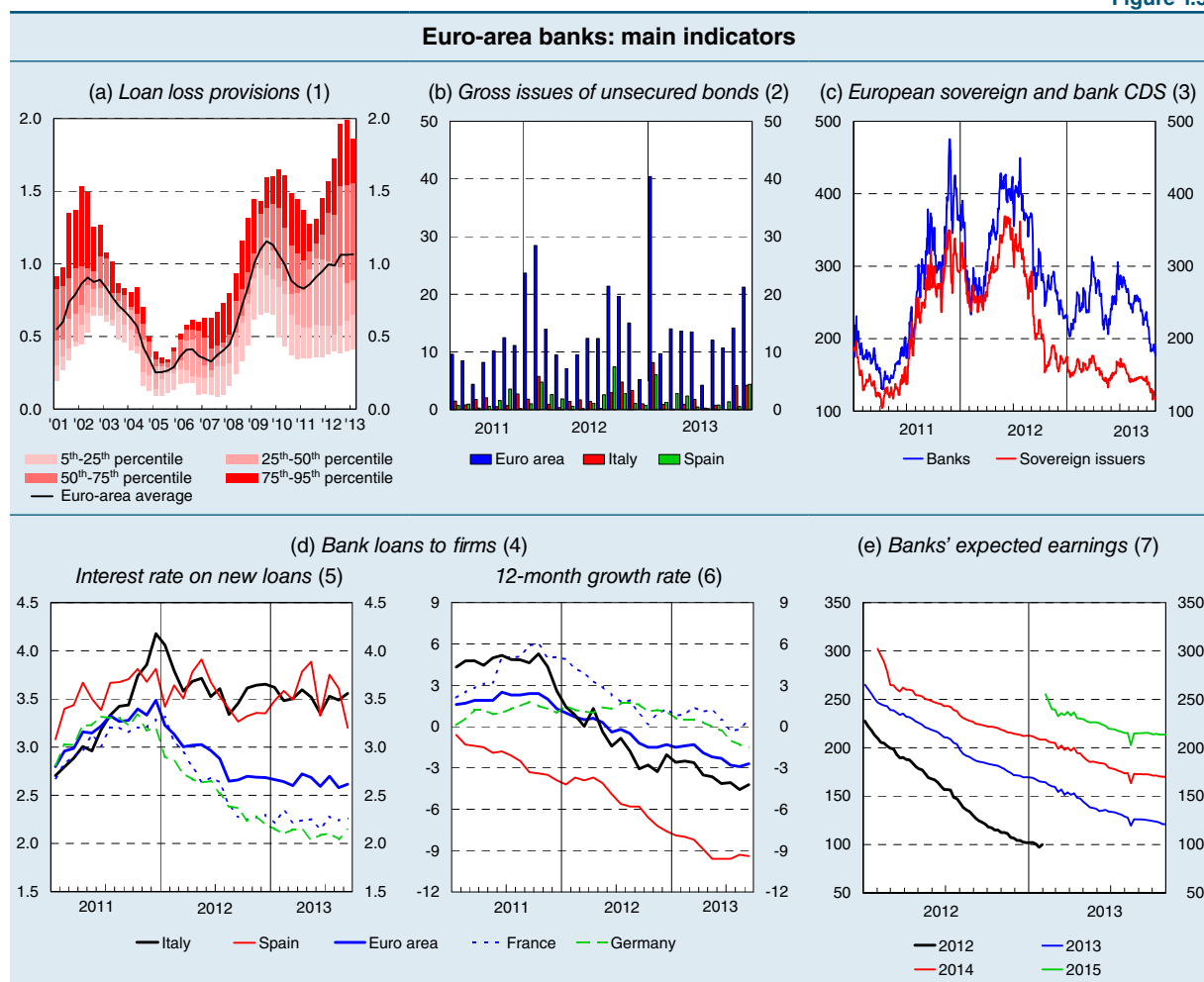
The euro-area banks are experiencing a further deterioration in credit quality (Figure 1.5.a), determined by two recessions and in some countries by falling property prices. Access to wholesale funding markets remains intermittent in an environment influenced in no small degree by sovereign risk premiums (Figures 1.5.b and 1.5.c). In the first nine months of 2013 banks' net bond issuance was negative in the majority of euro-area countries. In the most vulnerable countries, interest rates on new loans to firms remain relatively high (Figure 1.5.d). Even in some of the countries less exposed to the sovereign debt crisis, lending to firms is slowing or has begun to contract and credit risk is increasing. The worsening of analysts' expectations for banks' earnings (Figure 1.5.e) is common to the four largest euro-area countries.

1.2 THE MAIN RISKS FOR FINANCIAL STABILITY

The risks for financial stability diminish; they remain related to the fragile recovery ...

The global economic recovery is still fragile. Financial conditions in the emerging economies are not as favourable as in the past; in some cases there are significant current account or budget imbalances. Moreover, uncertainties persist over the future direction of budgetary policies in several countries: the confrontation over the debt ceiling in the United States could have destabilizing effects in the medium to long term, despite the agreement reached in October; in Japan there is still no medium-term plan for meeting the primary deficit targets set by the government. In the euro area the cyclical turnaround is

Figure 1.5



Sources: Based on Bank of Italy, ECB, Bloomberg, Dealogic, I/B/E/S and Thomson Reuters Datastream data.

(1) 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. – (2) Monthly data; billions of euros. Bonds not backed by collateral or by a government guarantee. – (3) 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 4 countries in the note to Figure 3.1. – (4) Monthly data; per cent. – (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 2012=100.

attenuating the risks for financial stability. These are still significant, however, mainly owing to the negative feedback loop between the weakness of the economy, growing budgetary imbalances and banks' vulnerabilities.

... a potential financial market correction ...

With risk premiums at very low levels, financial markets remain exposed to a potential brusque correction in financial asset prices if investor confidence should deteriorate. There is still considerable uncertainty over the course of monetary policy in the United States and its consequences for interest rates and financial asset prices in the rest of the world.

... uncertainties over the evolution of the sovereign debt crisis ...

Various political and economic factors could trigger a widening of sovereign spreads and a fresh increase in the fragmentation of financial markets in the euro area. In the countries most exposed to sovereign debt tensions the risk of adjustment fatigue remains, linked to the immediate economic costs of the

adjustment measures and the lag with which they foster growth and employment. A strengthening economy and credible public finance plans are essential conditions for exiting the crisis.

... and to the difficulties of the banks

The prospects for economic recovery are also affecting the risks for banks in the euro area, in connection with increased loan losses and poor profitability. Some rules for bail-ins, provided for by the new rules on state aid adopted by the European Commission last summer, could hinder the recovery of debt markets (see the box “The new rules on state aid to banks”). Against this backdrop, tensions could resurface next year as the Eurosystem’s three-year refinancing operations draw to a close, despite the ECB’s announcement that it is ready to use all instruments at its disposal to keep money market rates at levels consistent with its monetary policy stance. An important contribution to reducing uncertainty will come from the launch of the Single Supervisory Mechanism and next year’s comprehensive assessment of the largest euro-area banks.

THE NEW RULES ON STATE AID TO BANKS

On 1 August 2013 the new European Commission rules on state aid to banks in difficulty came into force.¹ The main changes are intended to improve the effectiveness of the restructuring process in the event of a crisis and ensure a level playing field for banks in different EU countries. In particular, banks will be required to draw up a plan for their restructuring or orderly winding down before they can receive public support in the form of recapitalizations or asset protection measures. Moreover, in the event of capital shortfalls, shareholders and subordinated creditors will be required to contribute to the cost of restructuring as a first resort (burden sharing), so as to minimize the amount of public support, moral hazard and competitive distortions.

The new rules also provide for burden sharing to be applied both when the capital shortfall emerges in a stress test and when it is established in an asset quality review (Paragraph 28 of the European Commission’s Communication). In particular, where the bank is unable to strengthen its capital position on its own, the application of burden sharing requires, as a condition for access to state aid, the conversion into equity or writedown of subordinated debt instruments. The rules distinguish between cases in which the capital ratio falls below the threshold established for the exercise but remains above the regulatory minimum² from those in which the ratio falls below the regulatory minimum (Paragraphs 43 and 44). In the first case, before authorizing public support, the European Commission requires, in principle, that subordinated debt be converted into equity; in the second case, it must be possible for subordinated debt to be converted or written down. In practice, in the first case a more favourable approach would be adopted for the subscribers of subordinated instruments. In both cases the application of burden sharing can be avoided when it might endanger financial stability or lead to disproportionate results, especially where the aid amount is small in comparison with the bank’s risk weighted assets (Paragraph 45).³

Although burden sharing may be commendable in principle, the capital shortfall determined on the basis of the results of stress tests cannot be compared with that of an asset quality review. When carried out as part of a supervisory action, asset quality reviews initiate a process of loss assessment; incurred losses must

¹ See the European Commission’s Communication 2013/C 216/01 (<http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2013:216:0001:0015:EN:PDF>).

² See, for example, the stress-test exercise carried out by the EBA in 2011, which set a threshold of 9 per cent for the core tier 1 ratio.

³ According to the Communication, depositors and senior creditors remain exempted from burden sharing. The latter are included, instead, in the definition of bail-in tool in Article 37 of the proposed Bank Recovery and Resolution Directive. For the Commission, the Communication is a provisional solution, pending completion of the work on crisis resolution currently under discussion in the European Community.

be recorded by the corporate bodies in balance sheets. The capital shortfall determined as a result of a stress test is based, instead, on a loss that is only potential and that, by definition, has a very low probability of occurring; it does not reflect either fair value writedowns or value adjustments to loans and thus, in accordance with the international accounting standards currently in force, does not have to be recorded in the balance sheet. At all events a forced conversion or writedown of debt instruments would have to respect the rights of the creditors and shareholders in accordance with the Charter of Fundamental Rights of the European Union and the European Convention on Human Rights.⁴

Maintaining legal certainty will help prevent the unduly broad application of burden sharing from holding back the recovery and growth of the subordinated debt instruments market at a delicate time for wholesale funding markets, such as the present.

Subordinated debt instruments can be classified in banks' tier 1 or tier 2 regulatory capital. In September 2013 the volume of these instruments issued by banks with their registered office in Italy was €61 billion (3.7 per cent of their risk-weighted assets and 1.9 per cent of total liabilities); it is estimated that about €35 billion of these securities were held by households. The liabilities of this kind issued by the 15 banking groups that participate in the asset quality review recently announced by the ECB amounted to €54 billion (4.5 per cent of their risk-weighted assets and 2.2 per cent of total liabilities); of this total just over half was held by households, a figure similar to that of the banking system as a whole. Within this sample, the banks with a core tier 1 ratio of more than 10 per cent accounted for €45 billion, of which €24 billion held by households.

⁴ Article 17 of the Charter, on the right to property (including claims), provides for persons to be deprived of their possessions if this is (a) "in the public interest and in the cases and under the conditions provided for by law" and (b) "subject to fair compensation being paid in good time for their loss". Article 17 also expressly states that "Everyone has the right to own, use, dispose of and bequeath his or her lawfully acquired possessions". Accordingly, compliance with the conditions laid down by the Charter would be necessary not only in cases of outright cancellation of debt instruments but also of their writedown or conversion into equity. According to the Charter's public interest requirement there must be a real and immediate threat to financial stability and not a merely hypothetical scenario, such as that produced by a stress test.

1.3 THE REAL-ESTATE MARKETS

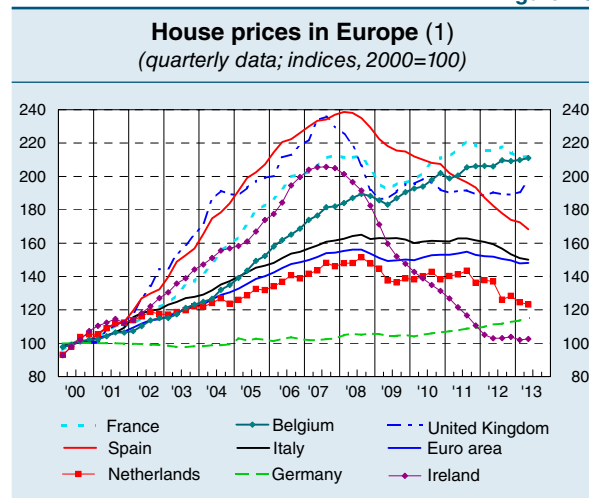
Real-estate markets are recovering in the US, stabilizing in Europe ...

The excess supply that had characterized the US property market since the onset of the crisis is being reabsorbed. Futures prices indicate that the rise in house prices will cease in the first half of 2014. For the euro area house prices stabilized in the second quarter of 2013 after a cumulative fall of nearly 5 per cent since the end of 2011 (Figure 1.6). The decline has continued in Spain, the Netherlands and Italy and halted in France and Ireland. In Germany and Belgium, by contrast, prices continue to rise.

... and still slack in Italy

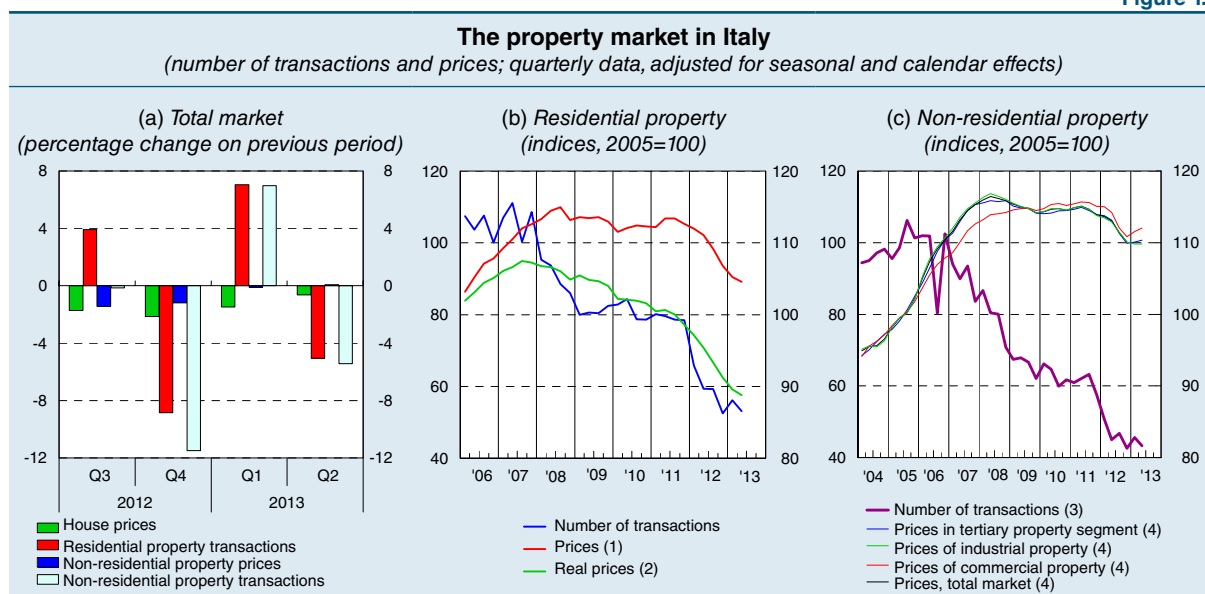
The property market remains weak in Italy, though with some signs of stabilization. In the second quarter, the fall in

Figure 1.6



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

Figure 1.7



Sources: Based on data from Bank of Italy, Istat, Osservatorio del Mercato Immobiliare, Nomisma, and Scenari Immobiliari.

(1) Right-hand scale. – (2) Deflated using the change in consumer prices; right-hand scale. This experimental price indicator uses data drawn from transactions actually concluded on the market. 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.

house prices was still very steep on a twelve-month basis (5.9 per cent) but eased to 0.6 per cent quarter-on-quarter (Figure 1.7.a). According to the Revenue Agency's Property Market Observatory (Osservatorio del Mercato Immobiliare), the number of transactions was about the same as in the fourth quarter of 2012 (Figure 1.7.b). The number of non-residential property sales also appears to have basically stabilized. The fall in prices has ended in all the main market segments (Figure 1.7.c).

The house price decline in Italy is consistent with the fundamentals

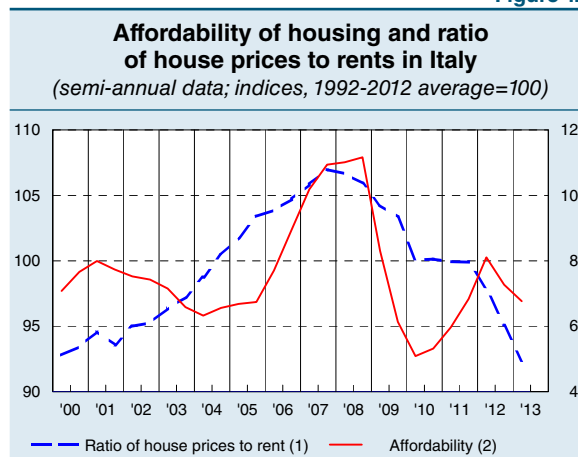
According to our estimates the decline in Italian house prices over the past two years is explained primarily by the fall in household income (down 7 per cent in real terms since the end of 2010) and by the persistent tensions in the credit market. The risk of further sharp price corrections, which can be ascribed to the overvaluation of houses, would appear to be limited, in the light of other indicators: both the housing affordability index and the price-rent ratio are low by historical standards (Figure 1.8).

The outlook remains uncertain ...

The short-term outlook for the real-estate market remains uncertain. Builders' confidence is still at low levels despite the gradual recovery in the industries that supply construction materials. Although estate agents expect further declines in house prices in the next few months, overall they foresee less unfavourable developments in the markets they operate in. For the national

According to our estimates the decline in Italian house prices over the past two years is explained primarily by the fall in household income (down 7 per cent in real terms since the end of 2010) and by the persistent tensions in the credit market. The risk of further sharp price corrections, which can be ascribed to the overvaluation of houses, would appear to be limited, in the light of other indicators: both the housing affordability index and the price-rent ratio are low by historical standards (Figure 1.8).

Figure 1.8



Sources: Based on Bank of Italy, Istat, Osservatorio del Mercato Immobiliare 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 mortgage loans – proxied by the product of house prices and interest rates – to household disposable income; a decrease indicates that housing is more affordable.

market, medium-term expectations have turned slightly positive (Figure 1.9).

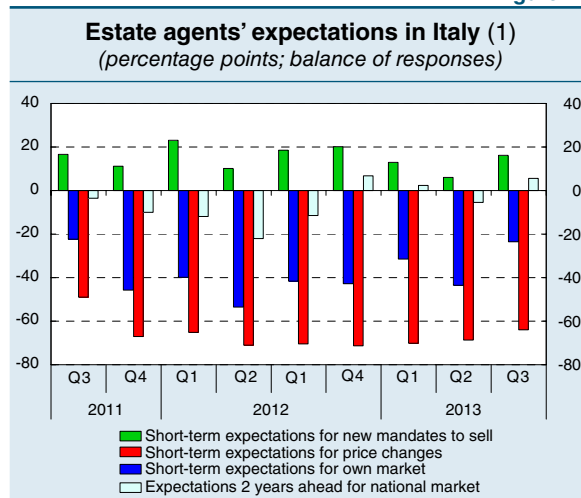
Assuming the gradual recovery of the economy, in keeping with the forecast set out in last July's *Economic Bulletin*, residential property prices should record a decline of 5 per cent on average in 2013 and a modest rise throughout 2014. The risk for this projection is downside. The uncertainty caused by the revision of real-estate tax rules, still under way, could hold back the recovery in prices and transactions in the months to come. In addition, 18 non-residential real-estate investment funds for retail investors will come to maturity between now and December 2016.

For the intermediaries, the risk lies in loans to construction firms Mortgage loans to households represent only a modest risk for intermediaries. The rise in bad debts in this segment in 2014 is expected to be small. However, the quality of loans to construction firms continues to deteriorate. In June, those classified as bad debts amounted to €38 billion, equal to 20 per cent of the total (17.5 per cent in December), while another 17 per cent were substandard, past-due or restructured. For loans to real-estate service companies (sales, rentals, management and brokerage), bad debts amounted to €15 billion, or 10 per cent of lending (9 per cent at the end of 2012), and another 16 per cent of loans were classed as anomalous.

Some firms are benefiting from the payment of general government arrears

Construction firms are heavily indebted. Data on their financial statements for 2012, still only partial, indicate a financial leverage ratio of around 70 per cent, some 20 percentage points higher than the average for the other productive sectors. In a Bank of Italy survey conducted in September, 44 per cent of the construction firms interviewed expected a profit in 2013 and 36 per cent a loss, about the same as in 2012. The firms that have received payments of debt arrears from general government reported an improvement in their liquidity position and an increase in their propensity to invest (see the box "The outlook for investment and the settlement of general government debts: findings of the Bank of Italy's business surveys," *Economic Bulletin*, October 2013).

Figure 1.9



Sources: Based on Bank of Italy, Osservatorio del Mercato Immobiliare and Tecnoborsa data.

(1) Quarterly data from the survey conducted by the Bank of Italy, Tecnoborsa and Osservatorio del Mercato Immobiliare. Balances between the percentages of replies indicating a situation that is improving or worsening. Short-term expectations for new mandates to sell, for agents' own market and for price changes refer to the quarter following the one indicated; expectations for the national market refer to a 2-year horizon.

2 THE FINANCIAL CONDITION OF HOUSEHOLDS AND FIRMS

2.1 HOUSEHOLDS

Italian households' gross wealth is affected by the fall in house prices

In the first half of 2013 households' gross wealth declined by 1 per cent as a result of the fall in house prices; net wealth followed the same path. The value of financial assets was unchanged, with disposals offset by a small increase in prices. The ratio of financial wealth to income remained constant at 3.5 (Figure 2.1).

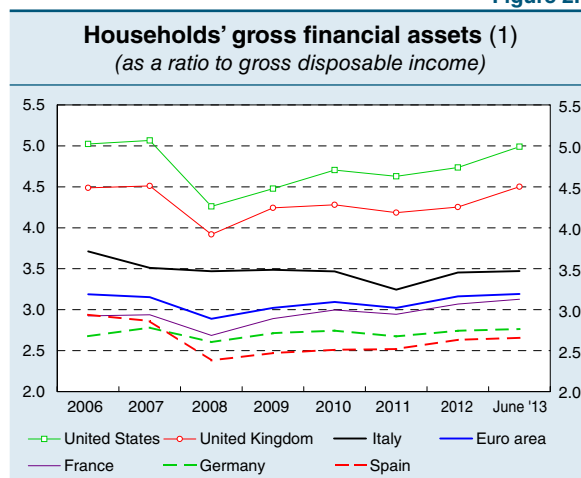
Fewer bank instruments among financial assets

In households' financial portfolios, between January and June, bank deposits and postal savings increased by €6 billion, while bank bonds decreased by €28 billion. Overall, the share of the portfolio invested in bank instruments declined from 28.5 to 27.8 per cent. However, there was an increase in investments in shares and investment funds and insurance policies, mainly placed through the banks. The banks' pricing strategies contributed to this reallocation, as did the positive performance of the financial markets.

Debt continues to decrease

In the first half of the year households' overall financial debt continued to decline (by about 1 per cent). It currently stands at around 65 per cent of disposable income, compared with about 80 per cent in France and Germany and 120 per cent in Spain. The decline in bank debt, for which we have up-to-date information, appears to have continued in more recent months. According to the qualitative information in the euro-area bank lending survey, the contraction in the demand for loans and the tightening of supply conditions came to a halt (Figure 2.2); however, the banks continued to maintain high margins on mortgage loans to their more risky customers.

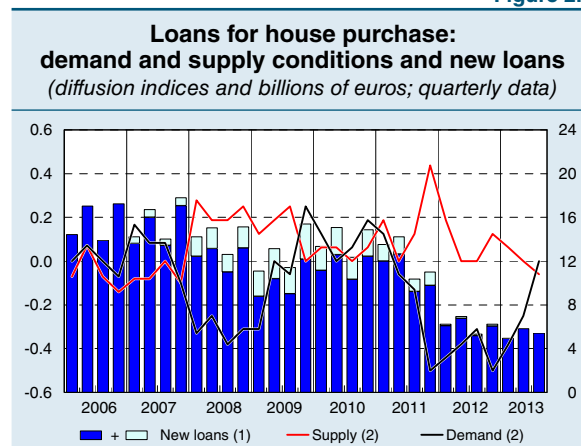
Figure 2.1



Sources: Bank of Italy and Istat for Italy; ECB for the other euro-area countries; Central Statistical Office and Bank of England for the United Kingdom; Federal Reserve System and Bureau of Economic Analysis for the United States.

(1) The data refer to consumer and producer households, except for the United States, for which they refer only to consumer households. For financial assets, end-of period data. The data for the second quarter of 2013 are provisional.

Figure 2.2



Sources: The euro-area bank lending survey, regional bank lending survey, and supervisory reports.

(1) Right-hand scale. Data in billions of euros. Includes subrogations and substitutions (shown in light blue). Data for the third quarter of 2013 are provisional. – (2) For the demand index, values above (below) zero indicate expansion (contraction); for the supply index, values above (below) zero indicate tightening (easing).

Low interest rates and measures to support mortgage loan holders in difficulties ...

Since the beginning of 2013 the interest rates on new loans to households have remained stable. In September the annual percentage rate of charge (APRC) on new mortgages was 4.0 per cent, about 0.5 percentage points above the euro-area average. The average cost of outstanding loans was 4.0 per cent (in line with that of the area), a modest value in historical terms thanks to the low yields on the money market, to which more than two thirds of house purchase mortgages are index-linked. March saw the end of the mortgage moratorium agreed by the Italian Banking Association and the consumers' associations, which allowed mortgage holders in difficulty to suspend payment of instalments. The Solidarity Fund is still in place and its endowment (€20 million for each year in the period 2013-15) should cover most of the demand for repayment suspensions.¹

... are holding down the proportion of financially vulnerable households

Low interest rates and measures to support mortgage holders in difficulty helped to limit the debt service burden. According to the preliminary results of the latest survey on household income and wealth, it is estimated that in 2012 vulnerable households (those with disposable income below the median and debt service higher than 30 per cent of income) represented about 3.0 per cent of all households, a similar result to 2008. The situation appears little changed in 2013: the ratio of new bad debts to outstanding loans in the case of mortgage loans is still low. In this market segment the share of loans in temporary difficulty (substandard loans) is stable, while the proportion of bad debts has only slightly increased (Table 2.1). In the consumer credit sector the dynamics are very much the same. Loan quality is lower in the category *Other loans*, which includes those taken out to fund professional activities.

The main risks derive from weak income growth

Assuming gradual economic recovery, in line with the forecasts published in the July 2013 issue of the *Economic Bulletin*, it is estimated that in 2014 the share of financially vulnerable households will remain unchanged at 3.0 per cent of the total. This could rise to 3.5 per cent in a very negative scenario, in which real income continued to decline and short-term interest rates recorded a sharp increase.

2.2 FIRMS

Firms' profitability continues to fall

The long recession continues to weigh on firms' profits. According to national accounts data, in June the ratio of gross operating profit to value added fell to its lowest level (31.4

Table 2.1

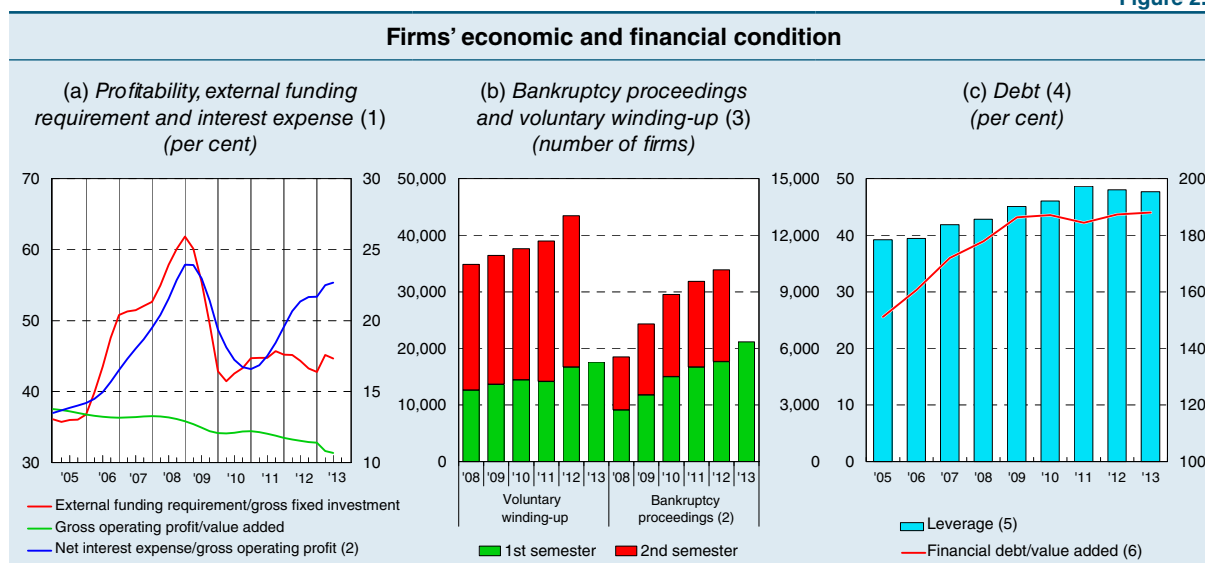
Loans to consumer households (1)				
(millions of euros and percentage composition)				
	December 2012		June 2013	
House purchase loans				
Total	343,550	100.0	341,970	100.0
Performing	325,003	94.6	322,079	94.2
Non-performing	18,547	5.4	19,891	5.8
Past-due (2)	2,632	0.8	3,149	0.9
Substandard	6,049	1.8	6,109	1.8
Bad debts	9,866	2.9	10,633	3.1
Consumer credit				
Total	117,380	100.0	116,510	100.0
Performing	105,243	89.7	103,554	88.9
Non-performing	12,137	10.3	12,956	11.1
Past-due (2)	1,795	1.5	1,876	1.6
Substandard	3,055	2.6	3,233	2.8
Bad debts	7,287	6.2	7,847	6.7
Other loans (3)				
Total	100,533	100.0	100,331	100.0
Performing	79,043	78.6	77,576	77.3
Non-performing	21,490	21.4	22,755	22.7
Past-due (2)	1,706	1.7	1,880	1.9
Substandard	4,294	4.3	4,543	4.5
Bad debts	15,490	15.4	16,332	16.3
Total loans				
Total	561,463	100.0	558,811	100.0
Performing	509,289	90.7	503,209	90.0
Non-performing	52,174	9.3	55,602	10.0
Past-due (2)	6,133	1.1	6,905	1.2
Substandard	13,398	2.4	13,885	2.5
Bad debts	32,643	5.8	34,812	6.2

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.

¹ Besides the possibility of suspending repayments, in a similar way to the moratorium arrangements, the Solidarity Fund also covers the payment of the interest part, although only that linked to the reference rate.

Figure 2.3



Sources: Bank of Italy, Istat and Cerved Group.

(1) Estimates based on national accounts data for the non-financial corporations institutional sector. The indicators are based on the sum of the data for the four quarters ending in the reference quarter. – (2) Right-hand scale. – (3) Limited liability companies; companies that did not file a financial statement in the three years prior to closure are not included among those wound up. – (4) The data refer to non-financial firms. The figures for 2013 are provisional and refer to the second quarter. – (5) Leverage is the ratio of financial debt to the sum of financial debt and net equity at market prices. – (6) Right-hand scale.

per cent) since the start of the time series in 1995 (Figure 2.3.a). While investment contracted sharply, firms' external funding requirement held virtually stable at about 45 per cent. The further increase in the impact of net interest expense on gross operating profit was essentially the result of the decline in the latter. Early indications put at 55 per cent the share of industrial and service firms with 20 or more employees expecting to close 2013 with a profit; the figure was similar for 2012 but some 10 percentage points lower than before the crisis.

Business owners are less pessimistic about the future

In recent months the indicators based on business surveys point to a less pessimistic view of the general economic outlook. While uncertainty remains high, the majority of firms expect investments and total orders to hold broadly stable and export demand to gain strength (see *Economic Bulletin*, October 2013). However, these improvements are slow to translate into a recovery of industrial production and orders.

Production halts become more frequent

The first half of 2013 saw a further increase in bankruptcy proceedings and voluntary winding-up involving limited liability companies (Figure 2.3.b). The balance between new registrations and closures (excluding cancellations by operation of law) was just 7,700 in the first nine months, much less than the average of around 60,000 recorded between 2004 and 2007 and over 36,000 between 2008 and 2012. The decline is due in equal measure to a drop in registrations and an increase in closures.

Bank loans continue to contract

In the last two years Italian firms' financial debt has decreased by over 2 per cent, mainly as a result of the reduction in bank loans, down by 7.1 per cent. The contraction in borrowing reflects not only the extremely low level of demand due to reduced investment and production, but also the selective lending criteria adopted by the banks. A large proportion of firms, particularly small ones, still report that they are unable to obtain credit (Figure 2.4). Business surveys indicate that in recent months the banks have continued to pursue restrictive credit supply policies in response to serious concerns about the high risk of the loans.

Large firms increasingly resort to bond issues

Faced with the contraction in bank lending, large Italian firms have turned increasingly to the bond market. In the first nine months of 2013 gross issues amounted to €28 billion, against €24 billion a year earlier. Out of a sample of some 260 industrial groups including all the largest corporations, the 23 groups that issued bonds in the first half of 2013 reduced their bank credit by 13 per cent, while the remainder increased it by 1 per cent. In November 2012 the first “minibonds” of unlisted firms, enjoying the same tax treatment as issues by listed firms, were offered to qualified investors. Placements of these securities were mainly made by large service companies for a total value of almost €5 billion.

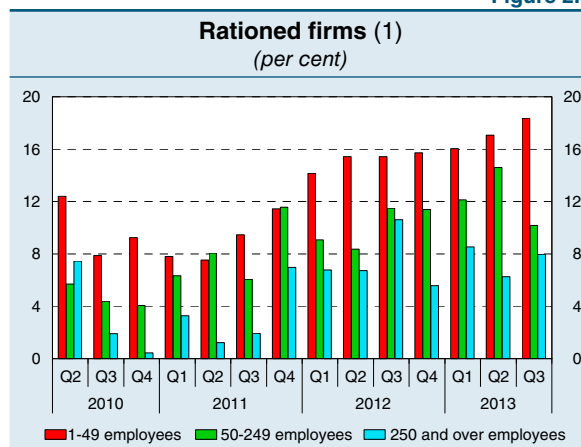
Financial conditions remain strained

Italian firms’ financial debt in relation to GDP is relatively low compared with the main advanced economies, but their leverage is above average and higher than in the past despite the fall in debt in the last two years (Figure 2.3.c). The financial strains affecting firms, caused more by low profitability than by the level of financial debt, are reflected in difficulties repaying bank and trade credit. Cerved data show that the average delay on commercial payments has risen from 19.3 days in the second quarter of 2012 to 20.5 days in the same period of 2013; however, the proportion of companies behind with their commercial payments was down by about 1 percentage point, to 52 per cent. The length of the delays increased more among small and medium-size firms and in the construction sector. Provisional data show that the proportion of companies in fragile financial conditions (i.e. the ones whose net interest expense exceeds 50 per cent of their gross operating profit) rose from 31 per cent in 2011 to 34 per cent in 2012. Their share of financial debt increased to 48 per cent (44 per cent in 2011),² a deterioration that affected all sectors. Assuming a gradual economic recovery in line with the forecasts published in the *Economic Bulletin* of July this year, it is estimated that the proportion of firms in a fragile financial condition will be lower in 2014, reflecting a reduction of financial debt and an improvement in profitability.

The payment of general government debts and the measures to support SMEs are producing benefits

At the end of October repayments of general government arrears (following the procedure set out in Decree Laws 35/2013 and 102/2013 allocating for this purpose €27 billion in 2013 and €20 billion in 2014) totalled approximately €14 billion. A survey conducted by the Bank of Italy found that the money repaid was mainly used to reduce debts with suppliers and banks (see the box “The outlook for investment and the settlement of general government debts: findings of the Bank of Italy’s business surveys”, *Economic Bulletin*, October 2013). The measures introduced in support of small firms remain in place, helping to attenuate the impact of difficult borrowing conditions (see the box “The principal support measures for small and medium-sized enterprises”).

Figure 2.4



Source: Istat.

(1) Firms reporting that they had applied for but not obtained credit as a percentage of total manufacturing firms that had contacted banks or finance companies in the last 3 months.

² The index is not directly comparable with the one used in the International Monetary Fund’s latest Global Financial Stability Report, according to which firms under severe strain are defined as those whose ratio of interest expenses to EBIT is over 100 per cent and which estimates that in 2011 Italian firms in this situation accounted for 30 per cent of total debt. The index employed in our analyses uses gross operating profit, which is close to the volume of fully available internal funds as it includes depreciation allowances and provisions; moreover the 50 per cent threshold was chosen in order to incorporate firms that are less financially fragile. If the threshold were set at 100 per cent for this index like the IMF one, in 2011 the debt (number) of firms under severe stress would amount to 26 (24) per cent of the total.

THE PRINCIPAL SUPPORT MEASURES FOR SMALL AND MEDIUM-SIZED ENTERPRISES¹

In the first nine months of 2013 the Central Guarantee Fund for small and medium-sized enterprises accepted around 51,000 applications in relation to loans worth €7.2 billion (up from €6.0 billion for the corresponding period in 2012). Provisions in Decree Law 69/2013 and in the Stability Bill in October increase the Fund's resources and aim to facilitate access to guarantees also for firms which – while retaining favourable prospects for growth – present balance sheets that have been weakened by the protracted recession. Based on our simulations, in this cyclical phase a relaxation of the eligibility criteria as regards firms' profitability could increase the number of potential beneficiaries significantly.

In July of this year the Italian Banking Association and business associations signed a new agreement allowing firms to request, until June 2014, the suspension of repayments of loans. Firms that benefited under the previous agreement signed in February 2012 are ineligible for this moratorium, the third since 2009. Adherence to the second moratorium was substantial: at 31 July 2013 some 105,000 applications had been accepted for an amount of suspended principal on loans of €4.3 billion. Data on previous moratoriums from a sample of 400 intermediaries indicate that in the three years 2009-12, about 40 per cent of the loans already with instalments in arrears at the launch of the moratorium began to be regularly reimbursed again at the end of the suspension.

In 2012 Cassa Depositi e Prestiti launched a new SME Fund accessible to banks at moderate interest rates to grant business loans. The instrument replicates the positive experience of the previous fund, which has since been depleted. By the end of last June scarcely €2 billion of the €8 billion available had been utilized. The limited recourse to the fund suggests that banks' funding difficulties do not currently represent the main obstacle to the supply of credit to firms.

¹ For a more in-depth account of these measures see G. Gobbi's testimony before the Finance Committee of the Chamber of Deputies in Rome on 16 October 2013 as part of the fact-finding on budgetary and financial measures to support growth, also in light of the most recent international developments (*Audizione nell'ambito dell'indagine conoscitiva sugli strumenti fiscali e finanziari a sostegno della crescita, anche alla luce delle più recenti esperienze internazionali*).

The main risks derive from the timing of the recovery and the difficulties in accessing credit

Against a background of improved expectations concerning the economic outlook over the next few months, the main risk factors for firms are the considerable uncertainty regarding the timing and strength of the recovery and the persistence of difficulties in accessing credit, particularly for small firms.

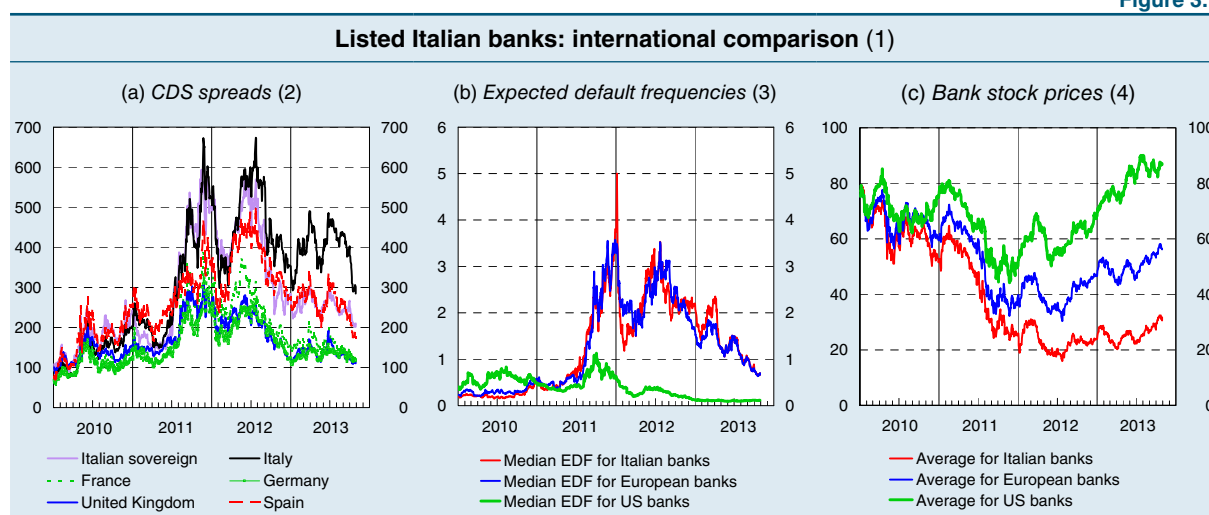
3 THE BANKING AND FINANCIAL SYSTEM

3.1 THE MARKET'S ASSESSMENT OF ITALIAN BANKS

Market indicators improve but considerable uncertainty remains

Market indicators (spreads on credit default swaps, expected default frequencies and stock prices; Figure 3.1) for the largest Italian banks are benefiting from the narrowing of sovereign spreads, despite showing fluctuations in this uncertain phase.

Figure 3.1



Sources: Based on data from Bloomberg and Moody's KMV.

(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, 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.

The first stage of the European Banking Union is now being completed

In October the rules of the Single Supervisory Mechanism for Europe were definitively approved. As a result, starting in November 2014, the ECB will be responsible for the direct supervision of systemic banks in the euro area following the comprehensive assessment of banks' conditions. The details of the exercise and the list of the banks involved were published on 23 October.¹ In Italy fifteen major banks will be assessed. In addition to the SSM, the Banking Union envisages a single resolution mechanism and harmonized deposit insurance mechanism. Once the SSM has become fully operational, it is expected that the banks in difficulty will have access to direct recapitalization via the European Stability Mechanism (ESM), helping to break the vicious circle between banks and sovereigns.

¹ ECB, "Note: Comprehensive assessment", 2013 (<http://www.ecb.europa.eu/pub/pdf/other/notecomprehensiveassessment201310en.pdf>).

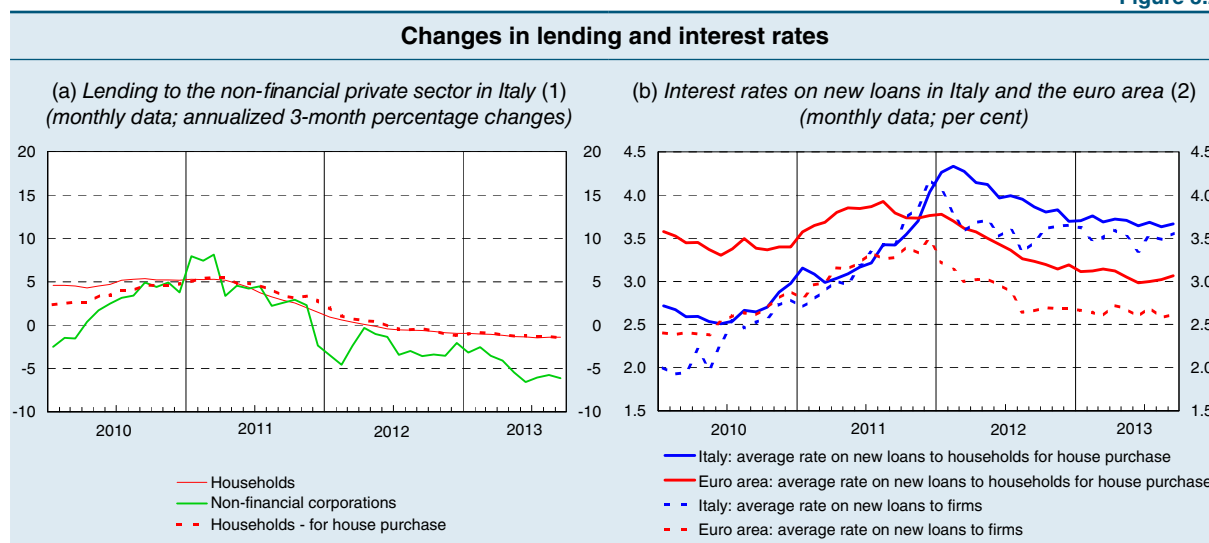
3.2 CREDIT

Lending to the economy

Credit continues to contract

The decline in credit to the private sector involved mainly lending to non-financial firms (Figure 3.2.a). The contraction primarily reflects slack credit demand, given lingering uncertainty over the prospects for economic activity and the real-estate market. High borrower risk explains the limited extent of the decline in interest rates (Figure 3.2.b) and is impeding the supply of credit.

Figure 3.2



Sources: Based on Bank of Italy and ECB data.

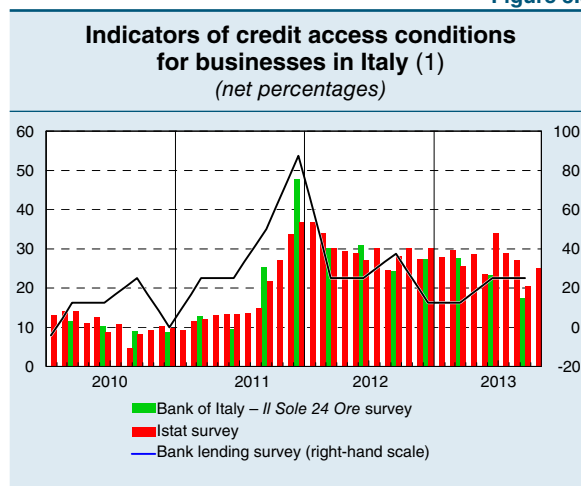
(1) The percentage changes are calculated net of reclassifications, exchange rate variations, value adjustments and other variations not due to transactions. Lending includes an estimate of loans not recorded in banks' balance sheets because they have been securitized. Where necessary the data have been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

Supply strains on credit to firms persist

The bank lending survey and other surveys of businesses indicate that overall credit supply conditions for firms remain tight (Figure 3.3). However, the tightening of lending standards for mortgages to households has come to a halt.

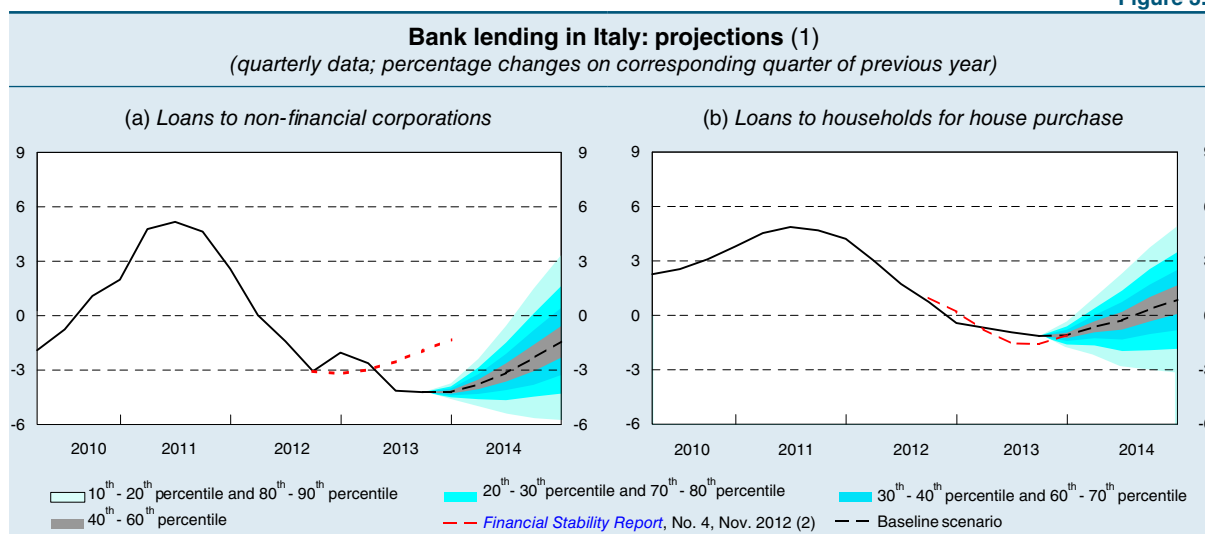
Assuming a modest strengthening of the economy as forecast in last July's *Economic Bulletin*, the contraction in lending to firms should ease in the course of 2014 owing both to the gradual expansion of demand in connection with the expected investment upturn and to the relaxation of supply constraints (Figure 3.4.a). The trend in loans to households for house purchase should be similar (Figure 3.4.b), still reflecting the uncertain outlook for the real-estate market despite a gradual improvement in

Figure 3.3



Sources: Based on Bank of Italy, Bank of Italy – Il Sole 24 Ore, and Istat data.
(1) A fall in the indicators denotes an improvement in credit supply conditions; net percentages calculated as the difference in percentage points between the percentage of responses indicating a worsening of credit access conditions and the percentage of those indicating an improvement.

Figure 3.4



(1) Includes an estimate of loans not recorded in the banks' balance sheets because they have been securitized. The probability distribution of projections (which allows estimation of the size of the risks to the baseline projection) was based on stochastic simulations using random extractions from the distribution of shocks in the Bank of Italy's quarterly econometric model. The distribution is graphed by percentile groups. – (2) Baseline simulation.

disposable income.² This forecasting framework is subject to considerable uncertainty in connection with the strength and timing of the economic recovery.

Credit quality

Credit quality worsens again

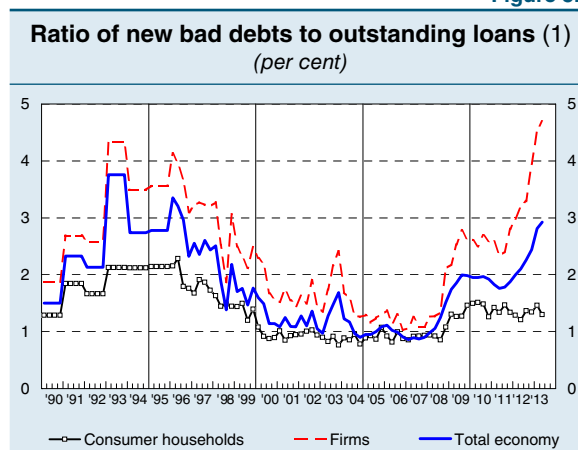
In the second quarter of 2013 the flow of new bad debts rose to 2.9 per cent of outstanding loans (Figure 3.5). The increase was accounted for entirely by loans to firms, construction firms in particular. The ratio of new bad debts to outstanding loans for households remains low.

The indicators of credit quality – the twelve-month probability of default and the index of transition among the banks' risk categories – were still worsening in June (Figures 3.6.a and 3.6.b). In the third quarter, however, the new bad debt rate was practically unchanged with respect to the second, according to preliminary data. The new non-performing loan rate, which ordinarily leads the new bad debt rate, also shows signs of steadying (Figure 3.6.c).

The bad debt flow is expected to moderate slightly in 2014

Assuming a modest strength-ening of the economy in the next few quarters, the flow of new bad business debts should decline slightly next year, insofar as cyclical improvements

Figure 3.5

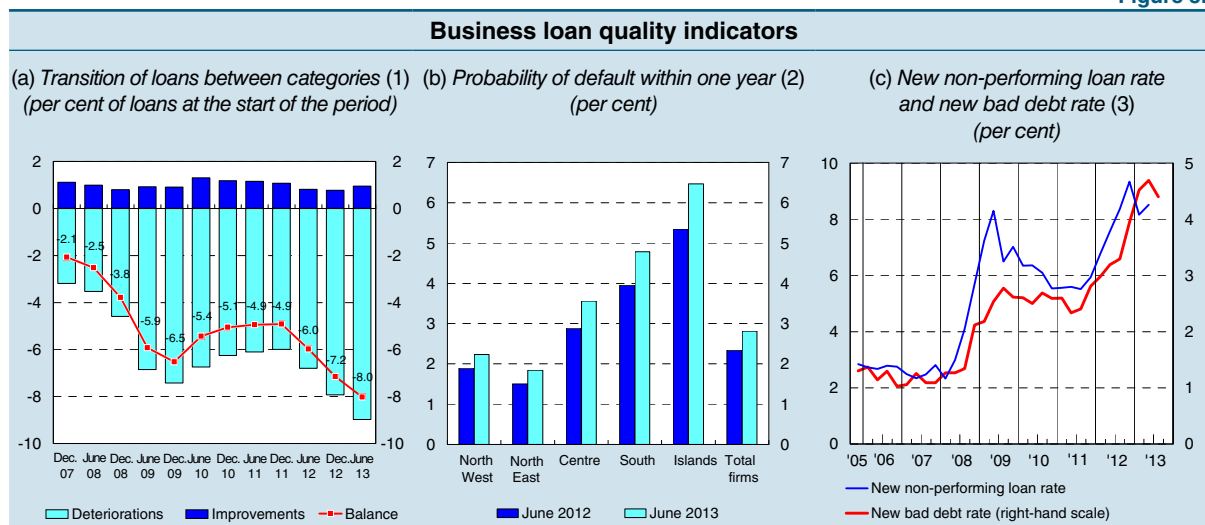


Sources: Supervisory reports and Central Credit Register.

(1) Quarterly flow of adjusted bad debts in relation to the stock of loans at the end of the previous quarter, net of adjusted bad debts; annual data up to the fourth quarter of 1995. Data seasonally adjusted, where necessary, and annualized.

² The projections of lending to firms presented in *Financial Stability Report*, No. 4, November 2012, underestimated the actual contraction that was recorded in the last two quarters, mainly because of the protraction in the decline in private sector investment.

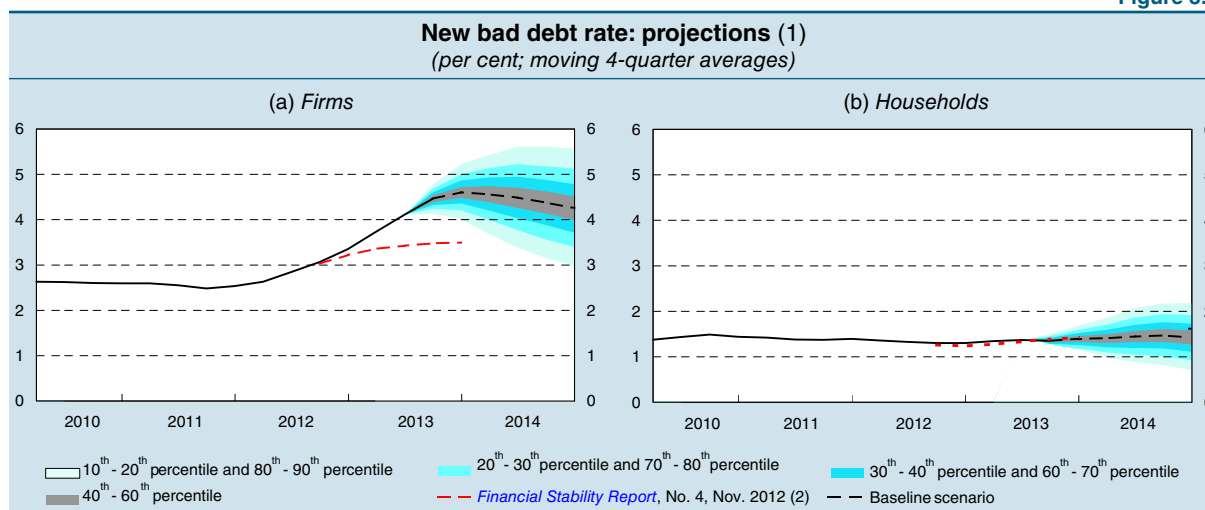
Figure 3.6



Sources: Supervisory reports, Central Credit Register and company accounts.

(1) The index considers the movements of loans to firms between the different categories (loans with no anomalies, overdrafts in breach of limits, past-due loans, restructured loans, substandard loans and bad debts). It is calculated as the balance between the percentages of loans whose quality deteriorated/improved in the 12 preceding months. – (2) The probabilities of default are estimated for some 700,000 companies on the basis of vulnerability indicators derived from company accounts and indicators of financial strain in credit relationships. – (3) Quarterly flows of adjusted non-performing loans and adjusted bad debts in relation to the stock of loans at the end of the previous quarter net of adjusted non-performing loans and adjusted bad debts. The latest new bad debt rate is partially estimated. Rates are annualized and, where necessary, data are seasonally adjusted.

Figure 3.7



(1) Quarterly flow of adjusted bad debts in relation to the stock of loans at the end of the previous quarter, net of adjusted bad debts; data seasonally adjusted, where necessary. The probability distribution of projections (which allows estimation of the size and sign of the risks to the baseline projection) was based on stochastic simulations using random extractions from the distribution of shocks in the Bank of Italy's quarterly econometric model. The distribution is graphed by percentile groups. – (2) Baseline simulation.

are reflected in banks' asset quality with a lag (Figure 3.7.a). The rate of new bad loans to households should remain low over the entire forecasting horizon (Figure 3.7.b). For these projections too, the main risk is economic uncertainty.

The volume of non-performing loans increases further

In June banks' bad debts, net of writedowns already recorded in the accounts, amounted to €74 billion, amply covered by collateral and guarantees. Other net non-performing loans, on which loss rates are significantly lower than those on bad debts, came to €114 billion. Non-performing loans were equal to 14.7 per

Table 3.1

Loan quality: ratio of performing loans and non-performing loans to total lending and coverage ratios (1)
(per cent; June 2013)

	Five largest groups		Large banks		Small banks		Minor banks		Total system	
	Percentage composition	Coverage ratio	Percentage composition	Coverage ratio	Percentage composition	Coverage ratio	Percentage composition	Coverage ratio	Percentage composition	Coverage ratio
Customer loans	100.0	6.7	100.0	5.0	100.0	6.4	100.0	4.8	100.0	6.1
<i>of which:</i>										
Performing	84.8	0.6	87.1	0.5	84.6	0.5	84.5	0.5	85.3	0.6
Non-performing	15.2	41.0	12.9	35.4	15.4	38.2	15.5	28.3	14.7	38.5
<i>Bad debts</i>	8.5	55.5	6.3	53.0	8.0	55.8	7.0	47.2	7.8	54.4
<i>Substandard</i>	4.6	24.9	4.6	22.0	5.2	22.7	6.4	15.0	4.8	22.9
<i>Restructured</i>	1.2	23.5	0.6	13.3	0.4	23.7	0.4	16.7	0.9	21.8
<i>Past-due</i>	1.0	10.9	1.3	8.5	1.9	8.7	1.8	4.0	1.2	9.2
<i>Memorandum item:</i>										
Customer loans (€ mn)	1,298,952		467,665		131,118		178,832		2,076,567	

Source: Supervisory reports.

(1) The coverage ratio is the amount of loan loss provisions as a share of the corresponding gross exposure. In the case of 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 June 2013 and total non-consolidated assets as of December 2008. The 5 largest 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. In practice, the 5 largest groups plus "large banks" constitute the group of 15 banks that will be subject to the Single Supervisory Mechanism's comprehensive assessment.

cent of total customer loans, up from 13.4 per cent at the end of 2012 (Table 3.1). Net of writedowns, the ratio was 9.6 per cent. For bad debts alone, the gross and net ratios were 7.8 and 3.8 per cent respectively. Net bad debts came to 32 per cent of regulatory capital. These figures are not readily comparable with those for banks in the rest of Europe, owing to the greater severity of Italy's standards for the classification of non-performing loans. But significant progress is being made in this area, which will permit the SSM comprehensive assessment to be carried out on the basis of comparable data (see the box "The EBA's definition of forbearance and non-performing exposures").

THE EBA'S DEFINITION OF FORBEARANCE AND NON-PERFORMING EXPOSURES

On 21 October the European Banking Authority (EBA) published its technical standards for non-performing exposures (NPEs) and forbearance, to be used in the framework of harmonized financial reporting across Europe (Finrep). Once the standards have been adopted under an EU Regulation, they will be directly applicable in all the member states.

The standards were developed not in order to change the accounting and prudential definitions now applied in the different countries, but to supplement them so as to reduce the current margins of discretion and enhance data comparability. The category of NPEs includes all loans classified as "impaired" and "defaulted" under IAS 39 and the Capital Requirements Regulation (CRR), whether or not they are backed by collateral or guarantees. The supervisory definition of default includes exposures more than 90 days past-due. The classification follows the debtor approach rather than that of individual transactions;¹ for retail exposures only, an individual transaction approach can be taken,

¹ Under the debtor approach, the classification of a single position as an NPE, if quantitatively significant, automatically produces the same classification for all transactions with the same counterparty.

but above a certain threshold (calculated on balance-sheet assets), there is a pulling effect so that all loans to the same debtor, including off-balance-sheet exposures, are classified as NPEs.

The EBA document introduces the category of “forbearance”, which includes exposures on which concessions have been granted in view of the debtor’s financial difficulties, and envisages the sub-categories of “performing” and “non-performing” exposures. Only the latter forms part of total non-performing assets.

The EBA definition of NPEs is broadly in line with “non-performing assets” as they are defined in Italy. This latter definition is independent of the presence of collateral or guarantees; it already includes restructured exposures (which come under “forbearance” for the EBA); it is mainly based on the debtor approach; and it provides for the pulling effect (although unlike that of the EBA) in the case of an individual transaction approach. In some cases, the Italian definition is broader than that of the EBA, including, for example, exposures in credit and financial derivatives and those in the trading book. Further, it also has stricter criteria for exiting the category of restructured loans (currently equal to about 1 per cent of loans to the customers of Italian banks): restructured positions remain such until they have been paid off, unless the company management makes a reasoned decision attesting that the debtor has returned to solvency – and not before two years have passed. Under the EBA approach, by contrast, exit from the “non-performing” subcategory of forbearance is possible one year after the restructuring agreement, without a specific requirement for a management decision, whenever the risk of non-payment of the restructured loans has been superseded.

**Coverage ratios
are stable**

The coverage ratio for the entire Italian banking system (the ratio of provisions to gross non-performing loans) stood at 38.5 per cent in June; for the five largest groups it was 41.0 per cent, about the same as in December (Table 3.1). For a sample of large European banks the average was about 43 per cent. However, the international comparison of non-performing loans is distorted by the lack of uniformity in national definitions. According to our own estimates, excluding non-performing loans that are backed by collateral or guarantees, as is the practice of many foreign banks, the coverage ratio of Italian banks would have been 58.3 per cent in June (58.1 per cent in December 2012).³

**Checks on the
adequacy of
provisioning continue**

Coverage ratios are being adjusted in response to the programme of ad hoc inspections initiated by the Bank of Italy at the end of 2012, which have resulted in additional value adjustments of €7.5 billion and estimated additional loan losses of €4.3 billion on the bad debts of the 20 banking groups inspected.⁴ The estimates are used in applying the extra capital requirements as part of the supervisory review and evaluation process of loans. Based on the inspection reports, supervisory measures have been reviewed and the banks called on to use updated estimates of the recovery value of their non-performing assets. Checks on the value adjustments of the two largest Italian banking groups have now been initiated.

**The stock of non-
performing loans will
have to be reduced**

At the end of 1995 bad debts exceeded 10 per cent of total lending. There was steady improvement over the years that followed (more than 7 percentage points by 2008), thanks to favourable economic conditions, improvements in banks’ techniques for managing these items, and the substantial growth of lending. A significant role was played by the transfer of loan assets to non-bank credit recovery firms

³ For details on the methodology of calculation, see the box “Non-performing loans and collateral and guarantees,” in *Financial Stability Report*, No. 5, April 2013.

⁴ See Banca d’Italia, “The recent asset quality review on non-performing loans conducted by the Bank of Italy: Main features”.

(in some cases with the assistance of public resources) and by loan securitizations. Between 1999 and 2008 Italian banks disposed of some €60 billion in bad debts using these techniques. The revival of the securitization market is impeded today by the difference between these assets' carrying value and what investors are willing to pay to acquire them. The Bank of Italy's recent checks on the adequacy of value adjustments will favour the market's revival by increasing the portion of losses already written off. The comprehensive assessment will further reduce the uncertainty over the quality of banks' assets and lower the risk premium demanded by potential purchasers. A similar effect should come from the gradual economic recovery and the attenuation of financial market fragmentation within the euro area. The Stability Bill for 2014 provides for less burdensome tax treatment of loan losses and value adjustments, which should incentivize banks to adopt stricter policies on provisioning, especially in cyclical downturns. Reforms to speed up credit recovery could also make an important contribution.

Exposures to euro-area sovereign risk and foreign assets

The exposure to Italian general government securities increases

During the first half of 2013 Italian banks' holdings of general government securities rose from €321 billion to €396 billion (Table 3.2; see the box "Banks' recent purchases of Italian general government securities"). Between July and September there were net disposals of about €10 billion, reflecting the easing of tensions on the wholesale funding market and repayments of the Eurosystem's three-year refinancing operations. In this context the reduction of government securities portfolios could proceed in the coming months.

Table 3.2

Exposures of Italian groups and banks to residents in euro-area countries by sector of counterparty (1) <i>(billions of euros at June 2013)</i>							
	General government		Banks	Financial corporations	Households and non-financial firms	Total	Per cent of the total exposures reported to the BIS (2)
	Total	of which: securities					
Italy	452.0	396.0	108.5	124.0	1,369.2	2,053.7	78.7 (3)
Germany	36.3	....	31.4	23.0	86.8	177.6	15.1
Austria	12.8	....	8.6	1.2	52.7	75.3	40.0
France	2.4	....	14.8	3.1	6.9	27.2	3.0
Luxembourg	0.3	....	4.8	8.8	4.5	18.4	4.3
Spain	2.8	....	4.5	2.4	4.7	14.4	3.6
Netherlands	0.3	....	3.8	4.7	4.6	13.3	2.2
Ireland	0.2	....	1.1	4.7	0.4	6.4	2.1
Portugal	0.4	....	0.1	0.2	0.5	1.2	1.1
Greece	0.0	....	0.4	0.0	0.5	0.9	2.9
Cyprus	0.0	....	0.0	0.1	0.9	1.0	4.0
Other (4)	5.8	....	2.7	1.1	17.1	26.7	4.4
Total (5)	513.3	....	180.7	173.3	1,548.9	2,416.2	

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. – (2) As a percentage of the total foreign exposures to each country in March 2013. – (3) The difference with respect to 100 is given by the lending of foreign groups and banks to Italian customers, via establishments in Italy and cross-border transactions. – (4) Belgium, Estonia, Finland, Malta, Slovakia, and Slovenia. – (5) Discrepancies in totals are due to rounding.

BANKS' RECENT PURCHASES OF ITALIAN GENERAL GOVERNMENT SECURITIES

In most of the countries of the euro area, after more than a decade of uninterrupted decline, domestic general government securities began growing again as a proportion of bank assets from the end of 2008. In Italy this trend has accelerated significantly since the middle of 2011 in concomitance with the worsening of the sovereign debt crisis and the sharp rise in interest rates on Italian central government securities.

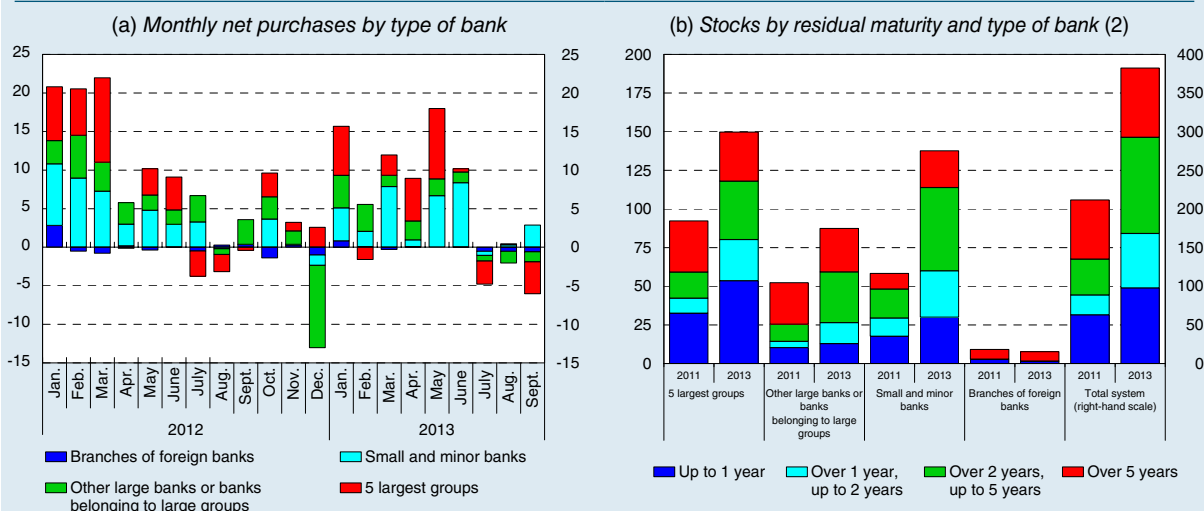
Between December 2011 and September 2013 resident banks' net purchases of Italian general government securities amounted to €150 billion (€91 billion in 2012 and €59 billion in the first nine months of 2013; Figure A.a). The five largest banking groups and small and minor banks accounted for the bulk of these purchases. Purchases by other large banks were less substantial, while branches and subsidiaries of foreign banks made net disposals totalling €1.4 billion. Nearly all of the securities were included in the banking book, above all in the available-for-sale portfolio. General government securities represented 10 per cent of total bank assets at the end of September 2013, compared with 6 per cent at the end of December 2011. Banks' total exposure (loans plus debt securities) to general government is equal to 12 per cent of total assets; it was 18 per cent in 1997.

The increase in holdings of general government securities was concentrated on those with a residual maturity of from one to five years (€123 billion), while the portions consisting of short- and long-term securities declined (Figure A.b). Overall, the average residual maturity of banks' portfolio of general government securities shortened from 5.8 to 4.3 years; the reduction involved all types of bank except small and minor ones, where the average term to maturity lengthened slightly (from 3 to 3.2 years).

In the last two years no clear relation emerges between the increase in banks' purchases of general government securities and the reduction in their lending to the economy. Calculated at individual bank level, there is no correlation between such purchases and the growth in lending to households and firms (Figure B.a). Time-series analysis shows that during the most recent period Italian banks reduced their lending and added to their portfolio of Italian general government securities, while the branches and subsidiaries of foreign banks reduced their loans and securities portfolio alike

Figure A

Bank investments in Italian general government securities (1) (billions of euros)

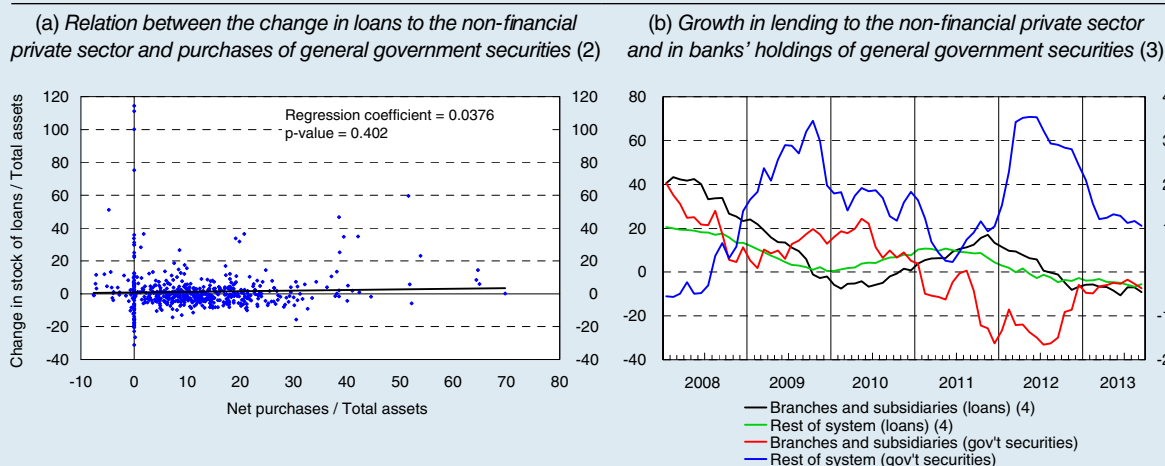


Source: Supervisory reports.

(1) Amounts of purchases are net of fluctuations in market prices. Holdings are shown at market values. All securities issued by the general government sector, including local government securities; excludes Cassa Depositi e Prestiti. – (2) At December 2011 and September 2013.

Figure B

Bank investments in Italian general government securities and lending to the private sector (1) (per cent and percentage changes)



Source: Based on supervisory reports.

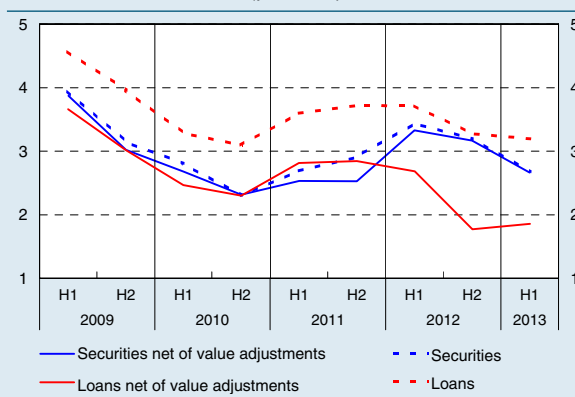
(1) Amounts of general government securities are net of fluctuations in market prices. All securities issued by the general government sector, including local government securities; excludes Cassa Depositi e Prestiti. – (2) Excludes observations before the 1st and after the 99th percentiles of the distribution of either of the two indicators. – (3) Twelve-month growth rate. – (4) Right-hand scale.

(Figure B.b). This confirms the weakness of the link between purchases of general government securities and the change in lending; further, it suggests that the large volume of purchases by Italian banks – and of disposals by foreign banks – were part of the general phenomenon of re-nationalization of euro-area financial markets during the period.

Italian banks' massive purchases of general government securities beginning in the second half of 2011 can be ascribed partly to the need to temporarily invest the funds obtained through the Eurosystem's LTROs in order to redeem maturing bonds at a time of funding difficulties on wholesale markets. They were also associated with a widening of risk-adjusted differentials between returns on investments in securities and returns on loans to resident customers (Figure C). Finally, the purchases reflect banks' balance-sheet conditions: econometric estimates for the last two years indicate that the most substantial purchases were made by banks with large funding gaps and low returns on assets.

Figure C

Rates of return on bank assets (1) (per cent)



Source: Supervisory reports.

(1) Income as a percentage of the respective balance-sheet items. Excludes branches of non-Italian EU banks.

The exposure to Central and Eastern Europe holds stable

In June Italian banks' exposures to residents in the countries of Central and Eastern Europe were unchanged from June 2012 at around €165 billion, equal to a quarter of their total exposure to non-residents. The ratio of non-performing assets was also broadly stable at around 10 per cent of the total exposure. In the first half of the year the economies of the region registered modest growth, less than in 2012. The forecasts of Consensus Economics indicate a moderate rise in growth next year.

3.3 BANKS' FUNDING, LIQUIDITY RISK, REFINANCING RISK

Funding contracts overall; retail funding declines slightly ...

Italian banks' total funding has contracted (Figure 3.8), mostly owing to the reduction in recourse to Eurosystem refinancing (down by 14 per cent in the twelve months to September 2013) and the ongoing contraction in wholesale funding (4.6 per cent). Retail funding also declined slightly (0.8 per cent). The 4.7 per cent growth in household deposits was not enough to offset the €39 billion decline in bond placements, due primarily to the change in the tax rate on interest.⁵ Over €8 billion of the decline in retail bonds is attributable to the repurchase operations concluded by some intermediaries as part of their asset liability management.

... in part owing to banks' choices

While retail funding has recorded a slight decline, the placement of units of investment funds and life insurance policies via bank branches has picked up. This phenomenon appears linked, at least in part, to the decision by banks to prioritize income from commissions on the sale of financial instruments to households over the expansion of direct funding. In recent months, in fact, the banks have recorded smaller increases in term deposits – the component of funding that is most responsive to variations in returns – and have also reduced the interest rates on them (Figure 3.9). The average cost of funding fell to 1.2 per cent; the cut in the key policy rates approved by the ECB last May was a contributory factor.

The funding gap narrows to record low levels

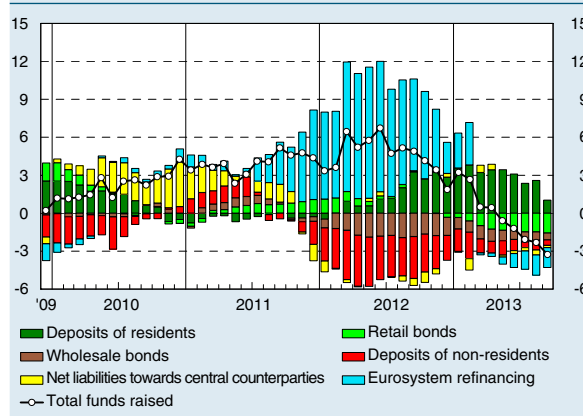
In the early part of the year the contraction in lending allowed Italian banks to reduce the funding gap further, bringing it back to levels close to those recorded around the middle of the last decade (12.2 per cent last September for the system as a whole, as against 19.3 per cent recorded in September 2011; Figure 3.10). In the third quarter the indicator rose slightly following the decline in retail funding. For the fifteen banks that will be subject to the ECB's comprehensive assessment exercise the funding gap equals 15.6 per cent (21.1 per cent in September 2011).

The liquidity position is satisfactory ...

The liquidity position of the banking groups subject to

Figure 3.8

Growth in bank funding in Italy: contributions of the various components (1)
(percentage points; 12-month changes)

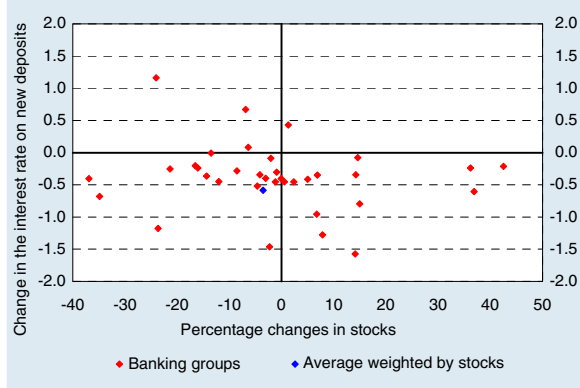


Source: Supervisory reports.

(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 MFIs are excluded. Net liabilities towards central counterparties are the funds raised by way of repos with non-residents via central counterparties.

Figure 3.9

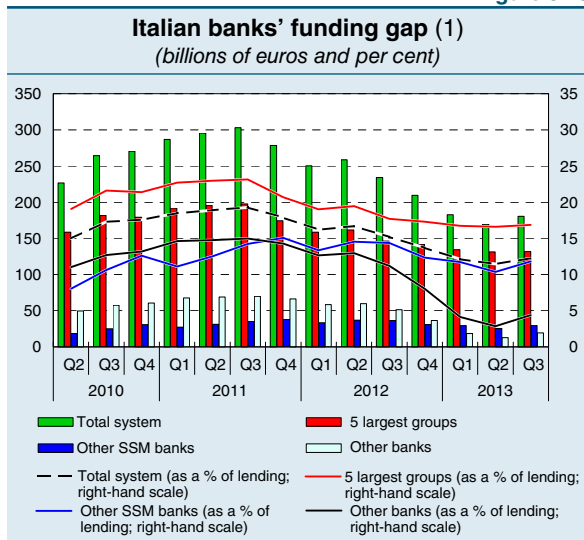
Fixed-term deposits held by firms and households (1)
(per cent and percentage points)



Sources: Based on supervisory reports and ESCB harmonized statistics. (1) Stocks and bank interest rates on transactions concluded from March to September 2013. Does not include observations below the 5th and above the 95th percentile of the distribution of changes in stocks.

⁵ Effective 1 January 2012 the tax rate on interest paid on all bank liabilities was increased to 20 per cent; it was previously 12.5 per cent for bonds and 27 per cent for deposits.

Figure 3.10



Source: Supervisory reports.

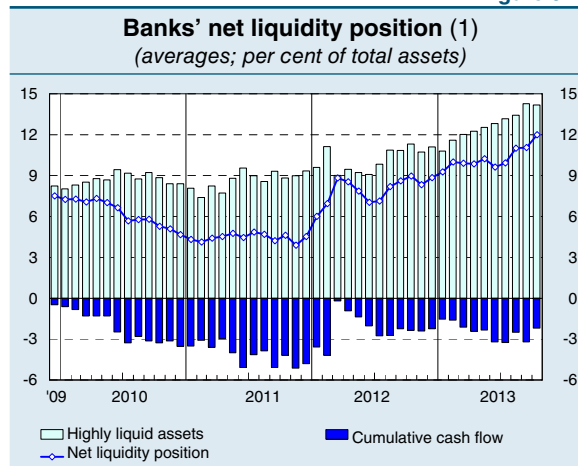
(1) Share of loans not financed by retail funding. For the calculation methodology, see the box "The funding gap of Italian banks" in *Financial Stability Report*, No. 4, November 2012.

the Bank of Italy's weekly monitoring is improving with respect to the start of the year (Figure 3.11). The analyses conducted by the IMF as part of its Financial Sector Assessment Program (FSAP), based on granular data for each bank, have shown the resilience of banks to a very acute stress scenario; recourse to Eurosystem financing remains, however, an extremely important factor for the liquidity of the system.

... also thanks to improved conditions on the wholesale markets

So far this year issues of secured and unsecured bonds by Italian banking groups on international debt markets have equalled €27 billion, up from €18 billion in 2012. The cost of funding has fallen sharply: the spread between the return on bonds issued and the swap rates has narrowed to 230 basis points, from 340 in 2012. Two thirds of the placements are attributable to the two main banks, but in recent months numerous medium-sized groups have launched programmes to issue covered bonds. The improvement in market conditions favours the early redemption of the Eurosystem's longer-term refinancing operations, which will end in early 2015. Nevertheless, the volume of wholesale bonds due to expire by end-2014 is still high at around €70 billion (Figure 3.12); net funding remains negative.

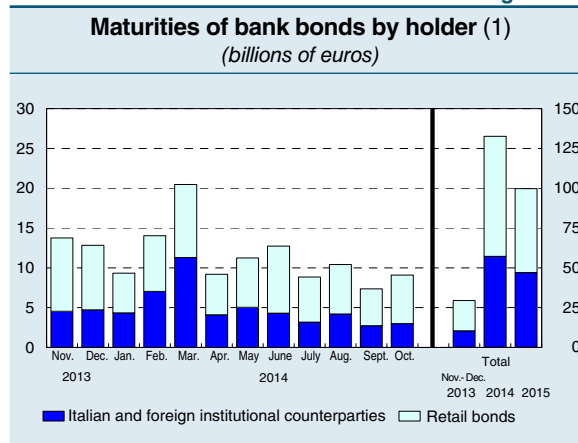
Figure 3.11



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 3.12



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 2013 and to 2014-15, right-hand scale.

3.4 INTEREST RATE RISK AND MARKET RISK

The risk from a rise in interest rates is generally limited

The risk for Italian banks associated with an unexpected upward shift in the risk-free interest rate curve (implied by swap contracts) is generally limited. The risk deriving from an unexpected rise in the yields on Italian government securities is

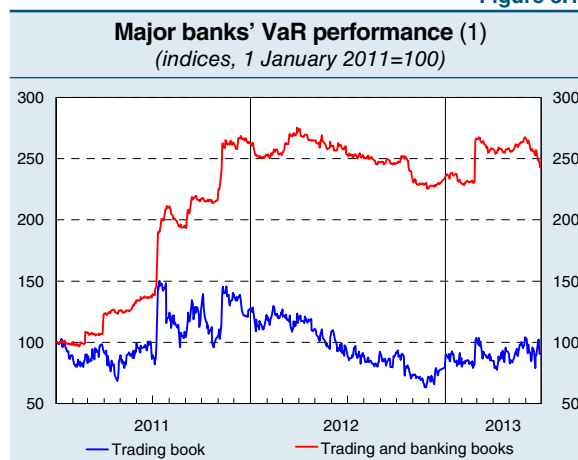
slightly greater (see the box “The risks for banks deriving from a rise in interest rates”).

Market risk is virtually stable

The financial risk to which the Italian banks are exposed mainly stems from their large positions in government securities. The VaR of the banks most active on the financial markets, for the entire securities portfolio evaluated at fair value (trading and banking books), is largely stable (Figure 3.13). The potential increase in risk as a result of heavy investment in government securities has been almost entirely offset by the reduced volatility of yields.

The Italian banks’ exposure to opaque financial instruments is very low by international standards (see the box “The weight of level 3 assets in the total assets of European banks”).

Figure 3.13



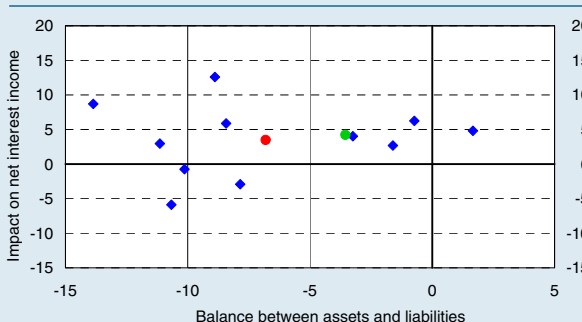
Source: Data from a sample of 6 banking groups using internal models to quantify market risk, collected as part of the periodic monitoring of market risk.

(1) Averages weighted according to the size of the single intermediaries’ portfolios. The indices are constructed so as to reflect the performance of the VaRs in relation to all positions (securities and derivatives) valued at fair value (in red) and to the trading book component alone (in blue). A decline indicates a reduction in risk.

THE RISKS FOR BANKS DERIVING FROM A RISE IN INTEREST RATES

Shifts in the yield curve can give rise to risks for banks’ accounts owing both to changes in the balance between their assets and liabilities and to the effects on their profitability of shifts in net interest income. The indications of the Basel Committee on interest rate risk focus on the former component.¹ A survey has been conducted in which 11 of the largest Italian banking groups were asked to assess the effects on their accounts of an upward shift of 200 basis points in the risk-free yield curve (considering both the aspects referred to above). For these banks the shift in the yield curve would have resulted in a loss equal on average to 6.8 per cent of their regulatory capital (see figure), well below the Basel Committee’s warning threshold (20 per cent). The loss would have stemmed from the reduction in the fair value of their long-term fixed-rate assets (especially securities and mortgages not hedged by interest rate swaps), not fully offset by the fall in the value of their liabilities. For most of the groups the adverse balance-sheet effect would have been partially offset by an increase of 3.5 per cent in net interest income in the twelve months following the shock that, for the sample as a whole, would have offset about a quarter of

The exposure to interest rate risk of a sample of Italian banks (1) (changes; percentage points)



Source: Data on a sample of 11 banks transmitted to the Bank of Italy as part of an ad hoc survey.

(1) Data at 30 June 2013. Distribution of the impact of an upward shift of 200 basis points in the risk-free yield curve on the value of the banks’ balance sheets – measured as the difference between the values of their assets and liabilities – and on their net interest income. The impact on the value of the banks’ balance sheets is set in relation to regulatory capital. The impact on net interest income is expressed as a 12-month percentage change. The red dot indicates the simple average of the sample. The green dot, the weighted average.

¹ In particular, if there is an upward (downward) shift of 200 basis points in the risk-free yield curve, the change in the balance of banks’ assets and liabilities must not exceed 20 per cent of their regulatory capital.

the adverse balance-sheet effect. The increase in net interest income is due to borrowing rates reacting more sluggishly than lending rates.

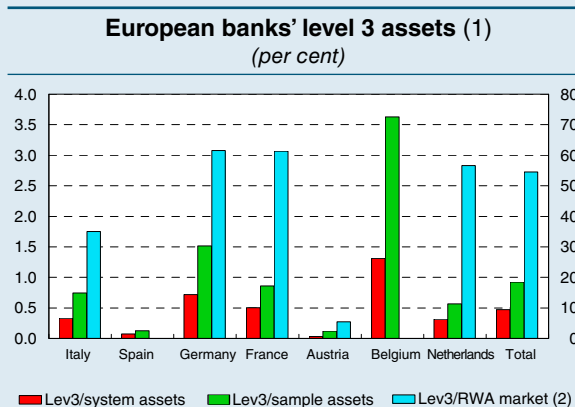
The sample banks were also asked to assess the effects of a 200 basis-point rise in the interest rates on items with maturities of between 5 and 30 years. The impact on the balance sheet would have been analogous to that of the earlier exercise (-6 per cent of the banks' regulatory capital), while net interest income would have remained basically unchanged.

Lastly, the banks estimated the impact of a 200 basis-point rise in the yield curve of Italian government securities with reference to a total portfolio worth €194 billion and with an average duration of 4.1 years. In this scenario the 3.4 per cent loss on the banks' portfolio would have been equal to 4.0 per cent of their regulatory capital. These results confirm those of the analysis conducted by the IMF as part of its recent FSAP for Italy.

THE WEIGHT OF LEVEL 3 ASSETS IN THE TOTAL ASSETS OF EUROPEAN BANKS

International accounting standards define level 1 securities as those with an active, liquid market whose prices are directly observable. Level 2 securities have inactive or less liquid markets, and their valuation is therefore less certain and based on comparison with similar but more liquid instruments or on models. Last, level 3 assets are over-the-counter instruments whose valuation depends on complex internal models; they include instruments (such as some types of asset-backed securities and collateralized debt obligations) that became very illiquid as a consequence of the crisis and in some instances generated massive losses for the banks holding them.

For a sample of 25 large international banking groups that had level 3 assets on their balance sheets at the end of 2012 values varied significantly from country to country. Their incidence in total banking system assets was 0.1 per cent in Spain, 0.3 per cent in Italy, 0.7 per cent in Germany and 1.3 per cent in Belgium (see figure). Relating level 3 securities not to the assets of the national banking system but of the sample banks alone, the divergences are even more pronounced: 0.1 per cent in Spain, 0.7 per cent in Italy, 1.5 per cent in Germany, and 3.6 per cent in Belgium. The national differences remained confirmed also when the denominator used was the sample banks' core tier 1 capital or their risk-weighted assets for market risk (Lev3/RWA market).



Source: SNL Financial.

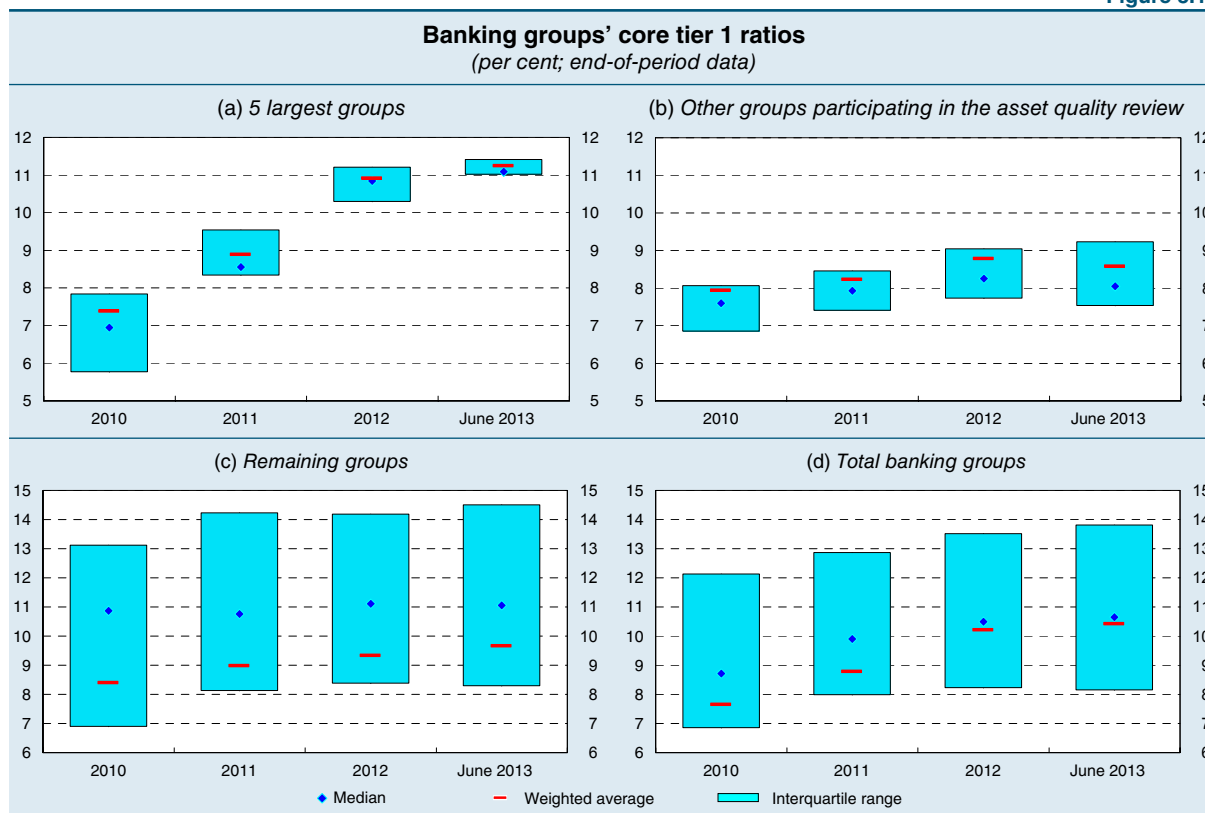
(1) Data at 31 December 2012. "Lev3/system assets" is the ratio of level 3 assets to the total assets of the banking system. "Lev3/sample assets" is the ratio of level 3 assets to total assets of the sample banks alone. "Lev3/RWA market" is the ratio of level 3 assets to the sample banks' assets weighted by market risk. Sample banks: Deutsche Bank, Commerzbank, Landesbank Baden, Bayerische LB, Norddeutsche LB, HSH Nordbank, Erste Group Bank, Raiffeisen Bank, Unicredit, Intesa Sanpaolo, Banca Monte dei Paschi di Siena, UBI Banca, Banco Popolare, ABN AMRO, Rabobank, ING, KBC, Belfius, BNP Paribas, Société Générale, Crédit Agricole, BPCE, Banco Santander, BBVA, Bankia. For Spain and Belgium "Lev3/RWA market" is not given, as the data on risk-weighted assets are not available. – (2) Right-hand scale.

3.5 BANKS' CAPITAL AND PROFITABILITY

Capital ratios continue to rise

Italian banks' capital ratios continued to rise in the first half of 2013, partly as a result of the fall in risk-weighted assets due to the reduction in exposures, portfolio rebalancing towards assets attracting lower capital charges and, in the case of the

Figure 3.14



Source: Consolidated supervisory reports.

largest groups, more extensive use of internal models under plans established some time ago and endorsed by the Bank of Italy.

In June 2013 the average core tier 1 capital ratio of the five largest banking groups reached 11.2 per cent, compared with 10.9 per cent in December 2012 (Figure 3.14.a); their tier 1 ratio was 11.9 per cent and their total capital ratio 15.0 per cent, up by 30 and 50 basis points respectively. The capital ratios of the largest Italian groups are in line with the average for the major European banks, which in several cases have benefited from substantial public support.⁶ Other Italian groups' capital ratios are stable in the aggregate (Figures 3.14.b and 3.14.c).

The need for additional capital in view of Basel III is limited, even under a stress scenario

The satisfactory level of the Italian banking system's capital base is confirmed by recent assessments conducted both by the Bank of Italy and by the IMF. Although differing in methodology, both analyses indicate that in recent months, in spite of unfavourable cyclical conditions, capital adequacy ratios have continued to approach the new objectives that will become effective at the end of the transition period. They also show that the Italian banking system can weather a further deterioration in the state of the economy and of the markets (see the box "The impact on capital of Basel III: static analysis and stress tests").

⁶ At the end of 2012, disbursements of public funds for the recapitalization of banks amounted to 0.3 per cent of GDP in Italy (and 0.2 per cent at the end of June 2013 consequent to reimbursements), against 0.3 per cent in France, 1.8 per cent in Germany, 4.2 per cent in the United Kingdom, 4.3 per cent in Belgium, 5.1 per cent in the Netherlands, 5.5 per cent in Spain and 40 per cent in Ireland.

THE IMPACT ON CAPITAL OF BASEL III: STATIC ANALYSIS AND STRESS TESTS

In the last few months numerous analysts have estimated the capital shortfall that Italian banks will face when the Basel III rules enter into force. The estimates are based on a wide range of hypotheses: (a) using the fully-phased-in capital requirements (as of 1 January 2019) or those laid down for the transition period; (b) referring to the version of the rules approved by the Basel Committee in 2010 or the CRD4-CRR version, which is binding on all EU banks; (c) measuring banking aggregates at a given date without incorporating any forecasts (static calculation) or assuming stress scenarios (dynamic calculation); (d) concentrating on the capital held against a subset of risks (e.g. credit risk) or examining the whole spectrum of banking risks; and (e) analysing a sample of intermediaries or the entire banking system. The different combinations of these scenarios lead to results that are not comparable; taken together, they suggest a relatively small shortfall.

For some time the Basel Committee and the EBA have been periodically monitoring the major banks of the different EU countries; the exercise covers 13 Italian banking groups that account for about 70 per cent of the total assets of the banking system. For this sample, a static calculation based on data referring to 30 June 2013 showed that the common equity tier 1 (CET1) capital needed, after the rules have been fully phased in, to achieve a CET1 ratio of 7 per cent (the minimum requirement of 4.5 per cent plus a capital conservation buffer of 2.5 per cent) was €6.1 billion (down from €8.8 billion in December 2012); the excess capital of the banks that already met the requirement was €23.2 billion (up from €22.4 billion in December 2012).

In its Financial System Stability Assessment for Italy,¹ published in September, the IMF assessed the capital shortfall that could arise in stress scenarios. The exercise was based on the data of the 32 largest Italian banking groups at 31 December 2012 and referred to the minimum requirements laid down by Basel III for the transition period. The capital shortfall was calculated for three macroeconomic scenarios: a baseline scenario, reflecting the forecasts for Italy published by the IMF in its *World Economic Outlook*, April 2013; a low-growth scenario and an adverse scenario (see table).

Under the low-growth scenario the total capital shortfall at the end of 2017 would be €5 billion in terms of CET1 and refer to 11 banks; in terms of tier 1 capital, the shortfall would be €10 billion and refer to 15 banks. Under the adverse scenario the CET1 shortfall would be €6 billion at the end of 2015 and refer to 13 banks; the tier 1 shortfall would be €14 billion and refer to 20 banks.

Overall, these results show that Italian banks would be able to cope with a further weakening of economic and market conditions without jeopardizing the gradual alignment with the standards laid

Results of the IMF stress tests (1)

	Baseline scenario	Low-growth scenario	Adverse scenario
Reference parameter CET1 ratio (Basel III)			
End of the assessment period	2017	2017	2015
Threshold at the end of the period	5.75%	5.75%	4.50%
No. of banks below the threshold	5	11	13
Shortfall at the end of the period (€ bn)	1.1	4.9	6.0
Reference parameter T1 ratio (Basel III)			
End of the assessment period	2017	2017	2015
Threshold at the end of the period	7.125%	7.125%	6.0%
No. of banks below the threshold	10	15	20
Shortfall at the end of the period (€ bn)	3.4	10.2	13.8

(1) In accordance with the IMF standards, the assessment of banks' capital adequacy after the stress was made at the end of the 5-year period 2013-17 for the baseline and low-growth scenarios and at the end of the 3-year period 2013-15 for the adverse scenario.

¹ IMF, "Italy: Financial System Stability Assessment", 2013 (<http://www.imf.org/external/pubs/ft/scr/2013/cr13300.pdf>).

down by Basel III.² Difficulties were found for a small number of intermediaries, which are currently subject to intense supervisory action by the Bank of Italy.

² The IMF's Italy assessment is consistent with the aggregate analyses it carried out in its last *Global Financial Stability Report*. According to these analyses, under a worse macroeconomic scenario than that currently expected, the losses on corporate loans that Italian banks would incur in 2014-15 would be covered by the provisions already made and the expected operational profitability. Overall, therefore, capital and reserves would not be eroded.

The comprehensive assessment of banks' conditions preparatory to the Single Supervisory Mechanism is announced

The comprehensive assessment of euro-area banks by the ECB and national supervisory authorities, in view of the launch of the Single Supervisory Mechanism, will begin in the coming weeks. The risk profile of the area's major banks will be examined for all exposures, including sovereign and market exposures and, among these, items classified as "level 3 assets". The goals are to enhance the transparency of balance sheets, to identify and implement corrective actions where needed, and to strengthen market confidence. In particular, risk analysis will be conducted together with an asset quality review and a stress test, which will be coordinated with the EBA; a number of other significant bank characteristics, such as financial

leverage, will also be evaluated.

For the asset quality review, the common equity tier 1 (CET1) ratio benchmark is set at 8 per cent, higher than the minimum regulatory requirement, including the capital conservation buffer, effective from 1 January 2014. The ratio is to be calculated under the definition of capital effective from 1 January 2014, taking the discretion allowed by Capital Requirements Directive IV into account. Banks with unsatisfactory capital ratios at the completion of the exercise, in about a year, will be asked to take corrective action. The Bank of Italy recently published a public consultation document on the discretion it would exercise.⁷

For the fifteen Italian banking groups that will take part in the asset quality review, the weighted average CET1 ratio under the definitions in effect from 1 January 2014 – if calculated on data at 30 June 2013 adopting restrictive assumptions for the exercise of national discretion – would come to 9.5 per cent. Compared with the 8 per cent benchmark, several intermediaries (already closely monitored by the Bank of Italy and asked to raise additional capital) would have recorded a capital shortfall of €1.2 billion, equal to about 1 per cent of risk-weighted assets.

The banks' financial leverage is still low by international standards

Italian banks' financial leverage, calculated as total balance-sheet assets over tier 1 capital, remains lower than in Europe as a whole: in December 2012 it stood at 19, against the European average of 22 (Figure 3.15). The data used for this calculation are not consistent with the Basel III definitions, which for now are only available for a sample of banks as part of the half-yearly monitoring coordinated by the Basel Committee and the EBA. On the basis of these data, at 30 June 2013 Italian banks' average ratio of tier 1 capital to total exposures, calculated according to the Basel III guidelines, was 4.1 per cent, well above the 3 per cent minimum required by the new prudential regime.

Profitability continues to be very low

The profitability of the 34 largest Italian banking groups remained extremely modest in the first half of 2013: their annualized return on equity was 1.2 per

⁷ The Bank intends to maintain the prudential filter on unrealized profits and losses on exposures to EU central government bodies that are classified in the available-for-sale portfolio. In the document the Bank also presented two alternative options for a series of other definitional issues, which for the system as a whole determine higher or lower capital ratios. The choice of one alternative or the other will be made at the end of the consultation period (see ["Applicazione in Italia del Regolamento \(UE\) n. 575/2013 e della direttiva 2013/36/UE: scelte normative relative al regime transitorio"](#)).

cent, compared with 1.9 per cent in the first half of 2012. This reflected the continual contraction in net interest income and the increase in provisions against credit risk, which absorbed three quarters of operating profit (compared with just under 60 per cent in the first half of 2012; Figure 3.16). The cost-income ratio edged up from 60 to 62 per cent, despite the decrease in operating costs (staff costs in particular). The ROE of the five largest banking groups, instead, improved slightly to 1.8 per cent in the first half from 1.6 per cent in the year-earlier period.

Operating results are expected to cover the increase in loan loss provisions

The Italian banking system's profitability is likely to remain modest this year and in 2014. According to our estimates, which do not incorporate the possible effects of the comprehensive assessment in terms of additional writedowns, the aggregate operating profit will be sufficient to cover loan losses in both financial years, keeping the coverage ratios broadly stable. Any capital shortfalls that should emerge for individual banks as a consequence of the comprehensive assessment will have to be made good first of all out of banks' own resources – by omitting dividend distributions, disposing of non-strategic assets and further curbing costs – and by raising capital on the market.

3.6 INSURANCE COMPANIES

The market's assessment

Market indicators improve

The financial conditions of the main Italian insurance companies continued to improve, according to market perceptions, as evidenced by the rise in share prices, modest upturn in forecast earnings per share, and further reduction in expected default frequencies implied by share prices (Figure 3.17).

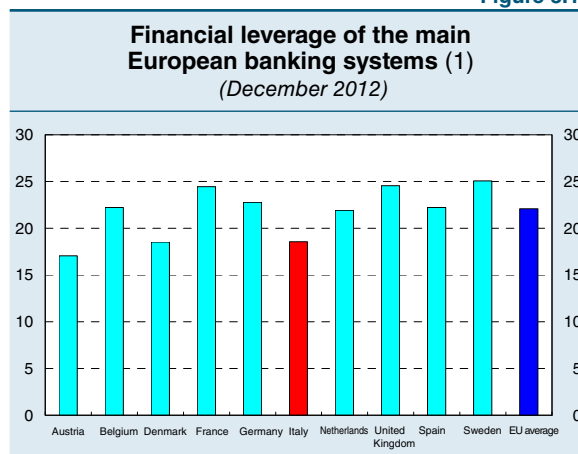
The credit ratings assigned by the main agencies are unchanged, except for that of Assicurazioni Generali, which was downgraded in July by Standard & Poor's in conjunction with the lowering of Italy's sovereign rating.

Premium income and the liquidity position

Premium income increases

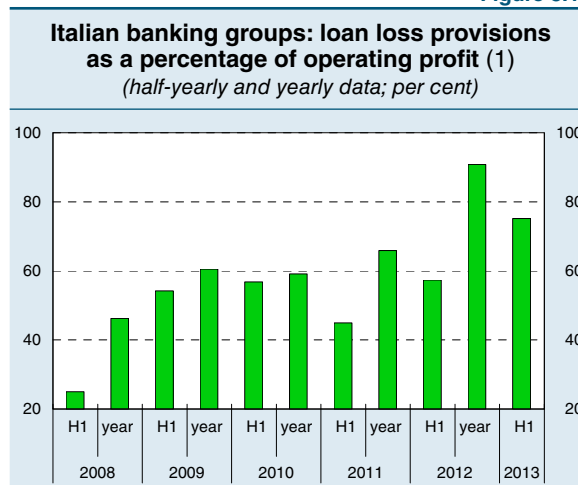
Premium income has continued to increase in 2013. In the first nine months of the year, premium income in the life sector rose by 23 per cent with respect to the year-earlier period, mainly thanks to policies marketed through the banking

Figure 3.15



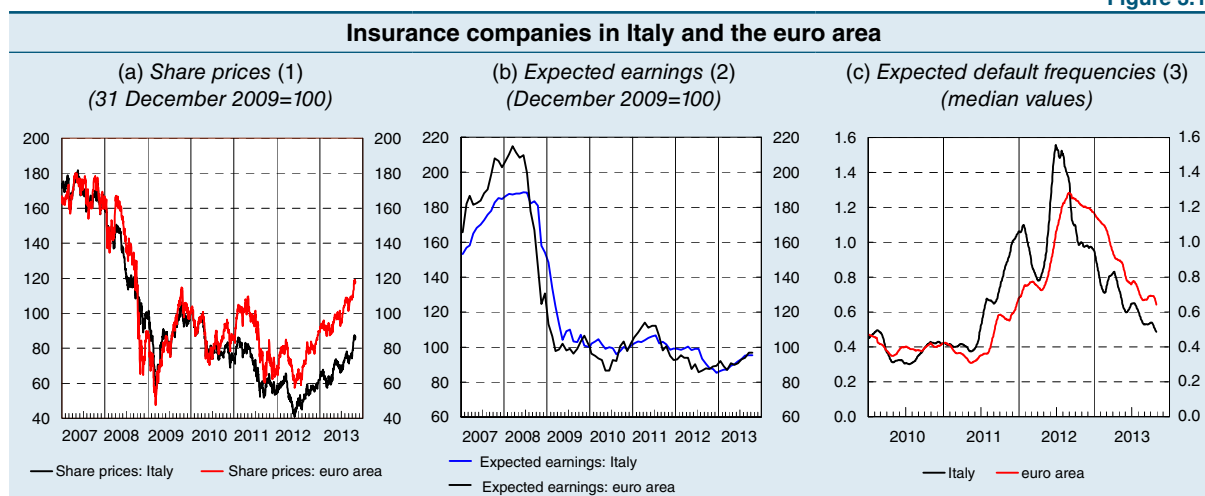
Source: Based on ECB, "Consolidated banking data"
(1) Ratio of total balance-sheet assets to tier 1 capital.

Figure 3.16



Source: Supervisory reports.
(1) For the years through 2012, the data refer to the aggregate of banking groups; for the first half of 2013, they refer to the 34 largest banking groups.

Figure 3.17



Sources: Based on Thomson Reuters Datastream and Moody's KMV data.

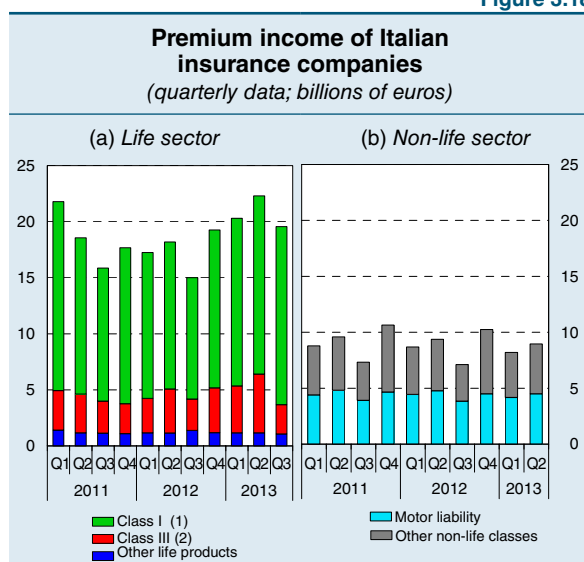
(1) Daily data. Insurance company share indices. – (2) Weighted average (by the number of shares in circulation) of expected earnings per share in the 12 months following the reference date. Monthly data. For Italy the data refer to the following companies: Assicurazioni Generali, Mediolanum Assicurazioni, 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 one 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.

channel. The increase was more marked for index-linked products (Figure 3.18.a). In the non-life sector, premium income fell by 5 per cent in the first half of the year owing to the reduction in motor liability premiums; this was due to the reduction in accident claims, itself a consequence of the drop in the number of vehicles on the road in response to the recession (Figure 3.18.b).

Liquidity risk continues to diminish

The strong performance of premium income, together with the reduction in surrenders, led to a decrease in surrenders and benefit payments in proportion to premium income, an indicator of liquidity (Figure 3.19).

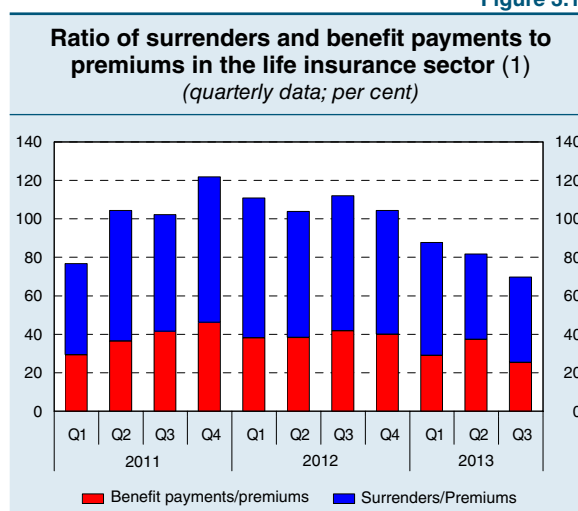
Figure 3.18



Source: IVASS.

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

Figure 3.19



Source: IVASS.

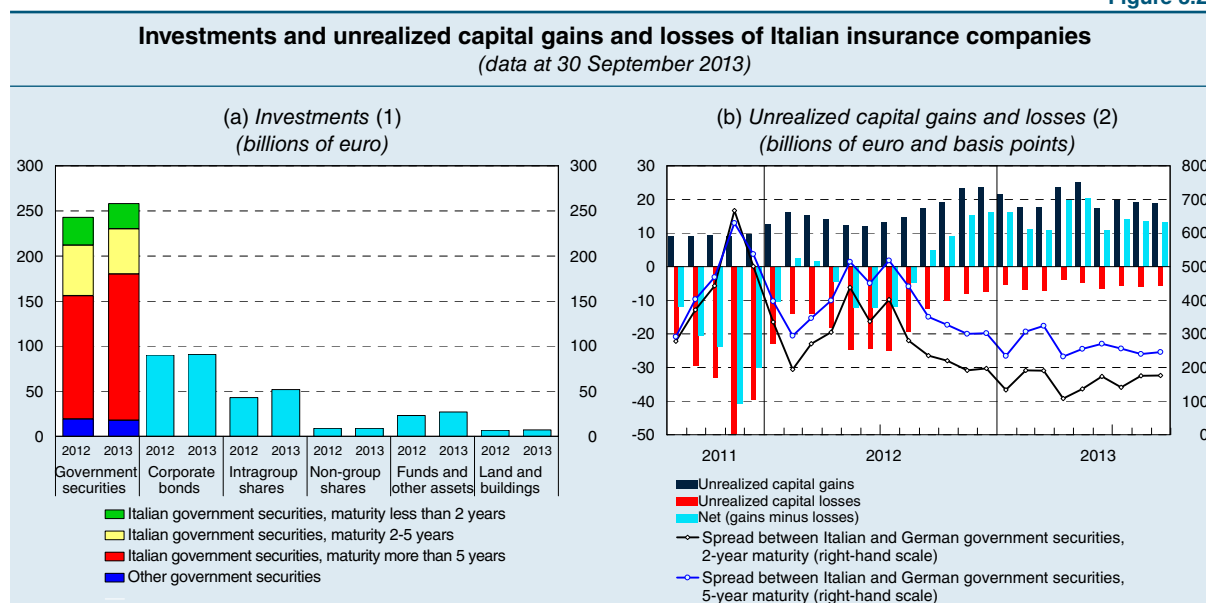
(1) The indicator is calculated as the sum of policy surrenders and other payments (principal, annuities and claims) in proportion to premium income during the period. An amount higher (lower) than 100 indicates a net outflow (inflow) of funds.

Investments

Investment in government securities is still strong

Italian insurance companies responded to their improved liquidity situation by reducing the percentage of highly liquid assets, particularly sight deposits. Apart from this, there were no other changes of significance in the composition of their portfolios. The share of Italian government securities with a long average residual maturity remains high (Figure 3.20.a). Unrealized capital gains again outweigh losses (Figure 3.20.b).

Figure 3.20



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.

Profitability and capital adequacy

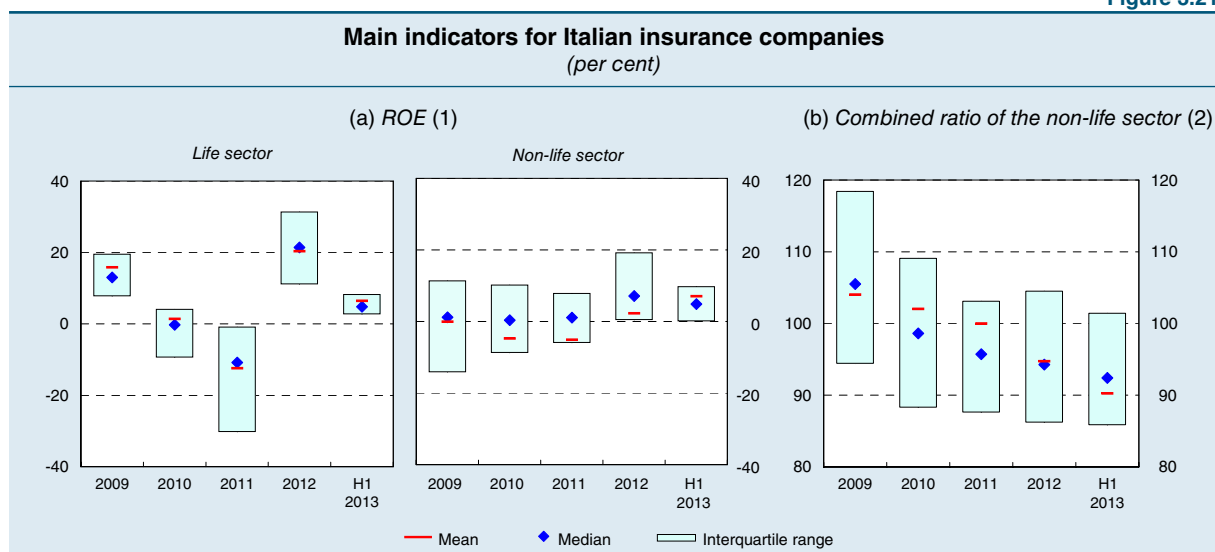
Profitability is still positive and the capital base sound

The results for the first half of 2013 show that insurance companies' profitability is still generally positive. Although ROE in the life sector declined to 4.8 per cent, average profitability in the non-life sector continued to improve – with ROE rising to 7 per cent – mainly thanks to the positive trend in the technical account, reflected in a constant improvement in the combined ratio of incurred losses plus operating expenses to premium income, particularly in the motor liability sector (Figure 3.21). This was partly due to the drop in the number of automobile accident claims and the early impact of the recent reforms, which include a tightening of standards for the valuation of minor injuries. The solvency ratios of the life and non-life sectors are still above the regulatory requirements, as confirmed by the half-year results for the main listed insurance groups. Going forward, the new system of valuation of balance-sheet items introduced as part of the new prudential supervision regime for the European insurance industry (Solvency II) could produce large swings in capital requirements; the authorities are currently discussing solutions to the problem (see the box "The impact of the introduction of Solvency II").

The main risks still stem from the weakness of the economy and the sovereign debt tensions

The main risks for Italian insurance companies stem from the persistence of economic uncertainty and the instability of the financial markets, which, going forward, could affect the profitability of the technical account. Recent amendments to the law have reduced the tax advantage enjoyed by some life insurance policies, with a potentially negative impact on future premium income, although this should be limited by the fact that such products do not constitute a large proportion of liabilities. A recent

Figure 3.21



Source: IVASS.

(1) Ratio of earnings to shareholders' equity. The figure for the first half of 2013 is provisional and not annualized. – (2) Ratio of incurred losses plus operating expenses to premium income for the period.

survey by IVASS, the insurance supervisory authority, confirms that the risks stemming from a protracted phase of low interest rates, which is causing concern among insurance companies in some northern European countries, are limited in the case of Italian companies, mainly because of the structure of their products and the composition of their investment portfolios, which contain a majority of Italian government securities (see the box “Survey of life insurance companies’ exposure to interest rate risk”).

THE IMPACT OF THE INTRODUCTION OF SOLVENCY II

The European Commission recently proposed postponing the entry into force of the new prudential supervision regime for the European insurance industry (Directive 2009/138/EC, the Solvency II Directive), currently scheduled for the end of this year. A recent report by the European Insurance and Occupational Pension Authority (EIOPA)¹ has shown that, with the fair-value balance-sheet valuations introduced by the Solvency II Directive, episodes of excess volatility on financial markets, such as those that occurred during the latest crisis, would risk producing large swings in insurance companies’ capital requirements, with a series of adverse consequences. Companies could be led to scale back their supply of products with long-term guarantees and, more generally, to change the composition of their portfolios significantly, not least in response to price changes having no impact on their effective exposure to risk, above all in view of the long duration of their balance-sheet assets and liabilities. Such conduct could increase the danger of fire sales and the procyclical bias of the entire financial system, thereby accentuating its instability.

The EIOPA report analyses a variety of solutions to the problem of excessive short-term volatility and suggests that the “volatility balancer” would be the best. This mechanism provides for an adjustment to the interest rate curve used for the valuation of liabilities in order to quantify the value of a new “special” own funds item, to be added to the ordinary own funds so as to attenuate fluctuations in the solvency indicators following episodes of excessive short-term market price volatility. The proposed

¹ EIOPA, *Technical Findings on the Long-Term Guarantees Assessment*, 2013

(https://eiopa.europa.eu/fileadmin/tx_dam/files/consultations/QIS/Preparatory_forthcoming_assessments/final/outcome/EIOPA_LTGA_Report_14_June_2013_01.pdf).

correction would make it possible to obtain more reliable and robust solvency indicators and avoid procyclicality.

The analysis carried out by EIOPA on data for December 2011 (the period of maximum tension on the Italian sovereign debt market) shows that the application of the Solvency II Directive would have led, for the sample of Italian insurance companies, and for samples in various other countries, to a very low solvency ratio (companies' own funds over their capital requirements). By contrast, introduction of the volatility balancer gives a solvency indicator that is more representative of insurance companies' capital situation in the medium term. Additional analyses carried out by IVASS on data for the Italian companies involved in the exercise² confirm the usefulness of the mechanism for this purpose, but show a significantly lower degree of effectiveness than that found by EIOPA. Accordingly, IVASS has suggested some amendments to the design and calibration of the volatility balancer that would allow the Italian insurance industry to continue to offer life products with long-term guarantees and maintain its institutional investor role.

The volatility balancer mechanism, calibrated in accordance with the Italian requests, is currently being discussed by the European Parliament, Council and Commission in trialogue meetings.

² IVASS, *LTGA Italian Report*, 2013 (http://www.ivass.it/ivass_cms/docs/F23206/LTGA%20national%20report%20Italy.pdf).

SURVEY OF LIFE INSURANCE COMPANIES' EXPOSURE TO INTEREST RATE RISK

IVASS asked life insurance companies to assess the impact of an unexpected change in interest rates on their ability to discharge their obligations under with-profits policies. Specifically, the companies were asked to assume instantaneous and parallel upward and downward variations of 100 basis points in the euro interest rate swap curve at 30 June 2013 and to measure the impact (increase/decrease) on the supplementary provision for interest rate risk, taking account of the foreseeable effects over a 15-year time horizon.

The exercise revealed that a downward shift in the interest rate curve would result in a 14 per cent increase in the supplementary provision required to meet the implicit guarantees in life insurance policies. The amount is in any event hardly more than 0.3 per cent of the total mathematical provisions. An upward shift in the interest rate curve would lead, instead, to an overall reduction in the supplementary provision.

These results reflect the structure of the products offered by the insurance companies and the composition of their investments covering related commitments. More than 90 per cent of the mathematical provisions refer to products with a minimum guaranteed return of 3 per cent or less; the investments consist primarily in Italian government securities, which offer relatively high returns (the average return on separate asset portfolios in 2012 was 3.5 per cent).

The impact of a prolonged period of low interest rates would appear to be greater in some North European countries, by reason of guaranteed returns offered on longer-term products placed in years past. The European Insurance and Occupational Pensions Authority is considering inserting the analysis of a scenario of prolonged low interest rates in the periodic stress testing of the European insurance market.

4 THE MARKETS AND EUROSISTEM REFINANCING

4.1 THE LIQUIDITY MARKET

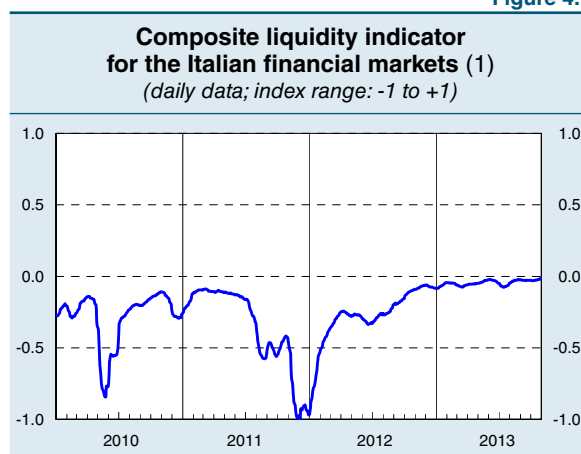
Liquidity conditions on the Italian financial markets are good

The composite liquidity indicator for the main Italian financial markets shows that liquidity conditions are basically back to what they were in the years leading up to the crisis (Figure 4.1).

Trading on the interbank market is still concentrated in the collateralized segments ...

The volume of repos traded on the MTS platform remains large overall (Figure 4.2.a). This market, in which small and medium-sized Italian banks are active participants, continues to attract new members. Although over 90 per cent of trading is concentrated in one-day maturities, relatively few long-term contracts bring the average residual life of outstanding contracts to 38 days. Practically all of the trades are cleared by the two central

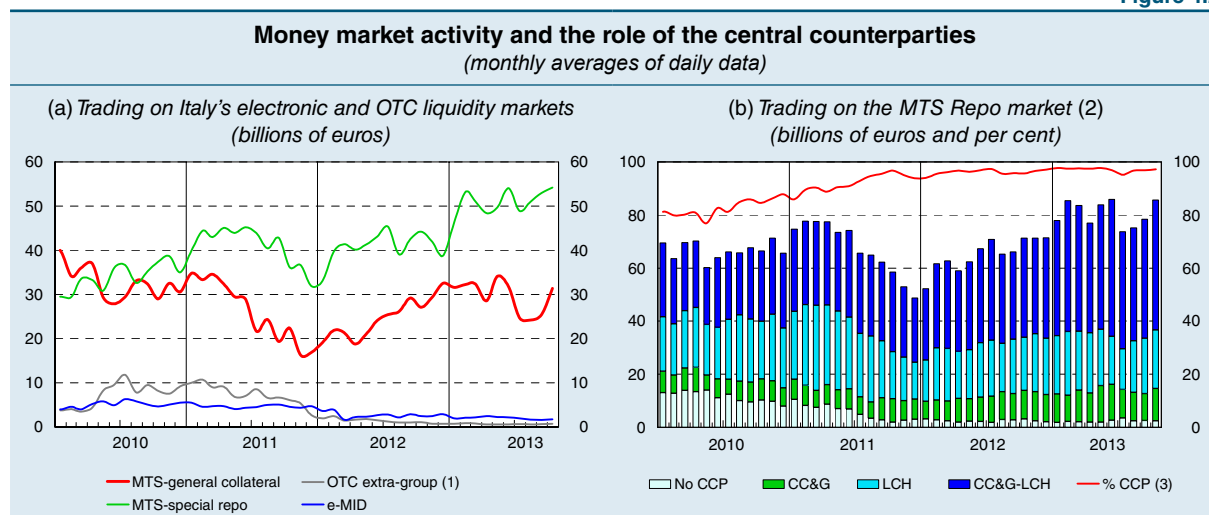
Figure 4.1



Sources: Based on Thomson Reuters Datastream, Bloomberg and Bank of Italy data.

(1) Positive (negative) values indicate higher (lower) liquidity than the average for 1999-2006; 20-day moving averages. For the method of constructing the index, see *Financial Stability Report*, No. 1, December 2010.

Figure 4.2



Sources: Based on e-MID SIM S.p.A., MTS S.p.A. and TARGET2-Banca d'Italia data.

(1) Estimates of unsecured money market trading with maturity up to one week by Italian banks with extra-group counterparties, based on TARGET2 data. – (2) The histograms show the distribution of trading according to central counterparty (CCP); the volumes attributed to CC&G-LCH refer to contracts between participants that do not use the same central counterparty. – (3) Percentage of total trading cleared by central counterparties.

counterparties active on the market, namely LCH.Clearnet SA (LCH) and the Italian clearing house Cassa di compensazione e garanzia S.p.A. (CC&G); the contracts between Italian and foreign intermediaries are routinely cleared through the interoperability link (Figure 4.2.b).

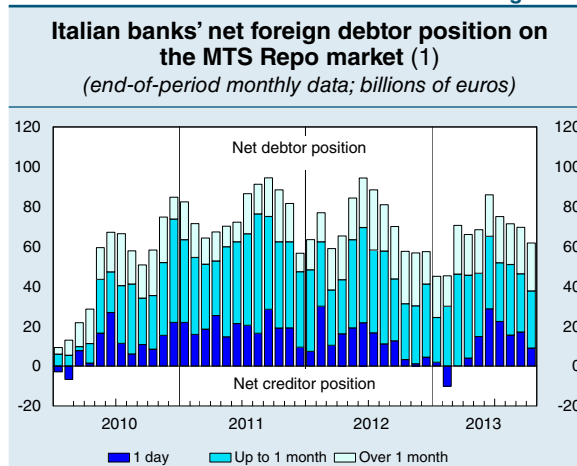
... used by the Italian banks to raise funds from abroad

In recent years the Italian banking system has relied primarily on the MTS Repo market for raising funds in the international markets. Banks' net debtor position currently stands at about €60 billion, with an appreciable share at maturities of over one month (Figure 4.3). The intervention of the central counterparties significantly attenuates the risks for the orderly functioning of the market in case of default by individual participants (see the box "An evaluation of the main risks for the MTS Repo market" in *Financial Stability Report*, No. 5, April 2013). The increase in the volume of transactions cleared by the central counterparties in recent years has nonetheless necessitated also managing the risk posed by the hypothetical default of either one. This is the context in which LCH.Clearnet SA amended its Regulations in August to comply with the requirements of the European Securities and Markets Authority (ESMA) concerning CCP interoperability.¹ A similar mechanism will soon be introduced by CC&G in respect of LCH. Despite the sometimes misleading interpretations of a few analysts, there is no evidence that these measures have had any significant impact on the market to date. Looking ahead, however, any further tightening of risk control policies by the central counterparties – by raising the costs of using the system – could encourage a return to bilateral trading.

On the unsecured segment exposures remain stationary

The volume of unsecured interbank trading is still low both on the electronic e-MID and OTC markets, for which estimates are available based on TARGET2-Banca d'Italia data (Figure 4.2.a). Excluding intragroup transactions, trades with foreign counterparties are negligible. The volume of short-term gross unsecured interbank liabilities of Italian banks, which plummeted during the most acute phase of the sovereign

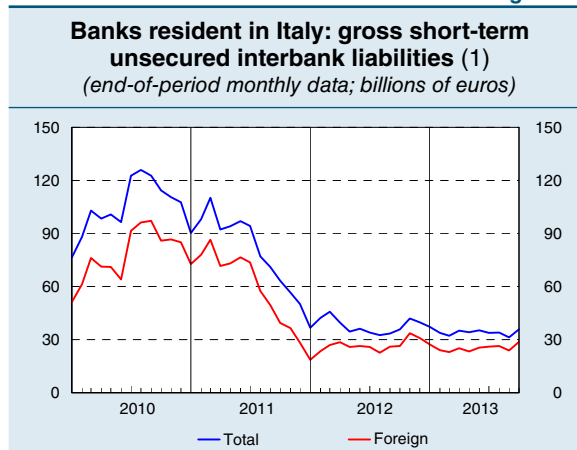
Figure 4.3



Source: Based on MTS S.p.A. data.

(1) The total net exposure is divided into 3 maturity buckets. Each one is calculated as the difference between the nominal value of the securities underlying the repos and the reverse repos of Italian participants in the MTS Repo market for the same bucket.

Figure 4.4



Source: Based on supervisory statistical reports.

(1) Interbank deposit liabilities of up to 3 months (partially estimated) of groups and banks resident in Italy. For the groups, only extra-group funding is considered, with the exception of that made through foreign branches, which is considered as originating abroad.

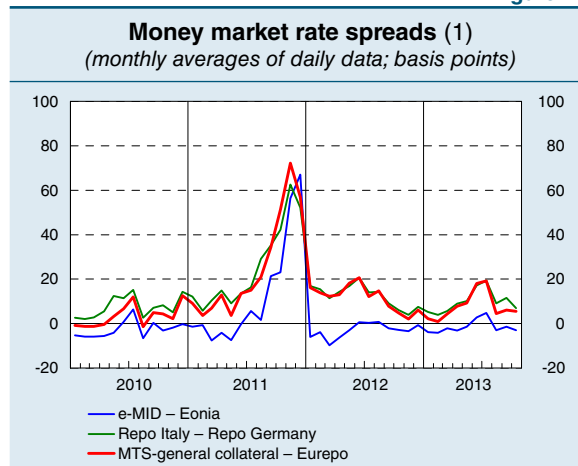
¹ As part of its adaptation to the requirements set out in the European Markets Infrastructure Regulation (EMIR), LCH provided that in the event of the default of CC&G any losses not covered by available margins should be divided among the participants, without drawing on LCH's own capital. In essence, the mechanism would only be triggered in the remote circumstance of a systemic crisis of the Italian banking and financial markets. CC&G, in fact, has already adopted measures covering the simultaneous default of its five main participants (compared with a minimum of two participants required under EMIR).

debt crisis, has steadied at around €30 billion (Figure 4.4). The largest share is attributable to funding through foreign branches.

Interest rates do not show significant tensions

In June and July the interest rates in the Italian liquidity markets increased with respect to the euro-area average (Figure 4.5). In a still segmented money market, the phenomenon essentially reflected the high temporary liquidity requirements of the Italian banking system in connection with tax payments; other factors may have been the early repayments of the Eurosystem's three-year refinancing operations and the participants' uncertainty concerning changes to the central counterparties' risk management policies, which were being finalized during that period. At the beginning of August these tensions were rapidly dispelled.

Figure 4.5



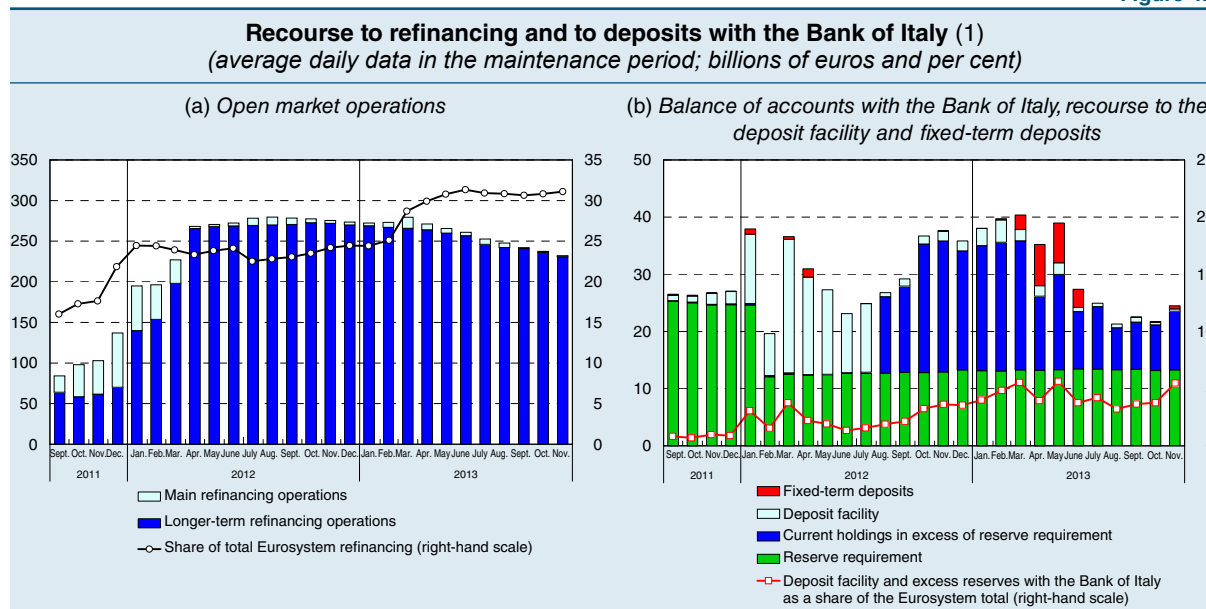
Source: Based on e-MID SIM S.p.A., MTS S.p.A. and RepoFunds Rate data. (1) e-MID and Eonia: overnight; Repo Italy and Repo Germany: contracts on government securities with maturity of one business day concluded on electronic trading platforms operated by MTS S.p.A. and ICAP, and guaranteed by the central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

4.2 EUROSISTEM REFINANCING

Eurosystem borrowing and excess liquidity diminish

Italian banks' recourse to Eurosystem credit has fallen to €232 billion since May, mainly reflecting the early repayment of funds obtained with the three-year refinancing operations (Figure 4.6.a). By 6 November, 22 of the 112 Italian counterparties that had obtained funds through these operations had repaid €38 billion, representing 15 per cent of the total amount allotted, compared with 39 per cent for the euro area

Figure 4.6



Sources: Based on ECB and Bank of Italy data.

(1) The date indicated on the horizontal axis refers to the month in which each maintenance period ends. For the last maintenance period the average is calculated up to 6 November.

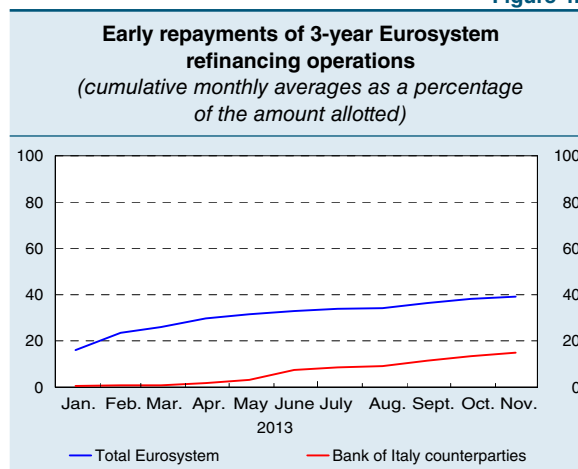
as a whole (Figure 4.7). The gap can be ascribed above all to precautionary motives. The government securities purchased through three-year refinancing operations can be readily liquidated, they support the short-term liquidity position and they allow the banks to cope with any difficulties in rolling over wholesale funding. The government securities investments also boosted interest income, thereby supporting the banks' profitability.

The excess funds deposited by banks with the Bank of Italy – either in the reserve account in excess of requirements or in the deposit facility – decreased from €19 billion in May to €11 billion in November; fixed-term deposits from €7 billion to €0.6 billion (Figure 4.6.b).

Available eligible assets continue to increase

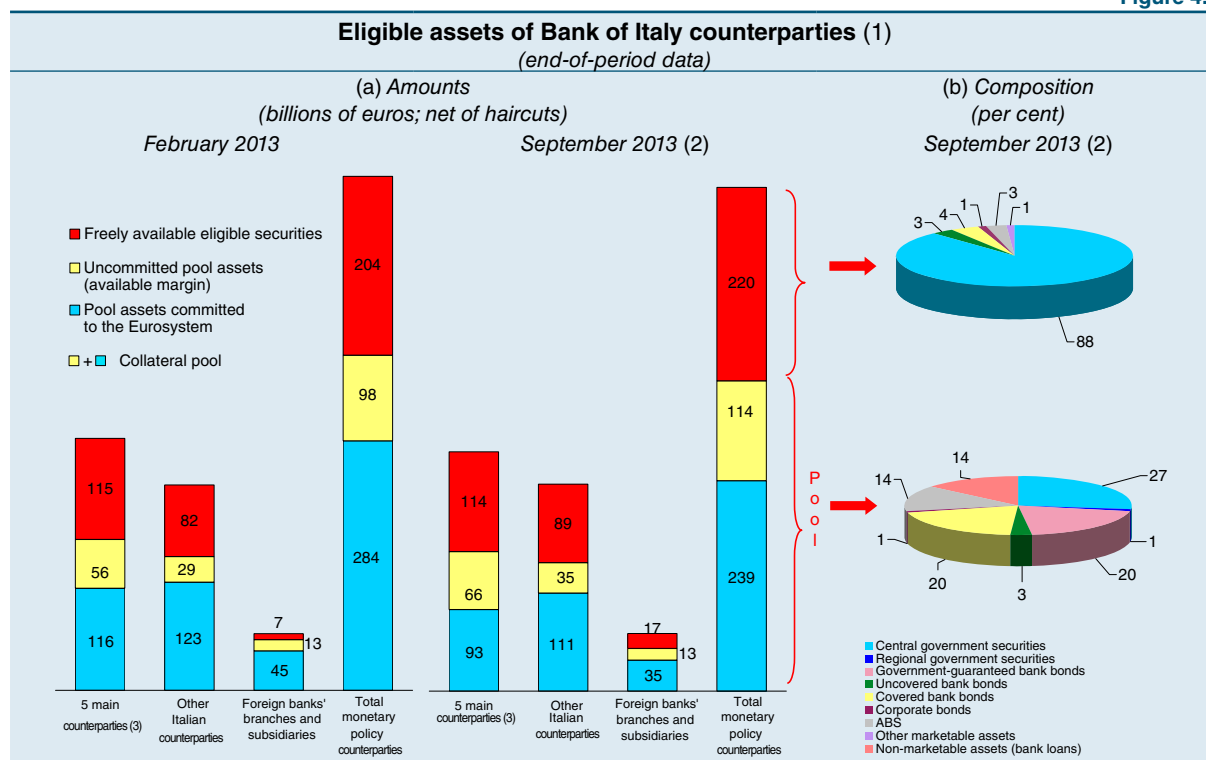
Including freely available assets held outside the collateral pool,² Italian banks are able to draw on a further €334 billion of Eurosystem credit (Figure 4.8.a), a larger sum than in February of this year. The composition of the pool has remained unchanged, with Italian government securities and bank bonds representing over two thirds of the total (Figure 4.8.b). Going

Figure 4.7



Sources: Based on ECB and Bank of Italy data.

Figure 4.8



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) Data on pooled collateral refer to 1 October 2013. – (3) Main monetary policy counterparties by volume of assets of the groups to which they belong.

² The collateral pool refers to the total assets deposited with the Bank of Italy as a guarantee for Eurosystem operations.

forward, a large amount of collateral should be kept available, varying its composition and extending the portion of eligible assets by allowing new technical forms.

The Eurosystem has recently revised its risk control framework. Haircuts have been reduced for almost all eligible assets rated single A or better, and raised for some securities with lower ratings and for the majority of non-marketable assets.³ For asset-backed securities, haircuts have been lowered and the minimum rating requirements at issue have been relaxed from AAA to A- following the gradual entry into force of the loan-level reporting requirements.⁴ Lastly, the valuation criteria for own-use covered bank bonds have been tightened. The new measures have reduced the value of the Italian banks' collateral pool by some €4 billion, while increasing that of the assets held outside the pool, mainly government securities, by an estimated €1 billion.

The Bank of Italy's new model for credit risk assessment is now available

From November 2013 Italian banks can also increase their eligible assets by using the bank loan valuation model developed by the Bank of Italy. When fully operational, the new valuation criteria could generate up to €20 billion of additional collateral (see the box "The Bank of Italy's new model for credit risk assessment").

THE BANK OF ITALY'S NEW MODEL FOR CREDIT RISK ASSESSMENT

In July the ECB Governing Council approved the model developed by the Bank of Italy for assessing credit risk on bank loans, known as the In-house Credit Assessment System (ICAS). Similar systems are already in use at the central banks of Austria, France, Germany, Slovenia and Spain. The new model introduces an important instrument for Italian banks, considering that loans – which are typically non-marketable and unrated, hence hard to use as collateral – make up a large portion of their assets.¹

The model calculates the borrower firm's probability of default (PD) over a twelve-month horizon. The estimates are obtained by applying a statistical model to balance-sheet data and Central Credit Register reports, also taking a range of supplementary information into account (such as sector risk and the quality of corporate governance). When a bank posts loans as collateral, the Bank of Italy accepts those granted to firms whose estimated PD is below the eligibility threshold.

Initially, the ICAS will generate PD estimates for about 3,000 firms to which banks have made potentially eligible loans. If they are fully utilized by the banks, the model would produce additional collateral, net of haircuts, of up to €20 billion. Utilization in the short run depends on the banks' requests to do so.

¹ The Eurosystem already accepts bank loans as collateral for monetary policy operations, evaluating them with three other instruments: credit rating agencies; statistical rating tools managed by third parties (in Italy, for instance, the credit risk assessment model developed by Cerved); and the banks' own internal rating-based models.

The volume of government-guaranteed bank bonds diminishes

On 20 September 2013 the first issue of government-guaranteed bank bonds, with a face value of €4 billion, matured; more, with a face value of €10 billion, will come to maturity over the next six months (see *Financial Stability Report*, No. 5, April 2013). Recently, several banks have announced their intention to cancel bonds held for own use before they mature in order to save on the commission due to the state and in view of the upcoming repayment of the three-year Eurosystem loans.

³ See the ECB's decision of 26 September 2013 at http://www.ecb.europa.eu/ecb/legal/pdf/en_dec_2013_35.pdf.

⁴ See the ECB press releases of 27 November 2012 at <http://www.ecb.europa.eu/press/pr/date/2012/html/pr121127.en.html> and 19 September 2013 at <http://www.ecb.europa.eu/press/pr/date/2013/html/pr130919.en.html>.

A lowering of the sovereign rating is the main risk for eligible collateral

The Eurosystem applies to Italian central government securities the haircuts envisaged for securities rated A or better, which is the rating currently assigned by DBRS.⁵ It is estimated that if the rating assigned to Italy and Italian bank issuers fell one notch below A-, the increase in the haircuts would reduce the value of the collateral pool by about €29 billion and that of collateral outside the pool by €12 billion. Another source of uncertainty concerns the banks' ability to meet the three-year LTRO maturities at the beginning of 2015. The Eurosystem stands ready to take any measures necessary to prevent undue liquidity tightening from triggering tensions on the markets and jeopardizing the economic recovery, but the support cannot last indefinitely. Italian intermediaries are drawing up strategies to ensure the deadlines can be met.

4.3 THE GOVERNMENT SECURITIES MARKET

Very-long-term issues resume

In the first ten months of 2013 Italian government securities placements totalled €414 billion (€111 billion net of the volume maturing). After a protracted suspension, issues of thirty-year bonds resumed in mid-May for €6 billion, followed in July by another €1.5 billion. Additional very-long-term issues were made on international markets, for a total of €1 billion.

The residual life of the debt stabilizes

Average yields at issue have held at around 2 per cent (Figure 4.9). The weighted average cost of the debt remained below 4 per cent. The average residual life of the outstanding government securities in the third quarter also held steady at 6.5 years (Figure 4.10.a). The volume of medium- and long-term securities maturing in 2014 will be larger than in 2013, €188 billion against €159 billion. Redemptions will be bunched especially in the months of August, September and December (Figure 4.10.b).

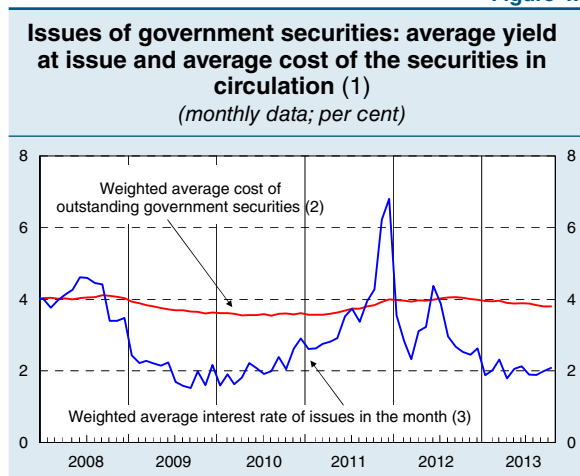
Secondary market liquidity improves further ...

The upswing in trading in Italian government securities on the MTS secondary market continued, favoured by the narrow bid-ask spread (Figure 4.11). Similar trends were observed on the platforms for institutional investors and in the over-the-counter segment, to which a portion of trading activity had shifted at the moments of greatest price volatility. It is estimated that trading on the electronic platforms now accounts for about 60 per cent of total trading in Italian government securities.

... as does that of the special repo and BTP futures markets

Market making and the refinancing of investors' government securities portfolios benefited from the liquidity of the MTS special repo market. The cost of the special repos, measured as the average difference between the interest rates on

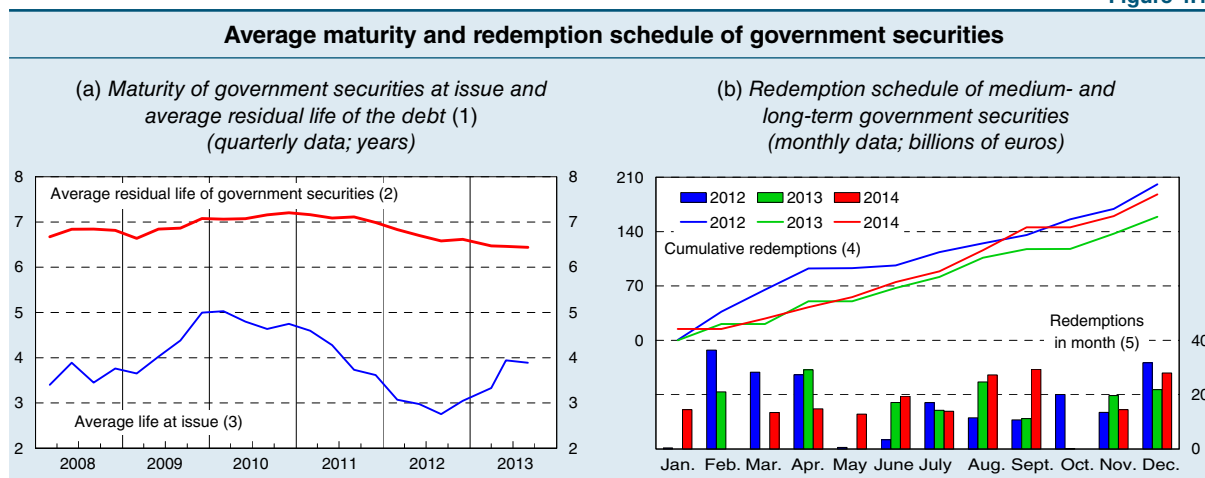
Figure 4.9



(1) Unindexed government securities placed on the domestic market. – (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.

⁵ Generally, the first best rule is applied: where more than one rating is available, the best is selected. For assets rated lower than A, larger haircuts are applied. DBRS currently assigns Italian sovereign debt a rating of A-; the remaining three agencies recognized by the Eurosystem's regulations on eligible assets (Fitch, Moody's and S&P) give it lower ratings.

Figure 4.10



Sources: Based on Ministry for the Economy and Finance and Bank of Italy data.

(1) The two series differ in level mainly due to the weighting of BOTs, which is greater in the series of average life at issue. – (2) End-of-quarter data, weighted by stocks outstanding. – (3) Government securities placed on the domestic market; weighted by issue volume in the quarter; 3-term moving average. – (4) Left-hand scale. Cumulative redemptions of government securities with original maturity of more than one year. – (5) Right-hand scale.

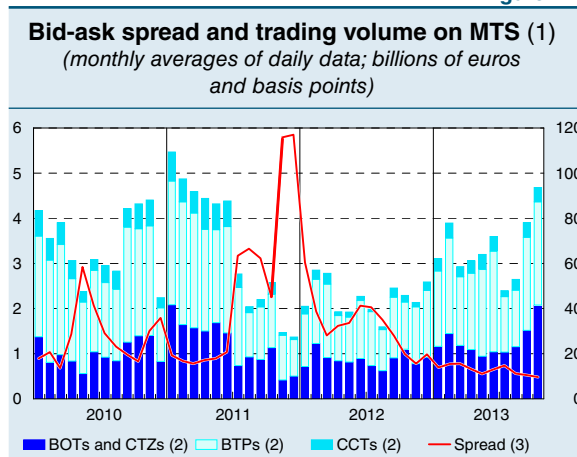
general collateral and on special repos, was relatively stable and low (6 basis points). The share of fails (trades not settled on the scheduled day) remained low (2 per cent) and was lower than prior to 1 November 2012, when the European regulation on short selling went into effect. No short positions in Italian sovereign debt as defined by the regulation were reported (see the box “The new European regulation on short selling,” in *Financial Stability Report*, No. 5, April 2013). Open interest and trading volume in futures on ten-year BTPs both increased (Figure 4.12.a), while the net notional volume of credit default swaps on Italian government debt diminished, in line with the trend in the other euro-area countries (Figure 4.12.b).

Purchases by non-residents continue

In the first half of 2013 foreign investors made further net purchases of

Italian government securities, bringing their holdings to 30 per cent of the total outstanding. The investor base remained highly diversified (Figures 4.13.a and 4.13.b). Purchases consisted mainly in BOTs (€13 billion) and BTPs (for the same amount, including inflation-indexed bonds). In August non-residents made substantial net disposals; based on TARGET2 balances, net purchases resumed in the following months.

Figure 4.11



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 all the BTPs listed on MTS. – (2) Volumes traded on MTS. – (3) Bid-ask spread; right-hand scale.

Figure 4.12

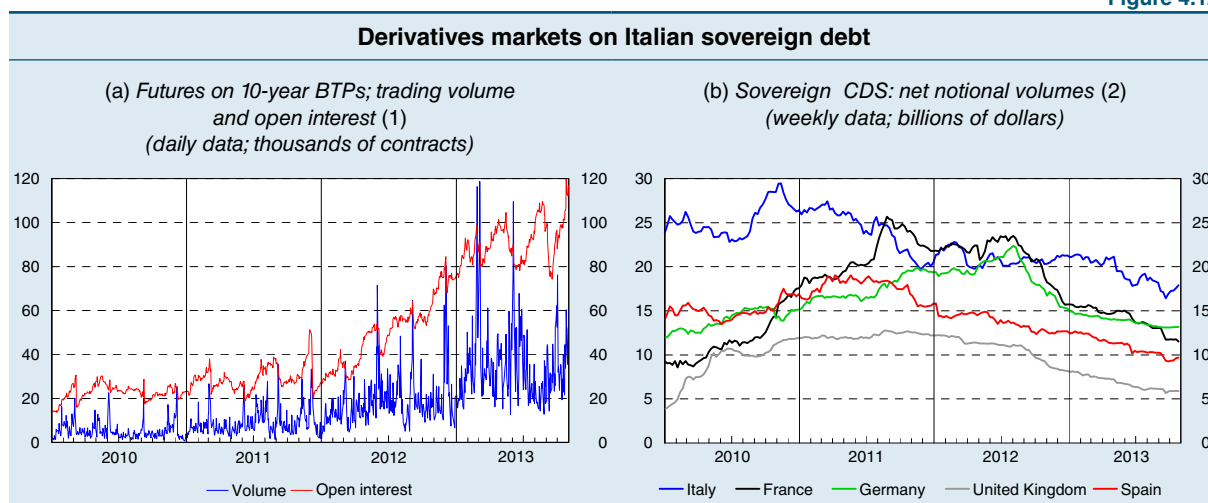


Figure 4.13

