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The Institute for Religious Works: key features of financial intermediation[1]

SUMMARY: 1. Introduction – 2. Background to anti-money laundering – 3. Financial intermediation, 2011–2014 – 4. Conclusion.

1 - Introduction

The Institute for Religious Works (Istituto per le Opere di Religione – IOR) was founded in 1942 by Papal Decree with the aim of serving the Holy See and its clients in the Catholic Church. Its origins date back to the "Commission ad pias causas" established in 1887 by Pope Leo XIII.

The IOR's purpose is "to provide for the custody and administration of goods transferred or entrusted to the Institute by physical or juridical persons, designated for religious works or charity. The Institute can accept deposits of assets from entities or persons of the Holy See and of the Vatican City State"2. It currently provides deposit taking, asset management, custodial functions and international payment transfers through correspondent banks, and holds salary and pension accounts of employees of the Vatican. The IOR operates from a single base in the Vatican City State and today it serves about 15,000 customers for a total 6 billion (bn) euro customers' assets3.

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[1] Article peer reviewed.

[2] **POPE JOHN PAUL II**, *Statute of the IOR*, Rome, 1990 (available at *http://w2.vatican.va/content/john-paul-ii/it/letters/1990/documents/hf_jpii_let_19900301_ist-opere-religione.html*

[3] In its 2014 annual reports, the IOR defines customers' assets as the sum of customers'

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The IOR is regulated by the Financial Intelligence Authority (FIA), which is an institution connected to the Holy See, in accordance with Articles 186 ff. of the Apostolic Constitution Pastor bonus. The Authority performs the following functions: (i) prudential supervision and regulation of those entities that carry out professionally a financial activity; (ii) supervision and regulation for the prevention and countering of money laundering and financing of terrorism; (iii) financial intelligence[4].

The entities subject to FIA supervision are currently two: the Administration of the Patrimony of the Apostolic See (APSA) and the IOR. The APSA was initially competent on the administration of the properties owned by the Holy See in order to provide the funds necessary for the functioning of the Roman Curia.[5] It works today as a national central bank and as the treasury, while the administrative function was transferred to the Secretariat for the Economy by *motu proprío* of Pope Francis in 2014.[6] On this basis, the FIA supervises the APSA consistently and proportionally to its institutional status and activity. The IOR is, however, subject to the full supervision of the FIA.

2 - Background to anti-money laundering

In the last five years the IOR has undergone profound changes, notably in the field of anti-money laundering with the adoption of Vatican rules and regulations. These changes started at the end of 2009, when the Vatican City State and the European Union entered into a monetary agreement through which the State adopted the euro as its official currency and

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deposits not included in the asset management accounts (2.1 bn euro in 2014), of the net value of assets – both deposits and securities – under management (3.2 bn euro in 2014) and of the net value of assets under custody (0.7 bn euro in 2014).

[4] **FIA**, *Statute of the Financial Intelligence Authority*, Rome, 2014 (available at *http://www.aif.va/ENG/Statuto.aspx*).

[5] **POPE JOHN PAUL II**, Apostolic Constitution *Pastor Bonus, 172*, Rome, 1988 (available at *http://w2.vatican.va/content/john-paulii/en/apost_constitutions/documents/hf_jp-ii_apc_19880628_pastorbonus-index.html*).

[6] **POPE FRANCIS**, Apostolic letter issued motu proprío, *Transferral of the Ordinary Section of the Administration of the Patrimony of the Apostolic See to the Secretariat for the Economy*, Rome, 2014

P. CONSORTI, *Le riforme economiche di papa Francesco,* in E. Bani, P. Consorti (eds), *Finanze vaticane e Unione europea. Le riforme di papa Francesco e le sfide della vigilanza internazionale*, il Mulino, Bologna, 2015.

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undertook to implement the European legislation on the prevention and countering of money laundering and financing of terrorism.

At the international level, the Holy See strengthened its efforts against money laundering and assessed the adherence of the internal system to the recommendations of the Financial Action Task Force (FATF). In 2011, it joined Moneyval, the Committee of Experts on the Evaluation of Anti-money Laundering Measures and the Financing of Terrorism at the Council of Europe (Resolution CM/RES-2011). Moneyval annually evaluates the new procedures and measures adopted in accordance with the European legal framework and international legal standards. The Holy See authorities have made significant efforts to implement the recommendations made by Moneyval, and wide-ranging legislative and institutional measures have been instituted to rectify deficiencies in all areas (legal, financial and law enforcement) of the Holy See anti-money laundering framework[7].

At the domestic level, significant legislation on transparency, supervision and financial intelligence was adopted. In 2010, the Pontifical Commission for the Vatican City State adopted the law on the prevention and countering of laundering of proceeds of crimes and financing of terrorism (law n. CXXVII) which entered into force in 2011[8].

At the same time, new supervisory bodies were created. Pope Benedict XVI, by means of the Apostolic Letter in the form of *motu proprío* for the prevention and countering of illegal activities in the financial and monetary field, established the Financial Intelligence Authority, presented in the previous section[9]. The same letter extended the scope of law n. CXXVII to all dependent bodies of the Holy See, if they professionally conducted financial activities, including the dicasteries of the Roman Curia, related institutions, bodies and agencies, as far as warnings on suspected activities were concerned.

In 2013, the Financial Security Committee (CoSiFi) was then established with the aim of coordinating the competent Authorities of the

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[7] **COUNCIL OF EUROPE**, *The Holy See (including Vatican City State) – Progress report and written analysis by the secretariat of core and key recommendations, Committee of Experts on the Evaluation of Anti-money Laundering Measures and the Financing of Terrorism, Moneyval 2015(36)*

[8] This law was modified in 2012 by Decree of the President of the Governorate of the Vatican City State, n. CLIX. In the same year, the decree was confirmed by Law of the Pontifical Commission for the Vatican City State, n. CLXXXVI and by Law of the Pontifical Commission for the Vatican City State, n. CLXXXV.

[9] **POPE BENEDICT XVI**, Apostolic letter in the form of motu proprío, *The prevention and countering of illegal activities in the financial and monetary field*, Rome, 2010.

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Holy See and the Vatican City State in the fields of the prevention and countering of money laundering, financing of terrorism and the proliferation of weapons of mass destruction.[10] The strengthening of the regulatory framework and the consequent extension of FIA's field of competence to prudential supervision required a reform and a reorganization of the Authority.

The FIA is now divided into two offices: a) the "financial intelligence" office; b) the "supervision and regulation" office. The cornerstone of the financial intelligence activity is the receipt and analysis of suspicious activity reports, which are subsequently transmitted to the Office of the Promoter of Justice at the Tribunal of the Vatican City State if there are grounded reasons to suspect any activity of money laundering or financing of terrorism.

In principle, the second office works on the prevention and countering of money laundering and financing of terrorism, supervising the IOR. In 2014, FIA carried out the first on-site inspection at the IOR. Following the Vatican legislation coming into force, the inspection was aimed at the evaluation (including sample tests on the accounts and individual transactions) of the compliance of the organization and the management of the IOR to the anti-money laundering legislation, verifying, inter alia, the: (i) internal organization; (ii) system of monitoring and evaluation procedures and risk management; (iii) procedures for customer, due diligence procedures and ongoing customer due diligence; (iv) procedures for the identification and reporting of suspicious activity; (v) relations with foreign financial institutions and the system of international transfer of funds. Overall, the results of the first on-site inspection showed no fundamental shortcomings, but the authority assigned the IOR an action plan and specific corrective measures, the implementation of which is monitored by a system of reports and periodic checks, including further on-site inspections.

Secondly, this office works on prudential supervision and regulation. In 2015, FIA approved the Regulation 1 on "Prudential Supervision of the Entities Carrying Out Financial Activities on a Professional Basis." The Regulation stipulates the criteria for the organisation and management of entities carrying out authorised financial activities on a professional basis, stipulating among other things the structure of the entity, the organisation of administrative and treasury

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[10] **POPE FRANCIS**, Apostolic letter issued motu proprío, *The prevention and countering of money laundering, financing of terrorism and the proliferation of weapons of mass destruction*, Rome, 2013.

functions, the policies, procedures, and mechanisms of internal control, and the policies and procedures of management.

The changes in the legislative framework deeply affected the IOR. In 2013, it reviewed and re-organized anti-money laundering procedures and improved transparency. First, the institute adopted a new handbook on anti-money laundering procedures, which defined a new, risk-based internal customer rating, and substantially strengthened customer data compilation and collection requirements. Specifically, the IOR expanded its data templates in areas such as verification of identification, source of funds, transaction activity, and overall customer risk profile. Second, the information technology (IT) system supported the assessment of internal customer rating systems. Indeed, by June 2014 the IOR had completed a systematic screening of all existing customer records in order to identify missing or incomplete information. In parallel to this process, the IOR reviewed unusual transactions and standardized reporting procedures under FIA supervision. This review included a reconciliation of the IOR's financial statements, comparing accounting entries with incoming and outgoing transaction payment records in order to verify abuses.

In addition, the institute's governance was strengthened, with the appointment of a chief risk officer at directorate level with a specific focus on compliance and reporting.

Finally, as mentioned above, the institute is now subject to prudential supervision by the Vatican regulator. In order for the IOR to be compliant with the provisions of the Regulation 1, specific work streams were put in place to allow for full compliance with the provisions by no later than 13 January 2016, the final date for complete compliance as required by article 121.3 of the regulation.

The main events of the history of IOR are summarized in Table 1.

Table 1 – History of the IOR

Year	Event
1887	Pope Leo XIII constitutes the "Commission of Cardinals for Charitable Causes" ("Commissione Cardinaliza ad pias causas") with an own regulation
1904	Pope Pio X changes the Commission's name to "Commission of Cardinals for the Works of Religion" ("Commissione Cardinalizia per le Opere di Religione")
1934	The Commission is turned into the "Administrative Prelate Commission of the Works of Religion" ("Commissione Prelatizia Amministratrice delle Opere di Religione") and

	Pope Pio XI approves its statute
1941	The Commission's name is changed to "Administration of the Works of Religion" ("Amministrazione per le Opere di Religione"), including a new statute approved by Pope Pio XII
1942	Pope Pius XII constitutes by Chirograph the "Institute for the Works of Religion" (Istituto per le Opere di Religione, IOR) with an own legal status, which absorbs the "Administration of the Works of Religion" ("Amministrazione per le Opere di Religione") (*Acta Ap. Sedis*, XXXIV/1942, pp. 217–219)
1990	Pope John Paul II approves by Chirograph the present Statute of the IOR
2010	Creation of the "Autorità di Informazione Finanziaria" (AIF), the Vatican's financial regulator. Introduction of the Act of the Vatican City State n. CXXVII on the prevention and countering of the laundering of proceeds resulting from criminal activities and financing of terrorism
25 January 2012	Amendment of anti-money laundering and countering the financing of terrorism (AML/CFT) Law by Decree n. CLIX
24 April 2012	Presentation of the Law CLXVI to confirm Decree n. CLIX on the prevention and countering of the laundering of proceeds resulting from criminal activities and financing of terrorism
14 December 2012	Law amending the Decree n. CLIX of 25 January 2012, converted into Law n. CLXVI on 24 April 2012
8 August 2013	*Motu proprío* of Pope Francis for the prevention and countering of money laundering, the financing of terrorism and the proliferation of weapons of mass destruction, pursuant to the steps already taken by Benedict XVI in this area with the *motu proprío* of 30 December 2010
1 October 2013	Publication of the institute's annual report for 2012
9 October 2013	New Law XVIII of Vatican City State on transparency, supervision and financial information
7 April 2014	Pope Francis approves a proposal on the future of the IOR, reaffirming the importance of the institute's mission for the good of the Catholic Church (Bollettino n. 0244)
9 July 2014	The Secretariat for the Economy presents changes in the IOR governance structure, announces the new IOR board and provides an update on the future strategy of the institute

Source: *https://www.ior.va/en-us/abouttheior.aspx*

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3 - Financial intermediation, 2011–2014

As reported in the introduction, the IOR currently provides deposit taking, asset management, custodial functions and international payment transfers through correspondent banks, and holds salary and pension accounts of employees of the Vatican. Indeed, at the end of 2014 it served approximately 15,000 customers split between 4,300 Catholic institutions, which account for more than 80 percent of customers' assets, and 10,700 individuals, with a link to the Holy See, accounting for less than 20 percent of customers' assets. According to the requirements of Vatican Law and international interbank payment systems, IOR accounts are held in the name of the respective customer. There are no anonymous accounts. As decided by the IOR Board of Superintendence on 31 July 2014 and 16 September 2014, the IOR does not provide loans.11 Nevertheless, even before 2014, lending activity was not relevant. The payment services are offered through a network of about 35 correspondent banks worldwide to IOR's institutional clients (religious orders and Church entities).

The first annual report was published in 2013 and it refers to operations as per year 2012. The financial statements are prepared in accordance with International Financial Reporting Standards (IAS/IFRS) issued by the International Accounting Standards Board.

Clients and services

The IOR is currently revising its operations and defining a new way forward to fulfill its mission. Its management team is currently finalizing with the board the last component of a long-term plan for the IOR (IOR, 2014). This plan revolves around two key objectives. First, the portfolio of products is being revised, shifting toward products more appropriate to clients' needs, and increasing the quality of the service overall. Second, it is de-risked through the development of a strategy that will allow the IOR to sustain and increase its annual contribution to the Holy See.

As for the first objective, the IOR's clients are institutional and are part of the Catholic Church (IOR, 2014). In 2013, the IOR updated its guidelines on customers, which are now (1) institutional counterparties (sovereign institutions of the Holy See and Vatican City State and related entities, embassies and diplomats accredited to the Holy See), (2) non-

[11] **IOR**, *Annual report*, Rome, 2014 (available at *http://www.ior.va/content/dam/ior/documenti/rapporto-annuale/IOR_AnnualReport_EN_2014.pdf*).

institutional counterparties (employees and pensioners of the Vatican and IOR), (3) institutes of consecrated life and societies of apostolic life and dioceses. Unlike the past, the IOR does not accept as customers individuals not related to the Holy See, nor does it accept business clients. The IOR annual report places together groups (1) and (2) while it splits group (3), presenting dioceses as a separate entity (Figure 1). At the end of 2014, the most important group by customers' assets is that of institutes of consecrated life and societies of apostolic life. These account for half of the IOR's customers' assets, followed by institutional and non-institutional counterparties (40 percent) and dioceses (8 percent).

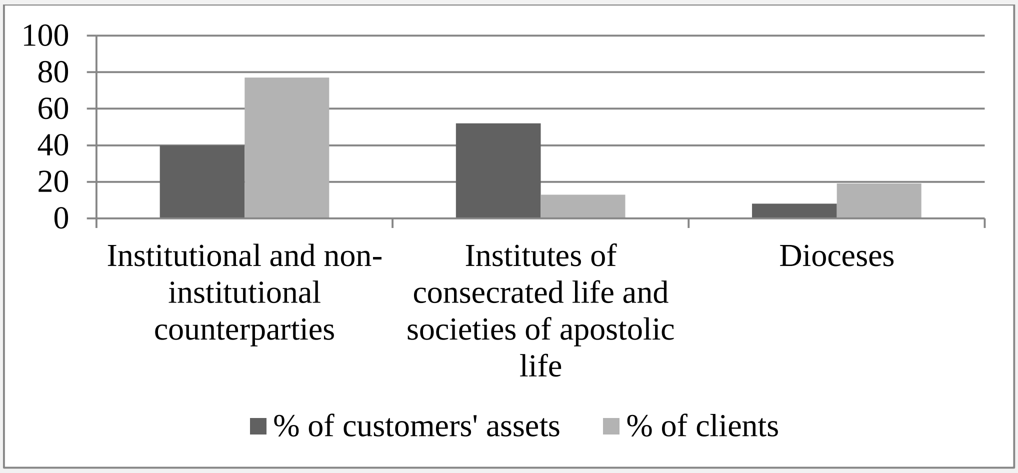

Figure 1 – IOR clients. Source: **IOR**, *Annual report*, Roma, 2014 (available at *http://www.ior.va/content/dam/ior/documenti/rapporto-annuale/IOR/AnnualReport_EN_2014.pdf*)

Customers' assets are shifting from deposit to asset management solutions. In fact, from 2008 to 2014, client deposits not included in the asset management accounts decreased from 3.2 billion (bn) to 2.1 bn euro, while assets under management increased from 2.3 bn to 3.2 bn euro (Figure 2). Following this trend, the IOR now focuses on the development of asset management solutions and moves away from deposits. By doing so, the IOR tries to meet its second goal of de-risking, and stabilizing a stream of recurring revenue for the Holy See. The section "Asset under management" reports more on this shift in strategy. The institute also acts as custodian of clients' portfolios. However, as of 31 December 2014, the net value of assets under custody was 673.2 million euro (-11.3 percent as compared to 2013). In parallel, the IOR provides payment solutions.

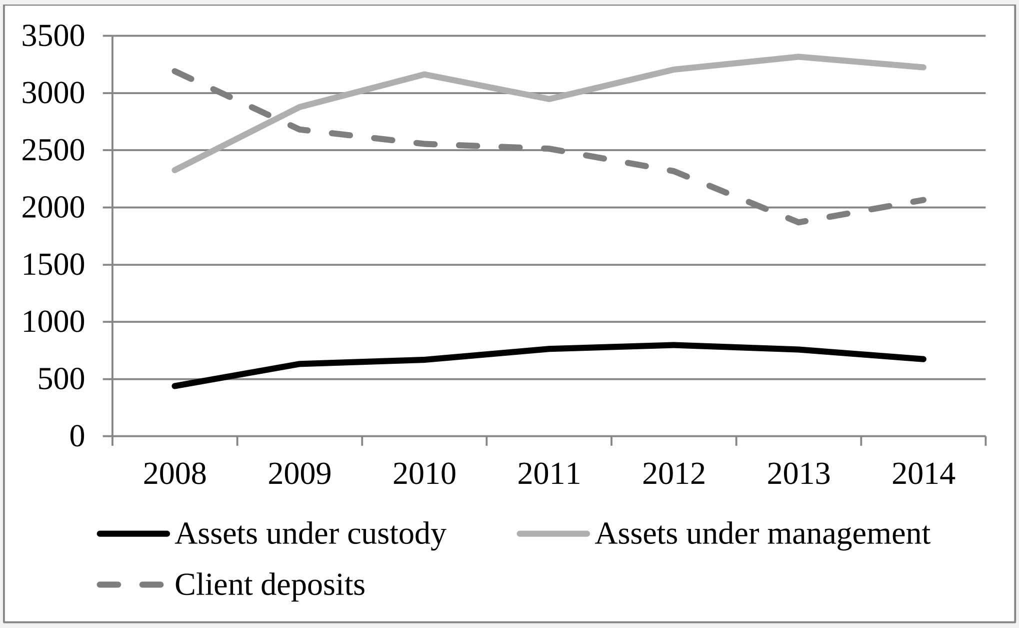

Figure 2 – Customers' assets (euro millions). Source: **IOR**, *Annual report*, Roma, 2014 (available at *http://www.ior.va/content/dam/ior/documenti/rapporto-annuale/IOR_AnnualReport_EN_2014.pdf*).

The reform process involving IOR is divided into two phases. Started in 2013, phase I is built around three pillars: compliance, focus on Church customers, and transparency. From May 2013 until May 2015, the IOR has systematically screened all existing customer records in order to identify missing or insufficient information required for the completion of customer identity data templates, which the institute introduced in the second quarter of 2013. That task has now been completed. Because of this screening process, as per 30 September 2015, the IOR has ended 5,478 customer relationships, 3,000 in only the first year of the process. Of those, 2,600 were dormant or recording prolonged inactivity, 809 did not meet the new customer definition criteria and 2,069 customer relationships ended by natural attrition (Table 2). The above described process has been closely coordinated with the Vatican regulator.

Table 2 – Client termination process 2013–2015

Client relationships	Number of accounts	in %
Ended since June 1st, 2013 (total)	5,478	
of which: actively terminated - dormant	2,600	47.46
of which: actively terminated - not fitting client category	809	14.77
of which: closed due to natural attrition	2,069	37.77
New since June 1st, 2013	1,488	
In process of being closed (total)	55	
of which: blocked	10	18.18
of which: open	45	81.82
Existing at September 30, 2015	14,754	

Source: authors' elaboration on data available at *http://www.ior.va/content/ior/en/servizi.html*

In 2013 and the first half of 2014, the ending of customer relationships led to an outflow of funds amounting to about 44 million (mn) euro. Thirty-seven million euro of those funds were transferred by wire to financial institutions in jurisdictions that ensure traceability of funds through an equivalent regulatory framework – 88 percent to Italian institutions. About 5.7 mn euro were transferred internally as donations. The remaining amount of 1.2 mn euro was paid out in cash and registered accordingly[12].

Phase I of the IOR reform was concluded in 2014, with all accounts checked, principal legacy cases investigated, and improvements in transparency and procedures.

Following the confirmation of the IOR's mission by the Holy Father on 7 April 2014 and under the guidance of the Secretariat for the Economy and its Council, phase II of the reform process was launched. The Secretariat for the Economy and the IOR Supervisory Commission of Cardinals agreed that this phase should be carried out under a new governance structure and by a new board and executive team, which were appointed in July 2014[13].

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[12] Press release of the Istituto per le Opere di Religione (IOR), Rome, 8th July, 2014 (available at *http://www.ior.va/content/dam/ior/documenti/ComunicatiStampaNotizie/2014/inglese/Press%20Release_IOR_8_July-ENG.pdf*).

[13] Press Conference for the presentation of the New Economic Framework for the Holy See, n. 0509, Rome, 9th July, 2014 (available at *http://www.ior.va/content/dam/ior/documenti/ComunicatiStampaNotizie/2014/inglese/B0509-XX.01(2).pdf*).

Over the 2015–2017 period, the IOR's statutes were revised and its operations redesigned, following a set of three strategic priorities: (i) strengthening the business foundation for the IOR; (ii) gradually shifting assets under management to a newly created central Vatican Asset Management (VAM), in order to overcome duplication of efforts in this field among Vatican institutions; (iii) focusing the IOR on financial advice and payment services for clergy, congregations, dioceses and lay Vatican employees. Currently, no additional information has been disclosed on phase II.

Asset side. Investments

As part of the financial sector, the IOR's results have been affected by the pronounced financial market instability over the 2011–2014 period. In 2011, the sovereign debt markets of a number of euro countries, including Italy and Spain, prompted a sudden increase in risk aversion. This fueled demand for government securities of more reliable countries and caused a sharp drop in securities and bond prices[14]. Banks' funding costs rose, and the IOR was no exception. Indeed 75 percent of the IOR's assets are in euro, and 24 percent in US dollars. Tensions temporarily worsened in several euro-area countries in 2012. International investors' concerns over Greece and the difficulties of Spain's banking system were compounded by the impression that the European authorities were not addressing the euro-area crisis consistently and by doubts regarding developments in US budgetary policies. In the last few months of 2012 the general reduction in risk aversion on the international markets benefited from progress made in the definition of the single supervisory mechanism in Europe and the restructuring of Spain's banking system, and also from the success of the Greek debt buyback operations[15]. Thanks to the intervention of the European Central Bank (ECB) the spreads stabilized at the start of 2013 at values lower than those observed in 2011 but still high compared with the start of 2010. Conditions in the financial markets of the advanced countries remained favorable, notwithstanding spikes in volatility towards the end of 2014[16].

Over the 4-year period the IOR's average assets were 3.13 bn euro (Annex 1 and 2). Total assets increased by 18 percent in 2012 but decreased in the next two years, with a total variation of -27 percent from 2011 to

[14] **BANCA D'ITALIA**, *Relazione annuale sul 2011, Rome, 2012.*
[15] **BANCA D'ITALIA**, *Relazione annuale sul 2012, Rome, 2013.*
[16] **BANCA D'ITALIA**, *Relazione annuale sul 2014, Rome, 2015.*

2014. The IOR invests predominantly in highly liquid, interest-bearing securities and bank deposits. Investment in the equity markets or similar financial instruments is small as well as investment in loans. As for the first, investment in subsidiaries is the value of the stake in the real estate company Società per gestioni di immobili Roma (SGIR), which is unchanged over the period. SGIR is 100 percent owned by the IOR. Secondly, loans to customers represent on average 0.7 percent of total assets and decreased by 27 percent over the 4-year period. Gross credits fell due to fewer loans and credit lines being granted during the period. The provision for specific impairment losses rose 16.8 percent in 2014 because of new provisions concerning credit positions considered totally or partially irrecoverable.

As for loans breakdown, loans to clergy, religious congregations and other ecclesial bodies decreased from 52.6 to 41 percent of total loans, whereas loans to non-institutional counterparts increased from 44.9 to 56.44 percent from 2012 to 2014. Following the recent decision by the IOR, however, this item is going to decrease over years as existing loans are fully repaid or withdrawn.

Consequently, the asset side of the balance sheet mainly consists of bank deposits and securities.

On average, bank deposits total 25 percent of assets, but this percentage decreases from 35 in 2011 to 17 percent in 2014. At the end of 2014, bank deposits accounted for 551 mn euro, mainly consisting of deposits on demand (51.4 percent) and in term deposits and money market investments (48.3 percent). At the closing date of the 2014 financial statements, the maximum maturity of term deposits did not exceed 9 months, except for a term deposit with APSA, which had a maturity longer than 1 year.

The IOR holds securities (bonds, equities and external investment funds) worth 2.6 bn euro (+3 per cent from 2011) and 80 percent of total assets in 2014. Within this category, bonds account for 77 percent of total assets (57 percent in 2011), while equities and funds only 3 percent (4 percent in 2011). This change in the composition of total assets is due to a change in the strategy adopted by the institute (Figure 3). With the aim of de-risking the proprietary portfolio, the IOR decided to increase investment in bonds, and correspondingly reduce investment in equities and in external funds.

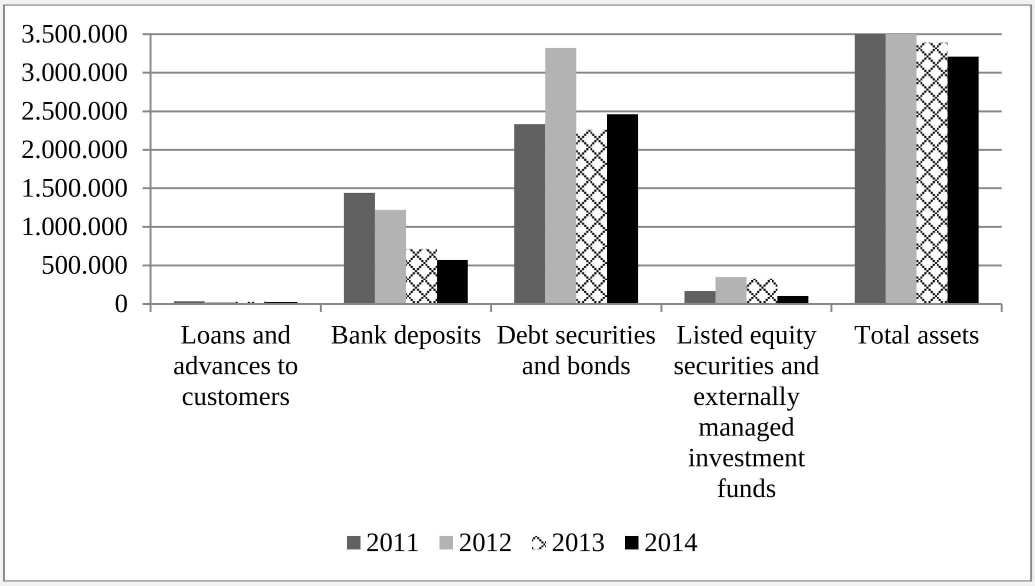

Figure 3 – IOR's assets composition 2011–2014 (in million euro). Source: authors' elaboration on data from IOR 2012, 2013 and 2014 annual reports.

Securities are allocated in trading, available for sale and held to maturity portfolios. Over the 4-year period, trading securities account on average for 51 percent of total assets, available for sale only for 7 percent and held to maturity for 15 percent. From 2011 to 2014, trading securities increased from 42 to 54 percent of total assets, held to maturity from 11 to 20 percent, and available for sale decrease from 9 to 6 percent (Figure 4). Trading securities and available for sale portfolio are almost entirely invested in bonds (on average 89 percent of trading securities and 96 percent of available for sale portfolio). In the available for sale portfolio, there are two main equity investments, which are Cattolica Assicurazioni and Carige[17].

[17] **IOR**, *Annual report*, Rome, 2012 (available at *https://www.ior.va/Portals/0/Content/Media/Documents/AnnualReports/425x00sc399T!/IOR_AnnualReport_E.pdf*). No additional information is available in the IOR annual reports on this topic. However, the 2014 annual report discloses the purchase of 6.3 mn euro new shares, following capital increase, but it does not provide information on the issuer. From additional information reported, we assume that the purchase refers to Cattolica Assicurazioni while investment in Carige is impaired by 2 mn euro, due to the further decline in its fair value to below the historical cost.

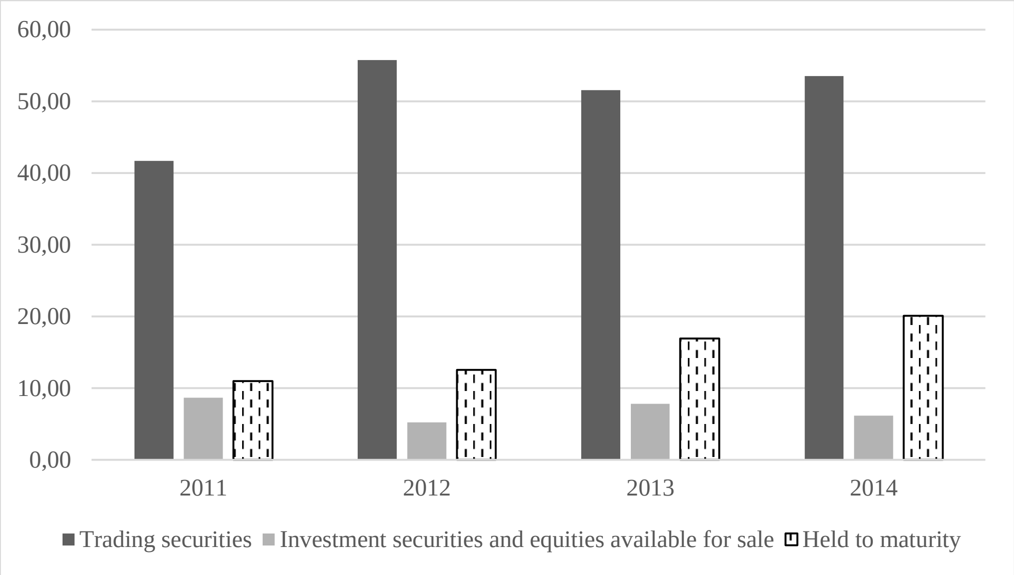

Figure 4 – Securities allocation in trading, available for sale and held to maturity portfolios (in percentage). Source: authors' elaboration on data from IOR annual reports.

Considering that about 80 percent of total assets is invested in securities, a Risk Management Department was created in 2007, and analyzes credit risks, market risks and operational risks. The IOR has exposure to various risks associated with the effects of fluctuations in the levels of market interest rates on its financial position and cash flows. To implement additional analyses, repricing and/or maturity dates should be made available to the reader, but they are not. Because of that, we can only say that the cumulative interest sensitivity gap shows exposure to a rise in interest rates on a short-term horizon (up to 12 months). On the contrary, the IOR seems exposed to the risk of a decrease in interest rates for assets and liabilities with repricing or maturity longer than 1-year. Modified duration on total portfolio, which measures price sensitivity to yield, falls from 1.8 years in 2011 and 2012 to 1.66 years in 2014.

The institute does not enter into hedge transactions and did not hold derivatives since the end of 2012. In 2011 the IOR held three derivatives separated from notes issued by a third-party bank that the directorate decided to present as "Loans and Receivables" securities. During 2012, these notes were sold, realizing a loss of 11.6 mn euro, which included the loss on derivative components of 7.1 mn euro recognized in the net trading income item of the income statement. The choice of not

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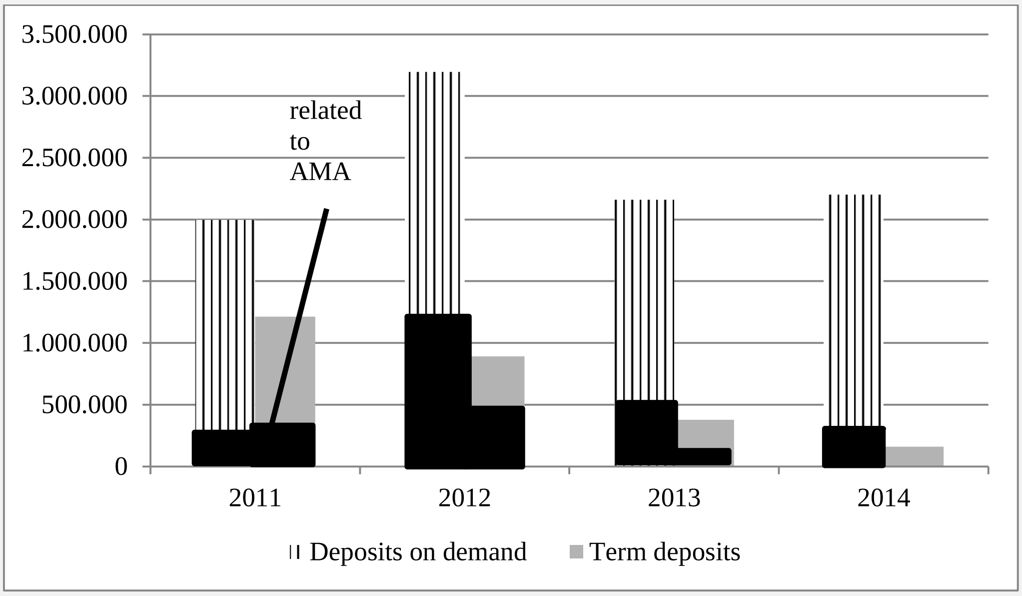
holding derivatives, however, may negatively affect risk management strategies, because hedging is not allowed.

Liability and equity side

On the liabilities side, the institute does not borrow in the interbank market nor issue debt securities. Therefore, due to depositors is the most significant item, representing 93.9 percent of total liabilities on the balance sheet in 2014 (Annex 1 and 2). This item, amounting on average to 3.1 bn euro, shows a decline of 27 percent from 2011, mainly due to the reduction of deposits on demand and of term deposits related to asset management accounts for which the IOR is the depository institution (Figure 5). Deposits on demand related to asset management accounts represented 16 percent of total deposits in 2011, 43 percent in 2012 and only 13 percent in 2014. Term deposits related to asset management accounts were 32 percent of total term deposits in 2011, 46 percent in 2012 and zero in 2014. The main reason for this is the IOR asset manager's decision to invest directly in securities rather than in cash and term deposits, in order to optimize returns.[18] This issue is further investigated in the "Profitability analysis" section. In addition, the ending of customer relationships led to an outflow of funds, as previously mentioned.



[18] The item "due to depositors" also includes a deposit at the Commission of Cardinals disposal to support works of religion (IOR, 2014).

Figure 5 – Due to depositors (euro million) – total and related to asset management accounts (AMA).
Source: authors' elaboration on data from IOR annual reports.

On average, capital accounts for 19 percent of total assets, ranging from 18 percent of total assets in 2011 to 22 percent in 2014. It is mainly formed by equity reserve and retained earnings reserve. Before Regulation 1 of the Financial Intelligence Authority, the institute generically referred to Basel II rules in its annual report. The Regulation compels the IOR to comply with capital requirements. The regulatory capital consists of the common equity, and its minimum shall exceed 8 percent of the IOR's risk weighted assets.[19] The IOR should calculate and report its capital requirements for credit risk, counterparty risk, market risk and operational risk and prove that its regulatory capital is above the combined minimum requirements for all these risks. In particular, the IOR maintains a total capital coefficient, which is the ratio between the regulatory capital and the total capital requirement multiplied by 12.5, of no less than 8 percent, and a core capital coefficient, which is the ratio between the core capital and the total capital requirement multiplied by 12.5, of no less than 6 percent. The Risk Management Department calculates the internal capital requirements for credit, market and operational risk. Even if net equity decreased from 741 in 2011 to 695 mn euro in 2014 (-6 percent), the IOR fully meets capital requirements as defined by the Regulation.

Asset under management

As previously said, due to depositors is the most significant item in the liabilities side of the annual report over the period 2011–2014. In 2011 and 2012, client deposits and funds from asset management portfolios are mainly invested on the IOR's behalf in fixed-income securities or in money market accounts, generating profits for the institute.

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[19] Common equity is defined as the sum of capital and supplemented capital deducting goodwill, intangible assets, adjustments to the value of receivables, losses recognized in previous financial periods and in the current period, and adjustments to the regulatory value of assets valued at their fair value. For regulatory purposes, common equity is equivalent to common equity tier 1. **FIA,** *Regulation No. 1, Prudential supervision of the entities carrying out financial activities on a professional basis, Implementing Title III of the Law introducing norms on transparency, supervision and financial intelligence, No. XVIII of 8 October 2013*, Rome, 2015 (available at *http://www.aif.va/ENG/pdf/Regolamenti/AIF_Regulation1_Prudential_Supervision.pdf*).

In particular, deposits on demand grew by four times from 2011 to 2012 and then decreased to about 300 million euro (-7.8 percent over the 4-year period). Term deposits increased in 2012 and decreased to zero in 2014. The total asset under management follows a trend similar to deposits on demand, peaking in 2012 and decreasing by about 60 percent over the 4-year period (Figure 6). Changes in market interest rates and the consequent impact on the bond markets partly explain these trends.

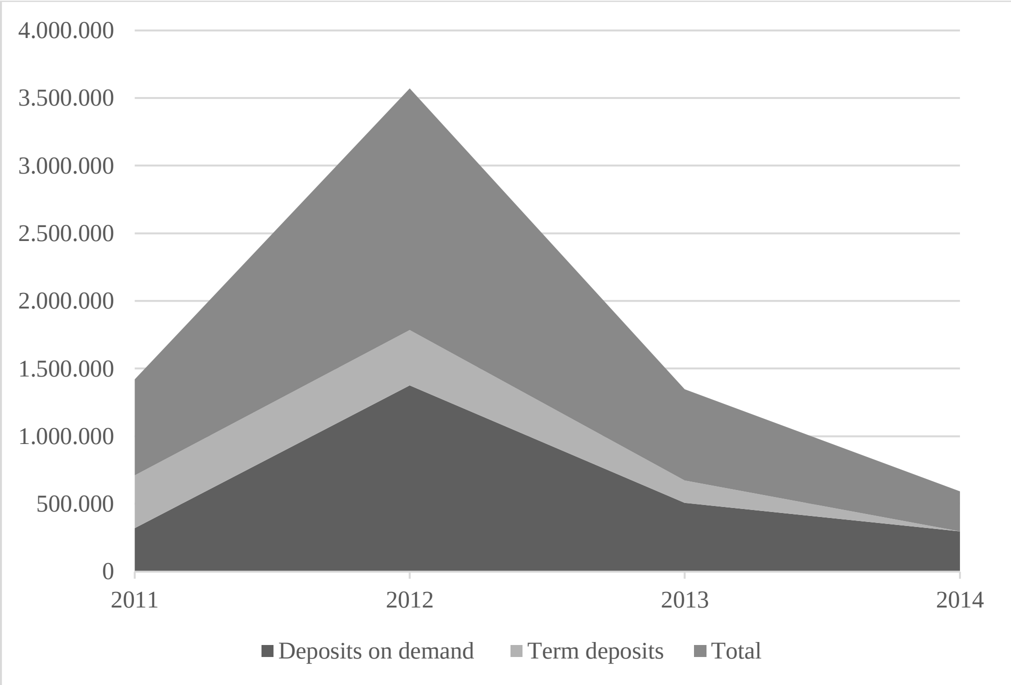

Figure 6 – Asset under management (in thousand euro). Source: authors' elaboration on IOR annual reports.

Changes in the asset, liability and equity side of IOR annual reports and in the asset under management are also a consequence of managerial strategies, which are illustrated below through the analysis of flow of funds.

Sources and uses of funds

As presented in Annex 3, over the 2012–2014 period cash has been invested in bonds (129 mn euro, 11 percent of total uses of funds) and to pay back clients' deposits (863 mn euro, that is 72 percent of total uses of funds). Sources of funds are largely due to liquidity reduction (875 mn

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euro, that is 73 percent of total cash inflows) and, in a small part, from selling equity securities and external investment funds (64 mn euro, 5 percent of total cash inflows).

In 2012, the IOR's cash flow departed from the usual flows of banks, where client deposits are the main source of funds and securities the largest investment. In 2012, client deposits accounted for 71 percent of total sources (878 mn euro) and were invested largely in bonds (991 mn euro, 80 percent of cash outflows) and equity securities and investment funds (182 mn euro, 15 percent of outflows). In 2013, cash was almost totally invested to pay back clients' deposits (1,559 mn euro, 96.4 percent of outflows), reducing liquidity (506 mn euro, 31 percent of inflows) and selling bonds (1,063 mn euro, 66 percent of inflows). In 2014, the situation changes again. Cash is still used to pay back depositors (182 mn euro, 37 percent of cash outflows) but it is also invested in bonds (201 mn euro, 41 percent of outflows). These uses of funds are covered by selling equity securities and investment funds (228 mn euro, 47 percent of inflows) and getting liquidity (149 mn euro, 31 percent inflows).

Asset management accounts help to explain the flow of funds. Over the period 2011–2014, assets managed by IOR increased by 9 percent, but portfolio mix among liquidity for settlement, term deposits and securities changed. This is partly due to the macroeconomic and financial markets environment, interest rate spread, debt crisis, flight to quality, and gold price volatility in 2012 and in 2013.

As far as IOR asset management accounts are concerned, in 2012 liquidity for settlement and term deposits increased (+1,075 mn euro) and securities decreased (-817 mn euro). In the same year, the institute's annual report shows larger client deposits (+878 mn euro) on the liabilities side and securities investment (+1,083 mn euro) on the asset side, thus proving transfer of funds between off to on balance sheet items. The difference between investment in securities and due to depositors (-205 mn euro) is financed through liquidity reduction (-220 mn euro).

In 2013, on the contrary, asset management account shows smaller liquidity for settlement and term deposits (-1,112 mn euro) and larger securities investments (+1,225 mn euro). In the same year, the IOR's balance sheet reports smaller due to depositors (-1,559 mn euro) and securities investment (-1,032 mn euro), confirming transfers between on to off balance sheet items. Once again the difference between investment in securities and due to depositors (-527 mn euro) is mirrored by liquidity reduction (-505 mn euro). The same flows of funds and securities can be found investigating 2014 data, but to a smaller extent. Liquidity and term deposits decrease by 377 mn euro, while securities in asset management accounts increase by 282 mn euro. On the balance sheet, due to depositors decreases by 182 mn euro as well as securities investments (-31 mn euro). The difference between securities and due to depositors (-152 mn euro) can be explained by liquidity reduction (-149 mn euro). Transfers between on and off balance sheet items are presented in Figure 7.

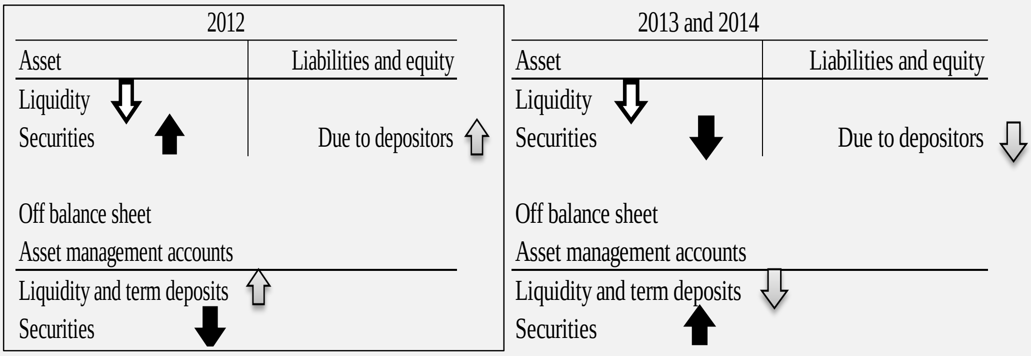

Figure 7 – On and off balance sheet transfers. Source: authors' elaboration on IOR annual reports.

Profitability analysis

The composition and evolution of asset and liability, and of the asset under management influences the net interest result, which decreases by 21 percent over the 2011–2014 period (Figure 8).

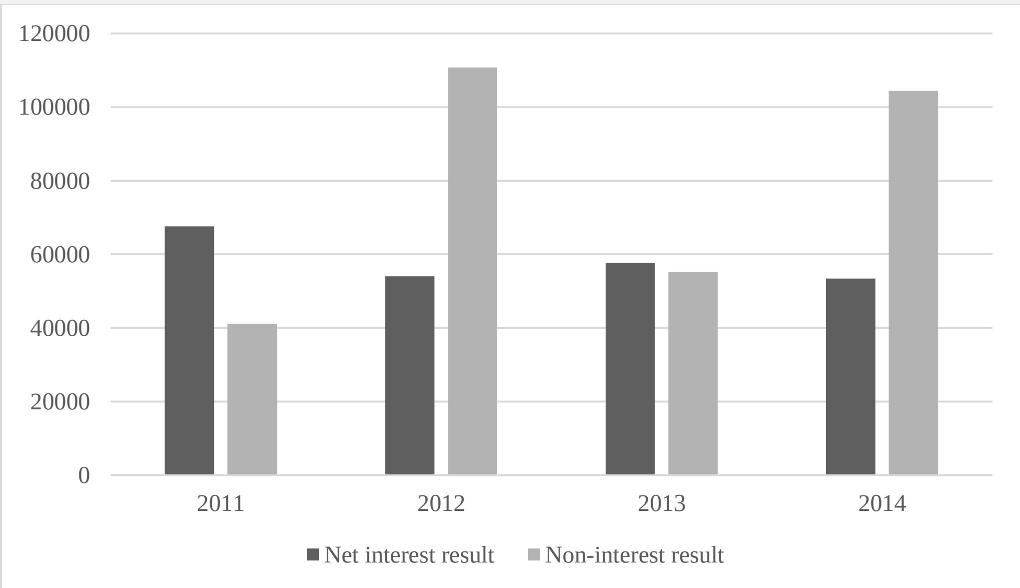

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Figure 8 – Net interest and non-interest results (in thousand euro). Source: authors' elaboration on IOR annual reports.

In 2013 clients shift their funds from deposits to securities, due to the low interest rate environment. Furthermore the ending of customer relationships leads to an additional outflow of funds, which are no longer available to the IOR for its own investment. As a consequence, in 2013, the IOR's net income is 2.9 mn euro, about one-thirtieth of 2012 86.6 mn euro. This decline from 2012 is mainly due to (i) an increase of fee and commission expenses and (ii) a decrease in the net trading income.

The increase of fee and commission expenses reflects the shift of customers from deposits to securities and it is a consequence of an increased number of transactions on the equity portfolio management, but also of the increase in fees paid to banks (+47.4 percent) due to more services being provided to customers in 2013.

The decrease of the net trading income is mainly due to the drop in the realized result from debt securities and bonds (-428.3 percent).

In 2014 the shift of funds from deposits to securities is confirmed (as already shown in Figure 2). However, as a consequence of fewer transactions related to equity portfolio management, as well as the rationalization of the IOR's external banking relationships, the fee and commission expense decreases.

On the other hand, the net trading income scores a net gain of 36.7 mn euro in 2014 compared to a net loss of 16.5 mn in 2013, due mainly to the positive performance of bond markets in 2014, compared to the previous year, as a result of lower interest rates.

Over the 2011–2014 period, IOR net income increases from 20.3 mn to 69.3 mn euro (+242 percent). However, the net income yearly variation has been relevant, as shown in Figure 9.

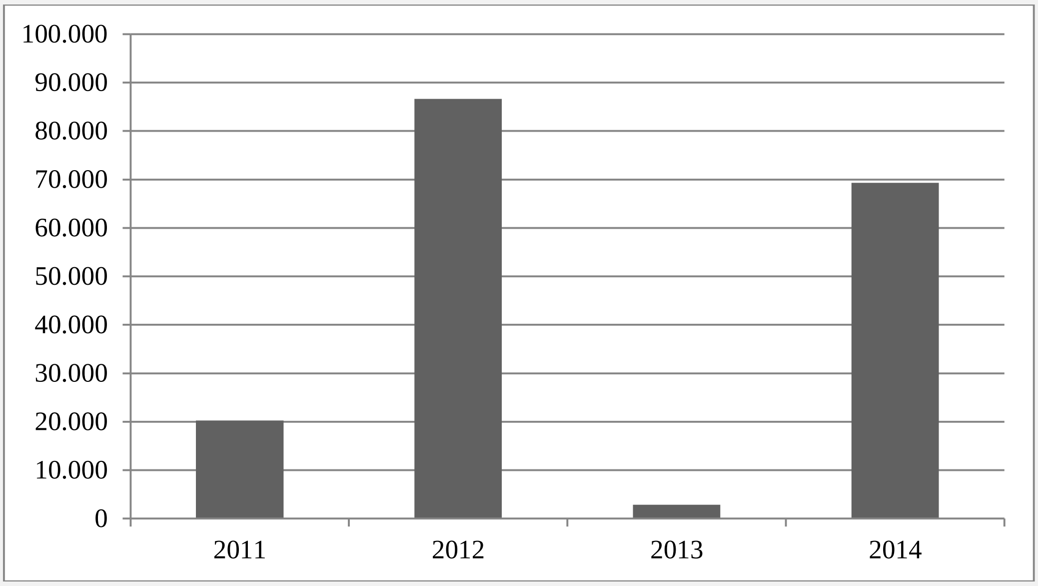

Figure 9 – Net income of IOR (in million euro). Source: **IOR**, *Annual report*, Roma, 2014 (available at *http://www.ior.va/content/dam/ior/documenti/rapporto-annuale/IOR_AnnualReport_EN_2014.pdf*

In 2012, the IOR transfers 63 percent of net income for the use of the Holy See. The remaining amount is transferred to the general operating risk reserve. In 2013, the fund at the disposal of the Cardinals' Commission, which is used to distribute charitable contributions approved by the board to members of the Catholic Church, is financed by the distribution of the net income of the year. Finally, in 2014, the net income is almost entirely transferred to the Holy See. A smaller part (20 percent) is transferred to the retained earnings reserve to strengthen the IOR's capital.

Over the 2011–2014 period, the IOR's profitability has been volatile (Annex 4). The average return on equity (ROE) is 6.1 percent, moving from 2.7 percent in 2011 to 11.3 percent in 2012, then dropping to 0.4 percent in 2013, and finally up to 10 percent in 2014. The average ratio of operating income to total assets is 1.2 percent and it mirrors ROE, peaking in 2012 and 2014. The financial leverage is 5.3 on average and decreases over the period from 5.5 in 2011 to 4.6 in 2014. The same happens to the ratio of net to operating income, whose average is 0.9 and goes from 1.2 in 2011 to 1.0 in 2014.

The ratio of operating income to total assets is explained by the gross income to total asset and by the operating to gross income ratios (average 1.3 and 0.9 respectively, both peaking in 2012 and 2014). These ratios show that both operating income and net adjustments for impairment of loans and other activities increase over the 4-year period. In particular, operating income to total asset ratio increases because of higher return on banking operations, which exceeds the increase of operating expenses. Indeed, non-interest result to total assets increases from 1.0 to 3.3 over the period (+200 percent). On the other hand, cost to income ratio decreases from 50.9 percent in 2011 to 27.7 percent in 2014.

If we consider assets under management rather than total assets, average ratio of operating income to assets under management is 0.6 percent, half the result previously found, but following the same trend as ROE.

4 - Conclusion

The IOR is undergoing a period of relevant reforms. It has improved disclosure and transparency, for instance by starting to publish annual reports and joining Moneyval, and was deeply affected by the changes in the legislative framework. Among other changes, the latter led to a review and re-organization of anti-money laundering procedures.

However it is difficult to classify the IOR since it is partly a commercial bank, and partly an asset management company. Indeed, it collects customers' deposits but does not provide loans, and it invests in securities. According to Bankscope, a Bureau Van Dijck database, the IOR is classified as a private bank/asset management company but the institute is completely different from other banks in the same group. In fact, due to the IOR's peculiar business model, it is almost meaningless to perform a peer analysis. First, comparing the IOR to private banks or asset management companies by total assets can be misleading, because of its significant off balance sheet activity. Transferring funds between on and off balance sheet items makes the IOR more similar to a dealer than to a commercial bank. Second, according to its statute, the IOR does not provide loans, which is, however, a standard investment for peers. Currently, eighty percent of the IOR's total assets are invested in securities, and 18 percent in liquidity and short-term deposits, which are used for payment services. According to the income statement, the IOR's net income is largely due to the result of asset management, both in terms of fees and trading net results.

This peculiar business model has been shaped not only by recent changes in Vatican regulation, but also by its past history, which is unique among banking and financial institutions. Today, it manages clients' assets and provides payment services in a captive market. Members of the clergy, religious congregations and other ecclesial bodies, IOR and Vatican City employees face a unique supplier for banking and financial services. The institute also provides financial advice to its clients, who therefore invest their assets following the investment strategy designed by the IOR itself. The analysis of annual reports seems to suggest that the mix of bond and liquidity held by clients would reflect the institute's choices on its own portfolio more than clients' preferences in terms of risk and return. Investment strategy seems to be set to strike a balance between maximizing the IOR's profits from its portfolio and the risks it is willing to take.

In terms of governance, the institute's shareholder, that is the Holy See, and other stakeholders overlap, since clergy, congregations and other bodies are all part of the Catholic Church. Therefore, the net income is almost entirely transferred to the Holy See for its use. The IOR's peculiar governance structure should minimize the principal–agent conflict. However, it might escalate in specific scenarios, if economic or financial conditions are not met. For example, if the IOR does not make net income but instead makes a net loss, it may opt to use retained earnings in order to stay afloat in the short term, but shareholders and other stakeholders might have different views on the long-term strategy to be implemented. The same would happen if the institute makes net income through investment strategies, which decrease clients' wealth. Similarly, since the IOR neither borrows in the interbank market nor has a lender of last resort, how could it pay back depositors in case of a bank run? The strategic plan built on the work of the Pontifical Referring Commission to the IOR (CRIOR), and the Pontifical Commission for Reference on the Organization of the Economic- Administrative Structure of the Holy See (COSEA) and briefly presented in this paper seems to address some of the above-mentioned problems.

This plan encourages the shift, which has already been recorded by annual reports, from term deposits to asset management solutions for the IOR's clients, further professionalizing the asset management services. Over the next few years, the IOR's statutes will be revised and its operations redesigned, gradually shifting assets under management to a newly created, central Vatican Asset Management (VAM) (Press Conference, 2014). The IOR will focus on financial advice and payment services for clergy, congregations, dioceses and lay Vatican employees, according to the new regulatory framework introduced by the Vatican and given the recently signed tax agreement between the Holy See and Italy.

The Vatican Asset Management will manage first the real estate assets, and in the future also securities and financial portfolios. Property and portfolios will still belong to the dicastery or organization that today have a legal title to them[20]. The transition is, however, complex. No official valuation of the real estate assets has been disclosed so far. The valuation should cover apartments and buildings but some properties have no market estimate. In addition, if the assets of religious congregations were to be involved, additional valuation problems could arise. Finally, financial assets are held not only by the IOR, but also by other ministries. It is unclear whether the VAM will manage these assets or buy them from the IOR, paying cash or VAM shares. A full estimate of the value of this portfolio is, however, not available.

In fact, even if the VAM was announced in July 2014, no additional information has been provided so far on the IOR's future development.

Annex 1 - Balance sheet – reclassification (in thousand euro)

Assets	**2011**	**2012**	**2013**	**2014**
Cash and bank deposits	1,442,260	1,221,548	715,990	567,358
Loans and advances to customers	30,619	25,823	29,462	22,408
Trading securities	1,697,102	2,780,675	1,748,901	1,718,136
Equities	*80,594*	*93,148*	*64,173*	*13,005*
Investment funds	*73,304*	*244,321*	*250,702*	*77,261*
Bonds and debt securities	*1,543,204*	*2,443,206*	*1,434,026*	*1,627,870*
Available for sale securities	352,382	261,871	264,800	198,067
Equities	*10,977*	*9,619*	*13,930*	*10,390*
Bonds and debt securities	*341,405*	*252,252*	*250,870*	*187,677*
Held to maturity securities	446,953	626,764	574,816	645,054
Derivative financial instruments	32,637	0	0	0
Total	4,001,953	4,916,681	3,333,969	3,151,023
Investment in subsidiaries	15,835	15,835	15,835	15,835
Gold, medals and precious coins	40,119	41,346	29,867	33,208

[20] **C. MARRONI**, *The Pope wants an asset manager for the Vatican's finances*, in *Il Sole 24 Ore* digital edition, April 21, 2015 (available at *http://www.italy24.ilsole24ore.com/art/panorama/2015-04-20/vaticano-asset-management--135101.php?uuid=AB2NFPSD*).

Investment properties, equipment and furnishings and other assets	832	2,140	2,328	2,304
Intangibles	403	436	1,099	833
Other assets	8,384	9,318	7,919	7,572
Total assets	**4,067,526**	**4,985,756**	**3,391,017**	**3,210,775**

Liabilities and equity	**2011**	**2012**	**2013**	**2014**
Due to banks	5,617	3	1	16
Due to depositors	3,224,981	4,103,473	2,544,278	2,361,863
Other liabilities	15,763	26,126	36,520	29,955
Post-employment benefit actuarial gain (loss) reserve	80,004	86,895	90,171	123,947
Equity	741,161	769,259	720,047	694,994
Total liabilities and equity	**4,067,526**	**4,985,756**	**3,391,017**	**3,210,775**

Annex 2 - Income statement – reclassification (in thousand euro)

	2011	**2012**	**2013**	**2014**
Interest income	94,419	92,374	80,152	63,869
Interest expenses	- 26,786	- 38,375	- 22,544	- 10,428
Net interest result	67,633	53,999	57,608	53,441
Net fee and commission income	10,219	12,194	14,110	14,362
Net interest and fee and commission result	77,852	66,193	71,718	67,803
Net trading income	- 36,673	44,564	- 16,545	36,641
Non-interest result	41,179	110,757	55,173	104,444
Operating expenses	- 20,957	- 23,949	- 32,187	- 28,880
Gross income	20,222	86,808	22,986	75,564
Net adjustments for impairment of loans and other activities	- 3,774	- 2,104	- 5,725	- 6,708
Operating income	16,448	84,704	17,261	68,856
Other net income (expenses)	3,805	1,911	- 14,396	477
Net income	20,253	86,615	2,865	69,333

Annex 3 - Flow of funds

a)

	2012		2013		2014		2014/12	
Uses of funds	000	%	000	%	000	%	000	%
Cash and bank deposits								
Loans and advances to customers			3,639	0.2				
Investment securities, equities	182,213	14.7						
trading	*183,571*	14.8						
available for sale	*-1,358*	-0.1						
Bonds and debt securities	990,660	79.9			200,889	41.2	129,039	10.7
trading	*900,002*	72.6			*193,844*	*39.8*	*84,666*	*7.0*
available for sale	*-89,153*	-7.2			*-63,193*	*-13.0*	*-153,728*	*-12.8*
held to maturity securities	*179,811*	14.5			*70,238*	*14.4*	*198,101*	*16.5*
Derivative financial instruments								
Investment in subsidiaries								
Gold, medals and precious coins	1,227	0.1			3,341	0.7		
Investment properties, equipment and furnishings and other assets	2,275	0.2					1,090	0.1
Due to banks	5,614	0.5	2	0.0			5,601	0.5
Due to depositors			1,559,195	96.4	182,415	37.4	863,118	71.7
Other liabilities					6,565	1.3		
Post-employment benefit actuarial gain (loss) reserve								
Dividends	53,000	4.3	54,700	3.4	55,000	11.3	162,700	13.5
Fair value reserve investment securities, equities available for sale	5,517	0.4			39,386	8.1	42,280	3.5
Total	1,240,506	100.0	1,617,536	100.0	487,596	100.0	1,203,828	100.0

b)

	2012		2013		2014		2014/12	
Sources of funds	000	%	000	%	000	%	000	%
Cash and bank deposits	220,712	17.8	505,558	31.3	148,632	30.5	874,902	72.7
Loans and advances to customers	4,796	0.4			7,054	1.4	8,211	0.7
Investment securities, equities			18,283	1.1	228,149	46.8	64,219	5.3
trading			*22,594*	1.4	*224,609*	*46.1*	*63,632*	*5.3*
available for sale			*-4,311*	-0.3	*3,540*	*0.7*	*587*	*0.0*
Bonds and debt securities			1,062,510	65.7				
trading			*1,009,180*	62.4				
available for sale			*1,382*	0.1				
held to maturity securities			*51,948*	3.2				
Derivative financial instruments	32,637	2.6					32,637	2.7
Investment in subsidiaries								
Gold, medals and precious coins			11,479	0.7			6,911	0.6
Investment properties, equipment and furnishings and other assets			548	0.0	637	0.1		
Due to banks					15	0.0		
Due to depositors	878,492	70.8						
Other liabilities	10,363	0.8	10,394	0.6			14,192	1.2
Post-employment benefit actuarial gain (loss) reserve	6,891	0.6	3,276	0.2	33,776	6.9	43,943	3.7
Net income	86,615	7.0	2,865	0.2	69,333	14.2	158,813	13.2
Fair value reserve investment securities, equities available for sale			2,623	0.2				
Total	1,240,506	100.0	1,617,536	100.0	487,596	100.0	1,203,828	100.0

Annex 4 – Ratios

	2011	2012	2013	2014
Net income/Equity	2.73	11.26	0.40	9.98
Operating income/Total asset	0.40	1.70	0.51	2.14
Total asset/Equity	5.49	6.48	4.71	4.62
Net income/Operating income	1.23	1.02	0.17	1.01
Operating income/Total asset	0.40	1.70	0.51	2.14
Gross income/Total asset	0.50	1.74	0.68	2.35
Operating income/Gross income	0.81	0.98	0.75	0.91
Gross income/Total asset	0.50	1.74	0.68	2.35
Non-interest result/Total asset	1.01	2.22	1.63	3.25
Gross income/Non-interest result	0.49	0.78	0.42	0.72
Non-interest result/Total asset	1.01	2.22	1.63	3.25
Net interest result/Interest rate sensitive asset	1.68	1.09	1.72	1.69
Interest rate sensitive asset/Total asset	0.99	0.99	0.99	0.99
Net interest fee and commission result/Net interest result	1.15	1.23	1.24	1.27
Non-interest result/Net interest fee and commission result	0.53	1.67	0.77	1.54
Operating income/Non-interest result	0.49	0.78	0.42	0.72
Operating expenses/Non-interest result	50.89	21.62	58.34	27.65
Operating expenses/(Total asset + asset under management)	0.27	0.27	0.43	0.41
Personnel expenses/number of employees	97.32	101.25	104.30	96.37