

Central Banking Series:

Inflation Expectations, Implications & Policy Response in a New Paradigm
for Commodities in partnership with the Banque de France

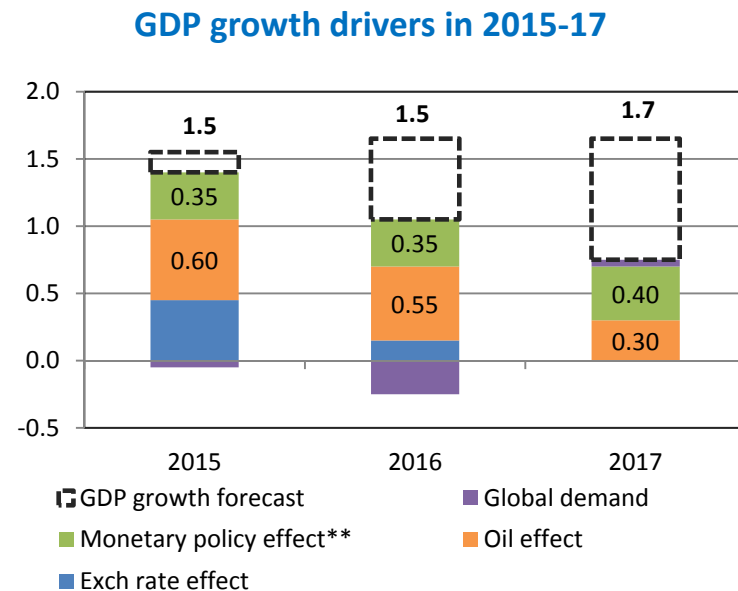
Paris – March 21, 2016

Eurozone outlook, ECB and Italian Banks

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Eurozone: tailwinds remain strong...



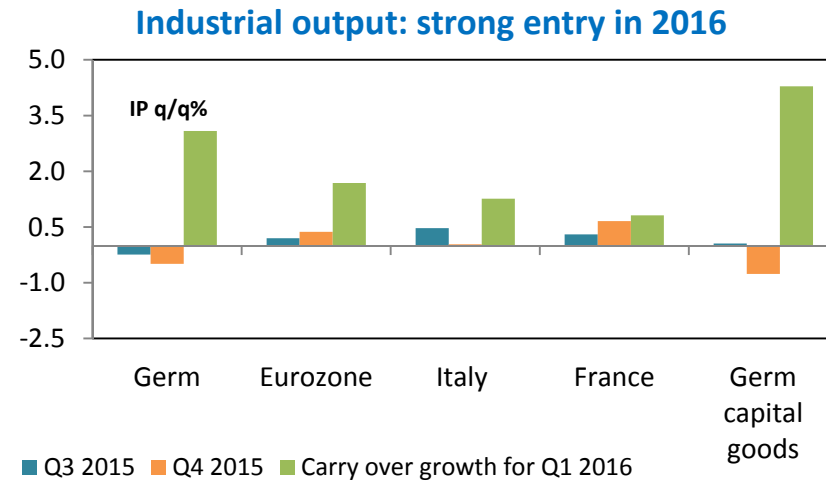
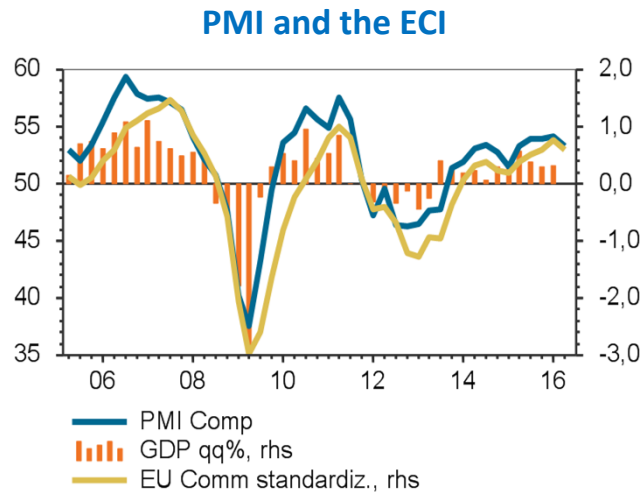
- **Oil price:**
2015: -47%; 2016: -25%. **Impact +1.5% in 2015-17**
- **Exchange rate:**
2015: - 9%. **Impact +0.6% in 2015-16**
- **Monetary policy:**
2015 (Jan): APP target announced +1,100 bn
2015 (Dec): additional 680 bn
2016 (Mar): further 240 bn + TLTRO II
Impact **: at least 1.1% extra GDP growth in 2015-17

*Note: ** Effect of the QE (Draghi, ECB press conference, December 2015): +1% GDP growth in 2015-17*

Source : Thomson Reuters-Datastream and Intesa Sanpaolo estimates with Oxford Economic Forecasting

... but growth unlikely to be faster than in 2015

- Business surveys point to a **deceleration in GDP growth versus 2015H2**, but might have been influenced by financial markets turbulence. **Industrial output data paint a rosier picture** and suggest some acceleration in Q1 2016.
- **Modest global growth and high uncertainty** still weigh on Eurozone economic prospects.

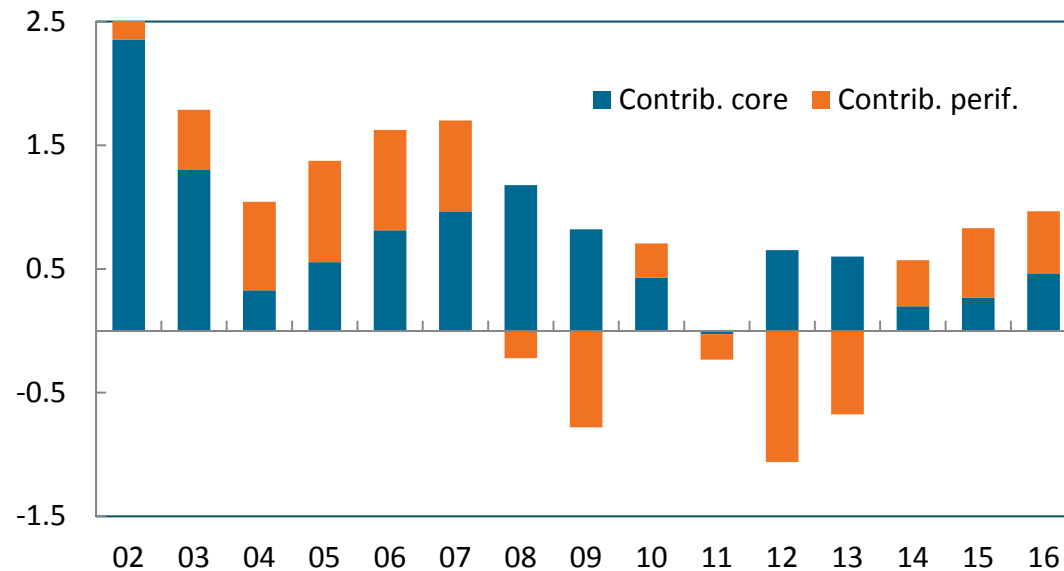


Source: Thomson Reuters-Datastream and Intesa Sanpaolo calculations

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Growth relies on domestic demand

Consumption will grow faster than in 2015

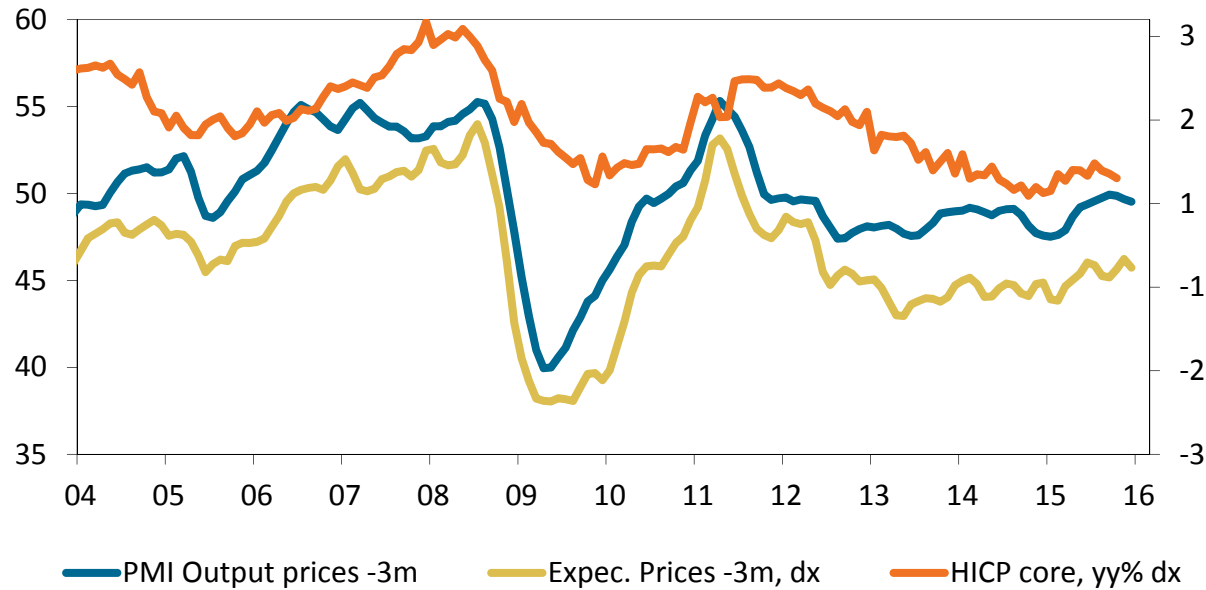


Source: Intesa Sanpaolo calculations

- Our outlook foresees oil prices in 2016-17 at 10% - 15% lower than in December 2015.
- This would imply a **positive contribution of around +0.6% to real disposable income**, broadly in line with the effect occurred in 2015.

Inflationary expectations too low for the ECB

Both market expectations and survey results remain at historically low levels

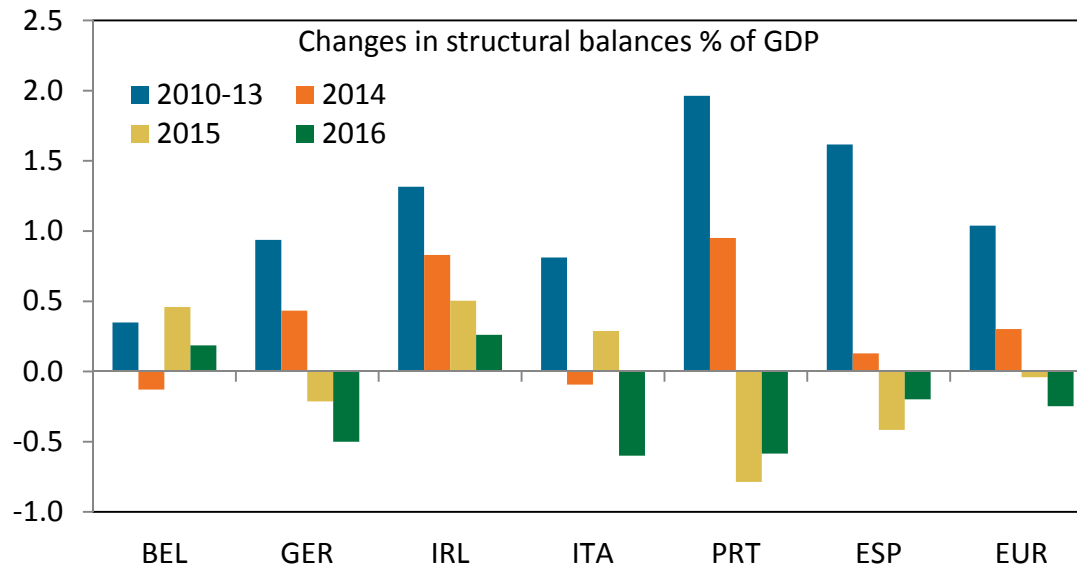


Note: expectations are derived from the EU Commission survey by sector. Series are standard deviations from the long-term average and are aggregated using the weights of the manufacturing, services and trade sectors in the value added.

Source: Markit (PMI), EU Commission and Intesa Sanpaolo calculations

Fiscal “flexibility”: only a pause in fiscal tightening

EU Commission estimates a fiscal easing of 0.2% of GDP in 2016



Source: European Commission, AMECO

- Fiscal policy to make use of maximum flexibility (reform efforts) in 2016-17 and possibly more (but only ex-post).
- Fiscal policies **will only contribute +0.1% to GDP growth** in 2016.

The only game in town is still monetary policy: ECB fired back

The ECB announced a set of “**Easing Measures**” to counter downside risks for growth and inflation.

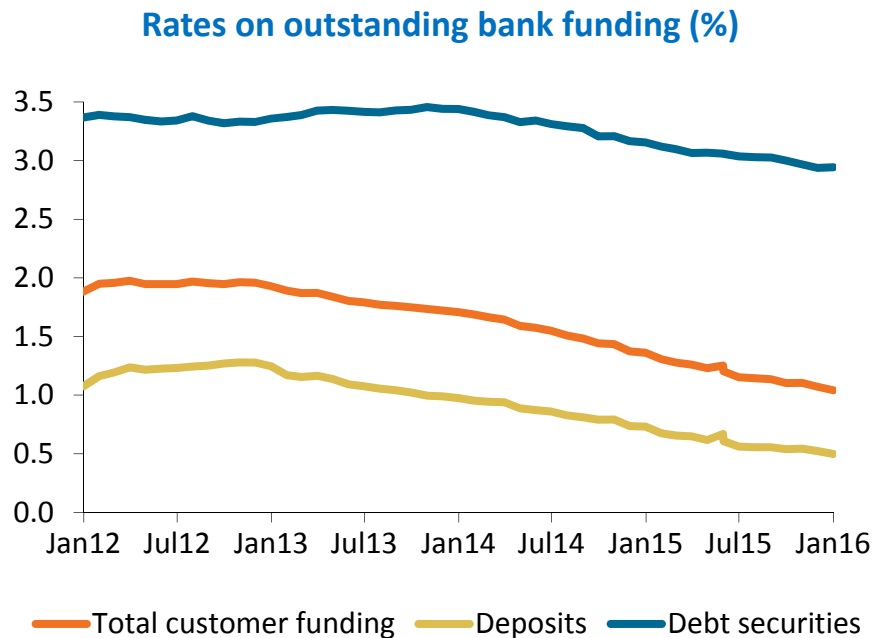
- Cut in **official rates**: marginal lending down to -0.25%, refi to 0.0% and deposit rate to -0.4%.
- Increase in the **APP target** to 80bn a month (effective from April).
- Extension of the purchases to **IG euro-denominated corporate bonds**, from June 2016 (bank bonds excluded). The ECB has not yet specified how much of a single issuance will be purchased: presumably, the limit will be set at no more than 30% (as is the case for government bonds). **We doubt the ECB will buy more than 5 billion a month.**
- **Forward guidance** reinforced: rates will remain « ... *at present or lower levels for an extended period of time, and well past the horizon of our net asset purchases*».

ECB March package a help mainly for banks' funding costs

The aim: « ... *offer attractive long-term funding conditions to the banking system to stimulate credit and provide funding certainty until 2021 ...*».

- Four new **4 year TLTRO II**, the first in June 2016, the last in March 2017.
- The **maximum amount banks can take is 1,480bn**: i.e., 30% of the loans' stock as of January 31 2016, excluding lending to the public sector and mortgages (EUR 5,642bn), net of the liquidity taken up with the TLTROs conducted in 2014 (EUR 218 bn).
- Banks will be charged an interest rate that could be "as low as" the deposit rate (-0.40%), depending on the **amount of new lending they will be able to provide** between January 2016 and January 2018. Conditions are easy to meet, so banks will be reimbursed easily.

Italian banks' wholesale funding costs can be cheaper

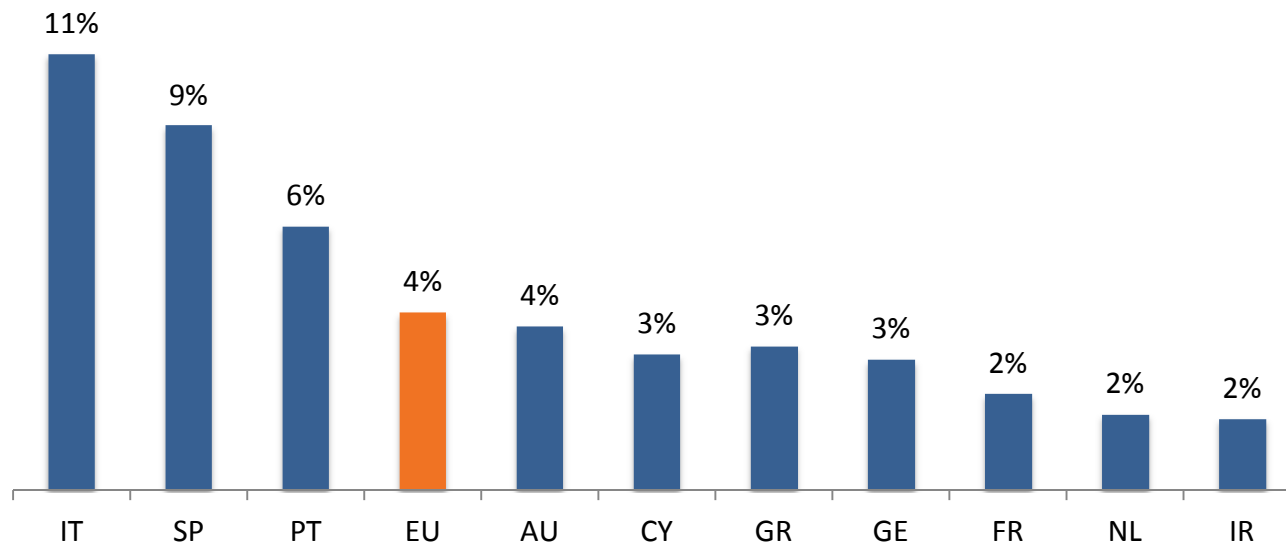


Source: Bank of Italy

- **TLTRO II** provides a less costly alternative to wholesale funding. In theory, the maximum take-up could be huge (EUR 320bn for Italian banks).
- **Wholesale funding costs will be impacted positively:** participating banks will enjoy tangible savings compared to the issue of bonds of correspondent maturity.
- **More fragile banks** and / or **banks located in peripheral countries** will benefit the most, because of their current levels of interest rates. The yield-to-maturity of senior Italian bank bonds 2020 is around 0.9% for sounder issuers, but several percentage points higher for the less solid.

Capital gains on Govies to partly offset the costs of negative rates

Eurozone banks' exposure to domestic sovereign as a % of total assets (1H 2015)



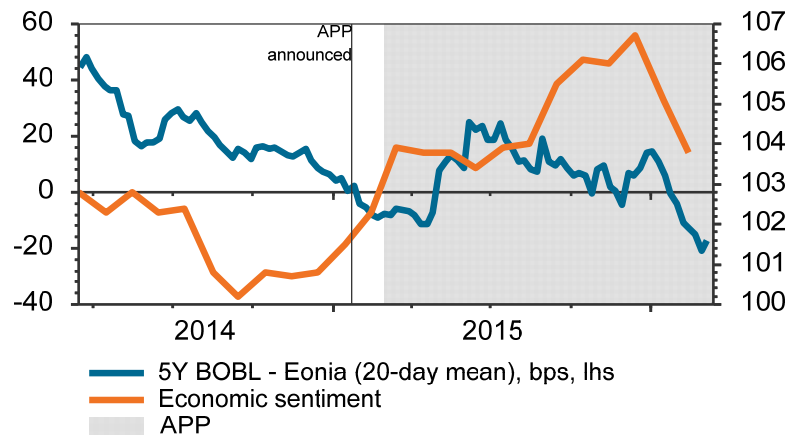
Source: ECB

- Capital gains on bond holdings temporarily **offset the unfavorable impact of negative rates on interest rate margins.**

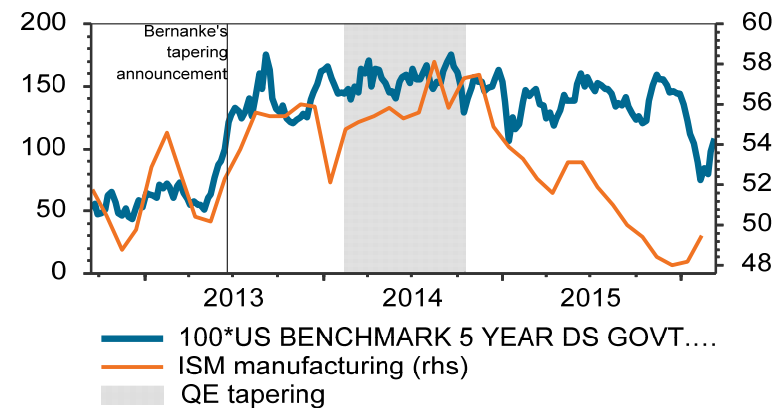
Yield curve to steepen, but only with stronger GDP growth

- The cost of non-conventional measures for banks would be lower if they produced a steepening of the yield curve. This is not the case.
- In the US the curve only steepened in response to strong evidence of economic recovery and with the beginning of the Fed's exit strategy.

**The APP has not steepened the yield curve.
This should come as no surprise**



**In the US, the yield curve only steepened
when the pace of economic activity picked up**



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Excess reserves more costly for core banks

Excess reserves: Netherlands and Germany have the lion's share

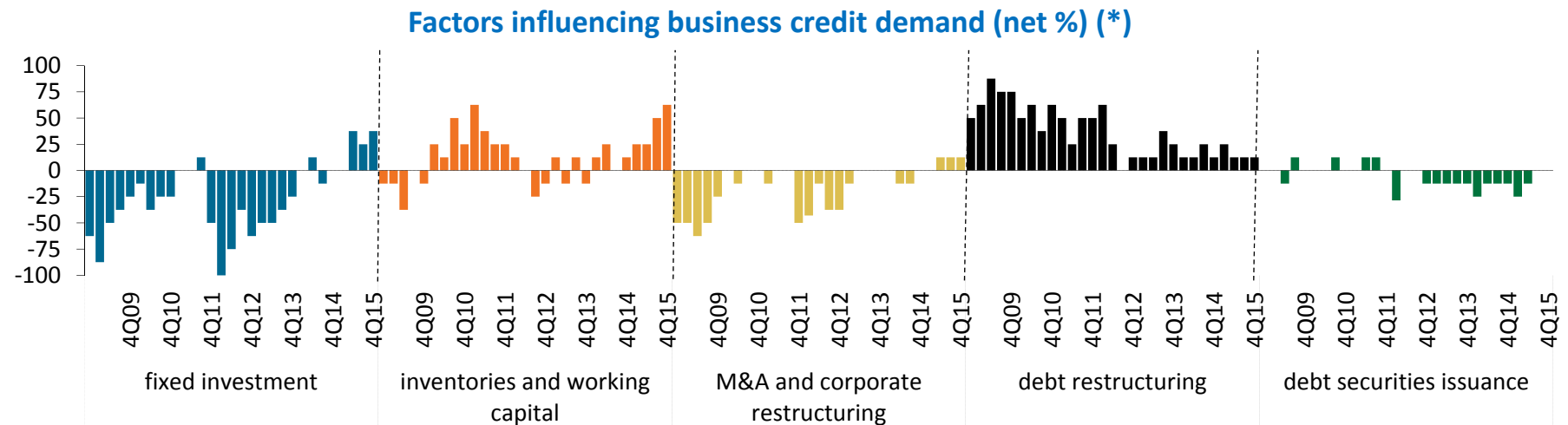
So far the cost is limited									
	Fr	Ger	Aus	Fin	It	Neth *	BG*	SP*	AE
Excess reserves (ER)									
Dec 11	3.1	-0.1	0.2	0.0	0.1	176	15	51	4.5
Dec 12	56.6	163.9	18.6	23.9	20.8	158	23	72	403.5
Dec 13	13.0	51.1	7.5	11.4	8.9	51	8	18	116.9
Nov 14	14.6	29.0	5.3	10.4	2.2	107	33	17	82.8
Oct 15	55.4	104.8	7.7	27.5	4.6	115	25	19	352.1
Dec 15	84.0	174.4	13.3	32.2	5.5	115	25	19	443.8
<i>Recourse to Depo where availble</i>	<i>77</i>	<i>53.58</i>		<i>10.4</i>	<i>5</i>				<i>220</i>
Current cost of ER bln euros	-0.25	-0.52	-0.04	-0.10	-0.02	-0.35	-0.08	-0.06	-1.98
MFI tot assets bln euros	8135	7,664	854	555	3919	2496	1076	2828	25923

Note: * the excess reserves is approximated by CA holdings in lack of statistics available to public on minimum reserves

Source: NCBs, ECB and Thomson Reuters-Datastream

The impact on Italian bank lending is uncertain

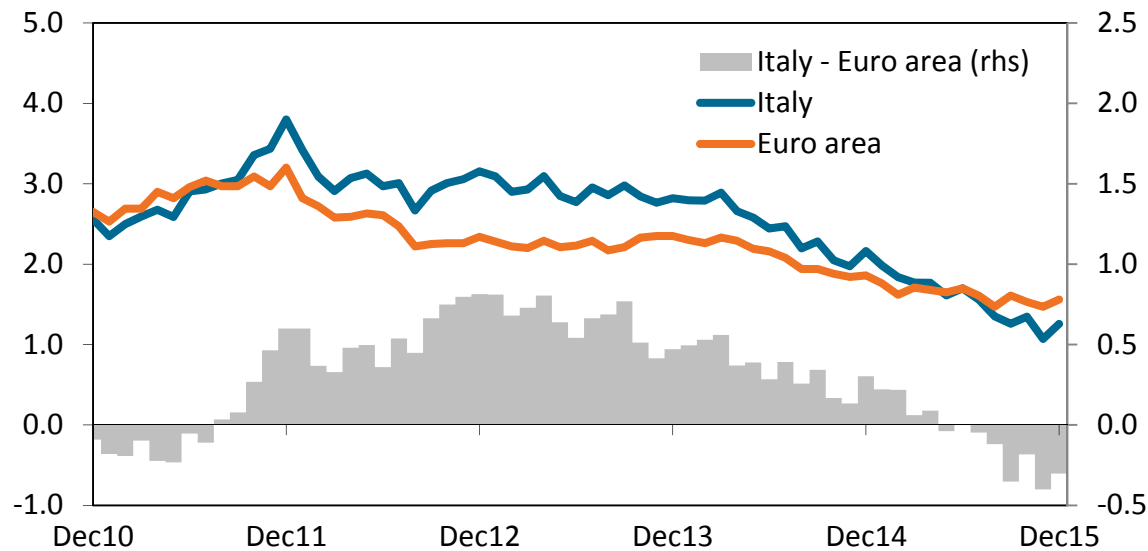
- The **credit trend** is currently affected (most of all) by demand factors, and by the constraints imposed by banking regulation.
- A “**crowding out**” effect could arise as a result of the opening of the purchase programme on IG corporate bonds. According to our calculations, total eligible Italian bonds amount to approximately EUR 69bn.



(*) a positive sign represents an increase in demand, a negative sign a decrease. Source: ECB, Euro Area Bank Lending Survey (BLS)

Italian bank rates to decline further

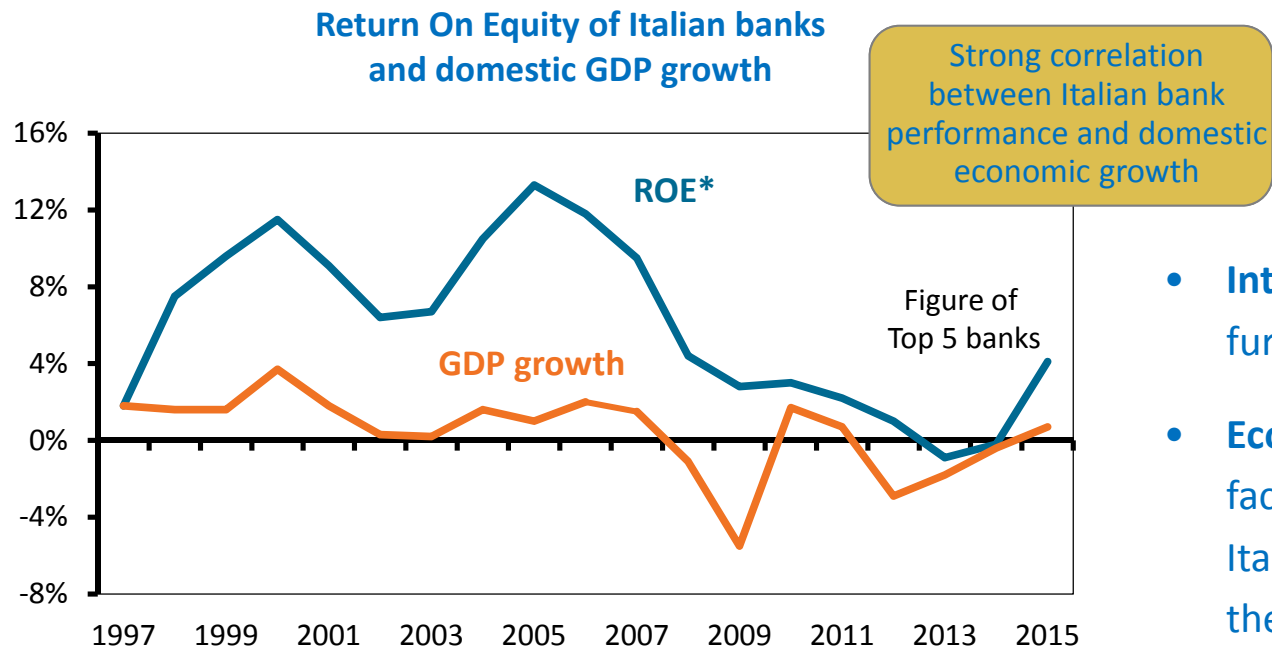
Rates on new loans to non-financial corporations
(%, loans other than overdrafts and revolving loans)



Source: Bank of Italy, ECB, Intesa Sanpaolo calculations

- For new loans over 1M to non-financial companies the spread with the Euro area **has been negative since May 2015** (reaching -30bps in December 2015).
- For loans of smaller amounts, the gap with the Euro area has narrowed to below 10bps.

Negligible effects on profitability



- **Interest margin** likely to be further compressed.
- **Economic recovery** is a key factor in the profitability of Italian banks, as a result of the business model.

**2010, 2012, 2013 and 2014 ROE net of goodwill amortization*

New measures to accelerate the disposals of NPLs

Changes in Insolvency & Foreclosure Regulation	Changes to the Fiscal Framework	State Guarantee on NPL securitization (GACS)
<ul style="list-style-type: none">• Persistence of NPLs due to a clogged judicial system.• A reform¹ of insolvency and foreclosure procedures (2015) aimed at:<ul style="list-style-type: none">- increasing speed and efficiency of insolvency procedures and property foreclosures;- promoting higher recovery rates.• Broader reform of civil justice to raise its efficiency.	<ul style="list-style-type: none">• New fiscal treatment of loan-loss charges adopted in 2015¹ to encourage write-offs and disposals of NPLs:<ul style="list-style-type: none">- loan-loss charges immediately tax deductible in full (instead of pro-quota in a 5Y period);- remove DTAs related to loan-loss charges in 10 years.	<ul style="list-style-type: none">• The buyers/sellers pricing gap is a key factor restraining NPLs' disposals.• Scheme to enable Italian banks to securitize and offload bad debt with a State guarantee in a way that would not be considered State aid (27 Jan 2016).• Banks' participation will be voluntary.

Notes: 1) DL83/Jun-2015/L132/Aug-2015. Sources: Intesa Sanpaolo Research Department, Bank of Italy

Structural reforms pave the way to consolidation

Reform of co-operative banks (*Banche popolari*)

- Approved in January 2015, to be enacted by year-end 2016.
- The reform will apply to 10 larger co-operative banks (out of 37 at YE14) with more than EUR 8bn in assets (c.15% of total asset of the system).
- The reform mainly envisages:
 - the transformation into joint-stock companies and removal of the-one-shareholder one-vote governance rule;
 - for a two-year transitional period banks can introduce a 5% shareholding limit.

Reform of mutual banks (*Banche di credito cooperativo*)

- Approved in February 2016, to be enacted by year-end 2017.
- The reform will apply to all mutual banks (> 370), but a few larger ones (equity > EUR 200M) that could opt to remain independent.
- The reform mainly envisages:
 - mutual banks will be required to participate in the capital of a holding company (equity > EUR 1bn), in turn controlling them;
 - mutual banks will benefit from a cross-guarantee scheme (legally obliged to support each other).