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Hearing:

**Effects and measures of
surveillance for public finance
flows as affected by the debt
trend with particular reference
to the non-State component**

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“Fact-finding investigation on the effects and measures of surveillance for public finance flows as affected by the debt trend with particular reference to the non-State component”

1. Introduction

The need for coordination between central and local finance has intensified with the passage from a system of derivative finance, based on transfers from the State, to one of decentralized finance, in which it is necessary to assure local authorities of adequate margins of taxation-related and financial autonomy, within the limits, of course, of the overall equilibrium of public finance.

In order for this transition to take place smoothly, it is important that those criteria of transparency are respected that, in addition to meeting fundamental needs of openness with regard to all facets of public finance, induce self-discipline and efficiency in administrative matters.

In the course of my speech, I will illustrate the institutional and normative framework in which the debt of local authorities lies. I will then focus my remarks, in particular, on the instruments of coordination and surveillance at the hands of the Department of the Treasury, instruments put into effect by Article 41 of the financial law for 2002 and the relative decree of enactment. I will omit the in-depth details of a mostly technical nature, which are, however, presented in the written report that I will submit for the record.

2. The Italian public debt

In the definition that takes into account the public finance criteria monitored by the European Commission and by Eurostat, the public debt is the general government consolidated debt as defined in the ESA 95, the coordinated European System of Accounts. Said aggregate is articulated by the central government, local government, and social security funds.

The methodology approved by European community regulations prescribes that the aforementioned debt be both gross and consolidated: gross means that the debt exposure cannot be net of potential asset items in the balance sheet¹; the consolidation, on the other hand, implies that if a liability of a subject belonging to the general government is held by another public authority, the value of the total debt is consequently netted, given that what matters is the exposure to the private sector.

One of the principal characteristics of the Italian public debt has always been represented by the dominant role of the central government, as shown in the table below.

	Consolidated public debt	<i>of which:</i>	Central government	Local government (*)	Social security funds
1999 millions of €	1,279,548		1,246,418	32,995	135
% of GDP	115.5		112.5	3.0	0.0
% of debt	100.0		97.4	2.6	0.0
2000 millions of €	1,297,449		1,258,198	39,15	136
% of GDP	111.2		107.9	3.4	0.0
% of debt	100.0		98.3	3.0	0.0
2001 Millions of €	1,348,234		1,307,139	40,919	176
% of GDP	110.6		107.3	3.4	0.0
% of debt	100.0		97.0	3.0	0.0
2002 Millions of €	1,360,684		1,314,131	46,412	141
% of GDP	108.0		104.3	3.7	0.0
% of debt	100.0		96.6	3.4	0.0
2003 Millions of €	1,381,74		1,282,519	98,992	63
% of GDP	106.2		98.6	7.6	0.0
% of debt	100.0		92.8	7.2	0.0

(*) For 2003, the value includes loans to CDP SpA, in the amount of 47,490 million Euros, equal to 3.7% of GDP and 3.4% of public debt.

As you can see, the trend of the last few years shows a growth in the component of debt attributable to local authorities, resulting from their increasing financial autonomy,

¹ A balance sheet for the general government was completed, still provisional and unofficial, which however made it possible to arrive at an early quantification of the asset items in the balance sheet on 31/12/2002.

though not as marked as it could seem if one looks at the final figure for 2003, which reflects the transaction of the transformation of the Cassa Depositi e Prestiti into a corporation. In fact, the burden on the total of public debt went from 2.6% in 1999 to 7.2% in 2003. If, however, this figure is netted of the loans contracted by local authorities with the Cassa DP and still held by the latter after the privatization, the debt burden of the local government on total debt is limited to 3.8%.

The transformation and privatization of the Cassa DP produced in fact a total benefit on the general government debt along the lines of about 12 billion euros, modifying however the distribution between the debt of the local government, which increased as a result of the loans that are now a liability towards a subject outside the general government, and the debt of the central government, which decreased in a more-than-proportional measure as a result of the quota of interest-bearing postal bonds no longer chargeable against the general government, due to both the sale of stock quotas of ENI, ENEL and Poste SpA to the CDP SpA, and to the sale to banking foundations of a 30% participation in the CDP itself.

It is clear, however, that a growing role of autonomous financial activity on the part of local authorities will contribute in the coming years to a further increase in the component of debt attributable to this institutional sector.

It is important therefore that the criteria of market recourse be motivated by a principle of sensible management, directed at safeguarding the financial equilibrium both at the local level and within the general framework of public finance, so as to assure that prudent criteria and professionalism guide the management of the debt at all levels, without neglecting the differences that necessarily exist between the debt of the central government, whose bond market is third in the world, and the debt of a more modest local entity, such as a municipality, or even a region.

To highlight similarities and differences, I will illustrate separately the characteristics of the central government debt and that of the local authorities.

3. The debt of the central government

The debt of the central government is in large part made up of government bonds that, with 1,157,176 million euros at end-2003, represent 90% of central government debt (the residual 10% is made up in part, namely 4.5%, by interest-bearing postal bonds that still represent a debt of the State, in part by loans and by treasury checking accounts in the name of subjects outside the general government).

The government bond issuance and management, carried out by the Public Debt Office of the Department of the Treasury, is designated to guarantee coverage of the financial requirements of the State and the renewal of bonds at maturity in such a way as to attain, in the medium-long run, an optimal ratio between risk and financing cost.

The objective is foremost that of sustaining a low level of exposure to interest-rate risk; in the past decades, in fact, too often the composition of the stock of Government bonds has rendered the structure of the debt excessively sensitive to the negative effects of an unexpected rise in rates: for example, at the end of 1992 the quota of short-term bonds or variable-rate bonds represented more than 67% of the total, and the consequences of the financial crisis of that year had an impact along the lines of 20,000 billion of the old lire on the cost of interest (more or less 1.2% of GDP) and therefore on the deficit for 1993. The average life of Government bonds was at that time less than three years (2.96).

At the end of 2003, on the other hand, thanks to a policy of elongating the average life of the debt, which hit a historical high of 6.05 years, and of reshaping the composition of the stock in favor of fixed-rate financial instruments (the quota of short-term or variable-rate bonds has now been reduced to about 27% of the total), the sensitivity to fluctuation of rates has been drastically reduced and, at the same time, the refinancing risk is also being

reduced, connected as it is to the necessity to renew bonds at maturity, especially those with high frequency and amounts, in any market condition.

In the conducting of this policy to lower risks, the Treasury has at the same time limited costs, thanks to the possibility of offering from time to time the most convenient combination of instruments and maturities; such discretionality was in turn guaranteed by the possibility of being present in all segments of the market.

This faculty to choose is, all the same, a prerogative only of large issuers, who can guarantee an elevated liquidity (and therefore ample amounts in circulation) for all issues. There are few issuers, even sovereign, that can benefit from the advantages of diversification at this level: even the debt managers of many member States of the European Union had to select few instruments to offer on the market, thereby giving up the possibility to be present in all segments of the yield curve.

If these operational limits are valid, for example, for states such as Austria, Belgium, or Portugal, they are even more so for far-smaller local entities, which can issue, as we will see farther along, only toward specific ends and not, like the central government, for the financing of total expenditures.

This state of affairs is reflected, thus, even in the structure of the debt of the local authorities.

4. The debt of the local government

LOCAL GOVERNMENT DEBT

(millions of euro)

YEARS	DEBT STOCK IN BONDS	DEBT STOCK IN LOANS	TOTAL
1999	4,722	28,115	32,837
2000	7,204	31,766	38,970
2001	9,072	31,643	40,715
2002	14,505	31,906	46,411
2003 ⁽¹⁾	(17,869)	31,186	49,055

(Source: Bank of Italy)

- (1) The figure for 2003 should be integrated with the value of CDP loans equal to 47,490 million and with the value of securitizations equal to 2,447 million euros, for a total of 98,992 million.

The debt of the local authorities demonstrates a growing dynamic, which is the fruit of a process of decentralization and of conferral of a more vast managerial autonomy, which in turn translates into a greater responsibility on the part of the administrators. Such responsibility must guarantee both the preservation of the economic-financial equilibrium of the authorities themselves and the respect of obligations assumed by the State within the context of the European Union.

The growth of this component of general government debt is not, therefore, a source of worry, but rather an indication of institutional maturity, so long as the aforementioned principles of responsibility are followed.

Moving on to an analysis of the composition of the debt of local government, one notes a net predominance of loans over bonds.

At first glance, one justification for this phenomenon is essentially historical in nature: until 1996 the loan was practically the only form of borrowing available to local authorities; and even regions, which from 1970 were authorized to issue bonds, resorted principally to the more traditional channel of financing.

A second explanation lies then in the characteristics particular to loans, which make them more adaptable to the managerial needs of these authorities, in so far as the amortizing plans allow for the alteration of expenditures in a more flexible manner, distributing them over time with lesser rigidity than normally present in bond issues. Furthermore, since the local authorities can assume debt only through investment, in all those cases in which investment becomes productive over time, the structure of the installment payments of a loan is at least partially counterbalanced by the inflows guaranteed by the utilization of the good produced or the service provided.

Finally, the bond issues are really opportune only in the presence of a “critical mass” that guarantees their visibility in financial markets and gives them an acceptable level of liquidity. In the absence of this fundamental requirement, the nominal negotiability of the bond is, in practice, made useless by the difficulty to exchange it on the market.

Therefore, only the local authorities able to plan for notable investment expenditure enjoy real opportunities to benefit from a reduction of financing costs by resorting to the bond market.

5. The present regulatory framework.

The financial ordinance of the local government is formed by constitutional norms, laws, and regulations that outline a diverse profile of autonomy of the authorities themselves.

Let's see, then, how this ordinance relates to the theme at hand.

Concerning in particular the local authorities' system of financing by way of borrowing, all the authorities are primarily subject to the constitutional law of 18 October 2001, no. 3 establishing “Modifications to Title V of the Constitution”, which in the new text of Art. 119, first paragraph, among others, grants to local government financial autonomy with regard to inflows and expenditures, while in the last paragraph it elevates to the level of constitutional principle the limitation of borrowing of the authorities solely for investment purposes.

Even today the principles of the new constitutional order in financial matters established with the new article 119 have not yet been incorporated into the national judicial ordinance, as articles 117 and 118 were with the law of 5 June 2003, no. 131.

There was instituted, however, with the D.P.C.M. of 9 April 2003 a research Commission with the task of indicating to the Government the general principles of the coordination between public finance and the taxation system.

It should be recalled, however, that the law of 5 June 2003, no. 131 in regard to the coordination of public finance, established in Art. 7, paragraph 7, that the State Audit Court must verify conformity with budget balance on the part of the Municipalities, Provinces, Metropolitan Cities, and Regions, both in regard to the objectives of the Domestic Stability Pact and to the limitations deriving from the membership of Italy in the European Union.

In particular the regional Sections of the State Audit Court, I'm citing the law, *“verify, in observance of the collaborative nature of management supervision, the pursuit of the objectives established by state and regional laws in principle or in practice, according to the respective competence, as well as the healthy financial management of the local authorities and the functioning of internal supervision”* .

To underscore the need for the good functioning of this norm, the legislator inserted a successive paragraph in which it is established that the Regions, or – if they exist – the Councils of local autonomy of Municipalities, Provinces, and Metropolitan Cities, can request the collaboration of the regional supervisory sections of the State Audit Court to achieve regular financial management and efficient and effective administrative action

(fundamental constitutional principals established by Article 97), even in the form of opinions in matters of public accounting.

Moving on to a more specialized examination of the normative excursus at the basis of the qualification of so-called local authorities, it appears that among all these authorities, the Special Statute Regions enjoy certainly the greatest degree of autonomy, in so far as the constitutional nature of the respective Statutes grants them a broader discretionality with regard to the management of forms of financing.

For the Ordinary Regions, on the other hand, law no. 281 of 16 May 1970 is still in effect, establishing, in Art. 10, that the Regions can contract loans and issue bonds exclusively to cover investment expenditure within the limit of 25% of the total amount of taxation income not earmarked – that is to say, the income not designated for the carrying out of specific functions of the region.

The same Article 10 establishes then that the raising of loans be authorized in the regional budget law, which must indicate “*the burden of the transaction on single future financial exercises, as well as the means necessary for the coverage of the debt*”.

The conditions for bond issues must be deliberated by the Regional Council, “*subject to the agreement of the Interministerial Committee for Credit and Savings*”. This, then, creates for the regions an initial form of surveillance of the borrowing through recourse to the market, alongside that established in the Sole Banking Text, which with Art. 129 requires the consent of the Bank of Italy – meaning an official communication is necessary – for the issue of bonds in amounts greater than the old hundred billion lire.

Local authorities, in the strict sense of the words, are subject, furthermore, to the dispositions of the Legislative Decree of 18 August 2000 no. 267 (“Sole Text of the laws on the ordinance of Local Authorities” – TUEL), which in the Third Title, redefines the normative framework for the borrowing of local authorities, unifying the pre-existing normative, and establishes the conditions for recourse to the borrowing by the authorities themselves.

The borrowing is allowed exclusively for the realization of investments and carries with it the obligation to indicate in the budget the coverage of the debt deriving from the use of the borrowing and the coverage of management expenditures (Art. 203).

Article 204 of the Sole Text of the local authorities also establishes how the maximum amount financeable with the borrowing is to be determined annually: said amount must be equal to the measure of 25% of the total income of the first three income-budget titles of the authority, minus the total amount of interest of the pre-existing liabilities as well as the amount of the guarantees issued in favor of dependent or shareheld companies.

The TUEL also establishes a discipline of responsibility for administrators and managers of local authorities, as well as for their treasurers in relation to the objectives of the authority: Article 107 makes explicit reference to administrative correctness, to efficiency and to the results of the management; Article 148, then, recalls the norms of management supervision of the local authorities, subject to the State Audit Court and to the relative normative, while article 211 establishes that *“for possible damages caused to the entrusting authority or to third parties, the treasurer answers with all his own activities and his own property. The treasurer is responsible for all deposits, however constituted, in the name of the authority”*.

Regions and local authorities, from 1999, with the financial law, are subject to the surveillance introduced with the Internal Stability Pact by virtue of which the MEF (Department of General Accounting of the State) is attributed with the power to conduct such surveillance with reference to the cost and deficit values at aggregate level, relative to the Local Authorities and the Regions.

To those authorities that present to the MEF financial plans of progressive reduction of the debt-to-GDP ratio (projected over a timeframe of at least 5 years) the reimbursement before maturity of loans contracted with the Cassa Depositi e Prestiti is granted, without additional penalty, apart from that of the reimbursement of the residual debt. The Pact is reiterated year to year, establishing the objectives of reduction of the debt-to-GDP ratio for the local authorities.

Concerning the forms of financing by market recourse, the local authorities are subject to the norms of the law of 23 December 1994 no. 724 and the norms of the relative regulation of enactment D.M. no. 420 of 5 July 1996 which establish the detailed conditions

for bond issue by local and local authorities, introducing, for the issues in foreign currency, the obligation of hedging against interest-rate risk by way of swap transactions.

More in detail, Article 35, third paragraph, of the law 724/94 stipulates that the local authorities can issue bonds only in the presence of specific economic-financial conditions confirmed in the deliberation of issuance:

- the final account of the preceding penultimate exercise must not present administration deficits, and the budget forecast of the financial exercise to which the deliberation of the loan refers must have been approved;
- the interest on the loans contributes to constitute the annual borrowing limit that for local authorities is given to be of the measure of 25% of the total income of the first 3 income-budget titles (taxation income, income from conferrals and transfers of the State or the Regions, and extra-taxation income).

The D.M. 5 July 1996, no. 420, regulation of enactment of law no. 724, not applicable to the regions, in addition to the detailed norms for bond issuance and for the covering of bonds issued in foreign currency, establishes in Article 1, that the deliberation of issuance of the loan should verify the subsistence of the requirements for issue, while Article 6 stipulates that the organ of economic-financial revision of the authority should provide certification of the last statement of accounts of the management.

Art. 10 of the regulation, recapitulating the analogous prescription of Article 35, eighth paragraph of the law 724/94, establishes that the service of the loan should be guaranteed by the deposit with the Treasurer of delegations of payment on behalf of the authority. Said delegations, in accordance with Art. 207 of the TUEL are not subject to the acceptance of the treasurer and constitute executive orders. The delegation of payment works on the income of the first three budget titles of the authority.

Such a form of guarantee does not, however, seem adequate to cover the authorities effectively in cases of *default* that could take place with respect to bonds contracted on the market.

Such transactions, in fact, if carried out in foreign markets, are regulated in most cases by English law and follow the rules established for specific types of contracts (ISDA

contracts, rules of *default* or *cross-default* on issues of Global or Euro Medium-Term Notes, etc.), if they consist, on the other hand, of domestic transactions they are conducted under Italian law and the rules of the civil code and those of the bankruptcy law prevail to the extent applicable in the case of the local authorities.

Thinking, therefore, of integrative normative instruments, we could consider, among others, the hypothesis of regulating more attentively all matters of guarantees, taking into consideration that no form of guarantee on the part of the State is foreseen, nor does it have to be.

To this end, it should be taken into account that the possible omission of one or more payments, bearing with it the acceleration of all the outstanding payments (which is what happens in the case of *cross-default*) or of the single outstanding payment mentioned (*default*) could have relevant effects on the budget of the authorities, and this despite the provision of possible "grace periods" that allow for an extension of the payment period, within a timeframe contractually established, of the payment not made at the due date.

A normative intervention on guarantees seems necessary especially if we consider that the discipline of financial difficulty of the local authorities was annulled by the financial law 2003, which repealed the whole of Title VIII of the TUEL while awaiting the coordination with the new constitutional text, and so there is not even the instrument of the recovery procedure thereby provided for that can come to the rescue of the authority in crisis.

Ministerial decree 420 of 1996 introduces, furthermore, the first form of surveillance by the MEF on the issues of the local authorities in foreign markets, in so far as it establishes that two communications be sent to the General Directorate of the Treasury – an advance notification and then a follow-up – of the financial and personal data pertaining to said issues, outlining in this way a sort of procedure of approval and surveillance of the liabilities raised.

Subsequent to the coming into effect of Art. 41 of the law of 28 December 2001, no. 448 which we will discuss in detail in another part of this report, additional norms concerning the borrowing of local authorities were set forth.

The financial law of 2003, in Article 30, paragraph 15, establishes that “should the local authorities resort to the borrowing for financial expenditures different from those of investment, in violation of Art. 119 of the Constitution, the relative acts and contracts are null and void”.

The financial law of 2004 in Art. 3, to the ends of supervision, transparency and containment of public expenditure, introduces the obligation for the Bank of Italy to transmit the information relative to the financial transactions of the authorities (paragraph 14); assimilates the amendments made to Art. 119 Cost., confirming that the Local Authorities and the Regions can resort to the borrowing only for the financing of investment expenditure (paragraph 16); specifies what constitutes borrowing transactions and activities that constitute investment (paragraphs 17 and 18); furthermore it introduces the prohibition of the borrowing for the replacement of losses by companies and businesses of the local authorities (paragraph 19) and extends also to the autonomous Regions the limits and prohibitions established in matters of finance for the regions of ordinary statute (paragraph 21).

6. Article 41 of the law 448/2001.

Article 41 of the financial law for 2002 takes on the burden of satisfying the many and various management needs of public finance:

- the diversification of local finance and the development of its autonomy
- the total economicity of the financing transactions of the general government
- the surveillance of the debt of the same authorities, both in terms of stock and flows.

Given the great number of subjects interested, in particular as regards the local authorities², it appeared essential to make certain that access to financial markets should take place in an orderly manner, avoiding the overlap of more than one public subject in the

² More than 8,000 municipalities, 20 regions, the 2 autonomous provinces with their own specificities, 103 provinces, plus all the aggregations of local authorities taken into account by the ordinance, including therein, in perspective, the metropolitan cities.

same segment of the market in a limited period of time. In such an event, in fact, there could be a crowding of issues, to the detriment of financing conditions.

Awareness of the relevance that such problems assume in a context of expansion of decentralized finance has brought about, with Art. 41, the introduction of coordination of capital market access on the part of local authorities by the Ministry of Economy and Finance. The relative modalities of enactment were left to a decree by the Minister of Economy and Finance, in conjunction with the Minister of the Interior, having heard the position of the Unified Conference.

Furthermore, the normative in place still in 2001 limited greatly the possibility of issue by local authorities since, with the exception of the regions, it allowed for recourse to the bond market only in the form of bonds amortizing capital through means of installments. The possibility was thereby precluded to carry out those issues that, representing the standard of the market, allow for access to a more vast public of investors: the so-called bullet bonds, which grant reimbursement of capital in a sole payment upon maturity.

That constituted a serious limitation not so much for the smaller local bodies, but for the large municipalities, which in many cases must finance investment expenditure in amounts greater than those of many regions. On the other hand, the logic underlying such a limitation, imposed by the regulation of '96, had a clear and common worry: to avoid the postponement to future exercises of the burden normally most relevant, that related to the reimbursement of capital. Even the use of derivatives was limited to the coverage of exchange (bond) in the case of issues in foreign currency.

With the norm of Art. 41 the legislator took into account the necessity to increase the opportunities of recourse to a plurality of financing channels, removing the obligation of the amortizing structure and abolishing at the same time the constraint of issues at the same level, which made the placement at market conditions particularly complicated. The principle has not been abandoned, however, that those structures are to be avoided that postpone till future exercises the most conspicuous payments. Thus, it has been determined that, in cases of bullet bond issues, there is the obligation to constitute a bond sinking fund

or the conclusion of a swap that, for the budget of the authority, renders equivalent the payment profile with the two possible structures: amortizing or bullet.

The conversion of existing liabilities into bonds or their renegotiation was also allowed for, conditional to the reduction of the financial value of the liability chargeable to the authorities.

So, in a context of extending the faculty to take advantage in a more flexible manner of the instruments present on financial markets, the accent has been placed at the same time on the acceptance of responsibility by the authorities, both with regard to the convenience of financial conditions and the distribution of debt over time.

By the same logic it has been determined that even recourse to derivatives could in some measure be extended and, given the highly technical aspect of the matter, we defer to the same joint ministerial decree mentioned above for a definition of the admissible transactions.

Finally, evidence was noted to the effect that the only source of information about the quality and quantity of the debt of local authorities was represented by the notifications that the Bank of Italy receives from them: no form of public survey of the institutional kind was explicitly contemplated and supported by the existing normative.

Given the importance of bettering as much as possible the quality and completeness of information, drawing directly from the source at which the debt originates, with Art. 41 the surveillance of the debt of local authorities was therefore instituted. In this case as well, the establishment of the modalities of such surveillance is deferred to the aforementioned joint decree.

7. The regulation of enactment of Art. 41 of the law 448/2001: principles

The joint Economy-Interior ministerial decree, which enacts the aforementioned Article 41, had to assume the form of Regulation, seeing as how it concerns dispositions of vast weight and general in character.

Its composition was designed to assure, on the one hand, the ability to know about local authorities' debt and, on the other, the compliance with principles of transparency, economicity, and prudence in activities of market recourse.

Regarding the contents of surveillance, which will bring about the creation of a data bank at the Department of the Treasury on which I will speak more broadly later, it was determined that surveillance should have a trimester cycle, in sync with other obligations of data transmission already considered by the law 468/1978.

The data to communicate regard not only loans and bonds, but also banking advances – because these too represent debt in the definition of the ESA 95 – and the securitizations, the latter with all the informative details necessary to establish whether each single transaction should or not be considered a debt according to the Eurostat classification. Likewise, all derivatives transactions are registered.

The choice of the deadlines for the transmission of data relative to the trimester just concluded (the 15th of the months of February, May, August, November) was determined in order to allow for the processing and use of the information in time enough for the predisposition of the trimester Reports of account and, above all, with reference to the deadlines of February and August, for the sending of semester notifications (March 1st and September 1st) to the European Commission, as stipulated by the supervisory procedure for excessive deficits.

Regarding the coordination of market access, given that the risk to guard against was a simultaneous presence on the market of more than one subject belonging to the general government thereby worsening financing conditions, a minimum limit was established of 100 million euros for the obligation of advance notification. It was accepted, in fact, that for transactions in lesser amounts the market conditions could not undergo changes.

Said advance notice extends to all medium-long-term financing transactions and to securitizations; and a very lean mechanism of silence-assent is foreseen.

The dispositions designed to guarantee a careful and prudent management of counterpart risk and market risk are outlined in Articles 2 and 3 of the decree and they aim

to allow all those transactions that imply the possibility of benefit from favorable market conditions, without however allowing for the assumption of further risks.

Let us move on to a brief analysis of these prudential dispositions.

8. The regulation: criteria for the management of amortizing

Article 41 allows local authorities to place bonds with the most simple structure, that of full reimbursement at maturity, toward the end of permitting savings in terms of cost of debt with respect to the placement of "amortized" bonds. On the latter, the market, faced with the amortizing structure, could in fact request a premium in terms of yield offered by the authority. Simultaneous to the *bullet* issue, the authorities must deposit the amounts that replicate the amortizing of debt in the sinking fund, managed by the intermediary according to criteria contractually pre-determined, and such as to guarantee the authority the availability of the amounts necessary for the reimbursement upon maturity.

Some risks have been identified, through information on hand, concerning the selection and, subsequently, the substitution of bonds in which the sinking fund invests, in order to determine the minimum criteria and requisites for the constitution of the funds themselves. The expectation of an adequate rating for the intermediaries who are potential counterparts in the swap or charged with the management of the fund, like the determination of the Countries and the type of bond issuers admitted in guarantee of the fund, makes it possible to reduce the so-called "credit risk". This risk implies that a possible missed or delayed payment in the transaction relative to amortizing would reflect negatively on the flows that the authority must in turn pay to its own financiers. Adequate credit-worthiness must be certified by one of the rating agencies recognized on an international level, while «the amounts set aside in the bond sinking fund can be invested exclusively in bonds of public agencies and authorities or in public companies belonging to States of the European Union.».

9. The regulation: criteria for use of derivatives

Another innovative element introduced by Article 41 is the use of derivatives by local authorities.

While the obligation to cover risk of exchange through swaps for issues in currency other than the euro remains firm, the last part of the Decree of 1 December 2003, no. 389, proposes to distinguish the derivatives transactions that, based on the current types present on the market, can be concluded with the objective to confer greater solidity on the budget of the authorities. This, above all, through the explicit placement among existing liabilities and derivatives transactions for the hedging of exchange or rate risk, in order to avoid risky, so-called "synthetic" exposure that has no direct correspondent in the liabilities of the local authority.

Among the various types of transactions currently available on the market, it was decided to list those that present a contained profile of risk or that even allow for a greater protection against market risks. This required a greater detailing of the more strictly technical aspects, exemplifying the range of usable instruments. The concern about not carrying over the costs to future exercises brought about the exclusion of the possibility to defer the deadline of the derivatives transactions with respect to that of the existing liabilities. It was likewise declared that the restructuring of an existing liability must not produce an «increasing profile for current values» of payment flows on the part of the authority.

Limiting risk exposure of the authority is, furthermore, the aim of the disposition contained in the fourth paragraph as well, which confirms the requirement of an adequate credit-worthiness (rating) of the counterpart intermediaries of the derivatives contracts and introduces the indication to subdivide among more than one counterparts the total of derivatives transactions put into being for total amounts greater than 100 million euros. This indication must not imply the re-modulation of the derivatives transactions concluded prior to the regulation; for the objectives of the application of this principle of diversification, the

authority must, however, bear in mind the exposure already acquired at the moment of the conclusion of the new derivatives transactions.

10. The explanatory circular for the regulation

The Department of the Treasury is in the process of preparing an explanatory Circular for the D.M. of 1 December 2003, no. 389, intended for the local authorities, the supervisory authorities, and the banking system so that the dispositions contained in the regulation are interpreted in a manner conforming to the spirit of the normative.

In the Circular there is explicit reference to the norms of the Regulation of enactment of D. Lgs. 24 February 1998, no. 58, adopted by the CONSOB with the deliberation of 1 July 1998 and amendments, with particular regard to the Articles 25 to 31 and to the “Document on general risks of investment in financial instruments” in attachment to the aforementioned CONSOB Regulation.

It was determined opportune in this way to highlight, for the authorities, the potential of risk connected with derivatives transactions and, for the intermediaries, the necessity to make the assumption of such risks by the authorities completely willful and transparent.

Given that the derivatives transactions will have to be registered in the data bank on which the surveillance activity is based, as a rule it will be possible to survey the measure of total exposure to financial risk that has been assumed.

In the Circular the authorities are explicitly invited to consider, on a case by case basis, the total cost of the bond issue, both in the form with full reimbursement at maturity and in the form with an amortizing schedule, keeping in mind the credit risk assumed with the constitution of the fund or of swaps for amortizing.

Furthermore, in the circular some criteria will be specified that help the authorities in their operations, in particular regarding:

- determination of the minimum rating of the intermediaries that manage the fund of swap for amortizing;
- the range of instruments admitted for investment of the fund;
- criteria of bond substitution in the fund itself.

Relative to the use of derivatives, in the Circular the types of transactions admitted, coherent with the principle of containing exposure to financial risks of the authorities will be explained. What is to be avoided, in fact, is that the immediate benefit in terms of flows deriving from the restructuring of a liability go to increment the risks to which the authority exposes itself in future exercises. Even under these conditions, the authorities maintain room for maneuver sufficiently ample to render more effective the management of their debt through the use of derivatives.

11. Surveillance: data bank

The Maastricht Treaty establishes in Article 104 that the single member States must notify the European Commission periodically of the data relevant to the supervisory procedure for excessive deficits. This notification presupposes the availability of an archive progressively more up-to-date with respect to all the borrowing transactions conducted by the general government as determined by the European System of national and regional Accounts (ESA 95).

Since the second half of 2001, the Department of the Treasury began to ready a system for the surveillance of data pertaining to loans and issues of the local authorities and to create an experimental data bank, even without the aforementioned regulation in Art. 41 which de facto specifies the modalities for surveillance.

The activity of surveillance requires different phases: first of all, the local authorities are contacted (8,222 authorities excluding mountain and island communities, and the municipality consortia, which will be surveyed in the near future) by sending via e-mail the

forms for surveillance in which all the significant financial headings related to bonds, loans, securitizations, and derivatives are listed in detail, in order to have a picture as whole as possible of the authority's debt. The data received, once checked for possible errors or inconsistencies, are inserted in the data bank for subsequent processing.

On 31 December 2003, 100% of the authorities represented by Municipalities, Provinces, and Regions was contacted: about 50% had responded to the request of the Ministry; the data already entered into the system cover about 78% of the local authorities that responded (which is to say, 40% of the total of all authorities). Even so, given that the data bank includes a good number of the authorities most relevant economically, from a comparison with the data published by the Bank of Italy, it is estimated that the registered debt covers about 70% of the global figure.

The attached tables illustrate the current state of surveillance which, again, is only partial at the moment. The regulation, when it goes into effect, will permit a more rapid completion of the information base.

It should in any case be noted that neither Article 41 nor the relative regulation stipulate any sanction in the event of omitted, incomplete, or untrue communication on the part of the authorities, as decided by the Unified Conference.

Work has already begun to produce in the short-medium term a new organizational model that will include the development of a web interface between the Minister and authorities capable of improving the timing of data acquisition, of facilitating communication of the data with a more simple and guided procedure, in addition to furnishing information immediately usable by the authorities. In particular it is our intention to make available summary data that could be useful to the authorities themselves, as support for financial decisions.

Furthermore, the “data base” of loans raised originally by the authorities with the Cassa S.p.A., now a subject outside the general government, is nearing completion. Previously such an integration did not seem necessary, since the consolidation of subjects belonging to the general government was ongoing and said loans did not represent an external debt.

12. Surveillance: Bank of Italy data

Finally, as mentioned before, with the publication of the financial law of 2004 the Bank of Italy, too, will furnish the Ministry with data in its possession relative to the debt of local authorities. This will allow, among others, for a cross-check of the data furnished by the authorities.

In order to make the disposition in question completely operational, a working group was established, in which, in addition to the Department of the Treasury and the Bank of Italy, the General Accounting Office also participates.

Obviously, the information furnished will be useful on a strictly institutional and classified level, and consequently the ultimate disclosure of the information will take into account only the data in the possession of the Ministry and in aggregate form.



DEPARTMENT OF THE TREASURY - SECOND SECTION OFFICE IV

BOND ISSUE DEBT OF LOCAL AUTHORITIES

SITUATION AS OF 02/29/2004

LEVEL OF GOVERNMENT	NUMBER OF AUTHORITIES		NUMBER OF ISSUES	CURRENCY	NOMINAL CAPITAL	RESIDUAL DEBT	NOMINAL CAPITAL EURO	RESIDUAL DEBT EURO
	TOTAL	IN DATA BANK						
Region	20	13	46	EURO	11,159,834,780.38	9,804,995,158.44	13,496,719,780.38	11,754,787,231.69
				USD	1,910,000,000.00	1,593,618,368.00		
Province	103	16	68	EURO	237,382,859.16	190,139,239.90	237,382,859.16	190,139,239.90
Municipality (capital of province)	104	30	113	EURO	2,391,338,629.26	1,924,516,164.27	2,451,106,604.26	1,957,323,443.19
				USD	48,850,000.00	26,814,286.00		
Other municipalities	7,995	89	201	EURO	370,090,735.92	280,500,211.21	370,090,735.92	280,500,211.21
TOTAL	227	59	227				16,185,209,243.80	13,902,249,914.78

Note: The nominal capital and the residual debt of the issues in \$ are re-denominated in € according to the exchange rate on the day of surveillance of the monthly situation.



DEPARTMENT OF THE TREASURY - PUBLIC DEBT - OFFICE IV

LOAN DEBT OF LOCAL AUTHORITIES TOWARD THE BANKING SYSTEM

AS OF 02/29/2004

LEVEL OF GOVERNMENT	NUMBER OF AUTHORITIES		NUMBER OF LOANS	NOMINAL CAPITAL	RESIDUAL DEBT
	TOTAL	IN DATA BANK			
Region (*)	20	19	227	14,916,607,611.04	10,919,848,967.77
Province	103	40	451	409,253,315.13	288,359,580.99
Municipality (capital of province)	104	95	2,636	10,513,822,681.88	8,352,945,168.49
Other municipalities (**)	7,995	1,089	5,540	3,869,914,872.77	2,035,152,009.07
TOTAL (***)	8,222	1,243	8,854	29,709,598,480.82	21,596,305,726.32

(*) The Trentino-Alto Adige region has no loan or issue debt. The Abruzzo region has all loans fallen due and has not yet communicated updated data.

(**) The Municipality of Montanaso Lombardo has no loan/issue debt.

(***) Up to today 1917 authorities have communicated that they have only loans contracted with the Cassa DD.PP., therefore the total of authorities imported to the DB is all together 3160.



DEPARTMENT OF THE TREASURY - PUBLIC DEBT - OFFICE IV

SUMMARY OF RESIDUAL DEBT AS OF 02/29/2004

LEVEL OF GOVERNMENT	Region	Province	Municipality (capital of province)	Other municipalities	TOTAL
Loans with total reimbursement at the expense of Public Entities (*)	1,123,494,325.28	1,186,928.63		1,319,392.43	1,126,000,646.34
Loans with the Cassa DD.PP. (**)					36,842,354,299.74
Loans with the banking system	9,796,354,642.49	287,172,652.36	8,352,945,168.49	2,033,832,616.64	20,470,305,079.98
Bonds	11,754,787,231.69	190,139,239.90	1,957,323,443.19	280,500,211.21	14,182,750,125.99
TOTAL (***)	22,674,636,199.46	478,498,820.89	10,310,268,611.68	2,315,652,220.28	35,779,055,852.31

NOTES:

1. The files for surveying data and soliciting responses were sent to all the regions, provinces, municipalities (capital of province) and other municipalities with a population > than 20,000. For the municipalities with a population =< than 20,000 the mailing was done in alphabetical order through the letter Z, for a total of 7995 towns. Further solicitations were sent to regions, provinces, municipalities (capital of province) and other municipalities with pop. =>20,000 letter G, for a total of 333 agencies.
 2. Social security agencies: they have a negative position for loans/issues. Concerning the direct management of Government bonds, only IPSEMA and SPORTASS are in possession of old bonds while the INPDAP has active bonds in a pool of banks.
 3. The total of the last column is not the total of Cassa DD.PP loans.
- (*) The data are those communicated by the entities and imported to the DB. These are transactions with full reimbursement at the expense of the Treasury, Regions, Provinces, Credito Sportivo etc.
- (**) The data relative to the Cassa DD.PP. represent the total residual debt as of 7/1/2003 of 8861 local authorities (loan quantity 333,064 for a nom. cap. of € 51.684.333.370,45) .
- (***) The residual debt is gross of possible participation in the expenditures on the capital quotas on the part of other public entities.