More swap terminations for Italy?

Italian politicians were involved in a tense exchange last month over four derivatives trades between the Dipartimento del Tesoro – the country's debt office – and Morgan Stanley, which were terminated by the US bank in January, forcing Italy to pay out €2.567 billion.

That was a unique situation, according to Italian education undersecretary Marco Rossi Doria, whose remarks were published in parliamentary transcripts on March 15. He said the trades contained alternative termination event (ATE) clauses, allowing Morgan Stanley to close out if Italy was downgraded below a certain threshold. The Tesoro has no other trades containing ATEs, Doria claimed.

That may be true – but dealers say it is unlikely to be the whole story. ATEs are only one type of clause allowing counterparties to terminate a trade – contracts can also include options allowing one or both counterparties to terminate at specific points during the life of a trade, also known as break clauses (*Risk* March 2012, pages 14–18, www.risk.net/2155501). If breaks exist in trades with the Tesoro, other banks that are in-the-money could choose to follow Morgan Stanley's example.

One European banker that has seen the details of a number of outstanding trades between the Tesoro and its other dealers claims at least two contain breaks, one of which is exercisable in a matter of months, he says.

Other banks contacted by *Risk* refused to say whether their own trades with the Tesoro contain breaks, but two said it was safe to assume some banks do have those options. "Do I think there are break clauses in trades with Italy? Yes, I do. There are some large

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portfolios out there, with some very long-dated, uncollateralised trades, so there's a high probability that some banks will have these clauses in the contracts," says one head of credit value adjustment (CVA) trading at a US bank.

Sovereigns do not like to be subject to break clauses. Four debt offices contacted by *Risk* said one or more of their dealers have recently tried to insert breaks into trades. In each case, the debt office refused.

However, according to the European banker, some of the Tesoro's swaps do include breaks because it traditionally uses swaps for duration management – paying fixed rates to guarantee its long-term cost of funding – and some of its outstanding trades are very long-dated, going out to as much as 40 years in tenor. "Because of the very long-dated nature of their trades, some banks have insisted on break clauses," he says.

Banks have become increasingly sensitive to capital and funding costs arising from trades with sovereign counterparties. Funding obligations can arise if a trade is subject to a collateral agreement in which only the dealer has the obligation to post collateral – this means that if a dealer had hedged itself by conducting an offsetting trade under the terms of a two-way credit support annex, it would not receive any collateral from the sovereign when the value of the first trade is in its favour, but would be required to post collateral to its hedge counterparty, creating a funding obligation (*Risk* February 2011, pages 18–22, www.risk.net/1949147).

And capital costs are set to increase as a result of the incoming Basel III charge for CVA. One of the key inputs to the charge is the exposure the bank has to the counterparty, which can only be reduced by posting collateral or hedging with credit default swaps (CDSs). The use of CDSs in this context potentially gives rise to a debilitating feedback loop in which an increase in the exposure produces demand for protection, and a consequent rise in CDS spreads, with the spreads then driving an additional increase in the exposure (*Risk* November 2011, pages 16–20, www.risk.net/2120808). Discussions about implementing European legislation for Basel III have seen both the European Parliament and the Council of the European Union propose that trades with sovereign counterparties be exempt from the CVA charge (www.risk.net/2157060).

According to data published by the European Banking Authority in December as part of its bank recapitalisation plan, a number of European institutions have significant derivatives counterparty exposure to Italy – and therefore a big implied CVA capital requirement. BNP Paribas reported it was in-the-money to the tune of €2.96 billion, with Deutsche reporting a positive exposure of €2.44 billion. Two Italian banks – Intesa Sanpaolo and UniCredit – were both in-the-money by just over €1 billion, as was Dexia Group.

The trades terminated by Morgan Stanley were closed on January 3, according to Doria's parliamentary remarks. They included two interest rate swaps and two swaptions. The Tesoro was forced to pay the net present value of the trade to Morgan Stanley, which amounted to €2.567 billion – and the CVA impact of the termination became public when the US bank reported its fourth-quarter results on January 19.

However, Doria's explanation of the ATE clause was met with scepticism by parliamentarian Antonio Borghesi, who pointed out links between Morgan Stanley and Italian politics.

"Goodness, no-one thinks it is a crime that the son of the prime minister works for Morgan Stanley and the chief country manager for Morgan Stanley in Italy is Domenico Siniscalco, who was minister of economy and finance in one of the previous Berlusconi governments. Of course, transparency in these cases is necessary because, before we get to a hypothetical conflict of interests – which needs only to be hypothetical to be negative – at least a little reckoning needs to be done," he said. Morgan Stanley declined to comment.

The total notional value of derivatives instruments transacted by the Tesoro, according to Doria, was around €160 billion, as of January 31, 2012 – roughly 10% of the size of Italian debt. This included about €100 billion in interest rate swaps, €36 billion in cross-currency swaps and €20 billion in swaptions.

The Tesoro declined to comment, while Doria and Borghesi could not be reached for comment.

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