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Preface

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

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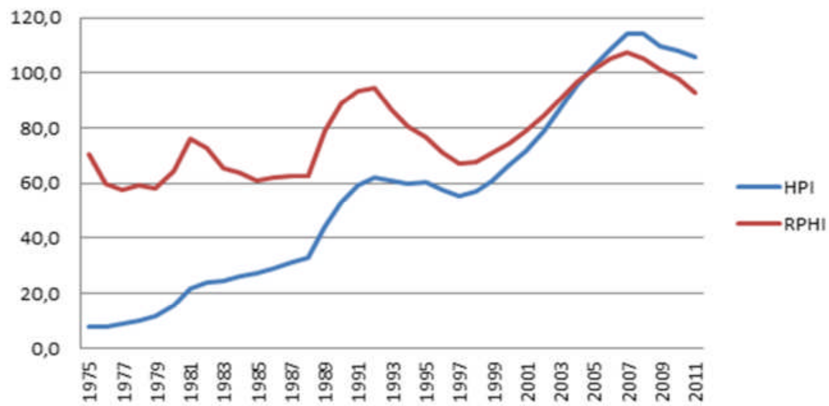
17.1 Evolution of house prices in Italy (1975 -2011)

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

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

A graphical analysis of the behaviour of the composite indicator of house prices adjusted for consumer price inflation, provided by Federal Reserve Bank of Dallas[4], allows us to identify four real estate market cycles in Italy starting in mid Seventies.

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



Source: Our elaborations on Federal Reserve Bank of Dallas database

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

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

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

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

Nevertheless, according to OECD (2005), Italian house prices can be considered not excessively overvalued, on the basis of the ratio of prices to rents. Whilst the ratio is rising, it is still considerably more contained in comparison to the United Kingdom and to a large number of metropolis of the United States. This ratio considers trends in the collateral housing rent market, which is useful both in terms of an analysis of a house purchased to be lived in or for investment. If we consider that the payment of rent is a possible alternative to purchase, a non-contingent, higher than average price/rent ratio could be the warning sign of a speculative bubble about to burst. An increase in house prices over rents will push more and more people to opt for renting rather than buying, thereby causing a drop in demand for houses and a knock-on fall in house prices. If the purchase is for investment purposes, a rise in the ratio implies an overvaluation in the price that is not justified by returns on the investment itself; such a situation will lead investors to look for alternative forms of investment.

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

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

Source: Our elaborations on Federal Reserve Bank of Dallas database

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

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

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

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

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

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

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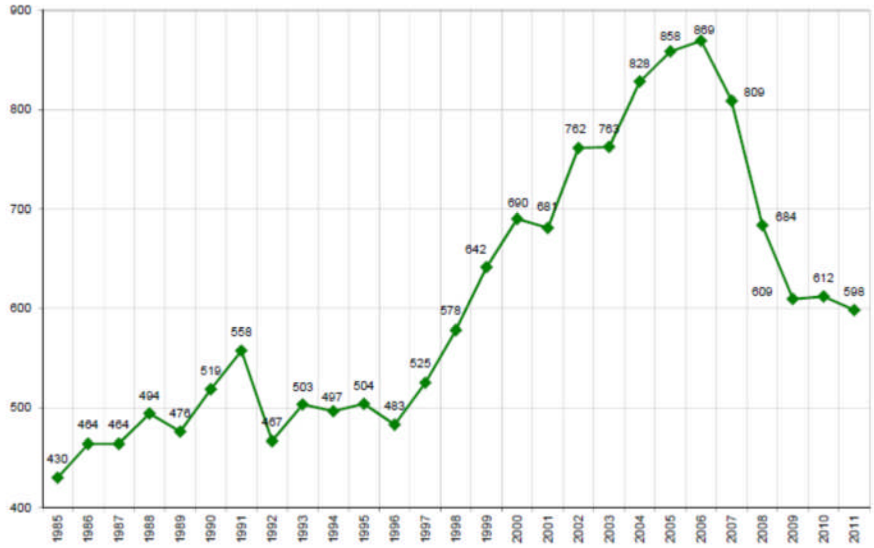
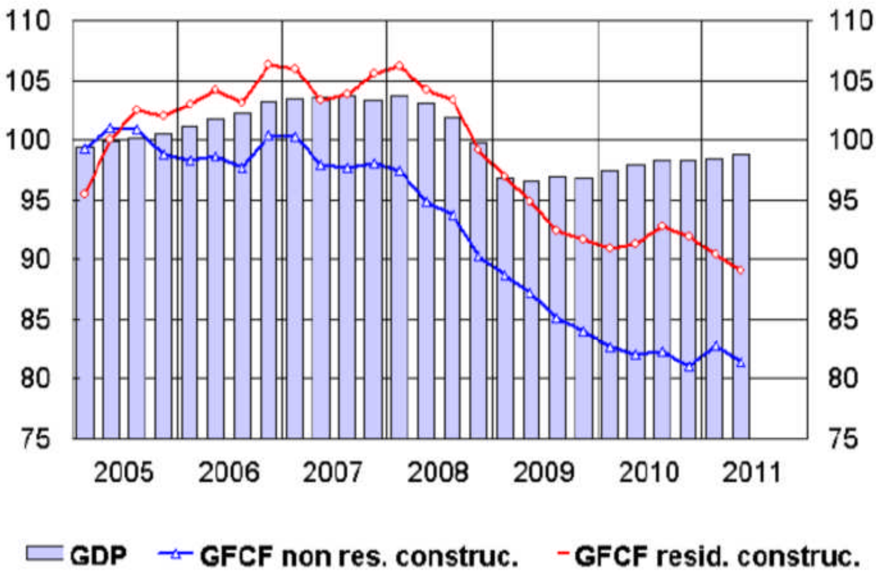
Figure 17.2 - Number of transactions 1985-2011



Source: Agenzia del Territorio (2012)

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



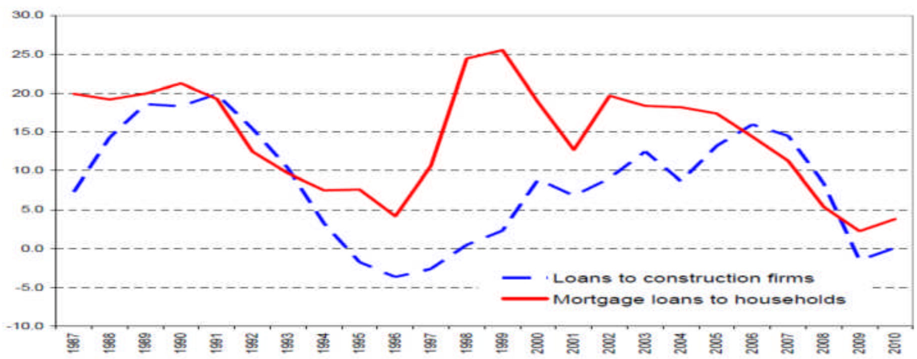
Source: Bank of Italy

17.2 Credit development to housing market

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

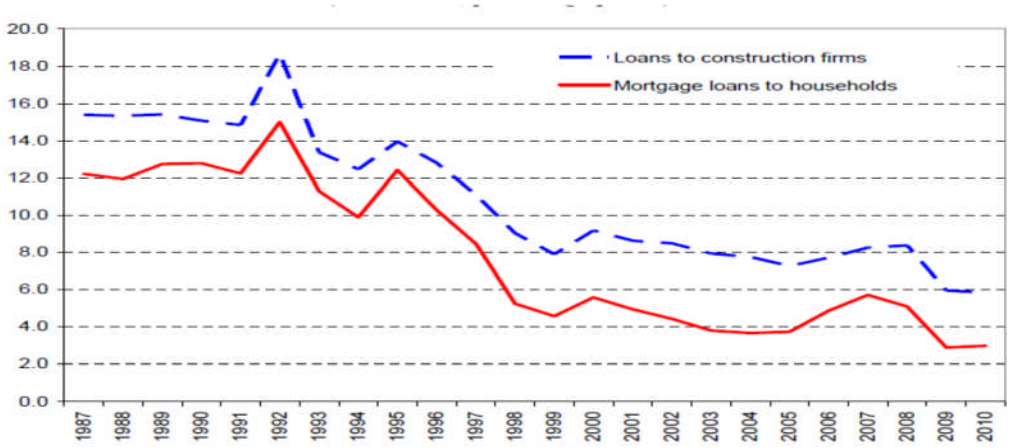
The cost of credit in Italy, broadly stable between the late eighties and the start of the nineties, showed a marked increase during the financial crisis of 1992, followed by a sharp decline in the wake of Italy's joining the Economic and Monetary Union (Figure 17.5). In particular, the average interest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

Figure 17.4 - Credit Development (annual growth rate %)



Source: Bank of Italy

Figure 17.5 - Bank interest rate (annual data %)



Source: Bank of Italy

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

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

17.3 Real Estate Investment Funds in Italy

One of the instruments which mostly contributed to the development of the Italian real estate market, attracting foreign capital and increasing market transparency has been the real estate fund, introduced in 1999. During the last decade real estate funds have been subject to a continous change in regulations, determining their development over time.

Real estate investment funds (REIFs) allow investors to convert real estate assets, which are typically hard to exchange, into units of financial products. In Italy they are established and managed by asset management companies (società di gestione del risparmio - SGRs) supervised by the Bank of Italy in cooperation with Consob (Commissione Nazionale per la Società e la Borsa, Companies and Stock Exchange Commission). In particular, the Bank of Italy receives supervisory and statistical reports regarding all the REIFs established by Italian management companies..

Italian real estate funds are closed-end funds that give investors the right to redeem the units only at predetermined intervals, under specific circumstances and for limited amounts. This feature reduces the liquidity problems that might otherwise arise if a real estate fund functioned as an open-end fund, by allowing investors to request the redemption of their units at any time. In spite of that, Italian real estate funds are exposed to different types of risk: property, economic and liquidity risks are interconnected and associated with the credit market conditions and financial constraints (including debt repayment obligations and capital reimbursements).

In 2009, in addition to the supervisory and statistical reports, the Bank of Italy (Bank of Italy, 2010 and FSB, 2011) requested that all SGRs managing REIFs provide detailed data on the financial structure of funds and conducted an analysis of three aspects: (1) the financial profile; (2) income structure, and; (3) property price behaviour of each REIF.

In Italy, REIF activity involves different entities: (1) the asset management company that manages the fund; (2) the external and independent appraiser, who twice a year evaluates the properties held by the funds; (3) the depository bank which is responsible for keeping the securities and ensuring the fund's liquidity and may also be responsible for the periodic valuation of fund units; (4) finally, the Italian stock exchange for listed funds.

In 1994 REIFs were introduced in Italian legislation. A REIF can be established only after the approval of the fund rules by the Bank of Italy. Fund must to comply with a number of rules regarding investment thresholds and risk concentration, portfolio allocation and the maximum permissible debt ratio (the amount of debt cannot exceed 60 per cent of the value of real estate assets and

20 per cent of other investments). However, exceptions to the prudential rules are provided for funds reserved to qualified investors. Further exemptions are envisaged for the so-called speculative (or hedge) real estate funds that are allowed to exceed the debt limit of 60 per cent of the value of the property; for these funds there is a minimum subscription of 500,000 €. The main difference between Italian legislation and that of other countries is that real estate products intended for qualified investors are also subject to prudential regulation even if at times they are more similar to separate accounts than to mutual funds, since some of these funds have a small number of investors. Real estate held by funds are evaluated twice a year by external and independent appraisers. Nevertheless, fund managers remain fully responsible for real estate evaluation and they are not obliged to comply with the appraiser's evaluation.

Table 17.2 – Italian real estate investment funds data

	Dec. 03	Dec. 04	Dec. 05	Dec. 06	Dec. 07	Dec. 08	Dec.09	Jun. 10
All REIFs								
Number	19	31	61	119	174	229	267	281
Total assets	5,141	12,309	18,326	27,248	36,058	42,390	47,517	47,771
Real estate assets	3,718	10,520	15,215	22,110	30,434	36,791	40,936	41,678
Debt	573	3,979	6,019	9,890	13,453	16,630	19,517	19,347
NAV	4,414	8,084	11,859	16,384	21,531	24,446	26,306	26,846
Financial leverage	1.16	1.52	1.55	1.66	1.67	1.73	1.81	1.78
Retail funds								
Number	14	19	23	29	30	29	27	27
Total assets	3,836	6,531	8,057	10,168	10,731	10,185	9,461	9,282
Real estate assets	2,847	5,105	6,407	7,949	8,914	8,591	7,985	7,774
Debt	312	1,301	1,797	2,687	2,960	2,983	2,978	2,915
NAV	3,435	5,108	6,065	7,219	7,547	6,976	6,290	6,159
Financial leverage	1.12	1.28	1.33	1.41	1.42	1.46	1.50	1.51
Reserved funds								
Number	5	12	36	78	116	156	176	179
Total assets	1,304	5,778	9,900	13,641	19,762	26,240	31,176	31,128
Real estate assets	872	5,415	8,472	11,537	16,682	22,665	26,654	27,241
Debt	261	2,678	4,015	5,311	6,931	9,636	11,796	11,529
NAV	979	2,977	5,646	8,023	12,143	15,707	18,155	18,608
Financial leverage	1.33	1.94	1.75	1.70	1.63	1.67	1.72	1.67
Hedge funds								
Number			2	12	28	44	64	75
Total assets			369	3,439	5,564	5,964	6,879	7,361
Real estate assets			337	2,624	4,838	5,535	6,297	6,662
Debt			207	1,892	3,563	4,011	4,742	4,903
NAV			148	1,142	1,840	1,763	1,861	2,080
Financial leverage			2.50	3.01	3.02	3.38	3.70	3.54
SGR number	10	14	26	33	48	51	55	54

Source: Bank of Italy

Notwithstanding the financial crisis, the number of REIFs continued to increase between January 2008 and June 2010. The number of active funds at the end of June 2010 amounted to 281 (27 retail, 179 reserved and 75 hedge, as shown in Table 17.2.

The number of asset management companies managing this type of vehicle was 54 at the end of June 2010. These SGRs mainly belong to banking groups but there are also property market operators (Italian and foreign) and private individuals with professional experience in the field. In recent years, the market concentration has significantly decreased, due to the entry of new operators.

Most of the funds buy properties and lease them, sometimes after significant restructuring initiatives and after enhancing the property portfolio to make them more suitable to lease. However, almost one third of the Italian REIFs are focused on real estate development (we refer to them as development funds): during the construction or restructuring phase, the funds bear the cost of debt but do not generate incomes. Thus, the riskiness of these funds may be higher, especially during property market downturns.

With reference to the asset allocation of investments by funds, in the very last years a tendency started towards higher a balance in real estate investments, based on European experience, reducing the office portion. This reduction, from 66.7% in 2004 to 51.7% today, has only been partly offset by the retail sector, up in the same period from 11.3% to 19.1%, still lower than the European average.

The geographical asset allocation of Italian real estate funds in 2009 was concentrated in the north-west with 43.8% of the total, followed by central Italy (30.4%), the north-east (14.7%) and the south and islands 8.9%). Investments abroad were a mere 2.2% (Nomisma, 2010).

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THE ABSTRACT OF THE PROJECT IS:

The research programme will integrate diverse levels, methods and disciplinary traditions with the aim of developing a comprehensive policy agenda for changing the role of the financial system to help achieve a future which is sustainable in environmental, social and economic terms. The programme involves an integrated and balanced consortium involving partners from 14 countries that has unsurpassed experience of deploying diverse perspectives both within economics and across disciplines inclusive of economics. The programme is distinctively pluralistic, and aims to forge alliances across the social sciences, so as to understand how finance can better serve economic, social and environmental needs. The central issues addressed are the ways in which the growth and performance of economies in the last 30 years have been dependent on the characteristics of the processes of financialisation; how has financialisation impacted on the achievement of specific economic, social, and environmental objectives?; the nature of the relationship between financialisation and the sustainability of the financial system, economic development and the environment?; the lessons to be drawn from the crisis about the nature and impacts of financialisation? ; what are the requisites of a financial system able to support a process of sustainable development, broadly conceived?'

FESSUD

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