



# Liabilities Management techniques. The use of derivatives

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# Approach of the Treasury to Liability Management

- The Italian Treasury actively uses derivatives to manage the risk associated with its fund raising activity in the capital markets
- Until a few years ago, the role of the Treasury was limited to the analysis of the incoming and out coming positions, while the execution of the trades was entrusted to the Bank of Italy
- Afterwards, the Treasury decided to bring the operations entirely under its responsibility, and therefore the Direction of Public Debt assumed a more active role in the derivatives policy
- Today all the operations are analyzed, priced and executed by the Treasury
- The swap book of the Republic of Italy is also managed internally

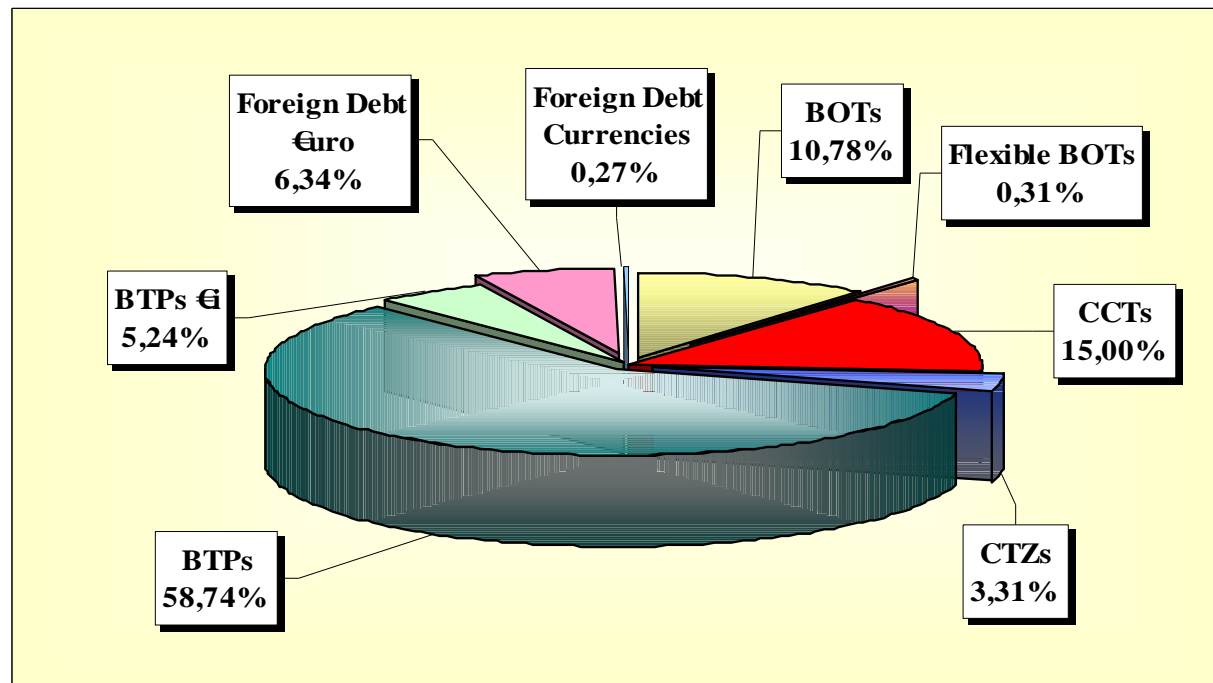
# Focus on the Risk Management activity / 1

- The Italian Treasury has a consolidated presence on international capital markets
- The domestic issuance program is complemented by an international funding program, through which bond are issued:
  - ✓ In different currencies (USD, CHF, JPY, GBP, etc.)
  - ✓ In different forms (Global, EMTN, etc.)
  - ✓ With different structures (long/short term, fixed rate or FRN, with option, etc.)
- Such activity generates an amount of exposure that needs to be reconciled with the overall liability portfolio of the Republic of Italy

# Focus on the Risk Management activity / 2

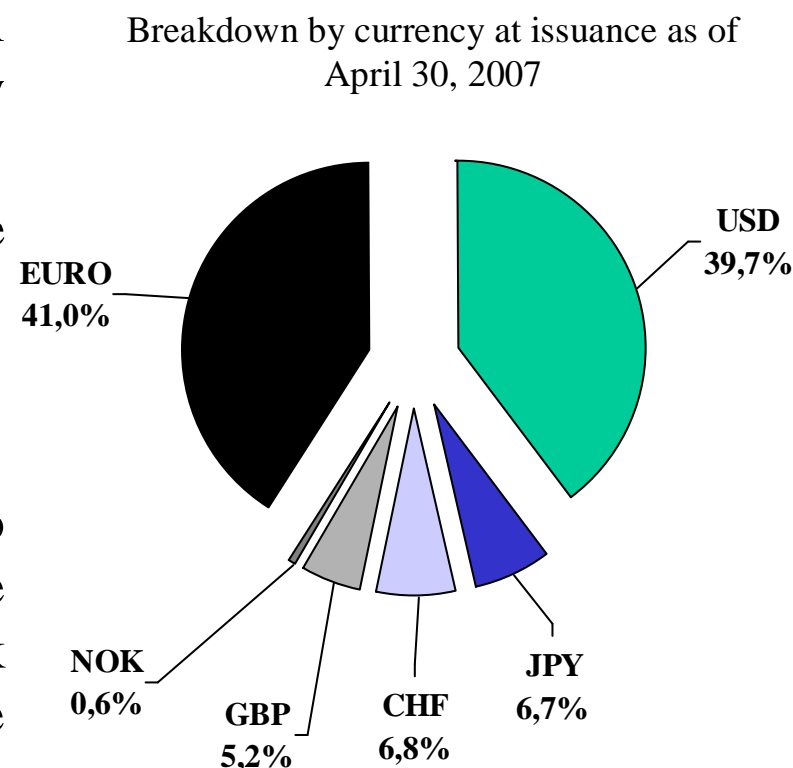
- This activity is relevant but limited if compared to the size of the outstanding debt of the Republic of Italy.
- More recently, the Treasury is also looking to the possibility of using derivatives to manage the risk of the domestic debt portfolio so that the exposure of the Republic of Italy is managed as a whole.

GOVERNMENT DEBT: BREAKDOWN BY INSTRUMENT AS OF 30 APRIL 2007



# Exposure from issuance activity

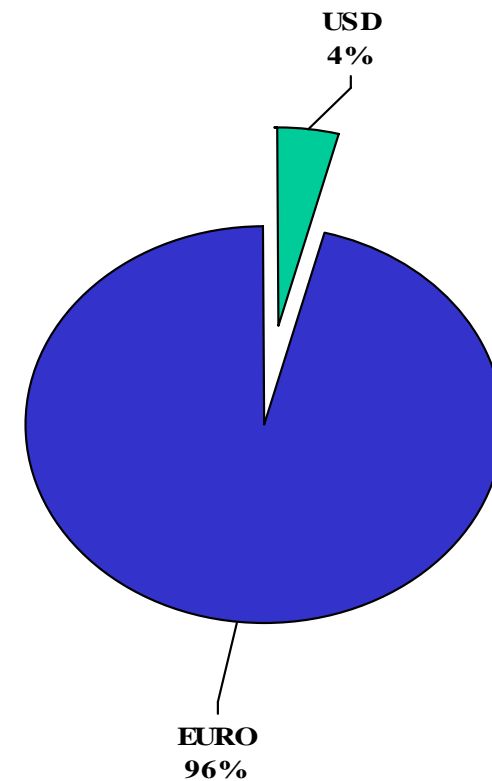
- Funding activity under the international program could be broken down by currency as shown by the pie chart
  - Bulk of international funding is done both in US dollars and in Euro
  - Some other currencies appear as well
- However, the Republic of Italy has no need to be structurally short in these currencies. Therefore n° 1 aim of risk management activity is to eliminate currency risk



# Cross currency swap / 1

- Cross currency swap are executed either during the funding transaction or after
- If executed during, counterparty is most likely to be chosen among lead managers
- If not, can be either one of the leads or any other

Breakdown by currency after swap as of April 30, 2007



# Cross currency swap / 2

- If cross currency swap is executed during or immediately after the funding deal, some FX rate is locked in and usually the position is not managed further until maturity
- Alternatively, if for some reason the currency position is not hedged immediately, the Treasury will actively monitor the position, with the intention to close the FX exposure should the market move in a favourable way.
- In the mean time, the FX profit/loss is not accounted. It will be registered at year end for debt recording purposes
- The Treasury seeks to maintain currency exposure low as much as possible, so as to avoid strong fluctuations of the debt stock due to currency appreciation / depreciation

# Interest Rate Exposure Management

- Management of interest rate exposure can be associated to issuance activity in international capital markets
- Hedge activity can be executed during funding transactions or afterwards
- More recently, the Treasury is looking into the possibility of using derivatives to manage the whole portfolio of the Republic of Italy, i.e. including the domestic debt
- This poses additional challenges in terms of execution, approach to the market and counterparty risk
- A process is ongoing to acquire a more sophisticated system to manage the swap book and all the related risks

# Risks encountered in Sovereign Debt Management

- Market risk: refers to the risks associated with changes in market prices, such as interest rates and exchange rates on the cost of the government servicing
- Rollover risk: the risk that debt will have to be rolled over at a higher cost
- Credit risk: the risk of non-performance by a counterparty on financial contracts
- Settlement risk: refers to the potential loss that the government could suffer as a result of failure to settle by the counterparty
- Operational risk: includes transaction errors, inadequacies in internal controls, reputation risk, legal risk.

# Credit Risk

- Law n. 887 of 1984 introduced derivative contracts for the Republic of Italy, and a Ministry Decree of 1995 specified that swap counterparties should be financial institutions with high credit standing rated by at least one of the three main rating agencies (Moody's, Standard & Poor's and Fitch)
- In order to be eligible for derivatives transactions, thresholds are set for counterparties. Such threshold is now equivalent to the Republic of Italy lowest rating
- Credit lines are allocated to every single counterparty on the basis of its rating. For counterparties with a low rating, the line is also split into time bands (less than 10 years and over) in order to limit long-term exposure