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«They say things are happening at the border, but nobody knows which border» (Mark Strand)

Cryptocurrency (and Bitcoin), a new challenge for the regulator

by **Mirella Pellegrini** and **Francesco Di Perna**

Abstract: *The evolution of the economic processes is reflected on the way the currency work. The recent development of new methods of payment based on the computer systems – and, in particular, the electronic-based systems used to register the debit\credit position, the operationalization of the market – have elicited the growth of the phenomenon of cryptocurrency, and bitcoin is nowadays the most common. There is still no precise definition of cryptocurrency at the moment, due to the complexity in matching the cryptocurrency with the proper related case in issue. That said, it is crucial as in the face of a growing interest in bitcoins, the predisposition of an adequate control mechanism, still missing, is assuming a more and more importance; and in such a critical context, this lack treats the potential traders in this new segment. The awareness of the effective consistency and diffusion of the phenomenon should encourage the authorities in taking actions against the potential risks, especially for those inexperienced operators that are not able to identify and evaluate them, attracted by the promise of high profits with low investments. One of the most critical aspect in subiecta materia is the fiscal treatment of those bitcoin operations with particular regard to money laundering and terrorism financing. The growing phenomenon of crypto currencies – in addition to introduce potential danger (with evident damages for those who use them improperly) – emphasizes the need to move forward new forms of regulation of such complex matter, so that it can be redefined under the competence of the public authority.*

1. The evolution of the economic processes is reflected on the way the currency works. It follows that the currency – due to its initial role as medium of exchange, and store and measure of value – nowadays has become a crucial point for the definition of a new method of payment[1]. An extension of the traditional functions of the currency leads to the so-called *monetary sovereignty*, defined as the power of the state to exercise the power over the economic and financial equilibrium of a country[2].
The recent development of new methods of payment based on the computer systems – and, in particular, the electronic-based systems used to register the debit\credit position, the operationalization

of the market – have elicited the growth of the phenomenon of *cryptocurrency*, and *bitcoin* is nowadays the most common. The abovementioned phenomenon, as far as comparable to the legal criteria to define a currency – this aspect will be discussed in the next paragraph – it cannot be defined as a substitute of the currency, neither it seems to be similar to the ordinary methods of payment diffused in the market.

The interest that cryptocurrency is increasingly attracting– and so far, the appeal that it arouses among the population – is generated mostly by the promise of possible financial returns in an economic context of low interest rates. It is clear that their nature and incidence on the market is significant. Furthermore, because the currency is acquiring a role more and more far from the original role that it had, we need to be sure that the cryptocurrency can be qualified as a financial instrument and that it needs a different legal framework that better reflects their real essence.

This analysis must take into account the typical features of these currencies (anonymity of transactions, lack of ties with the so-called *fundamental,* absence of a central bank, lack of intermediaries to validate and record the transactions, the overall riskiness due to missing regulation). Such analysis must highlight the general lack of any economic and legal prerequisites that enable to equalise the bitcoin to the legal currency[3]. On the other hand, it is crucial to understand the potential implications of a bad use of these instruments, for example the illegal purposes (e.g. money-laundering) to cover the payments related to criminal activities (thanks to the anonymity of the transactions)[4].
Moreover, it must be analysed the *information requirements provided* from the supervisory authorities[5]. The latter – although not allowed to take part in it (and so, unable to regulate the bitcoins in any ways) – have elaborated a series of guidelines (in a *soft law* regime) [6] finalized to show the possible risks for the traders in operating in such a deregulated context and, lacking the necessary compliance with prudential and risk aversion criteria[7].

2. To better understand the following discussion, some introductory remarks about the boundaries of the financial and banking supervision regarding the technological aspect are required.

The recent economic events show a growing number of technological platforms over the intermediation process (i.e. Directive EU 2015/2366, cd. PSD2, on payment services); so we must evaluate whether the cryptocurrencies can be treated as other instruments regulated in the legal system, with particular focus on bitcoins, that can easily turn into a dangerous speculation bubble[8] (*infra* par 4).
The phenomenon under investigation is furthermore different from the standard electronic payment systems regulated by the legal system[9]. It follows that such electronic payments (recurring in the recent market operational routines), in contrast to the cryptocurrencies, can be officially assimilated to the legal currency.

As a matter of fact, the evaluation of the cryptocurrencies phenomenon is not possible – together with the identification of the technical profile – without the awareness that a potential diffusion can lead to significant consequences on the production and consumption level, with subsequent impact on the social wealth and government intervention.

On the light of that, an uncontrolled development of cryptocurrencies seems to predict a “digital capitalism”, though hiding the possible negative consequences that can materialize if that reality would become true. In particular, there might be a possible imbalance in the market and consequent uncertainty about the stability of the rates of exchange if the tie between the currency and the sovereign authority, the central banking system indeed, would be suppressed[10].

It is known that the statist view of the currency is based on its standard of deferred payment, meaning that currency is able to settle any debts, if it is used as legal currency. This specific function cannot be attributed to the bitcoins, unless there is an agreement between the parties involved which acknowledge the bitcoins as an instrument to fulfil the obligations.

As the literature has emphasized, there is still no State that has adopted cryptocurrencies as legal currency[11]; for this reason, their standard of deferred payment is based only on the functional characteristic of the currency, and they (especially bitcoins) are only “imperfectly” able to fulfil that function[12].

In that context, relying on a system based on a technical formula (where, in addition, the value expressed by cryptocurrency is volatile) means abandoning the idea that the Law is able to legalize the payments through the regulation of the currency power. There can be little doubt that the phenomenon under investigation is a consequence of the financial crisis of 2007[13]. The crisis has determined an overall mistrust towards the financial system, a mistrust followed by a *growing disappointment* towards the government institutions and, in general, towards the State powers (first of all the monetary one).

It follows that the legislator is facing a scenario that requires a new regulation that enables a technological system platform related to an official regulated currency, and that ensures negotiations protected from the uncertainty of the cryptocurrencies. In other terms, we assert that the major duty for legislator is to regulate the fluctuating possibility to make profit from the bitcoins. In addition, we believe it is crucial also to control the potential use of bitcoins for money laundering, possible where there is no proper regulation[14].

Recently the European Commission, worried about the stability of the system, has included in its amendment proposal of the IV Anti Monetary Laundering Directive (“4AMLD”) (COM/2016/ 450/Final)[15], two new categories of legal entities to which the Directive is applicable: A) exchange platforms of virtual currencies, B) custodian wallet providers (from 6 and 7; art. 1, comma 9, lett. c). Such amendment, contained into the 5AMLD, indicates how the lack of a proper differentiation between legal currencies and virtual currencies can be problematic; only the latter in fact, can be subjected to the Financial Intelligence Units (EU FIU Platform) and, in general, to a reduction of the risks resulted by such innovative payment methods.

3. Nowadays there is still no precise definition of cryptocurrency[16], due to the complexity to find a proper legal shape for the phenomenon[17]. With no doubts the virtual currency expresses the digitalization of the various legal and economic areas. As a special case, it has legal value only between private parties and cannot be defined as currency (*a fortiori* legal)[18]. In addition, we must not forget the lack of legal protection for those who receive cryptocurrencies as a payment for a transaction. In other terms, the art. 693 p.c.[19] is not applicable, since the acceptance of bitcoins as currency is left to the discretion of the parties involved, and therefore, not mandatory[20].

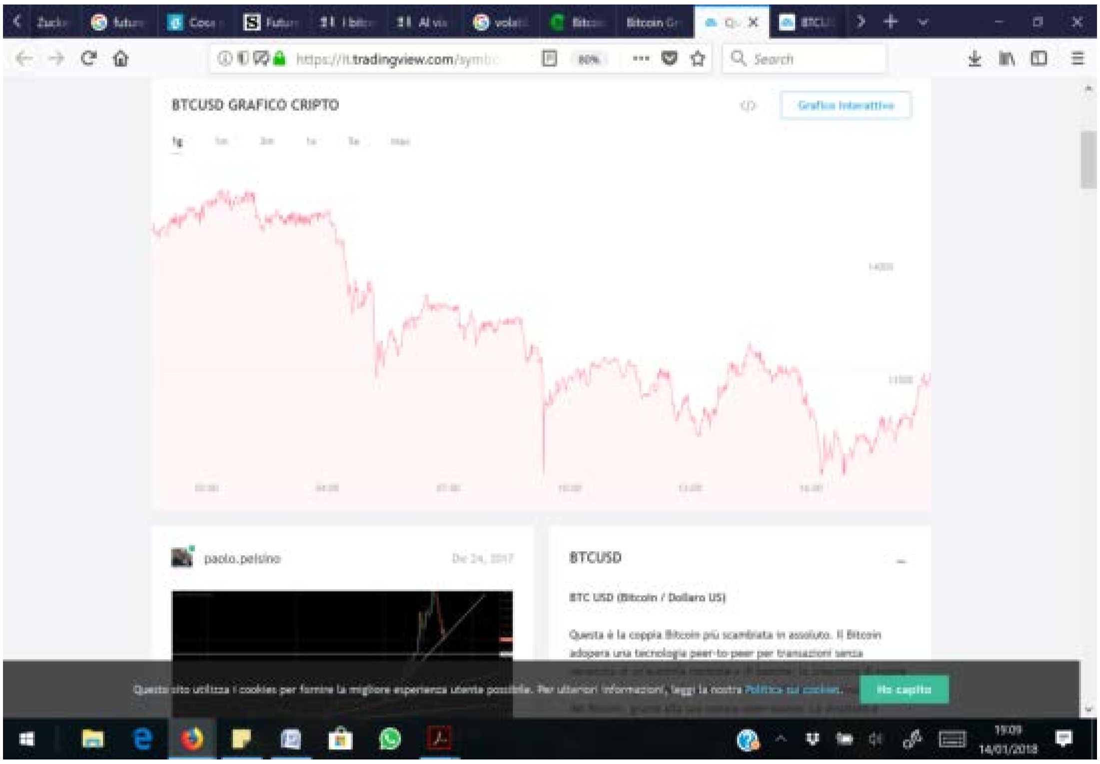
It seems clear that the genesis of bitcoins can be referred to the combined effect of the growing technology and the evolution of cryptography, combination that has enabled to execute anonymous transactions, without a (supervised) mandatory intermediary and with less costs. Furthermore, we should say that cryptocurrencies help to resolve some key problems created by the globalization; we

refer in particular to the *shadow banking system* ***[21]***, the *Individual Saving Plans* etc., financial instruments that although not illegal, are out of the regulation for the investor protection[22].
To better understand the extent of the above phenomenon, we need to analyse the underlying technology *(blockchain)*, a digital software platform for cryptocurrency transactions that lacks of a decentralized, public ledger authority to guarantee the transactions.
To be noticed also the fact that nowadays bitcoins represent the most common form of cryptocurrency. The latter represent an alternative monetary system, extremely diffused at global level[23].
In such context, we must acknowledge the significant innovative elements of the *blockchain* technology, especially the indelible tracking of the data, which cannot be changed or deleted in the future[24]. On the other hand, it must be taken into account that the use of such instrument, enables to avoid any form of abuse and corruption actually diffused in private-public parties' transactions[25]. The architecture at the base of the *blockchain*, is able to trace and verify each piece of information uploaded into the blockchain; this information will be further encrypted and transferred in a digital public ledger, that will be absolutely unalterable. Consequently, if we extend the use of blockchains – for example – to the citizen-public authority relation[26], we can see as the blockchains become a valid tool to avoid any contamination of the relations like corruption. In conclusion, the transparency of all the information available on the blockchain, together with the absolute impossibility of tamper with data, would makes the procedures of public administration (fundraising, public projects etc.) secure, so that nobody would altered it for personal or third partied interest[27].

4. From the beginning of its creation in 2009, the interest for bitcoins has increasingly grown, making the evaluation of all the possible consequences of its competition with the legal currency an absolute priority.

Recent studies demonstrate that the bitcoin is not in the position to exercise the regular monetary functions and that cannot be a valid substitute to the regular currencies[28]. In particular, it emerges that bitcoins are not able to fulfil none of the typical monetary functions (medium of exchange, store of value, unit of account). Furthermore, the spread of the phenomenon has reach a level such as to pose a threat for a "speculation bubble that may be a toxic concept for the investors", as the famous economist Stephen Roach[29] has pointed out. It follows that the bitcoin can easily be out of control that might undermine the fragile economic equilibrium.
On top of that, it must be taken into account also the potential abuses of bitcoins, related to the money laundering, terrorism-financing and new potentially dangerous functionalities inherent in the new technology. It is crucial at this point that the institutions start to work in order to fill the gap in the regulation, gap that may constitute an uncertain scenario in the context of financial system. And in addition, virtual currencies could represent a threat for the financial markets that might undermine the stability, in case the high volatility that characterize bitcoins could affect the dependence from the system. For example, the introduction of the futures on bitcoins at the Chicago Stock Exchange[30] may represent the first admission of the cryptocurrency in the financial market, by adversely affecting the operations. The abovementioned phenomenon may represent also a destabilising factor for the transactions, distorting the normal operation and the normal function attributed to the currency (economic and political stability).

On the light of that, the bitcoin phenomenon is at the bottom of a high speculative market, connected – as the graph below shows – to its high characteristic volatility.



GRAPH: *http://www.tradingview.com*

The graph shows high fluctuations in a short interval, due to the high uncertainty of the bitcoins value, that may constitute a fertile ground for speculation behaviours.

That said, it is crucial as in the face of a growing interest in bitcoins, the predisposition of an adequate control mechanism, still missing, is assuming a more and more importance; and in such a critical context, this lack treats the potential traders in this new segment. The awareness of the effective consistency and diffusion of the phenomenon should encourage the authorities in taking actions against the potential risks, especially for those inexperienced operators that are not able to identify and evaluate them, attracted by the promise of high profits with low investments[31].
These measures should be able to increase the level of protection for the investors that, as can be seen from the European law (see also the MiFID II)[32], are at the center of attention of the legislator[33]. Nowadays the only way to have a legal regulation for the bitcoins ecosystem is to refer to the *soft law* context, both in a domestic and European level. In particular, the EBA emphasize the risks related to the use of bitcoins, encouraging the need for a stronger regulation; Bank of Italy, at a domestic level, and according to the guidelines provided by EBA, released in January 2015 an official warning against the potential risks, specifying also that the enumeration of the possible cases in issue may be not exhaustive and that might be further and unknown threats[34]. It is clear that the Authorities, even if they acknowledge the regularity of the cryptocurrency transactions (they are not illegal *per se*), solicit – by using intervention mechanism under the *moral suasion**[35]*** context – a careful use of the instruments, whose legal identity is still undefined and not ready to guarantee a proper protection and to avoid the potential negative effects on the financial system[36].

The sense of the riskiness of the virtual currency leads the Russian Federation to take the necessary steps to prevent the risk: the Russian government has officially published a draft federal law which regulates cryptocurrencies through establishing that operators of the exchange of digital financial assets can only be legal entities, in a similar way as SPV does for credit sensitive derivative instruments[37].

In conclusion, since cryptocurrencies are at the moment out of the legal protection, it is impossible for the operator that does not succeed in closing a transaction in bitcoin to appeal to the authority.

5. One of the most critical aspect in *subiecta materia* is the fiscal treatment of those bitcoin operations with particular regard to money laundering and terrorism financing. To follow up the first aspect, we must clarify that the authorities have highlight the necessity of a different taxation for the cryptocurrency operations according to the objective they are used for; in other words, it can be for speculation purposes or for transactions purpose. That doesn't mean, as it happens most, that the two purposes can co-exist; we mean that an operator can use bitcoins to buy a product or a service and then the bitcoins can be used in trading operations in a financial market[38].

The first attempt for a legal regulation is attributed to the resolution 72/E/2016 of the Tax Agency, that aim to disentangle the issue of the fiscal treatment for the companies that provide services for bitcoin trading. In that resolution, the Revenue Agency replies to a tax clearance application of a company that asks the correct fiscal treatment of IVA and the companies' income tax (IRAP and IRES) of cryptocurrency transactions. The response of the Revenue Agency is based on the judgment of the European Court of Justice C-264/14, 22nd of October 2015.

With regard to the IVA, we need to consider the three prerequisites imposed by d.p.r. 633/1972 (objective, subjective, spatial)[39]. According to the law, is not possible to impose this tax; there are in fact all the condition for considering the bitcoin transaction as a IVA[40] exemption and so they are treated – for fiscal purpose – as any other legal currencies.

According to the company taxation system, the taxation is calculated on the net revenues of the trading company for the intermediary service. These revenues are recorded in the balance sheet at the financial year in question as any other asset subject to IRES and IRAP taxation.

And at the end of the financial year in question – during the Balance Sheet drafting – if the company has still bitcoin in its assets – in accordance with the international accounting standards – they will be measured at the *fair value*[41], considering the quotation of the currency at 31/12.

If the trade of virtual currency would be done not by a legal entity – as we have previous analysed – but by an individual, the taxation will be applied if there are speculative purposes. The bitcoins possessed for spot transactions won't be considered a taxable income as any other legal currency. But on the other hand, if the bitcoins are held for speculative purposes, the revenues from the bitcoin trading will be considered as the foreign currency asset. It follows that to give a legal definition of the purpose of the cryptocurrency we refer to the economic relevance principle, defined in the amount of 51.645,69 euro for at least seven consecutive days[42]. Consequently, only in the face of a longer possession of a higher amount in bitcoin the assets will be considered as for speculative purposes[43].

Therefore, the virtual currency is considered in the same way as foreign currency to simplify the process of how handle bitcoin operations. The fair taxation of the profits from the bitcoins speculation should be assimilated to the taxation imposed to other income[44], since bitcoin is not a real currency[45]. The best way to unravel the puzzle is on a case by cases basis, either for a legal entity, or for individual.

From the bank and financial perspective, the identity of bitcoins and any other virtual currency is clear: they are assimilated as any other foreign currency, both for simplification and for different purposes from the financial market regulation, where the investor protection theme is crucial and does not allow any simplification.

And on the light of that, we must point out that the virtual currency are potential candidates to foster phenomena like money laundering and terrorist financing[46]. If on one hand the anonymity that characterizes the bitcoin operations is likely to be used for criminal purposes, on the other hand the information, – embedded in the blockchain – are more trackable than the liquidity is. And indeed, the latter is unquestionably less transparent. What it mostly concerns the Supervisory Authorities is the anonymity that characterize the operations conducted in the blockchain; the operators or the "node" that operates in the blockchain with these currencies – under a pseudonym – cannot be identified as for other activities under legal supervision[47]. And this anonymity makes impossible to find the author of the operation and if necessary to adopt the appropriate anti-money laundering measures.
Clearly, it is a matter of absolute importance to trace and map the clientele that operates in bitcoins, and the great "dilemma" is represented by comprehending in which phase of the process the security systems should be. Essentially, the critical point is not the utilization of the virtual currency to buy a product or a service, but it is the moment when the virtual currency gets in touch with the real world and the virtual currency is converted into legal currency and vice versa (*Exchange*). That is why in that moment is possible to place money resulting from illegal activities in the blockchain and ten converting them in legal currency, contaminating in this way the system; in fact the anonymity is lost at the exact moment of the conversion of bitcoins into legal currency or vice versa (because to convert bitcoins into legal currency it is required to resort to an *Exchange* platform).
And to conclude, it must be pointed out that the MEF has recently proposed a draft decree, that requires that any entity that wants to offer any service through cryptocurrencies, is required to register in a special registry established at the OAM (Organismo degli Agenti e dei Mediatori)[48]. It seems to be the first attempt to build a preliminary regulation for those that operates in virtual currency, both for the safeguard of the investors and for the safeguard of the economic system.

6. In conclusion, we can say that the technological evolution and the digital evolution, even though their complexity, must be accepted and elicited.

As it has been assessed in the present study, the growing phenomenon of crypto currencies – in addition to introduce potential danger (with evident damages for those who use them improperly) – emphasizes the need to move forward new forms of regulation of such complex matter, so that it can be redefined under the competence of the public authority.

The questions arose, even if they identify the boundaries of the current legislation *in subiecta materia,* must not represent the source of abandonment of principles of market stability and security for investors; as we know, they are result of years and years of researches under strain for a long time. Embracing the modernity does not mean accepting the disorder without adequate, preventive investigations, in order to take into account of the possible patterns of implication that it can generate. The legislator is required to adequate the legal system to the occurring changes that, if not properly defined under a proper regulation system, can have serious negative impact on the social and economic equilibrium of the country. It is also a matter of scholars to elicit such normative process through developing analysis and researches that, highlighting uncertainties and critical issues in the above-mentioned legal-economic matter, may provide support to make coherent choices with the tradition of our countries.

It comes to mind the famous quote of Einstein: “I fear the day that technology will surpass our human interaction”.

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[3] See, among the others, Lemme, Peluso, *Criptomenta e distacco dalla moneta legale: il caso Bitcoin*, *Riv. Trim. Dir. Econ*., 2017, 148 ff.; Velde, *Bitcoin: a primer*, Chicago Fed Letters No. 317, The Federal Reserve Bank of Chicago, 2013; Hanley, *The False Premises and Promises of Bitcoin*, Cornell University Library, 2013; *contra*: Plassaras, *Regulating Digital Currencies: Bringing Bitcoin within the Reach of the IMF*, Chicago Journal of International Law, 14(1), 2013, p. 377 ff.; Folkinshteyn, Lennon and Reilly, T*he Bitcoin Mirage: An Oasis of Financial Remittance*, Journal of Strategic and International Studies 10, 2015, 118 ff.

[4] See *infra* Par. 5

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[9] See European Central Bank, *Virtual currency schemes – a further analysys*, cit.; in particular, ECB explains that “*In the EU, virtual currency is not currently regulated and cannot be regarded as being subject to*

the (current) PSD or the EMD. As the phenomenon is still relatively new and also moving into different areas, it would be too early to try making new, tailor-made legislation" (p. 24).

[10] Allow me to recall Pellegrini, *Banca Centrale Nazionale e Unione Monetaria Europea. Il caso italiano*, Bari, Italy, 2003, chapter 1.

[11] See Gasparri G., *Timidi tentativi giuridici di messa a fuoco del bitcoin: miraggio monetario crittoanarchico o soluzione tecnologica in cerca di un problema? Il diritto dell'informazione e dell'informatica*, 2015, 3, p. 418.

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[13] About global financial crisis see Capriglione, *Crisi a confronto (1929 e 2009): il caso italiano*, Padua, 2009; *Financial Regulation: A post crisis analysis*, ed. Wymeersch, Hopt, Ferrarini, Oxford University Press, 2012; Cassidy, *How markets fail : the logic of economic calamities*, New York, Straus and Giraux, 2009; Bernanke, *Essays on the Great Depression*, 2009; Micossi, Bruzzone, Carmassi, *The new European Framework for managing Banking Crisis*, Centre for European Policy Studies, Policy Brief, No. 304, 21 November 2013, 1 ff.; Visco, *The aftermath of the crisis: Regulation, supervision and the role of central banks*, Lecture delivered at Harvard Kennedy School, Cambridge MA, 16 October 2013.

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[17] For a complete analysis of the legal nature of bitcoins see: *The law of Bitcoin*, by Jerry Brito Et Al., cit.; Capaccioli, Criptovalute e bitcoin. Un'analisi giuridica; Mancini, *Valute virtuali e bitcoin*, cit., 117 ff.; Bocchini, *Lo sviluppo della moneta virtuale: primi tentativi di inquadramento e disciplina tra prospettive economiche e giuridiche*, *Dir. dell'informazione e dell'informatica*, 2017, 1, 27 ff.; Vardi, "*Criptovalute" e dintorni: alcune considerazioni sulla natura giuridica dei bitcoin*, Diritto dell'informazione e dell'informatica, 2015, 3, 443 ff.

[18] Another interesting aspect is the so-called "mining" of the virtual currency, namely the act of creating valid Bitcoin blocks which requires demonstrating proof of work. Miners are devices that mine or people who own those devices (sources http://www.bitcoin.org, http://www.ilpost.it).

[19] "Whoever refuse to receive legal coins can be punished with legal punishment".

[20] Even if "Internet giants" like Facebook and Amazon started to accept bitcoins as payment, it is not sufficient to accept bitcoins as alternative legal tender (source "*Amazon prossima a introdurre i Bitcoin come mezzo di pagamento?*", published on http://www.lastampa.it; Soldavini, "*Zuckerberg studia le criptovalute: Facebook pensa a un suo bitcoin?*", published on IlSole24ore.it.

[21] The literature labels "shadow money" situations characterized by the absence of regulation in the field of virtual money, distinguished by opacity and operational riskiness. A call for public intervention to control the monetary effects of this phenomenon is rather desired.

See Pozsar, Shadow Banking: The Money View, july 2, 2014, available at https://www.financialresearch.gov/working-papers/files/OFRwp2014-04_Pozsar_ShadowBankingTheMoneyView.pdf; Pozsar, A Macro View of Shadow Banking, 2015, https://ftalphaville-cdn.ft.com/wp-content/uploads/2015/07/Pozsar-A-Macro-View-of-Shadow-Banking-Levered-Betas-and-Wholesale-Funding-in-the-Context-of-Secular-Stagnation.pdf; Ricks, Regulating money creation after the crisis. Harv. Bus. L. Rev., 2011, 1, 75; Gabor and Vestergaard, Towards a theory of shadow money, 14 april 2016, 1 ff.

[22] There is no doubt that they have been created to cut the transaction costs, but they can easily turn into a speculation, thanks to the high risks (often associated to high yields)

[23] It must be taken into account that the novelty of the phenomenon is no into the cryptocurrency per sé, but relies on the technology behind it, the *blockchain.* There is a growing number of retailers accepting virtual currency, such as Apple, Reddit, Expedia or WordPress. The bitcoin phenomenon is the first implementation of that technology, but the two terms must not be overlapped. A *blockchain* is a continuously growing list of records, called blocks, which are linked and secured using cryptography.

[24] Each node has data about all the confirmed transactions, so each node works as an archive of previous transactions that cannot be altered, otherwise all the subsequent transactions will be deleted.

[25] Source: http://www.blockchain4innovation.it

[26] Similar role of SPID (Sistema Pubblico di Identità Digitale), an online platform that manage the relations between public authorities and citizens.

[27] Cf. Prosser, *Così la tecnologia blockchain può ridurre la corruzione,* published on formiche.egomnia.com. It should be recalled, however, the economist Nouriel Roubini, who claims that blockchain is not more efficient of the existing database and that it won't replace the financial intermediaries. See also Caparello, *Roubini: "Blockchain tra le teconologie più sopravvalutate di sempre",* available at wallstreetitalia.com., 6 March 2018.

[28] There are many studies supporting this statement, including the BCE's – supported by Bank of Italy – that says that bitcoin, due to the low degree of acceptance as payment method, and to the low purchasing power (resulting from the high volatility), is actually not a currency.

[29] The economist Stephen Roach, in an interview with CNBC, he highlighted the multiple negative aspects bitcoin, in particular regarding the high fluctuation of the currency "by any shadow or stretch of the imagination" as he defined.

[30] Cf. Soldavini, *I bitcoin volano al debutto dei futures. Allo studio due ETF*, IlSole24Ore, 11.12.2017.

[31] Actually, the reality shows the ignorance and irrationality of the average operator: many operators make their decision according to their prejudice or their emotions, without knowing, in many documented cases, neither the mechanism of the instrument nor the risk.

[32] Directive 2014/65/EU and Regulation EU No 600/2014 which impose stricter rules to the less experienced market operators. Cf. Pellegrini, Serrano and Motroni, in *La Mifid II*, by Troiano and Motroni, Padua, 2016. The Directive 2014/65/UE has been transposed with d.lgs., 03.08.2017, n. 129; with Delibera 16.02.2018, n. 20307 Consob approved the Communication for investor Protection to incorporate the Directive 2014/65/EU and Regulation No 600/2014.

[33] It follows that the major concern of such instrument is the fact that it is out of the control of the Supervisory Authorities. The applicability of the rules for those who consult the accredited intermediaries, that can verify the consistency of the investments and the personal needs, investment purposes, the expertise of the single investor is lost; and the latter, if he wants to get in touch with the bitcoin reality, he will have to do it by himself.

[34] Circ. BI *Avvertenza sull'utilizzo delle cosidddette "Valute Virtuali"*, 30.01.2015; *Opinion on "virtual currencies"* (EBA/Op/2014/08), 04.07.2014.

[35] Cf. Capriglione, *Le fonti dell'ordinamento finanziario*, in Manuale diritto bancario e finanziario, by Capriglione, Padua, 2015.
[36] it should not surprise that numerous banks are not anymore accepting transactions in bitcoin, also due to the numerous breakdown of the currency in the recent past and that might produce significant loss, altering the sound and prudent management.
[37] Cf. *La federazione russa intende regolamentare lo scambio del Bitcoin e delle criptovalute*, *rainews .it*, 16.03.2018.
[38] it should be emphasized a significant feature of cryptocurrencies – that cannot occur in any other stock in a regulated market – the different listing from a platform to another, inducing multiple arbitrage strategies. If the market would be regulated – not the case of the virtual currencies – the mismatch between different platforms would not be possible, and the arbitrage strategies would be discouraged. Cf. Lops, *Bitcoin: piattaforma che vai prezzo che trovi*, IlSole24Ore, 9 December 2017.
[39] See Guarasci, *IVA, presupposti per l'applicazione: soggettivo, oggettivo e territoriale*, http://www. informazionefiscale.it.
[40] It must be taken into account that the legal currencies are a mediem of exchange, and this seems to be their only function; there is no example of its use as a commodity and therefore the currency transaction has not imposed IVA (Art. 135.1 lett. e) Directive 2006/112). Virtual currencies are treated as any other currency, apart from the legal tender. Only if the cryptocurrency would be excluded from the other currencies, they could be subject to IVA. Cf. Capaccioli, *Regime impositivo delle monete virtuali: poche luci e molte ombre*, in "Il fisco" n. 37, 2016.
[41] The fair value is "*The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date*" (IFRS 13). Cf. http://www. revisorionline.it. It means that each asset or liability will be reported in the balance sheet at its current market value, avoiding any potential over and underestimation. So, we consider the market price of the bitcoin at 31/12.
[42] See also Zonca, *Il regime fiscale delle operazioni in valuta e delle differenze di cambio*, Approfondimenti *dirittobancario.it*, November 2016.
[43] Cf. *Come si tassano le rendite da bitcoin e criptovalute?http://www.valutevirtuali.com.*
[44] Other income is a residual category, artt.67 ss. TUIR, which contain all the not classifiable incomes (art. 6 TUIR) opposed to capital income.
[45] Cf. Econopoly, "*Bitcoin e tasse, domanda: il privato cittadino deve dichiarare le plusvalenze o no?*" Il Sole24Ore, 10 September 2016.
[46] Many studies show that the operations in virtual currency enable money laundering activities and terrorist financing; see also Goldman, Marumaya, Rosenberg, Saravalle, Solomon-Strauss, *Terrorist use of virtual currencies*, CNAS; Foley, Karlsen, Putnins, *Sex, drugs and bitcoin: How much illegal activity is financed through cryptocurrencies?* SSRN-id3102645, January 2018; Carlisle, *Virtual Currencies and Financial Crime*, RUSI Occasional Paper, March 2017.
[47] According on the cryptography it will be possible to identify an IP address, if it is not encrypted as well. The proper control represents one of the most important control required by the anti-money laundering legislation to monitoring the recurring operators: it consists in identifying the operator, acquiring information about the nature and purpose of the operation and keeping a constant monitoring of the operations in order to promptly identify any suspicious facts. Cf. Loconte –

Ogliaruso, *Antiriciclaggio: gli obblighi di adeguata verifica della clientela alla luce della nuova normativa antiriciclggio, Diritto 24*, IlSole24Ore, 07.07.2017.

[48] See the draft on *http://www.mef.gov.it*. Cf *Valute virtuali, il Mef vuole un registro: pronto il decreto,* http://www.repubblica.it, 2 February 2018.

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Paragraphs 1, 2, 3 and 6 by Mirella Pellegrini; paragraphs 4 and 5 by Francesco Di Perna.

Open Review of Management, Banking and Finance

«They say things are happening at the border, but nobody knows which border» (Mark Strand)

Mini-bonds unpicked

by **Patrizio Messina**

Abtract: *The article provides an analysis of the difficulties and risks but also the potential, needs and benefits for SMEs issuing Mini-bonds on the market. This tool represents an alternative to the bank financing, without aiming at replacing it. To give a wider European framework of the Mini-bonds' market, the article offers a comparison of some of the major European Member States and a focus on the peculiarities of the markets for SMEs trading instruments on the African continent.*

1. The European Commission launched in December a two month public consultation on the creation of a proportionate regulatory framework for listings carried out by small and medium enterprises (SMEs)[1].

In parallel, several initiatives such as Horizon 2020 and G20 2017[2] aim to create a dynamic environment for SMEs including from a financing perspective. Minibonds are considered a useful tool in each of these programmes due to their ability to boost SMEs' trading activities and foster platforms dedicated to nonlarge companies[3].

Small and medium enterprises can find it challenging to raise financing. In that sense, so-called mini-bonds are considered a useful tool because of their ability to help attract funding for these non-large companies. These debt financial instruments are directly placed on the market, meaning investors can build a loan agreement directly with the issuer. A mini-bond's value is typically no more than €50 million, and the product is subscribed by institutional investors (or even retail investors) and not the subject of a solicitation of public investment. Mini-bonds are set to grow in volume as recent market conditions in Europe and in developing countries create new channels for innovative financing for SMEs[4].

The phrase mini-bond is not a proper legal term but rather a journalistic expression to indicate debt financial instruments, principally corporate bonds. Setting aside their technicalities and peculiarities, these products are issued by companies and directly placed on the market, meaning investors can build

a loan agreement directly with the issuer. A mini-bond's value usually exceeds the limit of twice the value of net equity, is subscribed by institutional investors (or even retail investors) and is not the subject of a solicitation of public investment.
Mini-bonds are generally issued for no more than €50 million ($61.2 million approximately) on regulated markets, have an average duration of around three to five years and an annual interest rate of five to seven percent.

2. Recent market conditions in Europe, developing countries and Africa have shown the need to adopt new tools that can open innovative financing channels for SMEs, and help to partially detach them from bank financing[5]. Alternative tools offer a new option in addition to banking finance but don't entirely replace it: regular loans, infrastructure, services and networking have a relevant role to play which is not worth abandoning[6]. SMEs have faced some difficulties over the year when it comes to accessing capital markets: lack of credit ratings, and costs of verifying SMEs' creditworthiness and of performing a risk assessment without standardised information. From an SME perspective, it's worth reminding of internal barriers related to organisational resources and strategies for internationalisation. In addition, the typical structural features of SMEs put them in an unfavorable position compared to their larger counterparts. High default rates in previous years have had an impact on choice of financing and don't necessarily foster investor interest. Capital markets have typically been structured for medium and large companies, leaving micro and small enterprises out of potential funds. Of course, there are different kinds of alternative finance that could turn out to be useful for SMEs, but debt financing tools, together with well-structured and efficient platforms, are necessary to allow them to carry out funding activities efficiently and grow profitably. Mini-bonds are meant to provide a more fluid process, with fewer and more flexible requirements that allow a more economical issuance on ad hoc markets, and release resources for diversifying investors' portfolios by granting SMEs' further lending. Once the mechanism becomes efficient, the entire system becomes a virtuous circle, reduces the risk associated with this kind of investment, and widens the range of potential interested investors.

3. Since SMEs represent over 99% of EU businesses[7], a considerable number of member states have specialised retail bond markets. These have been organised in order to arrange a wider access to the market for these companies[8].
In 2005, an unregulated market was born, the Nordic ABM, dedicated to the listing and exchange of bonds and commercial papers up to 12 months. The list is divided into two segments: one open only to institutional investors and the other one for retail investors.
The London Stock Exchange's order book for retail bonds (ORB) is a platform opened for mini-bond emissions in 2010[9]. The price list is open to retail investors. According to the same list managers, due to the current requirements, the market is not efficient for issuers who are willing to raise less than £ 20 million (around $ 28 million). The UK also allows mini-bonds to be issued on specialised crowdfunding platforms.
Italy is also a stimulating environment for mini-bonds. It approved a regulation for mini-bonds in 2012[10] and hosted 300 issues on the ExtraMOT Pro market for a total value of more than €14 billion[11]. It's worth noting that emissions under €50 million in the last quarter of 2017 increased strongly, both in value and volume, establishing a record for the last three years. This means that mini-bonds are actually functioning as proper tool for SMEs and have so far had minor issues.

France has had three financial markets dedicated to SME bond issuances since 2012, all for institutional and retail investors: the B and C segments of the regulated Euronext market, and the multilateral trading system Alternext. The minimum amount of a mini-bond is €100 and the duration must be between five and 10 years.

Retail investors can subscribe to securities through banks and brokers, and are entitled to certain tax advantages. Notwithstanding the well-structured SME market, only 10% of French issuers had a market capitalisation below € 1 billion; in other words, bank loans are still considered the main financing source.

In Spain, the mini-bond experience is quite recent: in 2013 an unregulated debt securities market (Mercado Alternativo de Renta Fija or MARF) opened for SMEs[12]. It is managed by the Bolsa y Mercados Españoles, and both financial bills and bonds are listed. The latter are intended for professional investors only (the minimum denomination is €100,000). All companies listed on this market have a rating, as required under Spanish law. The boundaries set by the law are certainly intense; this can be considered the main cause for its reduced dimension. As of today, no defaults have taken place.

Every German financial centre has had its own list of SME debt securities (Mittlestand-Anleihen Bonds) since 2010. It is probably the only European country where the experience of mini-bonds cannot be considered successful so far with 128 transactions in 2016 and various insolvencies recorded in recent years following these issuances.

4. In the past few years, developing countries have focused on increasing the level of employment, innovation and economic growth. SME capital markets play a fundamental role that can be fulfilled only if the relationship between banks and companies does not impact the efficiency of lending and investing mechanisms. Because of the economic recession of the last 10 years, SMEs have been looking for alternative funding tools that can allow them to resort to lending even in periods of financial distress[13]. Therefore, in light of the above, different growth segments and multilateral trading facilities within the regulated market, but dedicated only to SMEs, have emerged. Equity platforms for smaller issuers typically have less strict listing and disclosure requirements as well as more contained costs.

Moreover, the 2015 G20 Action Plan on SME Financing confirmed that the particular regulatory and jurisdictional setting of a country is a important prerequisite requirement: the goal, indeed, is to think of new regulations and dedicated measures to allow an easier access of SMEs to funding[14].

China, in these terms, can be considered an important standard: its Banking Regulatory Commission outlined that, at the end of 2016, the total balance of SME loans by Chinese banks reached RMB26.7 trillion ($4.2 trillion). The edge of transferring at least part of these sums is wide[15].

5. The current unique African continent requires a dedicated analysis.Indeed, the majority of platforms for alternative investments is located in South Africa[16]. The number of SMEs in the country is high but the number of micro-enterprises cannot be underestimated either. No specific regulation exists for alternative finance schemes so, on the basis of the one-size-fits-all principle, existing laws have to be applied to all kinds of enterprises operating on the market. Moreover, due to region wide governmental instability, smaller companies prefer remaining in the informal sector, thus diminishing their tax and regulatory constraints. Despite their reduced chances of accessing many different funding resources and

of expanding, this approach has been the norm for so many years that companies operating in the agricultural, infrastructure, manufacturing and technological sectors would be encouraged to be placed and trade on the formal economy if there were important advantages.

Given the huge amount of micro-enterprises spread around the African states[17], numerous initiatives supporting them have been implemented, leaving the bigger SMEs more exposed to risks, a situation that economists and marlet players have called the missing middle[18]. In other words, a condition where SMEs are too big to benefit from schemes created for smaller enterprises, but at the same time not structured enough to compete with larger companies. Some individual countries have put a significant effort in developing local or inter-state programmes that could strengthen the network of local intermediaries who are well aware of the needs of their clients and of the local peculiarities.

Advantages and challenges of mini-bond issuances

Mini-bonds, as an alternative funding instrument, are quite generally spread on the markets that have an increasing appeal in countries that have realised the importance of exploiting the advantages of alternative finance at most. These countries have adopted regulatory reforms that often have provided for many (fiscal) advantages for SMEs.

Issuances of mini-bonds usually happen to support investments in research and development, possible acquisitions or the restructuring of a company's liabilities. They are carried out to ensure a constant cashflow to SMEs which allows them to carry on a policy of growth and enhancement. This circumstance usually goes together with the risk related to liquidity and credit[19]; specifically, risks faced by SMEs are more critical to deal with primarily due to lack of adequate information. Thus, assessment of credit risk must be as accurate as possible and the real challenge is to provide data that can somehow complete the picture. In this context, the costs of placing a mini-bond are a crucial element in the assessment of feasibility. The principal costs, although tax deductible for the majority, concern the certification of the financial statements and the hiring of a financial advisor for an issuing and a possible listing on the stock exchange. This is the reason why at the very beginning of the opening of a new market, mini-bonds may face some challenges in spreading[20]. Indeed, these instruments can end up being more expensive than bank loans, due to higher rates and issuance costs. In the future, however, the appeal of an alternative financing process usually leads to a continuous decrease of interest rates.

Although it remains to be seen how strong and successful minibond issuances (and markets for trading SME tools) will be, setting up dedicated platforms has to be considered an important first step for a more affordable and flexible alternative financing for borrowers.

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Open Review of Management, Banking and Finance

«They say things are happening at the border, but nobody knows which border» (Mark Strand)

Crisis of politics and economic process. The case of Italy.

by **Francesco Capriglione**

Abstract: *The results of the Italian political elections occurred on March 2018 have shown insecure majorities in the Parliament, with consequent difficulties in the formation of a national government. Therefore, it is likely that implementation of economic development programs will be significantly more challenging as well as the solution of certain endemic Italian ills (such as unemployment, social inequality, poverty). Such circumstance clearly preludes to the decline of politics, occurring, albeit in different ways, in many States of the EU. It seems that the conditions now permit a change in the evolutionary processes of the economics (also due to the "financialization" of the systems), previously characterized by a bi-univocal relationship with the politics. Economics has acquired a peculiar role in definition of the organizational models through which the political power operates, even if, within the European Union, the bureaucratic-regulatory dimension is still prevailing, according to the traditional intergovernmental pattern. Therefore, a new path for the Europe seems depending on a rearrangement of the relationship between politics and the economy.*

1. A climate of 'lack of truth' has featured the recent Italian election campaign, made of promises that have been formulated without an adequate knowledge of economic reality aimed of changes that – from different voices and in different ways – were announced within a logic of *captanda benevolentia*, then proved successful.

The launch of different political programs – that traditionally characterize the game of parties in the dispute that inflames the competition between different ideological views – has been evolved in an «upward race», as has been noted by the specialized press. In fact there have been mentioned programs of economic growth, founded on the introduction of remedies that should guarantee the removal of endemic malaise of our Country, from the unemployment (specifically the young one) to the strong inequalities that, recently, determine social tension and unacceptable life conditions for large layers of population at the margins of poverty.

As a result these promises have attracted a general, easy consensus from the electorate that has confused the wishful thinking announced before the elections with a realistic perspective of concrete achievements. In this light, politics and economics after the electoral process need – as it is well-known – to confront in a logic of compromise, necessary to arrange forms of government; in this way, it is evident a perspective of agreement between opposite interests, considered essential in an institutional context in which it seems difficult to reach a united democracy. In addition, there can be seen the margins of a relationship in which the fideism on politics is intended to an inevitable reshaping, with respect to a deficiency to pursue achievements at the level of economics. Once again, the success of politics reveals an inextricable dependency from the capacity to realize, on the concrete level, a wise mix between «wealth, organization and labor»; objective which it is aimed to offer an effective solution to the instances deriving from the social structure and from the market forces.

Honestly, the recent events – connected to the outcomes of a voting system that prevents a swift and clear identification of 'winners' and 'losers' – show uncertainties and difficulties in the organization of politics and, in particular, on the definition of programs designed by the opposite political parties during the electoral campaign; then the belief that, currently, the related processes are in a critical phase, because it arises the possibility that the commitments undertaken remain unexecuted or, in any case, subject to limitations directed to alter the original formulation.

The promise of change – that has influenced significantly the choices of Italians – could also be vanished on the wall of misunderstanding and the lack of availability to «social compromise» able to accommodate the expectations of those, in good faith, believed in suitable transformations to address the distortions caused from a progressive decay of politics. There is a generalized sense of incompetence of politics to overcome the limit of a formalism that has provoked the separation from the real structure of Country; there can be seen the preludes of its decline, that replace the «empty» and irrational «inconsistency» to its traditional adherence to absolute truth.

The recent voting results have marked an important rise of a new political party, the Five Star Movement that aims to replace some consolidated pillars of representative democracy, included the principle of prohibition of imperative mandate, with practices of participation "from the bottom", founded on the control of elected through the instruments offered by the web. Further, the uncertain parliamentary balances emerged from the vote of the 4th of March – with the related difficulty in the arrangement of a majority of government – place this political subject towards a difficult dilemma: to accept the recourse to the method of mediation – pillar of the parliamentary system – alternatively to exclude every form of material and equal collaboration with traditional political parties, and in particular with those more sensitive to maintain the balances of public finance and to respect the European constraints. In the first case, the recognition of interlocutor position with the other political forces could determine a gradual process of approval of the Five Star Movement with regard to political parties; in the second scenario, this political subject would end to renounce to the possibility to realize its project of change of the Italian society, leaving disappointed especially the expectations of the Centre-south electorate. The recent (and sharing) reference to the centrality of Parliament in the settlement speech of new president of the Chamber of Deputies – which like other members of Five Star Movement had always expressed his confidence towards forms of direct democracy alternative to the traditional representative channels – seems to confirm this widespread contradiction.

2. The decline of politics, although in different ways, affects many countries of the 'western world'. In literature, usually, the reasons for this phenomenon are found out in the tensions that have been

created by the globalization as well as, more in general, by the inability to manage both events and requests arising from it.[1] In other words, in front of the economic changes, in the relationship between politics and technocracy, the former would have increasingly weakened and consequently the running of society would have been left to the latter. This would have created forms of malfeasance by some market forces, that – in excluding political action – would have played a primary role in making decisions aimed at fostering the use of their own potential, consequently damaging those who do not have access to their mechanisms.
These views – although based on some true elements – are related to an idea of politics which is different from its typical structure, namely a framework in which the State governs its citizens.[2]
Historically, in the legal and philosophical debate, politics has been seen as the body having the highest power, being its essence the absolute sovereignty.[3] Accordingly, its limits are just the ones that it sets for itself,[4] since it is free to choose its own purposes (which are identified in light of the social body's safety and productive capability).
Moreover, such a feature of politics does not exclude the need to rationally justify the exercise of tasks exteriorizing in a dominion of the man over the man; as a consequence, those who lead a social community must set their interventions on the basis of the collective needs.[5] It follows that the rulers must be able to fully assess the effects of their own action (that interferes in the private sphere) and, in particular, to comprehend whether, and to which extent, its recipients can bear its impact. Differently – beside the configurability of a hypothesis of State's arbitrary action – the outcome is just a 'dominion' that is in contrast with the criteria of the «social contract» which, as known, is the basis for the modern models of civil society refoundation.[6]
In this premise – and coming to the recent events – it is clear how, due to the increasingly fast evolution of the economic processes in the last decades (and the financialization of the systems) the past two-way relationship between economics itself and politics has changed. Economics has, therefore, acquired a peculiar relevance in defining the organizational models aimed at providing the political power with factual concreteness; this has also consequences on the essence of *democracy*, which is considered to be proactive of a political constitution that allows for an organization scheme aimed at guaranteeing the widest and safest participation of citizens in making the decisions concerning the community.[7]

It is worth noting that politics has not been able to adequately interpret the relevance of the mentioned systemic changes and has also shown its own inability to govern the innovative phenomena brought about by globalisation. Hence, it has not managed to channel through appropriate regulatory mechanisms the economic change and its degenerative aspects, such as the crisis that in the last decade devastated many Countries, dragging their populations in terrible life conditions. Politics has substantially given up its institutional function; it has not been able to perform its main task of designing the development of the civil society through the adoption of rules aimed at assuring the congruity of the evolutionary processes.

This lack of intervention has caused a recessive trend of politics that has ended up being a sort of *self-harm*: the EU institutions have performed an inadequate action which has been almost only the imposition of *austerity measures* that in turn have shown the deep weakness of the solidarity mechanisms, social cohesion and reduction of inequalities.[8]The result has been a number of strong protests which underscore a deep disillusion of the European people with regard to the possibility to realise the European project.[9] All this has taken place in a systemic context in which new *negative*

factors have shown the limited tendency of the European executive power to foster the necessary boost for the development (article 15 of TFEU); this objective is assigned to an inefficient comitological mechanism, which has been defined as a «*retaggio di un equilibrio istituzionale anacronisticamente sbilanciato in senso intergovernativo*».[10]
With regard to the European context, I have already argued that such an operational inadequacy of the EU political leaders has given room to the increasingly relevant substitute role of the technocrats].[11] In this regard, we have seen the ECB's adoption of a number of measures (*non-conventional operations*, among which the so-called *quantitave easing*) that – along with the interventions of two temporary mechanisms (such as EFSM and EFSF) – have managed to stabilise the markets by solving extremely serious situations; nevertheless, the dysfunctions of a system no longer related to politics and characterised by differences have not been eliminated. Therefore, there are still economic imbalances between the EU member states, due to a sort of transfer of powers from the so-called «institutional triangle»[12] – which was the form of the European structure before the adoption of the Lisbon Treaty][13] – to 'techno structures' which have gained a very significant function.[14]
In addition to the above mentioned difficult relationships within the EU there are also the burdensome implications arising from Germany's prevaricating tendencies, UK's withdrawal from the Union, France's conduct aimed at gaining a leading position in each sector (politics, economy, culture, defence), Italy's substantial social immobilism. These are the reasons for an increasingly widespread *populism* which is divided between national-sovereignist positions and ideas advocating direct democracy, both oriented to manifest opposition against the so-called «Europe of bankers», immigration, and the euro.

Accordingly, it is clear how the Union is paying the limits of a systemic context still characterised by the prevailing burecrautic-regulatory approach that so far has accompanied the traditional intergovernmental paradigm. Therefore, the possible start of a EU innovative constituent project depends on the overcoming of such obstacles; obviously, this outcome will not be reached if the relationship between politics and economics will not be reshaped. Indeed, only by giving back to the former its decision-making role – aimed at counterbalancing the necessary guarantees for the economic development with the values characterising its function – it will be possible to restart a dialectical relationship with the latter, which will have to aim at facing inequalities, increasing widespread economic well-being and fighting against obscurantism.

3. Moving to the peculiarity of the Italian case, the recent reality after elections is spreading the belief that the discrepancies of a politics in crisis cannot be easily solved without the benefit of an adequate sense of responsibility, that cannot be disconnected from the aim to soften unsuitable programs launched during the electoral campaign. It is necessary to translate the interventions, put in place so far, from the mere proposition of an aggressive criticism to the constructive volunteer, that allows to realize at least the numerous 'promises' that have characterized the choices of electorate. It seems inevitable that the winner parties agree to change their programmes and turn down from populist positions previously announced; in particular, it is referred to the need to stop the denial of hospitality (that it has always been considered one of the main prerogatives of our Country), to the ambiguities linked to relations with the European Union, to the disputes that have affected the relationships between political parties. In general terms, it cannot be neglected to consider that the unresolved delays of Italy in the process of modern technology are attributed to lack of attitude to the *humus disciplinare* necessary to

adopt timely adequate measures of sustainable development. In the same way it is worth mentioning the burden determined to the growth of our Country as a consequence of the negative actions of a bureaucracy (that block and make difficult every initiative), nonetheless the low attitude to the rules, element that characterizes a system in which «the information is considered from the majority of mangers a necessary harm», as rightly observed.[15] It is evident the ambivalence affecting our Country that demonstrated, on one hand, to be proactive during the crisis, capable to identify the right solution, facing sacrifices and renunciations, but on the other hand reluctant to abandon the attitude of individualism, slyness, superficiality, deficiencies that are translated in factors obstructing the typical functions of politics.

At time of globalized economy that emerges, in idiosyncratic terms, as new paradigm of regulation of the relationships, the politics will have to overcome the huge uncertainties that raise with regard to the need to search adequate systems of checks and balances that aim to ensure the necessary dialogue towards a common enhancement of democracy and free market. This is a challenge that should be faced by the political parties in view of governability of recent technology developments – digitalization, cybernation, etc. – directed to change radically the forms of public intervention in the economy. In this light, the choices made in this sector affect significantly on the solution of problem of the young unemployment; being the same choices related to the job market.

The search for stability of system, to be achieved under the twofold political and economic scope, cannot disregard from a change of political behavior; it is desirable an action that, in benefiting of utilities provided by economy, is founded on the affirmation of values that are pillars of our Constitutional Chart, such as solidarity, rationality and honesty of *agere*.

This is a pathway of hope that shows several difficulties and various obstacles ... to this pathway we cannot, we must not give up.

References

[1] See Severino, Il tramonto della politica, Milano 2017.
[2] See Dewey, Problems of Men, New York, 1946.
[3] See Bodin, Les Six Livres de la République, published in 1576, where it is claimed that a cohesive and orderly society is based on the unified exercise of the power by the State. Also in the publication by Hobbes, Leviathan or The Matter, Form and Power of a Common Wealth Ecclesiastical and Civil, published in 1651, the issues of legitimacy and the structure of the State are dealt with in the context of the primary function of politics.
[4] See Montesquieu, De l'esprit des lois, XI, 6, where it is presented the well-known theory of the separation of powers, moving from the consideration that power has no limits that it cannot derogate itself.
[5] See Saint-Simon, L'organisateur, published in 1820 where the author talks about the case of a society made up of 'collaborators', giving politics the task of intervening in order to create the conditions to bring economic well-being within the society, which in turn will be used as a parameter to assess its quality.

[6] See Rousseau, Du contrat social, published in 1762, where the author suggests the creation of a society based on a fair deal aimed at making people the sovereign body, exercising the legislative power and only subjects to themselves.

[7] See Bobbio, Quale socialismo, Torino, 1976, p. 42.

[8] See Capriglione – Ibrido, La Brexit tra finanza e politica, Milano Assago, 2017, p. 93; see also Balaguer Callejón – Azpitarte Sánchez – Guillén López – Sánchez Barrilao, El impacto de la crisis económica en las instituciones de la Unión Europea y de los Estados miembros, Pamplona, 2015.

[9] See Poiares Maduro, A New Governance for the European Union and the Euro: Democracy and Justice, in RSCAS Policy Papers, 2012; Capriglione – Troisi, L'ordinamento finanziario dell'UE dopo la Crisi, Milano Assago, 2014, p. 121.

[10] See Savino, La comitologia dopo Lisbona: alla ricerca dell'equilibrio perduto, Giornale di diritto amministrativo, 2011, p. 1041.

[11] See Capriglione – Sacco Ginevri, Politics and Finance in the European Union. The Reasons for a difficult encounter, Wolter Kluver, London, 2015, passim, particularly p. 111.

[12] See Dieckmann, *The Announcement Effect of the Efsf, Afa 2013*, San Diego Meetings Paper, available at *http://www.ssrn.com/abstract=2022750*.

[13] The reference concerns the legal framework of the decision power in the EU that is based on an «institutional triangle», providing a codecision process under which the Commission makes the legislative proposals, while the Council and Parliament are meant to approve such proposals. For an analysis of the EU system before the adoption of the Lisbon Treaty see Weiler, *Il sistema comunitario europeo: struttura giuridica e processo politico*, Bologna, 1985; Shawj, *Law of the European Union*, 2000; Pocar, *Commentario breve ai trattati della Comunità e dell'Unione europea*, Padova, 2001; Tizzano, *Trattati dell'Unione e della Comunità*, Milano, 2004; Mengozzi, *Istituzioni di diritto comunitario e dell'Unione europea*, Padova, 2006.

[14] See Capriglione, Mercato Regole democrazia. L'Uem tra euroscetticismo e identità nazionali, Milano Assago, 2013, chapter V.

[15] See the editorial «*Il saluto di Ferruccio de Bortoli ai lettori del Corriere della Sera*», published in *Corriere della sera* of 30 April 2015, available at *www. corriere.it/cronache/15_aprile_30/saluto-lettori-direttore-de-bortoli*). A detailed analysis of cultural and cognitive limits of current time – which is characterized for a wide incompetence and disinformation that seem to prevail on the traditional consolidated knowledge – is found in the well-known seminal work of Nichols, *La conoscenza e i suoi nemici*, italian translation edited by LUISS University Press, 2018.

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«They say things are happening at the border, but nobody knows which border» (Mark Strand)

Capital management in European Banks. Critical issues

by **Fabiano Colombini**

Abstract: *This paper aims to analyse critical issues in the capital management in the light of recent financial crises, focusing on capital constraints by regulation and supervision in the composition of bank capital. Capital constraints by regulation and by supervision plays an important task in the level and composition of bank capital considering intensity and range of all risks. Instruments and business areas need to be considered.*

Bank discretional margins are very restricted and the influence of public authorities is substantial: it exerts an adverse effect on the quality banks that are capable of rational screening and monitoring and, at the same time, of sound risk management, efficiency, thereby achieving a good performance. Changes, incentives and recreating structural conditions postulate new and innovative measures build up by regulatory and also supervisory authorities.

The raising of capital is the main tool used by regulation on a prudential application and by supervision on a discretional application in order to maintain the viability of the banking system. Capital requirements are calculated through Basel III and the forthcoming Basel IV and are also imposed as an additional tool through discretional decisions by supervisory authorities. Considering only the capital level is misleading as it is unable to create the premises for a sound and stable bank in the future time.

The improvement of risk management through the identification, measurement and management of all risks linked with bank instruments and bank business areas is the best strategy to achieve structural reinforcement and, therefore, to ensure the soundness of individual banks and the banking system in the medium and long term.

The improvement of efficiency in the various forms of cost, revenue and profit, would be in line with the structural premises for sound and viable conditions leading to better frameworks for the economic account from one period of time to another.

The solvency risk concerns the different ability of banks to settle their debts at any cost. Solvency is achieved by means of systematically higher asset values as compared to liabilities, thereby indicating positive levels of the bank's capital. This highlights the problem of growth of profit and of a bank's recourse to market instruments in order to develop its capital and its monetary resources and *production volumes. The expansion path starts from the raising of capital and positive performance, which in turn increases sound business and generation of profit.*

Capital raising creates premises for solvency, stability, business evolution, business growth in individual banks in Europe and world-wide. Capital raising is inspired by regulation and, at the same time, by supervision. Bank management is conducted through choices concerning the actual current situation and the future situation.

Capital represents a key variable in business, but the improvement of risk management and efficiency constitutes the best reply as a means of reinforcing structural conditions for survival. This report aims to investigate these elements in order to express critical issues and critical points for the evolution of individual banks and their business.

Basel I, Basel II and Basel III and forthcoming Basel IV rules increase the compliance costs of individual banks while disregarding the fact that banks differ greatly between small and medium banks in comparison with the largest banking institutions. The issue for banks is the use of rational and rigorous methods for the management of business areas and correlated risks, from the viewpoint of producing profits in the short, medium and long term. The establishment of more and more rules introduces greater complexity in bank regulation and, at the same time, increases compliance costs. Therefore a comparison of costs and benefits arising from the introduction of regulation should be performed.

The habitual focus on increasing capital is not the correct approach, because it makes use of a unitary attitude, i.e. the "one size fits all" approach to banks which are profoundly different in their business areas and risk range. Rules essentially consider a loss coverage issue through an adequate capital level, and this is a very different matter from the actual ability to manage the entire risk range.

Increasing the number and complexity of rules tends to introduce further complications in the task of supervision, but the main aim of supervision is still that of checking and ensuring control over the application of the rules in European banks. A banking crisis requires supervision initiatives which usually involve the raising of capital as a standard approach to build up a "wall" against the worsening or failure of the situation of a bank.

Capital raising for satisfying regulatory and supervisory capital requirements contribute to increasing the capital level and therefore the absorption capacity in the event of unexpected losses. A higher level of capital will be able to handle negative economic results, and bank survival: solvency can be measured at given times.

Improving risk management and efficiency allows banks to achieve structural conditions to recreate positive premises towards positive trends in costs and revenue and, at the same time, in the evolution of assets, liabilities and capital. This is the key point to pursue in the evolution of management conditions within European banks and within world banks.

Summary 1. Financial crises – 2 Banking business – 3. Capital composition, capital constraints and solvency – 4. Capital management and financial stability – 5. Capital, regulation and supervision – 6. Final remarks.

1.Financial crises can be examined in the framework of crises involving financial markets, crises affecting financial intermediaries, sovereign debt crises and currency crises. Careful examination of the issues involved shows that financial crises are the result of interrelations among a number of circumstances: adverse trends on the financial markets, adverse situations affecting financial intermediaries, tensions focusing on the public debt and turmoil in the exchange markets.

Financial crises have effects that ripple through financial markets, financial intermediaries, financial instruments, states and central banks, thus highlighting correlations and interdependencies as well as financial instability (Colombini, Calabrò, 2011). In short, financial crises have repercussions of marked intensity that are projected in the short, medium and long term over financial systems and, at the same time, over economic systems. For example, the subprime mortgage financial crisis calls for state aid measures in support of crisis-ridden financial intermediaries; the sovereign debt crisis implies the need for action to restore balance in the public finances; the economic crisis necessitates economic stimulus initiatives which diverge from the measures suggested in the previous two cases and may indeed be in conflict with them.

One aspect that clearly emerges is the importance of a scale of priorities concerning the volume of public resources required. Decisions on priorities must take into account the margins for public expenditure without causing excessive imbalance in the public budgets.

It likewise becomes clear that the irrational strategies based on innovative finance must be downsized or abandoned, in favour of restoring the concept of cultural and regulatory financial responsibility. Profits should be achieved by rational risk management, rather than arising from practices inspired by a separation between risk and return which ends up offloading the negative impact of risk onto the state budgets, while the positive impact of returns is inserted into the balance sheets of individual banks.

These improper practices tend to exacerbate the risks weighing on the entire financial system, thereby undermining savers' confidence in financial intermediaries. The latter thus tend to be regarded as incapable of reducing the information asymmetries present on the financial markets. The move towards excessive risk-taking has been allowed to creep in partly on account of failure by the supervisory authorities to exert proper control over the individual financial intermediaries and over the placement of financial market instruments; however, it is partly also ascribable to systematic attribution of decidedly positive ratings that are totally mistaken in their quantification.

The subprime mortgage financial crisis can be identified as originating above all from the practice of selecting and transferring the credit risk associated with poor quality mortgage loans, thereby intensifying and transferring the overall credit risk. The collapse of the real estate market has led to markedly negative and widespread repercussions on the assets of banks and financial intermediaries that are characterised by significant levels of very bad mortgage loans and which, additionally, have made use of financial instruments of equally poor quality.

The sudden drop in house prices has induced adverse effects on the economy, triggering a recessive process of notable extension. A very worrying aspect is the situation of many families who are facing rising levels of unemployment and thus experience difficulty in meeting their mortgage instalment payments.

Thus on the one hand, the subprime mortgage financial crisis has made it necessary for governments to intervene in support of financial systems threatened by an unprecedented crisis, while on the other it has focused attention on the fragility of public budgets. Admittedly, massive resources have been made available to crisis-ridden banks in the different countries, but it is equally true that the shaky conditions of the public finances cannot exclusively be attributed to the subprime mortgage financial crisis.

Bailout plans to address the subprime mortgage financial crisis and expansionary policies designed to tackle the economic crisis have led to a marked deterioration in the public finances. However, the dramatic condition of the public finances should be ascribed not merely to the above described exceptional measures, but also to unbridled public expenditure that has risen to unsustainable levels. The most critical elements affecting the public finances involve the following aspects: rising pension and health care expenditure due to an aging population; fairly high expenditure on the national, regional and local level in matters pertaining to political affairs; intensity of tax evasion; amount of the public debt and its composition in terms of maturities and apportionment between residents and non residents; private debt levels and degree of solidity of the banking systems.

The elevated levels of public indebtedness create the premises for the sovereign debt crisis, leading to an increase in the returns that the markets demand on bonds issued by states perceived as being at risk and thereby bringing about an increase in spreads between the bonds of an individual state and those of the German state. This, in turn, exacerbates the fragility of the budgets of crisis-ridden states and makes it difficult, if not impossible, to intervene with measures aimed at economic recovery (Acharya, Philippon, Richardson, Roubini, 2009; Adrian, Shin, 2010; Allen, Carletti, 2010; Bernanke, 2015; Blanchard, Dell'Ariccia, Mauro, 2010; Boccuzzi, 2011; Bolton, Jeanne 2011; Calabria 2009; Capriglione, Semeraro, 2012; Cassidy, 2009; Claessens, Dell'Ariccia, Igan, Laeven, 2010; Colombini, 2011; Colombini, Calabrò, 2011; Crescenzi, 2010; Davies, 2010; Dowd, Hutchinson, 2010; Duffie, 2010; Eichengreen, 2008; Elson, 2017;Estrella, Schich, 2011; FCIC, 2011; Franke, Krahnen, 2008; Fratianni, 2008; Fornasari, 2009; Geithner, 2014; Goodhart, 2008; Haldane, 2009; Hubbard, 2009; King, 2016; Marconi, 2010; Masera, 2009; Mishkin, 2011; Reinhart, Rogoff, 2011; Shiller, 2008; Sorkin, 2009; Spaventa, 2010; Stiglitz, 2010; Wolf, 2014).

The trend of the spreads is thus linked to the situation within the various countries and to the perceived credit risk inherent in the sovereign debts as interpreted by the financial markets. Moreover, the trend is also influenced by the overall situation of the euro zone. Progress or worsening of the financial and economic situation within individual countries or involving the euro zone mechanisms leads to positive (reduction) or negative (increase) repercussions on the spreads.

It hardly need be added that speculation undoubtedly influences the fluctuation of the spreads. This makes itself felt not only in definition of the costs of individual public refinancing operations but also in the costs incurred by banks in raising funds, as well as in the costs dictated by the financial markets regarding bank loans to firms. Furthermore, the issue of contagion cannot be ignored, given that the interrelations among states transform the problems of individual states into global problems. This postulate is particularly evident in the context of the euro zone countries, triggering potential contagion among countries viewed as weaker on the financial level and therefore more fragile in the context of speculation.

It is imperative to examine the main causes, highlighting above all the role played by securitisation and credit derivatives in influencing the extent of credit risk transfer onto loan portfolios and sovereign bond portfolios. This issue is crucial because the repercussions can lead to fluctuations in value, weighing heavily on the losses suffered by financial intermediaries and by operators who invest in mortgages or in financial instruments linked to subprime mortgages, or in bonds and financial instruments linked to sovereign states.

One major aspect common to the financial crises discussed here resides in the contraction of liquidity due to the negative fluctuations and losses of value associated with subprime mortgages and the related financial instruments. This phenomenon also impacts on sovereign bond portfolios and the related financial instruments. The repercussions adversely affect the trends concerning the value of bank assets and the assets of financial intermediaries and operators, leading to the need for adjustments and deleveraging processes on various levels.

Such observations underline the importance of correct analysis and evaluation of the credit risk inherent in loan portfolios, asset-backed securities (ABS), credit derivatives, financial instrument portfolios and sovereign bonds. In short, the manner in which the credit risk is manifested, transferred and multiplied on the level of individual financial systems constitutes the basic thread allowing analysis and interpretation of the financial crises that form part of the broader context of the subprime mortgage financial crisis and the sovereign debt crisis.

In the process of credit risk transfer that has characterised international finance essentially since the beginning of the third millennium, it is not easy to identify precisely which repercussions have an impact on the direct circuit as opposed to those that impact on the indirect circuit. Only by exploring the integration between the two processes does it become possible to delineate more clearly the effects of the subprime mortgage financial crisis and the sovereign debt crisis.

Irrational criteria that turn a blind eye to the creation and intensification of credit risk have induced financial intermediaries to engage in unreasonable practices of experimenting with the transfer of credit risk to the financial markets, by means of securitisation and credit derivatives. This has triggered multiplicative impulses, raising problems concerning medium and long term sustainability. Moreover, such practices are suggestive of an original flaw which is of fundamental importance in the evolutionary path of financial systems.

On closer examination, credit risk transfer onto financial markets, where the main figure both in the field of sales and also of purchasing is represented by financial intermediaries, assumes the extended meaning of an increase in the burden of risk weighing upon the financial system, due to the numerous inter-relations among financial intermediaries (Shin, 2010). Basically, the problem can be traced partly to unorthodox practices in granting loans to a very poor quality customer base, and partly also to the subsequent experimental practices of risk transfer taken to excessive levels, as well as to failure of the supervisory authorities to exercise proper control.

In the context of financial crises of the period 2007-2017 at least in Europe, the ECB provides liquidity to the economy using conventional and unconventional instruments of monetary policy for support to issue and placing of public debt and, at the same time, contributing to prices stabilisation and yield reduction. It is worth to point out the *quantitative easing* (Qe) instrument that ECB is still using in the European context.

It is important to consider the increasing in balance sheet volumes and, at the same time, the risk growth of the ECB following the trend of Qe as buying public securities tend to increase assets.

Among the motivations at the basis of financial crises and, especially, of the subprime mortgage financial crisis the excessive borrowing has been indicated as the major factor (Admati, Hellwig, 2014). This is a wrong point of view as the main reason of the financial crisis of 2007-2009 lies in the irrationality of screening and monitoring and, at the same time, in the recurrent application of securitisation and derivatives, contributing to creation, transfer and multiplication of credit risk of financial intermediaries (Colombini, Calabrò, 2011).

2.Banks pursue the objective of expansion of on- and off-balance sheet instruments and volumes over time in order to create the premises for profits and positive performance. Banking balance sheets have grown rapidly in a low interest-rate environment and in the presence of a surge in innovative instruments (Richardson, Smith, Walter, 2010).

Traditionally, banks take deposits and make loans to individuals and firms (commercial banking). Some banks engage in underwriting, dealing, market making of securities and derivatives, management of personal and real estate property, consultancy, mergers and acquisitions, financial planning, custody and administration of securities, intermediation and selling of securities, derivatives, investment trusts and real estate investment trusts, pension funds and insurance policies (investment banking).

The growth of the banking business has underlined the shift from commercial banking to investment banking, and therefore an increase in the range of risks and in total risk. The process of identification, measurement and management of risks is of crucial importance in creating and maintaining conditions for profit and solvency. The above mentioned shift is evident when looking at the assets side, the liabilities side and income sources as the share of net interest income falls and non-interest income rises (Liikanen, 2012).

The universal model in the banking sector combines commercial banking with investment banking and can be regarded as a critical issue for managing risks at a sustainable level for the individual institution and for the whole financial system.

Large banks tend to apply the universal banking model in the European Union (EU) for production diversification and also for risk diversification, adopting jointly the instruments of commercial banking and investment banking. Moreover, the expansion of business areas leads to a corresponding increase in the range of risks, with the result that risk management assumes a progressively more significant role. As a consequence of the links among different business areas, a bank may encounter difficulty in estimating its total risk exposure; accordingly, many banks engage in risk transfer as a practice for management of asset classes that involve a higher credit risk.

The systematic use of this practice has negative repercussions on the two classical banking activities: screening and monitoring. Screening and monitoring reduce or – in a very optimistic assumption –

completely eliminate the problems, respectively, of information asymmetry *ex-ante* and, therefore, of adverse selection, and the problem of information asymmetry *ex-post* and, therefore, of moral hazard.

Screening and monitoring activities, together with the information content of bank loans, the uncertainty of return and of the value of their assets, and the "certainty" of remuneration and of the value of their liabilities, as well as the specific nature and depth of financial transformation, underline the importance of banks and, at the same time, highlight their differences in comparison with other financial intermediaries (Colombini, 2008).

A considerable number of banks have undertaken the development of business areas which are parallel to the classical areas of raising and lending funds. Many of these developments frequently involve high leverage areas, as in the case of derivatives (Colombini, 1999; Colombini, 2004; Colombini, Calabrò, 2011). Restoring rational choices in the context of commercial banks constitutes a requirement for medium and long period financial stability, with less importance awarded to growth of their capital.

Over time, the dealing and market making of securities and derivatives and proprietary trading have become increasingly important. There has also been a remarkable growth in derivatives, especially in the over the counter (OTC) market (Colombini, Calabrò, 2011; King, 2016; Oldani, 2008; Savona, 2010). Since the beginning of the third millennium, securitisation markets have grown rapidly and created the phenomenon of the shadow banking system, built up essentially by special purpose vehicles (SPVs) and structured investment vehicles (SIVs).

Extensive recourse to leverage and, at the same time, the development of the shadow banking system (Claessens, Pozsar, Ratnovsky, Singh, 2012; Gorton, Metrick, 2010; Lemma, 2016; Stein, 2010) imply avoidance of capital requirements in a banking context, through the constitution of off-balance sheet vehicles. The latter, in particular, run up debts on the market of commercial papers such as short-term securities, and use the resources thereby achieved to purchase long-term securities, such as asset-backed securities (ABS). The difference between return on purchased securities and the cost of financing through commercial papers makes it possible to obtain profits by means of special purpose vehicles.

Changes and innovations in rules should be accompanied by adequate levels of controls on bank practices of regulatory avoidance through off-balance sheet items (OBSIs). For banks, the shadow banking system represents one of the main ways in which a vast quantity of risk that is generated and transferred is rendered opaque (Pozsar, Adrian, Ashcraft, Boesky, 2012). It is important to bring greater transparency into financial intermediaries' balance sheets, above all as regards OBSIs, which, in the light of financial crises on a global scale, highlight irrationalities in the management of banks.

In this framework, the subprime mortgage financial crisis causes negative repercussions, because the liquidity crisis affecting banks does not allow special purpose vehicles to satisfy their continuous demand for re-financing through commercial papers.

It is worth pointing out that the paralysis of asset-backed securities markets, due to the collapse of the real-estate market and of the underlying assets characterising these securities, does not allow special purpose vehicles to raise funds to cope with their short-term commitments.

In their desire to reassure the markets of the commercial papers, banks are forced to re-enter the special purpose vehicles assets and the enormous losses recorded in the balance sheet perimeter. The repercussions are devastating and banks experience heavy write-downs both on the lending portfolio and the financial instruments portfolio, recording losses and bank failures.

National responses to financial and economic crises, together with years of waste in public resource management, cause a rise in public expenditure and imbalance in the major Western countries' public accounts, leading the way to a sovereign debt crisis. Essentially this means a credit risk for the country due to the non-payment of its debt maturity (debt default), or the intervention of an international financial authority, such as International Monetary Fund (IMF), to adjust deadlines and amounts of those payments as defined in the debt contract (debt restructuring) .

Considerable diversity in business areas, financial instruments and the associated range of risks can be observed among banking intermediaries. Typical financial risks include: liquidity, solvency, credit, the interest rate and exchange rate. A typical pure risk consists of operational risk. Such risks affect banks and are similar to those that affect other financial intermediaries. However, they do not exhaust the range of bank risks, as it is necessary to analyse and make comparisons among different instruments and the respective business areas, in order to assess the complete range of risks affecting the various areas. Additionally, this circumstance presupposes appropriate management capacity in the process of risk identification.

3.Bank capital is composed of three elements: capital constraints by regulation, capital constraints by supervision and free capital by bank choices. Bank discretional margins are very restricted and the influence of public authorities is substantial: it exerts an adverse effect on the quality banks that are capable of rational screening and monitoring and, at the same time, of sound risk management, efficiency, thereby achieving a good performance. Changes, incentives and recreating structural conditions postulate new and innovative measures build up by regulatory and also supervisory authorities (Colombini, 2018).

The raising of capital is the main tool used by regulation on a prudential application and by supervision on a discretional application in order to maintain the viability of the banking system. Capital requirements are calculated through Basel III and the forthcoming Basel IV and are also imposed as an additional tool through discretional decisions by supervisory authorities.

This is a sort of "recurrent stressing" for implementation by banks in order to pursue the stability objective. It is important to point out that raising of capital is useful only to hedge the solvency risk at the specific time date involved, and only if the solvency risk is correctly estimated at that time.

Looking at only the capital level is misleading as it is unable to create the premises for a sound and stable bank at a future time. Improving risk management through the identification, measurement and management of all risks linked with bank instruments and bank business areas is the best strategy to achieve structural reinforcement and, therefore, to ensure the soundness of individual banks and the banking system in the medium and long term.

This strategy can be completed by an improvement of efficiency in the various forms of cost, revenue and profit, as this would be in line with the structural premises for sound and viable conditions leading to better frameworks for the economic account from one period of time to another.

Solvency concerns the bank's ability to honour its debts at any costs. This, in turn, presupposes the availability of monetary resources during crisis periods. Solvency is measured by the ratio between capital and total deposits or total assets, or better, of assets exposed to risk. The latter concept basically reproposes that of capital adequacy.

The solvency risk concerns the different ability of banks to settle their debts at any cost. Solvency is achieved by means of systematically higher asset values as compared to liabilities, thereby indicating positive levels of the bank's capital. This highlights the problem of growth of profit and of a bank's recourse to market instruments in order to develop its capital and its monetary resources and production volumes. The expansion path starts from the raising of capital and positive performance, which in turn increases sound business and generation of profit.

Capital raising creates premises for solvency, stability, business evolution, business growth in individual banks in Europe and world-wide. Capital raising is inspired by regulation and, at the same time, by supervision. Bank management is conducted through choices concerning the actual current situation and the future situation. Capital represents a key variable in business, but the improvement of risk management and efficiency constitutes the best reply as a means of reinforcing structural conditions for survival. This report aims to investigate these elements in order to express critical issues and critical points for the evolution of individual banks and their business.

On closer inspection, insolvency arises from an excessive risk level, which brings about reductions in value of financial asset portfolios (Johnson, 1993; Kohn, 2004; Saunders, Cornett, 2008). This testifies to a problem of appropriate choices for risk identification, measurement and control, as well as the need to minimise the impact on a bank's capital and to ensure its survival on the market.

Maintenance of solvency presupposes management choices based on appropriate principles of rigour and, above all, on accuracy in credit risk assessment. It is also necessary to ensure the creation of a loan portfolio which, over time, will prove capable of restoring and renewing cash flow, together with the ordinary cash flow arising from interest collection.

Solvency has close links to liquidity because the sources of liquidity arise from assets, liabilities and off balance sheet items (OBSIs) and from the costs and revenue trend, because the sources of solvency are directly affected by asset and liability values and by achievement of profit.

Solvency is also linked to management of the other risks, as their impact influences the economic outcome and leads to fluctuations in the value of assets and liabilities. Raising capital will be able to offset the solvency at a given time and not in the medium and long term. Therefore regulatory and supervisory authorities require capital to protect the bank from insolvency, which is measured at a given time period. Evolution of competition, inputs, output, costs and revenue allow banks to create conditions in which the level of capital may not be inadequate for the evolution of economy.

Increasing capital constraints by regulation and supervision stresses the use of capital in order to solve bank problems: is this a rational approach or should it be investigated more deeply? Capital constraints should be able to mitigate the insolvency risk, but this is only a quantitative solution in order to absorb losses which have been generated by bank management.

Raising capital usually implies a deterioration in asset values and costs and revenue, attributable to poor quality in corporate governance as well as in risk management and efficiency.

It is important to stress that improvement in risk management and efficiency represents the structural conditions that are necessary to recreate the premises for a shift towards positive trends in costs and revenue and, at the same time, in the evolution of assets, liabilities and capital. This is the key point to pursue in the evolution of management conditions through European banks.

Raising capital is the most widespread regulatory and supervisory measure concerning banking intermediaries in the evolution of banking systems in Europe. In what direction will banks evolve after the raising of capital? The future of a well capitalised and well managed bank will be less unstable and less unpredictable than that of a poorly capitalised and badly managed bank. Competition can create growth problems for production volumes, reducing the basis for the bank's profit. Raising capital will change the dividend distribution and, at the same time, the distinction between the pay-out ratio and the retention ratio: profit will thus be split into the part for distribution and the part for retention.

In this context, supervisory authorities should create an organisation unit for monitoring the level and evolution of capital absorbed by individual banks in Europe and the number of capital procedures to reinforce the bank capital. The greater the number of procedures for raising capital and the more frequent the recapitalisation, the more serious the problems of individual banks are likely to be. This is a sign of intrinsic weakness of the individual bank, and the raising of capital imposed by regulation and by supervision in different time periods can be considered the clear signal. The problem, however, is the wasting of capital which can be measured only in the case of problems, crises or failures incurred with bank exits from the market.

Raising the level of capital and improving risk management and efficiency allow individual banks to achieve structural and solid reinforcement overtime: the bank will be more solid and thus better able to offset adverse events and stay on the market. This is a purely statistical observation, which is important but at the same time is not sufficient to grant insight into the genuine current status and future evolution, as capital plays a crucial role for banking business strategies.

Turnover of loans can be high or slow: in the former of these two cases it has a good impact on liquidity, in the latter case it has a bad impact on liquidity, underlying the relative strategies to set up. It is important to pursue an adequate level of turnover in order to obtain a genuine impact on liquidity and management of the individual bank.

4.In this framework, capital management is designed to encourage the growth of available resources, reinforce the bank's business wealth and ensure respect for adequacy criteria. Its development and management constitute a premise for solvency and profitability.

Bank financial structure rests to a large extent on indebtedness, rather than capital. The following types of indebtedness can be distinguished: short-term, medium-term or long-term maturities, fixed or indexed interest rate and the consequent financial charges that reduce the level of profits; the bank's capital, on the other hand, is characterised by indeterminate maturity, an oscillating rate of return and dividends that affect the distribution of profits.

The peculiarity of bank financial structure is associated with the trust and reputation acquired on the market. The acquisition of trust and reputation facilitates the issue and placement of banks' liabilities: accordingly, indebtedness may rise considerably to high levels. Changes in the financial structure and, therefore, the utilisation of instruments involving debt and capital respond to different needs on the part of the public: essentially, these divergent needs involve insufficient – or, alternatively, a vast quantity – of information concerning business areas.

The strategic role of capital arises from the protection awarded to depositors and purchasers of liabilities in the hypothesis of failed repayment of credits, which would reduce the value of a bank's assets and could lead to its insolvency and bankruptcy, since there exist well-known problems of adverse selection and moral hazard that can generate negative outcomes and ensuing chain reactions.

Capital is regarded as the bulwark of the stability and solidity of commercial banks for three fundamental reasons: absorption of fluctuations in value of the assets; stabilisation in the sources of financing; absence of contractually established remuneration constraints (Berger, Herring, Szegö, 1995; Pecchioli, 1987; Pringle, 1974; Taggart, Greenbaum, 1978).

Differences among risks, when the latter are related to different business areas, lead to unequal requirements as regards capital and processes aimed at increasing capital within banks (Lindquist, 2004). Information asymmetries, the extent of available instruments, the danger of massive and rapid requests to convert deposits into money must be taken into account when a bank seeks to identify the suitable level of capital.

A capital increase creates the premises for development of intermediated and productive volumes, providing positive influence on the formative process of the profit and loss account. Furthermore, the increased incidence of capital versus liabilities reinforces the degree of solidity of the bank's financial situation and, therefore, the solvency of individual banks.

The increase in capital and available resources is reflected in the effects on investments, regarding especially investment in new technologies.

With regard to commercial banks, for a medium and long time period horizon there exists a direct relation, as can easily be noted, between the expansion of capital and that of loans. This progressively enhances available resources, and also ensures protection of buyers of liabilities (Gunther, Moore, 1993; Moore, 1992).

The increase in capital is linked to the following aspects: retention of profits for reserve formation, placement of shares on the market, and creation of subordinate liabilities.

In screening and monitoring concerning the range of loans, the bank aims to encourage the size development of companies and, at the same time, to create the premises for economic growth. By granting loans to reliable clients, the bank pursues its own interests but also pursues the general interest consisting in the reinforcement of enterprises which, more than others, contribute to economic growth while maintaining solid bases for the future.

In European banks, capital is a tool used very frequently by regulatory and supervisory authorities essentially with the aim of creating a protection against bad events and negative impacts on the economic account. Raising capital is useful but at the same time creates remuneration problems and investment problems.

Therefore the "walls" against bad events should be able to provide safety and soundness for just a period of time. Changing production and distribution processes, rationalising costs and revenue and profits leading to best practices of risk management and efficiency constitute the true and real tools to activate for restoring and improving the internal conditions of individual banks and, as a consequence, of the banking system.

Banks in Europe have a loan portfolio distinguished by good loans and bad loans. The good loans create turnover and, at the same time, return rates; in contrast, bad loans create problems for repayment in capital and interest. Increasing deterioration worsens the economic conditions and liquidity conditions of the bank.

5.An adequate level of capital is necessary according to the regulations (Basel I, II, III and forthcoming IV) and in the supervisory framework: the former represents the prudential line while the latter (i.e.the supervisory framework) is in the discretional line. Prudence versus discretion: two different and opposite views create capital constraints and therefore contribute to the level of bank's capital.

Regulation imposes capital constraints by establishing capital coefficients for their achievement and respect through time periods (prudential view). Supervision intervenes generally when critical adjustments are necessary (discretional view). Whereas regulation is operational, reflecting changes through time, supervision is operational from time to time, checking the asset and liability values and costs and revenue trend of the given bank and, if necessary, making the decision to intervene. There is a remarkable point that should be emphasised: the time lag between the origin of the critical situations and the supervisory decision to impose the raising of capital is usually too long for several reasons, and this interval of time leads to deterioration in bank values.

Therefore, the level of bank capital is the final result of free choices, regulatory constraints and supervisory constraints. The free component involves a very restricted area as an individual decision: is this bureaucratic procedure underlining a rational approach? This is not clear and it appears to be based on a plurality of bodies and on a plurality of calculations with reference to the composition of the risk-weighted assets (RWA) and the off balance sheet items (OBSIs).

Available details seem to testify to the complexity and bureaucratic approach to distinguishing between banks with low or adequate level of capital. Credit risk and solvency risk are important in order to estimate capital needs for the present and future time. Therefore, the level of capital is a crucial variable for the business areas, as well as for the lending and investment process and development of the bank in question. Strategic and operational choices contribute to achieving good or bad results according to the professional skills and capacity of the management and the reactions of competition and markets.

The application of Basel III and the forthcoming Basel IV are inspired, as in the past, by prudential logic stressing progressive corrections and inadequacies in regulatory measures in the EU. Basel III has introduced higher and better levels of capital, in the framework of risk-weighted assets, and, at the same time, the liquidity risk and the leverage to be implemented progressively over time. It can thus be regarded as based on a prudential approach.

It does not exclude additional capital corrections for the banks which are subject to AQR, stress tests, on-site inspections and the SREP evaluation carried out by the supervisory unit at the ECB Accordingly, this can be regarded as adopting a discretionary approach which highlights overlapping and excessive regulations, and uncertainties for banks in the EU.

The transition to Basle III and recent additional steps show that the previous Basle I and Basle II regulations proved to be inadequate and unable of preventing the birth and the effects of subprime mortgage financial crisis and sovereign debt crisis in Europe, which produced serious repercussions on financial stability and economic growth.

The application of Basel III implies compliance with capital requirements indicated as equal for all banks and checked and reformulated in several cases by the supervisory authorities through additional corrections, thus increasing the impact on capital.

Balance sheet assets and off-balance sheet items, even when classified, are considered for subsequent evaluation and inclusion in the denominator for the capital requirement calculation.

Ratings are used to assess the credit-worthiness of borrowers who approach a bank and become customers. The application of ratings leads to the creation of different classes and different weighting coefficients, ranging from low values for not particularly risky loans to increasingly high values for risky loans, raising capital requirement differences.

The risk-based approach postulates the subdivision of the loan portfolio into different classes. For each class or class set, rating intervals are identified, which imply the application of increasingly high weighting coefficients upon the worsening of the associated rating interval.

Thus the loan portfolio is split into different classes and class sets for the internal application of percentage weighting coefficients on the basis of rating assignments.

The bank’s choices should be set according to rigorous principles, selecting the best customers for their positive effects on the credit risk, the lightest impacts on capital absorption and, therefore, the best stimulations for intermediated and production volumes.

Therefore, with equal rating interval, the uniform coefficient approach does not take into account this non-homogeneity in loan diversification which is often important for the resulting credit loss effects and the consequent impact on the economic account and on capital.

The types of capital ratios, and adherence thereto, sometimes necessitates a forcing in management choices. Their imposition has spread in various countries, mainly aiming at stability through internal reinforcement in crisis situations.

Taking a closer look, capital ratios neither eliminate nor lower corporate risks, which may even suffer increases; they merely create the premises for the reduction or elimination of losses occurring in negative events. This is a crucial point: regulatory and supervisory capital requirements do not contribute to shifts or reductions in the level and range of bank risks but create the resources for more greater absorption of losses in negative events. Therefore, bank survival relies on the financial operators' skills and professional capacity for rationality and sound risk management over time.

Capital ratios meet the need for prediction and allocation of an adequate level of capital, essentially with regard to negative impacts and losses caused by credit, market and operational risks. Capital is considered the main aid to commercial banking stability and solidity for three reasons: absorption of asset value fluctuation, stabilisation of financing sources and absence of contractual remuneration constraints (Berger, Herring, Szegö, 1995; Pecchioli, 1987; Taggart and Greenbaum, 1978; Pringle, 1974).

The main target for supervisory authorities, distinguishing between the significant banks, as examined by the supervisory unit at the ECB, and the less significant banks, as examined by the national competent authorities, is the setting of higher capital levels in relation to higher risk levels of financial instrument types, thus reducing the incentive for moral hazard. However, the effects of capital ratios on moral hazard are not entirely uniform, diverging according to the theoretical model followed.

Real guarantees, personal guarantees, credit derivatives and balance sheet compensations stress credit risk mitigation and, thus, benefits for the estimation of capital requirements.

Capital coefficients imply the calculation of ratios between the regulatory capital and balance sheet asset and off-balance sheet item types, appropriately risk-weighted. The total capital used is greater than the strict capital account, including not only the real capital but also any subordinated debts, as the latter are bound to periodical remuneration, and subject to repayment obligation.

The standardised model on credit risk postulates the partition of balance sheet assets and off-balance sheet instruments into classes for the application of the weights established by the regulatory authorities, in the same way for all banks.

The reactions and behaviour of individual banks differ widely. These distinctions are weakly justified by the uniform and generalised capital ratio application for issues, due to the lack of assessment for each instrument on the portfolio risk, and also to the identical weight assigned to different loans within the same class.

It also follows that the results achieved are the outcome of initial starting situations which postulate different levels of capital and different levels of composition of business areas and related instruments.

Each class incorporates diversity in its instruments and in the composition of customers, but this also gives rise to risk differences. In addition, the degree of correlation between different asset instruments is not taken into account, ignoring the postulates of diversification (Grenadier, Hall, 1996; Santomero, 1991; Shaefer, 1987).

The different capacity of individual banks to create a diversified lending portfolio is not taken into account (Colombini, 2008). An ideal system should consider the increase in risk to the portfolio arising from the introduction of assets instead of limiting itself to a mere capital addition. Thus the risk associated with different financial instruments should be correctly appreciated.

Even individual banks' capacity to select and monitor loans to customers is neglected, despite the existence of differences in methods and choices which influence the concrete risk of each individual loan and of the portfolio as a whole. A uniform coefficient application does not take into account these differences in risk screening and risk monitoring, which often prove to be fundamental in the subsequent credit loss and consequent impact on the economic account.

In the framework of the theory of information asymmetries, the position of individual bank intermediaries for news and data collection and in the production of information is necessarily very different. Accordingly, higher or lower costs will be involved. The creation and archiving of data on customer relations, as well as bank capacity to produce information and the related costs, reflect the strengths and weaknesses in comparison and competition with other similar intermediaries.

Therefore classes are rather broad; they do not take into account the existence of diversification, nor the benefits of methods of screening and monitoring; furthermore, they present substantial static elements and are essentially set up for the creation of conditions of control performed by supervisory authorities.

At the base of the internal models there is the value at risk (VaR), which constitutes the maximum potential loss affecting a portfolio of financial instruments in a precise time interval, calculated assuming a determined probability. VaR considers the impact of the variations in market factors on the value of each single financial instrument, such as interest rates and exchange rates. The internal model on credit risk introduces internal ratings for the appreciation of balance sheet assets and off-balance sheet items. This model reflects evaluations and calculations from individual banks and makes it necessary to obtain the approval of supervisory authorities.

The internal model presupposes individual banks' best capacity for risk appreciation and management, in comparison with the standardised model, drawn up and imposed by the supervisory authorities. The problem lies in the trade-off evaluation, between setting and realisation expenses, together with consequent capital constraints on one side and benefits inherent in the best risk management on the other.

The various Basel I, Basel II and Basel III and forthcoming Basel IV rules aim to increase the compliance costs of individual banks while disregarding the fact that banks differ greatly between small and medium banks in comparison with the largest banking institutions. The issue for banks is the use of rational and rigorous methods for the management of business areas and correlated risks, from the viewpoint of producing profits in the short, medium and long term. The establishment of more and more rules introduces greater complexity in bank regulation and, at the same time, increases compliance costs. Therefore a comparison of costs and benefits arising from the introduction of regulation should be performed.

The habitual focus on increasing capital is not the correct approach, because it makes use of a unitary attitude, i.e. the "one size fits all" approach (Bliss, 1995) to banks which are profoundly different in their business areas and risk range. Rules essentially consider a loss coverage issue through an adequate capital level, and this is a very different matter from the actual ability to manage the entire risk range.

Increasing the number and complexity of rules tends to introduce further complications in the task of supervision, but the main aim of supervision is still that of checking and ensuring control over the application of the rules in European banks. A banking crisis requires supervision initiatives which usually involve the raising of capital as a standard approach to build up a "wall" against the worsening or failure of the situation of a bank.

Therefore supervisory capital constraints, together with regulatory capital constraints, imply a reduction of the capacity to lend to the economy, and do not introduce improvements in risk management.

Quantitative data should be gathered and updated over time on banks that are experiencing a period of difficulties, or which are undergoing supervisory imposition of capital. Records should also be kept with regard to the time periods involved, in order to trace recurrent events and, potentially, to predict which banks are likely need new capital again in the future and which banks will improve and achieve stability. The repetition of supervisory capital raising from time to time for the same banks is an adverse phenomenon, as it points to survival by capital raising and unstable internal conditions. Such a situation is a signal of poor quality management.

Therefore, the supervisory measures are unsatisfactory and do not represent definitive solutions for banks in trouble; furthermore, in no way the issue of the lack of internal capacity for adding new resources to improve the quality of management is taken into consideration. In a medium and long time perspective, a correspondence between capital erosion and bad management will become evident. Thus macro supervision will highlight the problem of "wasting capital" and the absence of ultimate solutions. Moreover, building up and checking quantitative data at the central level of the ECB for significant banks and the national level of NCAs for less significant banks will provide insight into the evolution of the European banking system.

For instance, during the period from 2010 to 2017, Deutsche Bank achieved four capital increases, raising around €30 billion (Sole 24 Ore – Finanza e Mercati, 7th April 2017). It is very clear the massive and repeated recourse to the capital market with the aim to resolve situations of loss, and therefore, the fundamental data constituted by the need to restore physiological conditions with significant increases of capital, indicating a problem of wasting capital and, at the same time, highlighting that the problem lies in the need for an internal restructuring process that reduces costs and increases revenue for a short- and long-term rebalancing. Otherwise the structural problem remains, and capital increases will temporarily restore oxygen to a bank which has critical issues, raising risks of financial instability and systemic risks of considerable proportions, even if the geographical location is in Germany.

It is worth pointing out that this example is certainly not an isolated case. Often, there are problems linked to the revision of business models, production, distribution, costs, revenue and profits in the context of European banks, assuming complementarity and interaction between the bank and the management in the direction of improvement and strengthening of risk management and increasing efficiency at different levels.

Supervision is characterised by gathering and analysing information, checking bank evolution, drawing up an assessment on the bank. The result can be expressed in the overall SREP which reflects the supervisors' overall assessment on the bank's viability. The SREP is built up on quantitative and non-quantitative requirements: the principle applied is that an increase in risk should be matched by the raising of capital in banks involved.

The most important issue for a bank is the accurate and rational ability to identify, measure and manage the entire risk range, in a manner closely related to the bank's business areas. Attention should focus on instruments for a positive impact on profit production and on simple and risk-adjusted performance indicators.

The creation of the banking union and the experimental ECB asset quality review (AQR) concerning significant European banks lay the foundations for uniform analysis and modes of risk assessment ways for banks in Europe.

The Single Supervision rule postulates control over bank capital ratios on the basis of Basel III and the forthcoming Basel IV application, and control over economic, financial and capital trends. Problematic situations are monitored as soon as difficulties become evident, from their initial phase onwards, the development of an asset quality review also plays an important role, together with stress tests and the SREP as an overall indicator for identifying weaknesses, poor initiatives and bad practices.

However, the ECB alone cannot create strong premises for economic development in Europe. Political choices are necessary in order to move towards structural economic reforms in the short term, to be followed by much more solid integration, removing all sources of uncertainty affecting finance and economics (Andenas and Supino, 2015; Capriglione, Sacco Ginevri, 2015; McCormick, 2015).

In this framework, the performance considers the results achieved in different business areas. It examines the construction and analysis of a series of financial, capital and economic indicators, and in particular, the focus on profits.

The contraction in net interest income drives bank intermediaries to reinforce their non-interest income through a larger range of products. This causes an extension in instruments and business areas, and the consequent increase in risk range and mutual interrelations.

Responsibility for bad or good results is attributed to administrators of the bank. Therefore, in a crisis or bank-failure event, the responsibility falls primarily on the administrators, especially at the high bank levels, who are responsible for decision-making and choices regarding instruments, bank business, bank areas and risk management. Thus a sort of automatism should be introduced in the application of financial penalties on the administrators by the supervisory authorities, especially at the top level of the bank in question, who should be instructed to "fix" the damage on the basis of new and more severe rules in the event of crisis or bank failure. They should be very clearly aware of the warning signs and of initiatives to prevent or offset the worsening of bank situation.

Due to the fact that recent financial crises have dramatically focused attention on the adverse impact of bank crises on banking, and on the economy of crises and failures in the banking context, a tool against any morally hazardous behaviour is required. In this context, the new proposal concerns the creation of various precautionary funds fed through a percentage of administrators' high salaries, to be used in the event of crisis or bank failure, and to be returned in the event of no crisis or bank failure.

Administrators, especially at the top level, are always held responsible for crisis or failure; and therefore the bail-in should have a more serious and more incisive effect on the category in question.

Also necessary is a complete revision of corporate governance bank models, as well as a turnover of top management, raising the level of professional competence and capacities with the introduction of operators capable of accurately evaluating the risk-return relation in the medium and long term.

6.Capital raising for satisfying regulatory and supervisory capital requirements contribute to increasing the capital level and therefore the absorption capacity in the event of unexpected losses. A higher level of capital will be able to handle negative economic results, and bank survival: solvency can be measured at given times.

Improving risk management and efficiency allows banks to achieve structural conditions to recreate positive premises towards positive trends in costs and revenue and, at the same time, in the evolution of assets, liabilities and capital. This is the key point to pursue in the evolution of management conditions within European banks and within world banks.

There is a relationship between risk management and efficiency: improving risk management allows creation of the best conditions that will lead to bank efficiency, as it implies costs' reductions and, in good experiences, revenue' increases and, consequently, a more effective reshaping of costs and revenue in the composition of the profit and loss account. This means that improved risk management can be considered as a good premise for improving both bank efficiency and the bank's soundness and survival capacity. Additionally, an increase in bank resilience will enable a bank to reinforce its efficiency and economic account, moving from one position to another along a path of modernisation of business models with upgraded production and distribution conditions. These improvements constitute indicators of better survival capacity.

Capital raising can be useful to satisfy the need for solvency risk measurement at a given time; on the other hand, when moving through time periods the situation can change within a short or medium length of time, recreating adverse economic results. In particular, the capital problem may reappear, creating a vicious circle in which both capital need and capital "wasting" will be intensified. As an example, regulatory authorities could allow the efficient banks, especially on the plane of X-efficiency with high quality management, to benefit from greater flexibility on capital leverage. As another example, regulatory authorities could allow efficient banks with high quality loan screening and monitoring procedures to benefit from more flexible capital requirements. Uniformity in capital ratios will not, in itself, create conditions for excellent screening and monitoring methods and the application of the "one size fits all" is not adequate for modern times.

Therefore changes, incentives and competition constitute lines for reshaping regulation in Europe. They are inspired by the two fundamental lines of change, namely risk management and efficiency.

The extensive presence of NPLs in banking due to financial crises and related economic recessions has generated the credit crunch towards enterprises, especially those of small and medium size. Accordingly, the possibility of progressive reduction of NPLs, at economic conditions, is being explored, essentially by means of loan sales and bad bank creation. This would make it possible to move towards more favourable conditions for loan granting and economic development.

Quality criteria for risk analysis and evaluation, and, especially, for credit risk assessment through asset quality review, stress tests, on-site inspections and SREP assessment carried out by the ECB Banking Supervision over European banks, are of notable importance. The SREP assessment considers and evaluates the following aspects: the business model, governance, risk management, risks to capital, risks to liquidity. The overall SREP score reflects the supervisor's assessment of the bank's viability.

It is particularly important to make progress in supervisory cooperation between the ECB and the NCAs for improvement of performance in supervision of large banks, but even more so with regard to the supervision of small and medium sized banks, as these constitute the back-bone of the banking system in terms of the number involved across Europe.

The information is gathered and implemented at different national levels, and ensuring uniform criteria will not be easy, especially since different methodologies and different practices were used in the past as compared to the present-day set-up. The building of a ground of uniform principles requires hard work to be done in conjunction with supervisory authorities at a central level and at a national level. Without appropriate coordination, medium and small banks in different countries will be supervised and treated in different ways by NCAs whose operators differ in skills and competences. As it is unable to create the premises for a sound and stable bank in the future time, looking at only the capital level is misleading. Improving risk management through the identification, measurement and management of all risks linked with bank instruments and bank business areas is the best strategy to achieve structural reinforcement and, therefore, to ensure the soundness of individual banks and the banking system in the medium and long term.

This strategy can be completed by an improvement of efficiency in the various forms of cost, revenue and profit, as this would be in line with the structural premises for sound and viable conditions leading to better frameworks for the economic account from one period of time to another.

The following issues can be taken into consideration in order to complete the broad picture of capital management. Firstly, capital level is necessary to offset the solvency risk at a given time in a bank. Secondly, improving risk management and efficiency is the key issue in order to create structural premises for a bank positive evolution and performance in the future time. Thirdly, residual toxic assets in European large banks from the subprime mortgage financial crisis still constitute a weak factor in order to achieve profits. Fourthly, political choices in the economic and financial field which take into account the importance of the timing of their adoption and consequent impact which, even if considered positive, is less effective in the presence of indecision and uncertainties.

Therefore, the crucial point is the setting up of better internal conditions and premises for reinforcing the economic performance and the banks' resilience in the medium and long term.

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«They say things are happening at the border, but nobody knows which border» (Mark Strand)

Enhancing information disclosure to strengthen derivative counterparties

by **Martin Berkeley**

Abstract: *This article explores whether better information disclosure would improve outcomes for the counterparties of derivative transactions. Derivatives have two principal roles: hedging and speculation however the boundary between these elements can be indistinct and for the unwary a derivative trade can be dangerous exposing a counterparty to potentially unlimited losses and multiple risks. Derivatives play a significant role in the stability of the financial system as a whole. The growth of the derivatives market has led to the dispersion of risks through financial markets and when a crisis occurs this can lead to risk being rapidly transmitted and contagion. This article also considers a type of often non-disclosed risk and argues that better disclosure may ameliorate the risks of derivatives and led to improved outcomes for all counterparties. However this is likely to be resisted by banks who are the principal vendors of derivatives.*

Summary: 1. Introduction. – 2. The role of counterparties. – 3. The risks of derivatives and disclosure. – 4. Fostering the outcomes of derivative transactions.

1. Derivatives are fundamental building blocks of the financial system and underlie various aspects of the global economy. We are all exposed to derivatives either directly or indirectly, and an incomplete understanding of their function, impact and significance appears to be a root cause of many financial disputes and contribute to financial instability. This article explores the information disclosure requirements in respect of derivatives and argues that better disclosure would have a positive impact on both financial stability and investor protection. Specific risks are considered as the knowledge of them would then would be of direct benefit to all counterparties and by extension contribute to financial stability.

Derivatives are often for used hedging purposes but their primary use is speculative [1]. Derivatives are classified as complex investments under MiFID2 [2], and as a result of their complexities and the risks attached to them; they are subject to various regulatory controls – particularly when used by non-expert private customers [3]. Derivatives are some of the most complex financial transactions frequently entered into in the financial markets, with a market size of over $544 trillion [4]. Not only are the component parts of a trade complex, but there is a multiplying and compounding effect as a 'simple' derivative trade may be combined with other constituents to form an highly complex, or 'exotic' trade [5].

A derivative is an investment that derives its value from an underlying market, for example forwards, options and swaps are forms of derivative and they, derive their value from tradable (and hence quantifiable) markets, such as the stock, commodity or currency markets. At its simplest a derivative can be considered to be a choice; it is effectively a contract giving the holder the ability to make a choice at a future point in time.

As an example, a farmer may wish to lock in the price of their wheat crop (perhaps because he is concerned about future low prices due to a good harvest and market oversupply), so the farmer agrees a future price per tonne with the mill, which he must deliver on the agreed terms (e.g. date, amount quality etc.). This is a forward contract and both the farmer and the miller have an obligation to honour the contract as deliverer and receiver. Both parties know their products and markets so can assess the risks of entering into such an agreement. The problem with this type of arrangement arises when one party no longer wishes to be bound by the agreement or is unable to fulfil the terms of the contract; a devastating storm may have destroyed the crop or the mill may have closed. No doubt the contract will have provisions for such eventualities, but the question at stake is whether one party simply no longer wished to be bound as they can achieve a more advantageous price elsewhere. This is where the forward contract has limitations.

Let us assume a similar scenario but where each party is not tied to contractual obligations but rather has a choice. This would mean upon contract maturity each party could decide whether to exercise their rights under the contract. Had the grain price collapsed the farmer had a guaranteed price – effectively a hedged position. For this to function effectively one of the parties has to give up rights. By guaranteeing a price the mill is granting an option to the farmer and farmer receives the benefit of this option. This is effectively how options and derivatives function. For the benefit of a having the option the mill will wish to be recompensed for the risk they are taking on. This could be through the charging of an upfront premium or embedding the premium price in the agreed future price with the farmer. Essentially the farmer would have to be prepared to accept a lower guaranteed price in order to have the option to exercise it (or not on) maturity.

An interest rate swap is one of the most widely used derivatives [6], the concept being an exchange of cash flows to achieve either a fixed rate of interest from a floating rate, or alternatively a floating rate of interest from a fixed-rate. They are commonly used as a method of managing interest rate risk in loan portfolios. However, this simple concept belies an extremely complicated structure with profound implications. In British law the leading definition of a swap was given by Wolff LJ in *Hazell v. Hammersmith & Fulham L.B.C* 1990 [7], this gives an indication of the complexities in explaining and understanding how comparatively simple derivative such as a swap functions:
An interest rate swap is 'an agreement between two parties by which each agrees to pay the other on a specified date or dates an amount calculated by reference to the interest which would have accrued over a given period on the same notional principal sum assuming different rates of interest are payable in each case....normally neither party will in fact pay the sums which it has agreed to pay over the period of the swap but instead will make a settlement on a "net payment basis" under which the party owing the greater amount on any day simply pays the difference between the two amounts due to the other' [8].

As can be seen, a comparatively simple swap requires an agreement between two contracted counterparties. This agreement will cover the obligations and responsibilities of each party but also more mundane mechanistic parts of the swap such as dates and a reference to an interest rate. Most commonly this is LIBOR or another tradable interest rate such as Euribor. It is also possible to use a non-tradable interest rate such as Bank of England Base Rate, though this can incur further complexities such as 'basis risk', which is where there is a mismatch between indices being used, for example hedging Base Rate debt with a LIBOR hedge [9].

Additionally, the period or duration of a swap must be agreed, as well as the amount or 'notional' of the swap. The notional is reference to a sum of money on which the derivative is based, for example a debt that is being hedged; this is not the same as the actual amount of the debt. The consequence of this is any sum that is being used paid down any debt may become potentially disconnected from the swap which is used to hedge the original notional position. This can result in customers finding themselves in an over-hedged or under-hedged position as there is potentially a mismatch between the notional amount of the derivative and the original loan which was being hedged. The terms of payment or cash flow will also need to be agreed; these could be on a monthly, quarterly or semi-annual basis. Cash flows are exchanged on a net basis so only the party that owes money under the contract on a given date may actually suffer any negative cash flow impact. However, the exchange of cash flows may not only be on maturity of a derivative, but also possibly on a periodic basis, which will have been agreed under the contract. There may also be decision points within a swap structure on a unilateral or bilateral basis; for example, the bank may have the choice on a quarterly basis whether to cancel or to continue using the swap (these are a type of binary option) [10].

These complexities and subtleties in terms of construction and operation of derivatives gives rise to potential risks for both counterparties, especially if either is unaware of the risk and their significance. The difference in levels of knowledge between the parties to the derivative contract will depend on who the counterparties are.

2. Most derivatives are bilateral agreements between counterparties are known as Over the Counter (OTC) transactions [11]. In OTC transactions banks are often the market making counterparty and the other party may range from a large or small business, individuals or other financial institutions. The result is an enormous range of knowledge and experience between the counterparties, which can give rise to issues as are explored later in this article. By contrast, the listed derivative market is made up of standardised contracts traded via regulated exchanges. These listed derivative trades are facilitated and cleared by Central Clearing Counterparties (CCPs) who also become the counterparty to each trade.

One of the problems of the OTC derivative markets was maintaining and distributing knowledge of derivative contract existence and ownership. Derivatives may be novated to new parties and the counterparties themselves may merge, restructure or be liquidated. This is true for banks as well as non-bank counterparties. The result is not only a lack of clarity as to ownership, but also confusion as to where the derivative risks have been transferred to. This could have profound impacts on financial stability as was seen in the Global Financial Crisis (GFC). The introduction of European Market Infrastructure Regulation (EMIR) in 2012, in light of the risks highlighted by derivatives during the GFC, aims to increase transparency and reduce the risks of OTC derivatives [12]. A key element of EMIR is the introduction of the Trade Repositories (TR) scheme where detailed information is stored on OTC derivative contracts and their ownership with the European Securities and Markets Authority (ESMA) being responsible for scrutiny of trade repositories and for their accreditation [13]. The use of CCP has a number of advantages, these principally being contract standardisation, liquidity and stability.

Derivatives by their interconnected nature were a key element contributing to instability during the GFC [14], and hence even entities that may not have direct derivative exposure may effectively be indirect counterparties to derivative trades. They are not direct counterparties in terms of having entered freely into a derivative position but may be affected by the outcome of external derivative positions. Additionally, several investments have derivatives embedded within them. For example, structured products use derivatives to increase leverage or provide levels of protection and as a result the investor has derivative exposure though is not a direct counterparty to the original derivative trade. Some fixed rate loans also provide another example of indirect derivative exposure. The bank hedges the loan itself and the borrower is not a counterparty to the derivative. This has led to unsatisfactory outcomes for customers where they have still had to bear the mark to market break costs (as they typically indemnify the bank for costs), but do not have the same regulatory protections as a derivative investor [15]. This raises the question of whether an investor would have entered into a fixed rate loan had they known of all the risks, when they alternatively could have entered into a floating rate position and used an independent hedge – though this is also not a risk free approach.

3. Derivatives are fundamentally for managing or transferring risk between counterparties. However, they also entail a number of risks in themselves with some of the principle risks being default or breakage costs. They also entail other less obvious risks [16].

In respect of breakage costs, when a derivative is liquidated before maturity the derivative holder (effectively the person who ‘buys’ the derivative) will have to pay the derivative seller (or granter) the market cost of a replacement product if the market price so demands (the derivative is said to be ‘out of the money’). This is because before maturity the derivative seller must enter into an equal and opposite trade to synthetically cancel the original derivative trade position. It is possible that the situation may be reversed, and a derivative position is ‘in the money’ and a payment will be made from the derivative seller to the customer. Recently the decline in interest rates has led to many holders of interest rate hedging products to discover the break costs of their hedging products are substantial [17]. Not only is the magnitude of the break cost uncertain, but also the calculation methods are opaque and beyond the expertise of the non-expert, and even their existence can be unclear for non-expert counterparties [18].

The UK regulator the Financial Services Authority (as it was at the time), was very clear on disclosure of break costs and stated that ‘the nature of IRHPs [19] means the scale of any break costs is inherently uncertain as, depending on market conditions, the customer may have to make a payment to the bank or the bank may have to make a payment to the customer and for the disclosure of break costs to comply with our regulatory requirements, the bank should be able to demonstrate that: in good time before the sale, the bank provided the customer with an appropriate, comprehensible and fair, clear and not misleading disclosure of any potential break costs’ [20]. This is a clear indication that this most obvious of derivative risks should be disclosed in good time to counterparties.

However, not all derivative risks as well as their significance and consequences will be obvious to a non-expert customer. An example is the derivative risk known as Potential Future Exposure (PFE) or Credit Limit Utilisation (CLU) which forms part of derivative counterparty risk and can have significant consequences [21] [22]. The PFE risk is defined as ‘the risk that the counterparty will not pay the amount due in the future’ [23], effectively the potential loss in the event a counterparty does not honour their obligations under a derivative contract.

The value produced by the calculation of the PFE risk is used to quantify the risk in a worst-case scenario that a bank may be exposed to in respect of a future potential derivative default by a counterparty. It is also required for regulatory capital reporting and allocation purposes. Historically banks have used their own bespoke methodologies to calculate the PFE risk, this typically is seen as representing with 95% confidence the most a bank may expect to lose in the event of a customer default on a trade [24]. The bank will then make a provision for the risk [25].

Recent cases in the UK courts have considered PFE risk and in general have concluded that it is not a bank's duty to disclose this risk to a customer [26], though notably in *Parmar* 2018, HHJ Hochhauser QC noted there may be factual situations where because of the consequences of PFE, it may be beholden on the bank to disclose this in order to comply with the COBs rules [27]. However the non-disclosure of PFE or a counterparties lack of knowledge of even its existence may have significant consequences. For example, if a customer was aware that a particular derivative carried a very considerable PFE risk he or she may question why that particular derivative was riskier than another. PFE risk can vary with derivative types, for example interest rate caps typically carry no PFE risk as for these a premium is paid up front and hence the bank is not exposed to any counterparty risk. The knowledge that one type of derivative carries no PFE risk, whereas others carry considerable PFE risk, may raise a question in a non-expert customers mind as to the significance of the comparative risk levels between two derivative types. Should the customer be aware of this risk and use it as a method of comparing derivative types, a better and more fully informed decision can be made at the outset by the customer. This is obviously a benefit to the customer in obtaining a potentially more appropriate derivative structure, but also to the bank in not having to potentially deal with a dissatisfied customer's complaints and perhaps even a compensation claim.

Disclosure of PFE risk can also have a profound impact on financial stability in terms of the risks that banks are carrying. Banks that are deemed to be Globally Systemically Important Financial Institutions (G-SIFIs) are required under the Basel Accords to hold sufficient regulatory capital to act as a buffer to absorb unexpected losses and to promote stability of the financial system [28]. The capital buffer that a bank has to put aside in order to satisfy regulatory capital requirements cannot be further utilised by the bank for lending or speculative purposes, hence there is a conflict of interest as the bank not only wishes (and is required) to manage risk, but there may be also pressure to downplay this risk as the bank is unable to use capital put aside for risk management purposes for more profitable activities. This has led to disputes between banks and regulators as to what constitutes components of regulatory capital, with banks wishing to maximise their profitable activities, thereby increasing the risks in the financial system as regulatory capital levels may be diminished [29].

Risk Weighted Assets (RWA) are used in defining asset risk types for regulatory capital purposes and RWA 'are computed by adjusting each asset class for risk in order to determine a bank's real-world exposure to potential losses. Regulators then use the risk-weighted total to calculate how much loss-absorbing capital a bank needs to sustain it through difficult markets' [30]. PFE is classified as RWA and hence affects the banks regulatory capital and potentially may have an impact on global financial stability [31]. In recognition of the importance of PFE and other risk factors, the Bank of International Settlements (BIS) since 2014 has mandated a standardised methodology for measurement of counterparty credit exposures including PFE, due to inadequacies in the previous models [32] [33].

The PFE credit limit increases the overall credit exposure of the customer to the bank, as this credit limit 'utilises' some of the overall credit capacity or credit appetite a bank has for exposure to a particular customer. This credit capacity can also be thought of as the 'equity headroom' which a customer may have available for a given level of security to the bank [34]. In practice, this means a bank will assess its total exposure to a customer when looking at its overall credit appetite for a customer. The PFE is not be an actual amount of additional debt that a customer can borrow but it utilises some of the overall credit 'capacity' of a customer. This means that this could reduce the amount a customer could borrow both at the prevailing time and in the future. Furthermore, once a derivative has matured (or has been liquidated), the PFE in respect of that derivative would no longer apply to the customer and would liberate more credit capacity. The utilisation of credit capacity can have adverse consequences for a customer where they may erroneously believe they have headroom to borrow further funds (for a given amount of security), but latterly discover they are unable to so due when the total credit utilisation including the PFE and other non-lending limits that are taken into account [35].

In terms of bank security, if interest rates fall by a greater amount than the bank had accounted for, a bank may have the right to request customers to provide additional collateral or security to cover the additional liability. If a customer is unable to provide extra collateral, there is a risk that any covenants with a bank may be breached. There may also be consequences in terms of the bank taking of security for credit risk. For example, where a loan has been repaid and the bank has a charge over assets as security, the borrower may erroneously believe the charge will be lifted after repayment. However, if there is continuing derivative exposure (which is not unusual for customers with multiple loans), there may still be a requirement for a charge over customer assets by the bank in order to secure itself against any liabilities – as the bank will not wish to have substantial unsecured credit exposures. Hence the customer may not be free to do with his chattels as he wishes until the bank releases the charge over assets.

Derivatives can also entail other risks that may bring hazards for the unwary. Though loans and interest rate derivatives are typically separate legal constructs (the exception being fixed rate loans as noted), they may in their extensive documentation contain cross default clauses. The effect of these can be that once a loan is liquidated or even over paid, it may trigger the automatic breakage of an associated derivative that is hedging a loan. Without knowledge of this, a borrower who is taking a portfolio approach to hedging (using derivatives to hedge multiple loans – not an uncommon approach in larger loan portfolios), may find themselves unhedged and/or exposed to adverse break costs through the simple act of over paying their loan. The counterargument to this is perhaps that their legal advisors should have warned them of this risk – if indeed any advice was taken before the transactions were entered into. However, there is often a reliance on the bank counterparty for advice and information given the informational asymmetries. In this case, the advice is not independent.

4. Derivatives are a specialised area of finance and hence non-bank counterparties typically rely heavily on the bank counterparty for information and advice in respect of derivatives. This knowledge asymmetry and difficulty in knowing the risks and their consequences in derivative transactions has been shown to be a major concern for many companies [36].

The UK Supreme Court judge Lord Sumpton in *Plevin v Paragon Personal Finance Limited* 2014 recognised the dangers of information asymmetry, though commenting on Payment Protection Insurance (PPI), the point is equally valid for complex instruments such as derivatives: 'the provision to a financially unsophisticated debtor of bad advice or no advice about the suitability of a relatively complex product like PPI will commonly result in a one- sided relationship substantially limiting the debtor's ability to choose' [37]. Most counterparties to derivative trades can be considered to be 'unsophisticated' customers, in that they are not derivative experts.

As mentioned, most derivative transactions take place between unequal counterparties. Would enhanced information disclosure improve outcomes? If we take a straightforward case where a derivative is used for hedging purposes and the hedge performs well or alternatively for speculation and a profit is made. At face value it may seem that enhanced information disclosure would add little in these circumstances. However, this is to ignore the benefits of a more equal balance of information. If a customer understands a transaction better (through disclosure, advice or education), even if the investment performs well, they may make the same choice – *but* it will be a fully informed choice. Secondly, a customer armed with improved knowledge may make a different and hopefully better choice. This is not necessarily of benefit to both parties – for example where a customer chooses a different course of action based on enhanced knowledge, the bank would perhaps be giving up profit by the customer having the knowledge to make a better choice [38].

The investor Warren Buffet described derivatives as 'financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal' [39]. Buffett also said he would 'deal with derivatives by requiring every CEO to affirm in his annual report that he understands each derivatives contract his company has entered into....and I suspect you'll fix up just about every problem that exists' [40]. Buffet identifies many of the problems of derivatives and knowledge of their risks. The risks may be latent, not obvious or even hidden from the unwary. However, the consequences of when they 'blow up' can be significant. Mr Buffet by suggesting that CEO's effectively underwrite derivative positions graphically illustrates other problems of derivatives. Knowledge of their existence and exposure to them may be imperfect due to indirect effects of derivatives. Additionally, it is unlikely that a CEO will understand all the risks of derivatives sufficiently – perhaps he or she should be taking expert independent advice before agreeing to them. Buffet is effectively saying that derivative positions should not entered into unless absolutely necessary, as he recognises their hazards.

More recently the criticism of derivatives and their risks has also come from more spiritual quarters – the Vatican. The current Pope Francis has called derivatives markets a 'Ticking Time Bomb' [41]. The Vatican has said that in certain areas of the derivatives markets there's an 'ethical void which becomes more serious as these products are negotiated on the so-called markets with less regulation (over the counter) and are exposed more to the markets regulated by chance, if not by fraud, and thus take away vital life-lines and investments to the real economy' [42]. Again this is a recognition of the risks of derivatives, particularly in OTC transactions, which as noted are often between parties with significant informational asymmetries, but also that the risks are of consequence beyond the direct counterparties, but to the whole economy. Herein is the crux of the issue with derivatives: despite their risks they are useful and significant components of the financial system, but when they do not function as expected they can have catastrophic consequences – not only for the direct parties but also the wider financial system. However, the requirement to disclose risks is partial and incomplete. It also raises the question as to whether counterparties should be responsible for discovering the risks themselves and if there is a wider capacity question of whether a non-expert would be able to fully comprehend all the risks.

Naturally, banks will not want the additional burden (and potential) liability for explaining derivative risks in full. However, for some financial products (for example mortgages), banks are required in addition to explaining key risks, to ensure customers seek independent legal advice [43]. If this were also the case for derivatives, this would have the effect of deflecting some of this risk away from banks. It may also be beneficial for derivative sellers (who are principally banks) to not disclose all risks. If customers had perfect knowledge and the benefit of price transparency, derivatives would not be as profitable. Despite the potential advantages to customers and financial stability of improved disclosure in respect of derivatives, the aphorism *scientia potentia est* (i.e. knowledge is power) appears also to be the case in respect of derivatives [44]. If your counterparty has full knowledge, your ability to profit will be diminished, hence the motivation for removing or reducing informational asymmetries between counterparties is lacking on behalf of banks.

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[2] MiFID2, Art 19.

[3] See the Financial Conduct Authority, *Conduct of Business Rules (COBS),* particularly COBS 14.

[4] $544 trillion notional outstanding at June 2016, source International Swaps and Derivatives Association, *Facts and Figures,* June 2016.

[5] For helpful illustration of the potential complexity of derivative trades, see The European Structured Investment Products Association (EUSIPA) See their Derivatives Map at: https://eusipa.org/governance/#EusipaDMap.

[6] Bank of International Settlements, *OTC derivatives statistics at end June 2017*, https://www.bis.org/publ/otc_hy1711.htm.

[7] *Hazell v. Hammersmith & Fulham L.B.C* (1990) 2 QB 697.

[8] Ibid Wolff LJ at 739.

[9] Basis Risk is price dislocations occur where different reference indices are used, see Basel Committee on Banking Supervision, *Consultative Document Interest rate risk in the banking book*, 4.3, p31, 11 September 2015.

[10] Alistair Hudson, *The Law of Financial Derivatives*, 3rd edn, 38, 2002.

[11] OTC derivative truncations make up nearly 95% of the derivatives market, Source: European Commission, European Market Infrastructure Regulation definitions, *https://ec.europa.eu/info/business-economy-euro/banking-and-finance/financial-markets/post-trade-services/derivatives-emir_en*.

[12] European Commission, Derivatives (EMIR) Regulation (EU) No 648/2012, *https://ec.europa.eu/info/law/derivatives-emir-regulation-eu-no-648-2012_en*.

[13] ESMA Trade Repositories, https://www.esma.europa.eu/supervision/trade-repositories.

[14] Christopher Whalen, *Yield to Commission: Is an OTC Market Model to Blame for Growing Systemic Risk?* (2008) 14.2 Journal of Structured Finance 8, 11.

[15] Historically in the UK loans (including fixed rate loans) have not been considered investments and hence not subject to the same regulatory provisions as designated investments such as derivatives. This has led to considerable confusion as the fixed rate loan has effectively the same features and risks as a swap. This confusion and ambiguity was expressed by the House of Commons Treasury Select Committee when hearing *Oral Evidence on SME Lending*, 17 June 2014, questions 392-656, Q435 between Mr Brooks Newmark MP and Mr David Thorburn, CEO of Clydesdale bank: 'Mr Newmark: David, I may be flogging a dead horse here but I am really fascinated by this. What is the difference

between the break cost calculation of a standalone fixed rate interest rate hedging product and a fixed rate tailored business loan because there seems to be some sort of difference between the two? David Thorburn: No, there is no difference. They are one and the same'.

[16] Khader Shaik in *Managing Derivatives Contracts,* Apress 2014, Ch 3, 68-72, identifies the following principle types of derivative risk: Market, Credit, Counterparty, Concentration, Operational, Liquidity, Legal, Model, Settlement, Systemic, Compliance, Reputational.

[17] It may be seen counterintuitive to the non-expert, but as interest rates fall, break costs increase in interest rate derivatives where used for hedging.

[18] FSA, *Interest Rate Hedging Products – pilot findings*, March 2013.

[19] IRHPs stand for Interest Rate Hedging Products.

[20] FSA, *Interest Rate Hedging Products – pilot findings*, March 2013. The FSA made similar submissions in the matter of *Green and Rowley v RBS* 2012 EWHC 3661 (QB).

[21] PFE (Potential Future Exposure) is known variously as Potential Credit Risk (PCR), Credit Limit Utilisation (CLU), Credit Equivalent Liability (CEL), Credit Equivalent Exposure (CEE) and/or Contingent Liability (CL). Different banks use different terminology to describe the same risk.

[22] In addition to PFE, the major components of counterparty risk are Current Credit Risk, also known as current exposure, which is the risk that a counterparty will not pay what is already currently due. There is a risk that a counterparty may declare bankruptcy in the future because of the current liabilities owed to other parties.

[23] Khader Shaik, *Managing Derivatives Contracts*, Ch3. Derivatives and Risk Management, 69, (2014).

[24] See *London Executive Aviation v RBS* 2018 EWHC 74 (Ch), para 34.

[25] For an example of bank provisions see http://lexicon.ft.com/Term?term=loan_loss-provision.

[26] For example, see *Property Alliance Group Limited v. The Royal Bank of Scotland PLC* 2018 EWCA Civ 355 and *Ramesh Jadavji Parmar and Rama Ramesh Parmar v. Barclays Bank PLC* 2018 EWHC 1027 (Ch), see Paul Marshall, *Disclosure of risk in SME swap transactions: the Court of Appeal wreaks havoc with accepted principles*, Butterworth Journal of International Banking and Financial Law, Vol 33, 5 May 2018, 282-287, for analysis of the current legal position.

[27] Dentons, *Barclays successfully defends first swap mis-selling claim involving a claim by individuals for breach of statutory duty*, 16 May 2018, https://www.dentons.com/en/insights/alerts/2018/may/16/barclays-successfully-defends-first-swap-misselling-claim-involving-a-claim.

[28] Financial Stability Board, *List of global systemically important banks (G-SIFs)* http://www.financial stabilityboard.org/wp- content/uploads/r_141106b.pdf.

[29] The Economist, *Whose model is it anyway?* 19 September 2015 http://www.economist.com/news/finance-and- economics/21665039-regulators-are-taking-firmer-stand-how-banks-gauge-risk-whose-model-it.

[30] Financial Times Lexicon: *Risk Weighted Assets*. http://lexicon.ft.com/Term?term=risk_weighted-assets.

[31] Bank of International Settlements: Basel Committee on Banking Supervision, *An Explanatory Note on the Basel II IRB Risk Weight Functions*, July 2005.

[32] For a comprehensive overview of the complex processes involved with PFE and regulatory capital: Bank of International Settlements: *Basel Committee on Banking Supervision, The Standardised approach to measuring counterparty credit risk exposures* 2014.

[33] RWA as a methodology is not without its critics and a major weakness of the new Basel III standards is its failure to address the weaknesses of RWA exposed by Basel II, see Rogoff K, *Ending the Financial Arms Race* 6 September 2012.

[34] This why some banks, for example the Royal Bank of Scotland describes the PFE as 'CLU' (Credit Limit Utilisation).

[35] Other non-lending limits would include where the bank still has a risk exposure, which it must manage but are not strict 'lending' limits as such, for example trade finance lines or card back risk in merchant credit cards.

[36] Of 800 UK based companies surveyed the lack of ability to assess risks and fundamental knowledge of derivatives were cited as chief concerns: Chris Mallin, Kean Ow-Yong, and Martin Reynolds, *Derivatives usage in UK non-financial listed companies* (2001) 7.1 The European Journal of Finance 63, 77.

[37] *Plevin v Paragon Personal Finance Limited* 2014 UKSC 25.

[38] An example would be where a customer perhaps chooses a premium paid interest rate cap. As the premium is paid upfront by the customer it is harder for a bank to 'hide' profit. In a non-premium derivative, such as a swap no premium is typically paid, but the profit is embedded within the structure. Without detailed knowledge of how the structure works, the pricing and access to the underlying market data it will be difficult for a customer to learn the true level of profit being earned by the bank.

[39] Warren Buffet, *Letter to Investors* 17 March 2003.

[40] Warren Buffet, *Letter to Investors* 20 March 1995.

[41] Sridhar Natarajan, Bloomberg Markets, *Pope Calls Derivatives Market a 'Ticking Time Bomb'*, 17 May 2018.

[42] The Vatican, Oeconomicae et pecuniariae quaestiones'. *Considerations for an ethical discernment regarding some aspects of the present economic-financial system*of the Congregation for the Doctrine of the Faith and the Dicastery for Promoting Integral Human Development, 17 May 2018.

[43] These are regulated and advised financial products and failure to advise clients to seek independent legal advice has been a cause of criticism for banks in respect of misrepresentation or undue influence There is extensive case law in respect of undue influence in regulated mortgage contracts, for example *Barclays Bank Plc v O'Brien* 1993 UKHL 6, *CIBC Mortgages Plc v Pitt* 1993 UKHL 7, *Royal Bank of Scotland Plc v Etridge* (No 2) 2001 UKHL 44.

[44] Attributed to Thomas Hobbes, *The Leviathan*, Volume III, 69 (1668).

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«They say things are happening at the border, but nobody knows which border» (Mark Strand)

The Italian Financial Ombusdman (ACF)

by ***Vittorio Mirra***

Abstract: *The Alternative Dispute Resolution (ADR) systems have obtained a huge diffusion in Europe, aiming to the achievement of a high consumer protection. In addition to strengthen the protection of private individuals, ADR mechanisms also ensure significant effects on the public side, in terms of regulatory efficiency and improvement of access to justice. This last requirement is particularly relevant in Italy, in light of the "alarming" data on the (poor) functioning of civil justice. With respect to disputes arising between financial intermediaries and their clients, in Italy, after a failed attempt represented by the Conciliation and Arbitration Chamber at Consob (the Italian Financial Authority), a new Financial Ombusdman ("ACF", fully active since January 2017) has been set up in order to comply with the ADR Directive. This mechanism is reaching valuable results (in the first year of functioning more than 1800 claims were filed by investors, recognizing compensation due by intermediaries for over 5 million euro) and it is becoming an authoritative response to investor protection needs. The object of the dispute before the ACF must concern the carrying out of investment services (including cross-border transactions) up to a value of dispute of 500,000 euros (much more than similar mechanism in Europe: e.g. the Financial Ombudsman Service in the UK). There are still some improvements that can be adopted to further enhance the ACF functioning (requisites of the Board members, threshold of its competence, barriers for "reckless" disputes), nevertheless this Italian ADR mechanism seems to be able to determine a significant incentive to increase the compliance of intermediaries and a consequent reduction in the litigation (primarily with the effect of a reduction in costs and time to settle a dispute for customers), as well as a more proficient supervisory policies by the competent public Authorities. The "interactions" between the decisions of the ACF and the supervisory interventions of Consob should basically determine further improvement of relations between customers and intermediaries, with positive effects on the collective well-being.*

From a law and economics perspective, the existence of a relationship between the efficiency of civil justice and the proper functioning of the economic system is widely acknowledged in the scientific literature and demonstrated by the choices of market operators.

The troubles of the justice organization therefore restrain the efficiency of the financial system and the investments, especially those arising from cross-border transactions.

This matter is much more actual with respect to the Italian scenario.

Data on Italian civil justice system are straightforward: the studies by CEPEJ[1] and World Bank[2] highlight the unreasonable duration of civil trials in Italy. Indeed, about 1200 days are needed to reach a ruling on a civil dispute and this implies for the parties an expense of about 20% of the value of the dispute[3].
To face this long-lasting problem of slowness and inefficiency of the Italian judicial system, several law provisions have tried to introduce some potential solutions to relieve the workload of the Courts and improve the justice system. Among the most significant ones have to be mentioned the Alternative Dispute Resolution systems (ADR), originating in common law systems and which have progressively developed in Europe[4], becoming increasingly relevant, also in light of the economic and financial crisis of the latest years.

The rationale for the introduction of such ADR systems is mainly due to the deflationary effect of the dispute, as well as to the purpose of promoting the quickest and economic solution of the numerous existing small claims. The foregoing implies an improvement of access to justice with a broad "social" positive reflection; ADRs are also an excellent tool for customers, characterized by the flexibility of use as well as reduced costs and time.

Finally, the establishment of ADR systems can be considered as an integral part of a process aimed at fostering the maintenance of good relations in the financial markets (especially with respect to customers of large companies), as the amicable resolution of disputes does not necessarily imply an interruption of the contractual relationship between the parties.

Over the years the ADR mechanisms with the most effective enforcement instruments (e.g. the Financial Ombudsman Service in the United Kingdom[5]) have contributed to the compliance of the intermediaries' internal procedures and to a deeper attention to the relationship with customers, triggering a "virtuous circle" that has contributed to a more significant awareness of consumer protection instruments, in order to "lighten" judicial burdens and to create a more "transparent" environment with advantages both for intermediaries and consumers.

2. The Conciliation and Arbitration Chamber at Consob (i.e. the Italian Financial Authority) was established by Legislative Decree No. 8 October 2007, No. 179[6].
The mentioned Consob Chamber envisaged the applicability of a conciliation[7] and an arbitration, concerning the disputes arising between investors and intermediaries for the violation by the latter of the duties of information, correctness and transparency provided in the contractual relationships with investors[8].
The characteristics of this out-of-court mechanism (i.e. the lack of binding adhesion by intermediaries, as well as the absence of arbitration clauses in the contracts about investment services) determined a

very limited and ineffective effect on markets, despite the attempts to reform it[9]. The data on the activities of the Consob Chamber were, in fact, largely discouraging. In the last year for which full data are available (2016), the Consob Chamber was involved in the "administration" of "only" 80 conciliation proceedings (of which only 71 were eligible and therefore effectively processed[10]).
Therefore, the premature "retirement" of the Consob Chamber and the consequent establishment of a new ADR system for financial disputes[11], which moreover fully complies with the provisions of Directive 2013/11/EU (ADR Directive[12]), could no longer been postponed.

3. In Italy the ADR Directive has been implemented with the Legislative Decree 6 August 2015, No. 130; the main theme has been represented by the creation of a new ADR mechanism: the Italian Financial Ombudsman (ACF[13]), operative since January 9, 2017[14].
As a result, the main "weakness" of the old Consob Chamber was fixed, establishing for the new ACF the requirement of mandatory adherence by financial intermediaries, with a specific administrative sanction in case of non-fulfillment of this law provision[15].

The operational rules of the ACF are compliant with the ADR mechanisms active at European level.

All the main European Countries have several ADR systems active for financial markets issues: France has basically a system based on a private conciliation[16]; even Germany[17], The Netherlands[18] and Spain[19] have several ADR systems (private and public ones) operating on financial markets. Relations with the parties of the dispute and the activities of the ADR bodies are strictly formalized by procedure: the most advanced scenario is present in the UK, where there is a special Handbook governed by the Financial Conduct Authority.
In general, the ADR bodies have therefore realized a very high degree of effectiveness of their decisions (even in Countries where the latter are not binding[20]) and the intermediaries comply, as a matter of fact, with the ruling of the ADR entities.
Also with regards to the ACF in Italy, the "claimant" can be only a retail investor; counterparts of the relationship are the financial intermediaries[21]; the object of the dispute must concern the carrying out of investment services (including cross-border transactions).
The burden of proof (i.e. the burden of proving that a party has fulfilled its contractual obligations) is up to the intermediary[22].
The value of the dispute cannot exceed five hundred thousand euros.
The Board of the ACF is composed of five components[23], which reflect all the interests of the parties operating on the financial markets: three members, including the Chairman[24], are appointed directly by Consob, while the remaining two members are appointed by the same Authority among persons designated by the national associations of intermediaries and of the National Council of Customers. Honorability and professional requisites are provided for the ACF Board members, who are also required to observe a deontological code[25].
The Technical Secretariat is an essential "point of reference" between the ACF Board and the disputed parties.
In fact, through the Technical Secretariat (made up of Consob officers), the appeals are received and "filtered out" for admissibility and acceptability[26]; said Secretariat also receives communications and documents from both parties, carrying out all the preparatory activities for the decision of the

Board[27].
The appeal to the ACF is free for the applicant (who can be only the customer).
The decision-making process has to be fast: the deadline established for the Board decision is ninety days[28].
The financial intermediaries must comply with the decision of the ACF Board within the term indicated in the decision itself or within thirty days from its issuance.
In the event that an intermediary does not promptly comply with the above mentioned decision, a "reputational" penalty is set forth by the regulation: the defaulting conduct is disclosed by publication, at intermediary's full expense, on the ACF website, on two domestic newspapers, and on the home page of the intermediary's website for a period of six months[29].

4. The establishment of the ACF represents a concrete step forward for the investor protection and for the improvement of intermediaries' compliance, with positive effects in terms of systemic and collective well-being.

Its institution was finalized in a particularly "complicated" period for the Italian financial system (clearly underlined by the massive filing of the appeals received by the ACF during its first year of functioning). The new ACF in 2017 – also considering the "serial" appeals filed by investors "damaged" by the events involving Veneto banks (Veneto Banca and Banca Popolare di Vicenza) – received 1839 appeals[30], taking 779 decisions (61% favorable to the applicant), recognizing compensation due by intermediaries for over 5 million euro. Among the 1469 appeals considered as admissible, the minimum amount requested was 41 euros, the maximum amount was 500,000 euros (corresponding to the limit within which the ACF is competent). The total value of the requests made by the claimants is over 80 million euros (81.1 million euros); the average amount requested is 55,244 euros[31].

The above mentioned significant data are probably going to grow further with the continuation of the ACF activities.

This new ADR mechanism has unquestionably the merit of having rationalized the tools available to investors, "absorbing" the expertise of the Ombudsman-Giurì Bancario[32]in the same area. Another big step forward has been the immediate adherence to the FIN-NET network[33] (inexplicably never carried out by the "old" Consob Chamber), which put the ACF into a transnational context, which allows investors to get in touch and easily obtain information about the relevant ADR scheme for the protection of their rights in case of cross-border transactions[34].

There are, however, some regulatory choices that may cause some bafflements and which are susceptible to improvements, also in light of to the outcome of the first operational experiences of the ACF functioning.
First of all, the decision to allow Consob employees to be part of the ACF Board (although within the limits set by the ACF Regulation) could raise some concerns. The basic opportunity of such a choice is debatable, both for the role assumed by these subjects (ACF members, but still future Consob employees at the end of their assignment[35]) and for the close relations with the Technical Secretariat, also composed by Consob employees.

The impartiality of the public official outlined in art. 6, paragraph 2, of the ACF Regulation ("where an employee of Consob is appointed, the latter will carry out his/her duties with full functional autonomy") does not seem to be wholly determined. The presence of a Consob employee in the ACF Board could appear inappropriate, since, despite the above stated statement, the employee could be “influenced” – even indirectly – by the supervisory approaches kept by Consob, and mainly because he/she has been and will be an integral part of the mentioned Institution at the end of his/her mandate as ACF member. Furthermore, it should also be avoided that doubts arise concerning the actual independence of the ACF members and on the “relationships” (direct or indirect) with the Supervisory Authority, which must be “involved” only with regard to organizational profiles (as the role set out for the Technical Secretariat).

The growing number of appeals will probably require, moreover, to revise the decision not to arrange the ACF Board in different locations. In Italy, the example of the ABF for the banking sector (recently “enlarged” with the addition of a further four Boards, for a total of seven[36]) probably will have to be replicated also in the financial area, always for the purposes of strengthening the investor protection. Some doubts remain about the duration of the mandate for the ACF members. The choice made (five-year term for the Chairman and three years for the other Board members, with the chance of being confirmed only once) appears not faultlessly able to guarantee the independence and the neutrality of judgment. A more effective guarantee (at least from a formal point of view) could be granted by a long term mandate without the possibility of renewal (as like the mandate of the members of the Supervisory Authority: e.g. Consob[37]).

Moreover, turning to the operating issues, the topic of futility and recklessness of the appeals seems to have been underestimated.

The free access to the ACF[38] could cause the “slowing up” of its decision-making response, by virtue of the number of appeals filed, some of which could be “reckless” or otherwise purely instrumental (though not formally unacceptable), being no “barrier” when the appeal is filed. In fact, no elements seem to be formalized to classify the appeals presented as “pointless” (also to be able to correctly monitor them). As a matter of fact, in the ACF Regulation there is no provision similar to art. 96 of the Italian Code of Civil Procedure and therefore there are no specific powers of the ACF Board to establish a liability for “reckless litigation[39]”.
This risk could be minimized with the introduction of an entry “chip” for any appeal filed (obviously economically not significant, as required by the ADR Directive: “minimum costs for consumers”), possibly repayable at the end of the procedure in case of a favourable decision for the investor (as like the ABF for banking disputes in Italy).
It is worth noting that the limit of competence amounting to 500,000 euros (much higher than the 100,000 euros provided by the ABF at domestic level, as well as the 150,000 pounds set by the Financial Ombudsman Service in the United Kingdom[40]) may appear to be disproportionate and nearly in contrast with the inspiring rationale of ADRs, created to quickly address requests for “small claims” from retail customers.
By virtue of the ACF’s declared inspiration to the expertise gained by ABF in the banking sector, the choice to quintuple the limit for its competence does not seem to take into account the significant amount of appeals that have been filed and which will reach this ADR mechanism in the next months/years[41] (and that could undermine the timeliness of its decisions and its trustworthiness). Consob shows that it is not fully convinced of the choice (a rash decision?), establishing that the

suitability of this limit can be further assessed[42], taking into account the disputes submitted to the ACF and their proximity to the threshold introduced.

The ex-post analysis on the first operating results of the ACF functioning should help to “calibrate” the ADR mechanism in Italy. Consob must take into consideration the decision-making trends of the ACF to “shape” its supervisory actions towards the most frequent problems involving the relationship between intermediaries and customers, also facilitated by the “proximity” of the Technical Secretariat.

One of the main goals of the ACF must therefore be to determine a significant incentive for increasing the compliance of intermediaries and a consequent reduction in litigation[43], to which it is also necessary to increase the appropriateness of the supervisory policies.
We therefore have to wait for the “interactions” between the decisions of the ACF and the supervisory interventions of Consob, which should further improve relations between customers and intermediaries, adapting its policies, aiming to a full informative function, as well as becoming an instrument for a proper financial education[44] of the market players[45].

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[6] Further refer to the Consob resolution No. 16763 dated December 29, 2008.
[7] E*x multis* C. Cavallini, *La camera di conciliazione e di arbitrato della Consob: note a “prima lettura” del d.lgs.8 ottobre 2007, n. 179*, in *Società*, 2007, 1446; M. L. Serra, *Brevi note sulla disciplina istitutiva della Camera di conciliazione e di arbitrato presso la Consob* , in *Studium Iuris*, 2009, 262.

[8] Cfr. art. 2 of Legislative Decree No. 179/2007.

[9] Cfr. T. Mancini, *Sul regolamento di attuazione del decreto legislativo 8 ottobre 2007, n. 179 (Camera di conciliazione e di arbitrato presso la Consob)*, in *Riv. arbitrato*, 2008, 347; A. Nascosi, *La nuova camera di conciliazione e arbitrato presso la Consob*, in *Nuove leggi civ*., 2009, 963.

[10] Cfr. Consob, Annual report 2016, available on Consob web site.

[11] In 2012, the Regulatory Impact Assessment for the amendments to the regulation about the Consob Chamber, pointed out the option – to be adopted in the medium-long term – to set a new ADR system, characterized by the binding adhesion of the intermediaries, as like the mechanism currently in force with respect to the banking system (ABF: Arbitro Bancario Finanziario).

[12] Pursuant to article 5 of ADR Directive, Member States shall ensure that ADR entities:

(a) maintain an up-to-date website which provides the parties with easy access to information concerning the ADR procedure, and which enables consumers to submit a complaint and the requisite supporting documents online;

(b) provide the parties, at their request, with the information referred to in point (a) on a durable medium;

(c) where applicable, enable the consumer to submit a complaint offline;

(d) enable the exchange of information between the parties via electronic means or, if applicable, by post;

(e) accept both domestic and cross-border disputes, including disputes covered by Regulation (EU) No. 524/2013; and

(f) when dealing with disputes covered by this Directive, take the necessary measures to ensure that the processing of personal data complies with the rules on the protection of personal data laid down in the national legislation implementing Directive 95/46/EC in the Member State in which the ADR entity is established.

[13] The full denomination is “Arbitro per le Controversie Finanziarie”.

[14] For a thorough analysis, allow me to recall V. Mirra, *I sistemi di Alternative Dispute Resolution trovano nuovo vigore: il recepimento della Direttiva ADR e l’introduzione del nuovo “Arbitro per le Controversie Finanziarie”*, in *Riv. Arbitrato* n. 4/2016, 693.

[15] Cfr. art. 190 of the Italian Consolidated Financial Law (“TUF”: Legislative Decree No. 58/98).

[16] The bank mediators are subject to the control of a Committee (Comité de la médiation bancaire) chaired by the Governor of the French Central Bank.

[17] Currently 11 ADR entities are members of the FIN-NET network (they are both of private and public nature).

[18] Reference is made to *Klachteninstituut Financiële Dienstverlening* (KiFiD).

[19] The law (Ley Novembre 22, 2002, n. 44) provided for the following ADR mechanisms: *Comisionado para la Defensa del Cliente de Servicios Bancarios* before the Banco de España, the *Comisionado para la Defensa del Inversor* before the *Comisión Nacional del Mercado de Valores* (CNMV) and the *Comisionado para la Defensa del Asegurado y del Partícipe en Planes de Pensiones* before the *Direccíon General de Seguros y Fondos de Pensiones*.

[20] E.g. Germany, France etc.

[21] Subjects authorised to carry out investment services.

[22] Cfr. Italian Supreme Court, section I, sentence October 26, 2015, n. 21711). It has to be recalled also A. Dolmetta, U. Malvagna, *Vicinanza della prova e prodotti d'impresa del comparto finanziario,* in *Banca, borsa, tit. cred.,* 2014, I, 659.

[23] The members of the ACF Board are chosen among the following categories:

a) lawyers authorized to practice before the Supreme Court; accountants registered in Section A) of the register of chartered accountants and accounting experts for at least twelve years;
b) notaries with at least six years of experience; ordinary magistrates, in service for at least twelve years or retired; administrative and accounting magistrates with at least six years' of service or retired;
c) university professors in legal or economic subjects in service or retired; executives of the State or independent Authorities with at least twenty years of seniority graduated in legal or economic disciplines, in service or retired.

Consob employees who in the previous two years have been appointed or assigned to organizational units with supervisory or sanctioning functions in matters falling within the competence of the ACF cannot be appointed members of the ACF Board. Where an employee of Consob is appointed as a member of the mentioned Board, the latter operates with full functional autonomy.

[24] The Chairman remains in charge for five years, the other members of the ACF Board for three years and they can only be confirmed once.

[25] Cfr. Consob resolution No. 19701 dated August 3, 2016.

[26] The appeal with the ACF must, in any case, be filed within one year from the submission of the complaint to the intermediary or, if the complaint was filed before the starting date of the ACF's operation, within one year from that date.

[27] «The Technical Secretariat:

a)receives appeals submitted by investors and proceed with the opening and keeping of files relating to disputes;

b) ascertains the regularity and completeness of the documentation presented by the parties and, if necessary, requests any addition by setting the deadlines for transmission of documents;

c)verifies the conditions for starting the procedure and communicates it to the parties;

d)makes communications and receives documentation from the parties;

e)makes available to each member of the Board, before the meeting in which the appeal is discussed, the report and the dossier drafted;

f)submits to the Chairman the calendar of the meetings of the ACF Board and the agenda of each meeting;

g) attends the meetings of the ACF Board and draws up the minutes;

h) manages the archive of the ACF;

i) verifies compliance with the obligations of intermediaries related to membership of the ACF and reports any violation to the competent organizational unit;

j) keeps the list of intermediaries participating in the ACF;

k) takes care of the classification of decisions and their publication on the ACF website;

l) supervises the implementation of decisions by intermediaries and informs the Board thereof;

provides for the publication of the notice of the non-fulfillment by the intermediary on the ACF website;

m)complies with the obligations for the acquisition of the sums to cover the costs of the procedure
n)complies with the obligations related to the participation of the ACF in the Fin-Net network [...] (Article 5 of the Consob resolution No. 19700 of 3 August 2016).

[28] This deadline can be postponed only for the particular complexity or novelty of the issues dealt with or when both parties request it, also in order to attempt the settlement of the dispute.
[29] The intermediary may at any time ask the Technical Secretariat to publish on its website information on the filing of a judicial proceeding concerning the same facts based on the dispute submitted to the ACF or on its outcome (art. 16, par. 4, of the ACF Regulation).
[30] So much higher than the initial estimation of about 1.000 appeals expected in the first year of ACF's operation.
[31] Data provided by the 2017 Annual Report of the Arbitro per le Controversie Finanziarie.
[32] The Ombudsman-Giurì Bancario (also competent for some dispute regarding the financial intermediaries and their clients) ceased its activities from January 9, 2017.
[33] FIN-NET is a network of national organizations responsible for settling out of court consumers' complaints in the area of financial services. FIN-NET was set up by the European Commission in 2001 to promote cooperation among national ombudsmen in financial services, and to provide consumers with easy access to alternative dispute resolution (ADR) procedures in cross-border disputes about provision of financial services. Currently FIN-NET has 60 members in 27 countries.
[34] FIN-NET activity report 2016, available at https://ec.europa.eu/info/file/fin-net-activity-report-2016_it.
[35] The assignment as a member of the ACF has a limited and predetermined duration, after which the Consob employee would come back to be a Public officer.
[36] Currently, as regards the ABF, there are Boards operating in Bari, Bologna, Milan, Naples, Palermo, Rome and Turin.
[37] The Consob members are in charge for seven years without chance of renewal.
[38] The costs of starting the procedure before the ACF will be financed through the Italian "Fund for the extrajudicial protection of savers and investors".
[39] Cfr. A. Dolmetta, U. Malvagna, *Sul nuovo "ADR Consob"*, in *Banca, borsa, tit. cred.*, 2016, III, 277.
[40] *Ex multis* E. Ferran, *Dispute Resolution Mechanisms in the UK Financial Sector*, in *Civil Justice Quarterly*, 2002, 135, available at http://ssrn.com/abstract=298176; R. James – P. Morris, *The Financial Ombudsman Service: A Brave New World in "Ombudsmanry*", in *Public Law*, 2002, 640.
[41] This huge amount of appeals will also require a considerable organizational effort by Consob and an appropriate staff for the functions of the Technical Secretariat.
[42] With respect to Regulatory Impact Assessment in the Administrative Independent Authority in Italy has to be recalled V. Mirra, V. Miscia, L'*AIR* delle *autorità*indipendenti: Banca d'Italia e Consob, in Analisi giuridica dell'Economia, n. 2/2013, 517.
[43] Explanatory report of the consequences on the activities of companies and operators and on the interests of investors, arising from the regulation concerning the ACF, dated May 4, 2016, available on Consob website.
[44] Cfr. L. Klapper – A. Lusardi – P. van Oudhesden, *Financial Literacy around the World: Insights from the Standard & Poor's Rating Services Global Financial Literacy Survey*, Washington, 2015.
[45] The aim is to help induce intermediaries to pay more attention to "substance than to form" (cfr. M. Onado, *L'Arbitro del risparmio e della fiducia. Le responsabilità del nuovo organismo di conciliazione da oggi al debutto*, *Il Sole24Ore*, 09.01.2017).

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(*) *This contribution is the exclusive result of the author's personal opinions, which do not in any way be attributable to Monte dei Paschi di Siena Bank or LUISS University.*