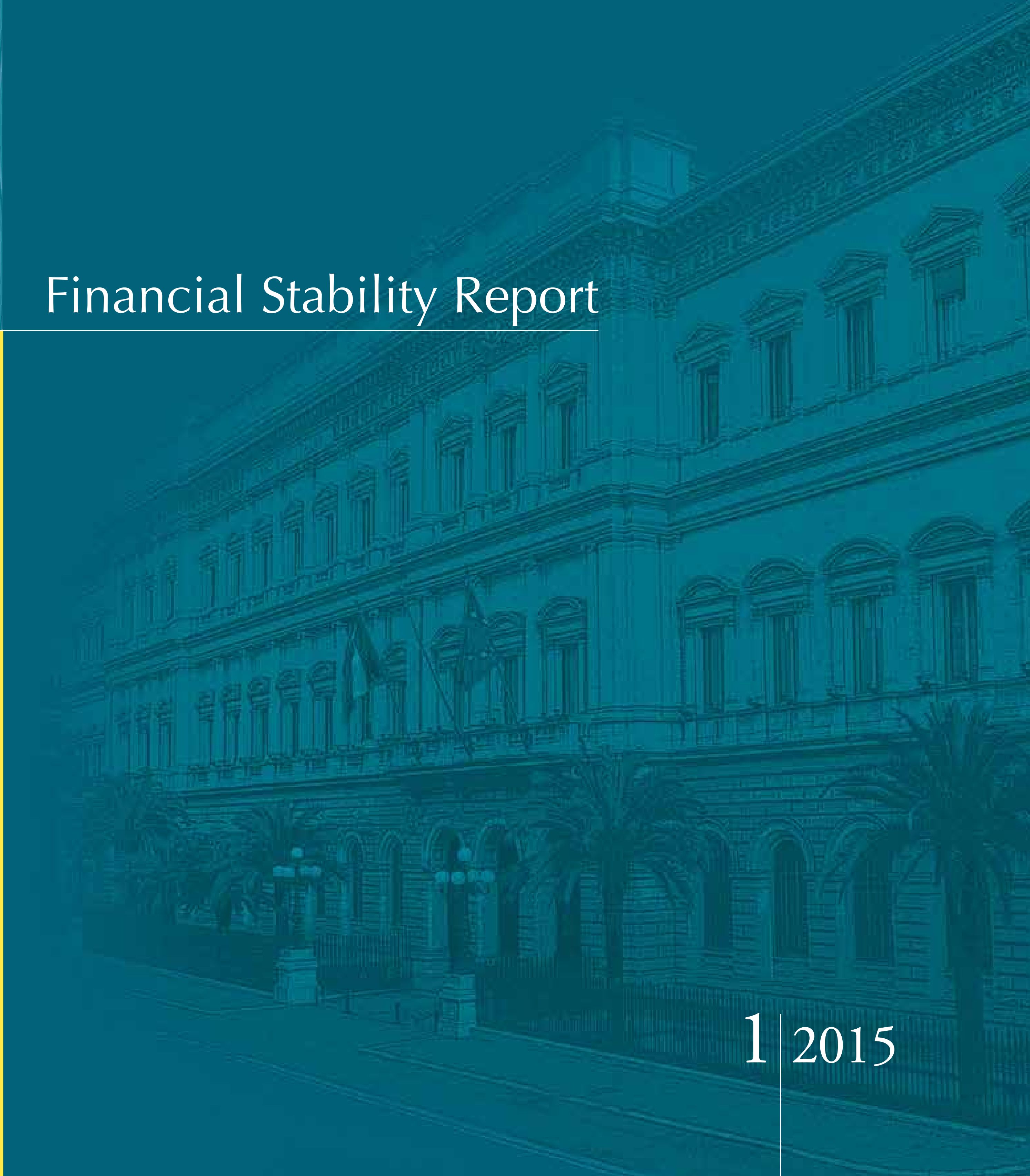
BANCA D'ITALIA
EUROSISTEMA

Financial Stability Report



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CONTENTS

BOXES

SYMBOLS AND CONVENTIONS

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

In the following tables:

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

OVERVIEW

Global risks are subsiding but are still significant

Improving growth prospects for the advanced economies have attenuated the risks to financial stability, but there are still areas of vulnerability. Growth is slowing in the emerging economies, which are exposed to the risks of a possible rise in official interest rates in the United States and a further appreciation of the dollar. The fall in oil prices could have adverse effects on the sustainability of debt in the oil-producing countries. Geopolitical tensions could trigger sudden increases in the volatility of financial asset prices.

The situation in Greece is a potential factor of instability

The uncertainty surrounding the negotiations between the Greek authorities and European institutions over the completion of the macroeconomic adjustment plan is causing sovereign spreads in the euro area to widen again. The Eurosystem stands ready to cope with the financial market repercussions of an aggravation of tensions, but the deterioration of the situation could provoke unpredictable consequences.

The Eurosystem has adopted measures to counter the risks associated with low inflation …

The risks to euro-area financial stability generated by low growth and stubbornly low inflation have diminished since the start of the Eurosystem's public securities purchase programme. The plan is already working its effects: medium- and long-term inflation expectations are adjusting upwards, while government securities yields have decreased, turning negative even beyond five-year maturities in some euro-area countries.

… while taking care to preserve the orderly operation of markets

Market indicators have shown no signs of disequilibrium in prices or trading volumes. The procedures for conducting the Eurosystem's asset purchases have been designed in such a way as not to distort the formation of securities prices.

Macroeconomic improvement can facilitate fiscal adjustment

In Italy the return to growth and a rise in inflation rates can speed up the adjustment of the public finances. The 2015 Economic and Financial Document presented by the Government estimates that the ratio of debt to GDP will begin to come down in 2016 thanks to the improving economic picture and the curbing of the budget deficit.

Households' financial situation is solid

The level of Italian households' debt remains low, and indebted households' vulnerability would be limited even in the event of a decline in nominal income or a rise in interest rates.

Firms' profitability decreases, but growth prospects are improving

Firms' profitability has declined further, but the latest surveys indicate that the outlook for sales and investment is improving, especially for large and export-oriented firms. Overall, firms' financial positions have continued to strengthen gradually. Liquidity and the conditions of access to credit have improved. However, a significant number of heavily indebted small and mid-sized firms are still having difficulty accessing credit.

The slackness of economic activity still weighs on banks' credit quality …

The continued weakness of economic activity and the incorporation in banks' balance sheets of the results of the asset quality review led to an increase in the flow of non-performing loans in the fourth quarter. Nevertheless, coverage rates are still rising. Measures are being studied to reduce banks' stock of non-performing exposures, which would help to boost lending to households and firms and hence strengthen the economic recovery.

... and profitability

Loan loss provisions absorbed practically all of banks' operating profits in 2014, and their ROE was negative. Banks are going ahead with reorganization, which in recent years has delivered efficiency gains by reducing the number of branches and employees. A recovery in earnings will depend strictly on the growth of the economy.

Banks' capital ratios continue to rise

Banks' endowment of capital has continued to expand. By the end of last year the CET1 ratio of the Italian banking system had risen to 11.8 per cent, and the ratios of the two largest groups were aligned with those of the other major European banks.

Exposure to interest rate risk is limited for banks ...

Italian banks' vulnerability to interest rate risk is low. Even for the most highly exposed intermediaries, the potential losses to the net value of assets and liabilities are far below the official warning threshold.

... and insurance companies

Italian insurers are among the least exposed in Europe to interest rate risk, even in the case of an extended period of low nominal yields. Most have balanced cash flows, with good matching of yields and duration between assets and liabilities. The impact of shifts in the yield curve on the net value of assets and liabilities would be modest even under stress scenarios. Insurance companies remain exposed to the risk of changes in sovereign risk spreads.

Italian markets are liquid

The Eurosystem's public securities purchase programme has had positive effects on the liquidity of the Italian equity and corporate bond markets, which are not involved in the plan. The yields on government securities have come down sharply; in the first two months of the year there were large-scale purchases from abroad. Yields have also fallen significantly in the Italian markets for ABS and covered bonds, which are specifically targeted by Eurosystem purchase programmes.

1 RISKS ORIGINATING FROM THE MACROECONOMIC AND FINANCIAL SITUATION

1.1 MACROECONOMIC AND FINANCIAL RISKS

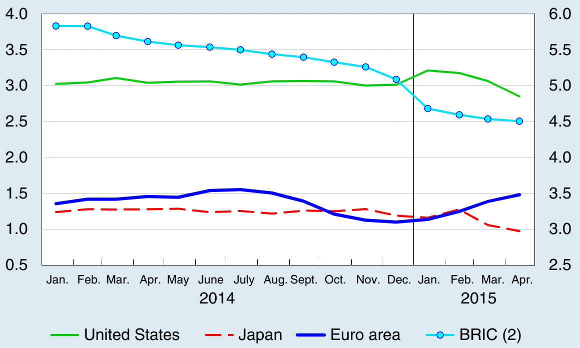
Vulnerabilities remain, connected with factors of global instability

The risks to financial stability deriving from the trend of the global economy are subsiding but remain high. The prospects for growth in 2015 are improving, above all in the advanced economies, following the sharp drop in the price of oil and the expansionary stance of monetary policies. Private analysts expect that productive activity will continue to grow strongly in the United States and the United Kingdom, will proceed at a modest pace in Japan, and will accelerate in the euro area (Figure 1.1) Instead, growth prospects for the emerging economies have worsened, especially in Brazil, China, Russia and a number of commodity-exporting countries. Geopolitical tensions and the continuing difficulties in resolving the economic and financial crisis in Greece are also major risk factors.

Figure 1.1

GDP growth forecasts for 2015 (1)

(monthly data; per cent)



Source: Based on Consensus Economics data.
(1) Forecasts made in the months shown on the horizontal axis. – (2) Right-hand scale; average of the forecasts for Brazil, Russia, India and China, weighted on the basis of each country's GDP in 2013 at purchasing power parity.

The fall in the price of oil is contributing to growth, but entails risks

In countries where crude oil exports make an important contribution to tax revenues, the fall in oil prices is causing a significant deterioration in the public finances and the current account of the balance of payments. The reduction in energy firms' profits has a negative impact on their capacity to service a very large volume of debt, which has more than doubled over the last ten years, reaching an estimated $2.5 trillion at global level in 2014. The risks are mitigated by the dispersion of debt among investors: 60 per cent consists of bonds and the rest mainly of syndicated loans. In the advanced countries, the largest banks' exposure to energy firms is less than 4 per cent of total loans, giving rise to only limited risks.

The risks deriving from low inflation remain significant ...

There are still risks to financial stability deriving from very low inflation rates, which make it more difficult to reabsorb the large volume of public and private debt. Inflation, already very low in 2014, has declined to negative values in some advanced economies, mainly reflecting the fall in oil prices. In the major emerging countries, such as China and India, the steep fall in producer prices could be transmitted to consumer prices.

... but in the euro area they are countered by the expanded asset purchase programme

The public sector purchase programme (PSPP) launched in March by the Eurosystem, is already producing its first effects (see *Economic Bulletin,* No. 2, 2015). Medium- and long-term inflation expectations, in sharp decline since last year, have begun to pick up (Figure 1.2). ECB staff projections point to a rapid rise in consumer price inflation as early as the end of this year and a return to a rate of 1.8 per cent in 2017.[1]

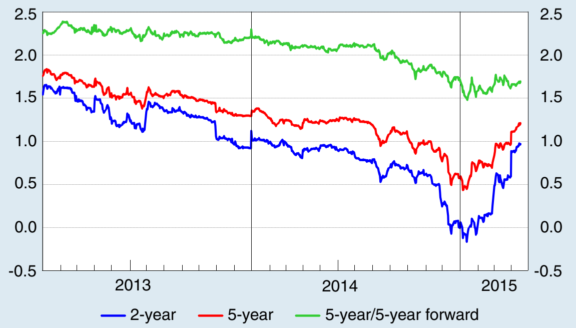
US monetary policy can have negative repercussions on the emerging countries

Emerging economies could also be affected by the raising of official rates in the United States, which the markets expect to happen in the second half of this year. The increase in US interest rates and a further appreciation of the dollar could have adverse effects on firms with foreign currency denominated debt and give rise to capital outflows. The Eurosystem's PSPP has significantly reduced the risk that future rises in US long-term interest rates will be transmitted to rates in the euro area.

Figure 1.2

Euro-area inflation expectations implied by inflation swaps (1)

(daily data; per cent)



Source: Bloomberg.
(1) Inflation rates implied by 2-year, 5-year/5-year forward inflation swaps.

The bond markets react to the Eurosystem's expansionary measures

The purchases of public securities under the PSPP have determined a rapid fall in medium- and long-term interest rates in the euro area (Figure 1.3). In some countries yields have turned negative on maturities beyond five years. The gradual nature of the purchases and the Eurosystem's securities lending operations should prevent the programme from interfering with the process of market price formation for financial assets (see Section 4.2). The indicators commonly used to evaluate the risks originating in the bond, equity, property and credit markets have not signalled any disequilibria up to now. In some countries the low level of interest rates could cause problems for pension funds and insurance companies, whose liabilities allow for defined benefits or guaranteed minimum returns (see the box 'The EIOPA stress test for the risk of low interest rates').

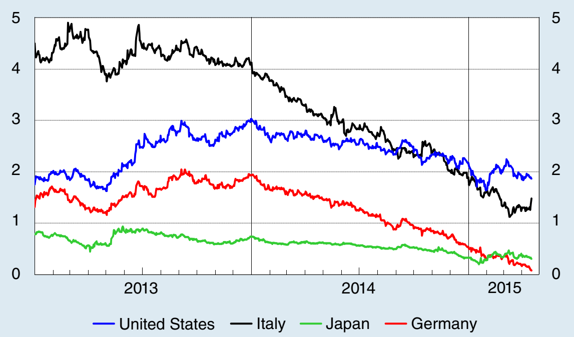
Spreads are affected by the situation in Greece

Developments in Greece remain a significant risk factor. Uncertainty about the negotiations for the completion of the macroeconomic adjustment programme has, over the last few weeks, caused a rise in the spreads on the

Figure 1.3

Ten-year government bond yields

(daily data; per cent)

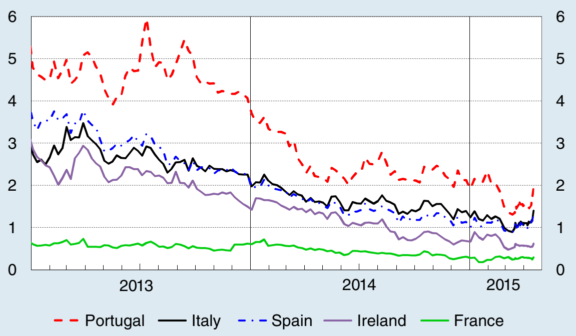


Source: Bloomberg.

Figure 1.4

Ten-year sovereign spreads vis-à-vis Germany (1)

(end-of-week data; percentage points)



Source: Based on Bloomberg data.
(1) Yield spreads between the 10-year government bonds of the countries indicated and the corresponding German Bund.

[1] See *March 2015 ECB Staff Macroeconomic Projections for the Euro Area*.

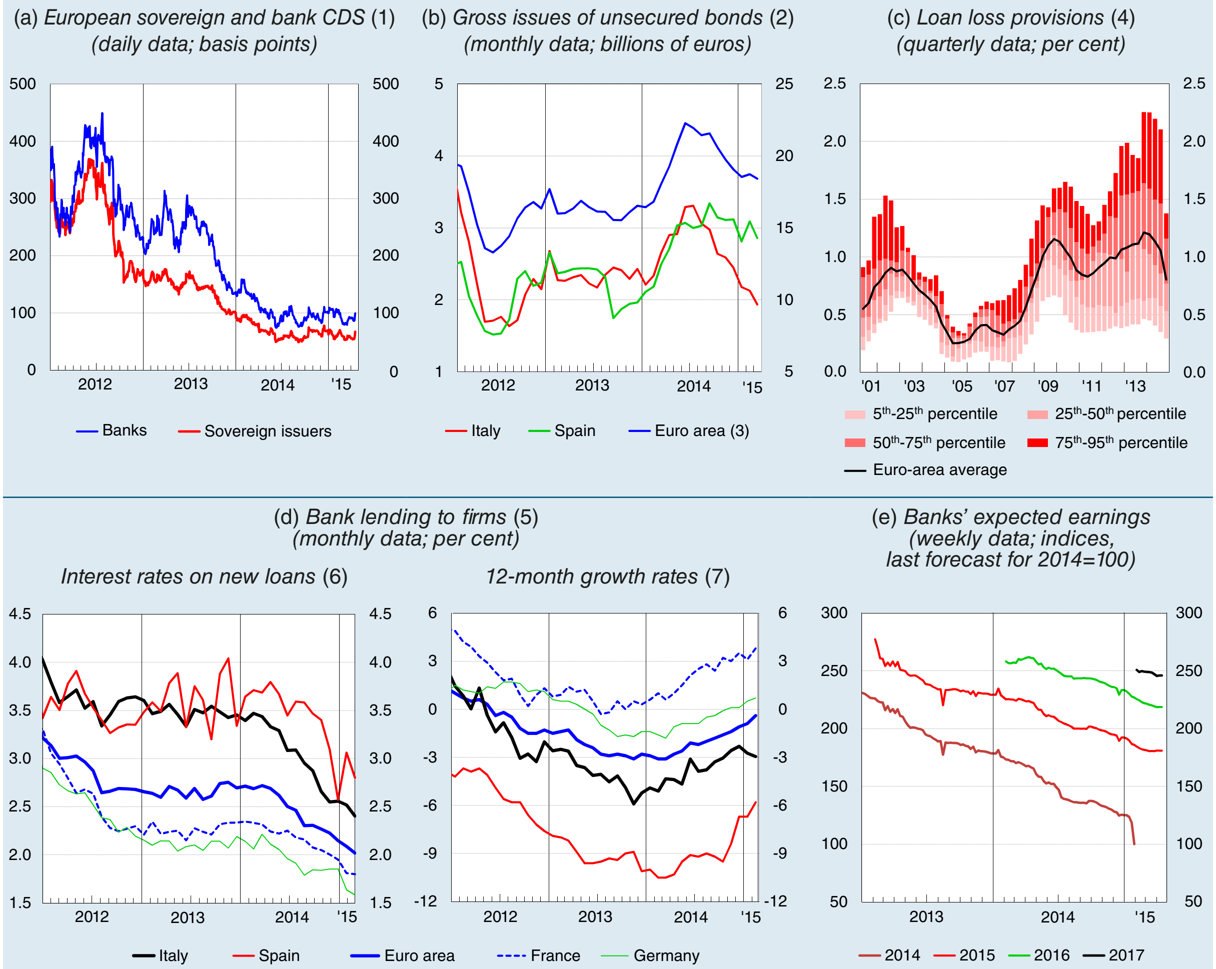
euro-area government bonds with the highest risk premiums (Figure 1.4). The granting of the support necessary for Greece to meet its impending financial commitments depends on the negotiations. The Eurosystem stands ready to respond to any worsening of tensions, which could nevertheless have consequences that are difficult to foresee.

Banks' operating conditions improve ...

Conditions in banks in the euro area improved overall. Bank bond credit risk premiums have fallen (Figure 1.5.a), helping to reduce the cost of funding, but new bond issues have declined further (Figure 1.5.b), owing to the substitution of short-term financing at very low rates for funding on the capital markets. Credit quality improved in the last quarter of 2014 for all the major banks, with less variability between them (Figure 1.5.c). Credit supply tensions continued to ease: interest rates on loans to firms came down and the contraction in volumes attenuated, although it remains significant in some of the

Figure 1.5

Euro-area banks: main indicators



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

large countries, including Italy and Spain (Figure 1.5.d). Analysts expect a sharp rise in banks' earnings in 2015 and 2016 (Figure 1.5.e).

... while the risks stemming from non-bank intermediation are still limited

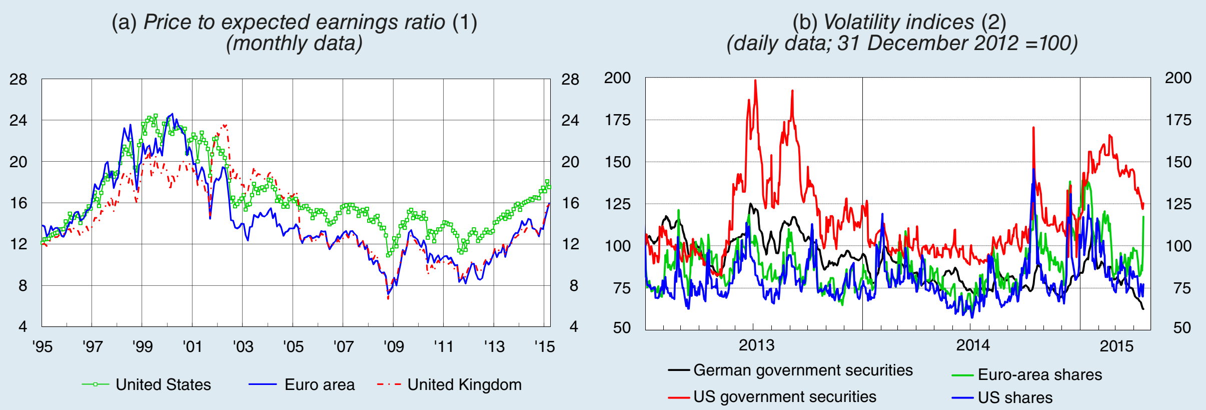
Risks to financial stability can arise from the shift of financing flows from the closely regulated banking sector to the shadow banking sector, a more opaque and potentially risky form of market based intermediation. The risks vary according to the level of development of the non-bank financial sector and the credit cycle. In continental Europe market-based finance has limited importance and the financial cycle is struggling to move into recovery (see Section 3.2). In this situation, the expansion of non-bank credit supports growth, in part counterbalancing the stability risks.

Stock markets can be vulnerable to geopolitical tensions

In the main advanced economies the ratio of share prices to expected earnings, though rising in the last few months, remains close to its long-term averages (Figure 1.6.a). There are no significant misalignments with levels consistent with the fundamental variables. But when the volatility of financial assets is generally low, as it is now, investors tend to take less diversified positions and react more strongly to bad news, as demonstrated by the wide fluctuations in share prices observed in recent months following the Russia-Ukraine crisis and the uncertainty linked to the situation in Greece and the conflicts in the Middle East (Figure 1.6.b). The risk of geopolitical tensions causing disorderly shifts in investors' portfolios should therefore not be underestimated.

Figure 1.6

Stock market indicators



Source: I/B/E/S, Thomson Reuters Datastream and based on Bloomberg data.
(1) Ratio of stock market capitalization of the general index to expected earnings over the next 12 months, surveyed by the company I/B/E/S. – (2) Index numbers taken from the volatility implicit in the prices of options.

In Italy the financial sustainability indicators remain favourable ...

In Italy, private sector debt remains low and the sustainability indicators for the public debt, which take account of the costs connected with population ageing, depict a basically balanced situation in the long term (Table 1.1). In April, in its 2015 Economic and Financial Document, the Italian government confirmed the net borrowing targets it set last October. General government net borrowing, indicated as 2.6 per cent of GDP in 2015, is forecast to fall to 1.8 per cent in 2016 and to 0.8 per cent in 2017, when the budget position is expected to reach structural balance. The debt-to-GDP ratio, still rising slightly in 2015, is expected to fall by about 1.5 percentage points in 2016.

... and benefit from improved nominal growth prospects

The adjustment of the debt-to-GDP ratio will benefit from the resumption of growth and the rise in inflation. According to our estimates, the Eurosystem's asset purchase programme will increase Italy's GDP by more than one

Table 1.1

Financial sustainability indicators

(per cent of GDP, unless otherwise specified)

	GDP (*annual growth rate*) (1)		Characteristics of public debt (2)				Primary surplus (2)	S2 sustainability indicator (3)	Private sector financial debt (4)		External position statistics (5)	
			Level		Average residual life of govt. securities (*years*)	Non-residents' share (*% of public debt*)			House-holds	Non-financial firms	Current account balance	Net International investment position
	2015	2016	2015	2016	2015	2014	2015	2012	2014 (6)	2014 (6)	2014	2014 (7)
Italy	0.5	1.1	133.8	132.9	6.4	36.0	1.4	-2.3	42.8	78.6	1.9	-27.7
Germany	1.6	1.7	69.5	66.6	6.6	61.0	1.5	1.4	54.8	53.7	6.2	36.4
France	1.2	1.5	97.0	98.1	6.8	61.2	-2.0	1.6	55.8	122.4	-1.0	-16.4
Spain	2.5	2.0	99.4	100.1	6.0	42.5	-1.6	4.8	72.3	109.6	0.8	-93.5
Netherlands	1.6	1.6	67.5	65.6	6.7	51.8	-0.7	5.9	115.4	127.0	10.3	65.8
Belgium	1.3	1.5	106.6	106.2	8.0	59.2	-0.3	7.4	57.0	136.1	1.8	54.7
Austria	0.9	1.6	88.8	87.4	7.7	75.5	0.4	4.1	50.7	89.9	0.8	2.1
Finland	0.8	1.4	61.7	62.8	6.1	78.5	-2.2	5.8	65.6	109.1	-1.8	4.7
Greece	2.5	3.7	172.7	162.4	….	81.5	3.0	….	63.6	62.1	0.9	-121.9
Portugal	1.6	1.5	126.3	124.3	6.4	71.8	1.7	….	81.9	122.5	0.6	-111.6
Ireland	3.9	3.3	107.7	104.9	12.4	62.2	0.6	….	89.4	187.2	6.2	-97.5
Euro area (8)	1.5	1.6	93.5	92.4	….	….	-0.1	2.1	61.3	101.1	2.3	-9.4
United Kingdom	2.7	2.3	91.1	91.7	14.5	28.4	-3.2	5.2	87.8	73.8	-5.5	-19.6
United States	3.1	3.1	105.1	104.9	5.7	33.8	-2.2	….	77.6	68.2	-2.4	-39.7
Japan	1.0	1.2	246.1	247.0	6.8	8.1	-5.7	….	62.5	103.4	0.5	77.2
Canada	2.2	2.0	87.0	85.0	6.5	22.4	-1.4	….	92.7	103.7	-2.2	7.4

Sources: IMF, Eurostat, ECB, European Commission, Istat, national financial accounts and balance of payments data.
(1) IMF, *World Economic Outlook*, April 2015. – (2) IMF, *Fiscal Monitor*, April 2015. – (3) European Union, Fiscal Sustainability Report 2012, December 2012. Increase in the primary surplus/GDP ratio (with respect to 2011) needed to satisfy the general government intertemporal budget constraint, given demographic and macroeconomic projections. The estimate takes account of the level of the debt, the outlook for economic growth, changes in interest rates and future primary surpluses, which are affected by the trend of age-related expenditure. – (4) Data for the euro-area countries from the ECB's Statistical Data Warehouse; data for the United Kingdom and non-EU countries from national sources; the data are compiled according to the new European System of Accounts (ESA 2010). – (5) Data for the European countries and the euro area as a whole from Eurostat, Statistics Database, ECB, Statistical Data Warehouse and national sources; data for non-EU countries from national sources; the data are compiled according to the new international accounting standards (see the box 'The new international accounting standards for external transactions and investment positions', *Economic Bulletin*, No. 4, 2014); data on the external investment position of Spain, Finland, and the euro area as a whole are as at end-Q3, 2014. – (6) As at end-Q3. – (7) Year-end data. – (8) Euro-area data refer to 19 countries for the public debt and the primary surplus; to 18 countries for GDP, private sector financial debt and external position statistics; and to 17 countries for the S2 indicator.

percentage point overall in the two years 2015 and 2016. Its impact on consumer prices and the GDP deflator should be of a similar size (see the box 'The macroeconomic impact for Italy of the Eurosystem's asset purchase programme', *Economic Bulletin,* No 2, 2015).

Capital inflows to Italy increase

Improving financial market conditions have encouraged the resumption of private capital inflows to Italy. In the first two months of the year net purchases of Italian government securities by non-residents amounted to €36 billion, of which €26 billion involved medium- and long-term securities. Calculated on the basis of average monthly data, between December and March the Bank of Italy's debtor position in the TARGET2 payments system declined from €187 billion to €163 billion (Figure 1.7). The TARGET2 balance is subject to particularly wide fluctuations, especially towards the end of each month as a result of technical deadlines and temporary operations which are usually reabsorbed in the following days.

1.2 REAL-ESTATE MARKETS

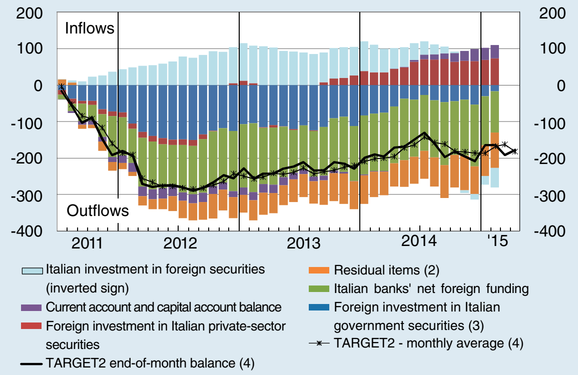
House prices continue to pick up in the euro area

House prices in the euro area rose again (Figure 1.8). The price-to-rent ratio has stabilized close to its long-term values (1995-2013 average). In some countries, such as Spain, the rise in prices reduces the risks associated with the weak real-estate sector. In others there are signs of overheating: after Sweden and the United Kingdom, the macroprudential authorities in Ireland recently adopted measures to limit the risks for the financial system of an excessive growth in credit to the sector.

Figure 1.7

Italy: TARGET2 balance and cumulative flows of the balance of payments (1)

(monthly data; billions of euros)



(1) Using the accounting identity of the balance of payments, an improvement in the debit balance of the Bank of Italy vis-à-vis the ECB in TARGET2 may reflect investments in Italy by non-residents (higher liabilities), sales of foreign assets by residents (lower assets) or a surplus on current and capital account. Non-residents' cumulative capital flows from July 2011 onwards. – (2) Foreign direct investment, derivatives, other investment, errors and omissions. – (3) Including funding intermediated by resident central counterparties. – (4) Data at 24 April.

The real-estate market shows signs of improvement in Italy

House prices continue to fall in Italy (Figure 1.9.a), but the seasonally adjusted number of sales has stabilized since last summer at a level on average 5 per cent higher than the year before (Figure 1.9.b). Similar trends are observed in the non-residential sector (Figure 1.9.c).

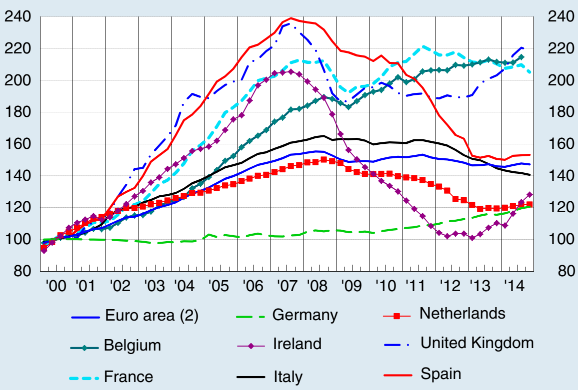
Weak house prices reflect the state of the economy

The price-to-rent ratio continued to decrease in the second half of last year (Figure 1.10), reaching historically low levels. Households' access to the real-estate market, measured by the affordability index (the ratio of debt service on new mortgage loans to household disposable income) improved further and at the end of last year was significantly better than the long-term average.

Figure 1.8

House prices in Europe (1)

(quarterly data; indices, 2000=100)



Sources: Based on national sources and ECB data.
(1) Nominal prices. – (2) ECB estimates based on the average of each country's indices weighted by their respective GDP.

The outlook is fairly good ...

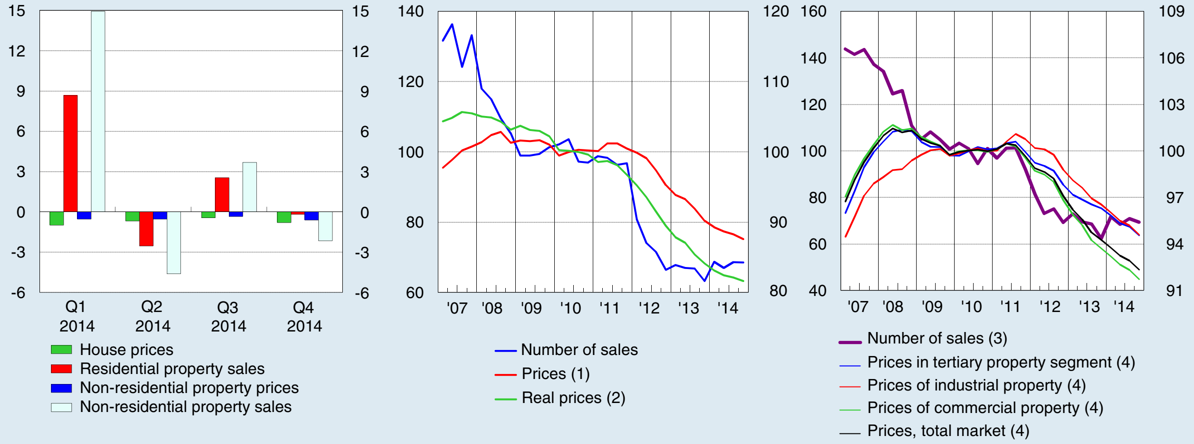
Several indicators signal that the recovery may get under way in the next few months. In March the indicator of construction firms' confidence rose. Production continues to pick up in the industrial sectors that supply the main inputs to building companies. Istat's latest figures on building licences point to a small increase, particularly in the residential sector. The expectations of estate agents have improved considerably for both the short and the medium term (Figure 1.11). The number of potential buyers has been inching upwards, particularly in metropolitan areas, since late 2014, although the gap between asking prices and offers remains substantial.

Figure 1.9

The property market in Italy

(quarterly data, adjusted for seasonal and calendar effects; number of sales and prices)

(a) *Total properties* *(percentage changes on previous period)* | (b) *Residential property* *(indices, 2010=100)* | (c) *Non-residential property* *(indices, 2010=100)*

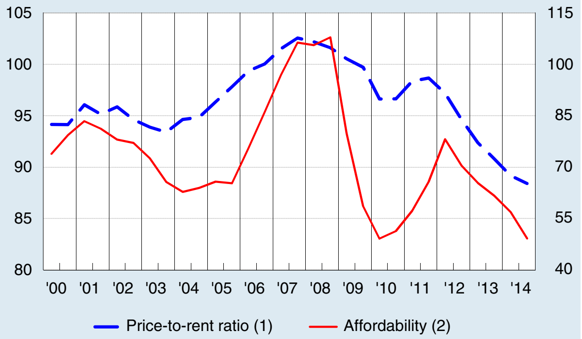


Sources: Based on data from the Bank of Italy, Istat, Osservatorio del Mercato Immobiliare (OMI), Nomisma and Scenari Immobiliari.
(1) Right-hand scale. – (2) Deflated using the change in consumer prices; right-hand scale. – (3) Total market. – (4) Right-hand scale. This experimental price indicator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

Figure 1.10

Affordability of housing and ratio of house prices to rents in Italy

(semi-annual data; indices, 1992-2013 average=100)



Sources: Based on data from the Bank of Italy, Istat, Osservatorio Immobiliare Italiano (OMI) and Consulente immobiliare.
(1) Ratio of house prices to rents for new rental contracts. – (2) Right-hand scale. Ratio of debt service on new mortgage loans – proxied by the product of house prices and interest rates – to household disposable income; a decrease indicates that housing is more affordable.

Figure 1.11

Estate agents' expectations in Italy (1)

(quarterly data; balance of responses)

Sources: Based on data from the Bank of Italy, Osservatorio Mercato Immobiliare (OMI) and Tecnoborsa.
(1) Data from the survey conducted by the Bank of Italy, OMI and Tecnoborsa. Balances between the percentages of replies indicating a situation that is improving or worsening. Short-term expectations refer to the quarter following that indicated; medium-term expectations refer to a 2-year horizon.

... but building activity is held down by the large number of unsold properties

Although the stock of unsold houses is coming down slowly from the 2012 peak, it is still very large, totalling an estimated 200,000 properties. According to surveys conducted by the Bank of Italy's branches, the stock has diminished in the last two years, particularly in the North-East of the country, where it had risen sharply at the height of the crisis. Nationwide, it is still over the normal level according to more than 70 per cent of construction firms.

2 RISKS TO ITALY'S ECONOMY BY SECTOR

2.1 HOUSEHOLDS

Households' financial conditions remain sound

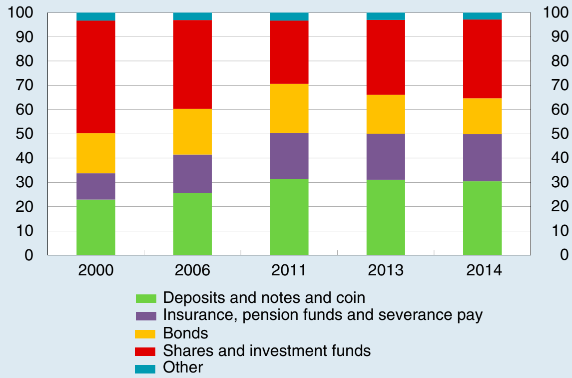
The financial conditions of Italian households are solid overall. In the second half of 2014 disposable income increased by 0.8 per cent on the previous six months. The latest surveys suggest that households' confidence has improved, reflecting expectations of economic growth and the rise in purchasing power due to the fall in energy prices.

Investment in shares and mutual funds increases, but the risks are limited

In the first nine months of 2014 net wealth expanded by 0.7 per cent, mainly owing to the increase in the prices of financial assets. The fall in already low interest rates drove households, presumably the wealthiest, to reduce the share of their portfolios invested in government securities and bank bonds, and to purchase riskier but more remunerative assets such as shares and mutual funds (Figure 2.1). The proportion of liquid assets (bank deposits and notes and coin) instead remained unchanged.

Figure 2.1

Composition of households' financial portfolios (1)
(per cent)



Source: Financial accounts data.
(1) Consumer and producer households; data for 2014 refer to the third quarter.

Debt declines, but new mortgage loans are picking up ...

The level of household indebtedness continues to pose limited risks. Financial debt declined again (in December 2014 it was down 0.8 per cent on an annual basis) and now stands at 63 per cent of disposable income (Figure 2.2.a). In 2014 new mortgage lending increased slightly (€23 billion, against €21 billion in 2013), but the average amounts were still well below those observed in the years preceding the crisis (Figure 2.2.b). The improvement in the outlook for the real-estate market and the more advantageous terms of credit supply both contributed to the rise in new mortgage lending, which continued in the first two months of 2015.

... also thanks to the reduction in interest rates

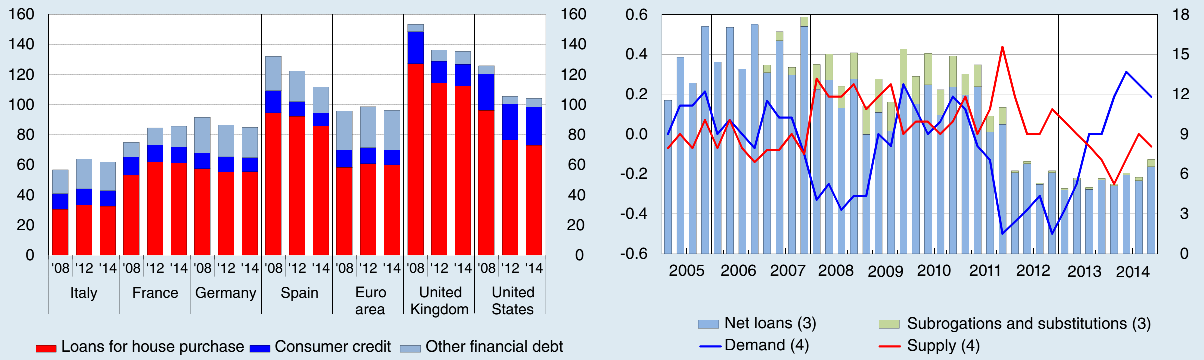
As of February 2015 the easing of supply conditions was reflected in a reduction in mortgage rates (to 2.5 per cent for floating rate loans and to 3.5 per cent for fixed rate loans). Even households that had already taken out mortgages were able to exploit the drop in interest rates: in 2014 mortgage loan subrogations and substitutions doubled from a year earlier and renegotiations as a share of total outstanding mortgages rose from 5.9 to 7.2 per cent.

Difficulties in loan repayments are mitigated by the suspension of instalments

In the last quarter of 2014 the annual flow of new bad debts as a proportion of total household loans came to 1.4 per cent, in line with the average for the previous two years. The ratio of bad debts to loans recorded a small increase. Overall, the share of non-performing loans (including those that are past-due, restructured or substandard) rose to 10.8 per cent in December 2014 (Table 2.1). Repayment

Figure 2.2

Households' debt



Sources: Bank of Italy and Istat for Italy; the ECB for the euro-area countries; Office for National Statistics and Bank of England for the United Kingdom; Federal Reserve System - Board of Governors and Bureau of Economic Analysis for the United States.
(1) The data include bad debts and refer to consumer and producer households, except for the United States, for which they refer only to consumer households. The data for 2014 refer to the third quarter. – (2) The data refer to consumer households only. – (3) Right-hand scale. – (4) For the demand index, values above (below) zero indicate expansion (contraction); for the supply index, values above (below) zero indicate tightening (easing).

difficulties were mitigated by the possibility of suspending instalment payments thanks to Italy's solidarity fund for the purchase of first homes. In operation since 2010, the fund was refinanced with €20 million in 2014 and by the same amount again in 2015; last year it helped 11,000 borrowers in difficulty. In April 2015 the Italian Banking Association and consumer associations signed a separate agreement to extend the suspension of repayments to consumer loans taken out for over 24 months to workers who have lost their jobs, or to those whose hours have been reduced under the terms of the Wage Supplementation Fund.

Table 2.1

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

	June 2014		December 2014	
Total	**550,853**	**100.0**	**548,154**	**100.0**
Performing	493,413	89.6	489,124	89.2
Non-performing	57,440	10.4	59,030	10.8
Past-due	*4,587*	*0.8*	*4,306*	*0.8*
Substandard (2)	*15,668*	*2.8*	*16,703*	*3.0*
Bad debts	*37,185*	*6.8*	*38,021*	*6.9*

Source: Individual supervisory reports.
(1) Loans include repos but not securitized loans. The data include loans granted by financial companies. – (2) The data for substandard loans include restructured loans.

Households' vulnerability is still low

Risks for households' finances stem from weaker than expected growth in nominal income. Our simulations indicate that, assuming a gradual recovery in nominal income and low interest rates, in 2015 the percentage of vulnerable households[1] will in any event remain stable at 3.0 per cent of the total (around 780,000 households); their share of total debt will equal 18 per cent, a low proportion by past standards. Even in an adverse scenario of a reduction in nominal income of 1.0 per cent in 2015, the share of vulnerable households will expand only modestly (to 3.3 per cent). The potential impact of a rise of 100 basis points in the three-month Euribor rate, something that is highly unlikely in current market conditions, would be even smaller.

[1] Households are considered vulnerable when the instalments they have to pay (principal plus interest) exceed 30 per cent of their income and their disposable income is below the median of the distribution; see V. Michelangeli and M. Pietrunti, 'A microsimulation model to evaluate Italian households' financial vulnerability', *International Journal of Microsimulation*, 7, 3, 2014, pp. 53-79.

2.2 FIRMS

Firms' financial conditions are very mixed

Overall, firms have continued to bring their financial structure gradually back into balance in recent months, and both liquidity and conditions of access to external finance have improved. However, a large share of small and medium-sized firms with high levels of debt are still having difficulty accessing credit and are operating with extremely low levels of liquidity; they could find it hard to get the best out of the recovery.

Profitability is low but expectations of growth are increasing

Operating profitability declined further in 2014. According to the national accounts, gross operating profit diminished by 1.0 per cent with respect to 2013. Although industrial production and orders have fluctuated quite considerably, the latest surveys point to better prospects of growth in sales and investment; the improvement is expected to be greater for large firms and exporting companies.

The increase in capital contributes to corporate deleveraging

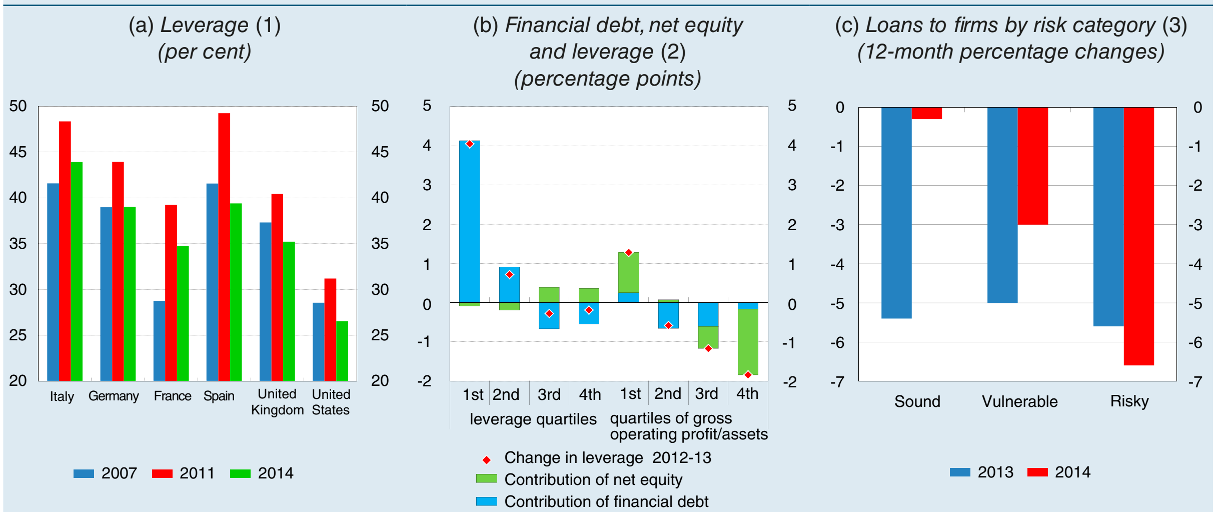
Leverage – measured by the ratio of financial debt to financial debt plus equity – came down from the peak of 48 per cent recorded in 2011 to 44 per cent last September, which is still high by international standards (Figure 2.3.a). At the end of the third quarter of 2014 equity had increased by about €180 billion compared with two years earlier, a fifth of which was due to new inflows of capital and the rest to a rise in the market value of shares. Information gleaned from the financial statements of a large sample of companies indicates that in 2013 equity contributed to deleveraging principally for the most profitable companies (Figure 2.3.b); very likely, capital increases were encouraged by the tax incentives introduced at the end of 2011 with the Allowance for Corporate Equity. Deleveraging also concerned firms with very high levels of debt, which reduced their exposure to the banking system.

Credit diminishes but there are signs that supply conditions are easing ...

Bank lending is still declining, mainly owing to firms' slack demand, while credit supply conditions are improving. Interest rates on new loans fell by over 1 percentage point in the twelve months to February this year, to 2.4 per cent. Moreover, the share of firms that are unable to obtain the loans requested has diminished: according

Figure 2.3

Indicators of firms' financial situation



Sources: Bank of Italy, Istat, Cerved group, ECB for European countries, and Federal Reserve System for the United States.
(1) Ratio of financial debt to financial debt plus net equity at market prices. Data for the non-financial corporate sector; data for 2014 relate to the third quarter. – (2) Contribution of financial debt and net equity at book value to the change in leverage. Data for a closed sample of about 480,000 companies in the two years 2012-13. – (3) Loans granted by banks and financial corporations. Data include bad debts and relate to a sample of about 410,000 companies divided by risk category according to points assigned by the Cerved group.

to Istat data on manufacturing firms, in the first quarter of 2015 the share averaged 11.9 per cent, more than 3 percentage points less than a year earlier.

... above all for some categories of firms

Substantial differences in firms' borrowing conditions remain, connected with their size, capital soundness, and outlet markets. The share of small firms whose loan applications are rejected is diminishing but it is still much higher than that of large firms. According to individual data from the Central Credit Register, in 2014 banks virtually ceased reducing loans to firms with a balanced financial situation (Figure 2.3.c). Our estimates indicate that in the last three years exporting firms have benefited from a reduction in interest rates almost twice the size of that enjoyed by other firms.

The share of bond debt continues to rise

Firms continue to diversify their sources of finance: bonds account for 12 per cent of total corporate financial debt, almost double the proportion recorded before the financial crisis. In 2014 gross bond issues amounted to €28 billion, down from the peak of €39 billion reached in 2013 but over a third more than average issues from 2002 to 2008. The number of new issuers was 97, the highest figure since 2009. Most of the firms concerned are small or medium-sized enterprises and many of them issued minibonds. Part of the capital raised on the market was used to reduce bank debt: for a sample of firms that issued bonds in 2014, accounting for more than three quarters of total gross issues, bank loans are estimated to have decreased by 18 per cent.

Liquidity levels are high, especially for large companies

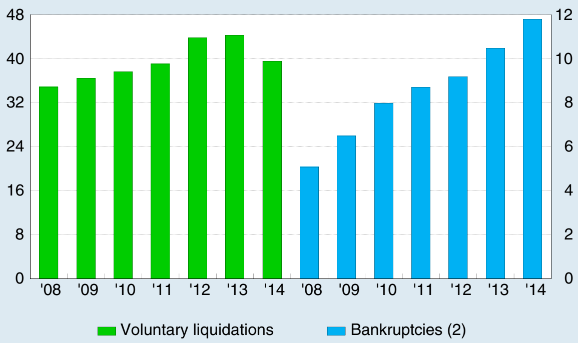
Firms' liquidity continues to increase, probably reflecting uncertainty about the prospects of a recovery. Overall, according to the financial accounts, cash and deposits were 8.0 per cent of total liabilities in September 2014, against an average of 6.4 per cent from 2004 to 2008. Liquidity is abundant, especially for large companies: according to the March edition of the Survey on Inflation and Growth Expectations conducted by the Bank of Italy and *Il Sole 24 Ore*, only 5.1 per cent of firms with more than 1,000 employees judged their liquidity to be insufficient for the following three months, compared with 17.0 per cent of those with fewer than 200 employees.

Firms are still vulnerable, despite some improvement

Irrespective of the reduction in interest rates, many firms are having difficulty repaying their loans. The number of bankruptcies was again high in 2014 (Figure 2.4), as was the flow of new bad debts to banks (see Section 3.2). Commercial debts are being repaid more punctually, however: according to data from the Cerved group, in 2014 non-payment claims fell by 17 per cent on an annual basis and payment times decreased slightly. The new moratorium recently signed by the Italian Banking Association and the main business associations allowing firms to suspend loan repayments provides liquidity support during the exit from the recession. The eligibility requirements for a suspension of repayments are slightly stricter than in the previous agreements. Banks may raise interest rates (by up to a maximum of 75 basis points) for firms having difficulty repaying their loans and which do not make use of the Central Guarantee Fund for SMEs.

Figure 2.4

Number of voluntary liquidations and bankruptcies of firms (1)
(thousands)



Source: Cerved group.
(1) Data for companies that deposited at least one set of financial statements in the 3 years up to the reference date. – (2) Right-hand scale.

3 THE BANKING AND FINANCIAL SYSTEM

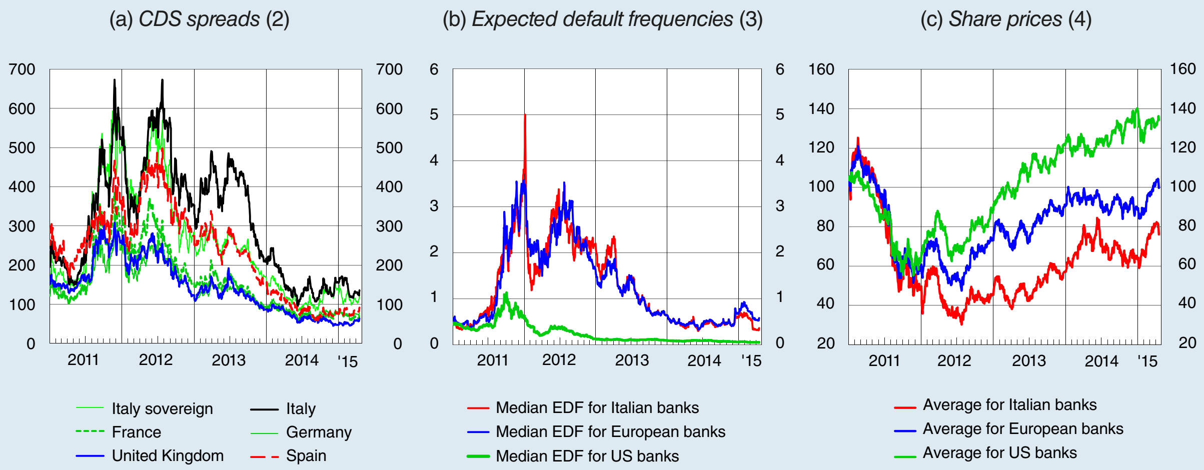
3.1 THE MARKET'S ASSESSMENT OF ITALIAN BANKS

Market indicators are improving

The Eurosystem's asset purchase programme and the publication of the results of the ECB's comprehensive assessment have helped to produce a broad-based improvement in the market's assessment of the soundness of the leading Italian banks (Figure 3.1). Since the end of October their share prices have been increasing, as have price-to-book ratios, which have risen on average from 59 to 71 per cent. CDS have come down from 150 to 136 basis points, paralleling sovereign CDS, and expected default frequencies are now very low, like those of banks in the other main European countries. The systemic risk indicators for Italian banks – such as the joint probability of distress (JPoD)[1] – have also continued to diminish.

Figure 3.1

Listed Italian banks: international comparison (1)



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

[1] JPoD estimates the probability of a number of banks being in distress at the same time. For the method of calculation, see the box 'Indicators of interdependence between banks,' *Financial Stability Report*, No. 2, 2011.

3.2 THE RISKS FOR BANKS

Credit

Lending is slack, even in relation to economic activity

In proportion to GDP, credit to residents is well below its long-term trend. The European Systemic Risk Board estimates that in the third quarter of 2014 the credit-to-GDP gap was negative by 8 percentage points.[2] The only large European country with a positive gap was France.

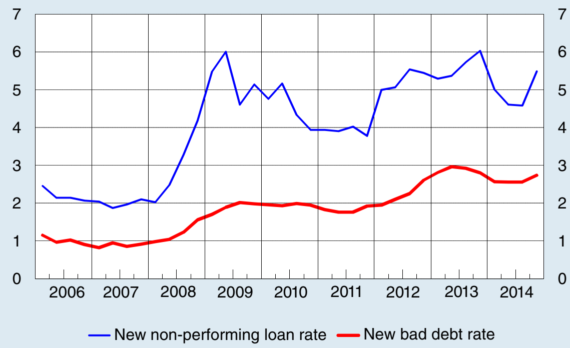
Default rates rise

In the fourth quarter of 2014 the flows of new bad debts and of all non-performing loans in proportion to total loans began to increase again (Figure 3.2). The improvement in credit quality was brought to a halt by the continued weakness of economic activity last year and by the full incorporation in banks' balance sheets of the results of the asset quality review. Preliminary data indicate that in the first quarter of 2015 the flow of new bad debts was essentially constant.

Figure 3.2

New non-performing loan rate and new bad debt rate (1)

(per cent)



Source: Central Credit Register.
(1) Annualized quarterly flows of adjusted non-performing loans and adjusted bad debts in relation to the stock of loans at the end of the previous quarter; seasonally adjusted where necessary.

Table 3.1

Credit quality: amounts and shares of non-performing loans and coverage ratios (1)

(billions of euros and per cent; December 2014)

	5 largest groups			Large banks			Small banks			Minor banks			Total system		
	Amount	Percentage composition	Coverage ratio	Amount	Percentage composition	Coverage ratio	Amount	Percentage composition	Coverage ratio	Amount	Percentage composition	Coverage ratio	Amount	Percentage composition	Coverage ratio
Customer loans	**1,231**	**100**	**9.2**	**434**	**100**	**6.9**	**131**	**100**	**8.2**	**177**	**100**	**6.6**	**1,974**	**100**	**8.4**
of which:															
Performing	1,003	81.5	0.7	366	84.2	0.6	108	82.2	0.6	147	83.2	0.6	1,624	82.3	0.7
Non-performing	228	18.5	46.6	68	15.8	40.8	23	17.8	42.9	30	16.8	36.5	350	17.7	44.4
Bad debts	*132*	*10.7*	*60.3*	*36*	*8.3*	*56.9*	*14*	*10.5*	*55.7*	*15*	*8.6*	*52.1*	*197*	*10.0*	*58.7*
Substandard	*75*	*6.1*	*29.0*	*24*	*5.6*	*25.9*	*8*	*6.0*	*25.9*	*12*	*6.7*	*22.0*	*119*	*6.0*	*27.5*
Restructured	*14*	*1.2*	*26.7*	*5*	*1.1*	*16.3*	*1*	*0.5*	*31.6*	*1*	*0.5*	*17.6*	*20*	*1.0*	*24.1*
Past-due	*7*	*0.6*	*16.9*	*4*	*0.8*	*12.4*	*1*	*0.9*	*11.1*	*2*	*0.9*	*5.9*	*13*	*0.7*	*13.9*

Source: Supervisory reports, on a consolidated basis for banking groups, solo for the rest of the system.
(1) The coverage ratio is the amount of loan loss provisions in relation to the corresponding gross exposure. In the case of performing loans, it is calculated as the ratio of generic provisions to the loans. The division into size classes is based on the composition of banking groups in December 2014 and total non-consolidated assets as of December 2008. The 5 largest groups comprise the banks belonging to the UniCredit, Intesa Sanpaolo, Banca Monte dei Paschi di Siena, UBI Banca and Banco Popolare groups. The size classes 'large', 'small' and 'minor' refer to banks belonging to groups or independent banks with total assets, respectively, greater than €21.5 billion, between €3.6 billion and €21.5 billion, and below €3.6 billion. Foreign bank branches are not included. Rounding may cause discrepancies in the totals.

[2] ESRB, 'ESRB Risk Dashboard', Issue 11, March 2015 (https://www.esrb.europa.eu/pub/rd/html/index.en.html). The early warning threshold for this variable, above which the competent authorities must consider measures to contain systemic risk, is set at +2 percentage points.

Non-performing exposures continue to grow ...

In December 2014 the stock of non-performing exposures for the entire Italian banking system amounted to 17.7 per cent of outstanding loans, and bad debts alone to 10.0 per cent. For the five largest banking groups the ratios were 18.5 and 10.7 per cent (Table 3.1).

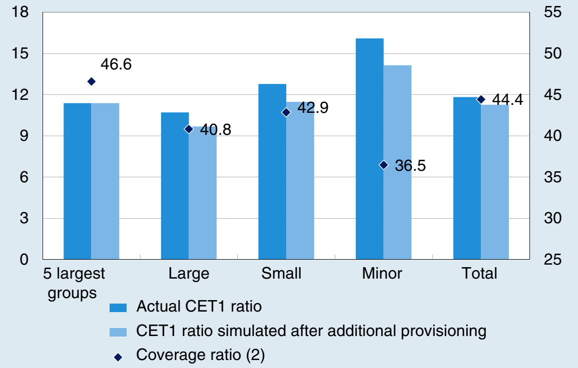
... but coverage ratios increase

The average coverage ratio of non-performing exposures (the ratio of loss provisions to gross non-performing exposures) rose further in the second half of 2014, from 42.4 to 44.4 per cent; for the five largest groups it was 46.6 per cent. Coverage ratios of minor banks are lower than average because more of their lending is secured by collateral or personal guarantees. Furthermore, our analysis indicates that the minor banks' excess capital over the minimum requirements more than offsets their lower coverage ratio (Figure 3.3).

Figure 3.3

Coverage and capital ratios of Italian banks (1)

(per cent; December 2014)



Source: Based on supervisory reports.
1) For banks outside the 5 largest groups whose coverage ratio for non-performing loans is below the groups' average, the figure shows the reduction in the CET1 ratio that would occur if the coverage ratios were brought into line with that average. The assumption used in the simulation – a particularly conservative one – is that the increase in provisioning required to bring the coverage ratios into line is entirely financed by drawing down excess capital (in other words, that operating profit is nil). For the banks with coverage ratios above the average of the 5 largest groups, obviously, the simulation envisages no reduction. For the classification by size, see the note to Table 3.1. – (2) Right-hand scale.

Reducing the stock of non-performing exposures may require targeted actions

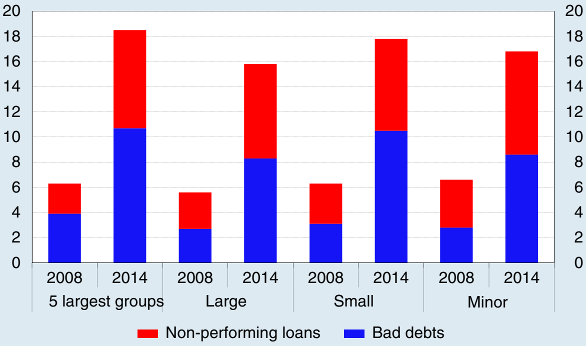
Measures are under study to reduce banks' stock of non-performing loans, which is an impediment to new lending (see the box 'A special purpose company for the purchase of Italian banks' bad debts').

A SPECIAL PURPOSE COMPANY FOR THE PURCHASE OF ITALIAN BANKS' BAD DEBTS

The severe recession that has beleaguered the Italian economy in recent years has caused a sharp deterioration in the quality of the loans on banks' balance sheets. Between 2008 and 2014 the non-performing loans of the entire banking system (including those of financial companies belonging to banking groups) grew from €131 billion to €350 billion (from €75 billion to €197 billion for bad debts alone) and their ratio to total loans rose by about 12 percentage points to 17.7 per cent (by about 7 points to 10.0 per cent for bad debts alone). The deterioration mainly concerned loans to firms; it was widespread across sectors of economic activity and geographical areas, and involved banks of every size class (see the figure).

Transfers of non-performing loans by means of sale or securitization and balance sheet derecognition have been of limited amount (less than €7 billion of bad debts in the two years 2013-14). A revival of this market could reduce the stock of non-performing loans more quickly, as happened after the recession of the 1990s, but a number of obstacles lie in the way. First of all, credit recovery and insolvency procedures are much longer in Italy than the average in the European Union and differ considerably from region to region and even between courts in the same region. Secondly, in Italy non-performing loans consist largely in exposures to SMEs operating in differing sectors. The resulting diversity of the collateral provided by borrowers makes it much more difficult to estimate its value than in countries where defaults are concentrated in just a few sectors, notably real estate. Thirdly, the fragmentation of the Italian banking market plays a part: many small banks lack both the expertise to manage the sale of non-performing loans – small banks accounted for only 5 per cent of the already modest volume of transactions on this market in 2013 – and the technologies for efficient in-house management of these assets. In addition, banks are required to make a prudential valuation of non-performing loans but not to take account of the (potentially very high) profit margin that the buyer intends to obtain from the transaction; this helps to create a gap between the book value of these assets and their demand price. Finally, the still uncertain prospects of economic recovery in Italy make potential buyers wary.

Credit quality by size class of banks (1)
(per cent of total loans)



Source: Supervisory reports, on a consolidated basis for banking groups, solo for the rest of the system.
(1) For the division into size classes, see note (1) to Table 3.1.

Together, these factors reduce banks' incentives to dispose of non-performing loans. This in itself would be one reason for measures to facilitate the reduction of the stock of bad debts. Interventions of this kind would also be justified on macroprudential grounds, since each individual bank does not consider the benefits resulting from the overall reduction of the stock of bad debts and banks with a severe decline in credit quality tend to restrict the supply of funds and increase interest rates.[1] If the problem concerns the majority of banks, the effects on the credit market have macroeconomic implications.[2]

Against this backdrop, the creation of a special purpose asset management company for the purchase of non-performing loans and the consequent reduction of their incidence on banks' balance sheets would bring a number of important benefits. Specifically, it would: (a) lead to lower management costs and make balance sheets more transparent, enhancing banks' ability to attract capital and their access to wholesale funding markets; (b) eliminate the remaining constraints on loan supply, helping to restart the credit market and investment; (c) spur competition on the banking market and efficiency gains by helping to create the conditions for bank consolidation; and (d) assist the development of a market in non-performing loans, since the asset management company would act as market maker and increase price transparency (among the European countries that have set them up, such asset management companies account for an estimated 40 per cent, on average, of the total volume of transactions in non-performing loans).

The intervention of the asset management company could be limited to bad debts and exclude the other categories of impaired assets (substandard, restructured and past due loans), so as to enable banks to continue to support customers in temporary difficulty. In order to avoid burdening the company with an inordinate number of operations, its purchases could exclude positions below a given threshold value and be limited to exposures to firms, the chief component of the stock of non-performing loans. Among the possibilities is a programme of purchases for a value of around €100 billion gross of loan loss provisions.

Under European Union legislation, if the creation of an asset management company by a public measure were interpreted as constituting State aid, this would trigger a series of consequences (requests to the participating banks for restructuring plans, burden-sharing with stockholders and

[1] See, for example, E. Bonaccorsi and E. Sette, 'Bank balance sheets and the transmission of financial shocks to borrowers: evidence from the 2007-2008 crisis', Banca d'Italia, Temi di discussione (Working Papers), No. 848, 2012; J. Santos, 'Bank Corporate Loan Pricing Following the Subprime Crisis', *The Review of Financial Studies*, 24, 6, 2001, pp. 1916-1943.

[2] Numerous studies indicate that reducing the stock of non-performing loans would bring major benefits for the country's economy. See, for example, N. Jassud and K. Kang, 'A Strategy for Developing a Market for Non-performing Loans in Italy', IMF Working Paper, 15/24, 2015; OECD, *OECD Economic Survey of Italy 2015*, 2015; M. Draghi, Hearing on the monetary policy of the ECB, structural reforms and growth in the euro area, testimony before the Chamber of Deputies, Rome, 26 March 2015 (in Italian).

subordinated creditors) which, in the Italian context, would make the intervention impracticable. Italy's asset management company therefore needs to have different characteristics from those set up in other European countries. Specifically, as has not been the case elsewhere, it would buy bad debts at market value; its intervention would therefore not constitute State aid.

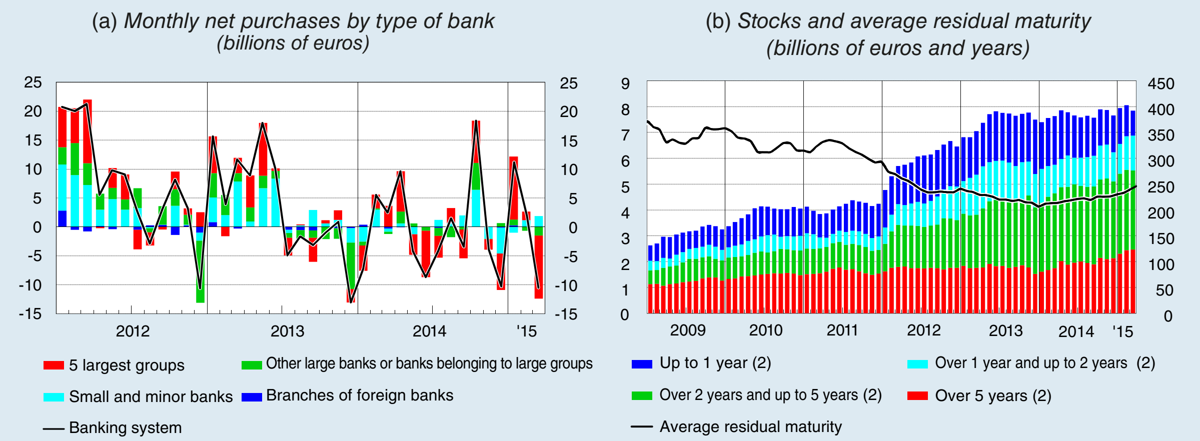
Exposure to sovereign risk and foreign assets

Banks' exposure to Italian sovereign debt is unchanged

Between July 2014 and March 2015 banks made very limited net purchases of Italian government securities, just €0.6 billion (Figure 3.4.a), increasing their total holdings marginally to €392 billion (Figure 3.4.b), or 10.6 per cent of total assets. Portfolio revaluation since July 2014 is estimated at €9 billion; disposals in the second half of the year produced capital gains of about €2 billion.[3]

Figure 3.4

Banks' investments in Italian general government securities (1)
(monthly data)



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

Lending to non-residents is still limited ...

Italian banks' exposures to non-residents remain concentrated within the euro area and Central and Eastern Europe (Table 3.2 and Figure 3.5) and in low-risk countries.[4] Indirect risk – i.e. exposure to Italian firms with significant foreign direct investment[5] in high-risk countries – is also modest (€15 billion at the end of 2014).

... especially to the riskiest countries

At the end of 2014 Italian banks had exposures amounting to barely €1 billion to Greece; those to Russia and Ukraine came to €17.7 billion and €3.0 billion.

[3] This estimate is for capital gains on sales of government securities held in the available-for-sale portfolio, some 84 per cent of which consists in Italian public sector securities. About 80 per cent of the banks' total holdings of government securities is in this portfolio.

[4] The country risk indicator is based on that calculated for 189 countries by the Italian export insurance agency SACE S.p.A. (http://www.sace.it/en/studies-and-training/country-risk-map), which assigns scores to six factors: sovereign default risk, bank default risk, corporate default risk, expropriation and breach of contract, war and civil disorder, and transfer and convertibility risk. For our analysis we use a composite indicator based on the average of the scores: countries above the median of this indicator are deemed risky, those below it less risky.

[5] 'Significant' is defined as investment equal to more than a quarter of a firm's total foreign direct investment.

Table 3.2

Exposures of Italian groups and banks, by borrowers' nationality and sector (1)
(billions of euros; December 2014)

	General gov.t	Banks	Financial corporations	Households and firms	Total	Percentage change of total over previous half	Per cent of total exposures reported to BIS (2) (3)
Europe	**551.1**	**202.7**	**198.5**	**1,591.9**	**2,544.1**	**-1.4**	**18.7**
Euro area	512.7	177.1	177.6	1,482.2	2,349.6	-1.5	28.9
Italy	*438.3*	*107.8*	*136.2*	*1,311.3*	*1,993.6*	*-1.3*	*77.0*
Germany	*35.6*	*25.7*	*12.7*	*79.6*	*153.5*	*-13.4*	*13.9*
Austria	*18.4*	*7.9*	*1.7*	*50.0*	*78.0*	*4.1*	*41.2*
France	*5.5*	*13.6*	*3.4*	*8.1*	*30.5*	*2.9*	*3.4*
Luxembourg	*0.4*	*2.7*	*11.2*	*4.0*	*18.2*	*-1.0*	*4.3*
Spain	*6.6*	*9.5*	*2.1*	*3.4*	*21.6*	*47.1*	*5.6*
Netherlands	*0.2*	*4.9*	*4.9*	*6.3*	*16.3*	*7.4*	*3.4*
Ireland	*0.2*	*0.7*	*4.2*	*0.7*	*5.8*	*-15.0*	*1.9*
Portugal	*1.1*	*1.1*	*0.2*	*0.6*	*3.0*	*21.2*	*2.8*
Greece	*0.3*	*0.4*	*0.0*	*0.4*	*1.1*	*70.9*	*3.1*
Other (4)	*6.1*	*2.7*	*1.1*	*17.9*	*27.8*	*5.7*	*4.3*
CEE (5)	44.4	9.8	4.2	114.0	172.3	-0.3	15.8
Poland	*10.7*	*0.6*	*2.2*	*24.3*	*37.8*	*2.2*	*16.8*
Croatia	*7.5*	*0.2*	*0.3*	*14.9*	*22.8*	*-1.3*	*47.3*
Slovakia	*2.9*	*0.3*	*0.2*	*11.7*	*15.1*	*1.1*	*26.4*
Hungary	*4.7*	*0.3*	*0.2*	*9.2*	*14.4*	*4.4*	*24.4*
Russia	*1.6*	*2.2*	*0.4*	*13.6*	*17.7*	*-12.3*	*11.4*
Ukraine	*0.2*	*0.0*	*0.0*	*2.8*	*3.0*	*-15.9*	*21.5*
Rest of world	**19.8**	**15.8**	**8.5**	**20.6**	**64.6**	**-1.8**	**0.6**
Advanced countries	7.5	6.9	6.7	7.8	28.9	-7.9	0.5
United States	*6.2*	*5.3*	*6.2*	*5.1*	*22.8*	*-10.1*	*0.5*
Developing countries	12.2	7.6	0.3	7.8	27.9	-9.9	0.9
Egypt	*2.4*	*0.2*	*0.0*	*2.4*	*5.0*	*17.1*	*25.7*
Offshore centres	0.1	1.3	1.6	4.9	7.8	16.0	0.4

Sources: Consolidated supervisory reports for banking groups and individual supervisory reports for banks not belonging to a group.
(1) Exposures to 'ultimate borrowers', gross of bad debts and net of provisions. Does not include BancoPosta and Cassa Depositi e Prestiti. – (2) As a percentage of the total foreign exposures to each country in September 2014 reported to the BIS by a large group of international intermediaries. – (3) As the BIS data for Italy do not include exposures to residents, the ratio is obtained by including exposure to general government (first column) in the denominator. – (4) Belgium, Cyprus, Estonia, Finland, Latvia, Malta, Slovakia, and Slovenia. – (5) Central and Eastern Europe: Albania, Armenia, Azerbaijan, Belarus, Bosnia-Herzegovina, Bulgaria, Croatia, Czech Republic, Estonia, Georgia, Hungary, Kazakhstan, Kyrgyzstan, Kosovo, Latvia, Lithuania, Macedonia, Moldova, Montenegro, Poland, Romania, Russia, Serbia, Slovakia, Slovenia, Tajikistan, Turkey, Turkmenistan, Ukraine and Uzbekistan; among these, European and euro-area countries are also counted under exposures to Europe and euro area.

Non-performing assets accounted for 12 per cent of the exposure to the latter two countries. At the same date Italian banks' outstanding loans to oil-producing countries amounted to €24.4 billion (4 per cent of their total exposure to non-residents).

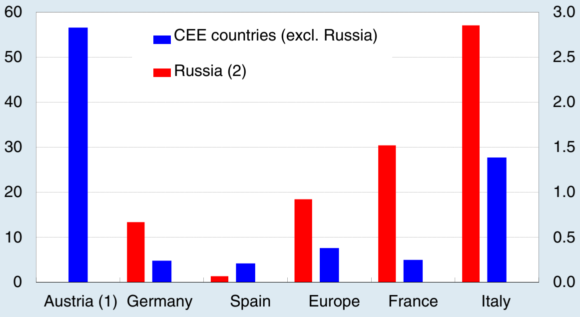
Refinancing risk and liquidity risk

Refinancing risk diminishes

Refinancing risk has diminished thanks to the growth of both retail and wholesale funding (Figure 3.6). Net bond issues on international markets came to €3.4 billion in the first quarter of 2015 (Figure 3.7). The average cost of funding came down further and is now historically low (0.81 per cent in February compared with 1.15 per cent a year earlier). Abundant availability of resources in various markets at very low cost has enabled banks to reduce their liabilities to the Eurosystem (see Section 4.2).

Figure 3.5

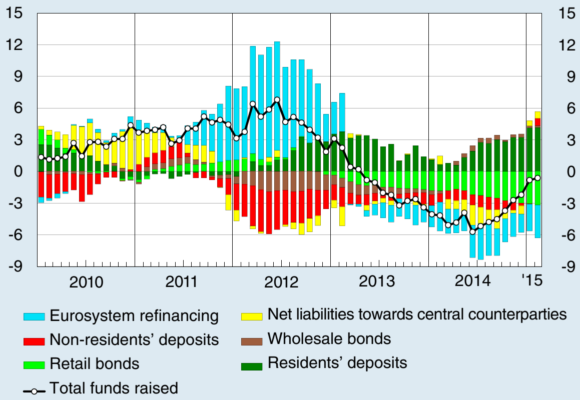
Exposures of the main European banking systems to Russia and other Central and Eastern European countries
(per cent of total outstanding loans to non-residents at end-2014)



Source: Based on BIS data.
(1) Austrian banks' exposure to Russia is classified as confidential on the BIS website. (2) Right-hand scale.

Figure 3.6

Growth in bank funding: contributions of individual components (1)
(percentage points and 12-month percentage changes)



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

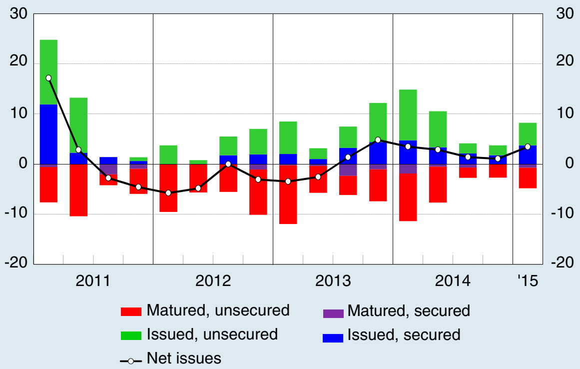
The funding gap – the portion of loans not financed by retail funding – remains modest (Figure 3.8). Over the past three years it has narrowed at all categories of bank, most markedly among small and minor banks, whose retail funding now exceeds loans by more than 15 per cent.

The net liquidity position remains strong

The net liquidity position of the major Italian banks continues to be greater than 10 per cent of assets. The ratio declined in the fourth quarter of 2014 owing to cash outflows and to a simultaneous reduction in highly liquid assets with the redemption of government-guaranteed bank bonds issued from 2011 onwards and eligible for Eurosystem refinancing operations until the beginning of 2015 (Figure 3.9). The

Figure 3.7

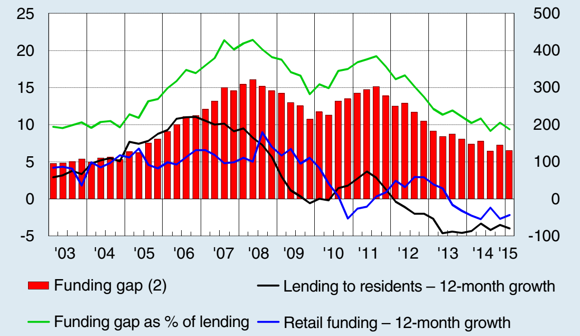
Bonds issued and matured (1)
(quarterly data; billions of euros)



Source: Dealogic.
(1) Italian banks' issues of securities on international markets with issue amounts of over €200 million. Does not include issues retained on issuers' balance sheets, those addressed to the retail market and those of Italian banks' foreign subsidiaries.

Figure 3.8

Italian banks' funding gap (1)
(billions of euros and per cent)



Source: Supervisory reports.
(1) Share of loans not financed by retail funding. For the calculation methodology, see the box 'The funding gap of Italian banks,' *Financial Stability Report*, No. 4, April 2012. Excludes Cassa Depositi e Prestiti and branches of foreign banks. For 2015, end-February. – (2) Right-hand scale.

maturity of the Eurosystem's second LTRO in February 2015 and access to the third TLTRO in March did not affect the net liquidity position.

Interest rate risk and market risk

There is only modest exposure to the risk of a rise in interest rates ...

The major Italian banking groups' exposure to the risk of an increase in interest rates is low. Based on end-2014 data, an upward shift of 200 basis points in the entire risk-free yield curve (the Basel Committee's scenario) would result in a reduction in the net value of assets and liabilities equal to 5.3 per cent of regulatory capital (compared with 4.4 per cent last June). The overall impact is limited by the high proportion of variable rate assets, whose value is fairly unresponsive to shifts in the yield curve. The effect differs between banks according to the term structure of their assets and liabilities. For some, net assets would increase in value by as much as 3.2 per cent of regulatory capital. Value losses at the other intermediaries would be well below the official warning threshold of 20 per cent.

... or of a fall

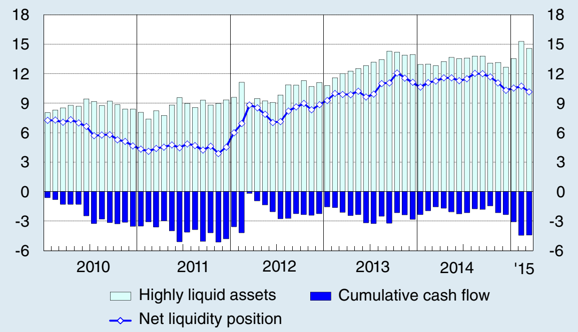
In a scenario of a fall in interest rates such as to cut yields to zero at all maturities, the net value of the assets and liabilities of Italian banking groups would increase on average by 2.9 per cent of regulatory capital. Only two groups would record a decrease in net worth, with a maximum loss of 3.5 per cent of regulatory capital.

Market risk at the main banks remains low

Last year's decrease in the volatility of the yields on government securities, which account for the bulk of Italian banking groups' exposure to market risk, brought Value at Risk for the combined trading and banking books to its lowest level since 2011 (Figure 3.10). In the first few months of 2015 VaR on the trading book alone turned modestly back upwards, reflecting the increase in open foreign currency positions.

Figure 3.9

Banks' net liquidity position (1)
(averages; per cent of total assets)



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

Figure 3.10

VaR performance of a sample of banks (1)
(indices, 1 January 2011=100)

Source: Data from a sample of 6 banking groups using internal models to quantify market risk.
(1) Averages weighted according to the size of the single intermediaries' portfolios. VaR represents the size of the loss of value in a portfolio that will not be exceeded over a given interval (10 days) at a given confidence level (99 per cent). The indices are constructed so as to reflect the performance of the VaRs in relation to all positions (securities and derivatives) valued at fair value (in red) and to the trading book component alone (in blue). A decline indicates a reduction in risk.

Operational risk

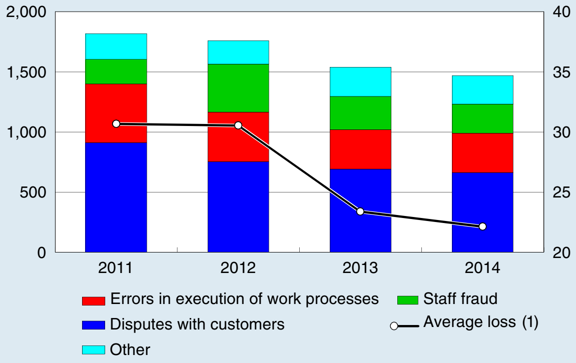
Operational loss declines in Italy

In contrast with developments in many foreign banking systems, between 2011 and 2014 the operational losses of Italian banks decreased by 19 per cent, from €1,816 million to €1,467 million. Losses due to customer disputes declined by 27 per cent and those due to errors in the execution of work processes fell by 33 per cent (Figure 3.11). The reduction in operational risk was achieved thanks to improvements in internal control and risk management systems,[6] introduced in part in response to the entry into effect of new rules issued by the Bank of Italy.[7]

Figure 3.11

Banks' operational losses

(millions of euros)



Source: Suprvisory reports.
1) Right-hand scale, thousands of euros.

3.3 BANKS' CAPITAL AND PROFITABILITY

Capital ratios have risen

At the end of 2014 Italian banks' common equity tier 1 (CET1) capital and total own funds amounted respectively to 11.8 and 14.5 per cent of risk-weighted assets; the CET1 ratio of the five main banking groups was 11.4 per cent. The average capital ratios of the two leading Italian banking groups are in line with that of a sample of major European banks; in both cases, the average CET1 ratio was 11.7 per cent in June 2014.[8] With the new regulations, which do not become operational until the end of the transition period established by European law (and under which banks deduct from regulatory capital deferred tax assets based on future earnings; see the box 'Deferred tax assets: loss absorption capacity and inclusion in Italian banks' capital'), the average CET1 ratio of Italian banks at the end of 2014 would amount to11.3 per cent.

[6] A survey conducted by the Bank of Italy found that in response to the new rules the major banks generally extended the responsibilities of their compliance function, strengthened the independence of their second-level control functions, and initiated coordination among the various bodies responsible for controls (*Analisi trasversale delle relazioni di autovalutazione sull'adeguamento dei sistemi di controllo interno presentate dall banche maggiori*).

[7] The supervisory provisions on internal controls were revised in July 2013 (15th update, available only in Italian, of Circular 263/2006, New regulations for the prudential supervision of banks, 2 July 2013); the measure provides for phasing in the new rules between July 2014 and June 2016.

[8] See EBA, CRDIV-CRR / Basel III monitoring exercise, 2015 (http://www.eba.europa.eu/risk-analysis-and-data/quantitative-impact-study/basel-iii-monitoring-exercise)

DEFERRED TAX ASSETS: LOSS ABSORPTION CAPACITY AND INCLUSION IN ITALIAN BANKS' CAPITAL

Deferred tax assets (DTAs) derive from the deferred recognition, for tax purposes, of costs incurred in the tax year in which they are booked. Such assets represent an expected saving of future taxes.

Italian banks' DTAs (€55 billion at the end of 2014) are mainly an effect of the limit on the tax deductibility of loan value adjustments.[1] Whereas in most other countries value adjustments are deductible immediately, in Italy the deduction is spread over a long period (18 years up to the 2012 tax year, 5 years since 2013), with a pronounced competitive disadvantage for Italian banks.

[1] See A. De Vincenzo and G. Ricotti, 'The use of tax law from a macroprudential perspective: the impact of some recent tax measures on procyclicality and banks' stability', Banca d'Italia, *Note di Stabilità finanziaria e vigilanza*, No. 1, 2014.

The Basel III framework envisaged specific rules for the prudential treatment of DTAs, rules that were subsequently incorporated into the European Capital Requirements Directive (CRD IV) and Capital Requirements Regulation (CRR).[2] The rules distinguish between two types of DTAs. The first type consists of DTAs that are able to absorb losses and whose realization does not depend on the company's future profitability;[3] for prudential purposes, a risk weight of 100 per cent applies to them. This category includes DTAs (for example, those deriving from value adjustments to loans) that under tax law are to be transformed into tax credits upon the occurrence of certain events (annual financial statements showing a loss, liquidation, inception of bankruptcy proceedings). Most of Italian banks' DTAs (€43 billion) belong to this category. The second type comprises DTAs that do depend on future profitability,[4] i.e. those whose realization relies on the capacity to generate taxable profit (for example, those deriving from valuation losses on exposures classified as available-for-sale assets). Considering their lower loss absorption capacity, DTAs of this type are deducted gradually, for the part exceeding a given threshold, from regulatory capital.

The European Commission recently asked Italy and several other member states for information on the characteristics of the tax rules that permit transformation of DTAs into tax credits, in order to make sure that the arrangements did not constitute State aid to the financial sector. In this regard, it should be noted that Italy's tax rules for the transformation of DTAs arising from value adjustments to loans into tax credits[5] are in conformity with Europe's Capital Requirements Regulation; they do not discriminate between sectors of economic activity. Value adjustments to loans are a recurring, typical part of financial activity, whereas for non-financial firms loans perform an ancillary function. Consequently, for financial intermediaries value adjustments are fully deductible, albeit over a number of years, while for non-financial firms they are only partially deductible. Moreover, the rules do not introduce a distortion in favour of Italian banks vis-à-vis other banking systems but only reduce the tax disadvantage to which they are subject.

[2] Directive 2013/36/EU and Regulation 2013/575/EU.

[3] CRR, Article 39(2).

[4] CRR, Articles 38(1) and 48(1).

[5] Decree Law 225/2010, converted with amendments by Law 10/2011.

The regulatory leverage ratio improves further

From June 2013 to June 2014 the average regulatory leverage ratio (calculated as the ratio of tier 1 equity to non-risk-weighted assets) of the Italian banks taking part in the exercise coordinated by the Basel Committee and European Banking Authority (EBA) rose from 4.1 to 5.0 per cent. Italian banks' leverage ratio is higher than the European average, which at the same date was 3.9 per cent for a sample of large international banks and 4.9 per cent for a sample of smaller banks.[9]

Profitability reflects the economic situation

The difficult credit conditions are reflected in the Italian banking industry's poor capacity to generate income, which is one cause of its vulnerability. Because of the prolonged period of economic weakness, earnings are stagnating and loan loss provisions are soaking up operating profits. The cost cutting and efficiency drives that banks have undertaken in recent years have helped the industry as a whole to limit losses but not to generate sufficient profits (see the box 'Developments in the profitability of the Italian banking industry: a comparison with the period before the crisis'). As a result, self-financing capacity, i.e. the ability to strengthen capital with internal resources, is suffering.

[9] See EBA, CRDIV-CRR / Basel III monitoring exercise, 2015 (http://www.eba.europa.eu/risk-analysis-and-data/quantitative-impact-study/basel-iii-monitoring-exercise)

DEVELOPMENTS IN THE PROFITABILITY OF THE ITALIAN BANKING INDUSTRY: A COMPARISON WITH THE PERIOD BEFORE THE CRISIS

The prolonged weakness of the economy has weighed heavily on Italian banks' profitability. A comparison limited to the banks operating in Italy shows that the return on assets (ROA) is currently (average for 2013 and 2014) some 110 basis points lower than in the period preceding the crisis (average for 2004-07). The decline stemmed equally from the fall in income, due above all to the slump in net interest income, and the increase in loan loss provisions.

Banks countered the fall in income largely by cutting operating expenses, especially staff costs (down by 10 per cent in absolute terms and by 23 basis points in relation to assets). The organizational restructuring was extensive: the number of branches was reduced by 8 per cent and that of employees by 12 per cent compared with 2008 (see the box 'Recent developments in banks' branch networks in Italy', *Financial Stability Report*, No.1, 2014).

If the return to growth gains traction, there should be significant scope for improvements in profitability. In particular, if the adjustment of costs proves structural and the economic recovery enables banks to make good the fall in income and to halve their loan loss provisions,[1] ROA could rise back to near its 2004-07 level (1.0 per cent). This is an ambitious objective but one that seems attainable in the light of past experience and the current projections for economic growth.

Income statements of Italian banks (1)

	2013-14	2004-07	1994-97
		Per cent of total assets	
Net interest income	1.02	1.50	2.50
Other income, net	1.20	1.40	0.97
Gross income	**2.21**	**2.89**	**3.48**
Operating expenses	**1.35**	**1.70**	**2.37**
of which: bank staff costs (2)	*0.69*	*0.92*	*1.51*
Operating profit	**0.87**	**1.19**	**1.11**
Allocations to provisions and net value adjustments	**1.09**	**0.29**	**0.75**
of which: for loan impairment	*0.84*	*0.21*	*0.57*
Profit before tax (ROA) (3)	**-0.23**	**0.91**	**0.37**
		Consistenze	
Total assets (*billions of euros*)	3,219	2,704	1,291
Employees (*thousands*)	298	338	333
Branches *(thousands)*	31.6	32.6	24.6

Source: Individual supervisory reports.
(1) Data referring to the entire banking system, excluding banks that did not transmit income statements. For each of the periods, averages of the annual data. The annual figures for total assets and employees are calculated as averages of monthly data. – (2) Wages and salaries, costs in respect of staff severance pay, social security contributions and sundry bonuses paid to bank staff; the data also include the extraordinary expenses incurred in connection with early severance incentive schemes. The number of bank staff is obtained by subtracting from total employees the number of those assigned to tax collection agencies and those seconded to other entities and adding the employees of other entities seconded to the bank. – (3) Profit before tax is calculated net of non-recurring income and expense.

[1] Even if loan value adjustments were halved over the next five years, they would still be nearly double with respect to the pre-crisis levels.

In 2014 the Return on Equity (ROE) of Italian banks, net of goodwill impairments, was almost nil (-0.2 per cent, against -0.9 per cent in 2013); the average ROE of the five leading groups was -1.8 per cent (Figure 3.12). Fee income fell by 0.3 per cent. Loan loss provisions absorbed virtually all their operating profit.

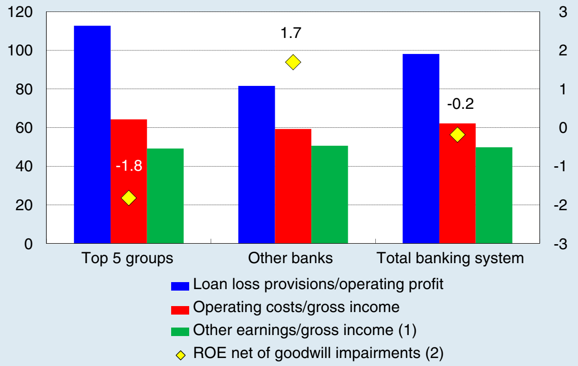
Returning to profitability rests on an improvement in the economy

A return to profitability for the banking system over the next two years will depend on the macroeconomic situation, principally through its impact on operating profits and on credit risk. The recent monetary policy measures adopted by the Eurosystem could make a significant contribution (see the box 'The impact of the asset purchase programme on banks' profitability').

Figure 3.12

Indicators of profitability

(per cent; 2014)



Source: Supervisory reports.
(1) Other earnings are the net result of fees and commissions and financial operations. (2) Right-hand scale.

THE IMPACT OF THE ASSET PURCHASE PROGRAMME ON BANKS' PROFITABILITY

The Eurosystem's expanded asset purchase programme influences Italian banks' profitability through numerous channels: changes in the interest rate, the exchange rate, and in the value of the securities held in banks' portfolios, as well as greater demand for banking services in connection with the improvement in the macroeconomic outlook (see *Economic Bulletin*, No. 2, 2015).

We have assessed the impact of these factors using the Bank of Italy's quarterly econometric model, assuming a decline of around 85 basis points in medium and long-term interest rates and a depreciation of the euro against the dollar of 11.4 per cent (and 6.5 per cent in nominal effective terms, considering Italy's trade with other euro-area and non-euro countries); these assumptions are in line with the effects of similar programmes by the other major central banks in the advanced economies in the past (see the box 'The macroeconomic impact for Italy of the Eurosystem's asset purchase programme', *Economic Bulletin*, No. 2, 2015).

The results of the simulations, which are subject to considerable uncertainty, indicate that the purchase programme will increase banks' pre-tax profits by about €300 million in 2015 and by €1.4 billion in 2016. Net interest income will contract in 2015 owing to the decline in long-term rates, leading to a fall in lending rates not offset by a reduction in deposit rates, which are already close to zero. From 2016, instead, the increase in the volume of lending due to economic growth will help to increase net interest income.

Other revenue will increase by around €400 million in 2015-16, mainly owing to earnings from securities trading. The estimate for this component is particularly uncertain because it depends on banks' decisions to sell or hold securities in their portfolios.[1] Operating expenses will rise slightly, reflecting growth in lending. Loan-loss provisioning will decrease by €1.5 billion in the two years, benefiting from a fall in business default rates due to both a reduction in debt service and growth of turnover.

[1] The potential capital gains on available-for-sale (AFS) securities (in the banking book) are entered in the AFS valuation reserve and treated as profits only if sold while changes in the value of securities in the trading book are entered directly in the income statement. The impact of this second component is however relatively limited: at the end of February, the public securities held in the trading book came to around €30 billion or 8 per cent of the total, of which half with residual maturity of over 2 years.

3.4 INSURANCE COMPANIES

The market's assessment

Shares rise, expected profits are stable

Market indicators of the outlook for the leading Italian insurance companies are broadly positive. Share prices have risen sharply (Figure 3.13.a), thanks in part to abundant liquidity on the markets, and analysts' forecasts of earnings per share have remained unchanged (Figure 3.13.b). However, the expected default frequencies implied by share prices rose in the second half of 2014, mainly owing to the greater volatility in the value of the companies' assets (Figure 3.13.c).

Figure 3.13

Insurance companies in Italy and the euro area

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

Liquidity and investments

Liquidity risk is still limited

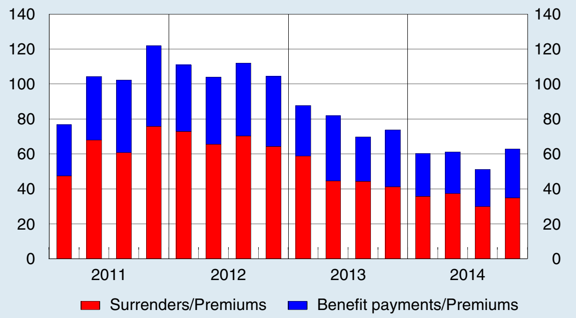
Liquidity risk for the insurance industry remains quite limited. In 2014 the decline in policy surrenders in the traditional insurance classes and the good performance of premium income, which increased by 30 per cent compared with 2013, lowered the loss ratio (surrenders plus benefit payments over premiums) from 73.9 to 63.0 per cent (Figure 3.14).

Investment in Italian government securities remains substantial …

Asset composition did not change significantly in the closing months of 2014 (Figure 3.15.a). The decline in market interest

Figure 3.14

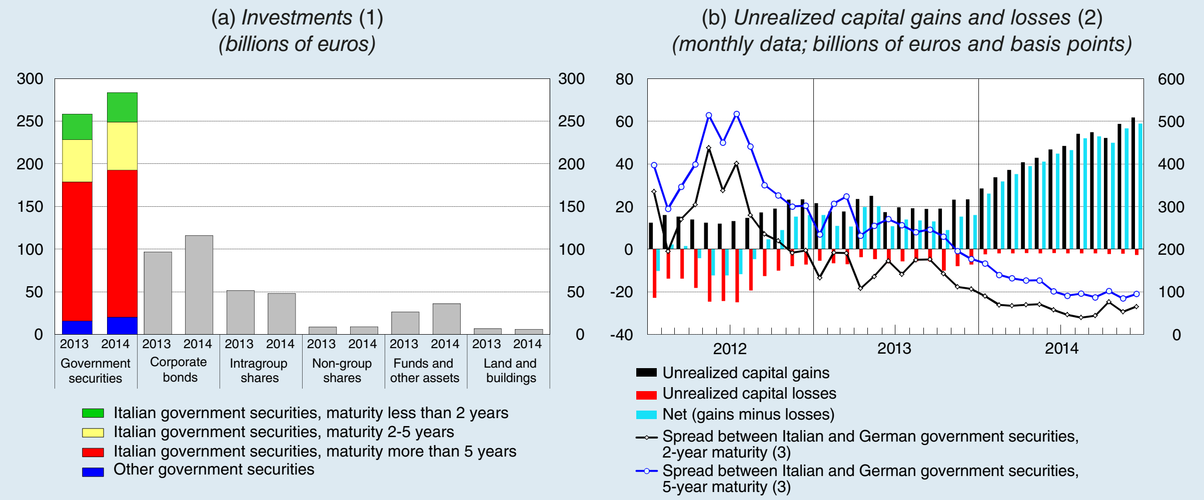
Ratio of surrenders and benefit payments to premiums in the life insurance sector (1)
(quarterly data; per cent)



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

Figure 3.15

Investments and unrealized capital gains and losses of Italian insurance companies (1)



Sources: IVASS and Bloomberg.
(1) Balance-sheet values. The composition of government securities holdings is partially estimated. – (2) Unrealized capital gains and losses are the difference between the market value and the balance-sheet value of the securities held. – (3) Right-hand scale.

rates translated into a further increase in net capital gains, generated primarily by Italian government securities (Figure 3.15.b). The periodic surveys conducted by the insurance supervisor IVASS have found that the main groups are moving to diversify their investments by increasing purchases of public and private sector securities outside Italy, mostly in the euro area.

... while that in illiquid assets and unlisted securities is modest

Following the recent rules change that extended the range of permissible investments, some insurers have begun to make small investments in minibonds issued by unlisted companies and in closed-end investment funds. For the time being no insurance company has taken advantage of the provisions of Law 116/2014 and the IVASS regulations issued in October to make direct loans to firms, although several major groups have expressed interest in doing so (see the box 'The new rules on lending to firms by non-bank intermediaries,' *Financial Stability Report*, No. 2, 2014).

Profitability and capital adequacy

Earnings remain strong and the financial position sound

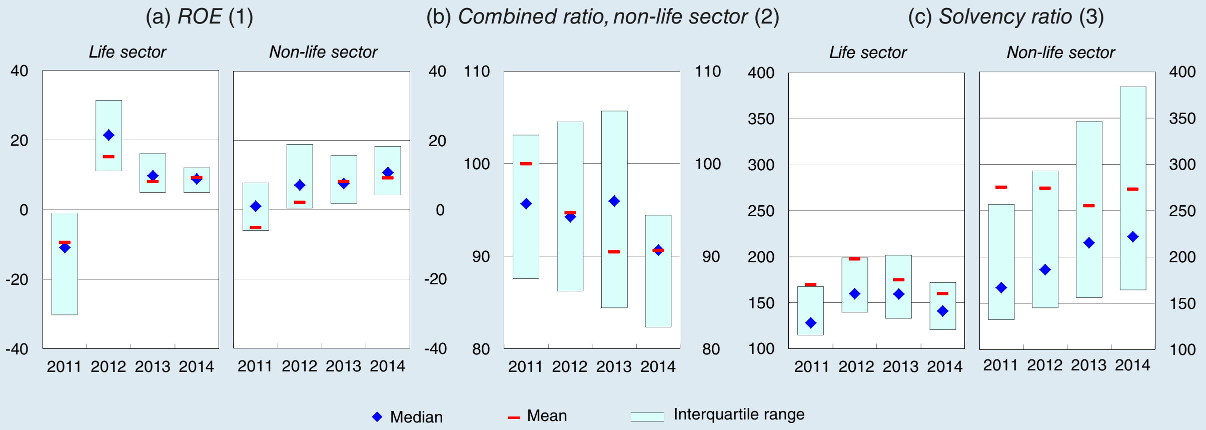
Insurers' profitability has continued to be high (Figures 3.16.a and 3.16.b). In the second half of 2014 ROE came to 9.2 per cent in life insurance and 9.3 per cent in non-life insurance. Earnings in the life sector have again been buoyed by the strong performance of premium income; in the non-life sector, although profitability was affected by a further decline in premium income (down 3 per cent by comparison with 2013), it was bolstered by a decrease in claims frequency (Figure 3.16.c).

The risk of low interest rates is limited in Italy ...

The European Insurance and Occupational Pensions Authority (EIOPA) conducted a stress test in 2014 to assess the impact of the impending Solvency II regime on the capital requirements for the insurance industry (the core test) and the effects of a prolonged period of low interest rates (the low yield scenario). All in all, the main source of risk for Italian insurance groups is the possible fall in government securities prices. By contrast, an extended period of low interest rates would have relatively little impact (see the

Figure 3.16

Main indicators for Italian insurance companies
(per cent)



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

box 'The EIOPA stress test for the risk of low interest rates'). Low market yields have nevertheless led some Italian insurers to reduce the financial guarantees on new policies and to step up their marketing of unit-linked policies, whose investment risk is borne by policyholders. In 2014 premium income from these policies, which account for barely over 20 per cent of the total, jumped by 41 per cent, compared with a gain of 27 per cent for traditional insurance products.

... but the risks in connection with economic and financial uncertainty remain

Over the next few months Italian insurance companies could face risks if the economic recovery falters, which would lower demand for insurance products and cut into earnings, or from a resurgence of tensions in financial markets, above all in the government securities market.

THE EIOPA STRESS TEST FOR THE RISK OF LOW INTEREST RATES

Persistently low interest rates pose a significant risk to the insurance sector by depressing companies' profitability and eroding their ability to meet obligations to policyholders; this is because a large portion of their liabilities are for a fixed nominal amount and long duration, typically greater than those of the assets that cover them.

Part of the 2014 EIOPA insurance stress test[1] assessed the impact on capital requirements and cash flows of two scenarios involving two different interest rate term structures: the first envisaged low rates for all maturities, and the second analyzed the effects of a negative-sloping yield curve. The analysis covered at least 50 per cent of the insurance market in each member state and was made according to the standards of the new Solvency II prudential regime that will enter into force on 1 January 2016.

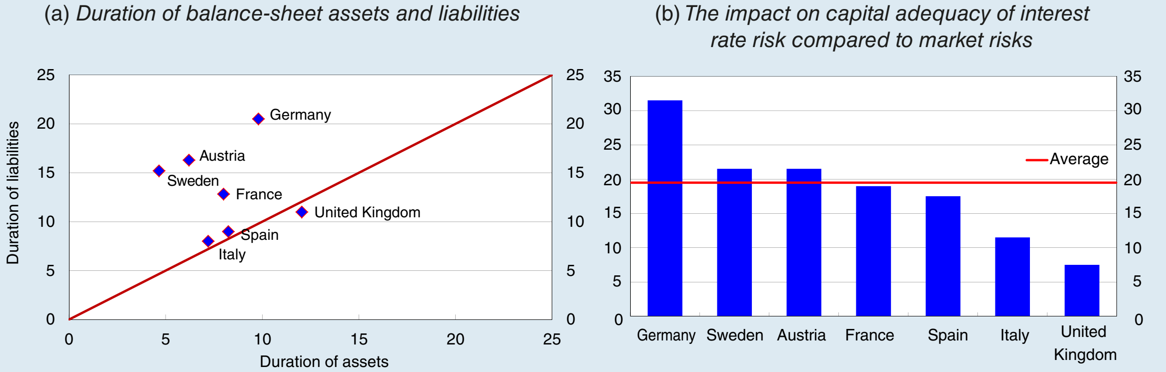
The results of the exercise show that Italian firms' exposure to the risk of low interest rates is relatively limited, since most of them have balanced cash flow, with good alignment of yields and duration

[1] The test comprised two modules: the core stress test for insurance groups, and the low-yield scenario for individual firms. The results are available on EIOPA's website at https://eiopa.europa.eu/Publications/Surveys/Stress%20Test%20Report%202014.pdf.

between balance-sheet assets and liabilities. The stress scenarios would accordingly have little impact on capital requirements.

The picture across Europe varies greatly. In several countries the insurance industry is characterized by substantial balance between obligations and investments, in terms of both yields and duration (panel (a) of the figure); this is reflected in relatively low capital adequacy requirements to cover the risk of low interest rates (panel (b)); in others, by contrast, risk exposure and the corresponding capital requirements are high on average.[2]

Low yield exercise of the EIOPA stress test: baseline scenario (1)
(percentage)



Source: Based on EIOPA data.
(1) Data refer to the baseline scenario.

In the months after the stress test was carried out the vulnerabilities of the European insurance sector to an environment of persistently low interest rates very likely increased. The current interest rate curve is in fact considerably below that used for the baseline scenario in the stress test.[3]

EIOPA recommended that the national authorities step up their supervisory activity and strengthen prudential safeguards also to avoid negative repercussions on financial stability.

[2] The sole objective of the EIOPA test was to highlight factors of robustness or vulnerability in the insurance sector. It is not therefore designed to define the capital adequacy of individual firms, also because it is based on the new insurance regulatory regime Solvency II, which is not yet in force and only a partial version of which was used for the exercise.

[3] The risk-free interest rate curves are available on EIOPA's website at https://eiopa.europa.eu/regulation-supervision/insurance/solvency-ii-technical-information/risk-free-interest-rate-term-structures.

4 MONEY AND FINANCIAL MARKET RISKS

4.1 MARKET LIQUIDITY AND THE RISKS FOR FINANCIAL STABILITY

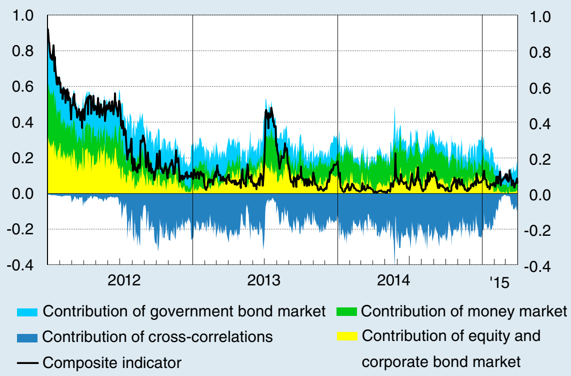
Liquidity conditions on Italy's financial markets are still good ...

The liquidity of Italian financial markets remains ample (Figure 4.1). Purchases of public sector assets under the Eurosystem's programme have had positive effects on the liquidity of other assets as well; the volume of trading on both equity and corporate bond markets has increased and risk premiums have fallen. The improvement in liquidity on the government securities market was partly offset by the increase in volatility recorded from October onwards, mostly linked to the situation in Greece (see Section 4.3).

Figure 4.1

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

(daily data; index range: 0 to 1)



Sources: Based on data from Thomson Reuters Datastream, Bloomberg, Moody's KMV, MTS S.p.A., e-MID SIM S.p.A., and Bank of Italy.
(1) The systemic risk indicator measures the joint risk in the money market, the secondary market for government securities, and the equity and corporate bond markets. The index range is from 0 (minimum risk) to 1 (maximum risk). The graph also shows the contributions to the composite indicator of the individual markets and of the correlations between them. For the methodology used in constructing the indicator, see *Financial Stability Report*, No. 1, 2014.

... but possible situations of tension must not be underestimated

Several recent episodes of acute volatility would appear, however, to suggest heightened market sensitivity to external shocks, especially in the fixed income segment (public and private bonds). The structural changes that have taken place in the way markets work, including the lower propensity of market makers to take positions on own account, could trigger sharp fluctuations in prices in the event of abrupt asset sell-offs by intermediaries.

The authorities are evaluating the systemic risks connected with cyber-attacks

Operators' growing interconnectedness has prompted authorities to scrutinize the potential systemic impact of cyber-attacks on the financial sector and market infrastructures.[1] The Bank of Italy's business continuity unit (CODISE), responsible for crisis management coordination in the Italian financial marketplace, periodically conducts simulations to strengthen the system's ability to withstand large-scale cyber-attacks.[2] A survey carried out by the Bank of Italy in the second half of 2014 highlighted growing awareness on the part of Italian operators of the risks such attacks pose to data confidentiality and availability.

[1] See, for example, Committee on Payments and Market Infrastructures, *Cyber Resilience in Financial Market Infrastructures*, 2014 (http://www.bis.org/cpmi/publ/d122.pdf) and Enisa, *Network and Information Security in the Finance Sector*, 2014 (https://www.enisa.europa.eu/activities/Resilience-and-CIIP/nis-in-finance/network-and-information-security-in-the-finance-sector).

[2] The latest exercise, in October 2014, simulated a cyber-attack on two key providers of technology services with an impact on the integrity of the data of banks and market infrastructures. For more details on the exercise and on the structure of CODISE, see http://www.bancaditalia.it/compiti/sispaga-mercati/codise/index.html?com.dotmarketing.htmlpage.language=1.

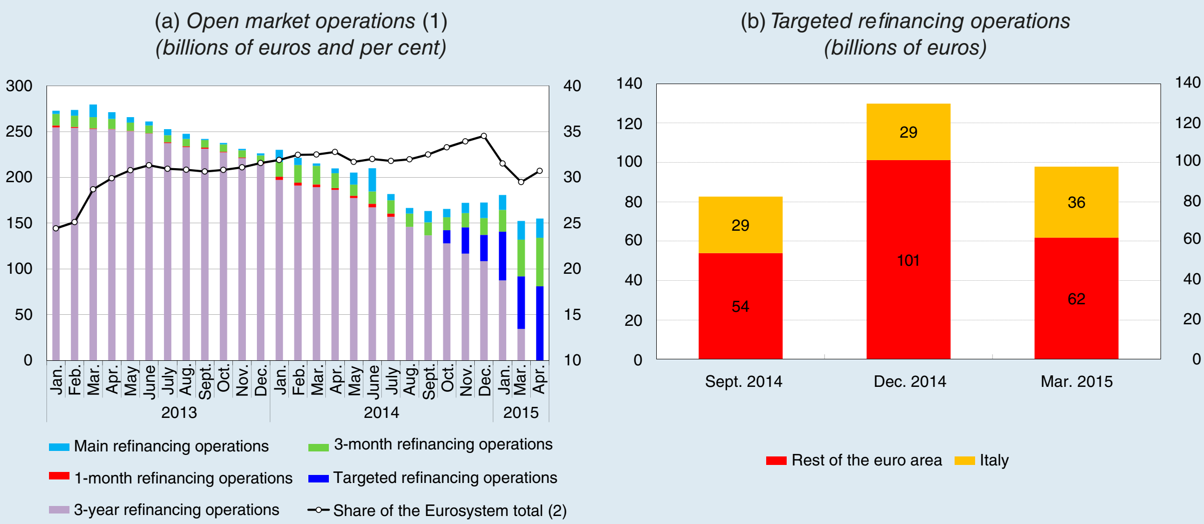
4.2 THE MONEY MARKET AND EUROSYSTEM REFINANCING

Italian banks' recourse to Eurosystem refinancing diminishes

The growth in retail and wholesale funding enabled Italian banks to reduce their recourse to Eurosystem refinancing, from €172 billion in November to €155 billion in April (Figure 4.2.a). Three-month refinancing operations account for one third of total borrowing from the Eurosystem (€53 billion) while longer-term targeted refinancing operations maturing in September 2018 account for more than half (€93 billion). Of the 143 banks in the euro area that took part in the targeted LTRO held on 19 March, the first in which allotments were determined based on credit disbursements between May 2014 and January 2015, 39 were Italian, receiving €36 billion in financing (Figure 4.2.b).[3]

Figure 4.2

Recourse to Eurosystem refinancing



Sources: Based on ECB and Bank of Italy data.
(1) Averages of daily data in the maintenance period. The horizontal axis gives the month in which each maintenance period ends: from January 2015 the duration of the maintenance periods has been extended from four to six weeks; see http://www.ecb.europa.eu/press/pr/date/2014/html/pr140703_1.it.html. – (2) Right-hand scale.

Yields on covered bonds and asset-backed securities decline

Following the announcement of the programmes last September, the Eurosystem started buying covered bonds and asset-backed securities; as at 3 April the purchases amounted to €64.7 billion and €4.9 billion respectively. The progammes had a significant impact on the yields of both types of security (see the box 'Initial effects of the Eurosystem's structured securities purchase programmes on ABS and covered bonds').

[3] For each counterparty the maximum amount that can be disbursed is equal to triple the difference between the cumulative net loans granted in the period and their own benchmark. For the calculation of the benchmark, see http://www.ecb.europa.eu/press/pr/date/2014/html/pr140729_updated_modalities.pdf?4d459ad30eb391d6651dba09960fda72.

INITIAL EFFECTS OF THE EUROSYSTEM'S STRUCTURED SECURITIES PURCHASE PROGRAMMES ON ABS AND COVERED BONDS

The aim of the Eurosystem's Asset-Backed Securities Purchase Programme (ABSPP) and Covered Bond Purchase Programme (CBPP3) is to reduce yields, increase issues, and boost trading on the secondary market, improving the transmission of monetary policy through the credit channel.

Comparing the prices of ABS eligible for monetary policy operations against those of non-eligible securities, it is clear that the programme began to affect yields as soon as it was announced. The prices of eligible securities rose by 1.2 per cent, against 0.15 per cent for non-eligible securities (Figure A), and the correlation between the two indices diminished after the programme was announced.

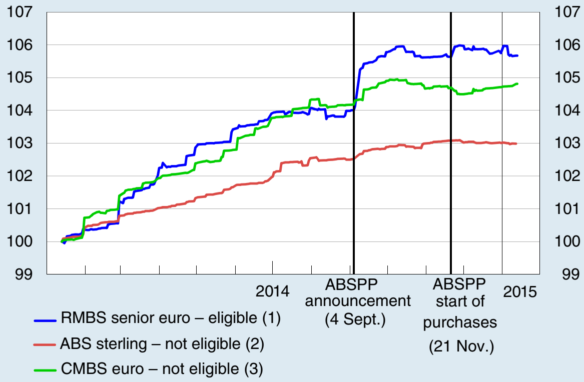
The two programmes have also had a significant impact on the Italian markets for ABS and covered bonds. In the seven months after they were announced, the spread over Euribor of a basket of Italian residential mortgage-backed securities (RMBS) rated AAA at issue decreased by 41 basis points; the asset swap spread of a basket of Italian covered bonds fell by 55 basis points (Figure B). We estimate that 30 points of the decrease for RMBS and 25 points of the decrease for covered bonds were attributable to the announcement; instead, the start of purchases had a limited impact on yields in the first seven months.

The effects of the programmes on Italy's primary market differ between covered bonds and ABS. In the case of covered bonds, the Eurosystem took part in 40 per cent of placements; although new issues, amounting to about €15 billion, were lower in absolute terms than in the two previous semesters, they did increase this funding instrument's weight with respect to that of uncovered bank bonds that were not part of the programme.[1] In the primary market for Italian ABS, in which the Eurosystem has so far had only a marginal role, issues (for about €12 billion) are in line with the low amounts recorded in the previous semester. However, the programme has allowed issuers to mobilize securities on their books: 70 per cent of Italian ABS purchased by the Eurosystem on the secondary market are securities previously earmarked for 'own use' in the monetary policy pool.

Figure A

Benchmark indices for ABS eligible and not eligible for the Eurosystem's securities purchase programme

(indices, 13 January 2014=100; daily data)

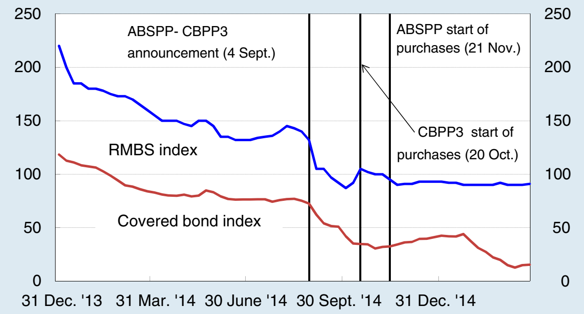


Source: Based on Barclays Capital indices.
(1) Barclays RMBS Floating Euro Bond benchmark index for euro-area RMBS consisting of a majority of securities eligible for monetary policy operations. – (2) Sterling Floating ABS Bond benchmark index of sterling RMBS not eligible for monetary policy operations. – (3) CMBS Floating Euro Bond benchmark index for euro-denominated commercial mortgage-backed securities (CMBS); almost none of the securities in this category meet the eligibility requirements for monetary policy operations and therefore the index is a benchmark for euro-denominated non-eligible ABS.

Figure B

Spreads on the Italian ABS and covered bond markets (1)

(weekly data; basis points)



Source: Based on Markit and JP Morgan indices.
(1) For covered bonds, asset swap spread of iBoxx Italy Covered Bond index; for ABS, spread over Euribor of JP Morgan Italian RMBS AAA Floating 6-7 year index.

[1] As regards eligible securities, the average ratio between covered bonds and outstanding uncovered bank bonds has risen from 57 per cent in the period August 2013-August 2014 to 65 per cent in the period September 2014-March 2015.

The Eurosystem starts buying public sector securities, taking care to maintain orderly market conditions

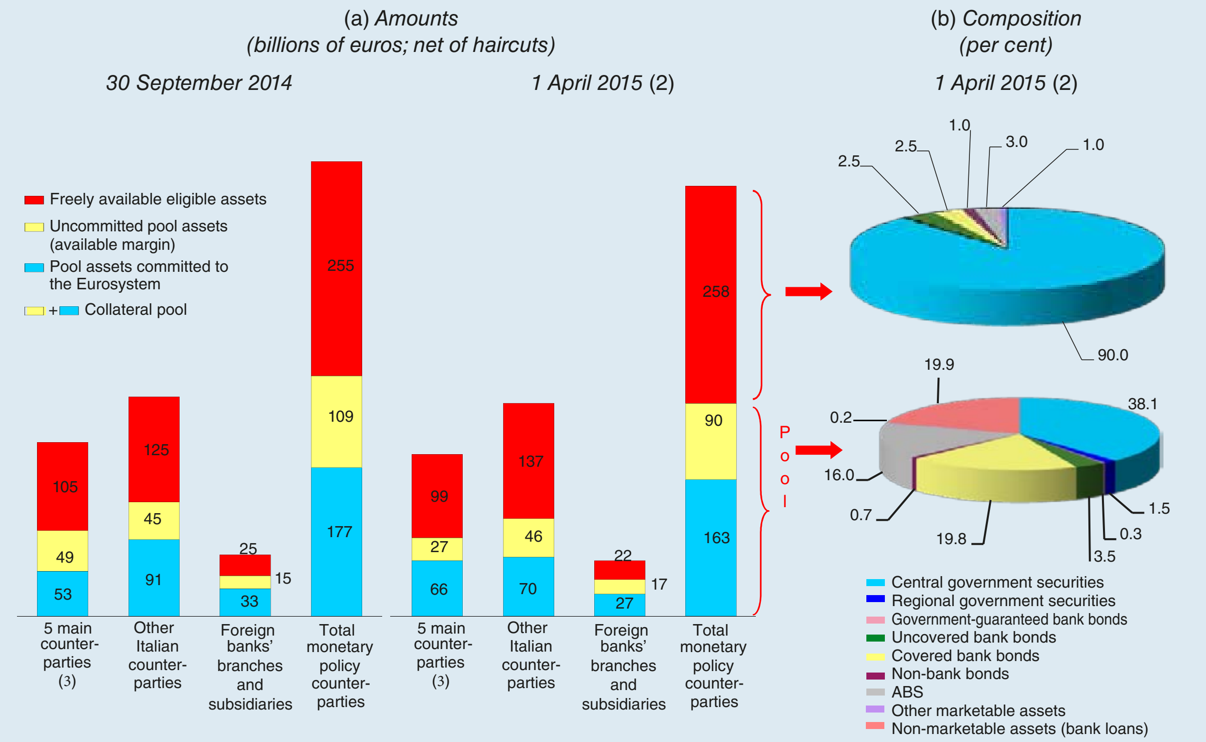
On 9 March the Eurosystem began buying public securities (see Section 1.1). The securities purchased must qualify as collateral for Eurosystem refinancing operations and have residual maturity of 2 to 30 years. At 31 March the volume of purchases came to about €47 billion, of which €7.6 billion in Italian government securities; the average maturity of the securities purchased was 8.6 years, 9.1 years for the Italian component. The purchases by the European Central Bank and the national central banks are wide-ranging and are being made gradually and continuously in order not to distort the formation of market prices.[4] To prevent any collateral shortages, which have not arisen so far in the Italian market (see Section 4.3), the securities purchased under the programme can also be lent by the Eurosystem.

The amount of public securities in the collateral pool declines ...

Reflecting the drop in refinancing, between 30 September and 1 April the assets deposited with the Bank of Italy in the collateral pool declined in value from €286 billion to €253 billion (Figure 4.3.a). Maturing securities and the early extinction of a number of bond issues practically wiped out the use of government-guaranteed bank bonds, which fell from €19.6 billion to €0.7 billion.[5] At 36 per cent the portion of uncommitted assets remains high; in

Figure 4.3

Eligible assets of Bank of Italy counterparties (1)



Sources: Based on ECB data and supervisory reports.
(1) The amount of assets committed to the Eurosystem includes the portion covering interest accrued. – (2) Data on freely available eligible assets at 31 March 2015. – (3) Main banking counterparties by volume of assets of the group to which they belong.

[4] See https://www.bancaditalia.it/media/notizia/il-programma-di-acquisto-di-titoli-pubblici-e-privati-dell-eurosistema-aggiornamento and http://www.ecb.europa.eu/mopo/implement/omo/pspp/html/pspp.en.html.

[5] On 1 March 2015 the ban on 'own use' came into effect (i.e. the inclusion in the collateral pool of bonds issued by the counterparty itself or by an entity closely linked to it) for the remaining securities. These have been withdrawn from the pool but remain available for use as collateral in Eurosystem monetary policy operations by banks with no close links to the issuer.

addition, securities (mostly government issues) freely available outside the pool amount to €258 billion or 1.58 times refinancing operations outstanding.

... while that of bank loans increases

All the assets in the collateral pool declined with the exception of bank loans, whose share rose from 14 to 20 per cent of the total (Figure 4.3.b); more than half of the increase in the value of loans can be attributed to the new possibilities of collateral utilization offered by the Bank of Italy since September (see the box 'The measures to promote the use of bank loans as collateral for Eurosystem credit operations', *Financial Stability Report*, No. 2, 2014).

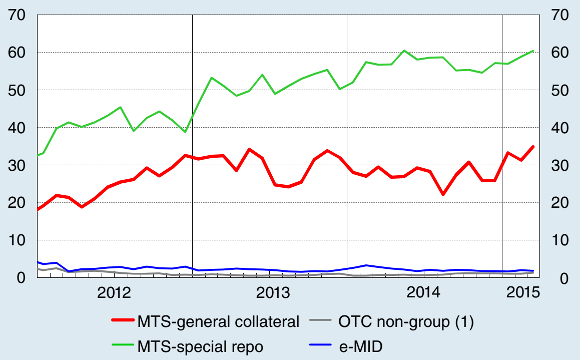
Trading on the repo market is still high ...

Trading volumes on the repo market operated by MTS S.p.A. continue to be high (Figure 4.4), facilitating Italian banks' liquidity management and the financing of their positions in government securities. In the first three months of 2015 outstanding contracts were at the highest levels ever recorded, more than €250 billion in mid-March; trades with maturity of up to 1 month also increased. Trading in the unsecured e-MID interbank market, concentrated on overnight funds, has been stable at the lows of recent years, as has the volume of trading on the OTC market.

Figure 4.4

Trading on Italy's electronic and OTC liquidity markets

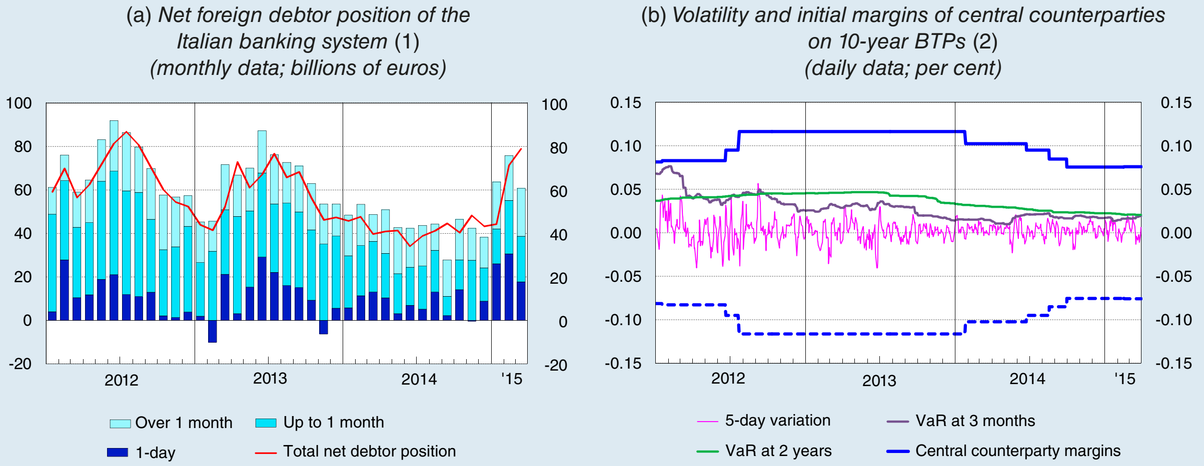
(monthly averages of daily data; billions of euros)



Sources: Based on e-MID SIM S.p.A,, MTS S.p.A, and TARGET2-Banca d'Italia data.
(1) Estimates of unsecured money market trading with maturity up to one week by Italian banks with non-group counterparties, based on TARGET2 data. In recent times the accuracy of these estimates is affected by errors in identifying trades at zero interest because of the large number of payments for identical amounts settled in TARGET2.

Figure 4.5

Net debtor position on the MTS repo market and central counterparty margins on 10-year BTPs



Sources: Based on data from MTS S.p.A and Cassa di Compensazione e Garanzia.
(1) The net debtor position is calculated on the cash value of the outstanding contracts: monthly average of daily data for total net position, end-of-month data for the breakdown by duration. – (2) Volatility is measured by the variation in the price of the benchmark 10-year Italian government bond (BTP) over a 5-day horizon and by the value-at-risk indicator (VaR) of these variations at 3 months and 2 years with a confidence interval of 99 per cent. The margins are those for the 7-10 year duration bucket; the broken line, which is the mirror image of the margins, highlights the adequacy of the margin requirements to cope with the negative price variations actually registered in the market.

... and Italian banks increase foreign funding again

In the first two months of 2015 Italian banks significantly increased their net foreign debtor position on the MTS repo market; the increase was greatest for the shorter maturities, with intermediaries taking advantage of the particularly low level of interest rates (Figure 4.5.a). The overall increase in net foreign funding progressively diminished in March following the settlement of the last longer-term targeted refinancing operation conducted by the Eurosystem, falling back to levels barely above those recorded in the year-earlier period (see *Economic Bulletin*, No. 2, 2015).

The margins required by central counterparties narrow for short-term securities

The two central counterparties, Cassa di Compensazione e Garanzia and LCH. Clearnet SA, further reduced the margins on transactions in short-term Italian government securities in the first quarter, while leaving those on medium- and long-term securities unchanged or raising them only very slightly, in view of the greater volatility of the latter in recent months (Figure 4.5.b).

4.3 THE GOVERNMENT SECURITIES MARKET

Funding conditions for the Treasury stay relaxed

As a result of the policy of limiting issues that the Treasury pursued as a result of the exceptionally large volume of liquidity in its accounts, in the second half of 2014 net redemptions of government securities totalled €32 billion, against €5 billion in the second half of 2013. Net placements were newly positive in the first three months of 2015, amounting to €51 billion, in line with the usual seasonal pattern of issuance.

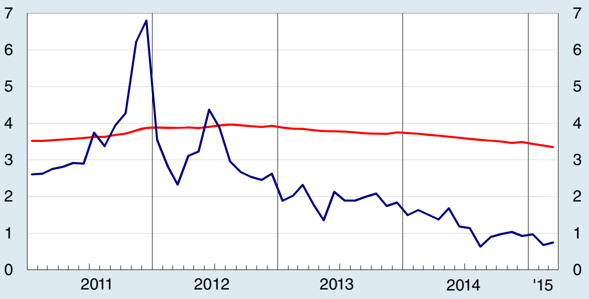
Yelds at issue fall sharply and the average life of new issues lengthens

The Eurosystem's securities purchase programme accentuated the downward slope of the yield curve. Average yields at issue fell to 0.8 per cent in March. The weighted average cost at issue of outstanding government securities fell to 3.4 per cent at the end of the first quarter (Figure 4.6.a). The sharp decline in longer-term yields made

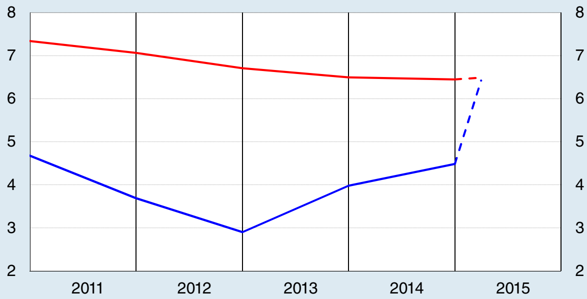
Figure 4.6

Government securities

(a) *Average yield at issue and average cost of securities in circulation* (1)
(monthly data; per cent)



(b) *Maturity at issue and average residual life of government securities* (4)
(annual data; years)



Sources: Based on data from the Bank of Italy and Ministry of Economy and Finance.
(1) Placements on the domestic market of non-indexed government securities. – (2) Weighted average of interest rates at issue of government securities outstanding at end of month. – (3) Weighted average of interest rates on government securities placed during the month, by settlement date. – (4) Government securities placed on the domestic market. The figure for 2015, indicated by the dashed line, refers to the end of March. The two series differ in level mainly due to the quantity of BOTs, which account for a larger share of new issues than of the stock of outstanding securities. – (5) End-of-period data, weighted by the stock of outstanding securities. – (6) Average term to maturity of issues during the period by settlement date, weighted by amounts issued.

it possible for the Treasury to lengthen the average life of the first issues of 2015; the average residual life of outstanding securities is stable at 6.5 years (Figure 4.6.b).

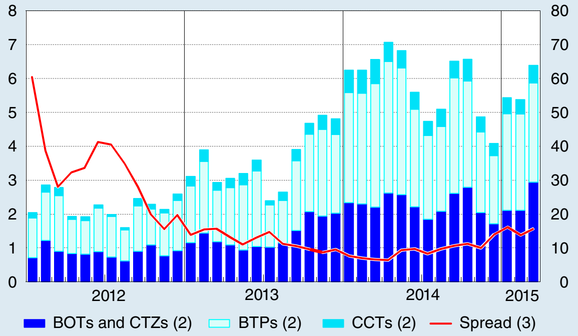
Secondary market liquidity is still good ...

Trading volumes on the MTS cash market were still high in the first quarter of this year, although smaller than in the year-earlier period (Figure 4.7). The behaviour of market makers reflected greater market volatility since the early months of 2014, leading to a slight widening of spreads and a drop in quantities quoted. The market's resilience remains good, despite some weakness at times of high volatility (see the box 'Developments in market making and the resilience of the MTS market', *Financial Stability Report*, No. 2, 2014).

Figure 4.7

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

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



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

... even after the Eurosystem begins purchases

The Eurosystem's Public Sector Purchases Programme is not expected to have any major repercussons for the smooth functioning of the secondary market in view of the expected volume of net issues this year and the large amount of outstanding Italian government securities. More than a month after the programme was launched, secondary market liquidity is still good. Trading volumes on the MTS special repo segment are high, specialness costs are still very low (5 basis points), and the percentage of fails is still within normal bounds (just over 2 per cent).

Trading increases in the BTP futures market and decreases in the Italian CDS market

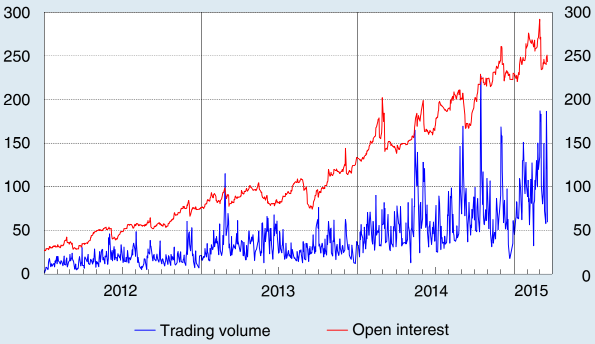
Trading in BTP futures continues to increase, with volumes peaking on auction days or days of high price volatility (Figure 4.8.a). With the development of this market, futures contracts are now widely used by market makers on the MTS as well, strengthening the link between the derivatives and the underlying markets. Preliminary analyses of high frequency data indicate that this link,

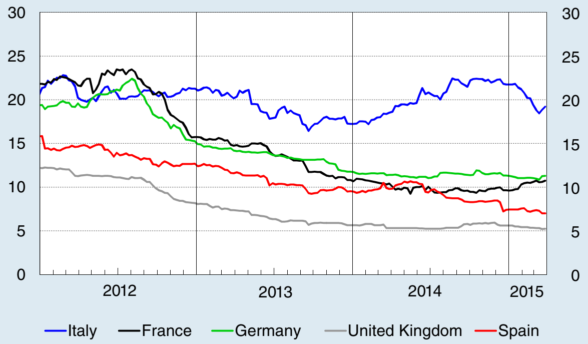
Figure 4.8

Markets in derivatives on sovereign debt

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

(b) *Sovereign CDS: net notional volumes*
(daily data; thousands of contracts)





Sources: Based on data from Thomson Reuters Datastream and Depository Trust & Clearing Corporation.
(1) Open interest is the sum of all open futures contracts on the date indicated; trading volumes are calculated on the most traded contract on each trading day.

which is natural and efficient in normal times, can rapidly transmit liquidity shocks between the two markets, heightening intra-day price volatility in conditions of stress. The net notional position of Republic of Italy CDS in dollars, which had risen in the first half of 2014, decreased in the early months of this year owing to the further reduction in the risk premium that the market demands for Italian securities and to the US currency's appreciation against the euro (Figure 4.8.b).

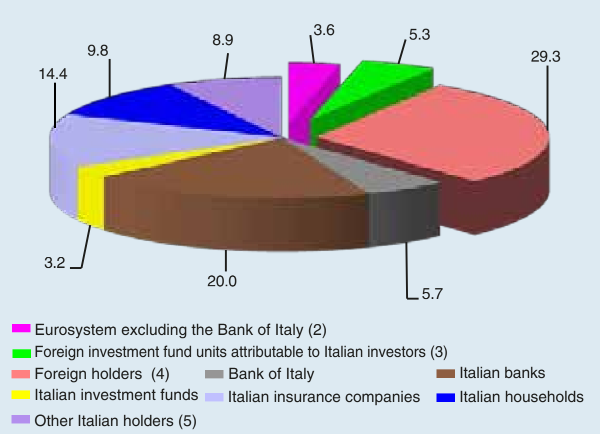
The share of Italian government securities held by non-residents is stable

At the end of 2014 the distribution of investors in Italian government securities was virtually unchanged with respect to six months earlier (Figure 4.9). The share of securities held by households fell slightly as they invested in riskier assets (see Section 2.1), while the share held by non-residents was stable. According to balance of payments data, in January and February non-resident investors' increased confidence in Italian government securities led to substantial net purchases (about €36 billion).

Figure 4.9

Italian general government securities: distribution by holder (1)

(data at end-December 2014; per cent)



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