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

Insurtech and interoperability of fintech firms

by **Alessandro Engst** and **Valerio Lemma**

Abstract: *This research aims at understanding if the current regulation would allow to an alternative market for risks and their coverages, due to the possibility that insurtech firms can offer the same insurance products and services, under different regulatory and prudential regimes then those provided for traditional insurance undertakings.*

We focused on the perspective of new licensing approaches to the insurtech and, therefore, on the possibility that European authorities will supervise any business model used in the insurance industry, including the one based on an intensive use of financial innovation and technological improvement.

As a result of such analysis, we highlight that insurtech firms could have a competitive advantage based on their tools for client's management, but these new intermediaries should be regulated in order to allow a fair competition between traditional businesses and fintech ones (excluding any benefit due to an asymmetry in the EU regulatory framework).

Summary: 1. General overview. – 2. Financial innovation and new ways of interoperability. – 3. The perspective of licensing for insurtech. – 4. New business models towards a shadow financial system.

1. Licensing approaches to the insurtech raises the attention of insurance companies on the possibility that European authorities aim at regulating and supervising any business model used in this industry, including the one based on an intensive use of financial innovation and technological improvement to cover risks or manage uncertain exposures[1]. Moreover, national authorities are showing their interest to enhance a more systematic control regime over insurtech start-ups and therefore to adapt their internal processes to manage the impact of digital transformation on these business[2].
This first observation aims at understanding the possibility that a new supervising approach can rely on a stricter interpretation of current rules and therefore a new standard for the application of the principle of proportionality to peer-to-peer insurance agreements, as well as to new technological activities to transfer risk (to a professional manager), thus the need for clarifying the current level playing field for all market participants within the insurance industry. Public intervention over the insurance companies and insurtech firms is going to explore specific options to set the scope of its

supervision, taking into account both the impact of tech-fuelled innovations on the traditional insurance business, the role of innovation facilitators (as significant or ancillary service providers of regulated firms) and the perspective of new networks of market participants aimed at sharing, managing, cover and transfer risks (and other uncertain exposures). In this context, the supervisor are also assessing the use of insurtech-related data, and therefore the need for protection due to the systematical collection and use of clients/counterparties relevant information[3].

2. The Joint Committee Report of the ESAs on the results of the monitoring exercise on 'automation in financial advice' (2018)[4], in its conclusions, does not remark on any significant change in the previously-identified risks. However, considering the overall importance of the topic, ESAs highlight the emergence of ongoing changes to the current business models of fintech firms.

In this context, regulatory issues are related to the algorithms supporting the partially automated activities in insurance undertaking (and other advanced technique of risk mitigation)[5]. The absence of any significant change of the national legislative framework should suggest a complete freedom in starting up a fintech firm that would support the business of insurance companies or distributors. This is supported by the EIOPA's view on the development of automated advisory services in this sector, even if national authorities are dealing with the possibility to publish specific guidelines in order to clarify whether public intervention shall oversee the servicing of certain insurtech activities (which are the 'perfect substitute' of risks' coverage)[6].

In this perspective, we should consider that insurance undertaking and distribution are both regulated (by Directive (EU) 2016/97 on insurance distribution (IDD) and Directive 2009/138/ECon the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II)). This is also true for banking, asset management and financial services, and leads to the conclusion that regulators could make no distinction between automated and physical provision of regulated activities. Therefore, both shall meet the same high-quality standards and duty of care, in order to satisfy the need to protect consumers/savers.

We expect that the success of insurtech firms will strengthen the impact of financial innovation on traditional insurance business models with regard to prudential risks and distributing issues. The same refers to anti-money laundering regulation and the need for money to flow through the safest conduits.

Lastly, any insurtech firm is going to be able to provide automated advice for clients. The common approach to automated advice is based on the application of machine learning, and therefore there are specific rules on the classification of data (and linear regression) having regard to the statistical inference (as it provides the foundation for most of the methods covered). This requires a high level of accuracy for the clients' onboarding and therefore also in the setting up of any relation between the output of the data made by a client (provided as a human) and the collection of the same by the firm (prepared by a machine) big data.[7]

From another perspective, strict rules shall control the information that should be provided to clients on insurance products. The algorithm chooses 'what and how' from amongst a set of combinations made by the firm, so that there is full responsibility of the managers for setting up both the algorithm and information[8].

As a result, insurtech firms rely on new tools for assessing the suitability of risk, the adequacy of the insurance product with particular attention to the use of cookies and other tools with limited or without human interaction. In this context, banks have a competitive advantage based on the knowledge of any transaction recorded on the clients' bank account. Therefore, this advantage should be regulated in order to allow a full competition between regulated firms and fintech ones.

3. The insurance industry is facing the possibility to improve the performance of its business by relying on artificial intelligence[9]and big data analytics[10]. In this context, 'client risk-profiling algorithms' and knowledge of client habits/characteristics is going to be designed and implemented adequately, resulting in clients classified and assigned an accurate risk profile, together with the possibility to offer the necessary products at the exact price.[11]

Insurance companies are developing automated tools for various products. This type of bundling (insurance and data-recording machine or security automation mechanism) is being used increasingly for products that have significant impact. Automated and semi-automated data recording tools are rapidly expanding in use in the consumer world, along with artificial intelligence tools that protect people and goods (and therefore reduce the probability and economic relevance of events covered by the relevant insurance policies). New technological developments are able to enhance the accessibility and quality of both data and algorithms.[12]

From a general perspective, a legal analysis of automated and semi-automated tools used in the insurance business encountered grey areas with respect to fulfilment of the duty of care, data protection and treatment parity. In addition, the review found that insurance companies' internal regulation should control the use of technologies and data, and its adoption should aim to improve the quality of the service provision. Based on this consideration, the regulator must prepare guidance to clarify the fulfilment of the duty of care in insurtech.

Therefore, insurtech does not refer only to sales of insurance and pension products via the Internet. Even if these activities could be based on smart contracts and tech-filled business models, they shall easily considered within the scope of the rules provided for the insurance distributing activities.[13]Such sales require the necessary and proportionate supervisory actions to ensure that online distributors comply with a duty of advice, the application of innovation to the insurance business goes far beyond increasing the saturation of potential clients' life (through the manipulation of information and risk perception).

This perspective also goes far beyond online comparisons of insurance products.[14]This involves the management of arising litigations, whereby the disputes concerning certain relationships does not involve the outcome of significant negotiations, but the *automatic* acceptance of standard agreements used to support other deals.[15]

The use of big data analytics in unsolicited marketing and other relevant areas (such as pricing, underwriting, claims management, sales and/or risk measurement) requires a safe and sound approach, in order to analyse the benefits of the innovation and potential risks related to any unfair treatment of consumers.

4. Automation in financial services is growing and the EU bodies have not yet regulated the insurtech nor have European Supervisory Authorities not yet taken immediate actions on this sector. In this respect, the need for protection of the investors requires EU directives or regulation on the tech-filled business models used in the internal capital market, whilst there are not evidences of the efficiencies due to the current absence of rules or to the *immobility*of the ESAs[16].

In this context, we shall consider that the current legislative approach for the adoption of a EU directive would not be timely for driving the innovation in this industry, anyway new rules should be able to set common standards (in order to ensure a fair competition in this market). There is no doubt that new technologies and different business models are spreading in the insurance business so the monitoring of outsourcing (and then the perspective of certain developments in licensing the ancillary service provided to traditional insurance companies) should allow the starting of new form of supervision without jeopardizing the 'market for servicing'. This requires to verify the possibility to extent the supervision up to the firms that are not involved in the coverage of risks, but perform processes, provide services or run activities which have an impact on the performance of the insurance or reinsurance undertaking itself[17].

In conclusion, the current framework for providing and receiving high-tech services allows fintech firms to execute more than one kind of activity in the capital market, and therefore to supply cross-industry demands. The current lack of regulation could allow to an alternative to insurance companies, as well as to banks and other financial intermediary; this also cast shadows on the efficiency of the market for risk and coverages and, therefore, on the whole capital market because of the possibility that firms subject to different regulatory and prudential regimes can offer the same services (under different conditions).

References:

[1]See the first draft on "*Report on Best Practises on Licencing Requirements, Peer-to-Peer Insurance and the Principle of Proportionality in an Insurtech Context*" published by EIOPA on April 2018. As part of the European Commission's Fintech Action Plan, EIOPA presents a draft of the mapping of current authorising and licencing approaches to financial innovation, including an assessment of how the principle of proportionality is applied in practice. The Report also includes an analysis of the approach to insurtech start-ups operating as peer-to-peer (P2P) insurers.

[2]For an overview of Italian Insurance Supervision Authority approach on insurtech, see the proceedings of the IVASS meeting on "Insurtech – Technological innovation in the insurance market" held in Rome on 15 December 2017.

[3]See *EIOPA Insurtech Roundtable How technology and data are reshaping the insurance landscape, Summary from the roundtable organized by EIOPA on 28 April 2017,* (EIOPA-BoS/17-165 05 July 2017). See also the current debate over the contents of the mandate from the EIOPA to a multidisciplinary Insurtech Task Force (ITF). Reference is made also to the tasks of the ITF include mapping current authorising and licensing requirements and assessing how the principle of proportionality is being applied in practice, specifically in the area of financial innovation (*e.g.*regarding Insurtech start-ups such as peer-to-peer (P2P) insurers), also with a view of determining efficient and effective supervisory practices in the form of best practices.

[4]See *Joint Committee Report on the results of the monitoring exercise on 'automation in financial advice*,published by thethree European Supervisory Authorities (ESAs) – EBA, EIOPA and ESMA. On this topic, see also Brummer – Yadav, *Fintech and the Innovation Trilemma*, in *Georgetown Law Journal, 2018* and in *Vanderbilt Law Research Paper No. 17-46*.

[5]With regard to the application of artificially intelligent algorithmic systems in the insurance industry, see Borselli, *Insurance by Algorithm*, in *European Insurance Law Review, No. 2, 2018*; see also Peters, *Statistical Machine Learning and Data Analytic Methods for Risk and Insurance*, in *Lecture*

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[6]On the adoption of regulatory sandbox for insurtech firms, see, Chen,*Regulatory Sandbox and Insurtech: A Preliminary Survey in Selected Countries*, November 2018.

[7]See Cornelius, *Smart contracts and the Freedom of Contract Doctrine*, in *Journal of Internet Law*, 2018, p. 3 ff.

[8]See Baker – Dellaert, *Regulating Robo Advice Across the Financial Services Industry*, in *Iowa Law Review*, 2018, p. *713* ff.

[9]See note VI.

[10]See Powell,*Big Data and Regulation in the Insurance Industry*, April 2017; Hacker – Lianos – Dimitropoulos – Eich, *Regulating Blockchain: Techno-Social and Legal Challanges*, 2018

[11]See Wright – De Filippi, *Decentralized Blockchain Technology and the Rise of Lex Cryptographia*, March, 2015

[12]See Susskind – Susskind, *The Future of the Professions: How Technology will Transform the Work of Human Experts*, Oxford, 2015

[13]See Raskin,*The Law and Legality of Smart Contracts*, 1 *Geo. L. Tech. Rev.*, 2017, p. 305 ss.; Kôlvart – Poola – Rull, *Smart Contracts*, in VV.AA., *The Future of Law and eTechnologies*, London, 2016, p. 133 ss.; Mik, *Smart Contracts: Terminology, Technical Limitations and Real World Complexity*, in *Law,Innovation & Technology*, 2017, p. 269 ff.

[14]See Weber, "*Rose is a rose is a rose is a rose*" – *what about code and law?,* in *Computer Law & Security Review*, 2018, p. 701 ff.

[15]See Koulu,*Blockchains and Online Dispute Resolution: Smart Contracts as an Alternative to Enforcement*, *ScriptEd*, 2016; Surden, *Computable Contracts*, in *U.C. Davis Law Review*, 2012, p. 629 ff.

[16]Regarding the developing regulatory approaches to the intersection of data, finance and technology, see also Buckley – Arner – Barberis, *FinTech, RegTech and the Reconceptualization of Financial Regulation*, in *Northwestern Journal of International Law & Business* and *University of Hong Kong Faculty of Law Research Paper No. 2016/035.*

[17] With regard to the increasing number and variety of new *TechFin*into the financial sector see Zetzsche – Buckley – Arner – Barberis,*From FinTech to TechFin: The Regulatory Challenges of Data-Driven Finance*, in *New York University Journal of Law and business* and *European Banking Institute Working Paper Series 2017*– No. 6.

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

Foreign Direct Investments screening: a short overview of the Italian, European and South American regulation

by **Lorenzo Locci** and **Pablo Velázquez**

Abstract: *This paper briefly analyzes the Italian and European regulation on Foreign Direct Investments and the possibility of strengthening such measures in order to avoid the risks of buy-out of each country's economy by foreign investors.*
In this scenario, we also provide a brief overview of the FDI control measures implemented in certain South and Latin American countries, which should promote FDI in order to close the productive and social gaps in the region by means of the integration processes between economies in the world.

1. Economic liberalism – which aims at protecting market freedom with minimum government intervention – is efficient only when there is a proper balance between public intervention in the economy and the autonomous functioning of the market.
In particular, public intervention in economy should aim at establishing a solid and healthy economic environment by providing rules which regulate the activity of all the market operators involved, without precluding the possibility for one country to grow through the implementation of integration processes and trades with foreign countries (this is particularly true for developing countries).
In this perspective, statistics of the last decades show that Foreign Direct Investments (FDI) have been considered crucial to achieve such objective[1]. More specifically, Foreign Direct investments are defined as "*a category of cross-border investment made by the direct investor with the objective of establishing a lasting interest in an enterprise that is resident in an economy other than his. The main motivation of this person is to exert some degree of influence over the management of its direct investment enterprise. The motivation to that influence or control an enterprise is the underlying factor that differentiates direct investment from cross-border portfolio investments*"[2].
FDI represent a key element in the evolving process of international economic integration and globalization due, at least, to the following reasons:

- they contribute to create direct, stable and long-lasting links between economies;
- they could serve as a tool for local enterprises development and may help to improve the competitive position of the recipient and – more in general – of the investing economy;
- they encourage the transfer of technology and know-how between economies;
- they represent an opportunity for the receiving country to promote its products more widely in international markets[3].

That said, we are now assisting worldwide to a renewed tension between market globalization, on the one hand, and the strengthening of populist positions and sovereign logics, on the other hand, both aimed at bringing back to light national-statist concepts which imply a return to a full sovereignty of each nation in the believe that the welfare of one country depends on the possibility for that country to autonomously determine the management guidelines of its economy[4].

In this scenario, the recent trend shows an increasing use by governments – inside and outside Europe – of foreign investment control measures which aim at safeguarding national security and avoiding the buy-out of each State's economy (so called "Golden Powers")[5]. As a consequence, any cross-border M&A practice which involves target companies located in countries where Golden Powers exist and are frequently used needs to adapt to such new regulatory environment.

Given the above, this paper first provides a short overview of the Golden Powers regulation in Italy and in Europe as a paradigm of the strengthening of such "economic neo-protectionism" focused on avoiding that public interests concerning strategic sectors could be harmed by FDI.

In comparison, the second part of the paper briefly analyzes the level of implementation of foreign investment control measures adopted in certain South and Latin American countries, who should welcome FDI in order to close the productive and social gaps in the region and to pursue the above-mentioned benefits deriving from the implementation of integration processes between economies in the world.

2. The regulation governing the special powers granted to the Italian Government in order to control FDI towards certain strategic sectors is provided by the Law Decree no. 21 dated 15 March 2012 (the "Law Decree"), converted with amendments into Law no. 56 dated 11 May 2012, as subsequently amended. The Law Decree governs the regulation of the Golden Powers by redefining their conditions and modalities of exercise by the Italian Government, in order to bring the national regulation in line with the rules provided by the "Treaty on the Functioning of the European Union", further to the objections raised by the European Court of Justice, according to which the former provisions of law governing the matter were contrary to the European principles concerning the right of establishment, the freedom to provide services, as well as the free movement of capital[6].

The regulation provided by the Law Decree affects companies operating in sectors deemed strategic, regardless of a shareholding held by the Italian State in the latter companies (hence the transition from the so-called "golden share" to the "golden powers"), while providing the Government with instruments deemed proportional to the concrete envisaged risk[7].

More specifically, the Golden Powers regulation provides for different rules depending on whether (i) companies carrying out activities having a strategic relevance in the sector of the national defense and security are concerned (Article 1 of the Law Decree), or (ii) companies holding strategic assets in the energy, transportation and communications sectors as well as in sectors having a high technological intensity are concerned (Article 2 of the Law Decree)[8].

With reference to the companies carrying out activities having a strategic relevance in the national defense and security sectors, the events triggering the potential exercise of the special powers are the following:

- any resolution to be adopted by the shareholders' meetings or of the management bodies of a "strategic company" concerning (i) company's merger or de-merger, (ii) the transfer of business and/or of its branches or of subsidiaries, (iii) the transfer abroad of the registered office, (iv) the amendment of the company's purpose, (v) the company's dissolution, (vi) the amendment of the provisions set forth in the by-laws (if any) adopted pursuant to Article 2351, paragraph 3, of the Italian Civil Code and Article 3, paragraph 1 of the Law Decree no. 332 of 31 May 1994, converted with amendments by the Law no. 474 of 30 July 1994 (as lastly amended by Article 3 of the Law Decree), (vii) the transfer of any right in rem or right of use relating to material or immaterial assets or the assumption of any obligation conditioning their use; as well as
- any acquisition, at any title whatsoever, of any shareholdings in "strategic companies"[9].

In this scenario, Article 1 of the Law Decree grants the Italian Government with certain special powers – to be exercised in case a threat of serious prejudice to the essential interests of national defense and security occurs[10] – and namely:

- the power to exercise a veto on the above-mentioned significant resolutions; this special power shall be exercised only through the imposition of specific prescriptions or conditions (and not through a veto of the transaction) any time this is sufficient to ensure the protection of the fundamental interests of national defense and security;
- the power to impose specific conditions concerning the security of supplies, the security of information, the technological transfers, the control of the exportation in the event of significant acquisitions pursuant to Article no. 1 of the Law Decree; as well as
- the power to forbid such significant acquisitions when performed by an entity other than the Italian State, Italian public entities or those controlled by the latter, should the purchaser hold, either directly or indirectly, also following the entering into subsequent purchases' agreements, by an interposer party or through otherwise connected entities, a level of shareholding in the share capital with voting rights capable of jeopardizing, in the case at hand, the interests of the national defense and security[11].

In order to allow the Italian Government to evaluate whether to exercise or not the special powers provided under Article 1 of the Law Decree, the "strategic companies" (with reference to the significant resolutions) and the relevant purchaser (with reference to the significant acquisitions) are required to submit a notification in accordance with the provisions set forth under Article 1 of the Law Decree and in the Presidential Decree no. 35 of 19 February 2014[12]. The decision concerning the exercise of the special powers shall be communicated by the Italian Government within fifteen days starting from the abovementioned notification. Once the term has elapsed, any significant acquisition or significant resolution may be implemented, even if the Government has not issued its green light. Pending the notification procedure and, in any case, the expiration of the abovementioned terms (i) the effectiveness of any significant resolution is suspended and (ii) the voting rights and the other administrative rights related to the shares representing any significant acquisition are suspended.

3. The discipline of Golden Powers provided by Article no. 2 of the Law Decree with reference to companies holding assets considered significant for the national interest in the energy, transport and

communication sectors – as well as in sectors having a high technological intensity – is similar, but not coincident, in comparison to the regulation set forth under Article no. 1 of the Law Decree[13].

In particular, the events triggering the potential exercise of the special powers pursuant to Article no. 2 of the Law Decree consist in:

- any resolution, action or transaction adopted by companies owning any asset relevant for the purposes of Article no. 2, upon condition that such resolutions, actions or transactions result in the loss of ownership, control or availability of such relevant assets or in a change in their destination of use, including resolutions of the shareholders' meeting or of the management bodies concerning the merger or de-merger, the transfer abroad of the registered offices, the change of the corporate purpose, the dissolution of the company, certain amendments to the by-laws, the transfer of the company's business unit or of a going concern which includes any relevant asset or the assignment of any relevant asset as a guarantee, as well as any resolutions adopted by the shareholders' meeting or by the management bodies concerning the transfer of subsidiaries that hold the aforementioned relevant assets;
- any acquisition by non-EU entities[14] of controlling interests in companies owning any relevant asset, if such equity investment(s) imply (x) a stable position of the purchaser, due to its control of the company and (y) a threat of serious prejudice to the abovementioned essential interests of the State.

Given the described perimeter of relevant transactions considered by Article 2 of the Law Decree, the Italian Government is granted with certain special powers – to be exclusively exercised on the basis of objective and non-discriminatory criteria and having regard to the nature of the relevant transaction[15] – and namely:

- the power to exercise a veto, in relation to significant resolutions pursuant to Article 2 of the Law Decree, in the event the latter trigger an exceptional situation – not governed by the national and European sector regulation – threating a serious prejudice to the public interests relating to the safety and operation of networks and installations and the continuity of supplies; this veto power shall be exercised only through the imposition of specific prescriptions or conditions whenever this is deemed sufficient to ensure the protection of the public interests relating to the safety and operation of networks and installations and the continuity of supplies;
- the power to impose certain duties and conditions to the effectiveness of the significant acquisitions according to Article no. 2, in the event the latter trigger (aa) a threat of serious prejudice to the essential public interests relating to the safety and operation of networks and installations and the continuity of supplies or (bb) or a danger for security or public order. In exceptional cases of risk for the protection of the afore-mentioned interests – which cannot be eliminated through the undertaking of the abovementioned commitments – the Government is granted with the power to forbid the acquisition (see Article 2, paragraph 6, of the Law Decree).

As well as for the procedure provided under Article no. 1 of the Law Decree, also Article no. 2 requires any interested company (with reference to significant transactions) and any purchaser (with reference to significant acquisitions) to submit a notification should a relevant transaction occur, in accordance with the provisions set forth under the same Article no. 2 of the Law Decree and in the already mentioned Presidential Decree no. 86 of 25 March 2014.

4. The circumstance that there is currently no comprehensive framework at the European Union level for the screening of FDI on the grounds of security or public order, while the major trading partners of

the European Union have already developed such frameworks (like Italy, as briefly described above), pushed the European regulator to adopt, on 13 September 2017, a "*Proposal for a Regulation of the European Parliament and of the Council establishing a framework for the screening of foreign direct investments into the European Union*"[16].

In particular, the proposed Regulation aims at providing legal certainty for Member States' screening mechanisms on the grounds of security and public order, and at ensuring Union-wide coordination and cooperation on such matter, without renouncing to the necessary flexibility which should be granted to each Member State in screening FDI by taking into account individual situations and national specificities. This in the believe that "*foreign direct investment contributes to the Union's growth by enhancing its competitiveness, creating jobs and economies of scale, bringing in capital, technologies, innovation, expertise, and by opening new markets for the Union's exports. It supports the objectives of the Investment Plan for Europe and contributes to other Union projects and programs*"[17].

In a nutshell, Article no. 1 defines the objectives pursued by the proposed Regulation, which consist in the establishment of a framework for the screening by the Member States and the Commission of foreign direct investments in the Union on the grounds of security or public order.

Art. 4 of the Regulation identifies certain elements which the Member States and the Commission may take into account in determining whether a foreign direct investment is likely to affect security or public order. In particular, they shall look at the potential effects of the FDI on, *inter alia*: critical infrastructure, including energy, transport, communications, data storage, space or financial infrastructure, as well as sensitive facilities; critical technologies, including artificial intelligence, robotics, semiconductors, technologies with potential dual use applications, cybersecurity, space or nuclear technology; the security of supply of critical inputs; or access to sensitive information or the ability to control sensitive information. In addition, paragraph 2 of Article no. 4 specifies that in order to determine whether a foreign direct investment is likely to affect security or public order, Member States and the Commission may take into account whether the foreign investor is controlled by the government of a third country, including through significant funding.

The proposed Regulation also aims at establishing a mechanism for cooperation according to which each Member State shall notify the Commission and the other Member States of any FDI in their territory that is undergoing screening. In this context, where the Commission considers that a FDI undergoing screening is likely to affect security or public order in more than one Member State, or has relevant information in relation to that FDI, it may issue an opinion addressed to the Member State undertaking the screening, and the Member State undertaking the screening shall give due consideration to such opinion, as well as to the comments of the other Member States (if any). In addition, the Commission may also issue an opinion with reference to FDI planned or completed in a Member State which is not undergoing screening in that Member State. Moreover, an opinion may be issued by the Commission also where it considers that a FDI is likely to affect projects or programs of Union interest on grounds of security or public order: in that case, the Commission may issue an opinion addressed to the Member State where the FDI is planned or has been completed.

5. The comparison between the regulatory framework on FDI screening currently in place in Italy and in Europe, on the hand, and the regulation adopted by certain South American countries (like Argentina, Chile, Paraguay, Colombia and Peru), on the other hand, shows that Golden Powers regulation in the latter countries is quite similar and only sometimes less invasive.

For example, all of such countries adopted provisions which aim at protecting certain strategic sectors (such as transport, electricity and telecommunications) by imposing a cap to the voting rights which may be held by a foreign investor in national strategic companies[18]; on the other hand, no veto powers or powers of prior approval of FDI are provided by the laws and regulations of such countries.
Other South American countries, especially more developed ones such as Mexico and Brazil, impose stricter restrictions to FDI in a larger number of sectors deemed strategic, such as media, telecommunications, internal and external transportation, and energy, which sometimes are closed to FDI. For instance, Mexican law imposes restrictions to FDI in certain sectors, such as the cargo transport by rail, cargo transport by inland waterways, wireless and digital communications, infrastructure, services, life and health insurance, and higher education, while, according to Brazilian laws, foreign investors cannot held more than the 20% and 30% of the share capital of, respectively, national companies operating in the airline sector and media.
Without prejudice to the above, certain South American countries are taking initiatives to remove restrictions to FDI in order to reverse the current trend which shows a significant contraction of FDI towards such countries in the last years[19]. In particular, the economic slowdown in the whole region, lower commodity prices and a decrease of profitability negatively affected FDI flows to Latin America and the Caribbean, in coherence with the statistics which show that, in a period of strong technological and geopolitical transformations, FDI flows to developing economies have fallen while flows to advanced economies have risen[20].
In this scenario, the energy transition to achieve a low-carbon economy enhanced by the Paris Agreement, adopted in December 2015, is seen as an opportunity for Latin American countries to become more attractive with respect to FDI since, according to the *Renewables 2017 Global Status Report of the Renewable Energy Policy Network for the 21st Century*, the Latin American and Caribbean countries are well placed to deploy renewable energies. Indeed, renewable energy project announcements have increased steadily over the past decade[21] due to the fact that this sector attracted the most greenfield investment in 2016, with its share of the total climbing from an average of 6% for 2005-2010 to 18% in 2016, making it the fastest-growing sector in that period. Many of these developments are the result of investment by transnational corporations, led by Spanish firms including Abengoa, Iberdrola and Acciona; the Italian company, Enel; Ireland’s Mainstream Renewable Power; France’s Engie; and firms from the United States and Canada[22].

6. We briefly analyzed the Italian discipline on Golden Powers and the new framework on FDI screening to be established at the European Union level in order to provide an example of the recent trend which shows the strengthening and the increasing use of measures aimed at restricting the possibility for a foreign investor to establish a lasting interest in an enterprise operating in sectors which are deemed strategic for the recipient country.
Such measures should be less invasive in countries which want to reach economic growth through the implementation of integration processes with foreign states in order to pursue the benefits connected to FDI. Coherently, the example of South American countries – which suffer a decrease of the flows of FDI in the last decades – shows an opposite trend aimed at weakening the mechanisms for FDI screening.
In any case, such measures appear to be necessary for avoiding the risks of buy-out of each country’s economy by foreign investors, but they should be balanced and applied consistently in order not to

make the country less appealing for investors. The recent proposal to adopt a new framework on FDI screening at the European Union level shall be appreciated in this perspective.

References

[1] For detailed statistics on inward and outward foreign FDI flows and positions of OECD Countries see OECD, *OECD International Direct Investment Statistics 2014*, OECD Publishing, Paris, 2014, available at *http://www.oecd-ilibrary.org*.

[2] See OECD, *OECD Benchmark Definition of Foreign Direct Investment 2008*, Fourth edition, 2009, p. 22, available at *https://doi.org/10.1787/9789264045743-en*.

[3] See OECD, *OECD Benchmark Definition of Foreign Direct Investment 2008*, Fourth edition, p. 14. See also *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions – Towards a comprehensive European international investment policy*, COM(2010)343 final, Bruxelles, 7 July 2010: "*FDI represents an important source of productivity gains and plays a crucial role in establishing and organising businesses and jobs at home and abroad. Through FDI, companies build the global supply chains that are part of the modern international economy. Innovation in transportation and information technologies has in turn facilitated trade and the globalisation of business enterprise beyond the confines of large corporations. Investment and trade are today inter-dependent and complementary. Around half of world trade today takes place between affiliates of multinational enterprises, which trade intermediate goods and services*" (p. 3).

[4] See Capriglione, *Non luoghi. Sovranità, sovranismi. Alcune considerazioni*, in *Rivista Trimestrale di Diritto dell'Economia*, 4/2018, pp. 393 and following.

[5] Statistics which confirm such increasing trend in Italy may be found in the Report concerning the use of the Golden Powers for the years 2014-2016, available at *http://www.camera.it*.

[6] See ECJ judgement C-326/07 – Commission v Italy (26th March 2009), where the Court deemed the original regulation on special powers attributed to the Italian Government in order to control FDI – *i.e.* Law Decree no. 332 of 31 May 1994 (converted into Law no. 474 of 30 July 1994) and subsequently amended by Law no. 350 of 2003 – in breach of the European provisions governing the criteria for the exercise of special powers. See on this topic Sacco Ginevri – Sbarbaro, *La transizione dalla golden share nelle società privatizzate ai poteri speciali dello Stato nei settori strategici: spunti per una ricerca*, in *NLCC*, 2013, pp. 109 and following.

[7] See Pellegrini – Sacco Ginevri, *Il ruolo dello Stato nei settori strategici dell'economia*, in *Corso di diritto pubblico dell'economia* (a cura di Pellegrini), Padova, 2016, pp. 453 and following; Scarchillo, *Dalla Golden Share al Golden Power: la storia infinita di uno strumento societario. Profili di diritto europeo e comparato,* in *Contr. Impr. Europa*, 2015, pp. 219 and following.

[8] The Law Decree is implemented by (i) the Decree of the President of the Council of Ministers no. 108 of 6 June 2014, concerning the identification of the activities having a strategic relevance in the sector of the national defense and security are concerned; (ii) the Presidential Decree no. 35 of 19 February 2014, concerning the identification of the procedures to be followed for the use of the Golden Powers in the sector of the national defense and security; (iii) the Presidential Decree no. 85 of 25 March 2014, concerning the identification of the assets in the energy, transportation and communications sectors, and (iv) the Presidential Decree no. 86 of 25 March 2014 concerning the

identification of the procedures to be followed for the use of the Golden Powers in the energy, transportation and communications sectors.

[9] Should the significant acquisitions concern an Italian listed company, the relevant thresholds triggering the potential exercise of the golden powers provided under Article 1 of the Law Decree are the following: the acquisition of a stake exceeding 3% of the share capital of the company (*i.e.* the threshold provided under Article 120, paragraph 2, of the Consolidated Financial Act); as well as any other acquisition of a stake exceeding the thresholds of 5%, 10%, 15%, 20%, and 25%.

[10] Article 1 (and namely paragraphs 2 and 3 of the Law Decree) provides the criteria on the basis of which the Government shall evaluate, from time to time, the existence of such threat arising from any significant resolution or any significant acquisition pursuant to Article no. 1 of the Law Decree.

[11] To this end, it also must be taken into account the shareholding held by third parties with which the purchaser has entered into one of the shareholders' agreements provided under Article 122 of the Consolidated Financial Act under the Legislative Decree February 24th, 1998 no. 58, and subsequent amendments or of one of those provided under Article 2341-*bis* of the Italian Civil Code.

[12] In the event of adoption of any Art. 1 Significant Acquisition – potentially subject to the powers to impose specific conditions and to forbid any Art. 1 Significant Acquisition – the purchaser is required to notify to the Presidency of the Council of Ministers a complete informative upon the content of the abovementioned Art. 1 Significant Acquisition (Art. 1, Paragraph 5, of the Law Decree). The notification shall provide for all necessary information, including a general description of the acquisition project, of the purchaser and of the relevant business activity.

[13] By means of the Law Decree no. 148 of 16 October 2017, the Italian Government has, *inter alia*, extended the application of the provisions set forth under Article 2 of the Law Decree to the sectors having a high technological intensity. Such sectors include (i) critical or sensitive infrastructures, including storage and management of data, financial infrastructures; (ii) critical technologies, including artificial intelligence, robotics, semiconductors (*semiconduttori*), technologies with potential dual-use applications (*tecnologie con potenziali applicazioni a doppio uso*), network security, spatial or nuclear technologies; (iii) security of supply of critical inputs (*sicurezza dell'approvigionamento di input critici*); (iv) access to sensitive information or ability to control sensitive information.

[14] Any non-EU person shall mean any individual person or legal entity which is not resident, habitual resident, does not have the registered office or the administration office or the center of main activity in a State Member of the European Union or of the European Economic Area or which is not established therein.

[15] In particular, the Government shall take into account the following criteria in order to assess whether to exercise or not the special powers provided by Article no. 2 of the Law Decree: *(a)* the existence, taking into account also the official positions of the European Union, of objective reasons which lead to deem possible the existence of links between the purchaser and third countries which do not recognize the principles of democracy or the rules of the State of law, which do not comply with the rules of international law or which have assumed behaviors at risk *vis à vis* the international communities, inferred from the nature of their alliances, or have relationships with criminal or terrorist organizations or with subjects in any case connected to them; *(b)*the suitability of the arrangement resulting from the legal act or the transaction, taking into account also the methods of financing of the acquisition and the economic, financial, technical and organizational capacity of the purchaser so to ensure: *(i)* the safety and continuity of supplies; *(ii)* the maintenance, safety and operation of the

networks and installations; *(b-bis)* for the Art. 2 Significant Acquisitions, further to the threat of serious prejudice to the public interests relating to the safety and operation of networks and installations and the continuity of supplies, also the danger to security or public order is assessed.

[16] COM (2017) 487, available at *www.eur-lex.europa.eu*.

[17] See whereas no. (1) of the Proposal.

[18] For instance, Chile imposes a 49% cap on voting rights in companies operating the internal transport sector; Colombia provides for a cap of 40% for the foreign ownership of companies in the television transmission sector, while voting rights held by a foreign investor in companies established in Peru which operate in the sector of international air transport of passengers are limited to the 49% of the share capital of such company.

[19] For instance, in 2016, Chile established a new foreign investment promotion and attraction strategy that included the creation of a new national investment promotion agency, “InvestChile”, that assists overseas companies with their investments in the country.

[20] See CEPAL, *Foreign Direct Investment in Latin America and the Caribbean*, September 2018, available at *http://www.cepal.org*.

[21] For instance, the energy reform in Mexico was passed in August 2014, amending the General Act on Climate Change adopted on 2 June 2012. The reform affected not only the oil and gas market, but also liberalized electric power generation. Previously, most of the country’s electricity was generated by the Federal Electricity Commission (CFE), a State utility. The reform package created an independent transmission grid operator, the National Electricity Control Centre, which controls a new market and allows clients to buy energy directly from generators. The establishment of CENACE created a market of independent power producers (IPPs) for the first time in Mexico. According to the International Energy Agency (IEA) scenarios to 2040, the reform will boost the production of oil, increase the proportion of renewable energy sources in the energy sectors, increase energy efficiency and reduce CO_2 emissions growth.

[22] ECLAC, *Keywords for development*, September 2018, available at *http://www.cepal.org*.

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

The BTP-Bund spread: public debt, banks, financial intermediaries, financial markets and the economy in Italy

by **Fabiano Colombini**

Abstract: *This paper analyses the BTP-Bund spread evolution by focussing on the impact it has on public debt, banks, financial intermediaries, financial markets and the Italian economy during the period January-to-October 2018.*

In this regard, the BTP-Bund spread represents the difference between the yield of Italian bonds and that of German bonds on the respective 10-year maturities. The spread level undergoes fluctuations almost daily, which concretely indicates the risk inherent in the issuer and, therefore, the higher or lower level of the cost of new issues of public securities on the basis of the higher or lower level of the spread.

The debt-to-GDP ratio, which is higher than 130 percent, simultaneously expresses an intrinsic weakness of the Italian economy regarding new production capacity wealth. This is a crucial result of low economic growth which increases the public debt level. This result can be ascribed to the economic policies pursued by Italian governments that have been negligent as to removing structural barriers, as well as dealing with serious financial crises since 2007 up to the present.

The structural factors that impact negatively on economic growth in Italy are tax evasion, corruption, excessive bureaucracy, an aging population, an imbalance between north and south, and protracted judicial processes. The negative impact of the latter factor is estimated at around one percent of the GDP in a year period.

In this context, the spread is an indirect measure of the ability of a state to repay the credit it received and, therefore, its insolvency risk. The spread is also a measure of investor confidence in the securities the state issued. A higher spread results in lower investor confidence in respect of public securities placed on the market and, as a consequence, higher spread increases the interest rates applied on public issues in the time frame taken into consideration. This, overall, has a negative impact on the total cost of debt.

This indicates the importance of elaborating fiscal policies and economic policies that pursue control over the spread trend, which should be considered a variable that cannot move without due supervision.

The increase in the spread and the consequent negative impact on the balance sheet asset values, and on the share values, imply asset losses for all investors in public securities, as well as for investors in the capital of banks and other financial intermediaries. The downgrade by rating agencies, at the same time, caused significant drops in asset values. Evidently, the high level of public debt is a serious problem that has been lingering for many years and weighs heavily on the Italian economy. Although there are remedies for the problem, the will to impose and bring them forward seems to be lacking.

Despite a scenario of progressively increasing rates and yields, the increase and the instability in the performance of the 10-year BTP-Bund spread has caused negative repercussions on bank stability, which is essentially expressed by fluctuations in asset values, higher collection costs, and continued negative impact on the expansion of loans and public securities.

Economic growth can be achieved by means of a strong push towards public and private investments through banks' and financial intermediaries' financial support and that of the financial markets.

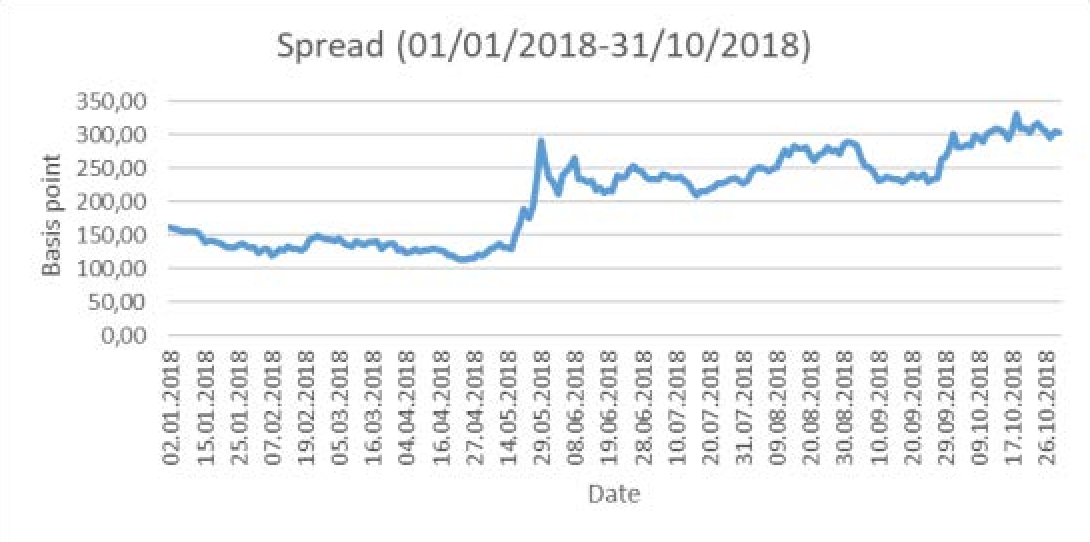
The importance of strengthening banking, insurance, mutual funds and financial markets has to be emphasised. Instability and increases in the spread that have occurred since the Conte government's establishment do not provide good assumptions, but rather tend to complicate the situation, with risks leading to large-scale financial crises and economic recession in Italy.

Summary: 1. Introduction – 2. Spread and public debt – 3. Spread and banks – 4. Spread, financial intermediaries, financial markets and the economy – 5. Conclusions

1. The BTP-Bund spread represents the difference between the yield of Italian bonds and that of German bonds on the respective 10-year maturities. The spread level indicates the risk inherent in the issuer and, therefore, the higher or lower level of the cost of new issues of public securities on the basis of the higher or lower level of the spread. Therefore, the spread constitutes the financial markets' risk perception vis-à-vis that of individual states.
In this study, the spread considers differences in Italian BTP yields compared to German Bund yields across their respective 10-year maturities.
Why is the German Bund used as a reference or benchmark? This is because in the euro area the German economy is the strongest, and therefore presents balanced public finances. It is worth pointing out that the German Bund is considered risk-free because the issuer is very solid, whereas the Italian BTP carries a higher risk level because the spread is higher.
Italy dynamically highlights an upward or downward spread compared to Germany and considers how the financial markets perceive the economic and financial conditions to be worsening or improving. In the current year, 2018, the spread exhibits a considerable increase in the transition from the Gentiloni government to the Conte government [1]. The uncertainty about fiscal measures and relations to European institutions have contributed to increases in the risk premium on Italian government

bonds [2]. Thus, as is reported in Figure 1, the spread shows increases after the appointment of the new government on 1 June 2018, and also in the preceding months.

Figure 1: **Spread BTP-Bund trend (January 2018-October 2018)**



Source: Data from website – Investing.com.

As Table 1 below reports, in the period from January to April 2018 the spread showed the highest value of around 163 points in January, while in the period from June to October 2018 the spread reached the value of 340 points in October. In the evolution of the country's policy and government, by October 2018 the spread increased to more than double the rate of January 2018.

Table1*:* **Spread BTP-Bund. Descriptive statistics**

Gentiloni Government		Conte Government	
MEAN	134,2432	MEAN	256,8744
MAX	162	MAX	340
ST. DEV.	11,25376	ST. DEV.	30,29907

Source: Data from website – Investing.com.

Regardless of the outlook for the various changes considered below, the deterioration *per se* implies a rise in interest expenditure on new issues of government bonds, which escalates the public expenses and, therefore, negatively affects the rise in public debt that still weighs down Italian citizens, and especially also affects future generations.

One has to note that a high level of public debt greatly reduces the room for manoeuvring fiscal policies for anti-cyclical purposes.

The debt-to-GDP ratio, which is higher than 130 percent [3], simultaneously expresses an intrinsic weakness of the Italian economy regarding new production capacity wealth. This is a crucial result of low economic growth which increases the public debt level. This result can be ascribed to the economic policies pursued by Italian governments that have been negligent as to removing structural barriers, as well as dealing with serious financial crises since 2007 up to the present [4].

The structural factors that impact negatively on economic growth in Italy are tax evasion, corruption, excessive bureaucracy, an aging population, an imbalance between north and south, and protracted judicial processes. The negative impact of the latter factor is estimated at around one percent of the GDP annually [5].

Frequent occasions of slow justice over a long time and without any corrections, have proven to be truly important and significant in terms of the reduced ability to increase Italy's wealth. Equally important is the macroscopic figure of tax evasion estimated at around 130 billion euro annually, which positions Italy very unfavourably in the context of European countries. Extended over time, these factors deplete public administration resources, thus exacerbating public debt [6].

In the period from 2001 to 2007, Italy showed a decline in productivity, measured in terms of the GDP per hour worked, equal to -0.01 per cent annually. This positions the country last in the ranking of industrialised countries' productivity. Between 2010 and 2016, Italy's productivity increased by +0.14 percent per year, thus achieving the worst result after Greece [7].

Italy stands out as a model of low technological innovation combined with inefficiency and uncertainty in justice.

The structural factors mentioned above represent serious obstacles to economic growth. Ignoring them, or leaving them unaltered, will create serious problems for Italy in the European and international context.

In this regard, the spread is an indirect measure of the ability of a state to repay the credit it received and, therefore, of its insolvency risk. The spread is also a measure of investor confidence in the securities the state issued. A higher spread results in lower investor confidence in respect of public securities placed on the market and, as a consequence, higher spread increases the interest rates applied on public issues in the time frame taken into consideration. This, overall, has a negative impact on the total cost of debt. Here, again, we find ourselves considering the case of increased public spending and related public indebtedness.

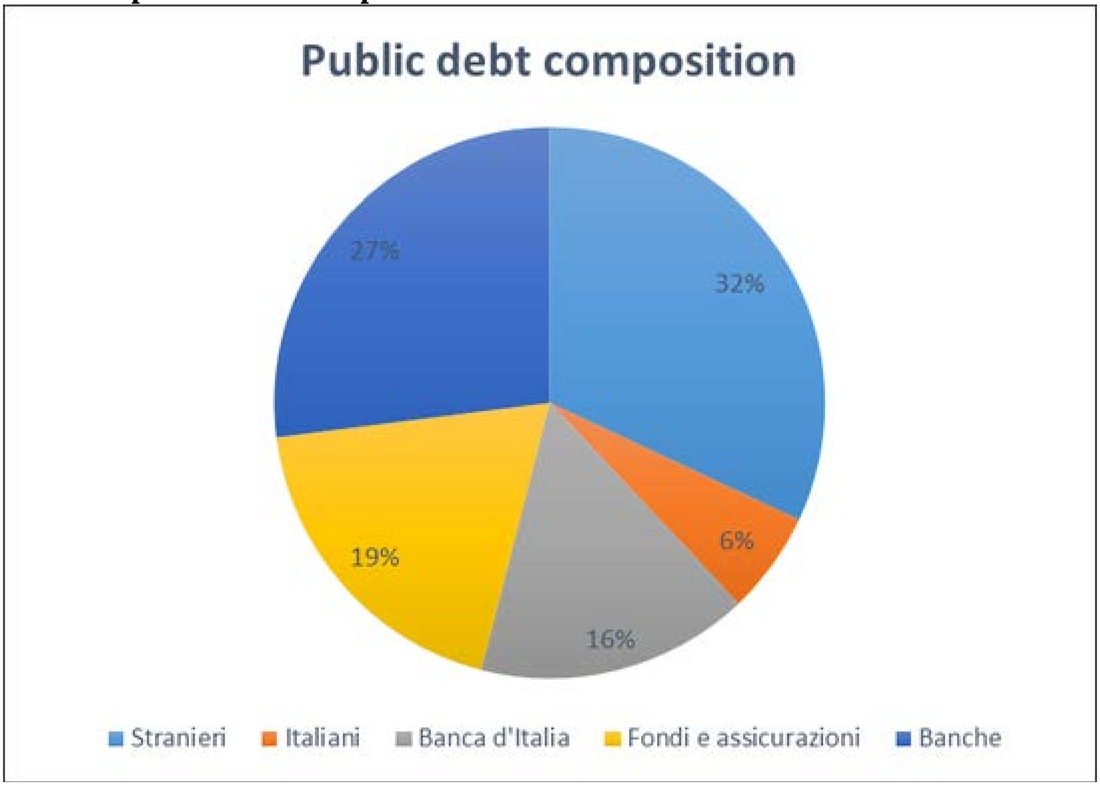
This indicates the importance of elaborating fiscal policies and economic policies that pursue control over the spread trend, which should be considered a variable that cannot move without due supervision.

The Austrian Government of Chancellor Sebastian Kurz, for example, has proceeded to reduce the deficit on GDP to almost zero level as it considered lowering and even zeroing the deficit on GDP, as well as a structural correction towards the recovery of areas of freedom in conducting fiscal policy, to be important.

This circumstance emphasises that in the European and international context, reducing the GDP deficit gap is a compelling pursuit to be actualised through economic policies and individual economies.

2. The level of the spread between the yields of the public securities of a single country and the yields of public securities of Germany reflects the economic and financial conditions of a single country, and so expresses the indications and investors' judgment on the state's ability to repay its debt. Economy, finance, economic and fiscal policies of the individual country thus enter into the full evaluation and consideration of the investors which are composed of domestic and foreign investors, as shown in Figure 2, the Italian debt placed indicates a 68 percent distribution to residents and 32 percent to non-residents [8], allowing for oscillations and changes in preferences from one period to another.

Figure 2*:* **Italian public debt composition**



Source: Banca d'Italia, Finanza pubblica: fabbisogno e debito, 2018.

An increase in the spread implies an increase in the cost of new issues of public securities, which increases public interest expenditure and, at the same time, overall debt. Increases in public spending and public debt tend to worsen public finances, creating assumptions towards recessionary pressures and, therefore, bringing quite the opposite of the economic growth objectives indicated in the Conte government budget proposal. The trend of spreads and its dynamism presuppose modalities of control.

A fundamental point should be emphasised: a very low spread level of close to zero would make encourage the use of international and domestic markets for the issuance and placement of public securities, as this would, from a European and international perspective, imply financing at the lowest rates.

A high level of public debt, expressed above the 130 percent of the debt-to-GDP ratio, as in the case of Italy, raises many questions and many doubts about the state's ability to control the spread because the higher the debt, the larger the renewal needs. At the same time, it is important to consider the average maturity, as a longer average maturity implies more margins for adjustment.

It is necessary to underline that a high level of the debt-to-GDP ratio implies an imbalance and a structural gap that can trigger financial instability through the spread increasing and, therefore, negative value oscillations in the public bonds. Simultaneously, negative oscillations in the portfolios of government securities in banks' assets have a negative impact on prices, thus creating a vicious circle which repeats the mechanisms of the sovereign debt crisis that, until recently, has been plaguing Europe. This circumstance shows negative elements both for Italy and for Europe. Italy does not live just including geographical borders of the boot. Economic relations go far beyond national borders. To rekindle and resuscitate the sovereign debt crisis with all the related negative effects would be very risky for Italy, Europe and the euro.

Hence, Italy represents an example of structural weakness that generates increases in the spread dynamics, starting from the high level of the debt-to-GDP ratio, together with repeated imbalances in the budget that delivers a relatively high deficit-to-GDP ratio.
At the same time, negative fluctuations in the values of bank assets, as well as in the values of bank shares and the ability to provide loans to customers, raise critical issues in the banking context that appear difficult to control.
The increase in the spread and the consequent negative impact on the balance sheet asset values, and on bank share values, imply asset losses for all investors in Italian public securities and in the capital of banks and other financial intermediaries. The downgrade by rating agencies caused significant drops in asset values. Evidently, the high level of public debt is a serious problem that has been lingering for many years and weighs heavily on the Italian economy. Although there are remedies for the problem, the will to impose and bring them forward seems to be lacking.
Regarding the downgrade by rating agencies expressed in October 2018, we need to note that Moody's cut Italy's sovereign debt rating to one notch above junk status because of concerns about government budget plans, but it found the outlook to be stable, while Standard & Poor's affirmed Italy's existing credit rating but lowered its outlook from stable to negative because of concerns about government's policies on economic growth prospects.

3. Instability in the spread with a rising tendency, produces a weakening of the banks that can extend to the level of capitalisation. This engages a dangerous mechanism that leads to a reduction in loans to the economy and, therefore, reduces the foundations for economic development that largely extend from adequate financing of companies and, in particular, small and medium-sized enterprises.
The financial turbulence in the euro area has highlighted the strong link between the credit risks of states and banks. Thus, the subprime mortgage financial crisis of 2007 caused the transmission of credit risk from the banking system to the public system. This gave rise to increases at the level of public expenditure and primary deficits or in public spending alone, leaving the primary deficit unchanged and so limiting fiscal correction possibilities. The second hypothesis implies balanced public finances and maintaining such equilibrium, thus producing no impact on the credit risk of public securities. This contrasts with the first hypothesis which focusses on the state's debt situation worsening, which introduces more or less serious deterioration factors and negatively impacts on the credit risk of public securities. The sovereign debt crisis caused the transfer of credit risk from the public system to the banking system to absorb value fluctuations arising in the context of government bonds due to still being present in the security portfolios of banks.
The increase in credit risk on public issuance is replicated in the market of credit default swaps (CDSs) showing its effect in the solvency of the states. Initially due to the subprime mortgage financial crisis, and later, more intensely, due to the sovereign debt crisis, the volumes of trading in derivatives under discussion showed an exponential growth in the economic choices of investors and in the strategies applied by the monetary authorities.
The measures that many states put in place to protect their banking systems and to overcome the economic recession increased the trade in CDSs. In particular, holders of government bonds poured into the market in question to purchase protection against a possible issuer default. In this regard, the crises manifested in Greece, Ireland, Portugal and Spain produced significant trade in the relevant CDSs.

Interestingly, although CDSs exist in almost all countries, many in emerging countries have characteristics that, given the lack of negotiation institutions, are intrinsically distinguished by high volatility. Given the circumstances, it is no coincidence that many parties have detected how the speculative attacks on CDSs provoke fluctuations in the relative prices and, consequently, have a considerable impact on the ability states subject to speculation have to finance at competitive rates.

Notably, CDSs usually imply worsening in state debts, generating increased spreads in sovereign debts perceived to be at greater risk and, as a consequence, the most exposed banks in these countries suffer losses in their financial instrument portfolios as their bonds, shares and derivatives.

Although there are many sales, the financial intermediaries represent the main holders of government securities. Therefore, the large sales that affect the government bonds of the countries most at risk subject the portfolio of financial instruments to heavy devaluation.

One can easily see that the hypothesis of imbalances in public finances through rescue plans, is affected by a return wave of credit risk initially transmitted by the banking system to the public system. This demonstrates the fact that if the sustainability assumptions of the credit risk the financial sectors generated are ignored, the process manifests diffusive and multiplicative features.

In such a context it is important to underline some points:

- Banks provide liquidity to the economy by broadly financing the private sector in various forms of loans to the economy; at the same time, they provide public sector financing to a large extent through purchasing public securities.
- Despite a scenario of progressively increasing rates and yields, the increase and the instability in the performance of the 10-year BTP-Bund spread has caused negative repercussions on bank stability, which is essentially expressed by fluctuations in asset values, higher collection costs, and continued negative impact on the expansion of loans and public securities.
- In the formulation of economic and fiscal policies it is for the reasons indicated above, necessary to consider and neutralise the negative impact on the spread.

The expansionary policies governments pursue should aim to avoid an increase in the spread due to the consequent negative impacts on banks and their ability to finance the economy by granting loans to the private sector and buying securities to the public sector.

It also follows that the mere objective of increasing economic growth can be nullified by an increase in the spread and the related negative repercussions on banks [9].

4. Economic growth can be achieved by means of a strong push towards public and private investments through banks' and financial intermediaries' financial support and that of the financial markets.

The importance of strengthening banking, insurance, mutual funds and financial markets has to be emphasised. Instability and increases in the spread that have occurred since the Conte government's establishment do not provide good assumptions, but rather tend to complicate the situation, with risks leading to large-scale financial crises and economic recession in Italy.

More generally, commercial banks can offer public and private financing through loans to public and private companies, and through purchasing public and private securities; insurance companies can do so through purchasing public and private securities, or mutual funds contribute to financing through purchasing public and private securities, while financial markets contribute through placements and purchases of corporate bonds and shares.

The increase in the spread expresses negative repercussions in granting loans and in purchasing public and private securities at the initiative of banks, insurance companies, mutual funds and financial markets. Further, the increase introduces negative and weakening elements to the ability of banks, financial intermediaries and financial markets to finance the economy.

Hence, we reiterate the importance of elaborating and conceptualising political and economic issues that, for the reasons indicated above, do not negatively impact on the spread. Economic policies should tend to reduce the spread for cost advantages and business competitiveness.

The stability and lowering of the spread to levels close to zero should be a priority and not a secondary objective in a country's economic and financial choices, due to the positive effects such spread will have on the cost of public funding, and on the cost of private financing. Further positive effects will be evident in grafting virtuous elements towards the process of economic growth that would be boosted by the lower cost of capital. Such lower cost is required for realising investments and production processes.

Increase and instability of the spread in the Italian BTP-German Bund across 10 years simultaneously show negative repercussions on financial market trends with reductions in the value of bonds and, especially, BTPs and in banking and financial equity. Additionally, they are also similar in creating obstacles on the basis of their capacity for new equity and even bond placements.

One has to recognise that the bond and equity placements attest to the industrial and financial firms' abilities to find resources of medium, long and indefinite terms that are best suited to supporting investments in input and new technologies.

In this context, the negative repercussions of high spreads and spread instability appear to be broad and different in intensity. They tend to involve banks (usually the most affected), insurance companies (affected at different intensities), mutual funds (affected in performance and in value fluctuations), and financial markets (affected by financial instability).

5. In the EU, the European Central Bank's pursuit of expansionary monetary policies has presented a frame and a general framework for all EU-membership countries.

The advantages of accommodative monetary policy were, however, not reflected equally in the economies of individual countries.

Quite obviously, the weakest countries in terms of economic growth should address the problem of reducing structural barriers to economic development through reform and, at the same time, should carefully consider the level of the spread of national government bond yields compared to yields of German public securities.

By retaining the spread at high levels (for example in the case of Italy), mechanisms of higher cost of interest expenditure on public debt, higher cost of fund collection, higher interest rates on bank loans to companies, and higher cost in the placement of corporate bonds are maintained. As a result, more obstacles to economic development remain.

Therefore, the BTP-Bund spread is not a slightly weighted, minor variable, but a variable of crucial importance. It relates strongly to the damage fluctuations in the spread increase due to its negative impact on banks' asset values, insurance companies' and mutual funds' holding public securities, and on bank and financial share values. Therefore, the BTP-Bund spread greatly affects the performance of financial markets. This points to the importance of the spread for adjustments to and the impact on various variables and on the financial system as a whole.

The subprime mortgage financial crisis and, in particular, the sovereign debt crisis have brought to the attention the spread and the dangers inherent in the increase in the spread, which are due to the negative repercussions of a higher spread on public accounts, public debt, the financial system and the economic system.
The choices of the Italian government seem to ignore the recent history of financial crises with all the dangers that financial instability hold and that have resulted from the financial instability inherent in the crises and bankruptcies of banks and financial intermediaries, in the crises and failures of financial markets, and in the events of economic crises themselves.
Italy's financial and economic problems derive from the structural factors explained above and that have been dragging on for many years. The challenges have certainly not been suitably addressed or resolved with measures of financial assistance; rather they have been exacerbated by increases in public spending and in public debt accompanied by increases in the spread, as well as by banking and financial instability already noticeable in the current phase.

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[2] See Visco I., Address, ACRI, *2018 World Savings Day*, Rome, 31 October 2018.
[3] See Banca d'Italia, *Bollettino Economico*, Aprile 2018.
[4] See Colombini F., Calabrò A., *Crisi finanziarie. Banche e stati. L'insostenibilità del rischio di credito*, Torino, Utet, 2011; Colombini F., *Risk, regulation, supervision and crises in the European Banking Union*, LEYR, vol. 4, part 2, 2015.
[5] See Banca d'Italia, Considerazioni finali del Governatore della Banca d'Italia, Roma, 31 maggio 2011, p. 12: "*Nostre stime indicano che la perdita annua attribuibile ai difetti della nostra giustizia civile potrebbe giungere a un punto percentuale*".
[6] See Cottarelli C., *I sette peccati capitali dell'economia italiana*, Milano, Feltrinelli, 2018.
[7] See OCSE, *Compendio degli indicatori di produttività*, 2018.
[8] See Banca d'Italia, *Finanza pubblica: fabbisogno e debito*, 2018.
[9] See Blanchard O., Zettelmeyer J., *The Italian Budget: A Case of Contractionary Fiscal Expansion?*, Peterson Institute for International Economics, 2018.

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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)

«The globalization paradox». Reflections and findings from Dani Rodrik's work

by **Francesco Capriglione**

Abstract: *The relevant socio-political implications connected to the significative changes of the global economic situation produced by such phenomenon need to be verified. In this regard, the analysis of the relationship between market globalization and political institutions carried out by Dani Rodrik appears to be crucial. The concrete solutions seek to guarantee democratic accountability by limiting the negative impact of the phenomenon under exam in relation to the possibility for each nation to autonomously determine its own way for development and well-being. Rodrik suggests the well-known «trilemma of the world economy», according to which the impossibility of simultaneously pursuing democracy, national self-determination and economic globalisation must induce countries to make choices. An intelligent globalisation must allow the pursuit of the return of power to national democracies in such a way that a more solid basis for the world economy is guaranteed, by the implementation of a restrictive revision of international rules, in order to leave adequate operating space to national governments.*

1. I accepted with strong interest the advice of Giancarlo Montedoro to arrange a debate between economists and legal scholars on *globalization*, keeping in mind the effect that the theory of '*smart globalization*' – which is at the basis of the seminal work of Dani Rodrik – has on such phenomenon. I believe that a common reflection from scholars coming from various disciplines can contribute to clarify the complexity of this peculiar time we are living, where the *uncertainties* derived from a slow economic process raise *questions* of different nature related to some political views which tend to mark a turning point in the traditional definition of «form of government».

More specifically, an analysis of the abovementioned phenomenon – which shall not be limited to the mere assessment of the gradual increase of economic and political relations between States occurred in the last decades – is absolutely relevant. Indeed, such analysis – if restricted in these terms – would allow to focus the new opportunities of growth that, following the globalization, interest all countries of the world[1], but, on the other hand, would exhaust its function in identifying the operative process that characterizes the increasing integration of capital markets and in influencing the definition of the conditions which are at the base of the stability of economic systems. Therefore, even if an analysis which allows to understand the financial reality – and, in particular, the problems related to gaps of growth, to insufficient incentives deriving from lower interest rates, to uncertainty of relation between growth of economy and credibility of politics[2] – is worth, it cannot be exhaustive because it provides only a partial view of the effects of globalization.

2. In this context, the relevant socio-political implications connected to the significative changes of the global economic situation produced by such phenomenon need to be verified. It has been argued that, as a consequence of the reduction of distances caused by the technologic revolution and the reduction of costs of transports, goods and persons[3], a «new middle class»[4] without territorial locations emerges, addicted to the «liquid modernity» life style [5], able to quickly move from one place of the globe to another, living in what Marc Augè defines «non-places or unknown places» standardized in the world (airports, hotels, etc.)[6]. In the perspective of such middle class, multinational corporations appear to be the leading actors of global economic expansion.
It derives the complexity of the examined situation. Further, the relationship between various realities and the increase of competition due to the globalization of the economy are associated to a different behavior of market actors who must face relevant risks (such as the risk of market turbulences), and to the limits of international institutions (whose role is characterized by forms of intervention of mere formal nature). It follows the identification of criticisms which move from the substantial reshaping of domestic productions to the nexus between economic growth of few States and the relocation of industries in emerging countries with lower labor costs (which, as a consequence, see the possibility of their autonomous development reduced). In this scenario, the increasing flows of irregular immigration (that lead to a path of «hope» fostered by illusory expectations of wealth) and the subsequent difficulty of a resultant «hospitality» that ensure conditions of common growth need to be considered as well since they contribute to create – from an ethical point of view – forms of extreme individualism and an unscrupulous cynicism which often translate into the dehumanization of personal relationships.
It is self-evident that, at present, the global market induces the research of interpretative methods applicable to the socio-economic reality and implies a regulatory system which should be aimed at identifying effective financial mechanisms based on a normative system characterized by rationality and fairness. In other words, the need to identify an *agere* criterion which, projected in an international context, implies (with reference to the action of single States) transparency of conducts and the respect of counterparties is perceived with much more pressure in an operative framework qualified by professionalism and by the preparation of a code of practice.[7]

3. On the other hand, the creation of a globalized market reflects the characteristics of a new *ius publicum*, «of modern *imperium* maritime investigated by Schmitt, without *limes*, without fixed boundaries, but based on the hegemony of a way of production, based on exchanges, on progress of *lex mercatoria*».[8] Indeed, globalization, on the one hand, acts as an incentive to enhance financial innovation (determining growing interdependences between market actors), but, on the other hand, determines the depersonalization of social relations. Such phenomenon affects the concept of *civitas*, in

which – because of the diffusion of a generally homogeneous organizational model – the rights of communities tend to a minimal level of services, which, however, may present some exceptions.

Hence, the crisis of the fundamental framework on which the modern legal positivism is based – centered on the «unity of law» as an essential aspect of completeness of legislation – emerges.[9] In particular, there are problems related to the structure of a legal polycentrism linked to the processes of globalization which is often hard to analyze under the light of past experiences of systems centered on sovereignty of state–nations. On the contrary, it seems clear that economic expansion is not only subject to market rules, which are unsuitable to ensure appropriate guarantees for all the members of civil society. Specifically, while evaluating the European context, the harmonization of domestic regulations shows inherent limits; furthermore, the options allowed to member States in the implementation of directives and their different transposition at the national level affect the 'system of legal sources', undermining the so-called juridical convergence (obstructed by the presence of intrusive control of effectiveness of the normative process, traditionally carried out by the political power).[10]

In addition, the clear changes in the public sphere should be mentioned. With the new *economic constitution*, based on principles of competition and market, we assist to a reshaping of the relationship between public and private, as well as of the administrative architecture. This distinction tends to progressively fade, causing indirect implications on the framework of results achieved by political regimes of various countries (in particular: the research for proper equilibrium between protection of the individual and safety of community values). The fact that the changes provided by globalization to international financial system stimulate the research of higher levels of efficiency cannot be neglected. In particular, efficiency is reached through competition between intermediaries and elaborated forms of risk allocation. In addition, the intense acceleration of the «process of financialization» in all economies should be underlined since, if excessive, it determines the disconnection of market activity from reality and contributes to spread a short-term perspective in all the players involved who expect benefits which may derive, for example, from a fluctuating variation of share prices.[11]

This operative context – even if intended to reflect positively on real economy – is not exempted from the imbalances caused by the growth of financial relations between countries in different conditions. The global market, despite an increase of production and consumption (adequately supported by a greater mobility of savings and by a significative contribution of funds to investments), still exacerbates the condition of dependence of certain countries against others (notwithstanding the expansion of developing countries productive capacity).

Therefore, the relevant opportunities of growth achievable by those countries are counterbalanced by negative effects. First of all, the risk of financial instability, which results amplified as a consequence of the fact that the extension of operativity on more markets determines the amplification of risk of *shock* that may spread producing a dangerous domino effect. The need to govern globalization in the examined context is a problem of fundamental relevance, which implies the possibility for fragile economies to recover and, more in general, the start of a phase of development of international systems which may determine the achievement of social objectives through a more equal division of the resources of the globe.[12] In this perspective, the circumstance that the analyzed process deteriorates in a wild *liberism* that leaves unchanged or exacerbates the inequalities between States and between different areas of planet shall be avoided.

In light of the above, the considerations formulated a few years ago by Giuseppe Conte in a seminal work where I acted as editor seem to be relevant. In order to illustrate the 'new paradigms of legal and economic research in the era of globalization', Giuseppe Conte emphasized the need to open a dialogue between «ethics law and economics» because «ethics introduces the principle and the practice of responsibility. Responsibility towards other citizens of the world, towards future generations and towards the entire context of biosphere». This is the premise for a plausible return of the politics to «that ability of synthesis and choice ... that arises from the foresight of thought and from the capacity to turn the initiatives to the benefit of entire collectivity».[13]

4. The inequalities caused by globalisation, the exploitation of labour and the poverty resulting therefrom, the undue profits of multinational companies which often take advantage of the economic processes thus triggered, the openness towards financial crises and other critical elements that characterize the phenomenon under exam have been subject to extensive analysis in literature. [14] The inadequate response of governments to the excesses of globalisation (especially in terms of social divisions and failure in establishing fair distribution processes) contributes to increase the intrinsic 'destructive' nature of globalization, and raises the problem to identify possible remedies for the preservation of democracy, without prejudice to economic progression.

In this regard, the analysis of the relationship between market globalization and political institutions carried out by Dani Rodrik appears to be crucial. The concrete solutions seek to guarantee democratic accountability by limiting the negative impact of the phenomenon under exam in relation to the possibility for each nation to autonomously determine its own way for development and well-being.[15]

Rodrik's mindset is focused on the connection between capitalism and democracy which has traditionally long characterized the essence of a model in which the socio-economic order is linked to the typical logic of liberal democracies. Indeed, the Author argues that it is possible to tolerate the process of 'creative destruction' induced by globalisation provided that political regimes are able to guarantee shared benefits, subject to the application of (technocratic) rules set out by a global government.

Hence, therein lies the «paradox» – pointed out by Rodrik – which consists in the conditionings – to which the positive function of the phenomenon under consideration is subordinated – deriving from the necessary uniformity of the aforementioned rules. This represents the logical premise in order to recognize a conceivable waiver of national sovereignty by the States and the possibility of autonomously determining the management guidelines of their economy. The reference to the difficulty of achieving this goal induces *our* Author not to consider a hyper-globalisation as unattainable *tout court*, having to clarify first some questions about the possibility of «restoring a healthy balance between national governance and global governance».[16]

While finding out the answer to such questions, Rodrik takes into account the socio-political reality that characterizes the current pluralistic system where «the various States keep having a sufficient degree of autonomy to resolve upon their social contracts and develop their own economic strategies». It follows the proposition of the well-known «trilemma of the world economy», according to which the impossibility of simultaneously pursuing democracy, national self-determination and economic globalisation must induce countries to make choices. If we want globalisation to progress – states Rodrik – we must choose between the different models of the nation-state or political democracy; and indeed, if «we want to defend and extend democracy, we will have to choose between the nation-state and international economic integration. And if we want to preserve the nation-state and self-determination, we shall make a decision between strengthening democracy and strengthening globalisation».

There is no point in stressing the complexity and difficulty of the way indicated by Rodrik, whose construction interacts on the problematic issues which, in recent times, have affected our country. The following is considered: *(i)* the criticism towards the technocratic *elite* due to its tendency to pursue hyper-globalization without adequate evaluation; *(ii)* the unknown variables of a sovereign logic aimed at the bringing to light national-statist concepts neglecting any possible negative repercussions of this political option; *(iii)* the prospect of an economic downsizing – related to hypothetical forms of 'happy degrowth' – inspired by the view of Serge La Touche, which is aimed at concreteness for the realization of a socio-economic egalitarianism, levelled downwards[17].

Rodrik does not hesitate to clarify that in «combining market and democracy integration»[18], the protection of social systems, in the presence of possible conflicts with the necessities of global economy, leaves no room for the need to proceed to the retreat of the latter. An *intelligent globalisation* must allow the pursuit of the return of power to national democracies in such a way that a more solid basis for the world economy is guaranteed, by the implementation of a restrictive revision of international rules, in order to leave adequate operating space to national governments. This construction may tend to overcome the negative aspects of an 'extreme globalisation', without affecting the economic benefits deriving from it, even if the suggested recipe could be mistakenly maintained as supporting *populist* positions, while the proposition of a less binding international regulatory system relies on the foundation of sovereign theses aimed at renouncing to political economy.

In particular, Rodrick's writings essentially aim at criticizing the strict neoliberalism dogma. He is fully aware that his analysis concerning the negative aspects of globalization could offer useful arguments to protectionists' positions, namely to the populist demagogues.[19] Therefore, he does not fail to emphasize that the maintenance of *democracy* implies the waiver of *economic sovereignty* in order to build a democratic space above the level of Nation-State.

There is no doubt that the crucial aspect of his research consists in finding out a rational point of equilibrium between economic progress, democracy and safeguard of national characteristics. All of the above is in accordance with what long time ago Hayek said, namely that, in a federation of national States, the difference among interests is larger than within a single State while, at the same time, the feeling of belonging to an identity through which overcome the conflicts is weaker.[20] Therefore, even the opinions of those who see the possibility to overcome the dichotomy between international markets and national laws by adopting more international rules through the Institutions governing global markets contrast with Rodrik's view; these opinions, in turn, show a clear distrust in the national laws, the regulatory limits of which are considered to be among the main reasons of the global financial crisis.[21]

Clearly, many have not realized that the primary purpose of *our* Author is to achieve a more 'human' and politically acceptable version of the globalization in relation to a renewed relationship between national entities and supranational entities. The pattern arising from his view may be realized through a sovereignty reduction to be achieved by means of the so-called democratic delegation, namely the self-limitation of sovereign entities' powers in light of the achievable benefits. It is not a coincidence that this view is led by the American example, in particular looking at the relationship between Federal dimension and State dimension, which is often taken into account in his writings!

5. I will conclude these considerations by mentioning the impact of Rodrik's theories on what he defines as the European dilemma, only after having underlined the difficulties – in terms of governing capacity and democracy – arising from the process of economic integration.[22]

It is well known that the European Union is currently divided between national-statist centripetal tendencies and the expectations of reforming the Treaties according to a more federalist and liberal-democratic logic. In the first case, the purpose of achieving progressive forms of cohesion induces to modify (*rectius*: to erode) from the inside the neo-functionalist setting, whereas, in the second case, the intention to maintain the values of cohesion and solidarity among people of the different Member States emerges.

Hence, the question is how to avoid anti–democratic drift risks which can end up in dissolving the EU, by ensuring, on the opposite, a 'new' path of unitary growth that in turn will create a social *status* and economic conditions which are suitable for the competition with the other giants of the global era.[22] The solution that has been proposed by Rodrik, according to his reconstructive logic, is of clear simplicity and consists in transferring part of national sovereignty without giving up democracy. The reference to the principle of subsidiarity – characterizing the EU's structure – is useful, since it allows self-regulation at local level and, at the same time, contributes to the creation of a common market, by limiting the European Union's functions to the regulation of the cross-border dimension.[23]

This is therefore the 'Gordian knot' that politics should untie: making a difficult choice, based on the knowledge of the different possible outcomes and consequently based on the convincement that sincerity towards voters (to use a Rodrik's expression) is betrayed if democratic statements which are not compatible with the above mentioned 'trilemma' are made. *Perhaps*, the real essence of 'change' lies in the ability to find out a suitable solution, also by giving up previous strategic preferences if necessary. This has been for long time a flag waved by populist movements, which have become popular over the last few years.

6. In light of the above, it is clear that, in Italy, Rodrik's theories are particularly interesting since they seem to contribute to the reflection and clarification concerning the difficult choices which – as I underlined at the beginning – should be made by politics in this difficult period of 'transition towards the new'.

In this regard, those – like me – who have believed (and still believe) in the building of a more unified Europe and, therefore, in the completion of the project started half century ago – certainly hope for the affirmation within the Union of a *pluralistic* context based on a democratic logic and for a better economic integration based on both cohesion and solidarity. And these objectives should avoid intermediate solutions, which are considered by Rodrik inadequate and inefficient.[24]

References:

[1] See Prasad-Rogoff-Wei-Kose, *Effects of Financial Globalization on Developing Countries: Some Empirical Evidence*, *LMF Occasional Paper*, No. 220, 2003.

[2] See Asso P.F., *Globalizzazione reale e globalizzazione finanziaria: aspetti teorici e problemi di regolamentazione*, in *Ragion pratica*, X, 2002, No. 18. At the institutional level, the reflection must be focused on the possibility to recognize permanent validity to the global economic order that lies in the management of monetary and economic relationships (*FMI, General Agreement on tariffs and trade-GATT, World Bank*). It seems self-evident that the realization of the «single currency», on the one side,

and the crisis of communist regime, on the other side, call for a definition of the examined reality, subject to the specification of roles and competences of individuals which, in the new international context, are called to carry out relevant functions. See on this argument Prasad-Rogoff-Wei-Kose, *Effects of Financial Globalization on Developing Countries: Some Empirical Evidence, LMF Occasional Paper*, mentioned.

[3] With the achievement of an integrated system of telecommunications improved by the information technologies we experience a development of new forms of commerce on «cyberspace»: on this discussion see Rifkin, *L'era dell'accesso,* Milano, 2000, *passim*, but in particular 22 and following; Alpa, *Relazione introduttiva* held at the conference "*Cyberlaw. Problemi giuridici connessi allo sviluppo di Internet*", organized on 9 July 1998 by the Cnel with the support of the Lawyers Council of Rome.

[4] See. Deaglio, *Postglobal*, Bari, 2004, where it is observed that globalization makes sense and advances only if the costs of production are lower than the costs of transport.

[5] See Bauman, *La modernità liquida,* Bari, 2002, who, in light of this terminology, underlines the metamorphic nature of modern humanity which releases from predetermined social roles as a member of a community, and becomes an individual who acts in the absence of norms moving from a material state to a liquid one.

[6] See Augè, *I non luoghi*, Milano, 1996.

[7] See Capriglione, *Etica della finanza mercato globalizzazione*, Bari, 2004, Chapter V.

[8] On the themes of globalization see Montedoro, *Attualità di Carl Schmitt nella lettura di Giannini e Nigro,* available at *http://www.giustizia-amministrativa.it.*

[9] See, *inter alia,* Balley, *Le Droit comme terra incognita: Conquerir et construire le pluralisme juridique,* in *Rev. Canadienne droit et societè*, 1997, 1 and following.

[10] See on this argument Cassese S., *Quattro paradossi sui rapporti tra poteri pubblici ed autonomie private*, in *Riv. trim. dir. pubbl.*, 2000, 390 ss.; Vilella, *Dove va lo Stato contemporaneo?*, in *Riv. it. dir. pubbl. comunit*., 2000, 43 and following.

[11] See. Capriglione, *Mercato regole democrazia*, Milan, 2013, 19.

[12] See Onida F., *La globalizzazione aumenta o riduce disuguaglianze e povertà?,* in *Il Mulino,* 2002, No. 1.

[13] See *I nuovi paradigmi della ricerca giuridica ed economica nell'epoca della globalizzazione,* in Aa.Vv., *Finanza impresa nuovo umanesimo*, Bari, 2007, 139 and following, in particular pages 161-162.

[14] See Stiglitz, *La globalizzazione e i suoi oppositori*, Turin, 2002; Id., *La globalizzazione che funziona*, Turin, 2006; irti, *Le categorie giuridiche della globalizzazione,* in *Riv. dir. civ.*, 2003, 1, p. 625; prasad-rogoff-wei-kose, *Effects of Financial Globalization on Developing Countries: Some Empirical Evidence,* LMF Occasional Paper, mentioned; Galgano, *La globalizzazione nello specchio del diritto*, Bologna, 2005; Esposito, *Istituzioni economiche internazionali e governance globale*, Turin, 2009.

[15] See, among the other works of Rodrik, *Has Globalization Gone Too Far?* Institute for International Economics,1997; Id., *The Globalization Paradox. Democracy and the Future of the World Economy,* 2011. (Italian translation by Cafiero, *La globalizzazione intelligente,* Bari, 2015); Id., *Dirla tutta sul mercato globale*, Turin, 2018 (Italian translation by Restani).

[16] See Rodrik, *Dirla tutta sul mercato globale*, quote p. 15.

[17] See, in particular, *Breve trattato sulla decrescita serena*, Italian translation by Grillenzoni, Turin, 2008, *passim*.

[18] See Rodrik, *Dirla tutta sul mercato globale*, cit.

[19] See Rodrik, *Populism and the economics of globalization* in *Journal of International Business Policy*, 2018, available at *https://drodrik.scholar.harvard.edu/files/dani-rodrik/files/populism_and_the_economics _of_globalization.pdf.*

[20] See Rodrik, *The Economic Conditions of Interstate Federalism*, Chicago, 1939, p. 121.

[21] See Lastra, *The Globalization Paradox: Review of Dani Rodrik, The Globalization Paradox: Democracy and the Future of the World Economy*, *International Journal of Constitutional Law*, 2013, p. 809.

[22] See *supra* note 3.

[23] See Rodrik, *supra*, p. 66.

[24] See Rodrik, *supra*, p. 67.

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

Fintech regulation: the need for a research

by **Valerio Lemma**

Abstract: *This article analyzes certain questions raised about the definition of 'fintech' and its fundamental elements, in order to highlight that the evolution of the European regulation (of the internal market for capitals, banking and financial services) suggests that the path will continue through the use of new technologies in banking and finance.*
In this respect, we focused on the key economic drivers and technological mechanisms of the market based financing, taking into account the results of the recent researches on the shadow banking system. This preliminary research suggests that the efficiencies of fintech should be the rationale for the development of the intermediation processes.

1. Questions raised about the definition of 'fintech' and its fundamental elements require an analysis of this phenomenon from a regulatory perspective; the answers should consider the definitions provided by the international bodies and European authorities, from both private and public perspectives. In this respect, this research aims at promoting a debate on the possibility that the legal analysis of a *wider* application of financial technology will promote an increase in the efficiency of the market for capital.[1]
In this context, US regulation (or deregulation) of Fintech offers a more comprehensive view of the relevant market. However, the scope of the aforesaid analysis shall take into account also the British approach to this topic, in the light of the Brexit perspective.
Nowadays, the recovery leads the financial markets to new equilibriums, and the operators are looking for new ways to improve the efficiency of banking and financial business. It shall be argued that fintech lies under the application of technological innovations to banking and finance, and such phenomenon requires specific rules to avoid asymmetries in the competition for providing banking and financial services.[2]Therefore, any clarification would start from the actual rules set forth the fintech, and will head towards the market structure which results from the latest regulatory acts.
In this context, the regulation of technologies (and their application to improve the performance of financial activities) relies on the same principle set forth the traditional banking and financial services'

industry. Then, the necessity of understanding if these principles would be able to satisfy the need for protection of the investors.

Nowadays, several researches cast the doubts that ICT service provider are able to produce the same *output* of banking and finance, as well as that the shadow banking system satisfy the needs of several firms and savers (in the market for capital and investments). Therefore, further researches shall clarify if such alternatives (to banking and finance) are able to play in the market (reserved to banks and financial firms) for competing with regulated firms for the supply and demand of (investing or obtain) capitals. Indeed, we need to understand whether there are rights to protect, and then the role of the international bodies, national governments and central banks in the oversight of the financial innovation (*i.e.* new tools and instruments provided by the evolution of personal devices, network infrastructures and software).

In this way, we expect that in the next months the regulator will assess the suitability of the EU regulatory framework concerning fintech more generally and in particular their impact on the financial stability or the rights of individuals. Hence, any critical analysis shall take into account the 'legal status' of fintech firms, as this intensive use of techniques means that traditional rules should apply anyway, so the question is how the public supervisory mechanisms shall ensure an adequate level of protection to investors.

2. In light of the above considerations, the assessment of the need for protection shall focus on the role that commercial and merchant banks are playing in the technological environment, and then identify the legal requirements able to apply an accurate control over risk taking and moral hazards.[3]

The key economic drivers and technological mechanisms of the market based financing – taking into account the results of the recent researches on the shadow banking system – would suggests that the efficiencies of fintech should be the rationale for the development of the intermediation processes[4]. Therefore, any research shall aim at clarifying that the current legal framework allows a lawful use of technology, but cannot allow an *escape* from the standards set by the regulator for the performance of certain activities or services.

From a regulatory perspective, it is essential to outline that, given the efforts at the supra-national level (*i.e.* the ones consolidated in the recent European Commission's Action Plan on Fintech, dated 8th March 2018), a coherent legal framework has not been established yet. This confirms the need for a specific legal analysis to support the forthcoming interventions, and that the importance of taking into account the externalities of the European Banking Union and their impact on the shadow banking system, having regard to the implementation of the Single Supervision Mechanism and the Single Resolution Mechanism.

According to this perspective, we expect that the regulator will be able to standardize the application of high-tech mechanism to the processes of financing and credit transformations, in order to manage the allocation of risks and benefits among the intermediaries and their clients.[5]

At this stage, the scope of fintech regulation shall refer to the most recent application of engineering to the activities falling under the rules governing the techniques of asset management and banking, and their impact on the open market operations. In this context, there is the need for assessing the use of blockchain technology (and the relevant matters due to its applications), taking into account the EU and the US perspectives.[6]

Notwithstanding the role of private law, good faith and dealing, public supervisor should assess the scope of the current need for transparency, having regard to the adoption of rules set forth both promoting the circulation of financial information and banning the use of bargaining power by one firm to exert influence over others.[7] This would help in addressing the responsibility of individuals in developing the fintech business and its market, taking into account the sanctions provided in order to avoid that the outcomes of this business does not improve the common welfare.[8]
In this context, the legal scholars should be in the best position for considering that fintech firms are applying new high-tech mechanisms to several stages of capital circulation. Therefore, they should raise specific questions concerning the need for regulating these firms, and then whether there is the possibility to set new principles (or rather the opportunity to recast the current ones) to ensure the safe and sound managements of the other people's money. The answers to such questions shall asses the possibility that fintech businesses would not jeopardize capital markets and, therefore, that public intervention is due in case of asymmetries, market failures or sunk-costs. In this respect, the role of central banks and supervisory authorities would be justified, as well as the possibility of a reserve concerning the 'high-tech service providers' operating in banking or financial markets.

3. At this stage of the analysis, we believe that the scope of the previously mentioned researches shall include also the use of currencies alternative to those reserved to central banks legally entitled to issue banknotes. We are going to highlight the need for investigating the operators that digitally issue and withdraw cryptocurrencies (as well as any one that pretends to issue money outside the traditional monetary systems). The results for such researches concern whether (and how) governments should oversee the activities of these operators and start any further intervention in order to ensure the proper functioning of the monetary mechanisms. [9]
Notwithstanding virtual currencies should enter into circulation via retail trade, we should exclude that these could support lending or reimbursement of savings (or any other activity reserved to supervised firms).[10] Furthermore, any money follows a specific path through the economy: people spend (online and in any other places that accepts virtual currencies) or deposit it (in any virtual warehouse eligible for such a goal).[11]
In this context, a deeper analysis will be able to start from the status of the current regulation of the shared record-keeping and processing system or the large global ledger account as a form of public intervention aimed at reducing the regulatory asymmetries in the capital markets.[12] This could lead to understand the need for other interventions (such as any improvement in the anti-money laundering regime of fintech firms) related to the regulation of the records made by every digital currency transaction that occurs (kept secure through cryptography).
In brief, we expect that the above-mentioned researches would verify the resilience of the financial system and the advantages due to the implementation of a mechanism which provides that if one party sends another party virtual currencies, then it will not send *files* from one party to another but it rather write the exchange down in a ledger (even if there is not a central authority or official body assigned with the task of updating a ledger and keeping track of all the transactions).[13] This leads to an un-centralized system and a set of information shared among an indefinite number of private operators. Therefore, we will investigate the need for additional tools able to monitoring these multiple ledgers and their synchrony, taking into account the risk arising from the lack of safeguards when a digital currency

transaction is made (which should be announced in the network so that particular transaction can be recorded by all the operators, making the ledger verifiable).[14]
Therefore, the results of such researches will bear out if the public authorities can oversight a peer-to-peer network, being maintained in terms of strict protocols and multiple copies of the same ledgers. In addition, these should suggests to verify whether central banks can improve sovereign virtual currencies in the context of their traditional activity. We cannot exclude that national central banks will issue 'public crypto-currencies'.[15]
As a result, blockchain technology and cryptography are, in the context of fintech business, part of the foundational innovations underlying the development of the financial markets. Hence, it should be verified the need for new rules related to this technology and, furthermore, if them shall be able to ensures that (public or private) crypto-currencies will not put savings at risk, jeopardize the monetary policies or reduce transparency, security and efficiency (of transactions that occur in the capital market).[16]

4. Concluding remarks highlight that the evolution of the European regulation (of the internal market for capitals, banking and financial services) suggests that the path will continue through the increase of fintech operations.[17] At the current stage, we are considering the fintech business as the outcome of the deregulation process started in the twentieth century, and we expect to observe that it will be a box for a large number of firms aimed at playing in the shadow banking system. Strands of research will be both the understanding of the credit transformation processes that find direct execution on the financial market and the focus on high-tech operational forms that can make the capital circulate from subjects in surplus to others in deficit according to different parameters from those established by the prudential supervision.

References

[1] We shall move from the consideration on the ' ongoing changes' to the current business models of fintech firms; see Engst – Lemma, *Insurtech and interoperability of Fintech firms,* in *Open review of management, banking and finance*, 2018, parag. 2 where it is highlighted that 'regulatory issues are related to the algorithms supporting the partially automated activities in insurance undertaking (and other advanced technique of risk mitigation)'.
[2] Thus, the need for a clarification of the scope of our research with regard to the role of the public in this sector; see Cassese, *Quattro paradossi sui rapporti tra poteri pubblici ed autonomie private,* in *Riv. trim. dir. pubbl.*, 2000, 390 ss.
See also Capriglione, *Considerazioni a margine del volume: il tramonto della banca universale?,* in *Rassegna Trimestrale di Diritto dell'Economia*, n.1/2018, p. 22 ff.
[3] See Engst – Lemma, *Insurtech and interoperability of Fintech firms,* in *Open review of management, banking and finance*, 2018, parag. 2 on the absence of significant changes of the national legislative framework, which 'should suggest a complete freedom in starting up a fintech firm that would support the business of insurance companies or distributors'.
[4] See Banca d'Italia, *FinTech In Italia. Indagine conoscitiva sull'adozione delle innova-zioni tecnologiche applicate ai servizi finanziari*, December 2017; Panetta, *L'innovazione digitale nell'industria finanziaria italiana*, Milano, 26 september 2017; Bofondi, *Il lending-based*

crowdfunding: opportunità e rischi, in *Questioni di Economia e Finanza*, n. 357, Banca d'Italia, March 2017, p. 7.

[5] See Capriglione, *Etica della finanza mercato globalizzazione*, Bari, 2004, Chapter V; see also Prasad-Rogoff-Wei-Kose, *Effects of Financial Globalization on Developing Countries: Some Empirical Evidence*, *LMF Occasional Paper*, No. 220, 2003; Lastra, *The Globalization Paradox: Review of Dani Rodrik, The Globalization Paradox: Democracy and the Future of the World Economy*, *International Journal of Constitutional Law*, 2013, p. 809

[6] See Engst – Lemma, *Insurtech and interoperability of Fintech firms*, in *Open review of management, banking and finance*, 2018, parag. 2 on both the consideration that 'the current legislative path for the adoption of a EU directive would not be timely for driving the innovation in this industry, anyway new rules should be able to set common standards (in order to ensure a fair competition in this market)' and the doubt 'that new technologies and different business models are spreading in the insurance business, so the monitoring of outsourcing (and then the perspective of certain developments in licensing the ancillary service provided to traditional insurance companies) should allow the starting of new form of supervision without jeopardizing the market for servicing'.

[7] See Financial Stability Board, *FinTech credit Market structure: business models and financial stability implications*, 22 May 2017

[8] See Simoncini, *The Constitutional Dimension of the Internet: Some Research Paths*, in *EUI Working Paper Law 2016;* Rosa, *Social acceleration: ethical and political consequences of a desynchronized high-speed society*, in *Constellations*, 1, 2003

[9] We shall consider that this article is influenced by the Italian approach to the regulation of money, in this respect see Ascarelli, *La moneta*, Padua, 1928; Savona, *La sovranità monetaria,* Rome, 1974; Stammati, *Moneta*, Enc. Dir., vol. XXVI, Milan, 1976; Capriglione, *Moneta, Enc. dir.*, Milan, 1999, p. 747 ff. In h respect, please see also the approach of Keynes, *A Treatise on Money*, London, Macmillan, 1930, I, chapter 1; Kelsen, *Il problema della sovranità e la teoria del diritto internazionale*, Milan, 1989

[10] See Troisi, Crowdfunding *e mercato creditizio: profili regolamentari*, in *Contratto e impresa*, Padua, 2014, p. 525

[11] See Plassaras, *Regulating Digital Currencies: Bringing Bitcoin within the Reach of the IMF*, in *Chicago Journal of International Law*, 14(1), 2013, p. 377 ff.; Pozsar, *Shadow Banking: The Money View*, 2014; Ricks, *Regulating money creation after the crisis*, in Harv. Bus. L. Rev., 2011, 1, p. 75 ss.

[12] See Nakamoto, *Bitcoin: a peer-to-peer cash system*, 2008; Troiano, *FinTech tra innovazione e regolamentazione*, relazione al convegno su «*FinTech: prime esperienze e prospettive di regolamentazione*», Roma, 4 dicembre 2017

[13] See Biferali, *Big data e valutazione del merito creditizio per l'accesso al peer to peer lending*, in *Diritto dell'Informazione e dell'Informatica* (Il), 2018, p. 487 ff.

[14] See Blemus, *Law and Blockchain: A Legal Perspective on Current Regulatory Trends Worldwide*, in *Revue Trimestrielle de Droit Financier*, 2017; Trautman, *Is Disruptive Blockchain Technology the Future of Financial Services?*, in *The Consumer Finance Law Quarterly Report*, 2016.

See also Hacker – Thomale, *Crypto-Securities Regulation: ICOs, Token Sales and Cryptocurrencies under EU Financial Law*, in *European Company and Financial Law Review*, 2018.

[15] The Euro was initially an electronic currency used by financial markets and for cashless payments (in 1999). Indeed, three years later, euro banknotes and coins entered into circulation in the form of physical notes, with physical security features regarding their authenticity (different from

cryptography), paper or centralized ledgers (for dematerialized transactions) to ensure that payments are not made to different parties using the same money and the possibility to circulate or stoke them with the traditional mechanisms.

[16] See Engst – Lemma, *Insurtech and interoperability of Fintech firms*, in *Open review of management, banking and finance*, 2018, on the current lack of regulation, where the Authors concludes that it could allow to an alternative to insurance companies, as well as to banks and other financial intermediary; this also cast shadows on the efficiency of the market for risk and coverages and, therefore, on the whole capital market, because of the possibility that firms subject to different regulatory and prudential regimes can offer the same services (under different conditions)

[17] See *European Commission's Action Plan on how to harness the opportunities presented by technology-enabled innovation in financial services (FinTech)*, 8 marzo 2018.

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