Collection of Research Papers in Conjunction with the 6th International Scientific Conference of the Faculty of Law of the University of Latvia

Constitutional Values in Contemporary Legal Space II

16–17 November, 2016

LATVIJAS UNIVERSITATE
ANNO 1919
UNIVERSITY OF LATVIA

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University of Latvia Press

This publication presents the second collection of research papers in conjunction with the 6th International Scientific Conference of the Faculty of Law of the University of Latvia "Constitutional Values in Contemporary Legal Space", Riga, 16–17 November, 2016, 294 pages.

Conference proceedings are supported by JSC "Latvijas Gāze".

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All contributions have been double-blind peer reviewed.
Layout: Andra Liepina
English language editor: Andra Damberga

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ISBN 978-9934-18-230-3

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LOCAL AUTHORITIES, CREDIT DERIVATIVES AND ART. 117, 119 OF THE ITALIAN CONSTITUTION

Summary

Financial derivatives are the most complex instruments conceived by financial engineering. In the past forty years, an increasing number of local governments – on both sides of the Atlantic – entered into derivatives transactions, such as the swap contracts, to lower expected borrowing costs. In the USA, Germany, France, Italy and other EU countries, derivative contracts were written in ways that obscured the underlying economics, generating huge losses, which created large problems in local governments. In Italy, the introduction, during the 1990s, of fiscal austerity and market-oriented reforms, in line with the EMU and the Stability and Growth Pact, and the devolution of fiscal and administrative authority, caused a reduction of fund transfers from the central state to local government level. The process of decentralization granted local authorities a greater autonomy in the administration of their finances and the possibility to use bonds and derivatives. The recurring, inappropriate use of derivatives by banks and intermediaries (for speculative rather than for hedging purposes), the passive role of unsophisticated municipalities – interesting that the Milan Court of Appeal ruled in 2014 to subvert the first degree sentence, which found several managers, officers and banks guilty – and the need to prevent them from postponing the financial burden of debt forward in time, has driven the Italian Parliament to restrict derivative transactions, firstly, limiting the scope only to debt restructuring, and eventually – by prohibiting new transactions to local governments. In the light on the last section of Art. 119 and Art. 117 (lett. e), the Constitutional Court (Decision No. 52/2010) declared that the law was constitutionally legitimate.

Keywords: Italian local authorities, credit derivatives, interest rate swaps, complexity, opacity, improper use, Milan derivatives misselling, Italian Stability Law of 2014, Constitutional Court Sentence of 2010, savings and financial markets (Art. 117), power to indebt (Art. 119), risky investment, exclusive competence of central government.

1. Credit derivatives and local authorities

Derivatives are contracts between counterparties to take certain actions based on the performance of some other, underlying security. They are complex financial contracts, in which one party pays another party, if 'something' should happen in the future. The "something" that can be quantified and verified, becomes the basis of a derivative contract. In particular, credit derivatives are financial instruments, whose payoffs are linked, in some way, to a change in credit quality of an issuer or issuers.

The derivatives market is the world's largest market, but is still relatively regulated. It has grown from virtually nothing two decades ago to the range of $630 trillion of notional amount of outstanding contracts in 2014. The largely unregulated credit derivates market has been cited as a cause of the collapse of the housing market

and resulting credit crunch, which has caused harm to the economy and the lives of millions by destroying trillions of dollars in global wealth. Commentators have judged credit derivatives good or evil: some have praised them for enabling banks to hedge credit risks, while others have warned of hidden dangers and systemic risks. Institutions have both saved and lost fortunes using credit derivatives.

In 2007, Frank Partnoy and David Skeel[1] noted that until a decade before the transfer and pricing of credit was straightforward. The typical credit relationship was between an individual or corporate manager and the lending officer of a bank, and the typical credit instrument was a loan.

In 2011 Lynn Stout,[2] investigating the origins of the 2008 financial crisis, defined derivative contracts as probabilistic bets on future events. They can be used to hedge, which reduces risk, but they also provide attractive vehicles for speculation that increases risk. But the hedging inevitably implies complexity. As Stephen Schwarcz[3] wrote in the wake of the crisis: "Complexity in financial markets does not necessarily arise for complexity's sake, nor from a desire to obfuscate. Rather, it arises in response to demand by investors for securities that meet their investment criteria and their appetite for ever higher yields, in order to facilitate the transfer and trading of risk to those who prefer to hold it, promoting efficiency". And this is one of the main goals of a financial derivative.

Both in the US and Europe[4] local governments used interest rate swaps to convert interest rate basis from floating to fixed or fixed to floating. An interest rate swap (IRS) is a sophisticated complex financial instrument that only experts with an access to market data and appropriate training and experience can truly understand, price and analyse. It is an agreement between two parties to exchange one stream of interest payments for another over a set period of time.

Local governments were particularly keen on using interest rate swaps to convert interest rate basis to manage liabilities, and (ideally) enable issuers to lower their costs of borrowing. IRS were typically used to optimize the costs by restructuring the debt position. Such debt restructuring aimed to save part of financial resources that were previously used to service debt, therefore generating greater liquidity in a municipal budget.

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1 The promise and perils of credit derivatives. Available at http://ssrn.com/abstract=929747 [last viewed October 30, 2015]. Individuals, small businesses, and large public corporations used credit instruments that were virtually identical in form and substance. Today, these practices continue for many individuals and small businesses. But for most public companies, the credit markets are no longer so simple. The typical credit relationship today is between sophisticated risk managers. Companies increasingly turn to hybrid instruments and derivatives in their financings.

2 Derivatives and the legal origins of 2008 credit crisis. Harvard Business Law Review, 2011, Vol. 1, p. 1.

3 Regulating Complexity in Financial Markets, Wash. U. L. Rev. 2009, Vol. 87, p. 211. Schwarcz believes that "Complexity is the greatest challenge to 21st Century financial regulation, having the potential to impair markets and investments in several interrelated ways. [....] Complexity impairs disclosure; it obscures the ability of market participants to see and judge consequences; and it makes financial markets more inclined to financial contagion and also more inclined to fraud".

4 Dodd R., Municipal bombs, Financial & Development, 2010, p. 33; Geckler P. M., Municipal derivatives use and the suitability doctrine, Wash. U.J. Urb. & Contemp. L., 1996, v. 49, p. 285.

Interest rate swaps are traded over the counter. The lack of a formal trading system for these derivatives can increase counterparty risk – essentially, an information failure caused by lack of transparency as to counterparty financial condition.

Many supposedly sound transactions were riskier than local governments believed. Deals usually involved unsophisticated local governments using derivatives traded between two parties, rather than on an organized exchange or through a central clearing counterparty. From the Mediterranean to the Pacific coast of the U.S., officials in government, public agencies, and non-profit institutions lost billions of dollars because of transactions they did not grasp.

In 2013, Harvard University lost 345.3 million USD, terminating interest-rate swaps, bringing its cost of unwinding debt derivatives since 2008 to more than 1.25 billion USD. Jefferson County, Alabama, went bankrupt in 2011 because of interest rate swaps it bought to hedge a portfolio of variable-rate bonds. Swaps and other complex, unregulated derivatives can become what Warren Buffett famously called "financial weapons of mass destruction".

2. The Italian local authorities

In Italy, the introduction of fiscal austerity and market-oriented reforms during the 1990s, in line with the EMU and the Stability and Growth Pact, as well as the devolution of fiscal and administrative authority, caused a reduction of fund transfers from the central state to local government level. The process of decentralization granted local authorities a greater autonomy in the administration of their finances and the possibility to use bonds and derivatives.[5]

The use of derivatives by Italian local authorities – regions, provinces and cities – dates back to 1994 with the termination – by Law No. 724 of 23 December 1994 – of the obligation for them to access to credit through the public body of *Cassa Depositi e Prestiti*. The law granted provinces and municipalities the right to issue bonds in order to finance their investments. Local authorities were attracted to the interest rate 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 this meant that local authorities could find their borrowing costs shrunk. 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.

In other words, hundreds of local governments, which had entered opaque and risky derivatives deals that turned sour, got locked into deals – and future payments – that they had scarcely understood or expected.

The number of local authorities using derivative instruments, almost always interest rate swaps, grew from 349 to 669 between the end of 2005 and the end of

[5] Capriglione F., The Use of 'Derivatives' by Italian Local Authorities in Public Finance Management. Still an Issue. Available at https://ssrn.com/abstract=2392709 or http://dx.doi.org/10.2139/ssrn.2392709 [last viewed March 8, 2017].

2007, before falling to 474 at the end of 2008. At the beginning of 2009 the local entities using them with counterparties operating in Italy numbered 496, including 13 regions, 28 provinces and 440 municipalities. The national value grew rapidly, rising from about 0.1 billion EUR at the end of 2000 to about 33 billion EUR at the end of 2006.

The negative market values, which approximate the amount local authorities would have to pay to the intermediaries, if the outstanding operations closed at the reporting date, grew from about 2 million EUR at the end of 2000 to nearly 1.1 billion EUR in 2009. The largest exposure was that of the municipalities (0.6 billion EUR), followed by the regions (0.4 billion EUR) and the provinces (0.1 billion EUR).

There were three main problems with local governments' use of financial derivatives:

1. The great complexity of the contracts;
2. Their accounting opacity (the future obligations do not appear in the governments' accounts);
3. The possibility of improper use (for instance, to obtain liquidity).

However, the lesson learned in Italy was that many local governments were unable to understand the maths of complex finance risks. The lack of information affecting the local authorities (due to the asymmetries notoriously characterizing the markets' operations) prevented them from acquiring the knowledge necessary to carry out activities qualified by sophisticated technicalities, with the result of performing them in the ways that were not in line with the regulatory provisions adopted to protect the public interest. Furthermore, in those years, the interpretations of the Italian law turned out in a series of violations – the spending power of local governments was virtually unlimited and budget deficits and extra-budget liabilities were generated, which led to the misuse of derivatives for obtaining immediate resources in exchange of larger debt burdens in the future.

Only in 2007 the Stability Law laid down an obligation for local authorities to submit all the underwritten contracts to the Department of Treasury, so that preventive control measures could be taken prior to the conclusion of said contracts.

In 2008, the Stability Law established rules providing the duty of a note to the accounts, in which budget commitments and obligations were reported. For the first time, these operations were entered into the accounts, indicating the mark-to-market value, the inflows and outflows generated from the transaction date, the projected cash flows for the next three years, and a report on the operation performance.

3. The Milan derivatives misselling

The case relates to a swap contract signed by the city of Milan council, when it issued a 1.68 billion EUR, 30-year bond in 2005, in order to restructure previous indebtedness. The city of Milan decided to enter, simultaneously, into a swap transaction with the banks, which acted as arrangers of the bond and as swap counterparties to the swap transactions. The Criminal Court held that the transaction

did not satisfy the "cost-effectiveness test" required by Art. 41 of the Law of 28 December 2001, No. 448 (the "Art. 41 Test"), which authorised public entities, upon satisfaction of certain conditions, to enter into swap transactions. It took the view that by entering into the swaps the banks had defrauded the city of Milan as they had concluded financial transactions in violation of the principle of *good faith*. Banks and managers were convicted. The trial was the first of its kind in Italy.

On June 3, 2014, the Appeal Court[6] upheld the verdict. According to the judges, city employees had been negligent, since they should have arranged an adequate professional structure (even through external resources) able to evaluate the overall consequences of the deal. They should not have completely relied on the information duties of the banks' officers. They could have recruited independent professionals in order to face the negotiations on an equal ground. Instead, the lack of knowledge and competence – inexcusable for a large municipality like Milan –induced to believe that the so-called initial implicit costs were absent, while in reality these costs were hidden and they implied a loss of about 52 million euro. Therefore, the convenience test was negligently erroneous.

The Court of Appeal heavily criticized the inadequacy and the unpreparedness of the City managers and officers. At one point of the 503 pages' sentence, judges wrote that, considering the *pecunia publica* they were managing, the civil servants should not have relied on the invisible hand of Adam Smith and should have been in no doubt that bank's job is profit making.

Following the case law of the Accounting Courts, the criminal judges passed a sentence that when the local government does not have an internal expertise in financial matters, it has to be counselled by independent and appropriate external consulting.

4. The civil settlement

The City of Milan, during the first degree suit, reached a settlement relating to the dispute with the banks. Under the terms of the 455 million EUR settlement deal, the banks would unwind the transactions and pay to the city the current mark-to-market of the swaps with a substantial discount. In exchange, the city agreed to release certain seized assets and drop claims for damages in the civil suit it had brought. The city also consented to withdraw as a plaintiff in the related criminal suit, although that case was continuing in the court. The banks did not admit any responsibility in connection with their fees as a part of the settlement.

[6] Danusso G. M., Il contenzioso sui derivati dopo la sentenza della Corte d'Appello di Milano, Riv. dir. impr., 2015, v. 1, p. 127.

5. The Italian Stability Law of 2014 and the end of the story

The Italian Stability Law of 2014 provided that Italian regions and local authorities:

(a) are permanently prohibited from entering into contracts relating to derivative financial instruments; and

(b) have to place new limits on their recourse to indebtedness.

In particular, they are prohibited from:

(a) entering into contracts relating to derivative financial instruments;

(b) re-negotiating existing derivative contracts;

(c) entering into financing contracts, which include components of derivative.

Conclusions

Actually, the principle of a deep contrast of Articles 117 and 119 of the Italian Constitution with the local authorities' power of entering in derivative contracts dates back to 2010, when the Constitutional Court ruled on a 2008 Law (d.l. No. 112/2008), which for the first time and temporarily prohibited such option. The Court (decision No. 52/2010[7]) declared that the law was constitutionally legitimate since, according to Art. 117 (lett. e), the central government has an exclusive competence "to protect savings and in matters of financial markets".

The court believed that the policy maker was correct when it temporarily banned the derivatives, considering the highly risky nature of such instruments, whose recourse could not be qualified as "investment" according to Art. 119, which gives local authorities an ordinary power to indebt, but no more than that.

Additionally, the court made clear that financial derivatives expose local authorities to market risks not initially computable and not easy to be forecasted at the time of the closing contract. Therefore, the state regulation aimed at protecting market and public savings, also making safe the finances of local authorities, considered local authorities as the weak part of the deal.

A convincing interpretation of the Italian Constitution which, recognizing implicit and great limits to local authorities (as history confirms based on many critical grounds), opted for a strict exclusion of their power to operate in financial matters.

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