Housing finance in Italy

Defining characteristics

One of the salient features of the Italian housing market is the high rate of ownership. According to data from the 2001 census, 71% of Italian households live in their own houses or apartments. Moreover, dwellings account for almost 60% of Italian households' net wealth.

In spite of the fast growth of recent years, the Italian market for housing finance remains small by international standards. Banks are virtually the only agents present on the supply side, and the majority of loans for house purchases are held on their balance sheets. More than three quarters of credit for house purchases is at variable rates or rates renegotiable in less than one year. Only a small fraction of new lending is at rates fixed for 10 years or more. Banks fund mortgages and housing-related loans principally by issuing securities on both the domestic and the international bond markets.

The distribution of mortgages in Italy is mainly bank branch-driven, although an increasingly important role is played by the leading national real estate brokers, which have established stable links with banks. Recent regulations issued by the Bank of Italy allow financial companies to promote and place mortgage loans by signing agreements with banks. In 2004, post offices also started to distribute mortgage loans. Placement via independent advisers and direct purchase of mortgages via phone or internet still account for only a small share of the market because by law mortgage contracts must be stipulated before a notary.

Loan recovery procedures are long and costly. From the borrower's default to the final settlement of the legal proceedings, the whole process may take from five to seven years.

Direct government intervention in the market for housing finance is negligible. Less than 2% of loans to households benefit from public subsidies for interest rate payments. For principal owner-occupied dwellings, up to 19% of mortgage interest payments can be deducted from personal income tax. Tax incentives for house renovation were introduced in 1998 and may have affected households' demand for housing and the demand for mortgages, although evidence from econometric estimates suggests that the impact has been fairly small.

Recent developments

House prices in Italy started to rise steeply in 2000 and have since increased, on average, by 8% a year. Several indicators suggest, however, that there is little evidence of overvaluation.

Developments in the housing market have been associated with a remarkable upturn in household borrowing after the long stagnation of the mid-1990s. Between 1993 and 1997, the combination of rising household defaults and declining real house prices led to severe losses for the banking system and put several specialised intermediaries in serious difficulty. Nonetheless, the overall restructuring of the Italian banking industry created favourable conditions on the supply side for a new, sustained expansion of credit.

Historically, low nominal and real interest rates curbed the cost of borrowing. Credit availability also increased significantly. The deregulation process completed with the 1993 Banking Law made way for the universal banking model, which produced a significant increase in the number of banks and other intermediaries offering mortgages. Moreover, entry encouraged the opening of numerous branches and a massive new presence in all local markets. This lowered interest rates and made loans much more readily available.

The establishment of the single currency area encouraged the growth of a thick and efficient eurobond market, which enhanced the funding opportunities for Italian banks.

Risk management practices have also improved. Several banks have developed and implemented credit rating techniques. Information on borrowers' credit histories is available from the public Central Credit Register for larger borrowers, and from private credit bureaus for the smaller ones.

Policy-related questions

The two key financial policy issues arising out of Italy's experience are:

1. The distribution of interest rate risk between financial institutions and households induced by the types of contracts prevailing in different national markets.

2. The risk for financial institutions associated with the increase in the share of their lending that is related to housing market developments.

Background note

Housing market and housing finance

After peaking in 1992-93, Italian house prices only began to rise again, albeit slowly, in 1997. The market finally gained momentum later, in 2000, and in the last four years the average annual rate of growth has been 8% (Chart 1, solid line). In 2004, the house price index was 60% higher than at the peak of the previous cycle in 1993.

While there is no agreed method for making a fair measurement of house values, several indicators are available for this purpose. The dotted line in Chart 1 represents the index number of house prices in real terms, ie adjusted for the consumer price index, which in 2004 was 30% higher than in 1993. Chart 2 shows the price-to-rent ratio (solid line) and a crude housing affordability ratio (dotted line), given by the ratio of the financial cost of a mortgage (proxied by the product of house prices and mortgage interest rates) to household disposable income. The price-to-rent ratio has increased substantially because rents have lagged behind, although it is still below the 1993 peak. Since the early 1990s, the affordability ratio has declined considerably because falling mortgage rates and rising incomes have more than offset the rise in house prices.

Evidence from survey data suggests that in recent years the vast majority of households entering the house market have bought dwellings for own-occupancy purposes. Nonetheless, the new law on rents passed in 1998 may have also spurred house purchases for investment purposes. Previous legislation imposed strict regulations on the rental market. Ceilings capped rents and ample protection was given to tenants, who were assumed to be the weak contracting party. The enforcement of ownership rights took a long time and discouraged investment in real estate for rental purposes. The new legislation substantially liberalised the rental market, and tenant protection is fostered by tax incentives designed to foster medium- to long-term tenancy contracts.

Prompted by the developments in the property market, bank lending to households for house purchases increased on average by 24% a year between 1998 and 2000. The ratio of outstanding housing-related loans to GDP has been increasing steadily over the period, but it remains small compared with other countries whose economies have similar characteristics, such as those that have adopted the single European currency (Chart 3).

The low level of mortgages and other housing-related lending is reflected by the small number of indebted households. According to the Bank of Italy's Survey of Household Income and Wealth, which is based on a highly representative sample of Italian households, in 2002 only 10% of Italian households had outstanding loans from banks in connection with house purchases (Table 1). The vast majority of households with outstanding bank debts contracted for house purchases have income and net wealth well above the median values.

Borrowing contract types

More than three quarters of the new loans for house purchases granted in 2003 and 2004 were at variable rates or rates renegotiable in less than one year (Chart 4). Roughly the same proportion holds for outstanding loans. This structure is strongly influenced by Italy's long tradition of variable rates, mainly due to the lengthy period of heavy inflation and high nominal and real interest rates lasting from the early 1970s to the early 1990s. Nonetheless, the range of products offered in the mortgage market has expanded considerably over the last 10 years. At the beginning of the 1990s, mortgages were mainly variable rate, with a standard 10-year maturity, and were granted only for house purchases.

The range of contract characteristics has widened greatly since then. Banks offer a variety of mortgages with interest rates that can be fixed, variable, mixed (allowing the borrower to switch from fixed to variable and vice versa at a specified date), capped, or balanced (partly fixed rate and partly indexed). Contracts generally range from five to 20 years, although longer maturities are granted subject to additional conditions.

Lending and funding

Lending to households for house purchases accounts for 16% of total bank lending and for 8% of total bank assets. Mortgages are offered by the majority of the 800 Italian banks and each of the 30,000 bank branches. On an unconsolidated basis, the five largest market players account for around 40% of the market, a somewhat higher value than their 25% of total domestic lending. Most of the loans granted by banks remain on their balance sheets, although some banks have started to securitise part of their portfolios.

Funding of mortgage lending is part of banks' overall asset and liability management strategies. The expansion of mortgage lending has been associated with an increase in the proportion of bonds and other market instruments among banks' liabilities, which at the end of 2004 accounted for about 40% of total funding.

Regulation

Mortgage lending in Italy is subject to prudential regulation and to the rules governing financial contracts.

The loan-to-value ratio is capped by prudential regulations at 80%. This ceiling can be exceeded, and the LTC can be as high as the market value of the house, only if additional personal guarantees are provided.

In Italy, all financial institutions offering financial services have to comply with a set of transparency rules designed to ensure that all the relevant information is provided to the party before contracts are signed. Mortgage lending is covered by the general regulations. Specifically, the contracts must also include an indicator summarising the annual cost of the mortgage, including not only interest charges but also such items as the cost of enquiries, preparation of documents and administration. In addition, the contract must state the total costs charged to the borrower in the event of early repayment.

International links

Foreign banks have played an important role in boosting competition in the Italian mortgage market. In particular, the entry of British and German mortgage specialists in the late 1990s introduced new products and put pressure on the large domestic banking groups, which reacted promptly by taking advantage of their large customer base and branch networks. At present, after the largest foreign institution has been bought out by one of the leading domestic banking groups, the market share of foreign banks is about 4% in terms of outstanding mortgage loans.

Table 1

Fraction of households with home-related loans from banks

By total income

Year	**Income quartiles**				
	1	**2**	**3**	**4**	**Total**
1995	0.049	0.097	0.157	0.22	0.131
1998	0.031	0.077	0.104	0.147	0.090
2000	0.022	0.065	0.1	0.175	0.090
2002	0.035	0.078	0.124	0.171	0.102
Total	0.034	0.079	0.122	0.179	0.104

Note: The quartiles are "by year". Representativity weights have been used to compute both the quartiles and the frequencies.

By total net wealth

Year	**Total net wealth quartiles**				
	1	**2**	**3**	**4**	**Total**
1995	0.021	0.110	0.190	0.202	0.131
1998	0.027	0.096	0.110	0.126	0.090
2000	0.028	0.082	0.112	0.139	0.090
2002	0.037	0.104	0.124	0.143	0.102
Total	0.028	0.098	0.135	0.154	0.104

Note: Net wealth includes all real and financial assets, net of all liabilities. The quartiles are "by year". Representativity weights have been used to compute both the quartiles and the frequencies.

Chart 1

House price indicators

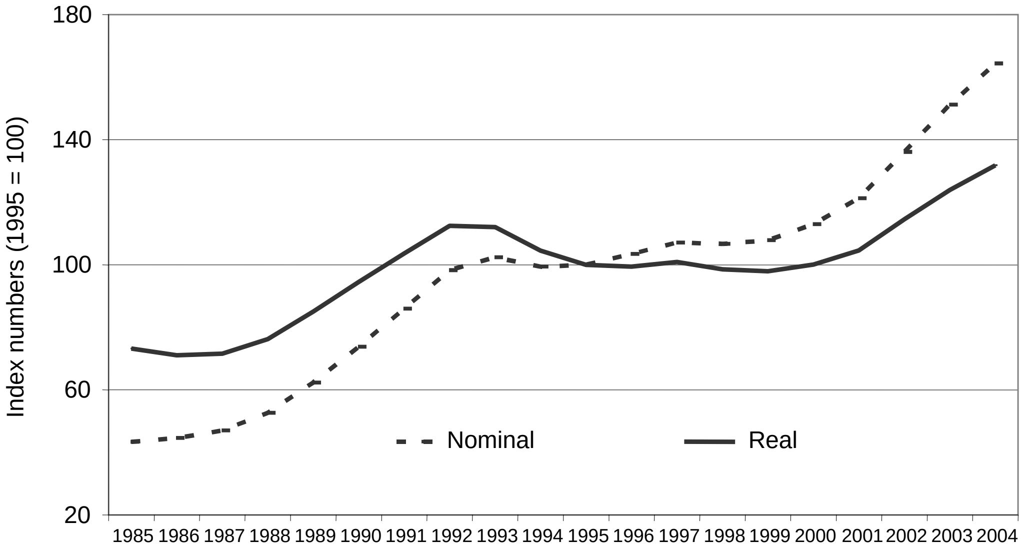

Chart 2

Indicators of fair value of house prices

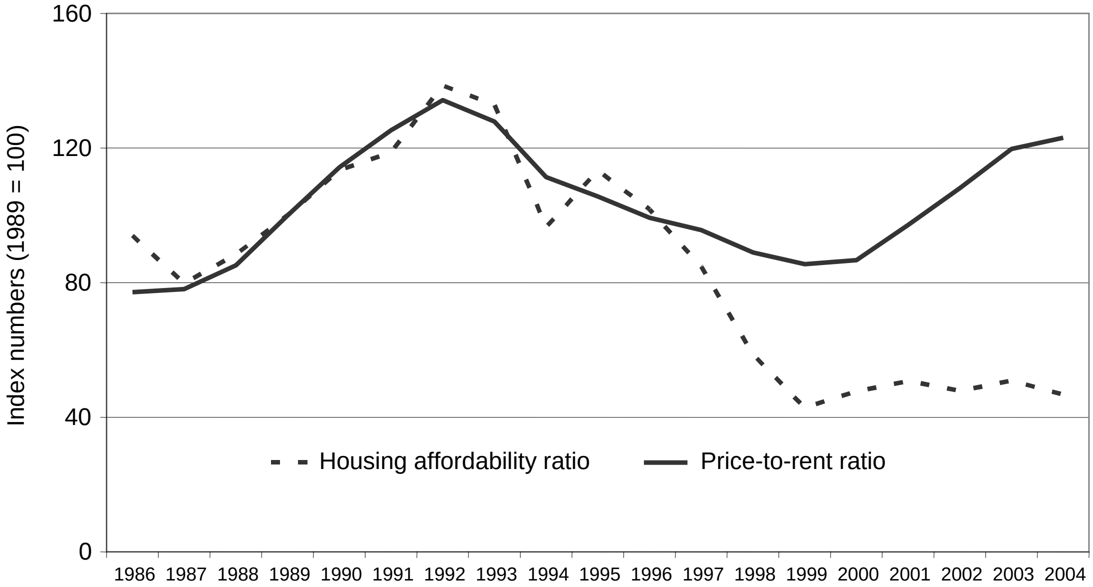

Chart 3

Bank lending for house purchase as a percentage of GDP

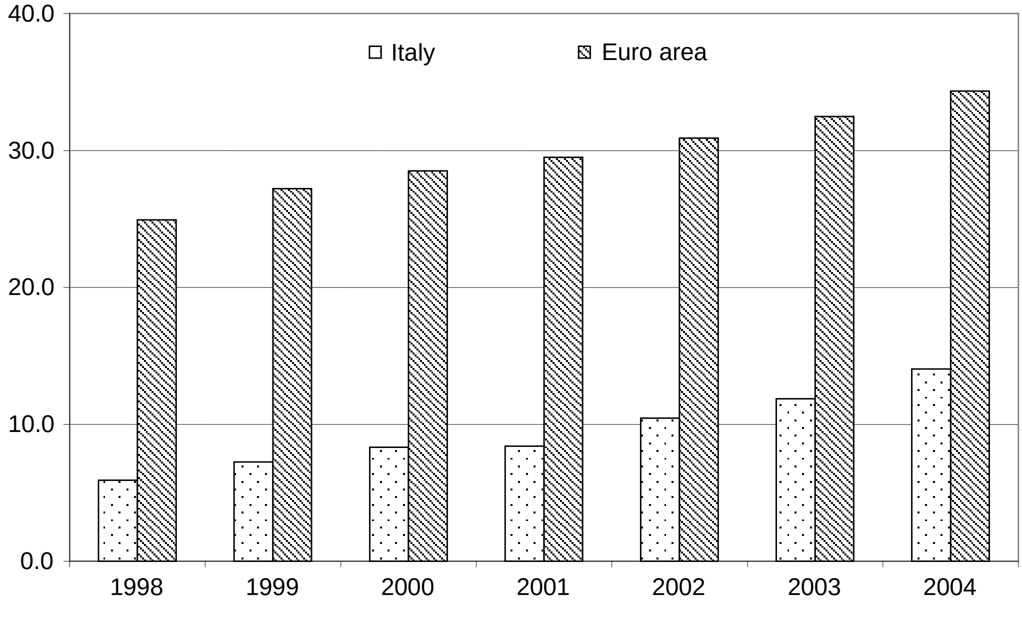

Chart 4

Shares of lending for house purchase by initial rate fixation