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ISSUES ON FINANCIAL MARKET REGULATION, BUSINESS DEVELOPMENT AND GOVERNMENT'S POLICIES ON GLOBALIZATION

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CONTENTS

OBSERVATORY ON BUSINESS RELATIONS

DERIVATIVE FINANCIAL INSTRUMENTS AND BALANCED BUDGETS: THE CASE OF THE ITALIAN PUBLIC ADMINISTRATION

Michela Passalacqua*

ABSTRACT: *The present paper aims to examine whether derivative contracts concluded by the Public Administration enable to assess the real financial commitment on the authority's budget, due to their intrinsic features and the current legal framework. The author claims that, on the whole, they cannot be easily reconciled with the obligation to ensure balanced budgets and public debt sustainability, as provided for by the reformed Articles 81 and 97 of the Italian Constitution.*

Therefore, it is to be hoped that there be an intervention by the legislator to regulate the use of these financial contracts by all public authorities, as well as companies with public shareholding. In the author's opinion, there are two possible regulatory options: either to introduce a ban on these innovative financial instruments for any public body, or to accurately regulate this issue, by ensuring the disclosure of necessary information to render derivatives thoroughly compatible with the constitutional principles aimed at protecting the stability of public finances.

SUMMARY: 1. Balanced budget and sustainability of public debt in the Italian Constitution. – 2. Public accounting rules and derivatives. – 3. Balanced budget and derivatives. – 4. Whether public bodies, other than local authorities, and local government-owned corporations can contract derivatives. – 5. Conclusions.

«*Which of a weak or niggardly projection*

Doth, like a miser, spoil his coat with scanting

A little cloth»

William Shakespeare, *The Life of King Henry the Fifth*, Act II, Scene IV

1. The substantial Italian public debt is mainly due to the decision made by the members of the Constituent Assembly not to extend the obligation of providing financial coverage to the budget law[1] (Article 81, paragraph 4 of the Constitution, prior to the reform of 2012).

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[1] See BRANCASI, *Le decisioni di finanza pubblica secondo l'evoluzione della disciplina costituzionale*, 8 August 2009, in *www.astrid-online.it*, pp. 4 ff.; ID., *L'introduzione del principio del c.d. pareggio di bilancio: un esempio di revisione affrettata della Costituzione*, in *Quaderni costituzionali*, 2012, p. 108.

The aforementioned article stated that «every other» expenditure law – other than budget law – shall «indicate» the measures to be employed to face such expenditures[2], thus complying with the obligation of financial coverage.

The members of the Constituent Assembly have therefore underestimated that the largest part of the Italian public expenditure would originate from the budget law approved yearly by the Parliament. As a matter of fact, because being able to record the revenues-expenditures imbalance, it allowed recourse to debt[3], whose maximum amount would be later established by the Finance Act presented on an annual basis starting from 1978.

However, by passing judgement no. 1/1966, the Constitutional Court accepted – as consistent with the Constitution – the practice of covering expenditures also through Treasury's debt, which thus increasingly turned to the financial market to find further resources in addition to tax revenues.

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[2] But it did not specify «to supply» the means by which to cover the expenditures, as provided in the original wording proposed in the Second Subcommittee on the Constitution by the Honourables Mortati and Vanoni, which was however not approved by the Constituent Assembly.

[3] For these reasons, we cannot endorse the arguments of the doctrine which supported the principle whereby a balanced budget is already encoded in this paragraph 4 of Art. 81 of the Constitution; in the sense that the inability of the Budget Law to introduce new taxes or charges, together with the obligation of the other expenditure laws to indicate the funding, should ensure a balanced budget (DI GASPARE, *Innescare un sistema in equilibrio della finanza pubblica ritornando all'art. 81 della Costituzione*, in *www.amministrazioneincammino.luiss.it*, 2005, p. 2; BOGNETTI, *Costituzione e bilancio dello stato: il problema delle spese in deficit*, in *www.astrid-online.it*, 2009, pp. 15 ff.; GIANNITTI, *Il pareggio di bilancio nei lavori della costituente*, 2 August 2011, in *www.astrid-online.it*).

However, the parliament has recently amended the Constitution of 1947 by reforming the aforementioned Article 81, which now states that an «equilibrium» between revenues and expenditures needs to be ensured.

Presumably, the balanced budget introduced by the legislator aims to orientate the revenues-expenditures ratio to be allocated in the budget by «taking into account favourable and unfavourable phases of the economic cycle»[4], in accordance with the EU regulations on public budgets[5].

The goal of this constitutional amendment is also to grant the Parliament a certain degree of autonomy and to enable it to approve budget deficits in bust phases of the cycle, provided that future budget surpluses shall follow during the boom phases of the same cycle, so as to ensure a sort of balance over the cycle by compensating cyclical deficits and surpluses[6].

Secondly, this amendment is intended to set a limit to the Parliament's power to finance public expenditures through borrowing. As a consequence, limits to the legislator's authority of resorting to the financial market by issuing national government securities to find resources for public expenditures have been introduced.

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[4] See Article 1, paragraph 1 of Constitutional Law no. 1 of 20 April 2012; the passage in which it modifies Article 81, paragraph 1 of the Constitution.

[5] See paragraph 3 of the Treaty on Stability, Coordination and Governance (Fiscal Compact), signed on 2nd March 2012 by the leaders of the entire Euro area and eight other EU Member States, which entered into force on 1st January 2013.

[6] For more information, see PASSALACQUA, *Presupuesto con igualdad entre ingreso y gasto e intervención pública: el equilibrio propuesto en la revisión de la Constitución italiana*, in *Cuadernos de Derecho Pùblico*, no. 38, septiembre-diciembre, 2009, p. 213, available at revistasonline.inap.es.

It has been furthermore acknowledged in the Constitution the requirement of extending the principle of balanced budgets to Regions, local entities and any public administration[7], which are now required to ensure «balanced budgets and sustainability of public debt»[8]. The new constitutional formulation aims to carefully vet public debt according to principles of asset and financial sustainability.

Extending to local entities the obligation to balance the budget has obviously required the modification of the so-called *golden rule* (see Article 119 of the Constitution); i.e. the possibility of Regions and local entities of resorting to borrowing to support productive expenditures, namely investments. On this point, it is essential to remember that over 70% of public investments in Italy are made by local entities, namely Municipalities and Provinces[9].

Concerning this issue, a midway solution has been pursued in order to reconcile the much-desired balanced budget and the possibility for the territorial autonomies to meet those expenditures representing a potential enrichment for future generations (such as expenditures for infrastructures or to promote knowledge economy), and consequently for the country. Therefore,

[7] Or rather, all public authorities – economic and non-economic – forming the Italian public administration, assuming that not every Italian public entity has budgetary autonomy and authority to contract indebtedness. This innovation has been approved by the Court of Auditors (the national judge of the accounts) which has evaluated it as respectful of international rules of national accounts (ESA 95), see Court of Auditors, sez. riun. contr., *Elementi per l'audizione in materia di introduzione del principio del pareggio di bilancio nella Carta costituzionale*, 26th October 2011.

[8] Articles 2 and 4 of Constitutional Law no. 1/2012, quot., amending respectively Art. 97, paragraph 1 and Art. 119, paragraphs 1 and 6 of the Constitution.

[9] Source: Court of Auditors.

the obligation being understood to ensure the balance of current expenditures, local administrations are allowed to incur debt to meet investment expenditures, as long as they can provide «a description of their amortization schedules and on condition that all local entities of each Region respect a balanced budget»[10].

In fact, unlike in the past, also due to the current economic-financial crisis, the Italian Constitutional Court has given quite a stern judgement on some Regional budget laws even before the aforementioned reform (in force since 2014), as it advocates they should comply with financial coverage, as provided for by Article 81, paragraph 4 of the Constitution (original version) concerning expenditure laws[11].

In particular, according to the Constitutional Court, budget laws should be regarded as expenditure laws and, as such, should meet a hedging requirement by means of a prior check of the resources available, in order to ensure a trend towards a balance between revenues and expenditures.

2. As previously mentioned, public administrations – including Italian ones – have been admitted to the financial services available in the regulated

[10] Article 4 of Constitutional Law no. 1/2012, quot.

[11] See CONSTITUTIONAL COURT, 28th March 2012, no. 70 (relating to the Budget Law of the Campania Region); Id. 18th June 2008, no. 213 (concerning the provisional budget of the Sardinia Region); Id., 31st October 2007, no. 359 (on the variation to the budget of the Sicily Region).

markets and have traded in derivative financial instruments too, since the second half of the 20th century[12].

The Finance Law approved in 1984[13] authorized the then Ministry of the Treasury to realize operations of external debt restructuring[14]; later, the restructuring of domestic public debt will also be authorized[15]. By virtue of the public administration's legal capacity in terms of civil law[16], which authorizes it to implement contracts, the same administrative body believed that the Ministry could proceed to debt restructuring also through debt swap operations, provided that they serve the institutional purpose of minimizing debt (principle of legality).

Since 1994, the local authorities have been likewise authorized by law to issue debenture loans with the subscription of derivatives, in particular warrants[17], and later to trade in swaps to repay debt[18]. In the following years, the state regulations progressively extended the authorization for local

[12] See PIGA, *The history of swaps in public debt management*, in *Derivatives and Public Debt Management*, Zurich, Isma, 2001, pp. 38 ff.

[13] Article 8, last paragraph, Law no. 887, 22nd December 1984. See also, Article 3, paragraph 1, letter c, Decree of the President of the Republic no. 398, 30th December 2003.

[14] To be intended as debt denominated in foreign currency.

[15] Article 2, paragraph 165, Law no. 662 of 28th December 1996.

[16] It is a general principle of national law.

[17] Article 35, paragraph 5, Law no. 724/1994.

[18] Article 41, paragraph 2, Law no. 448 of 28th December 2001.

autonomies to use derivatives until 2008[19], when interventions in the opposite direction occurred.

More specifically, the public administrations have shown interest in resorting to derivatives both for the purpose of restructuring their ever-increasing debt and in relation to the funds granted to make investments, because such financial instruments can serve a hedging function of the contracts subscribed. On the contrary, the legal order has always prevented public authorities from using derivatives to make profit.

In short, Italian administrations – both central and local ones – have used derivatives in order to manage their exposure to the market risks taken in the financial markets they addressed to raise the necessary funds for their activities[20].

The Italian regulations on this matter grant the State and local entities to trade in derivatives (see *infra* § 3) – where still allowed – by considering the latter as instruments for the management of an existing risk and not as a means of new risk-taking. More specifically, unlike the past, the local entities can no longer collect up-front payments upon concluding derivative contracts; ie. imprest payments, which shall constitute indebtedness if previously contracted. Nonetheless, following verifications on some local entities' accounts, some critical issues seem to emerge on this point; in that, the local entities have very

[19] For a more accurate reconstruction of the regulatory framework see CAPRIGLIONE, *The use of «derivatives » by Italian local authorities in public finance management. Still an issue,* in this *Review*, 2013, II.

[20] Source: Senate of the Italian Republic, Finance and Treasury Committee, *Survey on the diffusion of financial derivative instruments and securitisations in the public administrations*, 11th March 2010.

frequently allocated revenues from derivatives to finance their current expenditures[21].

The real problem is that derivatives can also serve a speculative purpose[22] affecting the very reason for subscribing the contract. This may result in insolvency risks due to various factors mostly connected with the general market trends and aggravated by the circumstance that the default of one or more contracting parties can in turn influence that of the others. In other words, derivatives generate systemic risk, against which the parties do not have any kind of hedging strategy.

It is therefore common for a contracting party, either private or public, to suffer a financial loss exceeding the capital invested.

Such occurrence has raised remarkable doubts on the suitability of using derivative financial instruments by the public administration. As a consequence, the legislator has adopted stern measures against the ever-increasing costumes of using derivatives by the local administrations[23] and the Constitutional Court has passed rather severe judgments on the conduct of certain regional administrations (see *infra* § 3).

This phenomenon has indeed become quite relevant. In the late 2000s, the Italian Municipalities and Provinces used to manage over half of their debt

[21] Source: Court of Auditors, sez. reg. contr.

[22] See CAPRIGLIONE, *I prodotti "derivati": strumenti per la copertura dei rischi o per nuove forme di speculazione finanziaria*?, in *Banca, borsa, tit. cred*., 1995, pp. 359 ff.

[23] Mainly Regions, Provinces and Municipalities.

by means of this type of operations[24]. Yet, generally speaking, it should be noted that the local self-governments' total debt is globally far lower that the national one[25]. It is no coincidence that, in absolute term, the amount of derivatives traded by the Ministry of Economy is much higher[26].

On the other hand, the use of derivatives by public administrations seems to be hardly compatible with the regulations of public accounting, since derivatives are characteristically connected to other activities, either financial of real – the so-called underlying assets (such as securities, commodities, interest rates, indexes and other derivatives) – on which a derivative's price is based.

On the basis of the definitions provided by the European directives, the Italian doctrine ranks derivatives in financial derivatives, commodities derivatives and credit derivatives[27]. On this point, it is essential to remember that credit derivatives allow the transfer of credit risk but, unlike financial derivatives, do not aim at the acquisition of a spread. The result is that there are

[24] Source: Court of Auditors, sez. riun. contr., *Survey on the diffusion of financial derivative instruments and securitisations in the public administrations*, 18th February 2009, p. 20.

[25] In 2007, for example, the total debt of Municipalities and Provinces amounted to 55.39 bn euros.

[26] By 6th April 2012, the total notional of exposure in derivatives, issued by the Italian Republic to hedge debt, was equal to about 160 bn euros, compared with securities in issue for 1,624 bn euros by 31st January 2012. Source: Court of Auditors, *Relazione scritta del procuratore generale*, *Cerimonia di inaugurazione dell'anno giudiziario 2013*, 5th February 2013, which shows the response to the parliamentary question, no. 2/01385, which took place during the public hearing of 15th March 2012 at the Chamber of Deputies; available at www.leg16.camera.it.

[27] For more explanations see BARCELLONE, *Strumenti finanziari derivati: significato normativo di una «definizione»*, in *Banca Borsa tit. cr*., 5, 2012, pp. 541 ff.

numerous diverging interpreta-tions on the legal nature of contracts[28]. According to the most convincing opinion, derivative contracts are claimed to have the negotiation of a risk as their object, which falls behind the legal sphere of both contracting parties. In fact, as we have seen, some contracts do not contain any reference to spread despite being defined as derivatives by the legislator.

In this context, the administrations have negotiated financial derivatives – used for a better management of their debt – in the attempt to control market risks and reduce borrowing costs. Such contracts are intended to create a spread between the value of the entity negotiated upon the issuing of the contract and the value it will acquire on the maturity date previously arranged[29].

These spreads – which periodically accrue interests – require recording in the administration's budget. The problem is that such amounts cannot be determined upon the issuance of a contract, since they depend on the uncertain future market-trends.

Consequently, their budgeting becomes a complex operation, because it concerns financial resources whose flow will not be stable over time, but will rather be bound to change in a fairly aleatory way.

Therefore, the amount to be recorded in the estimated budget might be positive (gain), when accrued in favour of the local entity, or negative (loss), when accrued in favour of the financial intermediary.

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[28] For an analysis see BARCELLONE, *Strumenti finanziari derivati: significato normativo di una «definizione»*, quot.

[29] See the Constitutional Court's interpretation no. 52 of 18th February 2010.

The point is that the Italian legal order does not include any written rule whereby the entities can unambiguously budgetize these spreads.

Paradoxically, even the European legislation has not promptly intervened yet, since Eurostat decisions until 2008 did not include any binding forecasts in this respect for the Member States[30;] and there are not any shared accounting principles for the public sector on a European level yet. Nor has the Italian national law adopted the International Public Sector Accounting Standards (IPSAS) issued by the Public Sector Committee (PSC) of the International Federation of Accountants (IFAC)[31].

Such a shortcoming in the regulations may give rise to opportunistic attitudes in the public administrations, which aim to account for such operations in the most convenient way for them.

In any case, the Italian public administrations are required to follow the principles of sound financial management, inspired to prudential rules, integrity, comparability and transparency of public budgets.

Conversely, should the public authorities be less rigorous in their accounting, the balance of the future budgets might be compromised (on this notion, see the following paragraph).

[30] See *Guidance on accounting rules for EDP Financial derivatives*, 13th March 2008, which responds to the question on how to deal with the flows given by swaps or options in accounting procedures.

[31] On this very subject, IPSAS 15 on «disclosure and presentation» of financial instruments – including derivatives – applies.

Such general principles were valid even before the constitutional amendment (see *supra* § 1) and, on the basis of interpretations[32], prescribed the administrations to carry out an accurate financial analysis on the future trend of the contract, upon approval of the yearly budget plan. Should a derivative generate a cash flow comparable to indebtedness, this positive cash flow would be either allocated to investment expenditures, as provided by Article 119 of the Constitution, or earmarked to pay back the financial intermediary in case of future negative flows.

Therefore, the administrations should have always adopted virtuous policies in employing these special revenues. In case of a positive assessment, they shall exclusively direct these cash flows to pay back the interests on the notional debt. On the contrary, they shall allocate the temporary revenues to the budget surplus reserved to the payment of negative cash flows in the future. Finally, if disbursements are to be faced in the administration's assessment, a special allocation for current expenditures shall be planned in proportion to the size of the financial loss.

The Court of Auditors is only partly responsible for overseeing the accounting regularity of these operations.

As a matter of fact, on a monthly basis, the national legislation[33] requires the Ministry of Economy to forward the Court of Auditors a copy of any derivative contracted by the local entities, which shall have in turn mandatorily

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[32] See Court of Auditors, sez. riun. contr., *Survey on the diffusion of financial derivative instruments and securitisations in the public administrations*, *cit*.

[33] Article 62, paragraph 7, Decree Law no. 112 of 25th June 2008 and Article 41, paragraphs 2 *bis*-2 *ter*, of the Law no. 448 of 28th December 2001.

notified the Ministry. Conversely, there are no transparency rules prescribing the Ministry to forward the Court of Auditors the derivatives contracted by the central administration. Nor are there similar information systems applying to the other non-local public administrations. The Directorate General of Ministry of Economy is simply required to send the Court of Auditors «a six-monthly report on the Treasury's liabilities emphasizing the appropriateness of the decisions taken»[34].

Finally, it should not be overlooked that the control operated by the Court of Auditors seems to be little effective considering that it is very hard to assume damages to the State, given the difficulty in applying rules of administrative liability to harmful events for the public finances that are hardly predicted, even with the best stochastic rules[35].

It clearly emerges that the implementation of a real European economic governance can hardly be reconciled with the context here described. As part of the Six Pack, the directive 2011/85/EU (the so-called Directive on national budgetary frameworks) states that the availability of complete, reliable and comparable budgetary data among the Member States is crucial to pursue a budgetary surveillance on a EU level.

In accordance with Article 16, paragraph 3 of the aforementioned directive, the European Commission is currently assessing the suitability of the International Accounting Standards applicable to the Member States' public

[34] Article 3, Ministerial Decree, 10th November, 1995.

[35] Towards a critique of the mathematical models in predicting risks, see PASSALACQUA, *Diritto del rischio nei mercati finanziari. Prevenzione, precauzione ed emergenza*, Padova, Cedam, 2012, pp. 140 ff.

sector (IPSAS), aiming to create a single set of accounting standards on any level of the public administration within the European Union[36].

3. Recently, the Constitutional Court has proved to be considerably severe in judging the use of financial derivatives by local autonomies, as they are believed to hinder debt control by these very administrations.

In more detail, following the appeal filed by some Regions, the Supreme Court has intervened on the legitimacy of state regulations limiting the use of derivatives. In 2008, a decree was passed and repeatedly modified, which introduced a provisional ban for the local entities on entering into contracts involving derivative financial instruments[37]. This ban was bound to expire upon issuance of a Ministerial Regulation aimed at more accurately regulating this subject-matter, which however has not been issued so far[38].

Actually, the Constitutional Court regards financial derivatives as 'dangerous' to the public finances, as they contain an evident non-predictable market risk falling beyond the parties' intention (see *supra* § 2) and facing the

[36] Commission Report to the Council and the European Parliament, *Towards implementing harmonised public sector accounting standards in Member States. The suitability of IPSAS for the Member States*, 6th March 2013, COM/2013/0114 final.

[37] Article 62, paragraph 6, Decree Law no. 112 of 25th June 2008, then amended by Article 3, paragraph 1, of Law no. 203 of 22nd December 2008.

[38] See CAPRIGLIONE, *The use of «derivatives» by Italian municipalities in public finance management. Still an issue*, *cit.*

administrations with inappropriate financial costs, unforeseeable at the time the contract was concluded[39].

Thus, the use of contracts with strong aleatory components for investment operations does not seem to be compatible with the standards of a good accounting practice.

The restrictions imposed by the state regulations onto the local entities, as concerns the use of derivatives, end up by ensuring also the protection of the assets of the public bodies.

Case records have fully demonstrated that – besides setting unfavourable conditions onto the entities in the first place – derivative contracts, when renegotiated following debt restructuring, involve further risk-taking, as they shift over the period the costs deriving from even more unfavourable conditions, compared to the initial ones.

In short, the renegotiation of derivatives is characterised by a high degree of uncertainty, which can endanger those public financial resources the entities could use for collective needs; and thus for the general interest of the community.

Furthermore, the rules applying to each derivative contract are bound to necessarily and directly influence those economic balances that are meant to be ensured on a regional and local level.

[39] See CONSTITUTIONAL COURT, 18th February 2010, no. 52, quot.; Id., 28th March 2012, no. 70, *cit.*

As a consequence, such negotiations appear to be dangerous also because they can prejudice the financial interest represented by balanced public budgets.

In light of the all reasons here provided, Article 62 of Decree-Law no. 112/2008 requires (only) local entities to enclose a report – in addition to final balance and budget plan – detailing the financial costs and liabilities, respectively estimated and undertaken, which originate from derivative contracts or contracts including a derivative component.

The regulation does not merely require a brief or general description of the derivatives contracted by the public administration, but it rather demands a detailed definition of any expenditure occurred and an estimate of the future ones, on the basis of the mathematical models adopted in connection to the financial markets trend. By doing so, the legislator compensates for a lack of clear accounting rules on cash flows deriving from the contracts; which therefore lays the foundations for a sound and prudential financial management of the public administration.

According to the Constitutional Court, such forecast aims to preserve balanced budgets; in that – as it imposes the compliance with financial as well as economic elements (the nominal value of the contract on the whole) – it also requires the entities to provide essential information to define public debt on a national level and enables them to make sure that budget planning and management comply with the rules of a sound accounting practice[40].

[40] See CONSTITUTIONAL COURT, 28th March 2012, no. 70, *cit.*

Hence, the goal of the Court is to extend the hedging requirements to derivatives by equating them to multi-year expenditures with variable and complex components, in accordance with a constant approach of the Supreme Judge[41].

Consequently, in relation to the derivatives contracted by the public administration, the hedging strategies need to be thoroughly and exhaustively presented in the aforementioned report, which shall also provide accurate information in order to adopt coherent contractual options and effective controls (within the competence of the Ministry of Economy).

This represents a guarantee for the balances of both current and future financial years.

Actually, the report is intended to disclose the activities recorded in the budget and it therefore enables the assessment of their future impact on both the entity's assets and the future financial balances.

Given the significant impact these multi-year aleatory contracts may have on structural elements of the Regional finances, if the local autonomies failed to provide the above-mentioned report, a conflict would inevitably arise with the trend to preserve the balance of the budget forecast for the current and future financial years. In particular, all this should be considered in terms of precautionary measures against potential inadequate decisions, which might be favoured by the lack of clear and strict reference standards.

[41] See decisions no. 68 of 2011, no. 141 and no. 100 of 2010, no. 213 of 2008, no. 384 of 1991, no. 283 of 1991, no. 69 of 1989, no. 17 of 1968, no. 47 of 1967 and no. 1 of 1966.

The Court's interpretation turns out to be very important to limit any incautious conduct shown by the Regions in assessing the risks connected to the derivatives formerly traded. In fact, the Court will declare unconstitutional any Regional budget law lacking a report containing the above-mentioned elements on the derivatives contracted, for violating the hedging principle.

Such an approach should motivate also the local entities to respect the rule of enclosing a report, at least in consideration of the interpretation and assessment the Supreme Court may give of the controls operated by the Court of Auditors.

No wonder the legislator has eventually introduced in the Stability Law 2014[42] the permanent ban on purchasing derivatives for the local entities, unless they are interest rate caps concerning loan agreements; that is a derivative guaranteeing the buyer against interest rates rising over the threshold agreed on.

In fact, the legislator's intervention appears to be short-sighted and not in line with the constitutional reform imposing balanced budgets and public debt sustainability on any public administration, including non-local ones (*supra* § 1)[43].

Despite the Court's warnings, the legislator has failed to extend the ban on purchasing derivatives to every public entity, either national or non-local in any case, and therefore to solve an interpretative issue that may damage financial stability (see *infra* § 4 for more details). In addition to that, it has not been taken

[42] Art. 1, paragraph 572, Law no. 147 of 27th December 2013.

[43] See also Article 13 of Law no. 243 of 24th December 2012, *Provisions for the implementation of the balanced budget principle in accordance with Article 81, paragraph 6 of the Constitution*.

into account the opportunity of introducing strict rules to the numerous government-owned corporations, which can almost surreptitiously undermine the solidity of the national public accounts (see *infra* § 4).

What is more, the real problem is that the new regulation does not require any public administration – not even local ones, which are once again allowed to purchase interest rate caps starting from 2014 – to carry out an economic assessment of the derivative proposed prior to purchase, also in consideration of the entity's initial financial portfolio.

In accordance with the constitutional requirement to ensure balanced budgets and public debt sustainability, it is crucial to guarantee greater transparency of the contracts involving public authorities by illustrating the scenarios of real world probabilities, according to the methodology suggested by the National Companies and Stock Exchange Commission (Consob)[44].

On top of that, the constitutional amendment does not bind the financial intermediaries to explicitly provide the derivative's fair value upon subscription, nor to indicate the implicit cost of the derivative operations.

On the whole, any regulation allowing a public administration to enter into contracts that may potentially generate hidden charges and increase debt is not

[44] See GIORDANO - SICILIANO, *Probabilità reali e probabilità neutrali al rischio nella stima del valore futuro degli strumenti derivati*, Quaderni Consob, August 2013; see also BAXTER - RENNIE, *Financial Calculus. An Introduction to Derivatives Pricing*, Cambridge, Cambridge University Press, 1996; CHENG YONG TANG – SONG XI CHEN, *Parameter estimation and bias correction for diffusion processes*, in *Journal of Econometrics*, 2009, no. 149, pp. 65 ff.; HUMPHREYS - NOSS, *Estimating probability distributions of future asset prices: empirical transformations from option-implied risk-neutral to real-world density functions*, Bank of England working paper, 2012, no. 455.

consistent with the Italian Constitution. This is because future expenditures – for which no hedging is available yet – may arise to the detriment of the financial balance. Any hidden charge – in terms of lost profits and losses – is against the principle of debt sustainability, which is based on the virtuous cycle between accumulated debt and owned wealth; as it undermines the possibility for the public entity to pay back its debt upon contact expiration[45].

4. As previously mentioned (s*upra* § 2), it is now a while that, under Italian national law, doctrine[46] and case law[47] have agreed on public bodies' full legal capacity in terms of civil law.

As a consequence, in the absence of prohibitions or restrictions imposed by the law, they are allowed to conclude any contract, typical or atypical[48], aiming to interests worthy of protection, on condition that they are not

[45] This principle can be drawn from Article 4 of Law no. 243 of 24th December 2012, *cit.*

[46] See AMORTH, *Osservazioni sui limiti dell'attività amministrativa di diritto privato*, in *Arch. dir. pubb*., 1938, pp. 455 ff.; PERICU, *Note in tema di attività di diritto privato della pubblica amministrazione*, in *Ann. Genova*, 1966, I, p. 166; ROMANO, *L'attività privata degli enti pubblici. Problemi generali, la capacità giuridica privata*, Milano, Giuffrè, 1979, pp. 143 ff.; MERUSI, *Il diritto privato della pubblica amministrazione alla luce degli studi di Salvatore Romano*, in *Dir. amm*., 2004, 4, pp. 649 ff.

[47] It has been established in case law since the well-known pronunciation of the Council of State, sect. VI, 12th March, 1990 no. 374. See also Council of State, sect. III, 11th May 1999 no. 596; Council of Administrative Justice of the Sicily Region, 4th November 1995, no. 336 and Council of State, sect. V, 1st March 2010, no. 1156.

[48] See Council of State, sect. V, 7th September 2011, no. 4680, as well as, in the doctrine, DUGATO, *Atipicità e funzionalizzazione nell'attività amministrativa per contratti*, Milano, Giuffrè, 1996.

incompatible with the institutional objectives, to the satisfaction of which the law established them.

More recently, like for private individuals regulated by civil law, this entitlement is no longer established through interpretation, but through a clear provision of positive law, as supported by Article 1, paragraph 1 *bis* of the Act on administrative procedure (Law 241/1990), introduced in 2005, which states «When a public administration issues non-authoritative acts, it operates according to civil law unless otherwise provided by the law[49]». This provision implies that any public administration can generally carry out agreements, such as contracts, which no one in Italy has ever doubted for over the past half-century.

Following a first general examination, any public body can apparently conclude derivatives for the Italian national law in the absence of special provisions of State law[50], which are currently applied only to the local authorities (*supra* § 3). We only have to remember here the case of the Ministry of Treasury.

Actually, this issue needs a more comprehensive examination, also to investigate how the constitutional reform on balanced budgets here illustrated might contribute to the hermeneutic solution of the problem.

There can be no doubt that any public administration may decide to conclude a contract, when it is considered to be the best instrument to achieve the public interest pursued by the administration itself. By no means could an

[49] Note that by explicit provision of art. 1 quot., this is a general principle.

[50] It should be remembered that in Italy only the central government has legislative power in matters of civil law.

administration resolve to conclude contracts that are in conflict with the interest pursued, unless under the penalty of infringing the law and therefore of declaring voidable the act at stake. As a consequence, the contract itself would be void for infringement of mandatory rules.

As stated by the far-sighted doctrine, public authorities began in fact to employ the legal instruments of civil law not much as alternatives to authoritative acts, but rather because of the «inadequacy of public legal instruments in specific cases; in short, the use of contracts was a matter of good administration»[51].

The functional use of contracts to pursue public interest is ensured by a series of public procurement rules – the first among all the other rules of administrative proceeding – established by European law for the choice of the contractor.

Public accounting rules – intended to protect financial interest – are within the same set of rules, which are now fully recognized in articles 81 and 97 of the Constitution. This is true at least of the authorities governed by public law, other than the State, for which budgetary constraints were not parameters taken into explicit account previously.

It should not be forgotten that there is a strong link between public contracts and public accounting, since any contract has consequences on a financial level.

[51] With these terms TRIMARCHI - BANFI, *Il diritto privato dell'amministrazione pubblica*, in *Dir. amm*., 2004, 4, pp. 661 ff.

According to the Italian national law, contracts involving expenditures charged to the central or local (not regional[52]) administration are indeed ineffective, or without obligation for the authority, until an authorization according to the law and an accounting commitment are recorded in the appropriate section of the public body's balance forecast[53].

Consequently, a public authority is bound by a contract only in case a regular expenditure commitment applies.

Such expenditure commitment requires in turn to certify the existence of a financial coverage. Should this requirement be lacking, the related contract remains ineffective for the administration[54].

In conclusion, the ineffectiveness of the contract derives from the lack of financial coverage of the administrative provision.

In the author's opinion, claiming the invalidity of the contract would be more questionable under the current law. The resolution to conclude the

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[52] A state law regulating the matter is missing. See *supra* note 50.

[53] See the Royal Decree of 18th November 1923 no. 2440, *New provisions on the administration of the assets and the State Accounts*, the Royal Decree of 23rd May 1924, no. 827, *Regulations for the administration of the assets and the State Accounts*, the Decree of the President of the Republic 20th April 1994, no. 367, *Regulations for simplifying and accelerating the disbursement and accounting procedures*, the Law of 31st December 2009, no. 196, *Public finance and accounting Law*, article 191 Decree of 18th August 2000, no. 267, *Consolidated law on local government*.

[54] Since 2009, the government has granted the Court of Auditors a power of «a priori» audit of the legality of every employment and consultancy contract awarded by any administration, whatever their value. These contracts take effect upon completion of the checks, or otherwise, within thirty days of receipt by the control office without being remitted to the examination of the control section of the Court (see Art. 3, paragraph f *bis* – f *ter*, Law 20/1994 introduced by Decree-Law 78/2009).

contract would be ineffective but valid, thus inadequate to identify a validity defect in the contract.

So public authorities, other than local ones, could definitely enter into derivative contracts before the reform of articles 81 and 97 of the Constitution, since the fact that they fell outside the common negotiating models on public accounting provided for by law did not preclude them.

It is nonetheless true that, as demonstrated in the previous paragraphs, contracts containing derivative components can generate risks in the form of «hidden» debt[55].

Obviously, nor the obligation on the public authority to indicate in the resolution the exact content of an atypical contract can remedy this[56].

Strictly speaking, the respect of the rules of public procedure in choosing the contracting party should ensure the satisfaction of the authority's financial interest. Therefore the authority is required to adopt the most economical solution – or at least the most advantageous – offered by the markets, as the one capable of minimizing costs and possibly maximize benefits in terms of quality of the performance.

On the other hand, given the financial commitment the contract entails, accountancy rules oblige the authority to subordinate the resolution to contract to the budget availability.

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[55] It is also expressly declared by the Court of Auditors, *Relazione scritta del procuratore generale*, *Cerimonia di inaugurazione dell'anno giudiziario 2013*, 5th February 2013, *cit.*

[56] This obligation has been long theorized in the doctrine, see for instance DUGATO, *Atipicità e funzionalizzazione nell'attività amministrativa per contratti*, *cit.*, pp. 153 ff.

Yet, if such contract does not enable to assess the real financial commitment on the authority's budget, due to its intrinsic features, one can infer that, on the whole, it cannot be easily reconciled with the constitutional obligation to ensure public debt sustainability.

In this case, one might wonder whether the lack of strict regulatory limitations on the capacity of authorities – other than local ones – to enter such contracts could mean that the authorities are entirely free to conclude derivative contracts.

It is apparently harder to support this solution when the pursuance of public finance targets (i.e. budgetary constraints) becomes a general principle of European law, even before being a constitutional rule of a national law. Is this not inevitable that, once this principles have been adopted, the authority's capacity to enter into contracts turns out to be further limited?

In the opinion of the writer, this should be so any time the authority's contractual activity fails to comply with the above-mentioned principles at the top of the hierarchy of sources, because of the specific features of the contract type chosen.

If we adopt a different reasoning, we will continue to consider the targets of balanced budgets and public debt sustainability as mere government guidelines, indirectly protected through public procurement on the one hand – which should ensure the authority to trade at the lowest market costs – and through hedging rules on the other.

However, such conclusion is not convincing, since accountancy rules on their own are not fit to protect the administration from financial risks that do not immediately surface as costs.

As previously stated, on the basis of positive law, the afore-mentioned public finance targets have become general principles of the administrative action, on a constitutional and European level. The authorities shall therefore follow them in the pursuit of their activities as a priority and such restrictions shall constitute limits to their activity. These rules of public finance prove to be binding in themselves; as a result, the authority's contracting activity shall be legitimate only if reconcilable with budgetary discipline, namely the respect of the requirement of financial coverage aimed at ensuring balanced budgets and debt sustainability.

In the author's opinion, it follows that authorities should not be permitted to conclude, at least, any derivative contract whose structural features prevent from thoroughly establishing the financial commitment to which the authority is exposed. In other words, the authority's legal capacity in terms of civil law has its limit in the financial and asset sustainability. This means that the authority shall be prevented from entering into any contract obliging it to financial charges whose amount can hardly be calculated or which, in any case, cannot be calculated on the basis of the estimated maximum potential risk to which the authority is exposed.

In essence, should one disagree on this point of view, on account of the lack of regulations restricting the capacity of a public authority – other than

local – to conclude derivatives, the authority's capacity to ensure balanced budgets and public debt sustainability would be considerably reduced.

Evaluating whether the constitutional reform may have affected the capacity of private companies with public participation to conclude derivatives is far more complex.

In actual fact, by analogy with what the Ministry of treasury has already been granted, a budget law dating back to 1996 (Dini government) explicitly allowed public bodies with economic interests and joint-stock companies with a majority of public shareholding to trade derivatives «for their domestic and external indebtedness»[57].

Such indebtedness, nevertheless, has been submitted to the authorization of the Ministry of Treasury.

Following the local self-government reform of the Italian Republic (2001), we raise doubts about the applicability of the rule to private companies with participation of local authorities.

We are once again faced with the problem of the authority's capacity of concluding this kind of contracts. As a matter of fact, it is a phenomenon which can gain substantial relevance for the stability of public accounts, if we just think that private companies with participation of local authorities total 5.000[58], according to recent statistical surveys.

[57] See article 2, paragraph 165, Law of 28th December 1996, no. 662, *cit.*

[58] To be more precise 4874, see ASSONIME, *Principi di riordino del quadro giuridico delle società pubbliche*, Roma, September 2008, p. 8.

The formal status of joint-stock company certainly prevents from equating them *tout court* to public authorities, in virtue of the national administrative law.

However, due to the interference with the European law, the very notion of public authority has assumed a variable structure according to where it applies.

Unfortunately, it is rather difficult to infer from the national law what the boundaries of the notion of public authority are, in order to apply the rules of public finance.

Even more worrying is the fact that the aforementioned provision to implement the reform of articles 81 and 97 of the Constitution (Art. 2 Law no. 243/2012) has not seized the opportunity to clarify this point. In order to illustrate to which public authorities the balanced budget and debt sustainability applies, the above provision confines itself to consider public authorities as companies included in the public administration's consolidated income statement, as identified by the National Institute of Statistics (Istat)[59].

More specifically, the Istat identifies the authorities to include in the consolidated income statement in accordance with the ESA95 Community Regulation. Yet, the regulation once more raises the still unsolved interpretative question on public procurement, as concerns the correct identification of a clear-cut notion of body governed by public law.

[59] Article 1, paragraph 2, Law no. 196/2009, *cit.*

According to the ESA95 regulation, any «for-profit» company controlled by local authorities should remain excluded from the institutional sector of the public authorities. It is far more complex to clearly infer which they are.

Not to mention the fact that the activity carried out by Istat is merely clarifying and not constitutive. This means that the public status of a company cannot be unambiguously determined by merely reading the list of companies included (at least to apply the rules of public finance). In addition, the sole analysis carried out by the Institute does not seem to be particularly representative of a company's real status. Even though such analysis is conducted by the State statistical authority, the result also depends eventually on the companies involved, whether they fulfil or not the requirement to provide the data requested for the survey of the national statistical programme. It is to be feared that the ambition of each authority (to either depart from or approach the notion of public authority), may determine the authority's selection of data to be forwarded.

In conclusion, for all the reasons presented in the first part of this paragraph, any non-profit company controlled by local authorities, such as – in the author's opinion – companies delivering public services to be included in the public administration's consolidated income statement in accordance with ESA95, should refrain from entering into derivative contracts, as they are subject to be included in the administrative system subordinate to the rules of public finance.

5. In the last decade, the Italian legislation concerning derivatives contracted by the public administration has probably paid too much attention to regulating the use of innovative finance by the local administrations. Inexplicably, it has been neglected the adoption of a coherent and uniform legislation to regulate the use of structured finance by any subject managing public finances, and therefore capable of affecting the stability of the public finance.

As a consequence, there is considerable concern for public accounts to be exposed to inappropriate risks, even due to the mere lack of an adequate information and control system.

The interpretation of the amended article 97 of the Constitution here suggested is an attempt to make up for the legislator's inertia and it reaches as far as assuming the existence of a constitutional ban on any public administration assuming obligations for indefinite and/or indefinable amounts, which may therefore exceed the financial resources available resulting from the entity's balance forecast or its financial capacity.

This prohibition could not derive from the provision previously in force, that is the principle of sound administration, later implemented in the principles of profitability and efficiency contained in article 1 of Law no. 241/1990, because such legislative framework only required a profitable use of the public resources.

At most, it could be implied form the original constitutional provision that failing to provide the financial coverage of any expenditure beforehand is a violation of the principle of sound administration.

The current regulation does not only require the administrations to proactively operate to achieve a balanced budget, but also to ensure future debt sustainability, namely the availability of financial and capital resources to pay off the debts incurred. In short, the active pursuance of balanced budgets and debt sustainability are among the interests of any administration, under penalty of illegitimacy of their activities.

For all the reasons here illustrated, these new constitutional provisions question the lawfulness of contracting derivatives for the public administration, firstly because they may result in losses greater than the capital invested and prejudice the entity's financial capacity as they bear systemic risk, and secondly because the future capital costs for the administration can hardly be estimated from the contractual clauses regarding a risk that is unrelated to the parties' conduct and intention.

Finally, in this new context, the decision to authorize such contracts might be considered illegitimate for being detrimental of the overriding interests proposed above.

This seems to reinforce the hypothesis of considering void any contract based on that resolution for violating overriding rules (Art. 1418, Civil Code).

In conclusion, an urgent intervention by the legislator is clearly needed to regulate the use of these financial contracts by all public authorities, as well as companies with public shareholding. There are two possible regulatory options: either to introduce a ban on these innovative financial instruments for any public body, or to accurately regulate this issue, by ensuring the disclosure of

necessary information to render derivatives thoroughly compatible with the constitutional principles aimed at protecting the stability of public finances.