Lost in the post

Poste Italiane could be the first European victim of fair-value derivatives accounting. But what trades were behind the €104 million of derivatives losses? Nicholas Dunbar reports

Fair-value derivatives accounting has arrived with a bang in Europe, with the discovery of significant mark-to-market derivatives losses in the corporate treasury of Italian state-owned postal and retail financial services giant Poste Italiane.

The reported €104 million losses, which resulted in the suspension of Poste Italiane's Rome-based finance director, Massimo Catasta, has led to an ongoing investigation by public prosecutors and a debate in Italy's parliament.

The losses have raised concerns over the effect of mandatory fair-value derivatives accounting on Italian companies, many of which routinely use exotic derivatives for speculative purposes.

And, six months after *Risk* broke the story of Gruppo Editoriale L'Espresso's losses from JP Morgan Chase-originated structured derivatives transactions, the giant derivatives dealer is now linked to a substantial proportion of Poste Italiane's losses.

According to a senior Poste Italiane official who has spoken to *Risk*, JP Morgan Chase is the company's biggest derivatives counterparty. Although Poste Italiane has derivatives exposure to numerous investment banks, a single JP Morgan Chase exotic swap accounted at year-end 2003 for €44.4 million of the €104 million reported mark-to-market loss. Moreover, *Risk* can reveal that this swap was entered into in July 2003 to restructure an earlier, loss-making exotic transaction with JP Morgan Chase that cost Poste Italiane €50 million.

According to Italian press reports at the end of February, an audit of Poste Italiane's accounts by Pricewaterhouse-Coopers (PwC) uncovered a 'hole' of €104 million relating to the company's debt management operations – operations that were understood to involve long-dated derivatives positions.

PwC had been appointed by Poste Italiane to replace the firm's previous auditor, Ernst & Young, in accordance with Italian law requiring rotation of auditors at four-year intervals. While PwC is not commenting, sources say the auditor was asked by Poste Italiane's management to apply IAS hedge accounting rules in order to prepare the company for future privatisation.

Poste Italiane's management seemed unprepared for the furore that resulted from PwC's scrutiny of the company's derivatives portfolio. As Catasta was placed under investigation for possible false accounting, Poste Italiane managing director Massimo Sarmi was quoted making dramatic threats against unnamed investment banks that had carried out debt management operations on the company's behalf. "We shall decide what steps to take to defend the company and obtain compensation for the damage caused," he told the *Corriere Della Sera* newspaper.

Meanwhile, under pressure from its sole shareholder, Italy's economy ministry, Poste Italiane appointed former Alitalia chief executive officer Francesco Mengozzi to oversee the company's finance division and Banco Posta subsidiary.

Sarmi's expressions of dismay have been met with coolness in banking circles. After all, the company's Banco Posta subsidiary, which accounted for 43% of the group's €8.1 billion revenues in 2003, has long been known as a packager of structured retail products, both for savings and life insurance customers. So competitive is Banco Posta's public tenders for equity derivatives products that sophisticated institutions often decline to bid, fearing a so-called 'winners' curse'.

A single JP Morgan Chase exotic swap accounts for €44 million of the €104 million reported mark-to-market loss

But some sceptics believe Poste Italiane's apparent sophistication may only be skin-deep. Take Banco Posta, which is arguably not a real bank at all. Prevented by law from lending money, Banco Posta acts purely as a broker or intermediary for its customers and up to now has transferred all deposits to the Cassa Depositi e Prestiti, the Rome-based public financing body.

For its fast-growing retail structured products business, Banco Posta depends on the international derivatives houses for ideas, although it does play these firms off against each other. The precise nature of Banco Posta's obligations to customers is a grey area. Thus, while Poste Italiane's own 2002 accounts show debts totalling €42.8 billion, the rating agencies Standard & Poor's and Moody's refuse to include the Banco Posta contribution in their calculations.

The only debt that the rating agencies do acknowledge is that owed by Poste Italiane's treasury. This division finances operations in mail and logistics through debt of approximately €2 billion. Some €750 million of this is in the form of a 10-year bond issue co-led by Deutsche Bank and JP Morgan Chase in 2002, while the remainder comes from bank facilities.

On the asset side, Poste Italiane maintains a so-called fiduciary deposit in order to maintain its AA–/Aa2 credit rating. This consists of a fund with over €600 million invested in highly rated bonds and financial instruments that is audited at three-month intervals.

Poste Italiane emerged in its current form in 1998, when Italy's then-socialist government appointed a management team charged to cut costs and increase efficiency in the state-owned behemoth, at the time deeply unprofitable. Perhaps understandably, the senior management gave Catasta considerable leeway in his management of the group's financial assets and liabilities.

While a treasury team reporting to Catasta would manage day-to-day operations from its small dealing room in Rome, Catasta made the big decisions himself. As a senior Poste Italiane official comments: "A lot of deals – the most important deals – were closed directly by Massimo Catasta."

Like many Italian corporate finance directors, Catasta showed an appetite for exotic interest rate derivatives, which happen to be a lucrative area for the banks. Investment bank derivatives salespeople flocked to Rome seeking Catasta's business – among them JP Morgan's team, led by then head of Italian corporate derivatives sales Antonio Polverino.

And in the highly competitive tussle for Poste Italiane's exotic derivatives trades, JP Morgan came out on top. This was noticed by rivals, who saw a clear change in Poste Italiane's attitude from 1999 to 2000.

For example, in 1999, UBS executed a

so-called 'top-side' exotic swap transaction with Poste Italiane. This contract, which had a maturity of five years, involved Poste Italiane paying a low fixed rate of interest that could jump to a much higher rate if floating rates hit a barrier. Since the barrier was set at a high level, this contract is not believed to have lost Poste Italiane any money. But in mid-2000, UBS learned that the swap – which had not been subject to an International Swaps and Derivatives Association master agreement – had been reassigned by Poste Italiane to JP Morgan.

Fault

Although JP Morgan Chase declined to comment for this article, it could be argued that in a highly competitive market, UBS was at fault for failing to use Isda master agreements in its dealings with Poste Italiane.

But most bankers dismiss this argument as a red herring. Isda agreements, which contain carefully framed netting clauses and credit risk provisions, are essential for interbank trading and other high-volume activity. But while banks prefer them, Isda's agreements are not considered essential for creditworthy corporate customers that trade infrequently. They legally require that swap counterparties obtain permission before assigning contracts elsewhere – although such permission cannot be unreasonably withheld.

According to bankers who worked with Poste Italiane, the treasury team was sometimes slow to negotiate Isda agreements. It appears that by negotiating a signed Isda agreement with Poste Italiane early on, JP Morgan may have taken advantage of its competitors' lack of such agreements.

However, Poste Italiane points out the existence of Isda agreements with not only JP Morgan but also ABN Amro, Royal Bank of Scotland, Commerzbank and others. Agreements are imminent with Lehman Brothers and UBS, the sources add.

When Poste Italiane assigned the barrier swap away from UBS, JP Morgan was effectively unwinding the transaction. Typically, exotic contracts are expensive to unwind and are often the most confidential part of a derivatives relationship. Thus, by mid-2000, Polverino had not only persuaded Catasta to share information with him about exotic trades with JP Morgan competitors, but was also out-performing UBS in unwind costs – perhaps as a sort of 'loss leader' to cement the relationship between the firms.

Regardless of the explanation, there is no doubt that from 2000 onwards, JP Morgan excepted, the large derivatives dealers only managed to trade exotics with Poste Italiane infrequently, and only in relatively small amounts.

But JP Morgan began reaping rewards by trading in large size, combining a barrier with a quanto component. According to a senior Poste Italiane official, the exotic swap of this type that would be restructured in 2003 at a cost to the company of €50 million dates from this time: "You have to consider that the quanto knock-in component had been in existence since 2000," he says.

At the level of plain vanilla swaps and semi-exotic derivatives such as standard quantos, Poste Italiane spread business around. Catasta delegated much of the decision-making to his treasury desk, which farmed out trades to numerous banks, always in small size.

Poste Italiane's list of counterparties (aside from JP Morgan Chase) reads like an industry directory. According to a senior official at the company: "At the end of 2003 we had three deals with Lehman, but also deals with ABN Amro, SocGen, CSFB, BBVA, Bank of America, Barclays, Bear Stearns, Citibank, Deutsche Bank, Morgan Stanley, Nomura, Merrill Lynch, Unicredito and Royal Bank of Scotland."

By the time of going to press, *Risk* had contacted all the major dealers in this group. Each confirmed that their positions with Poste Italiane were €5 million or less.

By 2002, Catasta was also pioneering the use of credit default swaps in managing the asset side of Poste Italiane's finance division, specifically for 'yield enhancement', according to the source.

Poste Italiane sells credit protection on European bank names – particularly those with which it deposits cash. This way, it gets paid for any risks it takes. The

Illustratiion: Chris Coady/nbillustration.co.uk strategy was well timed, continues the source: "We made a very important decision when credit spreads were very wide, during summer 2002. The mark-to-market of this derivatives portfolio was positive at the end of 2003." But, at €120 million, the total credit derivatives notional remains small relative to the company's €1.5 billion notional interest rate derivatives positions.

But the relationship with JP Morgan Chase continued to stand out. As Polverino was promoted to managing director and head of European corporate derivatives marketing for credit and rates, he was assigned more responsibilities with JP Morgan Chase. His immediate subordinate, vice-president Daniele Bartoccioni, began spending more time on the Poste Italiane account. According to the senior Poste Italiane official: "You have to consider that the relationship with Polverino and Bartoccioni was managed by Massimo Catasta."

The relationship led to a number of new transactions. In 2002 and early 2003, says the source, Poste Italiane and JP Morgan Chase "undertook some important activity in US dollar swaptions". These were typically options on 10-year swaps with maturities ranging from one week to one month, sold by Poste Italiane. According to the source, the trades were done to take advantage of high volatility and were all closed out by June 2003 with a net profit for Poste Italiane of €10 million.

Meanwhile, the quanto knock-in swap transacted in 2000 stayed in place, but Catasta would regularly tweak the provisions of the contract over the years. According to the source: "Poste Italiane could adjust the view of the deal. Or we could put or receive upfront. For example, we might put upfront to adjust the fixed rate."

It is unclear what cashflows were associated with such changes in contract specification prior to 2003. However, it is clear that in July 2003, the old contract was closed out at a cost of €50 million and replaced with a new knock-in quanto swap with a notional of €250 million.

The senior Poste Italiane source describes the deal: "We pay a fixed rate in euro, and we receive six-month Euribor until the end of 2006. After this, the maturity date of the swap is 2013. We have a knock-in, so if six-month US dollar Libor is above 7% we pay six-month dollar Libor."

Compelling

According to the source, the fixed rate proposed by JP Morgan proved compelling. "Their pricing was very good," he says. It is a further testament to JP Morgan's closeness with Catasta that no other dealer contacted by *Risk* appears to have been asked to compete for the trade.

And yet, Catasta's decision to enter this contract just before the US Treasury sell-off late that month was a fateful one.

At this stage, it is worth taking a brief digression to discuss the pros and cons of quanto swaps and other multi-currency interest rate derivatives.

Derivatives dealers like to pitch such trades in the following way. For corporate liability managers that benchmark their funding costs against a domestic currency floating rate, a case can be made for liability diversification. Splitting interest costs between domestic and various foreign currencies should lower the mean funding rate and funding rate volatility, according to portfolio theory.

Traditionally, such diversification can be achieved by borrowing in different currencies, either directly, or synthetically via cross-currency swaps. This introduces foreign currency risk, which is apparently avoided by quanto swaps since foreign interest payments are expressed in the domestic currency.

But this is not how things work under hedge accounting. Vanilla interest rate swaps hedge domestic term debt, and foreign exchange derivatives hedge foreign currency revenues, and these can be combined into single items. But a company that has no foreign currency revenues or foreign debt must treat a quanto swap as a speculative position. That means quanto swaps – and more exotic variants – must be marked to market.

The events of July and August 2003 provide a good argument for such accounting treatment. Quanto dollar swaps bought by domestic Italian companies performed particularly badly when US Treasuries sold off for two reasons. First, euro-denominated debt that was matched to the swaps did not cheapen. Second, unlike cross-currency swaps, quantos did not benefit from a weakening dollar.

This is significant in the context of JP Morgan Chase's Italian derivatives marketing activity. *Risk* understands that one of the rationales for the quanto trades was that domestic Italian companies had revenues correlated to the US economy. In other words, accounting issues aside, quanto swaps served as a macro hedge.

Clearly, the validity of this argument requires careful econometric modelling of future corporate revenues as well as back-testing of existing transactions. It may be that such modelling supports the use of simple quanto swaps. But market practitioners argue that it is far-fetched to imagine that 10 years of uncertain future revenues earned from postal delivery and financial services at Poste Italiane match the complex payout profile of the knock-in quanto swap sold by JP Morgan to the company in July 2003.

For one thing, the product was highly leveraged. Barrier options are a classical tactical tool, popular with hedge funds, especially in currency markets. Moreover, the use of a three-year option maturity meant Poste Italiane was not simply exposed to the spot level of US dollar Libor, which has stayed relatively low due to Federal Reserve policy. Rather, it was exposed to the three-year forward Libor rate, which was geared to the highly volatile US dollar swap curve.

Poste Italiane was familiar with euro barrier swaps (which were transacted profitably with Morgan Stanley in 2003), quanto swaps (which were traded with Credit Suisse First Boston, UBS and several other banks) and dollar swaptions (which it successfully traded with Goldman Sachs).

> **"A lot of deals – the most important deals – were closed directly by Massimo Catasta"** Poste Italiane official

It was also aware of the need to look at the entire dollar forward curve, as the senior official commented in an attempt to deflect concern that the option might be exercised: "Recently the maximum value of dollar Libor until 2013 was 5.7%. That's very far from 7%."

However, it appears that the complexity, size and the very high mark-to-market volatility of the JP Morgan Chase product, caught the company out. By September, Catasta had already contacted JP Morgan Chase to change the terms of contract, according to the source.

By end-2003, the JP Morgan Chase position was underwater to the tune of €44.4 million, dominating the total €103.8 million mark-to-market loss under investigation by Italian prosecutors. By the end of February 2004 the contract had recovered somewhat, to a negative value of €39 million.

Now, with Catasta suspended, Poste Italiane's finance department is in limbo pending the official investigation. Officials in the company, prevented from speaking openly, feel the situation has been misrepresented in the Italian press. "The Italian newspapers are talking about a shortfall," says the senior official. "But it's not a shortfall. It's only a potential loss." ■