BANCA D'ITALIA
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Press Release

By the Communications Directorate

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The Bank of Italy's intervention power concerning financial instruments: regular assessment of risks to financial stability

Article 7-bis of the Italian Consolidated Law on Finance (TUF), taking into account the provisions of Regulation EU/2014/600 (MiFIR), gives the Bank of Italy the power to prohibit or limit the marketing, distribution or sale of financial instruments (product intervention power) in order to preserve the stability of the national financial system.

In order to exercise its intervention power, the Bank of Italy regularly carries out analyses and assessments of the risks to financial stability that may arise from financial instruments circulating in Italy based on a specific legal, analytical and methodological framework, which is constantly updated and refined.

This press release provides the public with some information on these analyses and assessments.

For more detailed information on the Bank of Italy's intervention power and its activities in this area, see on the Bank's website: *The Bank of Italy's 'intervention power' concerning financial instruments, structured deposits and related financial activities/practices*.

Based on the most recent analyses and assessments, prepared using data up to 31 December 2021, securitizations, self-securitizations, additional tier 1 subordinated bonds (AT1, also known as contingent convertibles or CoCos), and certificates are the most important types of financial instrument focused on by the Bank of Italy for the purposes of its intervention power[1]: the first three as a result of the growth in their volume over the last few years, the last one because of the big price changes to which related securities may be subject. For all instrument categories, the risks to financial stability that may arise are currently assessed as being contained.

The fact remains that, especially for some types of certificates that are mainly held in retail portfolios, investors may suffer significant losses in value if adverse scenarios occur. It should also be noted that holders of AT1 subordinated bonds or certificates, in addition to market risk, are exposed to the risk of an issuer default.

A summary of the analyses underlying these assessments is provided below.

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[1] For the list and definitions of all the individual financial instruments analysed as part of the intervention power, see the Bank's website: *Glossary of the types of financial instruments analysed by the Bank of Italy within the scope of its intervention power*.

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Complex securities – At the end of 2021, debt securities with a face value of around €2,380 billion were in circulation in Italy, 16 per cent of which were instruments that can be considered complex.[2] Among the latter, the most common were securitizations and self-securitizations (both accounting for 27 per cent of the total number of complex securities), subordinated bonds (23 per cent) and certificates (11 per cent; Figure 1).

The total value of complex securities has remained broadly stable over the past five years, but there has been a decline in structured bonds, partly offset by an increase in certificates (Figure 2). Market shares by holding sector have also remained relatively stable in recent years, with Italian banks holding around one third of the total value of the complex securities outstanding. Households' direct holdings of complex securities account for around 20 per cent of the value of their debt securities portfolio and are mainly represented by certificates and subordinated or structured bonds.

Based on the trend in outstanding volumes, securitizations, self-securitizations, subordinated bonds additional tier 1 (AT1, also known as contingent convertibles, CoCos) and certificates, they can currently be considered as potentially threatening financial stability. The values of the first two types of instrument increased until 2020 as a result of the sale of non-performing loans by banks and the use of securities deriving from securitizations in Eurosystem refinancing operations respectively; however, they are currently below previous peaks and did not record any particular increases in 2021. Volumes of AT1 bonds do not appear to be high in absolute terms, and the absence of these instruments among banks' holdings of AT1 bonds excludes any contagion risks relating to possible impairment losses. The risks to financial stability stemming from these three instrument categories can therefore be seen as contained.

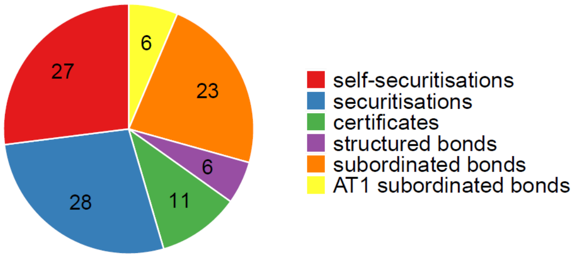
Certificates are securities whose value may vary widely as a result of changes in the prices of the underlying financial instruments. Since mid-2020, the total value of outstanding certificates in Italy has remained broadly stable, at just above €40 billion; excluding those with fully or partially protected capital, about one half may be considered as very risky for their holders. The Bank of Italy monitors developments in this market, as any losses could affect the financial conditions of households, the sector that holds most of these instruments, and give rise to possible crises of confidence in financial intermediaries issuing or placing securities. The risks to financial stability stemming from certificates currently appear to be contained. This does not rule out that the losses that could be incurred by holders in the event of an adverse scenario could in some cases be significant.

Complex derivatives – Around 5 per cent of derivatives in the portfolio of Italian banks can be considered complex. Credit default swaps dominate, while other types of complex derivatives are not very common (Figure 3). At the end of 2021, the total notional value of complex derivatives (i.e. the sum of long and short positions) was €295 billion, a level similar to that observed a year earlier. The historically low amount of derivatives currently in circulation in Italy suggests that there are no significant risks to financial stability associated with these instruments for the time being.

[2] The securities (either complex or non-complex) considered for the possible exercise of the intervention power comprise the bonds and securitized financial instruments with characteristics typical of derivative contracts, such as certificates and covered warrants, while shares and investment funds are excluded.

Figure 1

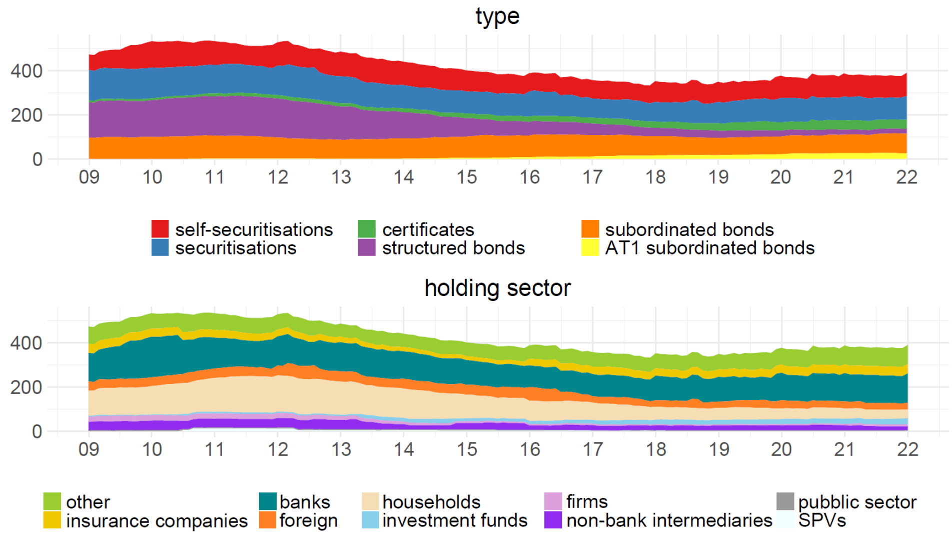
Breakdown of complex securities by type (1)
(data as at 31 December 2021; per cent)



(1) Shares are calculated on the basis of the value of the instruments.

Figure 2

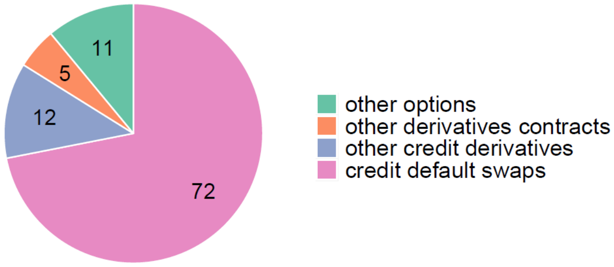
Amounts of complex securities by type of instrument and by holding sector (1)
(data as at 31 December 2021; billions of euros)



(1) The item 'other' in the panel of holders is a residual item that includes both the sectors of holders other than those shown and the cases where the holder sector is not available for the data reporting used.

Figure 3

Breakdown of complex derivatives in banks' portfolios by type (1)
(data as at 31 December 2021; per cent)



(1) The shares are calculated on the basis of the notional value of the instruments, which is the sum of the long and short positions.

For definitions of individual financial instruments, see the Bank of Italy's website: *Glossary of the types of financial instruments analysed by the Bank of Italy within the scope of its intervention power*.

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Methodological Appendix[3]

The Bank of Italy has developed a methodological framework to identify and assess risk areas that may concern financial instruments traded, distributed or sold in Italy or from Italy. The analysis uses the statistical and supervisory reporting that banks and other supervised intermediaries send to the Bank of Italy. Information from the securities register and from reports under Article 129 of the TUB are also used. The methodological framework is constantly updated and refined.

The methodology envisages splitting financial instruments into 'complex' and 'non-complex' types.[4] Each financial instrument is assigned a complexity indicator according to the type of instrument and the nature of any underlying assets. Thereafter, a two-stage analysis of risks is performed on complex securities.

In the first step, a complex financial instrument is considered potentially risky if the outstanding amounts exceed the 90th percentile of the historical distribution of its amount observed over the last five years.

The tools identified in the first step as being potentially risky are further analysed at a second stage, in which a risk assessment is carried out through the analysis of a variety of indicators (including the complexity, riskiness characteristics of the instrument, and characteristics of the reference market) using methodologies selected ad hoc by experts involved in the analysis based on the characteristics of the tools. At this stage, quantitative analyses are supplemented by discretionary assessments, for example of the adequacy of the effects expected from the imposition of prohibitions or limitations with respect to the risks identified.

The information currently available to the Bank of Italy allows a thorough analysis of debt and equity securities to be carried out. For derivatives, by contrast, the data available in supervisory reporting are not granular enough to allow an appropriate risk analysis to be used for the possible use of the intervention power. More in-depth analyses on derivatives are therefore necessarily partial at present. To overcome these shortcomings, work is under way to exploit the data contained in the EMIR database.

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[3] For more information on the methodologies used by the Bank of Italy for analyses relating to its intervention power, see the Bank's website: *The Bank of Italy's 'intervention power' concerning financial instruments, structured deposits and related financial activities/practices*.

[4] For securities, the following are considered complex: securitizations, self-securitizations, certificates (including credit linked notes and covered warrants), structured bonds, subordinated bonds, AT1 subordinated bonds; the following are considered non-complex, in addition to the residual types: shares, commercial papers, covered bonds, rights, ETFs, bonds (others), and Italian and foreign government bonds. For derivatives, the following are considered complex: credit default swaps, other options (not plain vanilla), other derivative contracts, other credit derivatives (including credit default options); the following are considered non-complex: forwards, futures, forward rate agreements (FRAs), plain vanilla options, and interest rate swaps.

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