Novembre 2013

The derivatives contracts of italian local bodies

Luca Zamagni e Matteo Acciari, Axiis Network Legale

Why is it important to assess the Italian regulation on swap of local authorities?

We know that many Italian local entities have signed contracts on the International Swap Derivatives Association forms, derogating the Italian legislation and also the Italian jurisdiction in favor of the English Courts and, more rarely, of the Tribunal of New York.

However, the article 3 paragraph 3 of the Rome Convention, provides that: *"the fact that the parties have chosen a foreign law, whether or not accompanied by the choice of a foreign tribunal, shall not, where all the other elements relevant to the situation at the time of the choice are connected with one country only, prejudice the application of rules of the law at the country which cannot be derogated from by contract, hereinafter called mandatory rules"*.

This article of the Rome Convention is the way, for the Italian mandatory rules, to "enter" in the litigation in London.

Obviously we are speaking about mandatory provisions of Italian law, rules which do not admit exceptions. But it is easy to understand that, once you "open the door" to the Italian regulation, even the "lower" rules of Italian law (the so called *"regolamenti"*, *"circolari"* etc.) become very important, because they are essential for the correct interpretation of the general mandatory provisions.

On the other side, it is also important to assess the Italian case law concerning these matters.

There are general provisions concerning financial intermediation, which are contained in the T.U.F. ("Testo Unico della Finanza") and in Consob Regulations (the so called "Regolamenti Consob") and there are also many specific provisions regarding the derivative contracts of local authorities.

For the purpose of our speech, we will refer to some of the most important rules:

- Article 21 of the T.U.F., which statues that: *"in providing investment and non core services and activities, authorised intermediaries must: a) act diligently,*

fairly and transparently in the interests of customers and the integrity of the market";

- Article 23 of the T.U.F., which provides that: *"any clause which refers to usage for the determination of the fee payable by customers or any other amount charged to them shall be null. In such cases, nothing shall be payable"*;

- Article 41 of Italian Budget Law for the year 2002, which requires the local authorities to enter into derivative contracts only for the purpose of debt amortization (paragraph 1), having the effect of reducing the total value of the authority's financial obligations (paragraph 2, the so called "economic convenience").

One of the most frequent issue of the local authorities in the litigation concerns the disclosure of the costs related to the derivatives transactions and, as we'll see, the Italian case law solves this question interpreting the above mentioned rules.

Article 41 requires that the derivatives contracts of local authorities must achieve the purpose of amortization of the debt and, at the same time, the debt restructuring must ensure the requirement of the economic convenience.

Under Italian law, every contract must have a *"causa"*, which, as specified by Italian Court of Cassation, means a social and economic function.

So, on the proper interpretation of Article 41, the only legitimate *"causa"* of a derivatives contract made by a public authority is to reduce the total value of the authority's debt, including its associated derivative obligations.

Some important examples of Italian case law:

1. Court of Account, Regional section of Liguria, concerning the case of the Comune di Levanto, statues that: *"the ratio of the provisions that allow public access to the capital market and derivative transactions is to reduce the exposure of the financial risks relating to the trends of the interest rates, for the purpose to reduce the cost of the debt. Therefore, the interest rate swap transactions of the public authorities are permitted only if they satisfy those purposes and only if they are not speculative"* (Corte dei Conti, Sezione Regionale di controllo per la Liguria, deliberazione n. 11/2008):

2. Tribunal of Milan, regarding the case of the Comune di Ortona, statues that: *"the presence of a contractual disequilibrium removes from the contracts the function (id est the "causa") of merely conservative financial instrument"* (Tribunale civile di Milano, sentenza n. 5118/2012).

*

And now some considerations about Italian case law concerning the very important question of the costs related to derivative contracts of local authorities.

Three questions:

1. what is the actual cost of a derivative contract?
2. is the bank compelled to disclose the costs of the contract before its conclusion?
3. what is the moment for estimate the value of a swap: *ex ante* (at the time of stipulation) or *ex post* (at the end of the contract)?

1. What is the actual cost of a derivative contract?

The cost for Part A (the local body) is not equal to the profit that Part B (the bank) wants to obtain with the financial transaction.

In other words, if we calculate the cost of a derivative transaction considering only the possible profit of the counterparty, we probably underestimate the actual cost.

There is an interesting example suggested by Professor Francesco Corielli, financial expert in the criminal proceeding regarding the derivative contracts signed by the Comune of Milan: *"Saying that the cost of bread for the costumer is equal to the profit of the baker is not correct. Obviously, those who buy the bread pay much more than the profit of the baker: the cost of flour, the labour of the baker, etc.. In some cases, for example in case of special offers, the baker can sell bread at cost, not making a profit, but this does not make the bread for free"*[1].

In brief, all that is a cost for the bank cannot be subtracted from the costs for the costumers (companies or local authorities). For the customers "all costs are costs" (and for local authorities all costs must be considered in the assessment of the "economic convenience" requirement imposed by Article 41).

There are two important Italian rulings treating the issue of the actual costs in derivative transactions in an opposite way.

In a recent ruling concerning the derivatives of the Comune of Milan, the Tribunal of Milan follows the above mentioned principle "all costs are costs", without any distinction between hedging costs and profit for the bank (a distinction that we do not find in the same Article 41) and, on this basis, does not assume the evidence, in that case, of the "economic convenience" requirement (Tribunale penale di Milano, sentenza n. 13976/2012).

On the other side, in a famous ruling regarding the derivatives of the Province of Pisa, the Council of State introduces a model that allows adjustments to the fair value of the

[1] See at http://www.almaiura.it/pagina.aspx?a=284

derivative, "justifying" all the recharges of the costs of the bank on the local authority, assuming, in this way, the evidence of the "economic convenience" requirement (Consiglio di Stato, sentenza n. 5962/2012).

In that way, the Council of State says in our opinion that "the cost of bread is equal to the profit of the baker".

Almost all the costs "justified" by the Council of State are related to market usages and market practices, like, for example, the assessment of credit risk made only in favor of the bank, not considering the credit risk for the local body. But we have to remember what says Article 23 of the T.U.F.: *"any clause which refers to usage for the determination of the fee payable by customers or any other amount charged to them shall be null. In such cases, nothing shall be payable"*. So, according to Italian law, the Council of State makes a very serious mistake.

2. Is the bank compelled to disclose the costs of the contract before its conclusion?

We can answer to this question using the words of a recent ruling of the Tribunal of Orvieto: *"the initial negative market value of a derivative contract is a cost that the local authority have to bear and, regardless of what that cost represents for the bank (id est: hedging cost or profit), it must be adequately explained, having regard to Article 21 T.U.F. and to the general duty of fairness and good faith of the Italian civil code"* (Tribunale di Orvieto, ordinanza 13/04/2012)

In other words, an effective disclosure of the costs helps the competition between banks (Article 21 T.U.F. speaks also about *"integrity of the market"*) and, at the same time, solves the problems of the hidden costs, the profit of the bank etc.

3. The value of a swap: ex ante or ex post?

A recent ruling of Italian Court of Cassation specified that: *"in order to determine whether the value of the mark to market of the derivative contract of a local authority is a benefit or a damage for the local body, we have to make an ex post examination, when the contract has reached its end"* (Cassazione penale, sentenza n. 47421/2011[2]).

However, most of the Italian Courts disagree with this view, basing their rulings on a very simple argument.

As we have already seen, the most important thing for estimate the economic convenience in a derivative transaction of a local body is the cost of that transaction and the cost must be considered *ex ante* (id est at the time of stipulation), not *ex post* (id est at the end of the contract).

[2] See L. Zamagni e M. Acciari, *Convenienza economica e mark to market dei contratti derivati degli Enti locali: note critiche alla sentenza n. 47421 del 21/12/2011 della seconda Sezione penale della Corte di Cassazione*, in *Riv. dir. banc.*, dirittobancario.it, 11, 2012.

According to the Tribunal of Milan, *"the existence of positive or negative cash flow, no matter the sign, does not change the initial damage: without the initial mispricing in favor of the bank, flows would have been more positive or less negative"* (Tribunale penale di Milano, sentenza n. 13976/2012).

Recently, a very important ruling of the Court of Appeal of Milan stated that, applying the theory of rational bet to derivative contracts, the *ex ante* evaluation is the only right way to assess this kind of contracts (Corte d'Appello di Milano, sentenza n. 3459/2013)[3].

[3] See at http://www.dirittobancario.it/giurisprudenza/derivati/i-contratti-derivati-over-counter-sono-sempre-contratti-con-causa-di-scommes