"La Dolce Vita"

"La Dolce Vita" ("The Sweet Life") is a classic Federico Fellini movie of 1960 vintage. I was reminded of it after the recent election in Italy, the euro zone's third largest economy (after Germany and France). One of the major players in the hung parliament, is the septuagenarian former Prime Minister Silvio Berlusconi who personifies "*La Dolce Vita".* Italians obviously are broad-minded: despite his famous "Bunga Bunga" sex parties, his Mafia connections and corruption scandals, he remains a major political force – and could even become the next prime minister under a centre-right coalition. As part of his election manifesto, he has promised an amnesty for tax evaders (including, presumably, himself) and refund of a property tax imposed by the present government headed by an unelected technocrat.

Another major political leader is a former comedian who advocates that Italy would be better off exiting the single currency, rather than continue with the fiscal austerity, the unemployment (12%), the continuing recession closing down a thousand businesses a day, and the social pain and unrest. (Many voters from the left and the right seem to agree with the sentiment.) As the political deadlock continues three weeks after the election, it does seem that the crisis in the euro zone could once again become front page news. (Italian bond yields have jumped up.)

One case which impacted the election result is a derivatives scandal in Banca Monte dei Paschi di Siena SpA (MPS), Italy's 3rd largest and the world's oldest (1472) bank. Its controlling shareholder (35%) is a foundation which runs hospitals, schools, etc. from the dividend income, and has strong connections to the centre-left party. The case goes back to December 2008 when MPS entered into large derivatives transactions, one with Deutsche Bank and another with Nomura (apparently, the contracts were kept locked in a safe and came to light only recently). The purpose was to hide/post-pone losses under two earlier derivatives transactions. In turn these had been undertaken to “augment capital” strained by a costly takeover (see next paragraph) but resulted in a loss of €367 mn. The new transactions yielded an immediate gain to MPS – and bank margins of € 60 mn to the counterparty banks. It is strange that “seasoned” bankers should be paying that kind of margins to hide a loss – and take on further risks. The loss on the new derivatives is estimated at €700 mn! The loss has led to MPS asking for a second rescue from the central bank. A new management is in place, and has sued members of the old management and the counterparty banks.

The earlier derivatives were linked to the acquisition of Antonveneta in 2007, another Italian bank, for € 9 bn, an amount larger than the market capitalization of MPS itself! (MPS’ share has slumped from on €4 before the acquisition to € 0.21 now.) One interesting co-incidence: I was adviser for India to the Amsterdam Rotterdam Bank for several years in the 1980s. It was then a dour, conservative Dutch Bank, which later merged with Algemene Bank Nederland. ABN AMRO was acquired in 2007 by the Royal Bank of Scotland, the Fortis group of Belgium and Santander, a Spanish bank; the last, in turn, sold the Antonveneta unit to MPS. Curiously, RBS, Fortis and MPS have needed huge bailouts by their respective central banks. The superstitious may well believe that there is a curse on ABN AMRO acquirers!

But to come back to derivatives, another ongoing case in Italy is equally interesting. This involves the City of Milan and a “structured” interest rate swap with a notional of € 1.7 bn it had entered into to “hedge” the interest rate risk on its bonds. The contract, new deeply in the red, had structuring margin of € 101 mn (Bloomberg), or 6% of the notional! No wonder, banks prefer to market “bespoke”, “structured” products! The City of Milan has sued the banks for mis-selling, and the court has ruled that the transaction was a fraud: the banks are appealing. Structured products clearly are “weapons of financial destruction" for the ignorant and unwary, as Warren Buffett described them once!

But to come back to Mr Berloscuni, "Beware of Greeks bearing gifts" is an old saying, following from the "Trojan horse" incident in Greek mythology. With the ongoing corruption scandal in India's defence purchases, we can perhaps paraphrase it to "Beware of Italians bringing arms to sell" – or promising to return under-trials released for voting! Mr. Berlusconi has defended the bribes apparently paid by Finmeccanica, openly arguing that bribes are unavoidable "when you are negotiating with third world countries and regimes" (Financial Times February 15, 2013): his authority on the subject can hardly be denied. The scandal reminds me of something I noticed in the 1970s. While the system of broker/middlemen was common in wholesale textile sales in those days (perhaps it still is), the brokerage used to be 0.25 to 0.5%. In the case of sales to the Canteen Stores Department of the armed forces, however, it used to be 5% plus! Things have obviously not changed much!

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