The Ministry of Economy and Finance

TREASURY DEPARTMENT - DIRECTORATE II

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Non applicability of delegations of payment to transactions in derivatives concluded by local authorities. Explanatory circular.

To:
The Regions
The Autonomous Provinces of Trento and Bolzano
The Autonomous Province of Aosta
The Provinces
The Municipalities
The Mountain Communities
The Island Communities
The Union of the Presidents of Regions
UPI
ANCI
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The Unified State-Regions Conference
The General Accounting Office of the State – IGEPA
The Court of Accounts
The Regional Inspection Departments of the Court of Accounts
The General State Attorney's Office
The Regional Departments of the General State Attorney's Office
The Bank of Italy
The Italian Banking Association

Following the modifications of norms that intervened on derivative instruments and on the definition of borrowing, and also in light of the evolution of local authorities' resorting to the derivatives market, some interpretative aspects regarding the use of

delegations of payment disciplined by article 206 of the Local Authorities' Consolidation Act (TUEL) – D.lgs.18 August 2000, n. 267 need to be clarified.

In this respect, the following needs to be specified:

1) Derivative rules

Pursuant to the introduction, provided by article 2 of the Ministerial Decree of 5 July 1996, n. 420, of the obligation of protecting oneself from the exchange risk through a currency swap, local authorities' swaps found their main regulatory reference in article 41 of the 2002 Financial Law (n. 448/2001), which at paragraph 1 states that debt amortization and usage of derivative instruments by local authorities are to be disciplined by a subsequent decree issued by the Ministry of Economy and Finance (MEF), in concert with the Ministry of the Interior. Paragraph 2 of the same article disciplines the possibility of *issuing bonds with a single capital reimbursement at expiry, prior to the establishment, at the time of issuance, of a debt amortization reserve, or prior to the conclusion of a debt amortization swap*.

In fact the foreseen rule intervened with the Decree of 1 December 2003, n. 389 (of a regulatory nature), which was followed by an explanatory Circular of the MEF of 27 May 2004 (published in the O.G. of 3 June 2004, n. 128). The 2007 Financial Law (of 27 December 2006, n. 296), article 1, paragraph 736, stated that: *debt management transactions that make use of derivative instruments, on behalf of the Regions and of the authorities mentioned in the TUEL and mentioned in the legislative decree of 18 August 2000, n. 267, must be geared towards the reduction of the final cost of the debt and to the reduction of exposure to market risks. Authorities may conclude such transactions only in correspondence of liabilities effectively due, taking care to contain the credit risks undertaken.*

Moreover, with paragraph 737 of the 2007 Financial Law, a monitoring system has been set up that provides for the transmission of derivative transactions to the MEF, before their subscription. With the Circular of the MEF – Treasury Department – Directorate II – of 31 January 2007 (published in the O.G. of 5 February 2007, n. 29), some technical aspects, introduced by paragraphs 736 to 740 of the 2007 Financial Law, in need of further insight, have been clarified.

It seems appropriate to remind that in the explanatory Circular of the Decree of the MEF 389/2003 a general consideration such that *no derivative is classifiable as a liability* was already quoted.

Therefore derivatives are identified, according to the rules cited above, as "debt management instruments and not as borrowing".

2) Article 3, paragraph 17, Law of 24 December 2003, n .350, modified by article 1, paragraph 739, Law of 27 December 2006, n. 296 – Definition of borrowing

Article 119, sixth paragraph, of the Constitution indicates that "*Municipalities, Provinces, metropolitan cities and Regions […]. May resort to borrowing only to fund investment expenses. […]*". In the implementation of this constitutional principle, the 2004 Financial Law (Law 350/2003) gave a precise and detailed definition of the concept of borrowing, pinpointing the types of transactions to be considered as such in reference to the mentioned constitutional norm.

With the 2005 Financial Law (Law of 31 December 2004, n. 311), article 1, paragraph 68, *part c)* credit openings were introduced (disciplined by article 205 bis of the TUEL), including them as debt transactions. In fact, the same TUEL disciplines them in Chapter II: *Financial and accounting Regulations* – Heading IV: *Investments* – Sub-heading II: *Sources of financing through borrowing;* besides, paragraphs 2 and 4 of article 205 bis confirm the debt nature of credit openings that, in respect to traditional loans and bond issuing, are a different way and however a more flexible form of financing local investments, allowing the cost of the operation to be related to expenditure needs that become manifest along the way.

Subsequently the 2007 Financial Law (Law n. 296/2006, article 1, comas 739 e 740) has further changed and integrated the definition of borrowing, adding to borrowing instruments *assignment of claims and securitization transactions of receivables towards goods and services suppliers for whose payment the authority assumes, even if indirectly, new obligations […].*

In support, the same MEF Circular of 31 January 2007 is referenced (published in the O.G. of 5 February 2007, n. 29) which at *Point 4)* gives an important clarification on the definition of borrowing.

So, in light of the recent legislative innovations introduced on the subject, these are to be considered borrowing transactions: loans and credit openings, bond issuing, securitizations of future income flows, securitizations with initial proceed below 85 percent of market price, securitizations with guarantees given by other public administrations, securitization transactions of claims towards other public administrations, transfers of claims and securitization transactions of receivables towards goods and services suppliers.

In conclusion, the definition of swap as mere instruments of debt "management" is further confirmed by the fact that derivative instruments are not mentioned in any of the norms cited; thus, in light of the above, derivate instruments are not classifiable as borrowing transactions.

3) Article 206 of the Legislative Decree N. 267/2000 (TUEL) – Delegation of payment

The TUEL, Sub-heading III called *Guarantees for loans and lending,* with article 206 disciplines the issuance of a delegation of payment as a form of guarantee for the payment of loans and lending amortization installments.

The issuance of such executive juridical title is explicitly referable to loans and to lending. Considered that derivative instruments, as is clear from points 1 and 2 of the present Circular, are not in this case loans and lending and neither in the wider definition of borrowing, it thus follows that no delegations of payment should be issued on such products.

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