Sixth Committee of

the Italian Senate

Fact-finding inquiry into the international financial crisis

and its effects on the Italian economy

A system with more rules, more capital, less debt and more transparency

Testimony of the Governor of the Bank of Italy

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1. The international financial crisis

1.1 The origins

The financial crisis is rooted in the structural changes that have reshaped the global economy in recent years, and in particular the financial sector itself. World growth, which has been increasingly sustained by emerging market economies, has been accompanied by the progressive worsening of significant and closely interlinked disequilibria. A chronic shortage of saving in several areas of the world, especially in the United States, coincided with a growing surplus in others, above all in China and other high-growth emerging market economies. The balance-of-payments disequilibrium has not been offset by appropriate foreign exchange rate movements.

This is not the first time that macroeconomic disequilibria have accompanied phases of rapid development. The international financial system performs the vital function of collecting savings wherever it is formed and channelling it to productive uses, anywhere in the world. It has successfully performed this task on many occasions in the past.

What are the sources of the critical problems this time around? Some of the profound transformations of the financial system can channel, distribute and diversify risk; if they spin out of control, as can happen in a period of financial exuberance, the risks become opaque and are multiplied. The longer it is delayed, the more violent will be the necessary correction.

In the last ten years, the perception of and the propensity for risk have changed significantly. The protracted period of low nominal and real interest rates led to a strong expansion of monetary and credit aggregates. At different times, risk premiums in the equity, property, government security and bond markets reached historic lows. These developments propelled the prices of financial and real assets to excessive levels. Since the beginning of the decade this has been particularly evident in property markets, above all in the United States and in some European countries.

The financial system and, within it, banks, have undergone rapid and radical transformation. The volume and number of financial transactions have experienced unprecedented growth. On the supply side, deregulation, technological progress, financial innovation and increasingly integrated international markets have enormously amplified the range of products and instruments and the possible combinations of risk and return, lowered transaction costs, created new markets and unified previously segmented ones. On the demand side, population ageing increased the proportion of savings invested in retirement and insurance products, while favourable lending conditions stimulated a sharp increase in demand for mortgages and consumer credit. Compared with the traditional model in which banks played a predominant role in the activity of financial intermediation, the role of markets and non-bank financial institutions has expanded enormously.

Internationally, banks responded to the challenges and opportunities of market development by extending their functions well beyond the traditional banking model. They broke up the lending process, using securitization to sell to other financial operators loans they had previously granted. This enabled them to increase their financial leverage. On the liability side, they diversified their sources of funding, increasing their reliance on direct recourse to the market and reducing that on retail deposits. The traditional distinction between financial intermediaries became less clear. Nowadays banks are intermediaries that provide liquidity and, at the same time, a broad range of highly complex financial instruments. Notwithstanding the reduction of their share in total assets, they continue to play a central role and their link with the market has become progressively closer and interconnected.

Financial leverage also increased outside the banking system. In the United States two government-sponsored institutions whose role was to support the home property mortgage market contributed to this process: Fanny Mae and Freddie Mac.

At the end of the nineties, this system facilitated massive capital inflows towards new activities, above all in the computer and communications sector; it accelerated technological innovation, bringing benefits for all. It contributed in part to a revolution in information technologies whose effects extend well beyond economic growth, creating extraordinary possibilities for developing and circulating new ideas.

However, the financial crisis also highlighted all the vulnerabilities inherent in these developments. The heightened complexity of the instruments and their lack of transparency made it harder to manage risks, increasing the danger that, against a sharp rise in market volatility and a lower risk propensity on the part of investors, banks could encounter difficulties in raising and managing liquidity. Evident problems of governance and distorted incentives arose in many financial service areas: remunerative strategies and practices aimed chiefly at short-term profits rather than at building a solid medium-term position. Due diligence of investors was insufficient and the assessments of credit rating agencies were applied uncritically. It became clear that the latter were suffering from grave conflicts of interest in their dual role as evaluators and consultants to issuers and investors. The greater risk diversification seemingly attained through securitization operations turned out to be illusory; it emerged that in reality risk was much more concentrated than had been previously supposed and that to a large extent it weighed on banks. At times innovation was pursued for the sole purpose of circumventing prudential rules. Financial institutions reached levels of debt and risk exposure that were at once excessive and underestimated.

The crisis also spotlighted weaknesses in the regulatory and supervisory framework. The Basel I standards proved inadequate in the new financial context. They gave incentives to shift risk off balance sheets and to create an authentic parallel banking system. New accounting rules designed to enhance the transparency of balance sheets sometimes proved counterproductive: they were insufficient to ensure a clear and complete accounting of risks, while at the same time they aggravated the cyclical effects on banking activity, reinforcing the expansion of credit aggregates in times of calm, and curbing it even more sharply in periods of restriction and illiquidity.

The supervisory system has clearly been inadequate in some countries. Not surprisingly, the epicentre of the crisis was in sectors or institutions that are supervised poorly if at all, in particular in the US subprime mortgage market. There was no lack of instances of recklessness, inability to evaluate risks correctly and, in several cases, unethical or even illegal conduct. It must be underlined that the practices followed in the sectors at the origin of the crisis would not have been admissible or possible in many other countries, particularly not in Italy. The initial flame fed on the broader weaknesses of the international financial system recalled above, provoking the failure of trust and the evaporation of liquidity in the financial markets that we have witnessed over the last year. This explains why losses that could have been contained are instead having such serious repercussions on the financial markets and the real economy worldwide.

There had been no lack of warning signs over the years. It was not possible to predict the moment or the precise mechanism, or the extent of the crisis, but the build-up of tensions could be seen very clearly indeed. I, for one, on a number of occasions, pointed to the imbalances in the international financial system, the risks that were associated with the undoubted benefits of financial innovation. In times of tranquillity, warnings often go unheeded.

1.2 How the crisis developed

The rise in interest rates in the United States, followed by the cyclical economic slowdown, burst the real estate bubble in America. The increase in households' debt service and the downturn in house prices led to a surge in defaults, especially in the subprime mortgage sector. Starting in spring 2007, the prices of structured products linked to the US mortgage market fell increasingly quickly and the market for them dried up. This caused funding problems first for issuing companies (SIVs and conduits), and then, following their inevitable re-absorption into the banking system, for the banks themselves. It became clear that the transfer of risk outside banking institutions had been largely illusory.

Some of the leading international financial institutions suffered significant losses; they coped in part by raising capital on the market.

The collapse of the Lehman group in September made the situation much worse. The crisis gathered momentum and became systemic. Market participants realized that failure was a possibility even for a large group with system-wide ramifications at the international level; worries about counterparty soundness became acute; the issuance of capital instruments on the market became extremely difficult; and the deepening distrust was accompanied by a thinning out of liquidity. Banks began to accumulate or deposit with the central banks large volumes of liquidity to counter any unexpected future needs. All this prevented the interbank market from working correctly; interest rates rose and spreads vis-à-vis government securities widened; beyond the very short term, trading became thinner and thinner to the point where almost all activity was concentrated on the overnight segment.

Central banks responded to the liquidity crisis on the money markets by increasing the size and number of refinancing operations, extending their maturities, and broadening the range of securities accepted as collateral. The ECB's operational framework proved both robust and flexible, responding effectively to the challenge posed by the contraction in market liquidity; some important changes have now been made to further increase its efficacy (see Appendix 1 "Central banks' recent liquidity operations in response to the crisis").

The injection of liquidity by the central banks was crucial in preventing a complete dislocation of the money market. This may cure the symptoms, however, not the underlying cause of the seizing up of the markets, namely the collapse of confidence. Concerns about capital soundness, adequate liquidity and the remaining exposure to structured securities were and still are key factors in interbank market tensions.

Alongside the generalized tightening of conditions for access to credit, there is an increasing differentiation between banks. The market is favouring a return to the traditional model of intermediation. The investment bank model suffered a crisis and in practice came to an end in the United States with the failure of Lehman Brothers, the announced takeover of Merrill Lynch and the transformation of Morgan Stanley and Goldman Sachs into commercial banks, now under way. The banks countered the deterioration of their balance sheets by deleveraging: – both selling assets and injecting new private capital. For some months the system was able to attract large flows of capital: $430 billion, $170 billion of it in Europe, in the face of declared losses of over $550 billion, about $220 billion in Europe. These inflows slowed down in the summer because of the strong rise in raw material prices, which depressed share prices, making it difficult and costly to obtain private capital. There was also a rapid change in the profile of investors: sovereign wealth funds, which had contributed about 60 per cent of total capital invested up to December 2007, were replaced by private and institutional investors.

The severe difficulties of the interbank market drove up refinancing costs for businesses and households. Corporate bond issuance was reduced and became more costly. As worries about the impact of the crisis on the real economy heightened, in September share prices plunged across the board.

1.3 Emergency measures

Initially, urgent steps to cope with the crisis were taken essentially at the national level. This is understandable, and to some extent inevitable, because of differences in the timing and the nature of the most acute problems, the close links with national financial structures, and the need to deploy public resources controlled by the national governments.

As the crisis deepened, the need to recapitalize the banking system became more pressing, and recourse to private capital more difficult. Inevitably, government itself had to step in. With increasing frequency, first in the United States and then in Europe, financial institutions found themselves actually insolvent. In the US, measures to stabilize the situation included corporate mergers, often assisted or guaranteed by the Treasury and the Fed, the rescue of the government-sponsored enterprises Fannie Mae and Freddie Mac and of the insurance company AIG, and finally the passage by Congress of a comprehensive plan to support the financial institutions with an allocation of over $700 billion.

In Europe, measures ranged from the rescue of several banks, on occasion with the contribution of private money, in the United Kingdom, France, Belgium, Luxembourg, the Netherlands and Germany, to enhanced guarantees for bank deposits, and plans to recapitalize the banking system in several countries (see Appendix 2, “Measures to stabilize the financial system in the leading countries”).

With the failure of Lehman Brothers the crisis engulfed the whole system; growing awareness of the interaction between the various countries’ policies pointed to the need for a coordinated response. On 8 October, acting in concert, the world’s leading central banks simultaneously cut the reference rates for monetary policy, a step without precedent in the history of monetary institutions. As a follow-up to the policy line formulated at the G7 meeting, on 12 October the ECOFIN Council approved a pan-European plan of action. Accordingly, the actions taken by each member state will be based on common principles, so as to maximize their impact on the confidence of the public and the markets and minimize the distortionary effects on competition and the repercussions on other countries, ensuring the maintenance of common rules. European governments, EU institutions, supervisory authorities and central banks have agreed to take a coordinated approach to ensure that financial institutions have sufficient liquidity; to guarantee deposits; to facilitate market refinancing for the banks, among other things by providing medium-term guarantees for new bank debt issuance; to help the financial system recapitalize by contributing directly to banks’ capital; to provide adequate injections of capital to banks in difficult conditions, having management and shareholders assume their own responsibilities; and to introduce more flexible accounting methods.

The clear intention of the European authorities and the authorities of the other leading countries to respond to the global crisis in a coordinated manner is an event of greatest importance.

2. The impact on Italy

The banking system

Italian banks have faced the crisis that has increasingly overtaken the global financial system since the summer of 2007, relying on its fundamentally sound business model, on the large efficiency gains of recent years, on adequate capital and on a broad and prudent regulatory framework™ founded on legislation. So far they have managed to weather the storm better than the banks of other advanced countries.

Yet, the dramatic deepening of the crisis in recent weeks has unleashed strong tensions in our country as well.

The situation up to the failure of Lehman Brothers

Most Italian banks engage principally in traditional banking business, which has helped to contain the impact of the turmoil. Investment banking, which has been hit so severely by the crisis, is limited; compared with other countries, Italian banks have been more cautious in issuing complex and opaque instruments and investing in structured financial products, and this is reflected in a less unbalanced degree of financial leverage.

Figures for end-June of this year indicate that non-bank customers' deposits and bonds represent 56 per cent of the total funding of monetary financial institutions, against a euro-area average of 51 per cent. The important role of fund-raising from customers, despite the increase in its average cost, has ensured the stability of liabilities and enabled Italian banks to support the domestic economy throughout the past months.

Although the economic situation has deteriorated, the level of risk in bank loans to Italian firms and households is generally modest. In the twelve months to June, new bad debts represented 0.9 per cent of total lending, slightly more than at the end of 2007 but still lower than during the downturn of the early 1990s, when the ratio was around 3 per cent.

Italian households have less debt than their counterparts in the other advanced countries. In the mortgage sector, although innovation and increased competition have allowed people to obtain more funds with which to buy homes, reckless lending without proper evaluation of the borrower's ability to repay has not been practiced in Italy.

For firms, too, although the ratio of financial debt to GDP is rising, it is still below the average for the other main countries. The cost of debt service in relation to value added remains historically low.

Albeit with a lag, the economic downturn could unearth still more bad debts in the banks' balance sheets. There are early signs of this in the proportion of non-performing loans (borrowers in temporary difficulty), which rose slightly in June, to 1.6 per cent of total lending, compared with 1.5 per cent last December. For households, the rise in interest rates has gone hand in hand with an increase in the cost of debt service in recent months, to 8.2 per cent of disposable income in the twelve months to June, one point more than a year earlier.

At the end of 2007 the total capital ratio of the five largest Italian banking groups was 9.5 per cent, against a minimum requirement of 8 per cent. Their average ratio of total assets to Tier 1 capital is less than 30:1, compared with around 40:1 for the leading European groups.

Italy's rules on asset transparency and the prudential treatment of securitizations are among the most rigorous anywhere. Parliament implemented the relevant Community directives promptly, and the Bank of Italy has always interpreted them strictly, especially as regards the transfer of risk. Benefits in terms of lower capital requirements have been allowed only when there was a significant transfer of the underlying risks.

More generally, Italy has successfully avoided the "regulatory capture" for which many observers reproach the American supervisory system. Thanks to rigorous legislation and supervision, Italy does not have that vast "shadow banking system" which in other countries originated and fueled the crisis.

Liquidity

From the very outbreak of the turmoil, the essential role of liquidity in ensuring the normal conduct of banking activity in times of strain has been evident. The Bank of Italy has intervened both at system level and with respect to individual banks. Since September 2007 we have stepped up our monitoring of the liquidity of the main banking groups, with weekly checks on their short-term positions, their holdings of liquid assets and their structural situation. The intermediaries with the most severe liquidity strains have been monitored on a daily basis. We have kept close watch on the banks' organizational arrangements to safeguard against liquidity risk and on the characteristics of the eligible assets held for refinancing operations. We have alerted all the banks to the need for strict surveillance of liquidity risk, for rigorous stress testing and for keeping their emergency plans up to date. For our part, based on the accounting situation at 31 March 2008, we conducted a stress test at aggregate level. It revealed no critical situation even positing the greatest possible strains that could be assumed on the basis of past experience.

The banks understood the necessity of paying significantly more attention to this aspect. The liquidity of the largest groups increased substantially towards the end of last year and has held at that high level since; internal controls have been stepped up.

Had this not happened, the second wave of crisis, when the turmoil turned acute once again to reach unprecedented degrees of severity, could very quickly have had devastating repercussions for the Italian banking system.

The second wave

The failure of Lehman Brothers in mid-September triggered a crisis of confidence that worsened progressively, involving large European and American institutions one after another and leading to the dramatic episodes of these last few weeks.

The failure's impact on the Italian banking system has been almost exclusively indirect. It had a more direct impact on savers, to which I shall return. Special reports submitted by all Italian banks except mutual banks indicate that on 30 September the system's exposure in loans and securities and in net derivatives was equal to 0.7 per cent of the institutions' end-2007 regulatory capital. Even assuming massive losses, the impact can be absorbed.

The unusual strains that arose in world financial markets had much more serious consequences, with sharp, repeated falls in share prices, greatly heightened volatility and soaring risk premiums.

In the month of September the average daily value of credit default swap premiums for the largest Italian banking groups – an indicator of the markets' perception of their risk – was 87 basis points, significantly less than that for the main European intermediaries (141 basis points), itself lower than that for their American counterparts (286 basis points). In the second half of the month the persistent strains and aggravated uncertainty were reflected in a significant rise in CDS premiums for all banks internationally. Nevertheless, they remained lower in Italy, on average, than in the rest of Europe. On 17 September the spread for the top three Italian banking groups reached 130 basis points, reflecting a rise of more than 50 points in just five days, and then fluctuated around that level. Last week the average for these three groups was 20 basis points lower than the European index. Share prices were also powerfully affected by the adverse climate following the failure of Lehman Brothers. Italian bank shares as a group were 28.8 per cent lower on 16 October than on 12 September; over the same period European bank shares lost 30.2 per cent.

In the last few weeks the situation has worsened. The interbank market virtually ceased to function, except for overnight loans. The spreading lack of confidence generated a downward spiral in the stock markets, where share prices seemed to have lost all connection with the actual equity value of the banks, either current or future. Crises at some of the most highly exposed European institutions raised the imminent risk of contagion.

The measures taken in Italy

The aims of the emergency measures adopted in the last few days by the Government and, within the sphere of its own responsibilities, the Bank of Italy, are to reassure savers, to get the liquidity market functioning again, and to ready the instruments for recapitalizations if and as required. The newly instituted Financial Stability Committee has held a series of meetings to enable the various Italian authorities to exchange information and coordinate their actions.

Europe has produced a common response. Measures originally taken independently at national level are rapidly coming together in a coherent scheme. Also, on the initiative of the four largest EU countries, the Eurogroup has made specific recommendations and supplied uniform standards. Coordination is especially close within the Eurosystem. Consistency of actions within the euro area is essential to preserve the single money market.

In these very hours the implementing provisions of the two recently passed decree laws are being drafted. In its areas of responsibility, the Bank of Italy offers full technical cooperation to the Government.

For banks' depositors, already protected by the interbank deposit guarantee system, the further safeguard of the additional State guarantee has been provided. On several occasions the Government has confirmed its clear commitment: no depositor will lose anything.

The most urgent problem concerns liquidity and particularly the revival of the interbank market. Decree Law 157 allows the Treasury to provide guarantees of bank issues and to adopt other measures to assist the recovery of the markets. The Bank of Italy has already activated a facility that makes it easier for banks to obtain eligible securities for refinancing with the European System of Central Banks. The Eurosystem has strengthened its interventions further, supplying unlimited liquidity to the banks.

The paramount risk for transmission of the financial strains to the real economy in Europe and in Italy is now the liquidity freeze. Prompt action by the authorities on the liquidity front is essential; for this reason, the measures just adopted at national and European level are fundamental.

Despite the further decline in the stock markets and securities prices, the capitalization of the major Italian banks remains sufficient. It has been shown that the shareholders of the major banks and other investors are ready, when necessary, to invest large amounts of fresh capital; they have confidence in the solidity and the prospects of our banks.

Households and firms

The repercussions of the crisis extend well beyond the banking system. Households and firms are hit both directly, by the loss of value of their holdings of Lehman Brothers securities, and indirectly, by the prospects of a restriction of credit consequent to the financial strains of the moment.

Lehman Brothers securities owned by households

Savers' exposure to Lehman risk takes various forms: direct purchase of securities; purchase of asset management products (investment funds and individually managed portfolios) that include those securities; and purchase of insurance policies linked to the performance of financial instruments that refer to the group. According to the survey of the banking system (excluding mutual banks) that the Bank of Italy undertook in the days following the Lehman failure, at the end of September the value of Lehman securities owned by households and deposited with banks for safekeeping amounted to some €1.5 billion; counting the securities in individually managed portfolios and those held by investment funds, the total rises to about €2 billion. Added to these are other financial instruments that expose investors to the Lehman default, on which other authorities have already reported or will report to this Committee.

The protection of savers and the action of the Bank of Italy

A large-scale failure severely tests the functioning of the institutional apparatus for the protection of savers. The risk of default is inherent in bonds; no financial asset is devoid of risk. However, it is essential that the intermediaries that offer financial products to savers behave with the utmost correctness; that they clarify the nature and size of the risks to be borne; and, in case of traumatic events, that they lend all the assistance and support that the law requires and their own reputation demands.

The law divides the tasks of protection among different authorities. Within the limits of their respective roles, collaboration is close, to ensure the maximum protection of the savers affected by the recent episodes, including cooperative initiatives that may prove necessary in order to provide effective and coordinated responses.

The marketing of products having an investment function, in whatsoever form and by whatsoever party, including banks, is subject to Consob controls within the limits of the Community directives. Public offers of financial products are always subject to the requirement to publish an information prospectus. Financial products embrace not only such instruments as shares, investment fund units, bonds, derivative contracts and certificates of deposit, but also the other forms of investment of a financial nature.

To assist the settlement of possible disputes between intermediaries and customers, conciliation and arbitration procedures envisaged by Law 262/2005 on the protection of savings are being instituted at a special unit at Consob.

The Bank of Italy is responsible first of all for supervision on the sound and prudent management of intermediaries for purposes of the stability of the financial system, the first line of defence for savers, depositors in particular. It is also assigned powers of regulation and control on the transparency and correctness of activities relating to bank or postal deposits not represented by financial instruments.

These powers are not directly relevant in the Lehman case. The group did not engage in traditional banking activities with the public in Italy.

The activity of the Bank of Italy has been significantly refocused towards strengthening the protection of bank customers and sustaining confidence in the banking system. A special unit has been instituted within the supervisory area. Banks have been obligated to set up a compliance function charged with verifying strict observance of the rules, particularly customer protection rules. We have called the banks' attention to the importance of customer relations, requiring that their branches maintain adequate standards of conduct and their offices give customers the necessary attention even in disputes involving modest amounts. We have begun work on a new, robust system for out-of-court settlement, as provided by the Consolidated Law on Banking; the Interministerial Committee for Credit and Savings approved the initiative in July and we will publish a draft of the implementing provisions for consultation by the end of the year. At the beginning of 2009 we will also release a proposed reform of the rules on transparency for consultation, the aim being to make the protection of transparency simpler and more effective. We have already made our inspections for transparency and correct conduct more incisive and intensified our follow-up action on the complaints customers file with us when they believe they have received unfair treatment from banks.

The strengthening of the rules and controls achieved in the past few years, the moral suasion exerted by the authorities, the ever greater awareness of the banking and financial system itself of the crucial need for adequate consideration of the reasons of customers must permit the most correct and transparent possible management of the difficult passage of these days and months.

What will happen to the Lehman securities held by investors?

A precise estimate for investors of the recovery value of Lehman securities is premature at this stage, owing to the uncertainty surrounding the value of the assets belonging to the group. The Lehman case is especially complicated owing to the group's international ramifications. I shall leave the Committee a memorandum (Appendix 3) that reconstructs, as far as is possible today, the map of the Lehman group companies that can be linked to the issues in Italian investors' portfolio and provides some preliminary indications as to how investors can enforce their rights. The procedures and the potential size of the reimbursement differ with the legal entity that issued the securities and other conditions; they vary with the form of the investment (direct ownership of securities, individual and collective portfolio management, and insurance policies); and, since the companies concerned are not resident in Italy, they are subject to legal systems different from Italy's.

It is not possible to ask individual investors to find their own way in this maze. The intermediaries (banks, investment funds and other companies) that promoted the placement of the securities or are handling their custody must not abandon these customers. They must assist investors promptly and effectively, each for the matters falling within its scope, and be ready to take all the actions on their behalf needed to protect their rights.

Adequate assistance and clear, open and complete information are essential. They are required by legal provisions, fiduciary duties and the need to safeguard the company's good name. We have called on intermediaries to act in this way.

There is an urgent need for banks and the other intermediaries concerned to enter into a dialogue with their investors, individually or organized in associations, to agree on the most effective forms of protection. The Bank of Italy – while respecting the competences of the other authorities and complying with every relevant article of the law, especially in the field of competition – is available to foster a dialogue between financial intermediaries and savers and to keep Parliament and the Government informed on the progress of the Lehman liquidation.

3. The outlook

The short-term outlook for the growth of the world economy has deteriorated sharply; the main international organizations and private analysts have lowered their forecasts. Economic activity has weakened considerably in the United States, the United Kingdom and Japan; in the euro area the slowdown in the first half of the year has become more pronounced; according to the IMF, the growth of the world economy in 2009 will be entirely due to the emerging countries, although they will also be affected by the crisis.

Italy is no exception to this general picture. The effects of the crisis come on top of pre-existing structural weaknesses. After the fall in GDP in the second quarter, the most recent indicators confirm the negative signals for the coming quarters. Household consumption is falling, owing to the erosion of disposable income by inflation and the increase in debt service costs. Opinion surveys point to pessimism among firms and households.

According to the Eurosystem qualitative survey, banks have been reporting a progressive tightening of the conditions of the supply of credit since the second half of 2007, but until now the lending of the Italian banking system to firms and households, although decelerating, has continued to grow at quite a rapid pace. The situation may nonetheless change abruptly. The continuation of liquidity strains and the increase in the cost of fund-raising could force banks to deleverage rapidly, which could lead to a contraction in credit.

The possibility that the tightening of credit conditions for firms and households and the deterioration in the economic cycle will be mutually reinforcing in a negative spiral remains the main risk for the world economy. Action must be taken on two fronts.

In the short term there is an urgent need to restore the climate of confidence among citizens and markets. The emergency measures taken to protect depositors, normalize liquidity conditions on the markets and, where necessary, recapitalize the banking system provide the basis for effective action; attention must not be allowed to flag.

Looking ahead, new rules are necessary at the international level to put the financial services industry on a more solid basis. At the request of the G7, the Financial Stability Forum has made a start on the structural response. The new financial system will need to have more capital, less debt and more rules. The plan provides for concrete actions to strengthen intermediaries' capital bases, manage liquidity and risks, improve transparency and evaluation methods, revise the role of rating agencies, and enhance the responses of the authorities to cope with situations of financial instability.

Significant progress has already been made in implementing these reforms. The steps taken include the proposal by supervisory authorities to introduce new capital requirements for the credit exposures in the trading books of banks and investment firms, new Basel Committee guidelines for the management of liquidity risk, and important changes to the requirements applying to rating agencies to improve the quality of ratings. The leading banks have already adopted the recommendations of the Financial Stability Forum aimed at ensuring more complete information on their risk exposures and their procedures for valuing problematic securities.

Preparations will have to be made for a new international agreement on prudential rules that will revise, radically where necessary, the mechanisms of the Basel II Capital Accord. The crisis has taught us that it is essential to strengthen the prudential regulation on banks, by reinforcing their capital defences and risk management and enlarging the sphere of activities and institutions subject to supervision. Substantial corrections will also have to be made to attenuate the procyclicality of the financial system, which is a source of financial instability.

The experience of the crisis has confirmed that derivatives, and in general innovative instruments for the transfer of risk, are a double-edged sword. If used carefully and prudently, they allow operators to hedge and diversify risk and can help to reduce the fragility of the financial system; when used without adequate consideration of the risks, they permit the unchecked multiplication of financial leverage. At the same time the proliferation of complex instruments has clouded the distribution of risk for the market, regulators and operators themselves. The ease of transferring risk, high leverage and scarce transparency have had the paradoxical effect of increasing rather than reducing the concentration of risk in the world financial system.

It is necessary to intervene without delay. Transparency requires a drastic simplification and standardization of contracts; non-standard instruments are, by their nature, difficult to value. The degree of financial leverage must be limited by well-designed rules. In order to ensure appropriate incentives, at least in the case of credit derivatives, a part of the risk must be left explicitly with the originator. Lastly, when derivatives are offered to the public, the protection of the weaker contractual party must be strengthened.

The time has come for a radical rethinking of the institutional apparatus at international level. The financial system is global. The integration of international markets needs to be preserved because it has been and will remain fundamental for economic growth. It is necessary to adapt the institutions to the new context, so that the international financial arena is not a “no man’s land”, and to ensure the possibility of prompt and internationally coordinated intervention as crises emerge.

Italy’s financial market and banks are part of the world financial system, but they have shared its errors and distortions only to a marginal extent. Italy does not have a shadow banking system. The Bank of Italy has interpreted its mandate rigorously, working to ensure that the mistakes made in other systems would not occur here.

Appendices and Figures

Appendix 1. Central banks' recent liquidity operations in response to the crisis

During the last few weeks, against a background marked by a significant deterioration in the liquidity conditions of the main banking systems, a series of measures were taken by the Eurosystem, the Federal Reserve and the other leading central banks to support the liquidity of the banking system. The monetary policy operational framework has been modified in order to allow the banks to borrow at more favourable conditions from the central banks. The amounts allotted in open market operations have been increased, the penalties in accessing the standing facilities have been reduced and the range of eligible collateral has been broadened.

The most important measures adopted by the Eurosystem and the Federal Reserve are summarized below.

The measures adopted by the Eurosystem

From mid-September onwards the dysfunctions of the money market became particularly serious in the euro area. The Eurosystem injected significant amounts of liquidity both in euros and in dollars at different maturities. In the absence of trading in interbank funds, banks increased their recourse to both overnight deposits and marginal refinancing with the central bank.

Refinancing in euros. Following the significant rise in auction rates, the amounts provided in the 1-week operations were increased. Today, they are well above the need for reserve requirements, which had previously been used as a benchmark for determining the volumes to be allotted in the ECB's operations.

The size of longer-term funding has also been increased, as a result both of a new supplementary 38-day operation amounting to €120 billion and of the doubling to €50 billion of the 6-month operations.

The Eurosystem's total refinancing in euros, which until 15 September had amounted to €476 billion (of which €300 billion was longer term), rose to €739 billion (of which €447 billion with a maturity of more than 1 week).

Refinancing in dollars. European banks' growing difficulty in procuring dollars led the Eurosystem to increase the amounts and maturities of dollar refinancing. After the introduction on 11 August of 84-day operations, in addition to 28-day operations already in use for some time, on 18 September overnight interventions were introduced for amounts allotted in the euro area up to $70 billion per operation.

Owing to the persistent strains in the money market, the ECB finally announced that, within the framework of an agreement with the Federal Reserve and the central banks of the United Kingdom, Japan and Switzerland, with effect from the forthcoming auctions, the allotment would be at a predetermined fixed rate, in order to avoid excessive dispersion of the bids at auction and a consequent increase in the uncertainty involved in such operations; in addition, the full amount requested would be allotted at each auction. Lastly, one-week auctions have been held on a weekly basis since 15 October in place of the earlier overnight interventions. The allotment rates are predetermined. These interventions have been accompanied by an extension of the dollar swap line that the Federal Reserve made available to the Eurosystem.

Changes to the arrangements for the operation of monetary policy. With two measures adopted on 8 and 15 October, the ECB announced a series of important changes to the monetary policy operational framework. In particular, <u>it symmetrically narrowed the monetary policy corridor around the Eurosystem reference rate to 100 basis points</u>. Therefore, the cost of the marginal lending facility has been reduced to 4.25% and the remuneration of the overnight deposit facility raised to 3.25%. Furthermore, it has been announced that all the operations will be carried out through a fixed rate tender procedure with full allotment at the official Eurosystem rate. The following extra operations were also announced for the coming months starting in November: four 6-month operations, one 3-month operation and the renewal of a 1-month operation.

The range of collateral eligible in monetary policy operations has been broadened and now includes euro-area issues denominated in dollars, pounds sterling and yen. Bank loans granted under English law will also be accepted.

The minimum rating for collateral to be eligible in the central bank's monetary policy operations has been reduced to BBB-; this measure does not apply to asset-backed securities. Fixed-term deposits with the Eurosystem will also be eligible as collateral for refinancing operations.

One-week foreign currency swaps will be introduced for the exchange of dollars and Swiss francs for euros.

Lastly, in order to broaden participation in fine-tuning operations and thus facilitate smaller counterparties' access to liquidity, from 6 October onwards all the monetary policy operation counterparties can participate in these operations instead of a select group, as was previously the case.

These arrangements, as announced by the ECB, will remain in place for as long as necessary, and at least until 20 January 2009, the end of the first maintenance period at the turn of the year. The measures concerning collateral will remain in force for the whole of 2009.

The measures adopted by the Federal Reserve

Starting in September the Federal Reserve has made a series of changes to the monetary policy operational framework that have supplemented the measures adopted in the previous months. In particular, the innovations provide for the extension of the collateral eligible for the Primary Discount Credit Facility. This instrument, introduced in the spring of 2008, gives open market counterparties access to central bank funds on a bilateral basis at a fixed interest rate 25 basis points above the monetary policy target rate.

At the same time a programme has been activated for the auction of options whose exercise gives access to the security swap programme in operation since the early months of 2008 and known as the Term Securities Lending Facility (TSLF).[1] The aim of the options auction programme is to allow counterparties to obtain collateral in exchange for illiquid assets in periods that are typically characterized by elevated stress in financial markets, such as quarter ends.

As part of the policy of extending collateral, on 7 October the Federal Reserve announced the creation of the Commercial Paper Funding Facility (CPFF). The Facility provides for the purchase by the Federal Reserve, through a special purpose vehicle, of US commercial paper (including asset-backed commercial paper) with a high rating and up to a maximum amount for each issuer. The Federal Reserve will finance the special purpose vehicle at the Fed funds target rate to permit the purchase of the securities. The Facility will remain available for the purchase of qualifying commercial paper through 30 April 2009.

[1] The programme also includes investment grade bonds and mortgage securitizations. A similar measure was adopted in the United Kingdom by the Bank of England, again in the first half of 2008.

Appendix 2: Measures to stabilize the financial system in leading countries

THE G7

The meeting of the Ministers of Finance and Central Bank Governors of the G7 countries on 10 October 2008

On 10 October 2008 the Ministers of Finance and Governors of the G7 countries approved an Action Plan that outlines a strategy for stabilizing financial markets and restoring the flow of credit, to support global economic growth. They agreed to:

1) take decisive action and use all available tools to support systemically important financial institutions and prevent their failure;
2) take all necessary steps to unfreeze credit and money markets and ensure that banks and other financial institutions have broad access to liquidity and funding;
3) ensure that our banks and other major financial intermediaries, as needed, can raise capital from public as well as private sources, in sufficient amounts to re-establish confidence and permit them to continue lending to households and businesses;
4) ensure that our respective national deposit insurance and guarantee programs are robust and consistent so that our retail depositors will continue to have confidence in the safety of their deposits;
5) take action, where appropriate, to restart the secondary markets for mortgages and other securitized assets. Accurate valuation and transparent disclosure of assets and consistent implementation of high quality accounting standards are necessary.

The actions should be taken in ways that protect taxpayers and avoid potentially damaging effects on other countries.

UNITED STATES

A) The Emergency Economic Stabilization Act

On 3 October 2008 Congress approved the Emergency Economic Stabilization Act (EESA), developed by Treasury Secretary Henry M. Paulson Jr. in order to re-establish the liquidity and stability of the US financial system. The so-called Paulson Plan allocates $700 billion to finance the purchase by the government of illiquid securities linked to the performance of the mortgages of the financial institutions within the scope of the so-called Troubled Assets Relief Program (TARP) and includes measures to support households in financial difficulty owing to the crisis of the housing market and a provision that temporarily raises the maximum payment to depositors the Federal Deposit Insurance Corporation (FDIC) can make in the event of default from \$100,000 to \$250,000.[2]

On 14 October 2008, also in relation to the lines of action agreed within the G7, the Treasury Department, the Federal Reserve and the FDIC jointly announced a three-pronged strategy:

1) drawing on the financial endowment of the Paulson Plan, resources are being made available for up to a maximum of \$250 billion for a programme involving direct investment in the capital of a broad range of financial institutions that apply by 14 November 2008. Treasury will determine eligibility and allocations for interested parties after consultation with the appropriate federal banking agency. The funds will be used to purchase non-voting senior preferred shares; the senior preferred shares will pay a cumulative dividend rate of 5 per cent per annum for the first five years and will reset to a rate of 9 per cent per annum after year five.[3] The minimum subscription amount available to a participating institution is 1 per cent of risk-weighted assets. The maximum subscription amount is the lesser of \$25 billion or 3 per cent of risk-weighted assets. In conjunction with the purchase of senior preferred shares, Treasury will receive warrants convertible into an amount of common stock equivalent in value to 15 per cent of the senior preferred investment.[4] It has been announced that nine large financial institutions have already agreed to participate in this programme for a total investment of \$125 billion.[5] Companies participating in the programme must adopt the Treasury Department's standards for executive compensation and corporate governance;

2) the guarantee provided by the FDIC has been extended to issues of senior unsecured debt made by FDIC-insured credit institutions and bank holding companies before 30 June 2009 for the three following years;[6] in addition, deposit insurance has been extended to non-interest-bearing accounts until 31 December 2009;[7]

3) the Federal Reserve has announced its intention to make direct purchases of commercial paper from high-quality issuers (see Appendix 1).

B) The purchase of Bear Stearns by JPMorgan Chase

On 17 March 2008 the bank JPMorgan Chase, in agreement with the Federal Reserve and the Treasury Department, made an offer to buy Bear Stearns at a price of \$2 per share, for a total consideration of \$236 million. On 24 March this was raised to \$1.1 billion, corresponding to \$10 per share. The transaction was completed at this price on 30 May.

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2 The measure, set to expire on 31 December 2009, may be financed by the Treasury Department if necessary and does not entail an increase in the premiums banks are required to pay.

3 The shares will be callable at par after three years and during the first three years may be redeemed with the proceeds of a special offer of ordinary shares or perpetual preferred stock. Treasury may also transfer the shares it holds to a third party at any time.

4 The exercise price on the warrants will be the market price of the participating institution's common stock at the time of issuance, calculated on a 20-trading day trailing average.

5 Bank of America, Wells Fargo, Citigroup, JPMorgan Chase, Goldman Sachs, Merrill Lynch, Morgan Stanley, Bank of New York Mellon and State Street.

6 The guaranteed debt may not exceed 125% of the debt outstanding on 30 September 2008 and maturing before 30 June 2009.

7 After a grace period of 30 days, the fee for guaranteeing new issues will be equal to the amount of debt issued multiplied by 75 basis points; for the protection granted to non-interest-bearing deposits in excess of \$250,000 a surcharge of 10 basis points will be applied to the insurance premium paid by the bank on such deposits.

In addition to the financing disbursed via the Discount Window, the Federal Reserve granted JPMorgan Chase a non-recourse loan of $29 billion guaranteed by $30 billion of mortgage-backed securities and other complex financial instruments. Under the agreement, JPMorgan Chase will cover any losses up to $1 billion.

C) The transactions involving the Government Sponsored Enterprises (GSEs) Fannie Mae and Freddie Mac

The plan for the GSEs announced by Treasury Secretary Paulson on 7 September 2008 is intended to guarantee the liquidity of the mortgage market and is divided into the series of measures described below:

- **Conservatorship of the GSEs:** the GSEs have been placed in conservatorship by the Federal Housing Finance Agency. Under the procedure, the powers of shareholders have been suspended and will be exercised by the conservator.
- **Preferred Stock Purchase Agreement**: The Treasury has concluded an agreement with the GSEs guaranteeing that they will maintain net positive equity value, appropriating $100 billion for each GSE to be used for its recapitalization if its net worth goes negative. In exchange, the Treasury acquires $1 billion worth of senior preferred stock with an annual dividend of 10 per cent and warrants to purchase 79.9 per cent of the GSEs' equity.
- **GSE Credit Facility**: The Treasury has granted the GSEs and the Federal Home Loan Bank system short-term lines of credit (at most one month) guaranteed by their own issues of mortgage-backed securities. The interest rate stipulated is Libor plus 50 basis points. The facility is scheduled to expire on 31 December 2009.
- **GSE Mortgage-Backed Securities Purchase Program**: To stabilize the mortgage market, the Treasury has announced a plan to buy up the GSEs' mortgage-backed securities on the market. The volume of the purchases is not specified; it will depend on conditions in the financial and real estate markets. The program is scheduled to terminate on 31 December 2009.

D) The banks' private fund for the orderly resolution of derivatives exposures between Lehman Brothers and counterparties

On 14 September 2008, when the difficulties of Lehman Brothers were made public, ten leading banks (Bank of America, Barclays, Citibank, Crédit Suisse, Deutsche Bank, Goldman Sachs, JPMorgan, Merrill Lunch, Morgan Stanley and UBS) formed a private fund to increase the liquidity, attenuate the volatility and help overcome the difficulties of the international financial markets. On this occasion they pledged to work together to facilitate the orderly unwinding of derivatives exposures between Lehman Brothers and its counterparties.

The ten banks agreed to:

- maximize market liquidity through a reciprocal commitment to continue trading;
- create a collateralized line of credit into which each would pay $7 billion, for a total of $70 billion, on which the banks themselves could draw for liquidity up to one third of the total amount. The fund could increase later as the number of participating banks rises.

E) Acquisition of Merrill Lynch by Bank of America

On 14 September Bank of America (Bofa) agreed to acquire Merrill Lynch for $50 billion with a share swap (0.8595 Bofa shares for each Merrill Lynch share) at $29.00 per Merrill share. The agreement provides that three of Merrill Lynch's directors will join the Board of Bank of America. The transaction should be completed in the first quarter of 2009.

F) American International Group (AIG)

On 16 September the Federal Reserve announced that it had authorized a loan of $85 billion to the AIG insurance group in order to enable the latter to make orderly disposals of a series of assets. The loan was later increased to $122.8 billion.

The loan is for two years at a rate equal to Libor plus 850 basis points. As collateral, the Federal Reserve has received all the assets of AIG and its main subsidiaries. The US government receives an equity stake of nearly 80 per cent in AIG and is given the possibility, among other things, of blocking dividend payments.

G) Guaranty Program for Money Market Funds

On 19 September the Treasury announced a specific measure to guarantee money market funds.[8] The guaranty program was decided on for fear that a decline in the value of the funds' units could trigger massive redemptions by investors, with an adverse impact on money market liquidity.

Under the measure, retail and institutional subscribers to the funds will be guaranteed by a federal fund in the event that their net asset value falls below par ("standard $1 net asset value").

The program has a duration of one year and guarantees investments made before 19 September 2008. It is financed by using $50 billion of assets of the Exchange Stabilization Fund.[9]

In connection with the Treasury's guaranty program to ease liquidity strains in the money market, the Federal Reserve introduced a special lending facility (terminating 30 January 2009) to facilitate banks' purchase, at amortized cost, of high-quality asset-backed commercial paper held by money market funds. The banks will use such ABCP as collateral for loans from the Federal Reserve.

To facilitate the banks' purchases of ABCP, the Federal Reserve has temporarily relaxed its prudential rules, so that the paper purchased under the program will be zero-weighted and will not count towards average consolidated total assets (the denominator of the leverage ratio); it has also removed the restrictions on banks' purchases of ABCP from related parties.

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8 Money market funds are funds that make short-term investments in government paper, certificates of deposit, asset-backed commercial paper and other liquid instruments. Such funds have about $3.5 trillion of assets under management.

9 Created under the Gold Reserve Act of 1934, this Fund empowers the Secretary of State to carry out transactions in gold, currencies and financial instruments in order to promote international financial stability.

H) Acquisition of Washington Mutual by JPMorgan Chase

On 25 September the Washington Mutual mortgage bank was placed in receivership in the wake of some $19 billion in mortgage loan losses. The FDIC, named as receiver, reached an agreement with JPMorgan Chase under which the latter would acquire Washington Mutual for $1.9 billion, taking over its deposits, its banking operations and part of its liabilities. The agreement did not involve the claims of shareholders, bondholders or other holders of unsecured senior debt, which remained with the holding company Washington Mutual, Inc.; on 26 September the latter asked the Delaware court for Chapter 11 bankruptcy protection.

I) Acquisition of Wachovia by Wells Fargo

On 29 September 2008 Wachovia Bank, with the support of the FDIC and the involvement of the Federal Reserve and the Treasury, began talks with a view to its takeover by Citigroup, which offered $2.2 billion. Citigroup was to assume Wachovia's $42 billion of losses on $312 billion of loan assets, and the FDIC was to cover the residual loan losses. To compensate the FDIC for the risk, Citigroup was to give it $12 billion in preferred shares and warrants.

However, Wells Fargo then submitted a better offer ($15 billion), not entailing the dismantling of Wachovia's operations and not requiring FDIC intervention. On 3 October the agreement for sale to Wells Fargo was reached, and on 12 October the Federal Reserve approved it.

EUROPE

A) Ecofin Council of 7 October

At its meeting of 7 October the EU Ecofin Council agreed on a strategy for responding promptly to the financial crisis, so as to restore confidence and the proper functioning of the financial sector, by adopting the following lines of action:

– take all measures necessary to reinforce the soundness and stability of the European banking system and to protect depositors;

– coordinate measures and consider the potential cross-border effects of national decisions;

– adopt measures for the recapitalization of vulnerable, systemically relevant financial institutions, based on common principles;

– urge the institutions responsible for accounting rules (the Commission and the IASB) to take the measures necessary to prevent distortions due to the application of different accounting standards by European and American banks, in particular as regards flexibility in applying mark-to-market valuations and in reclassifying assets before the end of October, so as to permit their application to the accounts for the third quarter;

– commitment by the Commission to act quickly and apply flexibility in decisions on the compliance of national recapitalization measures and government guarantees with the state-aid regime.

- raise the minimum level of coverage of deposit guarantee schemes from the current €20,000 to at least €50,000. Many Member States have raised it to €100,000. The Commission pledged to draft a proposal to foster convergence among national deposit protection schemes; the proposal was presented on 15 October.

B) Declaration of the euro-area summit, 12 October

The Heads of State and Government of the euro-area countries met on 12 October and agreed on a concerted action plan with the following objectives:

- ensuring appropriate liquidity conditions for financial institutions. To this end, they welcomed the intention of the ECB and the Eurosystem to react flexibly to the current market environment and to consider ways to improve its collateral framework further with regard to the eligibility of commercial paper;
- facilitating the funding of banks, which is currently constrained. To this end, governments would make available for an interim period and on appropriate commercial terms, directly or indirectly, a public guarantee, insurance, or other similar arrangements of new medium-term bank senior debt issuance (up to 5 years). The guarantee scheme must be limited in amount, be applicable only up to 31 December 2008, and be designed to avoid competitive distortions at the expense of non-beneficiaries of the arrangements;
- providing financial institutions with additional capital resources so as to continue to ensure the proper financing of the economy. To this end, each Member State will make Tier 1 capital available to financial institutions, e.g. by acquiring preferred shares or other instruments including non-dilutive ones, while using all available means to foster the raising of private capital;
- permitting an efficient recapitalization of distressed banks. In this regard, Governments remain committed to support the financial system and therefore to avoid the failure of important financial institutions, through appropriate means including recapitalization. Emergency recapitalization measures must be accompanied by adequate restructuring and by appropriate terms taking into account the interest of taxpayers and ensuring that existing shareholders and managers bear the due consequences of the intervention;
- ensuring sufficient flexibility in the implementation of accounting rules given the current exceptional market circumstances. Financial and non-financial institutions should be allowed to value their assets consistently with risk-of-default assumptions rather than immediate market value, which, in illiquid markets, may no longer be appropriate;
- enhancing cooperation procedures among European countries. The summit accordingly called for the setting up and strengthening of procedures allowing the exchange of information between governments, the President of the European Council, the President of the European Commission, the President of the European Central Bank and the President of the Eurogroup and recommended that the upcoming European Council create a mechanism to improve crisis management between European countries.

C) Conclusions of the European Council, 15-16 October

The European Council, meeting on 15 and 16 October, produced a statement of joint commitment to coordinated and thorough action to restore the smooth running of the financial system, ensure the normal and effective financing of the economy and protect depositors.

The Council welcomed the concerted action plan of the euro-area countries and endorsed its principles; it also welcomed measures by Member States under those principles and in conformity with the Treaty, so as to avoid distortions of competition affecting other countries. It called on the Commission to continue applying European rules on competition in a way that served the need for speedy and flexible action.

It was decided to establish an informal warning, information-exchange and evaluation mechanism (the financial crisis cell). The mechanism will bring together representatives of the Presidency-in-office, the President of the Commission, the President of the ECB (in conjunction with the other European central banks), the President of the Eurogroup and the governments of the Member States. It may be activated at the request of a Member State faced with a crisis and will help ensure smooth coordination of actions taken or to be taken.

The Council further welcomed the setting-up of a high-level group by the Commission to improve the coordination of supervision at European level and invited national supervisors to meet at least once a month to exchange information.

Finally, the Council supported the speeding-up of work to strengthen the rules on stability, including work on the Capital Requirements Directive, on reform of the rules on rating agencies and on deposit protection schemes. It welcomed the decisions taken concerning the accounting standards applicable to financial institutions and their interpretation. It called for more general consideration, in consultation with the international partners, of the effects, including pro-cyclical effects, that fair value and mark-to-market accounting would have on financial institutions and on the market. It concluded with a firm call for accountability on the part of all those involved in the financial system, particularly the banking sector, emphasizing that the real performance of company executives should be reflected in their remuneration and that care should be taken to ensure that the system of remuneration does not lead to excessive risk-taking or extreme concentration on short-term objectives. Member States were asked to put these principles into practice, and the Council was called on to report back on the decisions taken by the end of the year.

UNITED KINGDOM

A) The Bank of England’s Special Liquidity Scheme

In order to increase market liquidity, on 21 April 2008 the Bank of England introduced a Special Liquidity Scheme to enable banks and building societies to swap temporarily “sufficiently high-quality mortgage-backed assets” and other securities for special issues of UK Treasury bills for a fee equal to the spread between 3-month Libor and the interest rate on 3-month government securities.

The window for participating in the Scheme, which was to operate initially for a period of six months (from 21 April 2008 to 21 October 2008), was extended on 17 September 2008 until 30 January 2009 to enable banks to plan their participation in an orderly manner.

All of the banks and building societies that are eligible to sign up for the Bank of England’s standing deposit and lending facilities can take part in the Scheme.

The assets that can be used in the swaps are securities rated AAA issued by US and European residential mortgage providers and securities backed by credit-card debt. Raw mortgages are not accepted, nor are those with derivative products as underlying assets and those secured on properties not located in the UK or other EEA countries. The Bank of England can at any time exclude securities previously deemed eligible.

The asset swaps will be for sufficiently long terms (at least one year, renewable for a total of up to three years). The Scheme should therefore close by October 2011 with the return of all Treasury bills to the Bank of England and the return of all assets to the banks.

To prevent banks from using the liquidity obtained through the Scheme to undertake new lending, only assets existing before 31 December 2007 are eligible. Moreover, the risk of any losses on the assets swapped remains with the banks.

The Scheme is indemnified by the Treasury; however, to avoid the risk of potential losses being transferred to the public sector, the banks must provide as security assets worth significantly more than the Treasury bills they receive. If the value of such assets falls, the banks must provide more, or return some of their Treasury bills. If the assets are down-rated, the banks must replace them with higher rated assets.

The initial amount of the Scheme was around £50 billion (approximately €63 billion), later raised to £200 billion (see below).

B) The takeover of Bradford & Bingley plc by Abbey National plc

On 29 September 2008 the British Treasury announced that following a competitive auction conducted on its behalf by Morgan Stanley, Bradford & Bingley's retail deposit business and branch network had been transferred to Abbey National plc (a member of the Santander group); the remaining assets were to be nationalized, with control transferred to the Treasury.

The transfer of the retail deposits, designed to ensure continuity of service to customers, was backed by cash from the Treasury and the Financial Services Compensation Scheme, which will receive the proceeds from the sale of the nationalized assets. These include B&B's wholesale liabilities, to be secured by a renewable six-month guarantee which the government has put in place in order to preserve financial stability.

The FSCS has paid out £14 billion to enable the retail deposits covered by the guarantee to be transferred to Abbey and the Treasury has made a payment of £4 billion to Abbey for the transfer of retail deposits not covered. The FSCS has financed its payout through a short-term loan from the Bank of England, which will be replaced with a loan from the Government after a short period of time. Interest on the loan for the first three years will be paid annually from September 2009 at a rate of Libor plus 30 basis points.

C) Acquisition of Halifax Bank of Scotland (HBOS) by Lloyds TSB

On 18 September 2008 Lloyds TSB announced its takeover of HBOS, the UK's largest mortgage lender, for £12.2 billion. HBOS ran into difficulties as a result of its over-exposure in the mortgage market, its heavy reliance on the interbank market, which provided about half of its funding, and the loss of confidence that had overtaken the market. Together, the two banks will hold 28 per cent of the UK mortgage market.

D) Financial support to the banking system

On 8 October 2008 the British Government, after consultation with the Bank of England and the Financial Services Authority, announced it would take the following measures:

1. provide sufficient liquidity in the short term;
2. make available new capital to UK banks and building societies to permit them to restructure their finances;
3. ensure that the banking system has the funds necessary for medium-term lending.

1. Liquidity support

The Bank of England can take all actions necessary to increase financial stability and stimulate the flow of funds and liquidity to the markets, extending and widening its facilities. In particular, the Bank has broadened the range of securities eligible for use as collateral in liquidity auctions; it will continue to conduct weekly sterling long-term open market repos (OMOs) and one-week US dollar repo operations until the financial situation stabilizes. The Bank will review the size and frequency of open market operations as necessary.

The sum made available under the Special Liquidity Scheme (see above) has been raised from an initial £50 billion to £200 billion and a wide range of securities are eligible for use as collateral in the asset swaps.

Finally, the Bank will put in place a permanent regime to underpin banking system liquidity, including the introduction of a Discount Window facility. On 16 October 2008 consultations began on a proposed reform involving the introduction of new Operational Standing Lending and Deposit Facilities, the Discount Window Facility and open market operations against extended collateral.

2. Recapitalization

The second measure consists in making capital available to eligible institutions, i.e. UK incorporated banks, including UK subsidiaries of foreign institutions, which have a substantial business in the UK, and building societies. The Government will examine applications for recapitalization from other UK incorporated banks.

The eight institutions that have confirmed their participation in the recapitalization scheme are Abbey, Barclays, HBOS, HSBC Bank, Lloyds TSB, Nationwide Building Society, Royal Bank of Scotland and Standard Chartered. They have undertaken to increase their total Tier 1 capital by £25 billion by the end of the current year. The Government has declared it will subscribe for preference shares and PIBS[10] up to that amount issued by the intermediaries concerned. In addition to this, £25 billion of further support will be available for all eligible institutions. The Government is also willing to guarantee the raising of ordinary equity.

The Government's recapitalization of the banking system will be subject to specific agreements with the institutions concerned regarding dividend policies and executive compensation practices and will require a full commitment to support lending to small businesses and home buyers.

On 13 October 2008 the Government announced it would inject a total of £37 billion into RBS and the merged HBOS and Lloyds TSB. This measure will raise the banks' Tier 1 capital to over 9 per cent.

[10] PIBS (permanent interest bearing shares) are issued by building societies.

3. Guarantee of new short and medium-term debt issuance

The Government's third measure is to make available for an interim period a guarantee of new short and medium-term debt issuance to the order of £250 billion, which will be kept under review. The intention is to assist in refinancing maturing liabilities, reduce dependency on overnight borrowing and restore market confidence.

The measure envisages the issue of senior unsecured debt instruments for terms of up to 36 months in sterling, US dollars or euros. These instruments will be eligible for use as collateral in operations with the Bank of England.

To qualify for this support, the institutions must raise Tier 1 capital by the amount and in the form the Government considers appropriate. It is being made available immediately to the banks participating in the recapitalization scheme in recognition of their commitment to strengthen their capital position.

The participating institutions will be charged a fee for the guarantee,[11] which will reduce the cost to taxpayers; the latter may receive dividends on the equity securities acquired by the Government.

IRELAND

On 30 September 2008 the Irish Government announced it would apply, with immediate effect, a guarantee on all deposits, including institutional and interbank deposits, covered bonds and certain subordinate debt, of six Irish banks.[12]

Banks that make use of the deposit guarantee scheme will pay a fee and be subject to specific terms and conditions in order to safeguard taxpayers. The guarantee will have a duration of two years.

Following the Government's announcement the Credit Institutions Financial Support Bill was presented to Parliament on 1 October 2008.

Under the provisions of the Bill the Finance Minister may provide financial support in the form of loans, guarantees, asset swaps and any other measure in favour of any credit institution or subsidiary which the Minister may identify by order. The guarantee also covers liabilities and obligations to the central bank.

Financial support will be on such terms and conditions as are deemed suitable, which may include stipulations to fulfil all requirements of the central bank or supervisory authority, as well as conditions to regulate the competitive behaviour of the credit institution. The Government may subscribe for or purchase shares and other securities issued by a credit institution receiving support; for this purpose it may issue securities with terms and conditions which are deemed suitable (such as interest rate, repayment and cancellation).

[11] The fee charged will be based on a per annum rate of 50 basis points plus 100 per cent of the institutions' median CDS spread during the 12 months to 7 October 2008.

[12] The banks are Allied Irish Bank, Bank of Ireland, Anglo Irish Bank, Irish Life and Permanent, Irish Nationwide Building Society and Educational Building Society and their subsidiaries to be identified in agreement with the central bank and the supervisory authority.

Financial support provided by the Government will be repayable by the bank concerned once it is able to do so. Provision is made for annual reports to Parliament regarding any financial support provided.

Finally, if a merger or acquisition involving credit institutions is deemed necessary to maintain the stability of the financial system, antitrust powers will be transferred from the Competition Authority to the Finance Ministry.

On 9 October 2008 the Irish Government announced that the guarantee would be extended to subsidiaries of foreign banks with a significant presence in the country.[13]

BENELUX

A) Financial support of Fortis

On 28 September 2008 the Governments of Belgium, the Netherlands and Luxembourg agreed on a support package for Fortis, one of the twenty leading European financial institutions. The three countries jointly invested €11.2 billion in the group, of which Belgium contributed €4.7 billion (for a 49 per cent share in the parent company Fortis Banque Belgium), the Netherlands €4 billion (49 per cent of Fortis Banque Nederlands) and Luxembourg €2.5 billion (49 per cent of Fortis Banque Luxembourg).

Provision was made for the sale of the interests in RFS Holdings, the company that acquired ABN Amro.

On 3 October 2008 the Dutch Government, working closely with the central bank, bought out Fortis Banque Nederlands, Fortis Insurance Nederlands NV and Fortis Corporate Insurance NV for a total of €16.8 billion. It also acquired Fortis's participation in ABN Amro Holding. The transaction replaced the agreement of 28 September and was conducted in agreement with the Governments of Belgium and Luxembourg, the supervisory authorities and Fortis.

On 5 October 2008 an agreement was announced to the effect that:

- the Belgian Government would acquire the remaining shares in Fortis Banque Belgium from the Fortis Group for €4.7 billion, giving it a 99.93 per cent holding;
- the Belgian Government would then transfer 75 per cent of its holding in Fortis Banque Belgium to BNP Paribas in exchange for €8.25 billion of newly issued shares;
- a portfolio of Fortis Banque Belgium's structured assets to the value of €10.4 billion would be transferred to a new financial institution of which the Belgian Government would own 24 per cent, BNP Paribas 10 per cent and the Fortis Group 66 per cent;
- BNP Paribas would acquire Fortis's Belgian insurance business (Fortis Insurance Belgium) and 67 per cent of Fortis Banque Luxembourg; the Luxembourg Government would acquire the remaining 33 per cent.

[13] Ulster Bank, First Active, Halifax Bank of Scotland, IIB Bank and Postbank have already been authorized.

B) Financial support of Dexia

On 29 September 2008 the Governments of France, Belgium and Luxembourg decided to support Dexia, which provides financial services to the public sector. The package involved a total investment of €6.4 billion, €3 billion of which came from the Belgian Government and Belgian shareholders,[14] €3 billion was provided by the French Government and the Caisse des Dépôts et Consignations (CDC),[15] and the Luxembourg Government contributed €376 million. As a result the French Government and CDC have a stake of more than 25 per cent in Dexia, which represents a minority interest under Belgian law.

On 9 October 2008 the Governments of France, Belgium and Luxembourg undertook jointly to guarantee until 31 October 2009 all of Dexia's new interbank lending and bond issues with a maturity of up to three years destined for institutional investors. The guarantee is renewable for a further one year period and will be subject to payment of a fee reflecting the advantage obtained by Dexia.

C) Belgian legislation

On 9 October 2008 the Belgian Government announced it would present a Bill containing measures to ensure the stability of the country's financial system. It was approved by the Belgian Parliament on 15 October.

The Decree authorizes the Belgian Finance Minister to grant a state guarantee to cover liabilities entered into by credit institutions and/or financial holding companies incorporated under Belgian law vis-à-vis other credit institutions (and/or professional counterparts belonging to categories identified by the Minister) between 9 October 2008 and 31 October 2009, provided that such liabilities mature by 31 October 2011. The guarantee will be granted on condition that it is justified in the interest of the Belgian economy and of all depositors and that the beneficiary institutions commit themselves to take measures aimed at supporting their financial situation, solvency and liquidity. The Finance Minister is empowered to lay down further conditions for granting the guarantee. Beneficiaries are only entitled to invoke the guarantee if they prove that it is not possible for them to meet the liabilities covered at their maturity. The Finance Minister is entitled to terminate the guarantee at any time if the conditions for granting it are no longer met.

D) Dutch legislation

The measures taken by the Dutch Government on 9 October 2008 are aimed at providing liquidity and reinforcing the capital of Dutch banks; they also apply to the subsidiaries in the Netherlands of foreign institutions.

The Dutch Government will grant special credit to financial institutions against adequate collateral to ensure short-term financing needs are met.

The Government has also undertaken, for a year from 10 October 2008, to make capital available to financial enterprises that are fundamentally sound in order for them to maintain their own funds at the levels deemed

[14] The Federal Government will contribute €1 billion, Flanders €500 million, Walloon €350 million and the Brussels regional government €150 million. Of the shareholders, Gemeentelijke Holding NV has invested €500 million, Arcofin CV €350 million and Ethias €150 million.

[15] CDC, Dexia's third largest shareholder, already owned 11.7 per cent of the bank's capital.

necessary by the supervisory authorities. The Government's contribution can take various forms, such as participation via preferential shares. The measures will be subject to conditions in order to limit market distortions and the financial risks for the Government. The fund was not set up with a specified amount in advance, although €20 billion is available immediately. The Government's contributions will be provided on market terms.

On 19 October 2008 the Dutch Government announced that an agreement had been reached with the ING Group concerning measures to strengthen its capital with an injection of €10 billion from the bank recapitalization fund created on 9 October. As a result of the deal the Government will take securities with characteristics similar to those of shares;[16] they will count towards Tier 1 capital and will pay out 8.5 per cent, or more if the dividend for the year exceeds that rate, as an incentive for ING to buy back its shares. There will be no dilution of existing share capital. Under the agreement the Government will appoint two members of the ING Group's supervisory board, with power to veto any decisions concerning acquisitions and investments with a value exceeding 25 per cent of share capital, equity issuance or buy-back, and proposals to change remuneration policy.

FRANCE

On 12 October 2008 the French Government presented a plan to restore trust in the banking system and ensure that the banks would continue to provide financing of the economy. The plan is consistent with the measures agreed at European level and has two main objectives: to ensure the funding of the French banks' medium-long term debt and recapitalize the banks themselves.

To this end, the French Government will provide a guarantee, at market rates, of a maximum amount of €360 billion. The guarantee will cover new loans issued by a fund to refinance banks and by a public company for investment in financial institutions; it will also cover loans from companies in the Dexia group (in agreement with the Belgian and Luxembourg governments). The beneficiaries of these measures must undertake to finance the real economy and respect a code of ethics based on safeguarding the general interest.

In particular, the fund for refinancing financial institutions, closely monitored by the Government and the Banque de France, will obtain resources on the capital markets and will be supported by an explicit state guarantee provided at market rates. The financial institutions operating in France will borrow the resources they need through this fund, against collateral in the form of lending to the economy. The guarantee will remain in force until 31 December 2009.

As regards recapitalizing the banks, the French measures enable a state-owned company to subscribe for issues by French banks of subordinated debt and preference shares. The government will set the conditions for banks to benefit from these measures, which are in addition to the Government's commitment to subscribe for new share issues by institutions in difficulty.

[16] The price of the securities will be calculated on the basis of the price of ING's shares at closing on 16.10.2008. Prices on 17.10.2008 were not used as they were exceptionally volatile on that date.

GERMANY

A) Hypo Real Estate

On 29 September 2008 the Government and a pool of German banks granted a short and medium-term credit line of €35 billion, later raised to €50 billion, to the Hypo Real Estate group, the second largest German financial operator in the commercial construction sector.[17]

Initially the credit line was to provide two instalments of funds, of €15 billion and €20 billion respectively. Further liquidity of €15 billion was then agreed in the following days.

B) Stabilizing the financial markets

The package of measures proposed by the Federal Government on 13 October 2008 to stabilize the financial markets and safeguard the real economy was in line with the framework agreed by the Heads of State and Government of the G8 countries on 4 October, and took into consideration the decisions of the Ecofin Council of 7 October, those of the finance ministers and central bank governors at the G7 meeting of 10 October, and those of the summit of Heads of State and Government of the Eurogroup countries of 12 October. The Bundesbank, BaFin and the German financial industry were also consulted.

The Federal Government has established a special fund to stabilize the financial markets, available until 31 December 2009. The fund will be financed by issuing debt securities up to a maximum of €100 billion and used by the Government to ensure German financial institutions can meet their funding needs by issuing new financial instruments with 36-month maturities. The fund will provide guarantees up to €400 billion in exchange for a fee. In this framework, the Government has stressed that the current regulation of *Pfandbriefe* already provides adequate assurances of the soundness of these securities; however, should the *Pfandbriefe* market so require, the Government will adopt short-term measures to guarantee them.

The fund is also authorized to recapitalize financial institutions by means of various types of instruments; however, the fund’s provision of a maximum €80 billion is limited by certain conditions so as to ensure fair competition between the financial institutions and to safeguard taxpayers’ interests and ensure managers’ accountability.

German subsidiaries of foreign financial institutions will have access to the fund as long as they are solvent. Furthermore, in exceptional circumstances the fund may bail out a bank of systemic importance if it is in difficulty, as long as the rescue is linked to a clear prospect of restructuring.

Where necessary, the fund may purchase distressed assets or guarantee them until their expiry.

Lastly, the Government announced that the Bundesbank would shortly ensure the liquidity of money market funds by granting liquidity temporarily in exchange for adequate guarantees. It further announced a proposal to amend the laws on the supervision of the financial markets in order to improve the ability of the authorities to

[17] The Group has total assets of €395 billion, 1,900 employees and offices in Europe, America and Asia. The Group also includes Hypo Real Estate Bank International AG and Hypo Real Estate Bank AG, which operate in the real-estate sector, and DEPFA and DEPFA Deutsche Pfandbriefbank AG, which specialize in state sector funding.

intervene in a crisis. The Government will also present proposals to foster cooperation between the Bundesbank and BaFin and to improve supervision at both the European and the international levels.

AUSTRIA

On 13 October 2008, the Austrian authorities announced a series of measures to protect savers and stabilize the financial markets. The measures, contained in a bill presented to Parliament on 20 October, aim to provide the necessary liquidity for the financial system, strengthen financial institutions in difficulty and safeguard deposits, in line with the decisions taken by the summit of the Eurogroup countries, for a total amount not exceeding €100 billion; they also impose a ban on the short selling of securities for speculative purposes.

In order to ensure the liquidity of the financial system and to strengthen the interbank market, the banks will establish an ad hoc clearing house to disburse funds, up to a maximum of €85 billion, to banks in need of liquidity in exchange for appropriate guarantees. The Federal Government may guarantee loans provided by the clearing house to enable it to issue securities and create liquidity.

The Ministry of Finance will guarantee the liabilities of financial institutions in difficulty, provide loans and acquire equity both by subscribing for increases in capital and by other interventions on capital which could also affect the ownership structure of the institution concerned. Equity acquired in this way by the Federal Government will be sold to the public once the proposed objectives have been achieved and normal capital market conditions restored.

The deposits of individuals will be guaranteed in full, as of 1 October 2008.

The Austrian Financial Markets Authority has been authorized to prohibit large-scale short-selling operations and to sanction any violations in order to limit the potentially adverse effects of such operations on the stock exchange and companies.

SPAIN

On 7 October 2008 the Spanish Government announced the adoption of the following measures: 1) the creation of a Treasury fund with an initial endowment of €30 billion, extendable to €50 billion; 2) the strengthening of the Spanish guarantee scheme for deposits, by raising the minimum level of cover from €20,000 to €100,000.

The fund will buy high quality Spanish assets from financial institutions operating in Spain, on a voluntary basis and at prices that reflect the level of underlying risk, to ensure that households and businesses may continue to be funded by these institutions.

This is a temporary fund which will only last until normal market conditions return. The fund will operate in line with community regulations on state aid and competition so that all financial institutions doing business in Spain will be able to make use of it.

On 13 October 2008 the Spanish Government approved the decree law giving effect to the guidelines laid down in the Declaration of the Paris Summit of the heads of government of the Eurogroup countries. The decree establishes a guarantee for new issues of senior debt securities by credit institutions, with an initial ceiling of

€100 billion for 2008. The guarantee covers commercial paper and senior bonds with maturities up to five years and may be extended to interbank deposits, but only in the framework of a coordinated initiative at the euro-area level. The guarantees will be available until 31 December 2009 for all credit institutions operating in Spain, including subsidiaries of foreign companies with a sufficient level of lending operations in the country, at a cost in proportion to the risk borne by the Government and determined by market criteria. The requirements for obtaining the guarantee will be established by the Ministry for the Economy and Finance and could include, on the proposal of the Bank of Spain, special conditions regarding solvency.

The decree also authorizes the Ministry for the Economy and Finance to buy ordinary shares, preference shares or participation rights issued by credit institutions.

PORTUGAL

In the context of the initiatives adopted at European level, on 12 October 2008 the Government approved a plan to strengthen financial stability so as to ensure the regular financing of economic activity.

The plan provides for a state guarantee of up to €20 billion for credit institutions having their registered office in Portugal. The decision to grant the guarantee will be made by the Ministry for Finance, in cooperation with the central bank, having regard to the riskiness of the applicant bank, which will be required to pay a proportional fee and provide collateral of good quality. The state may revise the terms of the fee during the guarantee's period of validity if market conditions change significantly. The beneficiaries will be monitored by the state and by the central bank.

The plan will be financed through a fund, with resources raised through the issue of public debt securities, set up by the Government to cover the risk on guarantees granted and finance other possible measures to improve the financial soundness of credit institutions.

The measures introduced are temporary and will remain in force until normal market conditions are restored; they apply only to guarantees granted by 31 December 2009.

In addition to the above-mentioned measures, the Government has also approved a series of rules aimed at strengthening the disclosure requirements applicable to market intermediaries vis-à-vis their clients and the supervisory authorities. Moreover, the insurance cover provided by the Bank Deposit Guarantee Fund and the Mutual Agricultural Credit Guarantee Fund has been raised from €25,000 to €100,000.

GREECE

On 15 October 2008 the Greek government adopted a plan to limit the impact of the crisis and ensure the efficient functioning of the financial system, in conformity with the decisions of the Ecofin meeting of 7 October. The measures, which are temporary, are designed to:

1) assist the restoration of normal liquidity conditions in the markets through i) the provision of a public guarantee up to €15 billion on bank liabilities with up to 5 years' maturity issued or refinanced before the end of 2009, and ii) the issue of up to €8 billion of special Treasury bills that can be exchanged for other

instruments which may be used as good-quality collateral by Greek banks of systemic relevance, upon payment of fees ranging from 50 to 100 basis points per year depending on the maturity;

2) strengthen the capitalization of banks by allocating €5 billion for state purchases of preference shares to reinforce the Tier 1 capital of applicant banks. The shares will come with a repurchase option that can be exercised after a period of not less than five years. Where the Government provides a guarantee or buys preference shares, its representatives will sit on the boards of the interested banks, with decision-making powers concerning the compensation of top management.

In addition, the Government has increased the deposit guarantee cover from €20,000 to €100,000. This measure will remain in force until 31 December 2011.

DENMARK

A) Intervention regarding Roskilde Bank

On 11 July 2008 the Danish authorities (Ministry for the Economy, Financial Supervisory Authority and the central bank) promoted and coordinated, in concert with the Danish Banking Association, a public intervention in support of Roskilde Bank. The central bank granted Roskilde a liquidity line, backed by a guarantee against potential losses provided by a private organization (Det Private Beredskab) established ad hoc by the Danish Banking Association for DKK 750 million (about €100 million) and by the state for the remainder. The state guarantee, subsequently approved by Parliament, is effective from 11 July 2008.

B) Stabilization of the financial markets

On 5 October 2008 a Political Agreement on Financial Stability was adopted, establishing a mixed scheme, financed by both the public sector and the private sector, to cover the losses of all the depositors and creditors of banks declared insolvent.

In particular, a winding-up company was created to resolve the crises of insolvent banks and cover the losses of all creditors, even those not protected by the private deposit guarantee scheme. The banks will provide a guarantee covering the winding-up company's losses up to DKK 35 billion in two years (2 per cent of GDP) and the state will cover any losses above that amount. Measures are envisaged to avoid competitive distortions. The scheme is accompanied by a ban on dividend distributions, share buybacks and new stock option plans by participating banks.

ICELAND

In connection with the crisis of the country's financial system, on 6 October the Icelandic parliament passed Law 125/2008 authorizing the Treasury to disburse public funds to cope with the emergency and the supervisory authority to take extraordinary steps to minimize the damage to the financial system, such as taking over the powers of the shareholders' meeting, dissolving banks' governing bodies and placing banks under special administration, and deciding the sale or merger of banks. Pursuant to the new law, on 7 and 9 October the Glitnir, Landsbanki and Kaupthing banks were placed in receivership.[18]

SWITZERLAND

On 16 October 2008 the UBS and Credit Suisse groups announced capital strengthening measures in concomitance with the Swiss central bank's decision to allow illiquid assets to be transferred to a special purpose vehicle for their orderly liquidation. These measures are intended to strengthen the Swiss financial system and ensure its stability.

In particular, the central bank reached an agreement with UBS on a long-term loan and on the liquidation of illiquid securities and other "troubled assets"— for the most part debt instruments having US residential and commercial mortgages as underlying assets — for an amount not exceeding $60 billion. Credit Suisse Group declined to sign a similar agreement.[19]

Under the agreement, UBS will sell the securities to a special purpose vehicle and provide up to $6 billion as first-line protection against losses. The central bank, which will monitor the transfer, management and liquidation of the assets, will finance the purchase of the assets with a secured loan of not more than $54 billion to the special purpose vehicle and will have control of the vehicle. The loan will last 8 years and may be extended up to 12 years to permit orderly liquidation of the assets. In connection with these initiatives, UBS pledged to strengthen its own capital.

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[18] On 9 October the Finnish supervisory authority suspended the operations of Kaupthing Bank's Finnish branch. Sweden and Norway offered liquidity support to the Kaupthing's local branches. On 12 October Norway placed Kaupthing's local branch under administration. On 9 October the British Treasury transferred the retail deposits of the British subsidiaries of Landsbanki (Heritable) and Kaupthing (Kaupthing Singer & Friedlander) and of Glitnir's UK branch to ING Direct.

[19] Credit Suisse Group declared that it had received CHF 10 billion from Gulf region investors, including the Qatar Investment Authority.

Appendix 3: Crisis of the Lehman Brothers group. Operations with Italian customers

1. The Lehman Brothers group in Europe and its operations with Italian customers

Lehman Brothers Holding Inc., one of the largest US investment banks, heads a group that operates worldwide in the field of financial services. The parent company and some US companies of the group have been admitted to the reorganization procedure under Chapter 11 of the US Bankruptcy Code.

The available evidence shows that the group is present in Europe through a number of investment firms, banks and financial companies. The European units of relevance for the Italian market and Italian investors are the following:

– in Germany there is a banking subsidiary (Lehman Brothers Bankhaus AG) that operates in Italy through a branch in Milan;

– in the United Kingdom there are several investment firms that operate in Italy through their own branches, in the case of Lehman Brothers International (Europe), or under the freedom to provide services, in the case of Lehman Brothers Asset Management (Europe) Ltd., Lehman Brothers Europe Limited and Lehman Brothers International Europe. There are also companies, among them Lehman Brothers Holdings plc, whose securities are held in part by Italian investors;

– in France there is a banking subsidiary, Banque Lehman Brothers S.A., that does not operate in Italy, and an asset management company, Lehman Brothers AM France, that operates in Italy under the freedom to provide services;

– Lehman Brothers Treasury Co. BV, controlled indirectly by the US holding company in Chapter 11, has its registered office in the Netherlands. The company is active in the issuance of securities sold in Italy, among other markets;

– Lehman Brothers (Luxembourg) S.A. and Lehman Brothers (Luxembourg) Equity Finance S.A. have their registered offices in Luxembourg;

– finally, there are two Irish collective investment undertakings authorized to operate in Italy, Lehman Brothers Alpha Fund plc, whose securities are also held by Italian investors, and Lehman Brothers Liquidity Funds plc.

The Lehman Brothers group operates in Italy through the following intermediaries established in Italy as well as through the above-mentioned European units:

– Lehman Brothers A.M. Italy SGR. This asset management company, authorized recently (June 2008) to manage three real-estate hedge funds, has not started activity;

– four financial intermediaries entered in the register referred to in Article 106 of the Consolidated Law on Banking, active in the granting of loans, acquisition of shareholdings and provision of payment services, on which inspections are under way; and

– Lehman Brothers International, a financial company not operating on a public basis entered in the special section of the register referred to in Article 106 of the Consolidated Law on Banking pursuant to Article 113 of that law.

2. The procedures and measures adopted in respect of the group

In the United States, the parent company and some subsidiaries have been admitted to the reorganization procedure under Chapter 11 of the Bankruptcy Code, remaining in possession of the goods and continuing to operate the business (debtor in possession).

The Chapter 11 procedure in the United States does not have automatic effects on the other subsidiaries within the United States and abroad, which can continue to operate normally. Nevertheless, this development has induced the European supervisory authorities to take special measures in respect of the subsidiaries in their jurisdictions. These measures are essentially of a precautionary nature and intended to protect the subsidiaries' counterparties.

The German authority (BaFin) has ordered the suspension of payments vis-à-vis the German bank L.B. Bankhaus AG. The moratorium is also fully and automatically effective as regards the Italian branch pursuant to Article 95-*bis*, paragraph 1, of the Consolidated Law on Banking, applying Directive 2001/24/EC on the reorganization and winding-up of credit institutions, implemented in Italy with Legislative Decree 197 of 9 July 2004. Consequently, the special administration and compulsory administrative liquidation procedures provided for in Italian law are not applicable to the branch.

The British authority (the Financial Services Authority) has placed the British investment firm Lehman Brothers International (Europe) in administration, together with other companies of the group, including Lehman Brothers Holdings plc. In contrast with the above-mentioned case, this measure does not entail automatic application to the branches in Italy, which is envisaged for branches of EU banks.

The French authority (Commission Bancaire), as a precautionary measure, has appointed a temporary administrator, with powers of administration, management and representation, "to protect the recipients of the investment services" of the branch of the investment firm Lehman Brothers International. In regard to Banque Lehman Brothers, the Commission Bancaire has appointed a temporary administrator charged with ensuring the continuity of the French subsidiary's operations.

The Dutch authority (the District Court of Amsterdam) initially ordered the suspension of payments of Lehman Brothers Treasury BV and subsequently, on 8 October, declared the company bankrupt and appointed a trustee.

The Irish authority (the Financial Regulator) is monitoring the situation of three funds of the collective investment undertaking Lehman Brothers Liquidity Funds plc (Euro Liquidity, Sterling Liquidity and US Dollar Liquidity) for which the company has notified its decision to suspend redemptions.

The Luxembourg authority (Tribunal d'arrondissement de et à Luxembourg) has appointed a temporary administrator to control the activities of Lehman Brothers (Luxembourg) S.A. and has admitted the company to the suspension of payments for six months as of 3 October 2008.

The steps taken by the Bank of Italy in respect of the EU companies operating in Italy and the Italian intermediaries of the Lehman group have regarded the start of on-site inspections of the Italian branches of the German bank and of the intermediaries entered in the register referred to in Article 106 of the Consolidated Law on Banking. A joint inspection with Consob is being conducted at the branch of the British investment firm. The

Italian asset management company has not started its activity, at the advice of the Bank of Italy among other considerations.

At the legislative level, it should be clarified that the procedures of special administration and compulsory administrative liquidation provided for in Italian law are applicable only to the Italian asset management company, while the intermediaries under Article 106 and 113 of the Consolidated Law on Banking are subject to the ordinary bankruptcy rules. The above-mentioned Italian procedures for crisis management may not be applied to the branch of the German bank, which, as noted, is subject exclusively to the measures adopted in Germany in that it is the branch of an EU bank. Regarding the branches of the British investment firms, the Consolidated Law on Finance permits the start of compulsory administrative liquidation only in the event of revocation of authorization by the home-country authority.

3. The position of Italian customers

3.1 As regards Italian customers, it is necessary to distinguish the position of those who have dealings with the group's intermediaries operating in Italy, as customers of the German bank or the British investment firms, from that of holders of financial instruments issued by the group.

<u>For the customers of the German bank's Italian branch</u>, to whom the moratorium adopted in Germany applies directly, Community law contains various provisions intended to ensure equal treatment with home-country customers and facilitate the protection of rights. Among them, specifically, are the provisions concerning the information to be given and the right to lodge claims in the home-country procedure in accordance with the rules established for home-country creditors, using for such purpose the official language of the creditor's country of residence. Furthermore, in the case of the German bank's Italian branch, all the depositors, including Italian depositors, are entitled to access the German system's deposit guarantee schemes.

<u>For the customers of the British investment firms</u>, the above-mentioned Community provisions do not apply and the related rights are consequently subject exclusively to the rules governing the procedure in the United Kingdom. That procedure envisages, among other things, a moratorium on enforcement actions by creditors against the intermediary and the right of creditors to participate in meetings and vote on any proposals submitted by the administrator to effect the administration. According to the announcements of the administrators appointed by the British authority, the procedure will take several months, given the need to ascertain the existence of any liabilities of customers towards the company.

3.2 Concerning the issues of <u>financial instruments of the Lehman Brothers group</u>, the most important items include:

- €3 billion (of which €739 million held by consumer households) in relation to the Dutch company Lehman Brothers Treasury Co. BV, placed in bankruptcy. In general, the products issued by this company are guaranteed by the American parent company; in such cases, creditors can weigh the possibility of invoking the specific guarantee as well as taking action against the issuer in conformity with the rules governing the bankruptcy procedure in the Netherlands. According to the information currently available, the creditors' committee has not yet been appointed, nor has the assessment of liabilities begun;

- €2.7 billion (of which €972 million held by consumer households) in relation to securities issued by the US parent company. The holders can consider the possibility of participating in the Chapter 11 procedure under way in the United States on an equal footing with domestic creditors. In the case of financial instruments issued by US companies of the group not yet subject to procedures, foreign creditors may petition the court for the compulsory opening of a reorganization procedure under Chapter 11 or a liquidation procedure under Chapter 7;

- €97 million (of which €8 million held by consumer households) in relation to the UK company Lehman Brothers Holding plc, placed in the same administration procedure as the investment firm Lehman Brothers International (Europe). The observations above concerning the customers of the investment firm also apply to the holders of these securities;

- €70 million in relation to the Swiss company Lehman Brothers Finance SA;

- €18 million (of which €11 million held by consumer households) in relation to securities issued by the Irish collective investment undertaking Lehman Brothers Alpha Fund plc (specifically its Lehman Brothers Straus US Equity Fund). The securities in question do not appear to be among those covered by the temporary suspension of redemptions. In any event, the holders would be guaranteed by the segregation between the collective investment undertaking's different funds;

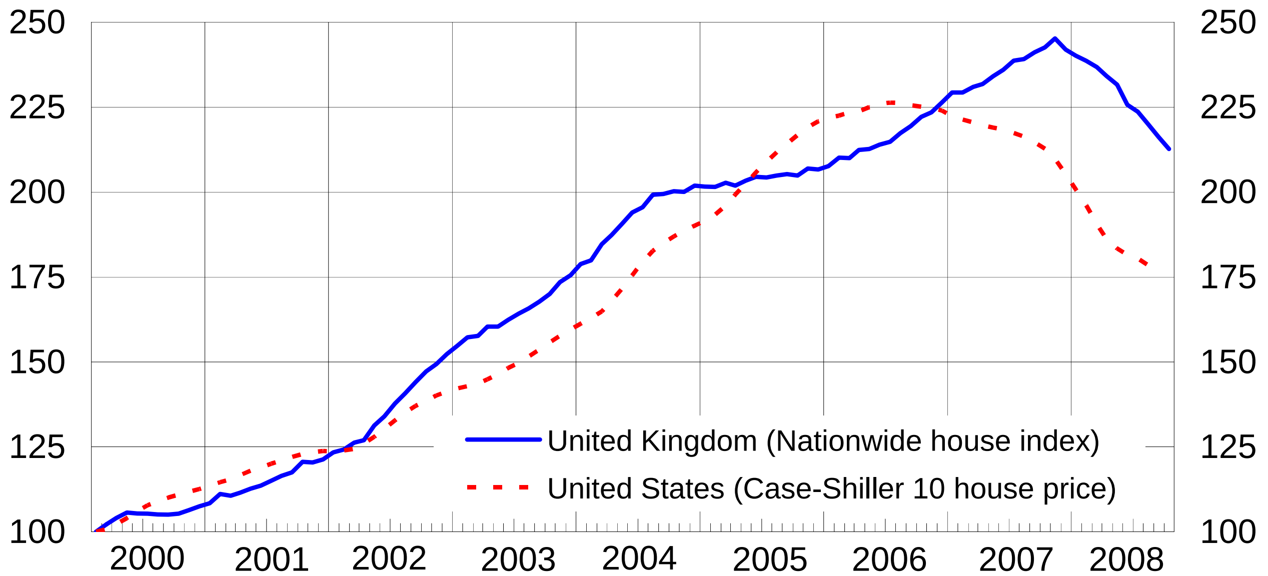
- €10 million (of which €2 million held by consumer households) in relation to ordinary bonds and subordinated loans (€7 million and €3 million, respectively) issued by the company Lehman Brothers UK Cap Fund.

Lastly, with reference to all the companies of the Group except for the German bank, the possibility would remain for creditors to bring individual enforcement or precautionary actions on the assets held by the companies in Italy.

On the basis of the information available, therefore, the units of the Lehman group are subject to measures of diverse nature that produce differentiated effects on the companies to which they apply and on the rights of counterparties. In this context, appropriate protection of such rights necessarily entails identification of the group companies with which the relationships are established, of the specific measures adopted in their regard and of the consequent steps to be taken in Italy and in foreign jurisdictions under the rules governing the measures.

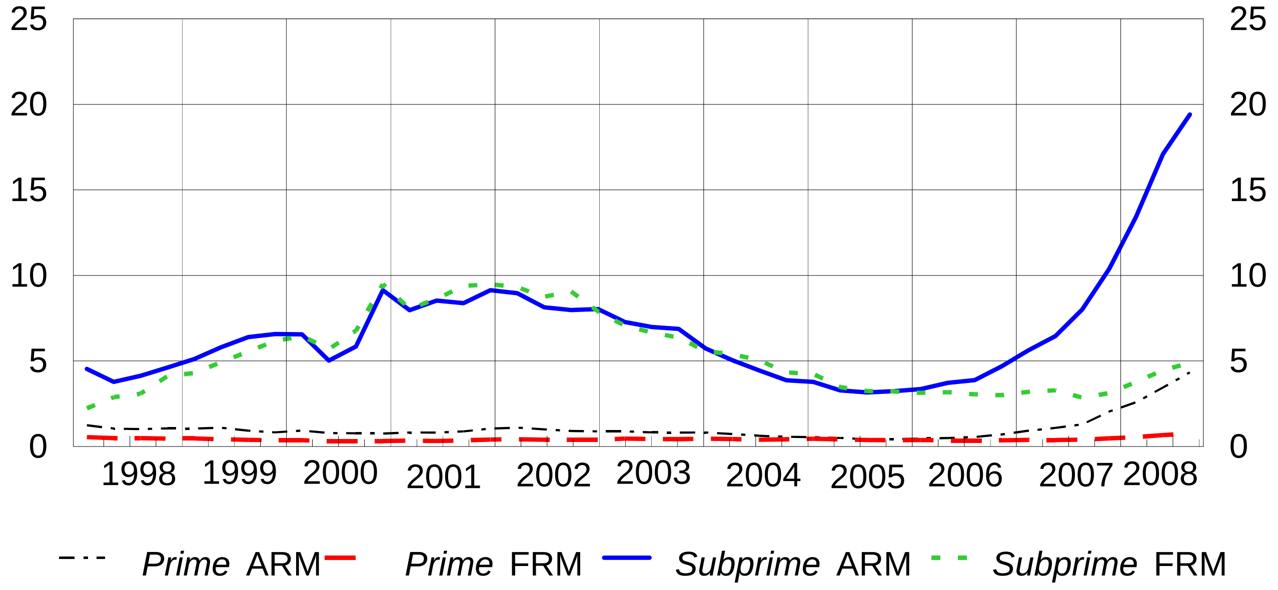
Real-estate market in the United States: house prices and mortgage defaults

Price indices of houses in the United States and the United Kingdom
(indices, January 2000 = 100)



Source: Thomson Financial Datastream.

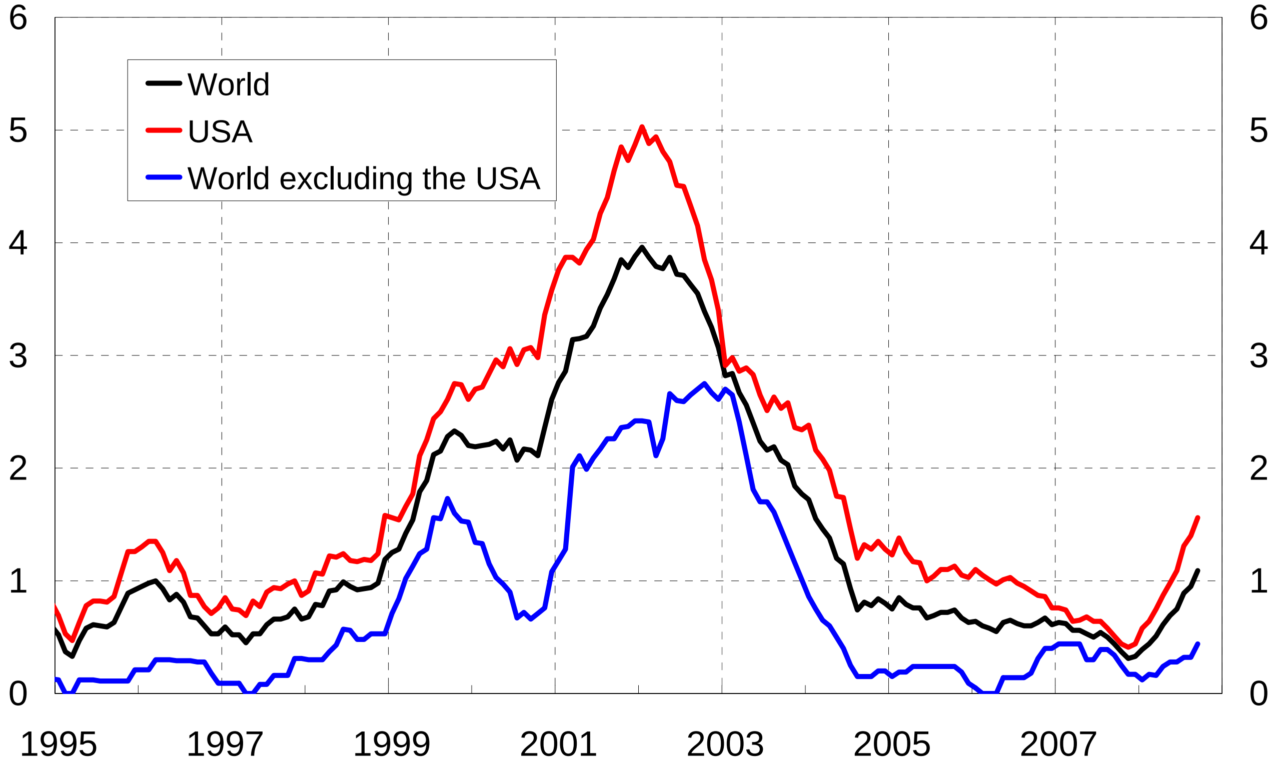
Residential mortgages in the United States: percentage of foreclosures to outstanding mortgages by type of mortgage (1)
(quarterly data; percentages)



(1) ARM = Adjustable Rate Mortgage; FRM = Fixed Rate Mortgage.

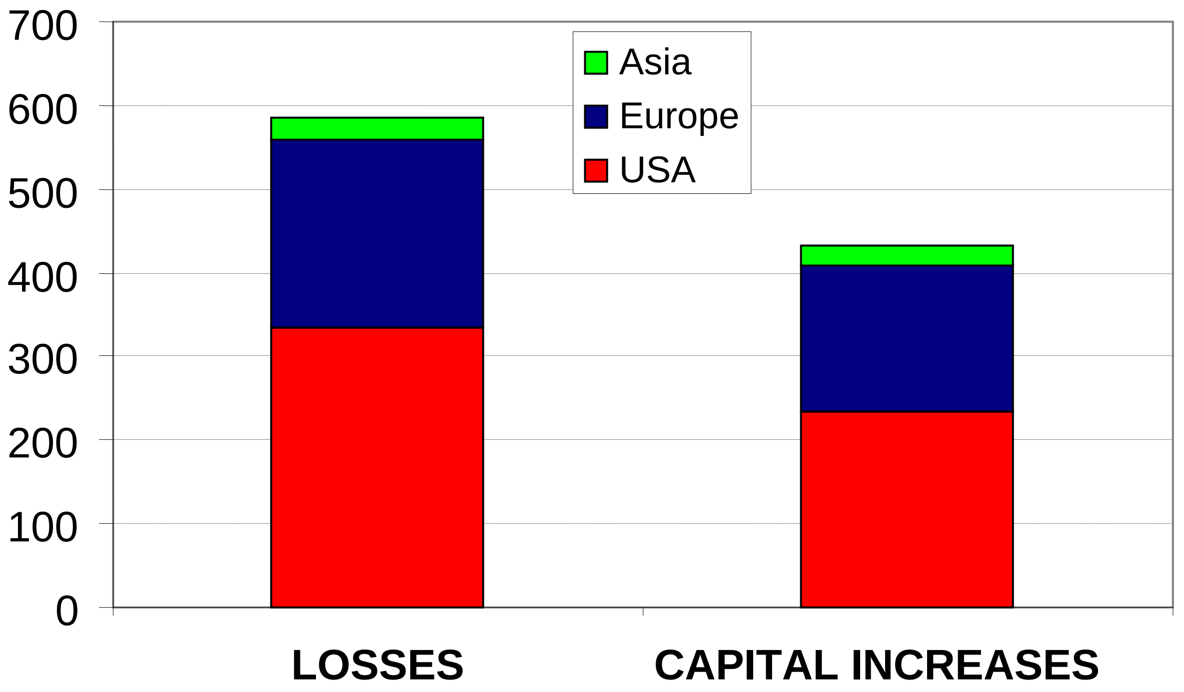
Source: Thomson Financial Datastream.

Bond default rates
(monthly data; percentages)



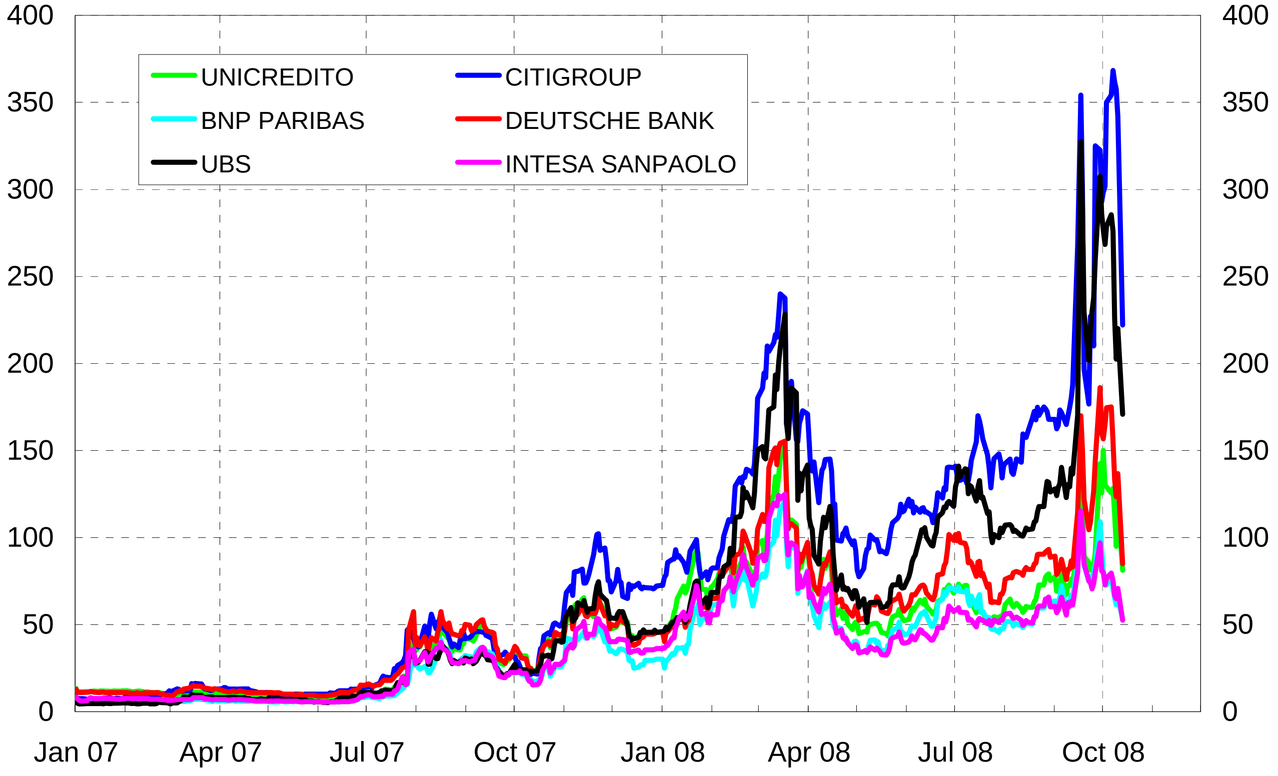
Source: Moody's.

Increases in capital and losses of the main international banks from 1 July 2007 to 30 September 2008
(billions of dollars)



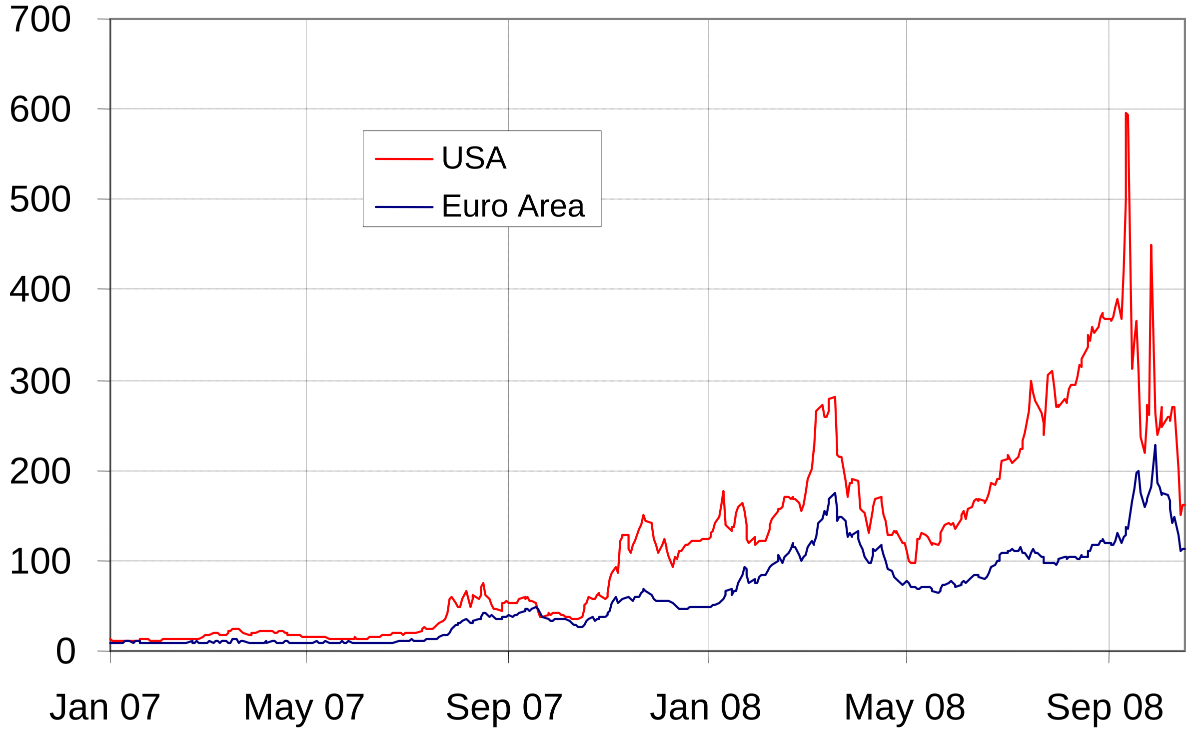
Source: Bloomberg.

Indicator of the probability of default of some leading banks
(premiums on 5-year CDSs in basis points; daily data)



Source: Thomson Financial.

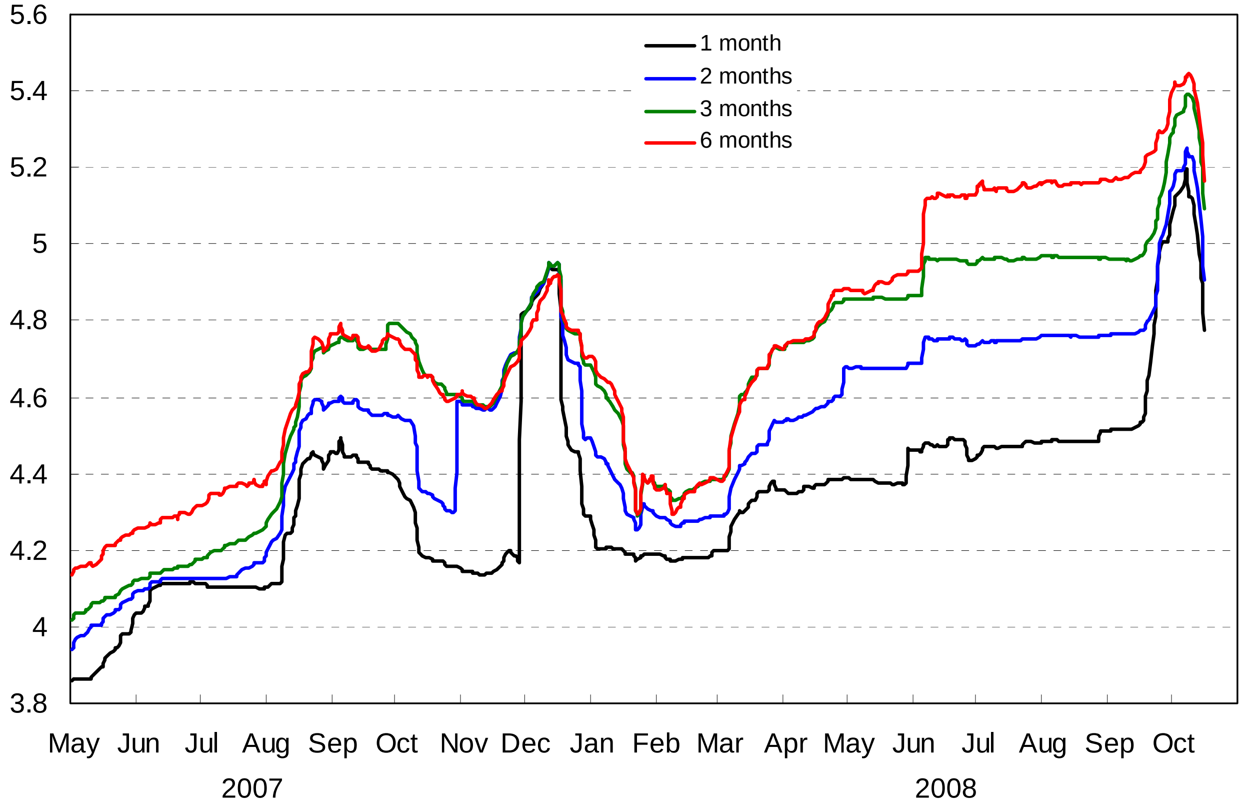
Indicator of the probability of default of the banking sector
(indices of CDSs in basis points; daily data)



Source: Thomson Financial.

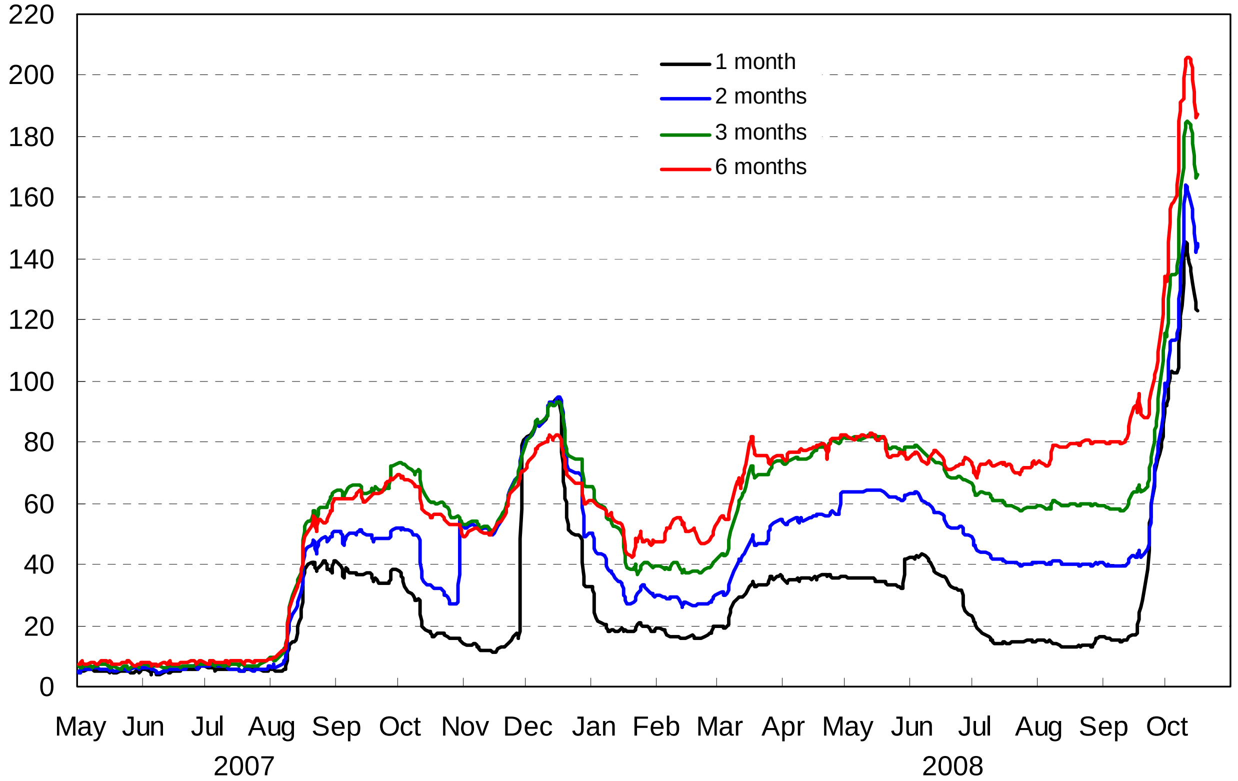
Interbank markets

Euribor interest rates



Source: European Banking Federation.

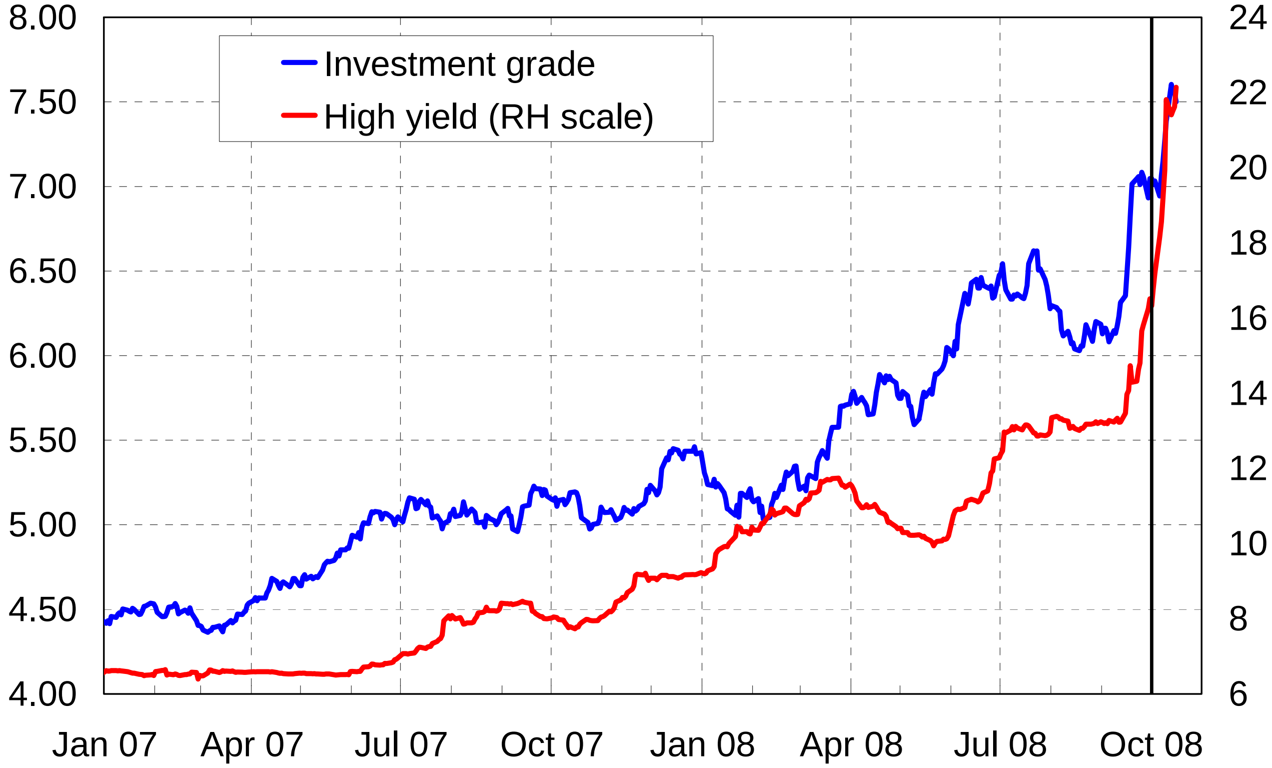
Euribor Eurepo differential by maturity



Source: European Banking Federation.

Yield of private-sector euro bonds issued on the Euromarket

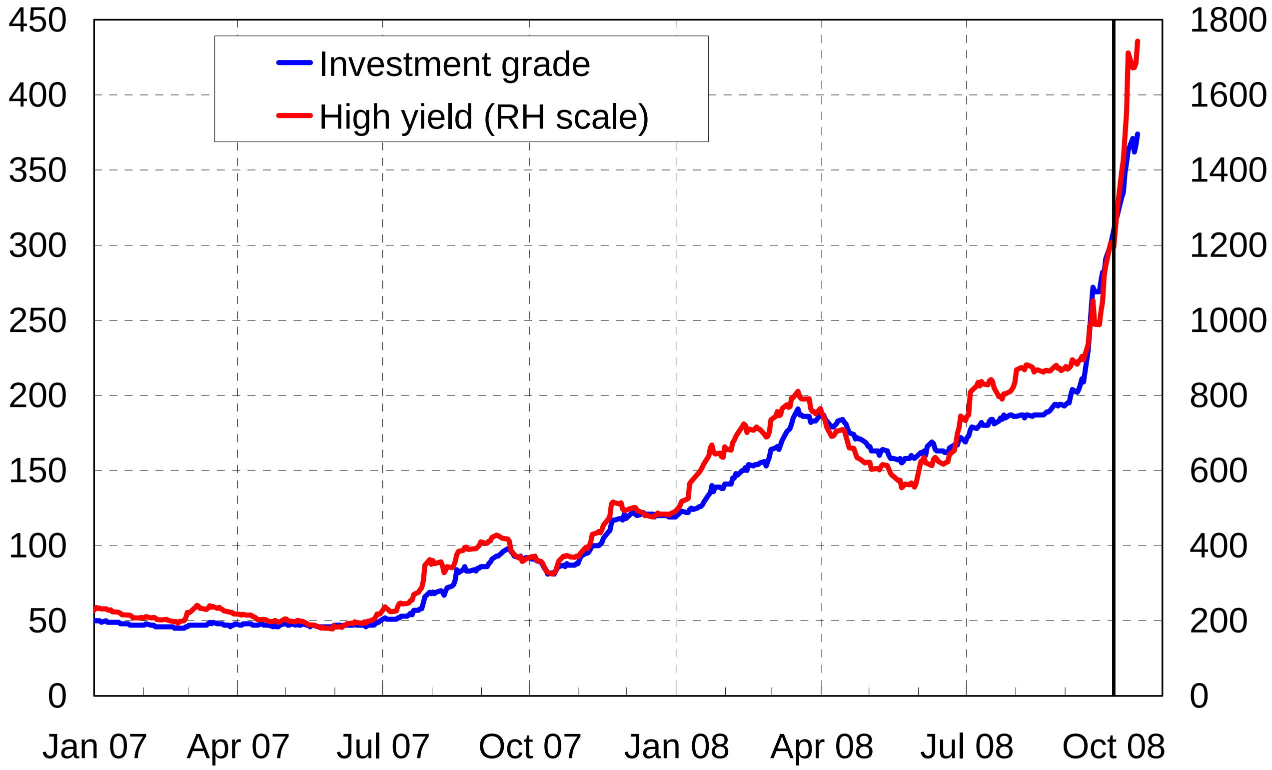
(daily data; percentages)



Source: Merrill Lynch.

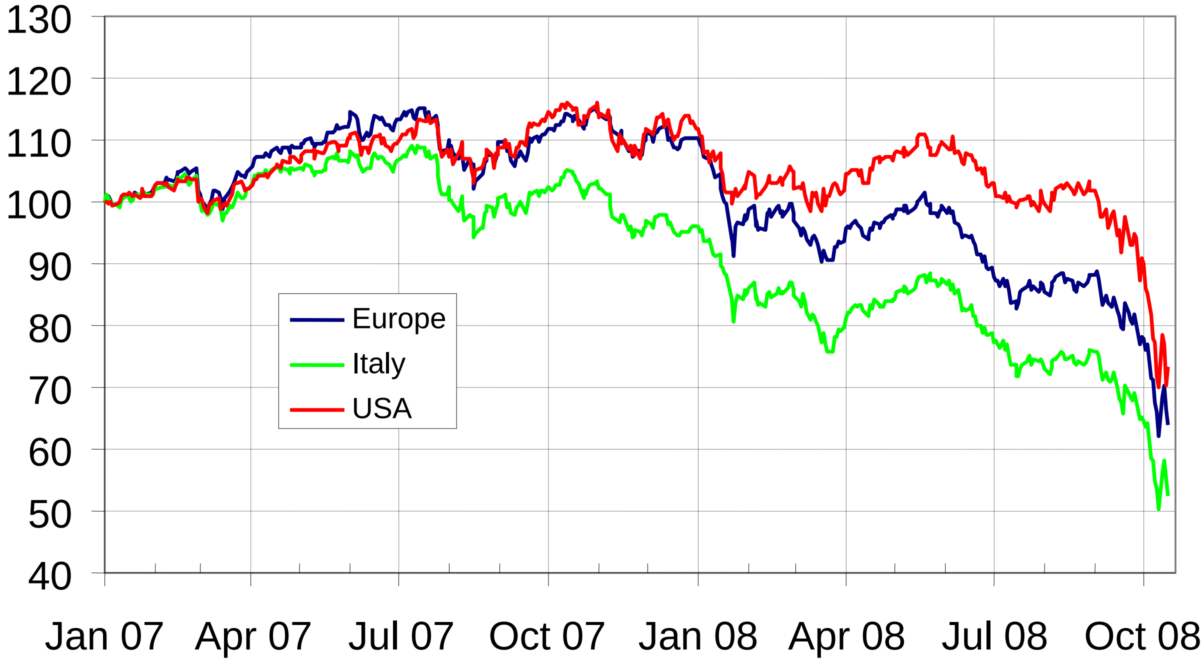
Yield differential between private-sector euro bonds issued on the Euromarket and corresponding government securities

(daily data; basis points)



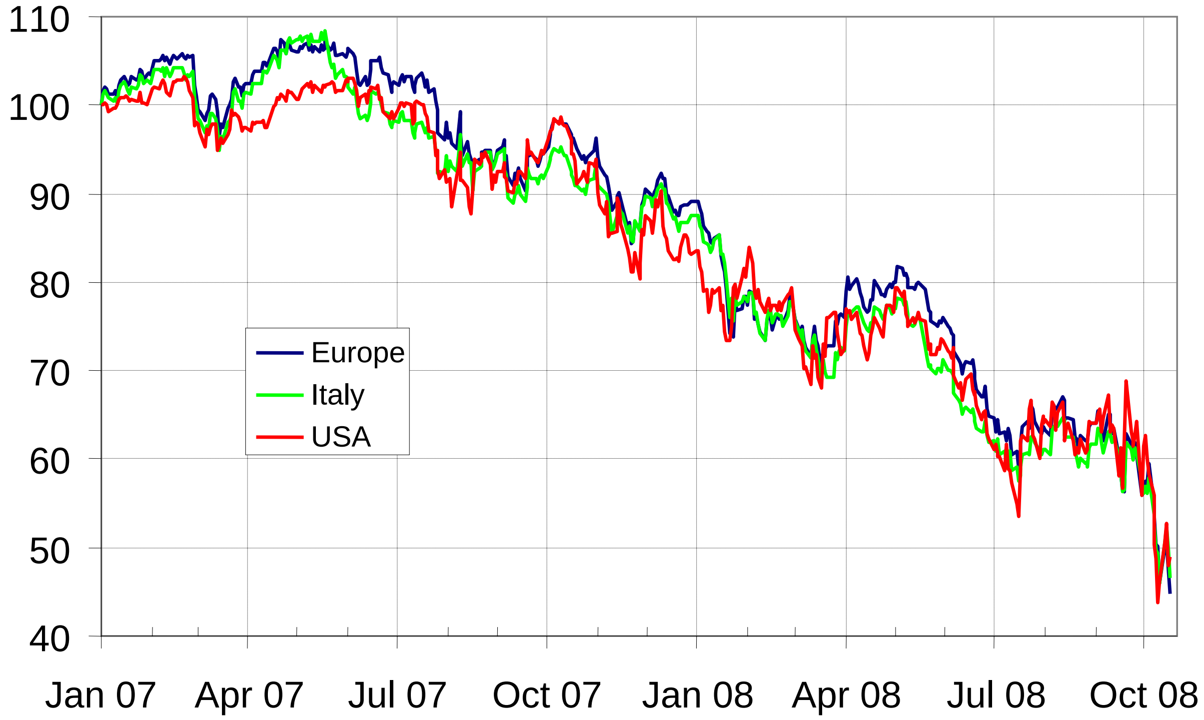
Source: Merrill Lynch.

Stock market indices: non-financial sector
(indices, 1 January 2007 = 100; daily data)



Source: Thomson Financial.

Stock market indices: financial sector
(indices, 1 January 2007 = 100; daily data)



Source: Thomson Financial.