The possible effects on the future management of local Italian authorities following the use of financial derivative instruments

Ubaldo Comite

(Department of Business Sciences, University of Calabria, Rende (Cs) 87036, Italy)

Abstract: The appeal from municipalities, provinces and regions to financial derivative instruments is tied to the need of overcoming the situations in a state of urgency inherent in a balance. On average, one local Italian authority in twenty has decided to underwrite a derivative product, giving life to a number of contracts that had a value of over 35 billion euro with an average value of 6.5 million for each contract until 2007. The boom of swaps has, since 2000 on, experienced a peak period from 2003 to the end of 2005, in which the Euribor rate touched a very low level, maintained itself for long periods at around 2% and fallen in some cases even under this value. Many of the contracts completed before 2006, which link the debt of local authorities to variable rates, but also many of those completed from 2006 onwards that moved debt onto fixed rate, which are now a source of loss for the balance of local authorities that have underwritten them. In the 2002-2008 period, the number of the stipulation of contracts local authorities reported to the Ministry of Economy and Finance is about 900, corresponding to more or less 150 per year, which affected 18 regions, 44 provinces, 532 municipalities and 4 mountain communities, for a total of 594 authorities. Therefore, the local authorities have approached the derivative instruments in an often approximate way without a real awareness, both for the conditions that were being negotiated and the effects that they would have produced in perspective. The purpose of this work is to highlight the consequences of the use of derivative instruments on the future management of local authorities.

Key words: public administration; financial derivative instruments; local authorities

1. The system of local autonomy in the constitutional reform in 2001

The issue of fiscal federalism in Italy, after being introduced in several laws which have promoted the adoption in its double meaning of federalism and fiscal administration, has most recently also been found in the consecration of constitutional norms.

For some time, the political and institutional debate had highlighted the need to rethink the entire title devoted to autonomy (Title V) from the viewpoint of the transformation in a federalist sense of the Italian system motivated by the need to modernize the country, to adjust to the trends of the European framework, to near the decisions of citizens, and to account for those rulings (Vandelli, 2004).

The new Title V of the Constitution establishes differences in the powers of the Republic relating to the profound innovation introduced by paragraph 1 of article 114, putting the different constituent authorities of the Republic on the same level: municipalities, provinces, metropolitan cities, regions and state. Thus the state is an

Ubaldo Comite, Ph.D., professor of budget and business organization, Faculty of Economy, Department of Business Sciences, University of Calabria; research fields: public administration, business administration, accounting.

equal subject compared to other established powers that have their own statutes, powers and functions. This leads to local co-responsibility in achieving the objectives of growth not only to their community but also within the country (Guerrieri, 2003).

The new wording of article 117 Constitution lists the areas in which the state has exclusive jurisdiction, allowing the regions legislative powers over all other matters not assigned to the state, that is, allowing the regions exclusive residual legislative power “in all other matters not expressly reserved to the legislation of the state”.

In order to ensure, for some subjects, the rules of principle which must inspire the regional legislature in exercising its legislative power, established the so-called “concurrent legislation”, which is the condition that the legislative power of the region is bound to the law of the state which has the task of determining the basic fundamental principles.

A further key reason underlying the constitutional reform is the need to adjust the finance of the regions and local authorities to the principles more directly related to the institute of fiscal federalism. The financial principles that govern the finances of the regions and local businesses are contained in the new article 119 of the Constitution, which introduces the principle of “territoriality of tax”, which should enable local authorities to support themselves primarily with their own instruments obtained through the exercise of independent activities of taxation put in place on its territory (D’Auro, 2002).

The new article 119 Constitution stipulates that local authorities have “financial autonomy of income and expenditure”, which means that the regions, municipalities, provinces and metropolitan cities have the ability to establish and enforce their own tax for the first time in recent history, and thus they have a margin of discretion and autonomy in determining the various structural elements of the tax (Monelli, 2001).

In the model of fiscal federalism established by the legislator, the forecast contained in paragraph 5 of article 119 Constitution occupies an important position, which states “to promote economic development, cohesion and social solidarity, to renew the economic and social imbalances, to facilitate the effective exercise of the rights of the person, or for the purpose of different aims from the normal exercise of their duties, the State allocates added resources and makes special interventions in favour of specific municipalities, provinces, metropolitan cities and regions”.

Moreover, the law states that all local authorities have their own assets, which are allocated according to the framework being determined by the state law, and may also make use of debt transactions, provided that these activities are aimed at investment but not to meet the needs of current expenditure (Atripaldi & Bifullo, 2001). The debt is a source of financing public expenditure on the part of local institutions and an alternative to those formed by taxes, and it results in a supply of provisions through financial intermediaries (banks, cash deposits and loans, bank sports, etc.) or directly through the special bonds general public of savers. Under this law, usual running expenses for activities that local authorities undertake must be fully covered by their autonomous revenues, by a share in state tax revenue, by the share in the equalization fund, as it is impossible to make use of credit to finance current expenditure. In other words, the autonomy of the new system of local finance, based on the principle of responsibility, which does not allow borrowing to cover the costs of current expenditure that must be kept within the limits of the received resources, both in an ordinary and extraordinary method. In fact, if it was not so, the administrators would run it for seeking excessive debt, leaving an inflexible balance to the next directors, and therefore, they devoid of any substantial self-governing (Francaviglia, 2008).

Compliance with the above mentioned prohibition of debt, and the respecting of the so-called “Stability Pact”, there represents an element of central importance for the protection of the economic unit of the Republic and the coordination of public finance (Meneguzzo, 2003).

2. The legal framework of financial derivative instruments

The first provision that expressly governs the use of derivatives by local authorities can be found in article 2 of the *Decree of the Ministry of the Treasury*, 5 July, 1996, no. 420, containing the “laws for the issuance of bonds by the local authorities”, which forced the local authorities to deal with exchange rate risks linked to the issuing of bonds in foreign currency, using a “currency swap”.

Subsequently, there was a turning point with article 41, paragraph 2 of *Law* 28 December, 2001, no. 448 (Finance, 2002), which entrustes the Ministry of Economy and Finance with not only the task of coordinating the access to capital markets by regions and local authorities, but also to establish the criteria for amortization of debt and for the use of derivative instruments (Astegiano, 2008).

For this purpose, the institutions in question regularly communicate to the Ministry data related to their financial situation. These interventions are aimed at the cost of containment and monitoring of developments in public finance.

The 2002 financial act also introduced the possibility of issuing bonds with a single repayment at maturity (so-called bullet titles) subject to the Constitution after formation, when the issue of a fund for the amortization of debt is after the conclusion or swap for amortization of debt (Atella, 2008). Therefore, article 41 of *Law* 28 December, 2001, no. 448 imposed on local authorities that make use of an emission “bullet”, the obligation to establish a depreciation fund (sinking fund) to distribute the burden of the loan repayment evenly over the financial years, or as an alternative to the fund, the power to negotiate a swap (amortizing swaps) with a financial intermediary to replace the repayment of capital in one solution, with a depreciation (Valensise & Brunetti, 2002).

Article 2 of the Ministerial Decree provides that the contracts relating to the management of a fund for the amortization of the capital to be reimbursed, or for the conclusion of a swap for the amortization of the debt can be concluded only with distinguished intermediaries, which are covered by an adequate credit rating and certified by rating agencies recognized at international level. Furthermore, Article 2, paragraph 2 provides the conditions of the fund to invest exclusively in bonds issued by public entities and institutions, and companies with public participation of states in the European Union.

Article 41 of Act 2001 was later specified in many laws, regulations and administrative provisions. In that sense, decree on 1 December, 2003, no. 389 was of particular importance, which was issued by the Ministry of Economy and Finance in consultation with the Ministry of the Interior and published in G. U. (Official Gazette) no. 28, 4 February, 2004. This decree, as well as regulating the access of local authorities into the capital market, has dictated the criteria for amortization of the debt (article 2) and derivative transactions (article 3) (Piscino, 2004).

Later, the explanatory circular of 27 May, 2004 intervened, circulated by the Ministry of Economy and Finance, published in G. U. no. 128, 3 June, 2004. It was considered appropriately to highlight the potential degree of risk related to the derivative operation to local authorities, and for the intermediaries, the need of taking on such risks by local authorities made fully conscious and transparent. In this regard, in the circular letter, the authorities are explicitly urged to consider, when choosing between issuing bullet and amortizing the total cost of the bond securities in two forms, and to assess, the relationship between this differential costs and the increased risks sustained by the authority under the fund or swap for depreciation, as evidenced by the inferable market conditions at the time of issue. In the circular letter, some criteria were also set up to help authorities in their operations, in particular in regards to: (1) the identification of a minimum rating of the intermediaries who manage the fund; (2) swap depreciation; (3) the range of instruments admitted for the investment of the fund; (4) the criteria for replacing the securities in the fund itself (Boccia & Nigro, 2008). Regarding the use of derivatives, in the circular letters the types of transactions allowed, are outlined consistent with the principle of containment of the risks of financial institutions. For transactions in derivative instruments, the legislation provides for mandatory recourse to swap in two cases: (a) to cover itself from the foreign exchange risk in debt exchange in value, (b) for the depreciation of bullet securities.

Not obligatory but simply allowed are: swaps on interest rates; A contract by which the counter-parties agree to exchange, on one or more prearranged dates and two sums of money calculated by applying many different parameters (interest rates or foreign exchange) to an identical amortization of reference. At the due date a single payment is made, on a net basis, pursuant to voluntary compensation:

- Forward rate agreements. A forward contract in which two parties agree on a fixed rate with interest applicable to a capital asset for a future period with a specific duration;
- Purchases of cap and collar of interest rates. The cap is a contract that guarantees the buyer, against a payment of a premium, compensation if a specific parameter of reference such as Libor or Euribor, exceeds a set level. The purpose of this contract is to cover financing at a variable rate from the risk of an excessive rise in rates. The collar is, instead, a contract by which the buyer cautions itself against the risks of changes in interest rate, guaranteeing an area with a minimum and a maximum rate. It is a contract which contains the characteristics of cap interest rate and floor interest rate;
- Other derivative products containing combinations such as the above mentioned, which allow the transition from fixed to variable and vice versa to achieve a threshold value that is predefined or passed or even to a predefined period of time;
- Other derivative products for the restructuring the debt, only when they do not provide a later deadline than that associated with the underlying liabilities.

The rule leaves out the possibility of using a number of other financial derivative instruments, such as options, futures, energy swaps, numerous forwards, different from the forward swap rate allowed (Trudu, 2005).

In this regard, the Ministerial Decree and the explanatory circular clarify that swaps, caps and collars, can be purchased only in its simplest form, called plain vanilla. That is, the most basic structure, consisting in the commitment of the contractors to exchange at certain deadlines, flows of interest related to the parameters of the money market.

The ministerial circular also reiterates that the interest rate level that the local authority has to support at the activation of the contract thresholds must be consistent with both the rates prevailing in the market and with the cost of liability prior to the termination of the derivative operation.

The decree also states that the derivative transactions: are allowed only in accordance with liabilities actually due (the so-called notional capital), can be indexed only by monetary parameters of reference in the G7 area (area of the countries belonging to the Group of the Seven most industrialized nations) and can be completed exclusively with intermediaries with appropriate rating (at least BBB/Baa/BBB, as explained in the Circular letter), attributed to primary agencies at international level (the circular indicates Standard & Poor's, Moody's Ratings and Fitgh).

The latter estimate aims to include the credit exposure to counter-parties, for the same purpose, an individual threshold of exposure of 25% is provided for in the event that the nominal amount of the derivative operations completed and put in place by the territorial authority, has come to pass 100 million Euros (De Biasi, 2007).

Following the reports and the gradual emergence of potentially harmful situations to the local authorities, the legislature with the financial law for 2007 again intervened, leading to more restrictive rules in the use of these instruments and promoting a special procedure for controlling them. The 2007 financial (L. 27 December, 2006, no. 296) determined that the operations of debt management through the use of derivative instruments "must be marked by the reduction of the final cost of debt and the reduction of exposure to the risks of the market". Moreover, it again reiterated that these kinds of operations can be completed "only in relation to liabilities actually owed, regarding to the containment of the credit risks taken on".

It is clear that the purpose of the law was not to introduce new constraints in public finance, but to raise the legislative rank, or rather that of "core principles for the coordination of public finance in Articles 117, third paragraph, and 119 second paragraph of the Constitution", some criteria that had been previously provided in regulatory and administrative matters.

From this point of view, the explanatory circular (issued by the Ministry of Economy and Finance on 31 January, 2007 and published in the G. U. (Official Gazette) no. 29 on 5 February, 2007) refers to the need to "unite the right to respect for local financial autonomy with necessary regard to the whole economic workings of operations put in place by institutions for the management of debt". Consequently, there are now four limits to be observed by the territorial authorities that intend to carry out transactions in derivatives: (1) reducing the final cost of the debt, (2) reducing exposure to market risks, (3) priority in respects to liabilities actually owed, (4) containment of the credit risks taken on.

The legislative directions may seem generic and in some ways contradictory, especially in reference to the joint "reduction of the final cost of debt and reduction of exposure to market risks". The directions given by the law do not intend to establish that both objectives which are necessary have to be achieved simultaneously. In fact, it is not a given the reduced exposure to the "market risks" (typically the foreign exchange and interest rate) effectively results in a reduction of the "final cost" of the debt. So, it seems that the directions of the law seems to imply that the derivative transactions should aim to reach an optimal relationship between cost and risk of the debt position, even in relation to the overall composition of the debt of the authority (Belles, 2008).

With regard to the requirement of liabilities actually owed, it is further reiterated and stated that for the territorial authorities, it is impossible to initiate derivative transactions which have as an underlying pre-existing derivatives, but only actual existing liabilities are referable to previous debtors' relationships belonging to the authority.

Instead, in relation to the requirement of "reducing the final cost of debt", it is still necessary to make it clear that the sum of the derivative (for example, the swap on exchange rates, which is even mandatory, or to swap of variable or fixed interest rate or the purchase of a collar) could be solved for the authority for a final total expense that is higher than what would have existed if financial transaction had not been completed.

However, the concerns that came up at the end of 2007 led the legislator to intervene again on the matter with the *Finance Act 2008*, making discipline more rigorous and establishing the requirement to enclose a note in the budget containing the expenses and the financial commitments aimed at ensuring appropriate conditions of transparency. The issue of transparency arises for OTC (Over the Counter) contracts, that is to say, is not traded on regulated markets but according to the needs of the counter-parties that have led to the creation of exotic swaps.

In particular, article 1, paragraphs 381 to 384 of the Law of 24 December, 2007, no. 244, has laid down some rules that can be summarized as:

(1) Contracts relating to all financial instruments stipulated by the regions and local authorities should have the greatest possible transparency;

(2) The contracts should be drafted according to a ministerial outline;

(3) The Ministry of Economy will monitor the compliance of the contracts;

(4) The authority that signs the contracts in question must specifically certify that it is fully aware of the risks and characteristics of them;

(5) The institution must show, in an appropriate note attached to the balance, the expenses, and the financial commitments derived from these activities;

(6) The contracts issued in conflict with the above mentioned rules are ineffective;

(7) Violations shall be reported to the Corte dei Conti (Audit Office) for the measures within its competence.

In the case that contracts are stipulated in violation of the provisions of paragraph 382 or paragraph 383, the Corte dei Conti is notified to adopt measures of competence. In addition, according to paragraph 383, the region or the local authority that signs the contracts must specifically certify that it is fully aware of the risks and characteristics of them, highlighting, in an appropriate note attached to the balance, the expenses, and the financial commitments derived from these activities. The latter intervention represents the first step designed to highlight the real financial situation of the institution and what possible negative situations can occur, and even to adapt the current management in relation to likely future financial commitments (Fontana & Rossi, 2007).

3. Usefulness and risks derived from the use of financial derivative instruments on the part of local authorities

The use of these particular financial tools on the part of municipalities, provinces, regions and mountain communities is linked to the need of overcoming situations of budget deficits. However, some recent investigations have, returned the spotlight on the use of these tools by the local authorities, highlighting a number of critical issues that have fuelled a major debate at an institutional level.

On average, one out of twenty local Italian authorities decided to sign a derivative product, often without even really knowing what they were signing. A volume of contracts at the end of 2007 had a notional value of over 35 billion Euros and an average value per contract of 6.5 million (Trudu, 2007).

The boom of swaps is from 2000 onwards, with peaks from 2003 until the end of 2005, when the euribor rate reached a very low level and remained around 2% for long periods and falling in some cases even below that value. In that situation, there was the feeling that the introduction of the euro had created financial stability and, therefore, the execution of financial transactions, such as swaps, had become customary practice, that each local authority had at least the obligation to consider, to not miss an opportunity to reduce the cost of interest, taking its debt into the most convenient market rates (Trudu, 2008) (see Table 1).

In the first few months of 2006, the contractual proposals towards local authorities changed, adapting to the financial market, but even with this, the race towards IRS by the local authorities, with the sanction of contracts that, at least intentionally, had to act as protection against the increase of the rates and give a breath of fresh air to the stifled funds of the institutions.

Many of the IRS contracts completed before 2006, that tied the debt of the local authorities to the variable rates, but even many of those completed after 2006, which moved the debt to a fixed rate, have today become a source of very heavy loss for the balance of the local authorities that underwrote them.

More precisely, the local authorities, in order to alleviate the burdens, have underwritten these instruments in a way, so that the bank would pay exactly the fixed rate on the debt, while the institution tied itself to the trend of the variable rate plus a spread with the prevision of a maximum and minimum rate. Consequently, the institutions that have underwritten these derivatives have been sucked in the vortex of the emergency when, as in 2007, the interest rates increased and the market value of the contracts took noticeable negative capacity (Bozza, 2007).

Table 1 Swaps articulated on the territory: Effect on the stock of the debt (sample institutions), year 2007

	Total debt (A)	Swap (B)	Inc. % (B/A)
Piemonte	421,525,431	161,619,127	38.34
Lombardy	584,607,349	169,521,376	29.00
Veneto	528,381,278	36,741,077	6.96
Friuli Venezia Giulia	378,691,634	87,383,827	23.08
Liguria	180,752,064	80,730,587	44.66
Emilia Romagna	582,790,191	82,855,321	14.22
North	2,676,747,946	618,851,306	23.12
Tuscany	671,547,358	67,612,470	10.07
Umbria	82,639,403	47,698,797	57.72
Marche	245,178,924	68,809,339	28.06
Lazio	273,739,361	196,389,887	38.87
Centre	1,273,105,046	290,510,493	22.82
Abruzzo	332,651,261	156,275,538	46.98
Molise	37,278,908	8,810,815	23.63
Campania	189,050,474	56,184,422	29.72
Puglia	441,502,873	167,110,753	37.85
Basilicata	28,540,504	12,040,159	42.19
Calabria	204,575,113	163,058,354	79.71
Sicily	96,094,005	64,122,653	66.73
Sardinia	178,572,106	53,092,328	29.73
South-Islands	1,508,265,244	680,695,022	45.13
TOTAL	5,458,118,236	1,590,056,822	29.13

Note: Data expressed in Euro.
Data source: Ministry of the Treasury, 2008.

Table 2 The derivatives of the local institutions as 30 June, 2008

Typology of Institution	Region	Province	Municipality (capital)	Municipality (non-capital) (*)	Total
Number of the institutions involved	18	44	48	484	594
Percentage of the total number	3.03	7.41	8.08	81.48	100
Total notional (value in millions)	16,891	3,495	11.14	4.11	35,644.34
Percentage of the notional total	47.39	9.81	31.25	11.52	100
Notional average of contracts by institution type	189,790,092.62	27,095,930.11	63,657,206.02	6,548,592.95	34,774,960.94

Note: (*) Mountain and island municipalities.
Data source: Ministry of Economy and Finances.

During 2002-2008, the local authorities have communicated to the Minister of Economy and Finance the agreement of about 900 contracts, corresponding to about 150 per year, that have involved 18 regions, 44 provinces, 532 municipalities and 4 mountain communities, for a total of 594 institutions (see Table 2).

Even the monetary values sustain the significance of the phenomenon, as it can be understood considering that the notional of reference results are equal to about 13 billion Euros (corresponding more or less than 36% of the debt of the local authorities), with a loss of market value around 1,055 billion Euros (see Table 3)

Table 3 Debt as 30 June, 2008

Institution	Grand total
Region	39,049
Province	9,313
Municipality (capital)	24,450
Municipality (non-capital)	24,712
Mountain and island municipalities	242
Total	97,765

Note: Value in millions
Data source: Ministry of Finances.

In essence, the appeal to derivative instruments on the part of local authorities was determined by the need of overcoming a series of criticalities pertaining to the derivatives even from the choice of regulations carried out: the constraints from the act of stability, the constriction of the funds available on the basis of transfers, the block on surtaxes to the IRPEF (income tax) and other restrictive laws, which have pushed many local administrations to search elsewhere for financial funds.

Some have combined several aspects of a more ample range, like the burden in the renegotiation of mortgages and loans and favourable progress of interest rates which have rendered the previous rates inadequate and with certain transactions on instruments of financial derivatives destined to transform fixed rates into attractive particularly and variable rates (plain vanilla swap) (Nigro, 2007).

Certainly, local authorities have come closer to derivatives in a way at times approximate but without effective awareness, inasmuch as the conditions that were being negotiated as the effects that they would have produced in prospective.

Among the most significant criteria that have characterized the appeal to derivative instruments from the part of local authorities, the following deserve to be mentioned:

- The absence of professionalism, specific skills and appropriate computer abilities in range of the financial instruments. This has determined the objective difficulty in understanding the real surroundings and the effects of the efficiency in derivatives, that in and of themselves constitute instruments ideal for a considerable complexity;
- The co-existence, in the same financial intermediary, as the role of advisor, which is a consultant for the institution, and of a counter-party, with the emergence of an obvious conflict of interest capability, comparing the benefit for the public administration and for the credit institution;
- The construction of operations that are objectively dangerous, without limits to possible financial burdens for the local authorities (for example by means of CAP) or with "corridors" of taxes that are exceedingly scarce, and left to hypothesize a rapid collocation of the same in an area of loss for public administrations;
- The search for a significant initial liquid asset (up-front) premium is useful to sustain the levels of expenses avoiding the appeal of fiscal imposition, which is the reduction of other burdens (even though keeping in mind that the constraints identified the Corte dei Conti and by accounting principles), without a careful evaluation of the impact in terms of a worsening of future annuities;
- The absence of a systematic monitoring the procedure, even perspectively, of the operations taking place (through an appropriate team) with possible restructuring of the defined position, is useful to modify risky conditions to which the institution is subject;
- The appeal of derivatives in relation to periods that are more or less extended in time, with the risk of future developments (in annuities that are even distant) that is unpredictable and difficult to monitor (Fontana & Rossi, 2007).

If it is true on one part that derivatives can carry out a function that is indubitably positive to protect operators from the risks and from fluctuation of exchanges and taxes; On the other hand, it is also true that they pose a series of problems relative to their management. The appeal of complex financial operations has caused a kind of imbalance in the objective functions of the local administrators in the short term. Local authorities have underwritten financial contracts that allowed for the immediate obtainment of liquid assets, or to move ahead the debt expiration, or at any rate to restructure the debtor cash flow immediately, lightening the output and neglecting the effects of a medium-long period. This sort of short-sightedness, other than the attention focused only on the immediate, also derives from the technical difficulties of perceiving the actual consequences of the contract, for which high and specialized levels of skill are necessary, and something that the public administration does not yet have.

Moreover, the excessive borrowing from banks could bring the local authorities towards a loss of their own political autonomy, destined to last in the long period. There have been too many cases, in which the administrators, enticed by proposals of immediate liquid assets, have accepted those tendence to exaggerate a disadvantaged up front acceptable levels of a variable rate with a philosophy of "everything and now" that have unloaded future administrations onto the less "noble" part of contracts that usually have a duration from 15 to 20 years.

Therefore the reference to maximum transparency is identified as a principle to which contracts relative to derivatives of the region and of public administration must be informed, with an instrumental logic finalized to assure the rationality in the use of such financial instruments (Fontana & Rossi, 2008).

4. The controls operated by the Corte dei Conti

For the purpose of the coordination of public finance, the Corte dei Conti (Audit Office), as a National

Institution for the external control differentiated according to the territory, has the duty to verify the respect of the stability of the balance from the regions and other corporations, in relation to an internal stability agreement and to the obligations deriving from Italy, being a member of the European Union, as well as to ensure a healthy financial management of local authorities (Francaviglia, 2008).

The accurate balance obligations imposed by the rules and the continuous limitations to the transfers from the national finances to the local finances constitute the whole of the causes that have lead a great deal of local government to search for solutions as much innovative as risky, in order to meet their financial necessities. As previously mentioned, the phenomenon emerging in the last few years has been to turn to the reorganization of the debt, by the utilization of derivative instruments, which has proved particularly risky due to the cost involving unforeseeable developments on the financial markets.

In relation to the use of financial instruments derived from the local governments, starting from 2004, the court, in area its responsibility, has started to analyse the exposure of the debts of the local authorities, in order to answer a series of questions, but above all to answer the questions relative to the utilization of the instruments of the financial derivatives, taken on as specific objective of the activity of control (Marotta, 2006).

In an earlier phase (2003-2004), the Court examined a sample of 148 smaller municipalities (with a resident population between 8 000 and 10 000) that on the basis of an estimated analysis were believed more exposed to possible risks connected to the use of the derivatives, as believed equipped, in relation with bigger municipalities, with a smaller degree of those technical capacities necessary to manage transactions of particular complexity.

In a second phase (2004-2005), the research was extended to almost all the Italian regions (17 out of 20) and to a sample of municipalities of medium and large size (among them Rome, Genoa and Naples).

In the two surveys (and in successive updatings relative to the period 2005-2006), all the contracts as subject activities on the derivatives stipulated in the time-frame 2003-2006 (a particularly significant period) were acquired, during which analytic rules for the management of the debt by the local authorities were approved. As it may be remembered, the main innovative rules of the years concerning the management of the debt by the local authorities are those relative to:

(1) In the year 2001, when the opportunity to resort to derivatives instruments and to issue bonds with a return in a lump sum at the due date (bullet), with the obligation to: (a) Establish a fund of reinvestable amortization (sinking fund), (b) Performing an amortization swap to transform the bullet debt into a redeemable debt was given to the local authorities;

(2) In the year 2003, when the transactions on the derivatives considered acceptable are identified, which are used as coverages for the interest rate risk in the area of the typology plain vanilla, namely: (a) swaps on the interest rate (interest rate swap—IRS), (b) acquisition of forward rate agreements, (c) acquisition of caps, (d) acquisition of collars, (e) mandatory coverage for the risks of exchange (cross currency swap).

As a consequence of reports and of progressive surfacing of situations potentially damaging to the local government, the legislator with a financial law for 2007 intervened again in the matter, dictating more restrictive laws for the use of these instruments, and establishing proper control proceeding entrusted to the Corte dei Conti. Under the substantial profile, it has established the management transactions of the debt through the use of derivative instruments have to be based on the reduction of the final cost of the debt and on the reduction of the exposure to the market risks, reaffirming that this kind of transactions can only be concluded in correspondence with actual due liabilities, with concern of the control on the credit risks assumed (Corte dei Conti, 2008).

The disposition contained in the financial law for 2007 has also provided for a phase of monitoring ex-ante from the Minister of Economy and Finance. For this purpose, the institutions are obliged to convey the text of the contract before its sanction to the Minister. The fulfilment is purely preventive since the rule foresees that the transmission should take place before the sanction of the same contracts, and in case of a missed transmission of the contract from the local authorities, the minister has to transmit a specific communication to the Corte dei Conti for the adoption of measures of its competence. The main observations of the Corte dei Conti connected to the analysis of the problems that arose during the course of the research about the contracts on the derivatives performed during the time 2003-2007 by the local authorities, are relative to the fact that with the diffusion of the derivative instruments, the risk of financial transactions non sustained by the necessary professional competences of the representatives of the local authorities, especially the small or medium dimensions, is appreciably increased. According to the Corte, the small local authorities, in order to face this lack of competence, have relied upon banks and financial intermediaries both for the strategy of restructuring of the debt, and for the evaluation of their effect and the connected risks. Additionally, the Corte highlights that those responsible for the local authorities of small and medium dimension have sanctioned, in accordance with the rules, the contractual clause of “qualified dealer”, even without a proven experience in the field of derivative products.

The laws issued in 2003 have had a positive regulatory and clarifying effect, but the transactions on the derivatives completed previously, that is before 2004, had been carried out without following optimum criterion, nor adequate precautions. Besides, the Court dwells on the fact that the derivative contracts have been often used to fill balance deficit or shortage of liquid assets (De Dominicis, 2008). Therefore, resorting to derivative instruments has caused advantages to the local authorities for the first years (2 or 3) in the duration of the contract, whereas for the following years, the local authorities would suffer heavy losses.

The concerns the Corte dei Conti contained in the report on the finance of the territorial institutions that analyses the phenomenon of the derivatives used by the municipalities, provinces, and regions from the beginning of 2000 until 2007, are relative to the fact that these financial instruments are often used improperly, for a speculative purpose or to secure liquid assets.

According to the Corte dei Conti, resorting to the derivatives is acceptable only when it is directed at covering the risk of fluctuation of the rate or to the restructuring of the stock of the total debt in a different balance between fixed rates or variable rates. The Corte recommends the creation of a central structure as an advisory and informative model in order to direct the local authorities of small and medium dimension on their choices of restructuring the debt and of recourse to derivative contracts, and to create an information technology web in order to offer a comparative examination of the contractual clauses suggested by financial intermediaries, as well as a constant updating the performance of ongoing contracts.

The attention intended to recall the Corte dei Conti on the use of financial derivative originate from the fact that these operations have to be carried out with caution at any rate. The action of the administration should be based on the respect of the principle in safeguarding the balance of the budget, not just of the immediate, but even as much as possible, for the future, and consequently the effects of the transaction even on future enterprises have to be evaluated. Therefore, maximum transparency and attention must be used, a degree of uncertainty tied to performance of the financial market must be expected, both during the phase of “construction” of the contract, with the inclusion of clauses that limit the exposure of the institution to the negative performance of the market, and under the profile of the waiting of positive cash flow (Formez, 2007).

5. The ban of local authorities to stipulate the financial derivatives contracts in 2009

In order to protect the economic unity of the Republic of Italy, and in respect for the principles of coordination of public finance provided by article 119 and 120 of the Constitution, the legislator intervened with article 62 of the law 6 August 2008, no. 133 (conversion of the Legislative Decree 25 June, no. 112), asking for a ban for local authorities' stipulating of contracts relative to financial derivative until the enactment of an appropriate regulation of the Ministry of Economy and Finance finalized to identify the typology of contracts that the authorities can stipulate. At any rate, the block cannot be less than a year (Trudu, 2008).

Article 62 of the law of 6 August 2008, no. 133 has also provided the ban for local authorities to get themselves into debt with contracts without providing the modality of reimbursement through instalments of comprehensive amortization of capitals and interests. Finally, it establishes that the duration of the amortization plans cannot be more than 30 years, therein including possible operations of refinancing or admissible renegotiation by law. However, for the period of a year since this decree came into effect (Paladino, 2008), article 62 also intervenes on the question of bonds, sanctioning the ban for local authorities on emitting bonds or other liabilities with reimbursement of capital in a single payment from the expiration, in fact, revoking the possibility to emit bullets. Regarding to the last paragraph of article 62, it provided that the possible premium of liquid assets (up front) collected at the underwriting of the contracts in derivative instruments is to be considered debt. The up front is non other than an early deposit of funds that deducts the discounting back on relative contractual rates or have repercussions on the value of the spread.

Even thought it is incorporated with IRS operations, it deals with an analogous transaction to the contracting of a loan, where its early payment is matched to a mechanism of discounting back that imposes the payment of an interest. In conclusion, it is stated that up front liquidation must be considered as a form of appeal to the financial market that asks for the respect of the same conditions and constraints established for each form of appeal to the debt among those impossibilities of intending it to sustain current expenses (Mazzini, 2008).

With the *Financial Law 2009* comes the reformulation of article 62 of the law 6 August, 2008, no. 133, "restraint in the use of derivative instruments and the debt of the regions and of the local authorities". The rewriting of article 62 of legislative decree 112 in 2008 provided that, until the date of enactment of the regulation of the Ministry of Economy on derivatives and at any rate at minimum for a year since the Legislative Decree 112 in 2008 came into effect, it is forbidden to stipulate contracts that is relative to derivative instruments.

Substantially, the ban of stipulating contracts of financial derivatives was extended by six months (for all of 2009). At the same time, with the aim of maintaining the correspondence between the renegotiated liability and the connected covered transaction, the possibility to restructure initial contracts was given to the local authorities. It will be the Ministry of Economy consulted by Bankitalia and Consob, to identify with one or more regulations, the typology of the contracts relative to financial derivatives that the authorities can complete. The Ministry of the Treasury must still indicate the derivative components (implicit or explicit) that the same authorities have the option of providing for in financing contracts (Marina, 2009).

In order to ensure the maximum transparency of relative contracts to financial derivatives instruments, let alone the relative clauses to the aforesaid derivative components, the same regulation likewise identifies the information, rendered in Italian, and the same must include.

6. Conclusion

The “derivative bubble”, better known as a swap, now seems exploded in the Italian system of local autonomies. The attention is geared both towards the banking system, which is considered too unscrupulously, and towards the territorial institutions, which are excessively ingenious in closing operations with high risk, whose negative effects are put off to the future.

The substantial absence of rules and the lack of practice of the ministerial powers of coordination, have allowed the development of strategies of “financial survival” from the part of the administrators of some institutions (often of small dimensions) crushed by the growth, and unbearable sometimes, of a traditional debt. They have often used derivative instruments, not to cover risks of interest or exchange, but rather to pursue objectives of a speculative nature, that is, to “make cash” without being aware or considering the impact on future risks.

Over time, the appeal of complex financial operations has caused a sort of imbalance towards the short period, about the functions-objectives of the local administrators. The local administrations have underwritten financial contracts that have permitted the obtainment of liquids immediately (up-front), or moving up the debt expiry, or at any rate, restructuring the debt cash flows, alleviating their immediate outputs. These operations, presenting these characteristics, have been easily underwritten by the local administrations, but ignoring, thought, the effects in the medium-long period.

To protect local administrations, the Ministry of Economy and Finance, with an understanding of the Bank of Italy and the Consob’s interference (article 62 of *Decreed Law* 112 in 2008), is asking for a restraint to the possibility of turning to, on the part of the territorial institutions, the use of derivatives, until the same Ministry had not passed a regulation that singles out the typology of contracts that the region and the local authorities can stipulate, as well as the criteria and conditions to carry out the various operations. The aim of such a legislative intervention was to arrange measures that attempt to put a brake on the resort of such instruments from the part of the local authorities in the moment of their use, at times with solutions characterized by complexity, finality and profiles of risks, but not consistent with the law in place and with the peculiarity of the local public administrations at all.

Finally, the *Finance Law* of 2009, article 62 of *Decreed Law* 112 in 2008 was rewritten, extending the ban of stipulating a derived finance contract by six months. Contemporaneously, local authorities were given the possibility to re-structure initial contracts, with the means of maintaining a correspondence between the renegotiated liability and the connected cover operations.

It is evident about how the dispositions cited tend to create a system of control at the root of the access procedure of the local authorities to the financial market, which limits the creative capacity of financial engineering and serves to demonstrate a real comprehension of the contents of the underwritten contracts.

References:

Astegiano G.. (2008). *Territorial institutions and derivative financial instruments: Margins of benefits and risks*. Rimini: Azienditalia.

Atelli M.. (2008). Instruments of financial derivatives. Milano, *II Sole 24 Ore.*

Atripaldi V. & Bifullo R.. (2001). *Fiscal and constitutional federalism*. Torino: Giappichelli.

Bellesia M.. (2008). *The accounting of swap contracts in local authorities*. Milano: Azienditalia.

Boccia F. & Nigro M.. (2000). Innovative financing, Boc, Bop, Bor, swaps and mortgages: Costs and opportunities to not err in investments. Milano, *II Sole 24 Ore.*

Bonelli E.. (2001). *Local government, subsidiarity and fiscal federalism*. Torino: Giappichelli.

Bozza E.. (2007). *The novelty of material of financial derivatives and reflections on the stability pact 2007-2009*. Rimini: Azienditalia.

Corte dei conti. (2008). Regional monitoring section for Lombard, derivative operations: The Corte dei Conti states rules to avoid excessive risks. Rimini, *Rivista guida agli enti locali.*

De Dominicis F.. (2008). Municipalities exploited by banks and advisers. *Milano, Quotidiano libero Mercato.*

D'Auro A.. (2002). Fiscal federalism after the referendum of approval of the text of the Constitutional law on amendments to title V of part II of the Constitution. Milano, *La Finanza locale.*

Di Biasi F.. (2007). *Financing local authorities: Innovative, facilitated and project financing*. Napoli, Sistemi Editoriali.

Fontana F. & Rossi M.. (2007). Derivatives, the rules to not find yourself overwhelmed. Milano, *II Sole 24 Ore.*

Fontana F. & Rossi M.. (2007). Derivatives, contracts to manage with care. Milano, *Guida agli Enti Locali.*

Formez. (2007). *Innovative finance in local authorities: An investigation on derivative instruments*. Roma.

Francaviglia R.. (2008). *Derivative instruments and local authorities: Checks and responsibilities*. Torriana (RN) EDK Editore.

Guerrieri G.. (2003). Federalism and the tributary system. Milano, *Finanza Locale*

Marina L.. (2008). *Financing 2009: Stopping municipalities from stipulating new derivative contracts but with the possibility of renegotiating old swaps*. Retrieved from http:// www.comunicati-stampa.net.

Marotta G.. (2006). Investigation in the use of derivative instruments: The reports of the Corte dei Conti. Rimini, *La Finanza Locale.*

Mazzini F.. (2008). The brakes on derivatives arrives from far for local authorities. Milano, *II Sole 24 Ore.*

Meneguzzo M.. (2003). *Manual of innovative financing for public administrations*. Soveria Mannelli (CZ): Rubbettino.

Nigro M.. (2007). Swaps and the market, a tutor for local authorities. Milano, *II Sole 24 Ore.*

Paladino A. G.. (2008). Derivatives prohibited to local authorities. Milano, *Italia Oggi.*

Piscino E.. (2004). Innovative finance: The ministerial regulation. Rimini, *La Finanza Locale.*

Trudu M.. (2005). *Instruments of innovative financing for local authorities.* Milano: Ipsoa.

Trudu M.. (2007). The local authority as a qualified operator in financial derivative contracts on the part of local authorities. Milano, *La Finanza Locale.*

Trudu M.. (2008). *New rules for the use of financial derivative instruments in local authorities*. Rimini: Azienditalia.

Trudu M.. (2008). *Financial derivative instruments in the guidelines of the Corte dei Conti*. Rimini: Azienditalia.

Valensise P. & Brunetti F.. (2002). Finance 2000: Swap contracts, local and intermediary finance. Rimini, *La Finanza Locale.*

Vandelli L.. (2004). The system of local autonomies. Bologna: *il Mulino.*

(Edited by Ruby and Chris)