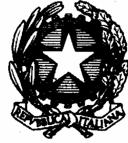

The Ministry of Economy and Finance

DEPARTMENT OF THE TREASURY – DIRECTORATE II

Circular 27 May 2004 (O.G. of 3 June 2004 N.128)

Decree of 1 December 2003, no. 389 denoting "Regulations concerning capital market access by provinces, towns, metropolitan cities, mountain communities and island communities, as well as consortiums of territorial and regional agencies, in accordance with Art. 41, paragraph 1, of the law of 28 December 2001, no. 448". Explanatory circular.

To the Regions
To the Autonomous Provinces of Trento and Bolzano
To the Autonomous Province of Aosta
To the Provinces
To the Towns
To the Mountain Communities
To the Island Communities
To the Union of Region Presidents
To the UPI
To the ANCI
To the UNCEM
To the Joint State - Region Conference
To the General Accounting Office – IGEPA
To the State Audit Court
To the Regional Delegations of the State Audit Court
To the State Attorney's Office
To the District Attorneys' Offices
To the Bank of Italy
To the Italian Banking Association

The Decree of the Ministry of Economy and Finance in conjunction with the Ministry of the Interior no. 389 of 1 December 2003, in enactment of Art. 41 of Law no. 448/2001 regulated capital market access by territorial agencies. In light of the numerous inquiries related to the application of this Regulation, the following sets out to make clear some interpretative aspects necessary for the correct application of the norms contained in the aforementioned Regulation.

Concerning applicability, only the derivatives transactions conducted and the amortizing covered by the territorial agencies after 4 February 2004, the date on which the Decree of the Ministry of Economy and Finance in conjunction with the Ministry of the Interior no. 389 became effective, are subject to the restrictions thereby provided for.

Given that one of the primary objectives of Art. 41 of Law no. 448/2001 and, thus, of the relative Regulation, is to assure the most effective, orderly, and prudent access possible to the capital market, the following guidelines are set forth.

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1) *Determination of 10-day silence-assent period* (Art. 1, paragraph 2)

The 10-day period during which the Department of the Treasury can express an opinion on the most opportune moment for access to the market by the agency in question begins from the date in which the appropriate Office of the Second Section of the same Department sends to the agency by fax or e-mail a confirmation that correspondence has in fact been received from said agency.

In addition to the usual postal means, correspondence can be sent by fax (06 4761-3197) or by e-mail (accesso.mercati@tesoro.it).

It should be noted that the activity of coordinating market access is aimed at avoiding the overlap of a number of public entities in the same segment of the market in a limited timeframe. Were this to be the case, in fact, there could be a crowding of issues, to the detriment of financing conditions.

2) *Amortizing* (Art. 2)

Concerning the criteria that determine the intermediaries with which it is admissible to undersign contracts relative to the management of a sinking fund or swap traded to amortize debt, see the rating specifications outlined in detail in the following paragraph pertaining to transactions in derivative financial instruments.

Concerning on the other hand the investment of sums set aside in the sinking fund or swap traded to amortize debt, the range of instruments admitted for that purpose is limited to bonds issued exclusively by the issuers indicated in paragraph 2 of the same decree no. 389 of 1 December 2003, which must not be further structured by derivatives transactions so as to render the profile of credit exposure different from that allowed. In light of the fact that the risk on the portfolio of bonds conferred to the sinking fund remains in any case at the total expense of the agency, it should be emphasized that the selection of the issuers of the aforementioned bonds must not be made in the spirit of credit-risk reduction. Furthermore, the greatest transparency is required of the contracts and the criteria by which bonds conferred to the sinking fund are selected and possibly substituted, attributing utmost attention to the rating.

In addition, the maturity of the investments should be limited to the maturity of the sinking fund.

Public enterprises are intended as those enterprises with a relevant/supervisory share of direct partnership held by States belonging to the European Union, in accordance with the principles established by Art. 2359 of the Italian civil code. In the event that a public

enterprise becomes privatized, it is recommended that should any bonds issued by said enterprise be present in the sinking fund, they are to be substituted as long as said substitution does not imply a loss for the fund. Should there emerge strong indications of risk resulting from the privatization, the substitution should be considered even in the event it might imply a loss.

It is considered opportune for the agencies to consider the total cost of the bond issue both in the form of lump sum reimbursement at maturity of capital and in the form of amortizing, and that they evaluate, to the extent possible based on market conditions at the moment of issue, the relationship between such a cost differential and the greater risk borne by the agency in connection with the establishment of the sinking fund or swap traded to amortize debt. This evaluation must also consider the fact that bullet issues, in so much as associated with a swap traded to amortize debt, are weighted at their entire amount until maturity for the purposes of Eurostat public-debt surveys.

3) *Transactions in derivative financial instruments* (Art. 3)

The types of derivatives transactions allowed, in addition to cross currency swaps[1] to cover the exchange risk in the case of indebtedness in currency, are those expressly indicated in points *a)* to *d)* intended in the "plain vanilla" form. In particular, point *a)* excludes all optional forms, while points *b)*, *c)* and *d)* refer exclusively to the purchase by the agency of the instruments there cited. The purchase of a collar implies the purchase of a cap and the contextual sale of a floor, permitted solely to finance the protection against an increase in interest rates furnished by the purchase of the cap. The level of the rate to be paid by the agency once the limits are met must be consistent with both the current market rates and with the cost of indebtedness prior to the derivatives transaction. Regarding the “other derivatives transactions” set out in letters *e)* and *f)*, it should be clarified that these same must in any case be transferable into combinations of the types indicated in the letters *a)* to *d)*. These types are in fact considered consistent with the containment of the exposure of the agency to financial risks resulting from the increase of interest rates and therefore with the objective of the containment of the cost of indebtedness.

Concerning the letter *f)* furthermore, the prohibition of an “increasing profile of actual values” refers, in the context of derivatives transactions, to the payments made by the agency. This prescription is to avoid that derivatives transactions should take place for which the payments by the agency are concentrated close to maturity, the exception being possible discounts or premiums, no greater than 1% of the face value of the underlying debt, so as to allow for the restructuring of the debt in the event that market conditions change with respect to what they were at the moment in which the debt was underwritten. Furthermore, said discount or premium must be determined with respect to the start date (Regulation) of the derivatives transaction and applied exclusively to restructuring transactions provided for precisely in point *f)*. Paragraph 3 limits to the monetary market, that is to say, to short-term interest rates, the realm of parameters by which all the derivatives transactions described in the preceding paragraphs can be indexed.

Inadmissible are those derivatives instruments that contain incentives or multipliers of financial parameters, such as, for example, paying 2 times the Euribor rate.

[1] The exchange of interest and capital flows expressed in the two different currencies must always be conducted at the same exchange rate pre-arranged at the moment of the conclusion of the transaction.

Inadmissible as well are those derivatives transactions that refer to other pre-existing derivatives transactions, based on the consideration that no derivative instrument can be configured as a debt.

In the event of a variation in the underlying debt of a derivative instrument, for example because the debt has been renegotiated or converted, or because it has reached an amount inferior to what was initially foreseen, the position in the derivative instrument can be readapted on the basis of conditions that do not determine a loss for the agency; only in the event that the agency feels it must close the position in the derivative instrument is the conclusion admissible of a derivative instrument, equal and of the opposite sign, with another counterpart.

Regarding credit risk, the intermediaries with which it is admissible to conclude derivatives transactions must necessarily be in possession of a credit rating certificate from the rating agencies currently recognized internationally: Standard & Poor's, Moody's and FitchRatings.

In the event that the ratings attributed by the various agencies do not concur, the lowest rating must be considered. "Adequate rating" for a counterpart is considered to be no less than BBB / Baa2 / BBB. Thus, should the intermediary undergo a rating reduction of even a single notch below this minimum level, the positions opened must be closed as quickly as possible.

Should a single derivatives contract be totally underwritten by the parent company of the counterpart, for the purposes of "adequate rating" that of the parent company is the rating considered.

The 25% ceiling allowed for every single counterpart on the total face value of the existing derivatives transactions, should these surpass 100 million euros, must not imply the restructuring of derivatives transactions concluded pre-Regulation. Furthermore, transactions totally guaranteed by collateral are excluded from this calculation of existing derivatives transactions. For the purpose of applying the ceiling, the agency will however have to take into account the exposure already purchased at the moment in which the new derivatives transactions are concluded. In the event of a first-time transaction, this can be concluded with just one counterpart. For subsequent transactions, the agency will have to move toward balancing its exposure, gradually proceeding to the 25% objective. For counterparts belonging to the same group. The 25% limit must refer to the entire group.

Taking into account, then, the particular nature of the risk intrinsic to the derivatives activity, it is recommended that the agencies receiving decree no. 389 of 2003, as a precautionary measure, refer to the norms stipulated by the Regulation in enactment of Lgs. D. 24 February 1998, no. 58, adopted by the CONSOB with the Decision of 1 July 1998 and subsequent modifications, with particular attention to articles 25 to 31 and to the "Document on the general risks of investments in financial instruments" attached to the aforementioned CONSOB Regulation.

Rome, 27 May 2004

THE DIRECTOR GENERAL FOR PUBLIC DEBT

(Maria Cannata)