MEF Dipartimento del Tesoro

Subnational Debt and Contingent Liabilities: Challenges and Lessons

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Control of Subnational Finance: a Crucial Concern for National/Federal Governments

Almost everywhere, central government needs to preserve the financial stability at every level of public sector, as the external perception of the country can be impacted also by problems arisen in a local authority or a public company.

This should be combined by the right level of autonomy and responsibility of local administrators, avoiding the risk of moral hazard. A suitable institutional framework is then important, as well as a solid system of control, to avoid the emersion of contingent liabilities.

Experiences vary in different countries, but the very dynamic evolution of legal frameworks testifies how challenging is the issue and how relevant are the potential consequences of every choice.

The Italian Experience

Italian Istitutional Framework

According to the Italian Constitution, legislative powers are shared between the State and the Regions in compliance with the Constitution itself and with the constraints deriving from EU legislation and international obligations. Anyway some subject matters, such as the currency, saving protection and financial markets are exclusive of the State.

Moreover, even if since 2001 the space for autonomous financing of Local Authorities has been increased, an important part of their functioning still depends on State transfers.

Local Authorities shall have revenue and expenditure autonomy, but they may resort to indebtedness only as a means of financing investment expenditures.

No-Bail Out Clause State guarantee on subnational debt is not admissible

Italian Istitutional Framework

If and when a local authority falls in serious budgetary problems, the law envisages graduated procedures, linked to the severity of the problem, strictly monitored by Central Government bodies, in order to restore sound and sustainable budgets.

In very limited cases, due to the relevance of the Local Authority, Central Government has undertaken the liabilities.

i.e. City of Rome debt outstanding at April 2008 is under a Special Central Government unit management

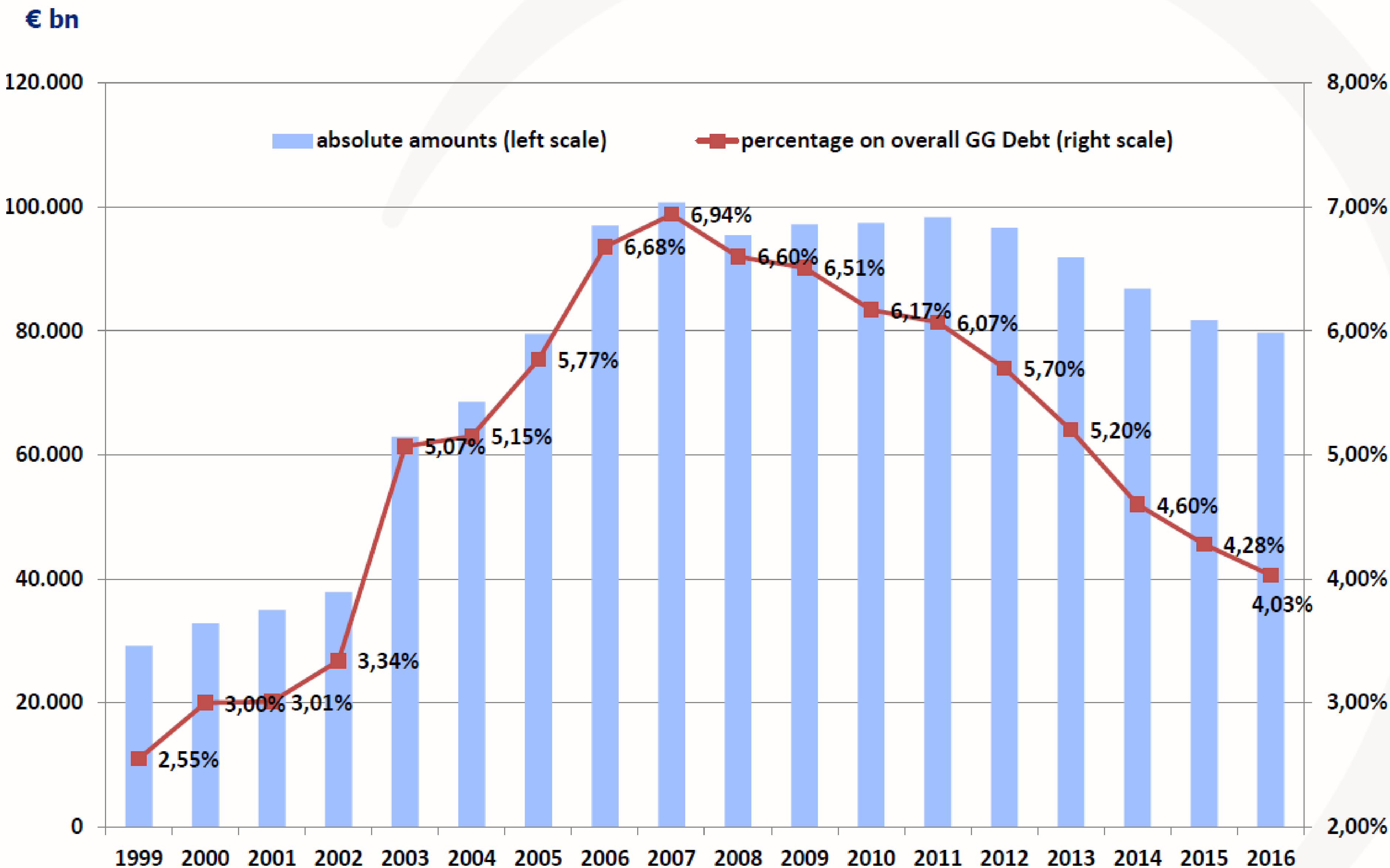
Italian Istitutional Framework

Before 2002, Local Authorities – at every level: Regions, Provinces, Municipalities - could be indebted with loans and bonds, but only in amortizing format. Starting from 2002, they were allowed to issue bullet bonds providing at the same time amortization plans in their budget or entering in amortizing swaps.

Despite a quite strict regulation, issued in 2004, on permitted type of derivatives, over time there was occurred a use of derivatives that the legislator felt as inadequate and this drove to a temporary stop in this activity in 2008.

Starting from 2014 the use of derivatives is prohibited for every level of Local Authorities. Consequently, today they can issue only in euro and in amortizing format.

Historical Evolution of Local Debt



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A Case of Emersion of Contingent Labilities: Commercial Arrears

- In the aftermath of the last financial crisis, the State steps-in to pay commercial arrears, providing oxygen to real economy. At the same time, new stringent rules were adopted to prevent similar future problems, implementing a system of mandatory electronic invoice at every level of government.

- Central Government borrowed in the market and made loans to Local Authorities for about € 30bn.

- Local Authorities must find in their budget resources for repayment: reducing costs or increasing taxes.

- In particular, the financial sustainability of the deal for Regions is monitored and evaluated in cooperation between Regions and the Ministry of Economy and Finance (MEF).

Regional Bonds Buy-Back

Another example of State intervention to relief difficulties at local level has been represented by a 2014 law.

Actions

-Restructuring of some old MEF loans to Regions

-Buy-Back eligible regional bonds

-Unwind related derivatives

Targets

-No increase in public debt

-Improving and simplifying local authorities financial conditions

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Regional Bonds Buy-Back

Thought, co-ordinated and supervised by the MEF, the offer has involved six Regions for a maximum of € 5,6 bn outstanding securities.

The public tender offer in December 2015 reached about € 3,7 bn, corresponding to a take-up of 66% of the eligible outstanding.

One year later, an additional tranche of bonds for about € 1 bn nominal outstanding was bought back, reaching a total take-up of 84%.

The buy-back was financed with a 30y loan by the MEF to each Region and with the proceeds of the related swap unwinding

For further information:

www.dt.mef.gov.it/it/debito_pubblico

Thanks!