

Italy: Financial System Stability Assessment, including reports on the Observance of Standards and Codes on the following topics: Banking Supervision, Payment Systems, Insurance, Securities Regulation, Securities Settlement and Payment Systems, Monetary and Financial Policy Transparency, and Anti-Money Laundering and Combating the Financing of Terrorism

This Financial System Stability Assessment on **Italy** was prepared by a staff team of the International Monetary Fund and the World Bank as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on **January 10, 2006**. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of Italy or the Executive Board of the IMF.

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ITALY

Financial System Stability Assessment

Prepared by the Monetary and Financial Systems and European Departments

Approved by Charles Enoch and Michael Deppler

January 10, 2006

This report is based primarily on work undertaken during two visits to Italy in October 2004 and July 2005, as part of the Financial Sector Assessment Program (FSAP), but it also integrates work undertaken in June 2003 on payment systems and banking supervision as well as work in April 2005 on AML/CFT. The FSAP findings were discussed with the authorities during the Article IV Consultation Mission in November 2005.

The FSAP team comprised Hervé Ferhani (Head), Arne B. Petersen, Laurent Bouscharain, Marie-Thérèse Camilleri, Andrea Maechler, Sandra Marcelino, Gianni De Nicolo, and Elias Kazarian (all MFD); Nicolas Blancher (ICM); Paulo Drummond (EUR); Eva Gutierrez (PDR); Salih Neftei (consultant, derivatives); Felice Friedman (consultant, corporate governance); Michael Hafeman (consultant, insurance supervision); and José Manuel Portero (IOSCO expert, Spanish CNMV). The main findings of the FSAP are:

- Italy's financial system appears sound, and no major vulnerabilities that could cause systemic risks were identified.
- The deep restructuring of the banking sector in the 1990s has helped improve the efficiency and competition of the Italian banking industry. Most standard performance indicators are now broadly in line with those of other large European countries, but operational costs remain higher.
- Competition in the Italian banking sector has not yet been fully reflected in the pricing and quality of core services. Enhanced market contestability by foreign intermediaries would help strengthen efficiency and competition.
- Italian banks suffer from structurally higher nonperforming loans compared to other leading European countries, despite more lenient loan classifications. Italy should move to the standard "90-day classification rule" as quickly as feasible. Current plans for strengthening regulation of connected lending should also be implemented without delay.
- Italy's overall strong supervisory framework needs to be supported by strengthening of governance provisions at the Bank of Italy as recognized by recent government reforms.

The main authors of this report are Hervé Ferhani, Arne B. Petersen, and Andrea Maechler, with contributions from the rest of the FSAP team.

FSAPs are designed to assess the stability of the financial system as a whole and not that of individual institutions. They have been developed to help countries identify and remedy weaknesses in their financial sector structure, thereby enhancing their resilience to macroeconomic shocks and cross-border contagion. FSAPs do not cover risks that are specific to individual institutions such as asset quality, operational or legal risks, or fraud.

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GLOSSARY

ABI	Italian Banking Association
ABS	Asset-Backed Securities
AML/CFT	Anti-Money Laundering/Combating the Financing of Terrorism
BCP	Basel Core Principles for Effective Banking Supervision
BFS	BI Banking and Financial Supervision Department
BL	1993 Banking Law
BI	Banca d'Italia
CADS	Company Accounts Data Service
CAL	Compulsory Administrative Liquidation
CAR	Capital Adequacy Ratio
CCR	Central Credit Registry
CDOs	Collateralized Debt Obligations
CESR	The Committee of European Securities Regulators
CLFI	1998 Consolidated Law on Financial Intermediation
Consob	Italian Companies and Stock Exchange Commission
COVIP	Italian Supervisory Agency for Pension Funds
CPSIPS	Core Principles for Systemically Important Payment Systems
CSD	Central Securities Depository
DIS	Deposit Insurance Scheme
ECB	European Central Bank
ELA	Emergency Liquidity Assistance
ESCB	European System of Central Banks
EU	European Union
FATF	Financial Action Task Force
FITD	Interbank Deposit Protection Fund
FSSA	Financial Sector Stability Assessment
FSIs	Financial Soundness Indicators
IAIS	International Association of Insurance Supervision
ICCS	Inter-Ministerial Committee on Credit and Savings
IFRS	International Financial Reporting Standards
IDPF	Interbank Deposit Protection Fund
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commission
IRB	Internal Ratings-Based
ISVAP	Italian Supervisory Authority for Private Insurance Companies
LGD	Loss Given Default
LOLR	Lender of Last Resort
MEF	Minister of the Economy and Finance
MFD	Monetary and Financial Systems Department
MOUs	Memoranda of Understanding
MT	Monte Titoli
MTS	Italian Government Bond Trading Platform
PD	Probability of Default

OTC	Over-the-Counter
RMBS	Residential Mortgage-Backed Securities
ROSC	Report on Observance of Standards and Codes
RSSS	Recommendations for Securities Settlement
RTGS	Real-Time Gross Settlement
SDBI	BI Statute
SGP	Stability and Growth Pact
SICAV	Open-end Investment Companies
SIMs	Securities Firms
SMEs	Small and Medium Enterprises
SPVs	Special Purpose Vehicles
TFR	Pension Fund Contributions
UIC	Italian Foreign Exchange Office

EXECUTIVE SUMMARY

1. **Italy's financial system appears sound and no systemic vulnerabilities were identified.** Despite the protracted period of low growth, the system's strength is supported by a high degree of conformity to supervisory and regulatory standards established by the Basel Committee, IAIS, IOSCO, FATF, and CPSS.
2. **The overall strong supervisory framework needs to be supported by further improvements to governance provisions at the Bank of Italy (BI) as recognized by recent reforms.** The reforms are designed to enhance the BI governance structure in a number of important areas. Their implementation will require amendments, as yet unspecified, to the BI statutes, which can provide the opportunity for some further desirable changes, noted further below. Moreover, ongoing investigations appear to indicate the need for greater vigilance in enforcing the supervisory framework.
3. **The deep restructuring of the banking sector in the 1990s has helped improve the efficiency and competition of the Italian banking industry.** During this period, the state has significantly reduced its direct ownership in the Italian banking system and cost reductions were achieved through consolidation. Although most standard performance indicators are now broadly in line with other large European countries, operational costs and nonperforming loans remain higher.
4. **The Italian banking sector has shown resilience to weak economic growth and appears able to withstand continued unfavorable macroeconomic scenarios.** Financial sector indicators have continued to improve, partly thanks to the low interest rate environment, and low household indebtedness further limits risks. Looking forward, a macroeconomic scenario combining low growth and higher euro area interest rates would pose the biggest challenge for the banking sector. However, stress tests results suggest that existing capital buffers in the major Italian banks would be able to absorb the impact of the shocks associated with this scenario.
5. **The Italian insurance industry has posted rapid growth rates in premiums and strong profitability in the recent period and prospects for this sector appear favorable.** Stress test results suggest that a number of small life insurance companies are vulnerable to shocks. However, risks are mitigated by the fact that most of the vulnerable life insurance companies are owned by banks, whose estimated available capital buffers appear to cover the estimated solvency shortfalls of the stressed insurance companies.
6. **More developed capital markets would be desirable to ensure greater diversity in financing sources and investment opportunities.** While Italy's government bond market is the largest in Europe, the comparatively small size of equity and corporate bond markets reflects a relative lack of "equity culture" due, in part, to the small number of big private corporations, and the predominance of family-owned SMEs in the economy, as well as the marginal importance of certain institutional investor classes.

7. Notwithstanding the strengths of the Italian financial sector, a number of issues emerged from the FSAP and deserve the authorities' attention; these are listed in broad order of priority below (key recommendations are summarized in Box 1):

- BI's governance has been strengthened in recent government reforms, with modifications to the appointment, revocation, and term of office of the Governor, the term of office of the Directorate, and the introduction of collegiality in decision making. However, key provisions are yet to be spelled out in the amendments to the BI statute, including the role and composition of the Board of Directors and the modalities of the transfer of BI ownership.
- BI's multiple objectives have been narrowed, with responsibility for competition transferred to the Antitrust Authority. The opportunity of forthcoming revisions of the BI statute should be used to clearly limit BI's mandate to that of safeguarding the stability of the financial system, omitting the current reference to "competitiveness".
- Competition in the Italian banking sector has intensified but has not yet been fully reflected in the pricing and quality of core services. Enhanced contestability by foreign intermediaries would help strengthen efficiency and competition, but foreign entry has proven difficult as evidenced by two recent high profile cases.
- Income generation and cost-cutting remain key challenges for banks, particularly in the current weak economic context. Further consolidation could thus be helpful.
- Italian banks suffer from higher-than-average provisioning costs due to structurally higher nonperforming loans compared to other leading European countries, despite more lenient loan classifications. The application of a standard 90-day past due definition of impaired loans would provide more meaningful information on banks' financial health and would imply a downward adjustment of measured profitability and possibly capital adequacy in some cases.
- The limited regulation of lending to related parties raises uncertainty about the extent of connected lending in the banking sector. The staff supports current plans for enhancing regulation to permit a careful monitoring of this issue.
- Liquidity buffers in the banking sector have decreased and show some vulnerability to stress tests.
- Margins in the insurance industry are likely to shrink in the coming years, as a result of increased competition and a stricter regulatory regime. Continued efforts to strengthen supervision and to promote better risk management practices in the industry are critical. While in some areas, the Italian corporate governance framework incorporates more stringent investor protection than international practice, its benefits are not always fully realized due to cross-shareholdings, highly concentrated ownership linkages, and pyramid structures.
- Recent initiatives should help strengthen consumer protection, but there is room for further improvement, including in the disclosure of fees and risks associated with financial products.

Box 1. Main Recommendations of the FSAP

BI governance and transparency

- Amend the BI statute in application of the Savings Law provisions to clarify the role of the Board of Directors in internal oversight and control and modify the ownership structure of BI.
- Use the opportunity of amending the BI statute to clearly limit its objective to safeguarding the stability of the financial system, omitting the current reference to competitiveness.

Supervisory framework

- Accelerate the convergence to the 90-day past-due criteria for impaired loans and probability of default (under the New Basel Capital Accord) and related provisioning requirements.
- Enhance the comprehensiveness of bank regulation on lending to related parties, including its definition, limit and reporting requirement.
- Continue to monitor closely banks' vulnerability to liquidity risks and, if necessary call for higher liquidity buffers.
- Provide legal protection to the supervisory authorities and their officers against lawsuits for actions taken in good faith while discharging their duties.
- Strengthen BI's ability to remove promptly bank directors or senior officers who may have become unfit for their duties.
- Increase both the number and scope of on-site inspections by ISVAP.
- Subject all insurance intermediaries operating in Italy to registration and direct supervision.
- Complement market contacts by formal on site inspection of markets and market operators by Consob and BI.

Governance

- Strengthen the application of minority shareholder rights by mandating a majority of independent directors and requiring that the Board of Directors include a representative of minority shareholders.

Consumer protection

- Enhance the monitoring of bank's internal guidelines on the marketing of structured products to small and medium size corporations to ensure that risks are appropriately disclosed.
- Strengthen disclosure of the financial situation of each insurer and the risks to which it is subject.
- Extend disclosure requirements to nonlisted debt instruments issued by banks.

I. BACKGROUND

A. Macroeconomic Environment and Vulnerabilities

8. **Following a lackluster growth performance in recent years, recovery is likely to be only gradual.** GDP growth was weaker-than-expected in the third quarter (0.3 percent seasonally adjusted), raising questions about the strength and the durability of the recovery going forward. The staff now projects GDP growth at around zero in 2005, with a pick-up to about 1½ percent in 2006. Consumer price inflation is steady, in line with the euro zone average. The Ecofin Council endorsed, under its excessive deficit procedures, the authorities' plans to bring the deficit under the 3 percent of GDP ceiling by 2007.

9. **The key potential macroeconomic vulnerability would be if the lackluster growth of recent years were to be followed by a continued protracted period of low growth.** While historical data do not permit a meaningful quantification of the impact on the quality of the loan portfolio of such an event, it would ultimately be significant. In the near term, high public debt and fiscal instability will continue to pose a potential risk of widening interest rate spreads.

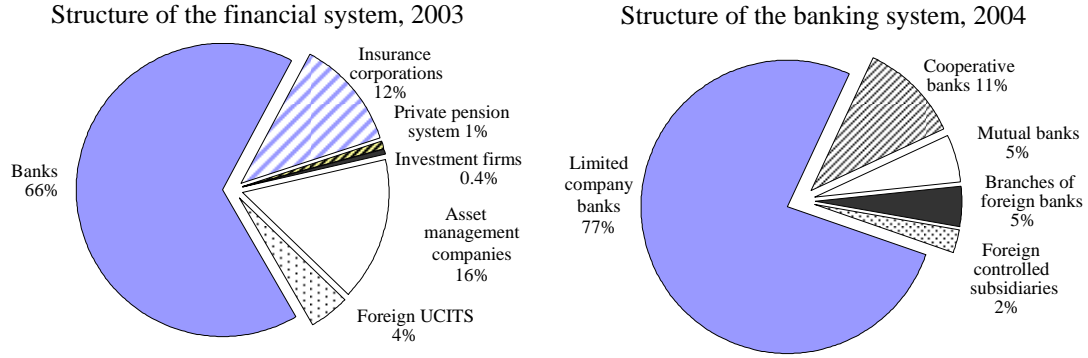
B. Key Features of Financial Sector Structure

10. **The Italian financial sector is diversified and advanced.** The banking sector remains a core funding source for the domestic economy (Figure 1). At end-June 2005, banking sector assets accounted for 66.5 percent of the financial system's total assets (Table 1) and were equivalent to 175 percent of GDP (compared with 300 and 215 percent of GDP in Germany and France, respectively). In addition, banks control a substantial portion of both the insurance sector (about a third of total assets in the sector) and the asset management industry (about 86 percent of assets under management at end-2004). The banking sector has consolidated rapidly and the six largest Italian bank groups accounted for 55 percent of total assets at end-2004. However, Italian banks remain relatively small and further consolidation is to be expected. Since 1994, successive waves of privatization have drastically shrunk the share of bank assets majority-owned by the state or (nonprofit) foundations (**Fondazioni**) from 58 percent to 10 percent at end-2004 (Figure 2).

11. **Asset management companies represent the second most important class of financial institutions with 16 percent of total assets, followed by insurance corporations (12 percent).** Life insurance has grown very rapidly in recent years (more than 20 percent annually in the early 2000s) and accounts for about 65 percent of total insurance premiums at present. Reinsurance activity is very limited.

Figure 1. Key Features of Italy's Banking Sector

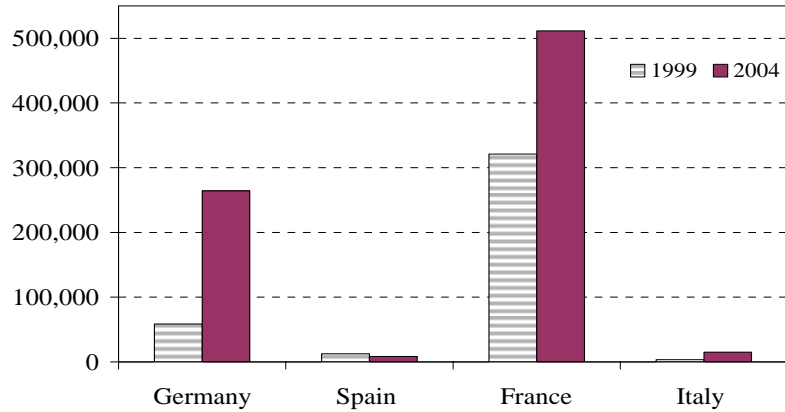
Italian banks constitute a core funding source for domestic economy



Sources: Bank of Italy, ISVAP, CONSOB, and COVIP.

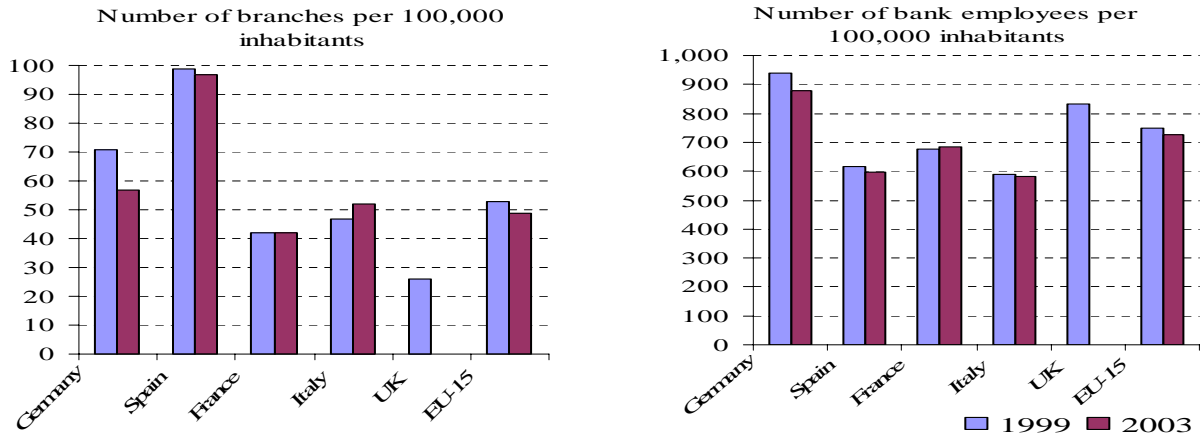
Debt Securities Are Not a Major Funding Source

(Gross issues of debt securities by non-financial companies, in EUR mill.)



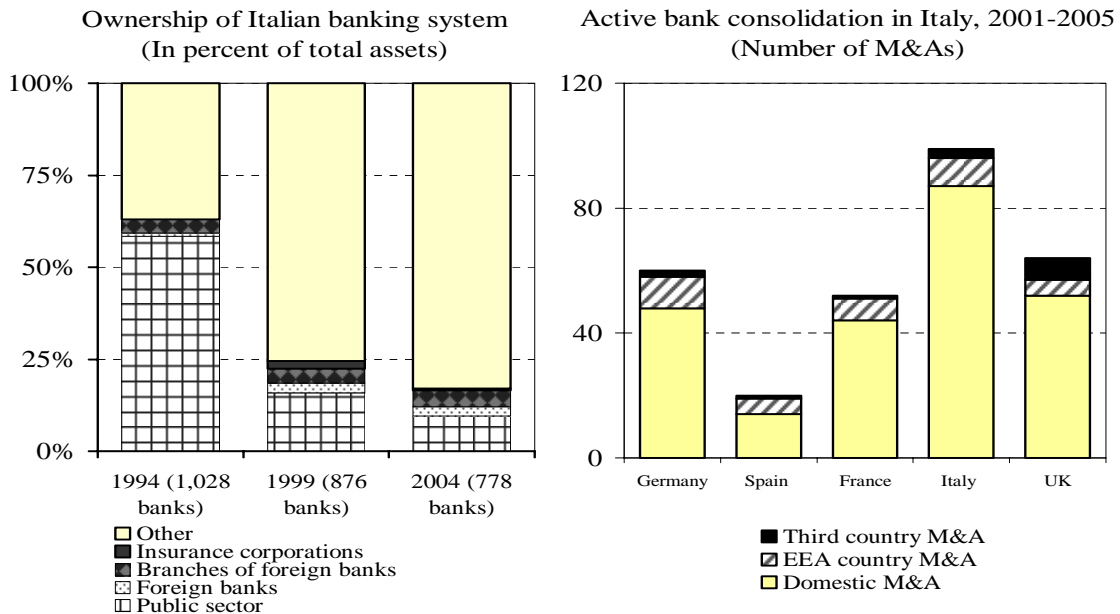
Source: EU Banking Structures (2005 ECB).

Bank penetration and employment are in line with the EU-15 average.



Source: EU Banking Structures (2004 ECB).

Figure 2. Restructuring of the Italian Banking Sector



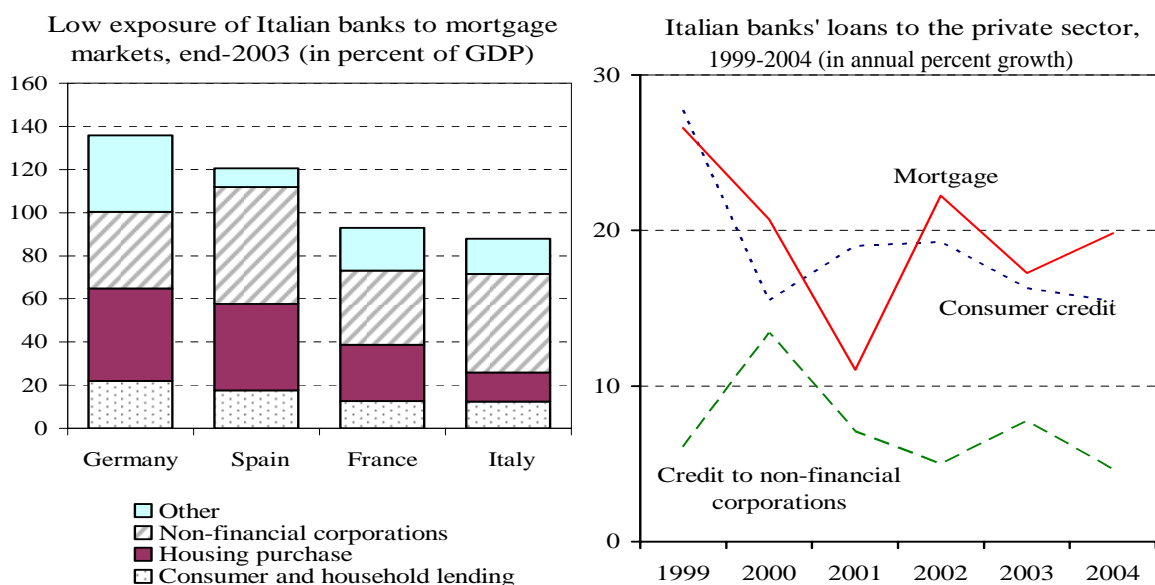
Source: EU Banking Structures (2005 ECB).

12. **While Italy's government bond market is the largest in Europe, its equity and corporate bond markets remain comparatively small.** Government debt, which accounts for 106 percent of GDP, is held largely in the form of long-term debt, in a market that is among the most liquid in the world. The total capitalization of the equity markets managed by **Borsa Italiana Group** represents about 40 percent of GDP. Activity on these markets and on the Italian corporate debt market declined between 2000 and 2003, before rebounding in 2004.

C. Counterparties

13. **The largest credit exposure of the banking system by far (60 percent) is to the corporate sector** (Figure 3). The debt to equity ratio of the corporate sector rose to 97 percent in 2004 from 76 percent in 2000 and, while these ratios are broadly comparable to those of other large European countries, the corporate sector is likely to be the highest source of risk, in particular in a continued low growth environment. Banks' exposure is quite diversified, with a few notable exceptions.

Figure 3. Exposure of Italian Banks to the Mortgage Market



Source: EU Banking Structures (2004 ECB).

14. Provided interest rates do not rise sharply in the next few years, household credit markets provide a potentially stable revenue source with a relatively low risk exposure. Since 2000, banks have been focusing increasingly on developing the Italian household credit markets, driven by new mortgage loans for house purchases. Italy's low household indebtedness (28 percent of GDP as compared to 57 percent for the EU-15 average) mitigates risk concerns in this segment (Table 2). Conditions would appear ripe for the development of new mortgage products, such as home equity credit lines.

15. **Relative to other large countries, Italy's banking sector exhibits a small overall risk exposure abroad** (Figure 4). In line with most developed countries, most of its exposure is to other mature industrial countries (75 percent of total consolidated foreign claims). The exposure of Italian banks to emerging countries is strongly concentrated in Central and Eastern Europe, accounting for 16 percent of total consolidated foreign claims and 14 percent of consolidated profits at end-2004.

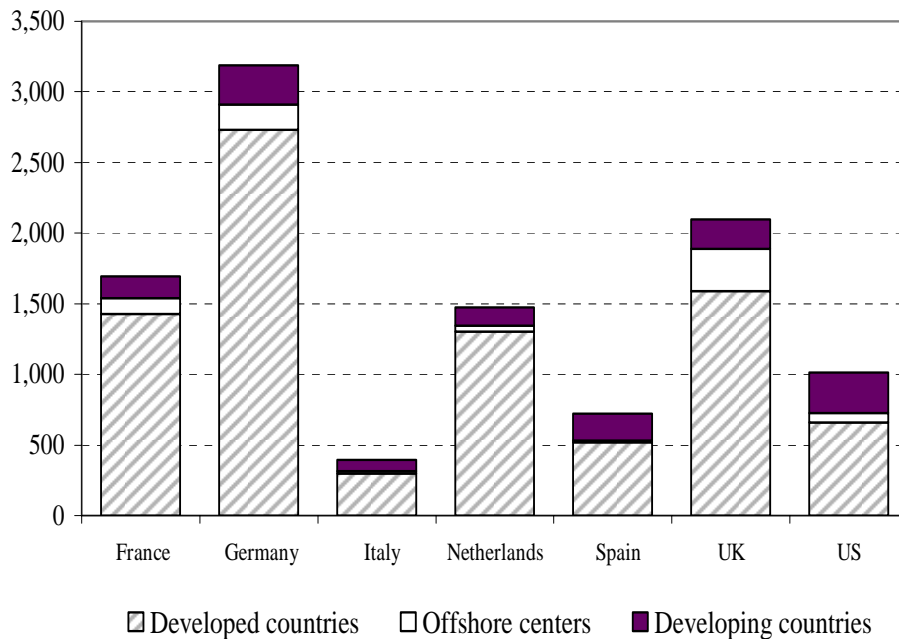
D. Regulatory and Supervisory Framework

16. **Regulation and oversight of financial markets are shared by six institutions.** BI has extensive powers and responsibilities as the supervisor of the banking system and, until recently, the authority in charge of enforcing Italian antitrust laws in the banking sector. It is also responsible for supervising the financial markets that are relevant for monetary policy purposes, such as wholesale markets for government securities and interbank markets. All insurance undertakings, including mutual insurance companies, are supervised and regulated by ISVAP. Its responsibilities include the solvency of insurance companies, the sound development of the insurance sector, and transparency and fairness in customer relations. The

Italian securities markets are supervised and regulated by the Italian Companies and Stock Exchange Commission (Consob). Pension funds are supervised by COVIP, the pension fund supervisory authority. Safeguarding competition is entrusted to the **Antitrust Authority**. **The Italian Foreign Exchange Office (UIC)** is responsible for anti-money laundering and combating terrorist financing.

17. **A new Law on Savings was adopted at end-December 2005 to enhance the protection of investors.** Drafted partly in response to the Parmalat case, the law includes new rules on corporate governance of the listed companies, minority shareholder rights, and the marketing and issue of corporate bonds, and allocates a more central role to Consob on securities markets. Reflecting recent amendments, the Law transfers the responsibility for regulating anticompetitive behavior to the Antitrust Authority while BI and the Antitrust Authority have been given shared responsibility for bank mergers and acquisitions. It also includes an additional set of reforms motivated by the public debate on the governance structure of BI. Concerns relating to the ownership and control of BI are discussed in more depth in Box 2, together with the reform proposals. The reforms adopted do not yet fully address staff concerns related to the need for clarity in the objective of BI, its ownership structure, and the role of the Board of Directors.

Figure 4. International Exposure for Selected Countries, 2004



Source: BIS Consolidated International Banking Statistics.

Box 2. Ownership and Governance of Banca d'Italia

Governance structure

The BI governance structure is based on three bodies: the Directorate (composed of the Governor, the Director General and two Deputy Directors General), the General Meeting of Shareholders, and the Board of Directors. Prior to the adoption of Art.19 of the Savings Law, the Governor was entrusted with the formulation and implementation of all BI policies (including banking supervision) with the possibility of assigning specific responsibilities to the other members of the Directorate. The General Meeting of Shareholders elected the Board of Directors, which appointed and dismissed the Governor and the other members of the Directorate. The Board also established a Board Committee, with an advisory role, intervening on administrative matters upon the Governor's request. *According to Art.19 of the Savings Law, all the Governor's non-ESCB responsibilities will henceforth be transferred to the Directorate (within which the Governor is attributed a casting vote). The BI Statute, further to the enactment of the Savings Law, should be revised within two months to provide the Board of Directors a role of internal oversight and control.*

Ownership and control

Article 3 of the BI Statute permits entities supervised by BI to own its share capital. Banks are thus voting members of the General Meeting of Shareholders which effectively elect the Board of Directors and the Board Committee, and participate in the appointment of the Directorate. 1/ Article 3 of the BI Statute stipulates that the majority interest must be retained by public institutions. Since financial sector privatization, however, the majority of BI share capital is no longer held by public institutions (banks currently account for 84.2 percent). The authorities emphasized that this provision has been superseded by the privatization law. Notwithstanding the ownership structure, the authorities assured the staff that supervised entities could neither influence policy decisions nor have access to privileged information. The mission found that prior to the adoption of Art.19 of the Savings Law, the risk of conflicts of interest was paradoxically mitigated by the concentration of power in the hands of the Governor and the lack of any oversight role of the Board. 2/ *The Savings Law now stipulates that the Governor is appointed by Presidential decree upon nomination by the Council of Ministers and advice of the Board of Directors to the Council of Ministers. The procedures for appointing the Directorate remain unchanged however. Although ownership will eventually be transferred to public entities, in the interim period between the enactment of an amended BI Statute with internal oversight responsibilities for the Board, and changes in the composition of the latter on account of the envisaged transfer of ownership, conflict of interest concerns remain.*

Principles of reforms and assessment

The reforms, included in Art.19 of the Savings Law are based on five principles: (i) reaffirmation of central bank autonomy, in line with ECB requirements; (ii) transfer of BI ownership to public entities within three years, subject to a gradual decline in private voting rights; (iii) enhanced collegiality, and the introduction of majority voting for decision-making by the Directorate; (iv) increased reporting requirements through the compilation of minutes, the motivation of decisions and reporting to Parliament twice a year; 3/ and (v) changes to the mandate of the Governor and other members of the Directorate to 6-year, once-renewable staggered terms. *Implementing these reforms will enhance transparency and accountability. However, key provisions are yet to be spelled out in the amendments to the BI Statute, including the role and composition of the Board of Directors, and the modalities of the transfer of ownership.*

1/ Subject to double-veto approval "by a decree of the President of the Republic acting on a proposal from the President of the Council of Ministers in agreement with the Minister of the Treasury after consulting the Council of Ministers" (Art. 19 of the BI Statute).

2/ Furthermore, a 1947 decree offered additional safeguards by precluding the influence of Board members in any of the matters under the competence of the ICCS (in bank supervision, stability, efficiency and competitiveness). Although the decree remains silent on supervised entities' access to privileged information through their participation in Board meetings, any violations of the professional secrecy provisions of the Banking and Consolidated Laws would be sanctioned by the penal code.

3/ Previously, external oversight was neither legally mandated nor subject to pre-specified schedules. The Governor reported within ICCS deliberations and parliamentary hearings, whenever Parliament requested technical advice on subjects related to BI functions.

II. STRENGTHS AND VULNERABILITIES

A. Banks

Recent performance and soundness

18. **Despite the protracted period of low growth, the Italian financial system appears stable with improving results overall, albeit with some continuing challenges ahead.**

Restructuring has contributed to improvement in banks' efficiency and asset quality. Low household indebtedness mitigates risk concerns in the retail sector and the low interest rate environment continues to sustain borrowers' debt-servicing ability. While competition appears to have improved, costs remain high (compensated by high revenues) and challenges include generating stable sources of income, further restructuring and cost-cutting, and managing the high level of impaired loans and adequate provisions for credit losses.

19. **Profitability indicators of the Italian banking sector continue to improve, arriving at levels close to the European average but further strengthening is needed.** At end-2004, return on equity rebounded to close to 10.7 percent on a consolidated basis and to 12.5 percent for the six largest banking groups. In 2004, improvements in profitability have been achieved largely through a fall in asset value adjustment and a small progressive reduction in costs, whereas revenue growth has remained weak. In 2004 the cost-to-income ratio for Italian banks remained below the European average (57.9 percent in Italy as against 63.7 percent for the EU-15). But much remains to be done, especially to counterbalance the low revenue growth potential in the current low growth and low interest rate environment.

20. **Revenue generating remains a key priority, as commission income continues to stagnate.** Over the last decade, Italian banks relied increasingly on fee and commission income but by end-2004, at 21 percent of gross income this represented a share 5 percentage points lower than its peak in 2000. Overall, noninterest income to total income has remained stable at around 44 percent since 2002.

21. **The deep restructuring of the banking sector in the 1990s, owing primarily to the almost complete privatization of the banking sector, has improved markedly the efficiency and competition of the Italian banking industry, but there is scope for further improvement.** Standard performance and competition indicators suggest that Italian banks are now broadly in line with other large European countries. However, competition has not yet been fully reflected in the pricing of products and quality of services provided, reflecting limited contestability. The authorities are concerned that high switching costs hamper competition and an investigation is being conducted in cooperation with the Antitrust Authority. According to the 2005 World Retail Banking Report, the average price of basic banking services in Italy (albeit not a comprehensive coverage) appears to be one of the highest in Europe. Competition and efficiency issues are analyzed in detail in a selected issues paper "*Italy—Assessing Competition and Efficiency in the Banking Sector*," issued as background to the Article IV discussions. Staff believes that improved efficiency and lower product pricing could help improve Italy's growth potential.

22. **The presence of foreign banks remains very limited in retail banking** (Figure 5). So far, foreign takeovers have proven difficult to carry out, prompting scrutiny by the European Commission (and the Italian legal system). At end-2004, 7 percent of total bank assets were owned by foreigners. Although this is similar to the situation in some other large western European countries, no significant Italian bank or bank group is majority-owned by foreigners.¹ Greater foreign ownership in the Italian retail banking sector would help strengthen efficiency.

23. **The quality of banks' loan portfolios has significantly improved over the last few years, but the level of nonperforming loans remains high and is understated under current lenient loan classification system.** After a sharp fall in the late 1990s, nonperforming and doubtful loans have stabilized around 6.5 percent of banks' total loans since 2002, compared with an average of 2.9 percent for Germany, France, Spain, the UK, and the U.S. (Figure 6).² The prevailing classification system allows Italian banks to recognize impaired loans and the cessation of interest accrual later than in most other European countries. BI is taking measures to align its definition of impaired loans to international standards.³ According to surveys conducted by BI on the basis of preliminary June 2005 data, under a standard 90-day past-due classification of impaired loans, NPL ratios would increase to 7.5 percent from 6.8 percent under the current classification. This will reduce measured asset quality, which in turn will alter provisioning needs and thereby profitability figures. If the increased NPL were to be provisioned at 40 percent, the impact would be approximately equivalent to 20 percent of 2004 profits.

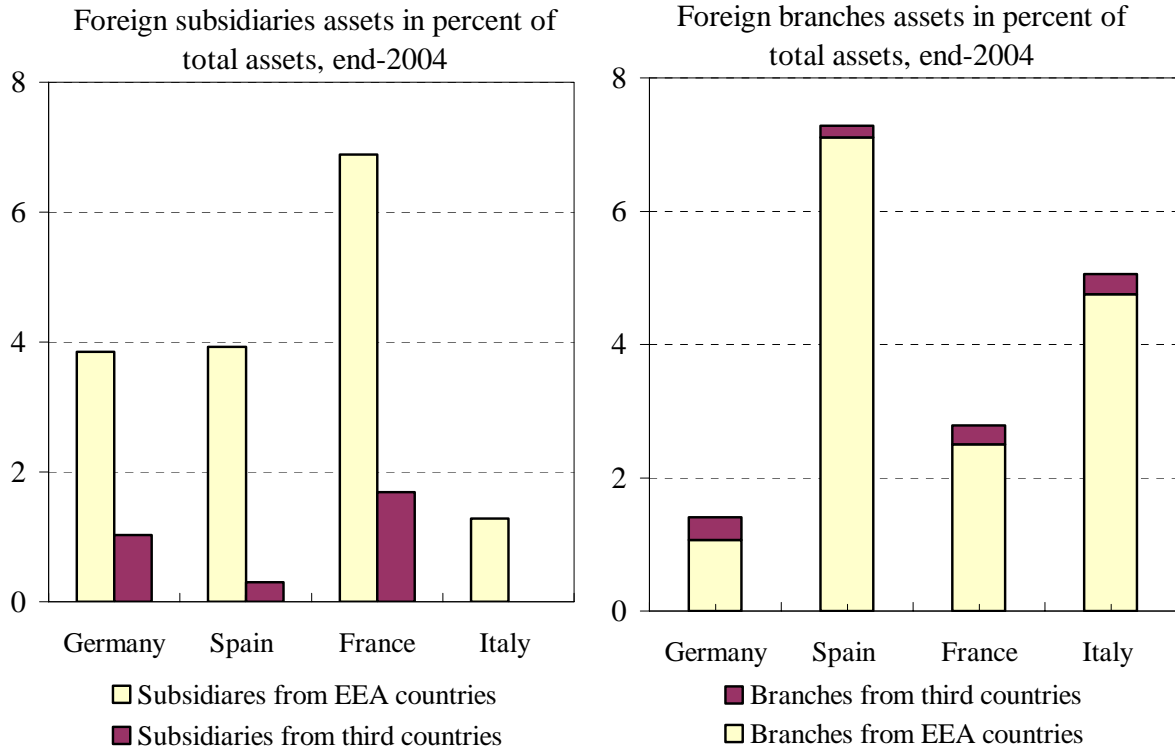
24. **Rising capital buffers mitigate banks' vulnerability to external shocks and are broadly in line with other leading European countries.** Between 2000 and 2004, the largest six bank groups increased their Tier 1 capital ratio from 5.8 percent to 7.3 percent and their overall capital ratio from 8.7 percent to 11.5 percent.

¹ At end-2004, foreigners were majority owners in two medium-sized banks (with total assets below €20 billion) and 13 small banks (with total assets below €7 billion), accounting in total for only 2.5 percent of total bank assets.

² Italy has a higher reliance on overdraft facilities, which are frequently repaid after long delays. Also lengthy judicial proceedings induce banks to keep nonperforming loans on their books longer.

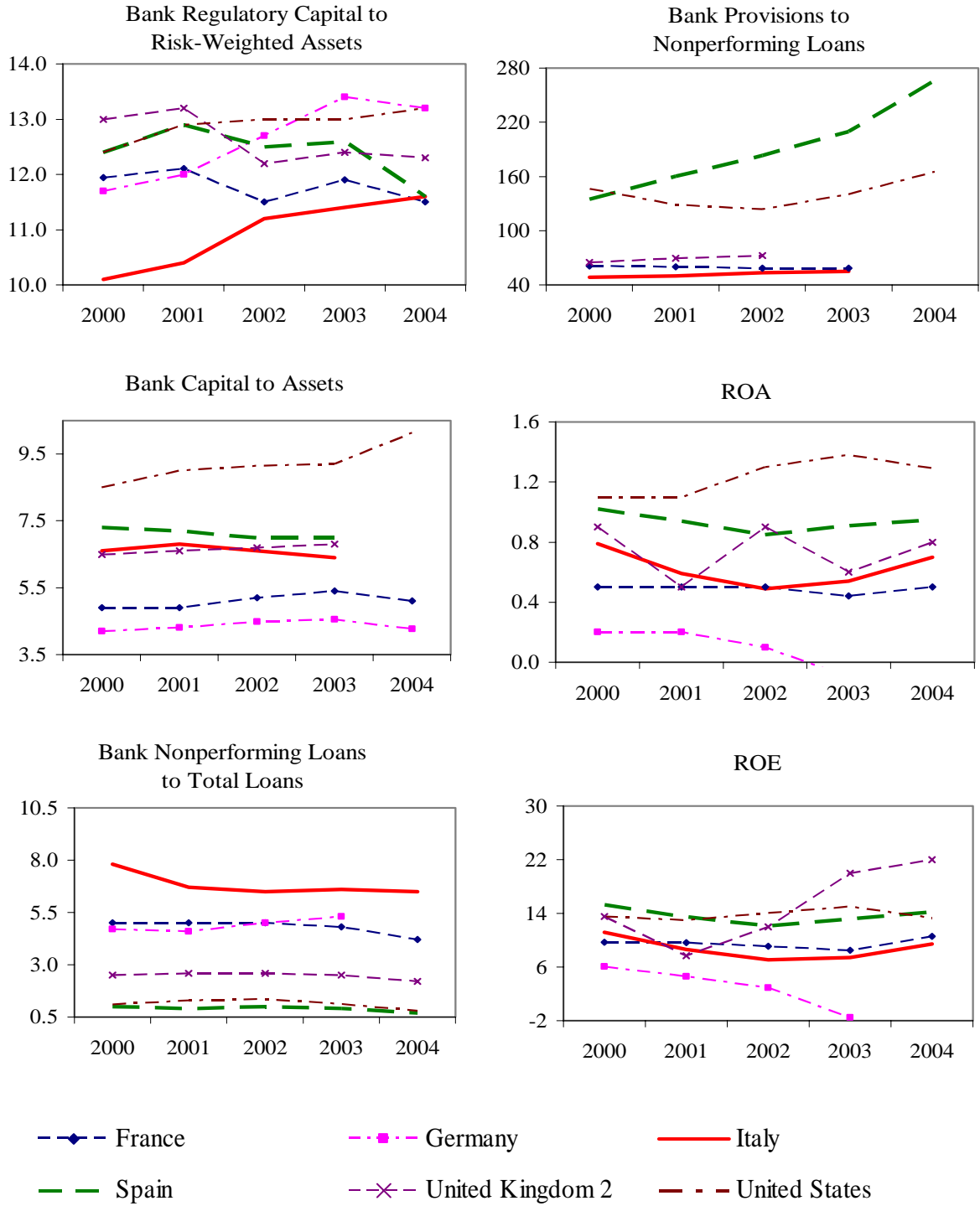
³ In the context of the "New Basel Capital Accord," the Basel Committee has granted Italy, on the basis of its local credit conditions, a five-year transition period to use a 180-day past-due definition for default (as opposed to the "more than 90 days past-due" criterion).

Figure 5. Foreign Ownership of Italian Banks



Source: EU Banking Structures (2005 ECB).

Figure 6. Selected FSIs in Large Developed Countries



Sources: National authorities and IMF staff estimates.

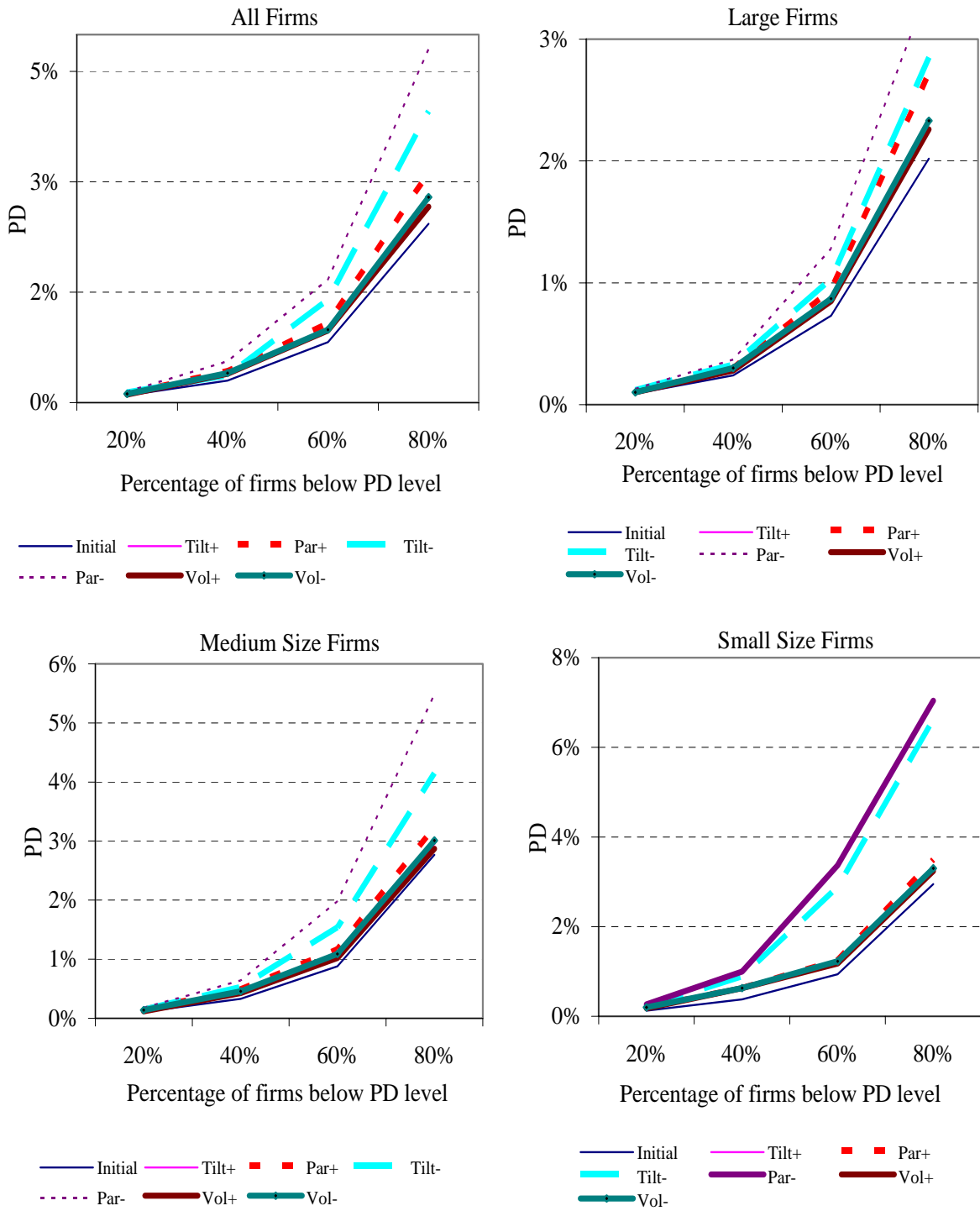
25. **Despite their rapid development, securitization transactions had not until recently led to substantial reduction in risk exposures in banks' balance sheets.** Since the 1999 enactment of a securitization law and introduction of tax incentives, Italy's securitization market has grown rapidly to rank as the second-largest in Europe. By 2004, bank loan securitization amounted to €55bn, €27bn of which related to NPL. It appears that since 2002 securitization transactions increasingly reflect funding purposes, as well as balance sheet and risk management objectives, suggesting that the market has further matured. However, the increasing use of more sophisticated products, such as synthetic securitizations, may also have introduced new risks in the system.

26. **Derivatives exposures do not appear to threaten the financial condition of Italian corporations, but might create legal and reputational risks for the banking system.** The largest Italian banks appear quite active in the sale of complex derivative products to corporate clients and consideration could be given to introduce capital charges for model risk for banks actively involved in structured products, in line with the recommendations in Basel II.⁴ The results of stress tests for a variety of shocks to derivative exposures of corporations indicate that the losses will only have a modest effect on the probability of default (PD). The most severe shock, a parallel decrease in the yield curve causes the maximum increase in the average PD (about 40 percent), but only 20 percent of the firms will have a PD higher than 5 percent (see Figure 7 and section I of Appendix I for details).⁵ The results of the banking sector stress test indicate that the largest Italian banks can sustain a much larger increase in the PD. Nevertheless, supervision of bank derivative activities is key to ensure stability and minimize legal and reputational risks. BI and Consob supervisors need to closely monitor bank's internal guidelines on the marketing of structured products and particular attention should be devoted to the practice of restructuring losing derivative positions by rolling them over into further structures, where the positions may be doubled.

⁴ The Italian over-the-counter (OTC) derivatives market is the fifth largest in the world in terms of turnover. Italian banks act mostly as dealers, holding about 90 percent of derivative contracts in their trading book.

⁵ Based on S&P data, the rating associated to a probability of default lower than 5 percent is B+ or better. The stress test performed is rather extreme since it does not consider that derivatives might be hedging on-balance sheet exposures. The fact that the higher increases in PDs occur in the event of interest rate declines suggest that most derivatives positions are for hedging purposes.

Figure 7. Italy: Stress Test of Italian Corporation Derivatives Exposures



Source: Bank of Italy. Shocks to the Euro-Curve include parallel shocks of +/- 100 b.p., Tilt+/-; s/t. rates +/- 110 b.p, m./t. rates i+/- 60 b.p. l./t rates =/- 40 b.p. , and volatility shocks of +/-30 %.

Vulnerabilities and stress test results

27. **Overall, the Italian banking system has low exposure to market and interest rate risk but liquidity buffers have decreased.** Banking system exposures to foreign exchange and equity risks are well below five percent of capital. Liquid assets in relation to short term liabilities has halved in the last five years. While the EU Banking Sector Stability Report indicates that this ratio remains in line with other European countries, some vulnerability to liquidity risk was identified by stress test results (see below).

28. **Stress tests examined the impact of a variety of shocks on the nine major Italian banking groups accounting for 62 percent of total bank assets.** The methodology for the stress tests was decided in consultation with IMF staff, and the tests were performed by both the banks and BI based on consolidated end-2004 balance sheets, yielding similar results, and updated by BI with data as of end-June 2005. The size of the shocks to assess market risk, sovereign risk, interest rate risk in the banking book and liquidity risk was in line with those applied in other FSAPs for Euro area countries, while the credit risk shock exceeded the largest historical shock in Italy. In addition, the stress tests assessed the impact of several adverse macroeconomic scenarios on the banking groups. (See section I of Appendix I for details).

29. **Stress test results indicate that the major Italian banking groups are resilient to shocks, but that some smaller banks would be exposed to a liquidity shock.** Even in the absence of profits, existing capital buffers are sufficient to absorb the shocks. The major Italian banks appear to be hedged to cope with market risk. The individual risk factors to which the Italian banks are more exposed are credit and sovereign risk (Table 3). Of the macro scenarios considered the oil shock that causes global slow down and resulting in a 30 percent decrease in global equity prices has the largest impact.⁶ The relatively low impact of stress tests is explained by the historically low impact on probabilities of default of similar shocks, on which the parameters of the exercise is calibrated. Historical relationships are not well suited to predict the impact of a prolonged period of low economic growth. Should low growth persist, the implications are likely to be more pronounced than that indicated by the current stress tests, especially through deterioration in the quality of lending to the corporate sector. That being said, these results were supported by VAR estimates conducted by BI on a system-wide basis.

30. **Stress tests indicated that, some banks (representing 22 percent of total bank assets) may not have appropriate liquidity buffers to sustain a liquidity shock.** The authorities emphasized that these banks were mainly members of banking groups and would

⁶ This scenario corresponds to an estimated increase in the PDs of 83 percent, far exceeding the largest historical observation.

be covered by liquidity buffers in the parent bank. Nevertheless staff believes that liquidity buffers should be monitored carefully and banks encouraged to increase them, if necessary.

Regulatory issues

31. **A June 2003 detailed assessment of compliance with the Basel Core Principles for Effective Banking Supervision (BCP) found the Italian bank supervisory system to be of a high standard.** Because of its timing, the assessment could not take into account information revealed in the context the current high profile bank take-over attempts. Some of the alleged actions, if proven, would indicate a need for greater vigilance in enforcing the overall strong supervisory framework. Also, progress on implementing key BCP recommendations has been slow, and the staff encouraged the authorities to promptly converge to a standard definition of impaired loans, as this would greatly raise transparency and cross-country comparison of banks' financial accounts. Regarding the recommendation to introduce comprehensive regulations on lending to related parties, the staff notes that the ICCS approved broad guidelines in July 2005, paving the way for more detailed BI regulations. Only limited data is available, raising uncertainty about the extent of connected lending. The staff welcomes the opportunity for BI to regulate lending to related parties and monitor the potentially negative impact of such lending on the quality of banks' balance sheets.

32. **The large banks are at an advanced stage of preparation for adopting Basel II requirements.** Two banks, accounting for roughly 30 percent of the system's total assets, have already had their market risk models validated by BI and a few more banks are in the process of submitting their models. Eight banks have been identified as potential candidates for the pre-validation of their internal ratings-based (IRB) approach to capital adequacy and BI follows closely the progress of five additional banks. Most of these banks are already using internal rating systems in the credit evaluation process of corporate customers.

33. **Market participants expect some restatement of balance sheets with the transition to IFRS in 2005 but the overall impact on capital is uncertain.**⁷ The higher provisioning rates for nonperforming assets under IFRS are expected to translate into a negative impact on banks' capital base because of the need to discount future income streams.⁸ For many banks, this effect will be balanced by the revaluation of real-estate property. Stricter accounting for pension costs may also affect some banks negatively. So far, only a few Italian banks have provided quantitative data on the impact of IFRS adoption on their equity and income; one bank has resorted to capital injections in anticipation of the changes.

⁷ Based on discussion with Standard & Poor's and Moody's.

⁸ Under Italian GAAP, banks compute provisions based on the likelihood of recovery, regardless of the recovery period, which is very slow in Italy, thereby underestimating the true costs of carrying impaired loans.

Policy transparency and potentially conflicting objectives

34. **The IMF Transparency Code is generally formally observed, but clarifying broad policy objectives would further strengthen the transparency of banking supervision.** Information on policy developments and regulatory changes is disseminated on a timely basis through the BI publications program. However, there is little discussion of the overall objectives, their linkages, and the manner in which they are being pursued. Consideration should be given to the publication of a financial stability report, which could include these issues.

35. **At the time of the assessment, BI was by law assigned at least three broad objectives, namely maintaining the stability of the financial system, enforcing Italy's antitrust laws, and promoting the efficiency and competitiveness of the banking sector.** While the authorities indicated that, staff believe that BI should not be promoting "competitiveness" and recommend that the wording should be changed in the Banking Law.

36. **BI's joint responsibility for enforcing competition laws and maintaining the stability of the financial system might lead to a potential conflict.** For example, short-term stability concerns might induce BI to facilitate the merger of a weak bank without considering the long-term competition implication. Such a conflict, however, could be addressed in several ways, including by imposing compensatory antitrust measures on the merging bank. Thus, provided merger reviews are supported by clear and transparent implementation procedures and adequate accountability mechanisms, competition and stability objectives are not necessarily inconsistent, as supported by the literature.⁹

37. **In an effort to improve transparency and accountability, the newly enacted Savings Law has transferred responsibility for regulating anticompetitive behavior to the Antitrust Authority.** In the area of merger reviews, BI and the Antitrust Authority have been given shared responsibility for authorizing bank mergers and acquisitions (BI on prudential grounds and the Antitrust Authority on competition grounds). For a successful implementation, the Antitrust Authority must have in place a clear and transparent decision-making process, appropriate resources and expertise to analyze the merger impact on competition, and utmost independence in forming its opinion. In the cases where BI may recommend a merger for stability purposes, the Antitrust Authority should be entitled to authorize concentrations on stability grounds, with compensatory measures if necessary.

38. **The role of the ICCS in bank supervision makes it difficult to assess BI's degree of operational independence on prudential issues.** While policy formulation and implementation are vested solely in the Governor (now, the Directorate), the ICCS remains

⁹ See selected issues paper *Italy—Assessing Competition and Efficiency in the Banking Sector* issued as background to the 2005 Article IV discussions.

the highest supervisory authority for issuing broad guidelines on prudential supervision and in the area of credit activities and the protection of savings.¹⁰ Although the 2003 BCP detailed assessment found BI to be operationally independent in day-to-day supervisory and regulatory activities, it also noted that the lack of clarity regarding the role of ICCS in bank supervision made it difficult to assess whether BI had full operational independence over supervisory policies and processes. For example, important supervisory regulations have been significantly delayed by the ICCS, as evidenced in the case of connected lending.

B. Insurance and Pension Sectors

Recent performance and soundness

39. **The Italian insurance industry has posted rapid growth rates and strong profitability in recent years.** The sector experienced premium increases of about 12 percent in both 2003 and 2004. Capitalization levels remain strong, profitability is one of the highest in Europe, and combined ratios¹¹ have dropped below 100 percent in 2003–04 for the first time in more than two decades (Table 4). Compared with other countries, activity in the Italian nonlife sector carries relatively low risk profiles because certain specific risks, such as environmental and asbestos risks, have not affected the industry.

40. **Prospects for the Italian insurance sector appear favorable in many respects.** Italy is a relatively under-insured market, and growth prospects for the insurance industry are generally seen as favorable.¹² Margins may still remain higher than in the rest of Europe for some time, and the life sector industry should cover this medium term benefit from the recently approved pension reform. In addition, the traditionally conservative investment strategies of Italian insurance companies, as reflected in low exposures to equities (about 12 percent) and high exposures to fixed income securities (57 percent), should continue to insulate insurance companies from market volatility.

41. **However, there are some significant challenges ahead for the industry.** Margins are likely to shrink in the coming years, including as a result of increased competition and the implementation of a stricter regulatory regime. In the nonlife sector, for example, the recent profitability improvements should slow down due to increased pressure from consumer

¹⁰ According to Article 2 of the Banking Law, the ICCS is composed of seven Ministers: the Minister of Treasury (Chairperson), together with the Minister of Finance, Foreign Trade, Coordination of Agricultural, Food and Forestry Policies, Industry, Public Works, and EC Affairs. The Governor of BI may attend its meetings and the Chairman can invite other Ministers to participate.

¹¹ Combined ratios provide a good indicator of underwriting operational performance but do not account for investment performance. A combined ratio is the sum of the claims ratio (claims/premiums) and expense ratio (expenses/premiums) and is expressed as a percentage.

¹² Gross domestic premium income accounted for 7.5 percent of GDP in 2004, compared with an E.U. average of close to 9 percent.

associations and from the government to reduce tariffs (following their strong increase in recent years). Revenue diversification will therefore be an important objective and challenge for most insurance companies, especially since most Italian insurers are exclusively domestic players.

42. **Against this background, continued efforts to strengthen supervision, and to promote better risk management practices in the industry, are critical.** ISVAP has undertaken increasing efforts to strengthen its risk-based approach to supervision and to promote internal controls, reflecting in particular changes in international regulatory frameworks, including at the European level and in anticipation of the Solvency II framework implementation. Such efforts are particularly important for the smaller insurance companies, where risk management and risk-based capital management are not widespread.

43. **The need to strengthen competition, transparency and product control has also attracted greater attention from a consumer protection perspective.** Concerns have emerged regarding the sale to retail investors of life insurance products with high fee structures and in a context of inadequate disclosure practices. More broadly, competition in the insurance market may be hampered by the rigid, vertically integrated structure of distribution networks, in which banks play a central role.¹³ Recent reforms, including the new circular on life insurance disclosure and, more broadly, the Law on Savings, are expected to address some of these shortcomings, including through a clearer division of responsibilities between regulatory agencies in these areas. In particular, ISVAP should be able to supervise insurers selling pension products, and COVIP to monitor the transparency of pension products (including those sold by insurance companies) without imposing duplicate or conflicting supervisory requirements on insurance companies.

Stress test results

44. **The stress tests assessed the impact of a variety of shocks on major Italian insurance groups** (Table 5 and Section II of Appendix I). They were applied to the balance sheets of the 10 largest insurance groups in Italy (as of end-2004), representing a market share of over 70 percent of premiums. Stress test assumptions were chosen to be consistent with those used in the parallel stress testing of the Italian banking sector. Specifically, the resilience of the insurance sector was assessed against a domestic macroeconomic shock, a range of interest rate shocks (interest rate risk being by far the main market risk for Italian insurance companies), and catastrophe risk.

¹³ For example, about 70 percent of life insurance products are sold through bank networks, and there is anecdotal evidence that some banks have conditioned the extension of consumer credit lines to the sale of their insurance products.

45. **Stress test results suggest that a number of relatively small life insurance companies are vulnerable to shocks.** Life insurance companies appear as the most exposed to adverse shocks, and their solvency may be particularly affected by an interest rate shock or by an adverse macroeconomic scenario. However, most of the vulnerable life insurance companies are owned by banks and, in case of shock, may benefit from the larger pool of capital available to their parent banking group. Indeed, the stress tests results also indicate that the potential solvency shortfalls in bank-owned insurance companies are very small compared with the amounts of capital available to banks, mitigating concerns about risks arising from the potential impact of correlated shocks across the financial system. As a result, only a limited number of relatively small life insurance companies appear vulnerable. In the nonlife sector, solvency levels seem unlikely to reach critically low levels due to their relatively high-level at present, and to the absence of significant exposures to catastrophic risk (especially once the impact of reinsurance is taken into account).

Regulatory issues

46. **In recent years, ISVAP has moved toward a more forward-looking approach to supervision, working toward the full implementation of a risk-based supervisory methodology and promoting better risk management practices by insurers.** Further changes are ahead, such as the implementation of Solvency II, which ISVAP has been actively involved in developing. The legal framework for supervision of the insurance sector is largely adequate, but legal protection of supervisors, independence of directors and licensing of intermediaries may need to be strengthened.¹⁴ ISVAP conducts extensive off-site financial analysis which it should continue to make more forward-looking, for example, by requiring insurers to regularly perform stress testing and report the results. On-site inspections of insurers should be increased significantly, both in breadth and frequency, supporting more comprehensive risk assessment processes. Inspections of insurance intermediaries should be more frequent and extended to include those employed in nontraditional distribution systems. Efforts to improve disclosure to consumers are commendable and should enhance the competitive environment. Increased disclosure of company-specific financial information, including by ISVAP, would support market discipline.

Role of pension funds

47. **Pension funds are small institutional investors in Italy, and recent reform initiatives that would stimulate their growth will not be implemented before 2008.** Pension benefits are still primarily provided by the public pension system, as private pension

¹⁴ The recently adopted new Insurance Code provides ISVAP with the power to license and conduct on-site inspections on all insurance intermediaries involved in product distribution.

funds cover less than 12 percent of the employed workforce.¹⁵ Italian pension funds are not a source of solvency concerns as they are almost exclusively defined contribution schemes, and generally invest their assets conservatively (a total of about €40bn, or 3 percent of GDP).¹⁶ Legislative changes approved in July 2004 include the possibility for employees to transfer their TFR (*Trattamento di fine rapporto*) to pension funds. This should help promote competition between private pension providers and stimulate the growth of pension funds and the asset management industries more broadly.¹⁷ However, the recent legislative changes are now planned to take effect only in 2008, and further modifications are possible before then.

C. Capital Markets

Securities markets

48. **The limited development of Italy’s equity markets reflects the relative lack of “equity culture” in Italy, the small number of big private corporations and the predominance of family-owned SMEs in the economy, as well as the marginal importance of certain institutional investor classes (such as pension funds).** The authorities have made efforts to (i) introduce various market segments and to improve market regulation in order to facilitate listing by small companies, and (ii) promote new indices to meet various investor needs. Similarly, the Italian corporate bond market (also managed by *Borsa Italiana*) remains underdeveloped, and corporate scandals led to a further reduction in domestic bond issuance by Italian corporations in the early 2000s. Some regulatory gaps that contributed to this trend are being addressed in the Law on Savings.

49. **In contrast, the Italian government bond market is the largest and most liquid in Europe, and has been a driving force of international capital market integration with the MTS platform.** The liquidity of the secondary market for Italian government bonds reflects the authorities’ efforts to issue a smaller number of benchmark instruments with greater outstanding amounts, while extending the overall duration of public debt. MTS, the trading platform introduced in 1988 with the initial objective of increasing liquidity and transparency in the Italian government bond market, evolved into a model adopted by a

¹⁵ However, it is estimated that the replacement rate provided by public pensions will gradually decline from about 70 percent at present, to 50 percent around 2050.

¹⁶ Typically in debt securities (46 percent), real estate (17 percent), mutual funds (13 percent) and equities (less than 10 percent).

¹⁷ The TFR is a severance payment provision required by law from Italian employers for the benefit of their employees. It currently represents 6.91 percent of gross salaries, and about €15bn annually in aggregate. Until recently, TFR resources had been largely used as a source of funding by companies. Implementing the recent legislative changes would automatically channel them into private pension funds, unless employees explicitly decide otherwise.

number of European and other countries. An estimated 70 percent of all euro zone government bonds are currently listed and traded on the MTS platform, offering standardized benchmarks for a wide range of fund managers and producers of financial instruments.¹⁸

50. **An increased size and role of capital markets in the economy is desirable, to provide the private sector with alternatives to bank financing.** Deeper capital markets would also support the further development of savings and investment opportunities for both institutional investors and households.

Securities market regulation, oversight and transparency

51. **The assessment of IOSCO Objectives and Principles shows very strong securities market regulation and oversight.** Moreover, recently enacted legislation has further strengthened Consob's powers to investigate, supervise and enforce compliance with the regulatory framework, including by giving Consob and BI the authority to impose pecuniary sanctions. The assessment of the IMF Transparency Code for securities regulation revealed a high degree of compliance. A few areas still require action, in particular:

- Consob and BI should include markets and market operators in their on-site inspection plans. BI has indicated that inspections will be carried out as necessary on the basis of a recently adopted ad hoc methodology. Furthermore, to strengthen the supervision of the government securities market, Consob should ensure that information from the wholesale market is timely and effectively integrated with that from the retail market.
- Disclosure requirements should be extended to nonlisted debt instruments issued by banks.

Corporate governance and investor protection

52. **An IMF staff study of the Italian corporate governance framework indicates that it incorporates a high degree of investor protection, in some areas more stringent than international practice, but its benefits are not always fully realized.**¹⁹ In particular, highly concentrated ownership, cross-shareholdings, and pyramid structures make it difficult for minority shareholders to implement or enforce the rights that they are given by law. The

¹⁸ The liquidity of the MTS market was tested on August 2, 2004, when a London-based market participant sold €12bn of euro government bonds (over half the size of average daily trading volumes) through the automated trading network in about 15 seconds. From a technical standpoint, the trading incident did not durably affect the functioning of the market (temporary limits on transaction size were removed after a few weeks).

¹⁹ "Corporate Governance and Investor Protection" by Paolo Drummond and Felice Friedman (<http://www.imf.org/external/pubs/ft/scr/2005/cr0541.pdf>)

recently adopted law incorporating the EU market abuse directive has addressed some of these issues by giving Consob more resources, augmenting its power to act independently of the Minister of the Economy and Finance, and raising pecuniary sanctions. Other areas where further changes are recommended include mandating a majority of independent directors, incorporating some of the provisions of the Preda (voluntary corporate governance) Code into regulatory requirements, and representing minority shareholders on the board.

III. INFRASTRUCTURE AND CRISIS RESOLUTION

A. Payments and Securities Settlement Systems

53. **A June 2003 assessment of Compliance with CPSS Core Principles for Systemically Important Payment Systems (CPSIPS) found high standards in payment system operation and oversight.**²⁰ The migration to the new Birel RTGS system was completed in 2004 and most of the recommendations were addressed. Birel (together with the German system) has been chosen as the basis for developing the new unified euro area RTGS platform.

54. **The assessment of CPSS/IOSCO Recommendations for Securities Settlement (RSSS) demonstrated that Italian securities clearing and settlement systems are safe, sound and efficient.** *Monte Titoli* (MT) has adequate procedures to monitor, identify and manage operational risk. It intends putting in place proactive risk-management procedures and externally auditing its procedures and arrangements for disaster recovery and business continuity and for the outsourcing IT company. Due to the de facto monopoly position of both MT and *Cassa di Compensazione e Garanzia* in the Italian financial market, their common holding company, *Borsa Italiana*, has indicated that it would increase the number of independent Board members.

B. Crisis Management and Safety Nets

Systemic liquidity arrangements

55. **BI maintains an element of institutional ambiguity in the provision of emergency liquidity assistance (ELA) to illiquid but solvent institutions.** There is no ex ante specification of terms and conditions, other than the use of collateral and the penalty rate slightly above market rates. Uncertainty regarding the granting of ELA and the perceived reputational cost are believed to deter banks from relying inappropriately on ELA. BI's role could be made more transparent, while precluding moral hazard, by disclosing that meeting pre-specified criteria is not a sufficient condition for support. There is a presumption in favor

²⁰ This assessment is published under "Italy: Detailed Assessment of Compliance with the Committee for Payment and Settlement Systems (CPSS) Core Principles for Systemically Important Payment Systems" (IMF Country Report No. 04/132), April 2004 <http://www.imf.org/external/pubs/ft/scr/2004/cr04132.pdf>.

of ex post disclosure, publishing aggregate terms and amounts, as in the latest cases of support in the early 1990s. Since 1999 no bank has requested ELA. A potential conflict of interest may arise from BI's Asset Management Department's privileged access to information on banks resorting to ELA, since it is entrusted with ELA decisions and is also responsible for handling the Bank's portfolio investments. Recent decisions to create a separate unit within the Department in charge of ELA-related matters, and to follow an investment strategy aimed at replicating a market index, represent moves in the right direction.

Bank resolution mechanism

56. **BI has extensive powers in bank resolution and liquidation procedures.** The special administrator appointed by the BI assumes all powers of the Board of Directors, including merger and acquisition negotiations. The criteria underlying purchase and assumption decisions are unclear; the authorities indicated that competitive mechanisms were used, including, in at least one case, through an informal auction to select the acquiring bank. Shareholders approve the final decision, but have limited recourse since only the special administrator may convene a shareholders' meeting and determine items on its agenda. Between 1990 and 2004, 94 banks were placed under special administration; of these, 30 were liquidated and 46 were merged with other banks. Since 1997, only small banks were under special administration.

Deposit insurance schemes

57. **Italian banks benefit from relatively generous deposit insurance schemes (DIS) which have worked well under BI surveillance.** Coverage of the two funds in operation (the Interbank Deposit Protection Fund or FITD and the Mutual Banks Depositors Protection Fund or FDGCC) is significantly higher than required EU minima. Contributions are subject to risk-based premia and charged on an ex post basis. There is no presumption for back-up public financing should DIS resources prove insufficient, although this happened in two cases (in 1996 and 1997), with BI supplementing DIS resources on one occasion. Between 1988 and 1997, the FITD intervened six times, in four of which it applied the purchase and assumption option. The DIS evaluates options on a least-cost basis and may provide support interventions such as credits, guarantees and acquisitions of equity.

C. AML/CFT

58. **Italy's comprehensive AML/CFT system has produced significant enforcement successes against money laundering,** but the complex legal framework needs consolidation and streamlining. The preventive system has generally not been updated to the latest FATF standard and requires greater implementation of the more detailed customer due diligence (CDD) requirements of the revised standard, more effective sanctions regime, the increase of suspicious transaction reporting of non-bank financial intermediaries and the introduction of a legal obligation to report suspicious transactions related to terrorist financing. The legal framework for nonfinancial businesses and professions urgently needs to be implemented.

The Financial Intelligence Unit has technologically advanced analytical capability but insufficient filtering limits its effectiveness. The authorities are diligently working to close these gaps.

Table 1. Financial System Structure
(2000–2005)

	December 2000			December 2001			December 2002			December 2003			December 2004			June 2005		
	Number	Total Assets (€ bill.)	Percent of total assets	Number	Total Assets (€ bill.)	Percent of total assets	Number	Total Assets (€ bill.)	Percent of total assets	Number	Total Assets (€ bill.)	Percent of total assets	Number	Total Assets (€ bill.)	Percent of total assets	Number	Total Assets (€ bill.)	Percent of total assets
Banks	841	1,897.4	65.2	830	1,960.6	64.8	814	2,148.5	66.6	788	2,270.7	66.0	778	2,436.8	66.4	781	2,594.9	66.5
Limited company banks 1/ <i>of which: foreign banks 2/</i>	240	1,464.5	50.3	252	1,478.9	48.9	253	1,696.3	52.6	244	1,836.9	53.4	242	1,959.1	53.4	245	2,068.7	53.0
<i>of which: foreign banks 2/</i>	13	45.4	1.6	14	42.9	1.4	14	49.0	1.5	17	54.3	1.6	15	60.1	1.6	16	71.9	1.8
Cooperative banks	44	266.9	9.2	44	309.5	10.2	40	258.4	8.0	38	221.2	6.4	37	238.3	6.5	36	252.2	6.5
Mutual banks	499	83.6	2.9	474	94.9	3.1	461	106.3	3.3	445	117.8	3.4	439	129.5	3.5	440	134.1	3.4
Branches of foreign banks	58	82.4	2.8	60	77.3	2.6	60	87.6	2.7	61	94.8	2.8	60	109.9	3.0	60	139.9	3.6
Banks by size 3/																		
Mega	10	681.6	23.4	9	721.1	23.8	10	879.2	27.3	11	911.6	26.5	11	943.2	25.7	11	980.1	25.1
Large	16	373.2	12.8	14	346.0	11.4	9	279.0	8.7	11	311.2	9.0	11	351.9	9.6	11	379.6	9.7
Medium	31	323.6	11.1	29	315.2	10.4	33	424.3	13.2	33	437.2	12.7	33	484.7	13.2	33	525.6	13.5
Small	784	519.0	17.8	778	578.3	19.1	762	566.1	17.6	733	610.7	17.7	723	657.1	17.9	726	709.5	18.2
<i>of which: Cooperative bank:</i>	34	58.7	2.0	35	65.6	2.2	32	53.5	1.7	31	54.3	1.6	30	60.4	1.6			
<i>of which: Mutual banks</i>	499	83.6	2.9	474	94.9	3.1	461	106.3	3.3	445	117.8	3.4	439	129.5	3.5			
Insurance corporations	208	298.2	10.2	208	338.2	11.2	202	378.2	11.7	198	421.6	12.2	179	467.5	12.7	179	495.5	12.7
Life insurance	80	122.5	4.2	84	157.2	5.2	83	186.1	5.8	79	230.3	6.7	76	262.6	7.2	76	284.1	7.3
Nonlife insurance	97	25.5	0.9	95	26.5	0.9	90	29.4	0.9	89	29.7	0.9	81	26.6	0.7	84	27.3	0.7
Composite	22	142.8	4.9	21	146.6	4.8	20	154.6	4.8	20	161.6	4.7	19	178.3	4.9	19	184.1	4.7
Reinsurance	9	7.4	0.3	8	7.9	0.3	9	8.1	0.3	10	-	-	3	-	-			
Private pension system	719	27.4	0.9	718	31.4	1.0	693	33.8	1.0	648	36.2	1.1	628	38.6	1.1		39.7	1.0
Contractual pension funds 4/	42	1.2	0.0	41	2.3	0.1	44	3.3	0.1	42	4.5	0.1	42	5.9	0.2	43	6.7	0.2
Open pension funds 4/	99	0.6	0.0	102	0.9	0.0	95	1.2	0.0	96	1.7	0.1	92	2.2	0.1	92	2.5	0.1
Pre-existing pension funds	578	25.7	0.9	575	28.2	0.9	554	29.3	0.9	510	29.9	0.9	494	30.5	0.8		30.5	0.8
Other financial intermediaries																		
Investment firms	171	16.8	0.6	162	13.9	0.5	158	15.5	0.5	131	14.7	0.4	115	23.9	0.7	114	23.4	0.6
<i>of which: bank controlled</i>	50	-	-	41	-	-	37	-	-	34	-	-	39	-	-	36	-	-
Asset management companies	101	548.1	18.8	132	549.3	18.1	142	526.7	16.3	153	547.4	15.9	162	546.3	14.9	170	565.4	14.5
<i>of which: bank controlled</i>	55	-	-	73	-	-	73	-	-	78	-	-	92	-	-	94	-	-
Foreign UCITS	-	122.3	4.2	-	133.2	4.4	-	122.7	3.8	-	152.1	4.4	3,183	156.7	4.3	3,217	180.9	4.6
Total financial system	-	2,910.3	100.0	-	3,026.5	100.0	-	3,225.3	100.0	-	3,442.5	100.0	-	3,669.8	100.0	-	3,899.8	100.0
Memorandum items:																		
Number of employees	348,448	-	-	346,100	-	-	343,904	-	-	337,818	-	-	339,111	-	-	-	-	-
<i>of which: abroad</i>	2,758	-	-	2,761	-	-	2,553	-	-	2,068	-	-	2,046	-	-	-	-	-
Branches of domestic banks	28,213	-	-	29,294	-	-	29,950	-	-	30,502	-	-	30,554	-	-	-	-	-
<i>of which: abroad</i>	94	-	-	91	-	-	88	-	-	75	-	-	76	-	-	-	-	-

Sources: Bank of Italy, ISVAP, CONCOB, and COVIP.

1/ Includes banks established as "Società per Azioni", central credit and refinancing institutions.

2/ Foreign controlled subsidiaries.

3/Banks with total assets above EUR 45 billions are mega banks, banks between EUR 20 and 45 billions are large, banks between EUR 7 and 20 billion are medium, and banks with total assets below EUR 7 billion are small.

4/Banks with total assets between 20 and 45 EUR millions.

5/Banks with total assets between 7 and 20 EUR millions.

6/Banks with total assets below 7 EUR millions.

4/ Net asset values of pension funds' portfolio allocation.

Table 2. Financial Soundness Indicators
(In percent and on an individual basis unless otherwise noted)

	1999	2000	2001	2002	2003	2004	2005-I
<i>Deposit-taking institutions</i>							
<i>Core set</i>							
<i>Capital adequacy</i>							
Regulatory capital to risk-weighted assets <i>1/</i>	10.5	10.1	10.4	11.2	11.4	11.6	11.6
Regulatory Tier I Capital to risk-weighted assets <i>1/ 2/</i>	9.3	8.5	7.8	7.9	8.2	8.5	8.8
Regulatory Tier II Capital to risk-weighted assets <i>1/ 2/</i>	2.4	2.4	2.8	3.2	3.4	3.4	3.2
<i>Asset quality</i>							
Nonperforming loans to total gross loans <i>3/</i>	9.8	7.8	6.7	6.5	6.6	6.5	6.3
Nonperforming loans net of loan loss reserves to Tier I capital <i>3/</i>	38.9	30.1	26.8	25.0	24.6	23.1	20.0
Sectoral distribution of loans to total loans							
General government	7.6	6.4	5.8	5.3	4.7	4.5	4.4
Financial corporations	13.0	14.4	14.7	14.6	13.5	12.1	11.9
Non-financial corporations and producer households	59.4	59.3	59.3	59.0	60.0	59.5	59.2
Building and construction	7.6	7.0	6.8	6.9	7.2	7.4	7.6
Consumer households	20.0	19.9	20.2	21.1	21.9	23.9	24.5
Large exposures to capital <i>1/</i>	80.5	86.7	88.6	81.6	63.2	51.3	61.7
<i>Earnings and profitability</i>							
Return on assets <i>1/</i>	0.6	0.7	0.5	0.4	0.4	0.6	0.7
Return on equity <i>1/ 4/</i>	10.6	12.9	9.1	6.4	6.7	10.7	13.3
Interest margin to gross income <i>1/</i>	57.3	55.9	59.7	63.2	60.8	61.1	63.8
Noninterest expenses to gross income <i>1/</i>	60.3	57.5	59.0	60.5	58.9	58.4	58.3
Non interest income to gross income <i>1/</i>	42.7	44.1	40.3	36.8	39.2	38.9	36.2
<i>Liquidity</i>							
Liquid assets to total assets (liquid asset ratio)	10.6	8.2	7.4	5.9	5.5	5.3	5.6
Liquid assets to short-term liabilities	31.6	25.4	21.8	17.3	16.9	16.7	18.3
<i>Sensitivity to market risk</i>							
Duration of assets (weighted average in months and days)	7M 28D	7M 18D	7M 21D	8M 18D	9M 6D	9M29D	10M0D
Duration of liabilities (weighted average in months and days)	6M 26D	6M 20D	7M 1D	8M 4D	8M 24D	9M14D	9M16D
Net open position in foreign exchange to capital <i>1/</i>	4.4	5.7	4.9	3.9	3.6	2.4	3.0
<i>Encouraged set</i>							
<i>Deposit-taking institutions</i>							
Capital to assets	6.8	6.6	6.8	6.7	6.4	6.4	
Average risk weight (ratio of risk-weighted assets to assets)	0.6	0.7	0.7	0.6	0.6	0.6	
Geographical distribution of loans to total loans							
North	59.3	61.9	62.2	62.2	62.3	62.2	62.2
Center	25.2	23.9	24.1	24.1	24.0	23.5	23.4
South	15.6	14.2	13.7	13.6	13.7	14.3	14.4
Geographical distribution of non-performing loans							
North	34.8	37.0	37.9	40.4	43.0	43.4	44.2
Center	26.5	28.0	27.1	27.4	26.5	26.5	26.0
South	38.7	35.0	34.9	32.2	30.5	30.2	29.9
Gross asset position in financial derivatives to capital	25.6	36.8	50.8	46.7	52.0	62.8	74.9
Gross liability position in financial derivatives to capital	25.1	25.2	37.0	44.8	45.0	58.1	73.1
Trading and fee income to gross income	34.0	36.7	32.7	32.0	32.7	33.9	36.0
Personnel expenses to noninterest expenses	64.8	63.3	63.4	63.9	64.8	65.7	66.7
Spread between reference lending and deposit rates							
Household lending (average for new loans)	3.1	3.0	3.3	3.0	2.9	2.2	2.1
Corporate lending (average for new loans)	2.2	2.3	2.2	2.1	2.1	1.9	1.7
Spread between highest and lowest interbank rate <i>6/</i>	0.039	0.021	0.021	0.044	0.021	0.008	0.015
Customer deposits to total (non-interbank) loans	107.8	100.3	100.5	103.7	101.1	103.0	102.5
Foreign currency-denominated loans to total loans	3.3	3.5	3.2	2.1	1.6	1.4	1.4
Foreign currency-denominated deposits to total deposits	2.3	2.2	2.3	2.4	2.5	2.4	2.3
Net open position in equities to capital <i>1/</i>	5.2	5.8	11.5	2.5	3.1	3.5	6.14
<i>Market liquidity</i>							
Average bid-ask spread in the securities market	0.0	0.1	0.0	0.0	0.0	0.0	0.0
Average daily turnover ratio in the securities market	1.0	0.9	0.9	0.8	0.8	0.7	0.6
<i>Nonbank financial institutions</i>							
Assets to total financial system assets	37.4	36.9	36.6	34.6	33.7	32.2	32.2
Assets to GDP	92.3	92.5	90.0	85.4	86.9	83.6	90.2
<i>Corporate sector</i>							
Total debt to equity	80.8	76.0	86.8	101.6	105.7	98.2	94.2
Return on equity	9.3	7.1	4.4	2.4	4.9	...	...
Earnings to interest and principal expenses <i>7/</i>	335.8	268.2	271.6	242.0	300.7	...	...
Corporate net foreign exchange exposure to equity	-3.1	-0.4	-2.6	-2.2	...	...	...
Number of applications for protection from creditors <i>8/</i>	1,164.0	571.0	605.0	883.0	...	...	...
<i>Household sector</i>							
Household debt to GDP	22.0	22.8	22.9	24.3	26.0	28.1	29.9
Household debt service and principal payments to income	1.4	1.7	1.9	1.8	1.7	1.7	1.8
<i>Real estate markets</i>							
Residential real estate prices (1990=100, deflated by CPI)	98.1	100.1	104.6	114.6	123.5	131.6	139.5
Commercial real estate prices (1990=100, deflated by CPI) <i>9/</i>	92.7	95.7	101.1	106.5	111.2	118.4	123.1
Residential real estate loans to total loans	9.6	10.3	10.3	12.0	13.8	15.7	16.3
Commercial real estate loans to total loans	7.6	7.0	6.8	6.9	7.2	7.4	7.6

Source: Bank of Italy and staff estimates.

1/ Based on consolidated data.

2/ Gross of deductions in participating entities and subordinated debts.

3/ Nonperforming loans include doubtful loans.

4/ Profit does not include change in the provision for general banking risks.

5/ Net earnings include the net change in the fund for general banking risks; capital and reserves are calculated on a 13 month average.

6/ Average overnight rate in December (June).

7/ Current earnings (gross of interest expenses) to net interest expenses.

8/ Special administration and private preemptive agreements.

9/ Elaborations on data from Nomisma

Table 3. Summary Results for Banking Sector Stress Tests, June 2005—Top Down

	Loss (-)/Gain (+) as percentage of June 2005 (annualized) after-tax profits		Loss as percentage of capital buffer at June 2005		CAR	
	Weighted Average	Largest Loss	Weighted Average	Largest Loss	Weighted Avg.	Min.
Pre-Stress CAR					11.01	8.78
Post Stress CAR 1/						
Sensitivity to market risk						
Parallel increase in major interest rates 2/	-5.7	-29.2	-2.0	-8.9	10.95	8.71
Rise and flattening of the main yield curves 3/	-8.7	-19.7	-3.1	-7.4	10.92	8.72
Fall in equity prices 4/	-4.3	-12.5	-1.53	-17.45	10.96	8.64
Euro depreciation against major currencies 5/	-17.2	-36.7	-6.1	-14.2	10.83	8.72
Sensitivity to Sovereign Risk 6/	-15.3	-178.0	-6.2	-40.9	10.33	8.77
Sensitivity to credit risk 7/	-24.3	-94.4	-9.8	-33.9	10.71	8.51
Macroeconomic scenario tests						
Rise in oil prices and fall in equity prices 8/	-35.8	-144.7	-13.6	-46.9	10.60	8.41
Dollar depreciation 9/	-17.9	-63.4	-8.5	-29.4	10.75	8.55
Sensitivity to interest rate risk in the banking book 10/	Loss of economic value as percentage of bank capital Weighted Average		Maximum loss			
	-6.34		-13.22			
Liquidity stress test (BI estimates) 11/	Banks with liquidity shortfall in the 1–7 days time-band Number of banks		Share of assets			
	82		22%			

Source: Bank of Italy

1/ Risk-weighted capital adequacy ratio, NOT allowing for losses to be covered first by before-tax profits.

2/ EUR, USD and JPY interest rates increase by 70, 65, and 60 b.p. respectively.

3/ EUR short-term, medium-term, and long-term interest rates increase by 110, 60 and 40 b.p. respectively. USD interest rates increase by 100, 50, and 30 b.p., while JPY interest rates increase by 100, 40, and 30.

4/ A 30 percent decrease in the equity prices.

5/ A 15 percent depreciation in the EUR against the USD and JPY, respectively.

6/A three-notch downgrade of claims on emerging markets countries that comprise at least 50 percent of banks' total exposure to emerging market, and a two-notch deterioration applied to all others.

7/ A 60 percent increase in the probability of default of all credit exposures, except interbank exposures.

8/ The price of oil increase to 85 USD per barrel and global equity prices decline by 30 percent.

9/ Sustained 20 percent depreciation of the USD with respect to the major currencies.

10/ EUR interest rates increase by 200 b.p.

11/ Interest rates for T-bills increase as in 4/. Withdrawal rate of interbank and consumer deposits increases to 40 percent and 15 percent respectively.

Table 4. Insurance Sector Financial Soundness Indicators, 1999–2004
(In percent unless otherwise noted)

	1999	2000	2001	2002	2003	2004
	<i>Life Insurance</i>					
Capital adequacy						
Capital / total assets	8.18	7.88	7.32	6.71	6.34	5.88
Capital / Technical reserves	9.82	9.50	8.57	7.78	7.27	6.67
Asset quality						
(Real estate + unquoted equities + debtors) / total assets	8.53	7.74	7.70	6.95	5.70	5.82
Debtors / (gross premium + reinsurance recoveries)	14.03	13.96	12.60	11.73	9.98	10.18
Equities / Total assets	10.22	10.59	7.61	6.28	6.06	6.14
Non-performing loans / total gross loans	0.00	77.92	2.87	1.69	24.67	0.15
Reinsurance						
Risk retention ratio (net premium / gross premium)	95.43	95.55	95.41	96.59	96.40	97.40
Net technical reserves / average net premiums received (3 yrs)	443.27	491.23	492.15	490.77	502.28	509.74
Management soundness						
Gross premium per employee (in euro thousands)	8,026	8,756	10,389	12,511	13,745	13,409
Total assets per employee (in euro thousands)	30,900	37,181	45,805	50,684	60,130	64,770
Earning and profitability						
Expense ratio (expenses / net premium)	8.22	8.32	6.79	6.25	6.04	6.01
Investment income / investment assets:						
Item C	5.15	5.56	4.03	3.87	4.00	4.18
Item D	6.83	-2.59	-3.80	-3.84	4.03	5.02
Return on equity (ROE)	8.69	10.58	7.54	7.51	8.83	10.50
Liquidity						
Liquid assets / current liabilities	66.89	75.55	239.96	275.43	246.87	286.81
	<i>Non-life Insurance</i>					
Capital adequacy						
Net premium / capital	176.21	167.66	194.15	195.58	187.89	184.20
Capital / total assets	19.67	19.89	16.12	16.04	17.20	17.64
Asset quality						
(Real estate + unquoted equities + debtors) / total assets	34.35	33.91	36.04	34.20	34.45	34.71
Debtors / (gross premium + reinsurance recoveries)	30.94	30.56	34.15	32.78	32.87	33.36
Equities / Total assets	20.83	22.92	24.77	24.23	24.88	26.18
Non-performing loans / total gross loans	0.00	2.75	2.30	0.86	1.65	4.46
Reinsurance						
Risk retention ratio (net premium / gross premium)	87.59	87.03	87.62	86.34	87.35	88.36
Net technical reserves / average net claims paid (3 yrs)	214.86	225.97	230.93	238.16	244.78	250.06
Net technical reserves / average net premiums received (3 yrs)	177.74	186.07	185.21	183.98	181.59	180.63
Management soundness						
Gross premium per employee (in euro thousands)	831	883	919	1,010	1,012	1,067
Total assets per employee (in euro thousands)	1,836	2,061	2,190	2,418	2,430	2,563
Earning and profitability						
Loss ratio	84.48	82.78	79.07	75.26	73.56	72.20
Expense ratio (expenses / net premium)	24.82	23.92	24.00	23.48	23.27	23.49
Combined ratio	109.30	106.70	103.07	98.74	96.83	95.69
Investment income / net premium	9.66	10.30	8.82	5.82	7.18	8.69
Return on equity (ROE)	0.17	1.19	8.58	12.36	9.49	13.36
Liquidity						
Liquid assets / current liabilities	31.70	28.23	44.89	57.66	51.39	47.18

Source: ISVAP

Table 5. Summary Results for Insurance Stress Tests
(December 2004)

	Solvency Ratio			Number of Individual companies with ratio < 1	Solvency shortfall/ Liabilities 1/ (in percent)
	Best	Average	Worst		
Life Sector					
Ante shock	6.02	1.64	0.86	3 2/	
Macrosenario	5.61	1.52	0.69	10	0.68
Shock 1 (Tilt+) 3/	6.06	1.64	0.80	3	0.12
Shock 2 (Shift +) 4/	6.01	1.62	0.80	4	0.36
Shock 3 (Tilt -) 5/	5.95	1.66	0.85	6	0.16
Shock 4 (Shift -) 6/	5.98	1.67	0.85	5	0.07
Nonlife sector					
Ante shock	7.56	3.14	1.04	-	
Macrosenario	7.55	2.73	0.96	2	3.07
Shock 1 (Tilt+) 3/	7.56	3.14	1.01	-	-
Shock 2 (Shift +) 4/	7.56	3.12	0.99	1	0.59
Shock 3 (Tilt -) 5/	7.56	3.15	1.04	-	-
Shock 4 (Shift -) 6/	7.56	3.15	1.04	-	-
Natural disaster before reinsurance	7.56	3.01	1.02	-	-
Natural disaster after reinsurance	7.58	3.13	1.04	-	-

1/ The solvency shortfall/liabilities ratio is the average shortfall of companies with shortfalls divided by their average liabilities.

2/ The three companies with initial solvency ratio <1 have been recapitalized.

3/ Shock 1: rise and flattening (increase in short term interest rate of 110 bp, in medium term interest rate of 60 bp, and in long-term interest rate of 40 bp);

4/ Shock 2: parallel upward shift of 70 bp;

5/ Shock 3: fall and steepening (decrease in short term interest rate of 110 bp, in medium term interest rate of 60 bp, and in long-term interest rate of 40 bp);

6/ Shock 4: parallel downward shift of 70 bp.

OBSERVANCE OF FINANCIAL SECTOR STANDARDS AND CODES—SUMMARY ASSESSMENTS

The annex contains summary assessments of seven international standards and codes relevant for the financial sector. The assessments have helped to identify the extent to which the supervisory and regulatory framework is adequate to address the potential risks in the financial system.

The following detailed assessments of financial sector standards were undertaken:

- The Basel Core Principles for Effective Banking Supervision (BCP), by Keith Bell (Consultant) and Ms. Maria Nieto (Bank of Spain);
- The Core Principles for Systemically Important Payment Systems (CPSIPS), by Peter Allsopp (Consultant);
- The IAIS Insurance Core Principles (ICP), by Michael Hafeman (Consultant);
- The IOSCO Objectives and Principles for Securities Regulation, by José Manuel Portero (Spanish CNMV);
- The Securities Settlement and Payment systems CPSS-IOSCO (RSSS), by Elias Kazarian (IMF-MFD);
- The IMF Code of Good Practices on Transparency in Monetary and Financial Policies (MFP), by Marie Thérèse Camilleri (IMF-MFD) in the context of the Basel Core Principles for Effective Banking Supervision and Core Principles for Systemically Important Payment Systems and Laurent Bouscharain (IMF-MFD) in the context of the IOSCO Objectives and Principles for Securities Regulation; and
- The FATF Recommendations for Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT), by Jean-François Thony (LEG), team leader; Richard Lalonde (MFD); Nadine Schwarz (LEG); Maud Bökkerink (MFD); and Michael DeFeo (LEG Consultant).

The IOSCO and CPSS-IOSCO assessments were carried out during a mission to Italy from October 18 to November 3, 2004, the AML/CFT assessment was conducted during a mission in April 2005 and the ICP and MFP assessments were carried out during a mission July 6–20, 2005. All the assessments were based on the laws, regulations, policies and practices in place at the time the assessments were made.

The Core Principles for Systemically Important Payment Systems (CPSIPS) and the Basel Core Principles for Effective Banking Supervision (BCP) were conducted in, respectively, March and April 2003 (the reports are available at www.imf.org).

The assessments were based on several sources including:

- Self-assessments by the supervisory authorities;
- Reviews of relevant legislation, regulations, policy statements and other documentation;
- Detailed interviews with the supervisory authorities;
- Meetings with the Ministry of Finance, Bank of Italy and other authorities and independent bodies; and
- Meetings with financial sector firms and associations.

SUMMARY ASSESSMENT OF COMPLIANCE WITH THE BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION AND TRANSPARENCY OF BANKING SUPERVISION²¹

Institutional and Macro Prudential Setting, Market Structure—Overview

59. **Since 1990, the Italian banking system has undergone a significant consolidation and successive waves of privatization have significantly shrunken the share of state ownership via (nonprofit) foundations (Fondazioni) participation in the banks' capital. Market discipline has improved with the greater transparency regarding the ownership structure of banks and the reduction in cross-shareholdings.** Shareholders are required to disclose the existence and content of private agreements to BI; for listed banks, this information is also disclosed to the public. There are still a few cases where cross-shareholdings allow a group of Fondazioni to control jointly more than 50 percent of a bank's capital.

60. **The Italian corporate insolvency regime results in lengthy and costly judicial proceedings, and a slow realization of collateral in the event of borrowers' default.** The government at the time of the assessment had proposed a legal reform aimed at simplifying legal proceedings and maximizing the value of the distressed enterprise through restructuring, which was approved in December 2005. In contrast, the insolvency regime for banks, based on administrative procedures led by BI, is fast and efficient, supported by deposit insurance and a framework for public intervention designed to prevent the distress in one bank resulting in systemic stress.

General Preconditions for Effective Banking Supervision

61. **The legal framework adequately defines the general principles governing the activity of both bank and nonbank financial intermediaries.** Detailed technical rules are deferred to secondary legislation, allowing for prompt adjustments to the evolving needs of financial intermediaries and markets. BI has extensive powers and responsibilities as the supervisor of the banking system. It is also responsible for supervising the financial markets that are relevant for monetary policy purposes, such as wholesale markets for government securities and interbank markets. All Italian agencies are legally required to cooperate through formal and informal contacts and may not invoke official secrecy against one another. BI has signed a protocol with ISVAP, the insurance sector supervisory authority, establishing a formal procedure for mutual cooperation between the two institutions on matters of common interest.

²¹ The assessment was conducted in June 2003. Subsequent developments are described in a separate section below.

62. **BI conducts its supervisory policies transparently, with adequate confidentiality considerations to preserve both the effectiveness of its actions and the market sensitivity of information regarding individual financial institutions.** BI makes public the principles and criteria of its supervisory activity; establishes the time limits for the adoption of measures; and specifies the persons responsible for each administrative procedure.

63. **A key challenge is to continue to strengthen the transparency and disclosure of banks' balance sheets and income statements as well as corporate governance practices.** Banks already disclose a highly detailed set of data to BI, which uses this information both for micro- and macro-prudential surveillance purposes. In addition, listed banks are required to disclose a large body of information to the markets. Further efforts in facilitating cross-country comparisons and investors' analysis of this information would contribute to enhance market discipline.

Main findings

64. **Italy has a high overall level of compliance with the Core Principles.** Nonetheless, some legal amendments are required to reach full compliance and, at the time of the assessment in some areas, it would have been beneficial if tighter and more specific prudential guidance was provided to banks. BI conducts a comprehensive, sophisticated, and continuous process of off-site monitoring, closely integrated with a cycle of thorough on-site inspections. The cycle of on-site inspections is long; for small banking institutions, inspections are conducted on a three-year cycle and at longer intervals (not more than six years) for large banks. In line with the rapid developments in the scope and complexity of the banking industry, BI is increasingly relying on focused and thematic inspections, thereby shortening the inspection cycle.

Objectives, Autonomy, Powers, and Resources (CP 1)

65. **There is a generally appropriate body of banking laws and regulations.** Broad guidelines on prudential supervision in the area of credit activities and the protection of savings are issued by the Inter-Ministerial Committee on Credit and Savings (ICCS). This makes it difficult to assess whether supervisory policies, plans, and processes are entirely independent from the government. In practice, however, BI takes the initiative in recommending regulatory and supervisory policy and has operational independence on day-to-day application of supervisory methods, once broad guidelines have been approved by the ICCS. The BI supervisory program is supported by adequate enforcement powers. In addition to fostering the overall stability of the financial system, BI has the legal responsibility to enforce Italy's antitrust laws²² and promote the efficiency and competitiveness of the banking

²² The Savings Law (No. 262 of December 28, 2005) has transferred anti-trust responsibility in the banking sector to the Antitrust Authority.

sector. One particular concern is that the law does not provide legal protection to its supervisors against court proceedings stemming from measures adopted in the performance of their functions in good faith.

Licensing and Structure (CPs 2–5)

66. **The licensing regime is well developed and appropriate, as is the process for review of change in ownership of significant shareholdings in banks.** BI complies with the Essential Criterion concerning *fit and proper test* for proposed directors and senior management at the initial authorization for a bank to commence business. Regulations adequately define the types of acquisitions and investments in which BI's approval is needed. BI has the power to prohibit acquisitions of holding banks, financial and insurance companies if such initiatives are likely to limit or impede the effective performance of supervision on a consolidated basis.

Prudential Regulations and Requirements (CPs 6–15)

67. **The supervisory regime would be strengthened by the promulgation of more stringent criteria for the classification of impaired loans and for the definition of or limits on “connected lending or lending to related parties.”** In comparison to practices in other G7 countries, loan impairment and cessation of interest accrual appears to be recognized later in Italy. Italy has opted for a five-year transition period to use a 180-day past-due definition for impaired loans (as opposed to the standard “more than 90 days past-due” criteria), as permitted in the EU Capital Requirements Directive. Another particular concern is the lack of a comprehensive definition of “connected lending or lending to related parties” in the banking law. It is strongly recommended that the authorities issue a comprehensive regulation on connected lending to address its definition, overall limits, and reporting.

68. **The supervisory and regulatory framework to ensure sound internal controls and risk management systems and to control money laundering are satisfactory, with the caveat that the supervisory authority lacks sufficiently clear legal authority to require expeditious change in the composition of a bank's board of directors and management whenever an incumbent no longer meets “fit and proper” criteria.**

Methods of Ongoing Supervision (CPs 16–20)

69. **There is a well-structured off-site analysis function based on very detailed statistical data requirements, frequent contacts with banks' management and staff, and smooth integration with the on-site analysis.** BI does not rely on external auditors for the purpose of on-site inspections. The cycle of on-site inspections is long; taking into account thematic inspections, the inspection cycle for large banks has recently been shortened to no longer than three years, as in the case of the small banks. BI should review the means by which it may derive greater benefit from the work of external auditors in the execution of its own mandate. In addition, revising the banking law would be desirable, so as to obtain the

authority to revoke the appointment of the external auditors of a bank when their performance is deficient and to establish the standards of banks' external audits and the scope of bank's audit programs. In the light of the rapid changes in the banking industry and risk management techniques, BI should continue to keep the adequacy of resources under review.

Information Requirement (CP 21)

70. **The mission's discussions with banks' managers suggested that the system in use delayed the recognition of impaired loans and the suspension of recognition of income from these loans.** As noted above (paragraph 69), Italian banks will have a transition period of five years to move to the Basel II "default" definition. The adoption of the new IFRS in 2005 will also help align loan-loss recognition with international practices.

Formal Powers of Supervisors (CP 22)

71. **A broad range of remedial powers is provided by law to BI, including explicit requirements to take prompt action in cases of insolvency.** The power of BI derives from a flexible and comprehensive set of notification and corrective action procedures, effective bank resolution procedures, and sound enforcement powers. One shortcoming is the lack of specific provision for BI to require subsequent removal of a director or senior officer who may have become unfit (see also paragraph 9 above).

Cross-Border Banking (CPs 23–25)

72. BI has established close cooperation, including memoranda of understanding, with many foreign supervisory authorities responsible for the foreign operations of Italian banks. Coordination with foreign supervisors to cover operations in Italy by foreign banks is also adequate. The regulatory framework for globally consolidated supervision over internationally active banking groups is satisfactory.

Table 6. Action Plan to Improve Compliance with the Basel Core Principles²³

Reference Principle	Recommended Action
BCP 1.5. Legal protection	<ul style="list-style-type: none"> • Introduce amendments to the legislation to provide legal protection to the supervisory authority and its officers against the possibility of legal action stemming from measures adopted in good faith in the performance of their functions.
BCP 8. Loan Evaluation and Loan-Loss Provisioning	<ul style="list-style-type: none"> • During the transitional period allowed by Basel II for the case of Italy to use less stringent 180 days past due requirements, rules and procedures should be modified to conform in due course to the widely accepted international practice of 90 days past due. • Revise the applicable instructions so as to better align provisioning with the estimated losses of the loan portfolio of the banking system so that banks can better withstand a sudden deterioration in credit conditions.
BCP10. Connected Lending	<ul style="list-style-type: none"> • Issue comprehensive regulation on connected lending to address the issues of definition, overall limits, and reporting.
BCP14. Internal Control and Audit	<ul style="list-style-type: none"> • Amend the banking law and applicable regulations to legally empower BI to remove expeditiously those banks directors or senior officers who may have become unfit for their duties.
BCP19. Validation of Supervisory Information	<ul style="list-style-type: none"> • Review the means by which it may derive greater benefit from the work of external auditors in specific areas (e.g., money laundering) in the execution of its own mandate. It should also review the status of some banks, albeit extremely small institutions, which are not subject to external audit. • Amend the banking law so as to obtain the power to revoke the appointment of a bank's external auditors when their performance is deficient and to provide it with the authority to establish the scope and standards to be achieved in banks' external audits. • Continue review of the adequacy of staff resources.
BCP 21. Accounting Standards	See recommendation on loan evaluation in BCP 8 above.

²³ Several of these recommendations have been addressed; see the section on subsequent developments below.

Developments subsequent to the assessment

73. **The authorities have addressed some of the recommendations highlighted in Table 1.** Following-up on these and other BCP recommendations would further strengthen the effectiveness of BI's framework for bank supervision.

74. **Regarding the recommendation to align Italy's criteria for impaired loans to international standards (BCP 8 and 21), BI introduced a new reporting requirement for banks to monitor the impact of moving to a 180-day (ultimately 90-day) past-due definition for impaired loans.** On the basis of such reports, the ratio of effective nonperforming loans (i.e., positions past-due or overdrawn continuously for more than 90 days) to total loans would rise from 6.8 percent to 7.5 percent at end-June 2005. According to the new accounting regulation, banking groups and individual banks are required to classify in their financial statements as of December 31, 2005, the 180-day past-due loans as impaired loans and to provision these in line with IFRS (consolidated) and national GAAP (individual). At the latest by 2011, banks will have to converge from the 180-day to the standard 90-day past due criteria for impaired loans, in line with the definition of default applied under Basel II.²⁴ The staff encourages the authorities to speed up the process, as this would greatly raise transparency and cross-country comparison of banks' financial accounts.

75. **The authorities have also made some progress in addressing the lack of regulation on lending to related parties (BCP 10).** In July 2005, the ICCS approved a guideline on connected lending and entrusted BI with issuing a more detailed regulation in this area. The Savings Law is consistent with the ICCS guidelines. Based on the 14 largest Italian banks (accounting for 75 percent of total banking assets), about 10 related parties' positions would exceed the highest threshold set by the ICCS, for an overall amount of around 9 billion euros. BI has prepared a draft regulation implementing the ICCS guideline, which will be issued for consultation shortly. The staff welcomes the opportunity for BI to regulate lending to third parties and address the risks associated with such lending.

76. **The supervisory authority and their officers continue to be liable to legal procedures stemming from measures adopted in good faith in the performance of their functions (BCP 1.5);** Italian compliance with this BCP can only be achieved by amending the laws, which is not within the powers of BI. BI continues to lack the legal power to remove expeditiously bank directors or senior officers who may have become unfit for their duties (BCP 14), even if BI officials feel that moral suasion can be a sufficiently effective tool to achieve this aim. Similarly, limited progress has been made toward granting BI the authority to remove bank external auditors when their performance is deficient (BCP 19). The authorities noted that a forthcoming EU directive will extend the scope of mandatory

²⁴ See paragraph 69.

external bank audits. Given that Consob will be managing the auditors' registry, Consob would have the legal power to remove unfit auditors. However, to ensure that deficient external auditors are removed promptly from their audit responsibilities, BI supervisors need to cooperate closely with Consob whenever the performance of an external auditor appears to be no longer satisfactory.

Authorities' response

77. BI considers that the assessment recognizes the high degree of compliance of the Italian supervisory system with the Basel Core Principles. The assessment highlights a number of very positive features of the Italian supervisory framework, such as the adequacy of prudential regulations, the effectiveness of controls, achieved, *inter alia*, thanks to the fruitful interaction between on- and off-site methods and to the flexible and wide-ranging supervisory tools.

78. The interaction with the IMF mission has stimulated BI's own considerations on a number of issues related with the subjects covered during the assessment.

79. On a number of issues the IMF recommendations and findings back up some strands of work to which BI had already begun to devote consideration, such as: the importance of providing legal protection to the supervisory authority and its officers against the possibility of legal action by third parties in response to measures adopted in good faith in the performance of their functions; the issuance of a comprehensive regulation on lending to related parties in order to address more thoroughly, in addition to the existing provisions in the context of large exposures, the issues of definition and overall limits. In 2006, BI will issue the supervisory regulation to comply with the July 2005 ICCS resolution and the Savings Law.

80. BI believes that the observations of the IMF mission on BCPs 14 (Internal control and audit) and 19 (Validation of supervisory information), although grounded in principle, do not imply that the existing framework does not allow BI to fully achieve the goals laid down in the BCPs. However, initiatives will be taken in order for the issues to be addressed by the competent authorities.

81. On BCPs 8 (Loan Evaluation and Loan-Loss Provisioning) and 21 (Accounting Standards) BI has tackled the issues by defining more objective criteria for the classification of impaired loans in line with the prevailing practices in most G-10 countries. Supervisory regulations will be amended consistently with the time frame envisaged by the New Capital Accord in order to achieve the standard 90-day past-due loan classification. However, BI does not agree with the IMF view that the existing classification criteria may determine an overestimation of income of Italian banks. As a significant share of "past-due loans" (other than bad and substandard) become current again within one year, this implies that such provisions tend to offset interest on the 20 percent of loans that eventually will be classified as bad loans or substandard loans.

SUMMARY ASSESSMENT OF OBSERVANCE OF THE CORE PRINCIPLES FOR SYSTEMICALLY IMPORTANT PAYMENT SYSTEMS (CPSIPS)

General

82. **The present document is the summary assessment of compliance of the Italian RTGS system, Birel (which has now been replaced by New Birel) with the CPSS Core Principles for Systemically Important Payment Systems.** The assessment was conducted during the period June 16–27, 2003. The assessment was based on detailed discussions with officials from relevant departments of BI, and with representatives of commercial banks, banking associations, and the Interbank Company for Automation.

83. **The methodology used for the assessment followed the Guidance Note prepared in August 2001.** It was greatly helped by a comprehensive self-assessment that had been prepared by BI.

Institutional and market structure

84. **Since 1926 BI has had by law the responsibility for providing the clearing procedures for settlement of interbank payments and securities transactions.** From 1991, new procedures have ensured that most interbank transactions would be settled in central bank money through the clearing system, rather than as hitherto through banks' bilateral correspondent accounts. In 1997 the RTGS system, Birel, was launched, and since 1998 all types of domestic high-value payments have been settled through the system (which was replaced by New Birel in January 2004).

85. **With the start of Stage III of European Monetary Union (EMU) in January 1999, Birel became the domestic Italian component of the EU-wide RTGS system, TARGET.** Therefore, procedures and policies of or relating to Birel have to comply with relevant decisions of the European Central Bank. Similarly issues relating to the functioning of Birel, and in particular to the availability and circulation of liquidity—cash or collateral—in the system, have to be considered in the context of the real-time cross-border links between Birel and the RTGS systems of other EU countries (both inside and outside the Euro-zone).

86. **Birel is used by 600 financial institutions holding RTGS accounts with BI.** (This number is reducing as a result of both consolidation within the Italian banking sector and the progressive introduction of New Birel.) There is no minimum amount for a payment to be made through Birel, so that it handles time-critical low-value payments as well as large-value transfers and payments in settlement of securities transactions. In terms of the total volume of transactions settled, Birel ranked second among EU RTGS systems in both 2001 (10.2 million payments) and 2002 (9.6 million); in terms of the total value, it ranked 5th in each year. The flows of payments in Birel are concentrated in a relatively small number of banks.

Effective payment system oversight

87. **Birel is operated and overseen by BI, in the context of TARGET rules, procedures and guidelines issued by the ECB.** The policies, procedures and practices of BI in respect of Birel are open and transparent; they are widely circulated through a series of publications and through close and continuing contacts with the system’s users. BI publishes regular reports on the operation of Birel, and on the volume and value of payments through the system.

Main findings—Summary

Table 7. Main Findings of Assessment of Observance of CPSS Core Principles for Systemically Important Payment Systems and of Central Banks’ Responsibilities

Reference Principle	Recommended Action
Well-founded legal basis in all relevant jurisdictions (CP 1)	<p>The legal basis of Birel is created by the Statute of the European System of Central Banks and by ECB rules, regulations and guidelines, as incorporated into Italian law; by domestic Italian legislation relating to BI, to the business of banking and to other relevant EU legislation; by the Italian Civil Code; and by legislation on insolvency procedures and other corporate issues.</p> <p>Although, Birel has a solid legal basis, there is a potential conflict of law in respect of the branches in Italy of banks incorporated outside the European Economic Area (EEA). BI together with other central banks members of TARGET, initiated a legal project analyzing particularly the conflict of interest for participants located outside the European jurisdiction.</p> <p>There are continuing uncertainties, in the absence of an expected Decree, about the validity of electronic instructions to make payments in Birel.</p>
Understanding of the system’s impact on risks; and procedures for the management of risks (CPs 2-3)	<p>The members of Birel are in a position to fully understand the financial risks involved. These are clearly set out in the BI Membership Agreement and Guide, and supporting material, and through contacts with BI in a number of fora.</p> <p>Credit risks arise in Birel principally in the context of the provision by BI of intraday liquidity against collateral: as mentioned under CP 1 above, there may be a slight credit risk for BI in respect of its ability to realize collateral it has taken from certain banks incorporated outside the EEA.</p> <p>Liquidity risks that arise for the members are effectively managed through the provision of real-time information on the flows of payments through the system; by the incorporation into the processing system of well-designed queuing and optimization mechanisms; and by the availability of intraday liquidity from BI to supplement the members’ own compulsory monetary reserves.</p>

Reference Principle	Recommended Action
Final settlement; inability to settle by the participant with the largest single settlement obligations (CPs 4-5)	As an RTGS system, Birel provides real-time immediate finality. It is not a multilateral netting system.
Assets for settlement (CP 6)	Birel settles in central bank money.
Security and operational reliability; and contingency arrangements (CP 7)	The security and reliability requirements imposed by BI on Birel are set within the framework of the security requirements set by the ECB for all the national components of TARGET. An annual risk assessment of compliance with these requirements is based on the ECB guidelines. Business Continuity, Contingency and Information Security plans and procedures are regularly reviewed, with the main users, and steps are in hand to achieve a system-wide set of Service Level Agreements among BI, the member banks and service providers (though this has not yet been achieved in full).
Practical for the markets and efficient for the economy (CP 8)	Birel appears to meet the key requirements, for any RTGS system, of speed, cost, practicality, and user relevance. Speed, as measured by end-to-end times, is well within TARGET and BI guidelines. The pricing policy seeks over time to recover through fees and message charges 80 – 85% of the system’s operational, development and overhead costs, with the balance being regarded as a public good contribution provided for the benefit of the economy. In terms of the intraday liquidity and collateral management arrangements, and the queuing facilities, Birel is practical for the users; and its relevance for the users is ensured through the extensive consultative framework adopted by BI.
Objective and publicly disclosed criteria for participation (CP 9)	The access criteria for Birel are those laid down by the ECB for every national component of TARGET.
Governance of the system should be effective, transparent and accountable (CP 10)	<p>The governance of Birel falls within the overall governance structure of BI. Within the Area for Payment Systems and Treasury Operations (APSTO), the Payment Systems Department (PSD) manages Birel, and is responsible for ensuring that it complies with international standards and best practice. Its work is subject to audit by BI’s Internal Audit Department, which reports both to BI’s Directorate and to the top management of the ECB.</p> <p>The PSD maintains close coordination with the Birel members through a structure of working groups, specialized meetings and questionnaires.</p> <p>A clear separation of the functions of operation and oversight might with advantage be considered, under which the PSD would remain responsible for the operation of Birel, and for setting its policies, while the PSOO would acquire the responsibility for overseeing Birel’s compliance with international standards and best practice.</p>
<i>Responsibility A - The central bank should define clearly its payment system objectives and should disclose publicly its role and major policies with respect to systemically important payment systems.</i>	BI’s objectives in respect of the national payment systems have been set out in depth in a variety of publications, regular and ad hoc.
<i>Responsibility B - The central bank</i>	Birel complies, in full or broadly, with all the Core Principles.

Reference Principle	Recommended Action
<i>should ensure that the systems it operates comply with the core principles.</i>	
Responsibility C - <i>The central bank should oversee observance with the core principles by systems it does not operate and it should have the ability to carry out this oversight.</i>	There are currently no privately-operated SIPS in Italy. It is however important that BI monitor the flows through “Group Settlement Arrangements,” in terms of the concentration risk that they may create.
Responsibility D - <i>The central bank, in promoting payment system safety and efficiency through the core principles, should cooperate with other central banks and with any other relevant domestic or foreign authorities.</i>	BI cooperates with the ECB and with other EU central banks, with which MOUs have been signed governing exchanges of information. There are however no arrangements in place for cooperation and the exchange of information with the home country central banks or banking supervisors of the Birel members that are incorporated outside the EEA.

Table 8. Actions to Improve Observance of CPSS Core Principles and Central Bank Responsibilities in Applying the CPSIPS—Birel

Reference principle	Recommended action
Legal foundation	<p>BI should, by agreement with the ECB, obtain satisfactory Capacity Opinions and Country Opinions in respect of the 14 Birel participants that are incorporated outside the EEA, or should take steps to exclude from participation in Birel and in New Birel any of those banks from whom satisfactory Opinions are not obtained.</p> <p>BI should seek to arrange that a Decree is issued covering the technical rules on the standards of security, authenticity and integrity for the electronic processing of instructions for payments to be made in Birel and New Birel.</p>
Understanding and management of risks	<p>BI should seek to ensure that every bank that will become an Indirect Participant in New Birel is fully aware of and fully understands the risks it will incur through the appointment of another bank as its Direct Participant in handling its New Birel receipts.</p>
Security and operational reliability, and contingency arrangements	<p>BI should (in the context of its work with the banking industry following the events of September 11, 2001) consider carefully the concentration risks, and the consequential operational risks and vulnerabilities that may be created for Birel and New Birel as a result of the out-sourcing of extensive elements of the payment system functionality of a large number of active participants to a very limited set of service providers. Similar risks arise, and need to be considered carefully, in respect of the use of “Group Settlement Agents,” acting on behalf of members of a sectoral or corporate group of banks.</p> <p>BI should clarify whether formal and monitorable Service Level Agreements have been signed between each participant in Birel (and, prospectively, in New Birel) and every single service provider on whom the end-to-end performance of the RTGS system depends.</p>
Criteria for participation (CP IX) Central Bank Responsibility C	<p>BI, through its PSD and PSOO, should keep a close watch on developments in the 2-tier system for access, as a part of the infrastructure of Birel and New Birel, so as to be alert to any changes which might adversely impact the integrity or the efficiency of the system and of the payment systems as a whole.</p>
Central Bank Responsibility D	<p>BI should put in place arrangements for cooperation and exchanges of information with the 7 central banks and banking supervisors of the Birel participants that are incorporated in non-EU countries.</p>

Authorities' response and next steps

88. The migration to the new Birel RTGS system was completed by May 2004, and BI considers that all the recommendations contained in the assessment were addressed except for some marginal aspects. Birel (together with the German and French systems) has been chosen as the basis for developing the new unified RTGS platform for the euro area.

89. In new Birel the non-EU banks directly participating in the system are three instead of fourteen and legal opinions (Capacity Opinions and Country Opinions) have been obtained; they have been assessed by the Bank's Legal Department that found them fully satisfactory and therefore concluded that no conflict of jurisdiction arises vis-à-vis the country (U.S.) where the three banks are incorporated.

90. Regarding the recommendation that a decree should be issued covering the technical rules for electronic processing, the need was significantly reduced following the amendment (with the legislative decree No. 82 of 7 March 2005) to law No.445 of 2000 that called for the issuance of such a decree.

91. As to the understanding and management of risk, BI has already amended the rules of new Birel in order to introduce a warning for indirect participants regarding their risk exposure vis-à-vis the respective direct participants, in case they opt for such form of participation in the system.

92. Concerning the recommendation to ensure that Service Level Agreements are in place between direct participants and service providers, banks have been required to sign such agreements. In addition, the risks stemming from the outsourcing of important elements of the payment system functionality to a few service providers are monitored by an ad hoc working group on business continuity, which covers the entire national marketplace. Indeed, both representatives from the Bank's competent functions and critical players (such as major banks, market infrastructures, public utilities and service providers) participate.

93. As regards the recommendation to keep a close watch on the developments in the 2-tier system for access, as a part of the infrastructure of new Birel and to consider carefully the concentration risks that may arise in respect of the use of 'Group Settlement Agents' acting on behalf of members of a group of banks, it is to be pointed out that in the first quarter of 2004 (when the participants' migration process was almost completed) the share of the payments settled by the first five banking group in the new Birel (that provides for the 2-tier structure for access) amounted to 45.2 percent compared to 42.4 percent in the correspondent period of the previous year in the old Birel (which only provided for direct access). In the same periods, the share of the payments settled by the first ten banking groups even decreased from 76.6 percent to 72.5 percent. This clearly shows that the launch of new Birel did not increase the concentration of payments among intermediaries.

94. As regards the recommendation concerning responsibility D, BI has entered into an agreement on information sharing with the U.S. Federal Reserve for information sharing.

95. Regarding the possibility of transferring the responsibility for compliance of the Italian RTGS system with the Core Principles from the Payment Systems Department (PSD) to the Payment System Oversight Office, the authorities noted that the separation of operations and oversight within the PSD had been strengthened by the reporting of each function to a separate Senior Manager within the Department. According to an ad hoc assessment carried out at the ECB level, no evidence of conflict of interest has been found.

SUMMARY ASSESSMENT OF IAIS INSURANCE CORE PRINCIPLES (ICP)

General

96. **This report summarizes the results of an assessment of the observance of the Insurance core principles (ICP) of the International Association of Insurance Supervisors (IAIS) in Italy.** Insurance is supervised in Italy by the Supervisory Authority for Private Insurance Undertakings and Insurance Undertakings of Public Interest (Istituto per la Vigilanza sulle Assicurazioni Private e di Interesse Collettivo—ISVAP). ISVAP is responsible for prudential and market conduct supervision of insurance companies and intermediaries. This assessment was done in the context of the IMF and World Bank Financial Sector Assessment Program (FSAP), using the ICP dated October 2003. This assessment was conducted during a mission to Italy July 5–20, 2005, and is based on the circumstances in place and the practices used at that time. Although Italy is undergoing significant changes in its insurance supervisory processes and Parliament is considering changes in legislation relevant to insurance supervision, prospective changes have not been considered in the assessment. The report includes recommendations for strengthening the supervision of insurance.

97. **Major sources of information used for the assessment included ISVAP’s answers to the questionnaire submitted by the IMF prior to the mission, a comprehensive self assessment carried out by ISVAP, ISVAP’s annual report, translations of various circulars issued by ISVAP, supplemented by publications of industry associations and ratings agencies.** Extensive meetings were held with management and staff of ISVAP to discuss each of the criteria within the ICP. In addition, meetings were held with representatives of a wide range of industry and professional organizations. All concerned gave willingly of their time and were cooperative, and this added significantly to the effectiveness of the assessor.

Institutional and macroprudential setting—overview

98. **While the insurance sector in Italy experienced strong growth in 2003 and 2004, with premium increases of about 12 percent in both years, Italy remains relatively under-insured.** Market penetration is low, with gross domestic premium income accounting for 7.5 percent of GDP in 2004, compared to the EU average of close to 9 percent. The total assets of the insurance companies amount to 34.6 percent of GDP in 2004. At year-end 2004, licensed domestic insurance companies included 76 life insurance companies, 81 non-life insurance companies, 19 companies licensed for both life and non-life insurance (composite companies) and 3 reinsurers. In addition, 67 branches of foreign companies were licensed to operate, primarily in the non-life sector. The industry is relatively concentrated, with the largest five and the largest ten life companies, respectively, accounting for 47 percent and 65 percent of the sector’s total insurance premiums in 2004. The largest five and the largest ten non-life companies, respectively, wrote 41 percent and 61 percent of the premiums in the same year. Insurers are frequently members of groups, with the five largest groups accounting for 53 percent of life premiums and 67 percent of non-life premiums in 2003.

Banks and post offices are the predominant life insurance distribution channel, accounting for 59 percent of sales in 2004. The agency distribution channel also remains important, accounting for about 30 percent of life insurance sales and 88 percent of non-life insurance sales in 2004. Financial advisors account for most of the remaining life insurance sales, with brokers handling the balance of the non-life sales, focusing on the medium to large commercial risks.

99. **Life insurance products are predominantly savings-oriented, and include traditional and unit-linked policies.** Legislation currently under consideration is expected to expand the opportunities for the sale of the life insurance to fund supplemental individual pensions. The life insurance business has been profitable, with an overall return on equity of 10.5 percent in 2004. Motor insurance is the predominant non-life product, accounting for almost 60 percent of the non-life premiums written. Motor insurance claims costs have been increasing rapidly, but premiums have kept pace. Both motor insurance and other non-life products have been profitable in recent years, with the overall combined ratio having declined steadily from 109 percent in 1999 to 96 percent in 2004. Return on equity was 13.4 percent in 2004.

100. **The supervisor for the insurance sector is ISVAP, an independent supervisory authority with a Board of Directors, funded by a levy on premiums.**

Main findings

101. **Insurance supervision in Italy occurs within a legal framework that incorporates the relevant EU Directives.** In recent years, ISVAP has moved toward a more forward-looking approach to supervision, working toward the full implementation of a risk-based supervisory methodology and promoting better risk management practices by insurers. This change in approach has clearly been noticed by the industry and, for the most part, appears to have its support (in principle, although not always on the specifics). Further changes are ahead, such as the implementation of Solvency II, which ISVAP has been actively involved in developing.

102. **The level of observance of the ICP in Italy is good, with the legislative and supervisory initiatives that are currently being pursued holding the potential to further improve the level of observance in the coming years.** In some areas, where frameworks are in place, it has been recommended that implementation be strengthened, e.g., by increasing the frequency and scope of on-site inspections of both insurers and intermediaries. In other cases, the legal framework should be strengthened, e.g., legal protection should be provided for those involved in the supervisory process, and governance requirements and disclosure requirements for insurers that are not subject to the requirements applicable to listed companies should be strengthened.

Conditions for effective insurance supervision

103. **Italy largely meets the conditions necessary for effective insurance supervision.** The harmonization of accounting standards and the development of an alternative dispute resolution mechanism would enhance these conditions.

The supervisory system

104. **Both the board of directors and staff of ISVAP should be protected against lawsuits for actions taken in good faith while discharging their duties.** Consistent with its move to a more risk-focused approach, ISVAP should develop criteria for assessing the overall risk of an insurer and define the nature of supervisory action corresponding to various levels of risk, and communicate this information to the industry. While ISVAP actively exchanges information with other EU/EAA insurance supervisors, greater sharing of information with other supervisors, particularly those responsible for other parts of the Italian financial sector and insurance supervisors outside the European Union would improve observance.

The supervised entity

105. **Broadening the application of fit and proper and corporate governance requirements, strengthening the assessment of corporate governance and internal controls, along with legislative changes to help ensure the flow of information from those involved in the control process, would improve observance.**

Ongoing supervision

106. **ISVAP's on-site inspections should seek to assess not only compliance with requirements but the effectiveness of an insurer in identifying and managing its risks.** Significantly increasing both the number and scope of the on-site inspections, and providing advance notice of most inspections, would facilitate more forward-looking and effective supervision.

Prudential requirements

107. **ISVAP is actively involved in international standard setting initiatives, such as Solvency II.** It has also taken steps to require insurers to perform stress testing. The ability of ISVAP to assess the financial condition of insurers and to take early action could be improved by making regular use of the results of the stress tests and by establishing and communicating solvency control levels.

Markets and consumers

108. **The new insurance code should strengthen the basis for the supervision of insurance intermediaries.** Disclosure practices are expected to improve with the move to

IFRS, although further action would be appropriate, e.g., to ensure that information is easily available to interested parties.

Anti-money laundering, combating the financing of terrorism

109. More frequent inspection of controls by ISVAP is recommended, along with explicit guidance to emphasize the need for foreign branches and subsidiaries of Italian insurers to observe AML/CFT measures.

Table 9. Action Plan to Improve Observance of IAIS Insurance Core Principles

Reference Principle	Recommended Action
Conditions for effective insurance supervision i.e., CP 1	<p>The responsibilities for the supervision of pension products should be clearly defined in a manner that supports the ability of ISVAP to conduct prudential supervision of insurers selling such products, while avoiding the duplication or conflict of supervisory requirements applicable to the insurers.</p> <p>The accounting and supervisory reporting requirements applicable to insurers under Italian GAAP should be harmonized with IFRS as far as possible.</p> <p>A specialized alternative dispute resolution mechanism, such as an independent ombudsman, should be established to deal with complaints of insurance consumers (or all financial sector consumers).</p>
The supervisory system i.e., CP 2 – 5	<p>ISVAP should explicitly communicate the principal objectives of insurance supervision and explain how its plans and activities support these objectives.</p> <p>Both the board of directors and staff of ISVAP should be protected against lawsuits for actions taken in good faith while discharging their duties.</p> <p>ISVAP should establish and enforce a code of conduct that includes a prohibition on dealing in shares and investing in companies subject to ISVAP’s supervision.</p> <p>ISVAP should develop criteria for assessing the overall risk of an insurer and define the nature of supervisory action corresponding to various levels of risk, and communicate this information to the industry.</p> <p>ISVAP should exchange information with relevant supervisors outside of the EU/EEA.</p>
The supervised entity i.e., CP 6 – 10	<p>Amend legislation to require that all senior management of an insurer meet fit and proper requirements.</p> <p>Fit and proper requirements should be defined and applied more broadly.</p>

Reference Principle	Recommended Action
	<p>Require that all insurers conform to all of the corporate governance requirements applicable to listed companies.</p> <p>Amend legislation to provide for legal protection from liability for those parties required to report concerns to ISVAP, in respect of such reporting.</p> <p>ISVAP should strengthen its off-site and on-site assessment of insurers' corporate governance practices.</p> <p>ISVAP should strengthen its off-site assessment of internal controls by routinely reviewing internal audit plans and reports, as well as reports of the board of statutory auditors.</p> <p>ISVAP should meet regularly with the head of the internal audit function, the appointed actuary, the external auditor, the auditing actuary and the board of statutory auditors to obtain information from them regarding the effectiveness of internal controls. Legislation should be amended to enable such meetings to take place on a confidential basis, without management present, and the persons involved should have legal protection from liability for providing information to ISVAP.</p>
<p>Ongoing supervision i.e., CP 11 – 17</p>	<p>ISVAP's market analysis process should include regular meetings and cooperation in quantitative analyses with the other Italian financial sector supervisors and regular meetings with various industry and professional associations. Results should be communicated widely within ISVAP.</p> <p>ISVAP should significantly increase both the number and scope of its on-site inspections, and should provide advance notice of its inspections, except in cases of specific compliance concerns.</p> <p>On-site inspections should assess not only compliance with requirements but the effectiveness of risk management.</p> <p>Amend legislation to provide that no breach of fitness or propriety requirements will be automatically disregarded after three years have passed.</p> <p>ISVAP should systematically exchange quantitative and qualitative information with relevant Italian supervisory authorities, where an insurer is a member of a group that operates in the other sectors.</p>

Reference Principle	Recommended Action
Prudential requirements i.e., CP 18 – 23	<p>The draft circular on reinsurance should be finalized and implemented with high priority.</p> <p>Amend legislation to extend the requirement for an appointed actuary to all non-life classes of business.</p> <p>ISVAP should require each insurer to have an overall strategic investment policy and provide guidance regarding the main elements to be addressed therein.</p> <p>ISVAP should establish and communicate a solvency control level in excess of the minimum solvency margin.</p> <p>ISVAP should regularly review the results of the stress testing undertaken by insurers, as well as their contingency plans.</p>
Markets and consumers i.e., CP 24 – 27	<p>Adopt the new insurance code and implement its provisions on insurance intermediation with high priority. These provisions should require that all insurance intermediaries operating in Italy be subject to registration and direct supervision, and that the conditions of registration include demonstration, through examination, of adequate insurance expertise.</p> <p>Amend legislation to clarify ISVAP’s power to require insurers to disclose information on their financial situation and the risks to which they are subject and to require all insurers to make their annual audited financial statements easily available.</p> <p>ISVAP should publish, on an entity-specific basis, some of the information provided to it by insurers in the supervisory returns. Amend legislation, as necessary, to facilitate such publication.</p>
Anti-money laundering, combating the financing of terrorism i.e., CP 28	<p>ISVAP should significantly increase the frequency of its on-site inspections of both insurers and intermediaries regarding AML/CFT.</p> <p>Amend legislation to make ISVAP a member of the FSC.</p>

Authorities’ response to the assessment

110. We would like to pay tribute to the International Monetary Fund for the fruitful discussions held during the assessment and the recommendations made, which will help to improve the effectiveness of insurance supervision in Italy.

111. ISVAP welcomes the IMF’s support to the efforts undertaken to strengthen Italian insurance supervision according to an approach that is more and more forward-looking and risk-based, and to increase the standards relating to risk management and insurance undertakings’ internal controls, in line with the developments of the *Solvency II Project*.

112. ISVAP is carefully assessing the recommendations by the IMF. The pre-requisites which will be necessary to carry out some of them have been already defined, especially as regards the two ISVAP circulars on the system of internal controls and risk management and on passive reinsurance; in other cases the carrying out of such recommendations is subject to objective limits set by the legislation in force, but it is now possible in 2006, with the entry into force of the New Insurance Code, which will also extend ISVAP's powers.

113. Moreover, as regards certain recommendations, ISVAP is already working on drawing up measures for their implementation, like the code of conduct for staff and the reinforcement of its own supervisory function, also in the light of the innovations contained in said Code, which extends ISVAP's supervision to all insurance intermediaries and introduces the possibility for ISVAP to have recourse to *Guardia di Finanza* (the Financial Police).

114. Finally, as regards other recommendations, the expected benefits from the introduction of the proposed improvements will be examined in the light of a comparison between costs and benefits of regulation and supervision.

SUMMARY ASSESSMENT OF IMPLEMENTATION OF THE IOSCO OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION

General

115. **An assessment of implementation of the IOSCO Principles was carried out as part of the first FSAP mission, between October 18 and November 3, 2004, by José Manuel Portero.**

116. **The assessment was carried out using IOSCO Assessment Methodology (the Methodology), adopted by IOSCO in October 2003.** The assessment relied on a detailed self-assessment completed by Consob and BI, in-depth interviews with Consob, BI and the Ministry of Economy and Finance staff, interviews with market participants and industry associations, and a review of key pieces of legislation.

Institutional setting and market structure

117. **The Italian securities market, as other European markets, is a bank dominated industry.** In 2003, there were 710 banks and 131 investment firms, mostly controlled by Italian banks and Italian financial groups, authorized to carry out investment services from the reception and transmission of orders to dealing on their own account and providing underwriting services.²⁵ Additionally 153 asset management companies, mostly controlled by Italian banks, and 1556 CIS were registered, including open-end mutual funds, close-end private equity funds, closed-end real estate funds and hedge funds, with a total of €403.722 million assets under management.²⁶

118. **In 2003, three market operators were authorized to manage regulated markets: the Borsa Italiana Spa (the Italian Stock Exchange), which is mostly owned by Italian banks, MTS SpA, whose control has recently been transferred to Euronext and Borsa Italiana²⁷ and Tlx SpA, which is fully owned by Italian banks.**

119. **The Italian Stock Exchange, which had 128 members in 2003, manages the following markets: three regulated equity markets (MTA, Mercato Expandi and MTAX, which replaced the segment previously known as Nuovo Mercato); one market for funds (MTF); a derivative market (IDEM); a securitized derivatives market (SeDex) and two fixed-**

²⁵ Consob statistics, as of December 2003

²⁶ BI statistics, as of December 2003.

²⁷ In July 2005 the majority shareholders of MTS accepted an offer led by Euronext and Borsa Italiana to become the owners of 51 percent of the MTS share capital, undertaking the commitment to a capital increase via subscription of new shares expressly reserved for Euronext and Borsa Italiana.

income markets (MOT for government securities and corporate bonds and EUROMOT, for Eurobonds and Asset Backed securities). In 2003, the Italian Stock Exchange had a total market capitalization of €488 million, €175 million corresponding to the MTA market, with 219 Italian companies listed. A total of €12,524 million in equity were issued (9,868 from IPO's) in that market in 2003. In 2003 total turnover for the MOT market was €142 billion, €133 billion corresponding to government bonds. Total turnover for EUROMOT market was €4 billion.²⁸

120. **MTS manages the wholesale government bonds market (MTS), a multidealer to client Internet-based government bond wholesale market (BondVision) and MTS Corporate wholesale (dealing on corporate bonds, ABS and quasi-government bonds).** In 2003 turnover for the MTS/cash segment market was €2,136 billion and of €12,464 billion for the MTS/repo segment. Turnover in the BondVision was €149 billion.²⁹

121. **Tlx manages the TLX market where corporate bonds, Italian and EU government bonds and funds and equity linked securities are traded.** In 2003 total turnover was €2 billion.³⁰

122. **Both the central depository (Monte Titoli) and the clearing house (Cassa di Compensazione e Garanzia SpA) are mostly owned by the Italian Stock Exchange.**

Description of the regulatory structure

123. **The 1998 Consolidated Law of Financial Intermediation (Consolidated Law) sets out the institutional framework for the regulation and supervision of the Italian securities market.** Under this Law, Consob has responsibility for market efficiency and transparency, proper conduct of business by intermediaries and investor's protection, while BI is responsible for prudential supervision and financial stability of intermediaries. It also has direct responsibility for the supervision of wholesale markets in government securities, although Consob is responsible for the regulation and supervision of market abuse in that market.

124. **The main provisions governing Consob are set out in Law 216/1974 as amended in the Consolidated Law.** BI's organization and competences are comprised in different legal sources: its bylaws ratified by Royal Decree 1067/1936 as amended, the Consolidated Law on Banking (Legislative Decree 385/1993 Consolidated Law on Banking) and the Consolidated Law. The Consolidated Law was recently amended by Law no. 62/2005, which

²⁸ Consob's statistics, as of December 2003.

²⁹ Consob's statistics, as of December 2003.

³⁰ Consob's statistics, as of December 2003.

implemented the Market Abuse Directive.³¹ Most of the changes needed to transpose the European Directives into the Italian legal framework have already been introduced; however, some are still needed to harmonize it with the Prospectus Directive.³²

General preconditions

125. **The IOSCO Principles list a number of preconditions to effective securities regulation.** These include the appropriateness of legal, tax and accounting framework within which the securities market operate, the effectiveness of procedures for the efficient resolution of problems in the securities market, and the soundness of macroeconomic policies (those aspects that could affect the operations of the securities market). These preconditions appear to be in place in Italy.

Main findings

Principles related to the regulator

126. **Two autonomous agencies, Consob and BI, share the responsibility for the regulation and supervision of the Italian securities market. Since 1997 there has been a protocol governing the terms of their cooperation, which was recently made public.** Both agencies have been given broad powers to carry out their mandates and seem to be exercising them in an adequate manner. Although Consob's budget is funded partly by the state budget and has a legal ceiling on its staff number, at this time both BI and Consob seem to operate within an appropriate budget and sufficient resources. Liability of Consob's staff is limited to cases of serious/gross negligence, fraud, deceit or willful wrong. There is no specific law offering legal protection to BI staff and its officers against the possibility of legal action resulted from actions adopted in good faith in the exercise of their supervisory functions. Both agencies are subject to accountability provisions, including, annual reporting, judicial review, and conduct rules.

Principles of self regulation

127. **There are no self-regulatory organizations in the Italian securities market.**

Principles related to compliance and enforcement

128. **Consob and BI have all the necessary powers to carry out investigations and inspections and have done so on a regular basis.** However, the Italian supervisory approach toward market and market operators has relied on different mechanisms such as

³¹ Directive 2003/6/EC.

³² Directive 2003/71/EC.

direct access to the trading systems, reporting obligations on market operators and visits to market operators, but it does not include on site inspections as a routine tool of supervision. Consob conducts real time surveillance of the regulated markets it authorizes, while BI conducts it for the government bonds wholesale market.

129. **Both agencies also have broad powers to enforce securities provisions in the area of their competence.** These include precautionary and remedial measures as well as the imposition of administrative sanctions.

Principles related to information sharing

130. **The Consolidated Law requires Consob and BI to cooperate effectively, both at the internal and external level.** No external approval is needed to exchange information with foreign counterparties and both agencies are legally empowered to use their powers at the request of foreign counterparties. There is no limitation with respect to the provision of unsolicited assistance. Internally, Consob has signed protocols with BI and the anti-money laundering authority. Externally, Consob is signatory of both CESR and IOSCO's MOU and BI is signatory of CESR MOU. Both authorities have signed bilateral MOUs. Moreover, due to the agreement between the Italian and the French Central Counterparties Consob and BI have jointly signed an MOU with the French authorities competent for clearing and settlement.

Principles related to issuers

131. **Public offerings are subject to previous authorization based on disclosure of relevant information, through a prospectus.** Periodic reporting as well as disclosure of material information is also mandatory. However, at the time of the assessment, those requirements did not apply to nonlisted debt instruments issued by banks.³³ Significant holdings as well as insider holdings are subject to disclosure requirements. There are equal treatment provisions in place, including mandatory tender offers in certain circumstances.

132. **Accounting and auditing standards are of internationally acceptable quality.** The use of IFRS is mandatory for the consolidated accounts of listed companies as of January 1, 2005. Consob has powers to review the quality of auditor's work and has done so through an inspection program. In addition, Consob can request disclosure of additional information and ask issuers to restate their financial statements. In case the issuer does not comply with Consob's request, Consob can sue the issuer before the Civil Court.

³³ This was rectified by the Savings Law of December 28, 2005.

Principles related to collective investment schemes

133. **Regulation of collective investment schemes is well developed.** Both the asset manager and the CISs are subject to licensing. The criteria for licensing asset management companies(AMCs) include capital adequacy, as well as integrity and experience requirements for control functions and adequacy requirements for management procedures. AMCs are subject to periodic reporting. CISs are subject to similar information requirements as issuers: mandatory prospectus, as well as periodic and material events disclosure requirements. There are rules in place to deal with legal form and structure, custody and net asset value calculations. AMCs and CISs are subject to inspections by Consob and BI.

Principles related to market intermediaries

134. **Investment firms are subject to licensing based on the fulfillment of a set of requirements that include capital adequacy, as well as the adequacy of internal controls and management systems.** They are also subject to market conduct rules. Periodic reporting is mandatory. Both BI and Consob conduct inspections on financial intermediaries. There is a process for winding up firms and an investor’s compensation scheme.

Principles related to secondary markets

135. **Secondary markets are subject to licensing based on the fulfillment of a set of criteria that include capital adequacy, integrity and experience requirements for control functions and conformity of its rules with community law.** Regulations are in place that promote the transparency of trading and also which aim to ensure proper management of large exposures, default risks, and market disruption. The Italian supervisory approach toward market and market operators has relied on different mechanisms such as direct access to the trading systems, reporting obligations on market operators and visits to market operators, but it does not include on site inspections as a routine tool of supervision. Consob conducts real time surveillance of the regulated markets it authorizes, while BI conducts it for the government bonds wholesale market.

Table 10. Actions to Improve Implementation of the IOSCO Objectives and Principles of Securities Regulation

Reference Principle	Recommended action
Principles for the regulator	Recommendations regarding legal protection of BI staff are included in the BCP Assessment.
Principles for the enforcement of securities	1. On site inspections of market operators and regulated markets should be included in Consob’s and BI’s inspection plans. 2. Transparency regarding investor’s complaints would be enhanced with a separate an extensive report on activities performed by Consob.
Principles for issuers	Full prospectus requirements as provided in the Prospectus Directive (2003/71EC) should be applied to nonlisted debt instruments issued by banks. 1/

Principles for market intermediaries	Consob should consider enhance monitoring of market intermediaries to ensure compliance with suitability and information disclosure requirements, within the limits of the MIFID Directive.
Principles for secondary markets	On site inspections of both market operators and regulated markets should be conducted by Consob and BI.
1/ This was addressed by the Savings Law.	

Authorities’ response to the assessment

136. BI and CONSOB contend that Principles 10 and 26 have been fully implemented.

137. They consider that, so far, planning routine on site inspections on the market operator on an annual basis has not been necessary to ensure effective supervision of markets and market operators. Both Consob—for all markets—and BI—for the wholesale government bonds market—have direct access to the information on the trading systems, which is complemented by the periodic information that market operators have to send to them, and that includes annual accounts, as well as an annual report on internal control issues.

138. In the view of Consob and BI, IOSCO Principle 8, as specified by the Methodology Key question 3), requires that the regulator is able to perform “surveillance” on the markets (which is defined under Principle 25) and leaves it to the regulator to decide which mix of supervisory tools should be used. IOSCO Principles (see Principle 26) do not require that on-site inspections of market operators be included in an annual plan of supervision (it is sufficient to have the power to perform inspections if necessary). The Principles require that mechanisms are in place (key question 1) which allow for a surveillance program of the trading or of the trading system and of the behavior of the intermediaries. Principle 28 (key Question 2) requires that the system provides (among the different methods listed) a combination which ensures the correct monitoring and detection of possible market abuse.

139. By directly supervising the trading on the market and the behavior of the market members (including through checks on their trading strategies and their positions) Consob and BI—for the wholesale government bonds markets—can identify any anomalies or inability of the market operator to maintain orderly trading on the platform. It should also be recalled that pursuant to Article 74 paragraph 3, in cases of necessity and as a matter of urgency Consob can adopt all necessary measures acting in the place of the market management company; the same powers are attributed to BI with regard to the wholesale government bonds market (Article 76, paragraph 1).

140. In addition, Consob and BI make regular use of other mechanisms for continuous monitoring, such as regular visits to market operators (twice per month) and contacts with the staff of market operators to keep informed of market’s developments; the company has also been providing the authorities with periodic reports required by the Supervisory Instructions on organizational risk management and technological infrastructure made by external

auditors. Furthermore the authorities receive in advance the agenda of the board's meetings and have the power to ask that items be included in it. Also, Consob has to approve the rules of the market.

141. However, it should be noted that following the privatization of the market operators in 1996, Consob has performed to date 2 on site inspections pursuant to Article 74 paragraph 2 of the Consolidated Law on the Italian Stock Exchange.

142. BI has statutory powers to conduct on-site inspections on the operators of wholesale markets on government bonds. Inspections will be carried out, as necessary, based on a methodology that has been recently adopted and is applicable also to other market infrastructures. This methodology aims at integrating the information received with an appraisal of the reliability and effectiveness of organizational structure, systems and procedures and internal controls.

143. Finally, the authorities consider that the system in place for the supervision of the wholesale government securities market is effective also on the issues of market manipulation and investor's protection. Consob receives all the data on the transactions performed in this market and stores it in its database so that it can be analyzed to identify possible market abuse. In addition, Consob conducts real time monitoring of the retail market for government securities, which constitutes an additional input for the purposes of detecting problems in price formation in the government bonds market.

SUMMARY ASSESSMENT OF THE OBSERVANCE OF MONTE TITOLI OF THE CPSS/IOSCO RECOMMENDATIONS FOR SECURITIES SETTLEMENT SYSTEMS

General

144. **This assessment of the Italian securities clearing and settlement systems was undertaken in the context of the IMF Financial Sector Assessment Program (FSAP) exercise for Italy in October 2004.** It covers Monte Titoli (MT) and the Cassa di Compensazione e Garanzia (CC&G).

145. **Prior to the mission, the Italian authorities—BI (BI) and Consob—conducted a comprehensive and very clear self-assessment.** The Italian authorities were fully cooperative and all relevant documentation to fulfill the assessment of the securities settlement was provided on time and without difficulties. The mission benefited also from meetings with market participants arranged by the Italian authorities.

Scope of the assessment

146. **The assessment covers MT as the central securities depository (CSD) and the securities settlement systems (SSS) for a broad range of securities, such as government bonds, corporate bonds, equities and derivatives traded in regulated markets and OTC financial instruments.** The assessment also covers the CC&G, the central counterparty (CCP) in Italy, which clears both equities and bonds, as covered in the CPSS/IOSCO Recommendations for Securities Settlement Systems. Consequently, CC&G is assessed only against Recommendation 4 on CCP, which mainly deals with the cost and benefit of introducing a CCP. The Italian authorities may consider assessing CC&G against the new CPSS/IOSCO Recommendations for Central Counterparties, which cover broader aspects of CCP activities.

Institutional and market structure

147. **The capital markets in Italy are well developed and diversified.** In terms of capital markets capitalization, the size of the equity market was €488 billion in 2003 and the number of listed companies was 219. A total of €2,524 million in equity were issued (9,868 from IPOs) in that market in 2003. However, compared to other European equity markets and taking into account that the Italian economy is the third largest in Europe, the size and activities in the equity market are still modest. The securities debt markets are relatively large in Italy. MTS manages the government market (MTS) and a multidealer to client Internet-based government bond wholesale market (BondVision). The annual turnover of trades taking place on the MTS regulated markets for government bonds was €2,136 billion in 2003 and the figure for BondVision was €149 billion.

148. **The Borsa Italiana is a private company owned mainly by the Italian banking community.** It manages and organizes the trades on the regulated markets for equities, traded derivatives, government securities, corporate bonds and asset backed securities. However, the

bulk of government securities are traded on the MTS, which is also a private owned company.

149. **The CC&G is the Italian CCP that clears both derivatives and cash instruments.** It is owned, up to 86 percent, by Borsa Italiana. The daily average number of transactions was 70,365 for derivatives and 307,773 for equities. Clearing equities traded on Borsa Italiana is compulsory for market participants. At the end of 2003, CC&G had 140 members, almost equally distributed between banks and non-bank financial intermediaries. Similar to other CCPs in Europe, the clearing activities are concentrated to a relatively few members, where the largest 15 members have 75 percent of all clearing activities.

150. **The institutional arrangements of MT have been reshaped during the last years.** It became the CSD and the SSS for all securities traded in the Italian market, after merging the settlement systems of BI and fully owned by Borsa Italiana. In December 2003 it introduced a new settlement system based on net and real time gross settlement functionalities. As end March 2004, MT had 471 participants in the CSD, and 143 participants in the settlement systems. MT has also a high degree of participant concentration; the largest 15 members have 90 percent of total settlement instructions. Securities held in custody average €2.000 billion. As the settlement system was recently introduced, the value of all transactions settled in MT between January and October 2004 total €9.360 billion and the number of transactions was 17 million.

Main findings

151. **The assessment demonstrates that MT is safe, sound, efficient and reliable.** Furthermore, it observes the CPSS/IOSCO Recommendations for Securities Settlement Systems.

Legal risk (recommendation 1)

152. **The clearing and settlement activities in Italy are governed by a consistent set of laws, regulations and instructions that form a sound legal foundation for clearing, settlement and custody activities.** The regulatory framework is clear and transparent to services providers and market participants. The most important laws are the “Legislative Decree 58/59 on consolidation Law on Financial Intermediation,” the “Legislative Decree 213/98 on the Euro introduction” and the “Legislative Decree 210/2001 on Settlement Finality Directive;” and “the Legislative Decree 170/2004 on Financial Collateral Arrangement.” The laws, regulations and rules in Italy support the enforcing of transactions, protection of customer assets, immobilization and dematerialization, netting, securities lending, and delivery versus payment. There are adequate rules for addressing the event of a participant default, including the effective use of collateral, and these rules can legally be enforced. There is no zero-hour rule in Italy.

Pre-settlement risk (recommendations 2-5)

153. **The straight-through processing (STP) for regulated markets allows electronic confirmation between direct market participants on the trading day.** Indirect participants' transactions can also be confirmed on the settlement day if they have an account with MT. Settlement timing varies between same-day settlement and up to three days for traded securities. For exchange-traded securities timely settlement is guaranteed through the use of a central counterparty (CCP). MT provides an automated securities lending facility and has the necessary sound legal basis.

Settlement risk (recommendations 6-10)

154. **The securities settlement system has adequate measures in place aimed at reducing settlement risks substantially.** In particular, the system operates on both net settlement and real-time gross-settlement (RTGS) basis. This allows the possibility to achieve intraday and real time settlement finality. Both the netting and RTGS systems settle on a delivery versus payment (DVP) basis in central bank money. The net settlement is designed in a manner to avoid counterparty risk. In particular, the net settlement batch is activated only after checking the availability of the securities and cash. This means that the transaction is excluded from the net batch if the assets are not available. In addition, the system provides an automated collateralization mechanism and securities lending facility aimed at reducing settlement failure. The mandatory use of CCP for transactions traded in the equity market allows also the reductions in counterparty risk. However, the level of end-of-day failure remains slightly higher in terms of value of transactions, while it is low in terms of volume. In order to reduce settlement failures to insignificant level in terms of value, MT may consider strengthening its stress testing by analyzing various scenarios for the uncovered cash positions and fine-tuning adjustment of the optimization algorithm.

Operational risk (recommendation 11)

155. **MT has adequate procedures and processes to monitor, identify, and manage operational risk.** Issues related to operational risk is handled by senior managers and checked by the managing director. Second, written documentation is in place in order to handle different contingency scenarios. Third, a "live" secondary site is in place that allows the resumption of operation within a short period of time in the event of malfunctioning of the primary site. However, it is advisable that MT put in place a proactive risk analysis methodology and include market participants in its full back testing. Furthermore, MT should carry out external audit of its procedures and arrangements for disaster recovery and business continuity and for the procedures used by the outsourcing company. Finally, BI and Consob may also wish to consider issuing regulation that allows them to have direct access to the service provider (SIA) that operates the IT platform of MT to check whether the company has adequate measures that ensure disaster recovery and business continuity in the field of clearing and settlement activities.

Custody risk (recommendations 12)

156. **Several technical and institutional arrangements are in place in order to ensure the protection of the customers' securities.** First, all traded securities are issued in dematerialized form. Secondly, specific legislative decrees and BI and Consob regulations have specific provisions that oblige MT and custodians to completely segregate between their own securities holdings and those of their customers. Custodians also have to reconcile on a daily basis the holdings within their own systems with their accounts held at MT. The balance of the securities accounts are subject to external audits.

Other issues (recommendations 13-19)

157. **In general, the governance arrangements for MT are designed to fulfill public interest requirements and to promote the objectives of owners and users.** However, due to the unique position of MT in the Italian financial market, (i.e., de facto monopoly in settlement and custody activities), it would be advisable to increase the number of independent directors at the Board of MT. The operations of MT are cost-effective in meeting the requirements of users.

158. **The role and responsibilities of BI and Consob with respect to securities clearing and settlement activities are clearly defined and transparent to the service providers and the general public.** Furthermore, the cooperation between both authorities is well defined. They cooperate on a regular basis to exchange information, drafting joint instruction and carrying out on-site supervision.

159. **Finally, all the links established by MT are free of payment (FOP).** The links are used to transfer securities without the corresponding cash amount, mainly as collateral for monetary policy operations. MT has carried out risk analysis covering, inter alia, the legal soundness, the protection of customer's holding, finality and operational reliability. Since the links are FOP, no analysis is needed with regard to DVP mechanism or the failure of the participants.

Table 11. Actions to Improve Observance of Monte Titoli of the CPSS/IOSCO Recommendations for Securities Settlement Systems

Reference Recommendation	Recommended Action
<i>Recommendation 5</i>	In order to reduce the legal uncertainty, MT should accelerate the work in developing standardized documentation for the securities lending facility.
<i>Recommendation 9</i>	The level of end-of-day failure remains slightly higher in terms of value of transactions, while it is low in terms of volume. In order to reduce settlement failure to insignificant level in terms of value, MT may consider strengthening its stress testing by analyzing various scenarios for the uncovered cash positions and further fine-tuning adjustment of the optimization algorithm.
<i>Recommendation 11</i>	<p>In order to fully comply with the recommendation, it is recommended that MT:</p> <ul style="list-style-type: none"> - Carry out full-back testing including also market participants; - Develop and implement a proactive risk analysis methodology to ensure that adequate measures will be taken to contain the relevant risks; - Carry out external audit of its procedures and arrangements for disaster recovery and business continuity; - Carry out external audit of SIA’s contingency plans and back-up facilities that ensure smooth and speedy disaster recovery and business continuity. <p>BI and Consob may also consider to issue regulation that allows them to have direct access to SIA to check whether the company has adequate measures that ensure disaster recovery and business continuity in the field of clearing and settlement activities.</p>
<i>Recommendation 13</i>	Due to the unique position of MT in the Italian financial market, (i.e., de facto monopoly in settlement and custody activities), and in order to reduce any concern among MT users with regard to the objectives of the respective company, it would be advisable to increase the number of independent directors at the Board of MT.

Authorities’ response

160. The Italian authorities (IA—BI and Consob) contend that Recommendation 11 has been fully observed. In this respect, the authorities underline that:

- as required, on December 3, 2005, Monte Titoli (MT) conducted a Disaster Recovery Plan (DRP) test, with an extensive involvement of participants and other market infrastructures; the results of the DRP test will be timely disclosed to the IMF staff as soon as available;
- the MT risk analysis framework has been fully successful in “proactively” preventing the materialization of any kind of risks even in the delicate phases of the implementation of services and procedures very complex and totally new;
- as required, an external audit on the MT Business Continuity Plan and Procedures and on SIA’s contingency plans and back-up facilities is being carried out and is expected to be completed shortly; if requested, BI would inform the IMF staff of the main findings of the audit report;
- BI is in the process of consulting the supervised entities on new guidelines aimed at managing and controlling risks arising from outsourced activities; these guidelines, inter alia, explicitly state that the authorities should be allowed to exercise their supervisory powers also with regard to the outsourced activities.

**SUMMARY ASSESSMENT OF OBSERVANCE OF THE CODE OF GOOD PRACTICES ON
TRANSPARENCY IN MONETARY AND FINANCIAL POLICIES—FINANCIAL POLICIES**

Transparency of Banking Supervision

General

161. **In the area of banking supervision, broad objectives are defined in the 1993 Banking Law, as the sound and prudent management of supervised institutions, as well as the overall stability, efficiency and competitiveness of the financial system.**³⁴ The institutional framework and the relationship between financial agencies are defined in both the 1993 Banking Law and the 1998 Consolidated Law. BI has established a structured and comprehensive public information system for the timely dissemination of data and information on policy developments and regulatory changes. Internal governance arrangements, the publication of audited financial statements and statutory provisions governing conflict of interest and staff conduct provide assurances of integrity.

162. **The assessment found that transparency in the conduct of policy may be further consolidated by more specifically explaining the broad objectives of stability, efficiency and competitiveness and openly discussing any potential tradeoffs.** A more extensive discussion of the progress achieved in achieving these objectives would also serve to complement accountability and transparency in BI practices such as the regular reporting on banking supervision activities, key public speeches by its senior officials and the Governor's testimony to Parliamentary committees. At the time of the assessment, while formal procedures for cooperation and the exchange of information were already in place, it was considered that disclosing the practical modalities for cooperation and the type of information that is exchanged would enhance transparency in this policy area.

Main findings summary

Clarity of roles, responsibilities, and objectives of financial agencies

163. **The roles, responsibilities, and objectives of the financial agencies are set out in the legal framework.** The 1993 Banking Law sets out the broad objectives of the credit authorities as being the sound and prudent management of supervised institutions, as well as the overall stability, efficiency and competitiveness of the financial system. The Banking Law and the Consolidated Law regulate the institutional framework and the relationship between financial agencies. The organization, the jurisdiction and the responsibilities of BI are established in its Statute.

³⁴ The assessment was conducted prior to the enactment of the Savings Law on December 28, 2005.

164. **Transparency would be strengthened by more readily explaining the objectives of BI in banking supervision and disclosing the criteria for the dismissal of the heads and members of the governing bodies.**³⁵ In the presence of multiple objectives, it is important for each objective to be disclosed and explained in more depth on an ongoing basis. At present, the objectives are explained in 1994 archives of the Annual Report and the text of related speeches by BI officials. As the analytical and operating framework for banking supervision by BI may evolve, the emphasis it places on these different objectives may change however. The public should be aware of any relative priorities, linkages and potential tradeoffs that may arise. At the time of the assessment, the criteria for dismissing the Governor and members of the Directorate were not clearly disclosed. Subsequently, BI broadened the information contained on its Web site on this issue.

Open process for formulating and reporting of financial policies

165. **The process for formulating and reporting of financial policies is generally transparent.** Financial reporting requirements are disclosed to supervised entities, with which BI engages in two-way communication on significant changes in financial policies. BI reports periodically on new developments in the international framework for banking supervision and its implications for future activities. Formal procedures for BI's cooperation and exchange of information with other financial agencies are articulated in the regulatory framework and at the time of the assessment, information on the actual conduct of such exchanges was not fully disclosed.

166. **Insofar as inter-institutional cooperation is concerned, the assessment noted that the disclosure policy could be broadened to include information on practical modalities, beyond public notification of the date of, and the parties to, an MOU signature.** To supplement the explanation of BI's overall objectives of stability, efficiency and competitiveness, and the discussion of potential tradeoffs, further disclosure of how these objectives are being pursued may also be beneficial for the openness of the process for formulating and reporting of financial policy decisions.

Public availability of information on financial policies

167. **Extensive information on banking supervision is made publicly available through BI documents.** BI has an extensive publications program supplemented by a user-friendly Web site. The publications include the supervisory bulletin (with information on measures issued by the credit authorities and other significant decisions), the Annual Report

³⁵ The Savings Law modified the procedures for the Governor's appointment and dismissal. As regards other members of the Directorate, the BI Statute must be amended in accordance with the provisions of the Savings Law.

(that reviews supervisory activities during the previous year) and periodic statistical bulletins (reporting on credit and financial aggregates). The information contained therein can be consulted via the Internet using an application that allows databases to be accessed directly and free of charge. Financial statements are published on a monthly and annual basis, information on deposit insurance is provided in the BI Annual Report, and, should BI act as lender of last resort, there is a presumption toward aggregate disclosure of liquidity assistance on an ex post basis.

Accountability and assurances of integrity by financial agencies

168. **The accountability of BI is essentially upheld through reporting, whether in conjunction with its publications calendar, or in the context of ICCS deliberations and parliamentary hearings.** There is no pre-specified schedule for the latter; they tend to occur whenever Parliament needs technical advice on subjects related to BI functions and they are not required by law. At the time of this assessment, responsibilities for policy formulation and implementation were vested solely in the Governor, without any other governing body exercising oversight on policy decisions. Financial statements, published in the Annual Report, are audited and fully disclosed, including information on operating expenses and revenues. BI has determined standards for the conduct of personal financial affairs of its officials and staff, as well as rules to prevent exploitation of conflicts of interest. These are either regulated in the BI Statute or available on demand. It must be noted that the BI legal framework does not offer any legal protection to banking supervisors in the conduct of their duties.

Table 12. Plan of Action to Improve Observance of IMF MFP Transparency Code Practices—Banking Supervision

Reference Principle	Recommended Action
V. Clarity of Roles, Responsibilities and Objectives of Financial Agencies Responsible for Financial Policies	
5.1.1 The broad objective(s) of financial agencies should be publicly disclosed and explained.	It was recommended that BI publicly disclose and further explain the objectives of stability, efficiency and competitiveness.
5.1.4 Where applicable, the procedures for appointment, terms of office, and any general criteria for removal of the heads and members of the governing bodies of financial agencies should be publicly disclosed.	It was recommended that BI publicly disclose the applicability of Article 14.2 of the ESCB Statute as regards the dismissal of the Governor and the general criteria for removal of the heads and members of the governing bodies in the absence of such provisions in the BI Statute. Further to this recommendation, BI has amended the on-line pamphlet entitled “le persone e l’organizzazione.” The recently adopted Savings Law now explicitly mentions Art. 14.2 of the ECSB statutes for the Governor’s dismissal procedures.
VI. Open Process for Formulating and Reporting Financial Policies	

Reference Principle	Recommended Action
6.1.5 Where applicable, formal procedures for information sharing and consultation between financial agencies (including central banks), domestic and international should be publicly disclosed.	It was recommended that BI publicly disclose the details on protocols that define the practical modalities of cooperation between domestic financial agencies, and the actual procedures that are followed for information sharing. Further to this recommendation, the MOU governing the cooperation and exchange of information between BI and Consob was made public on the Web sites of the two institutions.

Authorities' response³⁶

169. BI notes the assessment's recognition of the very high degree of compliance of the Italian banking supervisory system with the IMF Code of Good Practices on Transparency in Monetary and Financial Policies (MFPT Code). The assessment highlights such positive features as: (i) the extensive information on banking supervision made publicly available through the Annual Report, the publication of all general measures in the *Gazzetta Ufficiale della Repubblica Italiana* and in the *Bollettino di vigilanza*, the wide-ranging and detailed statistical publication program, the frequent Parliamentary hearings and speeches by the Governor, other top officers and senior officials; (ii) BI's cooperation with other domestic and foreign financial agencies in day-to-day activities through exchange of information and coordinated action (the Memorandums of Understanding with Consob and ISVAP are available on both authorities' Web sites); (iii) the practice of public consultation with market participants on significant regulatory changes.

170. Practice 5.1.1. BI observes that the Annual Report contains a section (about 100 pages in length) setting out the criteria, methods and results of supervisory activities, fulfilling the accountability obligation established by the 1993 Banking Law. The objectives of the banking supervisory function were explained initially in the 1993 Annual Report. Since then all relevant supervisory issues have been regularly discussed. For instance, the 2003 Annual Report has a detailed description of criteria and methods of supervision, while the 2004 Report focuses on regulatory changes such as the implementation of Basel II and IAS/IFRS, structural changes in the banking system such as international openness, and methods of macroprudential analysis. That is to say, the objectives for which the Bank is responsible are explained on an ongoing basis and that any significant modification of the Bank's stance is announced in a timely fashion. The Savings Law now provides for half-yearly reporting to both Parliament and Government.

³⁶ All the sections of this summary assessment entitled "Authorities' Response" were drafted by BI and are dated January 2006.

171. BI is studying the possibility of bringing out a new report on the evolution of the Italian banking and financial system and the issues relevant to its regulatory and supervisory mandate.

172. As regards links between the different objectives set out in Article 5 of the Consolidated Law on Banking (1993)—sound and prudent management of individual banks, the overall stability, efficiency and competitiveness of the financial system, and compliance with the provisions concerning credit—legislators deemed the objectives to be strictly complementary. BI shares this view, in that competition is essential to efficiency (both operating efficiency and in the allocation of resources) and hence to financial stability. More specifically, the stability and the efficiency of the banking system are objectives common to all supervisory authorities; and competitiveness, including that of the system as a whole, has been interpreted as referring to the necessity that the prices and the quality of the products and services offered by Italian banks meet the needs of firms and households.

173. As regards the dismissal of the Governor, BI observes that Article 19.8 of the Savings Law established a new procedure for the appointment and dismissal of the Governor that refers to article 14.2 of the ESCB/ECB Statute as being directly enforceable in all Member States; the grounds for its application are found in the principle of equal treatment throughout the ESCB. Without prejudice to remedies provided by national jurisdictions, to ensure uniform judgment in all the Member States on this matter, any decision concerning the dismissal of a Governor may be referred to the Court of Justice by the Governor concerned or by the Governing Council of the ECB on grounds of infringement of the Treaty or of any rule of law relating to its application. BI Statute provides for the appointment and dismissal of the Director General and the two Deputy Directors General. The principles and criteria for dismissal are specified in the general administrative law framework on public duties and in case law, according to which officials may be removed for failure to act in accordance with the purposes of their institutions. The EMI and ECB Convergence Reports and the ECB opinion imply that the safeguards against arbitrary dismissal in the ESCB/ECB Statute also apply to the Director General and the two Deputy Directors General who perform ESCB-related tasks. This applies in particular where they serve as deputy for the Governor.

174. As regards responsibilities for policy formulation and implementation, the Savings Law has attributed them to the whole Directorate.

Transparency of Payment System Oversight

General

175. **BI's oversight of payment systems is characterized by high levels of transparency, benefiting from clarity in the EU-wide institutional framework and actively contributing to its timely disclosure of policy developments and exchange of information.** The statutory mandate of efficiency and reliability in payment systems established in the 1993 Banking Law was redefined by BI in its 2004 Oversight Provisions, setting out the objectives of financial, market and systemic stability, competitive and fair

markets, client asset protection and regulatory enforcement. An active communication policy, based on a comprehensive publications and reporting program, serves to explain the instruments with which BI operates. In particular, a White Paper issued in 1997 explains the institutional framework and guiding principles while another, issued in 1999 provides a detailed analysis of methods of intervention and areas of interest.

176. BI routinely discloses the progress toward achieving its policy objectives, and engages in two-way communication with the markets. In addition to BI regular publications, strategic, operational and technical papers are the vehicle through which the oversight function informs and informally consults market operators (including financial intermediaries, service providers, and managers of infrastructures) on major reforms in payment clearing and settlement systems. Accountability of the payment system oversight function is upheld through the regular reporting and internal governance arrangements (including the publication of audited financial statements and statutory provisions governing staff conduct) provide further assurances of integrity.

Main findings summary

Clarity of roles, responsibilities, and objectives of financial agencies

177. The institutional framework for payment system oversight is defined in EU and national legislation and supporting regulations, setting out the relationship between the ESCB, the ECB and BI. The modalities for cooperation between BI and its international counterparts are clearly established through publicly disclosed MOUs. At a national level, the organization, the jurisdiction and the responsibilities of BI are also established in its Statute, and complemented by the 2004 set of payment system oversight provisions. The objectives of BI in its oversight of payment systems are clearly defined and explained through its publications, particularly the two White Papers issued in 1997 and 1999. The remarks on transparency of dismissal criteria for the heads and members of the governing bodies in the area of banking supervision may be reiterated since they apply to BI across all policy areas.

Open process for formulating and reporting of financial policies

178. The process for formulating and reporting of policy instruments and decisions in the area of payment system oversight relies on transparent regulatory framework and operating procedures. The process whereby BI shares information and consults its international counterparts is well documented. Significant changes in the conduct of policy are publicly explained and disclosed in a timely manner through periodic reports. In particular, BI usually publishes strategic, operational and technical papers to inform and informally consult market operators on major reforms in payment clearing and settlement systems. Consultations on ad hoc projects are proposed substantive changes to the regulations are also held with interested parties.

Public availability of information on financial policies

179. **BI, in its oversight of payment systems, issues extensive information through its publications program.** As mentioned above, financial statements are publicly disclosed on a preannounced schedule, although they do not single out the policy functions of BI but consider its activities as a whole. Information on payment system oversight is made publicly available through speeches by BI and ECB representatives, the text of which is generally posted on the relevant Web sites.

Accountability and assurances of integrity by financial agencies

180. **Over and above regular reports issued by BI within its publications program, and the possibility of responding to requests for Parliamentary hearings, accountability of payment system oversight is also upheld at the level of the Eurosystem through financial reporting rules and the ECB communications policy.** Providing assurances of integrity, BI Statute includes rules concerning conflicts of interests of BI’s officials and governing bodies, and general rules on staff conduct. BI functions and organizational structure are also explained in a pamphlet, available on its Web site, disclosing the existence of an Internal Inspectorate.

Table 13. Plan of Action to Improve Observance of IMF MFP Transparency Code Practices—Payment System Oversight

Reference Principle	Recommended Action
V. Clarity of Roles, Responsibilities and Objectives of Financial Agencies Responsible for Financial Policies	
5.1.4 Where applicable, the procedures for appointment, terms of office, and any general criteria for removal of the heads and members of the governing bodies of financial agencies should be publicly disclosed.	It was recommended that BI publicly disclose the applicability of Article 14.2 of the ESCB Statute as regards the dismissal of the Governor and the general criteria for removal of the heads and members of the governing bodies in the absence of such provisions in the BI Statute. The recently adopted Savings Law now explicitly mentions Art. 14.2 of the ECBS Statute for the Governor’s dismissal procedures.

Authorities’ response

181. BI considers that the assessment recognizes the high degree of transparency which characterizes the policy for payment system oversight.³⁷ The interaction with the IMF representatives has been very fruitful and the discussions highlighted a number of issues

³⁷ As regards the dismissal of the Governor of BI see paragraph 175.

which will influence positively also the future behavior of the agency. With regard to the institutional framework (point 5.1), BI has recently approved a new legislation which will implement a number of changes in the management of BICOMP, the retail payment system managed by BI itself. The new legislation—together with an explanatory note—will be published not only on the *Gazzetta Ufficiale della Repubblica italiana* but also on the BI's Web site, in order to enhance the awareness of the public on oversight objectives and institutional decisions taken on this issue. The draft provisions together with the opinion released by the ECB is already available on the ECB Web site.

Transparency of Securities Regulation

General

182. **In the area of securities regulation, the objectives and responsibilities of the two supervisory authorities, namely Consob and BI, and the modalities of cooperation between them, are clearly established in the 1998 Consolidated Law.** An area where further clarity may be warranted concerns the practical modalities of exchanging information with other domestic institutions. The regulatory framework is publicly disclosed and explained, through the two institutions' comprehensive publications program, a multi-faceted communication strategy including educational efforts and officials' public speeches, and a presumption in favor of consulting securities market participants. Regular reporting and testimony before the Ministry of Economy and Finance and/or Parliament also upholds accountability in this policy area, while internal governance arrangements, audited financial statements and rules on staff conduct provide further assurances of integrity.

Main findings summary

Clarity of roles, responsibilities, and objectives of financial agencies

183. **The broad objectives and the institutional framework of Consob and BI in securities regulation are defined in the 1998 Consolidated Law.** The responsibilities of the two institutions and their broad modalities of accountability are also set out in the law. In addition to BI channels of reporting, Consob submits a report to the Ministry of Economy and Finance (subsequently presented to Parliament) on an annual basis and presents its activity and sectoral prospects to market participants. While the terms and mandates of the head and members of governing bodies are publicly disclosed as far as Consob is concerned, at the time of the assessment, BI suffered from a lack of clarity of the grounds for dismissal.

Open process for formulating and reporting of financial policies

184. **The assessment found that securities regulatory policies are carried out in a transparent manner by Consob and BI, although it noted that the clarity of information exchange and consultation between them and other domestic financial agencies could be improved.** While the law requires Italian financial agencies to cooperate and broadly defines the objectives of their cooperation, the protocols that define the practical modalities of their

cooperation and information sharing were not made public at the time of the assessment. Both Consob and BI engage in two-way communication with market participants: significant policy changes are disclosed and explained in a timely manner and are usually preceded by a consultation process.

Public availability of information on financial policies

185. **Information on securities markets is provided to the public through the annual publications posted on the Consob and BI Web sites, supplemented in coverage, timeliness and frequency by weekly notes for Consob and the Monthly Bulletin of BI.** The publications program is complemented by a proactive communication strategy in which Consob strives to improve investor education, thereby enhancing investors’ ability to protect themselves. Among the data issued by Consob is information on persons holding significant shares in the capital of listed Italian companies. BI also maintains and disseminates an extensive database on activities of market operators in wholesale markets for government securities and management companies in the field of post trading.

Accountability and assurances of integrity by financial agencies

186. **To ensure that both Consob and BI are held accountable for the conduct of policies in the area of securities regulation, they regularly report to a designated public authority.** Internal governance, auditing arrangements and rules on staff conduct provide an assurance of integrity in Consob and BI operations. The budget and the financial statements of Consob, which provide detailed information on the use of its resources, are made available to the public on Consob’s Web site and in the Official Journal. BI also publishes audited financial statements with information on revenues and expenses, although these cover all BI activities and do not distinguish its capacity as securities regulator.

Table 14. Plan of Action to Improve Observance of IMF MFP Transparency Code Practices— Securities Regulation

Reference Principle	Recommended Action
V. Clarity of Roles, Responsibilities and Objectives of Financial Agencies Responsible for Financial Policies	
5.1.4 Where applicable, the procedures for appointment, terms of office, and any general criteria for removal of the heads and members of the governing bodies of financial agencies should be publicly disclosed.	It was recommended that BI publicly disclose the applicability of Article 14.2 of the ESCB Statute as regards the dismissal of the Governor and the general criteria for removal of the heads and members of the governing bodies in the absence of such provisions in the BI Statute. The recently adopted Savings Law explicitly mentions Art. 14.2 of the ECSB Statute for the Governor’s dismissal procedures.
VI. Open Process for Formulating and Reporting Financial Policies	

Reference Principle	Recommended Action
6.1.5 Where applicable, formal procedures for information sharing and consultation between financial agencies (including central banks), domestic and international should be publicly disclosed.	It was recommended that BI publicly disclose the details on protocols that define the practical modalities of cooperation between domestic financial agencies, and the actual procedures that are followed for information sharing. Further to this recommendation, the MOU governing the cooperation and exchange of information between BI and Consob was made public on the Web sites of the two institutions.

Authorities' response

187. BI and Consob consider that **the assessment recognizes a very high degree of compliance of the Italian supervisory system with the IMF Code** of Good Practices on Transparency in Monetary and Financial Policies (MFPT Code) for securities supervision.³⁸ The assessment shows that the objectives and responsibilities of the two supervisory authorities and the modalities of cooperation between them are clearly established in the 1998 Consolidated Law. The regulatory framework is publicly disclosed and explained.

³⁸ As regards the dismissal of the BI Governor see paragraph 175.

SUMMARY ASSESSMENT OF OBSERVANCE OF STANDARDS AND CODES FOR ANTI-MONEY LAUNDERING AND COMBATING THE FINANCING OF TERRORISM (AML/CFT)

Introduction

188. **This Report on the Observance of Standards and Codes for the FATF 40 Recommendations 2003 for Anti-Money Laundering (AML) and 9 Special Recommendations on Combating the Financing of Terrorism (CFT) was prepared by a team composed of staff of the Fund and an expert under the supervision of Fund staff using the AML/CFT Methodology 2004.**³⁹

189. **The report provides a summary of the level of observance with the FATF 40+9 Recommendations, and provides recommendations to strengthen observance.** The views expressed in this document are those of the assessment team and do not necessarily reflect the views of the government of Italy or the Board of the IMF.

Information and Methodology Used for the Assessment

190. **In preparing the detailed assessment, Fund staff reviewed the institutional framework, the AML/CFT laws, regulations, guidelines and other requirements, and the regulatory and other systems in place to deter money laundering and the financing of terrorism through financial institutions and designated non-financial businesses and professions (DNFBPs), as well as examining the capacity, the implementation and the effectiveness of all these systems.** The assessment is based on the information available at the time of the on-site visit by the team April 4–19, 2005, and immediately thereafter.

Main Findings

191. **Italy has a comprehensive AML/CFT system set up initially in 1991 and updated a number of times.** The law enforcement efforts against money laundering have been quite successful: almost 600 cases lead to conviction every year, which is one of the highest rates in Europe. Based on three different systems of confiscation of criminal assets, law enforcement confiscated over €130 million in criminal proceeds in 2004.

192. **The financial intelligence unit, the *Ufficio Italiano dei Cambi* (UIC), has an advanced system of computerized data collection.** Insufficient filtering at the level of the UIC limits the effectiveness of the system, and does not allow for an immediate feedback to the reporting entities.

³⁹ The mission was composed of Jean-François Thony (LEG), team leader, Richard Lalonde (MFD), Nadine Schwarz (LEG), Maud Bökkerink (MFD) and Michael DeFeo (LEG Consultant).

193. **While quite sophisticated, the AML/CFT preventive system has generally not been updated to reflect the revised FATF standard and the 2001 EU Directive on Money Laundering.** There is a high degree of awareness and broad implementation of AML/CFT preventive measures within the financial sector, as well as good cooperation between supervisory authorities.

194. **More efforts are needed by supervisors to ensure that the legal framework is effectively implemented by all reporting entities.** The most pressing challenges concern the need to i) implement the more detailed customer due diligence (CDD) requirements of the revised standard; ii) increase levels of suspicious transaction reporting of non-bank financial intermediaries and introduce a legal obligation to report transactions suspected of being related to terrorist financing; iii) increase on-site inspection efforts and resources for the securities and insurance sectors, Bancoposta and non-prudentially supervised entities; and iv) ensure the application of a more effective sanctions regime.

195. **The authorities are paying due attention to implementing the revised standard and to further strengthening the AML/CFT regime.** The existing AML/CFT legal framework is very complex and would gain in clarity and effectiveness if it were consolidated in a single instrument. The legal framework for DNFBPs, adopted in 1999 and 2004, urgently needs to be implemented by finalizing the draft regulations. A law to ratify the Palermo convention is under consideration by parliament, provisions to strengthen the terrorist asset freezing regime are to be adopted soon, according to the authorities, and supervisory resources are being increased for to the securities sector.

General

General Situation of Money Laundering and Financing of Terrorism

196. **Italy has historically suffered from a high rate of criminality, organized violence and penetration of political and economic life by organized crime groups.** The organized crime problem has become less visible in recent years, but diversion of funds from public contracts by groups like the Sicilian Mafia is still a law enforcement concern. On the mainland drug trafficking and distribution, loan-sharking, extortion and trafficking in smuggled cigarettes are lucrative activities for criminal groups. Because of more developed economic activity in north and central Italy, laundered funds from criminal activity elsewhere are often invested in properties and enterprises in those areas. The country has one the highest cash payment ratios in Europe, and tax fraud that exists in sectors such as real estate provides a favorable environment to money laundering.

197. **Terrorist financing has been the subject of highly publicized prosecution and is considered by the authorities to be a risk among large communities of legal and illegal immigrants.** Italy has been under specific terrorist threats since the war in Iraq.

Overview of the Financial Sector and DNFBNs

198. **The financial sector is characterized by a wide range of service providers.** The banking sector remains a core source of funding for the domestic economy. The UIC has primary responsibility for AML/CFT supervision of prudentially regulated financial institutions—a responsibility exercised in collaboration with the Bank of Italy (BI), the prudential supervisor for banks, Bancoposta, and securities and asset management firms; the *Commissione Nazionale per le Società e la Borsa* (Consob), the market conduct supervisor for securities and asset management firms; and the *Istituto per la Vigilanza sulle Assicurazione Private e di Interesse Collettivo* (ISVAP), the supervisor of insurance companies and brokers. The *Guardia di Finanza* (GdF), the financial police, is responsible for monitoring non-prudentially supervised entities, including bureaux de change and money transfer agents.

199. **The most important DNFBNs that Italy will include within the AML/CFT framework are lawyers, notaries, accountants, real estate agents, dealers in gold, and casinos.** Although legislation has been adopted bringing these professions within the scope of the AML law, further implementing regulations are required. AML/CFT supervisory authorities have not been designated for these businesses and professions.

Legal Systems and Related Institutional Measures

200. **The offence of money laundering is defined in line with the definition in existing conventions, and extends to the proceeds from any crime committed intentionally.** The offence does not extend to the author of the predicate offence (“self-laundering”). Money laundering is punished by 4 to 12 years of imprisonment, and by fines of a maximum of €15,240. While the imprisonment penalty provided by law is in line with normal standards, fines seem extremely low for a financial crime which can generate considerable amounts of proceeds. There is no penal liability for legal persons, but a system of administrative liability in the case of the commission of some penal offences committed by legal persons, which include financing of terrorism but not money laundering at present.

201. **The definition of terrorist financing is not fully consistent with the existing standards, as some key elements of the offence, like terrorism or financing are not defined, and it does not extend to individual acts of terrorism.** A law adopted on July 31, 2005, extended the definition of terrorist actions by adding two new offences: enlisting and training with the objective of terrorism.

202. **The law provides a very comprehensive and far-reaching confiscation framework based on a threefold approach: a traditional conviction-based confiscation of assets derived from the offence, a system of confiscation based on the alleviation of the burden of proof for convicted persons who cannot justify the origin of their assets, and a preventive system of confiscation for assets in possession of persons belonging to mafia-type organizations.** Law enforcement agencies are provided with more than adequate

legal means to identify, trace and seize criminal and terrorist assets and the statistics illustrate the efficiency of the system in place.

203. **Italy implements the decisions of the UN Security Council on the freezing of terrorist assets through EU Regulations, but also through national mechanisms.** In particular, the preventive system of seizure and confiscation of mafia-type assets has been extended to national and foreign suspected terrorists. The Financial Security Committee (FSC), established immediately after September 11, 2001, coordinates the implementation of these measures. It also decides about the submission to the UN of names of suspected terrorists: to date the names of 67 individuals and 15 entities have been submitted. Although there is no limitation as to the scope of the freezing of terrorist financial assets, the process of freezing of non-financial assets should be improved.

204. **The financial intelligence unit functions are carried out since 1997 by the UIC, an instrumental entity of BI.** Until 2004, the UIC has received around 36,000 suspicious transaction reports (STRs). One of the functions of the AML department of the UIC, composed of 109 personnel, is to collect, analyze and disseminate these STRs. The UIC uses a very elaborate computerized system to analyze aggregate data sent by reporting entities whereby STRs are checked against the information available to the UIC. This, however, does not include law enforcement information other than criminal records. The UIC is required by law to send almost all STRs to the Anti-Mafia Investigative Directorate (DIA) and the GdF for further consideration. Insufficient filtering at the level of the UIC limits the effectiveness of the system, and does not allow for an immediate feedback to the reporting entities. Also, guidance to reporting entities and general information through public annual reports is limited.

205. **The authorities are to be commended for the efficiency of AML/CFT law enforcement and prosecution efforts, which benefit from years of fight against organized crime and terrorism.** Three main police bodies, the State Police, the GdF and the Carabinieri, collaborate under the coordination of the Ministry of Interior. The National Anti-Mafia Directorate (DNA) and the DIA provide specific expertise and coordination for anti-mafia efforts. These bodies are adequately staffed and empowered with advanced legal powers to address all forms of organized crime and terrorism. As a result, Italy has a record of prosecutions in money laundering cases (around 600 per year) which scores among the best in the region. Despite the efforts of the authorities, the number of prosecutions has been limited to some 29 convictions for promoting, managing or financing terrorism in the period 2000-2004. The new law of July 31, 2005, strengthens investigative powers in terrorism matters aiming to improve the rate of prosecutions and convictions.

206. **Italy has implemented before most FATF countries measures to prevent the laundering of criminal assets through cross-border cash couriers, by establishing a system of declaration of cross-border transportation of funds, even by mail.** The Customs Agency and the GdF implement these measures using the necessary law enforcement powers. They forward all declarations, as well as information on suspicious

funds and non- or falsely declared funds to the UIC for analysis. These agencies seize on average per year more than €25 million as a result of these types of violations or suspicions.

Preventive Measures—Financial Institutions

207. **Sectoral coverage under AML/CFT requirements is comprehensive and the authorities have not exempted any sectors on the basis of risk.** In some instances the sectoral coverage has gone beyond the standard (e.g., tax collection agencies).

208. **Financial institutions are required to collect and record a wide range of customer identification data.** Any person who a) opens/changes/closes a business relationship, or b) carries out a single transaction, or several linked transactions of €12,500 or more, must be identified and the identifying details of the person on whose behalf the transaction is carried out must be recorded. A transaction cannot be executed if the financial institution cannot satisfactorily complete CDD. However, CDD is not required for occasional transactions below a €12,500 threshold that are wire transfers.

209. **In February 1993, the BI issued “Operating Instructions for identifying suspicious transactions,” the so-called “Decalogo,” which is legally binding on all reporting entities.** The Decalogo, which was updated in 1994 and 2001, instructs financial intermediaries to acquire a “thorough knowledge of the customer” to enable them to establish a risk profile of customer relationships and how the accounts will be operated. However, with respect to customers that are legal persons, there are no specific requirements in law or regulation to verify that the person purporting to act on behalf of the legal person is so authorized or to verify the legal status of the legal person.

210. **While the AML Law requires financial institutions to identify any person on whose behalf the transaction is carried out, there is no specific requirement in law or regulation to take reasonable measures to understand the ownership and control structure of a customer that is a legal person or to determine who are the natural persons that ultimately own or control the customer.** While financial institutions may accept as customers trusts established abroad or in Italy under foreign legislation, there is no requirement regarding the identification of the settlor, trustee and beneficiaries.

211. **Anonymous accounts are not permitted, but credit institutions and Bancoposta provide bearer passbook accounts, provided the balance is €12,500 or less.** Although CDD must be carried out upon issuance and upon closure, and, according to industry guidance and civil law principles, for any transaction at lower thresholds. However, the passbooks can be transferred anonymously between these events without limitation. The mission is not aware of any evidence of secondary market trading of such passbooks for criminal purposes and the authorities note that neither STRs nor border controls have so far detected such trading. However, their anonymous transferability poses a significant challenge for financial institutions to conduct ongoing due diligence throughout the life of the business relationship with the “customer.”

212. **While the Decalogo calls for precautionary measures to be taken with respect to electronic money and “distance banking,” there are no requirements for enhanced due diligence for higher risk categories of operations, transactions or customers—such as politically exposed persons (PEPs), nor are there provisions allowing discretion to apply simplified due diligence.**

213. **Financial institutions may rely on third parties to conduct CDD, but retain ultimate responsibility for fulfilling this obligation.** They must collect identification data from the third party and must ascertain that the third party has its head office in an FATF member country or the third party must certify that its foreign branch complies with the FATF standard. However, this does not fully satisfy FATF requirements that financial institutions take adequate steps to satisfy themselves that copies of identification data can be readily obtained from the third party or that the third party be regulated and supervised in accordance with FATF Recommendations.

214. **One unique feature of the Italian AML/CFT regime is that all the entities subject to the CDD requirements must file in a single and easily accessible computerized database, the *archivio unico informatico* (AUI), all information pertaining to the opening and the closing of an account, as well as transactions above €12,500, and must maintain these data for a period of ten years.** Financial institutions are not required to include originator information on wire transfers nor to have procedures in place to deal with incoming transfers with incomplete originator information.

215. **The Decalogo requires financial institutions to develop detailed customer profiles, review the operation of accounts against these profiles and to pay special attention to anomalous transactions.** Findings concerning anomalous transactions are to be recorded even if no STR was filed with the UIC. Special attention must also be paid to transactions involving persons located in countries and territories listed as non-cooperative by the FATF, tax havens published by the OECD, and to countries where drug trafficking is a notable problem. Beyond this, there is little guidance on how financial institutions should identify countries that lack appropriate AML/CFT measures.

216. **Every transaction which leads to believe that the money, assets or benefits involved might be derived from an intentional crime of money laundering must be reported to the UIC, where possible before carrying out the transaction.** Banks make extensive use of computer systems to screen transactions; they are the main reporting institutions responsible for almost 90 per cent of all STRs. Cash withdrawals and deposits make up for 40 per cent of the reported transactions. The frequency of reporting by non-bank financial intermediaries is disproportionately low. Systematic feedback is not provided to the reporting entities.

217. **While the mandate of the UIC extends to combating the financing of terrorism, the reporting obligation does not formally extend to this.** The authorities have issued circulars that require such a reporting. However, as is the case for money laundering, the reporting obligation for financing of terrorism should be based on an explicit legal provision

set in a law, not a circular. Since 2001, some 2000 STRs have been filed with the UIC in respect to CFT.

218. **The AML Law requires financial institutions to establish adequate internal controls and provide training for their staff.** The Decalogo provides more detailed guidance. Internal control requirements are generally well developed for and implemented by prudentially supervised financial institutions. They are far less well developed and implemented in other sectors.

219. **The Banking Law effectively precludes the establishment of a shell bank in Italy.** On the other hand, there are no CDD provisions for banks regarding the establishment of (cross-border) correspondent banking relationships, including with shell banks, nor are financial institutions prohibited from establishing relations with respondent foreign financial institutions that permit their accounts to be used by shell banks. Moreover, exemptions from CDD requirements extend to cross-border interbank transactions, regardless of whether the customer bank is located in a country that effectively implements the FATF Recommendations.

220. **Notwithstanding the strengths and weaknesses in the legislative framework noted above, the financial institutions the mission met appear to implement the legal requirements and, in particular, the Decalogo.** That said, the organizational and internal controls provisions of the Decalogo are difficult to enforce beyond the prudentially supervised sectors.

221. **UIC has overall responsibility for supervising AML/CFT compliance of prudentially supervised intermediaries; a responsibility carried out in collaboration with BI, Consob, ISVAP.** The GdF supervises AML/CFT compliance of non-prudentially supervised entities. This supervisory regime places a high premium on effective coordination and cooperation between the supervisors aiming to avoid overlap and duplication and to ensure that financial intermediaries are effectively supervised and in a consistent manner. Coordination and cooperation is effected through MOUs between the UIC and each of the supervisors and in practice, there is extensive cooperation.

222. **The supervisors of prudentially supervised intermediaries are appropriately structured and have appropriate powers to ensure compliance with prudential and market conduct requirements.** Although there are different supervisory goals and approaches, taken together AML/CFT supervision of these intermediaries is consistent. However, the supervisory approach with respect to non-prudentially supervised entities is not on par with that of the prudentially supervised ones. The resources and efforts directed to AML/CFT supervision and on-site inspections with respect to the securities and insurance sectors, Bancoposta and non-prudentially supervised financial entities are insufficient. Consob has recently been given a significant increase in resources, some of which will be earmarked for on-site inspections of the securities sector.

223. **The sanctions regime does not appear to be as effective, proportionate and dissuasive as it should be and is relatively complex.** The application of sanctions appears to be heavily skewed toward violations in record-keeping requirements and requirements not covered by the FATF Recommendations (e.g., controls on cash transfers). Indeed, there have been few sanctions imposed on failures to report suspicious transactions and deficiencies in internal controls. There are no sanctions for deficiencies in internal controls and training, notably for non-prudentially supervised entities.

224. **Measures in place for ensuring the integrity of financial institutions are generally appropriate.** Enforceable guidelines have been issued by nearly all supervisory authorities and in the case of the Decalogo and UIC guidance, apply to all reporting entities. However, little guidance is provided for identifying suspicious transactions possibly linked to terrorist financing.

225. **The UIC registers money transfer providers, and either the UIC or the GdF supervises them for AML/CFT compliance.** The UIC inspects providers that are authorized to execute cash transactions over €12,500 whereas the GdF focuses mainly on illegal providers. These inspection policies should be reviewed to ensure that all money transfer agents and subagents are adequately monitored for AML/CFT compliance.

Preventive Measures—Designated Non-Financial Businesses and Professions

226. **Although Italy has brought a long list of DNFBPs within the remit of the AML law, the required implementing regulations have not yet been promulgated.** As such, the DNFBPs are effectively not yet covered by AML/CFT regime. The authorities expect these implementing regulations to come into force before the end of 2005. Guidelines have also not been issued for the DNFBPs. Moreover, the AML law does not extend to independent legal professionals, internet casinos, dealers in precious stones and dealers in (other) precious metals.

227. **The authorities have not yet designated a supervisor for the DNFBPs, nor have they arranged additional supervisory capacity and resources that will be required. Lawyers, notaries and accountants have national and regional professional orders that have a general supervisory role.** These national orders have been consulted with respect to the implementing regulations.

Legal Persons and Arrangements and Non-Profit Organizations

228. **Listed joint stock companies may issue both nominative and bearer shares, and are required to publish lists of their shareholders and lists of persons who hold rights on securities.** However, the use of bearer shares is limited to specific circumstances and, according to the authorities, the shares are subject to dematerialization. They are therefore *de facto* no longer anonymous and do not appear to create a risk in terms of knowledge of the beneficial ownership and control of legal entities.

229. **Italian legislation does not specifically provide for legal arrangements such as trusts.** Foreign trusts may be handled by financial intermediaries, however, there are no legal requirements in respect of foreign trusts and the application, by analogy, of the CDD provisions of the AML law would not be sufficient to meet the standard.

230. **Italy has taken various measures in relation to non-profit organizations.** BI has issued operating guidelines that require financial intermediaries to pay special attention to relationships with NPOs and report suspicions to the UIC. A special fiscal category, *Organizzazioni non-lucrate di utilità sociale* (ONLUS), has been introduced to extend tax benefits to NPOs. The ONLUS Agency, created in 2000, and the Tax Revenue Agency are in charge of overseeing and inspecting all NPOs.

International Cooperation

231. **Italy is party to most international relevant AML/CFT instruments except for the Palermo Convention, which ratification has been pending in parliament since 2003.** An extensive network of international cooperation agreements exists. Italy seems to be an active and cooperative international criminal justice partner, as demonstrated by favorable comments made by other FATF members. The UIC has adequate powers for international cooperation, and can legally provide spontaneous information to counterparts.

Other Issues

232. **The legal framework for AML/CFT is scattered in more than 60 relevant laws and regulations, in addition to the circulars and other guidance.** The mission strongly recommends the consolidation and streamlining of all pertinent legislation in a unified text, to improve its clarity and effectiveness.

SUMMARY ASSESSMENT AGAINST THE FATF RECOMMENDATIONS

233. **Overall, Italy's current AML/CFT framework is comprehensive and has contributed to maintaining the integrity of the financial system; it achieves a satisfactory degree of compliance with most of the FATF 40+9.** Law enforcement efforts against money laundering have been successful. The efficiency of the financial intelligence unit is hampered by limitations in the processing of STRs. The AML/CFT preventive system is quite sophisticated, but needs to be updated to incorporate the new features of the revised FATF standard. More effort needs to be devoted by supervisors to ensure the legal framework is effectively implemented by reporting entities. The table below summarizes recommended actions in areas related to the FATF 40+9 Recommendations.

Table 15. Recommended Action Plan to Improve the AML/CFT System

FATF 40+9 Recommendations	Recommended Action (listed in order of priority)
2. Legal System and Related Institutional Measures	
Criminalization of Money Laundering (R.1 & 2)	<ul style="list-style-type: none"> • Penal liability of legal persons should be provided by law, or if it is not possible, money laundering should be added to the list of offences for which administrative liability can be sought, as proposed in the draft law of ratification of the UN Convention on Transnational Organized Crime. However, more deterrent sanctions should be provided. • Fines established for money laundering (maximum of €15,240) are far too limited. To strengthen the deterrent effect of imprisonment penalties and for an effective financial retribution it is suggested to increase the maximum amount of fines. • Although it is not a requirement under FATF Rec. 1 for countries which consider that it is contrary to general principles of penal law, it is recommended to criminalize self laundering. Countries with similar legal systems are progressively moving to including self laundering as a punishable offence. Law enforcement agencies pointed out the difficulties resulting from this situation. • Authorities may wish to consider clarifying the language of the law and to provide for a definition of assets which includes indirect proceeds of crime.
Criminalization of Terrorist Financing (SR.II)	<ul style="list-style-type: none"> • The definition of the offence should be made consistent with that provided by the 1999 convention. Alternatively, there should be a definition of the concept of “financing,” including with regard to the type of funds and assets which can serve the purpose of financing terrorism. • This definition should include the financing of “individual” terrorists and not be limited to the financing of terrorist associations. • More deterrent sanctions should be provided in the framework of administrative liability of legal persons.
Confiscation, freezing and seizing of proceeds of crime (R.3)	<ul style="list-style-type: none"> • It is recommended to give a broad definition of assets subject to confiscation that would include proceeds indirectly derived from the offence, or assets intermingled with criminal proceeds. A system of confiscation of assets of equivalent value should be considered (as currently proposed in the draft law on the ratification of the Palermo Convention). The law should allow for the confiscation of assets, regardless of whether it is held or owned by a criminal defendant or by a third party. • Authorities could consider extending the power to manage seized assets proposed by the draft law on terrorism financing to cases of assets seized in the course of an AML investigation. An agency to manage and dispose of seized and confiscated assets, for AML as well as for CFT, would strengthen the efficiency of the seizure and confiscation measures, as it is the case in a number of other countries.

	<ul style="list-style-type: none"> • The power to void transactions or dealings on assets belonging to persons listed on terrorism financing lists should be extended to persons against whom an AML investigation is conducted.
Freezing of funds used for terrorist financing (SR.III)	<ul style="list-style-type: none"> • Authorities should institute a notification system to inform banks of list updates, they should enhance the monitoring mechanism to check the even implementation of freezing measures and should effectively apply sanctions to financial and non-financial sectors in case of violation of the EC regulations and guidelines. • Procedures should be instituted to protect the rights of <i>bona fide</i> third parties. • Authorities are encouraged to adopt the measures detailed in the draft law addressing the issue of freezing assets other than bank accounts. This draft could also include some provisions to institute the procedures mentioned above.
The Financial Intelligence Unit and its functions (R.26, 30 & 32)	<ul style="list-style-type: none"> • The <i>Servizio anti-riciclaggio</i> of the UIC should improve its filtering function and send to police authorities only STRs where suspicion can be substantiated. • To achieve this objective, it is recommended that the UIC be granted access to law enforcement information during the analysis process so that it can perform a more effective screening function. Furthermore, it is recommended that more human resources be placed for the analysis function of STRs. • It would appear that a system-wide evaluation of the quality of STRs, which would require the cooperation of the UIC, of the recipient police services, and possibly of the judiciary and Ministry of Justice, would be appropriate. Similarly, it would be useful to undertake a further evaluation of the effectiveness of the analysis work done by the UIC.
Law enforcement, prosecution and other competent authorities (R.27, 28, 30 & 32)	<ul style="list-style-type: none"> • Authorities should review the effectiveness of law enforcement and prosecution strategies and action.
3. Preventive Measures–Financial Institutions	
Customer due diligence, including enhanced or reduced measures (R.5 to 8)	<p>The authorities should expand CDD requirements in line with the revised FATF Recommendations in the following areas:</p> <ul style="list-style-type: none"> • Need to expand in law or regulation the circumstances where CDD must be carried out, in particular for: the identification of occasional transactions that are wire transfers below the €2,500 threshold. For greater clarity, should also consider making explicit the requirement to identify and verify the identity of any customer when there is a suspicion of money laundering or terrorist financing. • Need to establish in law or regulation a requirement to verify that the person purporting to act on behalf of the customer is so authorized. Financial institutions should also be required to verify the legal status of a customer that is a legal person. • Specific requirements should be introduced in law or regulation for financial institutions to take reasonable measures to understand the ownership and control structure that is a legal person and to determine who are the natural persons that ultimately own or control the customer.

	<ul style="list-style-type: none"> • The requirement in the Decalogo for conducting ongoing due diligence should be set out in law or regulation. • The exemption from CDD in the case of customers that are banks or branches abroad should be limited to those that are located in jurisdictions that effectively implement the FATF recommendations. • Specific requirements should also be extended to the identification and verification of the identity of the settlor, trustee or person exercising effective control over trusts and the beneficiaries. • The need for enhanced due diligence in higher risk situations, e.g., for non-resident customers, private banking, legal persons and arrangements such as trusts or for companies that have nominee shareholders or shares in bearer form. • The timing of verification of identity should be clarified. • Full identification and recording of persons to whom a bearer passbook is transferred. • Additional specific requirements should be introduced for the identification of PEPs and senior management approval for establishing a business relationship with a PEP. • Additional specific requirements should be introduced regarding procedures for the opening and operation of cross-border correspondent banking relationships, notably with respect to gathering information on the respondent, assessing its AML/CFT controls, obtaining senior management approval before establishing new correspondent relationships, documenting respective responsibilities, and with respect to payable-through accounts, ensuring that the respondent has verified the identity of and performs ongoing due diligence regarding subaccount holders and is able to provide customer identification upon request of the correspondent. • Need to enshrine the documentary evidence required for verification of identity in law or regulation.
<p>Third parties and introduced business (R.9)</p>	<p>The authorities should introduce the following additional requirements:</p> <ul style="list-style-type: none"> • Financial institutions should satisfy themselves that copies of identification data and other relevant information relating to CDD requirements will be made available from the third party upon request without delay. • Beyond obtaining head office certification financial institutions should be required to obtain from the third party located abroad a copy of its customer acceptance and ongoing CDD policies and satisfy themselves that the third party is regulated and supervised in accordance with FATF Rec. 23, 24 and 29.
<p>Record keeping and wire transfer rules (R.10 & SR.VII)</p>	<p>It is recommended that the authorities:</p> <ul style="list-style-type: none"> • Consider removing the €12,500 threshold for the recording in the AUI transactions conducted on an account. • Introduce requirements to ensure that complete originator information is included in outgoing wire transfers and that beneficiary financial institutions adopt effective risk-based procedures for identifying and handling wire transfers that are not accompanied by account number and address information. • The threshold of €12,500 at or above which customer

	<p>identification and record keeping is required should be lowered to €1,000 or eliminated altogether as is envisaged in the forthcoming EU regulation.</p>
<p>Monitoring of transactions and relationships (R.11 & 21)</p>	<p>It is recommended that the authorities:</p> <ul style="list-style-type: none"> • Ensure that there are effective means to enforce the provisions of the Decalogo with respect to financial intermediaries that are not subject to prudential supervision. • Extend requirements to pay special attention to business relationships and transactions with persons from any country which does not or insufficiently apply the FATF recommendations.
<p>Suspicious transaction reports and other reporting (R.13-14, 19, 25 & SR.IV)</p>	<ul style="list-style-type: none"> • The authorities should introduce a specific requirement for the reporting of transactions suspected of being related to or to be used for terrorism, terrorist acts or by terrorist organizations, or those who finance terrorism. Under the Italian legislation, terrorist financing is a predicate offence to money laundering and is therefore technically included in the reporting requirements set out in the law. Special Recommendation IV nevertheless calls for a direct mandatory obligation to report suspicions of terrorist financing. • The reporting requirement is not effectively being implemented by bureaux de change, the postal bank, stockbrokers, investment companies, trust companies and insurance companies. The respective supervisory authorities should review this more closely as part of their on-site inspections and additional outreach and guidance should be considered. • While the suspicious transaction reporting requirement applies to all transactions regardless of threshold, the usage of GIANOS in the banking and other sectors (including the application of transactions thresholds) should be reviewed to ensure it is used as a complement rather than a substitute for ongoing vigilance. Moreover, they should ensure that there are effective means to enforce the provisions of the Decalogo with respect to financial intermediaries not prudentially supervised. • The authorities should review the scope of the legal protection from criminal and civil liability associated with the reporting of suspicious transactions and clarify in law that it is restricted to only those persons who report in good faith. • The authorities should introduce an explicit prohibition to disclose the fact that a report has been made to the UIC or the fact that the UIC has requested additional information. • The UIC should provide reporting entities with systematic feedback in the form of statistics and typologies, for instance by means of a periodic newsletter or an annual report.
<p>Internal controls, compliance, audit and foreign branches (R.15 & 22)</p>	<ul style="list-style-type: none"> • There is a need to introduce requirements for adequate screening procedures for hiring employees. In addition, more detailed guidance should be developed on how financial intermediaries other than prudentially supervised financial institutions should organize themselves to comply with AML/CFT requirements. • Additional requirements should also be introduced to further ensure that AML/CFT principles are implemented by branches and majority-owned subsidiaries located abroad. In particular,

	<p>the requirements should extend to foreign branches of other financial institutions (such as insurance companies and securities firms) and to majority-owned subsidiaries of financial institutions located abroad. Foreign establishments of Italian financial institutions should be required to notify competent authorities when they cannot do so.</p>
<p>Shell banks (R.18)</p>	<ul style="list-style-type: none"> • The authorities should prohibit financial institutions from entering into or continuing correspondent banking relationships with shell banks and from establishing relations with correspondent foreign financial institutions that permit their accounts to be used by shell banks. • A clearer prohibition on the establishment of shell banks should be considered.
<p>The supervisory and oversight system—competent authorities and SROs (R. 17, 23, 29 & 30).</p>	<ul style="list-style-type: none"> • The supervisory authorities of prudentially regulated financial institutions are appropriately structured and have appropriate powers to ensure compliance with prudential and market conduct requirements. However, the authorities should assess the effectiveness of its AML/CFT supervision of non-prudentially supervised financial intermediaries with a view to ensuring more comprehensive, systematic and uniform inspections for all financial intermediaries. • The resources and efforts directed to AML/CFT supervision and on-site inspections with respect to the securities and insurance sectors as well as financial intermediaries registered under Article 106 of the Banking Law should be increased. Where it is possible, the authorities should increase the frequency of on-site inspections of foreign branches and subsidiaries of Italian financial intermediaries. • Given its considerable importance as a provider of financial services more attention should be paid to Bancoposta, particularly following its introduction of new procedures and internal controls and now that BI has recently been granted supervisory authority over it. • There are also some gaps in supervision, notably with respect to independent distributors working with or on behalf of insurance undertakings (i.e., financial salespersons, subagents and brokers) and supervisory efforts should be increased, albeit on a risk basis. The authorities should continue with their plans to expand registration requirements and ensure they have requisite professional qualifications and integrity. • The authorities should amend the law in order to clarify the sanctions framework and ensure that it is effective, proportionate and dissuasive. They should render the financial institutions (i.e. legal persons) separately liable for all violations of the AML/CFT requirements. They should also extend the range of sanctions in order to include sanctions for deficiencies in internal controls and training, particularly for financial intermediaries that are not prudentially supervised.
<p>AML/CFT Guidelines (R.25)</p>	<ul style="list-style-type: none"> • Additional specific guidance should be developed to assist in identifying suspicious transactions possibly linked to terrorist financing. • Guidance to DNFBPs should be developed to assist them in identifying suspicious transactions.

	<ul style="list-style-type: none"> • Positive feedback should be provided to financial institutions on their STRs. • Periodic reports should be published on trends and typologies.
<p>Ongoing supervision and monitoring (R.23, 29 & 32)</p>	<ul style="list-style-type: none"> • The authorities should assess the effectiveness of its AML/CFT supervision of non-prudentially supervised financial intermediaries with a view to ensuring more comprehensive, systematic and uniform inspections for all financial intermediaries. • The resources and efforts directed to AML/CFT supervision and on-site inspections with respect to the securities and insurance sectors as well as financial intermediaries registered under Article 106 of the Banking Law should be increased. Where possible the authorities should increase the frequency of on-site inspections of foreign branches and subsidiaries of Italian financial intermediaries. • Given its considerable importance as a provider of financial services, more attention should be paid to Bancoposta, particularly following its introduction of new procedures and internal controls now that BI has been granted supervisory authority over it. • There are also some gaps in supervision, notably with respect to independent distributors working with or on behalf of insurance undertakings (i.e., financial salespersons, subagents and brokers) and supervisory efforts should be increased, albeit on a risk basis. The authorities should continue with their plans to expand registration requirements and ensure that they have requisite professional qualifications and integrity. • Authorities should maintain more systematically statistics regarding requests for assistance made or received by supervisors including whether the request was granted or refused.
<p>Money value transfer services (SR.VI)</p>	<ul style="list-style-type: none"> • Authorities should review their inspection policies with regard to money transfer agents and subagents and ensure that the whole sector is adequately monitored and complies with the AML/CFT requirements.
<p>4. Preventive Measures–Nonfinancial Businesses and Professions</p>	
<p>Customer due diligence and record-keeping (R.12)</p>	<ul style="list-style-type: none"> • Since the EU and the FATF have changed their requirements for the DNFBPs some time ago, the authorities are urged to implement these requirements without delay and ensure that all the DNFBPs are informed of their obligations to identify their customers and keep records. • The authorities should clarify which dealers and manufacturing of “valuables” are to be covered by the AML Law and ensure that the relevant sectors are informed of their upcoming duties. • The authorities should ensure that the identification requirements for DNFBPs are in line with the FATF Recommendations. The regulations specifying the identification and registration requirements should also include issues like specific measures for the identification of PEPs, ongoing due diligence in accordance with the FATF Recommendations.

	<ul style="list-style-type: none"> • The authorities should ensure that also other independent legal professionals are covered by the AML Law.
Monitoring of transactions and relationships (R.12 & 16)	<ul style="list-style-type: none"> • The authorities should ensure that either by law, regulation or other enforceable means, the DNFBPs are required to pay special attention to all complex, unusual large transactions, and all unusual patterns of transactions, which have no apparent economic or visible lawful purpose. The background and purpose of such transactions should, as far as possible, be examined, the findings established in writing, and be available to help competent authorities and auditors. • The authorities should ensure that either by law, regulation or other enforceable means, the DNFBPs are required to give special attention to business relationships and transactions with persons, including companies and financial institutions, from countries which do not or insufficiently apply the FATF Recommendations. Whenever these transactions have no apparent economic or visible lawful purpose, their background and purpose should, as far as possible, be examined, the findings established in writing, and be available to help competent authorities. • The authorities should require DNFBPs to conduct enhanced ongoing monitoring on business relationships with a PEP.
Suspicious transaction reporting (R.16)	<ul style="list-style-type: none"> • The authorities are advised to implement expeditiously the Legislative Decree that foresees the reporting of suspicious transactions by the DNFBPs. • They should also issue the necessary legal provision in order to grant legal protection from criminal and civil liability to the DNFBPs who report in good faith their suspicions to the UIC.
Internal controls, compliance & audit (R.16)	<ul style="list-style-type: none"> • The authorities should make sure that all DNFBPs are required to set up internal AML/CFT procedures, policies and controls. The DNFBPs should also be required to either have a program for employee training or have some other access to (compulsory) training either provided by the orders and associations or by the authorities.
Regulation, supervision and monitoring (R.17, 24-25)	<ul style="list-style-type: none"> • The authorities are urged to designate AML/CFT supervisors for all the DNFBP and ensure that these supervisors have adequate powers to inspect for compliance with AML/CFT requirements, including internal procedures.
5. Legal Persons and Arrangements & Nonprofit Organizations	
Legal Persons–Access to beneficial ownership and control information (R.33)	<ul style="list-style-type: none"> • The authorities could consider measures to ensure that criminals cannot establish legal entities, for instance by performing an integrity check on person setting up a company.
Legal Arrangements–Access to beneficial ownership and control information (R.34)	<ul style="list-style-type: none"> • The authorities should take measures to prevent the misuse of foreign trusts handled in Italy by ensuring that there is adequate, accurate and timely information on the beneficial ownership and control of (express) trusts and that this information can be obtained in timely fashion by the competent authorities. In particular, to allow transparency and timely access to information in relation to foreign trusts handled by Italian financial intermediaries, the latter should be required, when dealing with trust funds, to identify the settlor, the

	trustees or persons exercising effective control over the trust and the ultimate beneficiaries.
6. National and International Cooperation	
National cooperation and coordination (R.31)	<ul style="list-style-type: none"> Although informal coordination mechanisms exist in AML/CFT matters and seem to work relatively well it is recommended to improve coordination in AML matters, on the basis of the successful experience of the FSC, to include as part of the FSC consultative process as well as in the AML coordination representatives of the businesses and professions concerned to ensure their involvement at various degrees in the design and implementation of preventive and coercive measures.
The Conventions and UN Special Resolutions (R.35 & SR.I)	<ul style="list-style-type: none"> Legislative action, as discussed under Criminalization of the financing of terrorism, may be necessary to fully implement the financing convention, and adoption of the Palermo Convention is overdue.
7. Other Issues	
Other relevant AML/CFT measures or issues	<ul style="list-style-type: none"> Relevant laws should be consolidated and streamlined in a single legislative instrument as well as in unified regulations.

Authorities' Response to the Assessment

The authorities thank the IMF Team for the very fruitful assessment, which recognizes the high degree of compliance of the Italian system with AML/CFT international standards.

IMF Recommendations—supported by the FATF Plenary in October 2005—are broadly welcomed and will certainly be taken into account by the competent Italian authorities in order to improve AML/CFT national measures.

234. The authorities underline that the recently endorsed EU Directive on AML/CFT provides Member States with a common legal framework to implement the revised 40+9 FATF Recommendations. Enhanced measures to prevent tax evasion in the real estate sector were taken in 2004 and in 2005. Implementing measures for DNFPBs are now ready and will be published shortly.

STRESS TESTING PROCEDURES AND RESULTS

Banks

235. **The objective of the stress testing exercise performed in the Italian FSAP is to explore the resilience of the Italian banking system to a variety of shocks.** Stress testing is a partial equilibrium exercise that ignores the reaction of the institutions to the shocks and its results cannot be extrapolated to shocks very different from the ones applied. Nevertheless, the wide range and severity of shocks applied are illustrative.

236. **The procedures followed made use of the sophisticated stress testing capacity of the nine largest Italian banking groups, amounting to 62 percent of banking system assets and BI.** The effects of the shocks were estimated by the institutions in a bottom-up approach as well as by the authorities in a top-down approach using consolidated data as of end-December 2004 in order to check the consistency of results. The results of the top-down approach were updated by BI with end-June 2005 data. Top-down and bottom-up approaches yielded similar results, and therefore only the updated results of the top-down approach are reported. The exercise included sensitivity tests for individual risk factors including market risk, credit risk, sovereign risk, interest rate risk in the banking book, and liquidity risk, as well as tests for adverse macroeconomic scenarios.

237. **The market risk shocks applied are in line with shocks applied in other Euro area countries.** In addition to the sensitivity analysis for the individual market risk factors conducted by both banks and supervisors for the largest nine banking groups, BI calculated losses due to changes in market prices using a parametric Value-at-Risk approach (VAR). The calculations were performed under conservative assumptions (0.3 percent probability of the shock and a 20-day holding period).

238. **The credit risk shock applied a 60 percent increase in the probability of default (PD), which is larger than the largest historical observation (54 percent increase in PD in 1993).** In the top-down approach, the PD is measured as the flow of new bad debts over the stock of performing loans in the previous period. The increase in the PD translates in provisioning increases given the assumed loss given default (LGD) of 60 percent for the whole portfolio and an exposure at default equal to the drawn amount of the performing loan portfolio plus 75 percent of the undrawn credit lines. The assumed LGD is consistent with the loan loss provisions in the largest banking groups and considerably higher than the average 40 percent LGD reported by G-10 countries in the QIS3 study of the Basel Committee.⁴⁰ BI also performed a credit risk sensitivity analysis over the balance sheet of the whole banking system following the same methodology.

⁴⁰ Because data on the flow of doubtful loans (incagli) are unavailable, the definition of PD in the top-down approach is narrower than the one used by banks. However banks used a lower LGD, around 40 percent on average, based on their internal information on guarantees.

239. **Stress tests for sovereign risk were performed on exposures to “developing or transitioning countries.”**⁴¹ The top-down approach followed a methodology similar to the credit risk stress test. Countries were assigned a rating and a pre-shock PD for the exposures was derived from Moody’s default statistics for corporate firms. The assumed LGD for these sovereign exposures was 80 percent. Banks used their own internal ratings in the bottom-up approach

240. **The effects of adverse macroeconomic scenarios were simulated with the macro econometric model of BI’s research department.** The simulation of the macroeconomic shocks, arising from changes in exogenous variables, generated deviations from a baseline projection over a two-year horizon. The new macroeconomic projections were then used to calculate (i) an after-shock PD for the lending portfolio and (ii) after-shock operating profits using econometric models developed by the research and supervision departments of BI. Changes in operating profits arise from changes in the demand for financial services and personnel costs, associated with the level of economic activity, as well as changes in equity prices and interest rates. The effect of macro scenarios on the macroeconomic projections, probability of default, and operating profits are reported in Table 16 below:

⁴¹ According to the BIS definition—*Consolidated Banking Statistics*—these include the newest EU members and accession countries, which account for most of the sovereign exposures of the Italian banking system to non-industrialized countries.

Table 16. Summary of Macroeconomic Stress Testing Scenarios

	Scenario 1: Oil price increases to USD 85 per barrel and global equity prices decline by 30 percent	Scenario 2: USD depreciates 20 percent with respect to EUR due to loss of confidence in the currency	Scenario 3: Large corporate defaults in Italy trigger a 200b.p. increase in credit spreads and a 35 percent decline in Italian equity prices
Effect of shocks in macroeconomic variables (Effects after two years)			
Output GAP 1/ Short-term interest rate (in p.p.) 2/ Inflation 2/	-1.87 2.0 1.98	0.01 2.0 1.37	-1.54 2.0 1.62
Effect of changes in macroeconomic variables on banks' operating profits and the rate of default in the economy (percentage changes after two years)			
Banks operating profits Probability of Default (PD)	-5.8 83	17.2 52	-11.2 71

Source: Bank of Italy.

1/ Deviation with respect to baseline projection

2/ Levels.

241. **Banks performed a sensitivity analysis for interest rate risk on the banking book while BI performed it on the banking and trading books due to lack of disaggregated information.** In the bottom-up approach cash flows are mapped into different time buckets and the impact of interest rate fluctuations on the present value of the cash flows is calculated under the stress scenarios. The top-down approach methodology uses a modified duration approach where duration parameters are computed based on the prevailing interest rate levels. A convexity factor accounts for the non-linear relation between interest rate changes and position value changes. The main differences in methodology arise from the treatment of sight and saving deposits, which do not react immediately to changes in interest rates. In the top-down approach sight and saving deposits exceeding the assets in the first maturity bucket are proportionally distributed in the other time buckets up to one year, according to the length in months of the funding period of that class. In the bottom-up approach banks used different assumptions based on their historical internal information. In all cases, the economic value of losses due to interest rate increases was within the limits recommended by the Basel Committee (i.e., 20 percent of bank capital).

242. **Finally, BI assessed the liquidity position of over 700 banks under a liquidity stress scenario similar to those applied to other Euro area countries.** The methodology used for the off-site monitoring of liquidity risk allocates assets and liabilities to different time bands according to their residual maturity. A bank is considered vulnerable to liquidity shocks when mismatches in the first maturity bracket (up to one week) cannot be covered with liquid assets. Liquid assets include cash and T-bills, as well as assets eligible for access to collateralized ECB standing facilities, temporarily available unencumbered securities stemming from reverse repos (both with a 30 percent haircut) and 10 percent of sight loans.

Derivative positions of Italian corporations

243. **To assess the resilience of Italian corporations to losses in their derivative exposures, the two largest players in the derivatives market were asked to reprice the positions of a sample of corporations.** Since most of the derivatives sold to corporations are interest rate products, the exercise only included a variety of interest rate and volatility shocks. The increase in each firm's PD arising from the losses incurred in the derivative exposures was then calculated using a BI micro econometric model.

244. **The sample consisted of 2000 firms: 396 small firms, 788 medium sized firms, and 816 large firms.** The number of firms in each class reflects the weight of that class in the universe of the firms showing derivative exposures in the credit registry at end-June 2005. Within each class 50 percent of the firms were chose because they had the largest absolute exposure in derivatives, while the rest had the largest relative exposure. The sample was divided between the two banks, with each of them asked to report information on 1000 firms. Results were provided for 1762 firms (other firms did not have exposure to the risk factors considered), accounting for 28 percent of the total amount of derivative exposures of the corporate sector, and 4 percent of total credit to the corporate sector.

Table 17. Banking Sector Stress Test Results, June 2005 Update—Top Down

	Loss (-)/Gain (+) as percentage of June 2005 (annualized) after-tax profits		CAR	
	Weighted Average	Largest Loss	Weighted Avg.	Min.
Pre-Stress CAR			11.01	8.78
Post Stress CAR 1/				
Sensitivity to market risk				
Parallel increase in major interest rates 2/	-5.7	-29.2	10.95	8.71
Parallel decrease in major interest rates 3/	+5.7	0.0	11.01	8.78
Rise and flattening of the main yield curves 4/	-8.7	-19.7	10.92	8.72
Fall and steepening of the main yield curves 5/	+4.0	0.0	11.01	8.78
Rise in main medium-term rates 6/	-0.9	-4.0	11.00	8.75
Fall in main medium-term rates 7/	+0.9	0.0	11.01	8.78
Fall in equity prices 8/	-4.3	-12.5	10.96	8.64
Euro appreciation against major currencies 9/	+17.2	+1.9	11.01	8.78
Euro depreciation against major currencies 10/	-17.2	-36.7	10.83	8.72
Rise in financial market volatility 11/	-1.0	-15.1	11.01	8.78
Decrease in financial market volatility 12/	+1.0	-4.1	11.01	8.78
Sensitivity to Sovereign Risk /13	-15.3	-178.0	10.82	8.77
Sensitivity to credit risk /14	-24.3	-94.4	10.71	8.51
Macroeconomic scenario tests				
Rise in oil prices and fall in equity prices 15/	-35.8	-144.7	10.60	8.41
Dollar depreciation 16/	-17.9	-63.4	10.75	8.55
Domestic confidence shock 17/	-32.6	-137.7	10.66	8.47
	VAR over after tax profits		VAR over capital buffer	
<i>BI Value-at-Risk estimates 18/</i>	Banks with VAR >100%	VAR 95 th percentile	Banks with VAR >100%	VAR 95 th percentile
Interest Rate	7	45.18	2	5.21
Equity	3	11.53	2	1.37
Foreign exchange	4	19.82	1	4.4
	Loss of economic value as percentage of bank capital			
Sensitivity to interest rate risk in the banking book 19/	Weighted Average		Maximum loss	
	-6.34		-13.22	
	Banks with liquidity shortfall in the 1-7 days time band			
Liquidity stress test (BI estimates) 20/	Number of banks		Share of assets	
	82		22%	

Source: Bank of Italy

- 1/ Risk-weighted capital adequacy ratio, NOT allowing for losses to be covered first by before-tax profits.
- 2/ EUR, USD and JPY interest rates increase by 70, 65, and 60 b.p. respectively.
- 3/ EUR and USD interest rates decrease by 70, and 40 b.p. respectively.
- 4/ EUR short-term, medium-term, and long-term interest rates increase by 110, 60 and 40 b.p. respectively. USD interest rates increase by 100, 50, and 30 b.p., while JPY interest rates increase by 100, 40, and 30.
- 5/ EUR short-term, medium-term, and long-term interest rates decrease by 110, 60 and 40 b.p. respectively. USD interest rates decrease by 100, 40, and 30 b.p., while JPY short-term interest rates remain unchanged and medium and long-term rates decrease by 20, and 15 b.p.
- 6/ EUR, USD and JPY medium-term rates increase by 30, 25, and 20 b.p. respectively.
- 7/ EUR, USD and JPY medium-term rates decrease by 30, 25, and 10 b.p. respectively.
- 8/ A 30 percent decrease in the equity prices.
- 9/ A 15 percent appreciation in the EUR against the USD and JPY, respectively.
- 10/ A 15 percent depreciation in the EUR against the USD and JPY, respectively.
- 11/ A 30 percent increase in the volatility of all financial market prices.
- 12/ A 30 percent decrease in the volatility of all financial market prices.
- 13/ A three-notch downgrade of claims on emerging markets countries that comprise at least 50 percent of banks' total exposure to emerging market, and a two-notch deterioration applied to all others.
- 14/ A 60 percent increase in the probability of default of all credit exposures, except interbank exposures.
- 15/ The price of oil increase to 85 USD per barrel and global equity prices decline by 30 percent.
- 16/ Sustained 20 percent depreciation of the USD with respect to the major currencies.
- 17/ Italian corporate spreads increase by 200 b.p. and Italian equities decline by 35 percent.
- 18/ VAR at the 99.7 level of confidence, 20 days holding period.
- 19/ EUR interest rates increase by 200 b.p.
- 20/ Interest rates for T-bills increase as in 4/. Withdrawal rate of interbank and consumer deposits increases to 40 percent and 15 percent respectively.

Insurance sector

Overall methodology

245. **The stress tests consisted in a bottom up exercise coordinated by the Italian insurance supervisor, *Istituto per la Vigilanza sulle Assicurazioni Private e di interesse collettivo* (ISVAP), and conducted by Italian insurance companies based on the use of their internal models. They were performed on insurance companies' balance sheet exposures as of end-December 2004 (similar to the bottom up stress test conducted in the banking sector).**

246. **Ten Italian insurance groups participated in the stress test, representing a market share of over 70 percent as of end-2004.** This sample comprised of five domestically owned insurance groups, two foreign-owned groups, two companies fully owned by Italian banking groups, and one state-owned company. The stress tests were performed at the level of the 59 individual companies owned by the ten insurance groups (of which 37 in the life sector).

247. **As much as possible and relevant to the insurance sector, stress testing assumptions and modalities were chosen to be consistent with those used in the parallel stress testing of the Italian banking sector.** As described below and in the annex on stress-testing in the banking sector, the importance of bancassurance activity in Italy also required coordination between the two exercises to allow for a meaningful interpretation of the results.

Assumptions

Macroeconomic scenario

248. **The FSAP assessed the resilience of the Italian insurance sector to a macroeconomic scenario consisting in a domestic shock similar to that used in the stress test of the banking sector.** Specifically, the scenario consisted in a confidence crisis in the Italian economy triggered by large corporate failures in Italy, and resulting in the combination of (i) a 35 percent decline of domestic equity prices or, alternatively, the maximum decline in annual stock prices during the last 20 years, and (ii) a 200-bp increase in corporate credit spreads.

249. **The effects of the scenario were to be assessed on both sides of insurance companies' balance sheet, since stresses applied to the asset side may lead some policyholders to surrender their insurance policies.** Such an increase in the incidence of policy lapses potentially has two secondary effects for the insurer that combine to strain liquidity and profitability: (i) an outflow of cash (in the form of payments to policyholders), and (ii) a decrease in premium inflow and invested funds.

Market risk—interest rate sensitivity

250. **The exercise comprised a sensitivity test for the main market risk factor for the insurance sector, namely interest risk.** Reflecting traditionally conservative investment policies, Italian insurers still allocate a large majority of their assets to domestic sovereign bonds. Therefore, domestic interest rate movements are a key risk factor for sensitivity analysis. Relatedly, the comparatively small exposures to corporate credit, equity and foreign assets, make separate analyses of sensitivity to credit, equity price and foreign exchange risks less relevant to the stress testing exercise.

251. **Regarding the calibration of the interest rate shocks, the stress test covered the impact of both parallel shifts in the yield curve and changes in its slope as follows:**

- Shock 1: rise and flattening (increase in short term interest rate of 110 bp, in medium-term interest rate of 60 bp, and in long-term interest rate of 40 bp);
- Shock 2: parallel upward shift of 70 bp;
- Shock 3: fall and steepening (decrease in short term interest rate of 110 bp, in medium-term interest rate of 60 bp, and in long-term interest rate of 40 bp);
- Shock 4: parallel downward shift of 70 bp.

252. **In addition to these stress tests implemented on a bottom up basis, a rough top-down calculation was also made to estimate the potential impact on life insurance companies' solvency margin of a parallel upward shift in the yield curve of 200 bp.** This calculation consisted in a rule of thumb applied to the impact of the 70 bp upward shift, by multiplying by 3 its impact on the bond portfolio of the companies, and by 3.5 its impact on additional provisions.

Catastrophic events

253. **The assessment was based on the impact of an event (e.g., a natural disaster such as an earthquake or a flooding) that would cause damage twice as large as the worst previous experience, to be defined by the non-life insurance companies themselves.** In addition to the direct solvency impact of the event, and in order to gauge the remaining robustness of the system, the test included an analysis of the increase in loss ratio required to wipe out the residual excess over the required solvency margin following the event.

Results

254. **Tables 18 and 19 summarize the stress test results, and the following points provide some explanations on the presentation of the data:**

- The impact of shocks on solvency is measured through changes in the solvency ratio (i.e., the ratio of the available solvency margin to the required solvency margin);
- The results are presented both at the group and individual company levels (in the former case, the group solvency ratio is the weighted average of the solvency ratios of companies in the group according to their individual capital requirements);
- The results provide two calculations of the available solvency margin: one consisting only in regular forms of capital,⁴² and one including (i) unrealized net gains arising from the evaluation of assets under current accounting rules,⁴³ and (ii) one half of the unpaid equity capital;⁴⁴
- The impact of a catastrophic event is presented both before and after reinsurance.

Implementation issues

255. **Some issues arose during the implementation of the stress tests by insurance companies, affecting the accuracy of the results, and therefore imposing a degree of caution in their interpretation:**

- The stress tests were conducted on a company (or “legal entity”) basis. While this permitted to separate clearly the results between the life and non-life sectors, it did not allow to assess the potential double-counting of capital (or “double gearing”) when aggregating results at the group level;

⁴² These include in particular paid-up equity, reserves not corresponding to specific liabilities, profits, subordinated loan capital (up to 50 percent of the margin), and securities with no specified maturity.

⁴³ Within a 20 percent solvency margin limit for non-life companies, and 10 percent for life companies.

⁴⁴ At the request of insurance companies, ISVAP may authorize the inclusion of such items.

- Some parts of the stress tests were not fully implemented by all companies participating in the exercise, although the impact of these additional factors is likely to be limited:
 - Some companies did not include unit- and index-linked life insurance contracts (for which the market risk is borne by the policyholder) in the stress test, notwithstanding the fact that these contracts are subject to a (minimal) capital requirement (between 0 and 1 percent), and represent about 35 percent of technical provisions in the life industry;
 - Similarly, some companies considered ex ante that policy lapses as a result of the shocks were likely to be negligible, and therefore did not take into account their potential impact on mathematical provisions and on realized capital gains.

Conclusions

256. The above results lead to the following observations:

- **The life insurance sector is the most exposed to adverse shocks.** The solvency of life insurance companies may be particularly affected by:
 - an **upward shift in the yield curve**: a 70 bp shift would lead to a decline in the average solvency ratio from 2.05 (before the shock) to 1.98, with three companies (out of 37 in the life sector) representing a market share of 2.2 percent of total technical provisions, recording a solvency shortfall. In the case of a 200 bp shift, the solvency ratio may drop to an estimated 1.72, with 17 companies representing a market share of about 46 percent, recording a solvency shortfall. However, this shortfall would represent only 0.37 percent of (class C) technical provisions;
 - the adverse **macroeconomic scenario**: this scenario would lead to a decline in the average solvency ratio from 2.05 to 1.77, with seven companies recording a solvency shortfall, representing a market share of 13.7 percent of total technical provisions.
- **In the non-life sector, solvency levels seem very unlikely to reach critically low levels.** The macroeconomic scenario has the biggest impact,⁴⁵ but does not reduce average solvency ratios to low levels due to their high-level ante shock. Specifically, the average solvency ratio are reduced in this scenario from 3.35 (before the shock) to 2.92, with only one company (out of 22 in the non-life sector) recording a solvency shortfall. Furthermore, catastrophe risks are not a source of vulnerability for Italian insurance companies at this stage (as the proposed shock only reduced the average solvency ratio to 3.23, and no company recorded a solvency shortfall), especially once the impact of

⁴⁵ The macroeconomic scenario had indeed a larger impact than in the life insurance sector due to the greater share of equity in non-life insurance companies' portfolios. Conversely, the greater share of fixed-income securities in the life sector explains the larger impact of interest rate changes observed on the solvency of life insurance companies.

reinsurance is taken into account (the average solvency ratio then appears unaffected by the shock).

257. From a financial stability perspective, it is however essential to take into account the impact of bank ownership of life insurance companies. The widespread bank ownership of life insurance companies has key implications for their solvency levels since, in practice, the parent banking groups generally allocate only a minimum level of capital to their insurance subsidiaries, as needed to meet the required solvency margin. At the same time, in case of shock, bank-owned insurance companies may benefit from the larger pool of capital of the banking group, in effect reducing their insolvency risk despite apparently low solvency ratios. To illustrate, out of the 17 companies that may record a shortfall in the case of a 200 bp upward shift in the yield curve, 12 are owned by banks, representing a market share of about 38 percent of total technical provisions. At the request of the mission, BI and ISVAP aggregated the banking and insurance stress tests institution by institution, in order to assess the impact on capital adequacy at the group level. While the authorities did not provide quantified material to underpin such an assessment (for reasons of bank secrecy) they indicated that the potential solvency shortfalls in the insurance sector are very small compared with the amounts of capital available to parent banks.

258. Overall, only a limited number of relatively small life insurance companies appear vulnerable, suggesting that the insurance sector is resilient to shocks. In line with the above, only five life insurance companies owned by insurance groups (i.e., not by bank groups), representing a market share of less than 5 percent, would record a solvency shortfall under the most adverse circumstances (i.e., a 200-bp upward shift in the yield curve). Such a shortfall would represent 0/14 percent of (class C) technical provisions. This tends to indicate that systemic risks are very limited in the Italian insurance sector, even though, as noted, the above results should be interpreted with a degree of caution.

Table 18. Insurance Stress Tests—Solvency Ratio Changes at the Individual Company Level

	Excluding gains								Including gains							
	Solvency ratio			Number of companies with ratio < 1	Solvency shortfall / liabilities ^{1/}	Change			Solvency ratio			Number of companies with ratio < 1	Solvency shortfall / liabilities ^{1/}	Change		
	Best	Average	Worst			Best	Average	Worst	Best	Average	Worst			Best	Average	Worst
Life					<i>(In percent)</i>								<i>(In percent)</i>			
Ante shock	6.0	1.6	0.9	3 ^{2/}					6.0	2.1	0.9	1.0				
Macroscenario	5.6	1.5	0.7	10.0	0.7	-6.9	-6.9	-19.9	5.7	1.8	0.8	7.0	0.8	-5.2	-13.9	-19.2
Shock 1 (Tilt+)	6.1	1.6	0.8	3.0	0.1	0.7	0.4	-7.1	6.2	2.0	0.8	2.0	0.2	2.4	-1.7	-15.5
Shock 2 (Shift +)	6.0	1.6	0.8	4.0	0.4	-0.1	-1.0	-7.1	6.1	2.0	0.8	3.0	0.5	1.6	-3.7	-15.5
Shock 3 (Tilt-)	5.9	1.7	0.9	6.0	0.2	-1.2	1.2	-0.6	6.2	2.1	0.9	3.0	0.2	2.2	3.5	-0.6
Shock 4 (Shift -)	6.0	1.7	0.9	5.0	0.1	-0.7	1.9	-0.6	6.5	2.2	0.9	2.0	0.0	7.6	5.7	-0.6
Non Life																
Ante shock	7.6	3.1	1.0	-					7.8	3.3	1.1	-				
Macroscenario	7.6	2.7	1.0	2.0	3.1	-0.1	-13.0	-7.4	7.8	2.9	1.0	1.0	4.8	-0.1	-13.0	-10.5
Shock 1 (Tilt+)	7.6	3.1	1.0	-	-	0.0	-0.2	-2.6	7.8	3.3	1.1	-	-	0.0	-0.5	-0.3
Shock 2 (Shift +)	7.6	3.1	1.0	1.0	0.6	0.0	-0.5	-4.6	7.8	3.3	1.1	-	-	0.0	-0.8	-0.2
Shock 3 (Tilt-)	7.6	3.2	1.0	-	-	0.0	0.3	0.1	7.8	3.4	1.1	-	-	0.0	0.7	1.1
Shock 4 (Shift -)	7.6	3.2	1.0	-	-	0.0	0.3	0.1	7.8	3.4	1.1	-	-	0.0	0.7	0.5
Natural disaster before reinsurance	7.6	3.0	1.0	-	-	0.0	-4.2	-2.0	7.8	3.2	1.1	-	-	0.0	-3.5	0.0
Natural disaster after reinsurance	7.6	3.1	1.0	-	-	0.0	0.0	0.0	7.8	3.3	1.1	-	-	0.3	0.0	0.0

1/ The solvency shortfall/liabilities ratio is the average of individual companies' values weighted by their individual liabilities.

2/ The three companies with initial solvency ratio < 1 have been recapitalized.

Table 19. Insurance Stress Tests—Solvency Ratio Changes at the Group Level

	<i>Excluding gains</i>								<i>Including gains</i>								
	Solvency ratio			Number of groups with ratio < 1	Solvency shortfall / liabilities 1/	Change			Solvency ratio			Number of groups with ratio < 1	Solvency shortfall / liabilities 1/	Change			
	Best	Average	Worst			Best	Average	Worst	Best	Average	Worst			Best	Average	Worst	
Life																	
Ante shock	4.7	1.6	1.0						4.7	2.1	1.0						
Macrosenario	4.4	1.5	1.0	1.0	0.1	-5.1	-6.9	-2.7	4.5	1.8	1.0	1.0	0.1	-3.0	-13.9	-2.7	
Shock 1 (Tilt+)	4.7	1.6	1.0	0.0	0.0	0.9	0.4	-1.9	4.8	2.0	1.0	0.0	0.0	3.0	-1.7	-1.9	
Shock 2 (Shift +)	4.7	1.6	1.0	0.0	0.0	-0.2	-1.0	-2.0	4.8	2.0	1.0	0.0	0.0	2.0	-3.7	-2.0	
Shock 3 (Tilt-)	4.6	1.7	1.0	0.0	0.0	-1.3	1.2	-0.2	4.7	2.1	1.0	0.0	0.0	0.8	3.5	1.9	
Shock 4 (Shift -)	4.6	1.7	1.0	0.0	0.0	-0.9	1.9	1.9	4.7	2.2	1.0	0.0	0.0	1.2	5.7	2.1	
Non Life																	
Ante shock	4.6	3.1	2.0						4.8	3.3	2.2						
Macrosenario	4.3	2.7	1.6	0.0	0.0	-5.8	-13.0	-19.2	4.5	2.9	1.7	0.0	0.0	-5.6	-13.0	-21.9	
Shock 1 (Tilt+)	4.6	3.1	1.7	0.0	0.0	0.5	-0.2	-14.1	4.8	3.3	1.8	0.0	0.0	0.5	-0.5	-15.1	
Shock 2 (Shift +)	4.6	3.1	1.7	0.0	0.0	-1.0	-0.5	-14.1	4.8	3.3	1.8	0.0	0.0	-1.0	-0.8	-17.0	
Shock 3 (Tilt-)	4.6	3.2	1.7	0.0	0.0	0.0	0.3	-14.1	4.8	3.4	1.9	0.0	0.0	0.0	0.7	-12.8	
Shock 4 (Shift -)	4.6	3.2	1.7	0.0	0.0	0.0	0.3	-14.1	4.8	3.4	1.9	0.0	0.0	0.0	0.7	-12.8	
Natural disaster before reinsurance	4.5	3.0	1.7	0.0	0.0	-2.2	-4.2	-14.9	4.7	3.2	1.9	0.0	0.0	-2.1	-3.5	-13.5	
Natural disaster after reinsurance	4.5	3.1	1.7	0.0	0.0	-2.0	-0.5	-14.8	4.7	3.3	1.9	0.0	0.0	-1.9	0.0	-13.4	

1/ The solvency shortfall/liabilities ratio is the average of individual companies' values weighted by their individual liabilities.