Eurozone economy

Italy faces restructured derivatives hit

Guy Dinmore in Rome JUNE 25, 2013

Italy risks potential losses of billions of euros on derivatives contracts it restructured at the height of the eurozone crisis, according to a confidential report by the Rome Treasury that sheds more light on the financial tactics that enabled the debt-laden country to enter the euro in 1999.

A 29-page report by the Treasury, obtained by the Financial Times, details Italy's debt transactions and exposure in the first half of 2012, including the restructuring of eight derivatives contracts with foreign banks with a total notional value of €31.7bn.

While the report leaves out crucial details and appears intended not to give a full picture of Italy's potential losses, experts who examined it told the Financial Times the restructuring allowed the cash-strapped Treasury to stagger payments owed to foreign banks over a longer period but, in some cases, at more disadvantageous terms for Italy.

The report does not name the banks or give details of the original contracts – questions that worried the state auditors – but the experts said they appeared to date back to the period in the late 1990s. At that time, before and just after Italy entered the euro, Rome was flattering its accounts by taking upfront payments from banks in order to meet the deficit targets set by the EU for joining the first wave of 11 countries that adopted the euro in 1999.

Italy had a budget deficit of 7.7 per cent in 1995. By 1998, the crucial year for approval of its euro membership, this had been reduced to 2.7 per cent, by far the largest drop among the Euro 11. In the same period tax receipts increased marginally and government spending as a proportion of GDP fell only slightly.

The report was submitted, as required, early this year to the Corte dei Conti, Italy's state auditors. According to a senior government official, who declined to be named, the auditors were concerned by the numbers and requested the finance police to intervene.

In April police of the Guardia di Finanza visited the offices of Maria Cannata, head of the Treasury's debt management agency, asking for more information on the report drafted by the agency, including details of the original derivatives contracts, the senior official said.

The leaking of the 2012 Treasury report, which was also obtained by La Repubblica, the Italian newspaper, is likely to fuel debate over Italy's exposure to derivatives. It comes at a time when markets have begun to exhibit new nervousness with the cost of borrowing rising sharply recently for eurozone peripheral countries like Italy.

Only a handful of Italian officials, past and present, are aware of the full picture, according to bankers and government sources. The senior government official who spoke to the Financial Times and the experts consulted said the restructured contracts in the 2012 Treasury report included derivatives taken out when Italy was trying to meet tough financial criteria for the 1999 entry into the euro.

Mario Draghi, now head of the European Central Bank, was director-general of the Italian Treasury at the time, working with Vincenzo La Via, then head of the debt department, and Ms Cannata, then a senior official involved with debt and deficit accounting. Mr La Via left the Treasury in 2000 and returned as its director-general in May 2012 – with the backing of Mr Draghi, according to Italian officials.

An ECB spokesman declined to comment on the bank's knowledge of Italy's potential exposure to derivatives losses or on Mr Draghi's role in approving derivatives contracts in the 1990s before he joined Goldman Sachs International in 2002.

The report does not specify the potential losses Italy faces on the restructured contracts. But three independent experts consulted by the FT calculated the losses based on market prices on June 20 and concluded the Treasury was facing a potential loss at that moment of about €8bn, a surprisingly high figure based on a notional value of €31.7bn.

Italy does not disclose its total potential exposure to its derivatives trades. The experts contacted by the FT, who declined to be named, noted that the report revealed just a six-month snapshot on a limited number of restructured contracts.

Early last year Italy was prompted to reveal by regulatory filings made by Morgan Stanley that it had paid the US investment bank €2.57bn after the bank exercised a break clause on derivatives contracts involving interest rate swaps and swap options agreed with Italy in 1994.

An official report presented to parliament in March 2012 found that Morgan Stanley was the only counterparty to have such a break clause with Italy and disclosed, for the first time, that the Treasury held derivatives contracts to hedge some €160bn of debt, almost 10 per cent of state bonds in circulation.

The Bloomberg News agency calculated at the time, based on regulatory filings, that Italy had lost more than $31bn on its derivatives at then market values.

Releasing its own report in February on the state accounts for 2012, Salvatore Nottola, prosecutor-general of the Corte dei Conti, noted that “the damage done to the state’s income constituted by the negative outcomes of derivatives contracts is particularly critical and delicate”.

The Corte dei Conti declined to comment on the report and the finance police did not respond to inquiries. A finance ministry spokesman confirmed the existence of the report but declined to comment on its contents and possible losses, citing commercial confidentiality. He would not comment on requests made by the police to Ms Cannata.

Gustavo Piga, an Italian economics professor, caused a storm in 2001 when he obtained one such derivatives contract taken out in 1996 and accused EU countries of “window-dressing” their accounts. Mr Piga did not identify the country nor the bank involved but they have since been named in the media as Italy and JPMorgan.

“Derivatives are a very useful instrument,” Mr Piga wrote. “They just become bad if they’re used to window-dress accounts,” he said, accusing the unnamed country of disregarding standard derivatives contracts in order to delay until a later date its debt interest payments.

Last year Der Spiegel, a German magazine, obtained official documents which it said demonstrated that in 1998 Helmut Kohl, then chancellor, decided for political reasons to ignore warnings from his experts that Italy was believed to be “dressing” up its accounts and would not meet the Maastricht treaty criteria for entry, including a budget deficit less than 3 per cent.

Italian officials, including former finance minister Giulio Tremonti, have said the EU was aware and approved of Italy’s use of derivatives in the build-up to euro entry.

Greece followed suit two years later but irregularities in its accounts only became public in 2009. Bloomberg News lost a case before the EU General Court in 2012 when it used a freedom of information request to obtain files held by the ECB that Bloomberg said showed how Greece used derivatives to hide its debt. The Luxembourg-based court, in rejecting the case, said disclosure of the files “would have undermined the protection of the public interest so far as concerns the economic policy of the European Union and Greece”.

Additional reporting by Giulia Segreti in Rome