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The crisis of the Sovereign Debt markets and its impact on the Banking System: the Italian case

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MINISTERO DELL'ECONOMIA E DELLE FINANZE

Introduction

- In the case of Italy, the deterioration of the perception of the country's creditworthiness depends mostly on the high level of public debt in a contest of low growth and does not originate, as in other cases such as Ireland and partially Spain, from the crisis of the financial system.

- The Italian banking system, in fact, remained sound throughout the first phases of the crisis, it has always been far less exposed to Peripherals, and during the years following the Lehman default an extremely limited support from the Government was required. Furthermore, debt of financial corporations is about half compared to the EU average.

- Nevertheless, the "contagion" between the sovereign debt crisis and the banking system has undeniably occurred, as in the rest of Europe, so that even Italy had to adopt some of the measures recently addressed by the Council of Europe (*banking package*) at the end of last year.

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Italy’s banks are far less exposed to Peripherals

milion of $

600.000
500.000
400.000
300.000
200.000
100.000
0

Spain Portugal Ireland Greece

Netherlands		United Kingdom		Belgium		Switzerland		Germany		France		Italy	
Dec. 2009	Dec. 2010	Dec. 2009	Dec. 2010	Dec. 2009	Dec. 2010	Dec. 2009	Dec. 2010	Dec. 2009	Dec. 2010	Dec. 2009	Dec. 2010	Dec. 2009	Dec. 2010

Source: BIS

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Support to financial institutions has been extremely low during 2008-2010

EDP notification April 2011	General governement assets			General governement liabilities			Contingent liabilities		
	2008	2009	2010	2008	2009	2010	2008	2009	2010
BE	21546	20193	18727	21546	20890	20890	36235	62047	55829
DE (In € mio)	47925	88654	318038	51223	95354	334597	66300	159030	71232
IE	0	1416	3268	0	5246	35859	352329	281176	192781
GR	0	3769	3769	0	3769	3769	1890	7617	57834
ES	9337	19335	25982	9337	19335	25982	0	49008	59506
FR	10823	6751	2463	11452	5896	801	39211	100111	90579
IT	0	4050	4050	0	4050	4050	0	0	0
NL	81431	55978	49925	81358	58051	52622	2740	79756	39948
AT	900	5644	5394	900	5644	6094	7000	23300	22170
PT	930	1930	6225	550	1550	6294	1750	8350	5425
SE	222	2107	2342	222	637	654	13623	26406	19670
UK	37068	80687	108911	65132	125480	138390	325008	620686	417261
Euro area (EA17)	175398	210254	440375	178866	222285	493457	509346	773908	601837
EU27	214226	305755	562720	245758	361109	643625	847977	1428785	1065152

24/04/2011 1.04 Exchange rate - end of year — Exchange rate - end of year — Exchange rate - end of year

1. This table relates to activities undertaken to support financial institutions. It does not include wider economic stimulus packages.

Footnote:
The data are in euro. For those countries not belonging to the euro area, the rate of conversion into euro is as follows:
- for deficit / surplus and GDP data, the annual average exchange rate;
- for the stock of government debt, the end of year exchange rate.

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Measures adopted by Italy from the European banking package/1

- The banking package, set by the European Council in October 2011, addresses two different kinds of measures: term funding and capitalisation of banks.

- Following this, the Decree n. 201/2011, converted into Law by the Italian Parliament at the end of 2011, stated that the Minister of Economy and Finance is authorized, up to June 30 2012, to grant a State guarantee on the Italian banks securities, with a maturity from three months to five years (extended to seven years for covered bonds), that have been issued after the Decree took effect.

- The purpose of this measure, in accordance with the Euro Summit statement, is "to provide more direct support for banks in accessing term funding (short-term funding being available at the ECB and relevant national central banks), where appropriate".

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Measures adopted by Italy from the European banking package/2

- The granting of the guarantee is made on the basis of an assessment by the Bank of Italy referred to the capital adequacy of the bank requiring the guarantee, and also to its capacity to cope with the obligations assumed.
- For each bank, the maximum amount of issuances guaranteed by the Government cannot exceed its regulatory capital. The Bank of Italy monitors the compliance to this limit and shall promptly notify the results to the Treasury Department, who in turn shall notify monitoring results to the European Commission.
- The fees due by banks against the guarantee will be reallocated to the Sinking Fund (a fund specifically addressed to the public debt reduction).
- The first group of guarantees granted at the end of last year was referred to very short term bonds (from three to six months maturity), which have been utilized for the first ECB LTRO. We expect additional requests to guarantee longer tem bonds, before the second ECB LTRO announced for February 2012.

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The European sovereign debt crisis

ITALY CDS USD SR 5Y Corp
SPAIN CDS USD SR 5Y Corp
FRTR CDS USD SR 5Y Corp
BELG CDS USD SR 5Y Corp
GERMAN CDS USD SR 5Y Corp
UKT CDS USD SR 5Y Corp

700
600
500
400
300
200
100
0

Date
16/01/2010
01/02/2010
17/02/2010
05/03/2010
21/03/2010
06/04/2010
22/04/2010
08/05/2010
24/05/2010
09/06/2010
25/06/2010
11/07/2010
27/07/2010
12/08/2010
28/08/2010
13/09/2010
29/09/2010
15/10/2010
31/10/2010
16/11/2010
02/12/2010
18/12/2010
03/01/2011
19/01/2011
04/02/2011
20/02/2011
08/03/2011
24/03/2011
09/04/2011
25/04/2011
11/05/2011
27/05/2011
12/06/2011
28/06/2011
14/07/2011
30/07/2011
15/08/2011
31/08/2011
16/09/2011
02/10/2011
18/10/2011
03/11/2011
19/11/2011
05/12/2011
21/12/2011
06/01/2012

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The "contagion" between the sovereign debt crisis and the banking system

Italian banks vs sovereigns in Cds Market

- CDS 5y Italy
- Spread BTP Bund 10y
- Unicredit A.G.
- Banca Intesa
- Monte dei Paschi

800
700
600
500
400
300
200
100
0

02/01/2011 02/02/2011 02/03/2011 02/04/2011 02/05/2011 02/06/2011 02/07/2011 02/08/2011 02/09/2011 02/10/2011 02/11/2011 02/12/2011 02/01/2012

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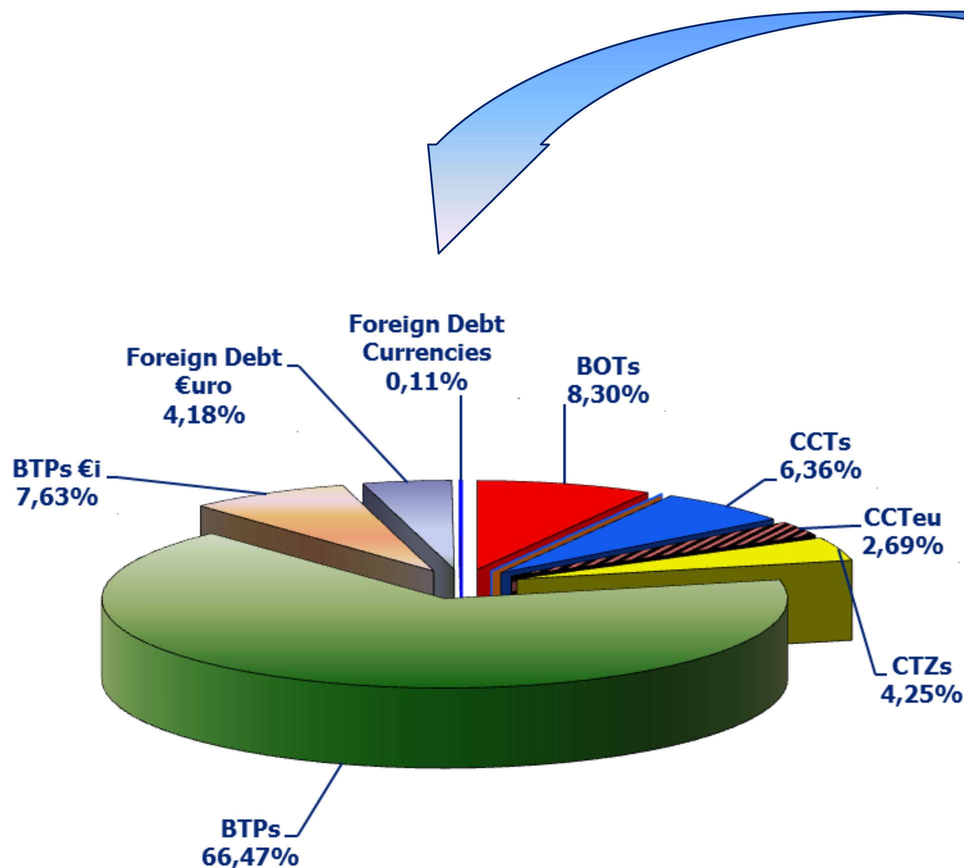
Recent market focus on the re-financing risk

- In recent months, concerns started to arise both from rating agencies and markets about the Republic of Italy capability to access the market, looking at the outstanding stock of debt (about 120% of GDP) and of the relevant amount to be refinanced in the first part of the current year.
- The concern is focused, among other factors, on the distribution of Italian debt between domestic and foreign investors, the latter considered to be less "committed" with regard to the Italian sovereign in case of difficult market conditions.
- The consequence on the Italian government bonds market has been a severe increase in volatility, a significant increase in the risk premium and a sharp reduction in the secondary market liquidity.

Government debt: breakdown by instrument as of 31 December 2011



Bonds	Amount (mln. €)	%
BOTs	131.693,00	8,30%
Flexible BOTs	0	0
CCTs	143.726,70	9,06%
of which CCTeu	*42.734,74*	*2,69%*
CTZs	67.425,21	4,25%
BTPs	1.054.011,83	66,43%
BTPs €i	121.110,34	7,63%
Atypical BTPs	662,81	0,04%
Foreign Debt €uro	66.372,07	4,18%
of which ISPA Bonds	*9.575,77*	*0,60%*
Foreign Debt Currencies	1.738,93	0,11%
Total Amount	**1.586.740,89**	**100%**
Average Life of Government Debt 6,99		

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Details of redemption up to 2013

30,000.00
25,000.00
20,000.00
15,000.00
10,000.00
5,000.00
0.00

BOTs BTPs BTP€i CTZs CCTs

2012: January, February, March, April, May, June, July, August, September, October, November, December

2013: February, April, June, July, August, November, December

As of December 31, 2011

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Internationalization of the investor base

Since 2003, the investor base has been quite equally allotted between domestic and non domestic holders, remaining such distribution quite stable afterwards.

Year	Non Domestic Holders	Domestic Holders
1999	38.21%	61.79%
2000	41.70%	58.30%
2001	42.37%	57.63%
2002	45.00%	54.91%
2003	48.91%	51.09%
2004	49.71%	50.29%
2005	52.64%	47.36%
2006	48.38%	51.62%
2007	47.11%	52.89%
2008	48.92%	51.08%
2009	51.02%	48.98%
2010	52.39%	47.61%
July 2011	50.63%	49.21%

Source: Bank of Italy

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Italian government bonds held by foreign investors: breakdown by instrument

BOT BTP CCT CTZ

70,00%
60,00%
50,00%
40,00%
30,00%
20,00%
10,00%
0,00%

1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 July 2011

Source: Bank of Italy

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The effect on the banking system

What has occurred recently on the market for Italian government bonds had a negative impact on the Italian banking system. The same phenomenon occurred in other European countries with similar characteristics. The transmission channel is twofold:

- On one hand, there is the regulatory channel: the increased riskiness of the assets related to Italy country risk (bond portfolios, loans to local authorities and public entities and exposures in derivatives), in conjunction with the tightening of accounting rules and measurement of capital adequacy of banks adopted by the European authorities, has forced the Italian banks most exposed to the Italian sovereign risk to hold down their exposure or, alternatively, to capitalize themselves, that in the current market conditions has been extremely painful.
- On the other hand, there is the credit standing channel: the methodology adopted by the major rating agencies include, in the case of many European sovereigns, a strong relationship between the assessment of sovereign risk and that of the banking system. The recent reductions of the ratings assigned to the Republic of Italy t has impacted also the creditworthiness of the Italian banks, increasing significantly their cost of financing and of the capital. In addition, recent downgrades suffered by the Republic of Italy have reduced the potential in the assets held by Italian banks as instruments of collateralization (i.e. in term of margins for clearing houses and CCPs).

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The negative spiral

- There is a combined effect of the two channels described above, which are in some way self-reinforcing: from the regulatory point of view, the Italian assets riskiness is certainly influenced, in some cases determined by the assessment of rating agencies. Debt perceived as more risky is more expensive, but the additional burden makes the same debt less sustainable and then even more risky. On the other hand, banks - the largest holders of government bonds - themselves become more risky, then their debt and capital become more expensive. This criticism of the banking system turns to be an additional risk factor for the same sovereign.
- The overall effect we are witnessing is a kind of negative spiral between sovereign and bank risk. A move towards more independent and sophisticated internal systems of credit assessment can allow to break the loop.