BANCA D'ITALIA
EUROSISTEMA

Financial Stability Report

1 | 2024

April 2024

BANCA D'ITALIA
EUROSISTEMA

Financial Stability Report

Number 1 / 2024
April

Other economic publications of the Bank of Italy:

Annual Report
Account of the main developments in the Italian and world economy during the year

Economic Bulletin
A quarterly report on developments in the Italian and world economy

Economie Regionali
A series of reports on the regional economies

Temi di Discussione (Working Papers)
A series of empirical and theoretical papers

Questioni di Economia e Finanza (Occasional Papers)
Miscellaneous studies of issues of special relevance to the Bank of Italy

Newsletter
News on recent research work and conferences

Quaderni di Storia Economica (Economic History Working Papers)
A series of papers on Italian economic history

These publications are available online at: www.bancaditalia.it/publications
Printed copies can be requested by writing to the Biblioteca Paolo Baffi at: richieste.pubblicazioni@bancaditalia.it

For the hard copy version: registration with the Court of Rome No. 209, 13 May 2010
For the electronic version: registration with the Court of Rome No. 212, 13 May 2010

The English edition is translated from the Italian by the Language Services Division of the Secretariat to the Governing Board.

Address
Via Nazionale 91 – 00184 Rome – Italy

Telephone
+39 06 47921

Website
http://www.bancaditalia.it

ISSN 2280-7616 (print)
ISSN 2280-7624 (online)

Based on data available on 23 April 2024, unless otherwise indicated.

Designed and printed by the Printing and Publishing Division of the Bank of Italy

CONTENTS

BOXES

The Appendix is available only online at: www.bancaditalia.it

SYMBOLS AND CONVENTIONS

Unless otherwise specified, Bank of Italy calculations; for Bank of Italy data, the source is omitted.

In the tables:

- – the phenomenon does not exist;
- .... the phenomenon exists but its value is not known;
- .. the value is nil or less than half of the final digit shown;
- :: not statistically significant;
- () provisional.

In the figures with different right- and left-hand scales, the right-hand scale is identified in the notes.

OVERVIEW

In 2023, the global economy slowed down and the growth forecasts for the current year, although revised slightly upwards, indicate that economic activity will remain weak overall. Over the past few months, the fall in inflation has come to a halt in the United States, while it has persisted in the euro area and the United Kingdom. There continue to be risks linked to the conflicts in Ukraine and the Middle East.

International financial market conditions have eased since last November, benefiting from expectations of a less restrictive monetary policy stance. Since the beginning of the year, however, interest rates on government bonds have turned upwards in the United States and this increase has spilled over to those of the other major world economies. The difficulties experienced in commercial real estate in some countries are also a source of vulnerability for financial intermediaries.

Despite high international geopolitical tensions, the risks to financial stability in Italy are declining somewhat, partly as a result of favourable market conditions. The yield spread between 10-year Italian and German government securities has narrowed since last November; liquidity conditions have improved further, with trading reaching a new all-time high last February. While still fragile, the macroeconomic situation has stabilized amid robust labour market conditions, disinflation taking hold and an improvement in the current account balance. In addition, the latest forecasts point to stronger growth in the second half of the year. However, a persistently high debt-to-GDP ratio remains a risk factor, particularly in the event of less favourable than expected developments in the economy.

House prices have continued to rise moderately in nominal terms and have also returned to growth in real terms, thanks to falling inflation. Sales have increased and the drop in prices has eased in commercial real estate. Overall, real estate market developments pose a low risk to financial stability in Italy.

Vulnerabilities in the household sector remain limited, although uncertainty about the economic outlook is still high. Financial wealth has increased, mainly as a result of the appreciation of financial assets, and savings have continued to shift towards time deposits and public sector securities. The ratio of debt to disposable income, already low by international standards, has fallen further. Credit quality remains good, although floating-rate mortgages are showing signs of slight deterioration due to high interest rates.

The overall stable cyclical situation and a longer average maturity of liabilities compared with the past have mitigated the impact of rising rates on firms' vulnerability, which is expected to remain limited, also going forward. Profitability continued to grow in 2023 and expectations for the current year are improving. Leverage declined as a result of capital strengthening and less recourse to debt. With high funding costs, cash reserves actually made it possible for firms to make early repayments of part of the loans obtained during the pandemic.

The financial condition of the Italian banking system remains sound. Profitability has increased significantly and is set to remain high in the current year too. The main sources of vulnerability are attributable to both the potential deterioration in loan quality and possible funding difficulties at a time when the Eurosystem is reabsorbing excess liquidity. In addition, the risks stemming from global geopolitical developments are not subsiding, which could have a significant impact on the macroeconomic outlook.

On 26 April, the Bank of Italy decided to gradually activate a systemic risk buffer (SyRB) to strengthen banks' resilience against any wide-reaching adverse events. If these circumstances were to materialize, the Bank of Italy would *release the buffer, allowing banks to use these resources to absorb potential losses and to continue to finance the economy.*

In the insurance sector, capitalization fell in the second half of last year, owing to the increase in the cost of non-life claims, but continues to be high. Profitability improved, driven by higher investment income and lower net unrealized losses on securities portfolios. The liquidity position remained sound overall, although surrenders in the life segment continued.

Net subscriptions to Italian investment funds were negative in the fourth quarter of 2023 and the first quarter of 2024, following the reallocation of savings towards direct investment in debt securities. Risks in the industry remain low.

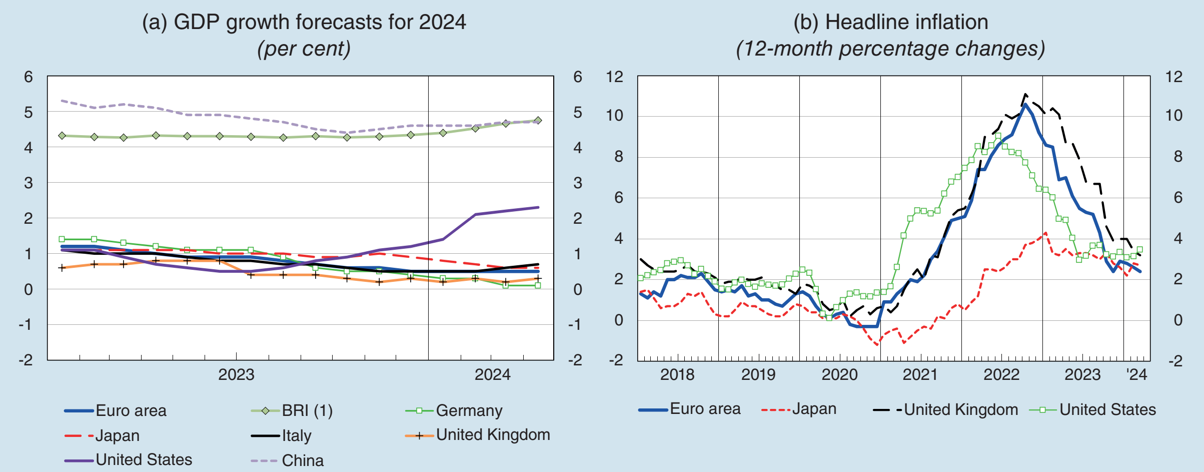
1 MACROECONOMIC, FINANCIAL AND SECTORAL RISKS

1.1 GLOBAL RISKS AND EURO-AREA RISKS

In 2023, the global economy slowed down and the growth forecasts for the current year, although revised slightly upwards since January (Figure 1.1.a), indicate that activity will remain weak overall. Since the beginning of 2024, the fall in inflation has come to a halt in the US, while it has continued in the euro area and the United Kingdom (Figure 1.1.b). There continue to be inflationary risks linked to the impact that the conflicts in Ukraine and the Middle East may have on energy prices.

Figure 1.1

Growth expectations and headline inflation
(monthly data)



Sources: Based on Consensus Economics for GDP, and on national statistics for inflation.
(1) Average of the forecasts for Brazil, Russia and India (BRI), weighted on the basis of each country's GDP (IMF, World Economic Outlook Database, April 2024).

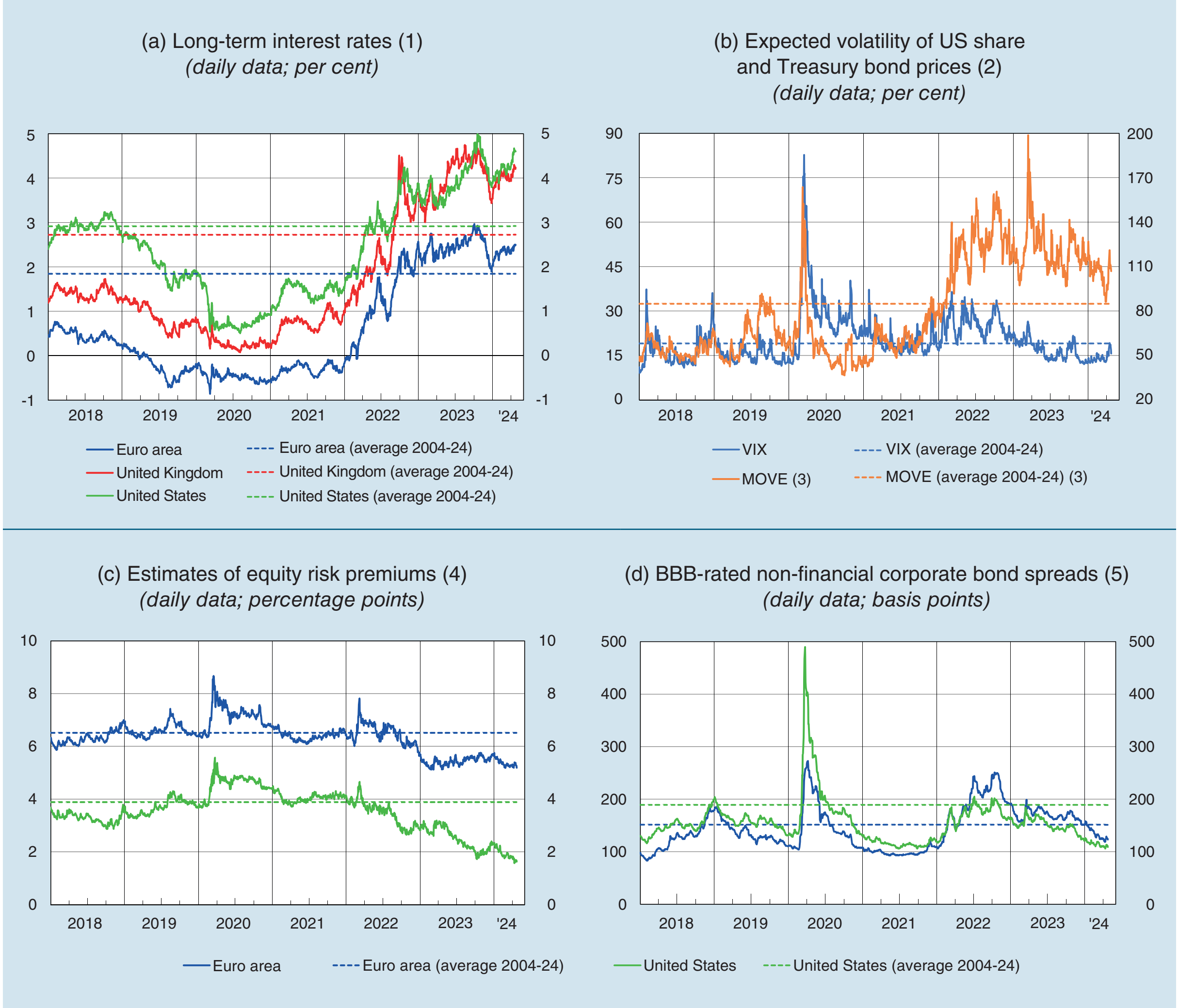
The main central banks announced that they may cut their official rates in 2024, but reiterated that their monetary policy stance will remain tight until the disinflation process is firmly established.

International financial market conditions have eased since last November, as investor confidence has improved, reflecting expectations of a less restrictive monetary policy stance overall.

The yields on long-term government bonds issued by the main advanced countries declined in the fourth quarter of last year (Figure 1.2.a), affected by expectations of a reduction in the reference rates. Since the end of December, however, yields in the United States have turned upwards again, in connection with stronger than expected economic growth and inflation persistently above the Federal Reserve's target; the increase has been partly transmitted to the yields in the other main economies. Interest rate volatility has remained high in the United States, about twice as high as before the start of the monetary tightening cycle, while it has stayed lower in the other advanced economies (Figure 1.2.b).

Figure 1.2

Interest rates, volatility and risk premiums



Sources: Bloomberg, ICE Bank of America Merrill Lynch (BofAML) and LSEG.
(1) Yields on the German 10-year Bund for the euro area; yields on the US 10-year Treasury for the United States and yields on the UK 10-year Gilt for the United Kingdom. – (2) VIX: implied volatility in the prices of 1-month options on the S&P 500 index. MOVE: implied volatility in 1-month options on futures on US Treasury securities with various maturities. – (3) Right-hand scale. – (4) For S&P 500 (United States) and Datastream EMU Total Market (euro area), the ratio of the 10-year moving average of average earnings per share to the value of the stock index (both at constant prices) is calculated. We deduct from the resulting ratio, which is an estimate of the expected real return on the shares, the real return on inflation-indexed 10-year government bonds to obtain an estimate of the equity risk premium. – (5) Yield spreads between corporate bonds issued by non-financial corporations and the corresponding risk-free bonds (obtained from the yield curve of German government bonds for euro-denominated securities and the yield curve of US Treasury bonds for securities in dollars), option-adjusted and weighted by market capitalization of the companies' individual stocks.

Since last November, equity prices have increased across all major economies, partly as a result of better than expected earnings. Volatility in the US equity market, as well as in the major stock market indices, continues to stand at historically low levels, despite temporary increases linked above all to rising geopolitical tensions (Figure 1.2.b). Equity risk premiums remain well below long-term averages, exposing prices to the risk of substantial downward revisions (Figure 1.2.c). In addition, the first quarter of this year was marked by considerable stock market heterogeneity across sectors, both in terms of returns and volatility; this has heightened the vulnerability of the sectors that benefited the most from expectations of declining inflation and resilient growth, such as the industrial, financial and non-essential goods and services sectors.

The spreads on the bonds of non-financial corporations continued to narrow in the United States and the euro area (Figure 1.2.d). Given the significantly higher issuance, this contraction reflected greater investor demand as they expect bond prices to go up following the decrease in official rates. The main rating agencies anticipate the default rate for firms in the high yield sector in 2024 to be lower than expected at the end of last year, partly thanks to the reduction in funding costs. The difficulties in the commercial real estate (CRE) sector seem to be affecting mainly smaller intermediaries, especially in the United States.

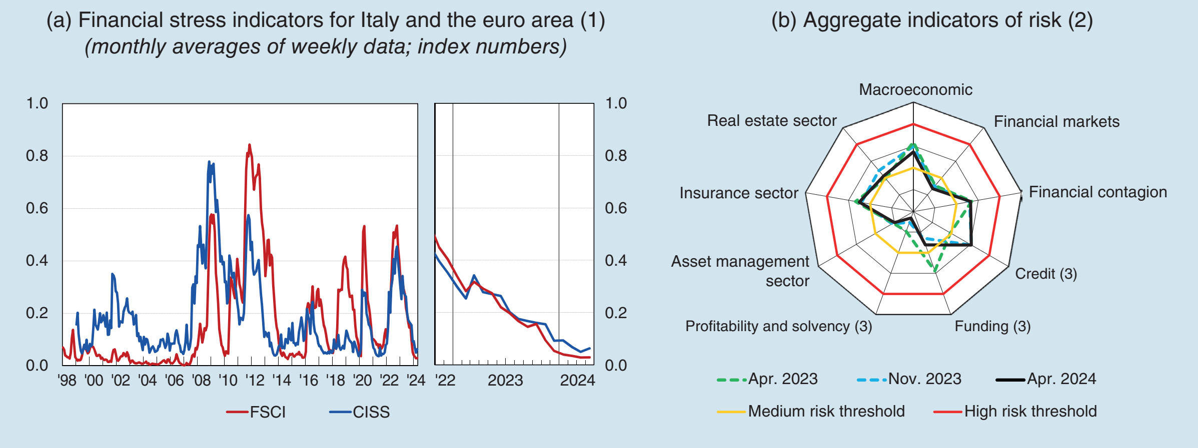
1.2 MACROFINANCIAL CONDITIONS IN ITALY

The risks to financial stability in Italy are slightly lower than last November, despite high international geopolitical tensions. In the short term, the main elements of uncertainty are attributable to a possible escalation of the ongoing conflicts and to persistently high interest rates.

The financial stress conditions index has reached 15-year lows (Figure 1.3.a), thanks to the favourable performance of both the equity and the corporate bond markets – which show no clear signs of overvaluation – and of the government securities market (see Section 1.3). The macroeconomic situation, albeit still fragile (Figure 1.3.b), has stabilized amid robust labour market conditions, disinflation consolidating and an overall improvement in the current account balance.

Figure 1.3

Synthetic indicators of risks for financial stability



Sources: Based on Bank of Italy, ECB and LSEG data.
(1) The index ranges from 0 (minimum risk) to 1 (maximum risk). The two indicators are comparable as they are based on the same estimation methodology. For further details on the Italian financial stress conditions index (FSCI), see A. Miglietta and F. Venditti, 'An indicator of macro-financial stress for Italy', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 497, 2019. Compared with the version used in this paper, the indicator used in this chart also includes the corporate bond, repo and short-term government bond market segments, which were not previously considered. For further details on the euro-area composite indicator of systemic stress (CISS), see D. Holló, M. Kremer and M. Lo Duca, 'CISS – A composite indicator of systemic stress in the financial system', European Central Bank, Working Paper Series, 1426, 2012. – (2) The aggregate indicators are based on the analytical framework for assessing risks described in F. Venditti, F. Columba and A.M. Sorrentino, 'A risk dashboard for the Italian economy', Banca d'Italia, Questioni di economia e finanza (Occasional Papers), 425, 2018. – (3) Risk indicators referring to the banking sector.

Last year, economic activity proved to be more robust than expected, expanding by 0.9 per cent compared with estimates of virtually nil growth at the beginning of 2023. According to our projections, GDP growth will remain muted in the first part of 2024 and accelerate in the following quarters (see *Economic Bulletin*, 2, 2024). Overall, it is expected to slow to 0.6 per cent in 2024 and then to pick up pace, reaching 1.0 per cent in 2025 and 1.2 per cent in 2026.[1] Inflation is expected to drop significantly this year, to 1.3 per cent, and then rise to 1.7 per cent in the following two years.

In 2023, the ratio of general government net borrowing to GDP improved, albeit less than envisaged by the government, decreasing by 1.2 percentage points to 7.4 per cent, compared with a target of 5.3 per cent. The difference is mainly attributable to the tax credits for building upgrades having a greater impact than expected. The debt-to-GDP ratio fell by around 3 percentage points, to 137.3 per cent, just over 3 points higher than prior to the pandemic.

Under the current legislation scenario in the 2024 Economic and Financial Document – which assumes that some temporary contribution relief will be discontinued as of 2025 – net borrowing as a percentage of GDP is expected to decline gradually this year and over the next three years, reaching 2.2 per cent in 2027. The debt-to-GDP ratio is expected to increase this year and over the next two years, up to 139.8 per cent, and then stabilize in 2027. Persistently high debt levels remain a risk factor, particularly in the event of less favourable than expected trends in the economy. A return to a downward path, in line with the new framework laid out in the recent reform of the Stability and Growth Pact, will require sustained strengthening of the GDP and an improvement in the structural deficit.[2]

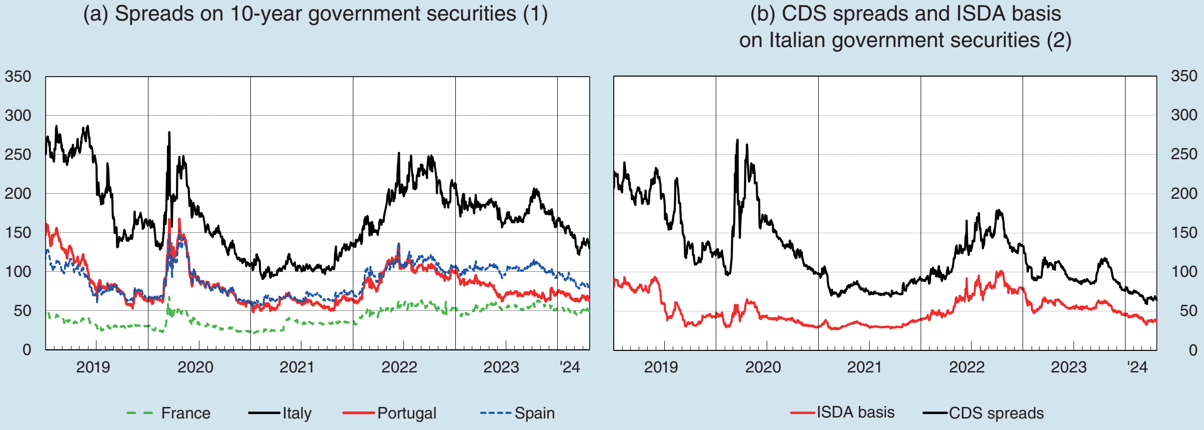
1.3 THE FINANCIAL MARKETS

The yield spread between 10-year Italian government securities and German ones has decreased since last November (Figure 1.4.a), as have the ISDA basis and the credit default swap (CDS) premium (Figure 1.4.b).

Figure 1.4

Risk premiums on government securities

(daily data; basis points)



Sources: Based on data from LSEG and ICE Data Derivatives UK Limited.
(1) Differences between the yields on the benchmark 10-year government bonds of the countries in the key and the yield on the corresponding German Bund. – (2) The International Swaps and Derivatives Association (ISDA) is an organization for participants in the OTC derivatives market. The ISDA basis measures the difference between CDS spreads on 5-year US dollar contracts under the 2014 ISDA Definitions, which provide protection in the event of redenomination, and the CDS spreads on the same contracts under the 2003 ISDA Definitions.

1 The growth rates are adjusted for calendar effects. Without any calendar adjustment, GDP growth would be 0.8 per cent in 2024, 0.9 per cent in 2025 and 1.3 per cent in 2026.

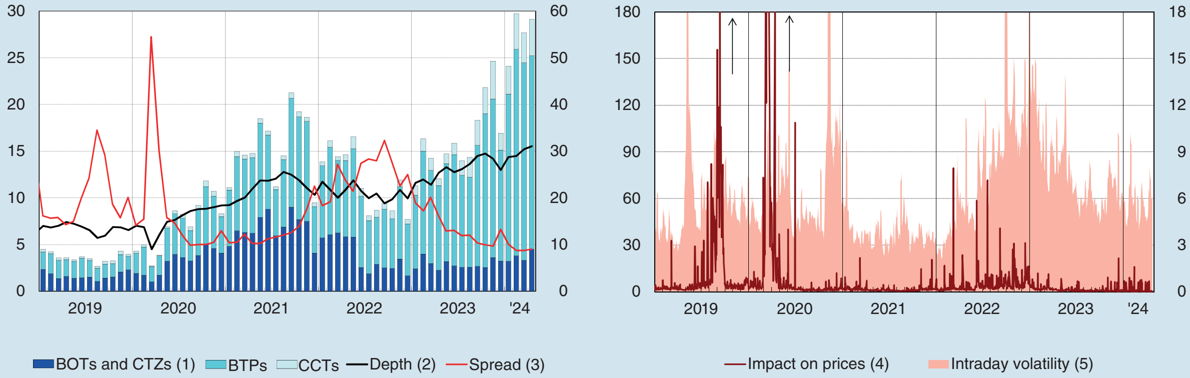
2 'Preliminary hearing on the 2024 Economic and Finance Document', testimony by S. Nicoletti Altimari, Director General for Economics, Statistics and Research at the Bank of Italy, before the 5th Committee of the Chamber of Deputies (Budget, Treasury and Planning) and the 5th Committee of the Senate of the Republic (Economic Planning and Budget), sitting jointly, Rome, 22 April 2024 (only in Italian).

Figure 1.5

Liquidity indicators for Italian government securities

(a) Trading volumes, market depth and bid-ask spread on MTS
(monthly averages of daily data; billions of euros and basis points)

(b) Impact of large orders on the prices quoted on MTS and intraday volatility
(daily averages of high-frequency data; basis points and per cent)



Source: Based on MTS data.
(1) Since October 2022, the series has only included data on BOTs because the stocks of CTZs were reduced to zero following the suspension of the placement of this kind of bond and the redemption of the last CTZs to mature. – (2) Average of the bid and ask quantities recorded during the entire trading day for the BTPs quoted on MTS. – (3) Simple average of the bid-ask spreads recorded during the entire trading day for the BTPs quoted on MTS. Right-hand scale. – (4) The indicator refers to the 10-year benchmark BTP and is based on data recorded at 5-minute intervals. Average daily impact on bid-ask prices quoted on MTS of a sale or purchase order of €50 million. – (5) A measure of volatility (realized volatility) based on the 10-year benchmark BTP intraday returns calculated at 5-minute intervals; 5-day moving average of annualized values. Right-hand scale.

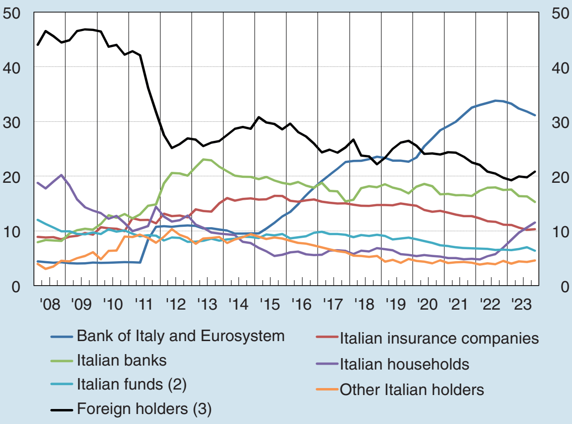
Liquidity conditions on the secondary market have improved further, reflecting expectations of a reduction in the monetary policy rates. On the MTS cash market, the bid-ask spread has remained at low levels and the market makers' quoted quantities have risen (Figure 1.5.a); trading has increased, and reached a new all-time high in February. In the context of the substantial supply in the primary market and the gradual reduction of reinvestment in securities by the Eurosystem, price volatility has remained stable, at higher levels than the minimum levels recorded in 2021 (Figure 1.5.b).

In the second half of 2023, the share of government securities held by Italian households increased markedly following the growth in yields, to over 10 per cent (Figure 1.6). The shares held by the Bank of Italy and the Eurosystem declined further, in line with the normalization of monetary policy, as well as those of banks and insurance companies.

The placement of government securities continued regularly, with quantities on the increase for medium- and long-term securities, and average yields at issue down from the peak recorded in October 2023 (Figure 1.7). Activity in the primary market continues to benefit from

Figure 1.6

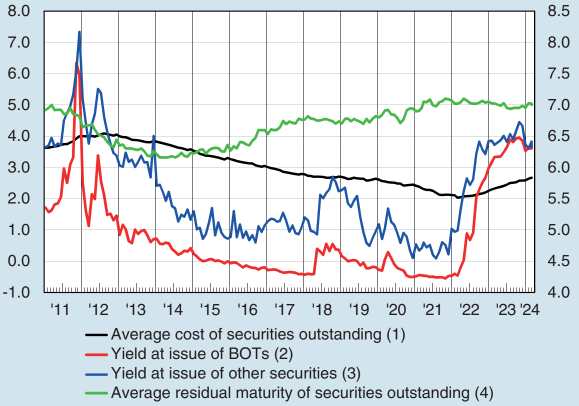
Italian government securities by holder category (1)
(quarterly data; per cent)



Sources: Bank of Italy, Financial Accounts, and estimates based on Assogestioni and ECB data.
(1) Shares calculated on data at market prices and net of securities held by Italian general government. The data refer to a subset of holders. – (2) Includes foreign individually managed portfolios and investment funds attributable to Italian investors (round trip). – (3) Securities held by foreign investors net of those held by the Eurosystem and by round-trip managed portfolios and investment funds.

Figure 1.7

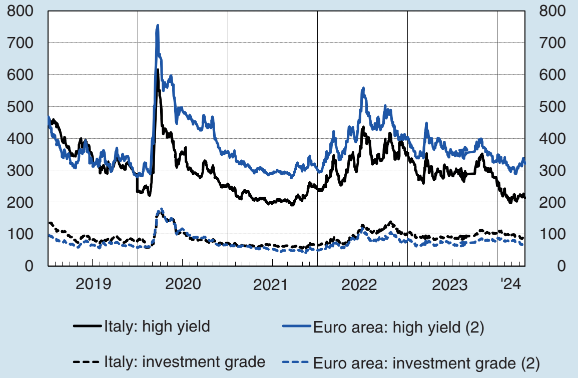
Average cost, yield at issue and average residual maturity of government securities
(monthly data; per cent and years)



Sources: Based on Bank of Italy and Ministry of Economy and Finance (MEF) data, updated to 31 March 2024.
(1) Weighted average of the yields at issue of government securities outstanding at the end of the month. – (2) Weighted average of the yields at issue of all the BOTs placed during the month, by settlement date. – (3) Weighted average of the yields at issue of securities other than BOTs and indexed BTPs placed during the month, by settlement date. – (4) End-of-period values weighted by the outstanding amounts. The figure does not include loans from the European Commission. Right-hand scale.

Figure 1.8

Asset swap spreads (1)
(daily data; basis points)



Source: Based on ICE BofAML data.
(1) Asset swap spreads weighted by the market capitalizations of individual securities issued by non-financial corporations. – (2) The BofAML indices for the euro area have been recalculated to exclude Italy.

direct placements with retail investors: €18.3 billion were raised at the end of February via the third placement of BTP Valore, a record for this kind of issuance.

The average cost of the stock of government securities outstanding has reached 2.7 per cent, continuing the growth phase that began in April 2022, and their residual maturity is stable at seven years.

At a time of gradual reduction in excess liquidity in the financial system, the repo rates on Italian government bonds have remained aligned with the remuneration rate on Eurosystem deposits. Their seasonal decline at the end of the year was limited, confirming a gradual reduction of the premium linked to the scarcity of bonds. Trading has remained close to historical highs; in the general collateral segment, which is more associated with refinancing needs, activity has gradually increased, partly because of the greater presence of the sovereign issuer. Activity in the unsecured interbank deposit market continues to be subdued.

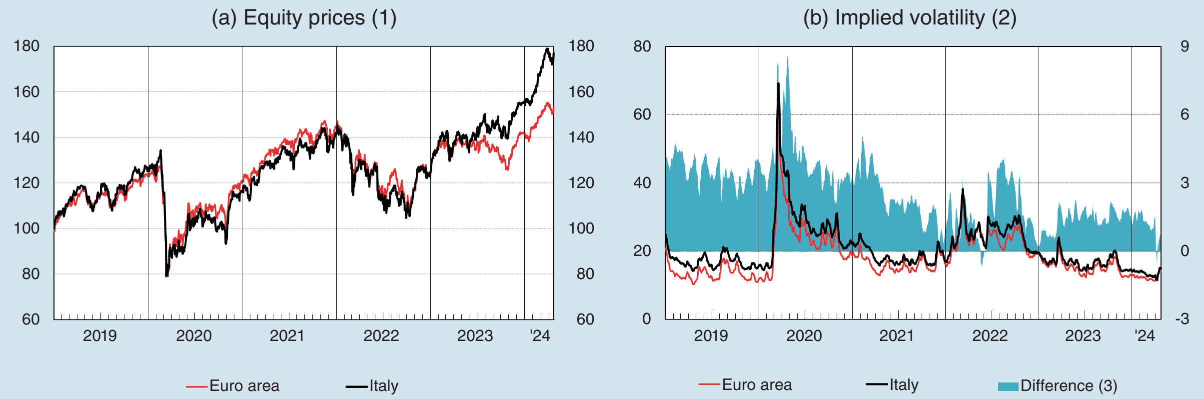
The average yield on bonds issued over the last six months by Italian non-financial corporations has fallen to 3.9 per cent for investment grade securities and to 6.4 per cent for high yield ones (from 4.4 and 8.1 per cent respectively compared with last November). The nominal value of the outstanding bonds of the riskier companies has remained stable, interrupting the decline that began in 2022 owing to the increase in funding costs.

The yield spread between bonds issued by firms and the risk-free rates (asset swap spread) has shrunk compared with the figures for late November, thanks to high investor demand (Figure 1.8). The biggest decline was observed for Italian securities with a low credit rating, mainly as a result of the marked narrowing of the yield spreads of some firms relevant to the index.

In 2023, the returns on the Italian stock market (up by 26 per cent) were greater than those of the other main global stock exchanges, benefiting from the contribution of the financial sector, together with the discretionary consumption and public utility services segments; the balance sheet results for firms in these

Figure 1.9

Equity market indicators
(daily data; indices, per cent and percentage points)



Source: Based on Bloomberg data.
(1) Indices: 1 January 2019=100. For Italy, MSCI Italy IMI; for the euro area, MSCI EMU IMI (see the disclaimer under 'Symbols and Conventions'). – (2) Implied volatility in the prices of 2-month options on the FTSE MIB index for Italy and on the Euro STOXX 50 index for the euro area. 5-day moving average. – (3) Difference between implied volatility in Italy and in the euro area. Right-hand scale.

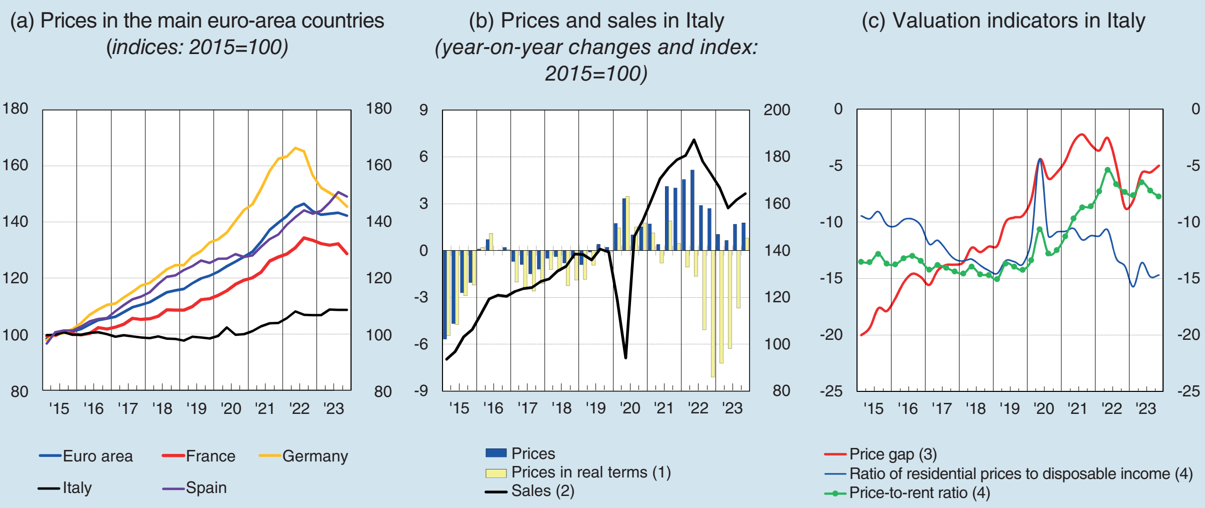
sectors were greatly welcomed by investors. In the early months of 2024, Italian share prices continued to record high gains, above the euro-area average (Figure 1.9.a), at a time of very low volatility (Figure 1.9.b).

1.4 REAL ESTATE MARKETS

In the second half of 2023, euro-area house prices continued to decline year on year (to -1.6 per cent), mainly reflecting the trend in Germany (Figure 1.10.a), although they stabilized at the levels

Figure 1.10

Residential property market in Italy and in the euro area
(quarterly data)

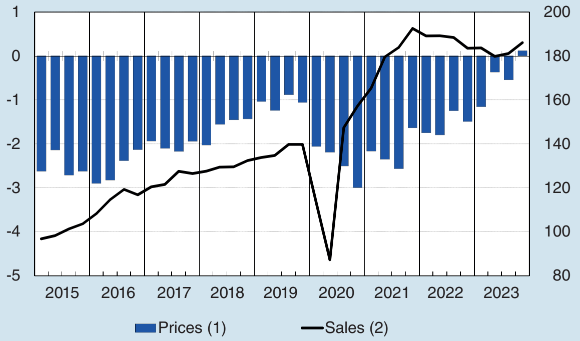


Sources: Based on data from the Bank of Italy, Eurostat, Istat and the Italian Revenue Agency's Osservatorio del Mercato Immobiliare (OMI).
(1) Data deflated using the change in consumer prices. – (2) Adjusted for seasonal and calendar effects. Right-hand scale. – (3) The price gap is defined as the percentage deviation of the house prices index in real terms from its long-term trend. – (4) The data are expressed as a percentage deviation compared with the long-term average.

seen in the first half of the year. Commercial property prices fell again in the main euro-area countries.

Figure 1.11

Non-residential property market in Italy
(quarterly data)



Sources: Based on data from the Osservatorio del Mercato Immobiliare (OMI) and Scenari Immobiliari.
(1) Percentage changes on year-earlier period; the indicator, which is still being tested, uses data drawn from transactions actually concluded on the market. – (2) Index: 2015=100; data adjusted for seasonal and calendar effects. Right-hand scale.

Residential property prices continued to increase moderately in Italy and house sales returned to growth over the same period (Figure 1.10.b). Real prices recorded a positive twelve-month change for the first time in two years at the end of 2023. According to the latest data from the Immobiliare.it digital platform, demand for housing remained weak in the early months of 2024. The real estate agents interviewed between January and February for our periodic surveys pointed to the high cost of mortgages as a factor limiting purchases (see Section 1.5). Our estimates suggest that house price growth will slow in 2024 and then come to a halt in 2025.[3] Looking at the long-term trends, the indicators that make it possible to assess the dynamics of the residential market continue to show no risks of overvaluation (Figure 1.10.c).

Sales returned to growth in the non-residential sector in the second half of 2023; over the same period, the fall in prices eased (Figure 1.11).

1.5 HOUSEHOLDS AND FIRMS

Households

The financial situation of households is sound overall, though the uncertain economic outlook may bear on its developments over the medium term. In the six months to December 2023, household purchasing power and the saving rate increased, though the latter has not fully returned to its pre-pandemic level. The latest issues of the ECB's Consumer Expectations Survey (CES) indicate that the share of households that plan to save over the next twelve months has risen slightly, although it has gone down among younger households, whose expectations for their individual financial situation have become mildly less optimistic.

According to preliminary financial accounts data, households' financial wealth increased over the same six months, mainly as a result of the appreciation of financial assets. The shift towards time deposits and bonds continued. More specifically, the share of government securities rose further, to 4.9 per cent of households' financial wealth. However, this is still a lower level than before the global financial crisis, when it was 6.6 per cent. Sight deposits, asset management products (see Section 2.3), shares and participating interests have further contracted.

In 2023, the growth in loans to households by banks and financial companies gradually reduced and eventually shrank to zero (Figure 1.12). The most recent data indicate that bank lending

[3] The estimates are based on the models described in S. Emiliozzi, E. Guglielminetti and M. Loberto, 'Forecasting house prices in Italy', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 463, 2018.

declined by 0.5 per cent in February 2024. The ratio of financial liabilities to disposable income declined further, to 58.6 per cent (its lowest level since June 2009), and remains particularly low compared with the euro-area average (89.1 per cent in the third quarter of last year).

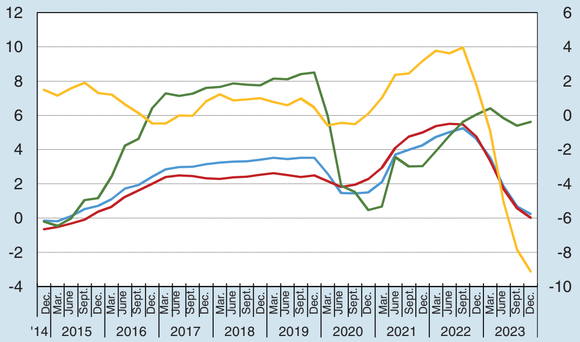
The average interest rate on outstanding loans for house purchase continued to increase until the third quarter of 2023 and then stabilized (at 3.1 per cent in February 2024, from 2.3 per cent in December 2022). The cost of new adjustable-rate mortgages has been stable at around 5 per cent since the last few months of last year, and the cost of fixed-rate mortgages has gone down to 3.6 per cent (from 4.0 per cent in September). Consistently with the widening of this spread, over 60 per cent of mortgage loans were granted at fixed rates in 2023 (against 49.6 per cent in the euro area; Figure 1.13), confirming the preference among Italian households for loans that initially guarantee lower repayment instalments (see the box 'Household exposure to the interest rate risk inherent in mortgage loans', *Financial Stability Report*, 2, 2022). The share of fixed-rate mortgages accounted for two thirds of the total outstanding amounts in December 2023.

Consumer credit continued to expand at a sustained pace at the end of 2023 (5.6 per cent), and stands at 12.5 per cent of disposable income, which is higher than the euro-area average (9.0 per cent in the third quarter). Special purpose loans contributed to this positive trend in greater proportion, mainly reflecting the increase in the average amounts of automobile loans, whereas growth in personal, non-specific loans slowed, with the exception of revolving credit cards, the use of which increased after about five years of contraction. The total cost of new loans (expressed by the annual percentage rate of charge, APRC) rose further (to 10.6 per cent in February 2024) and is higher than the euro-area average (8.6 per cent).

Figure 1.12

Loans by banks and financial corporation to consumer households

(end-of-period data; 12-month percentage changes)

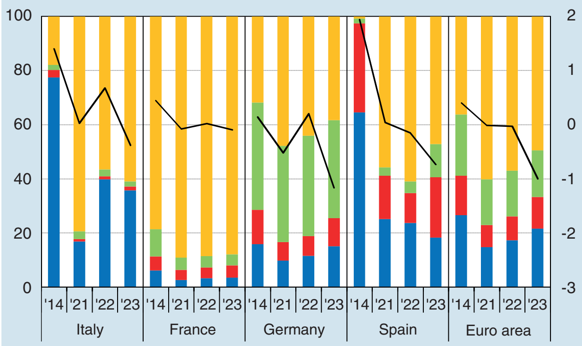


Source: Supervisory reports.
(1) The figure refers to bank loans only. – (2) The most significant are current account overdrafts and mortgage loans other than those for the purchase, construction and renovation of properties for residential purposes. Right-hand scale.

Figure 1.13

Composition of new loans by rate term and the spread between fixed and adjustable rate (1)

(per cent and percentage points)



Source: ECB.
(1) The data refer to the reference period average. – (2) The fixed rate is that applied to mortgage loans for which the interest rate is set for a period of more than 10 years. The adjustable rate is that applied to mortgage loans for which the interest rate is set for a period of less than 1 year. Right-hand scale.

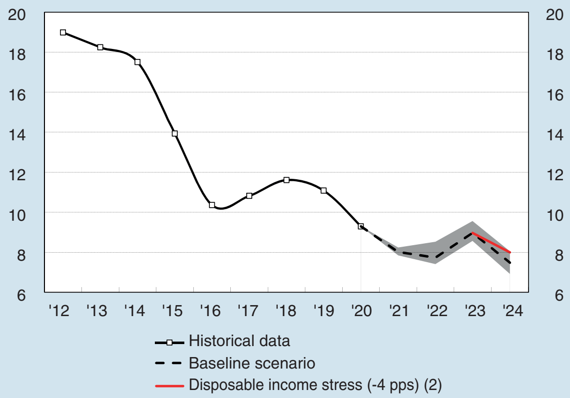
On the whole, the quality of credit to households remains good. The default rate on loans was 0.9 per cent in December 2023, up from 0.8 per cent in the second quarter of 2023 (see Section 2.1). Adjustable-rate mortgage loans deteriorated at a slightly greater rate, and the share of households with at least one instalment in arrears increased slightly over the course of 2023, although it is still lower than the last ten years' average. The default rate for consumer credit[4] remained stable (at 2.4 per cent) and is lower for special purpose loans (1.3 per cent, compared with 3.0 per cent for loans not for the purchase of a specific asset).

The projections of the Bank of Italy's microsimulation model[5] indicate that the share of financially fragile households is set to remain stable at 2.2 per cent over 2024. The debt held by these households is likely to go down to 7.5 per cent (Figure 1.14), partly as a result of the contraction in mortgage loans and of the income growth expected in the coming months. In a particularly adverse scenario, the share of debt held by vulnerable households would only marginally increase (to 8.0 per cent).

Figure 1.14

Share of debt held by vulnerable households (1)

(yearly data: per cent)



Source: Based on the Survey on Household Income and Wealth (SHIW).
(1) Households are considered vulnerable when their debt-service to income ratio is above 30 per cent and their equivalent disposable income is below the median. The latest available SHIW data refer to 2020. The shaded area represents the interval between the 10th and the 90th percentiles of the probability distribution in the simulations. – (2) Compared with the baseline scenario, the growth rate of nominal income is 4 percentage points lower in 2024.

Firms

Since the start of monetary tightening, Italian firms have shown they have ample capacity for resilience. The longer average maturity of financial liabilities than in the past (see *Financial Stability Report*, 1, 2023) and the relative strength of aggregate demand have mitigated the potential adverse effects of higher rates on debt repayment capacity. Looking ahead, even if financing conditions were tightened further and the macroeconomic environment weakened, the impact on the vulnerability of firms would still be limited.

Following the strong expansion phase in 2021-22, profitability slowed in 2023. Gross operating income went up by 5.2 per cent on an annual basis (from 15.5 per cent in 2022), with broad differences among economic sectors, but rose less in the most energy-intensive sectors (see *Economic Bulletin*, 1, 2024).

The outlook for the current year is positive. The expected revenues of non-listed companies show signs of improvement across firms of different size categories and in different economic sectors (Figure 1.15.a).[6] Analysts' profitability forecasts for listed companies also point to a more favourable trend than in 2023 (Figure 1.15.b).

In line with the decline in financing needs stemming from the slowdown in fixed investment and in inventories (see *Economic Bulletin*, 2, 2024), there was more limited recourse to

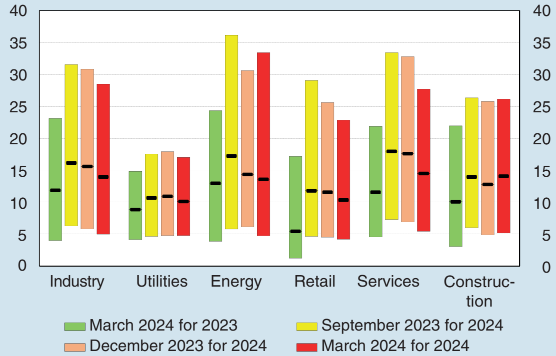
[4] The rate is calculated on the basis of data provided by Consorzio per la Tutela del Credito, a credit information company, which includes quarterly data on the characteristics of individual contracts and of borrowers for a representative sample of consumer loans.

[5] For details on the microsimulation model, see C.A. Attinà, F. Franceschi and V. Michelangeli, 'Modelling households' financial vulnerability with consumer credit and mortgage renegotiations', *International Journal of Microsimulation*, 13, 2020, pp. 67-91, also published in Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 531, 2019.

[6] The ECB conducts its Survey on the access to finance of enterprises (SAFE) on a quarterly basis, assessing their financial situation. The latest survey, carried out over February and March 2024, includes the opinions of firms for the period October 2023-March 2024 and their expectations for the subsequent six months. For further details, see ECB, 'Survey on the Access to Finance of Enterprises: continued tightening in reported financing conditions', press release, 8 April 2024.

Figure 1.15

Revenues and expected earnings in 2023 and 2024
(percentage points)



Sources: ECB (SAFE) and Bloomberg.
(1) Opinions of firms concerning actual revenues (October 2023-March 2024) and expected revenues (April-September 2024). The values refer to the balance between firms reporting an increase in revenue and those reporting a decrease. The data refer to a sample of about 1,500 Italian firms that took part in the SAFE survey, stratified by firm size (based on the number of employees: 1-9 = micro; 10-49 = small; 50-249 = medium-sized; 250+ = large) and by economic sector. – (2) Ratio between the operating income and total assets expected by analysts. The rectangles represent the interquartile difference, the middle line indicates the value. Based on a closed sample of 242 listed companies (as at December 2023), representing 97 per cent of the market capitalization of non-financial corporations.

external financing. Leverage (calculated as the ratio of financial debt to the sum of financial debt and net equity valued at market prices) decreased by 1.4 percentage points, reaching 35.3 per cent. This improvement was due both to the decline in bank debts and to more robust capitalization. Net of liquidity, leverage fell by 4.7 percentage points compared with the pre-pandemic level, which is a larger reduction than the average recorded in the euro-area countries.

Liquidity buffers contracted further in relation to total liabilities (11.2 per cent in 2023), but are still 1.5 percentage points higher than in 2019. The rise in interest rates has favoured a rebalancing between cash holdings and short-term financial assets: time deposits have grown by over 70 per cent on an annual basis and holdings of securities with a maturity of less than 12 months have almost doubled. With higher funding costs and more limited financing needs for investments, firms were able to use part of their cash reserves to make early repayments of loans obtained during the pandemic (see the box ‘Early repayments and the contraction in lending to firms’).

EARLY REPAYMENTS AND THE CONTRACTION IN LENDING TO FIRMS[1]

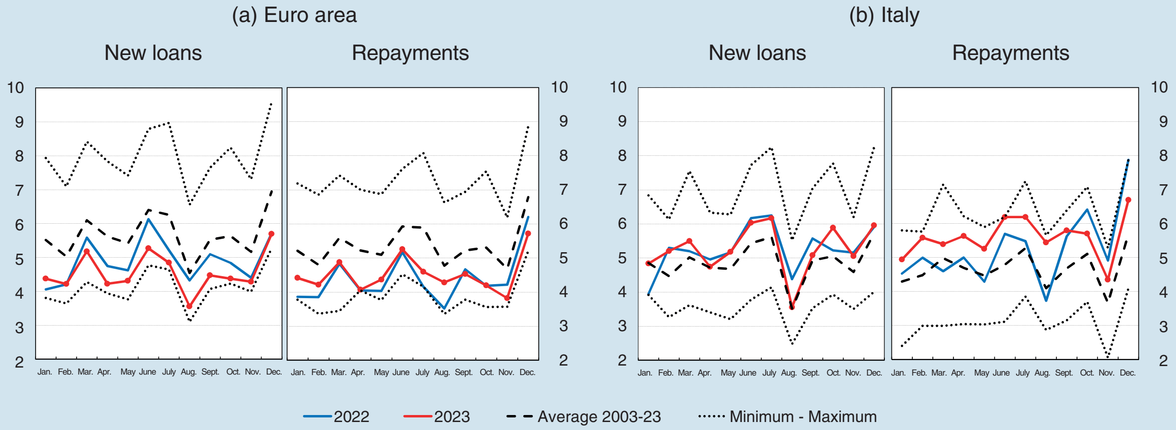
Since the ECB began its monetary tightening, lending to non-financial corporations has slowed considerably in both the euro area and Italy. At the end of February 2024, the twelve-month growth rate in lending in the euro area was virtually flat, against a peak of almost 9 per cent in the third quarter of 2022. In Italy, lending has decelerated sharply since August 2022, turning negative by the end of that year; it reached -3.8 per cent in February 2024 (see *Economic Bulletin*, 2, 2024).

In the euro area, the slowdown in lending has been associated with weak growth in new loans and repayments, both below the average values observed in the period 2003-23 (expressed as a percentage

[1] By Alessandro Modica and Davide Moretti.

Figure A

New loans to firms and repayments (1)
(per cent)



Source: ECB.
(1) Monthly flows as a percentage of the amounts outstanding in the previous month.

of the amounts outstanding in the previous month; see panel (a) of Figure A).

In Italy, this decline is attributable to the large repayments of outstanding loans. Since the fourth quarter of 2022, their share in total loans has been significantly higher than the average for the period 2003-23, reaching in the span of a few months the highest value observed so far (see panel (b) of Figure A). The share of repayments was sizeable across all sectors of the economy and mainly affected firms that had increased their borrowings to the greatest extent between 2019 and 2021, likely, among other reasons, to build up precautionary liquidity buffers at a time characterized by high uncertainty and very low costs of bank loans.

An analysis based on disaggregated loan-level data suggests that a substantial share of repayments in 2022-23 was ascribable to the early repayment of the full residual amount of the loans, accounting for around one fifth of total loans to firms outstanding at the end of 2021.[2] The share of repayments was higher

Figure B

Share of early repayments in Italy by firm size and type of loan (1)
(per cent)

Source: AnaCredit.
(1) Closed sample of approximately 300,000 firms with performing loans. Early repayments include loans for which the residual debt was paid off in full before the contractual deadline between January 2022 and December 2023. The histograms show the share of early repayments in total loans by firm size and type of interest rate. Floating-rate loans include those classified as such in AnaCredit or those with interest rate reset within 12 months. State-backed loans include those backed by public guarantee schemes introduced during the pandemic. – (2) Median value, for each group, of the loan interest rates at repayment. Right-hand scale.

[2] Early repayments are identified by looking at the outstanding amount of loans that cease to be reported in AnaCredit during the observation period. They are an overestimation of the phenomenon, as the data available do not allow loan sales and mergers or acquisitions that occurred between intermediaries during this period to be taken into account. The analysis is based on a closed sample, therefore new loans originated after December 2021 are excluded from its scope.

for larger firms and especially for floating-rate loans not backed by COVID-19 public guarantees (Figure B).

The high incidence of early repayments is consistent with the results of bank surveys, according to which internal financing, lower borrowings against fixed investments and high interest rates appear to have played a key role in the decline in lending in Italy (see *Economic Bulletin*, 2, 2024).

So far, early loan repayments have not led to a significant deterioration in the liquidity position of firms; they are also not a source of vulnerability for financial stability, as this phenomenon mostly affects larger firms, which typically have greater access to external financing channels. This evidence is in line with the results of a recent survey conducted by the Bank of Italy in which the majority of firms that drew on their own liquidity to repay their loans declared to be in an adequate financial position to meet their operational needs.[3]

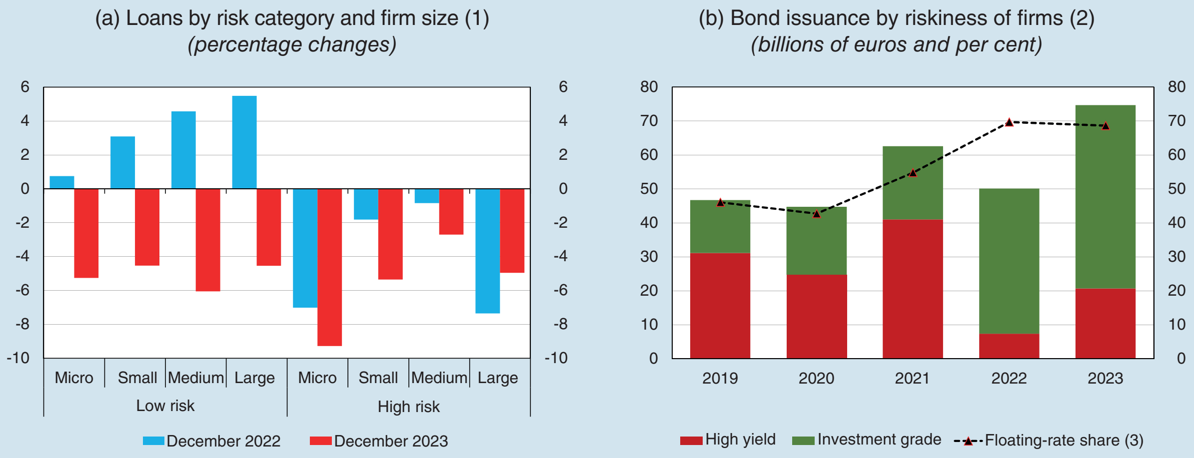
[3] See 'Business Outlook Survey of Industrial and Service Firms', Banca d'Italia, Statistics Series, 6 November 2023.

While common to all size and risk classes, the fall in loans was sharper among riskier firms (Figure 1.16.a). Lending to these firms has contracted by about twice the average rate since the start of monetary normalization.

Despite the increased perception of risk among intermediaries, general loan terms and conditions were eased in the fourth quarter of 2023, especially for less risky borrowers. Conversely, the share of firms whose loan applications were rejected rose again among smaller firms (those with up to 49 workers).

Figure 1.16

The trend in borrowing and bond issuance



Sources: Based on data from the securities registry database, Central Credit Register (CR), Cerved and Dealogic.
(1) The data refer to the annual change in lending for a sample of about 550,000 limited companies. Loans include those granted by financial corporations, take account of securitizations, and also include bad loans. Allocation into the risk groups is based on Cerved's CeBi-Score indicator. Low- (medium- and high-) risk firms have a score ranging from 1 to 4 (5 to 10). The breakdown by firm size is based on Commission Recommendation 2003/361/EC, which defines micro firms as those employing fewer than 10 workers and whose turnover or total assets do not exceed €2 million; small firms as those employing fewer than 50 workers and whose turnover or total assets do not exceed €10 million, not including micro firms; medium-sized firms as those employing fewer than 250 workers and whose turnover or total assets do not exceed €50 million and €43 million respectively, not including micro and small firms; and large firms as all the remaining ones. – (2) Gross bond issuance by Italian non-financial corporations and groups. The investment grade risk category applies to issuers with Cerved CeBi-Score rating of 1-4 whereas issuers with ratings higher than 4 are in the high yield category. The line indicates the share of new floating-rate bond issues. – (3) As a percentage of total issuance. Right-hand scale.

The average interest rate applied to new loans – excluding current account overdrafts – has risen by 4.1 percentage points since the first increase in official interest rates (July 2022). While marginally higher than the euro-area average, the rise for new loans remains lower than for official interest rates. Interest rate risk exposure stemming from the greater use of floating-rate financing is more common among large firms.

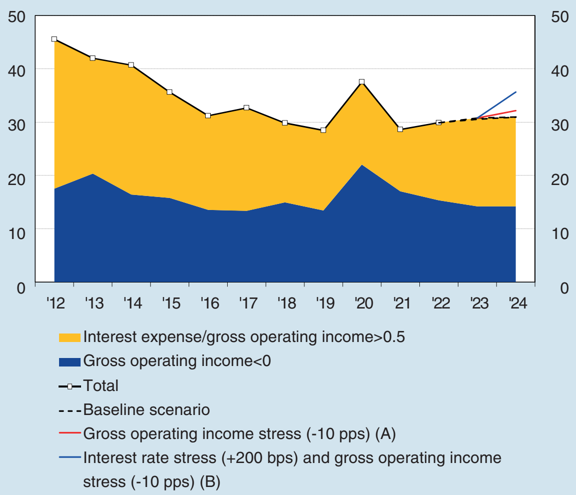
Loan repayment capacity has not been affected by worsening financial conditions; the loan default rate remained low in the last quarter of 2023 and in line with the pre-pandemic level. The trend also continued into the early months of 2024.

Gross bond issuance returned to growth in 2023. In line with the changes that occurred during the post-pandemic period, the composition of issuers continues to feature a concentration of investment grade firms (Figure 1.16.b), which are typically large and financially sound. The greater cost of bond issuance, reflecting the rise in official interest rates, has affected the type of securities issued, which are mainly floating-rate bonds with a shorter average maturity than in the past.[7] Issuers appear to have refinanced the bulk of the loans maturing in 2023 mainly through funding with a maturity of under one year. Since early 2024, the bond yields of Italian and euro-area non-financial corporations have declined, whereas the share of BBB-rated bonds, which are the most exposed to the risk of a downgrading to high yield, has gone up to 84.5 per cent of total investment grade issues in Italy since early April (from 84.3 per cent in November), against a euro-area average of 60 per cent.

Figure 1.17

Debt held by vulnerable firms (1)

(annual data; per cent)



Source: Based on Cerved data.
(1) Vulnerable firms are those whose gross operating income is negative or whose ratio of net interest expense to gross operating income exceeds 50 per cent. The definition excludes firms with bad loans. The latest available annual financial statements for the whole sample of firms refer to 2022. Compared with the baseline scenario, in 2024: (A) the nominal interest rate is 100 basis points higher; (B) the nominal interest rate is 200 basis points higher and the growth rate of nominal gross operating income is 10 percentage points lower.

Estimates based on the latest macroeconomic forecasts suggest that the share of vulnerable firms[8] and the share of total debt held by them may increase by 0.4 and 0.2 percentage points respectively, rising to 24.9 and 31.0 per cent in 2024 (Figure 1.17). Among vulnerable firms, there has been an increase in the number of those facing greater difficulties in repaying debts when the ratio of interest expense to gross operating income exceeds 50 per cent. Between the start of the interest rate rises and end-2024, the debt held by these firms is expected to increase by over 5 percentage points, to 16.8 per cent, which is around 2 points higher than prior to the pandemic.

[7] Around 44 per cent of gross issuance in 2023 has a maturity of under one year and originates from a limited number of large industrial groups.

[8] For details on the microsimulation model, see A. De Socio and V. Michelangeli, 'A model to assess the financial vulnerability of Italian firms', *Journal of Policy Modeling*, 39, 2017, 147-168, also published in Banca d'Italia, Questioni di economia e finanza (Occasional Papers), 293, 2015.

2 RISKS TO FINANCIAL INTERMEDIARIES

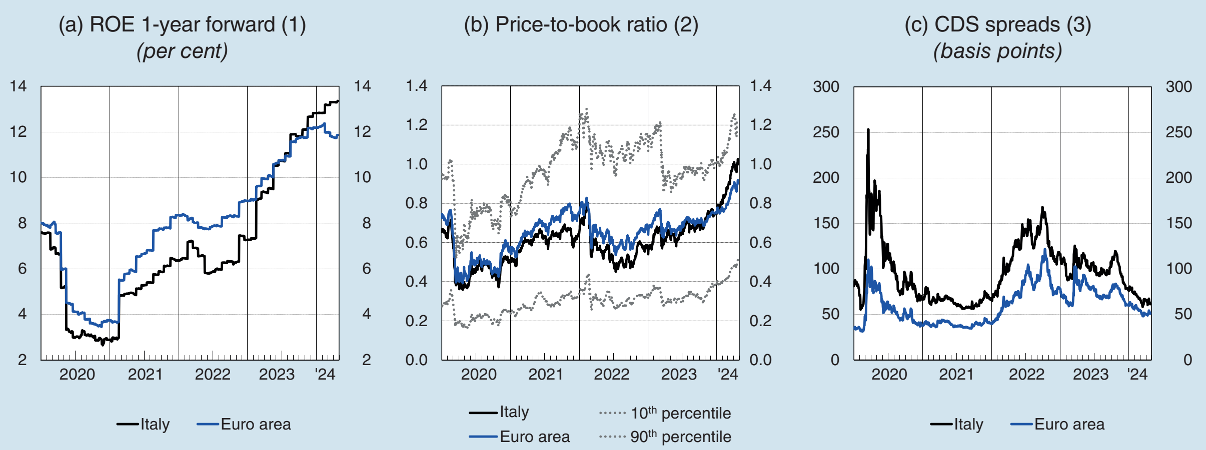
2.1 BANKS

The financial situation of the Italian banking system remains sound. The main sources of vulnerability in the medium term are associated with the potential deterioration in loan quality as a result of the high level of interest rates and with possible funding difficulties at a time when the Eurosystem is reabsorbing excess liquidity. In addition, there are persistent risks stemming from global geopolitical developments, which could have a significant impact on the macroeconomic outlook (see Sections 1.1 and 1.2).

Market indicators show a positive picture. The improvement in expected profitability has contributed to further growth in the average price-to-book ratio of Italian listed banks, which has risen to around 1 (it was around 0.5 in July 2022), above the levels of the leading listed banks in the euro area. Between October and March, the CDS premiums for banks gradually declined (Figure 2.1).

Figure 2.1

Italian listed banks: an international comparison
(daily data)



Source: Based on LSEG data.
(1) Return on equity (ROE) is estimated by market operators. Average weighted according to market value. The data refer to the banks included in the FTSE Italy Banks and the Euro STOXX Banks indices. – (2) Average weighted according to market value. For the banks included in the sample, see note 1. – (3) The data refer to the following sample of banks: for Italy, UniCredit and Intesa Sanpaolo; for the euro area, BNP Paribas, Société Générale, Crédit Agricole, Deutsche Bank, Commerzbank, Banco Santander, Banco Bilbao Vizcaya Argentaria. Simple average of 5-year CDS spreads.

Asset risks

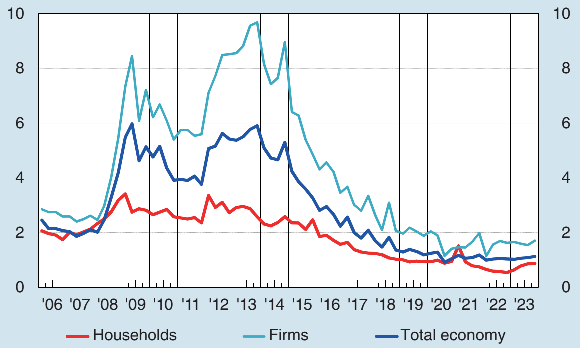
Asset quality remained satisfactory in the second half of 2023. The ratio of new non-performing loans (NPLs) to performing loans (loan default rate) was essentially unchanged (at 1.1 per cent in December, just 6 basis points higher than in June; Figure 2.2). The rate for less significant banks inched up to 2.0 per cent, from 1.8 per cent in June. The year-on-year rate for loans to firms that had taken out COVID-19 loans remained at around 2 per cent, showing a slight upward trend in the last quarter.[1] According to information provided by Mediocredito Centrale, which manages the Guarantee Fund for small and medium-sized enterprises, guaranteed loan liquidations were up in March 2024 compared with December 2023, although they remain below pre-pandemic levels.

Around €9 billion in non-performing loans were sold in 2023, compared with €20 billion in 2022. Recently, securitized state-guaranteed NPLs have experienced a deterioration in performance indicators (see the box 'Developments in the securitization of non-performing loans').

Figure 2.2

Credit quality indicators (1)

(quarterly data; per cent)



Source: Central Credit Register.
(1) Annualized quarterly flows of adjusted NPLs in relation to the stock of loans, net of adjusted NPLs, at the end of the previous quarter. Data seasonally adjusted where necessary.

DEVELOPMENTS IN THE SECURITIZATION OF NON-PERFORMING LOANS[1]

As at 30 June 2023, there were 941 active securitization transactions,[2] featuring both performing and non-performing loans as underlying assets. Of the transactions relating to non-performing loans originated by banks since 2017, 46 were backed by the guarantee scheme for the securitization of bad loans (GACS), amounting to total securitized assets inclusive of write-downs (gross book value, GBV) equal to around €118 billion in securitized assets (compared with 196 transactions not backed by GACS, amounting to a GBV of €82 billion). The performance of securitizations was largely influenced by the economic outlook. The increase in interest rates reduced demand for real estate purchases, adding to the difficulties in recovering these assets, which had already been affected by the slowdown in auctions during the pandemic. The difficulties faced by the borrowers whose debts were sold also reduced the opportunities for collection arising from out-of-court agreements.

With specific reference to the transactions backed by GACS, there was a deterioration in the coverage ratio for the senior tranches (i.e. the least risky class of securities), mainly owing to the payment of interest (generally floating-rate), which is repaid before the principal and which therefore has absorbed a portion of the recovered amounts otherwise intended to be used for repayment.[3] As at 30 June 2023, servicers' projections of expected collections indicated that for 11 transactions – all originated before the renewal of the guarantee in 2019 – there was a possibility that the GACS could actually be enforced. On the

[1] By Emanuele Frabotta and Giovanni Rillo.
[2] The figure excludes self-securitizations.
[3] Developments in the transactions are assessed on the basis of three indicators that make it possible to analyse them both in terms of the amounts recovered compared with the amounts expected in the investment plans and in terms of the coverage ratio for the senior tranche. The three indicators are the cumulative collection ratio, the cumulative profitability ratio and the senior coverage ratio. For a description of the methodology used for the calculation of these indicators, see the box 'The performance of operations backed by guarantee schemes for the securitization of bad loans', *Financial Stability Report*, 1, 2021, and the subsequent update included in *Financial Stability Report*, 2, 2022.

[1] Around 45 per cent of the loans backed by public guarantees that were issued during the pandemic (between March 2020 and June 2022) matured by the end of 2023. The loan default rate is calculated using a closed sample of firms in the Central Credit Register (CR) that benefited from at least one COVID-19 guarantee, other than those under Article 56 of Decree Law 18/2020 ('Cure Italy' decree). For the purposes of this analysis, the rate has been annualized using a four-quarter moving average.

contrary, for transactions originated from 2020 onwards, the indicators have not yet shown signs of possible default on the senior tranches, though they point to a slowdown in cash collections.[4]

For securitizations not backed by public sector guarantees, the trend in recoveries as at 30 June 2023 showed deviations from the forecast levels for about one third of the transactions considered (66 out of 196), corresponding to 37 per cent of the total GBV sold (around €82 billion). These developments were broadly in line with those observed as at 30 June 2022. For older securitisations (2017-19), cash collections almost fully covered the net disposal value. Analyses of cash collections have not revealed any widespread distorted recovery practices intended to encourage early closure, to discount the best positions or to delay the emergence of any losses on equity.

[4] This is due to slightly lower-than-expected recoveries, in keeping with the changed cyclical situation and the impact that the increase in interest rates is having on the ability to sell real estate collateral.

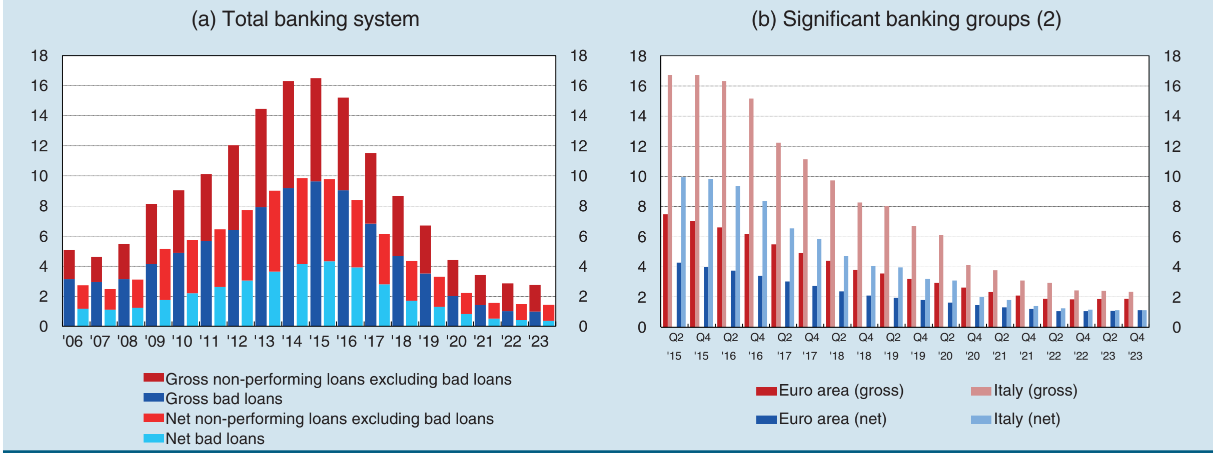
Partly as a result of the reduction in outstanding loans (see Table A2 in the Appendix), the ratio of non-performing loans to total loans (NPL ratio), net of loan loss provisions, held stable at 1.4 per cent (Figure 2.3.a). The gap between Italian significant banking groups and the intermediaries directly supervised by the ECB as a whole has closed (Figure 2.3.b).

The amount of Stage 2 loans under the IFRS 9 accounting standard remained unchanged from last June, below December 2022 levels.[2] However, the ratio of Stage 2 loans to total performing loans edged

Figure 2.3

Non-performing loans: share of total loans (1)

(per cent)



Sources: Consolidated supervisory reports for Italian banking groups and individual supervisory reports for the rest of the system; ECB, 'Supervisory Banking Statistics' for the euro area.
(1) Includes loans to customers, credit intermediaries and central banks. Includes banking groups and subsidiaries of foreign banks; excludes branches of foreign banks. Amounts are calculated net and gross of loan loss provisions. The data for December 2023 are provisional. – (2) The perimeter of significant banks and less significant banks differs between the dates shown in the figure: since June 2019, when the reform of the cooperative banking sector was completed, Cassa Centrale Banca has become a significant banking group for supervisory purposes and 143 cooperative credit banks (BCCs) have joined the ICCREA group, which was already classified as significant before the reform. Mediolanum and FinecoBank have been included among the significant banks since June 2022.

[2] The IFRS 9 impairment model is based on the classification of exposures in stages according to their degree of impairment: no impairment, significant increase in credit risk and impaired exposures.

up to 9.9 per cent in December 2023 (+20 basis points). The gap between significant and less significant banks is essentially nil.

The trends in the other early warning indicators of deterioration in creditworthiness have shown weak signs of worsening credit quality. The arrears rate – which measures the payment arrears of performing borrowers – inched up from last June, for loans to firms as well as loans to households;[3] for both counterparties, it increased more for floating-rate loans. As regards firms, the arrears rate grew more strongly for the construction sector, to 2.4 per cent, from 2.1 per cent in June 2023.

According to our projections, which are in line with the macroeconomic scenario published by the Bank of Italy in early April,[4] the loan default rate for firms is set to edge up to 2.8 per cent on average in 2025, driven by the higher cost of debt. The rate for households is expected to remain low, at 0.9 per cent in 2025. However, the loan default rate is projected to remain well below the level seen in previous times of crisis for both households and firms. Banks' vulnerabilities arising from exposures to the real estate sector as a whole remain limited (see the box 'An analysis of real estate lending standards in Italy').

AN ANALYSIS OF REAL ESTATE LENDING STANDARDS IN ITALY[1]

In 2023, loans to households backed by residential real estate (RRE) accounted for 15.9 per cent of the banking system's total assets (11.8 per cent in 2014), while commercial real estate (CRE) lending to firms accounted for 5.6 per cent.[2] Given the importance of both loan categories, it was considered appropriate to monitor some of the indicators that are particularly important for these types of loan, both at origination and subsequently: a deterioration of these indicators is generally correlated with a higher counterparty default risk and higher losses for banks in the event of insolvency.[3]

The average ratio of the value of new RRE loans to that of the real estate property pledged as collateral when the loan was granted (loan-to-value at origination, LTV-O) has increased in recent years. The share of loans with an LTV-O ratio above 80 per cent has grown more markedly (see panel (a) of Figure A).[4] For CRE loans, instead, the LTV-O indicator has remained stable and the share of loans for which it is above 80 per cent has been declining slightly in recent years (see panel (b) of Figure A). However, a wide dispersion in the debt-to-income at origination (DTI-O) ratio has been observed for CRE loans.

[1] By Alessandra Albanese and Gennaro Catapano.

[2] According to Recommendation ESRB 2019/03, amending Recommendation ESRB 2016/14, RRE loans are those granted to a natural person and secured by a residential real estate property (e.g. a residential property, either existing or under construction, acquired, built or renovated by a natural person), regardless of the purpose of the loan; CRE loans are those extended to a legal entity aimed at acquiring income-producing real estate (or a set of properties defined as income-producing real estate), either existing or under development, or real estate used by the owners of the property for conducting their business, purpose or activity, either existing or under construction, or secured by a commercial real estate property.

[3] For more information on RRE loans and CRE loans, see, respectively, J. Gaudêncio, A. Mazany and C. Schwarz, 'The impact of lending standards on default rates of residential real estate loans', European Central Bank, Occasional Paper Series, 220, 2019, and D. Mokas and R. Nijskens, 'Credit risk in commercial real estate bank loans: the role of idiosyncratic versus macro-economic factors', DNB Working Paper, 653, 2019.

[4] Mortgages with a high LTV are typically granted provided there is additional collateral.

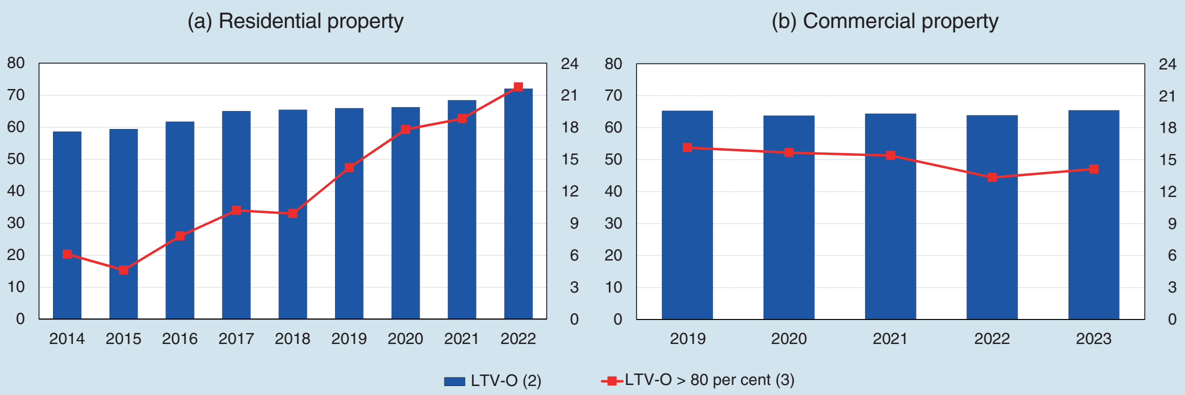
[3] The arrears rate is the ratio of the quarterly flow of new arrears (exposures past due for at least 30 days but not yet non-performing) to performing loans at the end of the previous quarter.

[4] 'Macroeconomic projections for the Italian economy', Banca d'Italia, 5 April 2024.

Figure A

Developments in the LTV-O on real estate loans (1)

(per cent)



Sources: AnaCredit and Regional Bank Lending Survey (RBLS).
(1) The LTV-O indicator is calculated on the basis of the loans granted during the year. Panel (a) considers the full sample of banks taking part in each edition of the RBLS. Panel (b) uses AnaCredit data and the figure for 2023 refers to H1. – (2) Weighted averages. – (3) Right-hand scale.

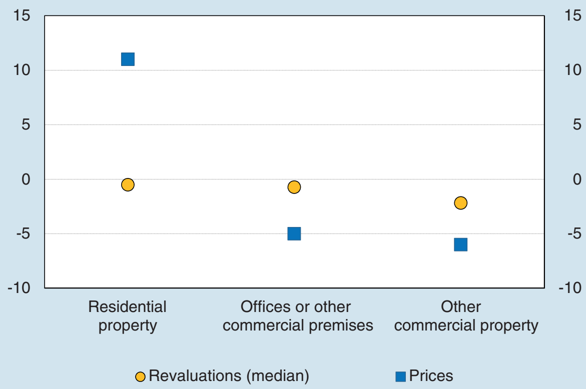
The ratio of the outstanding balance of the loan to the current value of the real estate property pledged as collateral (current loan-to-value, LTV-C) allows for an assessment regarding all outstanding loans as a whole. For CRE loans, borrowers with a high LTV-C (above 80 per cent) are mainly small businesses, firms operating in the construction and real estate sectors (which account for almost 50 per cent of the amounts involved), and those located in northern Italy (this region receives the largest share of CRE credit). The stock of loans with a high LTV-C amounts to 10 per cent of total CRE lending.[5]

The observation of the value adjustments for real estate collateral made by banks on CRE loans[6] has made it possible to assess the quality of the LTV-C data. Our analyses show that Italian banks update annually a substantial proportion of the real estate collateral (between 80 and 90 per cent approximately), but in recent years the reduction in the value of commercial property has been smaller than that recorded by the nominal prices of that type of property (Figure B). This deviation could be influenced by the partial representativeness of the sample of properties pledged as collateral. In the last four years, however, the deviation has been quite small.

Figure B

CRE loans, revaluations and prices by type of collateral over the period 2019-23 (1)

(percentage changes)



Sources: AnaCredit and OMI.
(1) The series for the prices of 'offices or other commercial premises' is calculated as the average for the two segments. For the prices of 'other commercial property', the series refers to the industrial segment. The analysis refers to performing loans only.

5 Such detailed information is currently not available for RRE loans.
6 The analysis uses the AnaCredit database.

Exposure to climate risks remains stable and mostly concentrated in local banks, both small institutions and cooperative credit banks (BCCs). In December, loans to firms in sectors highly exposed to transition risks were just over half of the total loans to firms.[5] With regard to physical risks, also in December, 28 per cent of loans were allocated to companies based in high-risk provinces.[6] Almost all of the loans exposed to both physical and transition risks were owed to intermediaries that hold about 5 per cent of the banking system's total loans. These exposures represent maximum risk values, as not all firms in a given sector or region are necessarily affected by regulatory changes or extreme natural events.

Market risk and interest rate risk

The value at risk (VaR) for the entire securities portfolio (banking and trading books) continued to fall (Figure 2.4), mainly due to lower fluctuations in credit spreads and, to a lesser extent, in interest rates.

Figure 2.4

The VaR trend of Italian banks (1)

(daily data; index: March 2016=100)

Sources: Based on data from the securities registry database, supervisory reports, and LSEG.
(1) Averages, weighted according to the size of each bank's portfolio. VaR is the loss on a portfolio that within 1 day will not exceed a given tail level (99 per cent). The indicator for the banking system as a whole is calculated, for each trading day, using granular data on the stocks and the characteristics of the assets in the portfolio of each Italian bank at the end of each month, taking account of the changes in risk factors over the last 250 business days.

In February, the share of Italian public sector securities out of banks' total assets dropped to 8.8 per cent, from 9.1 per cent in September (Figure 2.5.a). Amid a slight increase in their market value, this decline reflects net sales, particularly by significant banking groups. The duration of public sector securities increased (4.2 years; Figure 2.5.b). The share of securities valued at amortized cost rose to 75.2 per cent, mostly as a result of the increase recorded for significant banking groups (76.5 per cent).

The improvement in the market value of Italian public sector securities contributed to the reduction in unrealized losses in the portfolio valued at amortized cost. The impact of these losses on the CET1 ratio for the entire banking system with reference to the portfolio outstanding at the end of December 2023 was estimated to average 86 basis points in March 2024, taking into account the benefits from hedging derivatives.[7] At the end of September 2023, unrealized losses were almost double (171 basis points of the CET1 ratio).

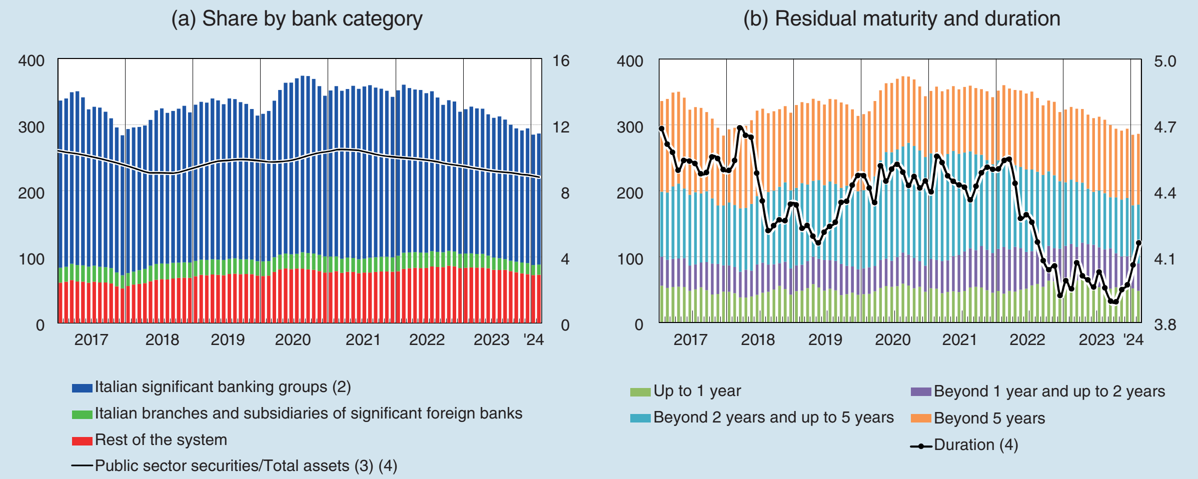
[5] Transition risks are measured by taking into account the fraction of bank loans to sectors that account for a large share of both total emissions and total loans (see I. Faiella and L. Lavecchia, 'The carbon footprint of Italian loans', *Journal of Sustainable Finance & Investment*, 12, 3, 2022, pp. 939-957, also published in Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 557, 2020).

[6] Provinces are defined as high-risk based on the climate risk index, a measure of both climate risk and adaptation capacity developed by the Euro-Mediterranean Center on Climate Change (see G. Meucci and F. Rinaldi, 'Banks' exposure to physical risk from climate events in Italy: an assessment based on AnaCredit data on loans to non-financial corporates', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 706, 2022).

[7] Unrealized losses do not directly affect banks' profitability or capital and materialize only if the intermediary has to sell those securities before maturity, e.g. in order to meet urgent liquidity needs. The CET1 ratio is calculated as the ratio of common equity tier 1 (CET1) to risk-weighted assets (RWAs).

Figure 2.5

Banks' investment in Italian public sector securities (1)
(monthly data; billions of euros; per cent and years)



Source: Supervisory reports.
(1) Comprises all public sector securities, including those issued by local authorities. Excludes Cassa Depositi e Prestiti SpA. – (2) Includes the cooperative credit banks merged into cooperative credit banking groups. – (3) Twelve-month moving average ending in the month indicated. The series 'total assets' does not include bond buybacks. – (4) Right-hand scale.

If risk-free rates were to move in line with expectations as implied by market interest rate curves, the economic value of the total assets and liabilities included in the banking book at the end of last December would fall on average for both significant and less significant banks (-29 and -19 basis points in terms of CET1 ratio, respectively).[8]

Refinancing risk and liquidity risk

In February, bank funding was down by 3.6 per cent year on year, reflecting the strong decline in liabilities vis-à-vis the Eurosystem, which was only partially offset by higher bond issuance.

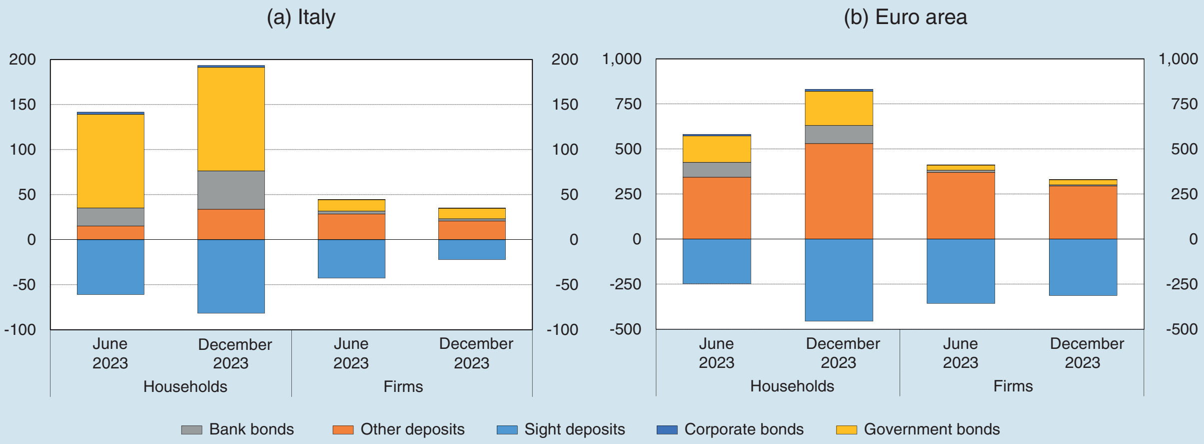
As in the euro area (Figure 2.6), the reallocation of liquidity by Italian households and firms towards higher-yielding assets continued (see Section 1.5). The decline in households' sight deposits in 2023 was stronger than in the 12 months to June 2023 and the increase in other types of deposit and investment in bank bonds was sharper. By contrast, firms' sight deposit outflows moderated.

In the first quarter of this year, net Italian bank bond issues rose to about €8.2 billion, from €3.3 billion in the third quarter of 2023 (Figure 2.7.a). This increase reflects higher net issuance of both senior covered bonds and subordinated debt. After peaking in October last year, bond yields fell rapidly to the levels recorded between late 2022 and early 2023 (Figure 2.7.b). Issuance of eligible liabilities to meet the minimum requirement for own funds and eligible liabilities (MREL), mostly by significant banks, remained strong in the second half of last year.

[8] This scenario suggests, as of December 2023, a reduction of up to 90 basis points in rates for maturities within two years and a slight increase for longer maturities. The estimates are based on the simplified methodology for determining exposure to interest rate risk as defined by the Bank of Italy (see Circular 285/2013, only in Italian).

Figure 2.6

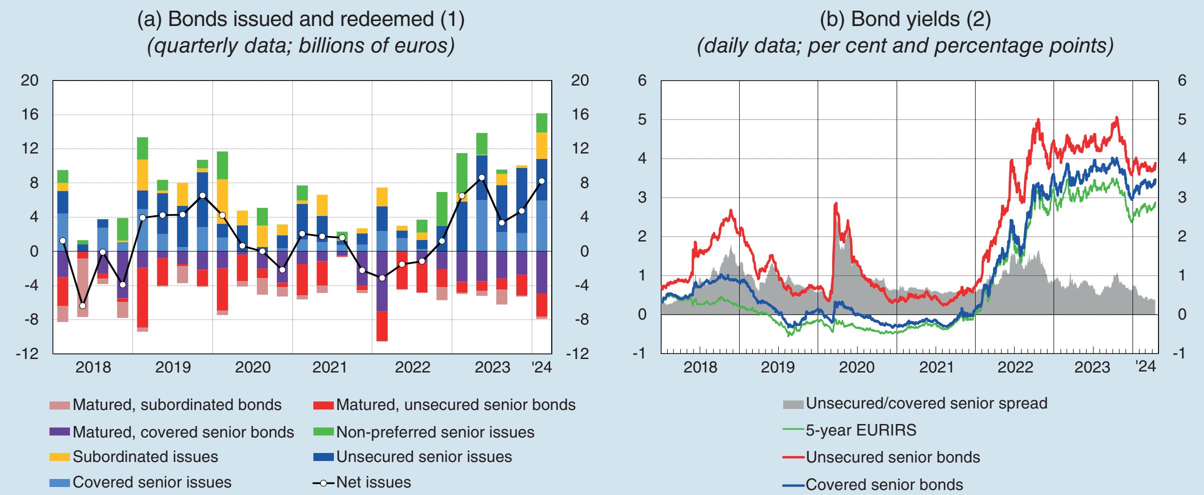
Deposits and bonds held in banks' custody
(billions of euros; cumulative flows in the 12 months ending in June and December 2023)



Sources: Based on Bank of Italy and ECB data.

Figure 2.7

Bank bonds placed on international markets



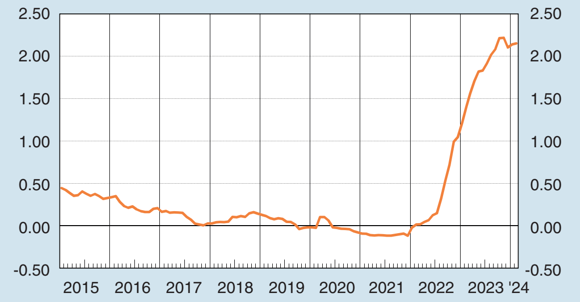
Sources: Bloomberg and Dealogic.
(1) Italian banks' issues on international markets. Does not include issues retained on issuers' balance sheets and those earmarked for the retail market. Includes securitized bonds. – (2) Yields to maturity of Italian bank bonds with residual maturity of 5 years.

In February, the funding gap came to -15.2 per cent (it was -14.4 per cent in September 2023).[9] The markedly negative value of this indicator points to low liquidity risks associated with recourse to retail funding for loan financing. The marginal cost of funding increased slightly compared with September, to 2.2 per cent, mainly as a result of higher interest rates on the interbank market, and is more than twice as high as at the end of 2022 (Figure 2.8).

[9] The funding gap is the difference between the value of loans and retail funding, expressed as a percentage of loans. It excludes transactions carried out by Cassa Depositi e Prestiti SpA and by branches of foreign banks.

Figure 2.8

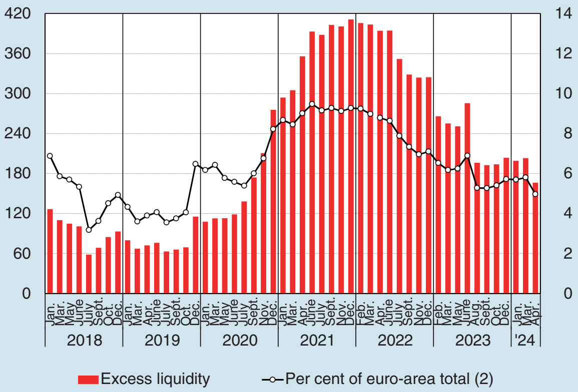
Marginal cost of bank funding (1)
(monthly data; percentage points)



Source: Based on supervisory reports.
(1) The marginal cost of funding is calculated as a weighted average of the costs of banks' various funding sources, using their respective outstanding amounts as weights. This is the cost that a given bank would incur to increase its balance sheet by one unit, drawing on funding sources in proportion to the composition of its liabilities at that time.

Figure 2.9

Excess liquidity of counterparties operating in Italy (1)
(billions of euros and per cent)



Sources: Based on Bank of Italy and ECB data.
(1) The months indicated on the x-axis are those ending each maintenance period. Excess liquidity is calculated as the sum of banks' average reserve balances, net of the reserve requirement, plus the average recourse to the deposit facility. – (2) Right-hand scale.

At the end of March, the outstanding targeted longer-term refinancing operations (TLTRO III) amounted to €55 billion. The €82 billion March repayments (of which €12 billion worth of voluntary repayments) were largely covered by excess liquidity (over minimum reserve requirements) held with the Bank of Italy. Banks' ability to raise new funding both on the repo market and the bond market reduced the need for recourse to the ECB's standard refinancing operations, especially for significant banks. In the maintenance period that ended in April, excess liquidity was €166 billion (Figure 2.9). For leading Italian banks, it was much higher than the outstanding TLTRO III amounts. Some, mostly small, intermediaries will instead have to borrow from the market or have recourse to regular central bank refinancing to repay their maturing operations.

The value of the assets pledged as collateral in Eurosystem operations (collateral pool) fell by a further €77 billion between September and March, to €204 billion (Figure 2.10.a). Loans were the largest asset class in the pool (67 per cent of the total; Figure 2.10.b). The measures taken in response to the pandemic emergency, which eased the eligibility criteria for assets posted as collateral, have continued to contribute to the availability of collateral, by €30 billion (15 per cent of the pool). These measures, alongside national additional credit claim (ACC) frameworks, will be reviewed in 2024,[10] considering that the new monetary policy operational framework will maintain a wide range of assets eligible as collateral for refinancing operations. Despite the decline in the collateral pool, overcollateralization remains substantial (€137 billion, or 67 per cent of the pool), as a result of TLTRO III repayments. In addition, Italian banks have €386 billion in eligible securities available outside the collateral pool, of which 62 per cent are government bonds (Figure 2.10.c).

Bank's liquidity profile remains balanced for both short- and medium-term maturities: in December, the one-month liquidity coverage ratio (LCR) averaged 189 per cent and the net stable funding ratio

[10] ECB, 'Decisions taken by the Governing Council of the ECB (in addition to decisions setting interest rates)', press release, 15 December 2023.

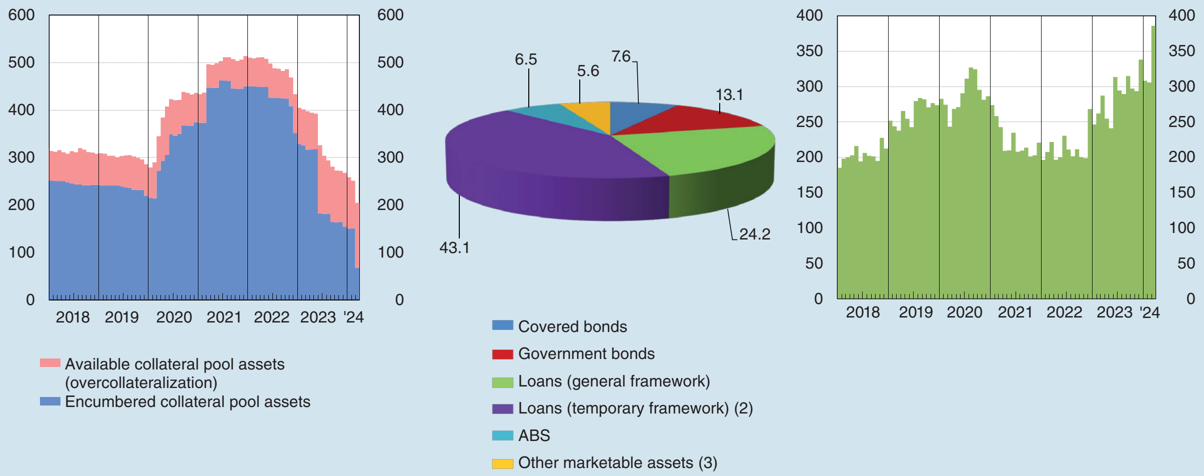
Figure 2.10

Eligible assets of the Italian banking system

(a) Eligible assets in the collateral pool (1)
(monthly data; billions of euros)

(b) Composition of the collateral pool as at March 2024
(per cent)

(c) Eligible securities outside the collateral pool (4)
(monthly data; billions of euros)



Sources: Based on Eurosystem data and supervisory reports.
(1) End-of-period data for the monetary policy counterparties of the Bank of Italy. The volume of encumbered Eurosystem collateral pool assets includes the part covering accrued interest and refinancing in dollars. The collateral pool is valued at the prices taken from the Common Eurosystem Pricing Hub, net of haircuts. – (2) Under the temporary framework, the eligibility criteria for assets that can be used as collateral are set by the individual national central banks pursuant to the rules provided by the ECB Governing Council (under the general framework, the criteria are set according to common rules that are applicable to the entire Eurosystem). – (3) Includes bank bonds, including those backed by the state guarantee scheme, and securities issued by non-financial corporations and supranational organizations. – (4) End-of-period data for the entire banking system, not including Cassa Depositi e Prestiti SpA and Poste Italiane SpA. Amounts at market values as reported by banks, net of the haircuts applied by the Eurosystem.

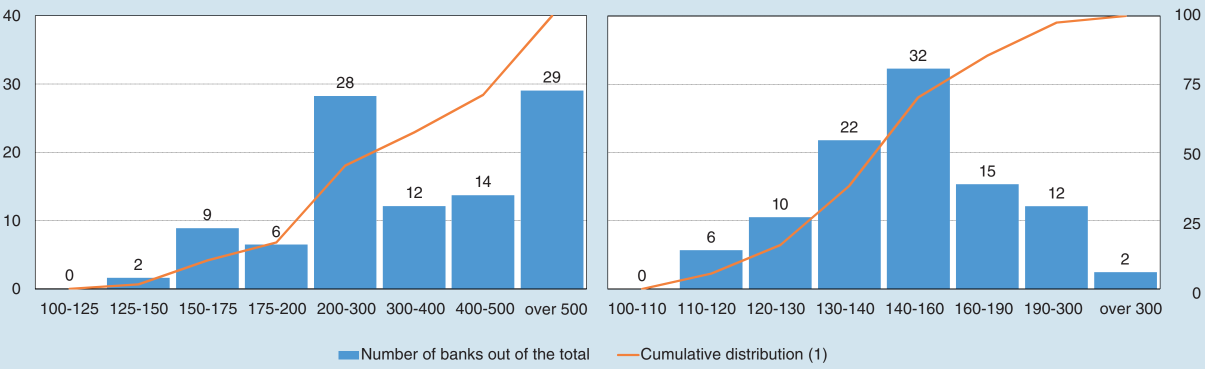
(NSFR) stood at 133 per cent (Figure 2.11; in June 2023, these two metrics sat at 175 and 134 per cent respectively).

Figure 2.11

Distribution of Italian banks by LCR and NSFR as at December 2023
(per cent)

(a) LCR

(b) NSFR



Source: Based on supervisory reports.
(1) Right-hand scale.

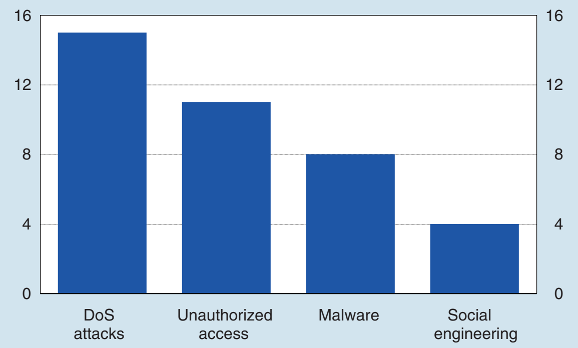
As part of its supervisory activities, the Bank of Italy assessed the feasibility of the 2023 funding plans of a large sample of Italian banks in the second half of last year.[11] In the first three quarters of 2023, banks relied more than expected on net bond funding and less than expected on Eurosystem funding (22.6 and -55.5 per cent, respectively). While the use of repos increased substantially (142 per cent), retail deposits declined slightly (-3.7 per cent), showing a less favourable trend than expected. Preliminary indications from the new 2024-25 plans point to a decrease in total liabilities, with maturing TLTRO III funding to be only partially replaced. On the assets side, banks expect a parallel reduction in assets other than customer loans, particularly in securities and reserves held with the central bank. Customer deposits, especially sight deposits, are set to shrink further in 2024, before picking up again in 2025; by contrast, market funding is forecast to continue to grow, thanks to the expected large issuance of covered bank bonds and recourse to repos.

Cyber risk

The Bank of Italy remains highly vigilant of cyber risks and banks' response plans (see the box 'Combating cyber risks to supervised intermediaries: data for Italy', in *Financial Stability Report*, 2, 2021). Based on the Bank's monitoring of operational or security incidents in the Italian market, financial intermediaries reported 30 significant cyber incidents in 2023,[12] a considerably higher number than in the previous years (12 and 13 in 2021 and 2022, respectively).[13] Denial-of-service (DoS) attacks, sometimes attributable to entities connected with the conflict in Ukraine, were the most frequent last year (15 reports, Figure 2.12).[14] However, the impact of these attacks was limited, with service downtime never exceeding five hours. There were also cyber incidents arising from malware and social engineering scams,[15] as well as unauthorized access to intermediaries' IT systems.

Figure 2.12

Cyber incidents by type (1)
(numbers)



Source: Based on supervisory reports.
(1) An incident can be classified into more than one type. Data for 2023.

In 2024, the ECB launched a cyber-resilience stress test for the banks under its direct supervision, including Italian banks. The purpose of the test is to assess the response and recovery measures to be taken by intermediaries in the event of a cyber attack affecting the day-to-day operations of their systems and services.

[11] The assessment covered the funding plans of the 12 significant Italian banks and of 73 less significant banks, accounting for 99 per cent of the system's total assets. Overall, banks had expected a material increase in net bond funding, a sharp reduction in liabilities vis-à-vis the Eurosystem, a decline in net funding through repurchase agreements and a slight increase in retail deposits.

[12] Banking groups, stand-alone banks, payment institutions and e-money institutions are subject to reporting.

[13] Monitoring activities are based on the reporting of significant operational or security incidents as required by the Bank of Italy. For more information, see the Bank of Italy's website: 'Reporting significant operational or security incidents'.

[14] In cyber security, denial of service (DoS) means an attack that exhausts the resources of an IT system providing customer services, resulting in customers losing access to those services.

[15] Social engineering is a cyber-attack technique that aims to mislead people into disclosing information or performing certain actions.

Capital and profitability

In the second half of 2023, the capital position of Italian banks remained broadly unchanged. The CET1 ratio for the entire system averaged 15.6 per cent in December. It was slightly down to 15.9 per cent for significant banks, while it was up by 50 basis points for less significant banks, to 17.3 per cent.[16] The former saw a small increase in risk-weighted assets (RWAs), with common equity tier 1 remaining essentially unchanged, as the positive contribution from profitability for the period was offset by the impact of new share buy-backs and growth in intangible assets, which are deducted from regulatory capital. Less significant banks benefited from both higher retained earnings and the decline in RWAs. At the end of 2023, the average level of capitalization of Italian significant banks was slightly higher than that of significant banks in countries participating in the Single Supervisory Mechanism (SSM).

In the second half of 2023, the leverage ratio for the banking system as a whole improved slightly, to 6.1 per cent, as a result of both the limited reduction in assets and the small increase in capital. In December, the leverage ratio of Italian significant banking groups stood at 6.1 per cent, still above the European average; for less significant banks, it was 6.9 per cent.[17]

The ratio of MREL liabilities to RWAs for significant and less significant banks subject to resolution rose to 33.8 per cent, well above regulatory requirements (25.4 per cent on average). All intermediaries are in line with current requirements. Holdings of subordinated instruments for intermediaries subject to the subordination requirement[18] remained stable, at 22.6 per cent of RWAs on average, which is higher than the minimum requirement (18.2 per cent).

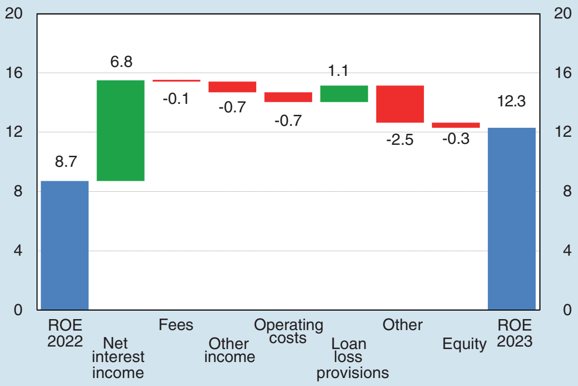
The profitability of Italian banks improved considerably in 2023. Net of non-recurring items, ROE rose from 8.7 to 12.3 per cent (Figure 2.13).

The increase in profitability was almost entirely due to the sharp rise in net interest income (36.4 per cent), which in turn resulted mainly from higher interest income on loans to firms and households. On the liabilities side, interest paid on deposits with an agreed maturity went up; by contrast, the cost of sight deposits remained low, with a lower pass-through than during the previous period of interest rate hikes (2005-08).[19]

Higher net interest income boosted gross income (up by 16.5 per cent), despite slightly lower fees and trading revenues.

Figure 2.13

Breakdown of the change in ROE between 2022 and 2023 (1)
(per cent and percentage points)



Sources: Consolidated supervisory reports for banking groups and individual supervisory reports for stand-alone banks.
(1) Changes are expressed as a ratio to own funds and reserves. A green/red bar indicates a positive/negative contribution to ROE in 2022, giving the final ROE value for 2023.

16 The total banking system also includes Italian subsidiaries of European significant groups, which are not classified as significant or less significant institutions, and for which the indicator is below average.
17 As with the CET1 ratio, Italian subsidiaries of European significant groups have a below-average leverage ratio.
18 These include large banks (with total assets exceeding €100 billion) and banks for which significant systemic risks are identified in case of failure.
19 The pass-through is the ratio of the change in the average rate on customer deposits to the change in key interest rates.

The decrease in loan loss provisions (-30.1 per cent) also contributed to the improvement in ROE. The low level of the cost of risk,[20] broadly in line with the figure for the other European significant intermediaries, also reflects the 2023 reversal of impairment on exposures previously classified as riskier under IFRS 9 (Stage 2 and Stage 3).[21] Operating costs rose slightly (2.9 per cent), mainly as a result of the higher staff expenses associated with the renewal of the national collective bargaining agreement for the banking sector.[22]

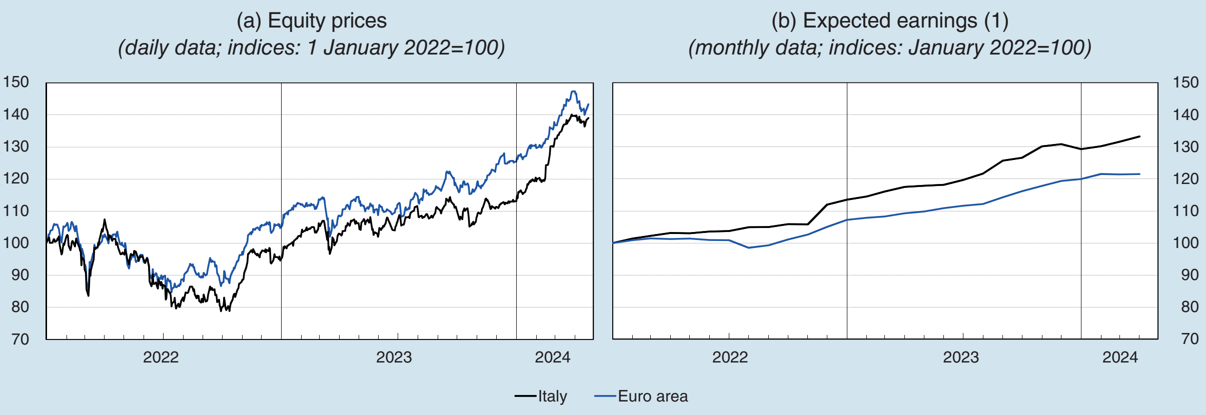
Based on estimates consistent with the macroeconomic scenario recently published by the Bank of Italy,[23] the profitability of Italian banks is set to remain high in the current year, just below 2023 levels, but above 2022 levels. It is expected to decline in the next two years, albeit remaining largely positive and above the average for the last decade. Net interest income is forecast to fall this year and to slow down more sharply in 2025-26. Loan loss provisions are estimated to grow significantly over the three years, in line with the expected increase in the loan default rate, to about twice the level of 2023. This would be close to pre-pandemic levels and well below the peak reached following the sovereign debt crisis.

2.2 INSURANCE COMPANIES

Market indicators for the Italian insurance sector show that equity prices and expected earnings of Italian insurance companies in March 2024 were higher than last November, in line with the euro-area markets (Figure 2.14).

Figure 2.14

Italian and euro-area insurance companies



Source: Based on LSEG data.
(1) Average of expected earnings per share in the 12 months following the reference date for a sample of the leading Italian and euro-area insurance companies, weighted by the number of outstanding shares. For Italy, the data refer to Assicurazioni Generali, Mediolanum Assicurazioni, Poste Italiane and UnipolSai. For the euro area, the data refer to the leading companies included in the Datastream euro-area insurance sector index.

20 The cost of risk is the ratio of the annual flow of loan loss provisions to the average stock of loans.

21 The decline in Stage 2 exposures in 2023 was mainly due to the return to Stage 1 of those that benefited from COVID-19 moratoria, whose credit rating had improved at the end of the monitoring period.

22 After rising in 2023, operating costs are likely to remain broadly stable in the coming years, as the further increases provided for under the national collective bargaining agreement should be largely offset by savings linked to the reduction in workforce following the implementation of early retirement schemes.

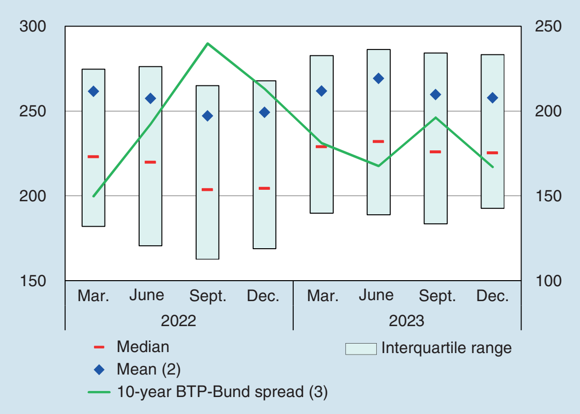
23 'Macroeconomic projections for the Italian economy', Banca d'Italia, 5 April 2024.

Capitalization fell compared with June 2023, owing to the increase in the cost of non-life claims, but continues to be high: the average solvency ratio in December was 258 per cent (Figure 2.15).

The composition of the investments for which insurers bear the risk held stable: public bonds (more than two thirds of which were Italian government bonds) accounted for 46 per cent of the total; private bonds, mostly issued by foreign companies and non-financial corporations (Figure 2.16.a), accounted for 20 per cent. Shares in investment funds and equities also remained unchanged, at 15 and 14 per cent respectively (Figure 2.16.b). Corporate bonds showed an improvement in credit risk: the share of A-rated securities increased to 32 per cent (from 28 per cent at the end of 2022), while that of BBB-rated securities remained stable (Figure 2.16.c).

Figure 2.15

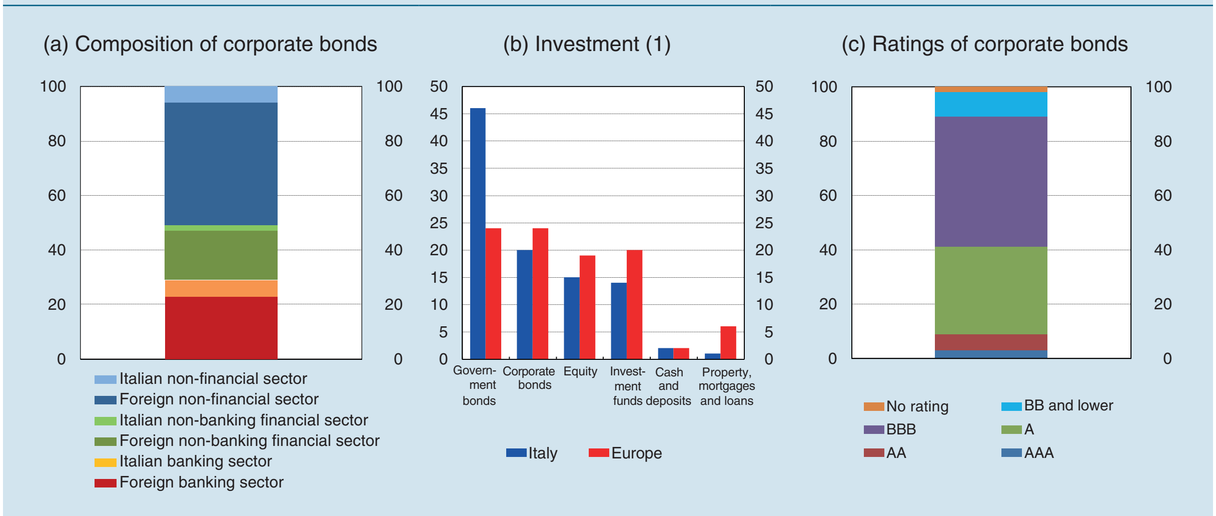
Solvency ratio and BTP-Bund spread (1)
(per cent and basis points)



Sources: IVASS and calculations based on LSEG data.
(1) The solvency ratio is calculated as the ratio of eligible own funds held for coverage to the solvency capital requirement established under Solvency II. The data are taken from the quarterly Solvency II supervisory reports based on the quantitative reporting templates. – (2) Weighted average with weights equal to the solvency capital requirement. – (3) The BTP-Bund spread refers to the end of each period. Right-hand scale.

Figure 2.16

Insurance company investments
(data as at 31 December 2023; per cent)



Sources: IVASS and EIOPA.
(1) The data for Europe, as at 30 September 2023, refer to the European Economic Area.

Insurance companies' exposure to the real estate sector is moderate (4 per cent of total investment at the end of 2023). It is mainly attributable to non-residential property and more than half of it is made up of real estate fund shares. Real estate-backed loans to firms issued by insurance companies account for a minimal share of the investments.

The decline in bond yields observed since late 2023 has reduced net unrealized losses on investments, which stood at €13 billion in March (€29 billion at the end of June last year; Figure 2.17).

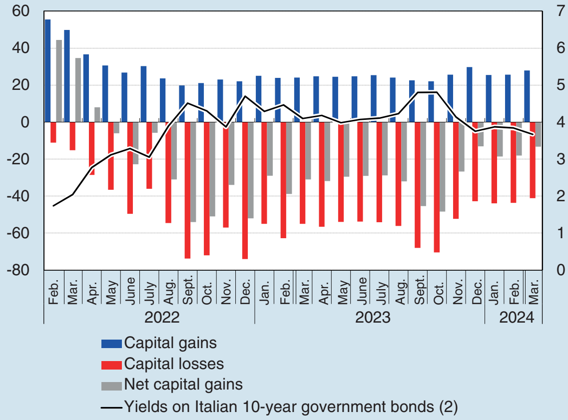
Over one third of Italian insurers, which account for around 60 per cent of the sector's assets, decided to temporarily suspend the effects of unrealized investment losses on the profitability for the financial year in their financial statements for 2023, as permitted by law in turbulent market situations.[24]

The implementation of this law, together with the improved return on investment, had a positive impact on the ROE of Italian insurance companies, which reached 11 per cent at the end of 2023: 14 per cent in the life sector and 6 per cent in the non-life sector (Figure 2.18.a).[25] In the former, profitability benefited from the reduction in net losses despite the fall in premiums (-4 per cent; Figure 2.18.c); in the latter, the higher premium income (7 per cent more than in 2022) offset the increase in claim costs, especially those relating to climate events.[26] The combined ratio worsened, reaching 98 per cent, from 94 per cent in June 2022 (Figure 2.18.b).

Figure 2.17

Unrealized capital gains and losses (1)

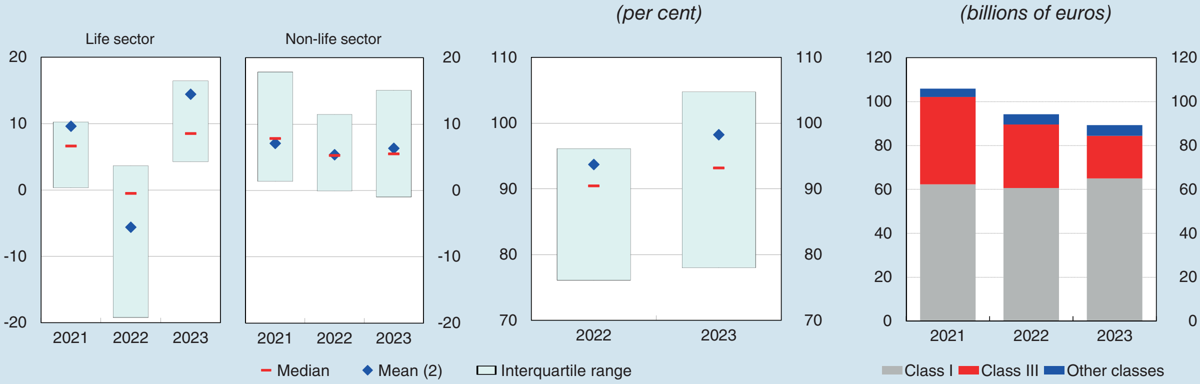
(billions of euros and per cent)



Sources: IVASS and calculations based on LSEG data.
(1) Unrealized capital gains and losses are the difference between the market value and the book value of portfolio securities. – (2) Right-hand scale. End-of-period data.

Figure 2.18

Main balance sheet indicators for Italian insurance companies and life premium income



Source: IVASS.
(1) Ratio of earnings to shareholders' equity. – (2) Weighted average with weights equal to the denominator of each ratio. – (3) Ratio of claims plus operating expenses to premium income. – (4) 'Class I' mainly includes with-profit policies (traditional life insurance policies with guaranteed returns); 'Class III' is mainly composed of unit- and index-linked policies (life insurance policies where policyholders bear the risk); 'Other classes' includes all the other kinds of life insurance policies.

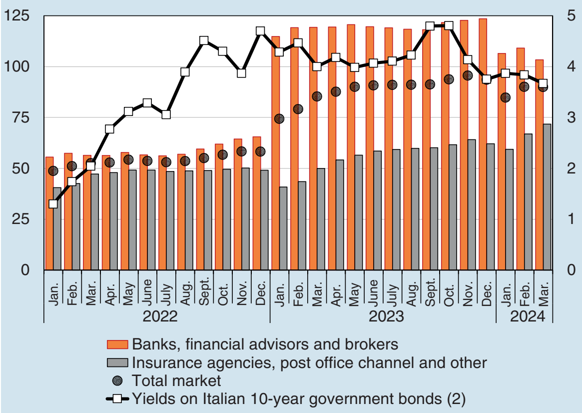
[24] This exception, which was extended to 2023, allows insurance companies that do not adopt the international accounting standards to recognize available-for-sale securities based on the book value as reported in their most recent annual financial statements, except in the case of impairment losses, using the unrecognized amount to build up a 'non-distributable reserve'. Italian Insurance Supervisory Authority (IVASS) Regulatory order 143/2024 introduced specific reporting requirements for the insurance companies availing of this option.

[25] Based on preliminary data for 2023.

[26] This indicator was affected by the sharp increase in claims in 'other motor insurance' and 'fire and other damage to property', which account for almost all of the natural hazard insurance coverage.

Figure 2.19

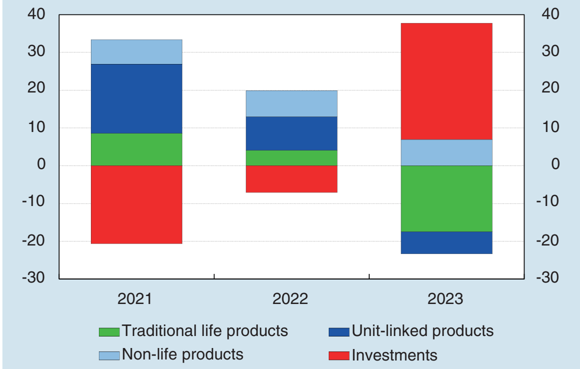
Surrenders to premium income ratio by distribution channel (1)
(per cent)



Sources: IVASS and calculations based on LSEG data.
(1) This indicator is calculated by dividing surrenders by premium income. – (2) Right-hand scale. End-of-period data.

Figure 2.20

Net cash flow of Italian insurance companies
(annual data; billions of euros)



Source: IVASS.

The ratio of surrenders to premium income in the life sector was still high at the end of March (at 90 per cent, up from 85 per cent in 2023), especially among companies that distribute products through banks and financial advisors (103 per cent, from 119 per cent in March 2023; Figure 2.19).

The cash flow composition of insurance companies has changed considerably over the last two years: lower premium income and higher surrender outflows have led to a gradual contraction in the net technical cash flow for the life sector, which has become negative since the first quarter of 2023 (Figure 2.20). This has resulted in liquidity needs that are met by companies mostly by reducing their reinvestment of maturing securities.

The liquid asset ratio of Italian insurers was broadly stable at the end of 2023 compared with June (with a median value of 63 per cent).[27]

The stress test recently launched by the European Insurance and Occupational Pensions Authority (EIOPA), which involves the main European insurance groups, will further assess the main solvency and liquidity risks in the insurance market. The stress test seeks to verify the resilience of the insurance sector against an adverse scenario that includes financial and insurance shocks, applied to end-2023 data. The findings will be published in aggregate form by EIOPA in December 2024.

2.3 THE ASSET MANAGEMENT INDUSTRY

In the fourth quarter of 2023 and the first quarter of 2024, the total assets of open-end investment funds managed by Italian groups increased by 11 per cent, to €606 billion, thanks to the increase in the value of assets held.[28] In the same period, net subscriptions were negative (by €4.4 billion; Figure 2.21.a),

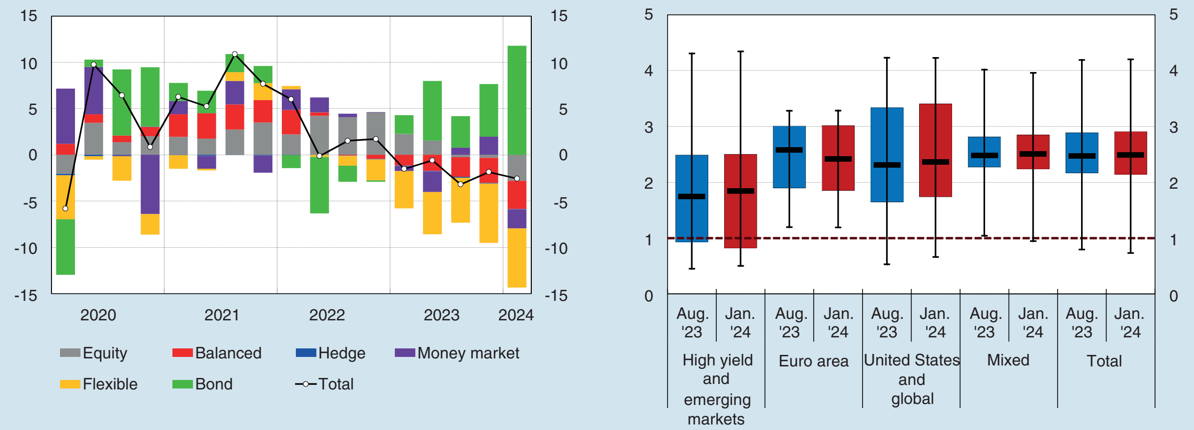
[27] The indicator is calculated as the ratio of liquid assets to total assets (for more details, see the box 'Launch of liquidity risk monitoring in the insurance sector', *Financial Stability Report*, 2, 2020).
[28] This sector still accounts for around 50 per cent of the total assets of funds distributed in Italy, which also include funds managed by foreign groups.

Figure 2.21

Open-end investment funds

(a) Net subscriptions to funds managed by Italian groups (1)
(quarterly data; billions of euros)

(b) Indicator of vulnerability to liquidity risk stemming from redemptions of Italian fund shares by segment (2)
(August 2023-January 2024; percentage share of assets)



Sources: Assogestioni, supervisory reports and ECB (Centralised Securities Database).
(1) The data refer to Italian and foreign funds run by asset management companies belonging to Italian groups. Provisional data for Q1 2024. – (2) Open-end investment funds in the bond, flexible and mixed segments are included. The liquidity risk indicator is equal to the ratio of the fund's assets weighted by the degree of liquidity of each exposure to net redemptions under a stress scenario. The stress scenarios are equal to the average of the values above the 99^{th} percentile of the distribution of net monthly redemptions in relation to total assets for each of the segments analysed between January 2008 and November 2020 (high-yield and emerging market: 14 per cent; euro area: 30 per cent; United States and global: 24 per cent; mixed: 24 per cent).

still reflecting the reallocation towards investment in debt securities that began following the increase in yields (see Section 1.5). Outflows were concentrated in the balanced and flexible fund segments; net subscriptions for funds that invest in accordance with environmental, social and governance (ESG) criteria were also negative. Conversely, bond funds, especially those investing in European government bonds, recorded net inflows.

In the second half of the year, the average duration of the portfolio of Italian non-equity funds remained unchanged at around 5 years, showing interest rate risk exposure below the euro-area average (6.4 years). Non-equity funds continued to reduce their cash holdings (from 11 to 8 per cent of their assets) and to increase their investment in government bonds.[29]

Among Italian investment funds,[30] the liquidity risk stemming from particularly high redemption requests was practically stable between August 2023 and January 2024 for all non-equity segments (Figure 2.21.b).[31] Vulnerable fund assets remained at historically low levels (1.7 per cent of the total).[32] The risks associated with derivative exposure also remained limited on average (see the box 'Italian investment funds' exposure to synthetic leverage'), as did borrowing from banks and other financial intermediaries.[33]

29 Cash holdings include current account holdings – net of transactions to be settled – and cash equivalent assets, such as bonds with a maturity of less than one year.

30 The total assets of Italian investment funds supervised by the Bank of Italy account for around 40 per cent of those of asset management companies belonging to Italian groups. The remainder is attributable to foreign investment funds.

31 The liquidity indicator is equal to the ratio of the fund's assets weighted by the degree of liquidity of its components to net redemptions under the stress scenario (see note (2) to Figure 2.21.b).

32 Vulnerable funds are those for which the liquidity indicator is less than 1.

33 Italian law provides that open-end investment funds can only take out loans on a temporary basis, according to the need to invest in or disinvest from fund assets, and within the maximum limit of 10 per cent of the overall net value of the fund.

ITALIAN INVESTMENT FUNDS' EXPOSURE TO SYNTHETIC LEVERAGE[1]

The use of financial derivatives and the resulting synthetic leverage – calculated as the ratio of gross notional exposure (GNE) to net asset value (NAV)[2] – may expose investment funds to liquidity tensions associated with an inability to cope with increased margin calls for counterparty credit risk. During periods of turmoil, the liquidity conditions of the funds may deteriorate also owing to the presence of additional risk factors (e.g. increased redemptions), which compound the use of liquidity connected to derivative exposures. This issue is being considered by the major international bodies such as the Financial Stability Board (FSB), which in April published a proposal for recommendations to make non-bank financial intermediaries better prepared to meet margin calls and collateral requirements.[3]

Using the information in the database available pursuant to Regulation (EU) No 2012/648 (European Market Infrastructure Regulation, EMIR) covering transactions in derivatives, supplemented by the Bank of Italy's supervisory reports, an assessment was made of the synthetic leverage and of the impact on the liquidity profile of Italian investment funds of both the margins linked to the use of derivatives and of redemptions. The analysis considered a sample of 1,568 Italian investment funds[4] over the period from January 2021 to December 2023. The assessment covered the gross notional exposure in derivatives (obtained as the algebraic sum of buying and selling positions), the impact of the margins paid on cash holdings and the effect of redemptions on the liquidity profile.

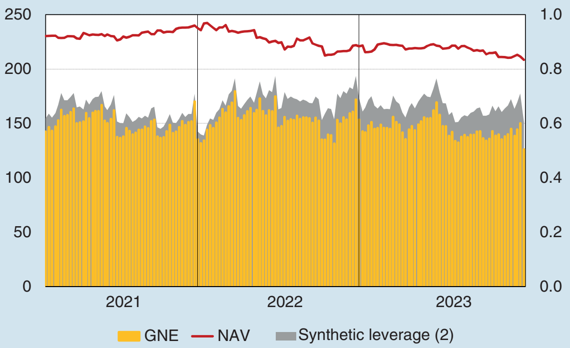
The results show that the gross notional exposure in derivatives of Italian investment funds is broadly stable over time and below the NAV, which translates into an average synthetic leverage below 1 (Figure A).

Open-end funds rely on synthetic leverage to a greater extent than closed-end funds; typically, the latter only use derivative instruments to hedge the interest rate risk of outstanding funding. As a result, the variability and size of derivative exposures are much smaller in closed-end funds.

The margins paid for the use of derivatives are low overall compared with the available liquidity (see panel (a) of Figure B), but tend to increase in the event of market shocks and increased volatility in the prices of the underlying assets.[5] On average, the liquidity absorption stemming

Figure A

Italian investment funds' exposure to synthetic leverage (1)
(billions of euros and index number)



Sources: Based on EMIR data and supervisory reports.
(1) Weekly data for the GNE in derivatives, the NAV and the synthetic leverage index, calculated as the ratio of GNE to NAV, for Italian investment funds. – (2) Right-hand scale.

1 By Dario Ruzzi and Riccardo Scimone.

2 Synthetic leverage is calculated by considering the entire derivatives portfolio, irrespective of the underlying financial instrument and without distinguishing between buying and selling positions. The ratio of GNE to NAV is one of the possible statistical measures of synthetic leverage (see IOSCO, *Investment funds statistics report*, January 2024).

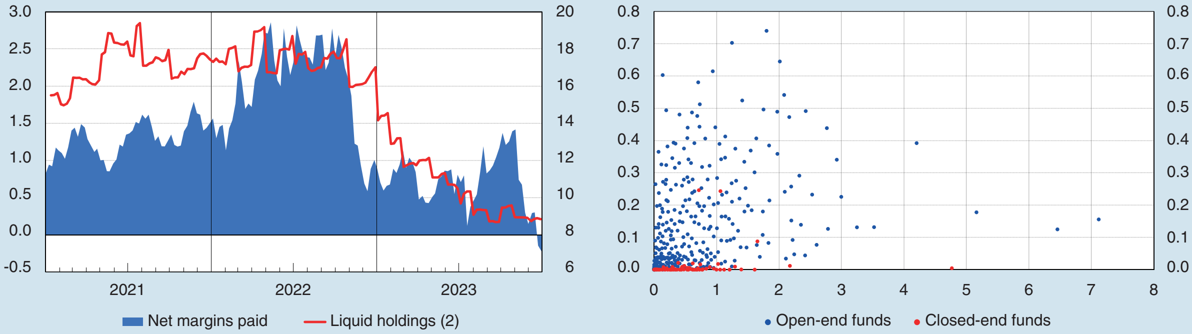
3 FSB, *Liquidity preparedness for margin and collateral calls: consultation report*, April 2024.

4 Both open-end and closed-end funds (the latter include real estate funds) with a derivative exposure and an available legal entity identifier were considered. Out of the selected sample, closed-end funds made up about 20 per cent in terms of total number of funds and 15 per cent in terms of NAV at 31 December 2023.

5 For example, between December 2021 and August 2022, net margins paid increased from €1.6 billion to €3 billion, even though the notional values remained practically unchanged.

Figure B

Margins hedging positions in derivatives



Sources: Based on EMIR data and supervisory reports.
(1) Aggregate value of margins paid net of those received for exposures in derivatives and aggregate liquid holdings from January 2021 to December 2023. Weekly data. – (2) Right-hand scale. – (3) Notional exposures as a ratio to NAV (x-axis) and net margin calls as a ratio to liquidity (y-axis). Average values for the period 2021-23. For confidentiality reasons, each point corresponds to the non-weighted average figure for a cluster of at least 3 funds. In general, the tails of the distribution of the indicators are occupied by small and medium-sized funds.

from margin calls – calculated as the difference between the stocks of margins paid, net of those received, on two consecutive dates – represents a small share of the current account balances of funds with custodian banks (around 20 per cent at the last reporting date);[6] however, the distribution of this absorption is heterogeneous and some funds may be more exposed to shocks than others (see panel (b) of Figure B). Finally, the size of the redemptions does not have a significant impact on the liquidity profile of the funds.

Taking into account the materiality of the risks arising from the use of synthetic leverage, asset management companies are required to adopt appropriate governance and control systems to strengthen their capacity to respond to requests for liquidity during episodes of market stress. In this regard, the Bank of Italy regularly monitors the liquidity risks of the funds in order to guide supervisory action from both a micro- and macro-prudential perspective.

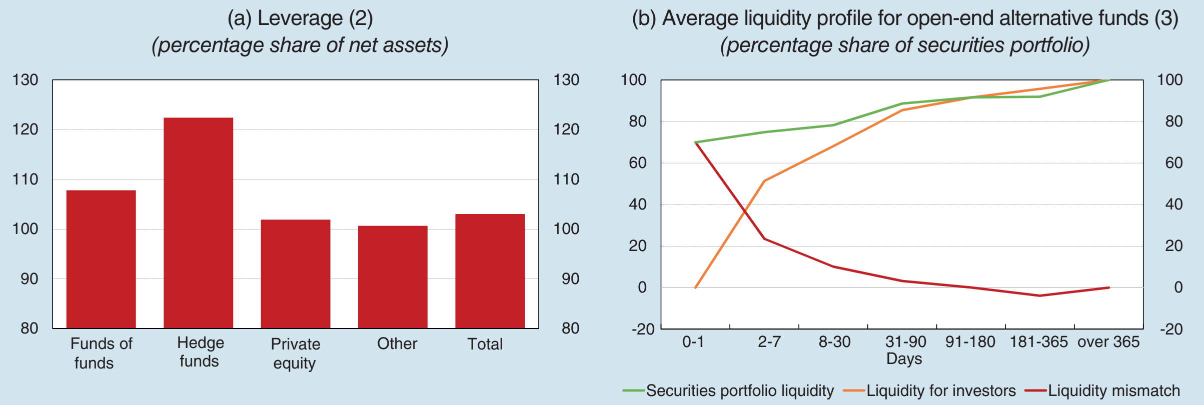
[6] Current account balances are a conservative estimate of the ability of funds to meet margin calls, as liquid securities in portfolios can also be used for this purpose (through direct use or sale and conversion into cash) and loans can be taken out within the regulatory limits.

In 2023, the total assets of Italian alternative investment funds (AIFs) rose from €46 billion to €50 billion, mainly reflecting the increase in private equity funds and private debt funds, which grew to €21 billion and €11 billion respectively. About 80 per cent of the sector's net assets were subscribed by Italian operators, mostly banks and other institutional investors. Banks' exposures are mainly concentrated in private debt funds. While the share of new loans is significant abroad, in Italy these funds mainly purchase loans originated by third parties (around 80 per cent of which are non-performing loans, mostly in the unlikely-to-pay category).

The risks to financial stability stemming from the activity of Italian AIFs continue to be low. Leverage remained broadly stable at 103 per cent (Figure 2.22.a) and below the euro-area average (122 per cent). Indirect leverage of private equity funds, attributable to the borrowing of subsidiaries, stood unchanged at 62 per cent of the sector's net assets. Short-term liquidity risks were mitigated by Italian legislation, which

Figure 2.22

Indicators for Italian alternative investment funds as at December 2023 (1)



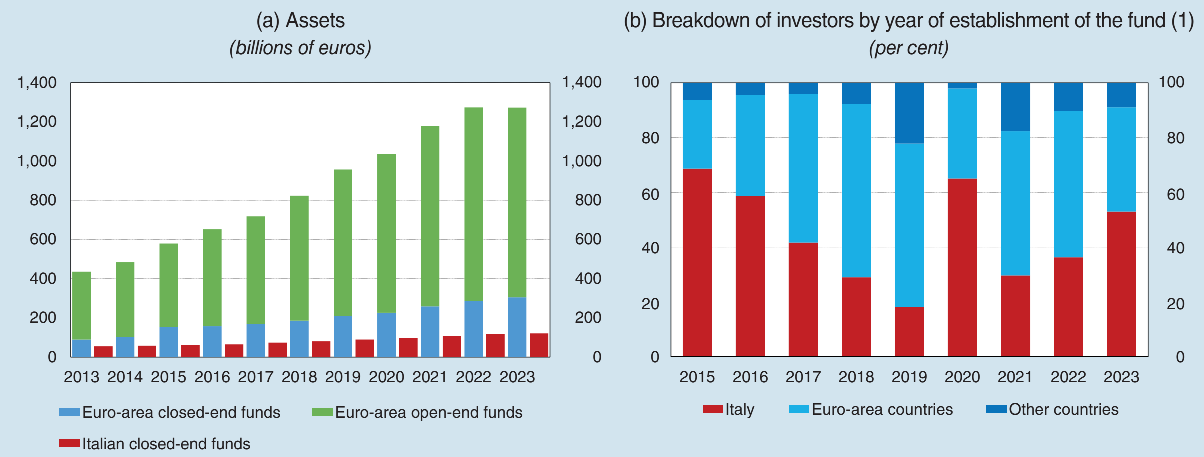
Sources: Supervisory reports and data submitted pursuant to the Alternative Investment Fund Managers Directive (AIFMD).
(1) The figure is based on supervisory reports and data submitted pursuant to Directive 2011/61/EU (AIFMD), which requires AIF managers to regularly provide the competent authorities with information on their main assets and exposures. – (2) Overall exposure calculated using the method based on the ratio of commitments to net assets of alternative funds managed by Italian asset management companies. 'Other' includes funds that provide direct financing or buy credit from other financial intermediaries and those not included in the other categories, according to the criteria adopted by the European Securities and Markets Authority (ESMA). – (3) For each period, the liquidity mismatch is the difference between the liquidity of the securities portfolio, equal to the average share of the securities portfolio that the open-end alternative funds can liquidate by that date, and the liquidity profile for investors, equal to the average share of assets that investors in these funds can redeem in the same period. The estimate does not take account of cash holdings.

provides that funds investing more than 20 per cent of their portfolio in illiquid assets be set up as closed-end funds. Liquidity risks remain limited also for open-end AIFs (Figure 2.22.b).[34]

Growth in the real estate fund segment fell to 3 per cent last year, from 9 per cent in 2022. Total assets reached €121 billion (Figure 2.23.a), with positive net inflows for around €4 billion. The investors in the

Figure 2.23

Real estate funds



Source: Supervisory reports.
(1) Share of net assets of Italian funds subscribed by the different categories of investor.

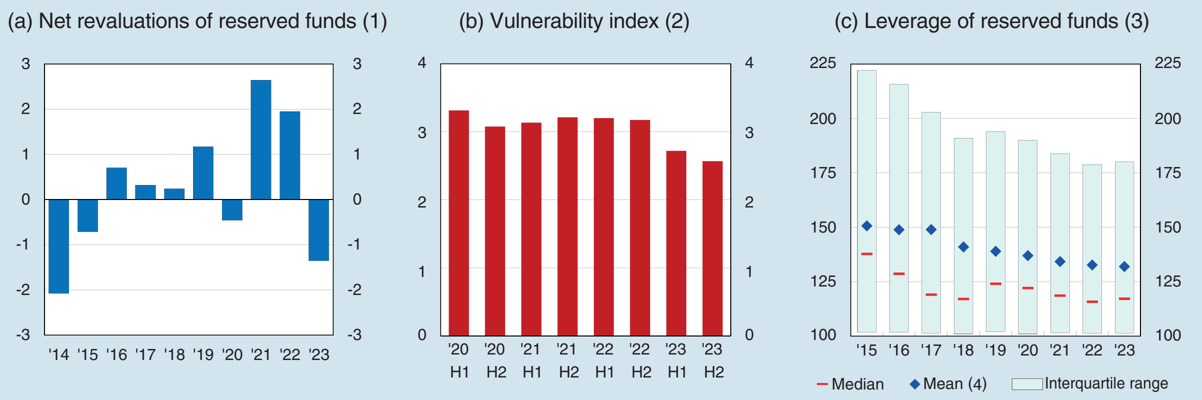
[34] In the event of persistent outflows over a time horizon of between six months and one year, there might be a mismatch between asset liquidity and redemptions for investors, equal to about 4 per cent of the securities portfolio, up slightly from 2.2 per cent in June 2023.

funds set up in 2023 were mainly Italian operators (Figure 2.23.b). More than half of the new investments in the sector were concentrated in the province of Milan and mainly in the commercial real estate sector, where purchases by funds accounted for more than a third of the total value of trades.

Overall, real estate funds made net write-downs equal to 1.4 per cent of their portfolio (Figure 2.24.a), especially for office and commercial property exposures, owing to weak growth in real estate market prices (see Section 1.4).

Figure 2.24

Main indicators for Italian real estate funds
(per cent)



Sources: Supervisory reports and calculations based on data from Istat and OMI.
(1) Ratio of reserved fund balance sheet revaluations net of write-downs to the average of total assets at the end of the reference year and at the end of the previous year. – (2) Share of the sector's total assets held by real estate funds for which the estimated difference between the book value and the market value of properties is greater than net assets. For each fund, the difference is calculated between the fund's cumulative net write-downs as a ratio to its assets and the cumulative variations of a theoretical price index for the properties in the portfolio. The index is calculated as the weighted average of the price indices for properties (divided into residential and commercial) for each Italian region. The weights are equal to the shares of the assets of each fund that are invested in the markets included in the price indices under consideration. Write-downs and variations in the indices are calculated from the year that each fund was established or from 2009 (the year in which data became available) if the fund was set up prior to that date. Excludes funds in liquidation and those set up in the half year prior to the reference period. – (3) Ratio of total assets to net assets. – (4) Weighted average with weights equal to the denominator of each ratio.

The risks to financial stability stemming from activity in this sector are limited because, unlike most European funds, Italian funds are closed-end. The risk that, at maturity, the valuation of the funds' real estate portfolio could diverge significantly from market values also continues to be low (Figure 2.24.b).

Leverage remains at low levels (132 per cent; Figure 2.24.c) and in line with the European average. In December 2023, around 3 per cent of the sector's total assets were held by highly leveraged funds (i.e. above 300 per cent). The share of funds with negative net assets, a condition that indicates particular financial stress, was stable at 1.1 per cent.

Direct exposures of banks and other intermediaries operating in Italy to Italian real estate funds remain modest: in December, the loans granted to this sector accounted for less than 1 per cent of total lending and the ratio of NPLs to total outstanding loans to the sector, gross of loan loss provisions, fell to 12 per cent.

3 FINANCIAL STABILITY POLICIES

On 26 April, the Bank of Italy announced its decision to activate a systemic risk buffer (SyRB), equal to 1.0 per cent of domestic exposures weighted for credit and counterparty credit risks, for all banks and banking groups authorized in Italy. The target rate can be achieved gradually: banks are required to build up a reserve of 0.5 per cent by 31 December 2024, while the remaining 0.5 per cent is to be set up by 30 June 2025.[1]

Setting up a capital buffer for macro-prudential purposes in the current macroeconomic and financial environment (see Sections 1.2 and 2.1) will make it possible to strengthen the resilience of the Italian banking system, at the same time minimizing the risk that adopting it could have procyclical effects. The quantitative analyses supporting the decision show that any reduction in GDP growth caused by introducing the buffer would be negligible, whereas if adverse events were to materialize, the benefits of its release would be significant.[2] The Bank of Italy's decision is part of a general trend for strengthening releasable macroprudential buffers, which began in many European countries during the post-pandemic period[3] and will contribute to the soundness of the Italian banking system by enhancing its capacity to finance the economy even if adverse events occur. If they were to happen, the Bank of Italy would (partially or fully) release the buffer, allowing banks to use these resources to absorb potential losses and to continue to finance households and firms. After its release, the buffer would be kept at the new lower level for as long as needed to support economic recovery and preserve the stability of the financial system. Its replenishment would be required on a gradual basis, taking into account both the situation of banks and the economic outlook.

In the absence of any risks to financial stability deriving from excessive credit growth, the Bank of Italy has maintained the countercyclical capital buffer (CCyB) rate at zero per cent for the first two quarters of 2024 (see Table A11 in the Appendix).[4]

In March 2024, the Bank confirmed the decision[5] it had already taken in 2022 not to reciprocate a Belgian macroprudential measure,[6] owing to the non-material exposures of Italian banks in Belgium.

1 Bank of Italy, 'Activation of the systemic risk buffer', press release, 26 April 2024.

2 G. Catapano, L. Del Vecchio, M. Galardo, G. Guerra and I. Petrarca, 'Increasing macroprudential space in Italy by activating a systemic risk buffer', Banca d'Italia, Questioni di Economia e Finanza (Occasional Papers), 848, 2024.

3 L. Bonato and M. Molinari, 'Strengthening releasable macroprudential buffers in European Economic Area countries', Banca d'Italia, Notes on Financial Stability and Supervision, 36, 2024.

4 Bank of Italy, 'The Countercyclical Capital Buffer (CCyB) rate for the second quarter of 2024 remains unchanged at zero per cent', press release, 22 March 2024.

5 Bank of Italy, 'Decision not to reciprocate three macroprudential measures adopted by Norway, one by Lithuania, one by the Netherlands and one by Belgium, pursuant to recommendations ESRB/2021/3, ESRB/2022/1 and ESRB/2022/3', press release, 2 September 2022.

6 Bank of Italy, 'Decision not to reciprocate a Belgian macroprudential measure under Recommendation ESRB/2023/9', press release, 22 March 2024.

Last December, the Bank of Italy decided not to identify any Italian bank as a global systemically important institution (G-SII).[7]

The tools available to the Bank of Italy for preserving the stability of the national financial system include the product intervention power under Regulation (EU) 600/2014.[8] To this end, the Bank regularly conducts analyses of the risks to the stability of Italy's financial system that may stem from financial instruments traded, distributed or sold in Italy or from Italy.[9] According to the most recent analyses of securities and derivatives, the focus is on certificates and securitized products. The risks to financial stability from these instruments in any case seem low.[10] However, it should be remembered that certificates may expose holders to significant losses if adverse scenarios occur, the likelihood of which is difficult to assess. Given the continuous growth in volumes, the risk profiles and the complexity of these products, the Bank of Italy will continue to monitor market developments.

Last December, when implementing Recommendation ESRB/2011/3,[11] the Government definitively approved the legislative decree establishing a macro-prudential policy committee in Italy,[12] in which the Governor of the Bank of Italy, who chairs it, and the presidents of IVASS, the Italian Companies and Stock Exchange Commission (Consob) and the Italian Pension Fund Supervisory Authority (Covip) participate; the Director General of the Treasury also attends the meetings, but has no voting rights. The Bank of Italy provides the secretariat. The committee's main functions are: (a) analysing the risks to the stability of the financial system as a whole and defining intermediate strategies and objectives for its pursuit, with the power to report to the Government – publicly or confidentially – on systemic risk; (b) making recommendations to its constituent authorities; (c) drawing up reports for Parliament, the Government, other authorities, public bodies and State bodies on whether to adopt measures, including legislation, aimed at safeguarding the stability of the Italian financial system; (d) providing opinions on draft legislation relevant to its objectives; and (e) requesting data and information important for financial stability from both private and public sector entities, including non-supervised ones. The role of the committee is without prejudice to the competences and responsibilities of its member authorities. The committee meets at least twice a year and submits an annual report on its activities to the Government and to Parliament by 31 March of the following year.

7 Bank of Italy, 'Annual identification of Italian global systemically important institutions (G-SIIs)', press release, 1 December 2023.

8 The same power is also granted to the Italian Companies and Stock Exchange Commission (Consob), with the aim of safeguarding investors and the orderly functioning and integrity of the financial and goods markets. For more information on the product intervention power, see the Bank of Italy's website: 'The Bank of Italy's 'intervention power' concerning financial instruments, structured deposits and related financial activities/practices'.

9 For further information on the criteria used by the Bank of Italy to exercise its product intervention power, see its website, 'The Bank of Italy's 'intervention power' concerning financial instruments, structured deposits and related financial activities/practices: legal, analytical and methodological framework', press release, 24 April 2024. For the list and definitions of all the financial instruments analysed within the scope of its product intervention power, 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'.

10 Bank of Italy, 'The Bank of Italy's intervention power concerning financial instruments: regular assessment of risks to financial stability', April 2024.

11 ESRB, 'Recommendation of the European Systemic Risk Board of 22 December 2011 on the macro-prudential mandate of national authorities', 22 December 2011.

12 Legislative Decree 207/2023.