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Close

An exposed position

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By Vincent Boland, Guy Dinmore, Rachel Sanderson and Gillian Tett
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Baschi, an Italian hilltop village, is a long way from the City of London. Getting there is difficult: take a flight to Rome, then the mainline train to Orvieto followed by a slow train through Umbria. Yet in her office near the central square, Antonietta Dominici, the local treasurer, is wrestling with the kind of decision more commonly taken by the risk officer of a London investment bank.

She can either keep open a €2.5m derivative deal that casts a shadow over the financial health of Baschi's 2,800 inhabitants - or she can close it, with the risk that the resulting losses will leave the schools, the offices and the medieval church containing a precious triptych by Giovanni di Paolo without electricity for a year.

Ms Dominici, who never learnt about derivatives at university, is opting for a third route. She has filed a lawsuit against the bank that sold the derivative. "We just want the contract closed, the losses forgotten. Derivatives should be banned," she says.

The story of how one village in particular - and Italian local authorities in general - ended up so high on derivatives that a former finance minister compared them to junkies is pertinent as scrutiny focuses on the use of complex financial instruments by states.

In recent weeks, there has been outrage among European politicians about Goldman Sachs' sale of derivatives contracts to Greece, which helped to flatter its debt profile. Now it is becoming clear that this was not an entirely isolated case. During the past decade, investment banks have sold complex derivatives to state authorities across the Continent, in countries such as Austria, Belgium and Portugal either with the aim of flattering their balance sheets or on the promise of high returns.

While the deals struck in Italy are not exactly the same as those between Greece and Goldman Sachs, the country stands out among its European neighbours because its local governments have been particularly enthusiastic in their demand for derivatives.

According to a leading Italian academic, the main difference between the two situations is that: "In Italy, the liabilities are scattered across the whole country, making it more difficult to see a clear picture."

Between 2001 and 2008, 525 Italian local authorities entered into almost 1,000 interest rate swaps with an aggregate value of €35bn, according to Italy's audit office and the central bank. This equates to almost one third of all of the debt owed by Italy's regions, provinces and municipalities.

Local authorities were attracted to the swaps because they saw them as an opportunity to borrow at rates lower than prevailing market rates. They would swap their existing fixed-rate lending for a variable rate with the investment banks. In a period of low rates, when many of the deals were struck, this meant local authorities on a variable rate could find their borrowing costs shrank. However, as interest rates rose, local authorities would find themselves on the losing side of their bet with the banks as the amount they owed increased.

Scores of these deals are now turning sour, dragging Italian banks such as BNL and global institutions such as Merrill Lynch, UBS, Deutsche Bank and JPMorgan, into court.

This is embarrassing for Italy, as the state is widely considered to have failed to control the deals involving cities as large as Milan to a tiny Order of Capuchin Friars near Genoa.

It is also extremely embarrassing for investment banks. Investigations by Italy's finance police have led to raids, the seizure of assets and bankers being named in criminal cases. One prosecutor in south Italy has asked that Merrill Lynch be banned from doing business with municipalities for two years.

The scandal also raises bigger questions about the ethics of the financial industry in relation to complex products. In recent years, most bankers assumed they were allowed to sell anything they wanted to non-retail clients, since it was presumed that "sophisticated" investors would be able to protect their own interests.

However, what has become clear in Italy is that many public sector clients were unable to understand the maths of complex finance risks. This is likely to force investment banks to rethink their definition of "sophisticated" clients; it

could also encourage politicians in Europe and elsewhere to clamp down much more aggressively on the entire derivatives trade. The example of the UK is instructive. Here, the market for selling derivatives products to local authorities closed in the early 1990s, when the House of Lords held that interest rate swap contracts entered into by the London council of Hammersmith and Fulham were null and void, and legally unenforceable.

In Italy, until the 1990s, local authoritiesborrowed, at fixed rates, mainly from the Cassa dei Depositi e Prestiti, a state institution. Legislation was then introduced to allow them to borrow at floating rates. Meanwhile, the central government, burdened by the world's third-largest debt, started to cut funding - putting the onus on the regions to find alternative access to cash.

In a well meaning attempt to enforce fiscal discipline, the government also passed a law requiring the creation of "sinking funds" into which a set amount of principal is repaid each year, similar to domestic amortising mortgages. So a council that borrows €1m is required to pay back not only the interest accrued yearly but also to set aside a portion of the balance of the loan in a separate account. In the early 2000s, these sinking funds were invested mostly in securities such as Italian state bonds. This was in part because the funds - run by teachers and priests as often as by business professionals - preferred a lower risk profile.

Over time, however, local authorities found themselves inundated with approaches from investment banks offering inducements and schemes for managing debt. The first came from Italian houses - in the case of Baschi, it was a salesman from BNL, a Roman bank now owned by BNP Paribas, who arrived in early 2004. (BNL did not respond to requests for comment.) He offered a two-year interest rate swap from fixed rates to variable rates to better manage the village's €2m debt, says Ms Dominici. In a benign interest rate environment, this worked well for Baschi.

However, the structure of deals became increasingly complex. More importantly, the London offices of the major international investment banks jumped into the fray, lured by a new source of derivatives demand and the hope of fat fees. The roll call of those involved included Merrill Lynch, Deutsche, UBS, JPMorgan, Nomura International and Dexia of Belgium.

The more complex the deals became the less the local understood them, claim several lawsuits against the banks. Derivatives specialists and some political sources dispute this and say local politicians chose to ignore the risks because of the potential gains. Domenico Siniscalco, finance minister, warned back in 2004 that local authorities were using derivatives "like hard drugs". In 2006, for example, Baschi was persuaded to undertake a more complicated restructuring of its debt. The swap's value rose to €2.5m; the maturity extended to 2034; and a sinking fund was established. The bank structured the deal so that the village received an "upfront" payment of €25,000 - in effect an advance on its loan. In return for the "upfront", rates would be tougher in the longer term.

Soon after Baschi restructured its swap, things turned sour as eurozone interest rates rose, eventually to a high of 4.25 per cent in the middle of 2008. Baschi's mark-to-market losses reached €250,000, says Ms Dominici.

Ms Dominici does not know what assets are in the sinking fund or why the swap is still carrying losses - currently about €90,000 - in a low-interest rate environment. She says attempts to get information from BNL on this have proved unsuccessful. BNL would not comment.

It was the "upfront" that caused many local authorities to get high on derivatives, say experts. In the revolving-door world of Italian local politics, each new administration wanted its own "upfront", so asked their bankers to restructure the deal to release more cash in advance. The terms of the swap tended to become more restrictive each time.

Some banks covered the cost of the "upfront" fee by pricing the interest rate swap more aggressively, so that only in unusual circumstances would the entity receive more each period than it paid out, say people familiar with the deals. In other cases, upper and lower limits on the movement of interest rates ensured the upside for the local authorities was reduced and downside risks were magnified.

In 2006, Taranto, one of the largest cities in south Italy, defaulted with an extensive exposure to derivatives. A few months later, in separate allegations related to a whistleblowing case in London, Piero Burragato claimed Nomura, his former employer, had levied illegally high fees and violated disclosure requirements in a €200m deal for Liguria's regional government. The employee tribunal dismissed Mr Burragato's whistleblower case. However, his comments raised alarm in Italy. Nomura has declined to comment.

Derivatives specialist Marco Elser, director of AdviCorp, says contracts continued to grow increasingly complex up until 2008.

Some local entities lost money not only on the swap element of the transactions and the structuring of upfront payments but also in the operation of the sinking fund, the very device supposed to instil budgetary rigour.

In some cases the sinking funds, under management by the very investment banks that had structured the swaps,

crashed in value as they were invested in riskier assets than Italian sovereign debt. An Italian Treasury source says Greek debt has been found in some funds. Other funds held Telecom Italia debt, sovereign debt from emerging economies and even bonds from other Italian regions that had already started to default because of their derivatives exposure, say advisers. The state banned local authorities from entering derivatives transactions in 2008.

Then, the same year, the municipality of Milan lodged a legal case accusing banks that in 2005 underwrote a €1.8bn bond and swap financing transaction - Deutsche, JPMorgan, UBS and Depfa, a German state funding institution - of making €100m profit at the city's expense. In a parallel criminal case, bankers, including Gaetano Bassolino of UBS, the son of a Naples politician Antonio Bassolino, were accused of aggravated fraud. The banks declined to comment.

The dispute relating to the Milan transaction is considered a test case. Questions remain as to who will pick up the tab for the losses. The Treasury has distanced itself from the disputes and says the losses do not present a macroeconomic problem. Giulio Tremonti, finance minister, calls the impact "very limited".

The Bank of Italy estimates losses of about €1bn on the basis of the swaps alone, as it admits it has no estimate for losses from the sinking funds. Senior Italian bankers say total losses, including sinking funds, could reach €10bn. Mario Ristuccia, chief prosecutor of Italy's administrative court, last month said derivatives losses could "wring sacrifices from future generations for 20 or 30 years".

In Baschi, Ms Dominici is angry and ready to fight, having filed a suit in the local town, Orvieto. "Derivatives must be banned - anywhere, everywhere - for all local authorities," she says, adding that she hopes her case will send a "message" to governments. Bankers across Europe would do well to listen - and watch.

Additional reporting by Vincent Boland

Interest rate swaps

How investment banks got Italy's local authorities hooked on derivatives

Italian and international investment banks structured a variety of derivatives for local authorities, particularly during the period from 2001-2008, *writes Rachel Sanderson* .

The most common was the interest rate swap, which in the case of the larger entities was often coupled with a bond issue. The local authority would pay, on a monthly or quarterly basis, an amount of interest on either a fixed or floating rate basis. In return they received floating or fixed rate amounts (which could be used to pay interest on the bond issue, if any). By doing this local authorities hoped to get lower interest rates and cut their borrowing costs. Whether they did so mostly depended on movements in eurozone interest rates.

According to Italian Treasury sources and those advising the authorities, the majority of these deals were on fair commercial terms. However, advisers say that in some cases the pricing of the swaps was modelled in such a way that the authority would lose money in almost any economic environment and would have to pay significant amounts to unwind the transaction.

Upper and lower limits on interest rate movements - "caps" and "floors" - were set so as to minimise the risk for the bank. For example, even if interest rates fell below the percentage identified as the "floor", the entity would still be required to pay interest calculated at the "floor" percentage. Upfront payments, effectively a cash advance, could be incorporated into a transaction to benefit the town or city at the start of a deal, but in return they would usually have to pay higher rates in the longer term, which could cause losses to add up. Banks could also restructure swaps to extend their maturity. Like a personal loan this would have the effect of reducing outgoing payments in the short term but those payments would run for much longer and the final sum would often be higher.

Local authorities could also lose out through a structure involving the management of the entity's sinking fund by an arranging investment bank. According to Treasury sources and advisers, money set aside to cover future payments was in some cases re-invested in risky assets by the investment bank acting as a fund manager. The bank could also charge a management fee and where assets in the fund delivered in excess of a set yield, could take the excess as further revenue.

Swap till you drop

Domenico Siniscalco (right) was one of the first Italian officials to ring alarm bells about the sale of derivatives to local authorities. On March 24 2004 Prof Siniscalco, then finance minister, told parliament that derivatives "sometimes resembled hard drugs" in the way they were used by local authorities. Now a senior banker at Morgan Stanley and president-elect of the Italian fund managers' association, he said that even he had trouble sometimes "reading and understanding the contracts".

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