BANCA D'ITALIA
EUROSISTEMA

INVESTMENT CRITERIA FOR EQUITY PORTFOLIOS

In addition to managing the country's official reserves and the tasks arising from monetary policy operations, the Bank of Italy is in charge of a financial portfolio comprising its own funds and capital reserves, including those relating to staff severance pay.

The objective of the financial portfolio management is to contribute to covering the costs borne by the Bank and to preserve its capital strength by diversifying its assets vis-à-vis the risk factors typical of central banks.

To this end, a small share of the portfolio (around 10 per cent) is invested in equity and units of collective equity-investment undertakings.

The equity component consists mostly of euro-area listed shares. It excludes investments in bank and insurance shares connected to the Bank of Italy's institutional role.

The management of a listed equity portfolio, which is diversified between Italy, other euro-area countries and, to a lesser degree, the USA and Japan, is informed by a general criterion of market neutrality, which is achieved through index replication. This criterion has recently been integrated with environmental, social and governance (ESG) factors to steer investment towards sustainability goals. It was therefore decided to 1) exclude from the investment universe those companies that operate mainly in sectors banned by the UN Global Compact (tobacco and controversial weapons) and 2) give preference to companies with the best ESG scores, based on an assessment carried out by an appropriately selected ESG score provider ('best in class' approach). The overall objective is to maximize the ESG profile of the portfolios while reducing their carbon-intensity (ratio of greenhouse gas emissions to turnover).

The investment policies resulting from this integration apply the following criteria to the individual portfolios, broken down by geographical area:

- The Italian portfolio replicates an equity index for the Italian market constituted by companies with an average capitalization of more than €500 million, customized to exclude securities issued by the banking, insurance, financial services, and media sectors.
  The weights of this customized index are proportional to the market capitalization of each security.

  The portfolio is built with the following constraints:
  - The stake in each company included in the portfolio may vary based on the ESG profile, within an interval of ±0.25 per cent compared with the corresponding stake in the customized index.
  - The weight of each sector cannot exceed by more than 3.5 per cent the corresponding weight in the index;
  - The intensity of greenhouse gas emissions must be lower than that in the index.
- The equity portfolio in the euro area replicates a widely diversified market benchmark that excludes Italian equity as well as bank, insurance and financial services securities. To reduce transaction and operational costs, the replication is conducted through a sampling method employing a subset of securities. The econometric model used for the sample replication is based on five macroeconomic factors[1] and integrates the ESG criteria by excluding securities with an ESG score below a pre-set threshold.

[1] The macroeconomic factors considered are: a) the credit spread; b) the term spread; c) core inflation in the euro area; d) a seasonally adjusted leading indicator of economic activity for the euro area; and 5) a part of the equity index return not explained by other factors ('market timing').

The implementation of the replication is controlled by minimizing the deviation of the expected return of the portfolio against the index (measured by the standard deviation of the relative return, a metric known as 'tracking error volatility') and complying with the following constraints:

  - The deviation of each sector's exposure compared with the index is within a threshold of about 1 per cent;
  - Any shifts in the weight of each security are limited compared with both the security's weight in the index and the corresponding shareholding in the index.

- The US and Japanese equity portfolios are represented by units of collective investment undertakings selected among those that adopt a passive strategy linked to ESG indices.

The portfolios for Italy and the euro area are subject to a quarterly rebalancing to adjust their composition to changes in the benchmarks.

The Bank of Italy does not take part in the shareholders' meetings of the companies in its portfolio.