BARCLAYS

Economics Research

Europe

14 December 2012

Euro Themes

Italy: Roadmap to the general elections

Fabio Fois
+44 (0)20 3134 1136
fabio.fois@barclays.com

Giuseppe Maraffino
+44 (0)20 3134 9938
giuseppe.maraffino@barclays.com

www.barclays.com

- Early elections are likely to be called by the end of February, a few weeks ahead of the natural term of the legislature (end of April).
- Italy's main problem is not fiscal, rather it is one of anaemic growth and a secular loss of competitiveness. In the eyes of financial markets, Italy needs to complete the reform agenda in order to raise long-term growth prospects. Hence, market focus will be on structural reforms.
- In our opinion, Italy should be careful to not erode the 'credibility capital' accumulated by Prime Minister Mario Monti so far. We believe his commitment to assuming a central role in Italian politics (a scenario that we would not rule out completely at this stage) would be the best way to preserve that in the eyes of Italy's European partners and financial markets.
- While a potential centre-left coalition formed by PD (Democratic Party) and SEL (Left Ecology Freedom) leads polls, the risk of a political impasse is not zero at this stage. The differing electoral systems of the two chambers make it possible for no clear majority to be reached in the Senate, while in the Lower Chamber the PD and SEL are likely to secure an outright majority, according to recent polls.
- The latest political developments have affected the market, although the weakness of Italian bonds was only temporary and limited to about 40bp, with no particular effects on this week's auctions (12m BOT, new 3y BTP and 15y BTP).
- We expect markets to be very sensitive to political noise during the electoral campaign, with Italian paper likely to be more volatile than the relatively stable September-November period.
- However, we do not expect a situation of stress on the Italian government debt securities as in Q4 11. A combination of more Italian debt being held by domestic accounts, significant forced liquidation in peripheral assets that has already occurred and, more importantly, the backstop provided by the ECB, should limit the intensity of a possible stress situation compared to what was seen in 2011.
- The Italian banking system has entered the critical electoral campaign period with more capital and better liquidity conditions than in 2011. We expect it to be more resilient to any pressure on the sovereign bonds.
- Should the political debate signal stability and a continued reform agenda, we believe any sell-off should be seen as an opportunity to pick up extra yield in a context of very low safe-haven yields.

Elections likely by the end of February

Political crisis triggered Parliament transition

On 6 December, the Italian government won two confidence votes, in the Senate and in the Lower Chamber. However, the political scene was unsettled as People of Freedom (PDL) MPs abstained from both ballots. A few days later, Prime Minister Mario Monti announced his intent to resign after the approval of the Budget Law (which is mandatory, according to the Italian Constitution by 31 December). PM Monti reportedly said his decision was in reaction to Silvio Berlusconi's party's decision to withdraw support from the government and that he will not consider seeking an alternative majority in the Parliament, paving the way for early elections.

Budget Law likely to be approved around Christmas

The Budget Law is scheduled for debate in the Senate on 18 December. It will return to the Lower Chamber (where it was approved on 22 November) for a final debate/vote on any amendments potentially introduced in the Upper House. We expect the process to be short and the Budget to be approved around Christmas. Reportedly, President Napolitano asked party leaders to make the Parliamentary transition as smooth as possible. A few key laws still require Parliament approval, among which the 2013 Budget Law and constitutional debt-brake rule stand out in importance. The PDL party has committed to vote for the Budget, but it seems that the balanced-budget rule is unlikely to be cleared ahead of Parliament dissolution.

PM Monti to resign and President Napolitano to call elections

Following PM Monti's (announced) resignation, we expect President Napolitano to dissolve the Parliament once the budget law is approved, and call for early elections (which must be held within 45-70 days after the Parliament is dissolved, according to the Italian Constitution). Interior Minister Anna Maria Cancellieri yesterday said that political and regional elections (in Lazio, Lombardy and Molise) could be held on the same day, likely to be February 17 (implying that Parliament should be dissolved, at the latest, around end December/beginning of January).

The deadline for PM candidates depends on the election date. Party manifestos, alliances and indications of prime minister candidate(s) must be presented by 6 January (for a 17 February vote) or by 13 January (for a 24 February vote). That being said, we do not think Mario Monti will have to align himself with any coalition necessarily by these dates. While he can be asked to lead a coalition and run at the next general elections (even in his position of life senator), he could still indicate his willingness to accept a role in the next government at a later stage and remain a potential candidate. In fact, these deadlines may be less relevant because, according to the Italian Constitution, the President of the Republic is the only person in charge of appointing the prime minister.

We welcome early elections as a protracted electoral campaign could increase the risk of a spike in rhetoric

Overall, we welcome early elections as a protracted electoral campaign could increase the risk of a spike in rhetoric. We also welcome the (likely) decision of holding general and regional elections on the same day because this would help to reduce volatility during the electoral campaign. Where local elections have been held before the general, defeated political forces could be tempted to campaign against outgoing governments to recover popularity. That being said, the argument might not work in the Lazio Region because early elections were called after the local government coalition (centre-right oriented) was alleged to have used public money improperly. Should the centre-right be defeated, it could be difficult to blame the central government for the loss of popularity. Were the centre-left coalition defeated, we doubt it would start to campaign against Monti's government as this would not fit with its communication strategy (likely to be mainly pro-Monti and pro-Europe) in the electoral campaign. Finally, we think it is particularly important that the PDL party votes the Budget Law before formally opening a political crisis.

Current state of electoral polls – PD party (centre left) leads

Electoral polls show PD (centre-left) has momentum, while PDL (centre-right) hovers around low levels

The Democratic Party (PD), led by Pierluigi Bersani (who won primaries within centre-left coalition on December 2), continues to have momentum. Its popularity has been on an upward trend since the beginning of October, increasing from 26.7% of Italians' preferences to nearly 35% at the most recent reading on 7 December (Figure 1). Meanwhile, the PDL party (People of Freedom, centre-right), led by Silvio Berlusconi (who has recently announced his intent to run for the sixth time), has been broadly unchanged. If anything, its popularity has declined slightly, edging down from 16.7% to 15.3%.

Popularity of NL and SEL parties (potential allies of PDL and PD respectively) is stable

The Northern League (NL, centre-right) has also been broadly stable, averaging about 5.4% since October. Among the smaller parties, though, Union of Centre (UDC, centre) has lost ground since October (from 6.4% to 5.0%), Left Ecology Freedom (SEL, radical left) has remained broadly unchanged, while Italy of Values (IDV, centre-left) has fallen considerably to 2.1% from 5.9% at the beginning of October (Figure 2).

Compared with previous elections (2008), former government parties have lost considerable ground

The comparison between the latest electoral polls and previous general elections (2008) is particularly striking. The popularity of the two former government parties, PDL and NL, has plunged to historical lows: PDL lost more than 22pp, to 15.3% from 37.4%, while NL almost halved its popularity (was 8.3% in 2008 and it is now 5.7%). In contrast, the PD party (which has been leading Parliament opposition) has improved slightly to 33.2%.

A new force hit the political arena: the "5 Star Movement"

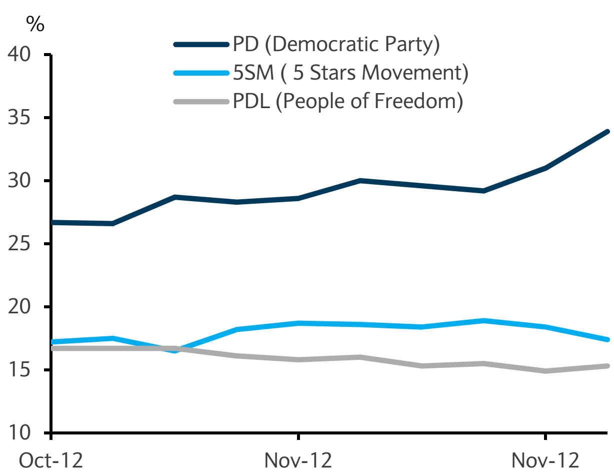
Polls seem to indicate that the electoral consensus lost by traditional parties was catalyzed by a new political party – 5 Star Movement (5SM) – anti-establishment movement led by former comedian Beppe Grillo. According to different polls, 5SM would attract 15-20% of voters, ranking it as the second-most popular party.

5SM electoral space might threaten by PDL party

It is difficult to assess whether the 5SM will continue to have momentum. Though this is the first time the party faces general election, its popularity has been rather stable over the past few weeks, after surging at the beginning of this year. That being said, we think that without a core electoral base, support for 5SM could be volatile. Silvio Berlusconi's party (which seems to have decided to campaign against the government) may occupy the space currently filled mostly by the 5SM. Moreover, smaller parties (particularly those that tend to use strong rhetoric during the electoral process) have recently polled better than results suggest.

FIGURE 1

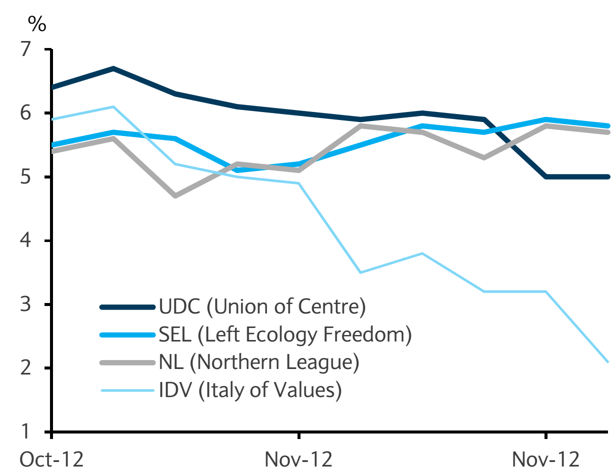
Polls indicate that PD gains momentum and PDL weakens



Source: Various electoral polls (average), Barclays Research

FIGURE 2

Popularity of SEL and NL parties is broadly stable



Source: Various electoral polls (average), Barclays Research

Uncertain outcome in Senate may bring political instability

The outcome in the Senate is particularly uncertain at this stage. While a centre-left coalition formed by PD-SEL (Democratic Party - Left Ecology Freedom) leads polls, it might not be able to secure an outright majority in both chambers. Different electoral systems between the two chambers, in fact, make it possible for no clear majority in the Senate, unlike in the Lower Chamber. Based on our analysis, a centre-right coalition formed by PDL and NL (People of Freedom/Northern League) may still be able to win a good portion of the votes in some Northern regions (Lombardia, Veneto and potentially Piemonte), thereby making the outcome of the Senate extremely difficult to predict. As we explain below, control of both the Congress and the Senate is crucial.

Parliament composition

To avoid political instability the needs to control both Houses

The Italian Parliament is a bicameral legislature with 945 elected members. It is formed by the Chamber of Deputies, with 630 members, and the Senate of the Republic, with 315 members (including six senators allocated for Italians living abroad)[1]. Both houses have almost the same power. Other than the budget, any law can be initiated in either house and must be approved in the same form by both the chambers. The government must have the consent of both to remain in office ("perfect bicameralism"). Finally, seats are allocated among the parties that pass voting thresholds on a national basis in the Lower Chamber and on a regional basis in the Senate. Specifically, thresholds are the following: 10% for a coalition or 4% for any party not in a coalition in the Lower House; and 20% for a coalition, or 8% for any party not in a coalition. The single-party limit continues to apply if coalitions do not meet requirements.

Lower vs. Upper House: Same electoral system applied to different basis

The block-voting system is nationwide for the Lower Chamber and regional for the Senate. Italy is divided into districts for the Chamber of Deputies, whereas each region elects its senators. Each district/region is assigned a number of seats proportionate to its total of the population of Italy. The winning coalition receives at least 55% of the seats on a national level in the House and on a regional level in the Senate, while the remaining seats are divided proportionally between minority parties using the so-called Hare Quota System[2].

The rule that assigns the majority premium to the most voted coalition differs in the two houses: while in the Lower Chamber, it is computed at a national level, in the Senate, it is assigned at a regional level. The coalition that wins a plurality in a region is automatically given 55% of the region's seats if it has not reached that percentage already.

To secure a strong presence in the Senate, political parties tend to pursue a regional strategy. Opposing parties or coalitions may benefit from a majority premium dislocation between the two chambers.

Populated regions are therefore the most critical. Figure 3 shows the possible regional seat distribution in the Senate. Only eight regions are assigned more than 20 seats; of those, three are located in Northern Italy (Lombardy, Veneto and Piemonte) and count for almost 30% of total seats (95), which have generally been a stronghold of the conservative, centre-right parties.

[1] Currently there are five life Senators seated in the Upper House which have to be counted in addition to the 315 elected (PM Monti included).

[2] The "Hare Quota" (HQ) is calculated as follows: total number of votes received by parties divided by the number of seats not assigned to the winning coalition. The number of votes received by each party is then divided for the HQ.

Potential composition of the Senate

We present below the underlying assumption of our analysis:

1. **Electoral polls –** Average of different pollsters (SWG, Demos, Euromedia, Ipsos, EMG).
2. **Latest observation:** 7 December.
3. **Coalitions –** We assume the following coalitions will be formed: PD+SEL (centre-left) and PDL+NL (centre right).
4. **Seat allocation –** We took the official estimate made by the Research Centre of the Senate[3], which is based on 2011 census.
5. **Vote distribution across regions** – Same as general elections held in 2008.
6. **Battleground regions –** We identify Lombardy, Veneto and Sicily as the regions where potential alliances with local movements may heavily influence the electoral outcome.
7. **Life Senators** – Our analysis excludes the votes of life senators.
8. **Other assumptions –** We assumed the 5SM party meets the single-party threshold in all regions[4]. We assume that UDC also meets the minimum required as a single party but only in Sicily.

Outcome in Lombardy Region will be key for political stability

We present below potential compositions of the Senate under different scenarios. Based on our analysis, a centre-left coalition would likely secure an overwhelming majority in the Senate if it won all the regions, battlegrounds included. It would reach 178 seats, against a required absolute majority of 158 (life senators excluded) (Figure 3). Should it be defeated in one battleground region, we believe a PD-SEL coalition would still be able to secure between 165 (if defeated region is Lombardy) and 170 seats (if defeated region is either Veneto or Sicily). Should a PD-SEL coalition win in Lombardy while being defeated in Veneto and Sicily, it would be able to secure a slight majority of 162. The outcome would be more uncertain if, instead, a centre-right coalition made by NL and PDL won in Lombardy and in one of the other two battleground regions. Under this scenario, a centre-left coalition formed by PD and SEL would win 157 seats. Finally, in our analysis, the worst-case scenario (from a political stability point of view) would be a PD-SEL coalition losing in all the battleground regions as it would secure 149 sets.

A word of warning

As a reminder (and due to the high uncertainty surrounding our analysis at this stage), below are a few points that should be taken into account when reading our estimates.

1. The decision of battleground regions is arbitrary. However, centre-right parties have historically led in those regions; therefore, there is likely to be a close call between the two coalitions.
2. It is extremely difficult to project the electoral result for the 5SM party at a regional level. Historical data for vote distribution are not available. We treat it as residual.
3. Seats assigned to a PD-SEL coalition in Molise, Trentino-Alto Adige/Sud Tirol, Aosta Valley and Abroad regions are arbitrary (7 over 16). However, our assumption is not too dissimilar from the result secured at previous elections.

[3] http://www.senato.it/documenti/repository/dossier/studi/2012/Dossier_356.pdf
[4] Please note that 5SM was not a candidate at general elections in 2008.

FIGURE 3

Possible Senate composition under different electoral scenarios for battleground regions (Lombardy, Sicily, Veneto).

	Number of seats assigned to PD-SEL coalition if:					
Region (Number of seats)	**Wins all Regions**	**Wins all regions but 1**	**Wins all regions but 1**	**Wins all regions but 2**	**Wins all regions but 2**	**Wins all regions but 3**
Potentially defeated battleground regions	*-*	*Lombardy*	*Sicily OR Veneto*	*Sicily AND Veneto*	*Lombardy + 1*	*Lombardy, Sicily, Veneto*
Lombardy (49)	*27*	*14*	*27*	*27*	*14*	*14*
Sicily (25)	*14*	*14*	*14*	*6*	*14*	*6*
Veneto (24)	*14*	*14*	*6*	*6*	*6*	*6*
Campania (29)	16	16	16	16	16	16
Lazio (28)	16	16	16	16	16	16
Piedmont (22)	13	13	13	13	13	13
Emilia Romagna (22)	13	13	13	13	13	13
Apulia (20)	11	11	11	11	11	11
Tuscany (18)	10	10	10	10	10	10
Calabria (10)	6	6	6	6	6	6
Liguria (8)	5	5	5	5	5	5
Marche (8)	5	5	5	5	5	5
Sardinia (8	5	5	5	5	5	5
Friuli Venezia Giulia (7)	4	4	4	4	4	4
Umbria (7)	4	4	4	4	4	4
Abruzzo (7)	4	4	4	4	4	4
Basilicata (7)	4	4	4	4	4	4
Trentino-Alto Adige/Sud Tirol* (7)	3	3	3	3	3	3
Abroad* (6)	3	3	3	3	3	3
Molise* (2)	1	1	1	1	1	1
Aosta Valley* (1)	-	-	-	-	-	-
Total seats secured	**178**	**165**	**170**	**162**	**157**	**149**
Absolute majority**	158	158	158	158	158	158

Note: * Barclays assumptions. ** Life senators excluded. Source: Various polls, Barclays Research

Market implication: Pressure but not panic selling

Sovereign debt

Resent weakness in Italian paper was temporary and was limited to about 40bp cheapening

The latest political developments discussed in the previous section have affected the Italian debt market, although the weakness was only temporary and limited to 40bp, with no particular effects on this week's auctions (12m BOT, new 3y BTP and 15y BTP).

Since 6 December, when PDL announced its intention to withdraw support from PM Monti's government, volatility on Italian government securities has increased across maturities. We envisaged a combination of factors causing the movement, mainly: market illiquidity at the end of the year and positioning ahead of mid-December auctions, in a context of increased uncertainty about political developments. Indeed, the increase in yields has been more related to the widening of the bid/ask spread (which is typical when uncertainty increases) rather than to significant sell-off flows. However, the weakness was temporary: after the initial 40bp sell-off to 4.80%, the 10y BTP yield reverted to about 4.60%. Easing supply pressures could favour a further decline in yields. However, with market focus now on political developments, volatility is likely to stay higher than in the relatively stable September-November period.

The next two weeks should see some moderate weakness in Italian paper, as end-of-year illiquidity in EGB markets should exacerbate the effect of positioning on yields ahead of end-of-December auctions.

BTPs likely to be affected by increase in political noise…

As is usual ahead of political elections, the market should become more sensitive to news and political comments. Therefore, in the coming months, BTPs are likely to suffer from increased political noise during what is expected to be a fierce electoral campaign.

… however, an increase in pressure as in H2 11, is unlikely

However, in our opinion, a significant deterioration in market sentiment, leading to an increase in BTP yields and widening of BTP/Bund spreads, as in October/November 2011[5], is unlikely. One of the reasons is the structural change in the structure of the EGB market (especially for peripheral countries), following the significant liquidation of peripheral assets by non-residents that has occurred. Moreover, market participants still exposed to Italy are more likely to be in a stronger position to manage their exposures. Among non-resident accounts, we believe a large part are "benchmarked" investors who should not be particularly keen to be underweighted Italy (which would be the case for most euro area real money investors).

A significant and quick liquidation of non-resident positions on Italy widened bid/ask spreads, lessened liquidity and increased volatility in Q4 11

Figure 4 shows the evolution of debt held by non-residents as a percentage of total debt securities According to the Bank of Italy data, currently about 36% of total Italian debt securities is held by non-domestic investors (excluding the ECB, which bought about €90bn of Italian debt under the SMP programme, according to our estimates). Note that before the beginning of contagion in summer 2011, non-resident holdings accounted for 52%. It is interesting to note that non-resident investors continued to hold Italian paper until summer 2011 (while for Spanish paper the liquidation had already started gradually in 2010); following the deterioration of sentiment regarding Italy in June 2011, there was a massive and quick liquidation of positions on Italy, which widened bid/ask spreads significantly, lessened liquidity and increased volatility. In such a scenario, risk management considerations prevent some domestic accounts (mainly banks) from increasing their exposure to Italian debt, while also affecting banks' capital strengths. After declining to an historical low of 32%, non-resident holdings have increased slightly to 36% in September on improved market sentiment.[6]

[5] The 10y BTP yield hit the historic high of 7.3% on 28 November 2011, and the 10y BTP/bund spread widened to its highest level of 552bp on 9 November 2011. PM Berlusconi resigned on 12 November 2011 and on the following day Napolitano asked Mr Monti to form a new government,

[6] This partially explains the improvement in the Target 2 liabilities. As highlighted in a recent Bank of Italy paper, "Determinants of Target 2 imbalances", October 2012, the increase in Target 2 Liabilities for Italy was a result of the reduction in capital inflows due entirely to a decrease in interbank market cross-border activity and portfolio investments by non-residents (which forced Italian banks to increase their dependence on the ECB).

The combination of several factors in addition to domestication should limit the effect of volatility on yields

In addition to the "domestication" of the public debt market, a few other important aspects are worth highlighting. First, there have been no liquidations in Italian paper since March 2012, and evidence shows that traditional foreign investors have come back over the past few months, especially at the short end of the curve, on improved sentiment from the ECB announcement of the OMT. Furthermore, there has been substantial progress in addressing some of the imbalances in peripheral countries (eg, current account deficit, competitiveness, budget deficits), and the Spanish situation is currently more under control. European authorities have set up potential solutions to the crisis, and markets now seem to understand better than at the beginning of the crisis politicians' modus operandi and the slow process towards more fiscal and banking integration in the euro area. Finally, and more importantly in our opinion, , the ECB is providing a crucial backstop by reducing the tail risks of the crisis significantly, first with the 3y LTROs and now with the OMT announcement. The combination of all these factors has improved sentiment, with the market now looking less vulnerable to any particular shock, such as a political crisis in Italy. This, in our view, should limit the intensity of any wave of selling pressure and its impacts on yields.

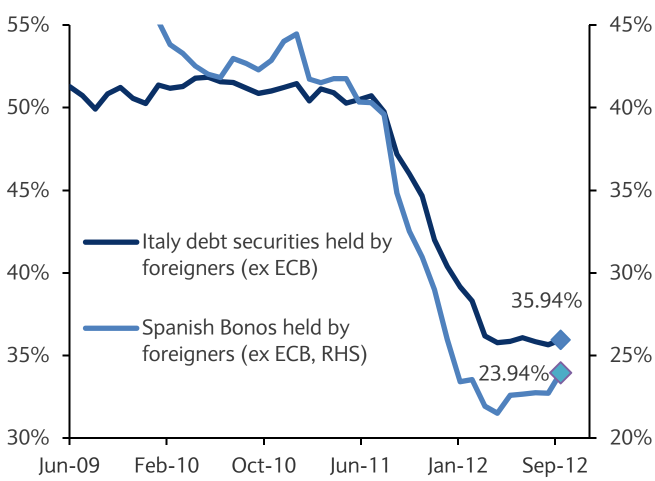
Also, in a context of near-zero yields on core assets, the search for yield should favour peripheral assets, especially at the short end of curves that also benefit from the "implicit protection" of the ECB's OMT programme. In this respect, we would not rule out the possibility that any sell-off on BTPs could be seen as a buying opportunity, should polls suggest a favourable outcome in terms of political stability and a continued reform programme.

The issuance and redemptions outlook for next year appears favorable as well

The issuance and redemptions outlook for next year looks more favourable as well. In 2013, we expect Italian gross supply (bills and bonds) of €410bn (from about €470bn in 2012): €220bn of gross t-bill issuance and €190bn gross bond supply (BTP, BTP€I, CCT, CTZ and BTP Italia). With bond redemptions amounting to €160bn (from about €200bn in 2012), the net issuance of bonds should be positive by about €30bn (approximately in line with 2012), while for t-bills it should be negative by about €4bn (compared with €20bn of positive supply in 2012). The redemption profile looks supportive as well, not only because the total amount of redemption is less than in 2012 (when it was about €200bn) but also because in Q1, which should be characterised by high volatility due to the general election at the end of February/beginning of March, only one big bond redemption is scheduled (€21bn on 1 February).

FIGURE 4

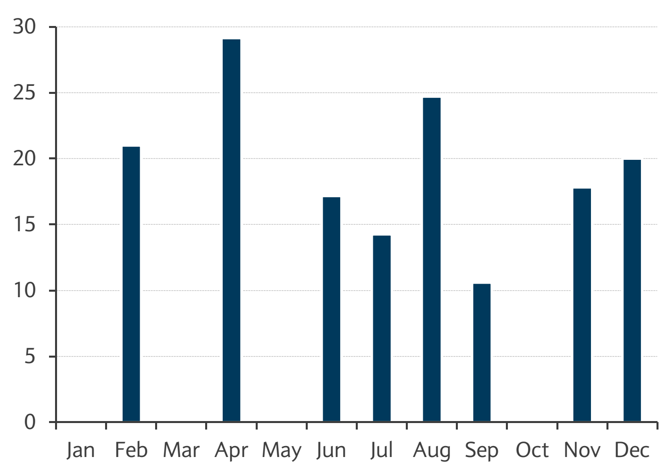
Non-resident holding over total debt: liquidation already occurred



Source: Bank Of Italy, Spanish Treasury Barclays Research

FIGURE 5

Bonds redemptions (BTP, BTP€I, CTZ and CCT) profile in Italy in 2013 (€bn)



Source: Italian Treasury, Barclays Research

Italian banking system

Italian banking system is vulnerable to pressure on the sovereign, even if the linkage has become less strict

Due to their exposure to sovereign debt (7.6% of the total assets, as of the end of October 2012), the Italian banking system was affected severely by the increased tension on sovereign debt in 2011. However, efforts by major banking groups to meet the EBA recapitalisation requirement and the ECB's liquidity measures have made Italian banks more resilient to tensions on sovereign bonds[7]. Indeed, in the April-July 2012 period, which was characterised by tension in the EGB markets and a rewidening of BTP/Bund spreads (to 533bp on 20 July, before President Draghi's speech in London), the repo market for Italian banks continued to work (although funding was available only for short maturities), with GC rates remaining low (at about 20bp) and stable. This was due to the removal of liquidity risk thanks to the ECB's 3y LTROs, with Italian banks borrowing €255bn (92% of total ECB borrowing for Italian banks).

Uncertainty regarding the election outcome could see Italian banks refraining from beginning to repay the ECB's 3y liquidity (the option could be exercised on a weekly basis from 31 January for the December 2011 3y LTRO and from 27 February for the February 2012 3y LTRO). We expect Italian banks to reibourse €40bn out of €255bn in the first months of 2013[8]

In general, Italian banks have entered the critical period of the electoral campaign in better condition versus 2011. We envisage a number of factors that should limit the effect on banks from any sovereign tensions driven by political uncertainty.

Less volatility should be supportive

First, volatility on the Italian Government securities is likely to be more limited compared with Q4 11. Thus, banks should be able to manage their Italian debt securities holdings, rolling the maturing debt and potentially increasing their exposures to the sovereign in case of a significant deterioration of sentiment on Italy that results in non-resident investors not rolling their exposures.

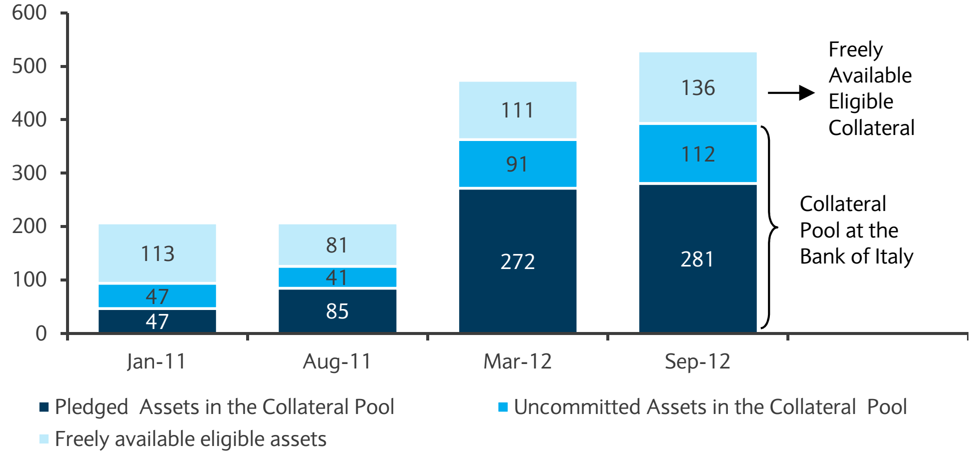
More solid liquidity, and capital conditions also a positive

The abundant and long-term ECB liquidity represents important protection. Moreover, anecdotal evidence shows the deposit base has increased over the past few months (on improved sentiment and declining public debt yields), which could explain the reduction in repo market usage (in November, the amount of CCP repo outstanding for Italian banks declined €20bn according to ECB data). Importantly, in its November Financial Stability Report, the Bank of Italy estimates that Italian banks had (at the end of September) a buffer of unencumbered ECB eligible collateral of about €248bn, slightly less than the current outstanding ECB borrowing (€276bn). This should offset any effects from possible funding market closure and the impact on collateral from a potential downgrade of the Italian rating to the BBB area by all the rating agencies[9], as well as any margin call to compensate for the reduced market value of collateral used at the ECB operations related to the cheapening of Italian bonds.

[7] While this is valid in general, important differences arise between large banks and medium-sized banks that are struggling because their asset impairment. Increased volatility is likely to weigh on weaker banks that are already in trouble and could need extra recapitalisation.
[8] See October 15 Euro Money Markets Weekly "3y LTROs: Moderate and gradual payback" for a more in depth analysis
[9] In the November Financial Stability Report, the Bank of Italy estimated that an increase in haircuts due to a downgrade of the Italian sovereign rating to the BBB area from all agencies should decrease the value of collateral already used at the ECB's operations by about €30bn. See *Italian banks: Plenty of ECB eligible collateral*, 23 November 2012, for a more in-depth analysis

FIGURE 6

Italian banks: Plenty of ECB eligible collateral



Source: Bank of Italy, Barclays Research

Conclusion

Market environment in better condition to face increased political uncertainty in Italy than in the past

The recent political situation in Italy is likely to keep volatility higher with respect to the September-November period, which was characterised by relative stability in the BTP market. The electoral campaign has just started, and we expect markets to become more sensitive to any political news. However, we believe the combination of more Italian debt that is now held by domestic accounts (with respect to 2011), significant forced liquidation in peripheral assets that has already happened, progress at the institutional level to lay the ground for structural solution of the crisis, and, more importantly, the backstop provided by the ECB should limit the intensity of a possible stress situation with respect to what was seen in 2011. A favourable supply and redemptions profile in Q1 should be an additional support in the worst-case scenario. The Italian banking system should be more resilient if sovereign market tensions increase significantly due to their better liquidity and capital positions. Eventually, together with the retail sector, Italian banks could also provide support to the Italian Treasury.

Should the political debate signal stability and a continued reform agenda, we believe any sell-off should be seen as an opportunity to pick up extra yield in a context of very low safe-haven yields.

Analyst Certification

We, Fabio Fois and Giuseppe Maraffino, hereby certify (1) that the views expressed in this research report accurately reflect our personal views about any or all of the subject securities or issuers referred to in this research report and (2) no part of our compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this research report.

Important Disclosures:

Barclays Research is a part of the Corporate and Investment Banking division of Barclays Bank PLC and its affiliates (collectively and each individually, "Barclays"). For current important disclosures regarding companies that are the subject of this research report, please send a written request to: Barclays Research Compliance, 745 Seventh Avenue, 17th Floor, New York, NY 10019 or refer to http://publicresearch.barcap.com or call 212-526-1072.

Barclays Capital Inc. and/or one of its affiliates does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that Barclays may have a conflict of interest that could affect the objectivity of this report. Barclays Capital Inc. and/or one of its affiliates regularly trades, generally deals as principal and generally provides liquidity (as market maker or otherwise) in the debt securities that are the subject of this research report (and related derivatives thereof). Barclays trading desks may have either a long and / or short position in such securities and / or derivative instruments, which may pose a conflict with the interests of investing customers. Where permitted and subject to appropriate information barrier restrictions, Barclays fixed income research analyst(s) regularly interact with its trading desk personnel to determine current prices of fixed income securities. Barclays fixed income research analyst(s) receive compensation based on various factors including, but not limited to, the quality of their work, the overall performance of the firm (including the profitability of the investment banking department), the profitability and revenues of the Fixed Income, Currencies and Commodities Division ("FICC") and the outstanding principal amount and trading value of, the profitability of, and the potential interest of the firms investing clients in research with respect to, the asset class covered by the analyst. To the extent that any historical pricing information was obtained from Barclays trading desks, the firm makes no representation that it is accurate or complete. All levels, prices and spreads are historical and do not represent current market levels, prices or spreads, some or all of which may have changed since the publication of this document. The Corporate and Investment Banking division of Barclays produces a variety of research products including, but not limited to, fundamental analysis, equity-linked analysis, quantitative analysis, and trade ideas. Recommendations contained in one type of research product may differ from recommendations contained in other types of research products, whether as a result of differing time horizons, methodologies, or otherwise. In order to access Barclays Statement regarding Research Dissemination Policies and Procedures, please refer to https://live.barcap.com/publiccp/RSR/nyfipubs/disclaimer/disclaimer-research-dissemination.html.

Limited is regulated by the South African Reserve Bank. This publication is not, nor is it intended to be, advice as defined and/or contemplated in the (South African) Financial Advisory and Intermediary Services Act, 37 of 2002, or any other financial, investment, trading, tax, legal, accounting, retirement, actuarial or other professional advice or service whatsoever. Any South African person or entity wishing to effect a transaction in any security discussed herein should do so only by contacting a representative of Absa Capital in South Africa, 15 Alice Lane, Sandton, Johannesburg, Gauteng 2196. Absa Capital is an affiliate of Barclays.

In Japan, foreign exchange research reports are prepared and distributed by Barclays Bank PLC Tokyo Branch. Other research reports are distributed to institutional investors in Japan by Barclays Securities Japan Limited. Barclays Securities Japan Limited is a joint-stock company incorporated in Japan with registered office of 6-10-1 Roppongi, Minato-ku, Tokyo 106-6131, Japan. It is a subsidiary of Barclays Bank PLC and a registered financial instruments firm regulated by the Financial Services Agency of Japan. Registered Number: Kanto Zaimukyokucho (kinsho) No. 143.

Barclays Bank PLC, Hong Kong Branch is distributing this material in Hong Kong as an authorised institution regulated by the Hong Kong Monetary Authority. Registered Office: 41/F, Cheung Kong Center, 2 Queen's Road Central, Hong Kong.

This material is issued in Taiwan by Barclays Capital Securities Taiwan Limited. This material on securities not traded in Taiwan is not to be construed as 'recommendation' in Taiwan. Barclays Capital Securities Taiwan Limited does not accept orders from clients to trade in such securities. This material may not be distributed to the public media or used by the public media without prior written consent of Barclays.

This material is distributed in South Korea by Barclays Capital Securities Limited, Seoul Branch.

All equity research material is distributed in India by Barclays Securities (India) Private Limited (SEBI Registration No: INB/INF 231292732 (NSE), INB/INF 011292738 (BSE), Registered Office: 208 | Ceejay House | Dr. Annie Besant Road | Shivsagar Estate | Worli | Mumbai - 400 018 | India, Phone: + 91 22 67196363). Other research reports are distributed in India by Barclays Bank PLC, India Branch.

Barclays Bank PLC Frankfurt Branch distributes this material in Germany under the supervision of Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin).

This material is distributed in Malaysia by Barclays Capital Markets Malaysia Sdn Bhd.

This material is distributed in Brazil by Banco Barclays S.A.

This material is distributed in Mexico by Barclays Bank Mexico, S.A.

Barclays Bank PLC in the Dubai International Financial Centre (Registered No. 0060) is regulated by the Dubai Financial Services Authority (DFSA). Principal place of business in the Dubai International Financial Centre: The Gate Village, Building 4, Level 4, PO Box 506504, Dubai, United Arab Emirates. Barclays Bank PLC-DIFC Branch, may only undertake the financial services activities that fall within the scope of its existing DFSA licence. Related financial products or services are only available to Professional Clients, as defined by the Dubai Financial Services Authority.

Barclays Bank PLC in the UAE is regulated by the Central Bank of the UAE and is licensed to conduct business activities as a branch of a commercial bank incorporated outside the UAE in Dubai (Licence No.: 13/1844/2008, Registered Office: Building No. 6, Burj Dubai Business Hub, Sheikh Zayed Road, Dubai City) and Abu Dhabi (Licence No.: 13/952/2008, Registered Office: Al Jazira Towers, Hamdan Street, PO Box 2734, Abu Dhabi).

Barclays Bank PLC in the Qatar Financial Centre (Registered No. 00018) is authorised by the Qatar Financial Centre Regulatory Authority (QFCRA). Barclays Bank PLC-QFC Branch may only undertake the regulated activities that fall within the scope of its existing QFCRA licence. Principal place of business in Qatar: Qatar Financial Centre, Office 1002, 10th Floor, QFC Tower, Diplomatic Area, West Bay, PO Box 15891, Doha, Qatar. Related financial products or services are only available to Business Customers as defined by the Qatar Financial Centre Regulatory Authority.

This material is distributed in the UAE (including the Dubai International Financial Centre) and Qatar by Barclays Bank PLC.

This material is distributed in Saudi Arabia by Barclays Saudi Arabia ('BSA'). It is not the intention of the publication to be used or deemed as recommendation, option or advice for any action (s) that may take place in future. Barclays Saudi Arabia is a Closed Joint Stock Company, (CMA License No. 09141-37). Registered office Al Faisaliah Tower, Level 18, Riyadh 11311, Kingdom of Saudi Arabia. Authorised and regulated by the Capital Market Authority, Commercial Registration Number: 1010283024.

This material is distributed in Russia by OOO Barclays Capital, affiliated company of Barclays Bank PLC, registered and regulated in Russia by the FSFM. Broker License #177-11850-100000; Dealer License #177-11855-010000. Registered address in Russia: 125047 Moscow, 1st Tverskaya-Yamskaya str. 21.

This material is distributed in Singapore by the Singapore branch of Barclays Bank PLC, a bank licensed in Singapore by the Monetary Authority of Singapore. For matters in connection with this report, recipients in Singapore may contact the Singapore branch of Barclays Bank PLC, whose registered address is One Raffles Quay Level 28, South Tower, Singapore 048583.

Barclays Bank PLC, Australia Branch (ARBN 062 449 585, AFSL 246617) is distributing this material in Australia. It is directed at 'wholesale clients' as defined by Australian Corporations Act 2001.

IRS Circular 230 Prepared Materials Disclaimer: Barclays does not provide tax advice and nothing contained herein should be construed to be tax advice. Please be advised that any discussion of U.S. tax matters contained herein (including any attachments) (i) is not intended or written to be used, and cannot be used, by you for the purpose of avoiding U.S. tax-related penalties; and (ii) was written to support the promotion or marketing of the transactions or other matters addressed herein. Accordingly, you should seek advice based on your particular circumstances from an independent tax advisor.