



This project is funded by the European Union under
the 7th Research Framework programme (theme SSH)
Grant Agreement nr 266800



FESSUD

FINANCIALISATION, ECONOMY, SOCIETY AND SUSTAINABLE
DEVELOPMENT

Studies in Financial Systems

No 12

The Italian Financial System

Costanza Consolandi, Giampaolo Gabbi,
Massimo Matthias, Pietro Vozzella

ISSN 2052-8027

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Costanza Consolandi, Giampaolo Gabbi, Massimo Matthias, Pietro Vozzella

Affiliations of authors: Università degli Studi di Siena (www.unisi.it)

Key words: Italy, financial sector, banking, insurance, inequality, financial and economic crisis, competition, efficiency, financial markets, exchange rates, real estate, regulation of banking and finance

Journal of Economic Literature classification: E44, E50, E58, E60, G01, G21, G22, G23, G28, N24

Contact details: Giampaolo Gabbi, Department of Business and Law, Università degli Studi di Siena, P.zza S. Francesco 7, 53100 Siena, Italy
e-mail: giampaolo.gabbi@unisi.it

Acknowledgments:

The research leading to these results has received funding from the European Union Seventh Framework Programme (FP7/2007-2013) under grant agreement n° 266800. We thank all the colleagues of Fessud projects for their comments during our presentations at University of Siena and in Berlin, October 2012.

Website: www.fessud.eu

Preface

This report on the Italian financial system is one of 15 studies of national financial systems undertaken as part of the research project Financialisation, Economy, Society and Sustainable Development (FESSUD) financed by the European Commission under the Seventh Framework Programme. The report main goal is to review the existing research and organize the most recent available data on the Italian financial system within in a framework that is broadly compatible with the studies undertaken in the other participating countries. The results of the study were first presented at the annual conference of the FESSUD project held in Berlin in October 2012, and were revised in August 2013.

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Summary

I. The Italian Financial System since 1980

1. Historical and political economic background

After national unification in 1861 Italy remained economically behind the leading European countries. Per capita GDP was less than half that of the UK and a little over half of the French figure. The banking system was composed of small individual banks, a small number of public institutions and a few banks of issue; banknote circulation was sparse. The banks of issue had been established in the pre-unity states during the first half of the nineteenth century. United Italy had a single currency but fragmented banknote circulation, because almost all of the banks of issue operating in the old states had maintained their right to issue their own banknotes in the new Kingdom of Italy. Three major upward movements in the price level stand out. The first two occur, not surprisingly, during the two world wars; the third in the modern period following the breakdown of Bretton Woods. On the other hand, only the years from 1927 to 1933 display a downward movement of the price level and hence a period of deflation. The Italian lira has lived through several monetary regimes: it has swung from the gold standard to inconvertible fiat money; has alternated periods of fixed exchange rates with periods of flexible rates; and has experimented alternatively with interest rate, total domestic credit, monetary base, and inflation rate targeting. The fixed exchange rate regime was often adopted to signal the country's determination to a course of deflation or disinflation, but just as often created unsustainable conflicts with other goals of economic policy and, hence, was not a credible pre- commitment device for deflation or disinflation. The successful disinflation of the nineties, which made it possible for Italy to join EMU, was the result of a tough-minded inflation rate targeting and was accompanied by stable output growth. A second related issue

is the behaviour of the average rate on bank deposits as a measure of the own rate for M2 series. As can be readily seen, the series on deposit rates was quite flat until the 1950s.

2. Growth of finance and its role in the decades of financialization

The analysis of the financial sector and its role for the Italian economic system can be measured in different ways. In terms of stocks, the Italian financial sector was not significantly different from the German and the Japanese cases. The output generated by the monetary and services sector to the Italian GDP ratio increased from 5.15% (1980) to 8.96% (2009). The ratio decreased only from 1993 to 1995, because of the devaluation of the Italian lira within the European Monetary System. The Italian job market from 1980 to 2010 has experienced events directly and indirectly linked with the financialization process: the services sector, in which the financial sector is included, has faced a huge growth of 41%. A switch from labor intensive to technology intensive and technology driven with the introduction remote banking solutions was observed, where a large number of employees have been transferred from financial divisions to outsourcing and/or off-shoring companies. The maximum percentage of employees was reached in 1994 (2.78%) and decreased to 2.57% in 2010. The recent slightly increase of the ratio (from 2006 to 2010) can be explained with the absolute reduction of employees in the industrial and commercial sectors essentially due to the real impact of the financial crisis. On the other hand, the productivity underwent a different dynamic over the last 30 years. The output per employees shows a starting point of 81674 in 1980 to 170252 euros in 2010. The same pattern has been observed for the value added per employee (from 60 to 98 thousand euros). At the end of 2010, the total financial liabilities of Italian households amounted to €887 billion (2010 prices). Financial liabilities include loans, consumer credit, home mortgage loans. Loans and residential mortgages account for larger shares of the total

household liabilities, but consumer credit grew 1332% between 1995 and 2010. The rapid increase in public sector debt that took place in the 1980s. Between 1980 and 1990, government debt grew from just above 52% to 92%. This debt then declined and reached its minimum in 2007, just before the financial crisis. Since then, a steep increase has been observed.

3. The structure of the Italian financial system

The core Italian financial system is strongly linked with the banking activity. Not only in terms of assets and capitalization, but also in terms of functions and services provided. Few intermediaries (less than 16% at 2010) are independent from banks or banking groups. Leasing, factoring and investment services are essentially managed by banks or companies owned by banks. Most of the largest banks operate as universal banks, while business line strategically chosen is retail and commercial banking. During the last years a concentration process has affected most of the financial institutions. On balance, the number of financial intermediaries reduced (1997 – 2011) from 2641 to 2005. The Italian financial system has been characterized by a high level of public dominance. In 1993 the largest privatization process has been implemented. The most important public banks and insurances have been sold through IPOs. Actually, most of them are controlled by banking foundations, with a public nature. At the beginning of the 1990s neither banks nor institutional investors played a significant role in Italian companies' ownership. Whereas banks still show a limited presence in non-financial companies capital, ownership by institutional investors significantly increased over the years between 1990 and 2010. Relevant differences emerge distinguishing between banks and non-financial companies: whereas institutional investors are present approximately in the same percentage of banks over the whole period, in 2010 they own stakes in twice the number of non-financial companies than in 1990.

4. International markets and currency

After 1980, the exchange rate became a major objective of the monetary authorities, offering a clear example of time-consistent monetary policy. In spite of several realignments of the central rate in the EMS, the exchange rate was managed in such a way that the real exchange rate strengthened. In January 1990 Italy entered the narrow band (± 2.25 per cent) of the EMS. This period was characterized by a strong commitment to maintain the exchange rate fixed. After the September 1992 devaluation and the temporary suspension of the lira's participation in the Exchange Rate Mechanism of the European Monetary System, a changeover to a managed float took place. From 1996 the lira-mark exchange rate stabilised and the lira was again pegged to the Deutsche Mark. The reserves increased from 1996 until 1998, when, in the run-up to the formation of monetary union and the adoption of the euro as a single currency, a sizeable reduction occurred.

5. Impact of financial globalization on national financial system

In Italy, the impact of financial globalization on the cost of equity capital has been driven mainly by economic and monetary integration in Europe, which has had both a direct and an indirect effect on the cost of equity capital. The direct effect is straightforward and consists in a reduction in real risk free rates. In fact, as a precondition to EMU entry, inflation and interest rates converged among EU countries towards the typically low levels of Germany. This convergence also resulted in lower real rates, implying that the opportunity cost of investing in equity decreased, reducing the cost of equity capital. Most importantly, economic and monetary convergence, and subsequent financial integration, has also an indirect effect on the cost of equity capital which consists in a decrease of the equity risk premium, the second component of the cost of equity capital. This effect is due to the gradual abolition of barriers to intra-EU investments and the launch of the common currency, the latter

eliminating currency risk in intra-EU transactions. As a result of both decreasing barriers and the launch of the common currency, risk sharing among EU investors increased, reducing the required equity risk premium and, hence, lowering the cost of equity capital.

6. Impact of European integration on financial systems

The combination of EMU with the concomitant institutional changes produced a dramatic convergence of the yields on national public debt on the eve of monetary unification. Legally, the rules within the European banking markets are quite homogeneous (for the Directives process), but interest rate differentials remain wider than in the bond market. In particular, there are persistent differentials in the medium- and long-term corporate loan market and in the consumer credit segment. Italian Markets regulated markets are 11: Electronic share market; Electronic market for securities derivatives (SeDeX); Electronic bond market (MOT); MTAX Market; "After-Hours" markets; Mercato Expandi; Derivatives market (IDEM); Wholesale Market for Government Securities (MTS); BONDVISION Market for the wholesale trading via internet of Government securities; Wholesale Market for Corporate and International Organisations Bonds; TLX. Mifid replaces rules in many markets that require trades to be executed at local exchanges. Instead, banks will be allowed to act as "systematic internalisers", matching customer orders internally rather than showing these to the market. Systematic internalisers, traditionally called market makers, are investment firms who could match "buy" and "sell" orders from clients in-house, provided that they conform to certain criteria. Instead of sending orders to a central exchange, banks can match them with other orders on its own book.

7. Regulatory Framework: Financial Market Regulation in Italy

The structure of financial regulation is based on the specialization. The bank of Italy is asked to supervise the activity of monetary and credit institutions; CONSOB (it is the Securities Exchange Commission) is expected to regulate markets and control actors' behaviour in order to protect investors; ISVAP (now IVASS) is the insurance regulator. In 1981 The Bank of Italy and the Italian Government agree to reform the bid system of government bonds ("divorce") and allowed the central bank to buy bonds only in the secondary markets. In 1985 the first Bank Directive (77/780) aimed at increasing the competitiveness and the openness of the banking activity. For Italy this was a fundamental reform, since until then the control of stability was managed through a structure-conduct-performance model, that is imposing an oligopolistic structure, where banks and branches could not be settled without the agreement of the regulatory body. The relationship banking orientation pushes banks to increase the number of branches and reduce the average distance between customers and distribution units. The first directive is the first step towards a prudential regulation which is confirmed with the introduction of Basel I principles (1988), based on a minimum capital requirement defined in standardized way for the credit risk. In the same year the Bank of Italy publishes the Second White Book on the banking system where regulators suggest to adopt the share company for banks, previously modelled as non-profit companies. This will be designed by the regulator in 1990 with the so called Amato Act, which reforms all the system, allowing banks to issue bonds, to operate as universal banks, to invest in non-financial stocks and, above all, to remove all the constraints between short and long term operations. In 1992 the second Directive is introduced in the Italian system. This reform is about the freedom to establish all over Europe (home country control). After few months a new Banking Law has been approved (TUB). This is the final step toward the liberalization of the financial system. In 2004 the Basel 2 principles have been

approved. Internal models can be introduced with the validation of the regulators. Italian way to validate appears to be generally more severe than other banking systems. In 1998 the New Financial Markets Act was approved. It is about the rules for intermediaries, financial markets, and companies issuing bonds and stocks. The five principles of the regulation are: (i) maintenance of trust in the financial system; (ii) investors protection; (iii) stability and well-functioning of the financial system; (iv) financial system competitiveness; (v) compliance of financial rules. More recently financial markets have been affected by the introduction of the MIFID directive.

8. The nature and degree of competition

Most of the banking and financial services and markets are technically designed with the purpose to increase the efficiency, which is one of the goals of regulation (art. 5 of the banking Act, 1993). Nevertheless, many reforms should be done in order to optimize the degree of competitiveness, since there high worries that a more intense competition could affect the stability and push banks to behave less safe and sound. The Herfindhal index for deposits and loans remains relatively high (respectively 18.07 and 15.18, in 2010. In 1983 they were respectively 20.87 and 17.94) and the only slightly change can be explained with the pressure introduced by foreign banks. This evidence is even stronger in business lines, such as trading, asset management, investment banking, where only few Italian players operate. The process of banking concentration has experienced 9 operations from 1984 to 1986, 20 M&A from 1987 to 1989, 45 operations on average each year from 1990 to 1994. After 1997 the concentration activity was accelerated: between 1990 and 1995 the assets of the first 5 largest banks was around 30%. In 1999 this ratio was 48% (compared with the European average of 57%). During the Nineties the banking M&A have been 514, affecting 50% of total assets of the Italian banking system. At the

same time, the number of branches increased from 1996 to 2008 of about 40% (718 branches). During the crisis 532 branches, on balance, have been closed.

9. Profitability of the Financial Sector and Sub-Sectors

In Italy, banks structurally dominate the domestic financial system (80% of financial assets in 2010), and their quasi monopoly position was even strengthened after the severe crisis that swept the asset management industry in 2000-2002. Although income statements of Italian banks in the last twenty years show an increase in net income of 70%, in the period 2001-2011 it decreased of more than 20%. The typical business model of Italian commercial banks has been focused on the originate-to-hold strategy. This used to affect directly the net interest income. In the early Nineties the net interest income to gross income ratio was approximately 80%. The contribution to the banking profitability of services fees was relatively marginal. During the following decade the model has progressively changed towards a originate-to-distribute strategy. The net interest income declined to 50% out of the gross income, to remain at the same level since 2000. The erosion of profits in recent years has strained the both return on assets, return on equity and the gross income on equity. The same trend was observed for the profitability on insurance companies, where the ratio of the balance between unrealized gains and losses to book value was equal to 3.4 per cent overall; it was 4.7% for durable and 1.6% for non-durable investments. The ratio was highest for shares and other equity, whose positive balance was equal to about 35% of book value, followed by land and buildings (26%). Investments in government securities deserve closer examination.

10. Financial sector and insurance

The Italian insurance market has been characterized by dramatic changes that have occurred in the market during the Eighties. The Italian life insurance

market experienced rapid premium growth during this period, spurred by a crisis in the Italian social security pension system and innovations in life insurance savings products. Insurers also experimented with new distribution channels, which have taken market share from the traditionally dominant exclusive agents. The government authorization in 1990 for banks to own majority shareholdings in insurance companies represented a major structural change that also is expected to have an impact on productivity and efficiency. The bank marketing channel ("bancassurance") has been especially successful in life insurance. The Italian nonlife insurance industry remains somewhat problematical, experiencing high loss ratios and low profits.

11. Availability and sources of funds

The volume of loans and deposits increased rapidly during the period 1995 – 2010, but in the same years we observed the continuous increasing of capital and reserves in absolute terms but the capitalization ratio raises only after 2007. This behaviour influenced the capability of Italian banks to sustain the market and the credit risk of their balance sheets. Only after the beginning of the crisis the Deposit to Loan (DTL) ratio increased, both for the credit crunch and for the increase of capital for most of the large banks driven by regulators. The Italian stock market capitalization increased from the early nineties to the end of the 2000: from 10.19 in 1992 to 70.02 in 2000. After this year it started decreasing until when, in 2007, the crisis has dramatically reduced it bringing it back to the values of the late eighties. The market is fairly closed to small caps, both in terms of capital and in terms of organizational features required to be listed. The number of companies in 15 years has increased only slightly: they were 266 (their market capitalization was 14% of GDP) in 1990; they are around 300 (15% of GDP) at the end of 2010. After the crisis the number of IPOs has collapsed. The financial intermediaries sector (banks and insurances) is the most important sector, both by number of listed companies and by capitalization.

II. Finance and the non-financial sector

12. Macroeconomic policy context

In 1979 the European Exchange Rate Mechanism (ERM) was introduced. The purpose was to initiate a stable monetary area within the European Community, with a final goal to reach an economic and financial integration. This period followed two decades of high growth rates, initially due to a real economy boom (Sixties), subsequently maintained with monetary and currency ease decisions. Italy was forced to follow an economic model aimed at stabilizing financial and social frictions. The impact of such a choice was dramatic reduction of growth rate (2.0% from 1979 to 1985, while the rate during the Seventies recorded 3.8%). The unemployment rate, on average 11.5%, was even higher in the Southern regions. The labour income on value added ratio declined from 0.52 (1975) to 0.41 (1997). This period was characterized by the abandoning of the growth oriented policy, substituted by a more liberistic policies, whose postulates were the monetary origin of the inflation and the market capability to generate the full employment. Italy addressed ambitious expectations to the euro introduction, in terms of price stability, efficiency and business opportunity, policy makers and private industrial firms had to change their former policies, essentially based on the currency devaluation and the domestic demand control. The policy based on the reduction of wages and salaries and the consumption affected the negative performance of the Italian macroeconomic scenario. This strategy appeared to be frustrating for an industrial system whose target was to invest in product and technology innovation. In such an environment, the financial crisis found a weak economy, essentially depending on banking credit and on foreign markets. Even though the financial system appeared to be less sensitive to the risk factors originating the crisis (real estate and financial exposure), the impact was remarkable once the credit crunch became effective, with a collapse of the GDP, particularly the component generated by small and business firms.

13. Sources of funds for business investment

Over the last decade, small and medium enterprises (SMEs) role has increased. In fact, SMEs are the 99.8% of the European enterprises and, among those, the 92% are micro-enterprises. Besides their number, the role of SMEs appears to be decisive also regarding the contribution to growth and employment: more than 90 million Europeans work for SMEs and the 58.6% of the EU wealth depends on these enterprises. Between 2000 and 2010 SMEs shared for the 85% in the net creation of work positions in the European Union. During this period, the net employment in the free market has considerably increased, on average of 1.1 million work positions a year. Within SMEs the annual employment growth rate has been of 1%, while in the large enterprises has been of 0.5%. The contribution to employment given by SMEs results to be higher than their contribution to the value added, especially in manufacturing activities and in those related to information and communication services; in fact, in some Member States has been observed that, due to their intrinsic features, small and medium enterprises have a quite low level of capital intensity and they do not allow to benefit from economies of scale and to adopt and/or develop innovations. As a consequence, large enterprises tend to reach higher work productivity indices than the SMEs.

14. Involvement of financial sector in restructuring NFCs

The non-financial companies restructuring in the Eighties and Nineties was driven by the privatisation process and by the goal to get financial benefits as opposed to raising capital through private equity or other such means is that it allows for a larger market of investors/more efficient access to capital (other expected benefits were corporate visibility, better transparency/corporate governance, advantages over seeking private funding). Once the high proportion of SMEs within the Italian industrial economy, equity capital as a source of external finance, become even more critical. The traditional source of external

equity funds for business investment is private equity. The private equity and venture capital market in Italy is relatively young in relation to powerhouses such as the U.K. or United States; having just instituted the Italian Private Equity and Venture Capital Association in 1986 . Until mid-Nineties only a limited number of professional investors played a role in the equity capital market, whilst between 1997 and 2001 we can observe a strong development in the private equity sector, thanks to the diffusion of ITC technologies which attracted significant amounts of financial resources, determining the entrance of new investors.

15. Privatisations in Italy and the financial system

The effects that privatizations have on public finance is a widely debated issue, especially in countries like Italy with a high public debt. Generally, a privatizations program should be inspired by a finance and economic efficiency rules; this means that the return of a state property good has to be higher than interest rate on public debt. An overall evaluation of the effects of privatization in Italy during last two decade on welfare of taxpayer is not simple and should consider both the net assets value of State as a consequence of privatizations and the contribution of these latter to the decrease in public debt. The main components of the variation of public debt in time are (i) the gap between average expenses of debt and the growth rate of GDP; (ii) primary surplus to GDP; (iii) a residual component including income from privatization. The latter relates to operations that do not affected the financial requirement but increase or decrease the stock of public debt. At the beginning of nineties, most of Households saving was invested in stock of Public debt, particularly in Treasury Bill. Privatizations would have had to offer new opportunities for investors and to encourage the shift towards riskier assets (equity shift). As a consequences of this process, equity market prices should be increased and this would have promoted privatizations process. In this scenario, thanks to an increase of

demand of more sophisticated financial assets, banking system would have had to be more efficient, less opaque and more opened to the international competition. Although in a long term perspective the data show that financial system in Italy recorded a meaningful transformation also thanks to privatizations process, the last worldwide financial crises insinuates doubt that the goal was reached.

16. Culture and norms

The access to credit represents a criteria to find out how financialization has become a factor to take into consideration for economic and social decisions. Usually, an individual can enter the credit market when he/she is not excluded from opening a banking account (with electronic payments, cheques, credit transfers), getting a revolving or consumer loan, holding savings in a financial institution. Italy appears to be relatively far being largely open to credit, and suffers a significant gap with countries whose consumer and investment behaviour are similar. These elements can be appreciated looking at the payment conduct and the microcredit, particularly to finance the access to education.

17. Housing finance

In Italy the ownership of houses is a widespread phenomenon, with a large percentage of people who own their house and with an impact on market price stability, due to the reduced mobility within the country.. After a period characterized by broad stability and by a peak reached at the end of 1974, when prices surged by more than 30 per cent, due to the first oil shock - which made investment in real estate more attractive as a hedge against the loss of real wealth caused by high actual and expected inflation -, the first cycle, from the end of 1974 to mid-1981, was characterized by a phase of volatility that was more accentuated around the second oil shock, interrupted by an abrupt rise in

prices, which reached a new peak in 1981, with a growth rate in the HPI higher than 30% in 1980 and 1981. The second cycle, from 1982 to 1992, began with a gradual downward correction, with prices down in 1986 to the low of the previous cycle. The ensuing uptrend, in which prices increased by more than 8 per cent per year in real terms, reached its peak in 1992. The third cycle, beginning at the end of 1992 and lasting up to the end of 2006, opened with the recession of the early 1990s, with a decrease of house prices, albeit with a pause in 1995 when the growth rate of household price index have been both positive, until the first half of 1999. With the start of Economic and Monetary Union, the decline in the cost of money and the recovery in households' purchasing power fuelled a prolonged upswing in house prices, which began to show some signs of slowing at the end of 2006. Compared with the low of 1999, albeit with some differences between provincial capitals and other cities, for Italy as a whole, since the start of the Monetary Union and before the financial crisis, house prices marked a more prolonged revaluation than in previous cycles, with an average growth of almost 6% per year in real terms.

III. Distribution, Inequality and crisis

18. Inequality in Italy

Italy is characterized by wide differences between geographical area in terms of distribution of households income. The usual Italian geographical distribution is shared in three macro-areas: North, Centre, South and Islands. The households disposable income is higher in the Centre and the North than in the South and Islands. Between 1989 and 2010 the gap widened: in 2010 the median income of households in the North and Centre was 53 and 56 per cent greater than that of households in the South and Islands, compared with a difference of 37 and 31 per cent in 1989. Between 1989 and 2010, the households net disposable income grew by 8.2 per cent in the Centre and 9.6 per cent in the North; in the South and Islands it declined of about 9.3 per cent. The Wealth represent an

important characteristic for household wellness and, in general, for a community. In the richest countries we observe higher levels of consumption, high education rate and higher life expectancy than poorest countries. To the other hand, the poorest countries are characterized by less wellness, high levels of mortality rate and lower schooling rate. To the extent we know the amount of wealth, the composition and how it is distributed among different groups of population, it can be much useful to address redistribution policies and, therefore, to decrease inequality. Household net wealth is the sum of real assets (property, businesses and valuable) and financial assets (deposits, governments securities, shares, etc.) net of financial liabilities (mortgages loans and other debts). In 2011 the relative poverty threshold, for a two members household, was equal to 1011.03 euros. In current euros, between 2000 and 2011 the relative poverty threshold has increased of 24.8 per cent but for the beginning of the last financial crises it has only grown of 2.5%.

19. Preliminary Outlook of the crisis

The variation rates both in terms of credit granted and credit used result to be negative in the last years for all the dimensional classes of enterprises. The high ratios of credit used and granted seem to confirm the hypothesis of the rationing because, especially in the medium/long-term and for all the categories of enterprises, the ration credit used/granted tends to unit. It is, however, to note that these ratios do not show structural changes over the considered years; data in terms of variations in credit granted show that there has been a decrease in the supply of credit by banks only since the crisis years. The impact for European banks appears to be impressive: according to the Quantitative Impact Study run by the Basel Committee, for the largest 45 European banks the impact of capital new regulation should require approximately 1.1. trillion euros; for the liquidity measures the cost can be estimated as 3.6 trillion euros. The Italian need to increase the capital quality

affected particularly large banks. The two largest banks (UniCredit Group and Intesa San Paolo) raised new Tier1 capital respectively for 5 and 7.5 billion euros. In terms of leverage risk, the Italian banks appear to be less exposed than other European banks. This strategy can explain the absence of formal public interventions to bail out banks after the crisis. The only intervention was in terms of Tier1 bond underwriting, able to re-capitalize banks. The post-crisis regulatory regime was designed to include a significant “macro-prudential” component. The diagnosis of regulatory weakness was accompanied with proposals for a new framework able to reduce the likelihood of a new crisis and, above all, another series of public sector interventions to bail out financial intermediaries finding themselves in a critical situation. The effects for banks can be summarized as follows: (i) changes to banks’ capital ratios under Basel III, and estimates of any capital shortfalls. In addition, estimates of capital surcharges for global systemically important banks (G-SIBs) are included, where applicable; changes to the definition of capital that result from the new capital standard, referred to as common equity Tier 1 (CET1); (ii) modified rules on capital deductions, and changes to the eligibility criteria for Tier 1 and total capital; (iii) changes in the calculation of risk-weighted assets (RWA) resulting from changes to the definition of capital, securitisation, trading book and counterparty credit risk requirements; the capital conservation buffer; the leverage ratio; two liquidity standards.

Part I

The Italian Financial system since 1980

1. Historical and political economic background

Giampaolo Gabbi

1.1 The origin and the history of the political economy and the origin of the banking system in Italy

After national unification in 1861 Italy remained economically behind the leading European countries. Per capita GDP was less than half that of the UK and a little over half of the French figure. The banking system was composed of small individual banks, a small number of public institutions and a few banks of issue; banknote circulation was sparse.

The banks of issue had been established in the pre-unity states during the first half of the nineteenth century. United Italy had a single currency but fragmented banknote circulation, because almost all of the banks of issue operating in the old states had maintained their right to issue their own banknotes in the new Kingdom of Italy: Banca Nazionale nel Regno d'Italia (which resulted from the merger of Banca di Genova and Banca di Torino) in the North; Banca Nazionale Toscana in the Centre, and flanked in 1863 by Banca Toscana di credito per le industrie e il Commercio; Banco di Napoli and Banco di Sicilia in the South. The number of banks of issue rose to six when, after the annexation of Rome in 1870, the Bank of the Papal States became Banca Romana. All of these banks issued lira banknotes, convertible into gold, and were in competition with one another. Two of them, Banco di Napoli and Banco di Sicilia, were public, the others private; all were supervised by the State. The end of convertibility of lira into gold, in 1866, caused banknote circulation to surpass metallic currency.

The first law of the newly unified State on banknote issuance was enacted in 1874. This law specifically identified the six institutions authorized to issue banknotes and thereby created a legalized and regulated oligopoly. That is, a single bank of issue was not established, largely because of the strength of regional interests that did not want to deny themselves a local issuing bank.

As bank deposits were not common, the principal source of funds for lending was the issuance of banknotes. In effect, by accepting these banknotes the public provided credit to the issuing banks, which in turn provided credit to their clients. It was only in the 1870s that non-issuing banks (i.e. banks analogous to those we know today) began to be founded, such as Credito Mobiliare and Banca Generale, with nationwide coverage and international contacts. In this context the banks of issue retained an important role. Mainly by discounting bills, they made an essential contribution to the financing of production and investment, helped to combat usury and favoured thoroughgoing transformation of Italy into a monetary economy.

The return to convertibility, decreed in 1881 and put into practice in 1883, marked the beginning of a short-lived illusion; euphoria caused economic overheating, to which the appropriate policy response was not forthcoming. By 1887, de facto, the lira was again non-convertible. The building boom triggered by the new national capital, Rome, and fuelled partly by foreign investment, also involved the banks of issue. Overexpansion brought a speculative bubble, followed by crisis. The banking crisis of the early 1890s, coupled with a foreign exchange crisis, took on a scandalous political and judicial dimension in December 1892, when the unsustainable situation of the banks of issue was revealed, and especially the grave irregularities committed by Banca Romana, until then kept secret by the government.

The law of 1893 introduced new regulations for issuing banknotes and led to the foundation of the Bank of Italy, with the merger of three existing institutions, Banca Nazionale and the two Tuscan banks. Banca Romana was liquidated, while the Southern banks of issue continued in business. In 1902 the old parity between the lira and gold (40 per cent of notes issued had to be covered by gold reserves) was reached; from then on Italy behaved as if it adhered to the gold standard, but, having learned from previous crises, did not officially declare the

convertibility of the currency. In 1906 the Bank of Italy conducted the fair conversion of pre-existing irredeemable government bonds. In parallel with the economic revival and industrialization, the credit system had changed: during the crisis of 1893-94 - which saw the failure of the largest two industrial credit banks - a new system evolved in which the bulk of credit business began to pass from the three surviving banks of issue (Banca d'Italia, Banco di Napoli and Banco di Sicilia) to the large mixed banks recently founded (Banco di Roma, Banca Commerciale Italiana and Credito Italiano).

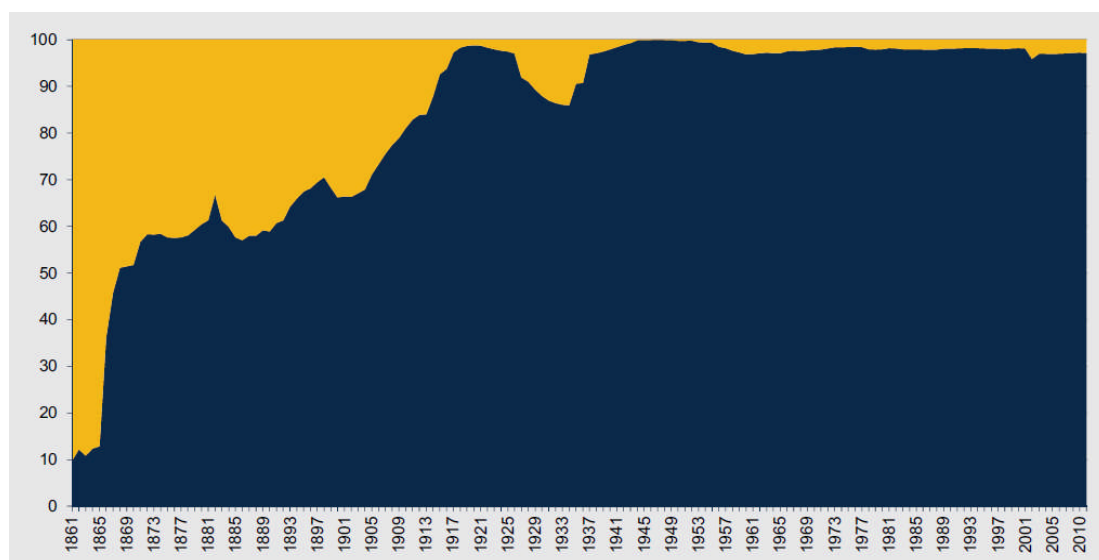
In 1907 the Bank of Italy intervened effectively to prevent a serious financial crisis, reinforcing its role as lender of last resort and consolidating its reputation. On the eve of the World War I the Bank of Italy held a central position within the national financial system, thanks to the importance of its credit for the economy, its action to guarantee financial stability, its consolidation of the gold reserve and its assistance to the Treasury in public debt management.

During World War I, the Bank assisted the Treasury massively: with direct credit, with help in arranging domestic war loans and with the management of foreign financial operations. The link between the lira and gold was abandoned and the state monopoly of foreign exchange was instituted. With war's end, problems of reconversion to civilian uses threw many sectors of industry into crisis, and with them the credit institutions that had financed them, to the point of causing major banking failures. The Bank of Italy, with government approval, intervened with massive salvage operations. The foreign exchange monopoly was ended, but in the new circumstances a return to monetary normalcy was impossible. The existing instruments for the control of the money supply in being proved to be totally ineffective. Within the country and at international level, the question under debate was how to return to a system based upon gold. Italy took a conservative stance, in favour of the classic gold standard.

In a slightly inflationary situation the Fascist government revalued the lira in 1926, thereby deflating the economy. As part of the monetary stabilization plan and the return to the gold standard, within three years important reforms were made.

The Bank of Italy was given the monopoly on banknote issue and assigned to manage the clearing houses, central nodes of a modern payment system. A law was enacted to protect savings. Banks' new special obligations were established, including a minimum capital requirement. The reforms were completed in 1927-28 with the fixing of a new gold parity for the lira and the re-establishment of convertibility into gold or convertible foreign currency (gold exchange standard), the introduction of the obligation to maintain a gold or hard currency reserve of at least 40 per cent of the money in circulation, and the redefinition of relations with the Treasury. The circulation of hard material money became marginal since the early years of the XX century (figure 1.1.)

Figure 1.1. Monetary Base circulation: coins (yellow) and paper money (blue) (1861 – 2010; percentage composition)



Source: Italian Office of Statistics (hereafter, ISTAT)

As a result of these provisions, the Bank, abandoning its old role of "bank of issue", became a true central bank and overseer of the credit system. The Bank's fundamental character as a public institution was reinforced.

At the depth of the Great Depression, the devaluation of sterling (in September 1931) and most other currencies was tantamount to a further revaluation of the lira. The deflationary effect of Italian policy was accentuated, with severe repercussions on economic activity and the financial system. The State and the central bank saved the major commercial banks from collapse, their assets swollen with ever more devalued equity holdings. The Bank of Italy found itself with severely illiquid assets, and was thus unable to conduct operations. The response was first the creation of Istituto Mobiliare Italiano (IMI) to provide medium and long-term financing and then the Institute for Industrial Reconstruction (Istituto per la Ricostruzione Industriale - IRI), which purchased equity holdings of the ailing banks and took a controlling stake in the banks themselves. In the mid-1930s the tensions that would lead to the World War II were foreshadowed in the monetary and currency sphere with the de facto termination of the convertibility of the lira and in the suspension of the gold reserve requirement.

In the context of preparations for war (the invasion of Ethiopia started in 1935) and under IRI, the Banking Law was drafted. The first part of the Law, which is still in force, defined the Bank of Italy as "a public law institution" and entrusted it definitively with the function of monetary issue (no longer just a concession); individual shareholdings were expropriated and equity was reserved to financial institutions of public relevance; the Bank was prohibited from discounting bills itself to non-banks, underscoring its function as banker to banks. A second part of the law (repealed almost completely in 1993) concerned credit and financial supervision, totally revamping the credit system via a separation between banking and industry and between short- and long-term credit; it determined

that banking was an activity of public interest; it concentrated supervision in the Inspectorate for the protection of savings and the exercise of credit (a newly created state body), chaired by the Governor and using resources and personnel of the Bank of Italy, but directed by a ministerial committee chaired by the Prime Minister.

At the end of 1936 the long-awaited devaluation of the lira stimulated economic recovery and improved the balance of payments. At the same time, by a simple ministerial decree, all limits on State borrowing from the Central Bank were abolished. World War II - with the country divided, combat throughout most of Italy and foreign occupation - inflicted substantial damage on the national economy. The lira fell to a thirtieth of its pre-war value (by comparison, during World War I it had fallen to one fifth of its initial value).

The reconversion to a civilian economy, though difficult, did not cause instability for banks, as it had at the end of the World War I, because, thanks to the 1936 reform, they did not have substantial non-liquid assets. But the situation of the lira was much more worrying and the end of 1946 saw the re-emergence of runaway inflation. The restoration of monetary stability, achieved between 1945 and 1948 with a sound, consistent plan, had four essential points. The first was halting inflation. In the summer of 1947 the compulsory reserve mechanism was refined and targeted to the needs of monetary control. The power to vary the reserve ratio was assigned to a new body, the Interministerial Committee for Credit and Savings (Comitato Interministeriale per il Credito e il Risparmio - CICR), chaired by the Treasury Minister. The reform, clearly specifying the determination of the monetary authorities to put an end to inflation, affected expectations and cut off the rise in prices. The second point was the re-establishment of a limit to the monetary financing of the State: in May 1948 the overdraft on the Treasury's current account at the central bank was limited to 15 per cent of budgeted State spending. The third point was joining the

international financial community: in October 1946 Italy was admitted to the Bretton Woods institutions.

The liberalization of trade and foreign exchange began, and after the devaluation of November 1947 the two-tier foreign exchange market disappeared. The Italian Foreign Exchange Office was formed to handle foreign currency transactions. Italy would later become part of the European Payments Union, created in 1950. The fourth point was the reorganization of banking supervision: after the abolition of the banking inspectorate, created in 1936, the supervisory function was assigned to the Bank of Italy; political responsibility was entrusted to the CICR, whose meetings were attended by the Governor as head of its technical arm. The protection of savings was enshrined in the new constitution of 1948 (Article 47).

From the aftermath of the war to the early 1950s, the actions of the Bank of Italy were essential to attracting and managing the international aid (Interim Aid, Marshall Plan and World Bank) that served to bring Italy out of emergency and to kick-start reconstruction.

For Italy the 1950s was a time of sustained economic development in a context of monetary stability. The choice of international opening, which introduced salutary competitive stimulus into the economy, was consolidated by membership in the European Economic Community (1957) and the introduction (1958) of convertibility of the lira into other currencies for non-residents (external convertibility).

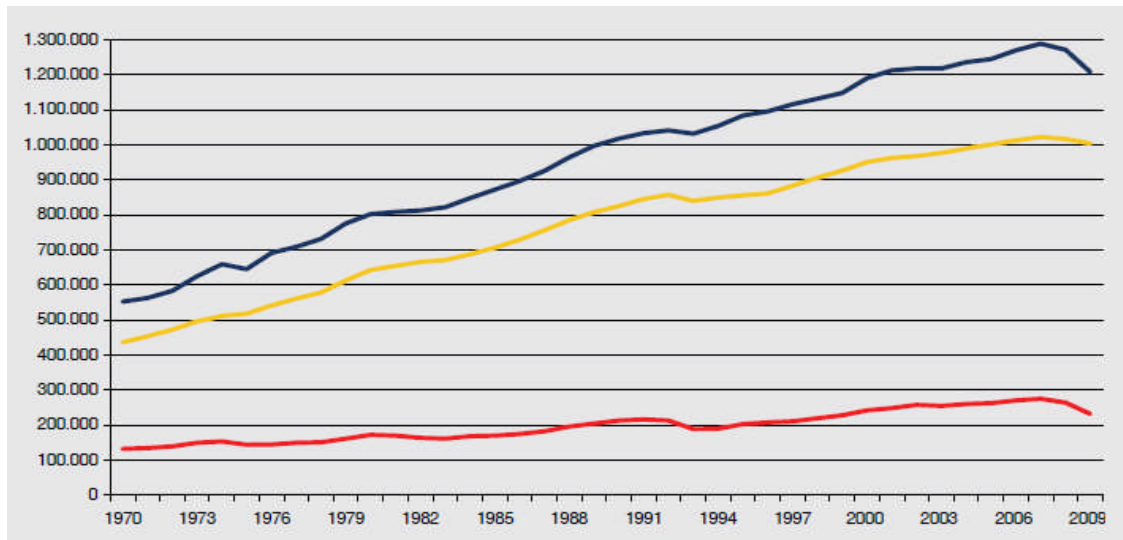
Banking supervision was directed primarily to avoiding the repetition of episodes of asset illiquidity. An effort was made to align the structure of the banking system with industry: hence the encouragement of smaller banks, presumed to be more closely tied to small businesses (localism). After 1960, the economic structure of the country was gradually transformed. More and

more the role of the credit system was to reallocate resources between consumption and investment and between the public and private sectors. From the mid-1960s onwards monetary policy was oriented to stabilizing security prices, to facilitate the placement of issues and thereby encourage investment. As regards the credit system, for the first time since the 1930s banking mergers were encouraged, in order to enhance technical efficiency, but definitely excluding a return to universal banking. The Central Credit Register was established.

The 1960s ended in the midst of serious economic difficulties. The end of the Bretton Woods System (August 1971), the switch to floating exchange rates and the sharp rise in oil prices ushered in a long period in which two evils previously considered antitheses coexisted: stagnation and inflation. Inflation in Italy was notably higher than the average for the other industrial countries. Between 1973 and 1984 the rate was never below 10 per cent. In addition to world price rises, Italian inflation had major domestic causes: severe labour market tensions, an increase in public expenditure without a corresponding increase in revenue and lack of competition. An important role was also played by the removal of the discipline of fixed exchange rates.

The positive trend of the GDP in Italy increased from 500 billion euros recorded in 1970 to 1300 billion euros in 2008. Since then, and for the first time, the recession brought the GDP value to values experienced in the late Nineties (figure 1.2.).

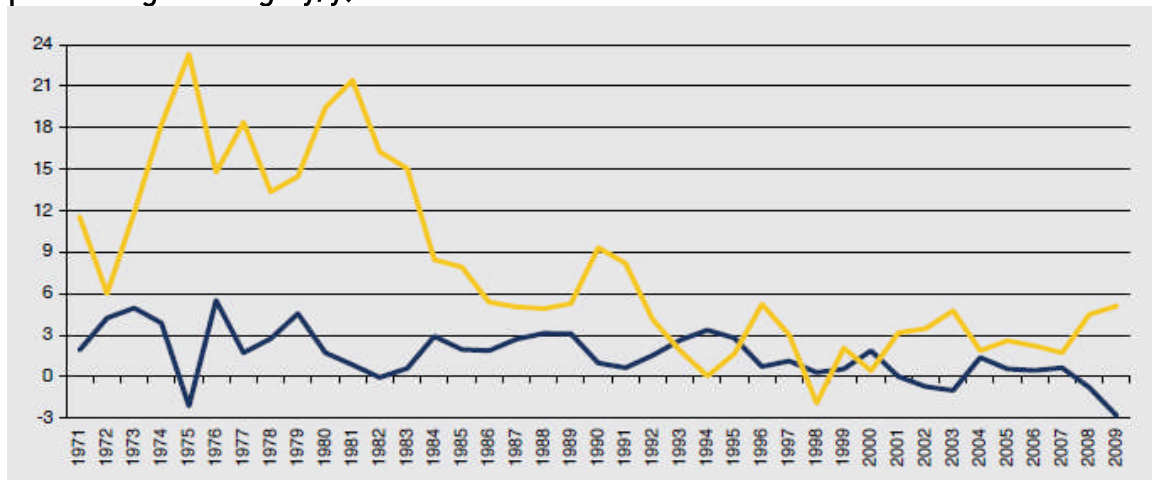
Figure 1.2. Gross Domestic Product market price, Final Consumes, Real Investments (values in million euros; 1970 – 2009; GDP blue line; Consumes yellow line; Investments red line)



Source: ISTAT

In terms of labour costs and productivity, Italy experienced a continuous decline since the Seventies. While the latter was strictly linked with inflation (see section 1.2.), the former (measures as the value added to total labour units ratio) ranged below 6% in the Seventies, between 0 and 3% in the Eighties and Nineties, to become negative during the two financial crisis of the first decade of this century (figure 1.3.).

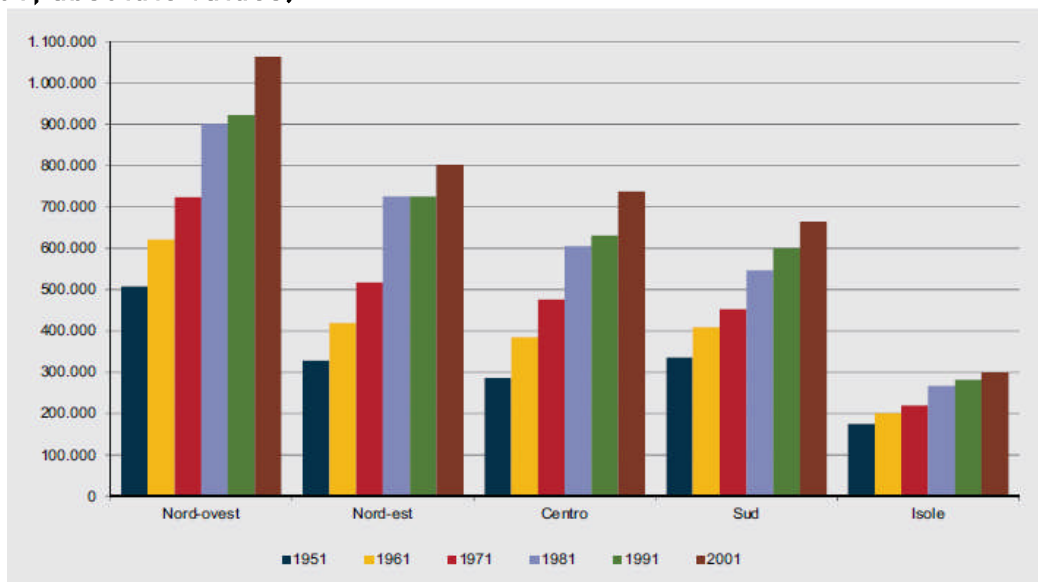
Figure 1.3. Labour cost and productivity per value added unit (1971 – 2009; percentage change y/y)



Source: ISTAT

The number of firms increased for all the Italian regions and in each decade, when the census survey occurs (figure 1.4.).

Figure 1.4. Companies by macro areas based on Census Surveys (1951 – 2001; absolute values)



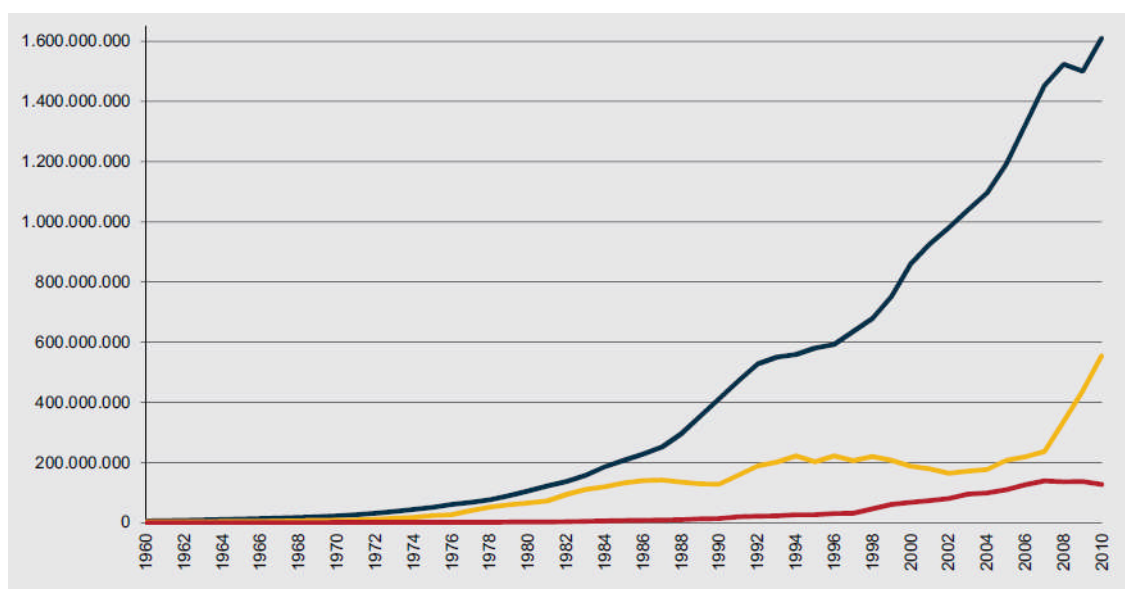
Source: ISTAT

In order to sustain investment and at the same time keep a check on domestic

demand, while containing rises in interest rates, in 1973 administrative credit control measures (a ceiling on bank lending and portfolio constraints) and foreign exchange controls were introduced. Monetary policy in Italy, as in the other industrial countries, tended to be restrictive and to focus on explicitly announced medium-term target aggregates (total domestic credit).

During the Sixties and the Seventies, banks' assets did not significantly change. An exponential increase was recorded only after the beginning of the Eighties for loans. Securities increased with the government need to be supported (figure 1.5.).

Figure 1.5. Banks' assets: loans (blue line), securities in trading book (yellow line), strategic shareholdings (red line) (1960 – 2010; thousands of Euros)



Source: Bank of Italy

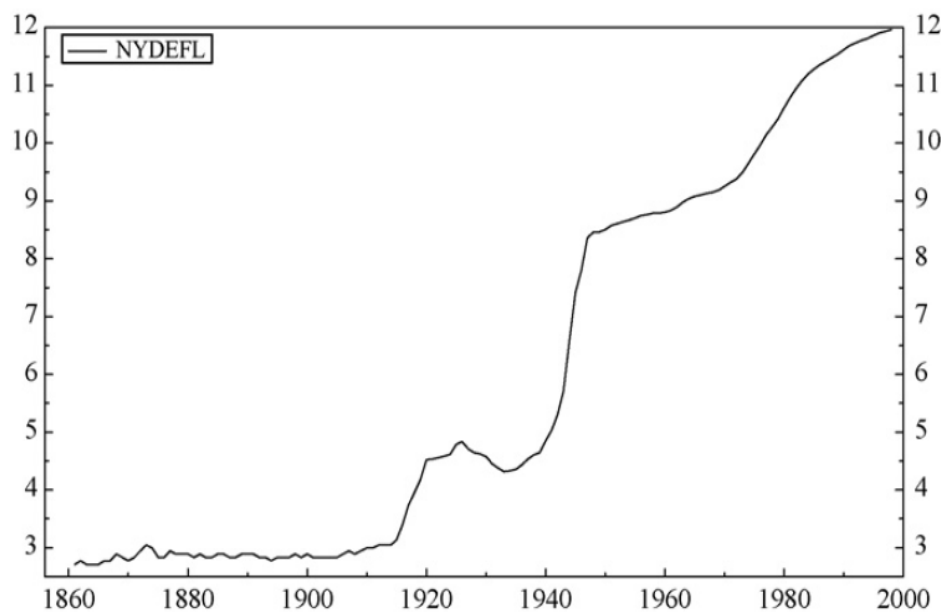
Action was begun to enhance the ability to conduct monetary policy through the market, especially via the buying and selling of securities (open market operations). To this end, in 1975, the first steps were taken to create a true

money market, with procedural changes in the issue of Treasury bills and a reform of compulsory reserves. In December 1978 Italy joined the European Monetary System, negotiating a broad fluctuation band for the lira of 6 per cent above or below the central rate, while the other participating countries had a narrower band of plus or minus 2.25 per cent, because Italy's inflation differential, though narrower, was still substantial. Supervisory action sought to encourage the capital strengthening of banks, to improve their by-laws and organization, and to broaden the scope for competition. In the second part of the decade on-site inspections became more extensive and analytical techniques were perfected. To meet the growing need for international supervisory cooperation, the Basel Agreement was signed in 1983.

1.2 Inflation and the demand for money in Italy

It is useful to identify the salient points of the behaviour of the price level and its rate of change during the entire history of the lira, from political unification in 1861 to Italy's entry into the European Monetary Union (EMU). Prices are relatively stable from 1861 to the start of World War I, a period largely characterized by the international gold standard. Three major upward movements in the price level stand out (figure 1.6.). The first two occur, not surprisingly, during the two world wars; the third in the modern period following the breakdown of Bretton Woods. On the other hand, only the years from 1927 to 1933 display a downward movement of the price level and hence a period of deflation.

Figure 1.6. The log of the price deflator of Italian national income, 1861–1998.

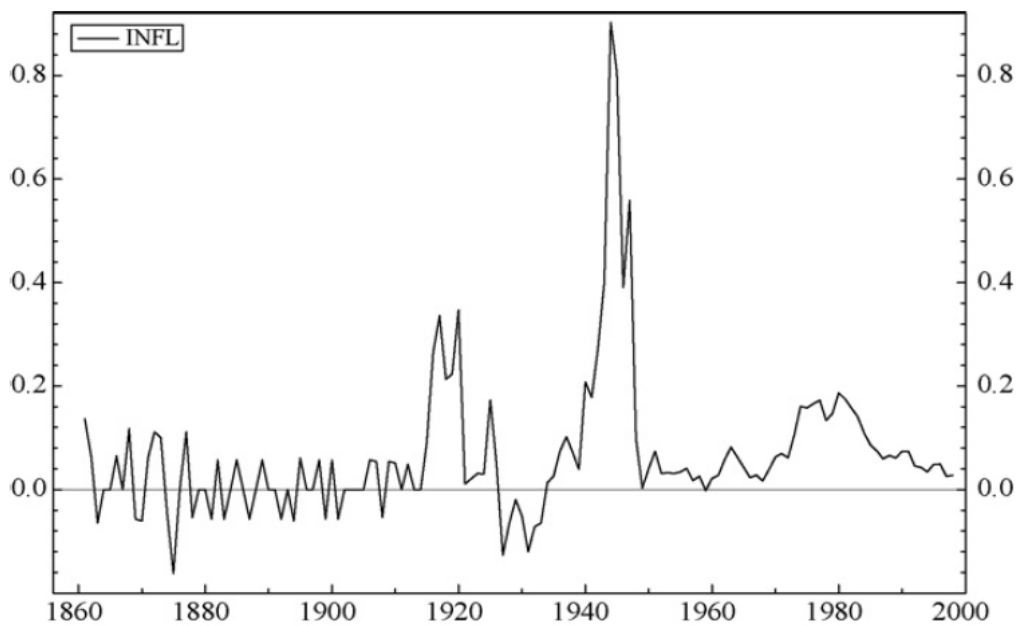


Source: Del Boca, Fratianni, Spinelli, Trecroci, 2008

Figure 1.7. displays the inflation rate, computed as the log change of the price deflator. It confirms visually the mean-stationarity of the inflation rate during the international gold standard; the sharp accelerations imparted by the two world wars; the deflation of the inter-war years; the rise and persistence of inflation in the 1970s; its decline in the 1980s, in sympathy with other industrial countries, and the significant disinflation of the 1990s.

The Italian inflation excess was contained within one percentage point during the gold standard but rose to eight percentage points in the 1970s. If we exclude the war periods, the drivers of the Italian inflation rate were fiscal and monetary impulses affecting aggregate demand against a relatively stable aggregate output supply. Overall, the fiscal impulse was dominant in the sense that it determined the course of monetary policy

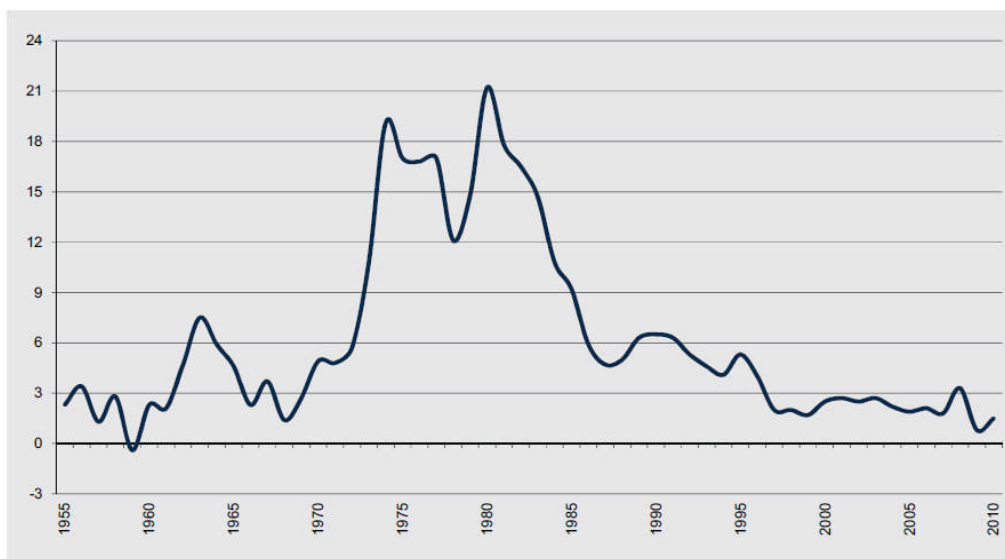
Figure 1.7. The log change of the price deflator of Italian national income, 1861–1998



Source: Del Boca, Fratianni, Spinelli, Trecroci, 2008

A distinctive feature of the most recent period is that inflation, once started, tends to persist. This is due in part to the dynamics of inflation expectations and in part to the overhang of the monetary base that declines slowly after the end of a monetary shock. Differences in the strength of inflation expectations, driven by credible monetary policy actions, explain differences in inflation persistence. For example, monetary tightening in 1926 and 1947 was well publicized and widely believed by the public to be permanent; inflation came down quickly. On the other hand, repeated monetary tightening in the 1960s, 1970s, and 1980s were perceived to be temporary or easily reversible; inflation stuck on the high side. The dynamics of inflation rate, between 1955 and 1990 shows three significant increases: 7.5% in 1963, and the oil shocks dependent inflations recorded in 1974 and 1980 (figure 1.8.).

Figure 1.8. Consumer Price Index (percentage change y/y; 1955 – 2010)



Source: Del Boca, Fratianni, Spinelli, Trecroci, 2008

The Italian lira has lived through several monetary regimes: it has swung from the gold standard to inconvertible fiat money; has alternated periods of fixed exchange rates with periods of flexible rates; and has experimented alternatively with interest rate, total domestic credit, monetary base, and inflation rate targeting. The fixed exchange rate regime was often adopted to signal the country's determination to a course of deflation or disinflation, but just as often created unsustainable conflicts with other goals of economic policy and, hence, was not a credible pre- commitment device for deflation or disinflation. It is worth pointing out that the successful disinflation of the nineties, which made it possible for Italy to join EMU, instead, was the result of a tough-minded inflation rate targeting and was accompanied by stable output growth.

Over the last 25 years, the empirical evidence on the stability of the demand for money in most developed economies has been mixed. Studies on quarterly and monthly data in OECD economies have tended to show a degree of parameter

instability which on occasions have led to forecasting failure. Applied economists have tended to use numerous additional explanatory variables and ad hoc data transformations to avoid these problems. In general, the justification for a richer specification is found in the major institutional and policy regime changes which took place in many countries (and especially in the UK and US) since the mid-1970s. Italy has experienced a wider range of real and monetary shocks over our sample period than economies such as the UK and the US, because of periods of political upheaval and several changes in monetary policy regimes. In particular, the post-World War II period has seen dramatic changes in the monetary authorities' attitudes towards inflation control. Second, the Italian monetary system has undergone various periods of rapid institutional change, both in the period immediately after unification 1861-1900, and in the period post-1970. Therefore, Italy provides us with an interesting testing ground for the demand for money function. Following political unification in 1861, Italian monetary policy experienced a period of gradual evolution and occasional shifts in policy regimes.

We shall focus on those episodes which are most relevant. After 1926, the system of monetary control resembles that of most industrial countries and therefore does not require detailed analysis. The small Kingdom of Piedmont became the Kingdom of Italy in 1861. Between 1861 and 1870 and subsequently following the First World War, this embryonic Italian State expanded through a process of conquest and annexation to roughly its current borders.

One of the peculiar features of the new Italian State was that, until 1926, the current Central Bank, the Banca d'Italia did not have a monopoly on issuing bank notes. As the Kingdom of Italy grew, monetary unification took place with the Italian Lira becoming the common currency and a single coinage system was put in place. But the banks of issue in the minor states annexed by Piedmont were allowed to survive alongside Banca d'Italia, leading to a system

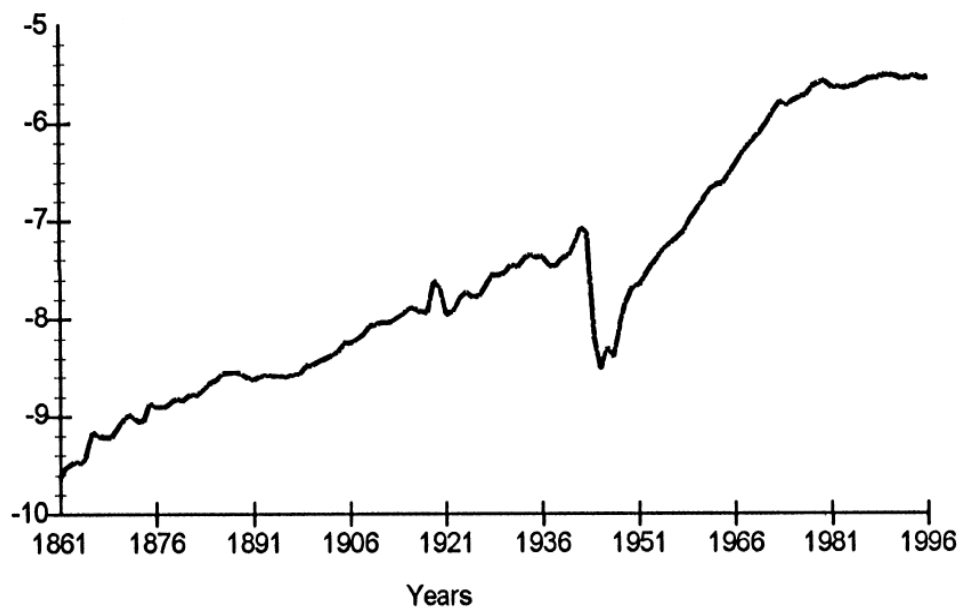
where several banks of issue competed alongside each other issuing banknotes. In 1870 there were six banks of issue operating in Italy. This number was reduced to just three in 1893, and finally Banca d'Italia acquired a monopoly of issue in 1926. These various banks of issue were also commercial banks, fulfilling a dual function in the financial system. In theory a competitive system of banks of issue need not lead to problems of monetary control. In periods when Italy adhered to the gold standard, convertibility acted as a discipline on individual banks of issue. In periods when Italy did not adhere to the rules of the gold standard, the government controlled money creation through two channels. First, the government tried to progressively impose some degree of control over the issue of bank notes through several bank laws which imposed limits on the amount of paper money which each bank could issue, and imposed minimum reserve ratios which issue banks should have adhered to. Second, the banks of issue official discount rate was brought increasingly under government control. The Italian government controlled the official discount rate of Banca d'Italia and the other banks of issue between 1866 and 1992. However, this system of monetary control took some time to put into place, and between 1861 and 1893 the banks of issue sometimes exceeded the limits on the issuance of bank notes. This was exacerbated by their role as commercial banks, which led to intense competition on the asset side of the balance sheet and the accumulation of bad debts. Therefore, there was a conflict of objectives between the exercise of effective monetary control and the issue banks' management of the commercial side of their activities. In addition, periods of major fiscal expansion, often led to a suspension of convertibility and a monetization of the fiscal deficits as the Banca d'Italia was required to make loans to the government in new notes. After 1893, tighter controls were imposed on the banks of issue. By reducing the number of banks of issue to just three and giving the Banca d'Italia a pre-eminent position amongst these, the government moved to a system of monetary control closer to that of other

countries with single central banks. This task was completed in 1926 with the creation of a monopoly of issue, and in 1936 when Banca d'Italia was made a public-interest institution and ceased its activities as a commercial bank. Italy's adherence to the gold standard between 1861 and 1913 was rather erratic. Official convertibility to gold was only maintained between 1861 and 1866, and subsequently there was a return to convertibility in 1880- 1883, which lasted only until the mid-1880s. Subsequently, Italy did not return to the gold standard until 1927-1936. The roots of this lie in the difficulties of exercising tight monetary control highlighted previously. Strict adherence to the gold standard proved impossible at times of excessive paper money creation following major fiscal expansions (such as in 1866), or following an unwillingness on the part of the government and the banks of issue to raise interest rates to prevent a loss of metal reserves, as in the mid-1880s. This led to banks violating the gold standard rules by refusing to convert paper money so that, de facto, the gold standard was abandoned in the mid- 1880s. Although Italy did not officially return to the gold standard until after the First World War, the period 1897-1913 was a period of much greater monetary stability during which Italy effectively shadowed the gold standard. During this period, the government pursued a more prudent fiscal policy, and both the government and Bank of Italy as the major bank of issue seemed to be much more sensitive to the need to use discount rates to protect metal reserves. The key point to note is that Italy's periods off' and on the gold standard do not correspond to distinct monetary regimes. The monetary policy stance in 1861-1913 was subject to much more subtle changes. The same applies to the interwar period. The post-World War I inflation led to two attempts at stabilization, in 1919-1921 and 1925-1927. The latter resulted in a return to the gold standard. This was at an overvalued exchange rate which, in the light of rising fiscal deficits and military spending, could only be defended through the imposition of capital controls and trade barriers. In the post-World War II period, Italy joined the Bretton Woods system

and, as in many other developed economies, monetary policy continued to be dominated by the stance of fiscal policy, with the stabilization of interest rates as the main objective. The pattern follows that of the high-inflation OECD countries from the mid-1960s to the early 1980s, with rising deficits leading to higher inflation. This fiscal dominance of monetary policy was only broken in the early 1980s, when Banca d'Italia gradually acquired greater independence in setting monetary policy, and did so independently of fiscal considerations. The process was completed in the 1990s: in 1992 Banca d'Italia was granted full instrument independence by allowing it to set the discount rate and since then the objective has been to achieve inflation convergence with the Euro-area.

Figure 1.9 plots the (log) series for real per-capita money balances. As can be seen, there is a dramatic break in the upward trend of money (broad money M2) – price (m-p) at the end and just after World War II as the Italian economy experienced a period of extremely high inflation. More recently the upward trend in (m-p) has become flatter, as interest rates have risen and inflation has fallen.

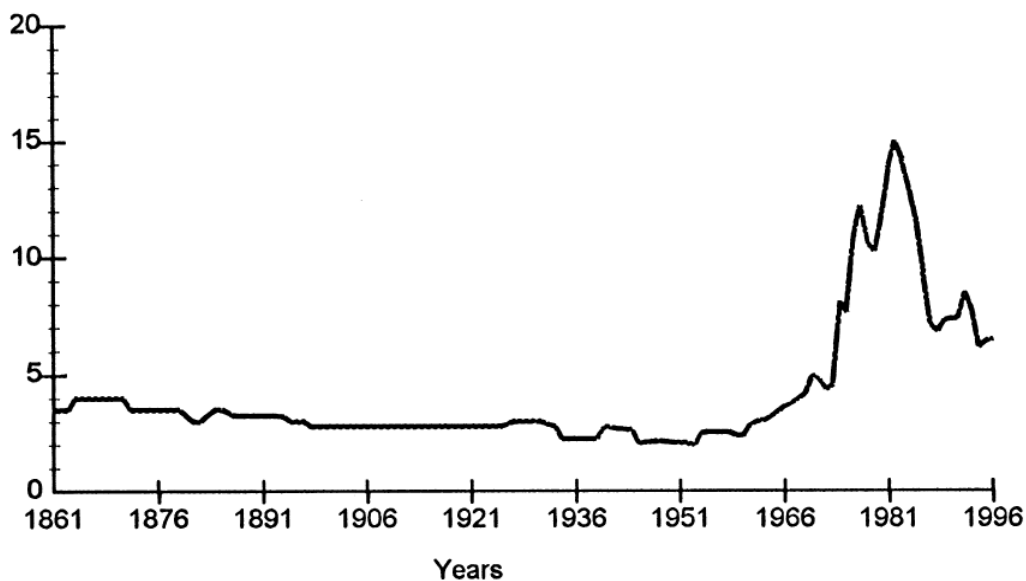
Figure 1.9. Real money balances (1861 – 1996)



Source: Del Boca, Fratianni, Spinelli, Trecroci, 2008

A second related issue is the behaviour of the average rate on bank deposits as a measure of the own rate for M2 series, which is shown in figure 1.10. As can be readily seen, the series on deposit rates was quite flat until the 1950s. Since then, deposit rates have responded more readily to movements in rates on alternative assets. In addition, the private sector's cash/bank deposit ratio was actually quite high (8.62) in Italy in 1861, falling rapidly to reach a value around unity in the mid-1880s. It then remained roughly constant until bank deposits grew rapidly relative to cash in the 1950s, falling to 0.3 in the Nineties.

Figure 1.10. Average rate on bank deposits (1861 – 1996)



Source: Del Boca, Fratianni, Spinelli, Trecroci, 2008

1.3 The currency rate

Initially the key instrument of exchange rate policy was the discount rate. Reserves were an ancillary tool; extensive use of them for exchange rate control was allowed only from 1903. Post-unification Italy adopted a bimetallic system, inherited from the Kingdom of Sardinia. Figure 1a shows how Italy was committed to maintain convertibility until 1866. Some variability of reserves is associated with a stable exchange rate, and the monetary authorities did not hesitate to raise the discount rate when necessary, as in 1864, when the markets were agitated. In 1866 the war against Austria induced Italy to suspend convertibility, de facto and de jure.

A clear change of regime occurred, with the lira weakening against all main currencies. Although convertibility was not restored until 1883, there were clear signs of attempts to control the exchange rate beginning in 1868-1869 when reserves turned downwards and the exchange rate strengthened considerably. This change in trend behaviour could be traced to the fact that Italy had joined

the Latin Monetary Union in 1865, and reflect the government's desire to curb the export of silver "subsidiary" money from Italy to member countries of the Union that had taken place after the suspension of convertibility. Reserves trended downwards from 1868-1869 to 1875. Afterwards they remained stable until the restoration of convertibility in 1883. The discount rate was raised by Banca Nazionale in 1870, but the difference between the Italian and the French discount rates diminished after 1870. It gradually increased during the 1870s. The exchange rate weakened from 1870 until the crisis of 1873, strengthened appreciably in 1874-1875, and then reverted to its declining trend. From 1876, the impression is that the monetary authorities allowed the exchange rate to weaken gradually, using the discount rate (not lowering it and so increasing the difference with foreign discount rates, in the second half) to control the pace of depreciation. The announcement of the imminent restoration of convertibility caused a strong appreciation of the lira in 1880-1881 but this was more the effect of speculative capital movements (made possible by the availability of British capital) than the result of the improved credibility of the country. This is shown by the short depreciation of 1882, probably caused by the uncertainty that followed the initial enthusiasm, and by the difficulty of maintaining convertibility (restored in 1883) in the mid-1880s. Reserves (increased in the early 1880s by the proceeds of international loans contracted by the authorities for the restoration of convertibility) fell from the end of 1884 to 1887, when convertibility was de facto suspended. The monetary authorities nonetheless remained committed to maintaining a de facto peg. This is shown by the continuous reduction in reserves (after the short rise of 1888) until the end of 1890, when the commitment to a fixed parity seems to have definitively vanished, as is demonstrated by the depreciation of the lira, the increase in reserves, and the behaviour of the discount rate and its differential vis-à-vis the French discount rate (both rates decreased in 1891). The discount rate was raised at the end of 1893 but only to face the well-known crisis of 1893-1894.

After the suspension of convertibility in 1894, data suggest that the control of the exchange rate was limited to reducing sudden and sharp fluctuations: reserves decreased in 1895, in 1896, and between the second half of 1897 and the first half of 1898, but the discount rate and the difference with the French discount rate remained unchanged. Between the end of 1898 and the end of 1902 the exchange rate strengthened, but the data suggest that this was due to other factors than a strong commitment to restore the parity: reserves show an increasing trend, the official discount rate remained unchanged, the difference between the Italian official discount rate and the French discount rate decreased after 1898. This does not mean that a commitment to a fixed exchange rate was not among the objectives of the monetary authorities given that the exchange rate was maintained between the gold points from 1902 to 1907. Moreover, Italy recorded a decrease of reserves in 1904.

The need of undeveloped countries to borrow abroad constituted a major reason for maintaining the link to gold, but only to the extent that this objective did not contrast with other internal objectives. In fact, from 1909 we see a progressive weakening of the exchange rate, even if it was still controlled, as is shown by the decreases in reserves in 1909, in 1910 and, more sharply, in 1913, and by the increase in the discount rate. The fact that convertibility was not restored even when the parity was reached suggests that the behaviour of the monetary authorities was characterized by what has been recently called “fear of pegging,” “namely the practice of de facto running a peg while avoiding a commitment to a fixed parity and the potential vulnerability to attacks that a legal peg may introduce” (Levy- Yeyati and Sturzenegger 2001), a pattern that Levy-Yeyati and Sturzenegger (2001) have found in many countries in more recent periods. “This ‘fear of pegging’ may be related ... with the fact that, as capital mobility increases, official pegs are more likely to be targets of speculative attacks that, given the economic (and political cost) of a currency

crisis, may discourage governments from overtly assuming a commitment with a predetermined parity" (Levy-Yeyati and Sturzenegger 2002). This seems to be the case of the Italian exchange rate policy in the early years of last century. With the outbreak of the First World War the convertibility of the currency was suspended by many countries. Italy, not formally committed to maintaining the parity, appears to have continued with the same policy. In 1917 exchange controls were introduced. From the second half of 1918 the USA intervened on the foreign exchange markets and granted loans in order to support the lira. In March 1919 Allied support ended and with the elimination of most of the exchange rate controls in May 1919 the lira strongly depreciated. A floating exchange rate regime seems to emerge. In 1921 the exchange rate tended to stabilise even though it remained highly volatile. Between 1921 and 1925 it weakened further. Reserves trended downwards throughout the period. After 1921 the residual exchange controls were eliminated and the official discount rate was lowered in 1922; the difference with the French official discount rate reached a minimum at the beginning of 1925. Hence the impression is that in this period the exchange rate was not a major objective of monetary authorities: there were attempts to stabilise it, but they failed and the exchange rate regime that actually prevailed was in effect a managed float. After the crisis of 1925 the government was determined to stabilise the lira, as is evidenced by archival documents. Exchange controls were reintroduced and a loan in dollars aimed at stabilising the lira was negotiated. Reserves decreased from the second half of 1925 and the discount rate was raised twice in June. While it is true that lira, after strengthening at the end of 1925, plummeted in the first half of 1926 and more drastic measures of stabilisation were adopted in 1926 and 1927 that led to the full restoration of convertibility at the end of 1927, a change of regime, in terms of the attention paid to the exchange rate as policy objective, seems to have occurred starting in the second half of 1925. The period from the end of 1927 through 1934 can be considered as a de facto and de jure peg. In this

period we see a decreasing trend of the reserves, with significant losses especially in 1928-1929, the second half of 1931 and 1934-1935. The discount rate was lowered in 1928, raised again in the first half of 1929 and reduced in 1930. In March 1930 full capital mobility was restored. The exchange rate remained stable. However, after the pound devaluation in September 1931, according to De Cecco (1993), the "Italian authorities tried [...] to protect their reserves by widening the lira fluctuation band against the dollar well beyond the gold points." They also raised the discount rate. Yet they continued their policy of de facto pegging. In 1932 and 1933 the discount rate was reduced, as was the difference with the French official discount rate, in order to facilitate the conversion of consolidated debt, but this contributed to the rapid loss of reserves observed from the beginning of 1934. From 1931 through 1934 measures were gradually adopted to limit commercial and foreign exchange transactions. In 1934 the change of regime was completed: capital outflows were forbidden and, in December, strict foreign exchange control was introduced. Under gold exchange standard, this was tantamount to a de facto suspension of convertibility. The discount rate was raised but these actions did not avert the continuous deterioration of the exchange rate. The continuous loss of reserves led to the introduction in 1935 of other measures such as the suspension of reserve requirements, the monopoly in gold foreign transactions and a government takeover of foreign exchange management.

In October 1936 the lira was finally devalued and the reserves increased. The monopoly in foreign exchange transactions was maintained unchanged until 1946, when it was attenuated by the introduction of accounts that allowed exporters to use 50 per cent of the currencies obtained in their transactions for payments abroad or for foreign exchange transactions and a partial delegation to the banks of some foreign exchange operations. Moreover, about 40 per cent of transactions were settled through clearing agreements. Hence there existed

different rates: the export rate, the official rate and the rate used in bilateral clearing operations. In this first period the exchange rate regime appears to be a de facto managed floating regime.

Table 1.1. summarizes the evolution of currency regimes in Italy from its unification in 1861.

Table 1.1 Currency regimes in Italy (1861 – 1996)

Period				Regime		Reference monetary system
				<i>de facto</i>	<i>de jure</i>	
January	1861	-	May 1866	hard peg	convertibility	bimetallic system
June	1866	-	March 1868	floating	inconvertibility	-
April	1868	-	October 1875	managed floating	inconvertibility	-
November	1875	-	September 1880	crawling peg	inconvertibility	-
October	1880	-	March 1883	soft peg	inconvertibility	-
April	1883	-	December 1886	hard peg	convertibility	bimetallic system
January	1887	-	August 1890	soft peg	convertibility	bimetallic system
September	1890	-	June 1893	crawling peg	convertibility	bimetallic system
July	1893	-	January 1894	floating	convertibility	bimetallic system
February	1894	-	May 1894	floating	inconvertibility	-
June	1894	-	September 1898	managed floating	inconvertibility	-
October	1898	-	November 1902	crawling peg	inconvertibility	-
December	1902	-	November 1907	soft peg	inconvertibility	-
December	1907	-	August 1914	crawling peg	inconvertibility	-
September	1914	-	March 1918	managed floating	inconvertibility	-
April	1918	-	September 1918	floating	inconvertibility	-
October	1918	-	March 1919	soft peg	inconvertibility	-
April	1919	-	July 1923	floating	inconvertibility	-
August	1923	-	August 1925	managed floating	inconvertibility	-
September	1925	-	April 1926	soft peg	inconvertibility	-
May	1926	-	July 1926	managed floating	inconvertibility	-
August	1926	-	November 1927	soft peg	inconvertibility	-
December	1927	-	September 1931	hard peg	convertibility	gold exchange standard
October	1931	-	November 1934	soft peg	convertibility	"tempered" gold standard
December	1934	-	March 1946	inconvertibility	inconvertibility	-
April	1946	-	August 1947	managed floating	inconvertibility	Bretton Woods
September	1947	-	December 1958	soft peg	inconvertibility	Bretton Woods
January	1959	-	August 1971	soft peg	peg to US dollar	Bretton Woods
September	1971	-	January 1973	soft peg	peg	Monetary Snake
February	1973	-	March 1976	managed floating	floating	-
April	1976	-	February 1979	crawling peg	floating	-
March	1979	-	January 1987	crawling peg	peg to DM (broad band)	European Monetary System
February	1987	-	January 1990	soft peg	peg to DM (broad band)	European Monetary System
February	1990	-	August 1992	soft peg	peg to DM (narrow band)	European Monetary System
September	1992	-	March 1993	floating	floating	-
April	1993	-	April 1996	managed floating	floating	-
May	1996	-	October 1996	soft peg	floating	-
November	1996	-	December 1998	soft peg	peg to DM	European Monetary System

Source: Garofalo, Banca d'Italia, 2005

The official exchange rate with the US dollar, fixed in 1943 at 100 lire, was raised at the beginning of 1946 to 225 lire and in August 1947 to 350 lire. In

November 1947 measures were adopted that led to the unification of the exchange rate market. The exchange rate was stabilised at 575 lire per dollar. The reserves declined in 1947 but the stabilisation of the exchange rate with the dollar at a realistic level caused their “spectacular” improvement between 1948 and 1949. From 1949 to 1971 the exchange rate remained stable at 625 lire per dollar, the convertibility of the lira was restored in 1960 with the declaration of its official parity to the International Monetary Fund.

The accumulation of reserves that we see in many years of this period was necessary to keep the exchange rate stable when necessary, as during and after the Korean crisis. Even during the crisis of 1963-1964 the parity of 625 lire per dollar could be maintained unchanged thanks to the availability of abundant reserves, which were drawn on during the crisis. From 1950 to 1969 the official discount rate was changed only in 1958, when it was lowered. In 1971 the dollar became inconvertible. After a short period of a dollar standard (Smithsonian agreements) and an attempt to link the European currencies (Monetary Snake), Italy introduced a fixed exchange rate for current account transactions and a flexible rate for financial transactions. In 1973 the fixed rate for current account transaction was abolished and Italy had a flexible exchange rate until 1979, when it joined the European Monetary System. However, after the currency crisis of 1976 a significant change in the orientation of macroeconomic policies occurred. In the years 1977-1978 the exchange rate was one of the main objectives of monetary policy aimed at reducing imported inflation and avoiding a fall in competitiveness. The weakening of the lira-dollar exchange rate in nominal terms was less pronounced than that of the lira-mark rate, reflecting the aim of the authorities to reduce the price of imports (mostly denominated in dollars) in relation to the price of exports (mainly originated from EEC countries).

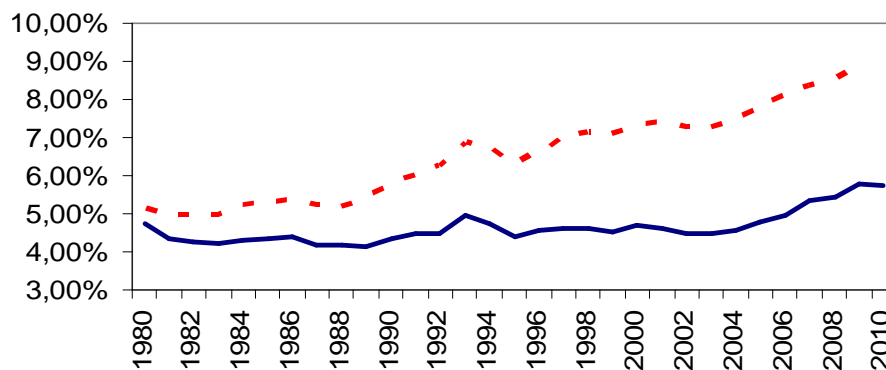
2. The Growth in Finance and its Role in the Decades of Financialization

Giampaolo Gabbi and Pietro Vozzella

2.1 Indicators of financialization

The analysis of the financial sector and its role for the Italian economic system can be measured in different ways, both using stocks or flows. In terms of stocks, one useful issue to appreciate how finance changed during these last 30 years, is that in 1980 the Italian financial sector was not significantly different from the German and the Japanese cases. The financial interrelations ratio (FIR), suggested by Goldsmith in 1955, determined as the fraction between gross financial assets and real wealth, in 1980 was 0.87, while in Japan 0.80, in Germany 0.81. The same ratio in the UK was 1.35, while in France and the US was 1.05. At the end of the Nineties, the values were 1.34 in Italy, 1.31 in Japan, 1.39 in Germany, 2.09 in the US and 2.86 per cent in the UK. During the last decade, FIR slightly decreased for the diminished capitalization of financial assets recorded during the dot.com crash from 2000 to 2002 and after the beginning of the subprime crisis in 2007. Actually (2009), the ratio is 1.21 in Italy. In order to focus the analysis on the monetary and financial services, we observe (figure 2.1) that that the ratio between the output generated by the monetary and services sector and the Italian GDP increased from 5.15% (1980) to 8.96% (2009), with an average rate of change of about 0.13 percentage points of GDP% each year.

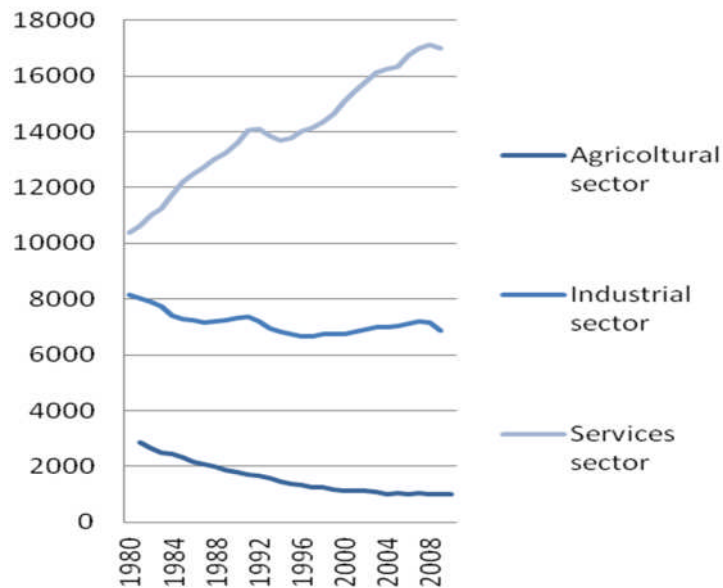
Figure 2.1. Output of monetary and financial services to GDP ratio (1980 – 2009, dotted line) and Added Value of monetary and financial services to Added Value (1980-2010, continuous line)



Source: Istat and our elaboration

The only period when the ratio has decreased was from 1993 to 1995. This can be explained with the devaluation of the Italian lira within the European Monetary System. Until 2004, the weight of the financial value added out of the total value added (VA) averaged 4.47%. In 2010, albeit the experience of more than 3 years of financial crisis, the contribution of the financial sector raised to 5.75% (figure 2.1). The Italian job market from 1980 to 2010 has experienced phenomenon directly and indirectly linked with the financialization process (figure 2.2.). The employment in the agricultural sector has faced a drastic reduction (its percentage on total employment has diminished from 14 percent in 1980 to almost 4 points in 2009, a percentage reduction of 70%), the industrial sector has faced a reduction as well even if not as big as the agricultural one (from 38 points in 1980 to 28 in 2009, 27% reduction) and the services sector, in which the financial sector is included (which will be analyzed in more details further on in the paper), has faced a huge growth (from 48 points in 1980, to 68 in 2009, growth of 41%).

Figure 2.2 Employment dynamic by sector (agriculture, industry, services; 1980 - 2010)



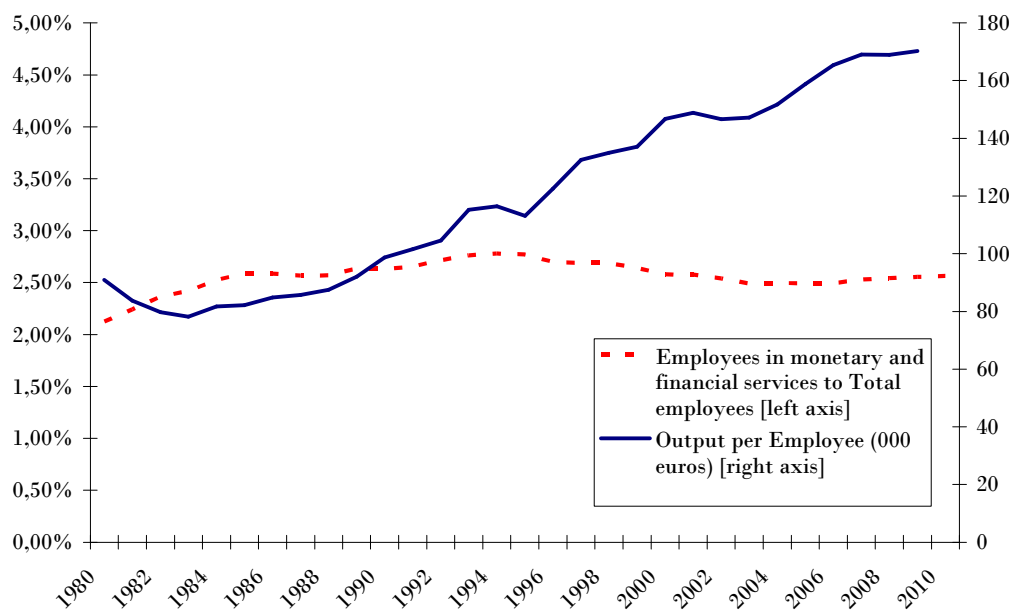
Source: ISTAT

Nevertheless, the previous indicators do not clearly show how employees in monetary and financial services changed as a ratio of the total employees.

The financial services have recently experienced a switch the orientation from labor intensive to technology intensive and technology driven (Mottura, 2006) with the introduction and development of automatic teller machines, cash dispensers, point of sales, phone banking, remote banking, TV banking, internet banking, where a large number of employees have been transferred from financial divisions to outsourcing and/or off-shoring companies.

This phenomenon can be appreciated in figure 2.3., where the maximum percentage of employees was reached in 1994 (2.78%) and decreased to 2.57% in 2010.

Figure 2.3 Employees in monetary and financial services to total economy ratio and output per employee (1980 – 2010)



Source: Istat and our elaboration

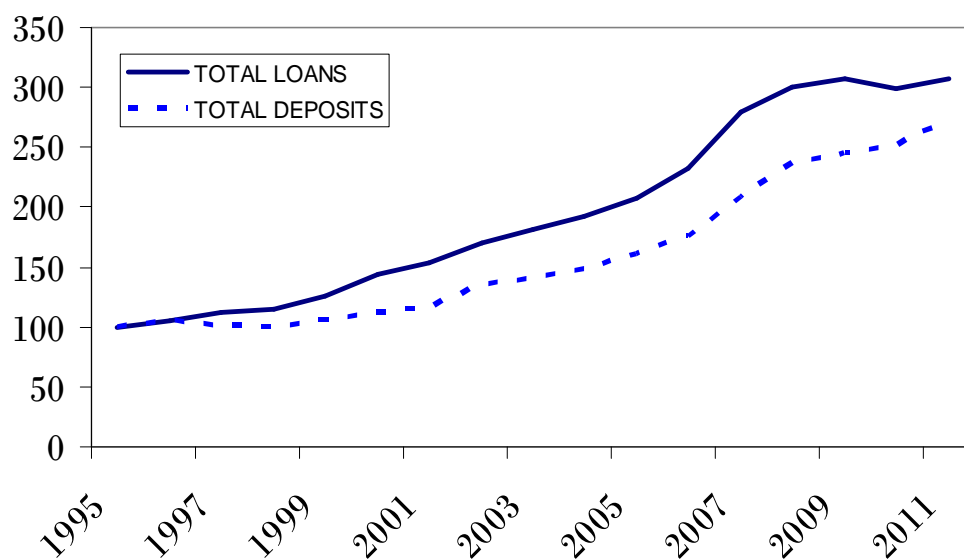
The recent slight increase of the ratio (from 2006 to 2010) can be explained with the absolute reduction of employees in the industrial and commercial sectors essentially due to the real impact of the financial crisis. On the other hand, the productivity has experienced a different dynamic during the last 30 years. When we look at the output per employees (Figure 2.3.), the starting point was 81674 euros, with an average increase of 3543 euros each year until 2010, when the output reached 170252 euros. The same pattern has been observed for the value added per employee (from 60 to 98 thousand euros), with an average increase of 1595 euros each year.

2.2 Banking activity

The volume of loans increased rapidly with the value of bank loans almost doubling between 1999 and 2009. This was partly due to the increased ability of households and the private sector to obtain loans with the use of their financial

assets as collateral and also due to less restrictive criteria on the part of banks with regards to approving loans (figure 2.4.). This was mainly done to increase the earning ability of banks in an environment that now encouraged competition between financial institutions which drove down profits. As we will see later, this increased competitiveness brought about by financialization also caused banks to end up in leveraged situations.

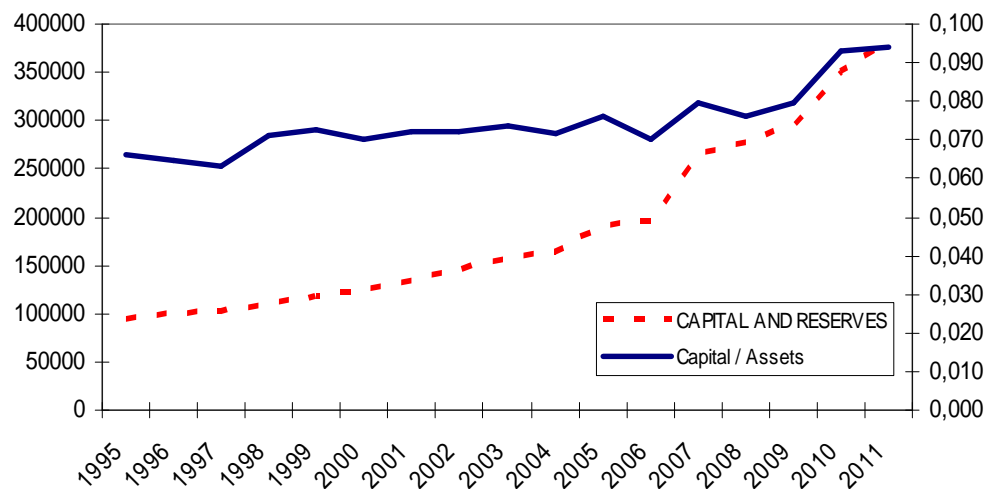
Figure 2.4. Bank Loans and Deposits (1995 – 2011; 1995 = 100)



Source: Bank of Italy, Statistical Database

In the same period we observe (figure 2.5.) the continuous increasing of capital and reserves in absolute terms (left axis) but the capitalization ratio (right axis) rises only after 2007.

Figure 2.5 (Capital and reserves) / Total assets of Italian banks (1995 – 2010)



Source: Bank of Italy, Statistical Database

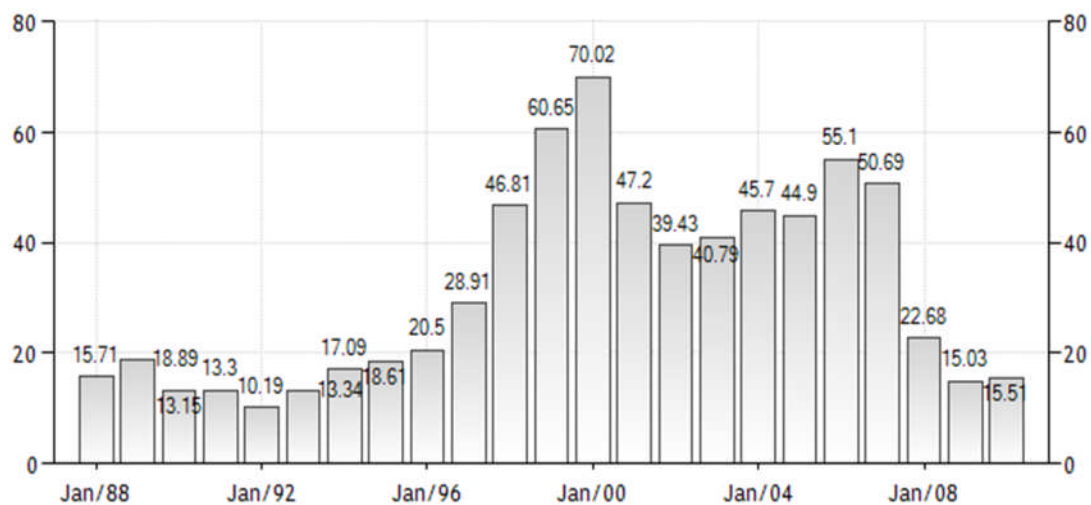
This behaviour influenced the capability of Italian banks to sustain the market and the credit risk of their balance sheets. Only after the beginning of the crisis the Deposit to Loan (DTL) ratio increased, both for the credit crunch and for the increase of capital for most of the large banks driven by regulators.

2.3 Stock market capitalization

The Italian stock market was booming from the early nineties to the end of the 2000: from 10.19 in 1992 to 70.02 in 2000. After that year it started decreasing until when, in 2007, the crisis has dramatically reduced it bringing it back to the values of the late eighties and of the first part of nineties (from 50.69 in 2007 to 22.68 in 2008 and 15.03 in 2009).

The market capitalization in 2010 (data released by the World Bank in 2011) was higher than the level of 2009 (figure 2.6.). The number of listed companies has grown of around 35% from 1995 to 2001 and after these years as carried on with the growth. It could definitely be stated that the financial sector has become necessary to the Italian economy

Figure 2.6 Market capitalization of listed companies (% of GDP) in Italy (1988 – 2010)

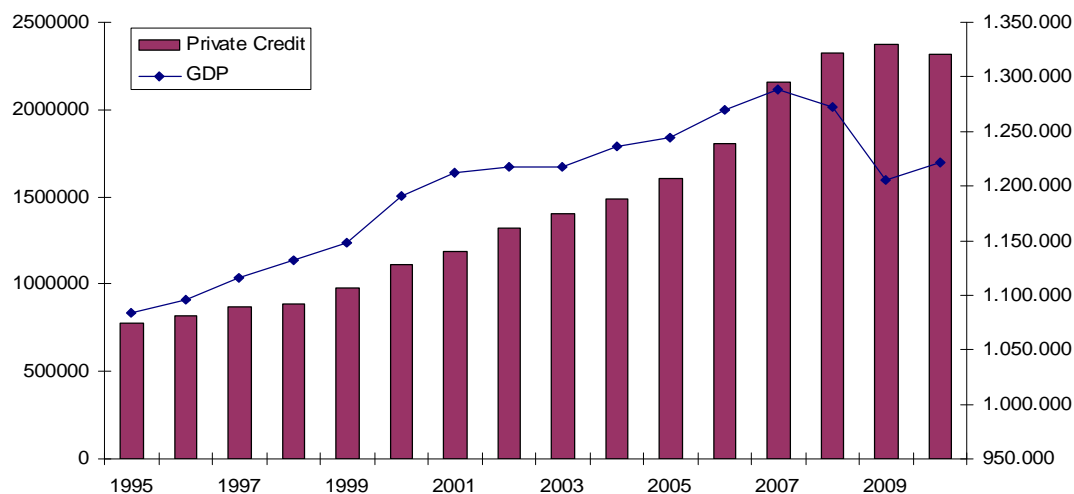


Source: Borsa Italiana and ISTAT, our elaboration

2.4 Private and public debt

At the end of 2010, the total financial liabilities of Italian households amounted to €887 billion (2010 prices). Financial liabilities include loans, consumer credit, home mortgage loans, other loans, insurance technical services, trade debts and other accounts payable. In 1995, this figure stood at €365 billion, indicating a 143% increase in the financial liabilities households in the 15 years (figure 2.7.).

Figure 2.7. Private credit (left) and GDP (right) (1995 – 2010)



Source: Bank of Italy and ISTAT

Looking at the features related to loans, consumer credit and home mortgage loans, we observe a definite increasing trend in all three over the 15 year period. Although loans and home mortgages account for larger shares of the total household liabilities, consumer credit grew the most by a factor of just over 14 (a 1332% increase between 1995 and 2010).

General government debt, is described by the Bank of Italy as “all the public sector’s financial liabilities valued at their face value at issue”. The rapid increase in public sector debt that took place in the 1980s, as mentioned earlier, is clearly visible in figure 2.7. Between 1980 and 1990, government debt as a percentage of GDP grew from just above 52% to 92%. OECD data indicates that government debt as a percentage of GDP in the period 1995-2010 reached its peak in 1996, about 114% of the country’s gross domestic product. This debt then declined and reached a trough in 2007, just before the financial crisis. Since then, a steep increase has been observed.

3. The Structure of the Italian Financial System

Giampaolo Gabbi and Pietro Vozzella

3.1. The structure of the financial system

The core Italian financial system is strongly linked with the credit function played by the banking system. Not only in terms of assets and capitalization, but also in terms of functions and services provided. Few credit intermediaries (less than 16% at the 2010) are independent from banks or banking groups. Leasing, factoring are essentially managed by banks or companies owned by banks.

Most of the largest banks operate as universal banks, while business line strategically chosen is retail and commercial banking.

The 1993 Banking Code has confirmed the traditional definition of banking business as the joint activity of raising funds from the public and granting credit. It likewise restricts this activity to banks. As regards the funds raising from the public, the Code clarifies that companies other than banks are prohibited from engaging in this activity, even if it is conducted separately from the granting of credit. There are some limited exceptions.

The Banking Code states that banks' corporate business comprises not only typical banking operations but "all other financial activities", as well as "related and instrumental activities" (Banking Act, Art. 10). Hence, universal banks can operate free of maturity constraints and carry on all the financial operations that are not restricted by law. Prudential supervision regulates maturity transformation and sets limits to banks' industrial share-holding. The Code requires banks to be chartered in the form of a company or co-operative limited by shares. Banks established as co-operatives may only take the form of cooperative bank ("banca popolare") or mutual bank ("banca di credito cooperativo").

Operationally there is no difference between co-operative banks and banks in

the form of a company limited by shares. In contrast, for mutual banks (formerly rural and artisans' banks) specific local and mutual assistance assignments apply.

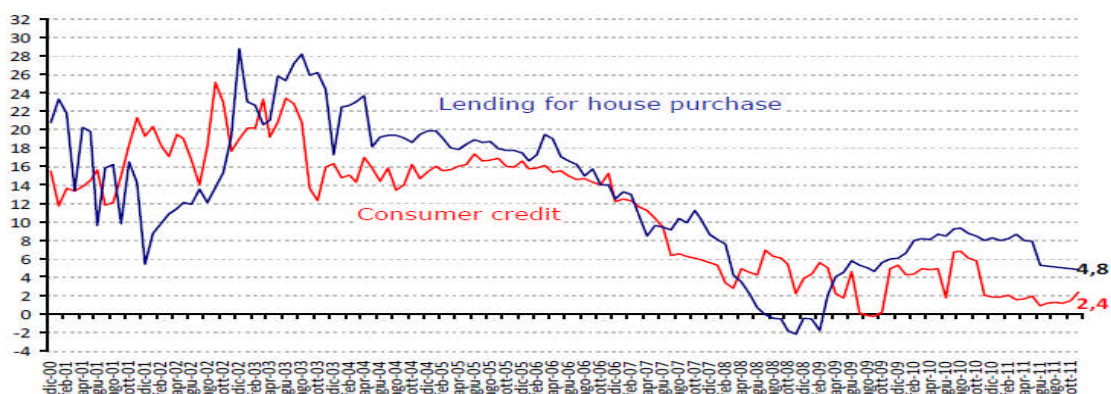
During the last years a concentration process has affected most of the financial institutions. On balance, the number of financial intermediaries reduced (1997 – 2011) from 2641 to 2005 (table 3.1). This process was induced essentially by the liberalization interventions which, after 1985 (when the first EU Directive on banking was adopted), have characterized the Italian financial sector. The increasing competition produced a significant impact in terms of X-efficiency and the subsequent need for economies of scale through mergers and acquisitions. The other players of the credit market are leasing and factoring for loans to companies. Households are provided with credit by banks and credit consumer companies. Few specialized building societies operate; most of them are foreign companies owned.

The dynamics residential mortgages and consumer credit declined since the top recorded in 2002, when the low level of interest rates associated with the portfolio decision to switch from financial investments induced an increasing percentage of households to enter the credit market in order to sustain real estate investments.

As shown in figure 3.1., the residential debt plays a leading role when compared to the consumer credit.

From the end of 2011 to the end of 2012, the residential mortgages volumes change has declined by approximately 50 per cent.

Figure 3.1. Loans and mortgages to households for residential and consumer purchase (yoy; %; Dec. 2000 – Nov. 2011; end of period figures)



Source: Bank of Italy and Assofin

The growth of investment funds and portfolio management services was especially rapid. Insurance companies recorded a smaller increase, while pension funds' share in households' financial assets decreased slightly.

Only recently (namely, after the introduction of Directive Mifid, in 2008) independent financial advisors have started to operate. Nonetheless, a large number of financial companies operate in the financial investments sector. In 1984 domestic mutual funds and SICAV have introduced, covering all the asset classes, with assets under management which increased from 109.019 million euros in 1996 to 654.620 million euros in 2005. The percentage out of financial assets owned by households increased from 6.23 to 20.03.

Table 3.1. Financial firms and Banks in Italy (1997 – 2011)

Type of financial firm	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Banking Groups	87	85	70	79	76	78	82	83	85	87	82	81	75	76	77
Banks	935	921	876	841	830	814	788	778	784	793	806	799	788	760	740
Capital Banks	228	243	239	240	252	253	244	242	243	245	249	247	247	233	214
Cooperative banks	652	619	580	543	518	501	483	476	475	474	478	470	459	452	448
Foreign banks branches	55	59	57	58	60	60	61	60	66	74	79	82	82	75	78
Financial Investments Companies	212	191	183	171	162	158	132	115	108	106	107	113	115	111	102
Portfolio Management Companies	64	72	86	101	132	142	153	162	182	199	214	214	204	198	190
Financial firms (107 TUB)	219	206	203	211	263	316	359	278	409	444	480	491	172	195	188
Financial firms (106 TUB)	1211	1221	1136	1146	1113	1143	1135	1028	1168	1201	1239	1189	1411	1288	782
Electronic Money Firms										3	3	3	3	3	3

Source: Bank of Italy

Open pension funds were introduced only in 1999. Taken into consideration also corporate pension funds, they actually manage 60 billion euros (1.63% of financial assets owned by households).

Within the Nineties, institutional investors' net assets rose by 37 per cent to 1,000 trillion lire and from 39 to 57 per cent of GDP. As a proportion of households' gross financial assets, they increased from 21.5 to 26.4 per cent (Table 3.2.).

Table 3.2. Institutional Investors: Net assets as a percentage of Households' Financial Assets (1990 – 1997, end of period data)

	1990	1992	1993	1994	1995	1996	1997
Investment funds	2.3	2.5	3.9	4.4	4.0	5.8	9.7
Portfolio management services	3.2	4.0	5.1	6.1	6.1	7.4	8.2
Insurance companies (1) (2) ..	3.7	4.1	4.3	4.2	4.7	5.1	5.5
Pension funds (2)	0.6	3.1	3.1	3.3	3.2	2.9	2.7
Securities firms (3)	–	..	0.3	0.2	0.2	0.2	0.3
Total	9.8	13.7	16.7	18.2	18.3	21.5	26.4

(1) Technical reserves, excluding securities entrusted to portfolio management services. – (2) The figure for 1996 is estimated. – (3) Own trading portfolios.

Source: Bank of Italy

From 1996 to 2005 the asset management industry did increase of about 258% for asset under management.

3.2. Corporate governance

The Italian financial system has been characterized by a high level of public dominance. In 1993 the largest privatization process has been implemented. The most important public banks and insurances have been sold through IPOs. Actually, most of them are controlled by banking foundations.

At the beginning of the 1990s neither banks nor institutional investors played a significant role in Italian companies' ownership. Whereas banks still show a limited presence in non-financial companies capital, ownership by institutional investors significantly increased over the years between 1990 and 2010. Considering investors that own more than 2% of the share capital, the

percentage of companies where they are present has grown from 29% in 1990 to 59% in 2010.

During the past 15 years the Italian banking system switched from a public governance to a private one. This process was induced through a legal system change. Savings banks, previously characterized by mixed objective function between profit and social allocation, have divided into two players: on one side the banking firm, aimed at increasing profit like an ordinary non-financial company; on the other side, their ownership was given to banking foundations with no profit purposes.

Along with this process, in 1993 the largest privatization process has been implemented. The most important public banks and insurances have been sold through IPOs.

Most of them are directly controlled by banking foundations, with a public nature. At the beginning of the 1990s neither banks nor institutional investors played a significant role in Italian companies' ownership (table 3.3.).

Whereas banks still show a limited presence in non-financial companies capital, ownership by institutional investors significantly increased over the years between 1990 and 2010.

The structure of corporate regulation allowed large banks to be re-capitalized during the financial turmoil after 2007 to sustain credit and market losses and new capital requirements. Nonetheless, in some cases, the excessive of asset concentration and the strategic model to hold the bank control stimulated their leverage, with a doubtful sustainable perspective.

Table 3.3. Ownership structure of listed banks (Percentages, weighted by market capitalization)

Shareholder	1990	1998	2007	2011
Insurance	0.6	3.2	2.1	2.7
Bank	5.8	11.3	3.5	7.3
Foreign	1.8	8.5	6.1	7.8
Foundation	11.1	17.4	13.8	14.5
Institutional Investor	0.5	0.1	0.0	0.0
Private Non-Financial Companies	2.1	0.9	4.2	2.3
State	36.8	1.0	0.0	0.0
Individuals ¹	2.6	1.4	2.0	6.9
Dispersed ownership ²	38.7	56.2	68.3	58.5

(1) It includes "Società in accomandita per azioni"

(2) Private shareholders and households. Sum of share lower than 2%, according to the Financial services Authority (Consob) regulation

Source: Del Prete (2008) and our elaborations on Consob data

Relevant differences emerge distinguishing between banks and non-financial companies: whereas institutional investors are present approximately in the same percentage of banks over the whole period, in 2010 they own stakes in twice the number of non-financial companies than in 1990. If we distinguish companies by listing period, we observe that institutional investors (both Italian and foreign) are present in a significantly greater number of companies which are recently listed, whereas they seem to "like less" firms listed in the 1990-98 period.

The number of listed companies in 15 years has increased only slightly (even if they have grown considerably in term of market capitalization): they were 266 (their market capitalization was 13.8% of GDP) in 1990; they are around 300 (48% of GDP) at the end of 2010. Entry and exit rates have shown similar behaviour except for the years 1998-2000 and 2005-07 when entry was significantly higher than exit, increasing the stock of companies. After the crisis the number of IPOs has collapsed.

The financial intermediaries sector (banks and insurances) is the most important sector, both by number of listed companies and by capitalization.

On balance, the issues on governance observed in the financial system relate on (i) ineffective governance, particularly concentrated in public foundation, often fully concentrated in banks' shares and politically driven; (ii) weak processes for strategy formulation, because of non-specialized managers and directors.

3.3. Intensity of intermediation

Non-financial companies are significantly oriented to manage their financial liabilities through banking relations. The indicator we estimated is

$$\text{Liabilities of firms to banks} / \text{Total financial liabilities of firms}$$

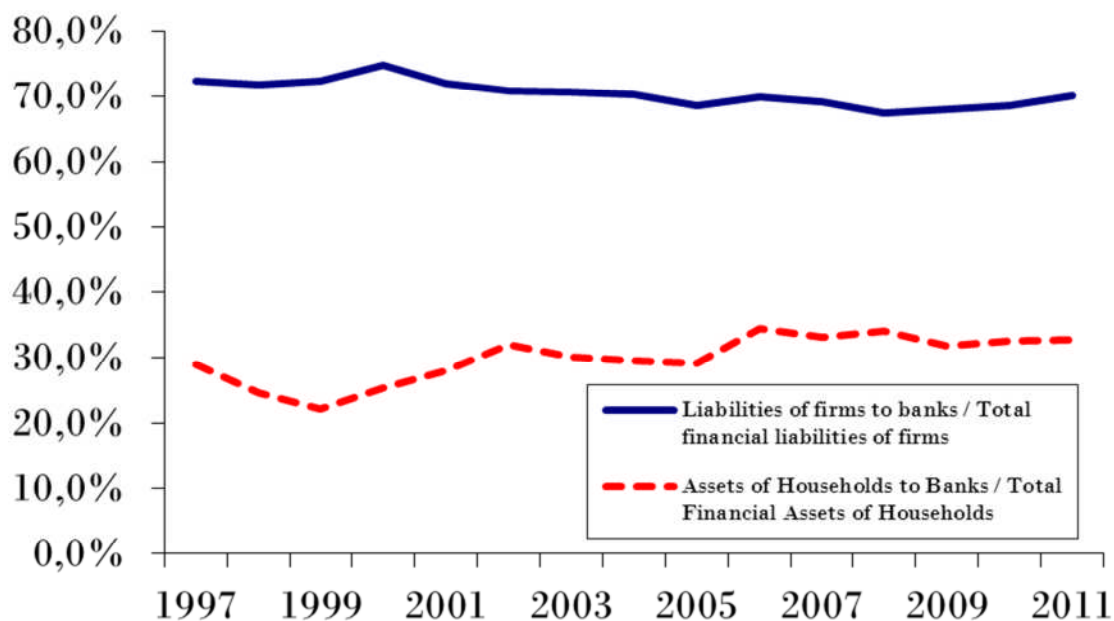
This average ratio is 70.4% (minimum 67.5%; maximum 74.8%). The trend is only slightly declining (Figure 3.2.).

On the other side, the increasing need to support the public debt has transformed the propensity of households to invest in assets issued by banks. The indicator we estimated (Figure 3.2.) is

$$\text{Assets of Households to Banks} / \text{Total Financial Assets of Households}$$

which ranges from 22.2% to 34.5% (average 29.9%) during the period 1997-2011.

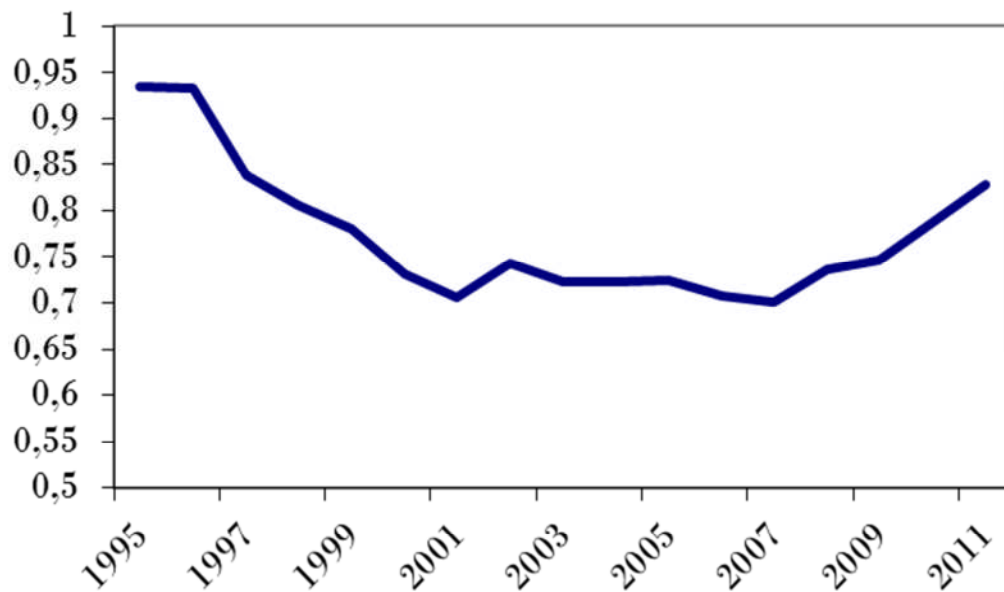
Figure 3.2. Liabilities of firms to banks / Total financial liabilities of firms and Assets of Households to Banks / Total Financial Assets of Households (percentage values; 1997 – 2011)



Source: Bank of Italy

The observation of the gap between firms' liabilities and households' assets to banks is strictly connected with the deposit to loan ratio (figure 3.3.). While in the mid Nineties it was approximately close to 1, with the introduction of the euro it showed a declining figure, since the minimum value of 0.7 with the beginning of the crisis. This data demonstrates the banks' dependence on exogenous source of funds, with an increasing unsustainable leverage ratio.

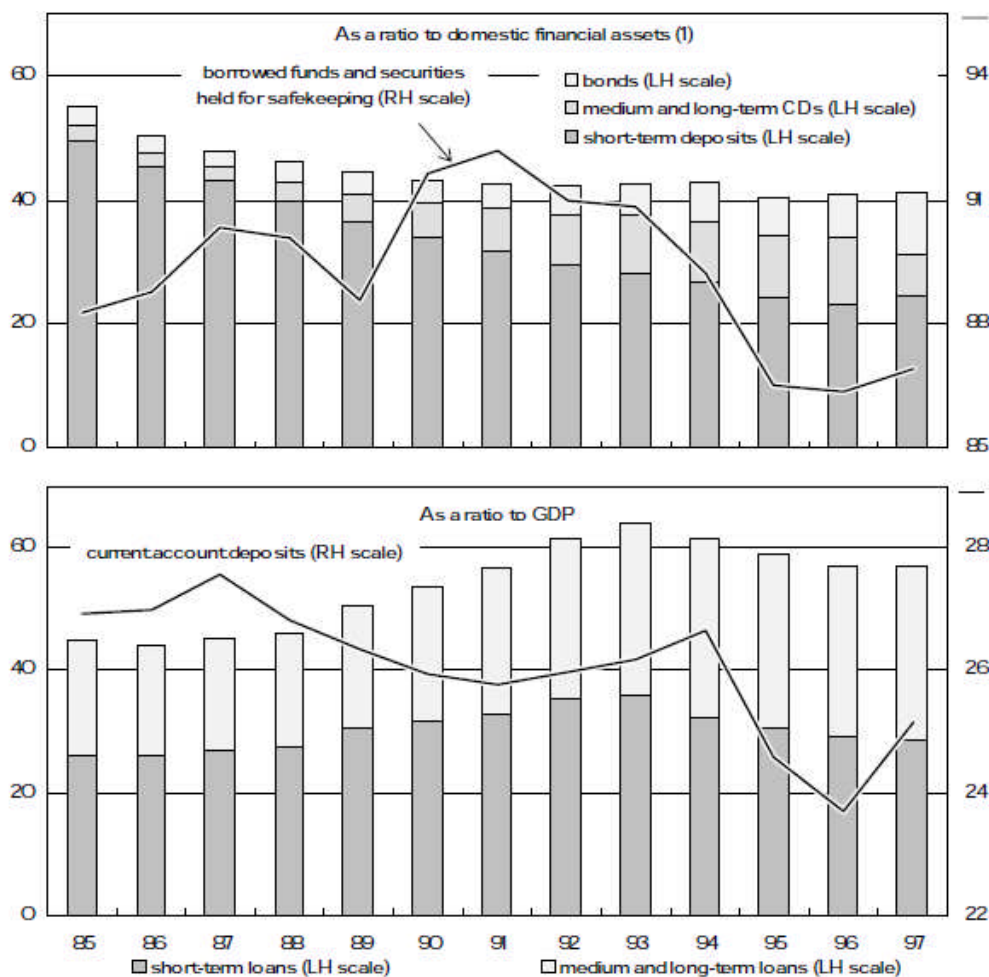
Figure 3.3. Deposit to Loan ratio (1995 – 2011)



Source: Our elaboration on Bank of Italy data

The disintermediation phenomenon began in the mid-Eighties, when the borrowed funds and securities continuously decreased. In particular short term deposits to financial assets ratio recorded a change from 50% to 25% in 1997 (figure 3.4.).

Figure 3.4. Indicators of Disintermediation (1985 – 1997)



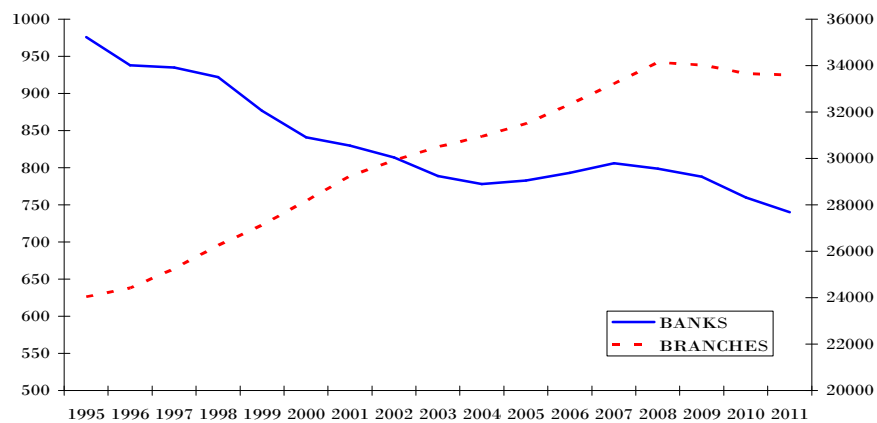
(1) Current and savings account deposits, CDs, bonds issued by banks and securities owned by the non-state sector held for safekeeping as a ratio to the domestic financial assets of the non-state sector excluding shares. The securities held for safekeeping are those owned by non-bank customers; they do not include shares, bonds issued by banks, foreign bonds or CDs.

Source: Bank of Italy

After 1997 the concentration process accelerated: between 1990 and 1995 the assets of the first 5 largest banks was around 30%. In 1999 this ratio was 48% (compared with the European average of 57%). The number of branches increased from 1996 to 2008 of about 40% (718 branches). During the crisis 532 branches have been closed.

Most of the large banking groups are planning to close branches both for technological and for operational reasons (figure 3.5.).

Figure 3.5. Banks (left hand scale) and banking branches (right hand scale) (1995 – 2011)

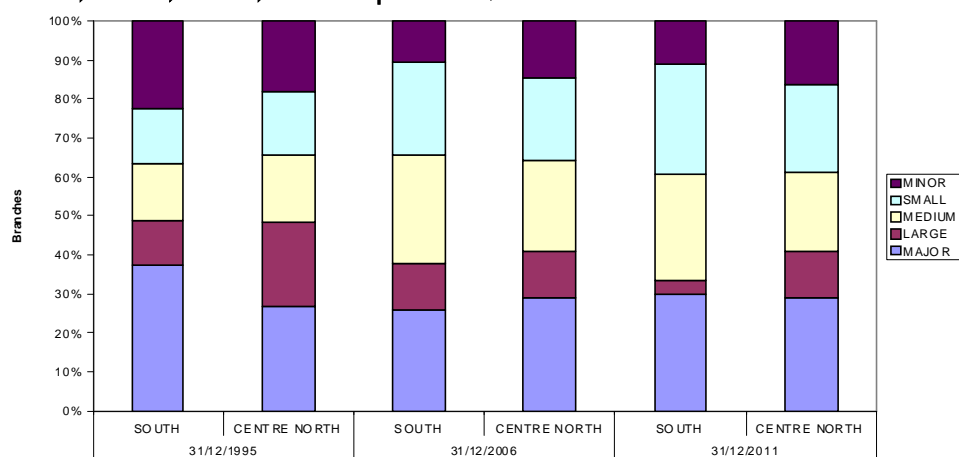


Source: Bank of Italy

The concentration process substantially modified the composition of Italian banking sector by size, increasing the difference between Centre-North and South Italy, mainly in terms of proportion of major and large banks.

Despite to the increased number of branches registered both in Centre-North and South Italy, the share of loans between 1995 and 2011 remains substantially unchanged (figure 3.6.).

Figure 3.6. Banking branches by size and geographical area (percentage of total; 1995; 2006; 2011, end of periods)

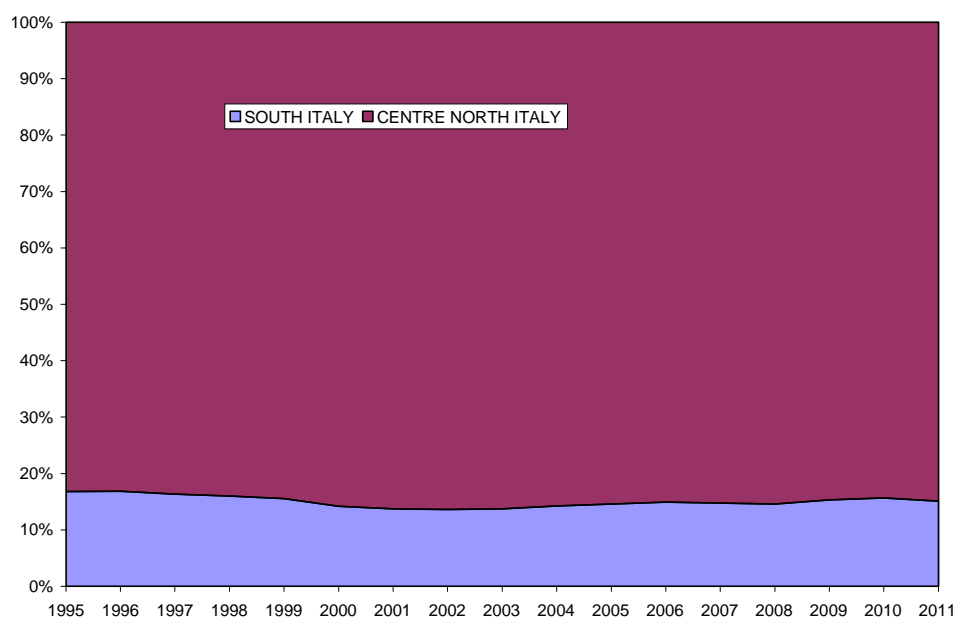


Source: Bank of Italy

A possible explanation of this phenomena might be given by the decrease of the number of larger banks: the consequent higher functional distance between branches and Corporate headquarters can determine negative effect on local SMEs, in terms of a higher probability of credit rationing, a lower financial innovation and a lower level of relationship lending (Alessandrini, Presbitero and Zazzaro, 2008).

Figure 3.7. shows the significant concentration of loans in the most industrialized areas of Italy, particularly North and Centre Italy.

Figure 3.7. Loans (% of total Italian loans). South vs North-Centre Italy



Source: Our elaboration on Bank of Italy data

The banking system appears to channel financial assets from South to North, particularly through the interbank system and the increasing issuance of bank bonds, especially subordinated liabilities, accepted within the regulatory capital.

4. International markets and currency

Pietro Vozzella

4.1 The currency policy. From the European Monetary System to the Euro

In March 1979, Italy joined the European Monetary System, obtaining wider margins of fluctuations around the central rate (± 6 per cent) than those prescribed for the majority of the participating countries (± 2.25 per cent).

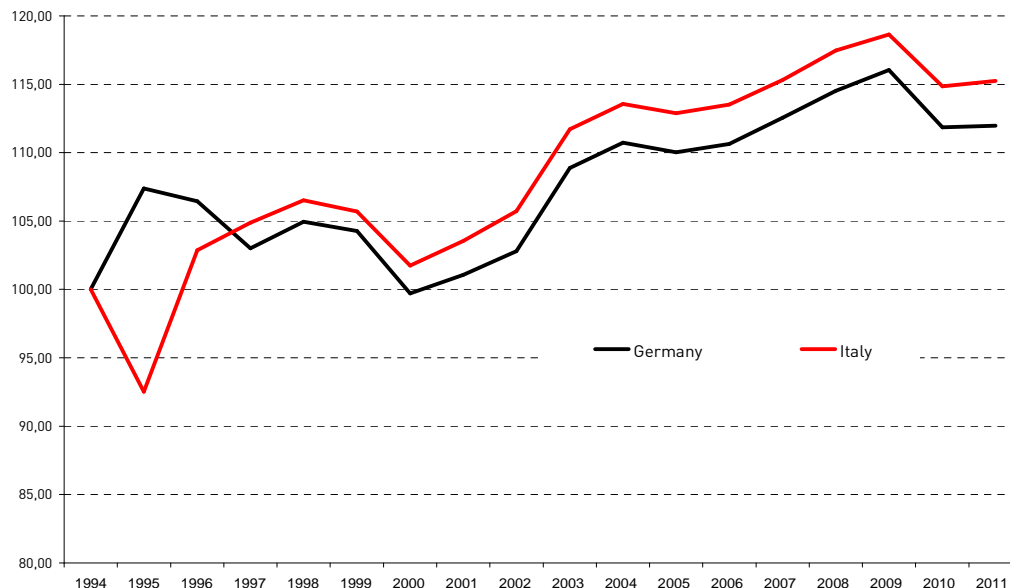
After 1980, the exchange rate became a major objective of the monetary authorities, offering a clear example of time-consistent monetary policy. In spite of several realignments of the central rate in the EMS, the exchange rate was managed in such a way that the real exchange rate strengthened. In this period there was a reduction in the reserves in 1982 and 1985- 1986. The discount rate was raised in 1979, 1980 and 1981, when it reached its maximum value. The maximum differential with the German discount rate was reached in 1983. Afterwards, with the oil counter-shock, the discount rate (and its differential) decreased (with a temporary increase in the second half of 1984) until August 1987, when it was raised again. Further increases followed in 1988 and 1989. Between the second half of 1987 and the first half of 1990, a substantial increase in the reserves was recorded. In January 1990 Italy entered the narrow band (± 2.25 per cent) of the EMS. This period was characterized by a strong commitment to maintain the exchange rate fixed. The reserves followed a decreasing trend from the second half of 1990 that culminated in the collapse leading to the crisis of September 1992. The discount rate decreased from May 1990 until the end of 1991, when it turned upwards (with a temporary reduction in August 1992), reaching a peak in September 1992.

After the September 1992 devaluation and the temporary suspension of the lira's participation in the Exchange Rate Mechanism of the European Monetary System, a changeover to a managed float took place. The reserves increased and the discount rate was lowered. The discount rate rose in 1994 and again in

1995 when a new crisis hit lira. From 1996 the lira-mark exchange rate stabilised and the lira was again pegged de facto and de jure to the Deutsche Mark. The reserves increased from 1996 until 1998, when, in the run-up to the formation of monetary union and the adoption of the euro as a single currency, a sizeable reduction occurred.

In Figure 4.1, we show the development of the nominal effective exchange rates of Germany and Italy. They are based on weighted averages of bilateral exchange rates against 36 trading partners (source Eurostat), with weights based on trade in manufactured goods with each partner. The constantly increasing rate starting from the adoption of the euro indicates that more and more foreign currency must be spent for obtaining one euro, thus indicating that our currency (and goods!) became more expensive for our main trade partners.

Figure 4.1. Nominal Effective Exchange Rate (1994-2011; Index 1994 = 100)

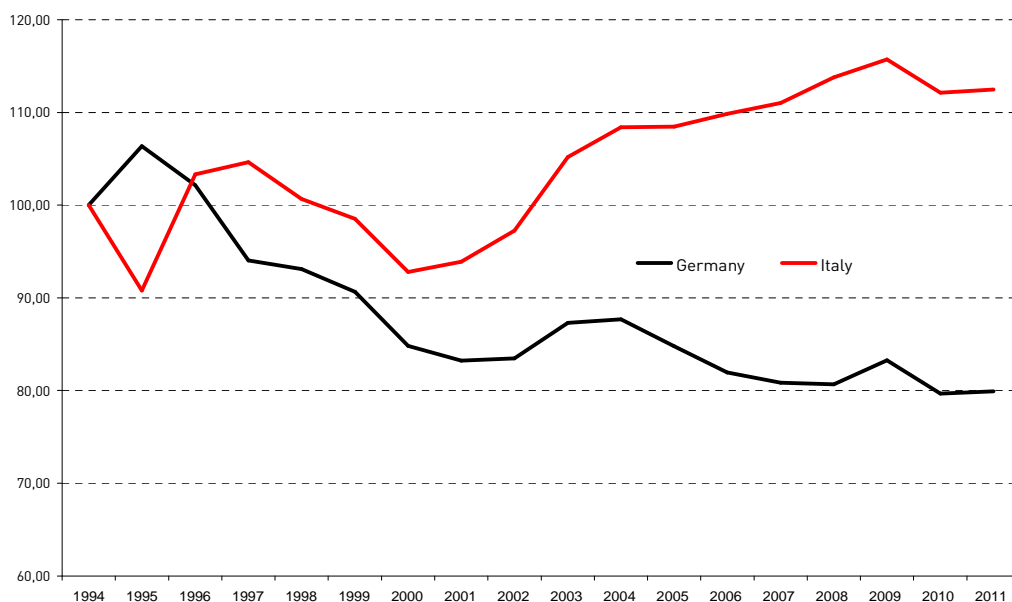


Source: Eurostat

Figure 4.2 shows the real effective exchange rates (REER), obtained by deflating the nominal rates by the nominal unit labor costs. REER are a good indicator of

a country's cost competitiveness relative to its principal competitors in international markets. Looking at this graph is very significative, as it shows the deteriorating cost competitiveness of Italy since the adoption of the euro and the divergence from Germany (which was more efficient in keeping unit labor costs low, in order to obtain what is generally called an "internal devaluation"), notwithstanding their completely similar path in the nominal effective exchange rates.

Figure 4.2. Real Effective Exchange Rate (1994-2011; Index 1994 = 100)



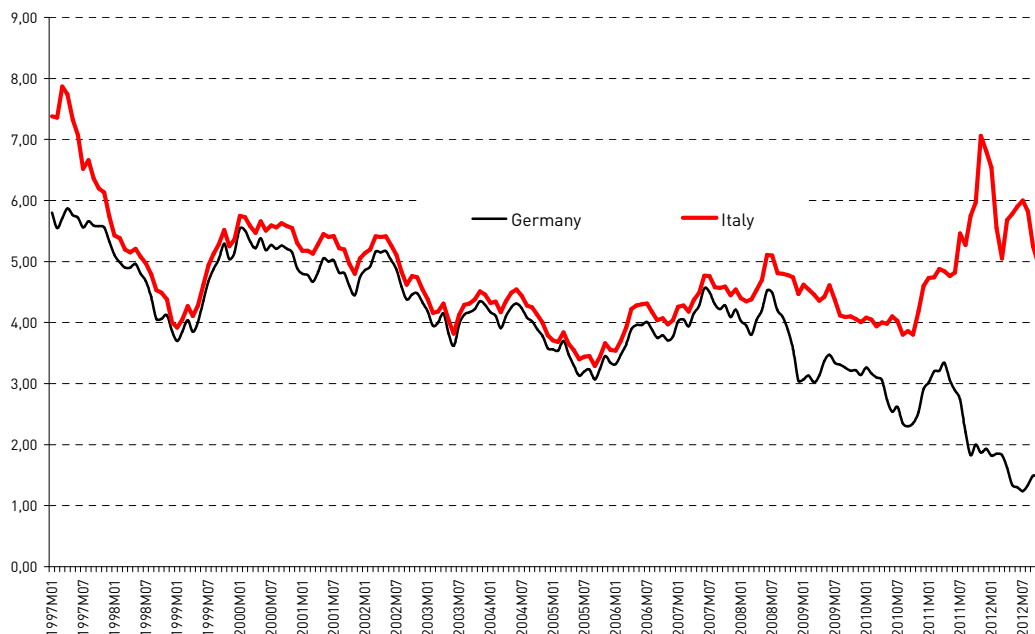
Source: Eurostat

4.2. Current account balance and Financial Account

The Current account balance as a percent of GDP provides an indication on the level of international competitiveness of a country. Usually, countries recording a strong current account surplus have an economy heavily dependent on exports revenues, with high saving rate and weak domestic demand. On the other hand, countries recording a current account deficit have strong imports, a low saving rate and high personal consumption rates as a percentage of

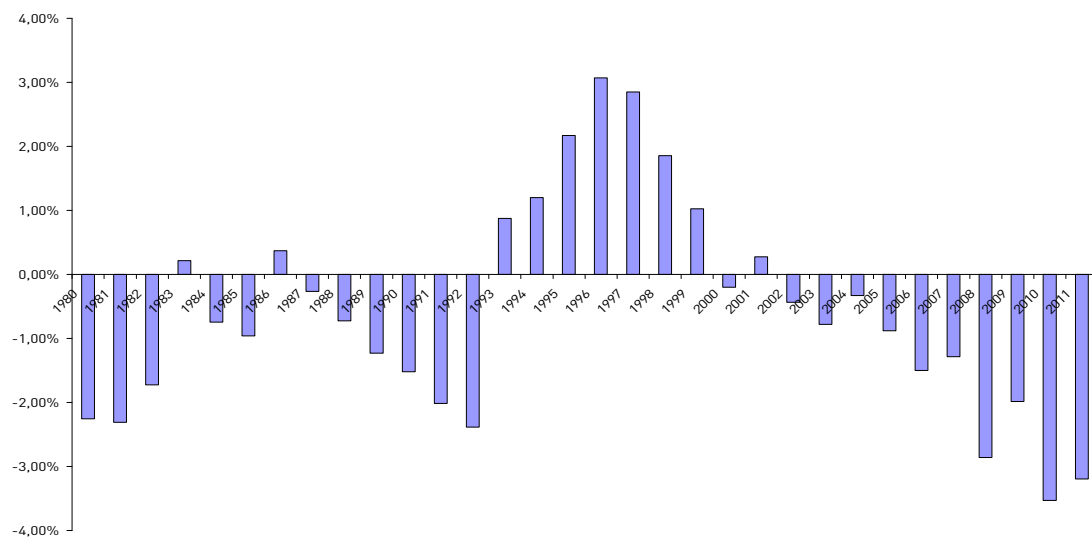
disposable incomes. Italy reported a Current Account deficit of 3.2 percent of the country's Gross Domestic Product in 2011. Historically, from 1980 until 2011, Italy Current Account to GDP averaged -0.6 percent. Partly as a consequence of the devaluation period started at the end of 1992, the current account balance turned positive between 1993 and 2002, reaching a peak of 3.1 percent in 1996. After the introduction of euro, the financial markets assessed the sovereign risk and the risk of bank failures as extremely low, because they did not believe that the no-bail out clause would be enforced. As a consequence of this, interest rates on government securities of the euro countries initially converged about to the German level (Figure 4.3) and increasing current account deficits were financed by massive capital inflows, especially from Germany, leading to a strong external debt burden. Italy, in particular, recorded a growing current account deficit that reached the lowest value of 3.53 percent in 2010 (Figure 4.4).

Figure 4.3. Euro Convergence Bond Yields (nominal rates; 1997-1H2012)



Source: Eurostat

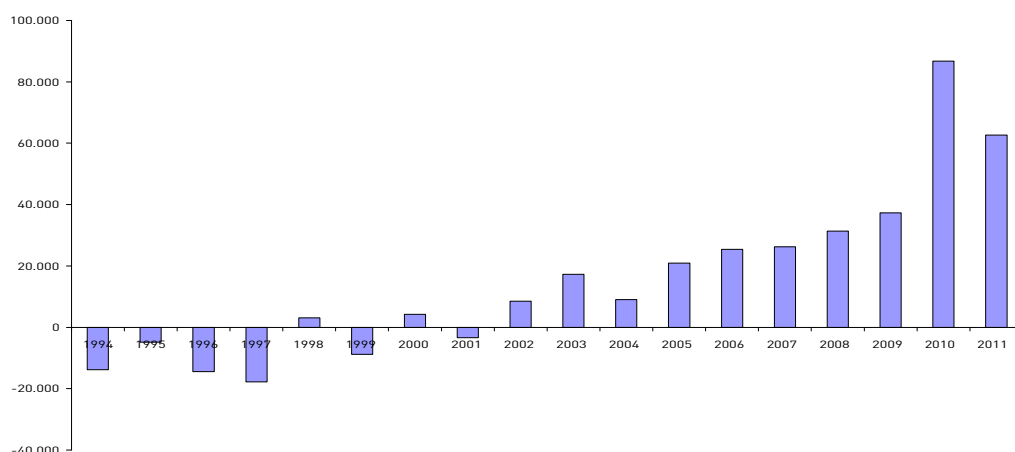
Figure 4.4. Current Account Balance in percent of Gdp (1980-2011)



Source: Bank of Italy and Istat

Although during the last crisis also Italy have experienced significant reversals of capital inflows (sudden stop), this was not evident from the official balance-of-payment statistics because the private capital outflows were compensated for by an equally sizeable increase in public capital inflows. These flows have prevented the official financial account from shrinking (Figure 4.5)

Figure 4.5. Net Financial Account (millions of Euros; 1994- 2011).



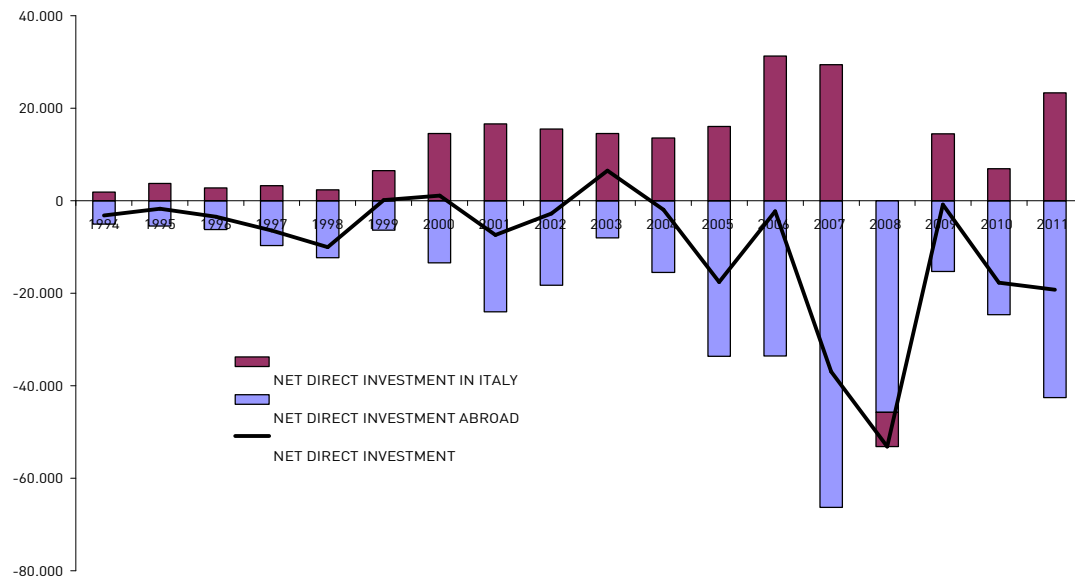
Source: Eurostat

The analysis of Financial Account is then broken down by components. Figure 4.6 shows the dynamic of Net Direct Investment. Direct investment is a category of international investment in which a resident of one economy – a direct investor – holds a lasting interest (at least 10% of the ordinary shares or voting power) in an enterprise resident in another economy – a direct investment enterprise. It is recorded on a directional basis: direct investment abroad as an asset and direct investment in the reporting country as a liability.

During last two decade net direct investment in Italy have recorded a stable increase until 2006 when they reached the peak (about 31 billion of Euros). In 2008 world flows of direct investment were powerfully affected by the financial crisis, owing both to the deterioration in the economic outlook and to firms' reduced self- financing capability and access to credit. The net inflows of direct investments (new investments net of disinvestments) towards Italy dramatically fell from 29.4 billion in 2007 to a negative value in 2008. Most of the reduction was due to a single foreign disinvestment: the transfer of the ownership of Banca Antonveneta from Banco Santander to Monte dei Paschi di Siena.

In contrast, net Italian investment abroad was basically stable until 2006. After a peak in 2007, it recorded a decreasing path until 2009. Between 2010 and 2011 it grew again but still significantly low with respect to 45.8 billion of euros of 2008.

Figure 4.6. Net Direct Investment (millions of euros) (1994-2011)



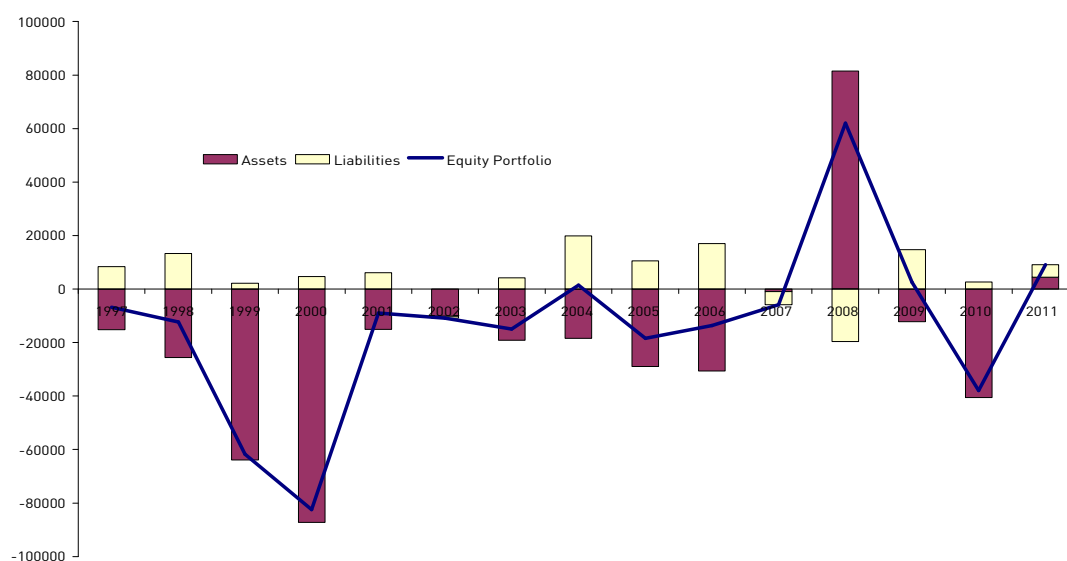
Source: Eurostat

With relation to the Portfolio Investment, Figure 4.7 and 4.8 show Equity and Debt securities Investment respectively.

Between 1997 and 2000 purchases of foreign equities strongly grew; residents bought an extremely large volume of foreign equities in 1999 reaching the peak in 2000. They began to scale down their holdings in 2001, and growing uncertainty about the timing of the world economic recovery caused them to make further reductions in the following years. The precipitation of the financial crisis in 2008 set off a “flight to quality”, boosting investors’ demand for the government securities of the major countries and leading to the repatriation of capital invested abroad in riskier assets. This last factor led to an exceptionally large capital inflow of about 81 billion of Euros in 2008 relatively to the equity portfolio. Between 2009 and 2010, the preference for relatively low-risk securities that had characterized capital movements in 2008 and the first half of 2009 gave way to a renewed appetite for risk on the part of Italian investors. The worsening of the sovereign debt crisis in the middle of 2011 had a major effect

on developments in the second half of the year. Italian households and firms restarted to sell foreign equities. For the first time since the 2008 financial crisis, Italians made net disposals of foreign portfolio assets; these amounted to €35.8 billion, of which equity portfolio accounted for about 4 billion of euros.

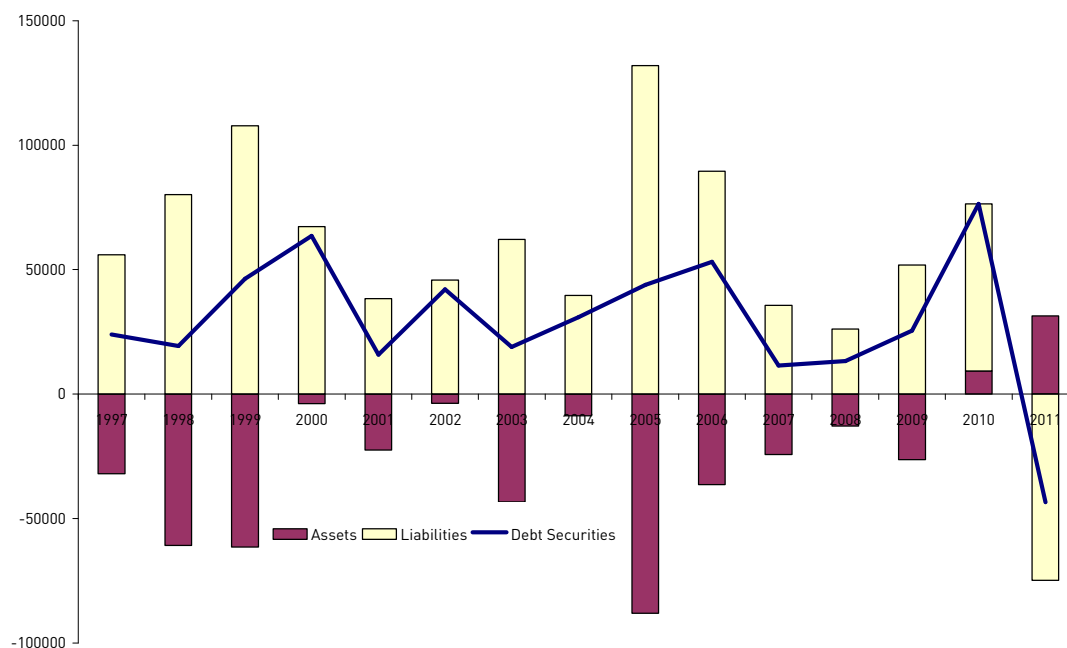
Figure 4.7. Equity Portfolio Investment (millions of euros) (1997-2011).



Source: Bank of Italy

After a significantly reduction in the amount of new Italian debt securities bought by foreigners recorded between 2006 and 2008, since 2009 they made again massive net purchases of medium- and long-term debt securities (almost all of them consisting of other types of public securities) totalling 67 billion in 2010, a sign of the firming up of confidence in Italian government securities after the lows of 2008. However, the strength of the sovereign debt crisis in the last year has affected foreign confidence toward our country; in the second half of 2011 non-residents significantly reduced their holdings, especially of medium and long-term public debt securities. In the year as a whole non-residents made net sales of 74.8 billion of Euros of debt securities issued in Italy.

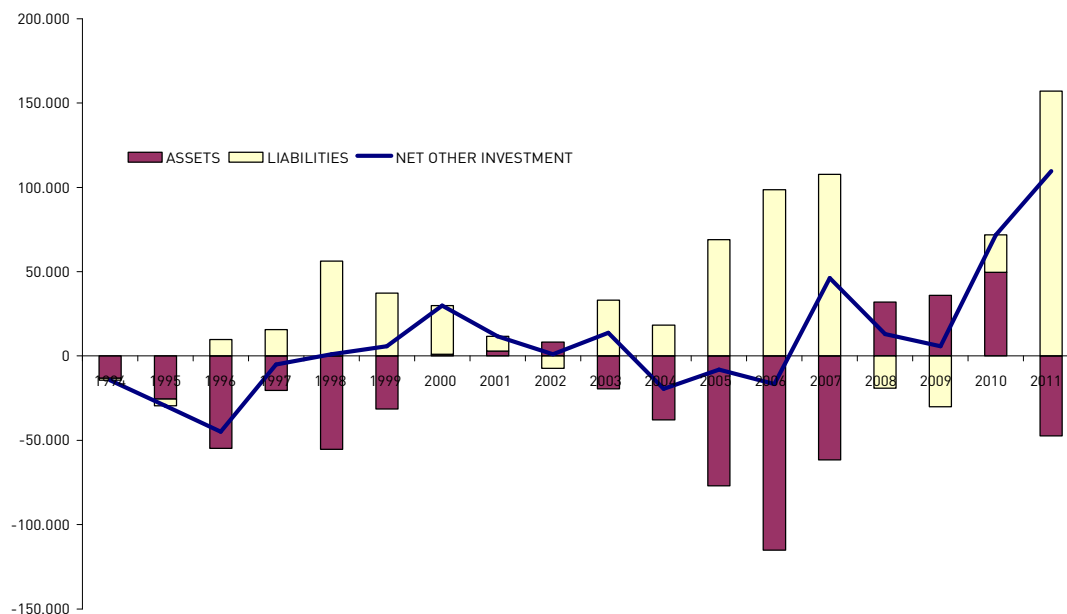
Figure 4.8. Debt Securities Investment (millions of euros) (1997-2011).



Source: Bank of Italy

The analysis of the “Other Investment” item highlights an interesting aspect about the role of Monetary Authorities (figure 4.9). This item covers trade credits, loans, deposits and other accounts receivable and payable. This item recorded a net inflow of 46 billion of Euros in 2007; the result is very meaningful if compared with the three previous years in which Italy was a net borrower abroad. After the sharp decline recorded in 2008 and 2009, it seems to see signs of a return to higher levels in 2010 when there was a net inflow of 71 billion of euro. In 2011, opposite to the net outflows concerning debt securities, “other investments” recorded net inflows for about 109 billion of euros, most of which due to the Bank of Italy in relation to the TARGET2 balance.

Figure 4.9. Net Other Investment (millions of euros) (1994-2011)



Source: Eurostat

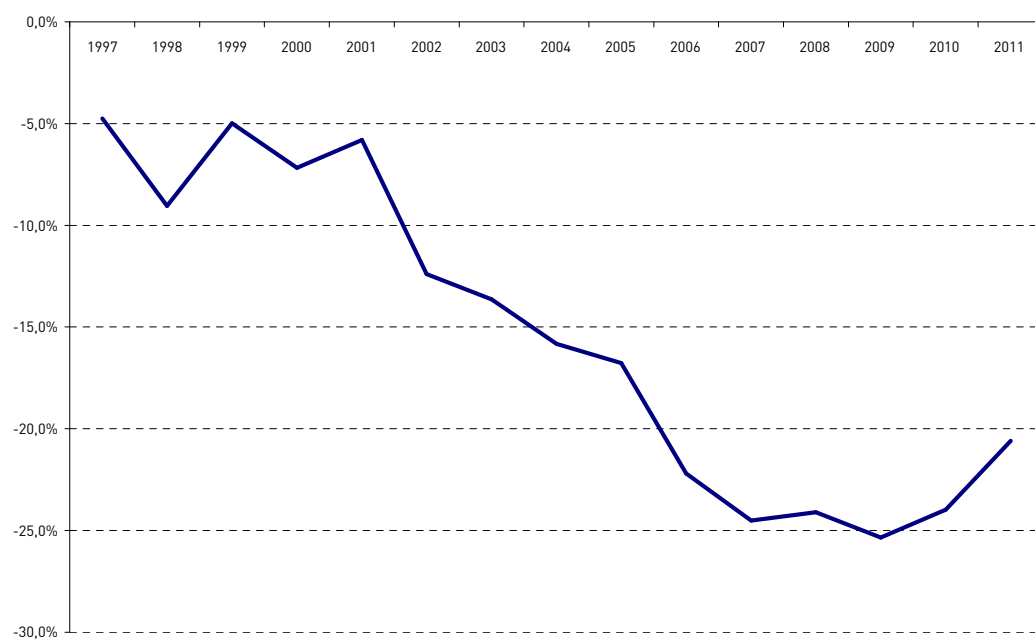
4.3 International Investment Position and External Debt

The international investment position is the balance sheet of the country's stocks of external financial assets and liabilities at the end of a specific period. The external financial assets consist of direct investment, portfolio investment, financial derivatives, other investment and reserve assets. The external financial liabilities consist of direct investment, portfolio investment, financial derivatives and other investment and, therefore, they are a broader concept than the liabilities that constitute the country's gross external debt (see below). Since the end of the Nineties, data show a continuous increase in Italy's negative net position. Between 2001 and 2009 this latter rose from 5.8 to 25.3 per cent of Gross Domestic Product.

From 2009 to 2011, Italy's negative net international investment position declined from 385.2 to 325.4 billion of euros (25.3 and 20.6 per cent of GDP respectively) (Figure 4.10). The increase of 73.5 billion of Euros in net borrowing on the financial account in 2011 was more than offset by the 120.6 billion of

Euros of valuation adjustments (i.e. changes in the valuation of previously issued, outstanding financial claims; these changes can result from movements in the market price of the underlying assets and/or from currency movements). The contraction in public sector liabilities as a result of the fall in market prices in the last part of 2011 actually accounted for 69.2 billion of Euros. With the return of the spread on Italian government securities to the high levels prevailing before the crises, the corresponding valuation adjustments will cause a decrease in Italy's net negative position.

Figure 4.10. International Investment Position as a percentage of Gdp (1997-2011).



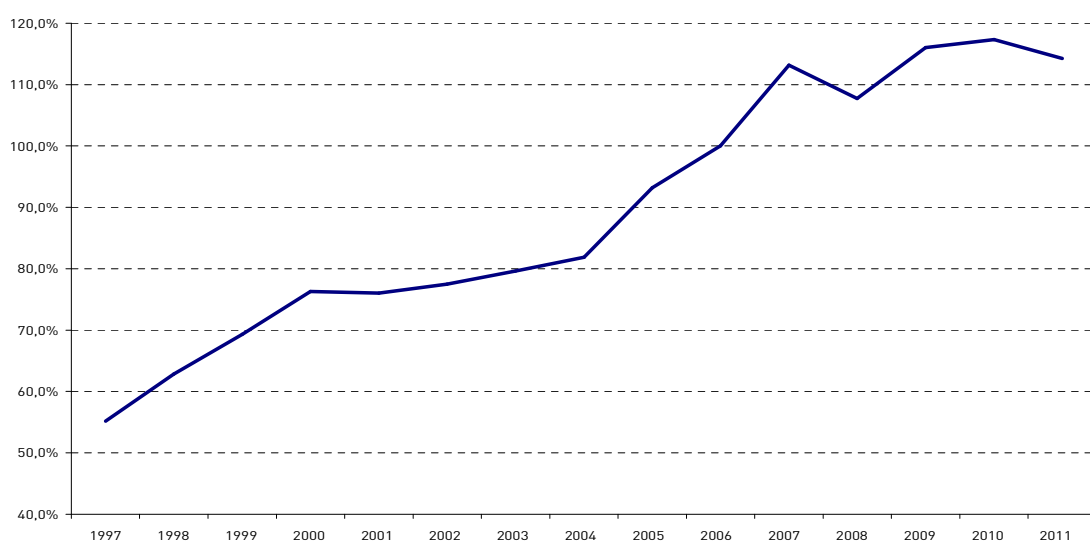
Source: Eurostat

The gross external debt of an economy represents the outstanding amount of its actual current liabilities that require payment of principal and/or interest to non-residents at some point in the future. These liabilities include debt securities, such as bonds, notes and money market instruments, as well as loans, deposits, currency, trade credits and advances due to non-residents.

The gross external debt positions of major advanced economies have increased considerably from the end of nineties.

The gross external debt in Italy has increased noticeably over the past decade. At the end of 2011, it amounted to 114.3 per cent of GDP, slightly down from the maximum value of 117.3 per cent in 2010 (figure 4.11). Since 1997, expressed in terms of GDP, the gross external debt has risen by as much as 59.1 percentage points. This increase was partly driven by higher financing needs of government in response to the last financial crisis. In addition, heightened global risk aversion on the part of investors contributed to higher external debt levels, by means of replacing equity by debt.

Figure 4.11. Gross Foreign Debt as a percentage of Gdp (1997-2011)



Source: Eurostat

Bank of Italy divide Gross External Debt into five categories:

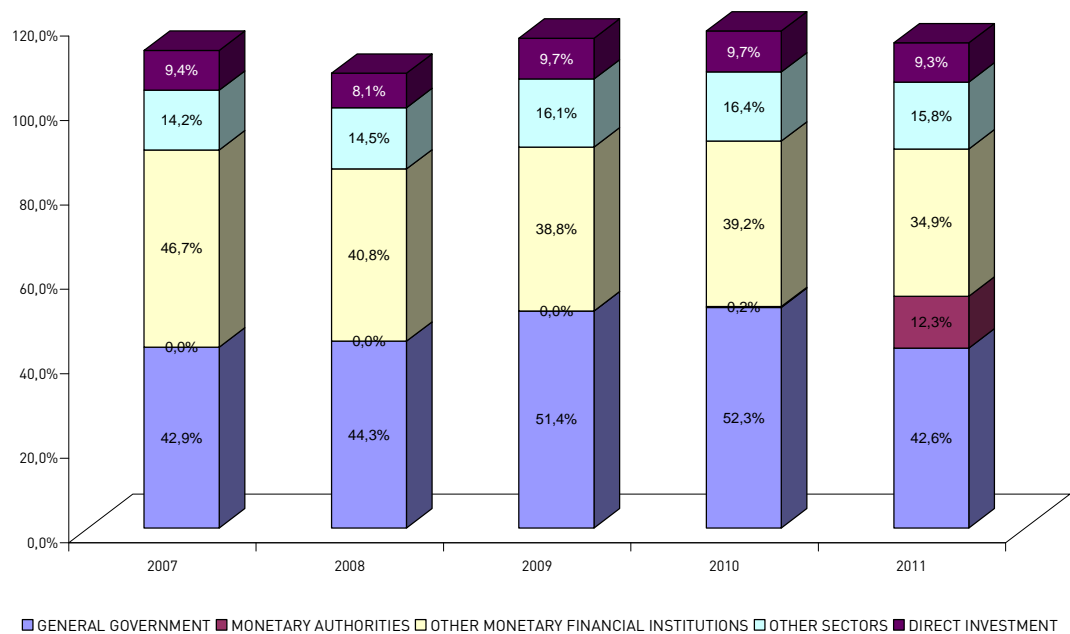
- Monetary authorities (Bank of Italy);
- General government (central government, regional and local government, social security funds);
- Other monetary financial institutions (banks, money market funds, electronic money institutes, Cassa depositi e prestiti SpA);

- Other sectors (non-financial enterprises, households, non-profit making institutions serving households, other financial institution not included in the “Other monetary financial institutions”;
- Direct Investment (debt liabilities to affiliated enterprises, debt liabilities to direct investors).

Most of the rise in gross external debt in the period from 2007 to 2010 reflects the increased borrowing undertaken by government in response to the crisis. Expressed in terms of GDP over this period, the gross external debt of the general government sector as a whole rose by 9.4 percentage points, reaching about 52.3 per cent of GDP at the end of 2010 (Figure 4.12). The increase in gross debt positions of the general government during the crisis may also have reflected portfolio re-allocation on the part of investors from equities to debt, against the backdrop of higher global risk aversion at the time. In 2011 the share of general government sector decreased by about 10 percentage points and remained stable during the first half of 2012. It is interesting to observe, on one side, the share of Monetary authorities sector’s external debt that reach 17.5 per cent at the first half of 2012, after a share of 12.3 per cent at the end of 2011, and on the other side the decreasing share of Other monetary financial institutions sector’s external debt from 39.2 per cent in 2010 to 34.9 in 2011 and 33.2 in the first half of 2012 . These reallocation of external debt among general government, banks and the Bank of Italy is mainly due to a refinancing credit through the ECB system that helped all the crisis countries. Beginning with the summer of 2011, TARGET (Trans-European Automated Real-Time Gross Settlement Express Transfer) credits financed a relevant capital flight from Italy. TARGET balances are claims and liabilities of the individual central banks of the Eurozone vis-à-vis the European central bank system; thus, increasing TARGET imbalances indirectly measure accumulated deficits in balance-of-payments with other euro countries (and, in particular, Germany). The share of “Other sector” and “Direct Investment” has substantially remained stable over

the period.

Figure 4.12. Breakdown of Gross Foreign Debt as a percentage of Gdp (2007-2011)



Source: Bank of Italy

5. Impact of financial globalisation on national financial systems

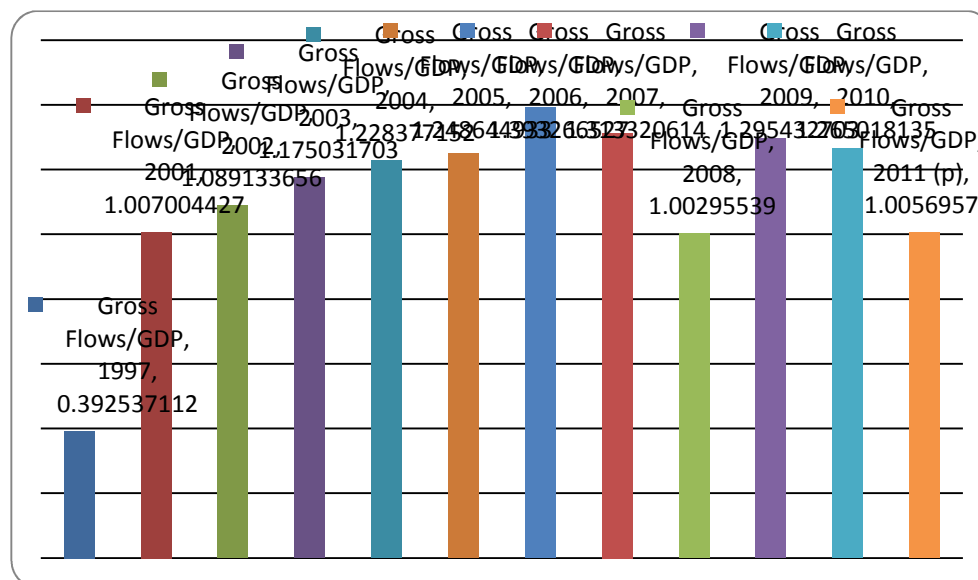
Costanza Consolandi

There have been an extensive literature on the measurement of the effects of the liberalization process (and subsequent market integration and globalization) on financial variables within national financial markets.

Focusing on national equity markets, financial globalization should affect the expected return of equity, through a decrease of the cost of capital, volatility and correlations with industrialized countries and contagion and market liquidity.

As can be seen in Figure 5.1, the volume of foreign investment in stocks and bonds on GDP increased noticeably from 1997 through 2010, with a growth rate of more than 200%. This indicator can be used as a proxy for market openness, as it capture one of the outcomes of financial globalization.

Figure 5.1: Cross Border security transactions on GDP



Source: World Bank, IMF

In Italy, the impact of financial globalization on the cost of equity capital has been driven mainly by economic and monetary integration in Europe, which has have both a direct and an indirect effect on the cost of equity capital.

The direct effect is straightforward and consists in a reduction in real risk free rates. In fact, as a precondition to EMU entry, inflation and interest rates converged among EU countries towards the typically low levels of Germany, which used to be considered as the benchmark country. As shown in Figure 4.3 of the previous paragraph, this convergence also resulted in lower real rates, implying that the opportunity cost of investing in equity decreased, reducing the cost of equity capital. Other things remaining equal, this effect on the cost of equity capital in Italy can be approximated by the difference in real short term interest rates from the German rates prior to 1995, when it became apparent to market players that European Monetary Union may materialize with high probability.

However, most importantly, economic and monetary convergence, and subsequent financial integration, has also an indirect effect on the cost of equity capital which consists in a decrease of the equity risk premium, the second component of the cost of equity capital. This effect is due to the gradual abolition of barriers to intra-EU investments and the launch of the common currency, the latter eliminating currency risk in intra-EU transactions.

As a result of both decreasing barriers and the launch of the common currency, risk sharing among EU investors increased, reducing the required equity risk premium and, hence, lowering the cost of equity capital.

Nevertheless, a recent work by Cappiello et al. (2008) point out the relevance of the time component: using an International Capital Asset Pricing Model (ICAPM) and introducing also an inter temporal risk premium in their analysis, they show how in the period after summer 2007, in correspondence with the US sub-

prime crisis, it contributed in increasing the total premium.

As argued by Stulz (1999), another relevant issue for the analysis of the impact of globalization on the cost of capital, is the decreasing of the home bias, as its reduction has an impact on the cost of equity. Thus, the decreasing of the home bias helps to improve a firm's value since the cost of equity is reversely related to the latter, consistently with the optimal global risk-sharing hypothesis and the market segmentation hypothesis.

To measure the degree of home bias, we follow Chen and Yuang (2011) and use Coordinated Portfolio Investment Survey (CPIS) data during 2001 to 2010 provided by the International Monetary Fund (IMF). We use the share of Italy's market capitalization in the world market as a benchmark and the Italian stock market capitalization is used as the market capitalization.

Formally, the measure of home bias can be defined as follows:

$$\text{Home Bias} = w - w^*,$$

Where w represent the proportion of domestic asset on domestic market capitalization, whilst w^* is the weight of domestic market capitalization on world market capitalization.

As shown in Table 5.1, the level of home bias for the Italian equity market noticeably decreased from the beginning of the century, thus confirming the increasing openness and integration of Italian financial system.

Table 5.1 The evolution of the home bias in Italy

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011 (p)
Total Foreign Assets	239,472	247,460	331,012	380,176	416,446	534,875	576,442	305,252	384,077	454,320	409,394
Total Foreign Liabilities	119,639	112,017	157,160	215,048	248,745	351,856	358,856	178,467	245,295	202,931	161,764
Domestic Market Capitalization	527,396	480,630	614,841	789,563	798,167	1,026,640	1,072,692	520,855	317,317	318,140	431,471
Domestic Equity Portfolio	647,229	616,072	788,693	954,690	965,867	1,209,658	1,290,278	647,640	456,099	569,529	679,100
World Market Capitalization	27,906,268	23,509,266	32,036,192	38,151,366	43,319,352	53,375,286	64,575,373	34,900,893	47,379,869	54,511,412	45,082,821
Domestic Market Capitalization/World Market Capitalization (%)	0.02	0.02	0.02	0.02	0.02	0.02	0.02	0.01	0.01	0.01	0.01
Foreign security holding/Domestic equity portfolio	0.37	0.40	0.42	0.40	0.43	0.44	0.45	0.47	0.84	0.80	0.60
Domestic securities holding/Domestic equity portfolio	0.63	0.60	0.58	0.60	0.57	0.56	0.55	0.53	0.16	0.20	0.40
Home Bias	0.61	0.58	0.56	0.58	0.55	0.54	0.54	0.51	0.15	0.20	0.39

Source: World Bank, IMF

6. Impact of European integration on financial systems

Giampaolo Gabbi and Massimo Matthias

6.1 Integration of financial markets

The main channel through which the removal of barriers to integration can spur domestic financial development is increased competition with more sophisticated or lower-cost foreign intermediaries. This competitive pressure drives down the cost of financial services for the firms and households of countries with less developed financial systems, and thus expands local financial markets.

The barrage of measures outlined in the Financial Services Action Plan (FSAP) seek to promote a more integrated, efficient and safer European financial marketplace. The ultimate aim is to create a single market across the broader spectrum of the financial services industry thus facilitating cross-border trade and improving competition, innovation and access to lower cost finance for individuals and companies.

This, of course, is an ambitious objective and one that has become increasingly important since the advent of the single currency. One can see that the removal, or reduction, of existing barriers is likely to have a substantial impact in promoting European wide change in the financial industry.

Sectors that are currently viewed as the least integrated - such as mortgage business, pensions, SME finance, insurance, securitisation activity and so on may well experience the biggest changes. Having said this, however, the implementation of Basel 2.5 and Basel 3 is likely to have a larger impact on the strategic behaviour of banks (see Chapter 7). As in the original 1988 Accord it will set the benchmark for regulators over the next decade and longer. The 1988 rules were transformed into EU legislation without major changes and (by all accounts) it has served its purpose well. A major issue relates to how the EU

should implement the new Accord. The new rules need to be implemented with the authority of a Directive but have the flexibility embodied under the Lamfalussy framework.

The new rules require the stipulation of minimum standards that allow for flexibility in implementation but also credibility in ensuring that they establish a uniform and competitively equivalent framework for financial service regulation in the EU. Where the new rules allow for substantial flexibility - such as in the area of operational risk - minimum standards can be set with national supervisory agencies having substantial discretion in implementation. In the supervisory review (Pillar 2) and market discipline (Pillar 3) these areas also lend themselves to the setting of minimum standards based on mutual recognition and home country control that embrace the single market programme ethos.

Interestingly, both Basle 2 and the FSAP place considerable emphasis on areas that are among the least integrated in the European financial services industry - retail lending, SME finance, bancassurance, securitisation and the regulatory treatment of collateral. The removal of barriers to trade in these areas coupled with new capital rules governing their regulation are likely to create a shift in the way in which this types of business is conducted over the next decade or so. A critical element in the integration process of European capital markets is the success of the EU's Financial Services Action Plan (FSAP). This seeks to introduce a wide range of legislation aimed at reducing barriers and promoting cross-border trade in financial services - especially for capital markets and retail / SME financial service areas. As was the case in 1992, it is likely that the expectation of further financial market integration will encourage market participants to adjust their strategies in the light of these developments.

Many banks are likely to accelerate their plans to sell financial products cross-

border given the changing environment. Stock and derivative markets will be encouraged to consolidate and investment and pension funds in the Euro zone will increasingly embrace the equity market culture and so on. Regulatory standards in the financial sector will move in line with international best practise and further harmonization will take place. The challenge for the financial services industry is to re-organise and adapt to this new environment. Targeting a successful pan-European strategy post-2005 (the deadline for the FSAP) will be of critical importance for financial services firms in general.

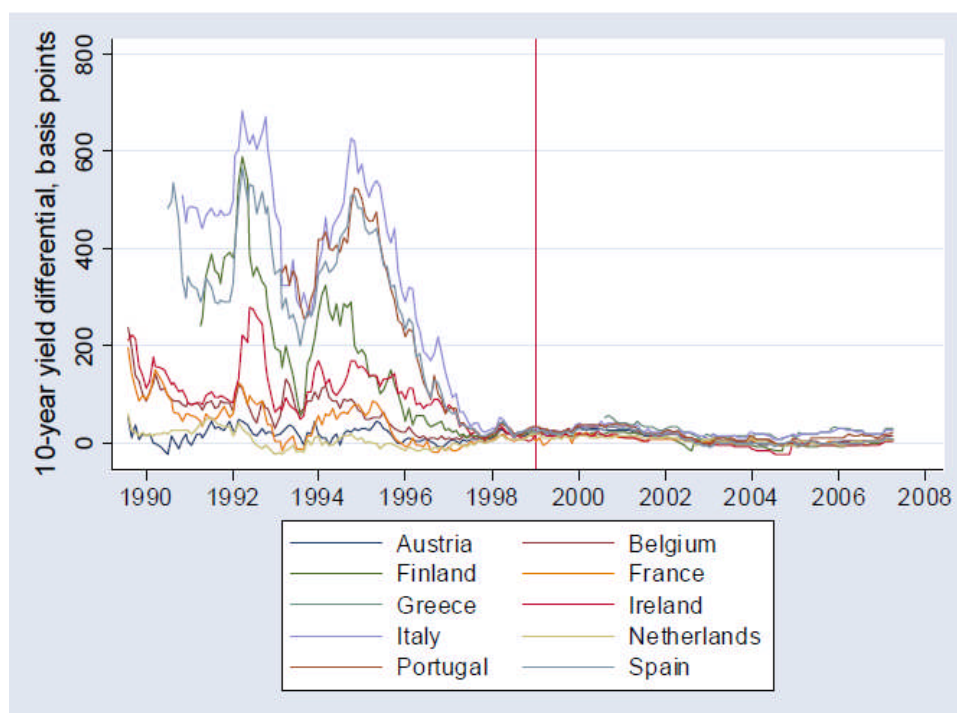
6.2 The money and bond market

The combination of EMU with the concomitant institutional changes produced a dramatic convergence of the yields on national public debt on the eve of monetary unification (Pagano and von Thadden, 2004). This is illustrated in Figure 6.1. for the 10-year benchmark bonds (and qualitatively similar patterns obtain for other maturities). The figure shows end-of-month yield spreads for euro-area benchmark government bonds relative to the 10-year German Bund from January 1993 to September 2007. The convergence toward zero is dramatic. Considering all initial EMU participants (and thus excluding Greece), the mean yield spread over the German yield fell from 218 basis points in 1995 to 111 in 1996, 39 in 1997, 19 in 1998 and 20 in 1999. It rebounded slightly in 2000-01, before resuming its downward trend. Most of the action came before the launch of the Euro and derived from the convergence of the non-core EMU participants: Italy, along with Finland, Ireland, Portugal and Spain, and later Greece, which joined the euro area at the beginning of 2001, while Austria, Belgium, France and the Netherlands already featured low spreads over German bonds in 1996. This is because before EMU the probability of depreciation relative to the D-Mark was considerable in the first set of

countries, but not in the second. For the non-core EU countries, the drastic narrowing of the 10-year yield spreads was due almost entirely to the elimination of this risk.

The introduction of the euro promoted soaring corporate bond issuance in 1999, when volumes more than doubled from \$273 billion to \$657 billion. Issue volume in the euro area thus jumped from less than 26 percent of that in the U.S. in 1998, to over 74 percent in 1999. The boom of the corporate bond market after 1999 was stronger in Italy than in other euro countries. This suggests that the introduction of the euro was a major causal factor in this development. That the development of an active euro-denominated corporate bond market is the true success story of EMU is confirmed by the great liquidity of the market. Euro-area corporate bonds have narrower bid-ask spreads than comparable sterling and dollar-denominated bonds, even after the introduction of the TRACE system, which increased post-trade transparency in the U.S. Biais et al. (2006) attribute this finding precisely to the integration of the European corporate bond market since the advent of the euro, which allowed investors from all European countries to trade in the same market, thus attracting a large pool of professional intermediaries to compete in providing liquidity. This mutually reinforcing process between liquidity demand and supply has driven bid-ask spreads down below those in the U.S. Has the convergence of euro-area government bond yields continued since the institution of EMU, so differentials should soon be a thing of the past? The distinct trend reduction in yield differentials from the Bund shown in Figure 6.1. might seem to suggest so, but this is only apparent.

Figure 6.1. 10-year benchmark yield spreads before and after EMU (1990 – 2007)

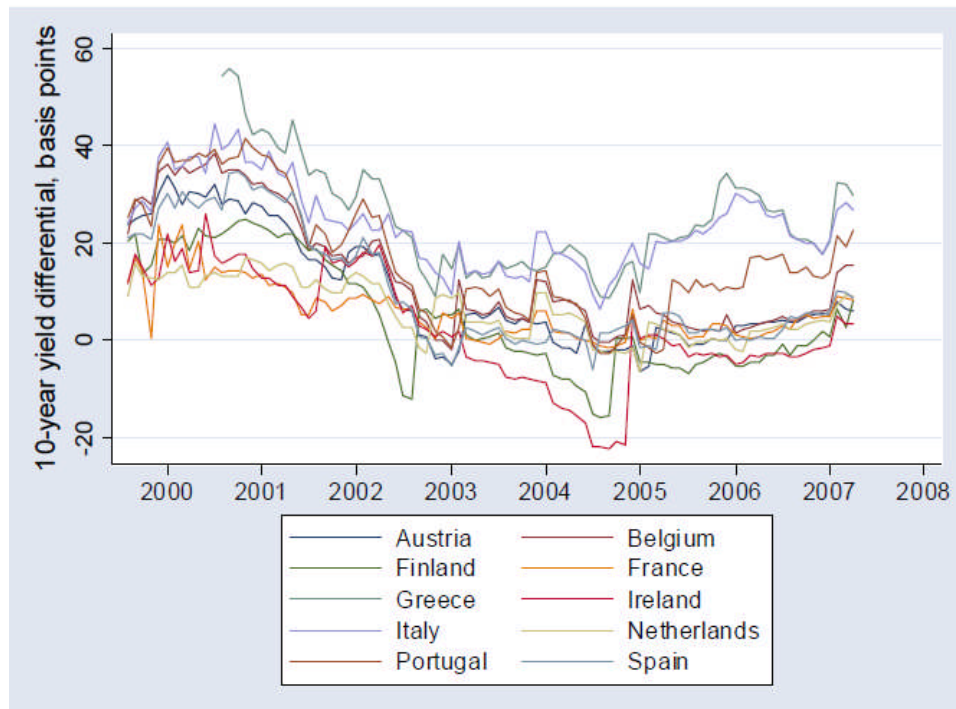


Source: European Central Bank

Most yield differentials have been trending downward because the Bund yield has been rising relative to most other euro-area public debt, as the German budget position has weakened. But yield differentials have not declined in absolute value since 1999, much less disappeared; euro-area sovereign bonds, that is, are still not perfect substitutes. This can be seen in Figure 6.2., which is based on the same data except that it covers only the period of EMU. Even after 1999, yield differentials vary considerably across countries, from a few basis points for French, Irish or Dutch debt to a maximum of 20 points for Portuguese debt and 30 for Italian or Greek bonds after 2005. Yield differentials also vary considerably over time for some countries, notably Ireland, Italy, Greece and Portugal. The differentials have a tendency to move together, which implies that yield spread risk cannot be fully hedged by holding a diversified portfolio of

euro-area bonds, so that their risk is to be taken into account and priced by investors.

Figure 6.2. 10-year benchmark bond yield spreads under EMU



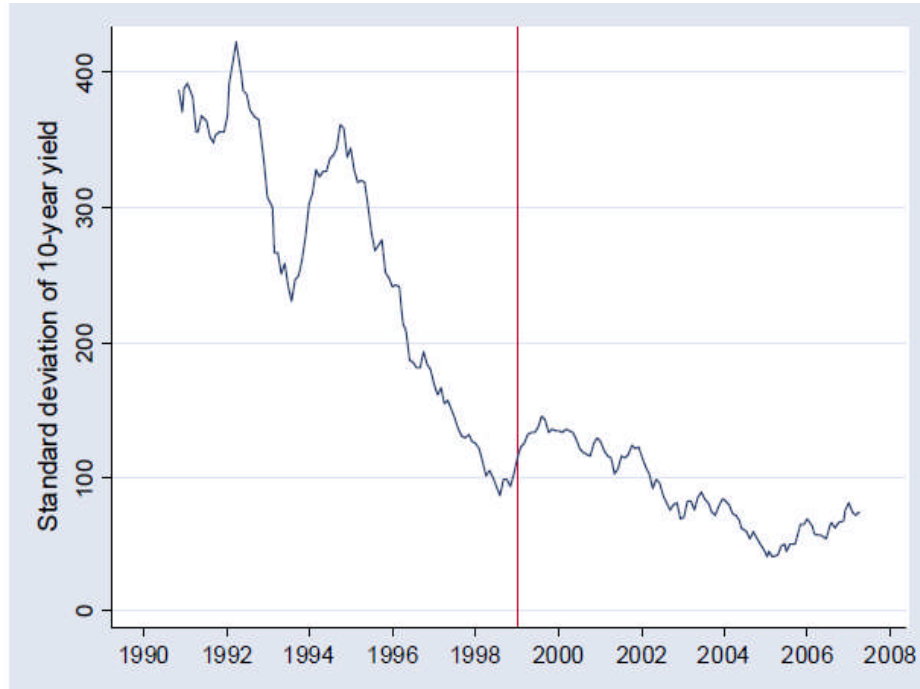
Source: European Central Bank

Figure 6.2. also suggests that convergence of interest rates on public debt may have reversed slightly after 2005.

This visual impression is confirmed by Figure 6.3., which shows the cross-sectional standard deviation of the yields from 1990 to 2007: this measure of convergence bottomed out in 2005 after a long decline and has risen slightly since. It remains to be seen whether this residual difference between public debt yields will be a persistent characteristic of the euro area for years to come. Credit markets have integrated much more slowly than bond markets, presumably because of the heterogeneity of borrowers and the local nature of the information that lenders need.

Legally, the rules within the European banking markets are quite homogeneous (for the Directives process), but interest rate differentials remain wider than in the bond market, as documented by Adam et al. (2002) and Baele et al. (2004). In particular, there are persistent differentials in the medium- and long-term corporate loan market and in the consumer credit segment. Furthermore, retail cross-border lending within the area is still limited; it only increased from 3 percent in 1999 to 4 percent in 2003. Credit market integration is now gaining momentum, especially because cross-border banking mergers and acquisitions have become more common, although much of the cross-border integration and restructuring has yet to take place.

Figure 6.3. Standard deviation of the 10 year benchmark bond yield spreads issued by Euro countries (excluding Greece)



Source: European Central Bank

In securities markets, most of the legal obstacles to integration were removed by the 1999 Financial Services Action Plan, and since 2005 all listed EU companies have been required to prepare their consolidated accounts using International Financial Reporting Standards (IFRS). The number doing so thus rose from some 350 to 7,000.

By making the accounting information available to analysts and investors more easily comparable, this is likely to provide further impetus to the integration of stock and corporate bond markets. The four main remaining obstacles to the integration of euro-area securities markets are (i) the segmentation of the clearing and settlement system, (ii) the fragmentation of the trading infrastructure among too many stock exchanges; (iii) the fragmented issuance of government bond markets, and (iv) the poor post-trade transparency in corporate bond markets. The segmentation of the clearing and settlement system entails improperly high costs for cross-border trades. Segmentation depends partly on the persistent fragmentation of stock trading platforms. Some exchanges, such as Deutsche Börse, in fact, are vertically integrated, with both a platform to provide trading services and a proprietary clearing and settlement system for the corresponding post-trading services ("silo structure").

This limits the competition from other trading platforms, since new entrants' customers would still have to use the incumbent's post-trade clearing and settlement system. Entry foreclosure generates rents for incumbent exchanges, and overcoming this problem is likely to require regulatory action at the EU level. This is recognized both by the EU Commission (whose competition and internal market departments conducted studies on the role of competition policy in securities trading and post-trading in 2006) and by the European Central Bank (ECB), which announced in July 2006 that it was considering the

desirability of going into the settlement business itself, with a system called “Target 2 Securities” (T2S). The ECB would not be the first public institution to provide central clearing and settlement services. In the United States, the Federal Reserve Board runs a bond settlement business, and both clearing and settlement are the product of the Depository Trust and Clearing Corporation, a user-owned service company that was created as a direct result of government pressure.

There is room for further progress towards integration in euro-area government bond markets as well. In the MTS platform for euro-area bonds, trading costs (median effective bid-ask spreads) are significantly higher than in the US Treasury market. They attribute this persistent liquidity gap to greater fragmentation, with many issuers and smaller issue size than in the US. Fragmented issuance is also at the root of investors’ often imperfect hedging strategies in the euro-area market. To hedge positions in bonds issued by small countries, investors often have to use German futures contracts or the liquid Italian spot market. To overcome this hurdle, however, euro-area governments should tackle the politically thorny problem of joint debt issuance, with the attendant implications for further fiscal policy coordination. Some progress might be made by limiting joint issuance to just a few maturities, at least initially, so as to test the potential magnitude of the liquidity gains and debt servicing savings from joint bond issuance.

In the Italian corporate bond markets are mainly organized as an OTC dealer market, where trading is decentralized and dealers satisfy customers’ sell and buy orders at their bid and ask quotes. Although electronic trading platforms are now starting to emerge, most orders are still routed to brokers and dealers by telephone. For investors, in such a decentralized market information on prices of the trades effected becomes an essential sign of “where the market is

going” and guide to trading strategy. Absent such “post-trade transparency”, investors hesitate to place orders, and the new information about fundamentals that their orders could convey is embodied in prices much more slowly.

As a result, price discovery is very slow: it often takes more than a day for the information content of a trade to be fully reflected in market prices. Increasing post-trade transparency is likely to speed up the price discovery process and to increase the liquidity of the market, although this prediction is not unambiguous, since greater transparency would also reduce dealers’ profits and might lead some to leave the market. Biais et al. (2006) do suggest that on balance “it would be reasonable to introduce some limited post-trade transparency”, as by requiring “anonymous reporting of transaction yields, after a delay of one hour, for trades below one million, and anonymous reporting of transaction yields after a delay of one day for larger trades”, but not exact reporting of the trade size, only its range.

6.3 Stock markets

Assessing whether European stock markets have become more integrated since the introduction of the euro is more difficult than for bond markets. The most common approach posits that when segmented markets start to integrate, stock market returns, like interest rates, should become more closely correlated. The evidence does show that European stock returns have increasingly been driven by common European shocks since the early 1980s (Baele, 2005), but these changes in the covariance of ex-post returns do not necessarily reflect Market returns may exhibit common patterns simply because markets are increasingly hit by the same shocks (oil prices, say, or monetary policy). This point is particularly relevant for the EU, where the integration of goods and labor markets is likely to have increased the common

component of real shocks across countries, and where by definition monetary policy has now become common. As a consequence some researchers, in search of the possible effects of financial integration, have turned to analyzing the ex-ante returns in European markets. Estimating and comparing expected returns is tantamount to gauging the risk premium required by investors and thus calls for the specification of an asset pricing model. According to the capital asset pricing model (CAPM), with fully integrated stock markets only covariance risk with the world portfolio is priced in ex-ante returns, while diversifiable country-specific risk commands no return. As Stulz (1999) points out, if the country-specific risk exceeds the world covariance risk, financial integration should be accompanied in equilibrium by a decrease in the risk premium required by investors, hence in the expected return on equity and the cost of capital. Possible tests of capital market integration then involve estimating whether the evolution of the risk premium of domestic stocks is sensitive to the country-specific risk in relation to the covariance with an EU-wide portfolio. This is the approach of Hardouvelis, Malliaropoulos and Priestley (2006), who inquire whether the convergence of European economies towards monetary union led to increased integration of European stock markets. They estimate a conditional asset pricing model, allowing for a time-varying degree of integration that measures the importance of EU-wide risk relative to country-specific risk. The results indicate that the degree of integration is closely related to forward interest rate differentials vis-à-vis Germany, i.e. to the probability of a country joining the EMU. Integration increased substantially over time, especially since 1995, when these differentials began shrinking, and by mid-1998, six months before the official launch of EMU, stock markets appear to have been almost fully integrated. An alternative measurement approach was proposed by Chen and Knez (1995), based on the law of one price

and the absence of arbitrage opportunities. Using this approach, Ayuso and Blanco (2001) find that financial market integration between stock markets increased during the nineties. Different tests of stock market integration rely on quantity indicators, such as the volume of capital flows or the composition of financial portfolios. There is abundant evidence for the “home equity bias”, i.e. investors’ failure to diversify sufficiently into foreign stocks (see for instance Tesar and Werner, 1995, and Lewis, 1999). If households hold portfolios that are not enough internationally diversified, their consumption growth will disproportionately reflect domestic shocks. Ayuso and Blanco (2001) study how foreign direct and portfolio investment evolved in selected countries. They find that the fraction of wealth held in foreign assets increased significantly in the last few years considered. This is also reflected in the behavior of institutional investors: Adam et al. (2002) and Baele et al. (2004) show that the home bias of euro-area investment funds decreased gradually after the introduction of the euro, while that of pension funds dropped more abruptly after 1999. Belgian and Dutch pension funds, in fact, increased the fraction of non- domestic assets from 60% in 1998 to more than 80% in 2000. Large increases also took place in Ireland, Spain and France. For equity markets too, then, both return- based evidence and quantity measures of home bias indicate increasing integration. However, significant institutional barriers to integration remain, notably the considerable costs for cross-border trades arising from the fragmentation of the clearing and settlement system (Giovannini Group, 2001).

The trading infrastructure of European stock markets – once organized on a national basis – is already being restructured along transnational lines at the initiative of exchanges and financial intermediaries, although fragmentation is not necessarily being reduced. For one thing, existing exchanges have pushed for consolidation: the Paris, Amsterdam, Brussels and Lisbon stock exchanges

merged into Euronext; Stockholm's OMX AB has acquired and now operates exchanges in Sweden, Finland, Denmark, Iceland, Estonia, Lithuania and Latvia; and in 2007 the London Stock Exchange acquired Borsa Italiana.

Meanwhile, the EU's Markets in Financial Instruments Directive (MiFID) has opened the door to the creation of new trading platforms operated by intermediaries, and a consortium of seven investment banks (Citi, Credit Suisse, Deutsche Bank, Goldman Sachs, Merrill Lynch, Morgan Stanley and UBS) has already launched a new pan-European equities trading platform called "Project Turquoise". All clearing, settlement and risk management services for "Turquoise" will be provided by a single company (European Central Counterparty Ltd), while Citi's global transaction services unit will serve as settlement agent. So, as existing platforms are consolidated, new ones are being instituted; in both cases the tendency is towards pan-European, not national, trading platforms.

Mifid introduced, along with regulated markets, the possibility to trade in different venues, such as systematic internalisers, and multilateral trading facilities. Article 16 of the Investment Services Directive (93/22) (OJ L 141, 11.6.1993) authorises each Member State to confer the status of "regulated market" on those markets constituted on its territory and which comply with its regulations. Article 1(13) of the Directive 93/22 defines a "regulated market" as a market for the financial instruments listed in section B of the annex to the Investment Services Directive, which is recognised as such by its home Member State (where home Member State is determined in accordance with article 1(6)c of ISD; functions regularly; is characterised by the fact that regulations issued or approved by the competent authorities define the conditions for the operation of the market, the conditions for the operation of the market, the conditions for access to the market and where Directive 79/279 (on admission to official

listing) is applicable, the conditions governing admission to listing imposed in that Directive and, where that Directive is not applicable, the conditions that must be satisfied by a financial instrument before it can effectively be dealt in on the market; complies with all the reporting and transparency requirements laid down pursuant to Articles 20 and 21 (of the ISD).

Italian Markets regulated markets are 11: Electronic share market; Electronic market for securities derivatives (SeDeX); Electronic bond market (MOT); MTAX Market; "After-Hours" markets; Mercato Expandi; Derivatives market (IDEM); Wholesale Market for Government Securities (MTS); BONDVISION Market for the wholesale trading via internet of Government securities; Wholesale Market for Corporate and International Organisations Bonds; TLX.

Mifid replaces rules in many markets that require trades to be executed at local exchanges. Instead, banks will be allowed to act as "systematic internalisers", matching customer orders internally rather than showing these to the market. Systematic internalisers (SIs), traditionally called market makers, are investment firms who could match "buy" and "sell" orders from clients in-house, provided that they conform to certain criteria. Instead of sending orders to a central exchange, banks can match them with other orders on its own book.

SIs are able compete directly with stock exchanges and automated dealing systems, but they have to make such dealings transparent. They have to show a price before a trade is made. After a trade is made, they have to give information about the transaction, just like conventional trading exchanges.

The rise in competition to local exchanges has also created quite a few 'Multilateral trading facilities' (MTFs - these allow parties to trade among themselves away from the exchanges), where trades can be directed to and which are taking market share away from some of the established exchanges

Italian Internalisers are 2: Banca Imi s.p.a. (Intesa San Paolo Group) and FINECOBANK s.p.a. (UniCredit Group).

The third venue allowed by the Mifid are the multilateral trading facilities (MTFs), defined as a multilateral system, operated by an investment firm or a market operator, and which brings together multiple third-party buying and selling interests in financial instruments - in the system and in accordance with non- discretionary rules - in a way that results in a contract. Operating an MTF is an investment service to which MiFID applies. MTFs are required under MiFID to comply with organisational, transparency and market surveillance requirements that are similar to those applying to regulated markets.

The Italian MTF are 10: E-Mider; E-Mid repo; EuroTlx; Multilateral Trading Facilities Order Driven; Hi-Mtf; Mercato Alternativo del Capitale; Trading After Hours (TAH); Bond Vision Corporate; Aim Italia - Mercato Alternativo del Capitale; Extramot.

In order to facilitate the post-trading process, there is a central counterparty clearing house: Cassa di Compensazione Garanzia (CC&G). In the markets that envisage this service, the central counterparty is interposed in each transaction so that intermediaries are not exposed to counterparty default risk. The central counterparty protects itself from the risk of default by collecting margins commensurate with the amount of the obligations taken on by its members.

The activity of CC&G, originally limited to derivative financial instruments, now also extends to the share market, where the interposition of a central counterparty is compulsory, and to the markets for Italian government securities, where it is optional. Traders of government securities on MTS, EuroMTS and BrokerTec may sign up for central counterparty service to be provided either by CC&G or by the French central counterparty LCH Clearnet.

7. Regulatory Framework: Financial Market Regulation in Italy

Giampaolo Gabbi and Massimo Matthias

7.1 Financial Regulation Organization

The Italian jurisdiction illustrates the Functional Approach to financial regulatory oversight. Financial regulation is organized along functional lines. Financial services activities are divided among four main activities: banking, investment services, asset management, and insurance. Each industry has its own supervisor, legal framework, and rules. Italy's approach to financial oversight incorporates elements of the Twin Peaks Approach. The twin peaks approach relies on two types of regulators: a prudential regulator and a conduct-of-business regulator, generally oriented to protect consumers' interests. Although defined as separate entities, these regulators are expected to employ a high level of coordination, as they are each responsible for overseeing the functioning of different aspects of the same institutions. The twin peaks approach is generally considered, like the integrated approach, to offer the type of flexibility needed to deal with rapid innovation in the financial sector, and the blurring of lines between what were once considered the "traditional" actors in finance.

The Bank of Italy, the central bank, has a monetary policy role within the Euro-system since 1999, and has supervisory and regulatory authority over Italian banks. It is a prudential regulator whose focus is on the safety and soundness of the institutions subject to its jurisdiction. In addition to its banking supervision responsibilities, the Bank of Italy focuses on the stability of the financial system. It has a statutory mandate to ensure overall stability, efficiency, and competitiveness of the financial system. The Bank of Italy has rulemaking authority and enforcement powers.

The Companies and Stock Exchange Commission (CONSOB) is the public authority responsible for regulating the securities markets and the provision of

investment services. Its mandate includes: (a) transparency of and reviewing business practices by securities market participants; (b) disclosure of complete and accurate information to the investing public by listed companies; (c) accuracy of prospectuses related to share and security offerings to the investing public; and (d) compliance with regulation by auditors. CONSOB also conducts investigations related to insider trading and market manipulation.

The supervisor of the insurance sector in Italy is the Insurance Industry Regulatory Authority (ISVAP). ISVAP is responsible for regulating and monitoring the activities of insurance intermediaries. It is also required to perform all activities necessary to promote consumer protection. The Finance Code mandates that the primary purpose of insurance supervision is both the sound and prudent management of the insurance and reinsurance business and the integrity of the insurance market and consumer protection. Thus, ISVAP is a functional regulator of the insurance sector with both safety and soundness and conduct-of-business mandates. Since 2004, there has been significant debate in Italy regarding the need for further structural reform of the supervisory oversight model. Some of the proposals have been aimed at reducing the number of supervisory authorities in the hope of designing a more efficient regulatory model. Specifically, the debate has focused on whether the number of supervisors should be reduced to two - the Bank of Italy and CONSOB - with a reallocation of the responsibilities of the other financial regulators. Such reform is moving Italy closer to a Twin Peaks Approach to regulatory oversight.

More recently, ISVAP has been reformed. The Istituto per la Vigilanza sulle Assicurazioni (IVASS), was established under law no. 135 of 7 August 2012 ratifying, with amendments, decree-law no. 95 of 6 July 2012. In performing their functions, IVASS and the members of its bodies act autonomously and independently, in observance of the principles of transparency and cost-effectiveness, and may not seek, receive or accept instructions or directions

from any other public or private-sector entities. Albeit IVASS is independent, its President is the Director General of the Bank of Italy. The function of the new regulator are to control the safe and sound management of insurance and re-insurance companies, their transparency with regards to stability, efficiency, competitiveness of the system, along with the customers protection.

In the case of pension funds there is a mixed institutional-functional approach. Here an activity, the payout of private pensions, is reserved to well-specified financial intermediaries while at the same time being an exclusive object coming under the control of Covip (Commissione di Vigilanza sui Fondi Pensione). Nevertheless, the Minister of Industry issues general directives in the matter of the supervision of pension funds (with the Minister of Finance), and supervises the Covip. The Minister of Industry does also authorize the exercise of this activity, while the Minister of Finance, after hearing the Commission's opinion, issues regulations setting limits and criteria in the matter of investments, and the rules to be observed in the case of conflicts of interest.

The model by objectives formally characterizes the regulation of entities officially authorized to perform investment services, with regard to such activities: banks, investment firms, investment management firms, mutual funds and Sicav (Società di Investimento a Capitale Variabile). These intermediaries are supervised by Consob insofar as transparency and investor protection and by Banca d'Italia insofar as "limitation of risk and financial stability" (Article 5, Banking Law).

The Antitrust Authority has exclusive competence for the rules on competition for all authorized subjects with the exception of banks. A supervisory model by objectives seems to emerge with respect to the entire securities market, and not just to the intermediaries. The recent evolution of the normative framework assigns to the Consob all the powers in the field of transparency in the market (secondary regulation of the solicitation of public saving, of insider trading, of

takeovers and public offers, etc.). Similarly, Bank of Italy might be considered responsible in the matter of stability (regulation - not necessarily exclusive - of compensation, liquidation, clearing houses, wholesale securities markets, central depository, settlement systems, etc.). The Antitrust Authority might be considered responsible for guaranteeing competition among different exchanges.

Finally, the decisions regarding crisis procedures are adopted by the Minister of Finance, acting on a proposal from the Bank of Italy or Consob; responsibility for directing the procedures and performing the related duties is assigned to the Bank of Italy.

Table 7.1. Financial Regulators and purposes

Intermediaries	Stability	Transparency and Compliance	Competition
Banks	Bank of Italy Minister of Finance	Bank of Italy Minister of Finance Consob	Bank of Italy (Since 2012 Antitrust)
Investments Firms	Bank of Italy Minister of Finance	Consob	Antitrust
Life Insurance	IVASS Minister of Industry	IVASS	Antitrust IVASS
Investment Funds	Bank of Italy Minister of Finance	Consob (Antitrust)	Antitrust
Pension Funds	Covip Minister of Finance	Covip Minister of Finance	Antitrust

Source: our elaboration on Di Giorgio, Di Noia, Piatti (2000)

7.2 The key changes in banking regulation

In 1981, The Bank of Italy and the Minister of Finance agree to reform the bid system of government bonds and remove the presence of the central bank, which is allowed to bonds only in the secondary markets. In 1985 the first Bank Directive (EEC Directive 85/611 of 20 December 1985) aimed at increasing the competitiveness and the openness of the banking activity. The Directive defined the general rules for engaging in management activity, extends the list of harmonized products and establishes minimum requirements for them.

For Italy this is a radical reform, since until then the control of stability was managed through a structure-conduct-performance model, that is imposing an oligopolistic structure, where banks and branches could not be settled without the agreement of the regulatory body. The relationship banking orientation pushes banks to increase the number of branches and reduce the average distance between customers and distribution unit.

Competition among banks in Italy began to intensify in the eighties as a result of the easing of restrictions on operations and the changes in the geographical structure of the banking system. Areas in which established banks exercised considerable market power saw the entry of competitors from other areas and a resulting decrease in the degree of concentration. During the nineties competition has intensified even more owing to further regulatory changes, the removal of exchange controls and the rapid international integration of financial markets (see chapter 8).

The first banking directive was the first step towards a prudential regulation which is confirmed with the introduction of Basel I principles (1988), based on a minimum capital requirement defined in standardized way for the credit risk. In the same year the Bank of Italy published the Second White Book on the banking system where regulators suggest to adopt the share company for banks, previously modeled as nonprofit companies. This will be designed by the regulator in 1990 with the so called Amato Act, which reforms all the system,

allowing banks to issue bonds, to operate as universal banks, to invest in non-financial stocks and, above all, to remove all the constraints between short and long term operations.

In 1992 the second Banking Directive is introduced in the Italian system. This reform is about the freedom to establish all over Europe in case a financial firm has already been authorized by its regulator (home country control). After a few months a new Banking Law has been approved (TUB). This is the final step toward the liberalization of the financial system. In 2004 the Basel 2 principles have been approved. They are about new capital requirements for credit, market, operational risks. Internal models can be introduced with the validation of the regulators. Italian way to validate appears to be generally more severe than other banking systems.

7.3 Market regulation

In 1998 the New Financial Markets Act was approved. It is about the rules for intermediaries, financial markets, and companies issuing bonds and stocks. The five principles of the regulation are: (i) maintenance of trust in the financial system; (ii) investors protection; (iii) stability and well functioning of the financial system; (iv) financial system competitiveness; (v) compliance of financial rules. More recently financial markets have been affected by the introduction of the MIFID directive. We find out the specificity of the third level of these regulations, which depend essentially on national decisions, in order to provide evidence of significant differences between the Italian case and other countries to protect investors in a system characterized by information asymmetries.

In order to enforce the regulation of financial markets and financial investments, Italian market players were required to introduce the compliance function. "The risk of non-compliance to the rules is the risk of incurring into judicial or administrative penalties, financial losses or consequent damages

due to a breach in the law, regulations, or the rules of self-regulations or codes of conduct” (Basel Committee, 2005, Bank of Italy, 2007). “To this end, the constitution within banks and bank groups of a control function dedicated to the control and verification of conformity becomes particularly important.” (Bank of Italy, 2007). With regards to the intermediaries operating in investment services, the call to adopt a conduct that is in line with the law, already present in Directive 2004/39/EC (MiFID), becomes an explicit request independent of the compliance function in Directive 2006/73/EC. The link between development of the compliance function for financial intermediaries in investment services and the MiFID compliant “rules of the game” becomes increasingly visible. “The Member States ensure that investment companies apply and maintain appropriate policies and procedures to identify the risk of failure to fulfil the obligations referred to in Directive 2004/39/EC from the company, and the resulting risks, and implement measures and appropriate procedures to minimise such risk and enable the competent authorities to effectively exercise the power conferred on them by the directive... The Member States require that investment companies maintain a function of permanent verification both effective and independent”. As a result, domestically: “Intermediaries establish and maintain permanent functions, effective and independent of conformity to standards and if, in line with the principle of proportionality, company risk management and internal audit” (Bank of Italy-Consob, 2007).

From January 2009 the requirement to establish the compliance function also extends to insurance companies: “Within the internal control system, companies should have, at each pertinent level of the company specific aid to prevent them from incurring into the risk of judicial or administrative sanctions, property loss or reputational damage, resulting from violation to the laws, regulations or actions of the Supervisory Authorities, in other words, self-regulatory norms...” Companies establish a compliance function, which is

proportional to the nature, size and complexity of the activities they carry out.” (Isvap, 2008).

7.4 Insurance regulation

Increasing inter-linkages between bank and insurance intermediaries have blurred the boundaries between the two areas of activity. Nevertheless, the process of convergence between the two sectors has not changed the prevalent risks that each sector must assume or the differences in their nature: credit risk for banks and technical risks for insurers. In addition, banks and insurance companies tend to approach the same type of risk using different terminologies and philosophies.

An insurance company's activity consists in accepting, for the payment of a premium, the obligation to make payment to a policyholder in the future if a given event occurs affecting human life (life insurance) or to indemnify him for damage caused by a loss (to the policyholder's property, estate or physical integrity) (non-life insurance). Companies accept risk in return for the anticipated payment of premiums, from which they obtain the means to make contingent payments in respect of the insured benefit, cover the costs of underwriting and managing the contract and provide an appropriate return on capital. The premium has, therefore, the function of guaranteeing the economic balance between revenues and payments. This technical balance, as at the date on which the contract was stipulated, is guaranteed in the following periods by allocating part of the premiums in special provisions known as technical provisions. These represent commitments towards policyholders, against which the company must make provisions according to prudent and objective evaluations if it is to be able to honour them in the future.

The performance of insurance activities therefore entails, first of all, the underwriting of technical risks insofar as the actuarial model used to determine

the premium and the amount of technical provisions may not be adequate to face the actual commitments entered into by the company. This risk is defined as the underwriting risk and concerns:

The risk of errors in the calculation of premium rates (premium risk), which is determined, for example, by the lack of reliable probability distribution functions as concerns the occurrence of "losses" when a premium is fixed; in other words, the incapacity of a company to replicate the probability distributions used to determine tariffs in its own "contract portfolio" (the risk of accidental deviations); or by the risk of excessive loss, ascribable to the possibility that expected payments are not in line with those actually incurred on account of unforeseen and unforeseeable changes in the probability distributions used when determining premiums (systematic deviation risk); such circumstances refer, for example, to legislative changes, inflation, adverse trends in market variables, etc.

The risk of insufficient technical reserves (reserving risk), referring to the underestimate of the reserves necessary to meet future commitments of the company as a result of erroneous estimates and changes in the reference context. This risk acquires different characteristics according to the duration of the guarantees given, which in general are longer in life insurance, and the arrangements for the payment of the benefits.

The distinguishing features of insurance companies raise the need to invest the volume of premiums received principally in financial assets that are appropriate to the commitments undertaken towards policyholders. Therefore, the insurance companies are exposed to risks typical of financial intermediation (investment risks) such as market, credit and liquidity risks. In many life-insurance products, these types of risk constitute technical risks.

As concerns credit risk, insurance companies are exposed to the counterpart risk contained in the bond portfolio (usually more important for life-insurance companies), to the risk of re-insurer's insolvency (more felt in non-life

insurance), and to risks on receivables due from policyholders, intermediaries (agents and brokers) and other insurance companies. The companies can assume credit risk within the framework of their "typical" activities, especially through credit and surety insurance policies.

Moreover, insurance companies, above all as concerns long-term insurance, face a liquidity risk in the event that the company's assets are not in line with the due dates and cash flows necessary for the commitments made and expressed in the technical provisions.

Policies on the duration of human life can be classified according to the guarantee offered, into: whole life insurance, whereby the insurer undertakes to pay a capital sum in the event of the policyholder's death; endowment policies, which principally serve social security purposes; mixed policies, in which death benefits and endowment benefits are combined in various ways. Although the historical function of life insurance policies serves social security objectives, in the course of time the need was felt to protect these policies against inflation and maintain their competitiveness with respect to other forms of savings. Consequently, adjustable, and later on indexed policies were introduced. In the early 1980s policies appeared in Italy, characterized by minimum guaranteed returns. In recent years the companies have started to offer policies with essentially financial features. The benefits of such contracts are linked to a share index or other reference value (index-linked policies) or to the value of units held in an internal insurance fund or an external unit trust or investment company (unit-linked policies). The characteristic of these contracts is that the investment risk is usually borne by policyholders.

Non-life insurance contracts constitute a heterogeneous set of policies that reflect the variety of risks covered. The main classes are as follows: casualty insurance, which offers protection against risks occasioned by accidents or illness; property insurance, which comprises insurance protecting property from various risks (theft and fire); financial insurance, or credit insurance (in

which the loan operations of the policyholder are guaranteed) and surety insurance (in which the performance of the debtor's obligations are guaranteed); and liability insurance, which safeguards the policyholder against the risk of having to pay indemnities for third party damage.

The peculiarities associated with banks and insurance companies, also in terms of the "prevalent" risks accepted in the performance of their respective activities, are reflected in the different prudential arrangements put in place by the sectoral supervisors, and hence certain characteristic differences that range from accounting rules to the definition of capital. Particular importance is attached to the characteristics and the different roles played by reserves and capital in the context of the their respective types of management which are, consequently, reflected in the prudential controls.

In the insurance sector "technical" provisions acquire paramount importance. These are set aside to meet the commitments deriving from the underwriting of contracts (payment of benefits and claims).

The correct estimate of the amounts to be disbursed as a result of a loss event and an adequate level of technical provisions to meet such disbursements lie at the heart of insurance business and of a sound financial position for the company. Therefore the instruments of prudential supervision are mainly concerned to contain the technical risks to which companies are exposed by ascertaining that correct actuarial principles are applied. The capital - to which recourse is made when the level of benefits paid to policyholders exceeds that of technical provisions - only plays a secondary role in the productive process.

As regards investment risks, sectorial regulations include rules on assets representing technical provisions. These assets must satisfy the criteria of safety, yield, marketability, diversification and dispersion. For some assets accepted as cover for technical provisions (e.g. real estate, shares, debts and claims) maximum limits are set forth. Additional limits are set for exposure to a single party.

The regulations of the insurance sector lay down rules on the minimum capital requirements (the so-called solvency margin) that companies must possess. These requirements essentially depend upon the overall volume of business conducted and are calculated according to premiums or the average cost of claims (non-life insurance) or to the mathematical provisions and capital at risk (life insurance). In specifying minimum capital requirements no provision is made for the level of risk inherent in the asset. However, community regulations on the solvency margin, implemented in Italy in November 2003, lay down that in case of deterioration in a company's financial position, which entails risks for policyholders, IVASS may order the company to set up a supplementary solvency margin in order to guarantee its short-term solvency. In the recent years, a deeper attention has been given to the regulation for non-insurance risks within insurance portfolios. In particular, the credit risk generated by investments is managed within legally established limits by the definition of guidelines indicating the types of appropriate assets, and the limits and scope for investment. The guidelines set forth vary according to the various areas of business managed by the companies.

Credit risk arising from the conclusion of reinsurance contracts is handled through an accurate risk assessment of the companies with which the reinsurance agreements are stipulated, and through the diversification of the counterparts offering such contracts, but it is principally handled by requiring that a guarantee be established in the form of a monetary deposit by the transferee. In addition, insurance companies sometimes request additional protection from reinsurance partners, in the form of collateral or letters of credit.

In conclusion, the credit risk accepted through the issue of credit and surety insurance policies is handled with essentially insurance methodologies based on the concept of pooling as well as, although to a secondary degree, the evaluation of the credit worthiness of the customer. The need to cover any

technical losses at the end of each financial year is dealt with by Italian insurance companies also through the establishment of an obligatory provision termed "equalisation reserve", which attenuates the volatility of losses and is strictly linked to the trend in economic cycle.

7.5 The compliance function within intermediaries

The establishment of a specific compliance function in financial firms can be attributed to a regulatory decision by the Basle Committee who, in 2005, stated that intermediaries had to "organise its compliance function and set priorities for the management of its compliance risk in a way that is consistent with its own risk management strategy and structures".

Ten principles were defined by the Committee in order to regulate responsibilities of the board of directors (no. 1), of senior managers (2-4), the compliance function itself (5), and resources involved (6-8). Two final principles were addressed to manage respectively cross border issues and outsourced processes.

Here we focus on principle no. 7 aimed at describing compliance function responsibilities which "should be to assist senior management in managing effectively the compliance risks faced by the bank [...] If some of these responsibilities are carried out by staff in different departments, the allocation of responsibilities to each department should be clear."

Particularly, sub points 37, 38 and 39 are devoted to the identification, measurement and assessment of compliance risk. This arises both a technical and an organizational concern for compliance officers. Technically, because there is no a universally accepted set of metrics to measure the compliance risk, but taking into consideration, on one side, legal and regulatory sanctions, and on the other side, material financial losses as operational events. Organizationally, because investment firms are expected to re-engineer their processes in order to map and control all the procedures that could lead to non

compliance behaviours, in some cases with the risk to overlap responsibilities assigned to other offices, such as risk management, audit, and legal.

Through the analysis of the Italian financial services industry, our purposes can be listed coherently with the identification, measurement and assessment of compliance risk assessed by the Committee.

Firstly, according the principle 7.37 (Basel Committee on Banking Supervision, 2005), “the compliance function should, on a pro-active basis, identify, document and assess the compliance risks associated with the bank’s business activities, including the development of new products and business practices, the proposed establishment of new types of business or customer relationships, or material changes in the nature of such relationships”. As a result, Gabbi et al (2012) survey finds out whether and how the definition and identification of compliance factors has been established in financial firms operating in the Italian market.

Secondly, the principle 7.38 (Basel Committee on Banking Supervision, 2005) suggests that “the compliance function should also consider ways to measure compliance risk and use such measurements to enhance compliance risk assessment”. We find out how effectively implemented are measuring approaches to compliance and whether there is a significant correlation between the measures implementation, financial specialization, and international activity of the intermediaries.

Thirdly, the principle 7.39 (Basel Committee on Banking Supervision, 2005) recommends that the compliance function “should assess the appropriateness of the bank’s compliance procedures and guidelines, promptly follow up any identified deficiencies, and, where necessary, formulate proposals for amendments”. Our purpose is to analyse how financial institutions carry out the compliance risk management, by assessing controls and tools to transfer economic losses generated by non compliant behaviours.

Besides the goals as previously described to verify whether financial intermediaries operating in Italian markets developed an effective compliance function within their organizations, we evaluate if the regulatory framework implies a measure cost asymmetry, depending both on the proportionality principle and on the existence of different supervisors with an heterogeneous set of enforcement rules (Coffee 1981; Braithwaite 2002 and Parker, 2006, Financial Services Authority, 2009). In particular, our last purpose is to verify whether the actual regulation on compliance differently induces financial firms – clustered by size, business and area orientation – to invest in measuring and managing solutions to face the compliance risk, generating asymmetric costs.

In Italy, goals and characteristics of the Compliance Function in banks, financial and insurance companies are expected to be addressed by different regulators. These range from the Supervisory Instructions of Bank of Italy for banks (July 2007), to the implementing the MiFID Directive (2007) and related banks and investment companies regulations set out by the Bank of Italy (2007) and Consob (2008), to the Isvap (now IVASS) rules for insurance companies (2008). External and internal regulation that potentially fall within the compliance perimeter, cover a wide range of subjects: from market abuse to conflicts of interest, from transparency and correct behaviour towards its customers on money laundering, from privacy to safety at work, up to covering issues of integrity and business ethics that are endorsed by the company's ethical code. There is no doubt that this suggests continuing, where company size allows for it, to set up the function according to a specialization criterion for each business area, or to create specialized compliance units for certain sectors, such as data protection, money laundering and prevention of crimes of terrorism (Basel Committee, 2005). As already stated, there is also the purpose to integrate compliance risk management by establishing a single second level control structure. This is however, a weak hypothesis because the specificity of the

models and the measuring and management mechanisms of each type of risk would require a specialist approach and hence a large differentiation of the roles and responsibilities within such a function. Conformity to the external and internal “rules of the game” is particularly critical when there is a change in regulation, as is actually occurring in European investment services because of the MiFID implementation process. This could be considered a critical point of the actual Italian regulation: while the Bank of Italy (2007) for banks and the IVASS (2008) for insurance companies are clearly devoted to define a list of measurement guidelines for the compliance function (such as identification of events, metrics and mitigation), the Consob (2008) appears to be more focused on the MiFID regulation. In particular, Bank of Italy and IVASS define precisely the importance to map and measure the compliance risk, respectively for banks and insurance companies. CONSOB regulation was less measurement oriented for the compliance risk process. The impact of this asymmetries can be estimated for intermediaries operating not only in the domestic areas and with a scale of higher concern for supervisors, especially after the recent debate on the too-big-to-fail doctrine.

The first factor characterizing the risk management process and affecting the organizational structure of the compliance risk is the mission. This is even more significant in the function of abiding to the laws which, due to their vastness and heterogeneity, require that an operating perimeter be singled out. Italian banking sector regulators, in their supervisory guidelines, issued on 10th July 2007, defined the compliance risk as the risk leading to legal or administrative sanctions, financial losses or reputational damages, as a result of conduct violating laws that are both external and internal to the bank.

Within Gabbi et al (2012) survey, intermediaries were asked how compliance risk was considered within the Function. They were to highlight if the approach was dominated by an essentially legal vision or whether their approach was more economics and law oriented, in order to evaluate the impact created by

the rulings of market opportunities.

Specifically, the question resumes the definition found within the Bank of Italy's Regulatory Instructions, distinguishing the following objectives for the compliance office of financial intermediaries:

- a) The financial intermediaries should not incur in civil, administrative or penal sanctions;
- b) Minimize operating losses;
- c) Minimize reputational damages linked to violation of external or internal laws;
- d) Not to incur in sanctions and minimize reputational damages.

Compared to the 2007 Survey outcomes, the number of intermediaries not answering changes from 36.9% to 10.7%. What remains basically unchanged is the weight of intermediaries addressing to the compliance function the mission to minimize administrative and penal sanctions. Intermediaries who believe more important optimizing company's reputation increased from 20.3% to 33.3%. 23.8% of the sample faithfully follows the Regulatory definition, stating that their purpose is not to incur in sanctions and, at the same time, minimize reputational damage (Figure 7.1.).

The analysis based on the prevailing area of activity (table 7.2.) shows how only 3.4% of intermediaries working on an international basis internationally do not answer about the purpose associated to the compliance function (panel A).

Table 7.2. Distribution of the objectives assigned to the compliance function based on main area of activity of intermediate (percentage values)

	Panel A: Citizenship		Panel B: Financial Intermediaries			
	Domestic	International	Cooperative Bank	Bank	Insurance	Financial firms
Not to incur in civil, administrative or penal sanctions	30.9	38.0	41.9	31.6	27.3	9.1
Minimize operating losses	1.9	3.4	2.3	0.00	0.00	9.1
Minimize reputational damages linked to violation of external or internal laws	30.9	27.6	20.9	31.6	54.5	36.3
Not to incur in sanctions and minimize reputational damages	21.8	27.6	25.6	15.7	9.1	45.5
No answer	14.5	3.4	9.3	21.1	9.1	0.00
Total	100.0	100.0	100.0	100.0	100.0	100.0

Source: Gabbi et al (2012)

Another distinctive element is the renowned importance international intermediaries give the function to defend the company's reputation, 65.5% of them considered it a priority compared to 52.7% of the domestic intermediaries. This feature makes a distinction based on the typology of the intermediaries (table 5 panel B): 67.4% of banks associate compliance to safeguarding their reputation; this compares to 47.4% of Cooperative Credit Banks (which are mainly small banks), 54.5% of financial intermediaries and 36.4% of insurance companies. The latter seem particularly oriented to minimizing the sanctioned implications, with a more traditional vision of the compliance function. This figures show how the size seems to be more correlated to a mission not only limited to minimization of sanctions.

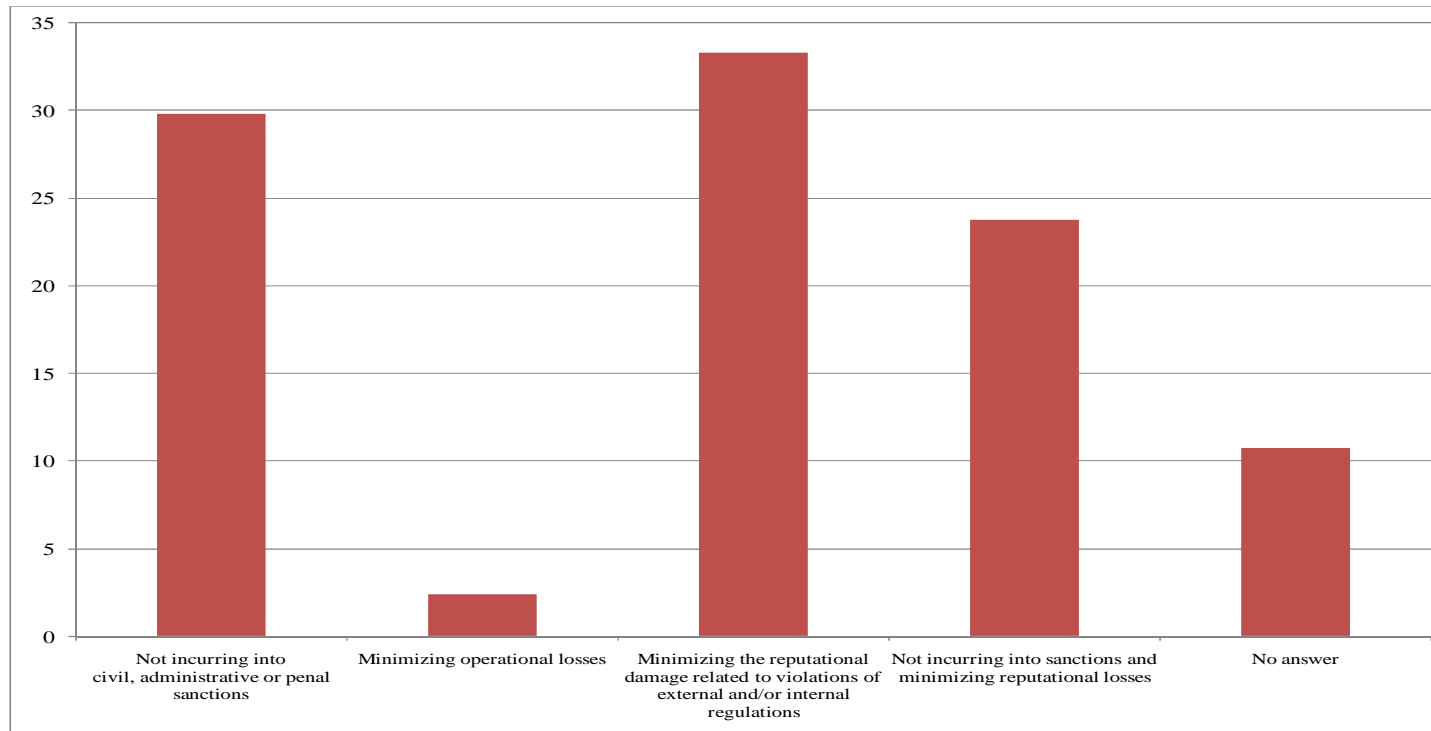
The exposure to compliance risks has been compared in three different situations:

- Failure to adjust to laws and regulations;
- Failure to adjust internal codes of conduct;
- Inadequacy of customer management.

It seems evident that incapacity to behave coherently with the changing laws and regulations is by far alleged as the main source of compliance risk. It is equally correct to believe that the negligence or non-fulfilment of banks and other intermediaries in protecting the interests of clients, can generate the same risk.

The comparison between national and international operators shows that the latter demonstrate a higher degree of sensibility to the perception of compliance risk in relation to all the outlined situations. On balance, domestic financial firms show higher variance of perception of the importance of the three risk factors.

Figure 7.1. Missions of the compliance function (total sample, relative frequencies)*



*Left scale shows the percentage value of respondents

Source: Gabbi et al (2012)

8.The Nature and Degree of Competition

Giampaolo Gabbi and Pietro Vozzella

8.1 The concentration process

The process of banking concentration has experienced 9 operations of mergers and acquisitions from 1984 to 1986, 20 M&A from 1987 to 1989, 45 operations on average each year from 1990 to 1994. After 1997 the concentration activity was accelerated: between 1990 and 1995 the assets of the first 5 largest banks was around 30%. In 1999 this ratio was 48% (compared with the European average of 57%). During the Nineties the banking M&A have been 514, affecting 50% of total assets of the Italian banking system (table 8.1.).

From 1990 to 2007 the total assets of Italian banks involved in mergers was 23% of total banks' assets. The domestic acquisition of Italian banks from Italian financial institutions encompassed 66% of total assets. After the introduction of the euro Italian banks did acquire foreign banks, increasing their relative size, especially in the case of UniCredit and Intesa SanPaolo, whose strategy to extend their group in Central Europe increased the total assets of about 26% (table 8.1.).

Table 8.1. Mergers and Acquisitions in the Italian Banking System

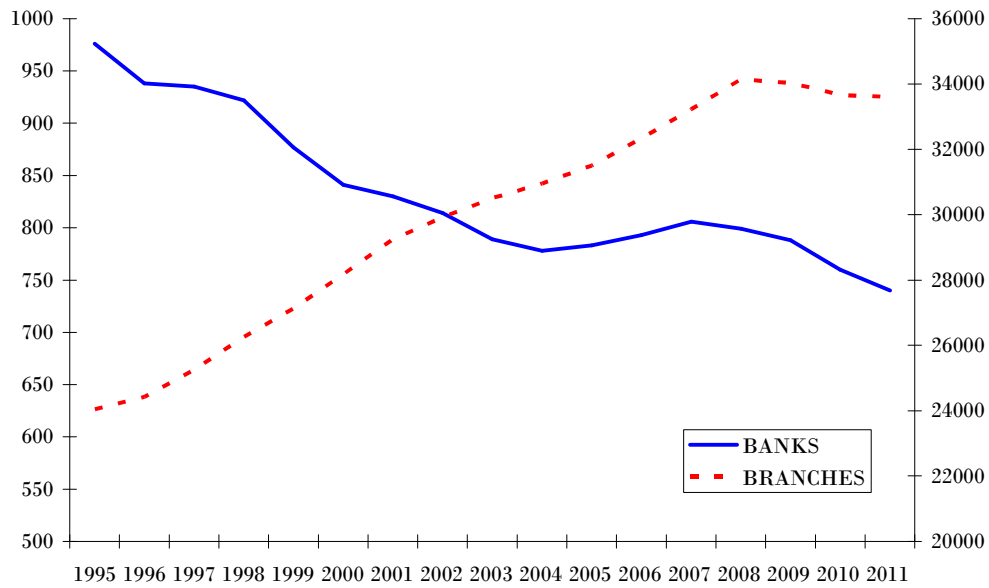
M&As in Italian Banking System						
Periods	Merger between Italian banks		Acquisitions			
	Number of operations	Share on total asset (%)	of Italian banks		of foreign banks by the side of Italian banking groups	
			Number of operations	Share on total asset (%)	Number of operations	Share on total asset (%)
1990	18,00	1,08	4,00	0,37		
1991	30,00	0,65	5,00	0,37		
1992	24,00	3,49	0,00	0,00		
1993	37,00	0,63	7,00	1,50		
1994	41,00	1,36	11,00	1,90		
1995	48,00	1,64	20,00	4,57		
1996	36,00	0,47	19,00	1,08		
1997	24,00	0,81	19,00	3,42		
1998	30,00	2,40	24,00	9,54		
1999	36,00	0,32	28,00	14,35		
2000	33,00	1,50	24,00	4,86		
Total 1996-2000					20,00	1,88
2001	31,00	0,08	9,00	1,55	4,00	0,33
2002	18,00	0,06	11,00	4,94	3,00	0,41
2003	20,00	0,20	9,00	1,50	4,00	0,20
2004	10,00	0,00	7,00	0,40	4,00	0,10
2005	4,00	0,00	7,00	2,30	4,00	22,90
2006	6,00	5,50	4,00	3,30	10,00	0,10
2007	6,00	3,20	8,00	10,10	6,00	0,40
Total 1990-2007	452,00	23,30	216,00	66,05	55,00	26,32

Source: Bank of Italy

The M&A process previously described lead to the reduction of the number of banks. At the end of 1995 there were 976 banks, mainly small and very small. The trend until 2011 is continuously negative, with an average reduction of 12.7 banks each year (figure 8.1.).

On the other side the number of branches increased from 1996 to 2008 of about 10000 units, with a continuous trend of 781 new net branches each year. From 2008 to 2011 the trend has changed, with the closure of 532 branches (figure 8.1.).

Figure 8.1. Banks and branches (Banks, left axis; Branches, right axis; 1995 – 2011)



Source: Bank of Italy

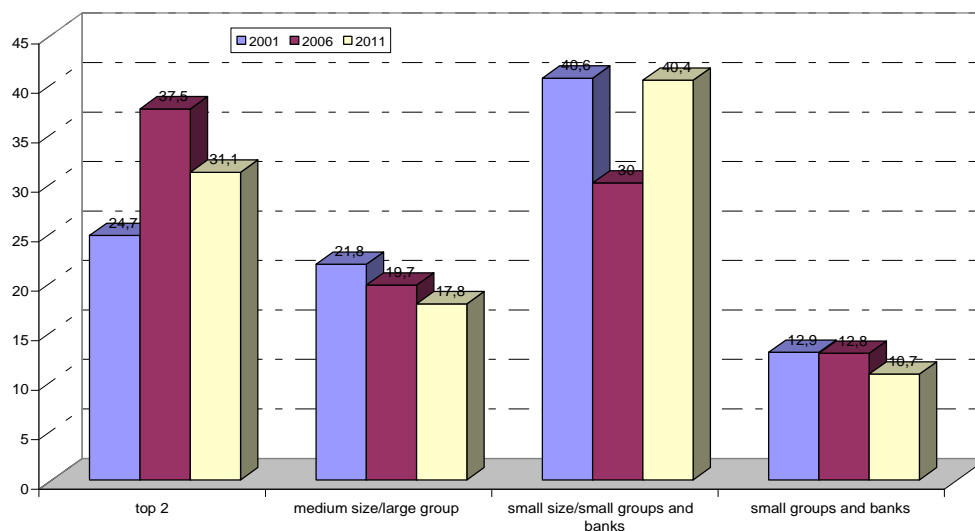
This trend is expected to accelerate both for the purpose announced by the majority of medium and large banks to cut operational costs and for technological rationales. We assess them as follows.

Issues on Technological Trends affecting the financial market structure	
IT Security	Description
<i>More distributed ICT environments</i>	Since banking strategies tend to become more flexible, technologies are expected to enlarge their reach in order to become more ubiquitous creating more issues in security management
<i>Global security (weak link approach)</i>	Global security is to provide scientific and technical support to firms and banks in order to minimize the risk of fraud, to assist for security adopting a global (end to end) approach
<i>Mobile security</i>	Mobile banking and wireless technologies are booming
<i>Internal threats</i>	Employee, consultants and other people working for the firm represent an increasing threat for IT security

IT Innovation	
<i>Virtual environments</i>	<i>The introduction of a technology which allows a user to interact with a computer-simulated environment, whether that environment is a simulation of the real world or an imaginary world</i>
<i>Computer to computer banking</i>	<i>The process aimed at making able deposit checks into a bank account from one's home or office without having to physically deliver the actual check to the bank. This is also applicable to the direct interaction between applications.</i>
<i>Social computing</i>	<i>Web 2.0 and other technologies are reshaping the boundaries and the environments for human to human interaction</i>
<i>Mobile banking and services</i>	<i>Mobile banking is a term used for performing balance checks, account transactions, payments etc. via a mobile device such as a mobile phone</i>
<i>Alternative IT powered banking channels</i>	<i>New channels powered by IT are: (i) Business Internet Banking; (ii) Balance and Transaction Reporting; (iii) Transfers; (iv) Inquiries; (v) Mail Options; (vi) Pay Bills; (vii) Business Telephone Banking; (viii) Fax Banking Services; (ix) SMS Banking; (x) Text Alert. On top of these channel new/alternative ones could emerge such as consumer to consumer credit.</i>
IT Sourcing Policies	
<i>Quick win cost reduction outsourcing</i>	<i>Banks are now turning to outsourcing of activities as a viable strategy for managing this key area of cost concern</i>
<i>Accountability and contract management issues</i>	<i>Management accountability is the expectation that managers are responsible for the quality and timeliness of program performance, increasing productivity, controlling costs and mitigating adverse aspects of agency operations, and assuring that programs are managed with integrity and in compliance with applicable law</i>
<i>Niche sourcing</i>	<i>Technologies will tend to be powered to face very special items by niche firms or solutions</i>
Technology Impact on Workplace	
<i>Desk monitors and tutorials</i>	<i>Technologies aimed at creating an environment in order to help workers in planning and monitoring day to day activities</i>
<i>Social interaction (employee communities / empowerment)</i>	<i>Dynamic sequence of actions between individuals (or groups) who modify their actions and reactions according to those of their interaction partner. In companies they can be accidental, repeated, or regulated, in particular staff meetings, feedbacks will be powered by specific IT technologies</i>
<i>Prosumer (professional-consumer) technologies</i>	<i>Banking sector sees the prosumer (professional–consumer) as a market segment, whereas economists see the prosumer (producer–consumer) as a new arena for IT technologies.</i>

The concentration of the banking market can be appreciated even more when we compare (figure 8.2.) the market share of assets on total assets of the 2 largest players (UniCredit Bank and Intesa Sanpaolo), with the rest of the market (medium-large groups, small and minor sized agents). From 2001 to 2006 the role of the top players did increase of 13% on total assets of the whole banking system, damaging particularly medium and small sized groups.

Figure 8.2. Concentration of the Italian banking system (percentage of market shares of total asset; 2001, 2006, 2011)



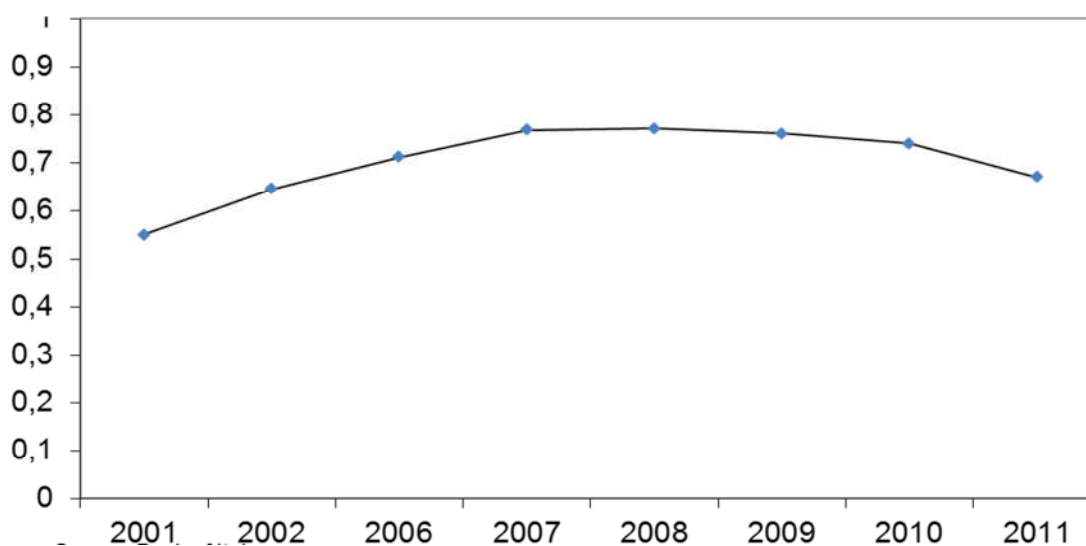
Source: Bank of Italy

The trend after the beginning of the crisis appeared to be the opposite, essentially for the losses recorded in the trading books and the largest credit exposures.

According to the Herfindahl-Hirschman Index, which in our case ranges from 0 to 1.0, moving from a huge number of very small firms to a single monopolistic producer (figure 8.3.), the degree of competitiveness has decreased with a growth from 0.55 (recorded in 2001) to the maximum value of 0.771 recorded in

2008. Later on the index appears to reduce, coherently with the loss of market share concentrated within the largest financial firms.

Figure 8.3. Concentration of the Italian banking system. Herfindahl-Hirschman Index (2001 – 2011)



Source: Bank of Italy

On balance, the analysis shows a significant market power which has increased after the liberalization of the banking and the financial markets, particularly due to the first two Banking European Directives, and after the introduction of the common currency, with the consequent removal of financial barriers within the euro area.

Table 8.2. shows the recent M&A transactions having as target insurance companies operating in Italy.

Table 8.2. Major Mergers and Acquisitions in the Italian Insurance System (2006 – 2011)

Life market - Recent transactions

#	Year	Target	Bidder	Stake %	Deal Size (€)
1	2011	Bipiemme Vita SpA	Covea	81.0%	243,000,000
2	2011	BNL Vita SpA	Cardif Assicurazioni SpA	51.0%	325,000,000
3	2010	Aviva Life SpA	Aviva Italia Holding SpA	50.0%	30,000,000
4	2010	Arca Vita	Unipol	60.0%	270,000,000
5	2010	Bipiemme Vita SpA	Banca Popolare di Milano Scarl	51.0%	113,000,000
6	2008	Ergo Previdenza	Munich Re	29.7%	117,414,000
7	2009	BCC Vita	Cattolica Assicurazioni	51.0%	43,997,700
8	2008	Quadrifoglio Vita	Axa Mps	100.0%	141,500,000
9	2008	Chiara Vita	Helvetia	100.0%	79,600,000
10	2008	Quadrifoglio Vita	Bmps	50.0%	92,500,000

Non-Life market - Recent transactions

#	Year	Target	Bidder	Stake %	Deal Size (€)
1	2011	Fondiarria-SAI SpA	Unicredit Group	6.6%	170,000,000
2	2010	Arca Assicurazioni	Unipol	67.4%	101,085,360
3	2009	Ubi Assicurazioni SpA	Fortis Insurance/BNP Paribas Ass.	50.0%	120,000,000
4	2008	Padana Assicurazioni SpA	Helvetia Holding AG	100.0%	44,000,000
5	2008	Credem assicurazioni SpA	Reale mutua	50.0%	18,000,000
6	2007	Nuova Tirrena SpA	Groupama SA	100.0%	1,250,000,000
7	2007	Aurora Assicurazioni	Unipol	100.0%	751,000,000
8	2006	Toro Assicurazioni	Generali	100.0%	3,855,000,000
9	2006	Duomo Assicurazioni SpA	Banco Mapfre	50.0%	473,000,000
10	2006	Liguria Assicurazioni SpA	Fondiarria - SAI SpA	100.0%	148,055,570

Source: Mergermarket.com

In 2012, the second and the third players (Unipol and Fondiarria SAI, respectively) of the insurance market were involved in a bail-out operation. Unipol decided to take over Fondiarria SAI, driven by the banking system, massively exposed in Fondiarria, whose corporate governance and management were directly connected with the real estate sector.

8.2 Cooperation among banks and other financial institutions

The Bank of Italy and the Italian Banking Associations (ABI) strongly oriented the banking system to cooperate both within the payment system and the money market. The payment system reform experienced three different important steps.

In 1988 with a White Book, the Bank of Italy underlined the inefficiencies and

the guidelines for a reform aimed at increasing the efficiency for wholesale and retail payments and their settlement. The introduction of the check truncation process (that is the possibility to pay checks by payee's branch) where the and the ATMs for the retail payments eased the efficiency of the payment system in terms of time certainty and costs.

The wholesale payments used to be settled with a multilateral netting. The creation of a centralized account managed by the Central Bank helped to increase the efficiency of the monetary base control and the risks within the banking system. Finally, a project to optimize the securities settlement was established. An increasing number of operators participate the reform processes (table 8.3.)

In 1998, the year before the introduction of the euro, the real time gross settlement (RTGS) system (BI-ReL) was introduced in order to optimize the settlement of large payments in euros.

The Bi-ReL settles wholesale operations such as large credit transfer (BIR), foreign credit transfers (BOE), trades in foreign currency (GEK), and the interbank trades (MID). This reform was managed within the TARGET system. As the same time, a RTGS settlement process was created for securities trades. The main purpose of the technological and organizational investments for the wholesale payments was to ensure the European market that payments were settled without generating a counterparty risk. Nevertheless, large banks did operate their treasury settlements in through alternative channels, particularly the EBA system, managed by the European Banking Association and settled within the Bank of International Settlements.

Table 8.3. Number of financial institutions participating and cooperating to the payment systems projects (1994 – 2008)

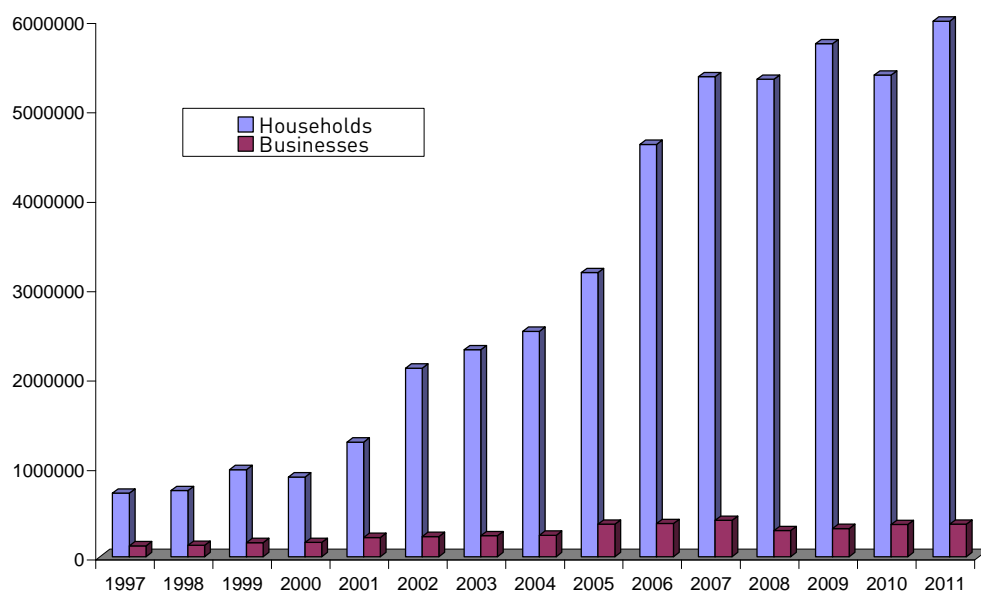
Year	Interbank National System	Interbank Procedures								
		Bancomat ATM	Check Truncation	Interbank Corporate Banking	Commercial payments	Credit Transfer	Large Credit Transfer (BIR)	Foreign Credit Transfer (BOE)	Electronic Payments	Securities Disposals
1994	943	678	892	–	895	35	–	–	–	–
1995	921	703	867	270	875	902	19	–	–	–
1996	929	722	839	472	852	886	892	13		836
1997	936	736	833	559	843	892	899	892	874	832
1998	923	732	810	623	820	876	891	884	854	810
1999	884	706	775	658	785	839	864	854	820	773
2000	859	679	747	698	758	807	840	828	795	741
2001	841	666	728	741	743	790	829	813	768	725
2002	824	660	719	772	742	783	821	805	757	713
2003	805	635	695	572	721	761	773	763	728	691
2004	791	630	689	605	716	751	–	–	717	689
2005	799	630	695	622	721	755	–	–	719	695
2006	811	638	699	684	725	758	–	–	725	700
2007	823	649	707	691	744	775	–	–	732	713
31-mar-08	819	646	704	693	741	771	–	–	729	710

Source: Bank of Italy, SIA-SSB, ABI, CIPA

In 2008, the Single Euro Payment Area (SEPA) Directive introduce homogeneous pricing and structural changes for all the EU countries. Banks also cooperate to define standards of many info structures, such as the interbank market (MID), the interbank deposit insurance system, the transparency agreement for banking fees. The most important role is played by ABI, which operates with other associations of intermediaries as a lobby in the legislative debates affecting the financial activities.

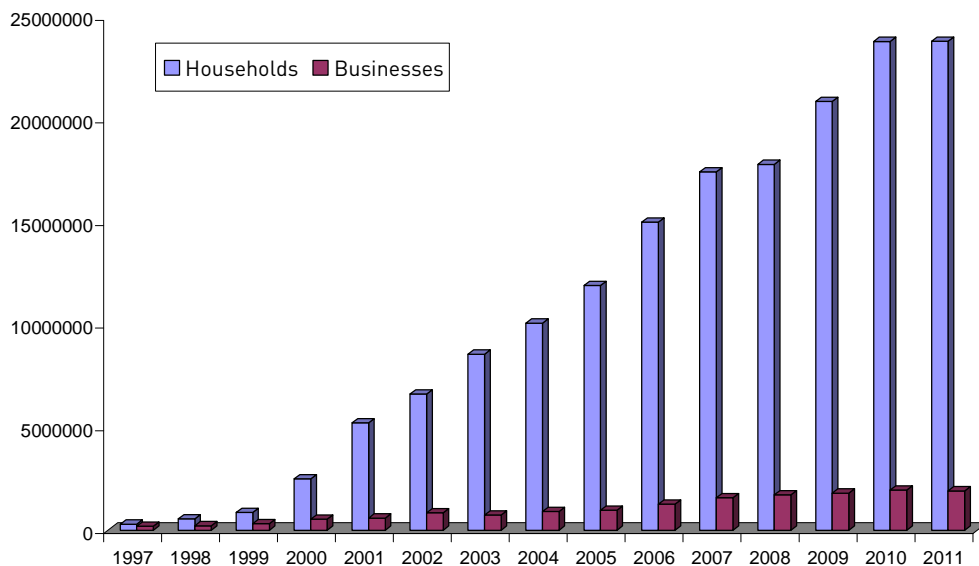
The impact of the previously described reforms was the huge amount of users of electronic payments systems (figures 8.4. and 8.5).

Figure 8.4. Number of users of home and corporate banking services – Information services (1997 – 2011)



Source: Bank of Italy

Figure 8.5. Number of users of home and corporate banking services – Information and transaction services (1997 – 2011)



Source: Bank of Italy

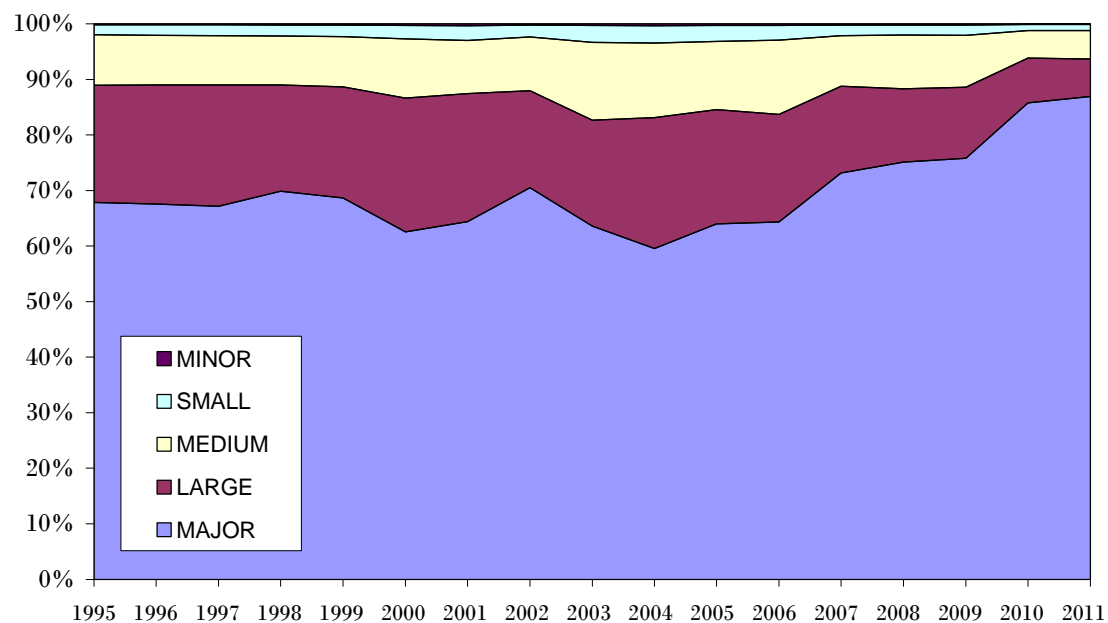
8.3 Area of competitiveness

Most of the banking and financial services and markets are technically designed with the purpose to increase the efficiency, which is one of the goals of regulation (art. 5 of the banking Act, 1993).

The Herfindhal index for deposits and loans remains relatively high (respectively 0.18 and 0.15, in 2010. In 1983 they were respectively 0.21 and 0.18) and the only slightly change can be explained with the pressure introduced by foreign banks.

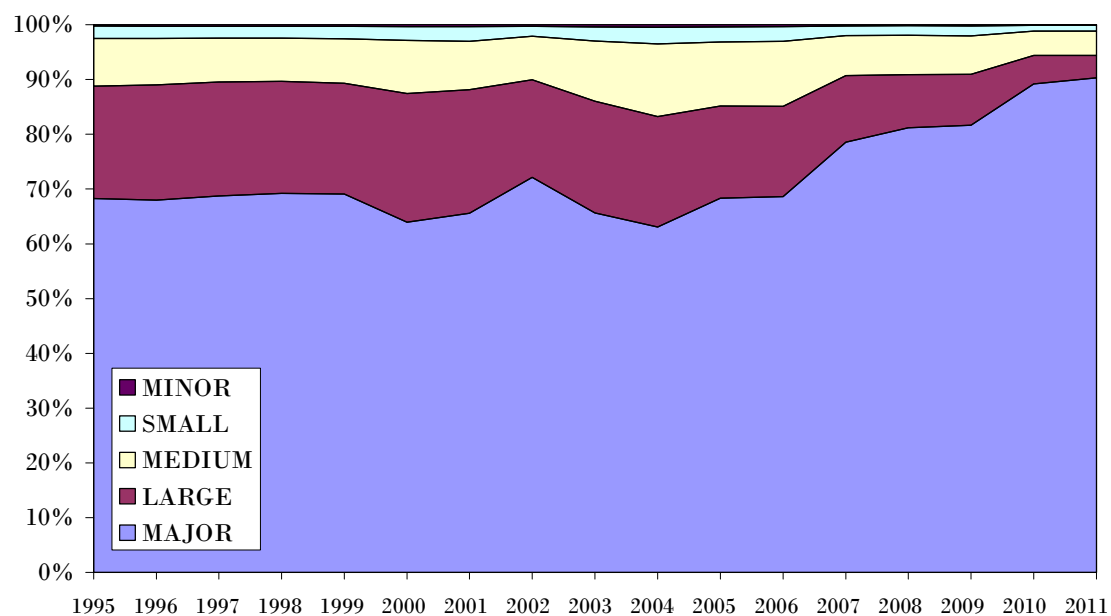
Figures 8.6 and 8.7 show the concentration of loans and deposits in large banks' portfolios. This evidence is even stronger in business lines, such as trading, asset management, investment banking, where only few Italian players operate.

Figure 8.6. Share of loans by size of banks (1995 – 2011)



Source: Bank of Italy

Figure 8.7. Share of deposits by size of banks (1995 – 2011)



Source: Bank of Italy

9. Profitability of the Financial Sector and Sub-Sectors

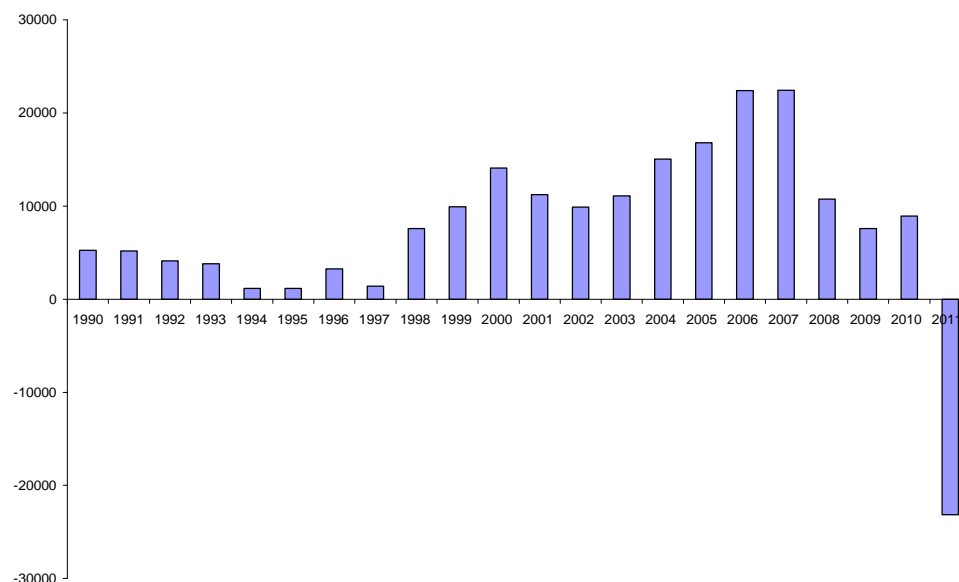
Giampaolo Gabbi and Pietro Vozzella

9.1 Banking profitability

In Italy, banks structurally dominate the domestic financial system (80% of financial assets in 2010), and their quasi monopoly position was even strengthened after the severe crisis that swept the asset management industry in 2000-2002. Although income statements of Italian banks in the last twenty years show an increase in net income of 70%, in the period 2001-2011 it decreased of more than 20%.

Between 2007 and 2010, the aggregate net income of Italian banks fell by more than half; profits levelled off in 2009 and 2010, but then banks ran up considerable losses in 2011 (figure 9.1).

Figure 9.1. Net profits of the banking system (1990 – 2011)



Source: Bank of Italy

The 2011 negative results depend on three major causes:

1. the net adjustment for impairment of loans;
2. the net adjustment for impairment of financial assets, generated by the euro sovereign crisis;
3. the impairment of goodwill, and intangibles.

The return on equity recorded an average, between 1995 and 2011, of 5.63%, with maximum 11.47 %the year before the crisis and the minimum of -6.10% in 2011, the only negative value ever experienced by the Italian banking sector.

In order to appreciate the contribution of the core business and the to the whole return on equity, we can decompose it as follows:

$$ROE = \frac{NP}{E} = \frac{GI}{E} \cdot \frac{EBT}{GI} \cdot \frac{NP}{EBT}$$

where:

NP is the net profit, E is the equity and reserves, GI is the gross income and EBT is the earnings before taxes. The values of the three ratios are shown in table 9.1.

Table 9.1. Income statements (1995 – 2011, percentage values)

YEAR	ROE	GI/E	EBT/GI	NP/EBT
1995	1.24	16.55	35.62	21.12
1996	3.30	16.99	45.46	42.73
1997	1.38	15.53	35.48	24.96
1998	6.99	20.13	65.53	52.95
1999	8.39	19.34	71.75	60.48
2000	11.35	23.43	78.00	62.10
2001	8.41	23.29	59.92	60.23
2002	6.77	18.53	58.77	62.17
2003	7.08	17.27	58.49	70.08
2004	9.22	16.84	75.24	72.77
2005	8.78	15.93	76.71	71.81
2006	11.47	18.42	83.91	74.20
2007	8.48	13.09	89.08	72.71
2008	3.89	10.21	42.83	88.92
2009	2.59	9.63	39.64	67.71
2010	2.56	7.29	47.10	74.50
2011	-6.10	6.07	-107.13	93.76

Source: Our elaboration on Bank of Italy data

The first ratio, $\frac{GI}{E}$, informs about the core profitability of the bank; the second ratio, $\frac{EBT}{GI}$, depends on exceptional factors (non-financial gains or losses); finally, $\frac{NP}{EBT}$, depends essentially on tax expenses and other fiscal policies.

Table 9.1. demonstrates that the banking sector profitability has been sustained by an increasing role of the extraordinary issues. As this is a temporary earning contribution, it could be seen as a signal of structural weakness.

Moreover, the banking system has benefited with a decreasing average tax rate, from 78.9% (1995) to 25.5% (2010)¹

The net interest income accounts for more than 50% of gross income, illustrating not only the extent to which Italian banks are almost exclusively geared towards retail activities, but also the high level of margins through 2010.

Table 9.2, up to 1990, shows the income statement items related to the Italian Banking System².

¹We do not take into consideration the rate of 2011, when the system experienced a loss of about 23 billion euros.

² Former Special Credit Institutions (SCIs), previously lending only at long-term, are considered as banks according to the new Banking Code of 1993. Since 1995 SCIs submit the same reports as all other banks. The inclusion of the former SCIs for the previous periods did not introduce significant breaks in the series. In each year, the data include those banks which have produced complete records for the income statement. The statistics published under the title "All Banks" refer to limited company banks (including subsidiaries of foreign banks), co-operative banks, mutual banks, central credit institutions and branches of foreign banks.

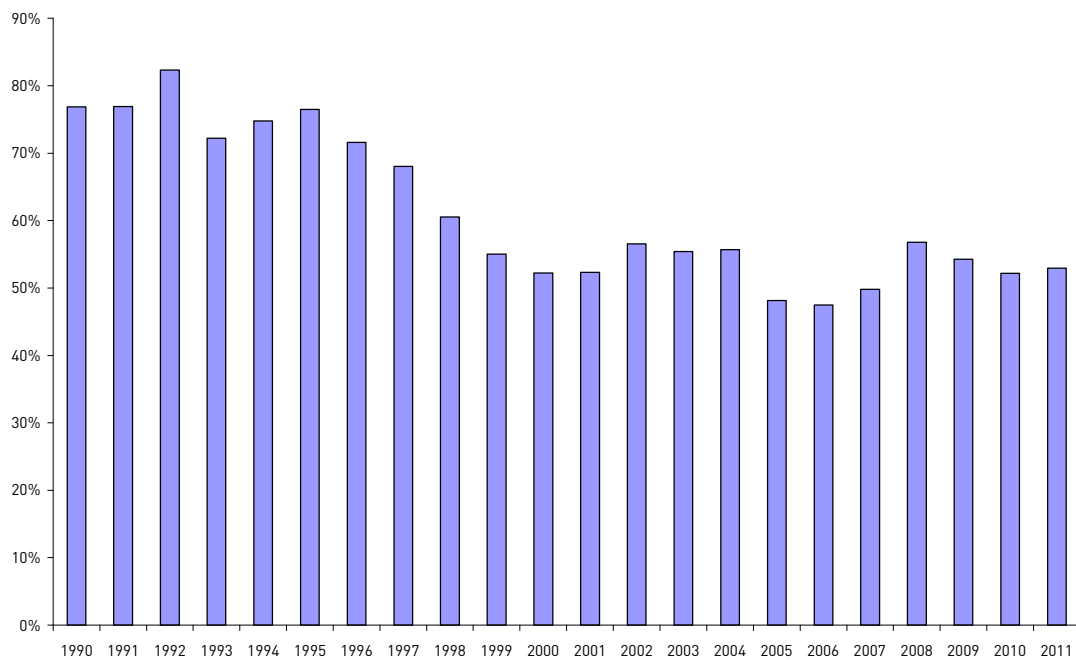
Table 9.2. Income statements (1990 – 2011, million euros)

YEAR	NET INTEREST INCOME	GROSS INCOME	OPERATING EXPENSES	(of which) STAFF COSTS	GROSS OPERATING PROFIT	EBT EARNINGS BEFORE TAX	NET PROFIT
1990	27.982	36.414	22.409	14.570	14.005	8.693	5.252
1991	30.305	39.395	25.383	16.404	14.012	9.002	5.177
1992	35.913	43.620	28.537	18.109	15.082	8.152	4.099
1993	36.192	50.116	30.294	18.904	19.822	10.533	3.787
1994	33.523	44.842	30.575	19.625	14.267	4.081	1.134
1995	36.462	47.678	32.161	20.271	15.516	5.527	1.167
1996	35.851	50.060	33.309	21.213	16.751	7.614	3.253
1997	34.045	50.034	34.314	21.214	15.720	5.578	1.392
1998	33.782	55.791	33.939	20.485	21.852	14.319	7.582
1999	31.894	57.973	35.105	20.503	22.867	16.406	9.923
2000	34.373	65.802	36.762	20.702	29.041	22.653	14.067
2001	36.411	69.570	38.447	20.966	31.123	18.649	11.233
2002	38.108	67.388	40.304	22.011	27.084	15.917	9.895
2003	38.419	69.343	42.275	23.166	27.067	15.832	11.095
2004	38.843	69.734	42.251	22.879	27.482	20.677	15.046
2005	35.970	74.747	44.258	23.637	30.489	23.388	16.796
2006	39.811	83.869	47.877	25.568	35.992	30.200	22.408
2007	41.975	84.255	49.618	27.426	34.637	30.853	22.432
2008	44.816	78.922	50.689	26.643	28.233	12.091	10.751
2009	41.561	76.581	48.267	24.873	28.314	11.225	7.600
2010	37.959	72.755	47.296	24.876	25.459	11.991	8.933
2011	37.642	71.087	48.049	25.029	23.038	-24.680	-23.140
MEAN	36.447	61.817	38.278	21.776	23.539	12.668	7.722
ST.DEV.	3.759	14.352	8.169	3.173	6.847	10.959	9.026

Source: Our elaboration on Bank of Italy data

The typical business model of Italian commercial banks has been focused on the originate-to-hold strategy. This used to affect directly the net interest income (NII). In the early Nineties the net interest income to gross income ratio was approximately 80%. The contribution to the banking profitability of services fees was relatively marginal. During the following decade the model has progressively changed towards a originate-to-distribute strategy. The net interest income declined to 50% out of the gross income, to remain at the same level since 2000 (figure 9.2.).

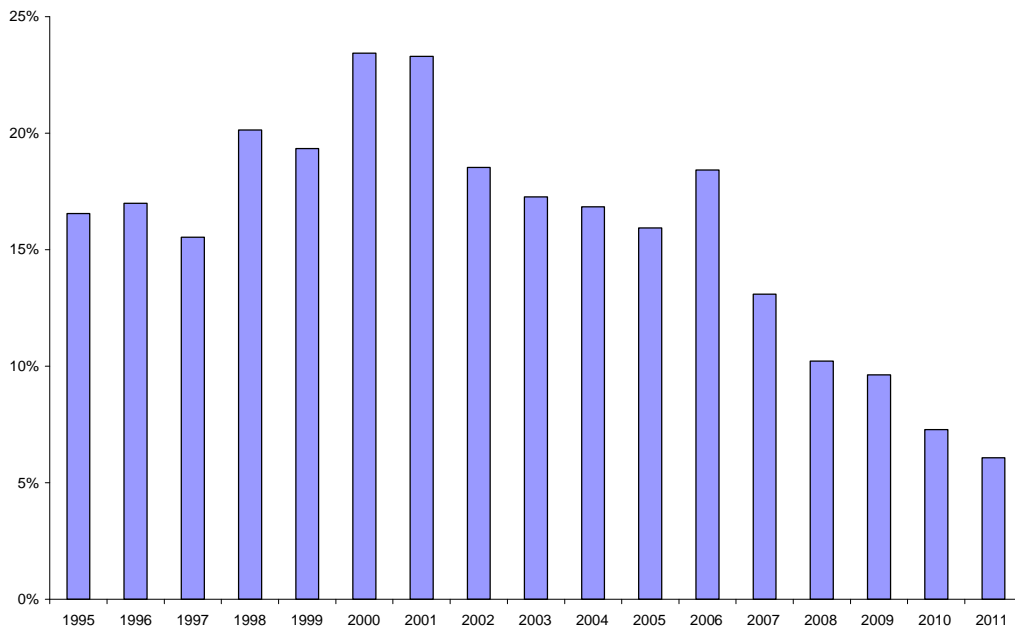
Figure 9.2. Net Interest Income to Gross Income ratio of the banking system (percentage values; 1990 – 2011)



Source: Our elaboration on Bank of Italy data

All profitability ratios follow, in general, a similar trend. The erosion of profits in recent years has strained the both return on assets (ROA), return on equity (ROE), and the gross income on equity. The latter can be measured through the gross operating profit to capital and reserves ratio. Figure 9.3. shows that the average ratio from 1995 was 15.80%, with a standard deviation of 5.60%, with a range from 23.43% (2000) to 6.07% (2011). The negative trend cannot be directly correlated with the financial crisis, but with the excess values recorded in the late Nineties.

Figure 9.3. Gross Operating Profit / Capital and Reserves (percentage values; 1995 – 2011)



Source: Our elaboration on Bank of Italy data

In order to analyse the contribution to the Gross Operating Profit (GOP) to Capital and Reserves (E) ratio, it can be easily decomposed in the following way:

$$\frac{GOP}{E} = \frac{NII}{E} \cdot \frac{GI}{NII} \cdot \frac{GOP}{GI}$$

where: GOP is the Gross Operating Profit, E is Equity and reserves, NII is the net interest income and GI is the gross income.

The three indicators can be interpreted as follows:

$\frac{NII}{E}$ is the profitability of the originate-to-hold model, particularly the difference between interest income from loans and interest expenses paid on deposits (credit intermediation profitability);

$\frac{GI}{NII}$ measures the contribution of total noninterest income (net fee income), such as commissions and fee income, net gains on financial assets available for

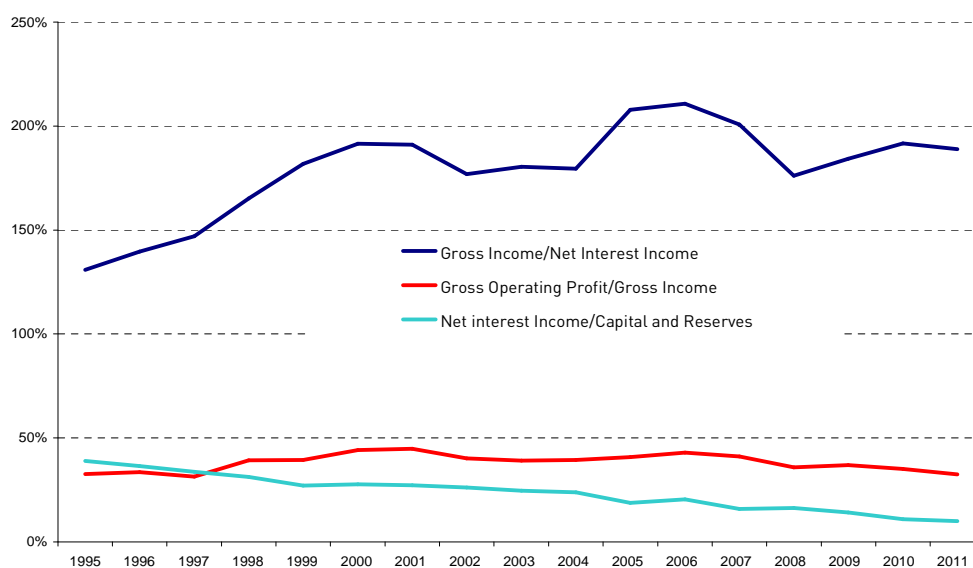
sale and other income. This is more dependent on financial services and, generally speaking, the originate-to-distribute model (financial profitability);

GOP

GI depends on the weight of operational losses, traditionally compensation and benefits, general and administrative expenses, impairment of intangible assets, restructuring activities (operational efficiency).

Figure 9.4. shows that the credit intermediation return on capital profitability (blue line) has continuously reduced from 38.89% (1995) to 9.92% (2011), as a demonstration that the traditional model of Italian banks was substituted by the more financial oriented model, approximated by the financial profitability (red line). Compared with the net interest income, the noninterest income ranged from 30.76% (1995) to 88.85% (2011). What is also clear, is that the net interest income was characterized by a relatively low volatility (10.5% of the average value, 36447 million euros). Alternatively, the financial income has a volatility which is 46.6% of the average value (25370 million euros).

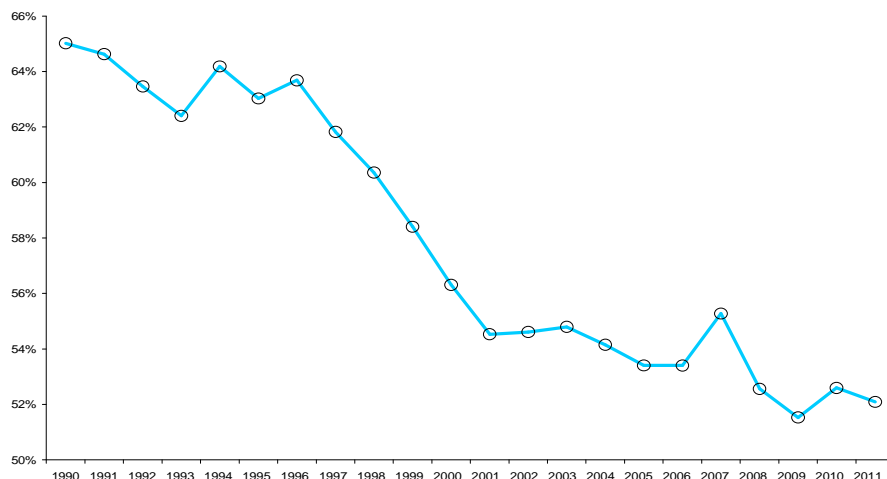
Figure 9.4. Contribution to Gross Operating Profit to Capital and Reserves ratio (percentage values; 1995 – 2011)



Source: Our elaboration on Bank of Italy data

The operational efficiency indicator in 2011 returned to the same value observed in 1995 (32.5%). Nonetheless, the incidence of staff costs decreased from 65% to 52% (figure 9.5.).

Figure 9.5. Incidence of staff costs out of operational expenses (percentage values; 1990 – 2011)



Source: Our elaboration on Bank of Italy data

In conclusion, banks show a decreasing orientation to contribute the net income with the net interest income (from 0.35 in 1995 to 0,10 in 2011) which represented the traditional strategic model. On the other side the financial services contribution increased from 1.31 to 1.89.

At the same time, its direct support to the employees income appears to be decreasing. The variation of the earnings before taxes from 1995 to 2007 is 458%, while payments to the staff increased only of about 35%.

9.2 The profitability on insurance companies

The ratio of the balance between unrealized gains and losses to book value was equal to 3.4 per cent overall; it was 4.7% for durable and 1.6% for non durable investments. The ratio was highest for shares and other equity, whose positive balance was equal to about 35% of book value, followed by land and buildings

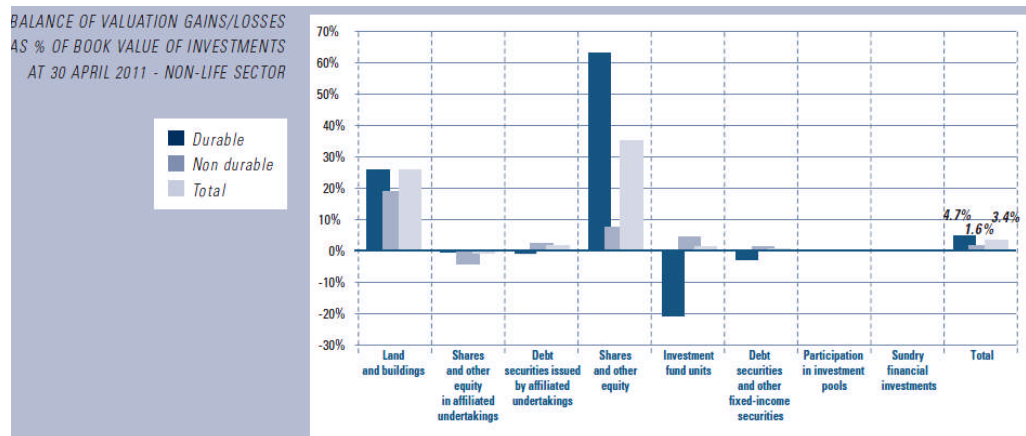
(26%). Investments in government securities deserve closer examination. Their relative importance differs between the durable and non durable investment portfolios (Table 9.3). In particular, government securities, with a current value of Euro 7.5 billion at the end of April 2011, accounted for about 16% of total Class C investments held on a durable basis, up from the increasing balance-sheet figures of the last three years (12.1% in 2008, 12.9% in 2009 and 13.9% in 2010). Valuation gains and losses were virtually in balance. Government securities worth nearly Euro 16 billion accounted for half the Class C investments not held on a durable basis, with valuation gains equal to valuation losses.

Table 9.3. Investments in government securities of insurance companies (2008 – 2011)

Listed and unlisted government securities held on a durable basis				
	Book value	Current value	Balance of valuation gains/losses	Govt securities/ Total Class C assets (current value)
2008	5.2	5.2	0.0	12.1%
2009	5.6	5.8	0.2	12.9%
2010	6.4	6.3	-0.1	13.9%
Apr. 11	7.7	7.5	-0.2	16.1%
Listed and unlisted government securities not held on a durable basis				
	Book value	Current value	Balance of valuation gains/losses	Govt securities/ Total Class C assets (current value)
2008	17.5	17.5	0.0	48.1%
2009	18.6	19.0	0.4	49.6%
2010	16.2	15.8	-0.4	50.0%
Apr. 11	15.8	15.8	0.0	49.7%

Source: ANIA, Associazione Nazionale fra le Imprese Assicuratrici

Figure 9.6. Balance of valuation gains/losses as % of book value of investments of staff costs out of operational expenses (percentage values; 1990 – 2011)



Source: ANIA, Associazione Nazionale fra le Imprese Assicuratrici

At the end of 2010 insurance companies with registered office in Italy, excluding reinsurers, had a solvency margin of Euro 46.6 billion for their total assets in the life and non-life sectors, showing an increase compared to the previous year (Table 9.4). The margin is 2.20 times higher than the minimum requirement (equal to 21.2 billion). For life business, the margin (Euro 27.4 billion) was equal to 1.88 times the minimum requirement (Euro 14.6 billion), determined in terms of mathematical provisions and capital at risk. The ratio had been 1.98 in 2009. For non-life business the margin (Euro 19.1 billion) was 2.89 times the minimum requirement (Euro 6.6 billion), determined in terms of the amount of premiums written and the average cost of claims in the last three years (taking the higher of the two criteria). The ratio had been 2.85 in 2009 and 2.61 in 2008.

Table 9.4. Solvency margin (2004 – 2010)

	2004	2005	2006	2007	2008	2009	2010
LIFE							
Solvency margin	20,954	23,999	24,435	22,722	19,699	26,578	27,449
Solvency margin required by law	10,266	11,544	12,041	11,890	11,587	13,444	14,582
<i>Cover ratio</i>	<i>2.04</i>	<i>2.08</i>	<i>2.03</i>	<i>1.91</i>	<i>1.70</i>	<i>1.98</i>	<i>1.88</i>
NON-LIFE							
Solvency margin	17,308	20,826	20,382	17,585	16,805	19,236	19,139
Solvency margin required by law	5,825	6,095	6,263	6,473	6,446	6,758	6,624
<i>Cover ratio</i>	<i>2.97</i>	<i>3.42</i>	<i>3.25</i>	<i>2.72</i>	<i>2.61</i>	<i>2.85</i>	<i>2.89</i>
TOTAL							
Solvency margin	38,262	44,825	44,817	40,307	36,504	45,814	46,588
Solvency margin required by law	16,091	17,639	18,304	18,363	18,033	20,202	21,206
<i>Cover ratio</i>	<i>2.38</i>	<i>2.54</i>	<i>2.45</i>	<i>2.20</i>	<i>2.02</i>	<i>2.27</i>	<i>2.20</i>

Source: ANIA, Associazione Nazionale fra le Imprese Assicuratrici

At the end of 2010 the Italian insurance industry employed a total of 47,185 people, 0.4% less than the previous year when the employees were 47,369 (+1.1% compared to 2008) (Table 9.5). The estimate for the whole market was made using data of a very representative sample of companies. Included among the 41,730 administrative employees were 3,735 employees of entities controlled by insurance companies, to whom the national labour contract of the insurance sector applied.

Overall, administrative staff decreased in 2010 by 151 units (-0.4%), despite an increase in the call-centre employees to both the first section (+2.0%) and second section (+2.2%) adding up to 2,205 units at the end of the year; the number of executives (-2.1%) is equal to 1,143. The number of dealers was 5,456, that is 32 less than the previous year (-0.6%). At the end of 2010 total labour costs of the industry amounted to Euro 3,456 million, of which Euro 3,192 million related to administrative staff and Euro 263 million to dealers.

To obtain per capita labour costs, as well as to calculate staff trends, the semi-sum method was adopted. Moreover it was necessary to employ a number of estimation techniques to allow consistent comparisons with data collected

before 2007, when for the first time about 5,000 employees and approximately 2,000 dealers of entities controlled by insurance companies were included in the count after a major corporate restructuring. In 2010 total labour costs of administrative staff increased by 1.6%, whereas the cost per worker, equal to Euro 76,400, increased by 1.3%. Total labour costs of dealers increased by 1.2%, while average cost per dealer (equal to Euro 48,100 in 2010) remained practically the same. Overall, total staff costs increased moderately (+1.6%), slightly more than unit costs (+1.2%).

Table 9.5. Number of staff and staff costs of insurance companies (2002 – 2010)

NUMBER OF STAFF				TOTAL STAFF COSTS Euro million			
YEAR	ADMIN.	DEALERS	TOTAL	YEAR	ADMIN.	DEALERS	TOTAL
2002	36,987	2,993	39,980	2002	2,119	117	2,236
2003	36,429	2,862	39,291	2003	2,268	115	2,383
2004	37,275	2,830	40,105	2004	2,379	129	2,508
2005	37,016	2,908	39,924	2005	2,457	142	2,599
2006	36,665	3,130	39,795	2006	2,533	154	2,687
2007	36,567	3,156	39,723	2007	2,711	169	2,880
2007 (*)	41,121	5,157	46,278	2007 (*)	2,972	277	3,249
2008	41,479	5,352	46,831	2008	3,118	273	3,390
2009	41,881	5,488	47,369	2009	3,142	261	3,403
2010	41,730	5,456	47,185	2010	3,192	263	3,456

(*) For the first time in 2007 the total includes 4,554 employees of other entities controlled by insurance companies and roughly 2,000 additional dealers as a consequence of a large corporate restructuring

(*) For the first time in 2007 total costs relating to staff include 4,554 employees of other entities controlled by insurance companies and roughly 2,000 additional dealers as a consequence of a large corporate restructuring

Source: ANIA, Associazione Nazionale fra le Imprese Assicuratrici

In life insurance distribution, 2010 was once again marked by the significant expansion of premiums written through bank branches. Premiums collected by financial advisers and by agents grew as well, although at a slower pace. Premiums collected by direct sales, after 2009's moderate expansion, contracted slightly. For non-life business, the main distribution channel still consists of insurance agents, whose business increased marginally.

10. Financial sector and insurance

Giampaolo Gabbi and Costanza Consolandi

10.1 The insurance structure in Italy

The Italian insurance market has been characterized by dramatic changes that have occurred in the market during the Eighties (Turchetti, 1994). The Italian life insurance market experienced rapid premium growth during this period (more than 26 percent per year from 1983-1993), spurred by a crisis in the Italian social security pension system and innovations in life insurance savings products. Insurers also experimented with new distribution channels, which have taken market share from the traditionally dominant exclusive agents. The government authorization in 1990 for banks to own majority shareholdings in insurance companies represented a major structural change that also is expected to have an impact on productivity and efficiency. The bank marketing channel ("bancassurance") has been especially successful in life insurance, capturing 32 percent of new life insurance sales (premium volume) in 1993. The Italian nonlife insurance industry remains somewhat problematical, experiencing high loss ratios and low profits.

Compared to insurance markets in other industrialized countries, the Italian insurance market is relatively underdeveloped. Italy ranks seventh among developed countries in insurance premium volume but ranks twenty-second in premiums as a percentage of gross domestic product (GDP) and twentieth in premiums per capita. The underdeveloped condition of the Italian insurance market on the one hand may imply inefficiency and low competition but on the other offers significant opportunities for development and growth.

Automobile insurance is the most important line of business in the Italian market, accounting for about 40 percent of premiums in 1993 (table 10.1.). However, the relative importance of life insurance has increased dramatically during the past ten years. Life insurance premiums have grown at an annual

percentage rate of 26.3 percent, and life insurance now accounts for 30 percent of Italian premium volume. The combined growth rate for all other lines of business was 12.9 percent over the same period (table 10.1).

Table 10.1. Distribution of premiums by line of business (1984 – 1993; values in million Italian lire ITL)

YEAR	Aviation Perils	Auto Property	Bond	Credit	Theft	Hail	Fire	Personal Accident	Health
ABSOLUTE VALUES (Million ITL)									
1984	82,835	1,260,848	269,099	128,987	469,872	209,802	1,219,641	1,202,319	237,724
1985	95,953	1,451,962	289,984	164,099	531,453	240,417	1,387,804	1,384,737	293,476
1986	114,710	1,667,755	305,918	198,444	601,414	282,496	1,549,326	1,602,087	361,632
1987	124,852	1,926,725	339,997	195,028	710,596	380,448	1,773,105	1,846,428	461,687
1988	127,775	2,236,434	354,869	219,126	781,578	396,603	1,910,128	2,123,781	582,651
1989	141,781	2,650,573	370,586	241,263	880,736	417,962	2,126,091	2,404,431	731,651
1990	155,029	3,068,892	392,895	273,529	988,964	501,778	2,328,776	2,714,481	918,782
1991	154,178	3,564,011	423,405	300,415	1,069,815	443,799	2,631,706	3,049,339	1,106,130
1992	150,284	4,116,281	434,723	330,092	1,160,067	488,287	2,890,757	3,305,318	1,314,876
1993	202,797	4,230,980	424,883	334,011	1,191,204	347,753	3,123,414	3,483,702	1,512,964

Pecuniary Loss	General Liability	Compulsory Auto Liability	Marine	Legal Defence	Other Lines	Total Non-Life	Life and Capitalization	TOTALS
13,958	672,134	5,806,901	623,399	14,962	122,271	12,334,752	1,933,293	14,268,045
25,520	799,852	6,702,477	556,051	17,058	140,564	14,081,407	2,598,063	16,679,470
33,119	940,205	7,624,839	556,486	20,505	155,353	16,014,289	3,583,616	19,597,905
44,110	1,132,736	8,299,198	634,749	25,598	189,251	18,084,508	4,993,578	23,078,086
55,086	1,255,866	8,837,501	691,014	30,336	202,989	19,805,737	6,303,721	26,109,458
76,294	1,455,289	9,845,002	754,693	34,119	241,566	22,372,037	7,332,458	29,704,495
69,110	1,655,274	11,272,785	854,692	38,406	275,899	25,509,292	8,677,087	34,186,379
68,878	1,874,248	13,052,346	1,018,415	48,439	352,721	29,157,845	10,597,575	39,755,420
66,021	2,121,188	14,689,500	1,267,743	79,119	430,971	32,845,227	12,508,264	45,353,491
60,740	2,329,263	15,840,987	1,447,058	99,709	480,721	35,110,186	15,143,042	50,253,228

Source: Associazione Nazionale fra le Imprese Assicurazioni (ANIA)

The increasing importance of life insurance is attributable in part to the crisis in the Italian social security pension system, which has led consumers to rely more heavily on personal savings for their retirement income. Italy has always had a relatively high rate of personal savings, but high interest rates on Italian government bonds have historically attracted savings away from private savings

vehicles such as life insurance. However, due to the increasing financial sophistication of consumers, the entry of new firms in the life market, and the use of innovative channels of distribution, life insurance has begun to attract a higher proportion of consumer savings. The growth of the life insurance market has focused more attention on the need to reduce costs, especially marketing costs, and to achieve higher levels of efficiency in the industry.

Return on equity in the industry has been relatively low, averaging 6.1 percent from 1983-1992 and 4.4 percent from 1988-1992. This poor performance can be traced in part to high loss ratios in non-life insurance, primarily due to compulsory automobile liability insurance and marine insurance. Improvements in the profitability are expected following price deregulation in July 1994. In 1993 there were 274 insurers in the Italian market, an increase of 63 during the ten-year period ending in 1993 (table 10.2.). The vast majority of companies are domestic stock companies. By 1993 there were 12 mutual insurances, one cooperative insurer, and 50 foreign insurers in the market. In 1993, 191 companies participated in the non-life insurance market, an increase of 10 companies since 1984. The number of companies in the life insurance market grew from 54 in 1984 to 99 in 1993.

Table 10.2. Distribution of insurers by organization form (1984 – 1993)

YEARS	PUBLIC BODIES	ITALIAN COMPANIES				ITALIAN COMPANIES TOTALS	FOREIGN COMPANIES	ITALIAN AND FOREIGN COMPANIES TOTALS
		Stocks	Cooperatives	Mutuals	TOTALS			
1984	2	145	1	15	161	163	50	213
1985	2	143	1	15	159	161	51	212
1986	2	146	1	13	160	162	54	216
1987	2	152	1	13	166	168	56	224
1988	2	170	1	12	183	185	57	242
1989	2	177	1	12	190	192	56	248
1990	2	185	1	12	198	200	52	252
1991	2	195	1	12	208	210	54	264
1992	-	205	1	12	218	218	50	268
1993	-	211	1	12	224	224	50	274

Source: Associazione Nazionale fra le Imprese Assicurazioni (ANIA)

During the last decade the dynamics of the insurance market recorded a slightly reduction of the number of operators. At 2001 (table 10.3.), 253 insurance companies were operating, of which 203 were insurance companies with registered Offices in Italy and 50 were branch offices of foreign insurance companies, mainly from European Union member countries (47). 94 insurance companies write only Life insurance business, (of which 12 are foreign branch offices) and 129 companies only write Non-Life business (of which 32 are foreign branch offices); 21 companies write both Life and Non-Life business; 9 companies write only reinsurance business (of which 5 are foreign branch offices).

Having regard to the legal status of the 203 companies that have Legal Offices in Italy, 196 are joint stock companies, 6 are mutual companies and one is a co-operative company. Companies with the registered Offices in Italy controlled by foreign entities represent more than 25% of the total premium income for direct domestic business.

Table 10.3. Number of insurance companies by juridical nature and business (2000)

	Life	Non-Life	Multi branches	Professional Reinsurers	Total companies
Situation at April 30, 2000					
Limited companies	76	93	18	4	191
Cooperatives	-	-	1	1	1
Mutuals	-	6	1	-	7
Domestic companies	76	99	20	4	199
Foreign branches	12	33	-	5	50
<i>in U.E. countries</i>	11	30	-	4	45
Total companies	88	132	20	9	249

Source: Associazione Nazionale fra le Imprese Assicurazioni (ANIA)

The number of staff employed by insurance companies as at 31 December 2000 was 42,264 (-358 persons). The number of administrative staff, including management, was 38,280 (-201 persons) while the number of sales staff was 3,984 (-157 persons).

The distribution system confirms itself as being highly competitive due to the incisive presence of other operators alongside the traditional channels, which are found attractive to customers, particularly with reference to standardised and readily understandable products. The consolidation of a structured distribution system for the Life classes, which has led to a reduction in acquisition and premium collection costs, is also followed by a continuous growth in business for Non-Life classes through the so-called innovative channels. It is therefore increasingly easier for the consumer not only to select the most appropriate product to meet the customer's needs, but also the channel through which to purchase that given product.

At the end of 2010, 242 insurance companies were operating, of which 151 were insurance companies with registered office in Italy (156 at 31 December 2009) and 91 were branch offices of foreign insurance companies (85 at 31 December 2009), mainly from European Union member States (89). During the year there have been cases of companies operating in Italy who decided to modify their presence on the territory operating as branch offices of European companies and not as Italian and non EU companies; this explains the increase of foreign companies with registered offices in the EU and the decrease of Italian companies and branch offices of non EU companies. Moreover, as at 31 December 2009, 959 insurance companies with registered offices in the EU (or in other States belonging to the EEA) were operating in freedom of services. 81 insurance companies write only life insurance business (of which 20 are foreign branch offices) and 131 companies write only non-life business (of which 55 are foreign branch offices); 23 companies (of which 9 are foreign branch offices) write both life and non-life business, accounting for 35% of the total premium collection in terms of market share; 7 companies write only reinsurance business (table 10.4.).

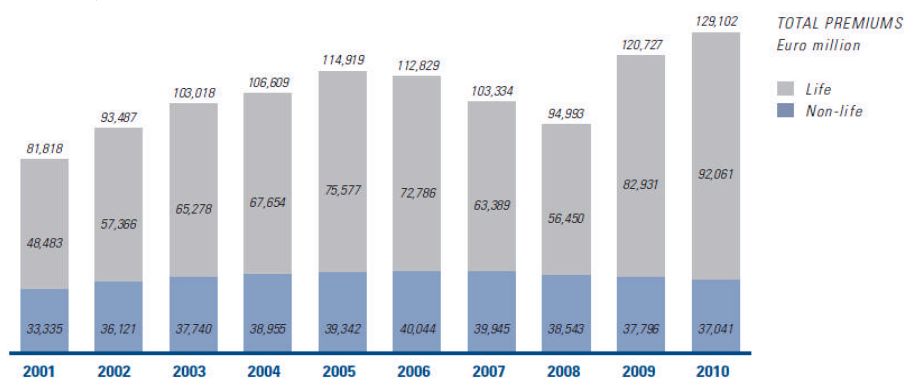
Table 10.4. Number of companies by legal status and business sector (1999 and 2000)

BUSINESS SECTOR	(situation as at 31 December)	DOMESTIC COMPANIES				FOREIGN BRANCHES		TOTAL
		Limited companies	Cooperatives	Mutuals	Total	with head office in EXTRA-EU countries	with head office in EU countries	
Non-life	2009	76	-	2	78	3	49	130
	2010	74	-	2	76	2	53	131
Life	2009	64	-	-	64	-	16	80
	2010	61	-	-	61	-	20	81
Professional reinsurers	2009	-	-	-	-	-	7	7
	2010	-	-	-	-	-	7	7
Multi branches	2009	12	1	1	14	-	10	24
	2010	12	1	1	14	-	9	23
Total	2009	152	1	3	156	3	82	241
	2010	147	1	3	151	2	89	242

Source: Associazione Nazionale fra le Imprese Assicuratrici (ANIA)

Following corporate operations, all 7 reinsurance companies are foreign branch offices. Considering the legal status of the 151 companies that have legal offices in Italy, 147 are joint stock companies, 3 are mutual companies and one is a cooperative company.

Figure 10.1. Total premiums of life and non-life insurers (2001 – 2010; million euros)



Source: Associazione Nazionale fra le Imprese Assicuratrici (ANIA)

The dynamics of premiums during the last decade shows a mixed nature. On non-life side, it appears relatively stable, while life premiums are more correlated to the financial market volatility (figure 10.1.).

10.2 The interconnection between the financial and the insurance systems

The interconnection among insurance firms and other financial companies can be appreciated looking both at the corporate governance and at the distribution channels used to supply both insurance products and structured contracts, with mixed insurance and financial components.

In addition to the interests of savers in alternative forms of investments that has led to commercial agreements and production and distribution joint ventures between the banking and insurance sectors, in Italy the interest of banks in the insurance market has been encouraged by the law on the kinds of investment that can be held. Prudential rules have in fact allowed banks to control insurance companies and vice versa.

In 2002, the absolute value of the share capital held by Italian insurance companies in banks amounted to about 5 billion euro while Italian banks or bank groups held about 4 billion euro in the share capital of insurance companies.

By the end of 2003 Italian banks held participations in 68 Italian insurance companies, 33 of which operating in life insurance. The participation in 18 of the foregoing 68 constituted a controlling interest. It also emerged that Italian banks hold participations in 19 foreign insurance companies or brokers. Similarly, at the same date, national and foreign insurance groups had holdings in 34 Italian banks; five such groups – of which two Community groups – had holdings in the first six national bank groups. Furthermore, insurance companies held a controlling interest in 9 small sized banks.

Only in a few cases do reciprocal holdings between the banking and insurance sectors refer to financial groups whose activities mainly occur in the banking and insurance sectors. A recent Community directive requires that such groups (the so-called financial conglomerates) should be subject to a special supervisory regime (the so-called supplementary supervision) aimed at

ensuring that the overall risks are managed correctly and that there are sufficient assets at the group-wide level.

Out of the 20 Italian bank groups that at the end of 2002 held participations (from a minimum of 20% to a controlling interest) in insurance companies and out of the 6 insurance groups that in the same period held participations in banks and/or stock brokerage companies, 3 exceeded the 10% threshold and 5 exceeded the cross-sectorial threshold of 6 billion euro. In the light of community law it will, therefore, be necessary to consider the risks of the banking and insurance components in an integrated manner with regard to the groups subject to this law. For example, from the standpoint of the subject matter of this report, the use and the exchange of CRT instruments between insurance and banking entities belonging to the same group would not satisfy the requirements of risk protection insofar as – although there is an actual transfer between sectors – the credit risk still remains within the same conglomerate. Moreover, community regulations require that, as concerns the single entities of each of the two sectors, whenever reciprocal capital ties exist account must be taken of the need to avoid any double gearing

The definition of "financial conglomerate" introduced by Directive 2002/87 is based on two concepts relating to the activities of the group: their essential financial and cross-sectorial nature. These features must be verified on the basis of the thresholds fixed by the directive, which, as their principal reference parameters, consider the balance sheet total of the single entities of the group and the relative minimum solvency requirements. In detail:

The threshold envisaged for determining whether the activities of the group mainly occur in the financial sector is 40%. This is calculated as the ratio between the summation of the balance sheet total of the companies operating in the financial sector and the summation of the balance sheet total of all the companies of the group. If this ratio is over 40%, the group is deemed to have a principally financial character.

The parameter used to determine whether cross-sectorial activities are significant is 10%. This is calculated as the ratio between the summation of the balance sheet total of the companies operating in one of the two financial sectors (insurance/banking) and the summation of balance sheet total of the financial sector entities in the group, and the ratio of the summation of all the solvency requirements of the same financial sector to the summation of the solvency requirements of the financial sector entities in the group. If the average of these two ratios exceeds 10%, the group is deemed to be a financial conglomerate.

In addition to these criteria, it is envisaged that financial groups with systemic importance be included in the scope of the directive. This means groups whose activities, while focused on only one financial sector (e.g. banking), reach high quantitative levels in the other sector as well. In practice, for purposes of the directive, groups whose activities in the smallest financial sector in the group exceeds EUR 6 billion in terms of the sum of the balance sheet total in the relevant financial statements are also to be regarded as financial conglomerates.

Insurance is distributed through a variety of distribution channels in the Italian market. The “traditional” channels are exclusive agents, independent agents, direct sales through company employees, and brokers. Among the “innovative” forms are banks, SIM, financial consultants, direct marketing (mail and telemarketing), and automated distribution. Table 10.5 shows the market shares of the principal distribution channels in 1992. Agents account for 75.6 percent of the non-life insurance market and 55.5 percent of the life insurance market. Banks and direct sales represent 40 percent of the life insurance market but only about 9 percent of the non-life insurance market. The market share of banks has increased dramatically since 1990, when banks were permitted to own majority shareholdings of insurers.

Table 10.5. Market shares by distribution channel (1992)

CHANNELS OF DISTRIBUTION 1992	Life and Non-Life		Life Business		Non-Life Business	
	Premiums (in ITL Billions)	Market Share	Premiums (in ITL Billions)	Market Share	Premiums (in ITL Billions)	Market Share
Agents	31,772	70.1%	6,942	55.5%	24,830	75.6%
Brokers	5,398	11.9%	438	3.5%	4,960	15.1%
Direct Sales Force	5,004	11.0%	2,639	21.1%	2,365	7.2%
Banks and Financial Consultants	3,179	7.0%	2,489	19.9%	690	2.1%

Source: Cummins, Turchetti, Weiss, 1996

A further increase in the premiums directly written by insurance companies was recorded in 2000 (+4.8% compared to 1999) or via bank counters (+21.3%) and agents (+11%) although the rate of growth for the Life insurance business was slower compared to the rates experienced in preceding years. Whereas, both the distribution through financial advisers (16.5% compared to 1999), due to a decrease in the collection of all forms of individual insurance, and the distribution through brokers (-14.3%), caused by a significant decrease in the sales of capital redemption policies, reflected a downturn. The collection of contracts for the management of pension funds is mainly achieved through agencies (43.7% of the total for this class) and at bank counters (33.3%): the overall volumes for this class remain however unsatisfactory, amounting to 80 million Euros.

Table 10.6. Premiums by distribution channel (1999 and 2000; billion ITL)

	1999 Premiums (Itl. billion)	%	2000 Premiums (Itl. billion)	%
Bank counters	34,325	49.8	41,624	54.1
Agents	18,748	27.2	20,805	27.0
Financial advisors	8,684	12.6	7,248	9.4
Direct sales	6,341	9.2	6,647	8.6
Broker	827	1.2	709	0.9
Total	68,925	100.0	77,033	100.0

Source: Associazione Nazionale fra le Imprese Assicurazioni (ANIA)

The sustained growth in the life insurance market in 2009 continued in 2010, although at a lesser pace, mainly owing to the business intermediated by bank branches; the performance of financial advisers and agents was positive too, but there was a contraction of premium volume collected through the direct channel (table 10.7). Premiums written through bank branches increased by 15%, causing an increase of this channel's market share (60.3%, 58.1% in 2009) and impacting positively on the five-year annual average change in premiums collected (+4.1%). Premiums written last year through financial advisers kept growing, but at a much lesser rate (+9.3%, from +143.3% in 2009), consolidating this type of intermediary as the second-leading distribution channel. In the last five years advisers have recorded average annual growth of 20.8% (table 10.7).

Table 10.7. Life Insurance business by distribution channel (2006 – 2010)

CHANNEL	Gross written premiums (euro million)					Market share (%)					Average (2006-2010)
	2006	2007	2008	2009	2010	2006	2007	2008	2009	2010	
Bank branches (*)	40,957	35,496	28,688	47,210	54,303	59.0	57.8	52.5	58.1	60.3	57.5
Financial advisers	5,907	5,237	5,409	13,141	14,365	8.5	8.5	9.9	16.2	15.9	11.8
Agents	13,830	12,969	12,852	12,897	13,809	19.9	21.1	23.6	15.9	15.3	19.2
Direct sales	8,086	6,862	6,811	7,057	6,688	11.7	11.2	12.5	8.7	7.4	10.3
Brokers	598	875	805	811	936	0.9	1.4	1.5	1.0	1.0	1.2
Total	69,377	61,439	54,565	81,116	90,102	100.0	100.0	100.0	100.0	100.0	100.0

(*) Includes premiums collected by post office branches

Source: Associazione Nazionale fra le Imprese Assicuratrici (ANIA)

Despite the growth of premiums intermediated by agents, their market share continued shrinking in 2010 to slightly above 15%. Direct sales decreased by 5.2%, after the increase registered during the previous year, and which inverted the 2006-2008 negative trend. Policies distributed by brokers recorded a limited premium collection (less than 1 billion in 2010), but nevertheless recorded a substantial expansion of 15.4%.

Table 10.8. Non-Life Insurance business by distribution channel (2006 – 2010)

CHANNEL	Gross written premiums (Euro million)					Market share (%)					Average (2006-2010)
	2006	2007	2008	2009	2010	2006	2007	2008	2009	2010	
Agents	31,315	31,751	31,381	30,516	29,532	84.1	84.3	83.8	83.0	82.4	83.5
Brokers (**)	2,779	2,771	2,854	2,921	2,749	7.5	7.4	7.6	7.9	7.7	7.6
Direct sales	2,438	2,427	2,359	2,187	2,273	6.6	6.4	6.3	6.0	6.3	6.3
<i>of which: phone and Internet</i>	994	1,054	1,042	1,081	1,282	2.7	2.8	2.8	2.9	3.6	3.0
Bank branches (***)	624	677	804	1,070	1,251	1.7	1.8	2.1	2.9	3.5	2.4
Financial advisers	28	29	54	51	48	0.1	0.1	0.1	0.1	0.1	0.1
Total	37,184	37,655	37,451	36,746	35,852	100.0	100.0	100.0	100.0	100.0	100.0

(**) The share attributed to brokers does not take account of a portion of premium volume (estimated at almost 20 percentage points in 2010) originated through this channel but presented to agencies and not directly to insurers

(***) Includes premiums collected by post office branches

Source: Associazione Nazionale fra le Imprese Assicuratrici (ANIA)

From the breakdown of life insurance business by type of policy (table 10.8) it emerges that in Class I agents' market share increased from 16.1% in 2009 to 16.6% in 2010 as a result of the 8.2% growth in premiums collected by this type of intermediaries. Banks and financial advisers' shares remained steady (60.7% and 15.3%, respectively), recording a growth in line with the average class I market average.

10.3 The evolution of the insurance market and its perspectives

The insurance market in Italy shows some interesting features to remark. Low premium rate per capita compared to other top European Countries. Persistent domestic financial crisis affecting securities prices and value of assets. Insurance companies highly dependent on Italian sovereign debt. Non-life market is improving; combined ratio equal to 97.9%, still high but representing the best performance since 2008. Technical results appear to suffer for the financial crisis, particularly for the increase of technical reserves, due to the increase of expected losses (table 10.9).

Table 10.9. Technical results of the insurance industry (2006 – 2011; million euros)

€ million	FY06	FY07	FY08	FY09	FY10	FY11
GWP	106,561	99,094	92,018	117,801	125,719	110,233
Claims	(83,665)	(100,395)	(93,085)	(86,171)	(93,401)	(100,412)
Changes in technical reserves	(18,925)	9,675	22,285	(41,148)	(32,707)	(3,137)
Other technical items	(84)	(185)	(643)	(697)	(813)	(884)
Administrative expenses	(13,249)	(13,872)	(13,214)	(13,143)	(12,996)	(12,554)
Net profit from investments	13,980	10,100	(10,256)	26,364	13,656	3,631
Reinsurance	(190)	(223)	178	98	(211)	(240)
Technical result	4,428	4,194	(2,717)	3,104	(755)	(3,364)

Source: PwC, 2012

Compared to other European insurance markets, the Italian shows a strong liquidity position of Italian insurers and a good increase on life premiums (+11% in FY10, relative to an overall +4.3% of European Insurance market). Non-life industry is imbalanced on Motor contracts, which are constantly showing negative profitability. Excluding Motor contracts, Italian non-life insurance market penetration falls under 1.0% relative to 2.7% of Germany, 2.3% of France and 2.6% of United Kingdom. The Eurozone crisis and Italian debt position are depressing Italian industry recovery and the impact on the solvency ratio appear to be significantly high.

11. Availability and sources of funds

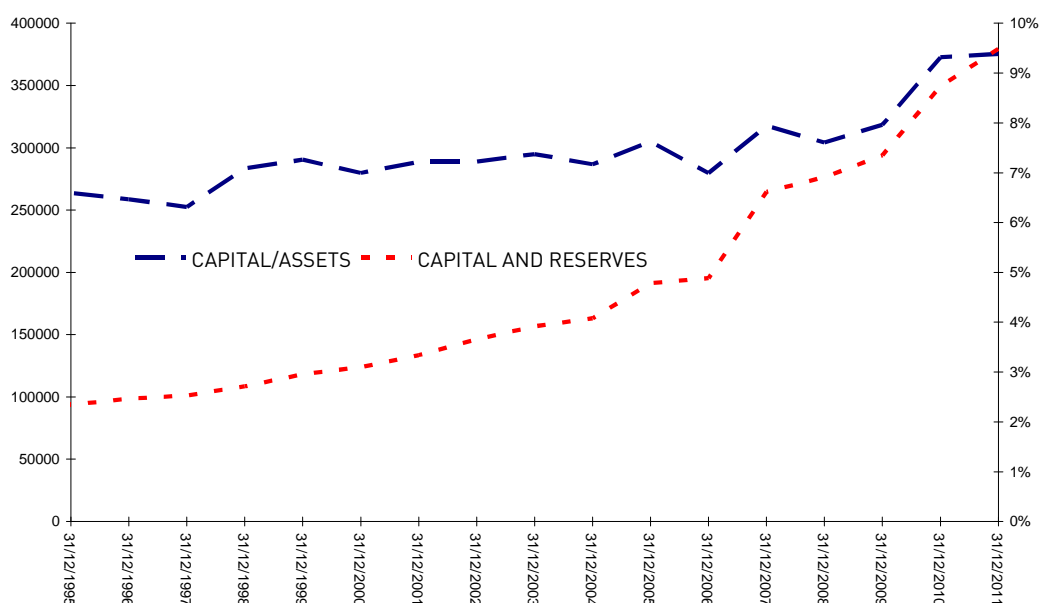
Giampaolo Gabbi and Pietro Vozzella

11.1 Introduction

The changing roles of availability and sources of funds, e.g. pension and insurance funds, rise of sovereign wealth funds, high wealth individuals, other major sources of funds say emanating from the involvement of firms in lending activities.

The source of funds for the banking sector can be basically shared between deposits/bonds on one side, and capital on the other side. Figure 11.1 shows the increasing capital on assets ratio from 1995 (when the value was roughly 7%) to 2011 (with a value of 9.5%).

Figure 11.1. The leverage ratio of the Italian banking system (1995 – 2011). Capital/Assets (right scale) and Capital and reserves (left scale)



Source: Bank of Italy and our elaboration

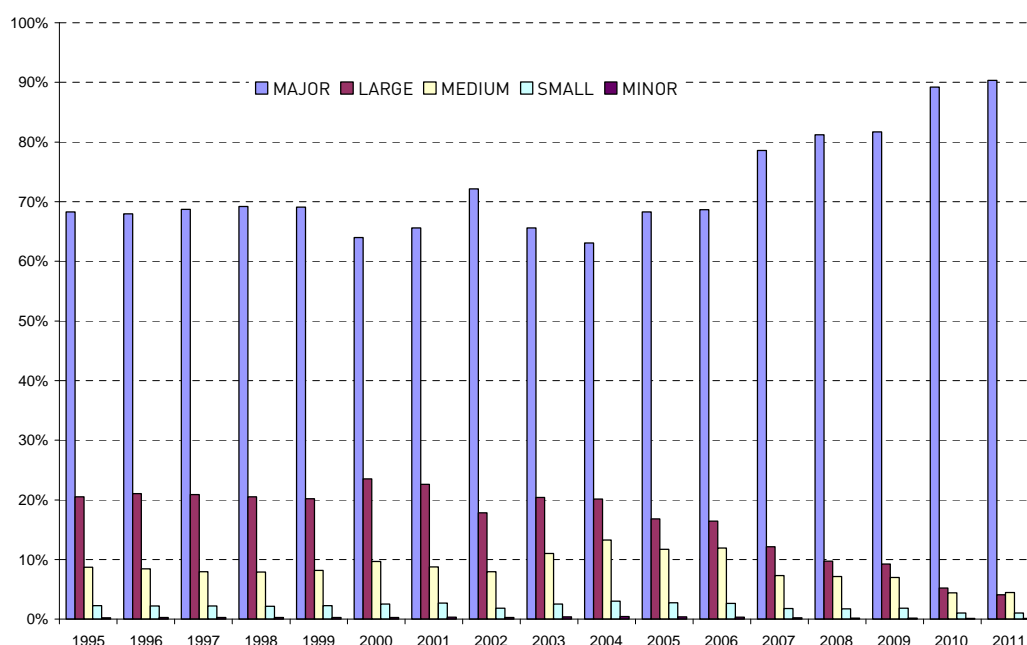
This structural change has been driven by regulatory constraints. The requirement for these new financial sources has been coupled with the need for

high liquid assets, particularly after the beginning of the crisis, and subsequent collapse of the interbank market efficiency.

11.2 The availability of funds in the money and bond markets

The first structural change over the last 15 years has been the absorption of deposits by top banks by size (according to the Bank of Italy classification, there are actually 4 banks). In 1995, their market share was about 68.3%. At the end of 2011, the market share was 90.3 (figure 11.2.).

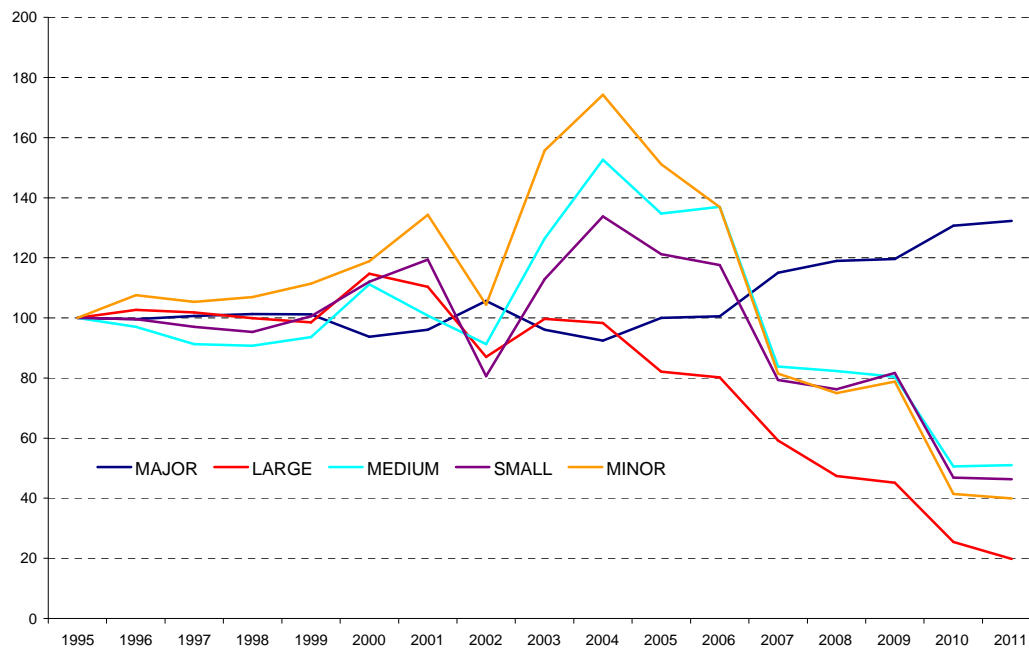
Figure 11.2. Market share of deposits by banks' size groups (1995 – 2011)



Source: Our elaboration on Bank of Italy data

This process was accompanied by the loss of market share for all the other banks, particularly large ones (figure 11.3.).

Figure 11.3. Dynamics of deposits by banks' size groups (1995 – 2011; 1995 = 100)



Source: Our elaboration on Bank of Italy

The contribution to the origination of financial funding was traditionally sustained by resident households' financial decisions. During the Eighties, the crowding out effect produced a structural change in portfolios, forcing banks to change their commercial policy, aimed at innovating the nature of liabilities.

The dramatic increase of the of the public debt (table 11.1.) and the bond debt coverage ratio which ranges from 79 to 86%, clearly explain the increasing impact of the government competition in the financial market with an impact on the capacity to finance banking firms.

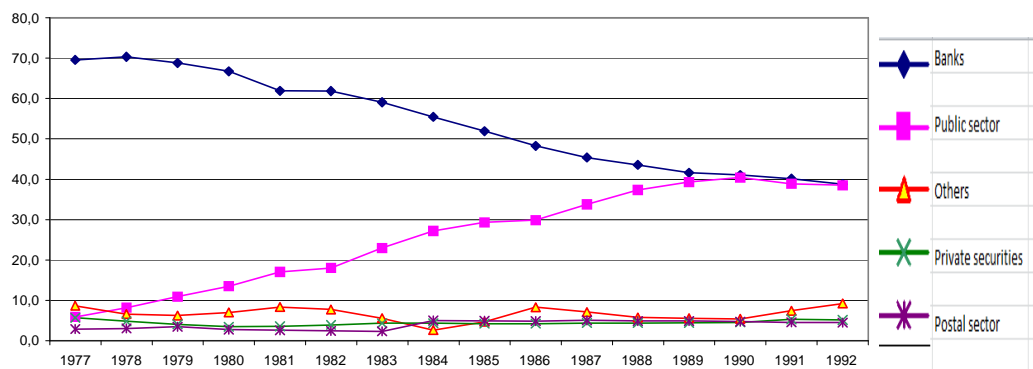
Table 11.1. Italian Sovereign Bonds and Public Debt (million euros, 1992 – 2010)

Year	Italian Sovereign Bonds	Public Administration Debt	% Public bonds to Public Administration Debt (bond debt coverage ratio)
1992	688.402	843.891	81,60%
1993	789.436	954.691	82,70%
1994	919.848	1.061.802	86,60%
1995	987.965	1.141.975	86,50%
1996	1.041.677	1.204.937	86,50%
1997	1.060.839	1.238.172	85,70%
1998	1.088.564	1.254.388	86,80%
1999	1.102.305	1.281.550	86,00%
2000	1.114.558	1.300.269	85,70%
2001	1.145.139	1.358.351	84,30%
2002	1.142.936	1.368.897	83,50%
2003	1.157.176	1.394.339	83,00%
2004	1.184.244	1.445.826	81,90%
2005	1.213.032	1.514.408	80,10%
2006	1.256.946	1.584.096	79,30%
2007	1.288.578	1.602.115	80,40%
2008	1.356.207	1.666.603	81,40%
2009	1.446.133	1.763.864	82,00%
2010	1.526.334	1.843.015	82,80%

Source: Minister of Treasury Italy

The effect for banks can be appreciated in figure 11.4. where banks deposits to total financial assets ratio collapsed from 70% (recorded in the late Seventies) to 40% (early Nineties). Symmetrically, the attractiveness of Government bonds increased from 5 to 40%. The rest of the financial investments is constantly shared among corporate bonds, the post office deposits and other minor liabilities.

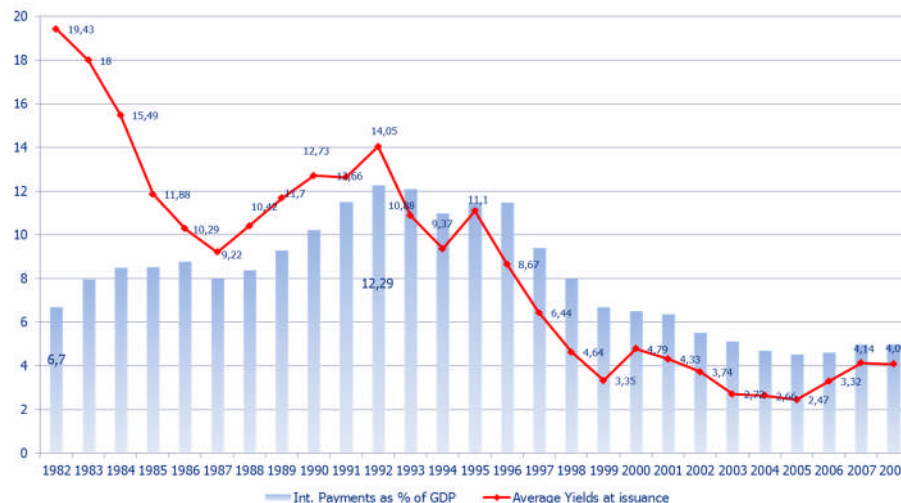
Figure 11.4. Banking disintermediation (Percentage composition financial assets; 1977 – 1992)



Source: Our elaboration on Minister of Treasury Italy data

The disintermediation process was accompanied by the increase of the interest payments to GDP ratio, which in one decade ranged from 6.7% (1982) to 12.29% (1992). This figure is partly incongruous with the declining dynamics of the average yield (from 19.43% to 14.05% in the same period), but it can be explained with the increasing issuance of public bonds (figure 11.5).

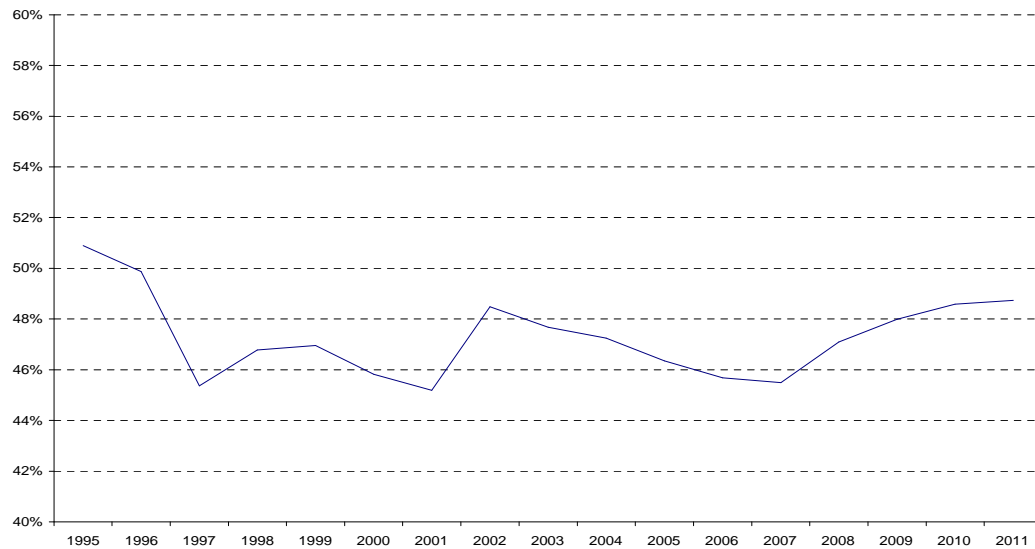
Figure 11.5. Interest Payments as % of GDP and Average Yields at issuance (1982 – 2008)



Source: Minister of Treasury Italy

The share of bank deposits to total liabilities issued by the Italian system remained stable around 48-50% from 1995 to 2011 (figure 11.6).

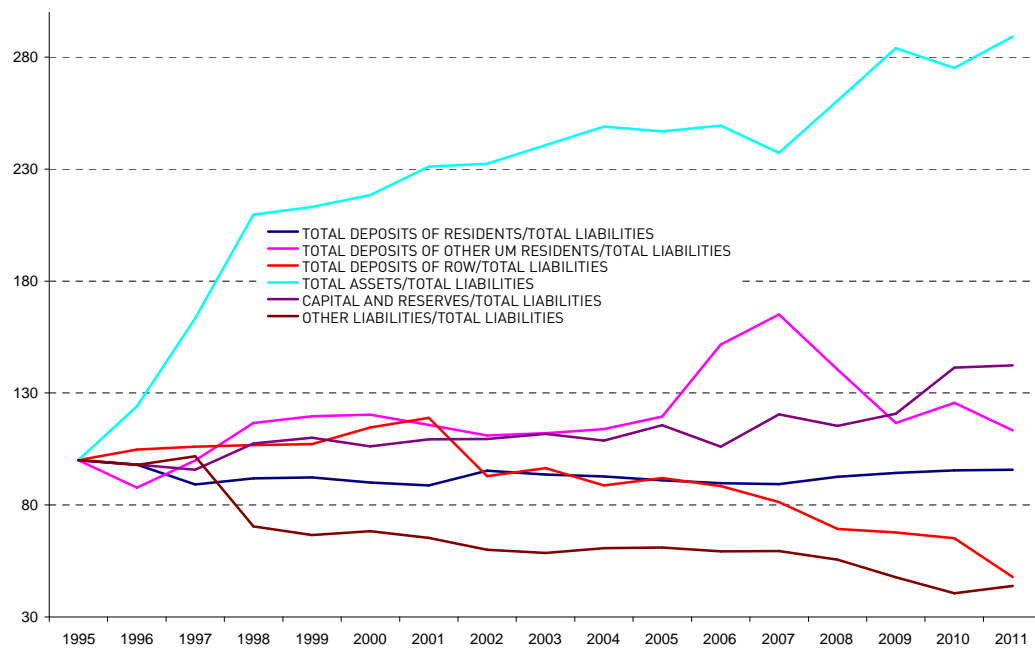
Figure 11.6. Share of deposits of domestic residents to total liabilities (1995 – 2011)



Source: Bank of Italy

The dynamics of the banking financial structure over the last 15 years can be appreciated in figure 11.7. The increasing share of bonds is explained with the relatively recent authorization given to bank to issue tradable and listed long term certificates. The second reason was the opportunity to issue subordinated bonds accepted within the regulatory capital (Tier 1 and Tier 2).

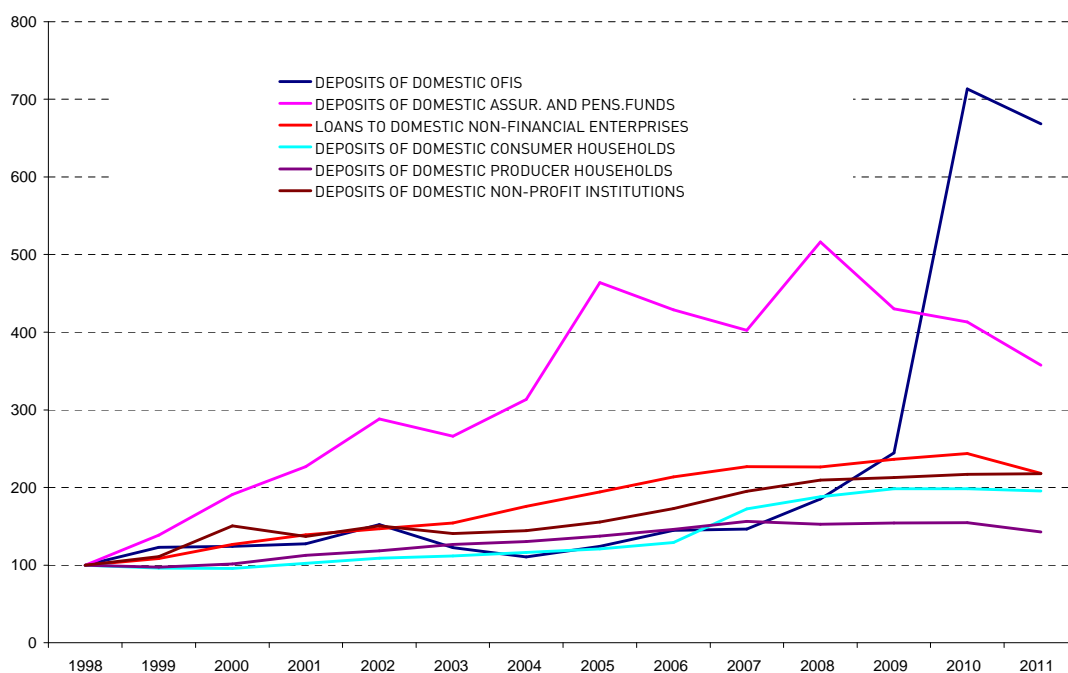
Figure 11.7. The banking financial structure change by components (1995–2011; 1995 = 100)



Source: Our elaboration on Bank of Italy data

The other source of fund which has recorded an interesting pattern are the liabilities of other euro residents (other EU residents). The introduction of the euro eased the convenience to manage Italian banks' deposits. After the beginning of the crisis the flight to quality was as strong as the previous trend. In terms of financial intermediaries, the higher increase was recorded by domestic financial institutions and domestic insurance and pension funds. Non financial companies and households recorded a slight but constant increase (figure 11.8).

Figure 11.8. Deposits of residents agents by sector of economic activity (1998–2011; 1998 = 100)



Source: Our elaboration on Bank of Italy data

The analysis of financial sources for non financial companies will be found out in chapter 13.

11.3 The availability of funds in the capital markets

In a capitalist and free market economy sources of funds for business investment and expansion depend on how strong and efficient is its financial market.

In order to analyse the role of financial markets in providing sources of funds for business investments in Italy, we must take into account three main features:

- a) the equity market is underdeveloped relative to the scale of the economy;
- b) publicly traded companies are the exception, rather than the rule;
- c) the size of Italian companies is relatively small compared to other developed markets.

These three factors can be seen as main determinants of the widespread use of bank loans as a source of external finance (together with tax incentives linked to debt and the conservative attitude of the owner/manager to maintain the control of the company). During the past thirty years, the Italian equity market experienced considerable changes in its size, composition, structure and role in the whole national economic system., thanks to the evolution of the new legislative and institutional framework and the processes of privatization and globalization of the national economy.

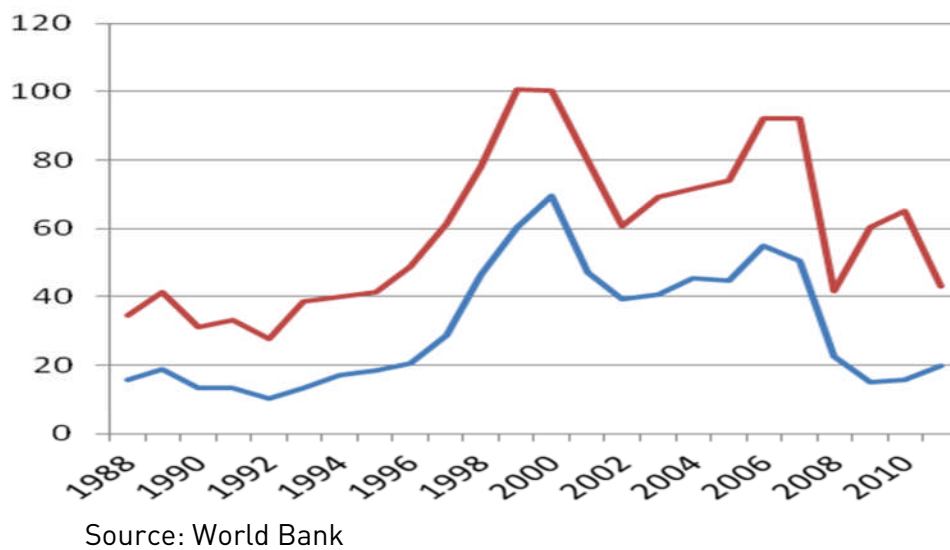
Nevertheless, from a European perspective, it still maintains a low profile: data show that during the period 1988-2011, the average weight of market capitalization on national GDP (31%) is lower of around 30% of the average EU countries (59%) (table 11.2.)

Table 11.2. Market Capitalization on GDP (%): 1988-2011

Year	Italy	European Union
1988	15.71	34.29
1989	18.89	41.25
1990	13.15	31.03
1991	13.30	33.09
1992	10.14	27.64
1993	13.27	38.63
1994	17.01	39.94
1995	18.51	41.42
1996	20.39	48.77
1997	28.75	61.29
1998	46.52	78.12
1999	60.28	100.44
2000	69.60	100.24
2001	46.93	79.95
2002	39.23	60.83
2003	40.60	69.40
2004	45.49	71.67
2005	44.68	74.09
2006	54.81	92.24
2007	50.43	92.08
2008	22.57	41.54
2009	15.03	60.24
2010	15.57	65.05
2011	19.66	43.10

Source: World Bank

Figure 11.9. Market Capitalization to GDP (%): 1988-2011. Market capitalization to GDP Italy (blue line) and average EU (red line)



Indeed, its rate of growth reached, in some years, the highest level in the world (Financial Times 1999). From 1992 up to 1999, for example, market capitalization jumped from 11.5% to 62.1% of GNP, and during 1998 the Milan Stock Exchange grew more than 40%, a rate that was twice the world and European averages (IRS 1999).

The expansion of the Italian equity market shows different features according to different economic periods. During the 1980s both national economy and stock market recorded a positive phase: starting from the mid of 1980s, the GDP growth rate was around 3% - closer to the G7 countries average -with the inflation rate going back to levels below 10%. In this period the average stock return is around 14%. Thanks to the dramatic increase of share prices, from 1982 to 1989, 125 companies were listed in the Milan Stock Exchange, with a market capitalization equal to 43% of the total market capitalization at the end of 1981 (Coltorti, 2011) . In 1986, for the first time, the number of listed companies became higher than 200 and total listed companies were 235 at the end of 1989. In 2001 the number of listed companies reached 282, also thanks

to the effect of the dot.com bubble which brought to the stock market 47 companies.

In 2000, due to the privatization process, market capitalization reached its maximum level to 70% of national GDP (Table 11.3.).

Table 11.3. Market Capitalization of Italian Stock Market (1986-2012)

Year	Market Capitalization *	% on GDP
1986	103.4	22,2
1991	99.1	13,3
2000	810.9	68,1
2001	593.9	46,2
2010	425.1	27,4
2011	332.4	21.1
2012**	327.1	21.0

*billion of Euro

**data as of June 30, 2012

Source: Consob (2012), Coltorti (2011)

The analysis of the last decade must be divided in two sub-periods: until the world financial crisis, started in 2007 we can observe an almost stable weight of market capitalization on GDP around 40-50%, which decreased to an average of 18.5% in the period 2008-2011. At the end of June 2012, the total market capitalization was equal to 327 billion of Euro, corresponding to 21% of GDP.

It is important to notice that the weight of the first thirty biggest companies represent 83% of the total market capitalization (Consob 2011), therefore confirming one of the peculiarities of Italian equity market structure compared to the one of other countries -such as Germany, France and UK – where the weight of lower size listed companies is noticeably higher.

Part II

Finance and the non-financial sector

12. Macroeconomic policy context

Giampaolo Gabbi

To find out the macroeconomic policy in Italy, the period from 1980 to the financial crisis can be conveniently divided in two phases: the first, we can call the pre-euro time, from 1980 to 1998; the second, we can call the euro time, from 1999 to 2012.

12.1 The pre-euro economic period

In 1979 the European Exchange Rate Mechanism (ERM) was introduced. The purpose was to initiate a stable monetary area within the European Community, with a final goal to reach an economic and financial integration. This period followed two decades of high growth rates, initially due to a real economy boom (Sixties), subsequently maintained with monetary and currency ease decisions. Italy was forced to follow an economic model aimed at stabilizing financial and social frictions. The impact of such a choice was dramatic reduction of growth rate (2.0% from 1979 to 1985, while the rate during the Seventies recorded 3.8%). The unemployment rate, on average 11.5%, was even higher in the Southern regions. The labour income on value added ratio declined from 0.52 (1975) to 0.41 (1997).

On the other hand, the international integration of the Italian economy process showed a continuous intensification: the import/GDP ratio changed from 12.7% (1979) to 18.1% (1997). The other positive impact of the new economic policy was the inflation rate, whose value declined from 15.3% to 4.0% (table 12.1).

This period was characterized by the abandoning of the growth oriented policy, substituted by a more liberistic policies, whose postulates were the monetary origin of the inflation and the market capability to generate the full employment.

Few considerations were made in order to calibrate this model to the Italian specificities, such as the North-South gap, the grey and black markets, the demographic and social issues. Italy followed the international community pressure to remove the obstacles to the markets efficiency.

Table 12.1. The pre-euro period. Real indicators

Items	1979-1997	1979-1985	1986-1991	1992-1997
GDP	2.0	2.0	2.9	1.3
Imports	4.5	3.0	7.2	3.2
Private Consumption	2.2	2.3	3.4	0.9
Public Consumption	1.6	2.8	2.6	-0.7
Gross Real Investments	1.5	0.9	4.1	-0.4
Exports	4.4	1.9	4.0	7.3
Employment	—	0.4	0.7	-0.1
Unemployment	—	9.0	11.5	11.1
Gross Real Investments / GDP	19.9	20.4	20.4	19.0
Unit Labor cost				
Industrial sector	5.4	11.5	4.7	0.2
Services	6.7	15.2	5.0	0.6
Imports/GDP	17.5	14.7	18.0	20.5
GDP inflation	8.7	15.3	7.0	4.0
CPI	8.6	15.1	6.2	4.7

Source: Bank of Italy

The major decisions were: labour market reform, public companies privatization, welfare system revision, introduction of supervisory bodies for markets and anti-trust authority. New acts were introduced to regulate the equity market, and financial and the banking system (see chapter 7).

During the period 1979-1985, the nominal currency rate lost, on average 3.4% yearly rate against the ECU (European Currency Unit). As shown in table 12.2., its weight within the European currency basket changed from 9.49% (1979) to 7.84% (1998).

The increasing economic integration and the expected currency stability, even

though within a corridor, enforced an equilibrium among real and monetary fundamentals of European partners. Therefore, Italian economic weaknesses became more clear, affecting both the public budget and the monetary policy (table 12.3).

The public deficit became more and more critical (ranging from 0.3 to 9.0). On the other side, a restriction for the private credit was introduced, through a credit cap, with a crowding out effect. The private credit, originated from banks increased only nominally, not in real terms.

On the asset side, monetary aggregates targets became more strategic in the early Eighties. The Bank of Italy used to introduce an inflation targeting policy adopting the broad money definition (M2), whose change rate was frequently lower than the inflation rate.

Table 12.2. National currency weights to the ECU value (% values)

Currency	13.03.1979– 16.09.1984	17.09.1984– 21.09.1989	21.09.1989– 31.12.1998
ITL	9.49	9.98	7.84
BEF	9.64	8.57	8.18
DEM	32.98	32.08	31.96
DKK	3.06	2.69	2.65
ESP	-	-	4.14
FRF	19.83	19.06	20.32
GBP	13.34	14.98	12.45
GRD	-	1.31	0.44
IEP	1.15	1.20	1.09
LUF	-	-	0.32
NLG	10.51	10.13	9.98
PTE	-	-	0.7

Source: Bank of Italy

Table 12.3. The pre-euro period. Public Finance and Monetary Policy indicators.

Items	Period	1979-1997	1979-1985	1986-1991	1992-1997
Public Deficit / GDP	Initial	-8.1	-8.1	-12.0	-10.4
	Final	-2.7	-12.4	-11.4	-2.7
Primary Savings / GDP (net interest)	Initial	0.3	0.3	1.8	4.1
	Final	9.0	0.9	4.4	9.0
Government short term rate (3 months)	Initial	13.7	13.7	11.9	14.0
	Final	6.9	13.9	12.2	6.9
Money, M2 (y/y rate)	Average	8.6	13.7	8.7	4.1
Credit from banks (y/y rate)	Average	11.4	15.4	14.3	5.8

Source: ISTAT, Bank of Italy

During the years from 1986 to 1991, the GDP growth rate appeared to be higher, primarily due to the wage agreements signed by the key agents (Government, Unions and Entrepreneurs Associations), the increasing domestic demand, and the reduction of energy costs. This expansion period ended in 1990-1991, with the increase of the foreign debt, the inflation rise and slowing of the industrial production rate. At the same time, powerful lobbies were asking the devaluation of the currency, easing a significant outflow of financial capital, helped by the liberalization of capital movements.

All these events were at the origin of the currency crisis of 1992. The attempt of the Bank of Italy to avoid the crisis pushed sovereign bond rates above 12% (with an inflation of 6.2%). The increasing of real interest rates sourced dramatic effects in terms of public deficit, a massive issuance of government liabilities and the consequent reduction of trust of their solvency.

The introduction of the European Union Treaty (generally referred to as Maastricht Treaty) signed by the Italian Parliament on 28th February 1992 can be considered as the starting point of a period characterized by structural reforms. The responsibility for the stagnation period was essentially, even without robust analysis, ascribed to the public sector inefficiencies. The consequence was a significant process of privatization of public companies (among them the largest Italian banks), accompanied with a new regulation on

former public monopolies (telecommunications, electricity, energy, highways) aimed at avoiding private abuses. Nevertheless, the technical process to privatize such companies was essentially driven by the financial pressure of the Treasury Department to transform the assets into cash. The effect in terms of corporate governance was a concentration of industrial and financial assets within few players, and not the expected origination of public companies.

A second set of economic interventions were concentrated on a huge budget cut in order to stabilize the debt curve, essentially concentrated on the tax side and the welfare reforms. The structural reduction of the public consumptions and investments can be considered the essential choice during the Nineties, with the goal to reach the Maastricht constraints (public deficit, interest rate, and inflation rate equilibriums). The lowering impact of these decisions will be appreciated more markedly during the following decade, typified by the introduction of the euro.

12.2 The euro period

The decision, taken on 3rd May 1998 by the European Union Council, to allow Italy within the first group of euro countries was taken after some economic interventions (particularly in 1996) aimed at cutting the public deficit below the target value of 3% (table 12.4). Albeit the gross debt on GDP ratio was above 110%, the trend appeared to be declining.

Interest rates, particularly those paid by long term bonds, were closed the average of the best European countries.

Table 12.4. The euro period. Public Finance and Monetary Policy indicators

Items	Period	1998-2009	1998-2001	2002-2006	2007-2009
Public Deficit / GDP	Initial	-2.9	-2.9	-2.9	-1.5
	Final	-5.3	-3.1	-3.3	-5.3
Primary Savings / GDP (net interest)	Initial	8.2	8.2	5.8	7.2
	Final	3.2	7.1	6.0	3.2
Government short term rate (3 months)	Initial	5.0	5.0	3.3	4.3
	Final	1.2	4.3	3.1	1.2
Government long term rate (10 years)	Initial	4.9	4.9	5.0	4.5
	Final	4.3	5.2	4.1	4.3
Money, M2 (y/y rate)	Average	6.9	3.2	8.1	8.8
Credit from banks (y/y rate)	Average	8.5	8.8	6.8	9.0

Source: ISTAT, European Central Bank

While Italy, in general, addressed ambitious expectations to the euro introduction, in terms of price stability, efficiency and business opportunity, policy makers and private industrial firms had to change their former policies, essentially based on the currency devaluation and the domestic demand control.

Moreover, the monetary policy was focused on the inflation stability. The inevitable trade-off with growth and employment was an obstacle to the made in Italy competitiveness and, consequently, to wages.

All the real indicators (table 12.5) show for the period a slow growth rate, even before the beginning of the financial crisis. Private consumptions have recorded a slow increasing rate (0.8%) when compared with the Seventies and Eighties (around 3%). Better performances have been shown by some industries, such as mechanics (+2.6%) energy (+2.1%) and constructions (+2.0%). The industrial sector in general was flat (+0.1%)

The good performance of the unemployment rate must be explained with a labour market reform, with the introduction of more flexible contracts, with a significant impact on job turnover and the associated statistics.

Table 12.5. The euro period. Real indicators

Items	1998-2009	1998-2001	2002-2006	2007-2009
GDP	0.6	2.3	0.9	-1.7
Imports	1.2	5.4	2.7	-5.3
Private Consumption	0.8	1.9	0.9	-0.5
Public Consumption	1.7	2.5	1.8	0.8
Gross Real Investments	0.5	4.2	1.7	-5.0
Exports	0.0	4.6	1.4	-6.7
Employment	*	1.6	1.3	-0.4
Unemployment	8.4	10.4	7.5	6.9
Gross Real Investments / GDP	20.7	20.2	21.2	20.5
Unit Labour cost				
Industrial sector	2.6	-1.0	2.2	6.3
Services	2.0	-0.6	2.3	3.7
Imports/GDP	26.6	25.2	27.1	27.6
GDP inflation	2.5	2.2	2.6	2.5
CPI	2.4	2.6	2.6	1.8

Source: ISTAT, Bank of Italy; * the series was interrupted

The policy based on the reduction of wages and salaries and the consumption affected the negative performance of the Italian macroeconomic scenario. This strategy appeared to be frustrating for an industrial system whose target was to invest in product and technology innovation.

In such an environment, the financial crisis found a weak economy, essentially depending on banking credit and on foreign markets. Even though the financial system appeared to be less sensitive to the risk factors originating the crisis (real estate and financial exposure), the impact was remarkable once the credit crunch became effective, with a collapse of the GDP, particularly the component generated by small and business firms.

13. Sources of funds for business investment

Massimo Matthias

13.1 The specificity of small and medium enterprises in Italy

Over the last decade, small and medium enterprises (SMEs) role has increased. In fact, SMEs are the 99.8% of the European enterprises and, among those, the 92% are micro-enterprises.

Besides their number, the role of SMEs appears to be decisive also regarding the contribution to growth and employment: more than 90 million Europeans work for SMEs and the 58.6% of the EU wealth depends on these enterprises. Between 2000 and 2010 SMEs shared for the 85% in the net creation of work positions in the European Union. During this period, the net employment in the free market has considerably increased, on average of 1.1 million work positions a year. Within SMEs the annual employment growth rate has been of 1%, while in the large enterprises has been of 0.5%.

The contribution to employment given by SMEs results to be higher than their contribution to the value added, especially in manufacturing activities and in those related to information and communication services; in fact, in some Member States has been observed that, due to their intrinsic features, small and medium enterprises have a quite low level of capital intensity and they do not allow to benefit from economies of scale and to adopt and/or develop innovations. As a consequence, large enterprises tend to reach higher work productivity indices than the SMEs.

Table 13.1 shows the results of an analysis of the European Commission in 2011 about SMEs and underlines the importance of these enterprises, especially those belonging to the micro segment, in the European economic context.

Table 13.1 – Small and medium enterprises in Europe (EU-27) 2008

	No. enterprises		Employees		Value added	
	(billions €)	(value %)	(billions €)	(value %)	(billions €)	(value %)
All enterprises	21.0	100	135.8	100	6.176	100
SMEs	20.9	99.8	90.6	66.7	3.617	58.6
Micro	19.3	92.0	39.3	29.0	1.348	21.8
Small	1.4	6.7	27.9	20.5	1.147	18.6
Medium	0.2	1.1	23.4	17.2	1.122	18.2
Large	0.0	0.2	45.2	33.3	2.559	41.4

Source: Eurostat

In 2008 SMEs are 20,9 millions, they nearly employ 91 million people (the 66.7% of the whole) and make 3 thousand billion euro of value added, almost 59% of the whole. Nearly all European SMEs are enterprises with less than 10 employees (more than 19 million units, which are the 92% of the whole) that employ 39.3 million people (29%) and make a value added of 1,348 billion euro (21.8%).

Compared to 2005 data, there are positive variations especially referred to the micro segment, where the number of enterprises has increased of 7.2%, the number of employees of 4.8% and the value added of 20.4%.

Although SMEs are significantly spread in all EU Member States, there are some differences among the various States (Table 13.2). Some of these differences can be explained by the importance of particular branches of the national economy or by the institutional and cultural preferences for self-employment and/or family business.

Table 13.2 – The importance of SMEs in some EU Member States

	No. enterprises (thousands)	Micro	Small	Medium	Large
		%			
EU-27	20.994	92.0	6.7	1.1	0.2
DE	1.880	83.0	14.1	2.4	0.5
ES	2.653	93.1	6.0	0.8	0.1
IT	3.947	94.3	5.1	0.5	0.1
PL	1.556	95.5	3.3	1.0	0.2
UK	1.731	89.3	8.8	1.5	0.4

Source: Eurostat

Table 13.2 shows that the importance of SMEs is particularly high in southern Member States, as Italy, Spain and Portugal, with a percentage of 99.9%; unfortunately, data for Greece are not available. The microenterprises segment is considerable in Serbia, Poland and Czech Republic: in these States we record percentages that achieve or exceed 95%. It is also remarkable the existence of small enterprises in Slovakia (24.2%), which is the country with the higher percentage of large enterprises (0.9%) but also the lowest percentage of microenterprises (71.2%). Anyway, the presence of the SMEs in the European context (EU-27) is never lower than 99%, so confirming a strong common trend of the Member States that prefer the economic activity to be carried out in form of enterprises of small dimensions.

The role of SMEs in the Italian economic context is essential: as well as representing the main industrial reality of our economy, the growth and development of the country depend on the capability of this segment to contribute to the creation of new jobs, to the development of innovations and, in general, to the economic growth (Gualandri and Venturelli, 2008).

The data contained in tables 13.3 and 13.4 confirm the relevant presence of small enterprises in the Italian economic context; for example, the last Istat data (2010) underline that microenterprises are 95,09% of Italian companies and they employ the 46.65% of workers.

Table 13.3 – Characteristics of Italian enterprises by size class (1998-2010)

Personnel class *	1998			Personnel class	2010		
	No. enterprises	Workers	Employees		No. enterprise s	Workers	Employees
				1-9	95.09%	46.65%	25.03%
1-19	98.40%	59.95%	38.77%	10-19	3.11%	10.64%	13.72%
20 - 49	1.13%	15.96%	23.75%	20 - 49	1.23%	9.57%	13.26%
50 - 249	0.40%	6.37%	9.87%	50 - 249	0.49%	12.36%	17.76%
> 250	0.07%	17.71%	27.62%	> 250	0.08%	20.78%	30.23%

* Employees and self-employees who work full-time and part-time in the enterprise. Among self-employees we have to include: owners, associates and managers of an enterprise on condition that they effectively work in the unit, that they are not enrolled in payrolls and are not paid by invoice or have an employer-coordinated freelance work contract. We consider employees (resident and not resident who work for enterprises located in the national territory) all the people enrolled in payrolls, even if responsible of the enterprise management. The employed persons are calculated in term of annual average

Source: Istat (Archivio Statistico delle Imprese Attive).

Table 13.4 – Main economic indices of Italian enterprises by size class (1998-2009)

Personnel class	1998			Personnel class	2009		
	Turnover	Investments	Value added		Turnover	Investments	Value added
				1-9	25.51%	31.04%	30.83%
1-19	42.56%	39.31%	42.98%	10-19	11.20%	10.17%	10.98%
20 - 49	19.62%	16.34%	18.78%	20 - 49	12.13%	10.77%	11.48%
50 - 249	9.57%	8.93%	8.82%	50 - 249	20.34%	13.76%	16.33%
> 250	28.26%	35.41%	29.42%	> 250	30.82%	34.26%	30.38%

Source: Istat (Archivio Statistico delle Imprese Attive)

Though the previous tables at first sight present a quite stable situation, characterized by an important and constant presence of SMEs (their percentage is never lower than 94%) in the national economic system, because of the crisis and especially since the last months of 2008, a significant downturn of the international demand was added to the strong slowdown of internal consumption.

The crisis has weakened the SMEs which do not have the same capacity of larger enterprises to recover in an economic scenario that is still problematic

and uncertain. The major criticalities remain with referral to the financial structure, that suffers a strongly decayed liquidity, to the lengthening of payment times and to a difficult access to credit.

13.2 The criticalities of SMEs: the relationships with the banking system

The economic literature has widely studied the problem of financial choices of the enterprises, trying to understand which are the elements that influence them (Tirole, 2006), but since the second half of the 90's has been affirmed that Italian capitalism has four fundamental characteristics that sometimes become impeding factors to the development and growth of the enterprises (Sarcinelli, 1996; Scanagatta, 1999):

1. a family ownership structure of enterprise, due to the influence of fiscal policies in orienting the enterprises' preferences towards one or another source of financial supply;
2. a strong predominance of banking activity in the financial system, accompanied by a limited development of the stock market;
3. the phenomenon of multiple lines of credit, especially for enterprises with smaller dimensions;
4. the inclination towards the use of short-term financial resources, with subsequent mismatch between source timing and use and fallouts in terms of financial burdens.

SMEs are characterized by an ownership structure which is mainly familiar: the percentage of firms controlled by or owned by an individual is higher than 90%. A decisive factor of this phenomenon (especially for the SMEs) is to be sought in the ancient distrust that the owner-businessman has towards some operations, such as the stock issue, that are perceived like a weakening of the control power upon the enterprise or like choices that impose too many severe duties of transparency. In the past this trend has been fostered also by tax politics of

the business incomes that were traditionally favourable to who resorted to the banking debt instead of the risk capital.

SMEs are characterized by the limited presence of internal financial systems and processes, so that they hardly have a complete budgeting process, coordinated with a control system on deviations. These internal processes within the enterprises are formalized when they happen to be strictly essential for the business activity (Perini and Piol, 2005); all that is inevitably reflected on the financial structure of the enterprises. The development of a governance which is adequate to the modern economy and the modern market, as well as a relationship between an enterprise structure more open to associates and external managers or to self-employed directors, can contribute to obtain a better and more efficient financial structure.

A relationship has been empirically found between capitalization, financial burdens and financial structure: the higher is the capitalization the more balanced is the relationship between the terms of assets and liabilities, with subsequent lower recourse to the personal assets of the businessman to support the debt of the enterprise. Therefore, it is a necessity to make the small and medium enterprises evolve towards more sophisticated control and governance structures (Giordano, 2005).

The traditional financing channels of enterprises' activities are divided into two large categories: internal and external. The former constitutes the so called self-funding, an extremely ephemeral source over time because it is based on retained earnings; they tend to "swell" during the expansion phase of the economic cycle and, on the contrary, to deteriorate when the trend reverses. On the other hand, the external sources are in turn divided in risk capital (equity) and capital of debts.

The Italian financial system is characterized by the centrality of the banking intermediation as well as the financing model of the enterprises and the choices of saving allocation of the families. According to various surveys

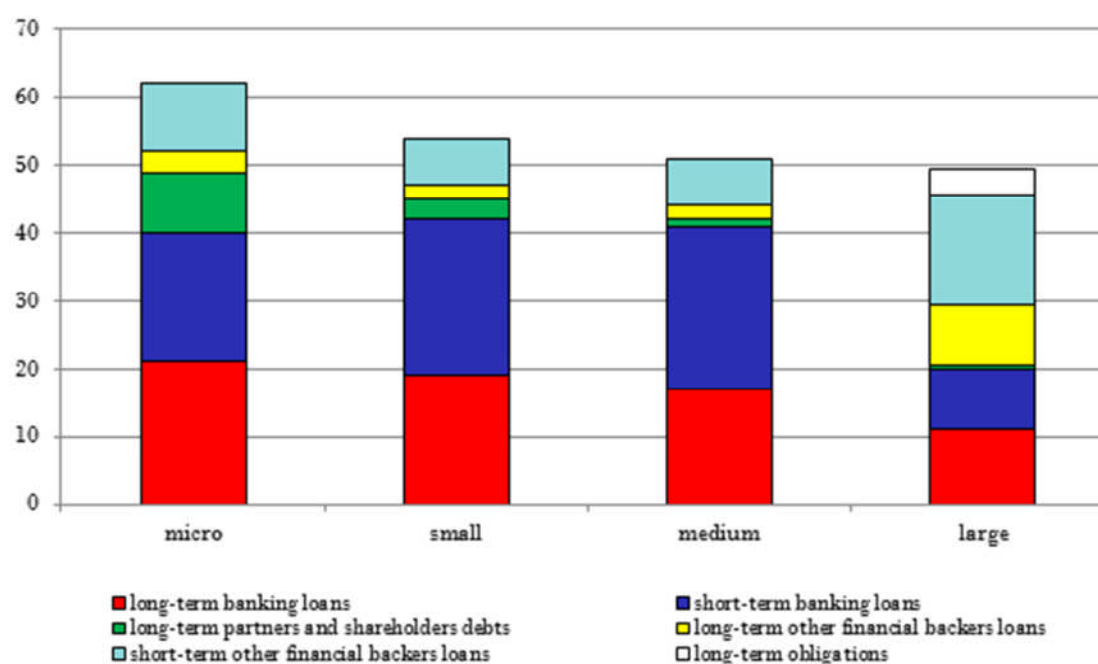
conducted by Banca d'Italia and European Central Bank, the financial structure of Italian SMEs is mainly bank-oriented and in a more relevant way compared to the other European countries. From the data referring to the first years of 2000 (ECB, 2003) it appears that the quotas of banking loans upon the whole debts taken out by SMEs is equal to the 66.4% in Italy against the 65.5% of Spain, the 56.4% of Germany, the 54.9% of The Netherlands and the 48.8% of France. Over the time the recourse to banking loans by Italian SMEs has increased compared to the other European countries: observing the 2010 data, it is notable that it reached the 73,30% while in the other European States such as Spain, France and Portugal the percentages respectively reached the 66.9%, 63.1% and 60.8%. To a financial system mainly based on bank loans, corresponds a scarcely developed capital market. The stock market generally constitutes an option for the large enterprises and in the last decade it has been downsized even more because of short-term adverse trends.

Many works examine two issues concerning, on one hand, the relationship between the development of stock markets and economic growth (finance and growth) and, on the other hand, the comparison of financial structures, which means bank-centred systems and market systems (financial structure and growth). About the first issue, the empiric facts that were widely collected (King and Levine, 1993; Levine 2005; Beck, Levine and Loayza, 2000) allows to consider as proved the existence of a positive relationship between liquid stock markets and growth. Concerning the second issue the most recent surveys (Rajan and Zingales, 2001; Lin and Li, 2001; Cetorelli and Gambera, 2001) show how the most developed financial systems have the tendency to part from the bank-centred structure.

Despite the last considerations, observing the national data one can infer that the main amount of financial debts for the enterprises continues to be represented by the banking loans (Figure 13.1). In the large enterprises the sector constituted by loans different from bank loans or obligations results to

be high: they are mainly intra-group debts towards those companies that carry out the activity of collecting and managing funds for all the affiliates. Furthermore, it can be noted that as the dimensions of the enterprise increase, the weight of short-term banking loans reduces.

Figure 13.1. Composition of Italian enterprises financial loans (% , 2009)



Source: Bank of Italy, Cerved, 2010.

The strong dependence on banking loans as primary source of external financing represents for the enterprises a factor of weakness and a clamp on development potentialities, especially in critical economic conditions such as the current one. The diminution of enterprises' productivity and turnover, as it happened in the last years, exposes them to a consequent worsening of the rating, that will inevitably be reflected on the politics of credit granting and cost, making the process of financialization of smaller enterprises less sustainable. In a survey conducted by the European Commission (2007) the criticality of the multiple lines of credit affecting the relationship between small dimension enterprises and banks can be appreciated. Among the EU Member States, Italy

shows the highest percentage of enterprises supplied by two or more banks (51%, while the average of EU is 35% and higher than the 45% of Austria and Portugal that would be at the second place of a hypothetic descending list). At the basis of this phenomenon there is a relationship between banks who grant the loans and SMEs, even if it is less evident compared to the end of the 90's, based in a culture of "spontaneous relationship" and not a market one. The small enterprise tried, on one hand, to preserve the consolidated personal relationships with a small number of banks, often located in the territory where the enterprise operates, and, on the other hand, to take advantage of the multiple lines of credit in terms of resource pegging and financial burden containing (De Laurentis, 1994, Ruozi, 2002). The growth of credit relationships allowed, in the past and to weak enterprises in reference to the financial merit and profitability, to diminish the possibilities of credit rationing. Tirri (2007) underlines how multiple lines of credit is positively related to the degree of concentration of local credit institutes: the higher is the number of available banks in the area of the enterprise activity the lower is the probability that they refer to a single credit institute. A survey conducted by Banca d'Italia (Bentivogli, Cocuzza, Fogli e Iannotti, 2007) points out the trend to the reduction of this phenomenon even if on a territorial level a big part of small enterprises, especially located in southern Italy, still tends to increase the number of financing banks and/or to change their main bank. From the research emerges a trend for SMEs to prefer entertaining relationships with a main bank with a quota of overall debts which is on average 57%. This recent trend may be partially due to the removal of overdraft commission fee replaced by the commission on credit line. As is known, the former incentivized the enterprises to refer to many banks in order to not record negative amounts on the loans granted to them and, subsequently, to not incur in the payment of the commission.

In the final remarks to the Banca d'Italia Annual Report 2010, the Governor Mario Draghi wrote that "Italian enterprises have on average less assets compared to the other advanced countries; the differentiation of financing sources is scarce, they mainly come from banks, and the weight of short-term loans is high". On the same topic his successor, Ignazio Visco, affirmed that "in Italy the 38% of loans granted to enterprises has a duration not longer than 12 months; the quota is of 18% in Germany and France, of 24% on the average of Euro zone. The great dependence from short-term loans exposes the Italian enterprises to higher risks of refinancing, it reduces the time horizon of investments. In our country, more than the half of short-term loans is constituted by credit line on current account".

The risk is that a financial structure with a high component of short-term loans entails the financing of long-term investments through short-term sources – renewed by banks several times – with the consequent incidence of higher financial burdens and an exposition to interest rate unpredictability. While larger enterprises have more choices concerning the channels of financing, SMEs tend to use more frequently short-term loans; this probably derives from a sort of "weak rationing" of loans by the banks more than from SMEs' will. Credit institutes seem to prefer containing the risk by mainly granting short-term solutions (Bianchi, 1993; Chiesa, Palmucci e Pirocchi, 2009). Usually, this kind of financing, mostly granted by commercial banks, is actually converted in long-term through the renewal of the granted loans (Modina, 2010).

With reference to bank loans, table 13.5. shows the preferences of Italian enterprises concerning loan terms.

Table 13.5 – Composition of credit for cash granted and used by term.

Producing families				
	Short-term/ Tot. Granted	Short-term/ Tot. used	Medium-long term/ Tot. granted	Medium-long term/Tot. used
1998	48.9%	37.1%	51.1%	62.9%
1999	44.4%	32.7%	55.6%	67.3%
2000	42.2%	31.3%	57.8%	68.7%
2001	40.8%	29.6%	59.2%	70.4%
2002	38.4%	27.6%	61.6%	72.4%
2003	35.3%	24.6%	64.7%	75.4%
2004	32.5%	22.1%	67.5%	77.9%
2005	31.5%	21.0%	68.5%	79.0%
2006	29.8%	19.7%	70.2%	80.3%
2007	28.5%	19.0%	71.5%	81.0%
2008	28.8%	19.7%	71.2%	80.3%
2009	30.1%	20.6%	69.9%	79.4%
2010	28.0%	19.4%	72.0%	80.6%
2011	27.8%	19.3%	72.2%	80.7%
Non-financial small corporations				
	Short-term/ Tot. Granted	Short-term/ Tot. used	Medium-long term/ Tot. granted	Medium-long term/Tot. used
1998	60.4%	48.8%	39.6%	51.2%
1999	58.0%	45.3%	42.0%	54.7%
2000	57.0%	44.8%	43.0%	55.2%
2001	55.7%	43.5%	44.3%	56.5%
2002	54.1%	42.1%	45.9%	57.9%
2003	51.7%	39.6%	48.3%	60.4%
2004	49.6%	37.4%	50.4%	62.6%
2005	49.5%	36.4%	50.5%	63.6%
2006	48.4%	35.4%	51.6%	64.6%
2007	46.9%	34.3%	53.1%	65.7%
2008	46.5%	34.6%	53.5%	65.4%
2009	45.9%	33.2%	54.1%	66.8%
2010	44.3%	32.2%	55.7%	67.8%
2011	44.4%	32.5%	55.6%	67.5%
Non-financial medium/large corporations				
	Short-term/ Tot. Granted	Short-term/ Tot. used	Medium-long term/ Tot. granted	Medium-long term/Tot. used
1998	54.6%	42.1%	45.4%	57.9%
1999	53.0%	39.0%	47.0%	61.0%
2000	49.7%	37.4%	50.3%	62.6%
2001	48.4%	36.4%	51.6%	63.6%
2002	47.3%	35.3%	52.7%	64.7%
2003	46.1%	33.8%	53.9%	66.2%
2004	44.8%	32.7%	55.2%	67.3%
2005	45.5%	32.5%	54.5%	67.5%
2006	44.9%	32.2%	55.1%	67.8%
2007	43.2%	30.6%	56.8%	69.4%
2008	42.0%	30.6%	58.0%	69.4%
2009	41.1%	28.7%	58.9%	71.3%
2010	40.5%	28.5%	59.5%	71.5%
2011	40.8%	29.5%	59.2%	70.5%

Source: Bank of Italy

Bank credits to Italian enterprises are mainly represented by medium/long-term loan, although the percentage of short-term loan is significant. Specifically, the producing families witnessed a structural change in their financial situation: from 1998 to today the short-term loan is diminished from 48.9% to 27.8% with reference to the whole credit granted and from 37.1% to 19.3% with reference to the whole credit really used. In 2009, to face the scarce liquidity due to the current crisis, has been observed a growth of short-term loan granted of 8.0% and of the credit used of 7.4% compared to 2008, in fact has been recorded a reduction of medium/long-term credit.

The same can be said about non-financial small enterprises: has been recorded a gradual decrease of the utilization of short-term credit, from 48.8% in 1998 to 32.5% of 2011. It is of paramount importance to underline that the short-term factor is still very significant: the relationship between short-term credit and the whole credit granted is equal to 44.4%; this because until the early 2000 the larger part of credit granted was represented by loans expiring in less than 12 months (short-term/total granted equal to 60.4% in 1998 and to 49.6% in 2004).

The data highlight that the non-financial medium/large corporations base their financial structure on medium/long-term loans, with a usage percentage in 2011 equal to 70.5% against a percentage of 57.9% in 1998. Therefore, also for the latter category of enterprises there has been a progressive decrease of the utilization of short-term credit in favour of medium/long-term credit.

The switch towards loans with longer terms is due, among other reasons, to the increase of interest rates applied on short-term loans and to the introduction of the commission on credit line instead of the overdraft commission fee. The latter was applied from the banks to the maximum registered overdraft; subsequently, the enterprises were used to apply for a credit amount that was higher than what they really needed (and used). In this way, the allocation of financial resources of the banks wasn't efficient. The commission on credit line

is applied, instead, to the amount of credit granted, incentivizing the enterprises to apply for financial sources that are coherent to the real short-term needs.

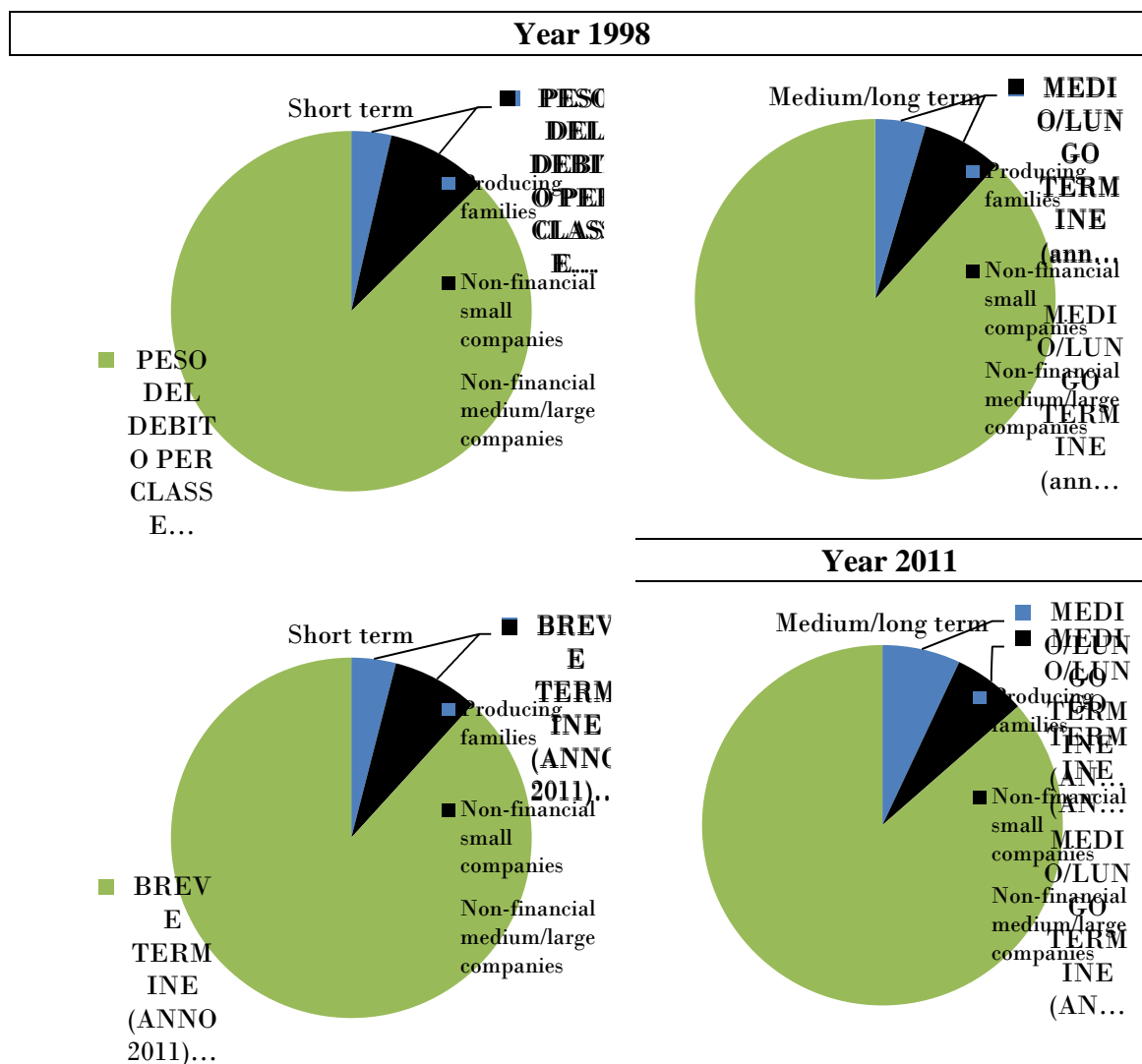
Despite all this, for all the categories of enterprises the credit levels with term shorter than one year are still high (between 20% and 30%): this financial structure expose the enterprises to the unpredictability of short-term rates and to the fluctuations of the economic cycle. Quite often the banks simply assure the continuity in the course of time of the financial support to the ordinary management; small is the contribution to the growth process that should be helped by extraordinary financial interventions and by granting medium/long-term credit (Vegas, 2011).

After having observed the main criticality existing in the relationship between banks and SMEs – remaining in the topic of enterprises financing – in the following paragraph we will examine the issue of the quality and amount of the credit granted, analysing, in particular, the difficulties encountered by SMEs in the repayment of credits.

For the SMEs, and more generally, for all the enterprises, can exist, in relation to the credit granted, both a problem of quantity – measured in terms of amount (and rationing) – and of quality, measured in relation to its heaviness (rates paid by the clients) and to its risk.

In relation to the amount of credit, by a compared analysis from 1998 to 2011, it is possible to affirm that there have not been structural changes in the repartition of the credit supply from the banking system relatively to the dimensional class of enterprises. From figure 13.2 it emerges that both for short-term credit and for medium/long-term credit the higher percentage of credit has been supplied to non-financing medium/large corporations. Furthermore, in favour of producing families (proxy microenterprises) has been registered an increase of 2.46 percentage points of medium/long-term credit with relation to the whole credit supplied.

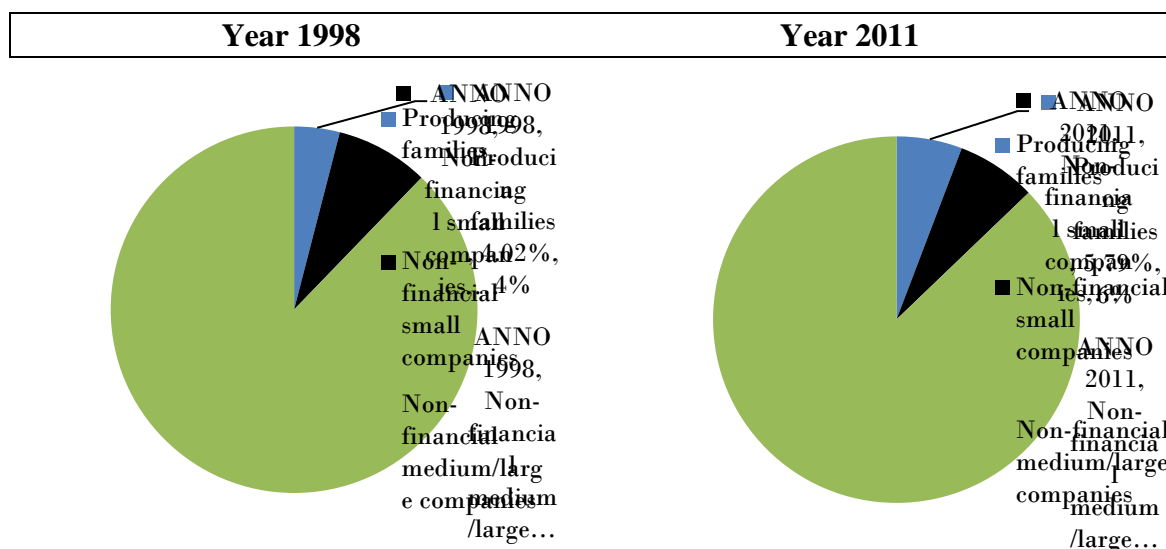
Figure 13.2 – Bank credit by size and maturity (1988 and 2011)



Source: Bank of Italy

If we consider the total amount of credit granted, independent from the term, it can be noted that over the time (1998-2011) the percentage of credit granted to non-financial small and medium/large enterprises has diminished in relation to the whole of the 1,77%. On the other hand, in 2011 the producing families record a percentage of credit in relation to the whole granted higher than in 1998 (from 4,02% to 5,79%) (figure 13.3).

Figure 13.3 – Banking credit by size class of enterprise (1998 - 2011)



Source: Bank of Italy

Remaining on the topic of the amount of the credit supplied by the banks, one of the most popular indicators is the relation between used and granted credit: although it actually gives information on the liquidity availability for the enterprises, it also can be interpreted, in general terms, as a credit rationing indicator. Some studies (Busetta and Sacco, 2001) affirm that one can talk about credit rationing when the enterprises use a high quota (near to the maximum limit) of the credit that have been granted to them, that is when the ratio tends to one. The checks of the hypothesis of credit rationing concerning Italy are relatively few and for the biggest part they follow the same methodology used by Fazzari, Hubbard and Petersen (1988). The researches on the early '90s (Galeotti, Schiantarelli and Jarmillo 1991; Bagella, Becchetti and Caggese 1996) confirm a significant role of self-funding on investment both in SMEs and in large enterprises, though the coefficient for the former results to be higher.

Moreover, the authors assert that the enterprises that declare to be subjected to rationing are those who present the highest coefficients in the relation between self-funding and investments (SMEs).

However, using a different methodology, another research (Guiso 1998), whose object was the specification of the characteristics of the enterprises subjected to rationing phenomena, showed that the enterprise dimension doesn't allow to predict the existence of difficulties to obtain credit and, furthermore, small private enterprises show a lower probability to be rationed.

Other studies (Focarelli, Panetta and Salleo, 1999) point out how banks that are interested by mergers and takeovers reduce their lending activity to SMEs. Similarly, Bonaccorsi di Patti and Gobbi (2001) underline how to merging operations in the banking sector follow, in the short-term, a contraction of credit for all the debt classes (though it is stronger for SMEs) and an increase of the sufferings.

Table 13.6 explains the relationship between the amount of credit granted by banks and the amount of credit used by enterprises (cash loans and endorsement loans) as well as the variations of annual percentages relating to the two amounts in order to check the existence or not of a credit rationing damaging the producing families and/or non-financial small and medium/large corporations.

Table 13.6 – Amount of credit (cash loans and endorsement loans) granted and used by term

PRODUCING FAMILIES									
Cash loans									
Short term				Medium/long term			Endorsement loans		
	Used/ granted	Variation % granted	Variation % used	Used/ granted	Variation % granted	Variation % used	Used/ granted	Variation % granted	Variation % used
1998	61.7%			100.0%			94.1%		
1999	59.8%	7.5	4.2	98.5%	28.7	26.7	92.4%	15.5	13.4
2000	60.9%	8.2	10.1	97.6%	18.1	17.1	92.3%	7.7	7.5
2001	59.5%	4.7	2.3	97.4%	11.2	10.9	90.2%	13.3	10.7
2002	59.9%	6.4	7.0	97.9%	17.4	18.0	93.8%	3.3	7.5
2003	58.5%	2.9	0.6	97.7%	17.8	17.6	88.9%	4.7	-0.8
2004	57.3%	4.1	2.0	97.2%	17.9	17.3	91.2%	-8.6	-6.3
2005	56.6%	7.9	6.5	98.1%	12.8	13.8	89.0%	-1.8	-4.1
2006	56.5%	6.7	6.5	97.8%	15.4	15.0	88.8%	5.4	5.0
2007	57.1%	6.4	7.6	97.5%	13.5	13.1	85.1%	10.3	5.8
2008	59.2%	-0.2	3.4	97.7%	-1.7	-1.5	86.7%	-4.5	-2.8
2009	58.9%	8.0	7.4	97.8%	1.8	1.9	86.5%	-6.3	-6.5
2010	60.7%	-3.6	-0.6	98.3%	6.4	6.9	87.7%	-2.7	-1.3
2011	61.5%	-6.4	-5.1	99.2%	-5.4	-4.5	88.7%	-3.8	-2.7
NON-FINANCIAL SMALL COMPANIES									
Cash loans									
Short term				Medium/long term			Endorsement loans		
	Used/ granted	Variation % granted	Variation % used	Used/ granted	Variation % granted	Variation % used	Used/ granted	Variation % granted	Variation % used
1998	59.6%			95.1%			89.3%		
1999	56.9%	5.3	0.7	94.9%	16.5	16.3	92.6%	23.0	27.5
2000	57.7%	6.7	8.2	94.0%	11.0	10.0	89.4%	-5.2	-8.4
2001	57.4%	2.9	2.3	93.8%	8.3	8.1	88.6%	2.8	1.9
2002	57.1%	4.7	4.2	92.5%	12.0	10.4	88.6%	0.9	0.9
2003	56.7%	2.0	1.3	92.8%	11.9	12.3	87.5%	4.7	3.5
2004	55.7%	0.7	-1.0	91.8%	9.9	8.7	87.8%	5.2	5.5
2005	54.4%	5.5	3.0	93.2%	5.7	7.2	82.9%	9.3	3.2
2006	54.4%	4.8	4.7	93.0%	9.6	9.3	82.8%	6.8	6.6
2007	54.8%	4.4	5.2	92.5%	11.1	10.5	82.1%	4.8	4.0
2008	56.9%	0.2	4.2	93.7%	1.7	3.0	80.8%	-5.8	-7.4
2009	55.5%	0.2	-2.3	94.7%	2.5	3.6	79.3%	-6.9	-8.7
2010	57.2%	-6.1	-3.2	96.0%	0.2	1.5	79.0%	-5.6	-6.0
2011	58.4%	-6.2	-4.3	96.7%	-6.4	-5.7	80.2%	-7.0	-5.5
NON-FINANCIAL SMALL COMPANIES									
Cash loans									
Short term				Medium/long term			Endorsement loans		
	Used/ granted	Variation % granted	Variation % used	Used/ granted	Variation % granted	Variation % used	Used/ granted	Variation % granted	Variation % used
1998	48.2%			79.6%			79.2%		
1999	45.0%	5.7	-1.2	79.5%	12.3	12.1	78.0%	10.8	9.2
2000	47.6%	7.3	13.3	78.5%	22.7	21.1	82.1%	17.5	23.7
2001	49.0%	3.6	6.6	80.1%	9.1	11.4	81.0%	-9.7	-10.9
2002	47.6%	3.7	0.7	78.3%	8.1	5.6	79.3%	4.5	2.3
2003	47.0%	3.2	1.8	78.7%	8.5	9.0	78.9%	0.1	-0.5
2004	45.2%	3.7	-0.2	75.7%	9.2	4.9	74.9%	5.5	0.2
2005	43.6%	9.3	5.5	75.5%	6.5	6.3	73.4%	11.0	8.8
2006	44.1%	10.6	11.9	75.7%	13.0	13.4	71.3%	13.0	9.8
2007	44.4%	7.6	8.2	76.7%	15.2	16.6	70.6%	16.3	15.1
2008	47.8%	-0.3	7.3	78.5%	4.8	7.3	69.3%	5.1	3.1
2009	45.7%	-5.9	-10.0	79.1%	-2.3	-1.5	68.3%	-2.9	-4.3
2010	46.7%	-3.1	-1.1	79.8%	-0.7	0.3	67.8%	2.9	2.1
2011	49.4%	-2.9	2.8	81.6%	-4.2	-2.0	66.4%	0.9	-1.2

Source: Bank of Italy

Data related to the credit used show that:

1. Concerning the short-term credit, producing families use on average 60% of the credit granted to them from banks. On 13 annual variations that have been examined, only in 2008, 2010 and 2011 we can notice negative variations in terms of loans granted compared to the previous years (respectively -0.2%, -3.6% and -6.4%), while positive variations even reach the 8 percentage points (8.2% in 2000). Also the portion of credit used shows a negative yearly variation in the two last years that of the analysis (2010 and 2011) whilst in 2000 the highest positive variation (10.1%) can be observed.

2. Concerning the medium/long term, in 1998 producing families used all the credit granted to them (100%) and, though in some years we can notice a drop of some percentage point, lately the ratio reaches high levels, close to 100%. In 2008 and 2011 we observe two annual negative variation both in terms of credit granted and used, respectively -5.4% and -4.5%. Until 2007, however, variations of credit of both categories recorded two-digit levels, reaching in 1998 the 28.7% of granted and 26.7% of used.

When the dimension of the enterprise increases we note that:

1. relating to the short-term the relation between used and granted tends to decrease: in the considered span of time it was under the 60% for non-financial small companies and under 50% for medium/large companies.

Shifting the attention from the relations to the annual percentage variations it emerges that:

a. for non-financial small companies in 2010 and 2011 there are negative variations, respectively of 6.1% and 6.2% of the amount of credit granted by the bank, while in 2004, 2009, 2010 and 2011 we record negative variations respectively of 1.0%, of 2.3%, 3.2% and 4.3%, of the amount of credit used by the enterprise;

b. for non-financial medium/large companies there is to underline the negative variation of 10% relating to the credit used in 2009 compared to the

previous year. Negative variations of credit granted are registered on in the period 2008-2011.

2. relating to medium/long-term credit:

a. for non-financial small companies we observe a relation between credit used and granted that reaches considerable level, near to 100%, with a progressive increase in the last years. Only in 2011 we record negative variations of credit granted (-6.4%) and credit used (-5.7%) while in the other years that were analyzed we observe positive two-digits variations for both categories of credit;

b. for non-financial medium/large companies the used/granted credit relationship has reached the highest level (81.6%) in 2011, while in 1998 was equal to 79.6%. Relatively to the annual variation, it is possible to extend the same consideration made for the other dimensional classes of enterprise: we observe negative variations in 2009, 2010 and 2011 and positive ones, even two-digits, for the other years (22.7% for the credit granted and 21,1 for the credit used).

Data related to credit granted show that in the period 1998 -2011 producing families (which can be considered as a proxy for microenterprises) have witnessed the largest increase in the amount of credit granted , compared to the other categories of enterprises, especially for the medium/long-term segment. In 2009 – while the non-financial small and medium/large companies recorded a decrease of the amount of credit granted compared to the previous year – producing families recorded an increase of 4% (+8% for short-term loans and +1.8% for medium/long-term loans) of the credit granted to them.

In terms of consistencies, comparing the amount of credit granted, independently from the term, in 2008 (when we observed the first consequences of the crisis) with the amount granted in 2011, we note that:

- a.* non-financial medium/large companies recorded a drop of 8.9%;
- b.* non-financial small companies observed a drop equal to 7.5%;

c. producing families showed an increase of 1%.

Finally, data related to endorsement loans show that as the size of the enterprise increases, the relationship between credit used and granted decreases; the percentages for 1998 and 2011 are respectively:

a. 94.1% and 88.7% for the producing families;

b. 89.3% and 80.2% for the non-financial small companies;

c. 79.2% and 66.4% for the non-financial medium/large companies.

The variation rates both in terms of credit granted and credit used result to be negative in the last years for all the dimensional classes of enterprises.

14. Involvement of financial sector in restructuring non-financial companies

Costanza Consolandi

In 2009 a survey conducted by Mergermarket among 53 senior Italian corporate executives who have either undergone an IPO on the Borsa Italiana in the past two years, or are considering a listing in the future reported that 51% of respondents believe that one of the benefits of listing as opposed to raising capital through private equity or other such means is that it allows for a larger market of investors/more efficient access to capital (27% of respondents also consider that going public allows for greater corporate visibility and, similarly, 22% believe it allows for better transparency/corporate governance. Only 8% are unsure that going public confers any advantages over seeking private funding).

Nonetheless, it is widely acknowledged the importance of equity, compared with debt, as an external source of finance, especially in the case of innovative firms, on the basis of both agency theory (Jensen and Meckling, 1976) and control rights (Aghion and Bolton, 1992).

Once we consider the high proportion of SMEs within the Italian industrial economy, equity capital as a source of external finance, become even more critical.

The theoretical literature states that small companies, given their higher asymmetric information problems, which strongly affect their relationship with external financiers and the shape and nature of contracts, might find it more difficult to collect external funds. When they need them, due to their information problems, on the basis of the Pecking Order Theory, bank loans are the most frequent choice (Myers and Majluf, 1984).

The recent birth, in March 2012, of AIM Italia – Alternative Capital Market, the market of Borsa Italiana devoted to the Italian small and medium enterprises with high growth potential, might be considered an important step through the

increase of equity capital funding by Italian companies, as it should ensure the leveraging of the experience of the British AIM and the specific needs of Italian entrepreneurial system on the other side.

This is particularly true if we look at the number of IPOs in the Italian market, as we can observe that at the end of September 2012, out of the 7 companies who have undergone an IPO, 6 of them have done it on the alternative market, thanks to the less expensive, faster and more flexible procedure of listing.

The traditional source of external equity funds for business investment is private equity.

The private equity and venture capital market in Italy is relatively young in relation to powerhouses such as the U.K. or United States; having just instituted the Italian Private Equity and Venture Capital Association, known as AIFI, in 1986 . Until mid 1996 only a limited number of professional investors played a role in the equity capital market, whilst between 1997 and 2001 we can observe a strong development in the private equity sector, thanks to the diffusion of ITC technologies which attracted significant amounts of financial resources , determining the entrance of new investors.

Latest official data show that SGR (the SGR is the management company authorized by Italian Law to manage closed-end funds) and others, different from generalist SGR, specifically focused on Italy (country funds) represented 52% of the total number of players, while pan-European funds² accounted for 25% and regional and public investors for 10% (AIFI, 2009).

Statistically compared to other countries in Europe, Italy's private equity market is fairly weak. In 2007 the European Private Equity and Venture Capital Association (EVCA) ranked Italy 17th in Europe based on private equity as percentage of gross domestic product. Only reaching a mere 0.2% whereas the U.K.'s was 1.03 and Europe's average was at 0.57 (EVCA, 2007).

Focusing our analysis to venture capital investments, in the period 1994-2011 they registered – on an aggregate basis- a significant increase, from 26 million

€ in 1994 to 756 million € in 2011, with a compounded annual growth rate of 22%., average yearly investments for 675 million € and a standard deviation of 390 (table 14.1.).

Table 14.1. Venture Capital Investments in Italy (1994-2011)

Year	Invested amount (€ mln)		Invested amount (%)		Number of Investments		Average Investments (€ mln)	
	early stage	expansion	early stage	expansion	early stage	expansion	early stage	expansion
1994	8	18	31%	69%	n.a	n.a	n.a	n.a
1995	18	40	31%	69%	n.a	n.a	n.a	n.a
1996	52	123	30%	70%	n.a	n.a	n.a	n.a
1997	72	156	32%	68%	93	82	0.8	1.9
1998	109	300	27%	73%	94	92	1.2	3.3
1999	147	361	29%	71%	153	124	1.0	2.9
2000	540	966	36%	64%	339	235	1.6	4.1
2001	291	745	28%	72%	222	186	1.3	4.0
2002	66	806	8%	92%	49	745	1.3	1.1
2003	59	583	9%	91%	65	137	0.9	4.3
2004	23	458	5%	95%	50	126	0.5	3.6
2005	30	413	7%	93%	56	135	0.5	3.1
2006	28	1094	2%	98%	62	105	0.5	10.4
2007	66	786	8%	92%	88	102	0.8	7.7
2008	115	796	13%	87%	88	133	1.3	6.0
2009	98	371	21%	79%	79	112	1.2	3.3
2010	89	583	13%	87%	106	109	0.8	5.3
2011	82	674	11%	89%	106	139	0.8	4.8

Source: AIFI

Nonetheless, the investments' trend is not constant, as a consequence of the speculative bubble of 2000, when the amount invested reached the peak of 1,506 billion € (with an increase of almost 170% on 1999). In the following years the level of investments decreased until 2006, when the amount reached a level similar to the one of 1997.

A separate analysis of the data referred to early-stage and expansion investments, reveals that the latter are predominant, with an average share of invested amount higher than 80% over the total amount of venture capital investments. The weight of expansion investments is not constant over the period, especially after the dot.com bubble, when investment in seed financing and start up financing (mainly linked to new economy) strongly decreased to 2% in 2006.

In the most recent years, after a 2008 characterized by a considerable level of amounts and deals, the international financial crisis affected also the Italian private equity and venture capital market, that in 2009 experienced a slowdown. In particular, the investment activity in venture capital decreased in 2009 of 57% in comparison with 2008, when the amount invested was equal to 911 million €. In the same year, analysing the distribution by stage, the largest part of resources continued to flow into expansion investment, even though the share of seed and start up financing started to increase. Considering the whole market, the crisis determined a decrease in the average invested amount per deal, that fell from 4.6 million € in 2008 to 3 million € in 2011.

The economic effect of venture capital investment on Italian companies is reported to be positive. An analysis conducted by AIFI and PWC between 2002 and 2004, venture capital backed companies increased staff members at a rate faster than medium enterprises benchmark and increased their revenues by 24.3%, more than 8 times higher than the medium enterprises benchmark with positive effect also on EBITDA, which registered a positive growth rate, compared to the negative one registered by the benchmark.

An explanation of these figures could be found in the nature of venture backed companies, typically characterized by high growth potential, innovation ability and small size, giving higher chances to private equity players to increase revenues than in consolidated companies.

Figure 14.1. Venture Capital Investments (1994 – 2011; million euros)

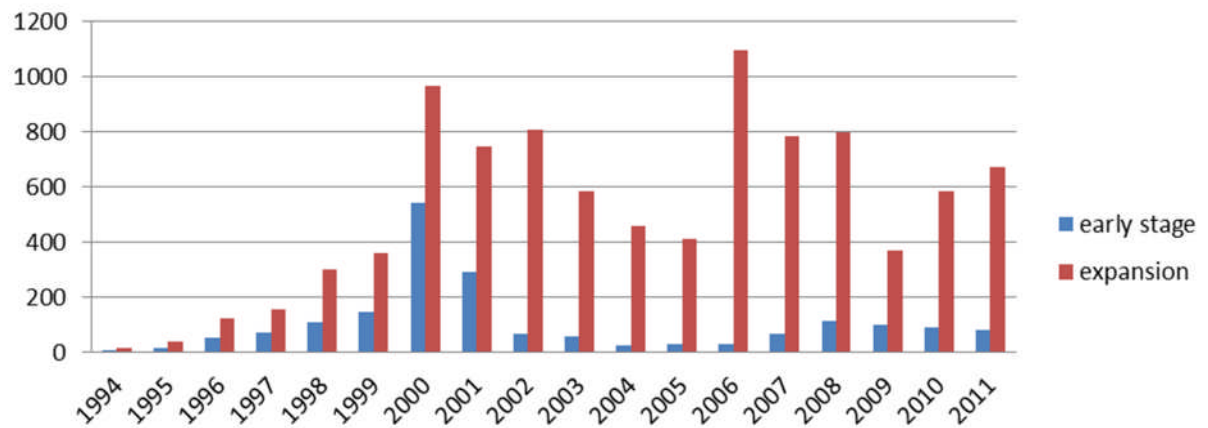
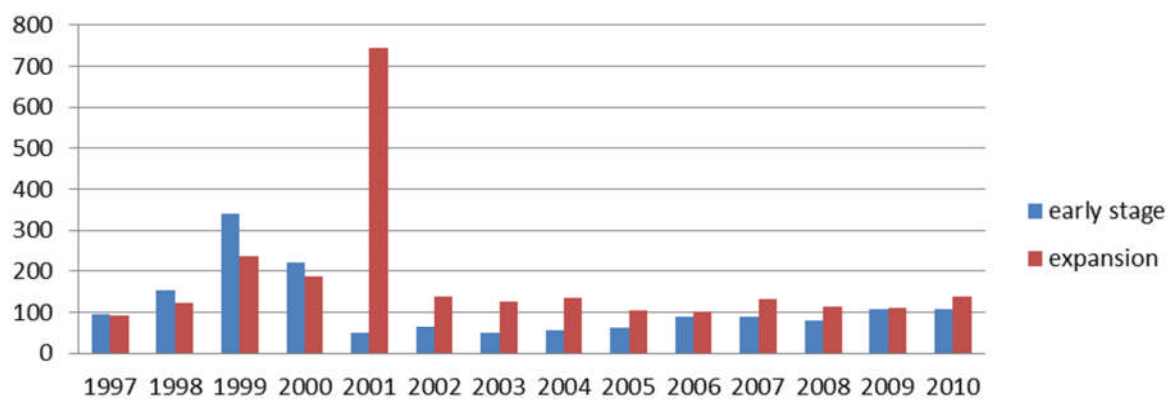


Figure 14.2. Number of Venture Capital Investments (1994 – 2011)



15. Privatisations in Italy and the financial system

Pietro Vozzella

15.1 Privatisations in Italy

In Italy, from 1992 till 2009, there have been 93 operations of privatization that have realized about 119 billion euros (Department of the Treasury). According to Privatization Barometer of Mattei Foundation, between 1985 and 2007 the operations of privatization were 114 and the gains were 152 billion of euros (table 15.1).

Table 15.1. Privatizations in Italy, 1985-2007 (million €)

Stage	MEF (June 2009)		PB (June 2009)	
	Value	Number of Operations	Value	Number of Operations
(1985-1991)			4441,17	12
(1992-1995)	13878,51	19	16128,77	25
(1996-2000)	71820,4	37	79209,95	40
(2001-2005)	33333,08	35	50027,12	32
(2006-2008)	33,97	2	2314,29	5
Total	119065,96	93	152121,3	114

Source: MEF and Privatization Barometer (PB); Corte dei Conti

The data of Privatization Barometer relate to both operations with income higher than 80 million of euros and operations relate to the societies local authority-owned, such as public utilities. The table 15.2 shows how Italy is in the second place (after Japan) in the global ranking for income by privatization and in the seventh for number of operations.

Table 15.2. Privatizations in OECD Countries, ex Italy (1977-1Half 2007)

Country	Number of Operations	Income (in current millions of euros)	Income to Gdp ratio (%)	Income from Public Offering to Total Income (%)
Japan	30	168.092	4,65	99,84
France	148	124.663	0,07	66,17
United Kingdom	193	110.425	0,06	77,24
Germany	182	98.384	0,04	58,19
Australia	150	57.444	0,09	37,38
Spain	103	45.220	0,04	69,28
Netherlands	42	30.844	0,06	71,82
Portugal	95	28.267	0,18	79,82
Finland	77	25.136	0,14	58,29
Poland	275	24.029	0,09	37,74
Sweden	66	23.580	0,07	69,50
Greece	62	19.697	0,08	77,11
South Korea	31	18.065	0,02	94,47
Czech Republic	104	17.003	0,14	1,69
Austria	69	16.762	0,06	48,67
United States	40	16.391	0,00	34,76
Norway	37	15.994	0,06	51,82
Mexico	71	15.113	0,02	23,69
Hungary	177	12.350	0,13	28,52
Canada	65	11.708	0,01	51,09
Slovakia	84	8.282	0,18	0,00
Ireland	23	7.441	0,04	61,60
Belgium	22	7.305	0,02	25,86
Switzerland	8	6.527	0,02	96,50
Denmark	12	6.167	0,03	47,95
New Zeland	43	6.104	0,07	13,29
Turkey	33	4.493	0,01	78,68
Iceland	2	117	0,01	100,00

Source: World Bank; Privatization Barometer (PB); Corte dei Conti

15.2 The effects on public finance

The effects that privatizations have on public finance is a widely debated issue, especially in countries like Italy with a high public debt. Generally, a privatizations program should be inspired by a finance and economic efficiency rules; this means that the return of a state property good has to be higher than interest rate on public debt.

An overall evaluation of the effects of privatization in Italy during last two decade on welfare of taxpayer is not simple and should consider both the net

assets value of State as a consequence of privatizations and the contribution of these latter to the decrease in public debt.

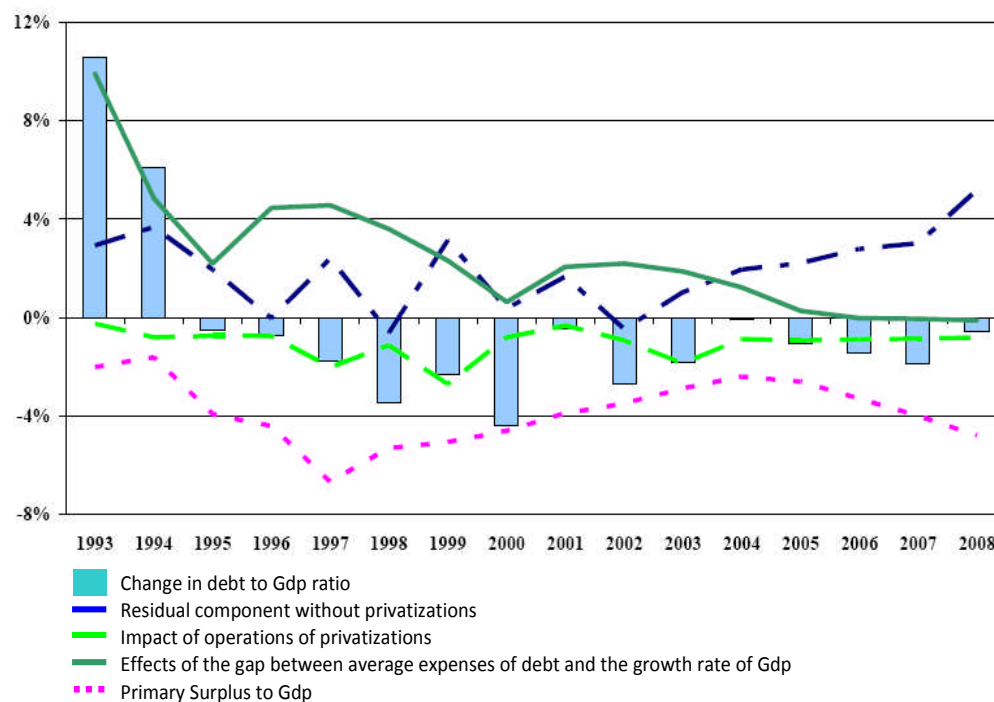
The analysis of the Court of Auditors (Corte dei Conti) on “Purposes and Results of Privatizations of Public Shares” (Obiettivi e Risultati delle Operazioni di Privatizzazione di Partecipazioni Pubbliche) published on 2010 shows that the main components of the variation of public debt in time are three:

1. the gap between average expenses of debt and the growth rate of Gdp;
2. primary surplus to Gdp;
3. a residual component including income from privatization.

The latter relates to operations that do not affected the financial requirement but increase or decrease the stock of public debt.

Figure 15.1 shows that between 1992 and 2004 the decrease of debt to Gdp ratio has affected by incomes from privatizations (without residual component). The figure also shows (green dotted line) an estimate of the effects on debt according to the DPEF forecasts for 2005-2008 that considered incomes from privatizations equal, on average, to 1 per cent of GDP yearly.

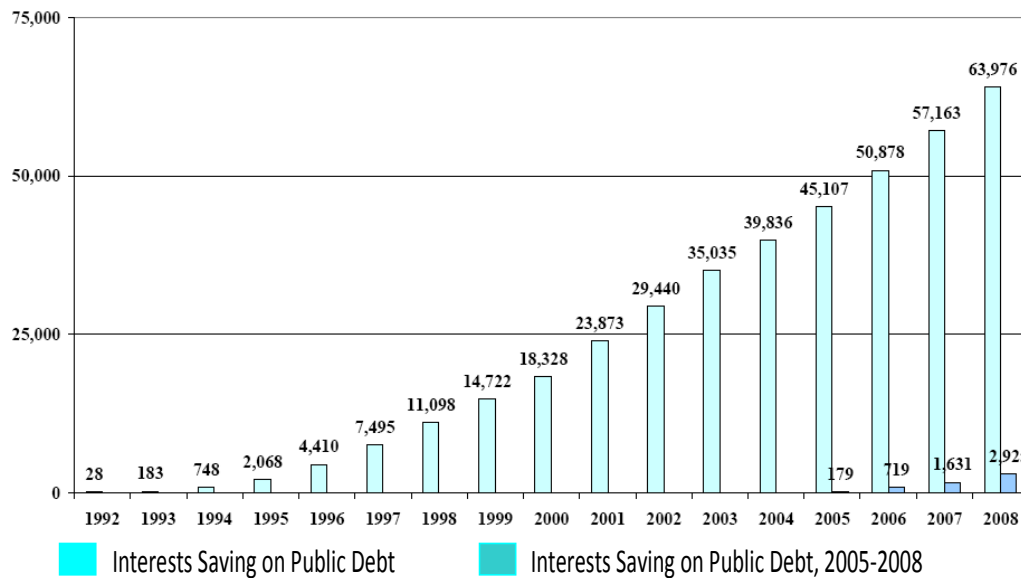
Figure 15.1. The contribution of Privatizations to the decreasing of debt to Gdp ratio during 1992-2004 and 2005-2008 (forecasts)



Source: Corte dei Conti, 2010

Between 1992 and 2004 incomes from privatizations decreased interests expenditures on debt of about 40 billion of Euros (figure 15.2). According to the Dpef forecasts for 2005-2008 if the privatization program had continued there would have been a saving for interests expenditures of about 2.9 billion of Euros more.

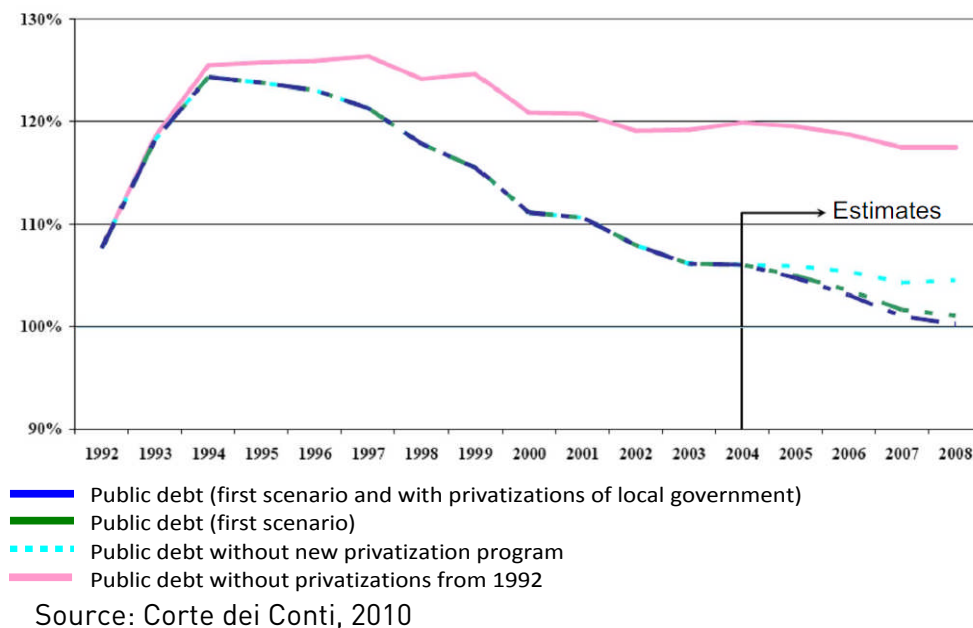
Figure 15.2. Interests saving during the period 1992-2004 and 2005-2008 (forecasts) (million €)



Source: Corte dei Conti, 2010

In Figure 15.3 has shown the trend of debt between 1992 and 2004 with and without the effects of privatization truly realized. According to the Corte dei Conti study, without privatization process the debt to Gdp ratio in 2008 in Italy would have been about 118 per cent. On the contrary, the debt to Gdp ratio estimated in Dpef 2005-2008 would have been close to 100 per cent if privatization program had continued.

Figure 15.3. Debt to Gdp ratio during the periods 1992-2004 and 2005-2008 (forecasts).



Although data highlight the positive effects of privatizations, if we consider that the most important objective of privatization in Italy was the decreasing of stock of public debt, the results have only been temporary and the impact on stock of public debt has been very weak and not much incisive. In light of the financial problems come to the last crises, it seems that privatizations are necessary to satisfy more immediate needs of cash than to a structural recovery of public finance.

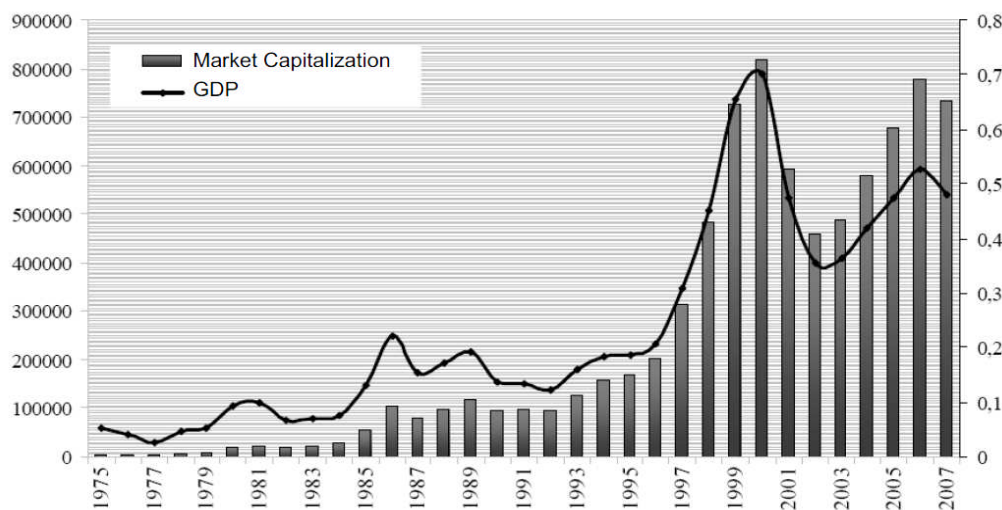
15.3 Impact of Financial Markets

In the last two decade, Italian financial market has dramatically changed and it is common opinion that privatizations played an important role in this changing. At the beginning of nineties, most of Households saving was invested in stock of Public debt, particularly in Treasury Bill. Privatizations would have had to offer new opportunities for investors and to encourage the shift towards riskier assets (equity shift). As a consequences of this process, equity market prices

should be increased and this would have promoted privatizations process. In this scenario, thanks to an increase of demand of more sophisticated financial assets, banking system would have had to be more efficient, less opaque and more opened to the international competition. Although in a long term perspective the data show that financial system in Italy recorded a meaningful transformation also thanks to privatizations process, the last worldwide financial crises insinuates doubt that the goal was reached.

At the end of 2000 the Italian market capitalization was about 800 billion euros. After a rapid decreased up to 2003 it increased again up to 2007 when was more of 700 billion of euros. Between 1990 and 2007 market capitalization has increased of 7 times at current prices and it trebled in relation with Gdp (figure 15.4).

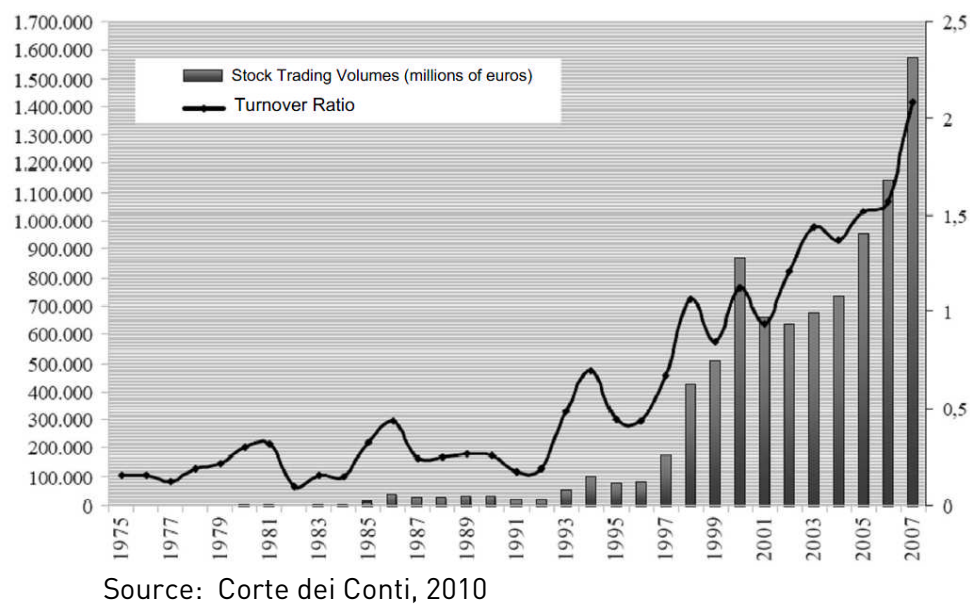
Figure 15.4. Italian Stock Market, 1975-2007. Market capitalization million € (left scale) vs Market capitalization to Gdp (%) (right scale)



Source: Corte dei Conti, 2010

During the same period, the number of listed companies has increased of 30 per cent and at the end of 2007 their weight on total market capitalization was of 59 per cent. Between 1990 and 2007, the trading volumes rose of about 60 times and turnover increased from 25.2 to 208.3 per cent (figure 15.5).

Figure 15.5. Stock trading volumes million € (left scale) and Turnover ratio (%) (right scale) (1975-2007)



In 2000 the privatized listed companies represented the 60 per cent of total float; it was 16 per cent in 1996. On average, the impact of privatizations on stock market size in Italy is higher than other industrialized countries (table 15.3).

Table 15.3. Impact of Privatizations on Financial Markets (2000)

Impact of Privatizations on Financial Markets				
Country	Number of privatized Companies	Number of privatized Companies (%)	Capitalization of privatized Companies	Value of Stock Trading Volumes of privatized Companies (%)
Japan	16	1	6	4
France	54	6	83	35
United Kingdom	54	2	15	9
Germany	20	2	19	9
Australia	20	2	23	15
Spain	24	2	54	52
Netherlands	11	3		11
Portugal	39	35	45	61
Finland	22	14	8	9
Sweden	10	3	10	5
Austria	26	2	23	15
United States	7	0	0	0
Norway	13	6	1	0
Canada	26	2	5	5
Ireland	4	4	12	
Belgium	3	1	10	18
Switzerland	3	1	2	3
Denmark	6	3	10	14
New Zealand	7	4	30	48
Italy	45	15	41	33

Source: Privatization Barometer (PB); Corte dei Conti

Even if data are particularly interesting, it would be wrong to assign all these changes only to the privatizations process. The most important role from the end of 1990s has been played by a general decrease of interest rates and a strong monetary stability thanks to the euro monetary policy.

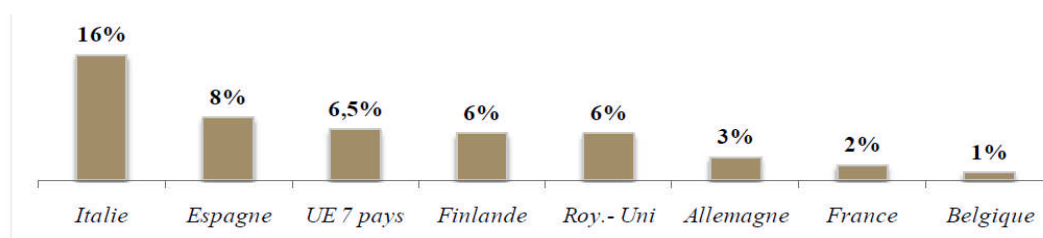
16. Culture and norms

Giampaolo Gabbi and Pietro Vozzella

16.1 Introduction

The access to credit represents a criteria to find out how financialization has become a factor to take into consideration for economic and social decisions. Usually, an individual can enter the credit market when he/she is not excluded from opening a banking account (with electronic payments, cheques, credit transfers), getting a revolving or consumer loan, holding savings in a financial institution³.

Figure 16.1. People older than 18 years excluded by credit (percentage values, 2003, European countries)



Source: RFA

Italy appears to be relatively far being largely open to credit, and suffers a significant gap with countries whose consumer and investment behaviour are similar (figure 16.1.). These elements can be appreciated looking at the payment conduct and the microcredit, particularly to finance the access to education.

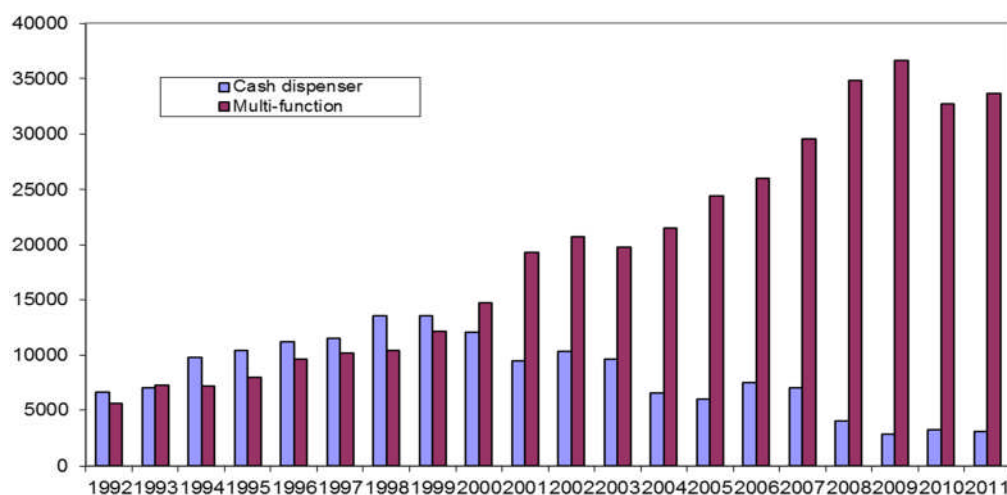
³ At the moment, insurance contracts are not taken into consideration to determine the access to credit.

16.2 The use of banking payment system

As explained in chapter 8, since 1988, the Italian payment system has been reformed in order to reduce the infrastructural gap observed with other European countries. These changes affect also the households behaviour, previously mainly cash oriented.

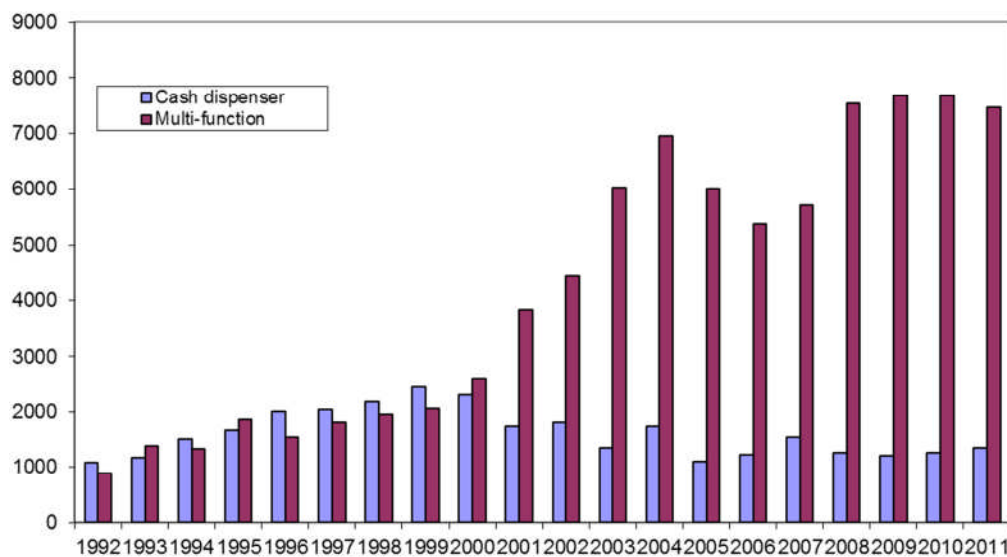
The first phenomenon worth to be noted is the increasing rate of the points of access to payments (figures 16.2.). The trend can be divided in two: during the Nineties the high development was experienced by the cash dispensers (+103% for banks' ATMs; +126% for other ATMs).

Figure 16.2a. Points of access to payment system. Banks' Branch ATMs (1992 – 2011)



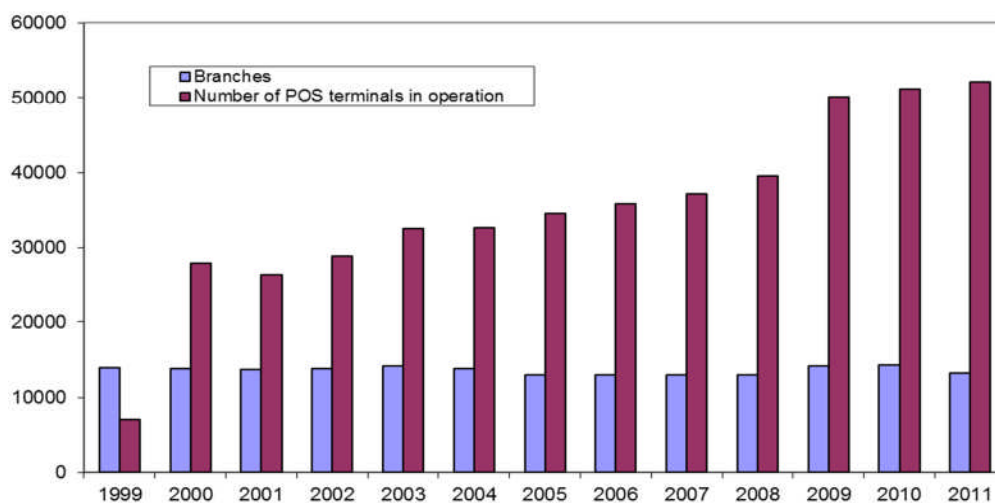
Source: Bank of Italy

Figure 16.2b. Points of access to payment system. Other ATMs (1992 – 2011)



Source: Bank of Italy

Figure 16.2c. Points of access to payment system. Post Office (1992 – 2011)



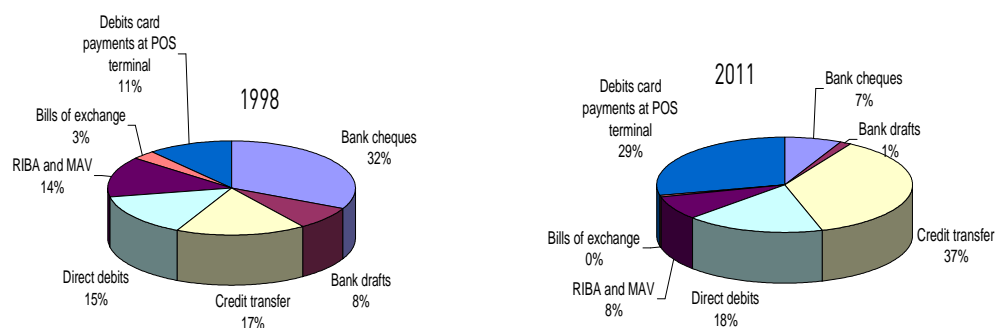
Source: Bank of Italy

Afterwards, the cash dispensers have been progressively substituted by the multifunction machines (+503% for banks' ATMs; +746% for other ATMs). The number of POS terminals in operation increased of 2260% from 1992 to 2011.

The Post Offices became, in first decade of the new century, a competitor of the banking system. Their POS terminals increased of about 648%.

Not only debits cards and POS payments increased. As shown in figure 16.3., from 1998 to 2011 the number of credit transfers changed from 17% to 37% of total payments, while bank cheques dropped from 32% to 7%.

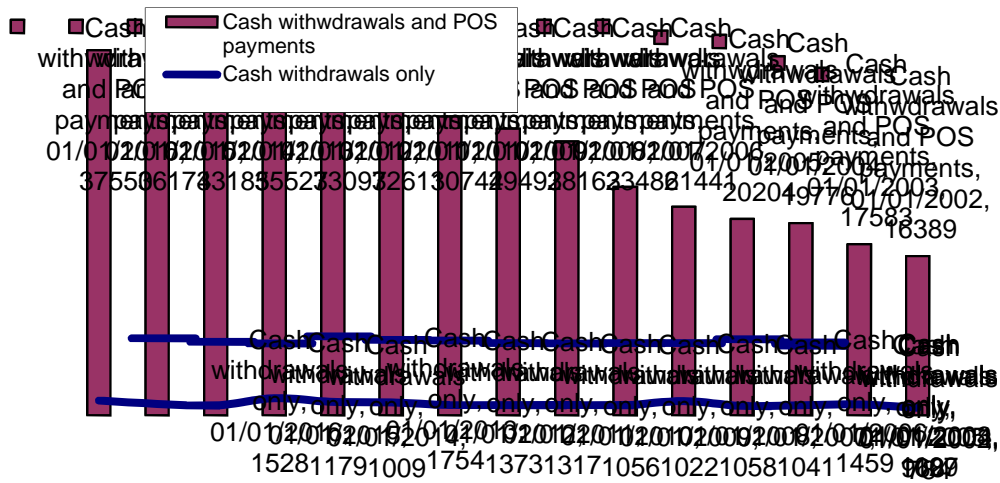
Figure 16.3. Payment and services and instruments (numbers; 1998 vs. 2011)



Source: Our elaboration on Bank of Italy data

Albeit the widespread circulation of ATMs and POS and the growth of cash withdrawals (see Figure 16.4), only 1% of payments is associated through them (figure 16.5.).

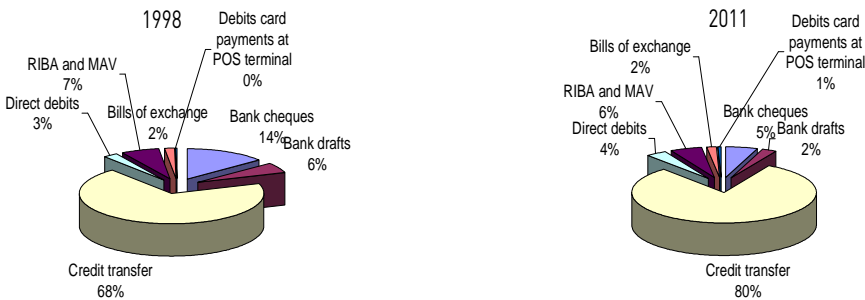
Figure 16.4. Number of cash withdrawals only (left scale), cash withdrawals and POS payments (right scale) (1997 – 2011)



Source: Bank of Italy

The weight of payment decision by amount demonstrates the central role of credit transfers (80% of total payments in 2011).

Figure 16.5. Payment and services and instruments (amounts; 1998 vs. 2011)



Source: Bank of Italy

The amount of paperless credit transfer were 15% of total credit transfer in 1998. The raised to 49% in 2011 (table 16.2).

Another important innovation introduced in the Nineties was the collection order, through direct orders, electronic periodic payment orders and bills of exchange. They respectively increased, from 1998 to 2011, of 147%, 45% and 61%.

Table 16.1. Payments services and instruments (1998 – 2011; numbers in thousands)

Year	Bank cheques	Bank drafts	Credit transfer		Collection orders			Debits card payments at POS terminal	Total
			of which: paperless	Direct debits	RIBA and MAV	Bills of exchange			
2011	249020	42599	1261724	496398	600700	273050	16076	981116	3424284
2010	269199	45918	1227202	464725	593173	235166	12771	914755	3298187
2009	285361	49928	1210017	418651	575822	252865	15632	908545	3298170
2008	325683	58873	1148584	404630	554079	329023	16850	873308	3306400
2007	359350	66518	1094716	310977	508794	336483	15058	825354	3206272
2006	382934	71012	1070076	281295	480769	317771	15700	770653	3108915
2005	390782	74416	1050728	258233	463244	307878	15341	732799	3035184
2004	411896	74879	1050484	232822	453217	302432	16805	671969	2981683
2003	426654	78534	1019460	206276	414350	286836	17024	610729	2853581
2002	447546	78934	359109	193582	401548	268844	16868	525592	2098891
2001	491000	87058	339809	173501	361871	248691	27874	422788	1979092
2000	472435	87549	319658	169836	326438	243384	18729	317924	1786116
1999	472825	105043	292852	143579	276662	220056	21974	248057	1637469
1998	491719	126163	256752	119614	226400	209900	46500	171659	1529093

Source: Bank of Italy

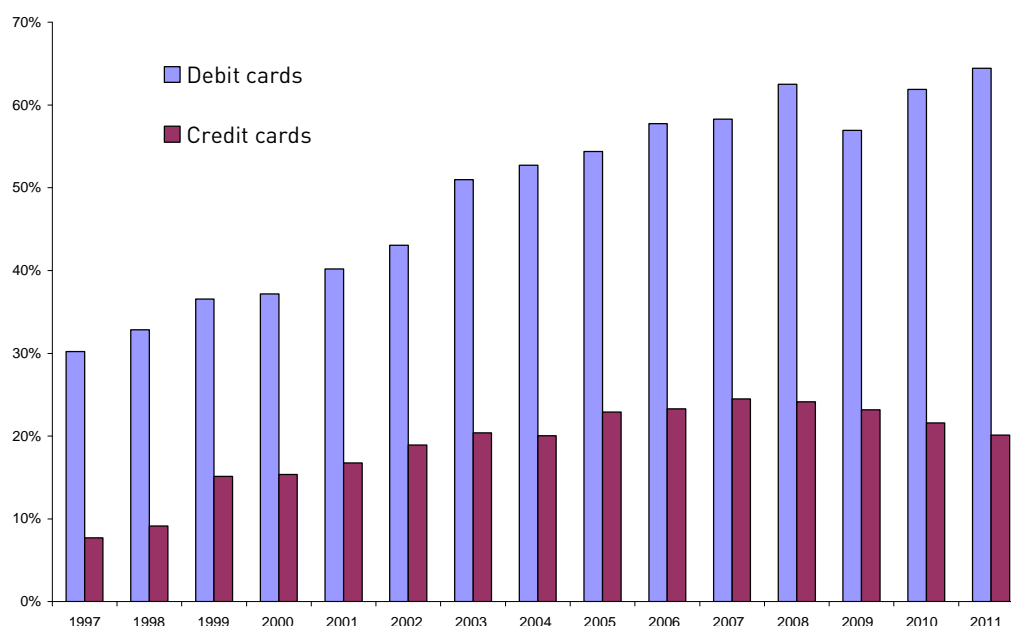
Table 16.2. Payments services and instruments (stocks in million of euros; 1998 – 2011)

Year	Bank cheques	Bank drafts	Credit transfer		Collection orders			Debits card payments at POS terminal	Total
			of which: paperless	Direct debits	RIBA and MAV	Bills of exchange			
2011	547520	245795	8075298	3940279	356556	553330	155433	67005	10000938
2010	590559	251557	7938216	3706768	364796	439258	120174	63202	9767761
2009	636327	273413	7388177	3170470	359851	450638	153031	62604	9324041
2008	764319	323344	7438573	2088093	345230	650977	168985	62538	9753966
2007	815853	345517	7134023	1856502	332716	687509	133768	76570	9525955
2006	850518	341413	6272451	1623647	299286	648017	123851	71316	8606849
2005	836688	317094	5737837	1388553	289072	617348	68971	63543	7930551
2004	877059	301732	5389416	1112519	274288	593814	65064	58035	7559409
2003	885628	285540	5001775	937991	234607	559252	56725	50875	7074404
2002	846431	284071	4552693	1024319	213942	525745	46210	37856	6506948
2001	887810	277163	4368090	797754	203898	495914	52521	29486	6314882
2000	853011	281164	4509926	706917	188578	466591	42293	23116	6364679
1999	799650	276717	3719635	557812	175061	400415	48849	19018	5439345
1998	799910	323483	3911596	588195	144209	381093	96761	14007	5671061

Source: Bank of Italy

The use of credit cards was relatively lower than debits cards. Figure 16.6. shows that in 1997, 30% of Italians held, on average, an ATM card, while only 8% a credit card. The maximum difference was recorded in 2011, when more than 64% of people used an ATM or POS card and only 20% a credit card.

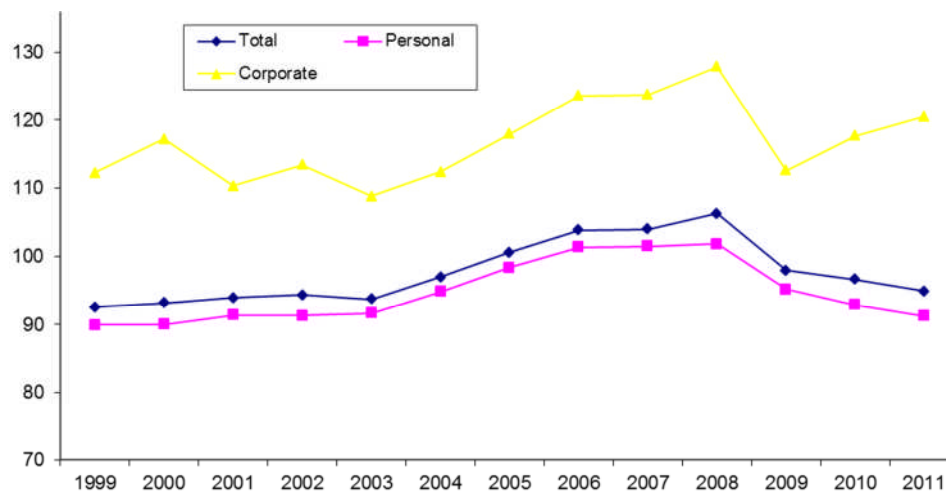
Figure 16.6. Credit cards and debit cards per person (percentage values; 1997 – 2011)



Source: Our elaboration on Bank of Italy data and Istat

The payments with credit cards on average was flat, over time, around 97 euros (figure 16.7.). The maximum was experienced in 2008 (106 euros). The same for corporate cards: an average payment of 117 euros, and the maximum in 2008 (129 euros).

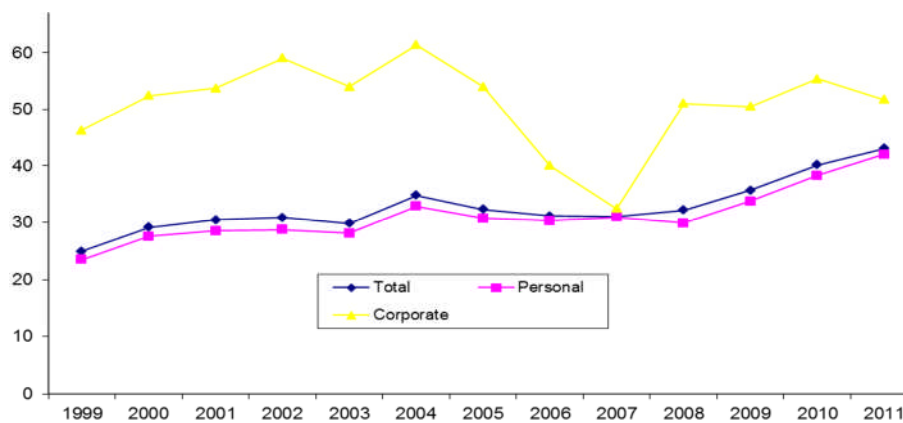
Figure 16.7. Average value of payments by credit cards (1999 – 2011; value in euros)



Source: Bank of Italy

The crisis appears to be relevant for the average number of transactions by credit cards each year. Especially corporate payments dropped in 2007 to 32 each year, with an average of 51 between 1999 and 2011 (see Figure 16.8)

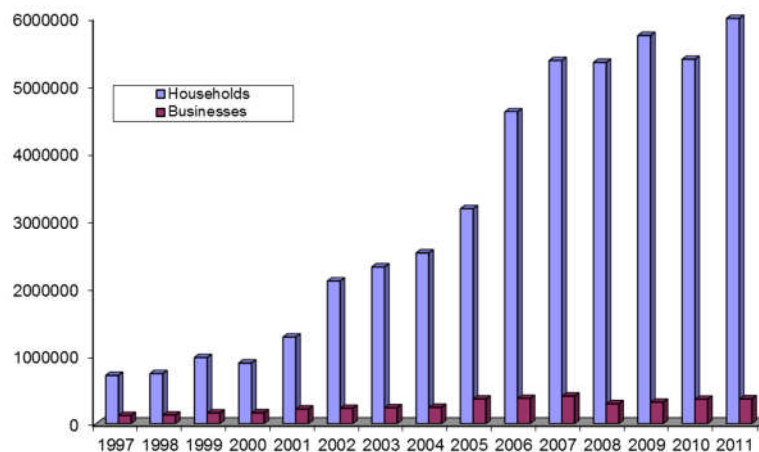
Figure 16.8. Average number of payments by credit cards (1999 – 2011)



Source: Bank of Italy

Finally, we underline the exponential increase of information services and electronic transactions using the home banking (households) and corporate banking (businesses).

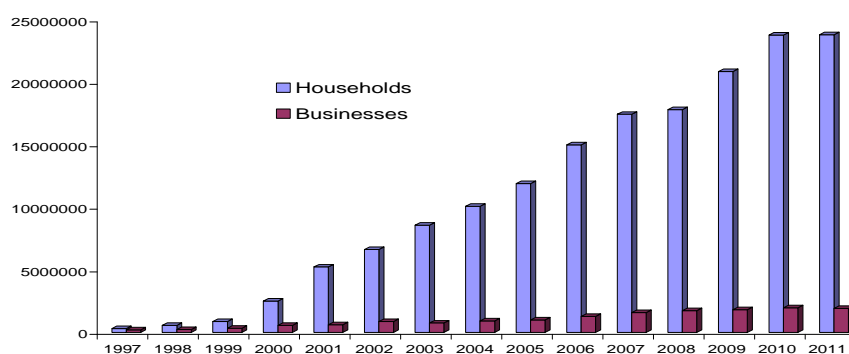
Figure 16.9. Home and corporate banking services. Information services (number of users, 1997 – 2011)



Source: Bank of Italy

The increase of all the services (information and transaction services, by households and companies) recorded a rate, from 1997, of about 2314%. Households appear to be considerably the most sensitive to the diffusion of the remote banking services.

Figure 16.10. Home and corporate banking services. Information and transaction services (number of users, 1997 – 2011)



Source: Bank of Italy

16.3 Microfinance and access to education

Italy, among European countries, records the highest number of institutions supplying microcredit, with a large diversity of typologies of intermediaries. Moreover, 44% of the Italian market is covered by foundations and 22% by ONG. These organizations are based on a system of three pillars:

- a) cooperative companies which offer guarantees and collateral to loans given by banking institutions;
- b) micro-firms supplying directly microcredit;
- c) ONG and financial institutions ethically oriented to the non profit sector.

A large part of the sector developed in order to operate against usury. This contributes to the development of personal microcredits. Banks are becoming more interested in microfinance at the national and local level and are starting to enter into local partnerships. Public bodies are also progressively increasing their action in this sector, but still in a limited way. The microfinance sector is thus still fragmented, with some very dynamic institutions which are aiming at strong growth and real sustainability.

At the end of the 1960s, the mutual guarantee system Confidi was created: not-for-profit bodies act as guarantors for credits supplied by banking institutions to their members, generally small and medium-sized enterprises (SMEs).

Furthermore, in the 1970s, the creation of the MAGs (Mutue di Auto Gestione), "self-managed" mutual benefit societies providing credits, advice and training, was an important step in the fight against banking exclusion. Having turned into cooperatives, they set up, in 1994, jointly with other non-profit bodies, Banca Popolare Etica, an alternative to the traditional banking system.

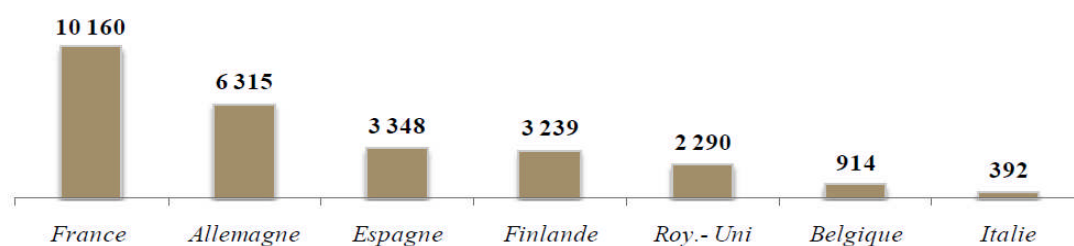
Today, little by little the microfinance sector is becoming structured, in particular since the creation in 2008 of RITMI, the Italian microfinance network. This network brings together the Italian institutions involved in microcredit and endeavours to coordinate and facilitate the development of this activity through the sharing of experiences and common practices.

In recent years, the Italian government for its part has tried to facilitate business start-ups, in particular microenterprises, through simplified procedures and fiscal incentive measures (leg. decree of April 2000, and the Bersani Decree of July 2007).

The Italian Government assists the sector with fiscal policies and a programme for the microcredit called “Incentives for the the self-entrepreneurship and self-employment” (since 2000). In addition, in December 2007, the State set up the Permanent Microcredit Committee, which is however essentially oriented towards the international market.

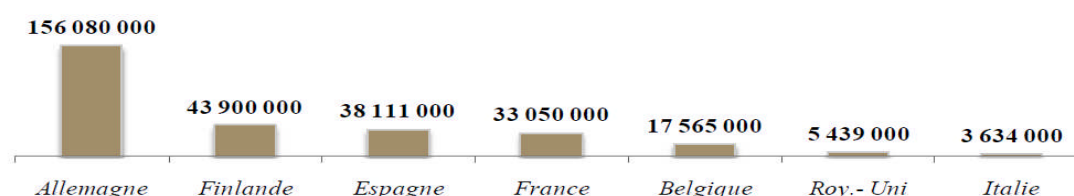
Nevertheless, when compared with other countries, microcredits actually supplied is in absolute terms marginal, both in number (figure 16.11) and in values (figure 16.12).

Figure 16.11. Number of microcredit loans supplied (2007; Italy and other European countries)



Source: REM

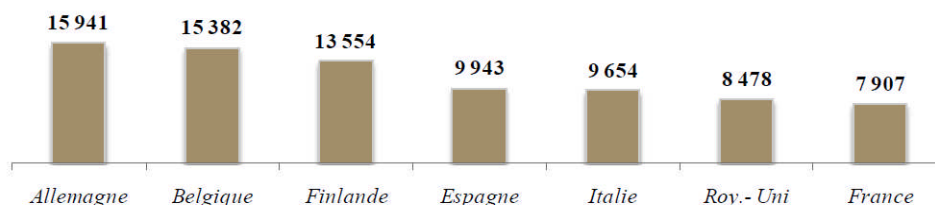
Figure 16.12. Value in euros of microcredit loans supplied (2007; Italy and other European countries)



Source: REM

Relatively higher is the average amount given by the microcredit system (9654 euros), higher than the UK and France experience (figure 16.13).

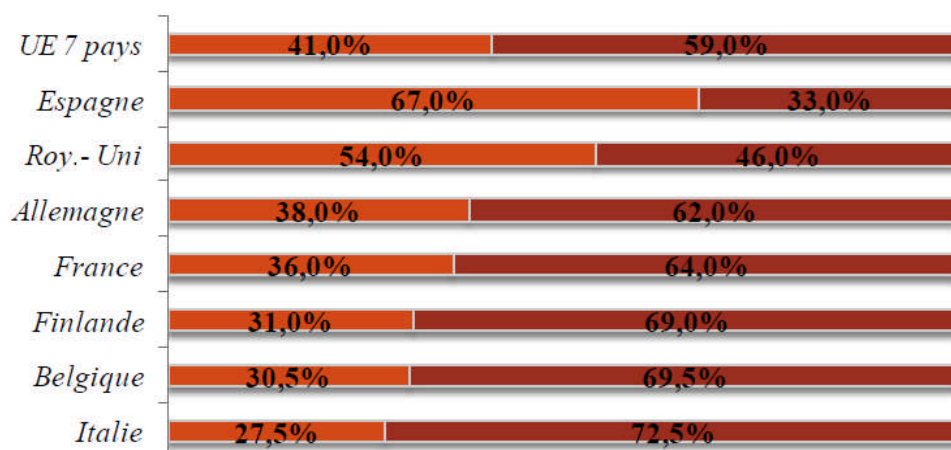
Figure 16.13. Average amount in euros of microcredit loans supplied (2007; Italy and other European countries)



Source: REM

The beneficiaries of microcredits are new small firms (start-ups) and micro-companies of less than five employees, as well as women and immigrants. On average, 27.5% of the credits granted are provided to women (against an average of 41% for the largest European countries, see figure 16.14), 21% to immigrant populations and 11% to young people.

Figure 16.14. Beneficiaries of microcredit loans by gender (2007; Italy and other European countries; females = red; males = brown)



Source: REM

16.4 Finance and education

Among credit to young people, it is worth to analyse loans to support the access to education. Honor Loans have been firstly regulated with the Law n. 390 of 1991, art. 16 on the right to university education. Following the German example, loans had to be given at zero rate, to students having the right to fellowship, to be repaid only after the beginning of the working experience, and with a cash flow within 20% of the borrower's income. But this model has never been implemented since the Act regulating the guarantees has never been written and approved. Along with the widespread aversion to borrow money of Italian individuals can explain the marginal diffusion of these loans.

The only experience of support to education depend on regional funds (particularly, Valle d'Aosta, Lombardia, Veneto, Toscana e Calabria) and single Universities that signed agreements with financial institutions.

In the early 2000s the propensity to incur debt increased and with two Acts (Law 23 October 2003, art. 7; Public Budget Law 2004 art. 4) the Italian Government eased the access to credit. Students who enter the perimeter of it are 0.1% of the total. The opportunities were honor loans and trust loans. In the period between 2003 and 2011, the sum devoted was respectively 4.1 million euros to honor loans and 10 million to trust loans.

Table 16.3. Number of honor loans (DM 23 October 2003), academic years 2003/04-2010/11.

Academic years	Honour loans
2003/04	388
2004/05	466
2005/06	495
2006/07	460
2007/08	410
2008/09*	1624
2009/10	949
2010/11	504
Average 2003-2011	662

Source: Ministry of University. * The growth recorded in 2008/09 depends on Bocconi University.

The trust loans have been distributed by only few regions since 2007 (table 16.4.)

Table 16.4. Number of trust loans (Budget Law 2004), academic years 2007/08-2010/11

Regions	Trust Loans			
	2007/08	2008/09	2009/10	2010/11
CALABRIA	-	1	2	-
EMILIA ROMAGNA	-	21	31	38
LOMBARDIA	30	4	8	-
MARCHE	2	2	3	2
PIEMONTE	103	75	2	-
SICILIA	5	-	-	-
TOSCANA	45	4	3	-
TRENTINO-ALTO ADIGE	53	85	119	103
VENETO	23	19	24	33
TOTAL	261	211	192	176

Source: Ministry of University

17 Housing finance

Costanza Consolandi

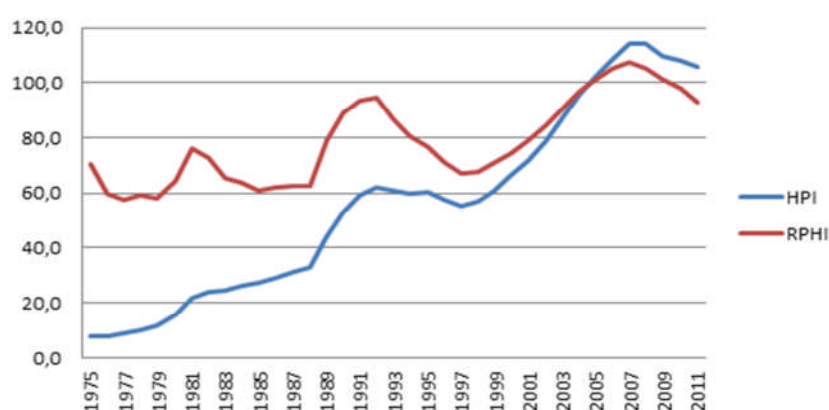
17.1 Evolution of house prices in Italy (1975 -2011)

It is generally accepted that the household credit channel played an important part in the boom preceding the crisis, as well as in accentuating the crisis with its origins in the sub-prime mortgage market.

The global financial crisis led to a growing attention on the links between the cycles in the property market and those in the credit sector and a large amount of evidence has been provided about the role of the transmission of “boom-bust” cycles from the property markets to the credit sector in determining financial crises (Nobili and Zollino, 2012) and in affecting the real economy.

A graphical analysis of the behaviour of the composite indicator of house prices adjusted for consumer price inflation, provided by Federal Reserve Bank of Dallas⁴, allows us to identify four real estate market cycles in Italy starting in mid Seventies.

Figure 17.1 Evolution of house prices. House Price Index (HPI) and residential house price index (RHPI) (1975 -2011; index 2005 = 100)



Source: Our elaborations on Federal Reserve Bank of Dallas database

⁴ For methodological issues, see Mack and Martinez-Garcia (2011)

After a period characterized by broad stability and by a peak reached at the end of 1974, when prices surged by more than 30 per cent (Bank of Italy, 2008) due to the first oil shock - which made investment in real estate more attractive as a hedge against the loss of real wealth caused by high actual and expected inflation -, the first cycle, from the end of 1974 to mid-1981, was characterized by a phase of volatility that was more accentuated around the second oil shock, interrupted by an abrupt rise in prices, which reached a new peak in 1981, with a growth rate in the HPI higher than 30% in 1980 and 1981.

The second cycle, from 1982 to 1992, began with a gradual downward correction, with prices down in 1986 to the low of the previous cycle. The ensuing uptrend, in which prices increased by more than 8 per cent per year in real terms, reached its peak in 1992.

The third cycle, beginning at the end of 1992 and lasting up to the end of 2006, opened with the recession of the early 1990s, with a decrease of house prices, albeit with a pause in 1995 when the growth rate of HPI and RHPI have been both positive, until the first half of 1999. With the start of Economic and Monetary Union, the decline in the cost of money and the recovery in households' purchasing power fuelled a prolonged upswing in house prices, which began to show some signs of slowing at the end of 2006. Compared with the low of 1999, albeit with some differences between provincial capitals and other cities, for Italy as a whole, since the start of the Monetary Union and before the financial crisis, house prices marked a more prolonged revaluation than in previous cycles, with an average growth of almost 6% per year in real terms.

Nevertheless, according to OECD (2005), Italian house prices can be considered not excessively overvalued, on the basis of the ratio of prices to rents. Whilst the ratio is rising, it is still considerably more contained in comparison to the United Kingdom and to a large number of metropolis of the United States. This ratio considers trends in the collateral housing rent market, which is useful both in

terms of an analysis of a house purchased to be lived in or for investment. If we consider that the payment of rent is a possible alternative to purchase, a non-contingent, higher than average price/rent ratio could be the warning sign of a speculative bubble about to burst. An increase in house prices over rents will push more and more people to opt for renting rather than buying, thereby causing a drop in demand for houses and a knock-on fall in house prices. If the purchase is for investment purposes, a rise in the ratio implies an overvaluation in the price that is not justified by returns on the investment itself; such a situation will lead investors to look for alternative forms of investment.

Table 17.1 – Housing Price Index 1975 -2011 (2005=100)

Year	RHPI		HPI	
		%growth rate		%growth rate
1975	70.5		7.7	
1976	60.0	-14.8%	7.9	3.2%
1977	57.8	-3.8%	8.7	10.0%
1978	59.2	2.5%	10.0	15.3%
1979	58.1	-1.8%	11.6	15.9%
1980	64.3	10.5%	15.4	32.3%
1981	76.2	18.6%	21.5	39.8%
1982	72.6	-4.7%	24.1	12.0%
1983	65.6	-9.7%	24.7	2.6%
1984	63.6	-3.0%	26.2	5.9%
1985	61.1	-3.9%	27.4	4.8%
1986	62.2	1.8%	29.3	6.8%
1987	62.5	0.4%	31.1	6.1%
1988	62.5	0.0%	32.9	5.9%
1989	78.6	25.9%	44.1	34.1%
1990	89.2	13.4%	52.9	19.9%
1991	93.6	4.9%	59.1	11.7%
1992	94.3	0.8%	62.3	5.3%
1993	86.6	-8.2%	61.0	-2.1%
1994	80.7	-6.7%	59.6	-2.2%
1995	76.5	-5.2%	60.2	1.0%
1996	70.8	-7.5%	57.3	-4.8%
1997	67.3	-4.9%	55.6	-3.0%
1998	67.8	0.8%	56.9	2.3%
1999	70.8	4.4%	61.0	7.1%
2000	74.7	5.5%	66.4	8.8%
2001	78.9	5.7%	71.7	8.0%
2002	84.3	6.8%	78.9	10.1%
2003	90.9	7.9%	87.4	10.8%
2004	97.0	6.8%	95.7	9.5%
2005	101.4	4.5%	102.5	7.0%
2006	105.3	3.8%	108.8	6.2%
2007	107.4	2.1%	114.1	4.9%
2008	105.5	-1.8%	114.3	0.1%
2009	101.2	-4.1%	109.7	-4.0%
2010	97.8	-3.3%	108.1	-1.4%
2011	92.6	-5.3%	105.5	-2.4%

Source: Our elaborations on Federal Reserve Bank of Dallas database

The fourth cycle, beginning in 2007, is still under way. As the financial crisis deepened and the economy experienced the worst recession since WWII, real house prices started a gradual decline, recording an average negative growth rate of housing price index in real terms of -2% and an overall decline of -14% in the four years to the end of 2011.

Another important indicator to represent cyclical movements in the housing market is represented by residential investments and transactions, an house volume indicator, which usually reflect fluctuations in a more timely and pronounced way.

Starting from mid 1980s, after a decade of relative stability, in 1997 began a period of dramatic growth in the number of house transaction, until late 2006, when the number of transactions reached its maximum level of around 870 thousands, with a growth rate of almost 80% on 1996. In 2007 an inversion of the trend began until 2009, with a cumulative decrease of around 30% compared to the end of 2006. After a slight recovery in 2010, negative results are shown for 2011 (see Figure 17.2).

According to the quarterly survey conducted by the Bank of Italy on a sample of 1500 estate agents since Q1-2009, the short term outlook confirms negative (and stable) for the local markets (Bank of Italy, 2012).

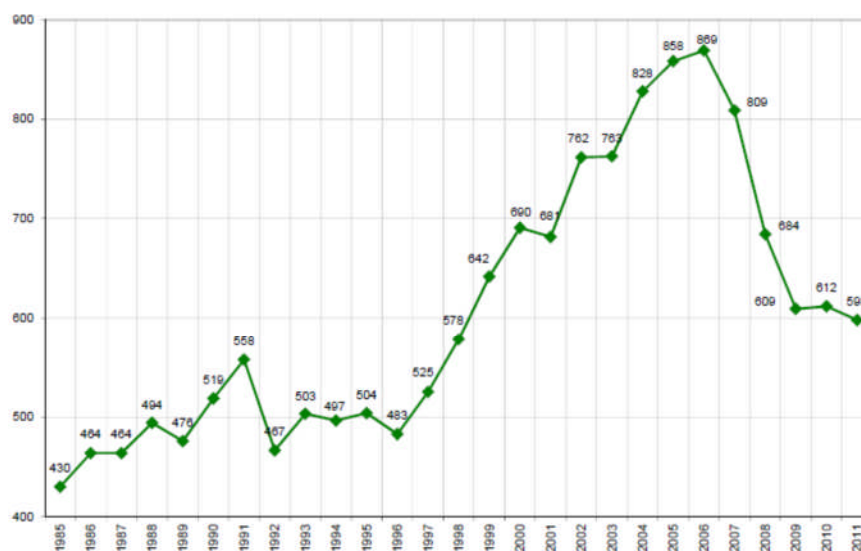
Comparing Figure 17.1 and Figure 17.2, it is interesting to notice that real prices turned down later (at least one semester) than transactions, confirming the timely information provided by volume indicators.

Finally, we show evidence of the impact of the housing market bust on the primarily correlated sector, i.e. the construction sector. As Figure 17.3 shows, the impact of the crisis on construction activity was more severe and persistent than on GDP, and recovery seems far to happen.

Finally, we show evidence of the impact of the housing market bust on the primarily correlated sector, i.e. the construction sector. As Figure 17.3 shows,

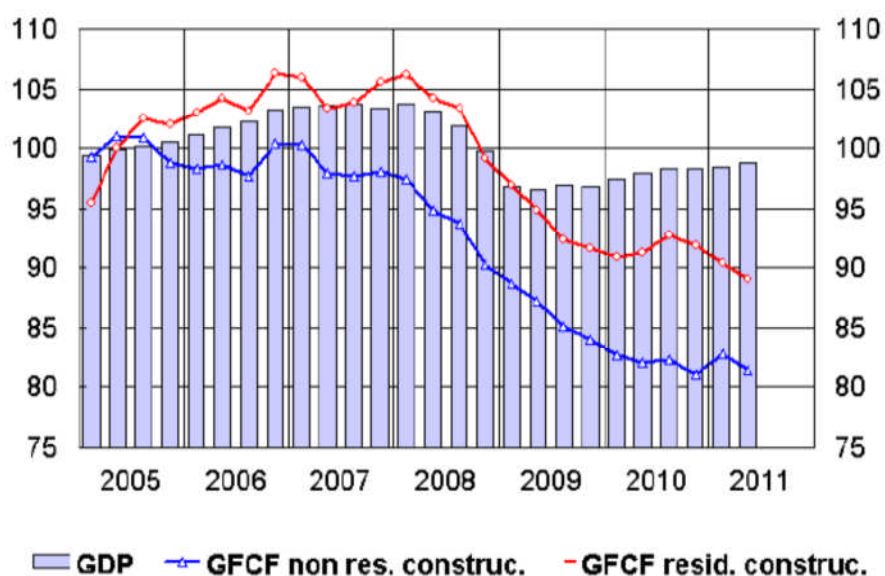
the impact of the crisis on construction activity was more severe and persistent than on GDP, and recovery seems far to happen.

Figure 17.2 - Number of transactions 1985-2011



Source: Agenzia del Territorio (2012)

Figure 17.3 - GDP and investment in construction (quarterly data; 2005=100)



Source: Bank of Italy

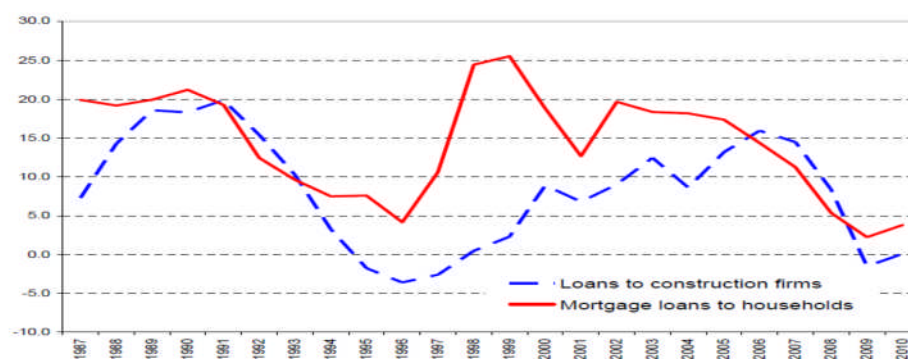
17.2 Credit development to housing market

Credit related to the housing market also showed large cyclical fluctuations in timing and phase similar to those observed for house prices. Figure 17.4 shows the dynamics of mortgage loans to households and loans to construction firms over time. The annual growth rate of mortgages, after stabilizing between 1987 and 1991 at around 20%, declined rapidly until 1996. Following the gradual acceleration between late 1997 and 2006, mortgages registered a marked slowdown with the eruption of the financial crisis. Interestingly, periods of booms and slowdowns in the mortgages sector have been associated with similar developments in the growth rate of loans to construction firms.

The cost of credit in Italy, broadly stable between the late eighties and the start of the nineties, showed a marked increase during the financial crisis of 1992, followed by a sharp decline in the wake of Italy's joining the Economic and Monetary Union (Figure 17.5). In particular, the average interest rate charged on mortgage loans to households diminished to about 5% in 1999 from 12.5% in 1995; for construction firms, the average loan rate declined from 18% to 8%.

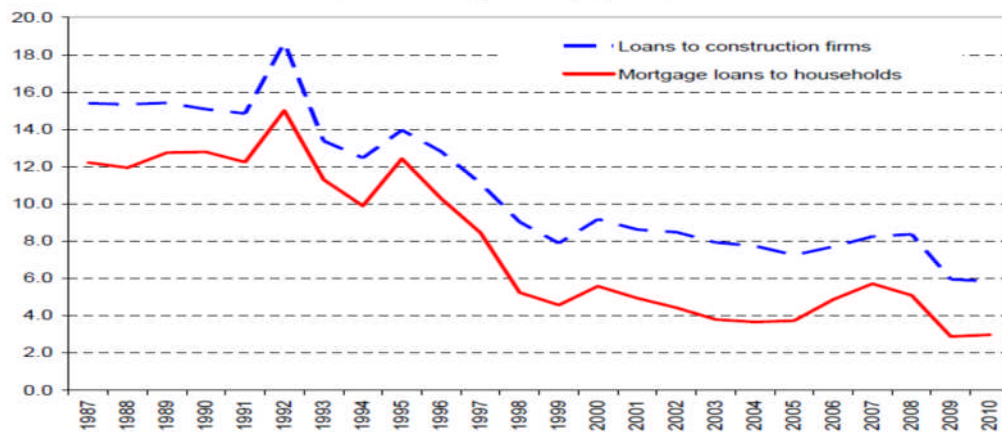
With the establishment of the euro area, bank rates closely followed the pattern of money market rates and the effects of monetary policy decisions.

Figure 17.4 - Credit Development (annual growth rate %)



Source: Bank of Italy

Figure 17.5 - Bank interest rate (annual data %)



Source: Bank of Italy

A further explanatory factor behind the decline in the cost of credit in recent years stems from the common international trend of financial liberalization and product de-specialization shared by the Italian banking system, as well as from the rapid increase in the number of intermediaries, both domestic and foreign, especially in the mortgage loan market (Nobili and Zollino, 2012).

For a comparison of loans and mortgages to households for residential and consumer purchase, see Chapter 3, Figure 3.1.

17.3 Real Estate Investment Funds in Italy

One of the instruments which mostly contributed to the development of the Italian real estate market, attracting foreign capital and increasing market transparency has been the real estate fund, introduced in 1999. During the last decade real estate funds have been subject to a continuous change in regulations, determining their development over time.

Real estate investment funds (REIFs) allow investors to convert real estate assets, which are typically hard to exchange, into units of financial products. In Italy they are established and managed by asset management companies (società di gestione del risparmio - SGRs) supervised by the Bank of Italy in

cooperation with Consob (Commissione Nazionale per la Società e la Borsa, Companies and Stock Exchange Commission). In particular, the Bank of Italy receives supervisory and statistical reports regarding all the REIFs established by Italian management companies..

Italian real estate funds are closed-end funds that give investors the right to redeem the units only at predetermined intervals, under specific circumstances and for limited amounts. This feature reduces the liquidity problems that might otherwise arise if a real estate fund functioned as an open-end fund, by allowing investors to request the redemption of their units at any time. In spite of that, Italian real estate funds are exposed to different types of risk: property, economic and liquidity risks are interconnected and associated with the credit market conditions and financial constraints (including debt repayment obligations and capital reimbursements).

In 2009, in addition to the supervisory and statistical reports, the Bank of Italy (Bank of Italy, 2010 and FSB, 2011) requested that all SGRs managing REIFs provide detailed data on the financial structure of funds and conducted an analysis of three aspects: (1) the financial profile; (2) income structure, and; (3) property price behaviour of each REIF.

In Italy, REIF activity involves different entities: (1) the asset management company that manages the fund; (2) the external and independent appraiser, who twice a year evaluates the properties held by the funds; (3) the depository bank which is responsible for keeping the securities and ensuring the fund's liquidity and may also be responsible for the periodic valuation of fund units; (4) finally, the Italian stock exchange for listed funds.

In 1994 REIFs were introduced in Italian legislation. A REIF can be established only after the approval of the fund rules by the Bank of Italy. Fund must to comply with a number of rules regarding investment thresholds and risk concentration, portfolio allocation and the maximum permissible debt ratio (the amount of debt cannot exceed 60 per cent of the value of real estate assets and

20 per cent of other investments). However, exceptions to the prudential rules are provided for funds reserved to qualified investors. Further exemptions are envisaged for the so-called speculative (or hedge) real estate funds that are allowed to exceed the debt limit of 60 per cent of the value of the property; for these funds there is a minimum subscription of 500,000 €. The main difference between Italian legislation and that of other countries is that real estate products intended for qualified investors are also subject to prudential regulation even if at times they are more similar to separate accounts than to mutual funds, since some of these funds have a small number of investors. Real estate held by funds are evaluated twice a year by external and independent appraisers. Nevertheless, fund managers remain fully responsible for real estate evaluation and they are not obliged to comply with the appraiser's evaluation.

Table 17.2 – Italian real estate investment funds data

	Dec. 03	Dec. 04	Dec. 05	Dec. 06	Dec. 07	Dec. 08	Dec.09	Jun. 10
All REIFs								
Number	19	31	61	119	174	229	267	281
Total assets	5,141	12,309	18,326	27,248	36,058	42,390	47,517	47,771
Real estate assets	3,718	10,520	15,215	22,110	30,434	36,791	40,936	41,678
Debt	573	3,979	6,019	9,890	13,453	16,630	19,517	19,347
NAV	4,414	8,084	11,859	16,384	21,531	24,446	26,306	26,846
Financial leverage	1.16	1.52	1.55	1.66	1.67	1.73	1.81	1.78
Retail funds								
Number	14	19	23	29	30	29	27	27
Total assets	3,836	6,531	8,057	10,168	10,731	10,185	9,461	9,282
Real estate assets	2,847	5,105	6,407	7,949	8,914	8,591	7,985	7,774
Debt	312	1,301	1,797	2,687	2,960	2,983	2,978	2,915
NAV	3,435	5,108	6,065	7,219	7,547	6,976	6,290	6,159
Financial leverage	1.12	1.28	1.33	1.41	1.42	1.46	1.50	1.51
Reserved funds								
Number	5	12	36	78	116	156	176	179
Total assets	1,304	5,778	9,900	13,641	19,762	26,240	31,176	31,128
Real estate assets	872	5,415	8,472	11,537	16,682	22,665	26,654	27,241
Debt	261	2,678	4,015	5,311	6,931	9,636	11,796	11,529
NAV	979	2,977	5,646	8,023	12,143	15,707	18,155	18,608
Financial leverage	1.33	1.94	1.75	1.70	1.63	1.67	1.72	1.67
Hedge funds								
Number			2	12	28	44	64	75
Total assets			369	3,439	5,564	5,964	6,879	7,361
Real estate assets			337	2,624	4,838	5,535	6,297	6,662
Debt			207	1,892	3,563	4,011	4,742	4,903
NAV			148	1,142	1,840	1,763	1,861	2,080
Financial leverage			2.50	3.01	3.02	3.38	3.70	3.54
SGR number	10	14	26	33	48	51	55	54

Source: Bank of Italy

Notwithstanding the financial crisis, the number of REIFs continued to increase between January 2008 and June 2010. The number of active funds at the end of June 2010 amounted to 281 (27 retail, 179 reserved and 75 hedge, as shown in Table 17.2).

The number of asset management companies managing this type of vehicle was 54 at the end of June 2010. These SGRs mainly belong to banking groups but there are also property market operators (Italian and foreign) and private individuals with professional experience in the field. In recent years, the market concentration has significantly decreased, due to the entry of new operators.

Most of the funds buy properties and lease them, sometimes after significant restructuring initiatives and after enhancing the property portfolio to make them more suitable to lease. However, almost one third of the Italian REIFs are focused on real estate development (we refer to them as development funds): during the construction or restructuring phase, the funds bear the cost of debt but do not generate incomes. Thus, the riskiness of these funds may be higher, especially during property market downturns.

With reference to the asset allocation of investments by funds, in the very last years a tendency started towards higher a balance in real estate investments, based on European experience, reducing the office portion. This reduction, from 66.7% in 2004 to 51.7% today, has only been partly offset by the retail sector, up in the same period from 11.3% to 19.1%, still lower than the European average. The geographical asset allocation of Italian real estate funds in 2009 was concentrated in the north-west with 43.8% of the total, followed by central Italy (30.4%), the north-east (14.7%) and the south and islands 8.9%). Investments abroad were a mere 2.2% (Nomisma, 2010).

Part III

Distribution, Inequality and crisis

18. Inequality in Italy

18.1 Income inequality and the Geographical Gap

The economic literature is unanimous in identifying greater inequality within countries income and wealth distribution over the last two decades (Cornia, 2003; Berg and Ostry, 2011; Bergh and Nilsson, 2010; Bollè, 2008; Celik and Basdas, 2010; Dreher and Gaston, 2008; Goldberg and Pavcnik, 2007; Jauomotte et al., 2008; Palma, 2006; Qureshi and Wan, 2008; Ulubasoglu, 2004). In developed countries, the theme of income distribution was evident before the start of financial crises (Bryan and Martinez, 2008; Lawrence, 2008). The graveness of the last financial crises and the speed who it spread, has attracted the attention on the role of US income inequality in the origin of financial crises. As a consequence of the growing interest about this problem, official reports published by the International Labour Organization (ILO, 2008), and OECD (2008, 2011) show that the recent period of globalization has also been characterize by a rising of inequalities. Basically, empirical results show the concentration of income and wealth at the top of the distribution curve.

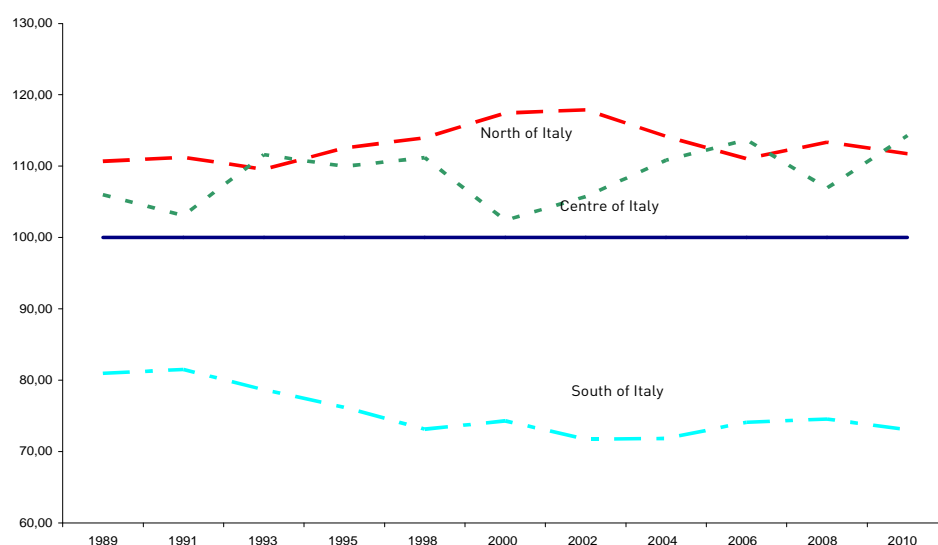
Italy is characterized by wide differences between geographical area in terms of distribution of households income. The usual Italian geographical distribution is shared in three macro-areas: Northern (green), Central (white) Southern and Islands (red) (figure 18.1).

Figure 18.1. Italy's geographical distribution



The households disposable income is higher in the Centre and the North than in the South and Islands. Between 1989 and 2010 the gap widened: in 2010 the median income of households in the North and Centre was 53 and 56 per cent greater than that of households in the South and Islands, compared with a difference of 37 and 31 per cent in 1989 (Figure 18.1). Between 1989 and 2010, the households net disposable income grew by 8.2 per cent in the Centre and 9.6 per cent in the North; in the South and Islands it declined of about 9.3 per cent.

Figure 18.2. Average Households Net Disposable Income by geographical area (1989 – 2010; Italy = 100)



Source: Our elaboration on Surveys on Households Income and Wealth, Bank of Italy

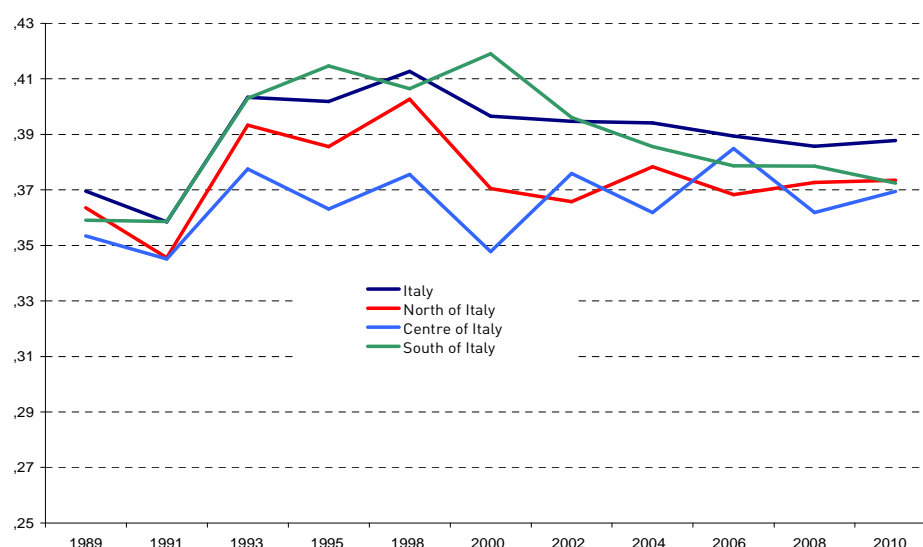
The most widely used and available inequality measure is the Gini coefficient, which ranges between 0 and 1 (or in percentage terms between 0 and 100), with 1 representing respectively the highest and 0 the lowest inequality. If the index were equal to 0, all individual in a country would have the same identical income. On the other hand, if the index were equal to 1, all domestic income would go to just one individual. As a consequence, an upward movement of the coefficient signals rising inequality.

Figure 18.3 shows the Gini Index computed on Average Households Disposable Income. Italy recorded an increase of income inequality in the last two decades, mostly concentrated during the severe economic recession of the early 1990s. From 1998 the Index recorded a weak decrease. At the end of 2010, the Gini concentration index for average household disposable incomes was 38.6 per cent, slightly decreased compare to 2000 (39.4 per cent).

Although the trend is through the convergence, it is interesting to observe the differences of Gini Index between different geographical areas. In 2000, the concentration was higher in the South and Islands (41,6 per cent) than in the Centre (34.8 per cent) and the North (39 per cent). During the last decade, Gini

coefficient decreased by 4 percentage points in South of Italy (37.4 per cent in 2010) and 2 percentage points in North of Italy while it increased in the Centre of Italy (36.9 per cent).

Figure 18.3. Gini Index for Average Households Net Disposable Income by geographical area (1989 – 2010)



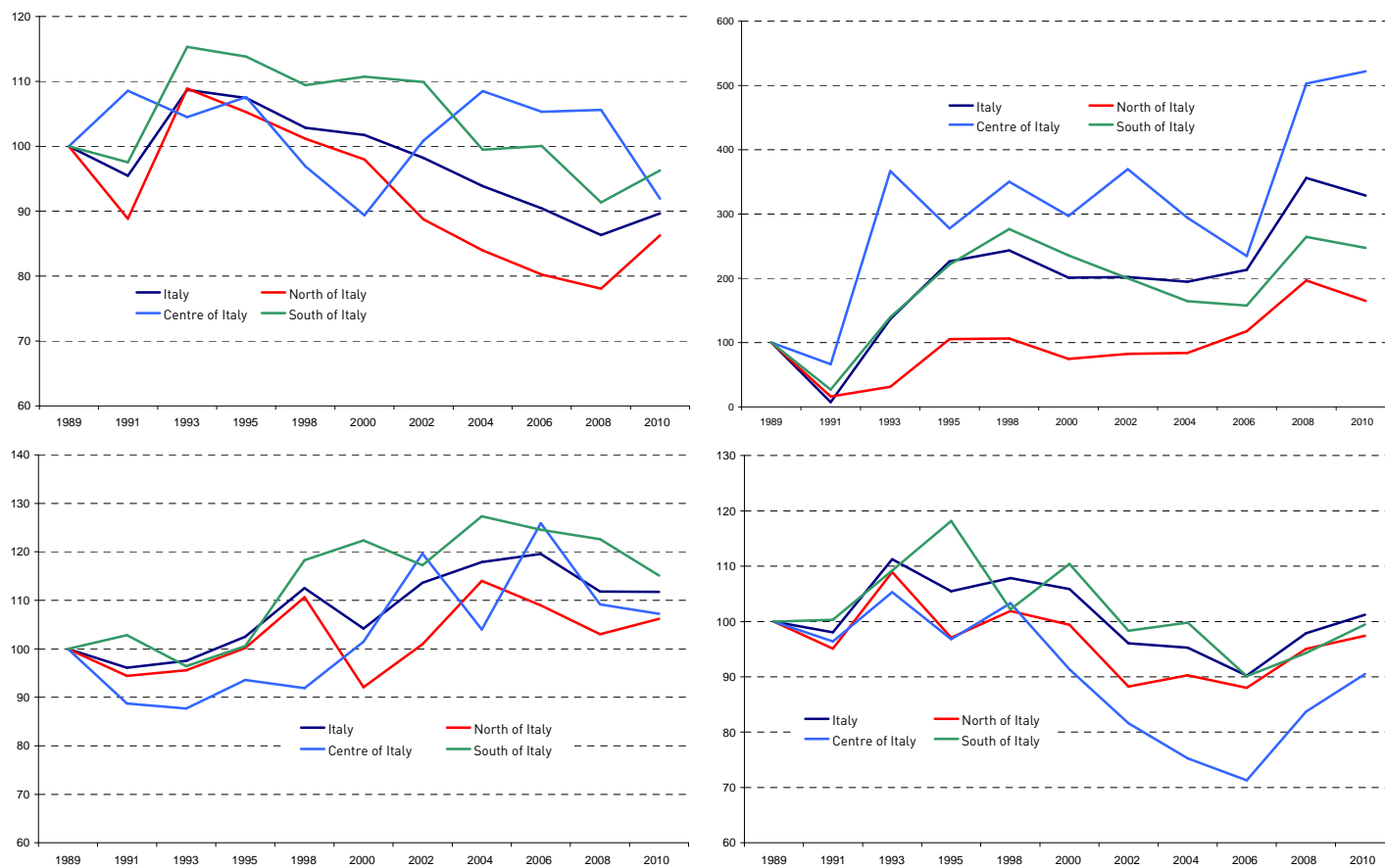
Source: Our elaboration on Surveys on Households Income and Wealth, Bank of Italy

Focusing on different sources of income at regional level, we found some interesting outcomes. First, each area recorded, on average, a recovery of average households disposable income from salaried employment (figure 18.4 top left). Second, after a remarkable decrease in concentration of property income between 1993 and 2004, from 2006 along with financial crises, Gini index values are almost the same of the starting period (figure 18.4 bottom right).

The main sources of inequality come the self-employment incomes and transfers incomes (respectively, figures 18.4 top right and 18.4 bottom left). The growth rate of Gini index for this latter source of income is very high, especially in central and southern regions.

Although the Gini is sensitive to what happens to income shares in the tails of the income distribution, it is more sensitive to changes in shares in the middle of the distribution. For this reason, it is common to use the Gini with an analysis of inequality at the extremes of the income distribution. The information given by distribution ratios is generally a useful complement to the Gini index.

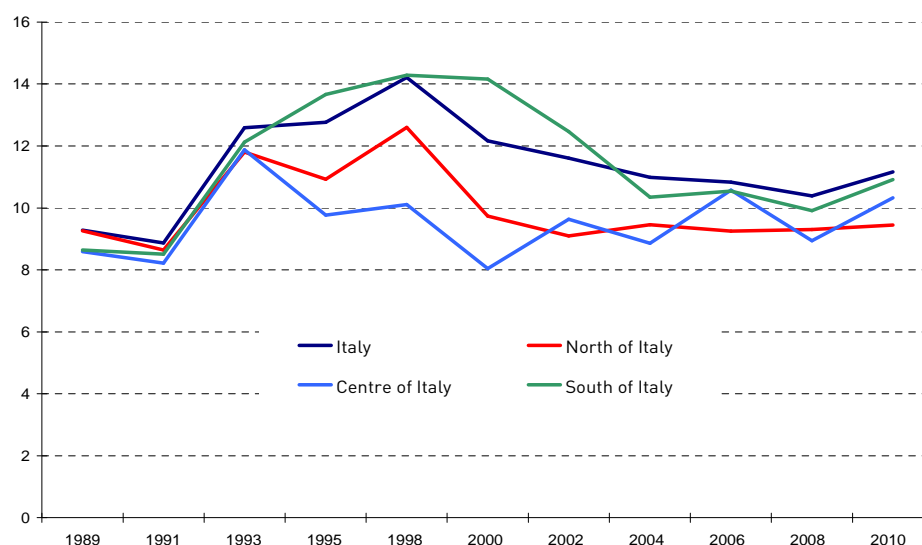
Figure 18.4. Gini Index for Average Households Net Disposable Income by geographical area (1989 – 2010). Pay Roll employment (top left); Transfers (top right); self employment (bottom left); property (bottom right)



Source: Our elaboration on Surveys on Households Income and Wealth, Bank of Italy

At the end of 2010 in Italy, the average income of the richest 10% of the households is about eleven times that of the poorest 10% – a ratio of 11 to 1; in 1989 the ratio was 9. Within Italy there are many differences among regions. Between 1990 and 2000, the higher values were recorded in South of Italy and only in the last decade it seems to converge (figure 18.5).

Figure 18.5. Concentration of Income by geographical area: share held by 10% richest to share held by 10% poorest (1989 – 2010)

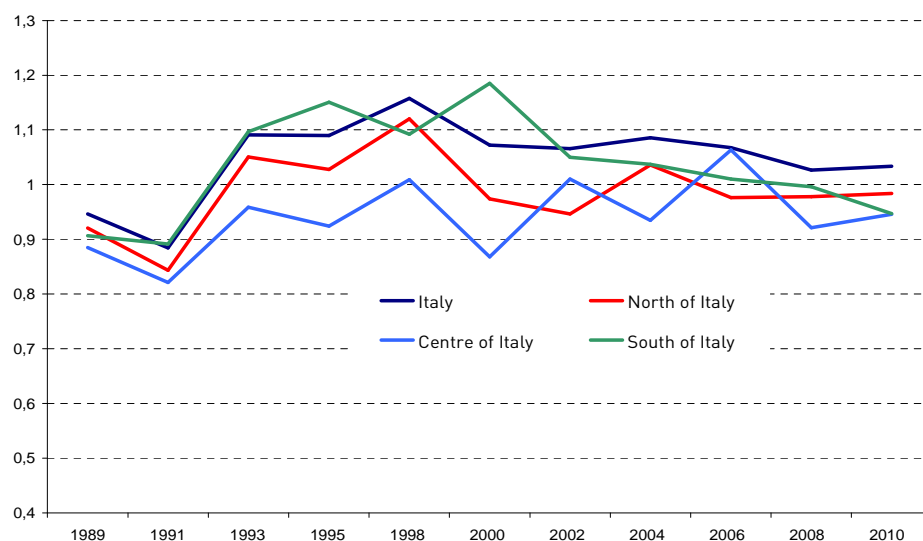


Source: Our elaboration on Surveys on Households Income and Wealth, Bank of Italy

To confirm the increase of inequality in the last two decade, we show the ratio between the average income of the richest 10% of the households and the average income of the least well-off 50% (Figure 18.6). Although in the last years the ratio has slightly fallen, it is higher than the past and this is true for all regions. Inequality particularly increase during nineties, especially in North and South of Italy.

The values of this ratio are particularly important because, an increase means that there is a higher concentration of income in the hands of relatively few people at the expense of the middle class which comprises the majority of the population.

Figure 18.6. Concentration of Income by geographical area: share held by 10% richest to share held by 50% least well-off (1989 – 2010)

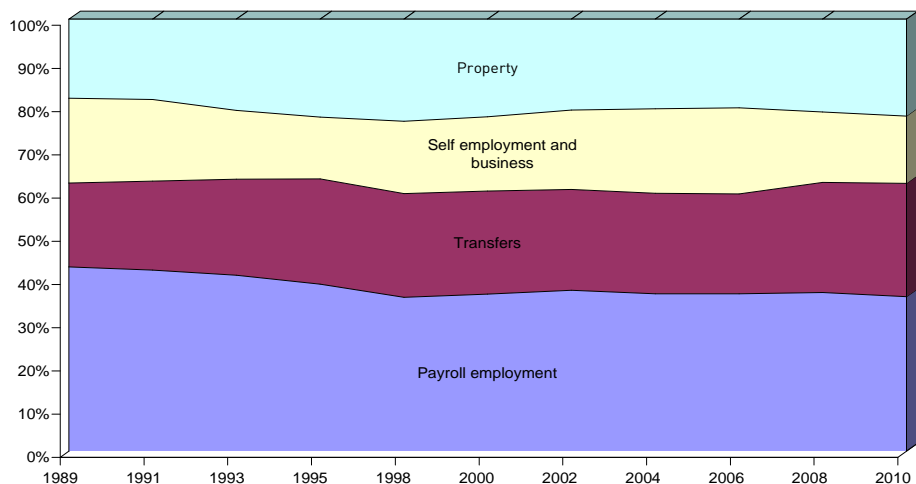


Source: Our elaboration on Surveys on Households Income and Wealth, Bank of Italy

18.2 The composition of Household Income Inequality

At the end of 2010 the largest share of household income consists of income from wages from employment (35.8 per cent), while income from transfers, property, and self-employment and business activity account respectively for 26.2, 22.4 and 15.6 per cent (Figure 18.7). Between 1989 and 2010, the shares of income from salaried employment and self-employment have decreased of 6.9 and 4 per cent respectively while those from property and transfers have increased of 6.8 and 4.1 per cent.

Figure 18.7. Composition of Average Households Income (1989 – 2010)



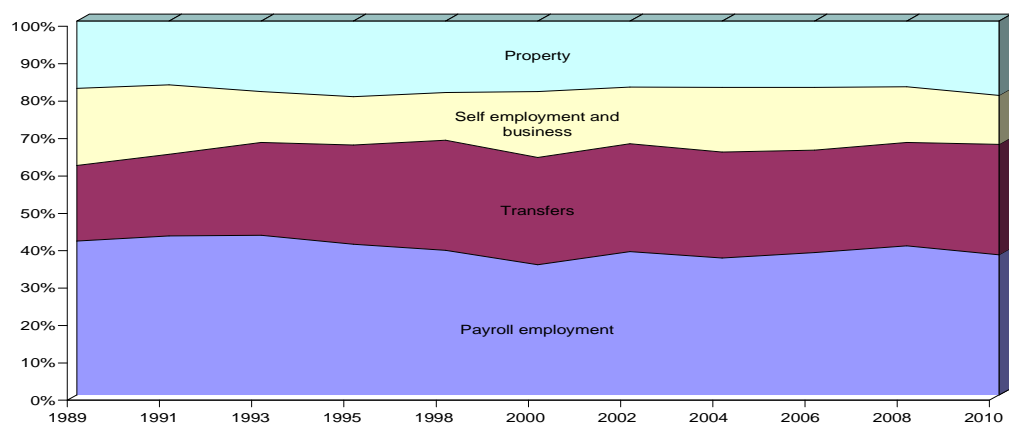
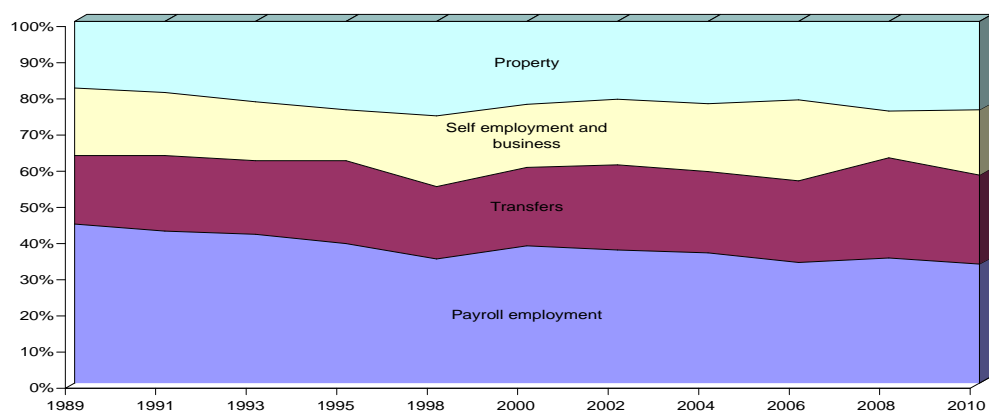
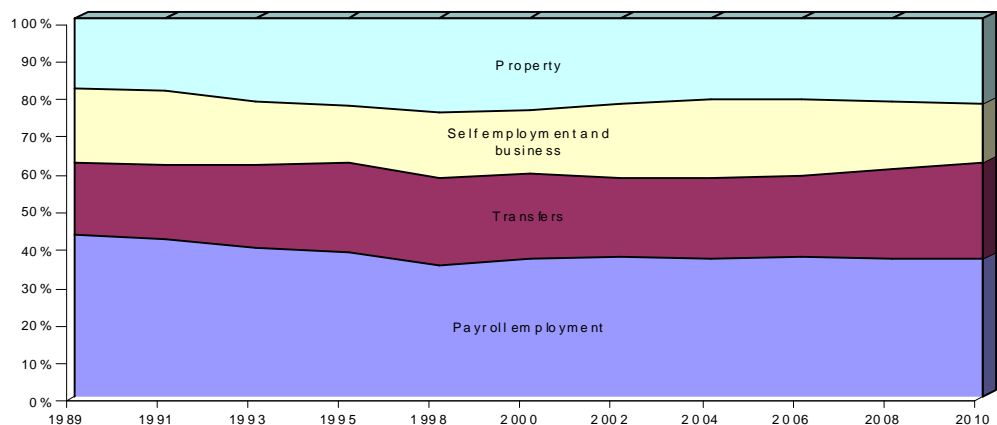
Source: Our elaboration on Surveys on Households Income and Wealth, Bank of Italy

Payroll employment has progressively declined both for real fundamental reasons and for the reduction of stable employment incidence. On the other side, the contribution of property inequalities has been originated by self-employment earnings and by property. This last income source is explained by the real estate property and by financial assets returns.

The analysis at regional level shows some important differences. Although the trend was the same between 1989 and 2010, the variation of the various type of sources of income are very different within Italy (figure 18.8). In Southern Italy the decrease of share of household disposable income from payroll employment has been 3.6 per cent during last two decade, while in Northern Italy and especially in Centre of Italy it has been stronger (-11 and -6 per cent respectively). On the contrary, the increase of share of income from transfers has been much higher in South of Italy than in Centre and North of Italy (+9 per cent and +5.7 and + 6.3 per cent respectively). Income from self-employment account for 15.6 per cent in Northern Italy and 13.1 per cent in South of Italy at the end of 2010 recording, compared with 1989, a decrease of 3.8 and 7.6 per cent respectively. The share has basically held steady in Centre of Italy. Finally,

income from property is higher of 6 per cent in Centre, 4.2 per cent in Northern Italy and only 1,8 per cent in South of Italy.

Figure 18.8. Composition of Average Households Income (1989 – 2010). Northern (top); Centre (middle), Southern Italy (bottom)



Source: Our elaboration on Surveys on Households Income and Wealth, Bank of Italy

18.3 The Italian Households Wealth

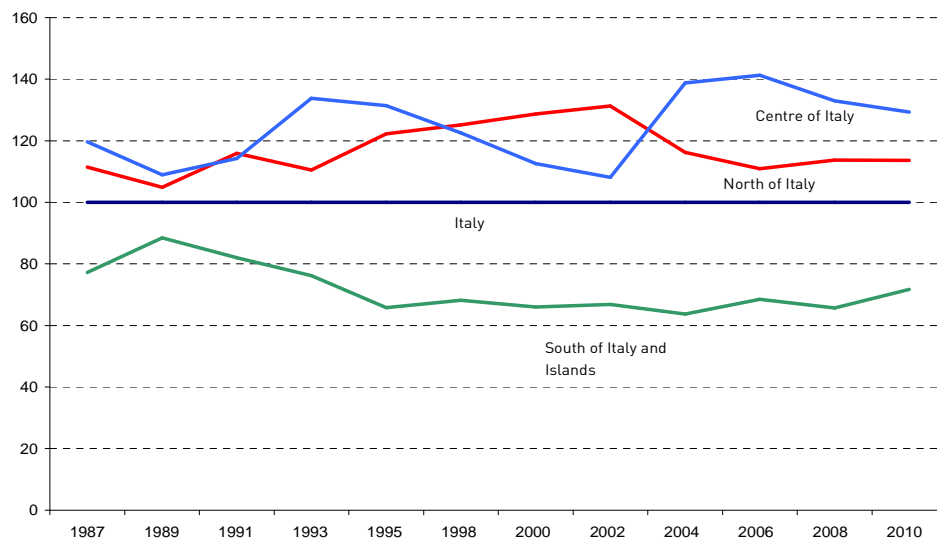
The Wealth represent an important characteristic for household wellness and, in general, for a community. In the richest countries we observe higher levels of consumption, high education rate and higher life expectancy than poorest countries. To the other hand, the poorest countries are characterized by less wellness, high levels of mortality rate and lower schooling rate. To the extent we know the amount of wealth, the composition and how it is distributed among different groups of population, it can be much useful to address redistribution policies and, therefore, to decrease inequality.

Household net wealth is the sum of real assets (property, businesses and valuable) and financial assets (deposits, governments securities, shares, etc.) net of financial liabilities (mortgages loans and other debts).

At the end of 2010, median wealth was higher in the Centre (€ 216.000) and in North (€ 189.800) than in the South and Islands (€ 119.750)⁵. The gap widened between 1987 and 2010 (Figure 18.9): in 2010 the median wealth of households in the North and Centre was 58,5 and 80 per cent greater than that of households in the South of Italy and Islands, compared with a difference of 44 and 55 per cent in 1987.

⁵ The values can slightly be different from those in Supplements to the Statistical Bulletin of Bank of Italy because of different version of SHIW.

Figure 18.9. Median Household Net Wealth by geographical area (1987 – 2010; Italy=100).



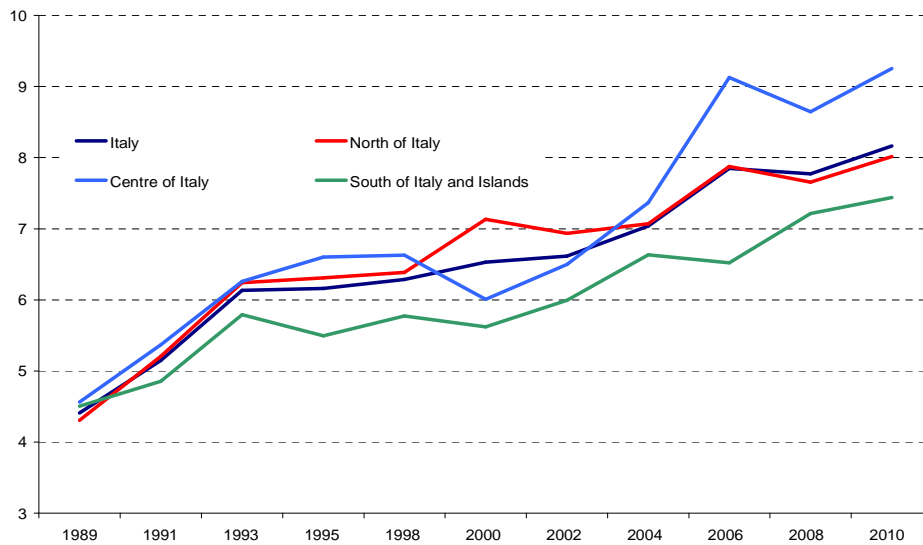
Source: Our elaboration on Surveys on Households Income and Wealth, Bank of Italy

There is a strong increase in the wealth-income ratio throughout the 1990s and 2000s. At the end of 2010, Net Wealth was equal 8 times household income, up from 4.4 times in 1989⁶ (Figure 18.10). The trend is the same in each macro-area in which is shared Italy. The increase reflects appreciation of the housing stocks (about 75-80 per cent of wealth is held in real estate) and this latter is particularly strong in Centre of Italy where the prices of real estates recorded a high increase between nineties and twenties. The increase in the wealth-income ratio also reflects higher rates of homeownership. Between 1980 and 2010 the share of households owned their homes has grown of about 10 points per cent⁷.

⁶ The increase is confirmed by the aggregate estimates (see "Household Wealth in Italy, 2010") according to which the ratio stood at 8.2 in 2010, up from 8 in 2008, 7.2 in 2000 and 6 in 1995. The estimates are based on Historical database.

⁷ See "Supplements to the Statistical Bulletin, 2010".

Figure 18.10. Average Household Net Wealth to Average Disposable Income by geographical area (1989 – 2010).

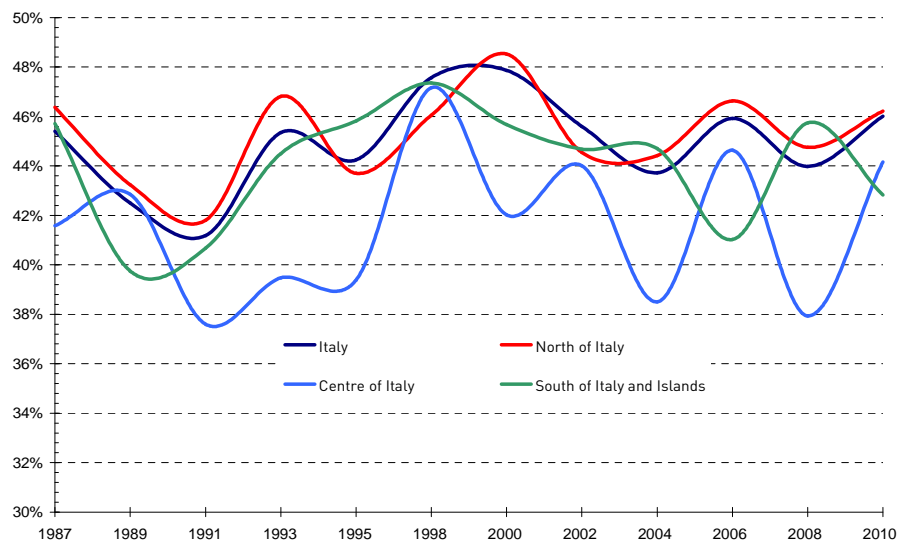


Source: Our elaboration on Surveys on Households Income and Wealth, Bank of Italy

18.4 Inequality through time

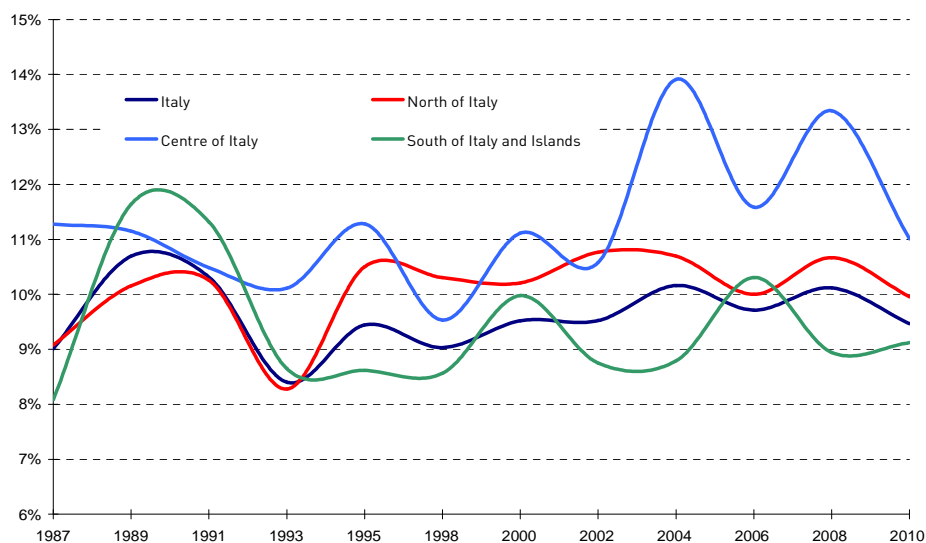
In Italy, the ten richest persons hold an amount of wealth equal to that held by three millions poorest Italians (Cannari and D'Alessio, 2006). Net wealth is much more concentrated than income: the richest 10 per cent of households held 46 per cent of Italian households total net wealth in 2010 (45% in 1987 and 48% in 2000) (Figure 18.11). At regional level, Centre shows a higher variability than North and South of Italy. Moreover, while in the former the share at the end of 2010 was higher than 1987 (44 and 41.8 per cent respectively), in South of Italy it reduced from 45.7 to 42.8 per cent and in North of Italy it held substantially steady. On the contrary, the share of wealth held by households in the bottom half of the distribution is higher in Centre than in North and Southern Italy over last two decade (on average, 11 per cent and 10 and 9 per cent respectively) (Figure 18.12).

Figure 18.11. Share of Wealth held by richest 10 per cent by geographical area (1987-2010)



Source: Our elaboration on Surveys on Households Income and Wealth, Bank of Italy

Figure 18.12. Share of Wealth held by least well-off 50 per cent by geographical area (1987-2010)

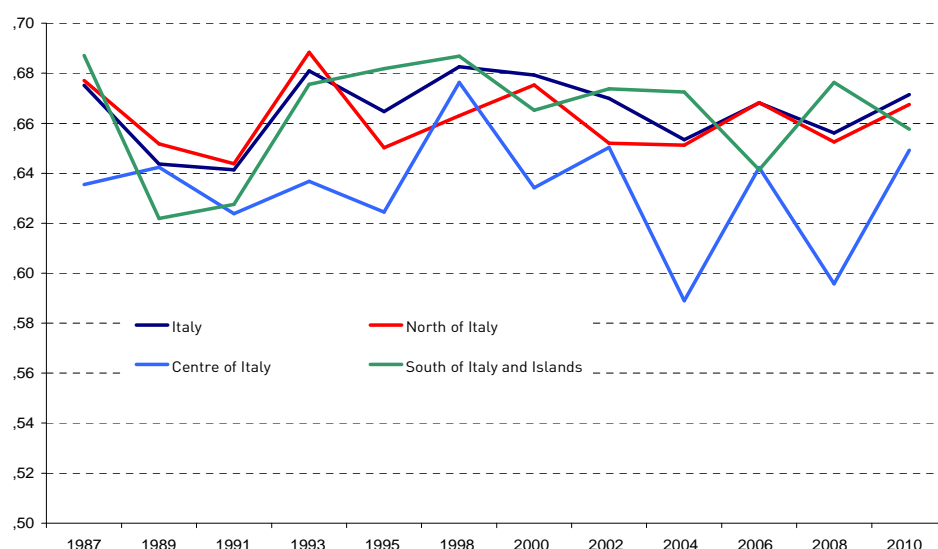


Source: Our elaboration on Surveys on Households Income and Wealth, Bank of Italy

The Gini Index computed on average household net wealth, between 1987 and 2010 fluctuated around a mean of 66 per cent (Figure 18.13); there is a strong increase of concentration throughout the 1990 and a slowdown in the 2000s. From 2008, the index probably because of financial crises , on average, is rising

again. Within Italy it is possible to observe some interesting outcomes. First, on average, inequality is lower in Centre than North and South of Italy; second, the slowdown of index during the 2000s is much more marked in the former probably due to the increase of real estate market. Finally, from 2008 while the concentration in South of Italy decrease, North and particularly Centre of Italy show an important growth.

Figure 18.13. Gini Index for Average Household Net Wealth by geographical area (1987-2010)



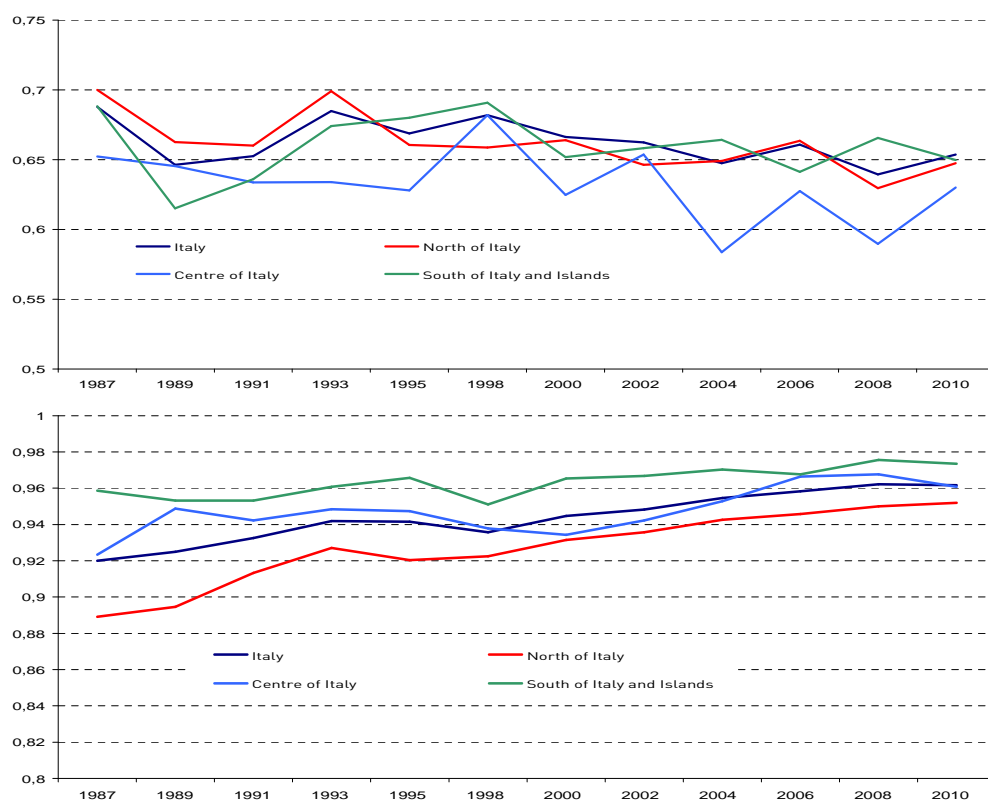
Source: Our elaboration on Surveys on Households Income and Wealth, Bank of Italy

The most important effects on wealth distribution come from changes of its value and this latter depend on asset prices. Generally, because of richest hold higher investments in financial markets than the poorest, an increase of stock prices tend to increase inequality while in case of slowdown of stock market occur the contrary. Differently, an increase of house prices lead up to less inequality while when the prices drop inequality rise.

Although concentration is very high, while inequality in total wealth is fairly stable, there is a great difference between Real Assets and Financial Assets (Figure 18.14). First, concentration is much stronger in Financial Assets than

Real Assets: the Gini Index values are higher in the former than the latter and this is true for each area. Second, while the concentration index of real assets show a decreasing long term trend that probably depend on the increase in home ownership (from 50 per cent in 1980 to 68.4 per cent in 2010⁸), inequality in financial wealth hardly grew between 1987 and 2010 but the growth rates are very different among regions. In the Southern Italy, although the Gini index values are higher than Centre of Italy and especially Northern Italy, concentration has substantially remained stable. On the contrary, while Centre of Italy recorded an increase of inequality in the 2000s, in Northern Italy concentration has constantly grown during over the period.

Figure 18.14. Gini Index for Average Household Net Wealth by geographical area (1987-2010). Real Assets (top). Financial Assets (bottom)



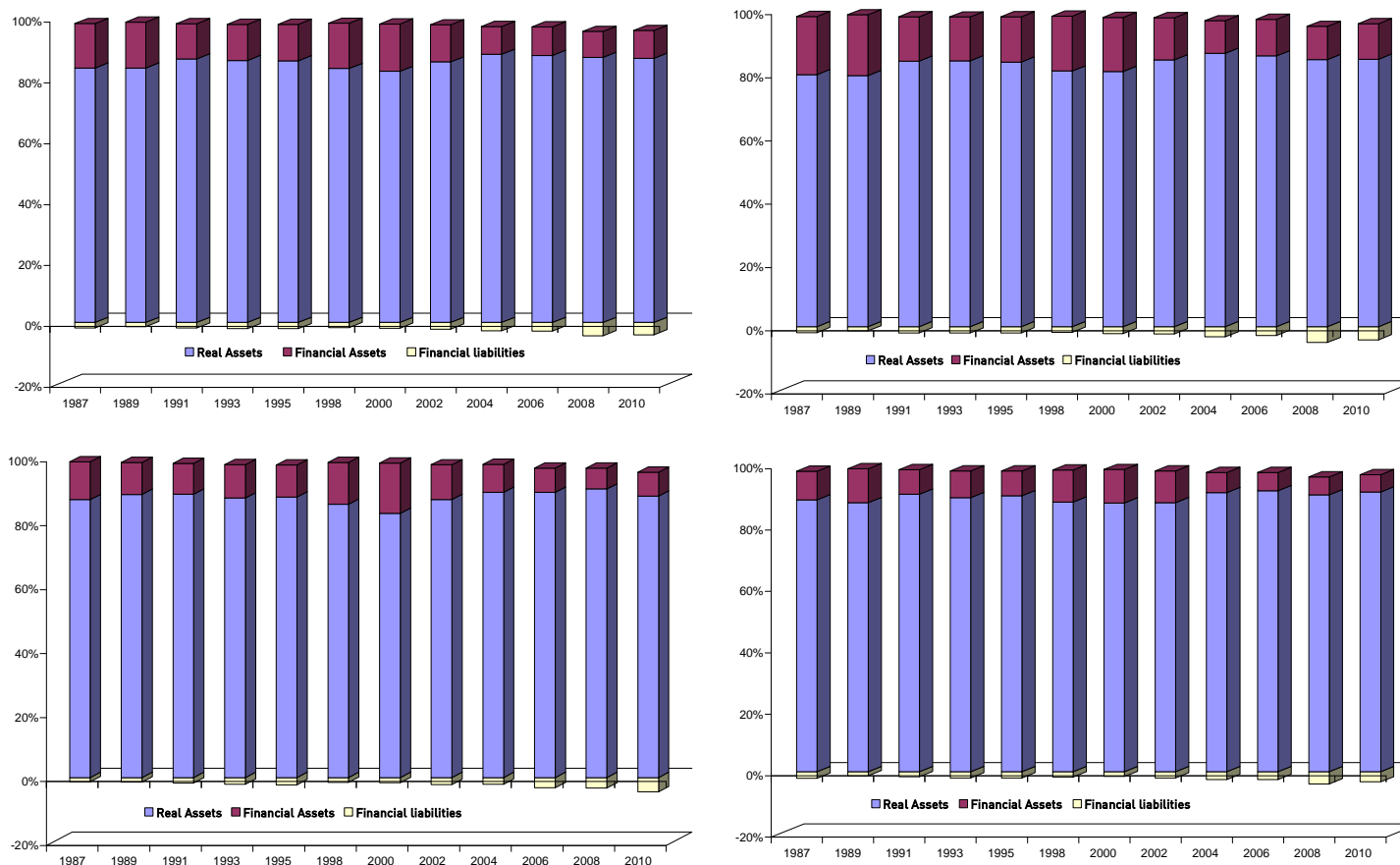
Source: Our elaboration on Surveys on Households Income and Wealth, Bank of Italy

⁸ See "Supplements to the Statistical Bulletin, Bank of Italy" (2010)

18.5 The composition of Wealth

The largest share of household wealth consists of real assets. In Italy, at the end of 2010 the share of average household real assets was 94.5 while wealth from financial assets and financial liabilities was about 10 and -4.4 per cent respectively (figure 18.15 bottom left). Between 1987 and 2010 the share of average real assets increase of about 8 points where the average financial assets decreased from 15 to 10 per cent and that of financial liabilities grew from 2 to 4.4 per cent. At the geographical level, although the most of wealth consists of real assets, there are some differences. In 1987 wealth came from real assets was about 92.5 per cent in Southern Italy (figure 18.15 bottom right), much higher than Centre (89%) (figure 18.15 bottom left) and Northern Italy (82.4%) (figure 18.15 top right); on the contrary, average household net financial wealth (the difference between financial asset and financial liabilities) was about 18 per cent in North of Italy, 11 per cent in Centre and only about 7 per cent in South of Italy. During last two decade, the share of wealth from real assets dramatically increase in each region but the magnitude of changes was different. The most changes was recorded in North of Italy where the share of real assets increased of about 10 points per cent and financial assets decreased of 7 points per cent (share of financial liabilities grew of 3 points per cent). Centre of Italy shows a similar pattern with a high growth of share of wealth from real assets (89 in 1987 and 96.6 per cent in 2010) and a strongly decreased of share in net financial wealth (- 4 points in financial assets and + 4 points in financial liabilities). South of Italy shows a smoother changes: share of real assets come from 93 in 1987 to 97 per cent in 2010 and financial assets decrease of 3 points per cent in the same period. The share of financial liabilities only increase of about 1 point per cent.

Figure 18.15. Composition of Average Household Net Wealth by geographical area (1987 – 2010). Italy (top left); North of Italy (top right); Centre of Italy (bottom left); South of Italy (bottom right)

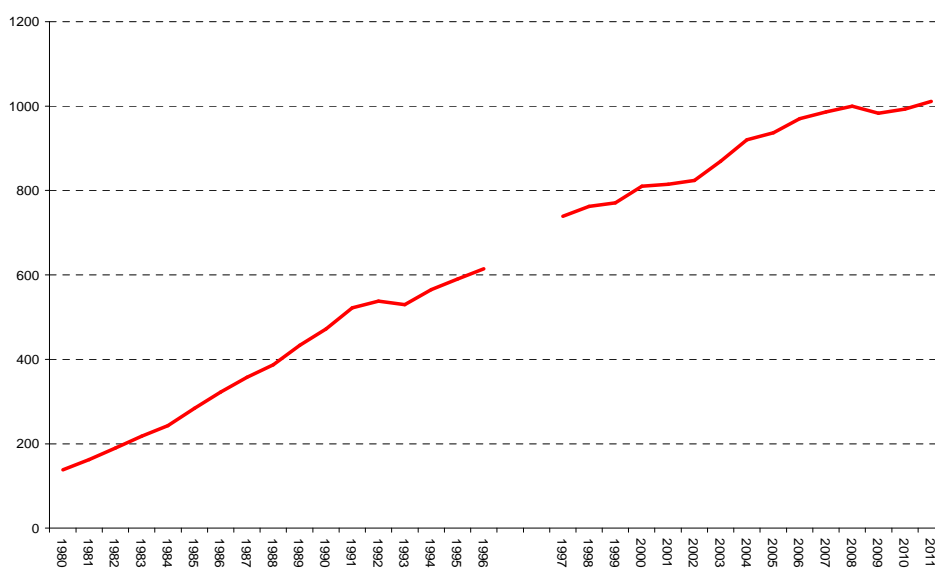


Source: Our elaboration on Surveys on Households Income and Wealth, Bank of Italy

18.6 Poverty in Italy

In 2011 the relative poverty threshold⁹, for a two members household, was equal to 1011.03 euros, around 18 euros higher than the 2010 threshold (+1.9%). In current euros, between 2000 and 2011 the relative poverty threshold has increased of 24.8 per cent (from 810.21 to 1011.03) but for the beginning of the last financial crises it has only grown of 2.5 per cent¹⁰ (figure 18.16).

Figure 18.16. Poverty line threshold in Italy (1980-2011)



Source: Household Budget Surveys, Istat

To the aim of synthesise the information about different poverty aspects, we show the trend of two well known poverty indices: the relative poverty intensity and the relative poverty incidence. The first is the poverty mean gap. It

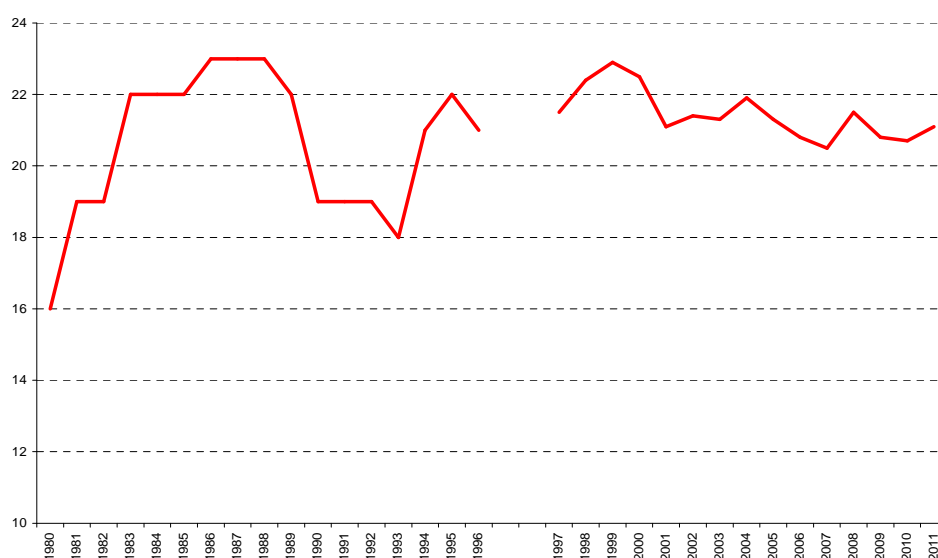
⁹ The Poverty is measured at the household level, assuming that household members resources are equally distributed within the household and that all members share the same standard of life. In particular, the measure of relative poverty, known as the International Standard of Poverty Line (ISPL), is calculated on the basis of the distribution of consumption expenditure among households residing in Italy. A two-member household is defined poor if its consumption expenditure is lower than or equal to the average per-capita consumption expenditure. In other words, a two-member household is considered poor if its expenditure level is lower than or equal to the average level for a single person.

¹⁰ Data from 1980 to 1996 and those from 1997 on are not comparable because of a deeply modifications of Survey methodologies.

measures how poor are the poor, that is, in percentage terms, the difference between the mean equivalent consumption expenditures of poor household and poverty line. The second is the ratio between the number of households with a monthly consumption expenditure lower than or equal to the poverty line and the total number of residing household. This index expresses the share of households living in poverty.

After the dramatic increase that intensity of relative poverty recorded between 1980 and 1996, in the last decade it substantially remained stable round about 21 per cent (figure 18.17).

Figure 18.17. The intensity of relative poverty in Italy (1980-2011).

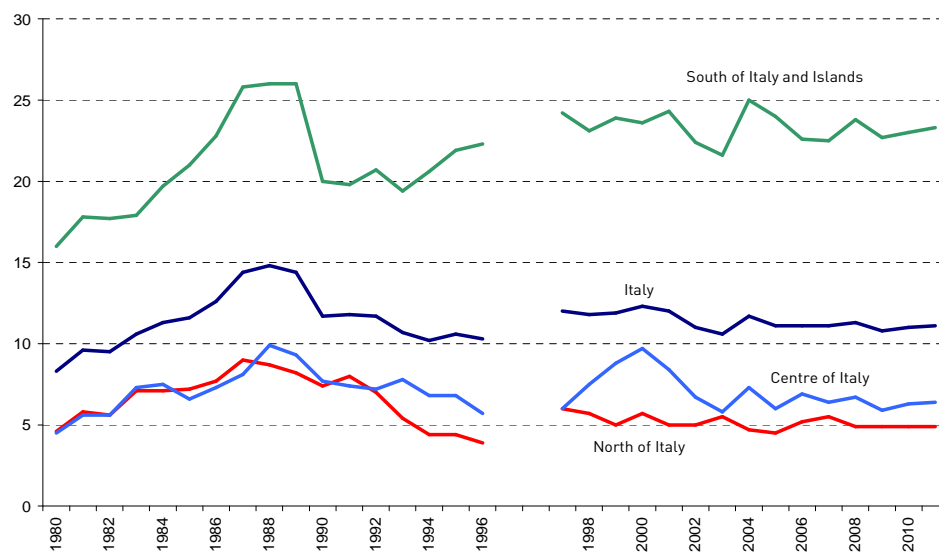


Source: Household Budget Surveys, Istat

The incidence of relative poverty in Italy after an increase between 1980 and 1996 (8.3 and 10.3 respectively), it held round about 11 per cent during last decade (figure 18.18). Compared to the stability observed in the North (4.6 in 1980 and 4.9 in 2011), in Centre and particularly in South and Islands the incidence of relative poverty grew in considerable manner and this is true for both two sub-period 1980-1996 and 1997-2011. In the Centre the index got from

4.5 to 5.7 in the first sub period and from 6 to 6.4 in the second one while in the South and Islands it grew from 16 to 22.3 between 1980 and 1996 and it remained stable around of 23 per cent in the last period.

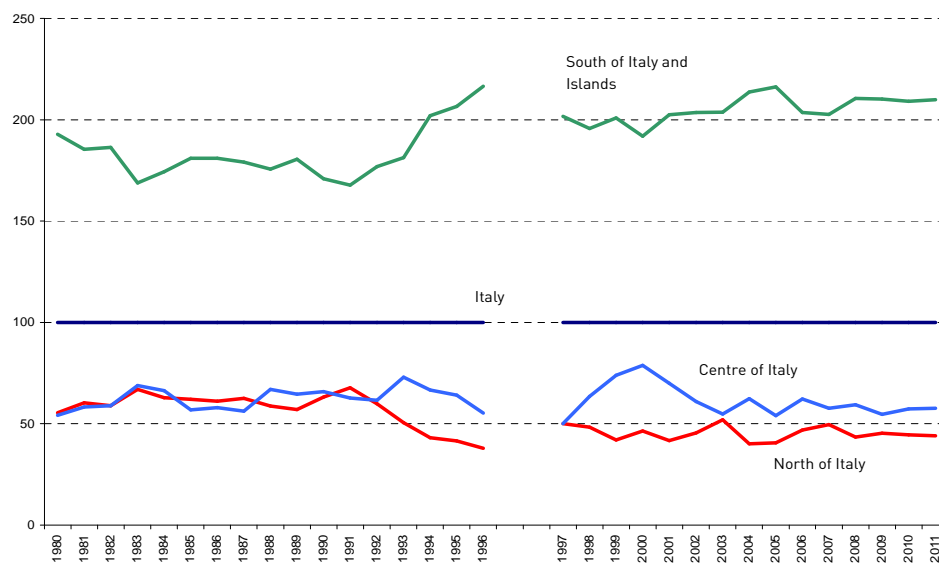
Figure 18.18. The incidence of relative poverty in Italy by geographical area (1980-2011).



Source: Household Budget Surveys, Istat

Between 1980 and 2011 the gap widened: in 2011 the incidence of relative poverty in the North and Centre was 4.76 and 3.64 times lower than in the South and Islands, compared with a difference of 3.48 and 3.55 times in 1980 (Figure 18.19).

Figure 18.19. The incidence of relative poverty in Italy by geographical area (1980-2011; Italy=100).



Source: Our elaboration on Household Budget Surveys, Istat

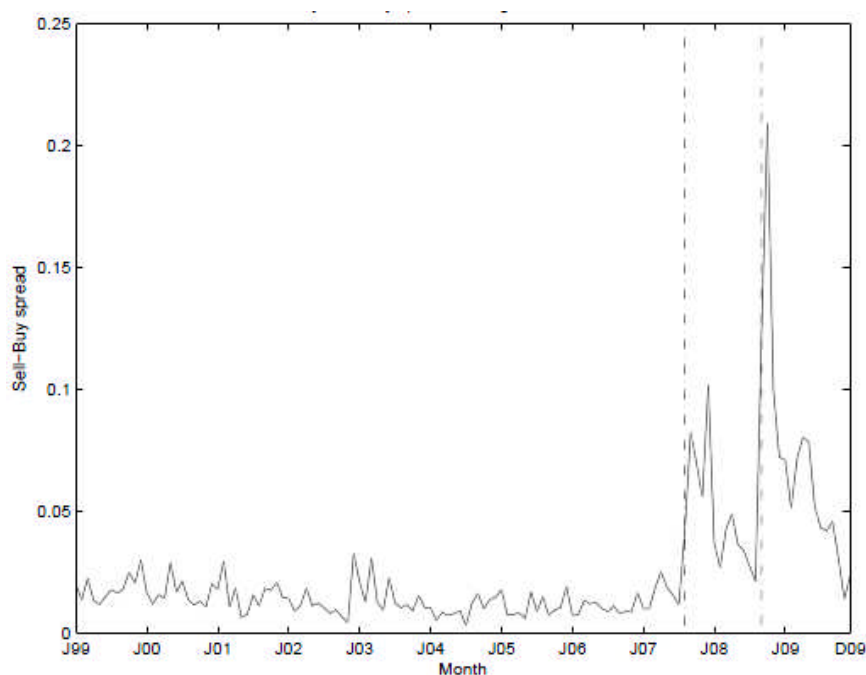
19. Preliminary Outlook of the crisis

Giampaolo Gabbi

19.1 The crisis and the financial system

How the financial crisis within the banking system in Italy was recorded can be measured through the volatility of the interbank market. It was structurally flat, at least when measured in terms of bid-ask spread. During the crisis some bid-ask spreads experience values higher than 200 basis points, when the usual pre-crisis level was around 3 basis points (figure 19.1).

Figure 19.1. Monthly average of the daily Italian interbank bid – ask spread of overnight deposits (1999 – 2009)*



* the first vertical dotted line designs the beginning of the crisis, 9th August 2007; the second dotted vertical line designs the Lehman Bros collapse, 12th September 2008).

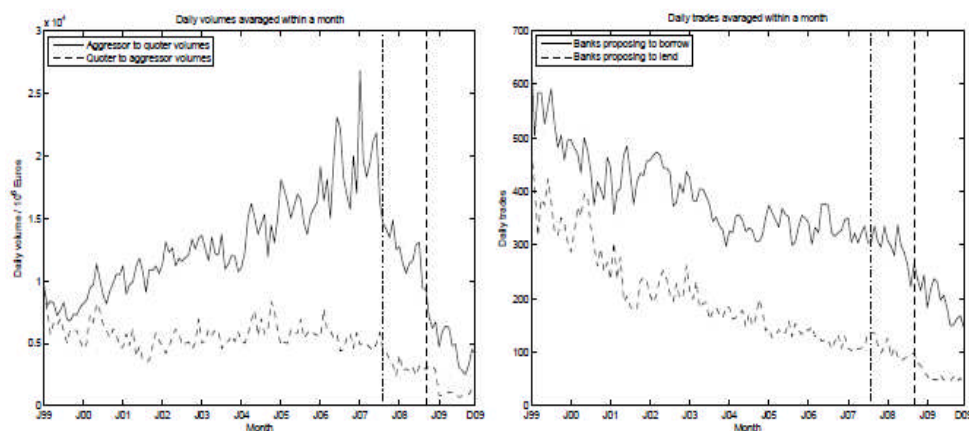
Source: Gabbi et al. (2013)

The liquidity stress seems to be absorbed just before the Lehman bankruptcy, when the bid-ask spread drops below 5 basis points, the resistance level

empirically observed before the sub-prime shock. This is certainly due to the massive liquidity intervention of the European Central Bank, that from June 2007 to June 2010 increased their assets of about 600 billion euros (+65%), using standing facilities, marginal lending facilities and open market operations, easing the procedures and the eligible assets required to borrow money.

Liquidity is also measured via volume approaches comparing both the number and the volume of trades, and the number of active banks. The Italian interbank market is quote driven. The results are presented separating trades into deals where liquidity went from the aggressor bank to the quoter (Sell label) and the opposite (Buy label). The main difference between the pre and post crisis periods is the magnitude of the traded volumes (figure 19.2.).

Figure 19.2. Daily volumes (left) and daily trades (right) within a month (1999 – 2009; aggressors to quoter and quoter to aggressors data)



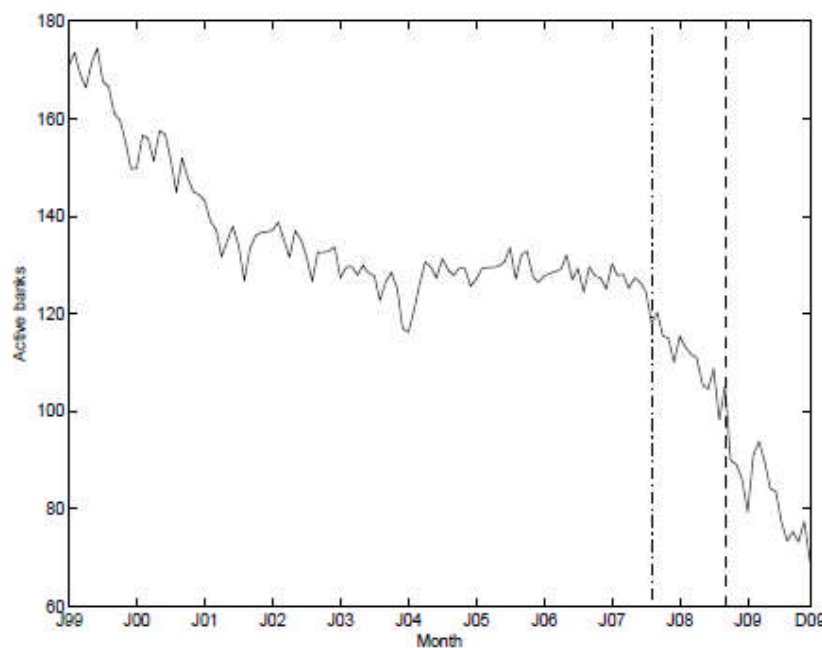
Source: Gabbi et al. (2013)

The crisis significantly affected the number of daily trades, even though the trend appears to be negative since 1999, both for quoters and for aggressors.

One of the most significant impacts on the interbank market functioning can be appreciated looking at the number of active banks. By active banks we define interbank agents borrowing or lending money at least once a day. Figure 19.3.

shows three long-term trends. First, from 1999 to 2004, the number decreases for two reasons: the market was basically domestic, that period was characterized by a lower number of medium and large banks, due to mergers and acquisitions; moreover, during the period 2000-2003, banks preferred the flight-to-quality strategy to exit the equity market, enhancing their liquidity reserves. Second, from 2004 to mid-2007, when the market become more international oriented, and the number of foreign banks equals the domestic ones: this period is characterized by a constant number of daily active banks, around the monthly average of 130 agents. Third, after the beginning crisis when the number of active banks drops below 80 (figure 19.3.).

Figure 19.3. Daily active banks (1999 – 2009; A bank is considered active if part of at least one trade during a given day without considering its side)

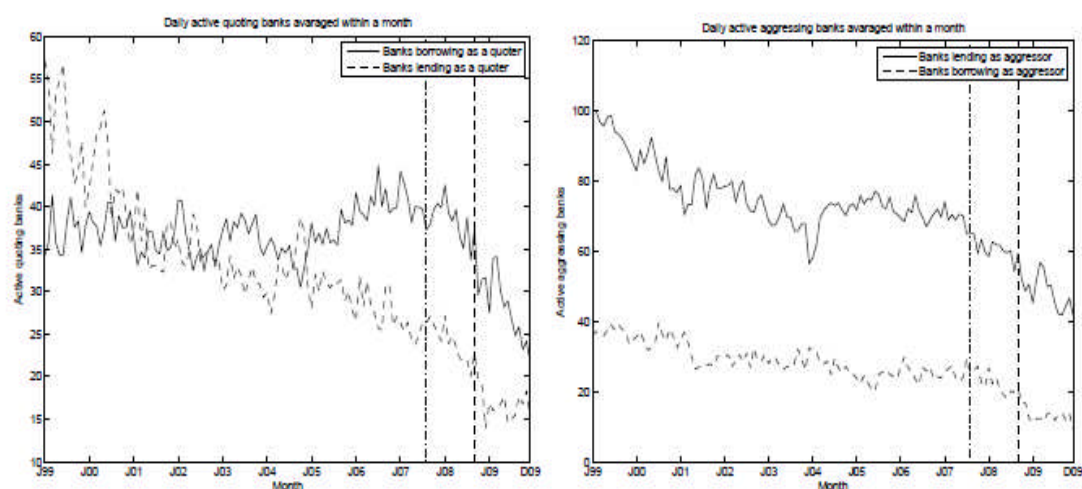


Source: Gabbi et al. (2013)

The impact has been dramatic especially for borrowers (figure 19.4.), who declined on average of 51% from 2007 to 2009 (respectively -54% and -49% for aggressors and quoters), while the decay rate of active lenders was about 40%

(respectively, -36% and -44% for aggressors and quoters). A significant reduction in daily volumes was recorded for most of the different maturities of time deposits exchanged within the interbank market (Figure 19.5.).

Figure 19.4. Daily active banks. Left: monthly average of the daily active banks as quotes: Right: monthly average of the daily active banks as aggressors (1999 – 2009)



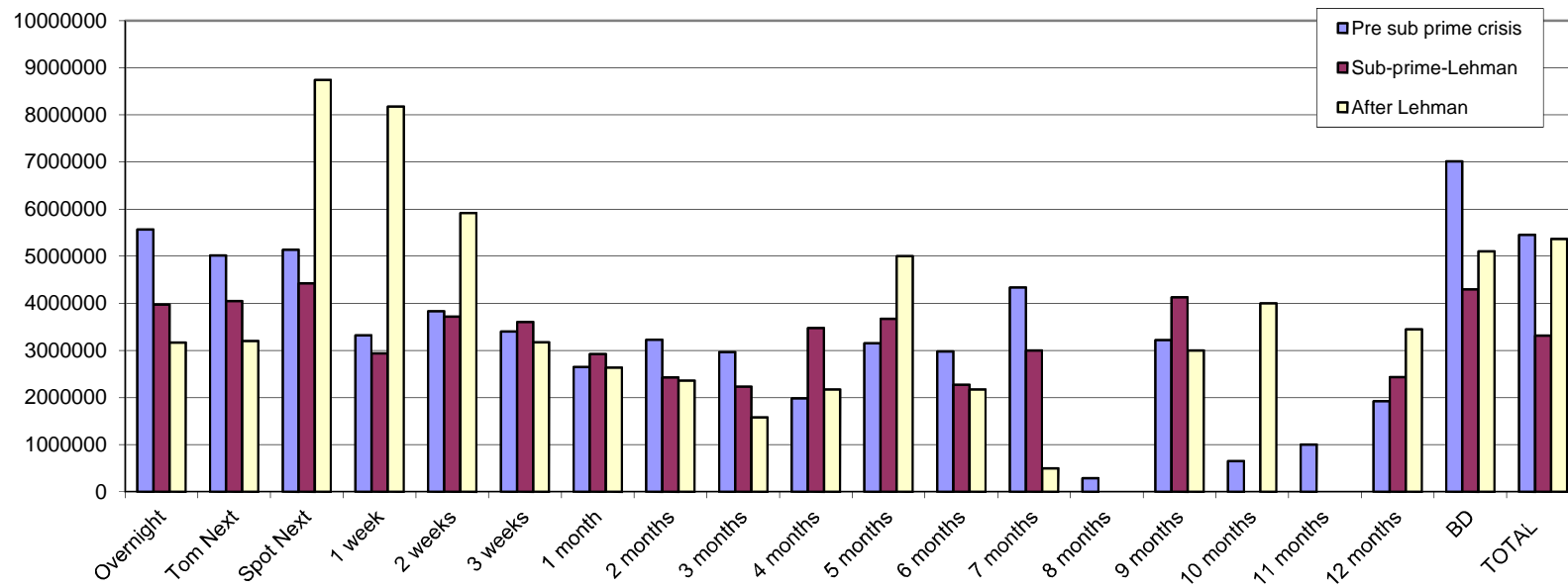
Source: Gabbi et al. (2013)

To foster a recovery in trading on the interbank circuits and a greater diversification of contract maturities, the Bank of Italy, together with e-MID and the Italian Banking Association, has prepared an initiative to enable market participants to trade funds through a procedure that minimizes counterparty and liquidity risks. The initiative is based on the creation of a special market segment in the e-MID trading platform, the Collateralized Interbank Market (MIC), which ensures complete anonymity of trades. Initially, the new market segment will handle trades on maturities of one week and longer. Participating banks will share in covering the risk up to predetermined limits. In the new interbank market segment's operational scheme, the Bank of Italy: (i) evaluates the collateral provided by banks; (ii) verifies that trades comply with established

limits and conditions, and (iii) ensures the prompt settlement of transactions in the event of default by a participant, subsequently recovering the amount from the collateral deposited. The collateralized market is available for Italian banks; it may be extended to EU credit institutions that satisfy requirements similar to those established for Italian participants, subject to an understanding with their home-country authorities. For each banking group only a single bank may participate, but it will nevertheless be able to contribute collateral pertaining to other group banks.

The impact of the reform is that trading on the Italian interbank market remains concentrated in the collateralized segments. The liquidity position is gradually improving; cost conditions are in line with those in markets abroad.

Figure 19.5. Daily volume per contract (pre sub-prime crisis 1999 – august 2007; sub-prime Lehman August 2007 September 2008; After Lehman September 2008 – December 2009)



Source: Our elaborations on MID data

19.2 The crisis and the real system

The variation rates both in terms of credit granted and credit used result to be negative in the last years for all the dimensional classes of enterprises.

We observe that:

- a) the high ratios of credit used and granted seem to confirm the hypothesis of the rationing because, especially in the medium/long-term and for all the categories of enterprises, the ration credit used/granted tends to unit. It is, however, to note that these ratios don't show structural changes over the considered years;
- b) data in terms of variations in credit granted show that there has been a decrease in the supply of credit by banks only since the crisis years (numbers in bold):
- c) The producing families in the short-term record the drop of credit supply in 2008 and 2010, with the exception of 2009, while in the medium/long-term credit crunch interested years 2008 and 2011;
- d) non-financial small companies show a drop of the credit granted in 2010 and 2011 for the short-term and in 2011 for the medium/long-term;
- e) non-financial medium/large companies recorded a credit contraction from 2008 to 2011 for what concerns the short-term and from 2009 to 2011 for the medium/long-term.

Companies that mainly suffered a real credit crunch are those of medium/large dimension and only in 2008. From the Bank Lending Survey it emerges that the interviewed banks indicates that in the years 2009/2010 the conditions of loans supply to the enterprises would have become more restrictive: the hardening would have started at the end of 2007 reaching the peak at the end of 2008: then it would have been lower in 2009, until its disappearance in January 2010. From the surveys do not emerge significant differences among enterprises of different dimensions. The restriction of credit supply would be due, firstly, to the increase of the borrower risk (enterprises), deriving both from the

worsening of the Italian economic conjunction and from the difficulties of specific productive sectors. According to the banks, even the budget constraint connected to their capacity to find loans and to the balance sheet and the liquidity would have contributed to slow the granting of loans. The restriction would have been carried out by widening the margins on the loans, especially those to the most risky clients; between the end of 2008 and the beginning of 2009, banks have declared to have diminished the credit granted and reduced the lines of credit (Panetta and Signoretti, 2010).

In addition to the amount of credit the enterprises can have difficulties also in relation to the quality of the credit granted to them, which is measured both in terms of interest rates and repayment difficulties.

A first issue concerns the fluctuations of interest rates that can significantly influence the financial balance of the enterprise. For example, an increase of the market interest rates implies more financial burdens against debt positions with variable rates; subsequently, the enterprises that have a financial structure mainly based on short-term credit are more vulnerable to the interest rates fluctuations applied by the banks.

In the late '90s, thanks to the reduction of interest rates, the financial burdens have weighed less on the gross trading margin (GTM) of the enterprises allowing the increase of self-funding; this implied a slight decrease of the recourse to bank credit. It emerges, however, that in the following years (early 2000) the enterprises (especially the medium/large one) have increase their credit demand to face the needs of reorganization thus reaching a ratio between financial burdens and GTM equal to 20% in 2008.

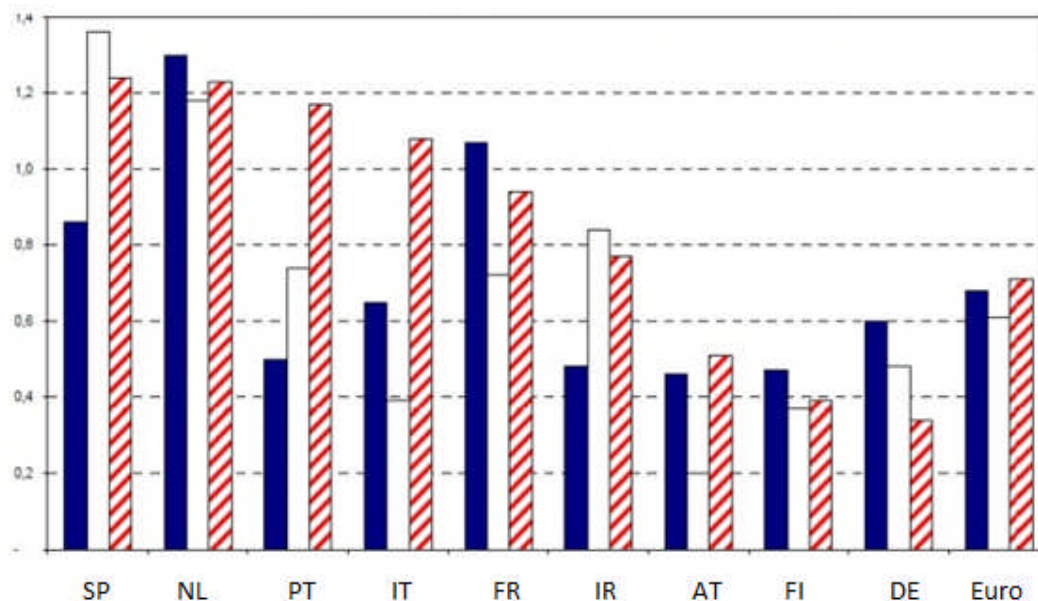
In 2009 and 2010 the interest rates in Italy, though higher than the euro zone average, have decreased; however, the gap between the rates applied to SMEs and those applied to medium/large enterprises is still high (nearly 3 percentage points). This can be explained by the higher risk perceived by the banks towards smaller enterprises; it has been underlined the existence of a strong negative

relationship between net financial burdens and enterprise dimensions (Warner 1977, Altman 1984).

In 2011 the growth of bank rates applied to enterprises has increased because of the particular difficulties of supply for Italian banks; in this case as well the growth of Italian interest rates has been bigger than the rest of the euro zone. The ECB data concerning June 2012 point out that Italian SMEs pay nearly four tenth of percentage point more than the average of the euro zone to obtain a new bank loan. The gap progressively increases if we consider Germany (0,5 percentage points), France and The Netherlands (0,7 percentage points), Finland (0,8 percentage points) and Austria (1,1 percentage points). Only compared to Spain, Portugal and Ireland, Italian SMEs manage to obtain better conditions (2 tenth of percentage point than the Spanish and Irish enterprises, nearly 2 percentage points with reference to the Portuguese).

About enterprise dimensions it is important to stress the differential between the rates applied to large enterprises and those applied to SMEs. Usually, the latter, because of their lower contractual strength compared to the larger enterprises, suffer increase in the economic conditions, especially when the credit system needs to increase its profitability in short terms. From the international comparing data (figure 19.6), it is notable how in Italy SMEs suffer a bigger financial burden compared to the large enterprises and how this has grown in the last year.

Figure 19.6. – Differential in percentage between the interest rates applied to large enterprises and to SMEs on the new financing operations (June 2010 in blue; June 2011 in white; June 2012 in red)

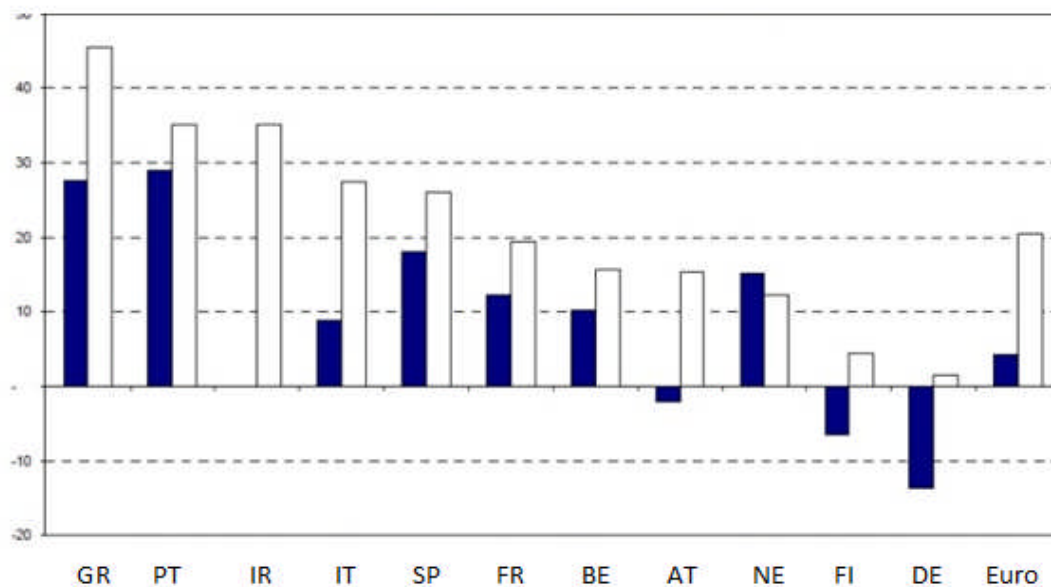


Source: ECB

In 2010 the differential of rates between large enterprises and medium/small enterprises was aligned to the average of the euro zone, while in the middle of 2012 it was higher than the 50%. An evolution similar to the Italian one has been registered only in Portugal and Spain.

A survey on the access conditions to loans conducted by the European Commission and ECB confirms that the difficult financial situation suffered by Italian SMEs. Recent data underline that the net percentage of small and medium enterprises that in Italy suffered a worsening of the access conditions to bank loans was equal to 27% against the 9% of the larger enterprises (figure 19.7).

Figure 19.7 – Net percentage of enterprises that suffered a worsening on the access to financial loans in the last 6 months (large corporates in blue; small and medium enterprises in white).



Source: European Commission and ECB

In the last two years SMEs, compared to the enterprises with larger dimensions, suffered a credit rationing due to a worsening of the economic conditions (increase of applied rates) concerning the access to bank loans. Still remaining on the topic of the quality of credit, another important issue to examine is that related to the repayment difficulties of the enterprises, where an important indicator is given by the ratio between the net non-performing loans and the whole loans obtained.

Table 19.1 shows the evolution of this factor between 1998 and 2011, in relation to the producing families and the non-financial small and medium/large enterprises; there are also showed the annual variation rates of the net sufferings.

Table 19.1. Debt repayment difficulties

Year	PRODUCING FAMILIES		NON-FINANCIAL SMALL COMPANIES		NON-FINANCIAL MEDIUM/LARGE COMPANIES	
	NPL/ Total Loans	Variation % NPL	NPL/ Total Loans	Variation % NPL	NPL/ Total Loans	Variation % NPL
1998	49.7%		14.8%		10.3%	
1999	39.6%	-5.7	13.0%	-4.7	9.1%	-5.8
2000	31.8%	-7.8	11.1%	-6.9	6.8%	-11.5
2001	25.1%	-14.7	8.9%	-15.5	5.0%	-19.3
2002	21.4%	-2.1	8.3%	0.9	4.8%	0.0
2003	20.0%	5.3	8.5%	9.6	5.4%	18.1
2004	18.5%	5.1	8.7%	8.2	5.6%	7.1
2005	13.0%	-20.8	7.3%	-11.4	4.4%	-17.2
2006	11.8%	2.3	7.3%	7.7	4.1%	5.4
2007	10.1%	-3.5	6.5%	-3.2	3.6%	0.0
2008	9.0%	-12.0	5.6%	-10.9	2.9%	-11.4
2009	10.9%	24.6	7.3%	32.6	4.6%	50.8
2010	12.4%	20.0	9.2%	25.9	6.1%	32.0
2011	17.2%	32.7	12.6%	29.6	8.6%	39.0

Source: Bank of Italy

If we consider the ratio net sufferings on loans, we note that over the time the trend shows a reduction of the ratio for all the enterprise categories that were analysed, with increase in the last three years due to the credit crunch by the banks.

Examining the case of the producing families, the quotient shows a switch from 49,7% in 1998 to 17,2% in 2011 (compared to the other enterprises dimensional classes, the gap 1998/2011 is larger). The non-financial small companies recorded a percentage of 14,8% in 1998 and 12,6% in 2011, while the medium/large companies recorded a percentage of 10,3 % in 1998 and 8,6% in 2011. For all the categories of enterprises, the lowest percentage has been recorded in 2008 (9,0% for the producing families, 5,6% for the non-financial small companies and 2,9% for the medium/large ones).

With reference to the annual variation rates, producing families until 2002 have observed important decreases (until -14,7% in 2001); then six years of fluctuations alternated , with negative and positive variations that reached the

highest level respectively in 2005 (-20,8%) and in 2006 (2,3%). From 2009, because of the crisis and the following recession that hit Italy, sufferings recorder an increase, until the 32,7% in 2011.

The same can be said about non-financial small companies: seven years of positive and negative variations (2002-2008) were preceded by three years (1999-2001) characterized by negative variations that reached -15,5 percentage points in 2001. For this category of enterprise we can as well observe a growth of net suffering variations in the last three years, equal to 32,6% in 2009, to 25,9% in 2010 and to 29,6% in 2011.

Analyzing the net suffering variations of non-financial medium/large enterprises we can infer the same conclusions made for the other categories of enterprises. Having considered the high level of increase, it is necessary to underline the variations in the last three years (2009-2011): has been recorded an increase of the 50,8% in 2009, followed by a percentage equal to 32,0% in 2010 and 39,0% in 2011.

From the data listed above we can affirm that in the last years the difficulties of repayment of loans granted by banks have increased, especially as the dimension of the enterprise grows.

In conclusion, the strong bank-oriented financial structure of the smaller enterprises, the small dimensions of Italian business system – followed in many cases by a simple management, in most cases familiar – the informative opacity, many times deriving from the use of the sole hard information on credit supply, make the recourse to the capital market by SMEs difficult.

To encourage the recourse to risk capital can be useful fiscal-type interventions: in a context where SMEs balance sheets are largely influenced by fiscal requirements and still represent the most used instruments by banks to take decisions of granting credit, the choice of a proper regime of taxation may reveal to be a very efficient instrument to balance the financial preferences of SMEs towards the capital risk market.

It must be underlined that the bank-small and medium enterprise relationships in Italy are characterized by multiline financing, that are typical of a transaction banking approach (Forestieri and Tirri, 2002); this implies a difficulty for the bank system to accurately evaluate the profiles of risk and yield of the client enterprises. It is evident the opportunity to encourage the development of the relationships between banks and SMEs which should be more oriented to a logic of relationship banking, towards the establishment of continuous and long-lasting relations based on qualitative nature information, the so called soft information.

From the research emerges a larger recourse to short-term loans of the smaller enterprises compared to the larger ones – that to the risk capital and self-funding prefer a financial structure based on medium/long-term loans. Specifically, between 1998 and 2008, the producing families have witnessed the increase of the amount of short-term loans granted to them of the 69% against the 44% of non-financial small companies and the 67% of non-financial medium/large enterprises.

Although over the time it results reduced compared to the longer term loan, the short-term loan of Italian enterprises is still on considerable levels, if we then add the high cost of capital, the so called process of financialization of Italian SMEs may reveal to be unsustainable, especially for those enterprises where GTM is notched by financial burdens. Switching the attention to the medium/long-term, in the period 1998/2008 the growth of credit granted to families has been of the 300%; lower were the increase in favour of non-financial small and medium/large companies, respectively of 152% and 180%.

From the point of view of credit rationing, has been observed that the relation used/granted hasn't suffered significant variations in the decade '98-'08, neither with reference to short-term credit nor to medium/long-term. It has been observed, however, that in the last years, especially because of the financial/economic crisis, begun in October 2007, Italian enterprises – and in

particular those of large dimensions – have met many difficulties in many sectors:

- a) Repayment of the debts. The percentage of the sufferings on loans, that over the time registered a slow decrease, started to enhance again, following the drop of productivity of the enterprises and the high cost of debt;
- b) Credit rationing. If we observe the relation credit granted/used and the variations in terms of consistency, we notice a slight increase of the indicator and the weak contraction of credit supply compared to the previous years. On the other hand, examining the matter from the interest rates point of view, also in relation to the enterprise dimension, the credit access difficulties are high for Italian enterprises of smaller dimensions (high differential between rates applied to SMEs and those applied to large dimension enterprises), especially if compared to the other European countries.

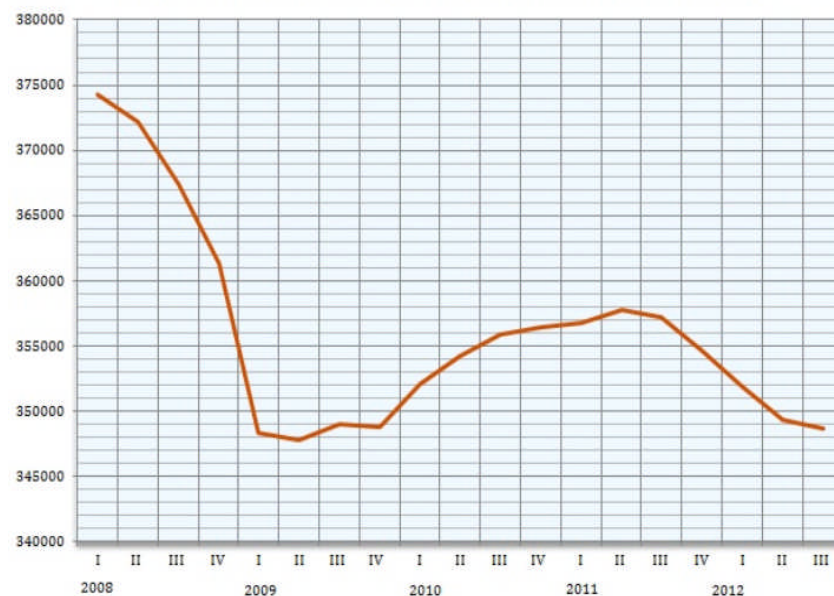
In Italy, the development of the economic system is influenced by the capacity that banks have had to locate and assist from the beginning the business initiatives. Banks can have an important supporting and leading role, accompanying the most promising enterprises towards the capital market (Tarantola, 2007). Despite the improvements, the investments in venture capital and private equity, with which even smaller enterprises managed to finance their starting, growing and developing phases, still constitute low developed markets (Gervasoni, 2007).

More steps forward must be done to make the bank-enterprise relationship, and especially bank-SMEs, more fluent and efficient and able to answer to the financial needs of the business sector; positive effects may derive from a higher transparency from SMEs and a stability of the bank system assured by a proper regulation.

The impact on the economic growth of the banking system behaviour can be

appreciated looking at the GDP dynamics (figure 19.8). The bottom line was experienced in the second quarter of 2009, but the third quarter in 2012 seems to reach the same value. The difference is that in 2009 the recession was essentially due to the collapse of exports partly compensated with social interventions to ease the labour cost for firms. The 2011-2012 recession is more domestic and, accordingly to the Italian Government policy, without resources to inject by the public sector.

Figure 19.8. Quarterly GDP Growth (values in million euros; 2008 – 2012)



Source: ISTAT

The weakness of domestic demand (figure 19.9) is fostering a significant improvement in the external accounts. Notwithstanding the worsening economic picture, budgetary policy remains oriented towards fiscal discipline.

Figure 19.9. Consumption, disposable income and consumer confidence in Italy (percentage changes and indices).

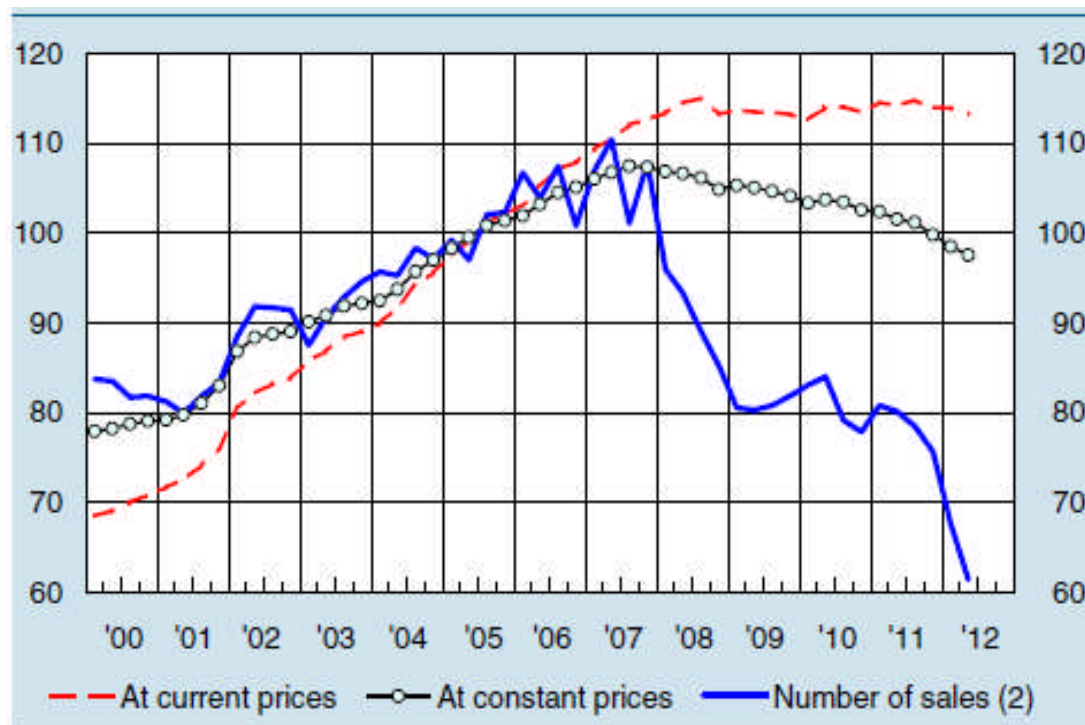


Source: ISTAT and Bank of Italy

Notes (1) Chain-linked volumes; percentage changes in relation to the previous year. Annual data up to 2011; for 2012, percentage changes in the first half on the same period in 2011. (2) Obtained using the consumption deflator for resident households. (3) Monthly data, seasonally adjusted. Indices, 2005=100. (4) Monthly data; moving averages for the 3 months ending in the reference month

The contraction in output and the uncertain prospects for recovery are reflected in property prices. The housing market is weak. Since the end of 2011 the decline in the number of sales has been accompanied by a moderate fall in prices, due to the contraction in households' disposable income and strained credit supply conditions. There is no evidence of an overvaluation of houses. The fall in prices is expected to continue in the coming months, and it could extend beyond that if the timing of the economic recovery were pushed further back (figure 19.10.).

Figure 19.10. House prices and sales in Italy (quarterly data; indices, 2005=100)



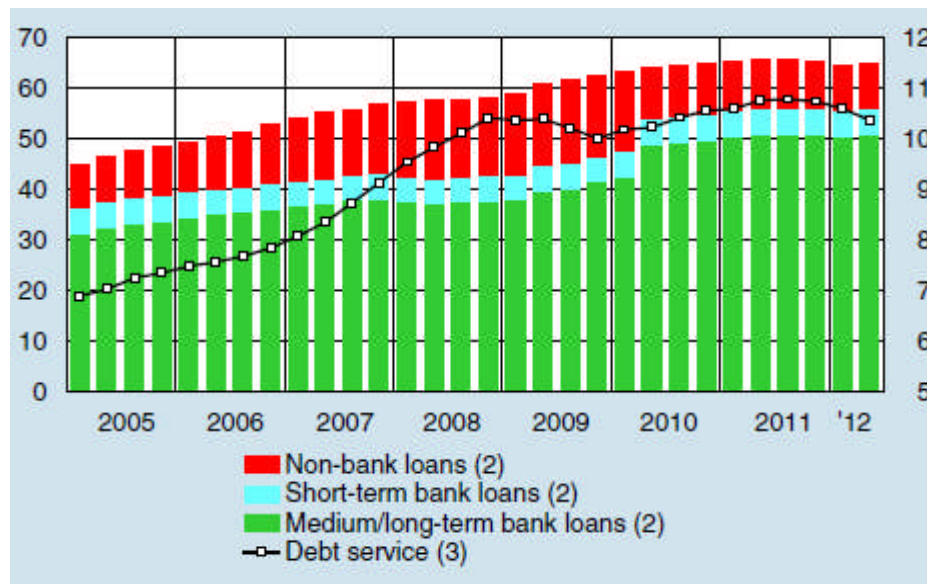
Sources: Based on Agenzia del Territorio, Bank of Italy, *Consulente Immobiliare* and Tecnoborsa data

The financial situation of households remains balanced overall, thanks to their relatively modest debt and large proportion of financial wealth held in the form of low-risk assets. In the current phase debt service is being kept down principally by low interest rates. The main risk consists in the sluggishness of income. The recession continues to affect the profitability and self-financing capacity of firms, whose financial situation shows signs of strain. Expectations for the coming months have become less pessimistic. The chief risk factors have to do with the performance of the economy and persistent difficulties in accessing credit.

The fall in bank lending reflects the weakness of demand. The attenuation of the strains on bank liquidity can be discerned in a gradual improvement in credit supply conditions, which nevertheless remain more restrictive than in the

first half of 2011 (figure 19.11.).

Figure 19.11. Household debt (as a percentage of gross disposable income; End-of-quarter stocks and flows in the 12 months to the end of the quarter). (Data for the last period are provisional. Includes securitized loans).



Source: ISTAT and Bank of Italy

Notes: (2) There is a break in statistics on the distribution between bank and non-bank loans for the second quarter of 2010. (3) Right-hand scale. Estimated cost of debt service (payment of interest and repayment of principal) for consumer households only.

Credit quality continues to show the repercussions of the recession. Non-performing loans to firms have increased again in all sectors of economic activity, most markedly in construction. By contrast, the impairment rate on loans to households remains low, reflecting their solid financial position, traditionally prudent lending standards and a legislative and regulatory framework that encourages limiting loan-to-value ratios and requires the borrower to repay his debt, regardless of any change in the value of the property.

Banks' retail funding continues to grow; the funding gap (the difference between lending and retail funding) has narrowed to 16 per cent and to 13 per cent excluding foreign banks' subsidiaries. Banks' liquidity position has

improved markedly since July, with the easing of sovereign debt risk. Several banking groups have resumed issues on the wholesale markets; recourse to Eurosystem refinancing has levelled off. Italian banks hold the necessary liquid resources to cover liabilities falling due and to finance the economy; collateral also remains ample. The core tier 1 ratio of the main Italian groups has risen further, to 10.2 per cent. Capital strengthening is a response to the deterioration in the economy. The financial leverage of Italian banks remains low by comparison with the main European banking groups. Banks' profitability continues to be dampened by the deteriorating quality of credit. Banks must continue, and intensify, their cost-cutting policies. The main Italian insurance companies recorded an increase in profits, due mainly to the positive results on financial activity. The solvency indicators for life and non-life insurance are well above the regulatory requirements. Overall, the greatest risks to the sector come from the protracted economic downturn, which is depressing growth in premiums and increasing policy surrenders, and from the conditions of uncertainty on financial markets, given insurers' substantial government securities portfolio.

19.3 Financial markets after the crisis

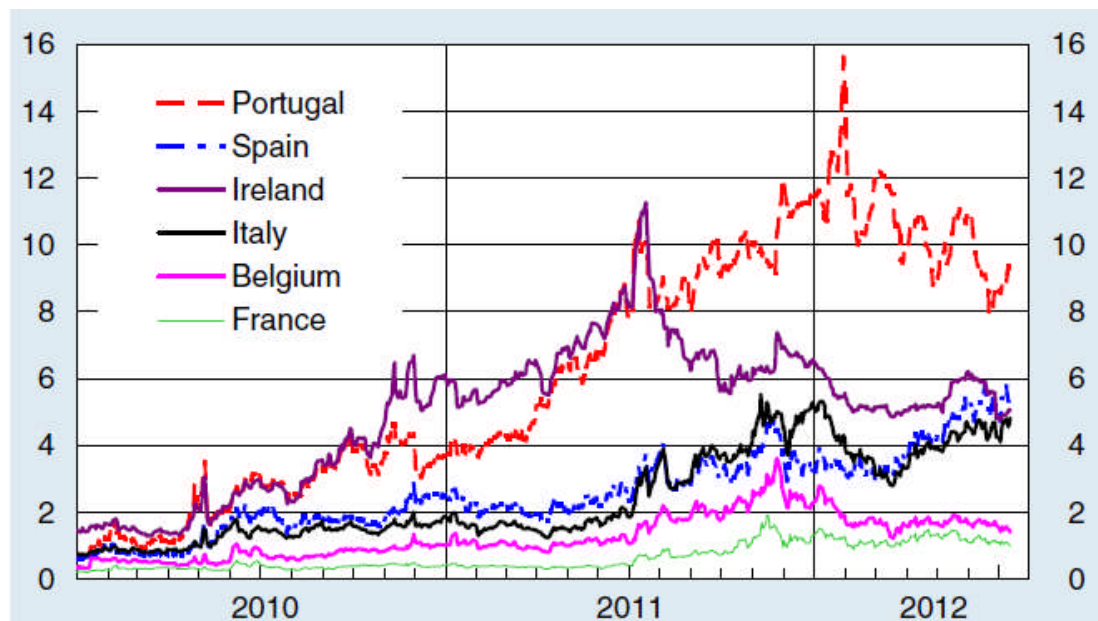
Government securities issuance has proceeded regularly, even at the times of greatest tension. The resumption of purchases by foreign investors in recent months has followed the considerable decline in rates on new issues. The average residual life of the public debt is still long compared with the main sovereign issuers in the euro area. The liquidity of the secondary market in government securities has improved further. The amount of medium and long-term securities maturing in 2013 will be less than in 2012 and will be distributed more evenly throughout the year.

The Greek crisis was the first signal that the financial crisis changed into a Sovereign debt crisis, at least within the euro area. Figure 19.12. shows the

pattern of the credit spreads with the German Bund yields of some of the most indebted countries (but Greece) Government bonds, with the same maturity (10 years).

Soon after the Greeks shocks (April 2010) the Italian spread recorded a slightly increasing gap which remained around 170 basis points until mid-2011. In the second semester of 2011 the risk perception, associated with the political conditions, affected the rally of the spreads, whose top was recorded in November 2011.

Figure 19.12. Yield spreads between ten-year government bonds and the German Bund (daily data; percentage points)

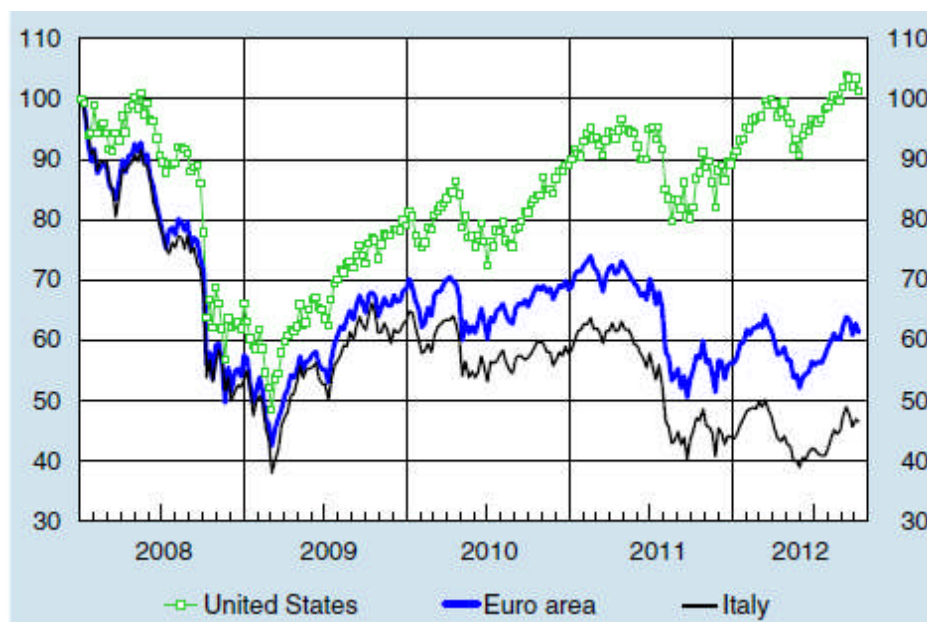


Sources: Bloomberg and Thomson Reuters Datastream data

In the euro-area countries most exposed to the sovereign debt crisis yield spreads over the German Bund widened significantly, narrowing after the decisions of the European summit meeting of 28 and 29 June (Figure 19.12.). Between the end of March and 13 July the spread on ten-year bonds increased in Greece, Spain and Italy. At the end of 2012, the spread is around 350 basis points.

The impact of the crisis of equity markets can be evaluated in figure 19.13. Until the end of 2009 the Italian equity index was perfectly correlated with the European one. After the Greek crisis a negative gap was experienced, associated with the country risk perception.

Figure 19.13. Share prices (end-of-week data; indices, 4 January 2008=100; Indices: for Italy, FTSE Italia MIB storico; for the euro area, Dow Jones Euro Stoxx; for the United States, Standard & Poor's 500.



Source: Bloomberg

19.4 Changes in regulation in response to crisis

The causes of the crisis are many, and several observers have tried to rationalize them. According to Taylor (2011) we should seek to answer three separate questions: what started it?; what prolonged it; and what made it so severe, such that it led in particular to the Lehman collapse? Among the answers to the first question, we might list the following: 1) monetary excesses, where the interest rates, during the early 2000s, were lower than expected if one applies the Taylor rule; 2) financial engineering, which originated

sophisticated and hard-to-track contracts; 3) mispriced concentrated portfolios, which facilitated the risk assumption of financial intermediaries which were confident they could manage (or transfer) it; 4) rating procedures and model risk, particularly for securitizations tranches, driving the underestimation of the probability of default.

In response to the second question (why did the crisis last so long?), the answers most frequently quoted are: 1) central bank policy-making, which treated the crisis as an illiquid situation; 2) the behaviour of bankers, which must considered a long-term strategy not easily changed overnight; 3) the interconnection of banking institutions, which determined a systemic crisis.

The intensity of the crisis was probably strengthened by the uncertainty among bailout schemes, where in some cases both equity and bond holders were protected (Bear Sterns and, to some extent, AIG), in other cases only bond holders were protected (Fannie Mae and Freddie Mac), and where sometimes no-one was protected (Washington Mutual and Lehman Brothers).

The remedies to the crisis are held to be of three different categories: natural response or self-regulation; market pressure; public regulation. The regulatory issue and the debate on what might be an optimal regulatory framework is based on the idea that self and market regulations are scarcely effective, at least in reducing the likelihood of a new systemic risk within the financial system and that behind all the causes explaining the crisis, a lack of effective regulation must be recognized.

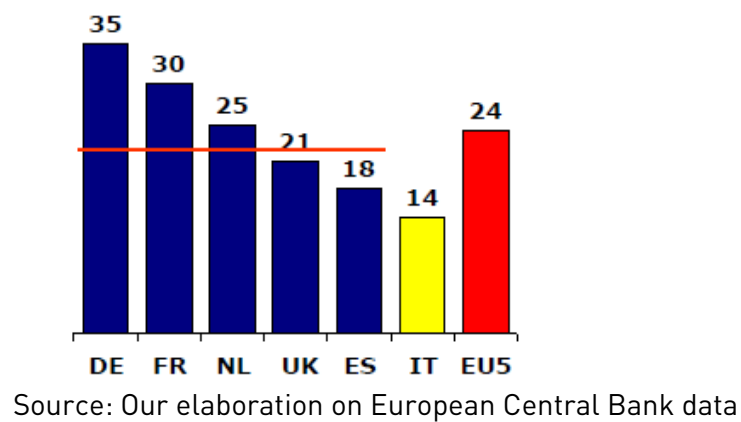
In December 2009, the Basel Committee published a consultative document ("Strengthening the resilience of the banking sector") aimed at defining the guidelines of the new framework for a macro-prudential regulation, after the lessons learnt from the crisis.

According to most of the agents, the regulatory regime before the crisis was focused on idiosyncratic risks, in other terms it was a micro-prudential regulation. In particular, the Committee stated that "*one of the main reasons*

the economic and financial crisis became so severe was that the banking sectors of many countries had built up excessive on- and off-balance sheet leverage. This was accompanied by a gradual erosion of the level and quality of the capital base. At the same time, many banks were holding insufficient liquidity buffers. The banking system therefore was not able to absorb the resulting systemic trading and credit losses nor could it cope with the re-intermediation of large off-balance sheet exposures that had built up in the shadow banking system. The crisis was further amplified by a procyclical deleveraging process and by the interconnectedness of systemic institutions through an array of complex transactions. During the most severe episode of the crisis, the market lost confidence in the solvency and liquidity of many banking institutions. The weaknesses in the banking sector were transmitted to the rest of the financial system and the real economy, resulting in a massive contraction of liquidity and credit availability.” (Basel Committee, 2009, p.1, no. 4).

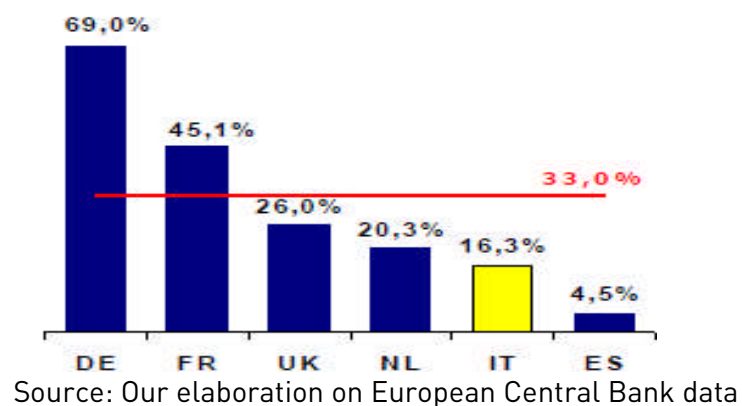
The impact for European banks appears to be impressive: according to the Quantitative Impact Study run by the Basel Committee, for the largest 45 European banks the impact of capital new regulation should require approximately 1.1. trillion euros; for the liquidity measures the cost can be estimated as 3.6 trillion euros. The Italian need to increase the capital quality affected particularly large banks. The two largest banks (UniCredit Group and Intesa San Paolo) raised new Tier1 capital respectively for 5 and 7.5 billion euros. In terms of leverage risk, the Italian banks appear to be less exposed than other European banks (figure 19.14.).

Figure 19.14. Leverage ratio of Italian banks compared with some European countries (assets to equity ratio, 2010)



Italian banks propensity to trade in securities markets appears to be lower than other banking systems (figure 19.15.).

Figure 19.15. Trading propensity of Italian banks compared with some European countries (financial instruments to Tier 1 capital ratio, 2010)



Moreover, the exposure to the most indebted countries within the Euro area (Greece, Ireland, Spain and Portugal) is absolutely lower than France and Spain (table 19.2.).

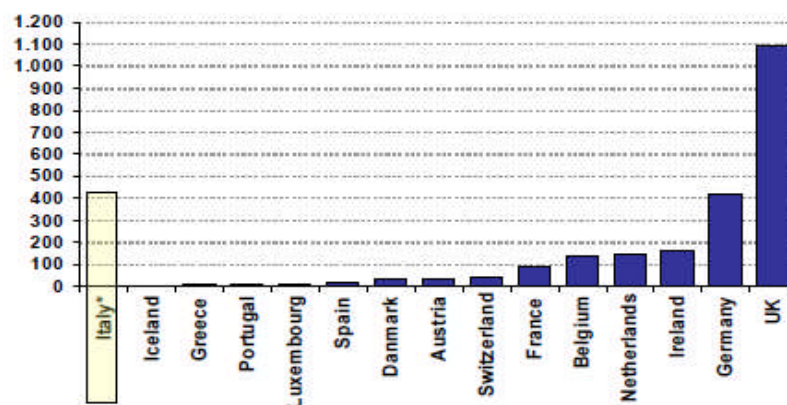
Table 19.2. Banks' exposure to GIPS countries (bln €; June 2011)

	Total foreign claims	European Banks	Italy	France	Germany	UK
All countries	27.255	18.948	962	3.284	3.143	4.179
Greece	131	120	3	55	21	12
Ireland	467	380	14	32	110	140
Portugal	204	196	3	25	35	25
Spain	741	643	29	150	177	100
Total 4 countries	1.544	1.340	52	264	345	279

Source: European Central Bank

This strategy can explain the absence of formal public interventions to bail out banks after the crisis (figure 19.16.). The only intervention was in terms of Tier1 bond underwriting (called Tremonti bonds), able to re-capitalize banks.

Figure 19.16. State support to financial institutions (June 2007- June 2011; bln €)



Source: European Central Bank

The post-crisis regulatory regime was designed to include a significant “macro-prudential” component. The diagnosis of regulatory weakness was accompanied with proposals for a new framework able to reduce the likelihood of a new crisis and, above all, another series of public sector interventions to

bail out financial intermediaries finding themselves in a critical situation. According to the Federal Reserve “*No one wants another TARP programme*” (Tarullo, 2011, p.2).

The new international proposals are articulated along the following concerns: increasing quality, consistency and transparency of the capital base; enhancing risk coverage; introducing a global liquidity standard; supplementing the risk-based capital requirement with a leverage ratio; reducing procyclicality and promoting countercyclical buffers; addressing new rules to minimize the systemic risk. Although the Basel Committee formulates international supervisory standards and guidelines, it has no legal authority. Within the European Union, the passing of Basel banking standards into legislation has hitherto been achieved through the means of directives, which in turn were implemented through national measures (see EU Implementation of Basel II). In order to “maximise harmonisation”, the EU has chosen to implement the majority of Basel III rules through direct regulation, without the need for them to be written into national law. This is designed to prevent EU member states ‘gold-plating’ or adding to EU legislation. The EU Directive (CRD IV) has been presented with “*the overarching goal [of ensuring] that the effectiveness of institution capital regulation in the EU is strengthened and its adverse impacts on depositor protection and procyclicality of the financial system are contained while maintaining the competitive position of the EU banking industry*”. Confusingly, Basel III is implemented through what is known as CRD IV, even though rules on the quality and quantity of capital, counterparty risk, liquidity and leverage are in fact contained within the CRD IV Regulation. However, some rules, most notably those concerning the capital conservation and countercyclical buffers, are implemented by the CRD IV Directive. The effects for banks can be summarized as follows:

- a) changes to banks’ capital ratios under Basel III, and estimates of any capital shortfalls. In addition, estimates of capital surcharges for global systemically

important banks (G-SIBs) are included, where applicable; changes to the definition of capital that result from the new capital standard, referred to as common equity Tier 1 (CET1),

- b) modified rules on capital deductions, and changes to the eligibility criteria for Tier 1 and total capital;
- c) changes in the calculation of risk-weighted assets (RWA) resulting from changes to the definition of capital, securitisation, trading book and counterparty credit risk requirements; The capital conservation buffer;
- d) the leverage ratio;
- e) two liquidity standards – the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR).

A preliminary conclusion on the impact of the new regulation for Italian banks is that, when compared with France, Germany, Spain, Switzerland and the United Kingdom, the serious concern is about deductions, particularly goodwill and other intangible assets (table 19.3.).

Table 19.3. Preliminary evaluations on the major impacts of Basel 3 by country.

	Quality of capital	Deductions	Counterpart risk	Leverage ratio	Liquidity Standard
France	X	X	X		X
Germany	X	X		X	X
Italy		X			
Spain		X			X
Switzerland			X	X	
UK		X	X	X	X

Source: European Central Bank

Other regulations under debate are affecting the insurance market (Solvency II) but it is expected to be introduced not before 2015. The major issues on financial regulation can be summarized as follows.

Issues on Regulation	Description
Regulation on capital ratios	
<i>Change of VaR methodologies</i>	New regulatory approaches to compute the banking capital requirement: expected shortfall or simulation models. Re-introduction of a sort of gearing ratio
<i>More stress tests</i>	The impact of losses depending on events or scenarios with low probability
<i>New definition of TIER 1 and 2</i>	Create a new definition for eligible hybrid capital instruments to protect banks from unexpected losses
Market transparency & Client protections	
<i>Ethical codes</i>	Since the effectiveness of such codes of ethics depends on the extent to which to management supports them with sanctions and rewards, a new regulatory framework could be introduced
<i>Reduction of top managers remuneration</i>	The remuneration consists of the following four components: a fixed (base) salary component; a variable component (annual bonus or short-term incentive); a long term component (long-term incentive) in the form of stock options; pension provisions and fringe benefits. Some changes in the variable components are expected to be likely.
<i>Communication to regulators</i>	Introduction of new reporting procedure to reduce the information asymmetry between banks and stakeholders

Structural regulation	
<i>More tough rules to enter the banking industry</i>	Entering the banking market is expected to become more tough in order to reduce the risk of free riding
<i>Bail out solutions</i>	Alternative resolution are expected to face the systemic risk
<i>Rules against credit crunch</i>	Agreements between banks, regulators and non-financial firms associations to reduce the credit crunch (both volume and price)
<i>New regulators</i>	New regulatory models, in order to increase the information and to improve the external control efficacy
Other Laws	
<i>Accounting innovations</i>	IAS should be changed in order to reduce the impact of earning volatility on capital need
<i>Fiscal reduction for banks</i>	Fiscal incentives to optimize the banks' capital allocation
<i>Public role in financial sector</i>	Bail out interventions in banking is making this sectors more public. Problems in terms of corporate governance

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This project is funded by the European Union under
the 7th Research Framework programme (theme SSH)
Grant Agreement nr 266800



Financialisation, Economy, Society and Sustainable Development (FESSUD) is a 10 million euro project largely funded by a near 8 million euro grant from the European Commission under Framework Programme 7 (contract number : 266800). The University of Leeds is the lead co-ordinator for the research project with a budget of over 2 million euros.

THE ABSTRACT OF THE PROJECT IS:

The research programme will integrate diverse levels, methods and disciplinary traditions with the aim of developing a comprehensive policy agenda for changing the role of the financial system to help achieve a future which is sustainable in environmental, social and economic terms. The programme involves an integrated and balanced consortium involving partners from 14 countries that has unsurpassed experience of deploying diverse perspectives both within economics and across disciplines inclusive of economics. The programme is distinctively pluralistic, and aims to forge alliances across the social sciences, so as to understand how finance can better serve economic, social and environmental needs. The central issues addressed are the ways in which the growth and performance of economies in the last 30 years have been dependent on the characteristics of the processes of financialisation; how has financialisation impacted on the achievement of specific economic, social, and environmental objectives?; the nature of the relationship between financialisation and the sustainability of the financial system, economic development and the environment?; the lessons to be drawn from the crisis about the nature and impacts of financialisation? ; what are the requisites of a financial system able to support a process of sustainable development, broadly conceived?'

THE PARTNERS IN THE CONSORTIUM ARE:

Participant Number	Participant organisation name	Country
1 [Coordinator]	University of Leeds	UK
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Published in Leeds, U.K. on behalf of the FESSUD project.