

Public debt management guidelines



*Analysis of debt management
in 2009*

Introduction

This document outlines the achievements obtained during 2009 in the management of public debt represented by Government bonds.

The issuance and management of Government bonds is the responsibility of Division II of the Treasury Department. These activities are geared towards ensuring coverage of the needs of the State sector and of the management of market risks, in continuous dialogue and discussion with investors and other participants in the Italian public debt market.

At the end of 2009 there were 1,446,133.4 million euros of outstanding stock of Government bonds, an increase of 6.63 % compared to the end of 2008. In relation to the General Government's overall debt at the end of 2009 this stock made up around 82 %, a proportion that should not change significantly at the end of 2010.

1. The market context

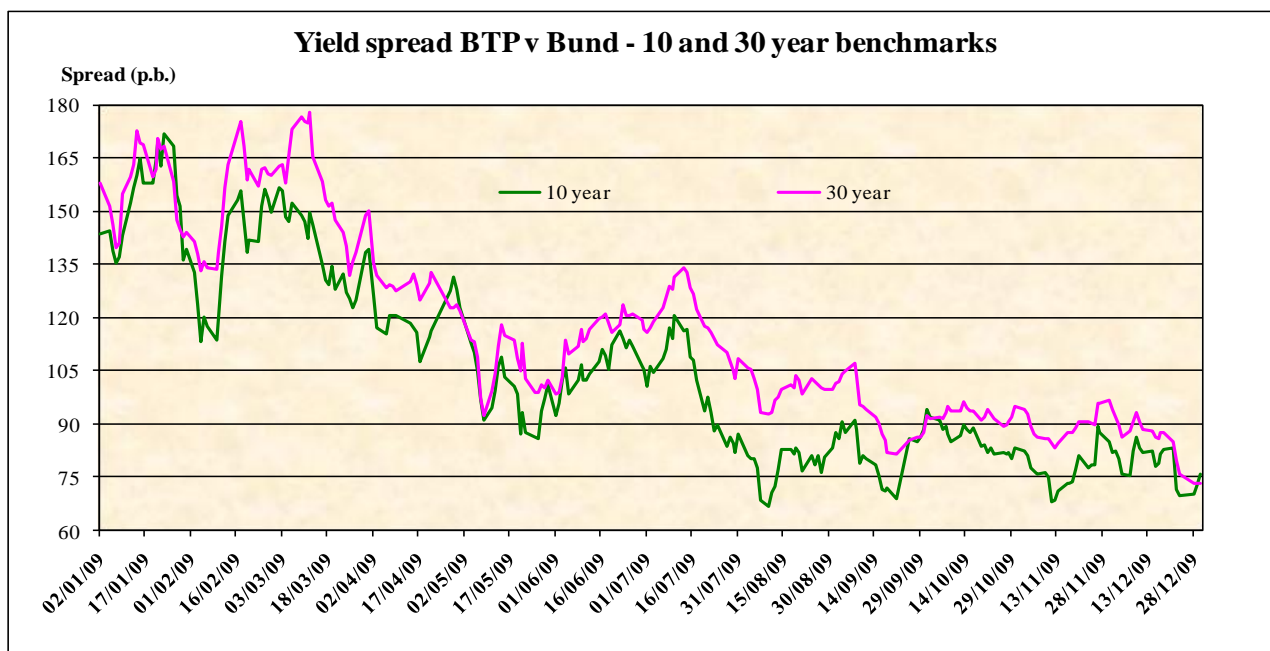
a) The trend of Italian and euro area Government bonds in 2009

Public debt management in 2009 took into account the different phases that characterised financial markets during the year.

Following the initial quarter, which was much determined by the consequences of the international financial crisis, with volatility at historically high levels and as a result critical moments in the functioning of Government bond markets for a large part of the euro area countries, in the second and third quarters of the year the situation gradually improved also thanks to a progressive, even if very sluggish, normalisation of European monetary and interbank markets. In this phase the Government bond market went through a process of recovery of trading which was favoured by and in turn stimulated bond liquidity, thus reducing average transaction costs for dealers with respect to the very high levels arrived at between the end of 2008 and the beginning of 2009. In this context, Italian bonds, which normally guarantee some of the highest liquidity standards in Europe, registered a very positive performance, as shown by the continuous trend of diminishing yield spread against German bonds (with the exception of the period between the end of May and the beginning of July) with respect to the first months of the year (Chart 1).

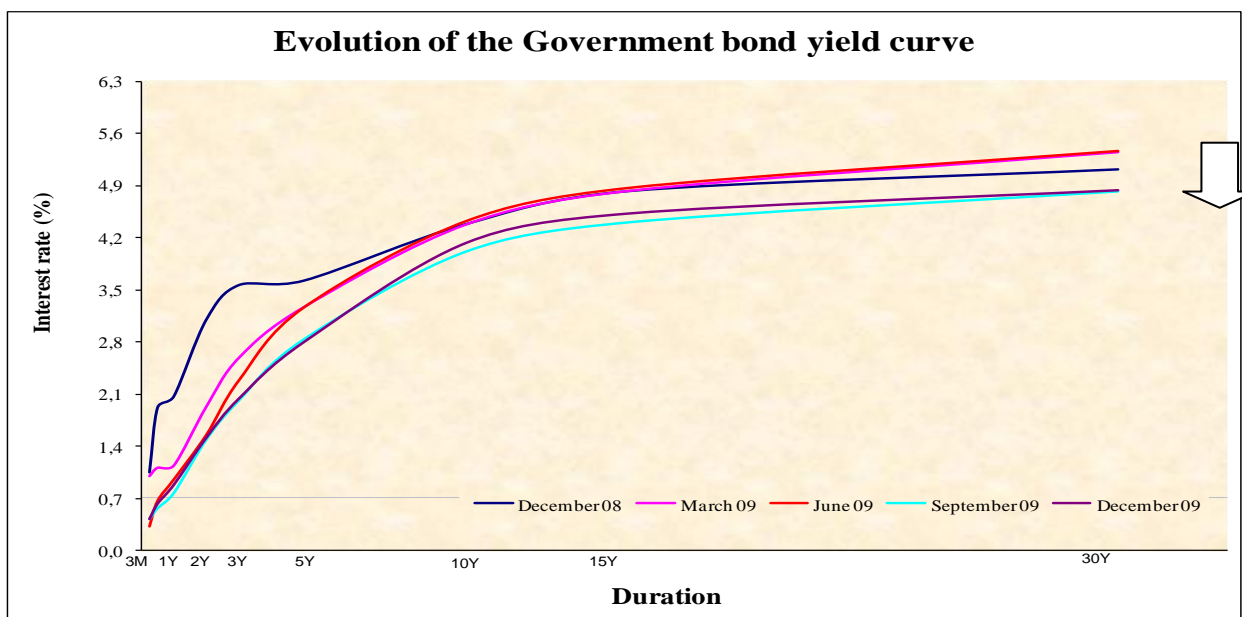
During the final part of the year the results obtained in the previous six months were consolidated, interrupted only in the month of December when market dealers, having to register in the balance sheets the results obtained in a very difficult year, significantly slowed down their activity compared to what normally happens in this part of the year.

Chart 1



Notwithstanding the difficulties present in financial markets, management of public debt ensured full coverage of the State sector’s needs – which presented a significant increase on previous years, combining elements of flexibility and predictability within a context that, in continuity with the past years, privileged transparent and regular debt issues. In this way the Treasury was able to achieve considerable results in terms of reducing exposure to the risk of refinancing and to the interest rate risk, in a situation of considerable fall in financing costs which was made possible by the very marked decrease of market interest rates (Chart 2).

Chart 2



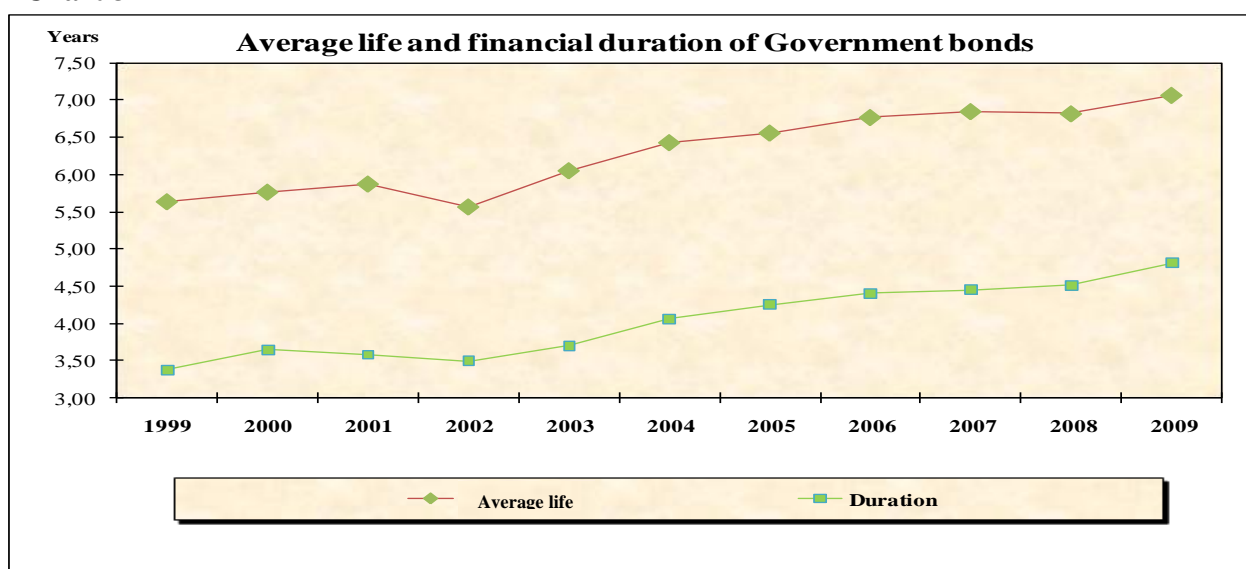
2. Results obtained through debt management

a) Evolution of costs and risks

As has just been stated, the issuance policy enacted by the Treasury during 2009 continued to maintain as primary objectives the control of exposure to the risk of refinancing and to the interest rate risk, taking into account the cost of debt management.

At the end of 2009, the figure for the overall average life of bonds (Chart 3), equal to 7.07 years, was longer than that of the end of 2008, equal to 6.82 years; the financial duration of debt stood at the end of 2009 at 4.81 years, more than that of 2008 (4.51 years) and confirming the gradual increase of these last years. The Average Refixing Period¹ too, calculated only for Government bonds of the domestic programme, confirms this trend: at the end of 2009 the value was 5.87 years, compared to that calculated on 31 December 2008, equal to 5.63 years.

Chart 3



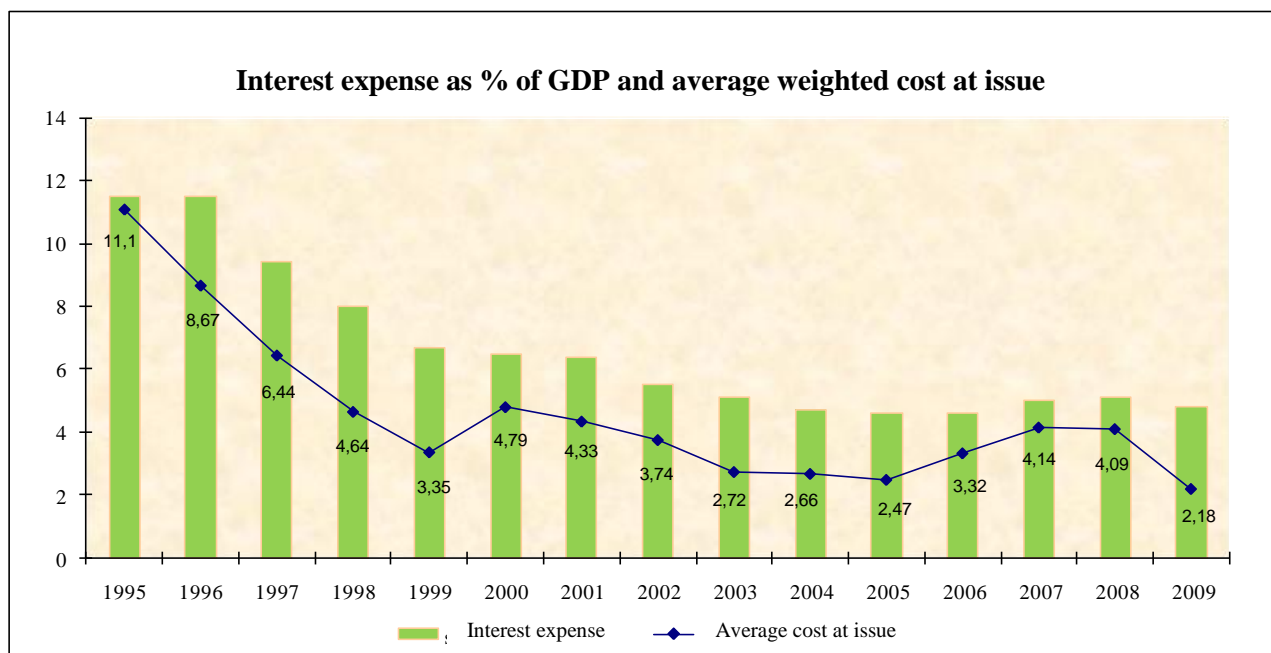
The weighted average cost of issues in 2009 (Chart 4) was 2.18 %, a noteworthy decrease from that recorded in 2008 (4.09 %). This is explained by the downward trend of the general level of interest rates which began in the last quarter of 2008 and continued in a more manifest manner during 2009, as a result of the ECB's expansive monetary policy aiming to sustain the real and financial sectors after the effects of the international crisis.

The reduction of interest rates affected the entire yield curve, more notably on the short-term sector, as a consequence both of increased liquidity and of investors' reduced aversion to risk, and also of expected lower inflation.

In this way the cost at issue was reduced by a large margin, especially for short-term bonds like BOTs.

¹ The Average Refixing Period (ARP) measures the average time in which debt coupons are refixed. For zero-coupon or fixed coupon bonds it corresponds to the bond's residual maturity. For floating rate bonds, it corresponds to the time remaining till the next coupon is fixed.

Chart 4



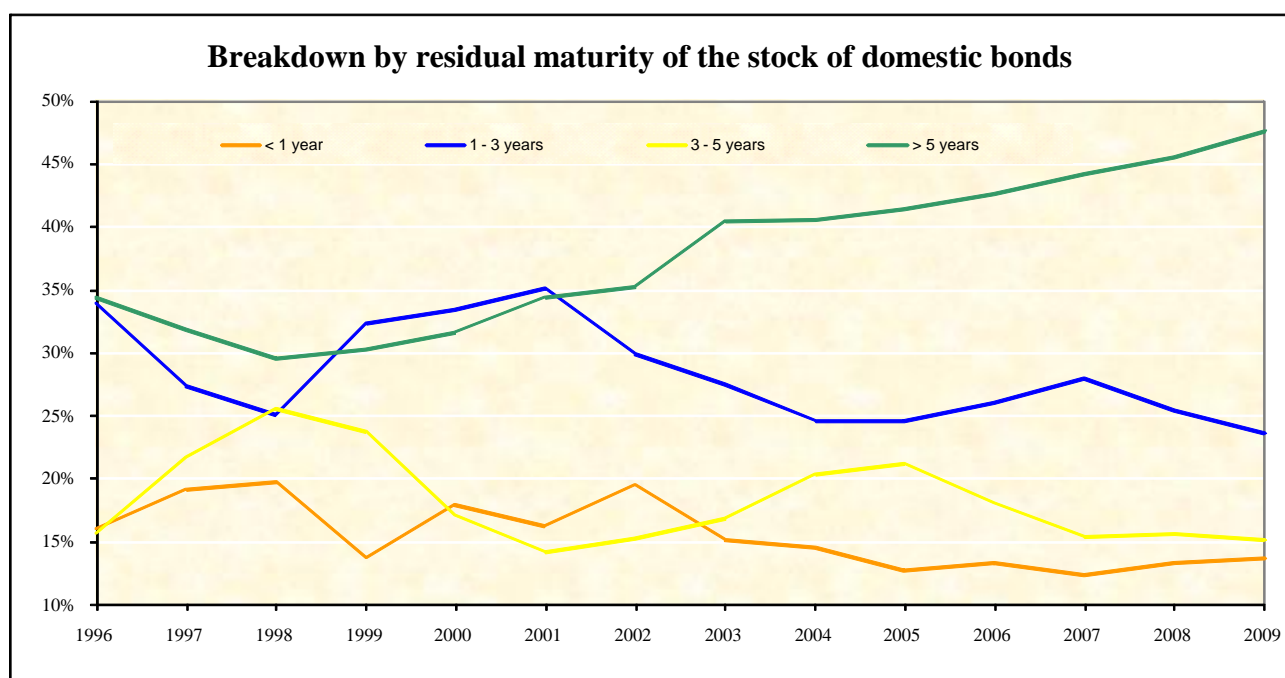
The interest rate risk

The January 2010 update of Italy's Stability Programme confirmed the small risk of exposure of Italian debt to rate fluctuations. Due to the current composition, and also to the evolution of the overall financial duration and of the structure of payments for coupons and reimbursements, an instantaneous and permanent increase of one percentage point of the yield curve creates an impact on interest expenditure for the period 2010-2013, relative to GDP, of 0.17 % in the first year, 0.37 % in the second year, 0.48 % in the third year, 0.55 % in the fourth year. With respect to 2008, sensitivity to rates has not changed in the first three years, while in the fourth year there is a slight decrease, of around 0.01 %. The result is due both to a forecast of increased economic growth in the period compared to the previous update, and to a smaller increase of expense for interest, even with a growing stock of outstanding debt.

The refinancing risk

The evolution of the structure of debt by residual maturity at the end of December 2009 (Chart 5) confirms the trend of an increase in the portion of debt with residual maturity above five years and the levelling of the very short term sector (maturities of less than one year). Also the medium-term share (residual maturities between three and five years) maintained nearly the same value as in 2008 and went to its lowest levels since 2000 (ca. 15 %), while the short/medium-term sector (residual maturities between one and three years) from around 35 % in 2001 fell constantly over the years reaching around 24 % at the end of 2009.

Chart 5



The exchange rate risk

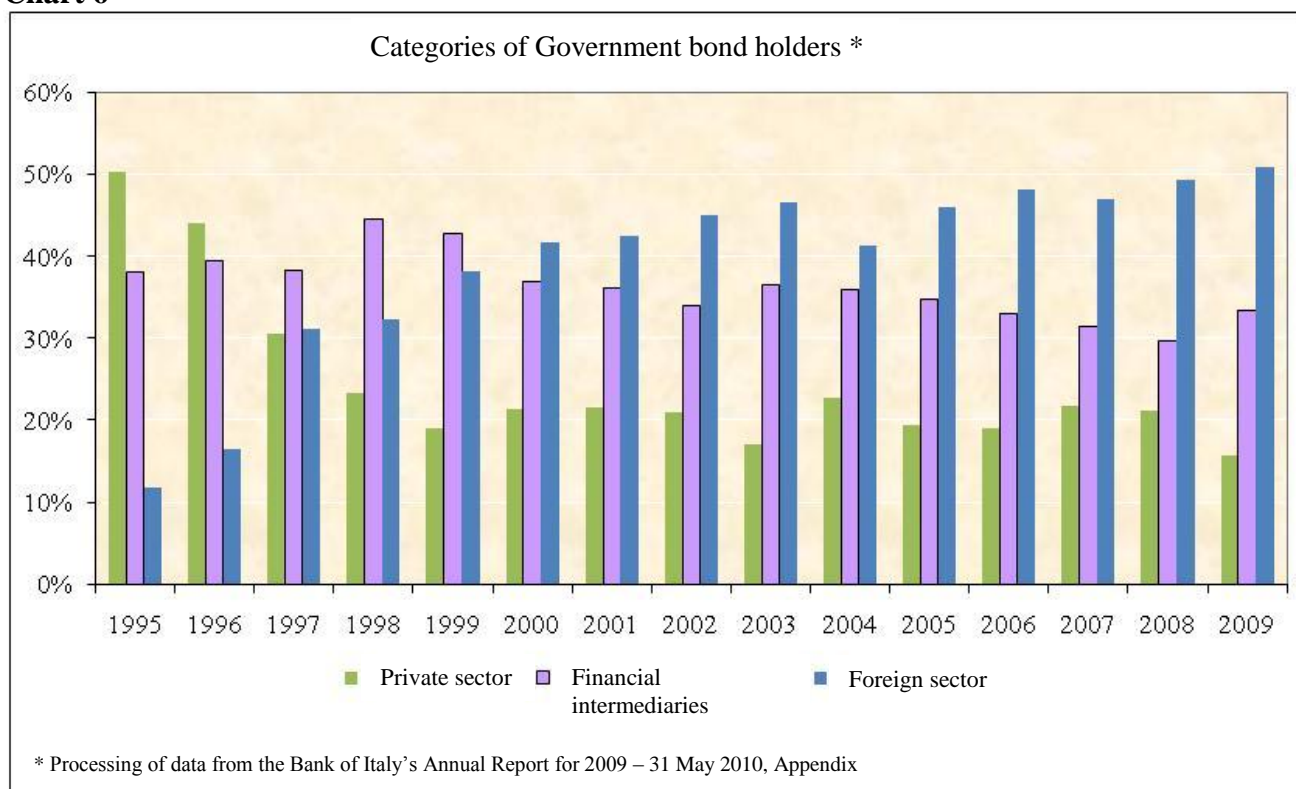
In continuity with previous years, debt management policy was oriented to limiting the risk of exposure to exchange rates. In fact, at the end of 2009, the portion of bonds issued on international markets exposed to fluctuations in exchange rates was 0.17 %, in line with that of 2008.

b) Debt distribution at the international level

In 2009, debt management, in continuity with previous years, permitted the continuation of the efficient penetration of Italian Government bonds in portfolios of a broader and more diversified assemblage of investors, both by institutional type and geographical location, in order to make the performance of debt ever less dependent on sudden domestic and/or international shocks. Between 2008 and 2009 there was a minor increase of Government bond debt stock held by non-residents (Chart 6), going from 49 % to 51 %, as also for the part held by domestic institutional investors, which went from 30 % to 33 %; instead the share held by the domestic private sector decreased, going from 21 % to 16 %.

In 2010, analyzing the flow of trading reported by Specialists in Government bonds², one notes a significant increase of interest from clients residing in Italy, whose slice of trade conducted did in fact increase, registering a value of ca. 52.1 % in 2010 against a value of ca. 47.8 % in 2009. The penetration of Government bonds with international investors is confirmed, even though there was a minor reduction of trade with clients residing in Europe (from 43.5 % in 2009 to ca. 40.9 % in 2010) and residing outside Europe (whose portion went from 8.7 % in 2009 to about 7 % in 2010).

Chart 6



c) Issuance policy for domestic instruments

2009 continued to be characterised by the effects of the international financial crisis. The euro area Government bond market was very influenced by a fly to quality, preferring to buy Government bonds with higher credit ratings. The many issues of Government bonds, deriving from the augmented State needs to be able to sustain the economy and the financial sector, and the widespread critical situations in terms of adequate assets and liquidity of many dealers of the international financial sector, brought about a heightened aversion to risk that weighed more on Government bonds of the so-called “peripheral” countries. However, this only marginally touched

² Specialists in Government bonds at 31 December 2009 were: Banca IMI S.p.A., Barclays Bank PLC, BNP Paribas, Calyon – Corp. Inv. Bank (later Crédit Agricole Corp. Inv. Bank), Citigroup Global Markets Ltd., Commerzbank A.G., Credit Suisse Securities (Europe) Ltd., Deutsche Bank A.G., Goldman Sachs Int. Bank, HSBC France, ING Bank N.V., JP Morgan Securities Ltd., Merrill Lynch Int., Monte dei Paschi di Siena Capital Services Banca per le Imprese S.p.A., Morgan Stanley & Co. Int. PLC, Nomura Int. PLC, Royal Bank of Scotland PLC, Société Générale Inv. Banking, UBS Ltd, UniCredit Bank A.G.

our country; in fact the major international rating agencies maintained a constant rating and outlook for Italy in 2009, both as an effect of the budget policy and due to the same debt management.

Therefore, international, as opposed to domestic, elements of instability determined the performance of Government bonds. As a confirmation, one can see how the decrease of the spread between BTP and Bund continued its trend for the entire year, notwithstanding noteworthy monthly ups and downs. In this context, featuring imbalances and conditions of significant instability on financial markets, the Treasury guaranteed coverage of the State's needs taking into account how market conditions evolved. Discriminatory price auctions continued to be used, introduced back in October 2008, for the placement of medium/long-term bonds (BTPs and CCTs), as also the possibility of placing one or more bonds that are no longer running (off-the-run bonds).

BOTs

The BOT sector in 2009 witnessed an important innovation: in February also auctions for one year BOTs – as announced in the 2010 Guidelines – were re-opened to Government bond Specialists. The aim was to allow investors to better confront increased market volatility guaranteeing at the same time satisfactory outcomes in the placement of these instruments.

Issues of BOTs in 2009 maintained the levels of 2008; however, the percentage of BOTs with respect to overall domestic issues was reduced by 5 percentage points, ending at around 51 %.

By looking in detail at the different bond maturities, one notes that the decrease is mainly due to a reduced use of the so-called mini-BOTs (or flexible BOTs), whose quota went from 7 % of domestic bonds in 2008, to 2.9 % in 2009. The reduced usage of these instruments is proof of how a slight improvement of the international financial context allowed the Treasury to operate in market conditions that were smoother than in 2008, as regards liquidity management.

In 2009, the intensity of 6- and 12-month BOT issues grew slightly in absolute terms, while they remained unchanged for 3-month bonds. In relative terms, issues were slightly reduced for all kinds of BOTs, resulting as a percentage of overall domestic Government bond issues equal to 6.9 % for 3-month BOTs, 24.1 % for 6-month BOTs and 16.6 % for one year bonds.

It should be noted that, as has been the case during the years, the Treasury uses flexible and 3-month BOTs purely as instruments of cash management, to be placed on the market to meet usually less than one-year-long cash needs and to satisfy very short term coverage needs connected to the volatility of monthly and daily cash requirements.

At the end of 2009, the BOT portion of overall outstanding debt decreased slightly, placing itself a little below 10 %.

CCTs

2009 also confirms the decrease of the quota of floating rate bonds. As a matter of fact, issues were markedly less than maturities (quite outstanding at nearly 45 billion euros), but in absolute terms were however more than those in 2008 (ca. 25 against 17 billion euros), thanks also to investors' renewed interest for this instrument. The Treasury heeded demand's trend, even while continuing to pursue the

widely publicised goal of a progressive reduction of outstanding stock: CCTs in fact, as a proportion of total circulating Government bonds, went from 13.47 % in 2008 to 11.31 % in 2009.

CTZs

Also during 2009 the Treasury regularly offered the market 24-month CTZs. Its portion as a percentage of overall Government bonds issued in 2009 increased a tad going from 7.13 % in 2008 to about 8 % in 2009, with an increase of issues compared to 2008 of around 8 billion euros in response to demand. Also in order to take into account demand, the CTZ share of debt reached 4.48 % in 2009, an increase on the level of the end of 2008, which was 3.45 %.

BTPs

In 2009 total issues of BTPs (nominal and inflation-linked) were higher than those of 2008, further reinforcing the centrality of this tool in the management of debt.

The proportion of BTPs as a percentage of total domestic issues alone amounted to ca. 36.7 % (around 33.2 % in 2008); while it was 40.6 % (38.9 % in 2008) if one considers total domestic issues net of BOTs with maturity of less than or equal to three months.

The Treasury, therefore, has increased the use of this tool also in order to make the structure of its debt ever less exposed to the risk of interest rates.

i) Nominal BTPs

Issues of nominal BTPs therefore increased on the previous year. As a matter of fact, its percentage of domestic issues went from 29.4 % in 2008 to 33.4 % in 2009. The three and five year segment decreased slightly, going from a total of 16.3 % of overall domestic issues in 2008 to 15.7 % in 2009. On both maturities new bonds have been issued. The BTP sector with maturities of 10 years or more increased compared to last year, going from 13.1 % in 2008 to 17.7 % in 2009 as a percentage of overall domestic Government bond issues. This trend is confirmed even looking at the single maturities: issues of 10 year maturities – where two new bonds were launched – went from 8.5 % in 2008 to 10.8 % in 2009; the 15 and 30 year sector as a percentage of all domestic issues went from 4.66 % in 2008 to 6.9 % in 2009. In addition, when market tensions decreased during the year, with an improvement of interbank market conditions and a moderate increase of liquidity on the secondary market, two new fixed rate nominal bonds were issued through a syndicate with maturities of 15 and 30 years, in the months of July and September respectively.

ii) BTP€is

In 2009 the Treasury placed a volume of about 17 billion euros of euro-area inflation-linked bonds on the market. The reduction of issues, mainly due to the macroeconomic context which was not favourable to inflation-linked bonds, produced the result with respect to overall domestic issues of going from around 3.8 % in 2008 to about 3.3 % in 2009. Notwithstanding this, in October, a new

euro-area inflation-linked bond was launched on the 30 year sector, with a significant response by the market both in terms of the volume issued and of the quality of the participants to the placement. The issue of the 30 year BTP€i bond continued the trend that evidences a strengthening of the presence of inflation-linked bonds within the range of Government debt instruments. Moreover, the regularity of the issues confirmed a BTP€i share of debt at the end of 2009 above that of the previous two years.

d) Issuance policy of foreign currency bonds and private placements

The International Issues Programme complements the domestic programme guaranteeing the Treasury access to international markets through the Global Bond Programme, which operates mainly in US dollars, and the Medium Term Note Programme which is oriented to European and Asian investors both via public issues and private placements, the latter aimed at satisfying the demands of single investors.

In the first six months of 2009 the overcrowding in the dollar market together with the absence of arbitrage conditions and a demand for highly rated bonds (basically issuers with triple A rating) made a new issue in USD impossible within the Global Bond Programme. Instead, in the second half of the year, better market conditions and the preference of investors for the short term permitted the placement of a new global bond for a notional of 2.5 billion with a 3 year maturity.

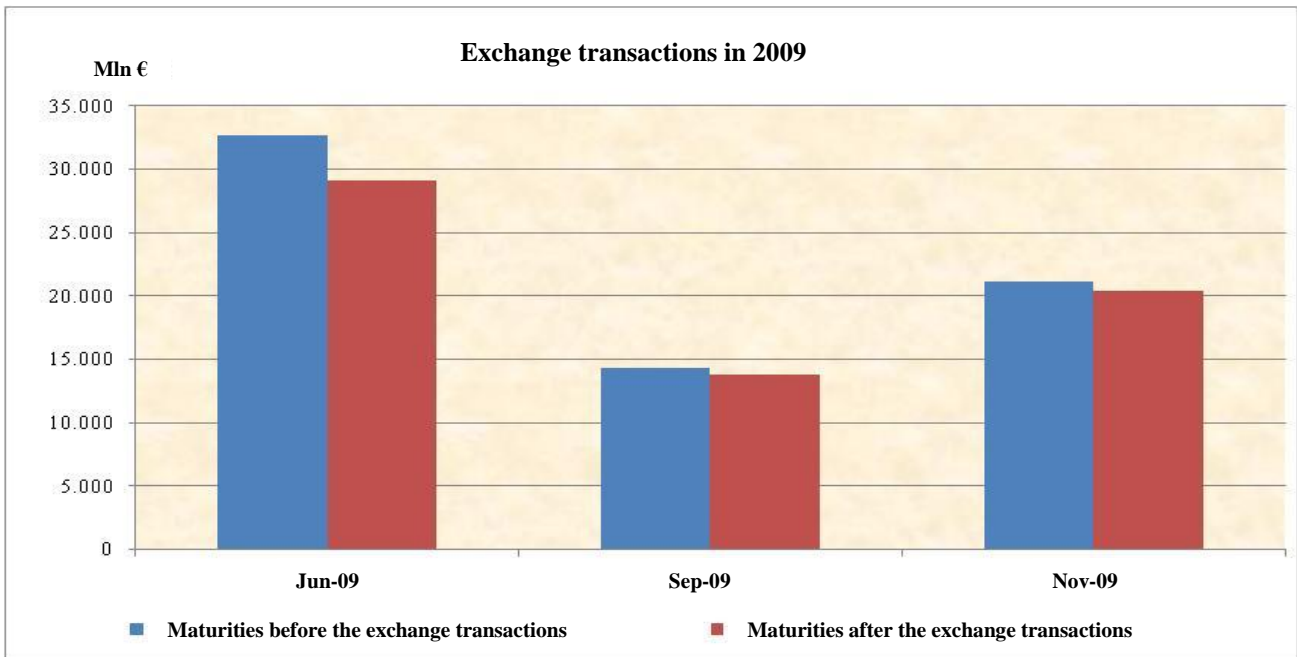
Alongside the Global Programme there were three private placements, part of the MTN Programme, which allowed the Treasury to once again achieve a reduction of the cost of financing, insomuch as the yield of the notes was ca. 5 basis points below that of BTPs of the same maturity. These issues were performed according to specific needs of single investors that bought the bonds with the intention of keeping them in their portfolios until maturity. Private placements made during 2009 amounted to a total just below 800 million euros.

e) The role of buy-back and exchange operations reserved to Specialists

In 2009 the Treasury continued to make use of exchange operations as an instrument to reduce the risk of refinancing, by reshaping future maturities, optimising the management of cash flows and supporting the liquidity of the secondary market. There was one exchange operation during the year for a total of 2,094 billion euros, with which Government bonds maturing in 2010 were exchanged with BTPs maturing in 2014. The transaction was carried out on the primary market, through the auction procedure managed by the Bank of Italy.

Finally, in 2009 there were no buy-back transactions.

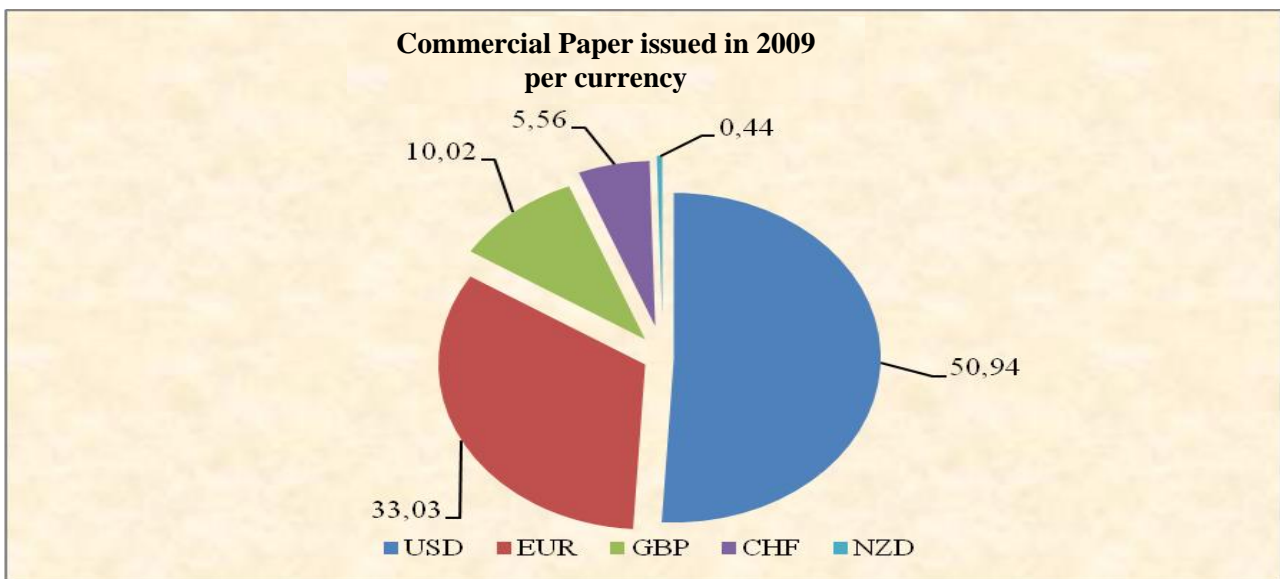
Chart 7



f) *Cash management activities*

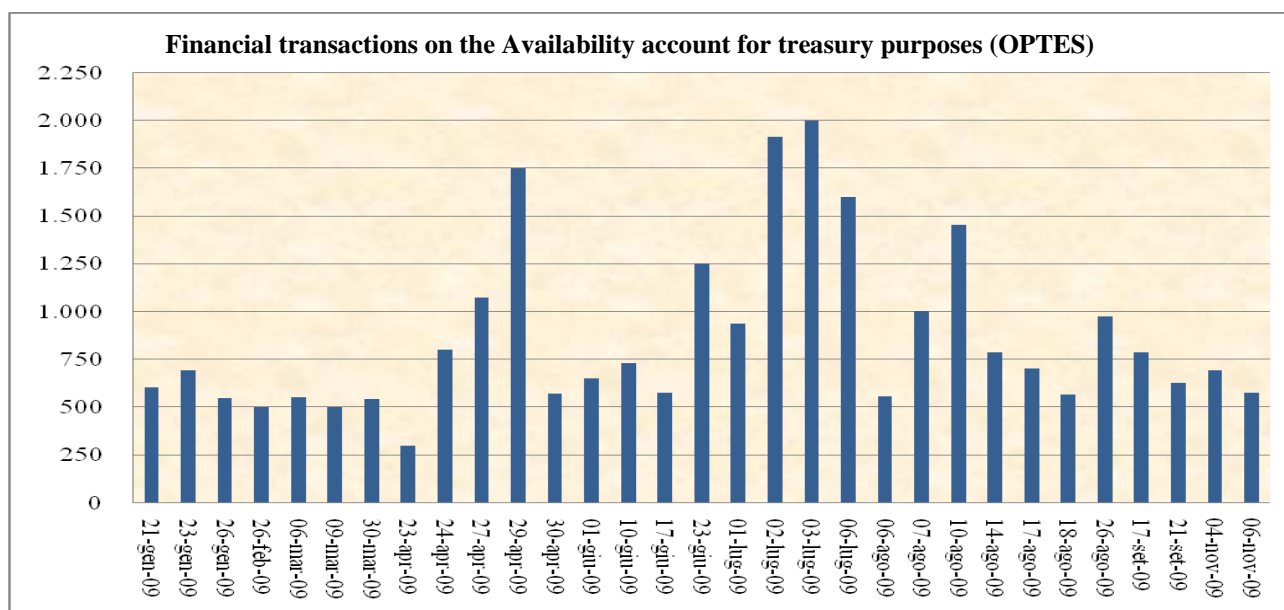
Apart from the mentioned use of flexible and 3-month BOTs, cash management activity in 2009 continued also through issues of Commercial Paper. In detail, CP was issued in euros, dollars, pounds, New Zealand dollars and Swiss francs – all converted to euros – for a total of 5,782 million euros (Chart 8).

Chart 8



To complete the set of liquidity management instruments, 31 funding transactions were performed on the monetary market in 2009, using the Treasury's availability account for treasury purposes (OPTES), with an average amount of funds collected by the Treasury of 865 million euros per transaction and an average ratio between dealers' supply and Treasury demand equal to 2.33 (Chart 9).

Chart 9



g) Debt composition by instrument

Debt composition at the end of 2009 was in line with that of the end of 2008, even though there has been some slight acceleration of the dynamics of the most recent years. In fact, debt structure at the end of December 2009 (Chart 11) compared to that of the end of December 2008 (Chart 10), highlights a small growth of fixed rate bonds, a small decrease in the short term sector (BOTs and flexible BOTs) and a further reduction of the floating rate component (CCT), as also for foreign debt.

Chart 10

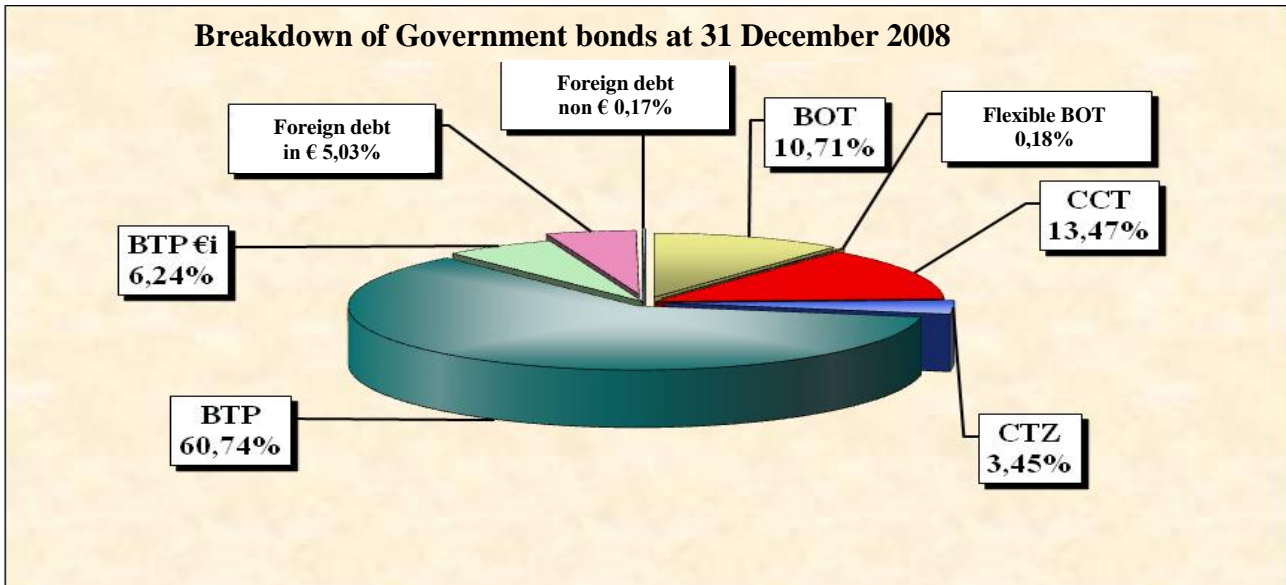
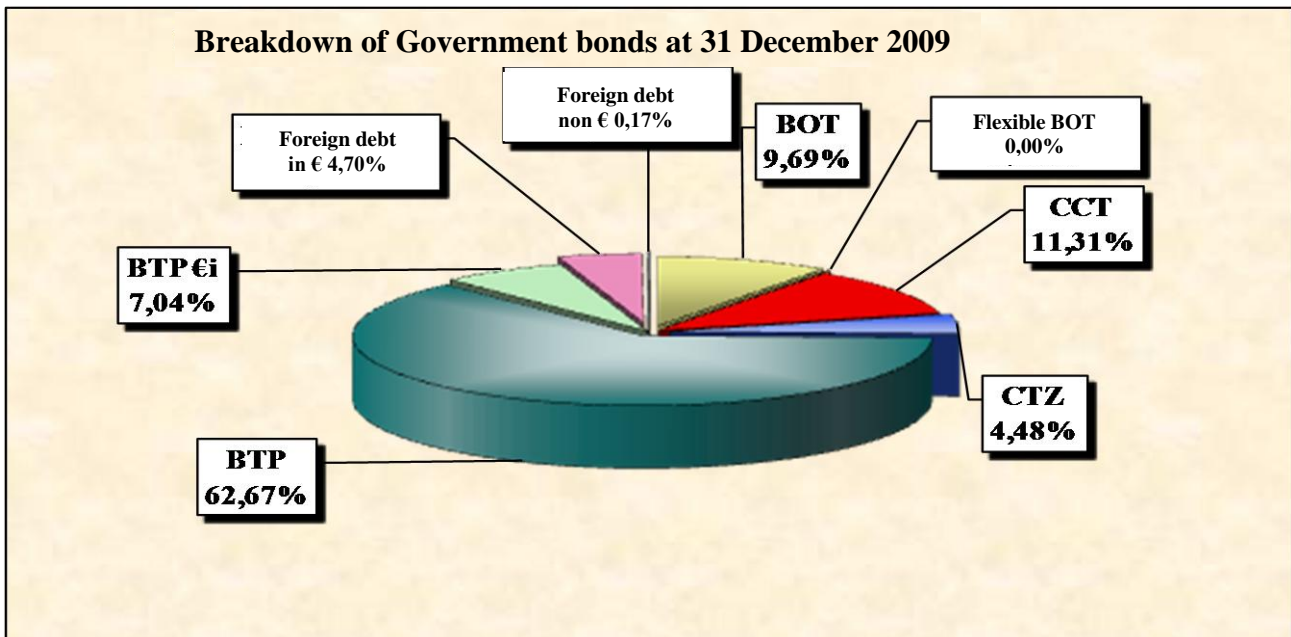


Chart 11



The profile of bond stock issued on the domestic market is a summary of these trends (Chart 12). Looking to the medium term the chart allows us to see the progressive reduction of the floating rate portion, the increase of fixed rate nominal bonds (at around 70.5 %), and the consolidation of the inflation-linked bond portion.

Chart 12

