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‘Doom Loop’ Fears Are Putting Italian Banks to the Test

The European Central Bank is expected to unveil a program to shield indebted economies. Italian bank shares will be a test of the plan’s success.

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Rising interest rates in Europe are making investors worry about an old ghost haunting Italy’s banks: the “doom loop.”

The European Central Bank is expected to unveil a special bond buying program later this month to shield highly indebted eurozone economies—and their banks—from rising borrowing costs. The “anti-fragmentation” program is a response to a widening of bond yields in Italy in particular and a punishing selloff in bank stocks in the eurozone’s third largest economy.

The program’s success will be measured in the share prices of Italian banks. An index of Italian banks plunged nearly 14% in the days after the ECB announced it would increase interest rates last month. The shares have recovered somewhat on the hopes that the program will calm investors’ worries.

At the center of the concern about Italy's banks is the doom loop—a phenomenon in which banks, holding a pile of government debt, are forced to take a hit to their capital as yields on that government debt rise and the price of the debt drops. Weakened, the banks cut lending, hitting the economy and government finances, and creating a negative spiral. The doom loop brought Italy to the brink of a sovereign debt crisis in 2011. There was another scare in 2018 when antiestablishment parties prevailed in parliamentary elections.

Analysts say there have been some key changes since then to soften that doom loop: Big banks are better capitalized and have cleaned old bad loans from their books. A change in accounting rules now allows lenders to stash their government bond portfolios in a part of the balance sheet where they don't need to take immediate losses if prices fall.

But other links between banks and their governments remain. In Italy, banks collectively hold domestic government bonds worth about 10% of their total assets, little changed from the sovereign debt crisis period, according to data from the European Central Bank. In fact, they piled into government debt during the coronavirus pandemic.

Italy's government debt, meanwhile, has risen to about 150% of gross domestic product from about 130% during the crisis. That means refinancing that debt will be harder as interest rates rise. Investors can get easily spooked, driving the price of the bonds up, as they did a decade ago.

Yields of 10-year Italian government bonds are nowhere near the 7.5% peak reached during the crisis, but they have risen to 3.2% currently from 1.2% at the end of 2021.

“The doom loop risk is probably less but is still there,” said Ignazio Angeloni, a former board member of the ECB’s Single Supervisory Mechanism, which directly supervises the biggest eurozone banks.

Mr. Angeloni said that while big Italian banks such as UniCredit SpA and Intesa Sanpaolo SpA are well capitalized and have cleaned their balance sheets from bad loans, a handful of smaller lenders remain in bad shape. Banca Monte dei Paschi di Siena SpA, the world’s oldest bank, is emblematic of that. It has struggled for years under a state bailout to raise fresh capital.

UniCredit has cut its domestic bondholdings, which are now lower than 5% of total assets, according to Citigroup. But they are still 80% of its tangible equity, a measure used to evaluate a financial institution’s ability to deal with potential losses. For other banks such as Banco BPM SpA and Monte dei Paschi, their domestic bondholdings are above 140% of tangible equity.

A UniCredit spokesman referred to a comment from Chief Executive Andrea Orcel, who recently told reporters at an event that the market reaction was driven by investors thinking “I’ve seen this movie before,” but that banks were in much better shape than a decade ago.

Spokespeople for BPM and Banca Monte dei Paschi didn’t immediately respond to requests for comment.

Nicola Nobile, chief Italian economist at Oxford Economics, said Italian banks have in the past faced political pressure to help their government when borrowing costs have surged, and may be forced to do the same in the future, raising risks.

“They were acting as lenders of last resort for the government,” said Mr. Nobile.

JPMorgan analysts said in a note that higher funding costs for Italy would trigger a broad tightening in financing conditions in the country, “which we expect to become a significant headwind later on in the year.” It downgraded its growth projections for Italy for next year. Lower growth, in turn, would be bad for banks.

“There is a macroeconomic doom loop that you just can’t break,” said Jérôme Legras, head of research at Axiom Alternative Investments.

Mr. Legras, however, said he doesn’t believe the eurozone is in for a 2011 sovereign debt crisis repeat because of the ECB’s commitment to control government-bond yields in the periphery.

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