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ISSUES ON FINANCIAL MARKET REGULATION, BUSINESS DEVELOPMENT AND GOVERNMENT'S POLICIES ON GLOBALIZATION

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FOCUS ON GLOBAL PERSPECTIVES

DO WE REALLY UNDERSTAND DERIVATIVES?

Paolo Savona *

ABSTRACT: *The Author highlights that financial innovations are a constant presence in the financial market; this is both to resolve open issues and bypass regulations, as was the case of Eurodollars in the sixties to fill up the scarcity of Dollars and has been, since the nineties, for derivatives to manage increasing risks.*

With regards to derivatives, the literature maintains that they managed risk better than traditional instruments; they reduced the asymmetry of information; they were better at price discovery than other financial instruments; they lowered transaction costs; and they reduced exchange frictions. The Author has recourse to use the well-known logical construct of reverse causation objection maintaining that these advantages were in fact countered by several disadvantages: derivatives created risks as the opportunities to use them increased; they increased the asymmetry of information between operators in derivative and other market operators; rather

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* Paolo Savona is Professor Emeritus of Economic Policy, Chairman of Fondo Interbancario di Tutela dei Depositi [Italian Deposit Guarantee Scheme], Rome. Paper presented at the 8th Conference on Risk, banking and financial stability, Bali/Nusa Dua Convention Centre, September 24-27, 2013.

I'd like to thank Riccardo De Lisa for his assistance in preparing this Report.

than predicting market trends, they determined them; they increased transaction costs for some and reduced them for others; and they created new transaction frictions. The tentative to elaborate a risk indicator for derivatives must pass through the definition of assessment methods that can generate a fair value to be used for the purpose of the accounting requirements for banks, with a range of its variation as far as possible reduced.

1. Towards the end of the 1960s, when the dollar shortage became a dollar glut, the world wondered how on earth such a thing had come about. Fratianni and Savona [1970, 1971, 1972 and 1972] explained that the market had done what the international community had been unable to do creating the SDRs as an international currency, but with a statute which prevented to perform this role. Fratianni and Savona explained that converting what they called IMB (International Monetary Base) through the international banking system it was possible to get an abundance of dollars via the international deposit multiplier mechanism. This theory met with agreement from some [Kostanzer Seminar, 1970; Machlup, 1971; New York Times, 1971] and criticism from many [Klopstock, 1968; Heller-Drexler, 1972; BIS, 1974]. The problem ended up, along with those notorious ostrich heads, buried in the sand, also by initiative of official national and super-national authorities [Masera-Savona, 1972; Savona,

1974, and 1975]. The multiplication of dollars created by the American balance of payments on an IMB basis continued; they swelled up disproportionately under the effects of the universal “dollars welcome!” philosophy since the world monetary system collapsed.

When the United States withdrew from the Bretton Woods Agreement in 1971, the dollar became both fiat money chosen by the market and a ‘free rider’ that could be manipulated by public and private hands; the change of the official stance was inspired by the philosophy that “the dollar is our money, but your problem”. The central bankers reaction was to ask to increase the bank capital known as Basle requirements.

The problems of dollar excess were soon overtaken by the problems of the spreading of derivative contracts. At the beginning of the 1990s, everyone wondered how useful these contracts really were and many economists [The Group of Thirty, 1993; Greenspan, 1999; Cohen, 1999; ECB, 2000; Hunter-Smith, 2002] came together to ‘demonstrate’ that derivatives improved the functioning of financial markets in at least five ways: they managed risk better than traditional instruments; they reduced the asymmetry of information among market operators; they were better at price discovery than other financial instruments; they lowered transaction costs; and they reduced exchange frictions. This author sought recourse in that well-known logical construct, the reverse causation objection [Savona-Maccario, 1999; Savona-Maccario-Oldani, 2000; Savona, 2007; Oldani, 2008; Savona, 2010], maintaining that these advantages were in fact countered by several disadvantages: derivatives created risks as the opportunities to use them increased; they increased the asymmetry of information between derivative operators and other market operators; rather than predicting market trends, they determined them; they increased transaction costs for some and reduced them for others; and they created new transaction frictions. The logical conclusion of this counter analysis was that sooner or later, central banks would have to 'serve up' these contracts in the event of market crisis, also because some of the contracts were quasi-money. However, it was thought that the rationality of the market would never be pushed into generating serious crises, such as those triggered by the insolvency of large counterparties — which was the case with Lehman Bros. Even so, it was clear that at least central banks should have taken into account the derivatives that potentially formed part of total liquidity when deciding monetary creation and official rate policies. Yet rather than tackling the problem, the United States stopped producing M3 statistics.

The creation of derivative instruments spun out of control, first beyond the reach of the authorities and then beyond that of the market operators themselves, who were driven by the philosophy that financial markets were perfect too. This sparked a global crisis that did not have the consequences of the 1929-33 crisis because experience had left the authorities and the markets better prepared. Contrary to the Eurodollar explanation, the crisis came about because the arguments against derivatives were not taken into account, also because this author no longer found himself operating in a public or private techno-structure (or in weighty media), thanks to unpleasant currents running through the worlds of work and of culture. In those spheres, your ideas count if you are powerful, not because they are good ideas, and the functioning of markets is skewed by the weight of vested interests.

When speaking with derivative operators, I frequently asked them whether they truly understood what these instruments were. The question was considered irrelevant. Derivatives were an easy way to make a profit and pass on hot potatoes (and a true “lemons”) to those less provident, which is what happened with the American subprime credits that were packaged in complex derivatives. The operators usually replied: What’s the problem? The first warning signs were already there in the form of several large cases [the British bank Barings, 1995; the American firm LTCM, 1998], but the market was able to absorb them. The full virulent force of the crisis only appeared in 2008, when many primary operators faced difficulties that culminated in the failure of one of their biggest institutions (the above-mentioned Lehman Bros.).

The derivatives problem had many faces – or rather, many levels of complexity. The authorities really only tackled one of them, that of reinforcing private and public guarantees in the event of counterparty bankruptcy, asking banks to increase capital ratios, and creating (or trying to create) a shared fund, a ‘central counterparty’ controlled by the authorities and able to provide second-line guarantees to avoid involving already stretched public funds and the funds of central banks. With the power to create the monetary base, the latter would have the resources to intervene, but they have no intention of using their resources to improve the governance of the amount of money available, avoiding the indispensable and weighty task of being the lender of last resort.

In October 2012, the *Fondo Interbancario di Tutela dei Depositi,* the Italian Deposit Guarantee Scheme, approached its near 300 associated banks with the proposal of carrying out a survey on 'derivative risk'. The proposal was met with agreement. Its official purpose was to complete the series of risk indicators that the guarantee scheme uses in line with its mandate, but in fact, the research aimed to understand how to handle the financial instruments Warren Buffet [2002] described as 'time bombs'.

This is not a progress report, but rather a memorandum on the research carried out. It contains several personal observations on the subject, for which I alone am entirely accountable. The first official report will be released at the end of this year, and the conclusions will be available by October 2014.

2. The working group has identified three main issues to investigate, in both their theoretical and practical aspects: derivative contract valuation methods; existing or ongoing domestic-European-international regulations; and regulatory accounting or internal governance rules for reporting to managerial bodies. [1] The first conclusion reached by the group was that the probability of being able to control ex-ante the negative effects of market risks on derivatives was low, if not zero, and that as a consequence, it was necessary to stem the flow of these risks. In other words, we need to intercept the risks and redirect

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[1] The working group is headed by myself and reports to the FITD's Executive Committee. Riccardo De Lisa leads the technical guidance team, which comprises three experts, one for each issue: Rainer Masera, assisted by Chiara Oldani, for valuation methods; Stefano Mieli for regulations; and Umberto Bertini for accounting. Several outstanding young professionals also work with the group: Alberto Cagnazzo, Manuela De Cesare, Alessio Veccia e Roberto Mencarelli.

them before they hit the private (banking capital) or public (central counterparty fund) flood defences. But this solution does not reduce the extent of the risk created by operating in derivatives; it merely raises the barrier, which in any case remains too low to contain the risk in its entirety. Therefore, risks should be reduced by addressing the nature and regulation of contracts.

Two possibilities present themselves: eliminating OTC markets, or regulating them and/or banning them from these operations, at least for certain types of contract that are difficult to evaluate — all the non-plain-vanilla contracts. The authorities have been working on the first approach for some considerable time, but as yet, the only agreement reached – which was reiterated officially at G20 level – is that all contracts must have been reported to a central statistical body by the end of 2012. As far as the second option is concerned, the opposition to it professed by operators and economists/analysts, in good and bad faith, appears to be insurmountable.

3. The working group has identified five different categories of derivative risk:

- Market risks arising from adverse movements in the market prices (share prices, interest rates, exchange rates, prices of goods, volatility of risk factors, etc.) underlying the negotiated instruments.
- Counterparty risk tied to the possibility that the counterparty to a derivative contract may default before the transaction is settled.
- The operational risks of incurring losses due to inadequate/dysfunctional procedures, human resources or internal systems (e.g. losses caused by fraud,

human error, interrupted operations, system downtime, contractual default); legal risks; and moral hazards.

- Compliance risks in terms of the failure to comply with regulations (e.g. the MiFID directive that sets out the measures to adopt in order to bridge the information gap between intermediaries and clients).
- Reputational risks arising from a negative perception of a particular bank on the part of customers, counterparties, shareholders, investors or regulators following profit fluctuations, loss of current capital or the bank's prospects in terms of derivative contracts.

We spent a little time examining the first two types of risk (market and counterparty). However, for the other two (operational and compliance), the group deemed it necessary to extend analysis to the internal governance rules of banks dealing in derivatives, and the rules imposed by the authorities. These were considered from the starting point that the flood defences are unable to contain the risks inherent in these contracts and that the flow of said contracts needs to be controlled by internal and external rules that nonetheless do not restrict the usefulness of these instruments, when they are used correctly.

From this plurality of risks, there seems to be a need for a multiple indicator that captures:

- the impact on value of fluctuations in market variables (fair value VaR / -Stress Var – Sensitivity);
- the quality of the counterparty (the existence of collateral, whether counterparties are regulated);

- the quality of internal control systems and the organization in charge of risk management (sophistication);
- the quality of internal control systems and the organization in charge of compliance; and
- the company's compliance policies.

Clearly, arriving at an index that summarises a bank's derivative risk is a long and difficult process that calls for specific skills. To devise a practical solution, information was gathered via a survey of 25 associated banks, their full collaboration being testimony to the concern this problem raises at the highest levels of management. The same survey was then implemented in 20 banks outside Italy to give a preliminary overview of international differences, thereby ensuring that the working group was not working in isolation from what was happening outside Italian banks, and checking whether the research framework was sufficient to capture the whole picture. The results of the survey confirmed two pieces of information, one of which was already known: with the exception of a few large organizations, Italian banks are less involved in derivative operations than banks in other parts of Europe and of course, than those in other parts of the world. However, the news is that some small Italian banks have carried out these operations — few in number, but significant in size.

4. There are multiple pricing models, which complicates the task of ensuring that complex operations are correctly reflected in the accounts, both because of objective valuation difficulties and because the operations need to

be transmitted by those who carry them out to the accountants in charge of recording them.

The following table summarises the results, which still require deeper investigation:

Type of underlying	Valuation models used	Main market data and input parameters of models
Interest rate	- Net present value - Black - SABR - Libor market model - One-factor and two-factor Hull-White model - Bivariate log-normal - Yield on Italian government securities (*Rendistato*)	- Yield curves (deposits, FRA, futures, swaps, *Rendistato* basket) - Cap/floor option volatility - Correlation among interest rates
Exchange rate	- FX net present value - Garman-Kohlhagen - Log-normal model with uncertain volatility (LMUV)	- Yield curves - Spot and forward FX curves - FX volatility
Equity	- Net present value equity - Generalized Black-Scholes model - Heston - Jump Diffusion	- Yield curves - Spot prices of underlyings - Expected dividends - Volatility and correlation of underlyings

Inflation	- Inflation bifactorial	- Nominal Yield curves - Inflation rate curves - Seasonal coefficients of the Consumer Price Index - Inflation rate correlation
Commodity	- Net present value commodity - Generalized Black-Scholes model - Forward independent	- Yield curves - Spot prices - Forward and futures prices of underlyings - Volatility and correlation of underlyings

Source: Internal progress report n. 2 of the FITD Working Group on Derivative Risks, Rome, July 2013.

5. Following the introduction of the IFRS principles, derivatives are no longer considered to be off balance sheet transactions, a status they enjoyed until 2000. They are now recorded on balance sheets at fair value.

IAS 39 divides financial assets and financial liabilities into categories, each with its own specific accountancy procedure. In line with current legislation, derivative instruments appear on the balance sheet as either:

- assets/liabilities held for trading: this category is for financial assets/liabilities that deliver short-term results. From an accounting point of view, assets and liabilities are measured at fair value, with the corresponding gains and losses recorded on the profit and loss account;
- hedging derivatives: this category has a separate entry in assets (for positive fair value) and in liabilities (for negative value).

In line with the fair value measurements made for the balance sheet, the profit and loss account contains the variations and net results resulting from derivative operations, classified according to the nature of the contract.

IAS 39 only permits devaluation for lasting losses: it stipulates that a financial institution has sustained a lasting loss if its book value is higher than its estimated residual value. Accounts must be checked for lasting losses at the close of each accounting period.

The value expressed by the fair value measurement depends on fluctuations in the prices of the underlying compared to the prices at the time of the negotiation (mark-to-market accounting).

The use of fair value presents several accounting problems:

- ✓ It does not reflect the existence of connected cash contracts/positions or speculative derivatives contracts (whose fair value is recorded individually), such that a combination of two separate purchase and sale contracts for the same underlying must be recorded as separate financial assets and liabilities (at nominal values);
- ✓ It is not a measure of credit risk because it does not reflect the existence of netting and/or collateralization agreements;
- ✓ However, the IAS principles favour fair value accounting above that of notional volumes because the latter produces distorted values.

In fact:

- It does not reveal underlying risks, especially non-linear risks;
- It does not facilitate the weighing up of the different financial durations of risks; and
- It does not take into account reductions in credit risk resulting from compensation guarantees or agreements.

In conclusion, even from an accounting point of view, we have yet to find a satisfactory presentation for derivatives.

6. The aim of this research is to arrive at a risk indicator that facilitates the functioning of the deposit guarantee scheme's indicator system. Yet it is also driven by the desire of a bank's managerial boards to have a satisfactory system that reports on derivative operations in their offices and those of regulators. As such, the problem becomes one of identifying the governance rules for this activity in order to guarantee that information flows in a correct, transparent, uninterrupted fashion.

This is the only way that a risk indicator can be meaningful, both for operational and for monitoring purposes.

In terms of how to create this pairing of governance rules/indicator for derivative risk, the working group has not yet reached a conclusion. This is in part because – and this is an important aspect of the problem – there are no case studies or even pilot programmes to study, neither among Italian banks nor abroad.

Herein lies the legitimacy of the question posed at the very start of this memorandum: "Do we really understand the risks faced by a bank that operates in derivatives?" As banks play an important role in the economic system – they are the judges (magistrates) of credit risk – and because their request for an intermediation margin has an ethical justification in that they are better at performing this role for society than any other institution (the so-called "asymmetric information"), the failure to provide a response and the difficulty of obtaining a response from the banks themselves, as well as from academics, poses a serious problem to the legitimacy of entering into contracts of this nature.

It may well be a question of ethics, but its economic consequences are severe.

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DERIVATIVES' PRICING AND MODEL RISK

Rainer Masera – Giancarlo Mazzoni*

ABSTRACT: *Derivatives play a key role in financial markets. Pricing of complex and highly-non standardized product can be difficult posing serious problems in terms of model risk. Valuation uncertainties may seriously jeopardize a proper valuation and a prudent risk management of these instruments. This paper summarized the key issues in terms of model risk by highlighting the main weaknesses implicit in standard pricing techniques used by practitioners and academics.*

The last part of the paper is devoted to analyze how the new CRR/CADIV capital standards and the EMIR seek to improve the safety standards in respect of derivative transactions of banking firms.

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1. Derivative markets can be OtC (Over-the-Counter) or organised exchanges. OtC markets are in general bilateral, with all characteristics negotiable between the parties. Exchange traded markets are standardised and cleared through a clearing house. The size of both markets has shown very significant increases, notably in the New Millennium. The trend was briefly reversed during the 2007-2009 global financial crisis, but end-2013 amounts have returned to pre-crisis levels. Total notional amounts outstanding of derivatives are much larger in OtC, as against exchange traded markets (Oldani, 2013 tabs 1-6).

The valuation of derivatives which is necessary for operational, accounting and regulatory purposes can be highly complicated. It is relatively simple for linear derivatives (forwards, features, most swaps), but it becomes complex and requires specific models for non-linear contracts (plain and exotic options, credit default swaps, which are in general option contracts). A key common element of derivative valuations is represented by the discounting of cash flows. Following the Black-Scholes approach (1973), in active, efficient markets valuation is based on the so-called risk-free replicating portfolio. Under IFRS standards, IAS 39 requires that all derivatives be marked at “fair value” (mark-to-market).

Valuation techniques, therefore, play a fundamental role in measuring and assessing derivatives markets. Risk models have acquired paramount importance. However, as recently pointed out by Jarrow (2010): “*Financial risk management models were often used wrongly prior to the 2007 credit crisis, and* *they are still being used wrongly today. This mis-use contributed to the crisis……The 2007 credit crisis was a wake-up call with respect to model usage*".

Uncertainty on the choice of a derivative pricing model can lead to "model risk". With the proliferation of quantitative methods in risk management and the advent of complex derivative products, mathematical models have acquired an increasingly important role in the context of pricing and hedging. Obviously the use of models has led to a better understanding of risks, but, at the same time, it has given rise to a new type of risk, known as "model risk" or "model uncertainty," linked to the uncertainty on the choice of the model itself.

It is a widespread feeling among both academics and practitioners that, although some models do a better job than others, the search for one ultimate model is futile.

Uncertainty regarding the pricing model can determine a mispricing of derivatives. Even if model uncertainty is acknowledged by most operators who make an effective use of quantitative models, most of the discussion on this topic is qualitative and we don't have a quantitative framework for measuring model uncertainty. As pointed out by Cont (2006), when we deal with "model risk" the key questions are:

- How sensitive is the value of a given derivative to the choice of the pricing model?
- Are some instruments more model-sensitive than others?

- How large is the model uncertainty of a portfolio compared with its market risk?
- Can one provision for "model risk" in the same way as one provisions for market risk and credit risk?

Furthermore, Cont (2006) points out that: "*One could wonder whether model uncertainty deserves a separate treatment from other sources of uncertainty in financial markets. Indeed, the classical approach to decision under uncertainty …… does not distinguish between different sources of risk: model uncertainty should be indistinguishable from market risk, credit risk, . . .which would imply that "model uncertainty" simply amounts to weighting various models with probabilities and representing all sources of uncertainty using a probability distribution on the enlarged space comprising "models" plus scenarios".*

Market participants typically use different criteria to measure "traditional risks" (i.e. market risk, credit risk, etc…) and "model/valuation" risks. The former are valued by using probabilistic models while the latter is typically approached through a worst case approach, for instance by stress testing of portfolios and/or running two (or more) competing alternative models. This has led to "*…the distinction between risk (uncertainty on outcomes for which the probabilities are known) and ambiguity or model uncertainty—when several specifications are possible for such probabilities (Knight 1921). Ellsberg (1961) has shown that aversion to ambiguity clearly plays a role in decision making."* (Cont, 2006) .

2. Derman (1996) recognizes that there are at least three different meanings implied by the word model in finance:

1. fundamental models;
2. phenomenological models;
3. statistical model (i.e. a regression/best-fit between different data sets).

For instance, Black-Scholes theory belongs to fundamental models. These models attempt to build a fundamental description of some instrument or phenomenon. On the other hand, phenomenological models are less fundamental and more expedient, but may be equally useful. Both the first two classes of models embody some sort of cause and effect.

The last class (i.e. statistical models), rely on correlation rather than causation. Users of these models probably hope that the correlation is a consequence of some dynamics. Strictly, statistical models describe tendencies rather than dynamics (Derman, 1996).

"…*Equity and fixed-income option trading and structuring grew in part because of the confidence that developed in using the Black-Scholes model and its extensions. The growth in model building and model adoption has also depended on the rapid acceleration in computing power. Computing and modelling have played a sort of leapfrog: more power allowed for fancier* *models which then ran too slowly, and so in turn required even more power…."* (Derman, 1996).

Jarrow (2011) distinguishes between two types of assumptions used with respect to any model: robust and non-robust (critical) assumptions. *"A robust assumption is one where the implications of the model only change slightly if the assumption is modified only slightly. This corresponds to a "continuity" in the topology of the model's structure. In contrast, a non-robust or critical assumption is one where the implications of the model change discretely if the assumption is only changed slightly. This corresponds to a "discontinuity" in the topology of the model's structure…… This distinction is important because since models are approximations of a complex reality, we may not get the assumptions exactly correct. With robust assumptions, we do not need to worry too much. For small errors in the robust assumptions, the implications only change by a small amount. We need to be careful, however, with the critical assumptions. If we get the critical assumptions wrong, by just a little, the implications completely change. Of course, for large errors in robust assumptions, the implications will also change significantly, despite the "continuity." So, even the robust assumptions are important in model construction. There is only one way to determine if an assumption is critical or robust. This is to extend the model, relax the assumptions, and determine analytically if the implications are changed continuously or not. This determination is a key purpose of generalizing models".*

The standard derivatives' pricing models assume frictionless markets with:

- no transaction costs;
- no trading restrictions or short sale constraints;
- competitive markets, with price-taking agents;
- no arbitrage opportunities.

By adopting the Jarrow's criteria/distinction only the absence of transaction cost can be labelled as a "robust" assumption. All the remaining assumptions are "non-robust"/"strong" assumptions. In particular:

- hypotheses of no trading restrictions (short sale constraints) is crucial for all the models used. Its violation makes the market incomplete and may eliminate the opportunity to implement hedging strategies. Therefore pricing may change completely;
- competitive markets (or no permanent quantity impacts on the price process) is another critical assumption. Its violation generates market manipulation, by causing a complete reversal of pricing and hedging (Jarrow 1994).

Furthermore, when analyzing derivatives' pricing it is important to remember than when build a valuation model of any type, we are implicitly assuming that the variables studied are causally related to each other, and that the relationship is stable, at least for the time that we intend to apply the model. Both these hypotheses may be questioned when we deal with derivatives' pricing. As Derman (1996) pointed out: "*The physical sciences where* *quantitative modelling originated, the variables in models are universal quantities like time, position and mass, that (presumptively) have an existence even when human beings are absent. In contrast, in the financial world, you are dealing with variables that clearly represent human expectations. Even the simplest statement "More risk, more return" refers to expected risk and expected return, not realized quantities. These are hidden variables: they cannot be directly observed except perhaps by surveying market participants, or by implying their values insofar as they impact other measurable quantities by way of a theory or model. Thus, models that use concepts like return or volatility are in most cases assuming a causal and stable connection between the values of these hidden (often unarticulated) variables and security values."*

3. Derman (1996) defines different types of model risk in derivatives' pricing:

1. wrong model (i.e. inapplicability of model and/or incorrect model). The most fundamental of risks is that modelling is just not applicable to a particular pricing/risk management problem. Unfortunately there's frequently a temptation to think that complex mathematics has an applicability of its own. However, even when we accept the applicability of a model we could face serious problems in terms of variables specification, incorrect assumptions, etc.;
2. model implementation and usage: like technical mistakes in finding the analytic solution to a model, errors in the numerical solution to a

correctly formulated problem, programming mistakes, hardware flaws, unstable data, etc.

One of the most relevant sources of error in using a model to value options is that even a correct model requires the user to input a value for the unknown volatility of the underlying from the present through expiration day. Volatility estimation error causes model risk when forecasted values are used in place of the true volatility in a pricing model. Model risk will produce mispricing of derivatives and also inaccurate hedging calculations. To give a fair analysis of model risk exposure, it is important to allow option writers to make optimal use of the information they have available in making their decisions.

For instance, European options are often priced and hedged using Black's model (1976), or, equivalently, the Black-Scholes model. In Black's model there is a one-to-one relation between the price of a European option and the volatility parameter. Consequently, option prices are often quoted by stating the implied volatility, the unique value of the volatility which yields the option's dollar price when used in Black's model. In theory, the volatility in Black's model is a constant. In practice, options with different strikes require different volatilities to match their market prices. Handling these market skews and smiles correctly is critical to fixed income and foreign exchange desks, since these desks usually have large exposures across a wide range of strikes. Yet the inherent contradiction of using different volatilities for different options makes it difficult to successfully manage these risks using Black's model. The development of local volatility models by Dupire (1994) and Derman-Kani

(1994), was a major advance in handling smiles and skews. Local volatility models are self-consistent, arbitrage-free, and can be calibrated to precisely match observed market smiles and skews. Currently these models are the most popular way of managing smile and skew risk.

4. An important problem associated to derivatives' pricing is related to its possible "time inconsistency". The practice of re-initializing interest rate models daily with observed prices is so widespread that it has become an accepted market tool. This practice, however, is inconsistent in the sense that it violates the dynamic assumptions underlying the model and from which derivative prices and hedge factors are computed. This behaviour is similar in spirit to the practice of using current ''implied'' parameters, such as the implied volatility, from quoted market option or cap prices. Both behaviours grew from the model inability to reproduce relevant aspects of price dynamics, along with the need for trading books to be marked to market prices.

Correlations play a central role in financial markets, and therefore, in derivatives' pricing. Correlation between asset returns change over time. Asset return correlations often peak during financial crises when multiple markets suffer severe declines in asset values. More generally, it is well known that equity return correlations increase when prices go down. Despite this evidence, the pricing of correlation risk and its importance in terms of model risk has not received enough attention in the literature (on these points see Masera and Mazzoni [2013]).

As previously pointed out standard derivatives pricing theory relies on the assumption that one can borrow and lend at a unique risk-free rate. Piterbarg (2010) stressed that: "*The realities of being a derivatives desk are, however, rather different these days, as historically stable relationships between bank funding rates, government rates, Libor rates, etc, have broken down. The practicalities of funding, that is, how dealers borrow and lend money, are of central importance to derivatives pricing, because replicating naturally involves borrowing and lending money and other assets".*

These peculiarities determine valuation formulas for derivative contracts that incorporate the modern realities of funding and collateral agreements that deviate significantly from the textbook assumptions. Piterbarg has shown that the pricing of non-collateralised derivatives needs to be adjusted, as compared with the collateralised version, with the adjustment essentially driven by the correlation between market factors for a derivative and the funding spread.

5. Even recognizing that there is no magic strategy for avoiding model risk, Derman (1996) proposes several rules of thumb for its mitigation. His main suggestions are reported below:

- "*regard models as interdisciplinary endeavours*". Modelling is multidisciplinary: it touches on the practicality of doing business, on financial theory, on mathematical modelling and computer science, on computer implementation and on the construction of user interfaces;
- "*test complex models in simple cases first*". It is important to test models against simple known solutions;

- "*test the model's boundaries*". Often, a new model overlaps on older and simpler models. In that case, test the boundaries. If it's an option model, make sure that when the option is deep in the money it behaves like a forward. For a convertible bond model, guarantee that it behaves like a straight bond when it's deep out of the money. Too many complex models go wrong because complexity obscured the error in the simple part of the model.
- "*don't ignore small discrepancies*";
- "*provide a good user interface";*
- *"diffuse the model slowly outwards"*.

6. The CRR/CADIV capital standards and the EMIR seek to improve the safety standards in respect of derivative transactions of banking firms. The new rules have an important bearing on risk modelling, which will adopt improved methodologies, with a clear distinction between OtC transactions (which are disincentives) and trades which are cleared through a central counterparty (CCP).

Banks' operating in the OtC market are exposed to a direct counterparty credit risk (CCR), i.e. the risk that the counterparty will default and will fail to pay contractual future payments. Modelling of CCR should, therefore, be taken fully into account when the fair value of derivatives positions is calculated: this adjustment is referred to as credit value adjustment (CVA).

Prior to the 2007-2009 financial crisis, a common market practice was to neglect this crucial adjustment when modelling mark-to-market OtC derivative portfolios: cash flows were discounted at the (risk-free) Libor interest rate curve. The CVA is the difference between the risk free and the true portfolio values, i.e. the monetised value of the CCR. A common measure of CCR exposure is the maximum peak exposure (MPE), which represents the maximum loss in case of counterparty default at any point in the future.

CCR is a primary concern of CRDIV, which imposes a mandatory CVA charge, thereby giving precise indications on the modelling process of this type of risk.

The new CRR/CRDIV capital requirements rely on IFRS 13 (Fair Value Measurement), which has become effective in January 2013. Fair value is characterised as an exit price that would be received or paid in an orderly transaction. A key component of fair value is precisely the CVA. As indicated, reference to an exit price requires to move from historically based to risk neutral parameters. Counterparty risk capital standards, through the introduction in general of CVA VaR, significantly increase capital held against bilateral credit exposures. Banks must evidently align front office, accounting and capital requirements. A major challenge is posed by stress conditions/scenarios and, therefore, by stress tests, when exposures and credit spreads widen simultaneously. Traditional greeks are usually complemented by more sophisticated instruments, such as jump to default and cross gamma. In any event, the deficiencies of VaR approaches under endogenous risk can hardly be overcome (Masera and Mazzoni, 2013).

Derivative trades that are cleared through a CCP are collateralised daily, which clearly reduces CVA charges. Each end-investor trades with a clearing broker, which in turn faces the CCP. The exposure that the broker has vis-à-vis the client is the same it has to the CCP. The CADIV approach takes into account that centrally cleared trades present lower risks, but it recognises that banks face, in any event, an exposure to CCPs.

Risk modelling must, therefore, take this factor into account through: (i) risk weighting on exposure to the CCP (2% capital charge) and (ii) a contribution to the CCP default fund, based on a *pro rata* calculation of banks' percentage contribution to the fund itself.

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INSTITUTIONS AND FINANCIAL MARKETS:

AN INSTITUTION-BASED VIEW OF DERIVATIVES

Paolo Boccardelli – Ilaria Supino*

ABSTRACT: *In a period of great institutional changes as is the one in which we live nowadays, the need for a context-based analysis of economic phenomena is progressively emerging. In the light of this, the article's contribution is basically twofold: on one hand, it defines an institutional view of the financial sector by analysing the extent to which some environmental variables shape finance diffusion; and on the other, it narrowly focuses its attention on peculiar financial instruments (i.e. derivatives). The paper aims to identify and highlight the institutional roots of financial derivatives through the analysis of political, regulatory and country-specific factors that may concur to enhance or discourage the adoption of the instruments in question. From an institution-based perspective, the use of derivatives widely relies upon contextual elements and, hence, cannot be exclusively attributed to purely economic conditions.*

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Although this paper is the result of a joint reflection of the Authors, Paolo Boccardelli wrote the paragraphs 1 and 5 and Ilaria Supino wrote the paragraphs 2, 3 and 4.

SUMMARY: 1. Introduction: institutional predictors and economic phenomena - 2. Institutional determinants of financial derivatives - 3. Banks, legitimacy and institutional underpinnings: the role of compliance in the use of derivatives. - 4. An institution-based view of financial derivatives. - 5. Concluding remarks.

"Let me issue and control a nation's money

and I care not who writes the laws"

Mayer Amschel Rothschild

1. Even though for a long time the economic science has neglected the role of institutions in the evolution of social systems of production and exchange, recently they returned to the centre of theoretical speculation as preeminent conceptual means devoted to explain different types of economic phenomena.

Generally speaking, for *institutions* we mean "the written and unwritten rules, norms and constraints that humans devise to reduce uncertainty and control the environment[1]". They massively impact on economy meant as a common field where individuals interact in repetitive settings and share mutually valid prescriptions.

As Hayek wrote "human reason can neither predict nor deliberately shape its own future. Its advances consist in finding out where it has been

[1] See MÉNARD – SHIRLEY, *Handbook of New Institutional Economics*, Springer, 2005.

wrong[2]": this quote, with regard to our discussion, clearly suggests that institutions should not be perceived as passively watching individuals who make decisions in full possession of the necessary information since the instrumental rationality postulate of neoclassical theory at the base of this reasoning does not contemplate the possibility that the actors involved can be partially informed and the markets can be imperfectly conducted. Thus, the neoclassical perspective does not account for the *cost of transacting*, i.e. that cost due to the expensive nature of information asymmetrically held between the parties protagonists of an exchange. Institutionalists tried to fill this *lacuna* arguing that both formal rules and informal norms help in lowering transaction costs.

As is easily intelligible, the attempt to unfasten the *protective belt* of neo-classical economics (that is, rational choice as maximizing individual utility, no information/transaction costs, stable preferences, equilibrium outcomes) has been put in place by institutional economics in several forms: some have sought more exhaustive answers in the issues of human interdependences[3] or power distribution and interests protection[4]; others

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[2] See HAYEK, *The Constitution of Liberty,* University of Chicago Press, Chicago, 1960.

[3] See VEBLEN, *Why is Economics Not an Evolutionary Science?* In *The Quarterly Journal of Economics, 12(4),* 1898, pp. 373-397; HODGSON, *Economics and Institutions: A Manifesto for a Modern Institutional Economics*, Polity Press and University of Pennsylvania Press, Cambridge and Philadelphia, 1988; SJÖSTRAND, *Towards a Theory of Institutional Change*. in Groenewegen, Pitelis and Sjöstrand (eds.): On Economic Institutions: Theory and Application. Cheltenham: Edward Elgar, 1995; VATN, *Institutions and the Environment*. Cheltenham UK and Northampton USA: Edward Elgar, 2005.

have explored the theme of institutions as *value articulating* structures[5] or as *equilibria position*[6]; still others have contextualized the institutional theory in the fields of firm organization[7].

Institutional infrastructures may include formal rules, informal norms, established conventions, shared beliefs and observed constraints. They make human activities meaningful and unhinge self-reporting relationships. They build up a bundle of interrelated elements evolving in a path-dependent way, channelling interactions and creating dominant models of acting.

According to a *structuralist* approach[8], institutional factors play a leading role in determining the overall performance of an industry. Elements such as governmental incentives for investment, regulatory intervention, tax reliefs or macroeconomic policies direct impact on the industrial structure (for example by preventing horizontal mergers or breaking up large incumbents), on the conduct of economic agents (for

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[4] See SCHMID, *Property, Power, and Public Choice. An Inquiry into Law and Economics*, Praeger, New York, 1987; BROMLEY, *Searching for sustainability: The poverty of spontaneous order*. Ecological Economics, 24(2-3), 1998, pp. 231-240.

[5] See JACOBS, *Environmental Valuation, Deliberative Democracy and Public Decision-making*. In Foster, (ed.): *Valuing Nature? Economics, Ethics and Environment*, Routledge, London, pp. 211-231, 1997.

[6] See AOKI, *Toward a Comparative Institutional Analysis,* The MIT Press, Cambridge Massachusetts, 2001

[7] See DI MAGGIO - POWELL.. *Introduction,* in Powell and Di Maggio (Eds.), *The new institutionalism in organizational analysis*, University of Chicago Press, Chicago, 1991, pp. 1-38.

[8] The underlying logic here has its roots in the structure-conduct-performance paradigm of industrial organization economics as it has been formalized by the Harvard economist Edward Mason, in the 1930s, and by his student Joseph Bain, in the 1950s.

instance, imposing price controls in order to avoid a profit-maximizing price) or on firm-specific performance (e.g. environmental constraints, employment policies, fiscal restrictions).

In the light of this, it is intuitive to understand why, during the last decades, institutional dynamics have drawn the attention of theorists and researchers in the attempt of explain why some economic constructs stand and why some others do not.

Institutional factors such as contractual guarantees, codes of conduct, property rights protection, standardized weights and measures, disclosure agreements, and imperative enforcement contribute to several economic functions: lowering transaction costs, mediating perceived risks, reducing environmental uncertainty, and encouraging trust in shared and fair precepts.

Such an institution-based approach derives its origin from the observation that "organizations compete not just for resources and customers, but for political power and institutional legitimacy, for social as well as for economic fitness[9]": in our discussion, we will treat institutions as exogenous entities embodying the cumulative learning that a society is able to endogenously create.

Consequently, the staring point for developing this metatheoretic framework is to admit that all players of the economic arena govern their relationships for reaping "*community-justified*" benefits and they cyclically

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[9] See DI MAGGIO – POWELL, *The "iron cage revisited" institutional isomorphism and collective rationality in organizational fields*, in *American Sociological Review,* 48*,* 1983, pp. 147-160.

seek for external legitimacy.

From a theoretical point of you, institutional insights have been widely used for interpreting several economic and financial topics such as transaction costs [10], firm performance [11], production structure [12], modes of governance [13], economic development[14], reactions to legal system [15], foreign direct investment strategies[16], property rights[17]; corruption[18],

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[10] See WILLIAMSON, *Transaction-Cost Economics: The governance of Contractual Relations*, in *Journal of Law and Economics*, 22 (2), University of Chicago Press, 1979, pp. 233-261.

[11] See NORTH, *Institutions, Institutional Change and Economic Performance*, Cambridge University Press, Cambridge, 1990

[12] See COESE, *The institutional Structure of Production*, Nobel Prize in Economics documents 1991-1, Nobel Prize Committee, 1991

[13] See MÉNARD, *Markets as institutions versus organizations as markets? Disentangling some fundamental concepts*. *Journal of Economic Behavior and Organization,* Vol. 28(2), Elsevier, 1995, pp. 161-182.

[14] See ENGERMAN – SOKOLOFF, *Institutional and Non-Institutional Explanations of Economic Differences,* NBER Working Paper, 2003; MURREL, *Firms facing new institutions: transactional governance in Romania*, in *Journal of Comparative Economics,* Elsevier, vol. 31(4), 2003, pp. 695-714; SHIRLEY, *Institutions and Development*. in the *Handbook of New Institutional Economics.* Co-editor with Claude Menard. Springer, 2005.

[15] See LA PORTA, *Do Institutions Cause Growth*? in *Journal of Economic Growth*, vol. 9(3), Springer, 2004, pp. 271-303; RUBIN, *Legal Systems as Frameworks for Market Exchanges*. In Ménard and Shirley (eds.), *Handbook of New Institutional Analysis,* Springer, 2005, pp. 205-228.

[16] See GLOBERMAN – SHAPIRO, *Governance infrastructure and US foreign direct investment*, in *Journal of International Business Studies,* Palgrave Macmillan, vol. 34(1), 2003, pp. 19-39; CHUNG – BEAMISH, *Investment mode strategy and expatriate strategy during times of economic crisis*, in *Journal of International Management*, 11 (3), 2005, pp. 331–355.

[17] See ALSTON – MUELLER, *Property rights and the state.* In Ménard and Shirley (eds.), *Handbook of New Institutional Analysis*, Springer, 2005, pp. 573-590.

[18] See LEE, *Corruption in Asia: pervasiveness and arbitrariness,* in *Asia Pacific Journal of Management*, 24, 2007, pp. 97-114.

venture capital [19], dynamic capabilities [20], rents and profitability [21].

By discovering the overwhelming importance of institutions in predicting the level of development in countries around the world, it is nevertheless desirable to specify in advance that the institutions under consideration herein depart somewhat from the traditional view of institutions as *societal organizations*.

Concretely, both institutions and organizations give a structure to human interaction; but conceptually we should carefully differentiate the rules from the players. Rules (i.e. institutions) define the way the game (i.e. economic interaction) is played by actors (i.e. organizations). This means that institutions should not be perceived as passive background conditions but, conversely, as proactive means instrumental to economic harmonisation.

Several recent [22] and less recent [23] contributions have tried to show

[19] See AHLSTROM, BRUTON, YEH, *Venture Capital in China: Past, Present, and Future,* in *Asia Pacific Journal of Management,* 24, 2007, pp. 247-268.

[20] See DUNNING – LUNDAN, *The institutional origins of dynamic capabilities in multinational enterprises*, in *Industrial and Corporate Change*, 19 (4), 2010, pp. 1225-1246.

[21] See AHUJA – NARAYANAN, *Explaining Influence Rents: The case for an Institution-Based View of Strategy*, in *Organization Science*, 22 (6), 2011, pp. 1631-1652.

[22] See DJANKOV, *Regulation and Growth*, World Bank Working Paper, 2006; JACOBZONE, *Assessing the Impact of Regulatory Management Systems: Preliminary Statistical and Econometric Estimates*. 2010, OECD Working Papers on Public Governance n. 17. Paris, Organization for Economic Co-operation and Development.

[23] See HALL and JONES, *Why Do Some Countries Produce So Much More Output per Worker than Others?*, in *Quarterly Journal of Economics*, 114 (1), 1999, pp. 83-116; ACEMOGLU, JOHNSON and ROBINSON, *The Colonial Origins of Comparative Development: An Empirical Investigation*. American Economic Review, 91(5), 2001, pp. 1369-1401; RODRIK,

up how the economic development of a country or of a sector could be described in institutional terms in order to appreciate not just resourced-based or market-related elements but also configurational and environmental features.

The final aim of such a new theoretical framework consists in seeking for the reasons why some economies/segments/companies thrive and others fail, with the difference of making such research not in the usual places of the speculative inquiry (namely, markets and resources) but in the less explored field of institutional intermediation.

2. Past literature has thus far concentrated on the role of institutions in shaping economic performance by demonstrating that institutional adequacy may sustain or magnify growth [24]. More specifically, some working papers focused their attention on the influence that a country's institutional heritage exerts on *financial* activities. In fact, many researchers try to theoretically and empirically test the link between *finance* and, namely: *law issues* [25], *long-term growth* [26], *political forces* [27],

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SUBRAMANIAN and TREBBI, *Institutions Rule: The primacy of Institutions Over Geography and Integration in Economic Development*, CEPR Discussion Papers 3643, C.E.P.R. Discussion Papers.

[24] See ACEMOGLU, *Reversal of Fortune: Geography and Institutions in the Making of the Modern World Income Distribution*. Quarterly Journal of Economics, 117(4), 2002, pp. 1231-94; GORGENS, *How does Public Regulation affect Growth?* University of Aarhus Department of Economics Working Paper N. 2003-14, 2003.

[25] See LA PORTA, *Law and Finance,* in *Journal of Political Economy*, 106(6), 1998, pp. 1113-1155.

creditor protection [28], and *political instability* [29].

Schumpeter [30] inaugurated the interest in the study of the relationship between financial development and economic growth, stating that financial intermediaries play a crucial role in fostering innovation and long-run prosperity. The concept of a well-functioning financial sector as engine of economic development was then taken up by Goldsmith[31], McKinnon [32], Khan [33], Levine [34], and many other more recent authors. The starting point of their consideration is that well-developed financial systems helps efficient resource allocation, identifies hidden investment opportunities, fosters entrepreneurial innovation, and reduces the risk of moral hazard or adverse selection, by containing simultaneously the costs

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[26] See BECK, *Finance and the source of growth*, in *Journal of Financial Economics* 58(1-2), 2000, pp. 261-300.

[27] See RAJAN – ZINGALES, *The great reversals: the politics of financial development in the twentieth century*, in *Journal of Financial Economics,* 69(1), 2003, pp. 5–50.

[28] See DJANKOV, MCLIESH, and SHLEIFER, *Private credit in 129 countries*, in *Journal of Financial Economics,* vol. 84(2), 2007, pp. 299-329.

[29] See ROE – SIEGEL, *Finance and Politics: A Review Essay Based on Kenneth Dam's Analysis of Legal Traditions in The Law-Growth Nexus*, in *Journal of Economic Literature*, 47(3), pp.781–800.

[30] See SCHUMPETER, *The Theory of Economic Development: An Inquiry Into Profits, Capital, Credit, Interest and Business Cycle*, Harvard University Press, Cambridge, 1912 [1934]

[31] See GOLDSMITH, *Financial Structure and Development,* Yale University Press, New Haven 1969

[32] See MCKINNON, *Money and Capital in Economic Development*, Brookings Institution, Washington, 1973

[33] See KHAN, *The finance and growth nexus*, Federal Reserve Bank of Philadelphia Business Review, January/February, 2000, pp. 3-14.

[34] See LEVINE, *Bank-based or market-based financial systems: which is better?*, in *Journal of Financial Intermediation,* 11(4), 2002, pp. 398-428.

of transactions. Financial intermediaries have more accurate information or, more precisely, have greater ability in managing and exploiting that information. For this reason, by leveraging on their expertise, financial operators are able to generate economic opportunities in a more productive and valuable manner than ordinary individuals actually do.

Having a clear idea of that, the next logical step in our work is to describe the extent to which some factors, different from market-based ones, do contribute to the development of the financial sector and, consequently, of the domestic economy. A country's structure inevitably channels the roads of financial growth since no financial advances may be reached without fair *governmental legislation* [35], favourable *legal constructs* [36], stimulant *cultural background* [37], or adequate *social capital accumulation* [38].

Rajan and Zingales assert that "the essential ingredients of a developed financial system include the following: (1) respect for property rights, (2) an accounting and disclosure system that promotes transparency, (3) a legal system that enforces arm's length contracts cheaply, and (4) a regulatory infrastructure that protects consumers,

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[35] See BENCIVENGA - SMITH, *Financial Intermediation and Endogenous Growth*, in *Review of Economic Studies,* 58, 1991, pp. 195-208.

[36] See RAJAN – ZINGALES, *Financial dependence and growth*, in *American Economic Review*, 88(3), 1998, pp. 559-586.

[37] See STULZ – WILLIAMSON, *Culture, Openness, and Finance*, in *Journal of Financial Economics*, 70(3), 2003, pp. 313-349.

[38] See GUISO, *The Role of Social Capital in Financial Development*, in *American Economic Review*, 94(3), 2004, pp. 526-556.

promotes competition, and controls egregious risk-taking [39]." As it is easily understandable, the human likelihood to exchange money and assets strictly depends on the institutional framework in which actors are asked to operate. In the financial sector, institutions play a direct and prominent role since they permit non-simultaneous exchanges of money and assets that boost investments and, hence, growth. Where the institutional context proves to be weak, economic players may avoid financial transactions not believing in the reliability of subscribed contracts.

Consider, for example, the banking segment where non-simultaneous transactions are held and a risk for the value of the assets in transit is faced. This branch of the financial system primarily relies on lending and borrowing activities, and no profit will be earned if people involved do not trust about the security of their transaction. For this reason, banking transactions require a kind of market more likely to need third-party enforcement. When banking entities do not rely on third-party enforcement of property rights, lenders may feel unsecure about mortgaged assets in the event of borrowers' defaults. First, the *law system* enforces financial contracts through property rights, courts and registers and it limits the types and terms of contracts that a bank is permitted to write down. Second, the *government* aligns incentives of both bankers and depositors by imposing the constitution of reserves against risk or by defining minimum standards of capital adequacy. Third, the *authorities*

[39] See RAJAN – ZINGALES, *The great reversals: the politics of financial development in the twentieth century*, in *Journal of Financial Economics*, 69, 2003, pp. 5–50.

periodically control banking activities promoting best practices and sanctioning unfair conducts. Fourth, the *rating agencies* matter for banks since they judge their ability to recover liabilities and their likelihood of default.

From an institutional-based point of view, different environments differently shape banking systems worldwide.

So, if we analyse the banking world in institutional terms, we learn that licences for entering the business of banking are released with a heterogeneous degree of restrictions in different countries, as well as for the rigidity of regulatory restrictions on the possibility for banks of owning shares in non-financial firms, on the capital requirements, and on the government interferences and active ownership and control on financial institutions.

The bank field is a particularly fertile ground for an analysis of institutionalist type since, being peculiarly sensitive to changes in regulations and thrusts of political innovation, can be the object of a comparative intra-systemic study. For doing that, we will focus our discussion on a specific aspect of the financial world: the usage of *derivatives*.

Originally born as commercial *bets* on the future prices of agricultural commodities, derivative contracts represent largely abused financial instruments devoted to pursue different aims including hedging, speculation, risk management and infra-markets arbitrage. The logic behind is quite easy: derivatives are “simple bets on the future - nothing less, and nothing more. Just as you might bet on which horse you expect to win a horse race and call your betting ticket your 'derivative contract,' you can bet on whether interest rates on bank deposits will rise or fall by entering an interest rate swap contract, or bet on whether a bond issuer will repay its bonds by entering a credit default swap contract[40]". Thus, they are delegated to enhance future expected cash flows by reducing financial risk (commodity, interest rate or currency one).

It is deemed necessary to clarify that the aforementioned derivatives have been originally largely diffused with the intention of risk coverage, and only subsequently and improperly they have been converted as means of risk-taking for speculating on the market. And these undisciplined speculative impulses have put derivatives to the centre of the economic investigation after the disastrous financial crisis started a few years ago. In regard of this, however, it would be not correct or at least exhaustive to address the aforementioned issue without contextualising it within the institutional places where facts have occurred and still occur.

Very often, in fact, the use of derivatives traces its roots in particular institutional arrangements that promote or suppress the recourse to those financial instruments. Exemplifying, in this respect, is the case of local authorities in Italy, which, starting from the first half of the 90s, began to use derivatives for their financial purposes. It is

[40] See STOUT, *Why re-regulating derivatives can prevent another disaster,* 2009. Comment on derivatives regulation in the Harvard Law School Forum on Corporate Governance and Financial Regulation.

peacefully acknowledged that the massive deployment of such financial instruments has been dictated by contextual conditions. As one can intuitively understand, the derivative market access is in general linked to the economic size of a country, since more solid and liquid financial pools are typically associated to wider economies. This is certainly not the case of Italy which, in the last twenty years, has witnessed a not light collapse of its GDP, and in spite of this, has seen a massively increase in the domestic exposure to financial derivatives, particularly at local government level. To give an explanation for this phenomenon, it would be incomplete to look at purely economic and financial factors since "behind the scenes" we can discover *cultural* as well as *political* reasons.

Firstly, according to the Mifid directive and Italian regulation, local authorities may be treated as professional clients since they are supposed to be more experienced than retail ones. Decentralized governments are intended to be more knowledgeable with financial issues and risk assessment to the point to be afforded less regulatory protection than private clients. In fact, no obligation applies to financial intermediaries (*i.e.* sellers of derivatives) in order to submit their counterpart to an *adequacy* assessment in the view of the derivative transaction. And this because it is assumed that the local administrations, handling large amounts of public money and implementing investment decisions on a daily basis, should perfectly know how to assess the convenience of the relevant financial transactions. On the contrary, the Italian experience shows very frequently that local administrators do not have the right amount of competence and financial knowledge for ensuring a fair assessment of risk management. Thus, in such a case, it is evident how the usage of derivatives in funding management of local authorities may strictly depend upon country-specific variables such as regulatory precepts. In Italy, it has been recorded several disputes on this topic, because sometimes the freedom to agree derivatives contracts has been misused by local administrators. This is why the Ministry of Economy and Finance - wishing to stem the aforesaid phenomenon of "risky hedging" at the level of local administration - has vehemently stressed the need of protection of local authorities. This explains both the choice to treat municipalities as retail investors (in order to ensure them a full set of information concerning what they are intended to buy) and the prohibition of derivative agreements (temporarily stated by Article 62 of Law Decree No 112 of 25 June 2008 and then permanently imposed by the recent financial 'stability law' for 2014).[41]

Secondly, an *abuse* of derivatives could enable local administrators to immediately obtain large amounts of money (as upfront). This positive cash flow is at once accessible and permits, in the short run, optimal response to municipal needs that bind the consensus of local population. Hence, under this circumstance, there is the risk that this abuse is inevitably linked to political reasons (since the primary factor that drives the local governors to make use of such financial instruments is the ability

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[41] See CAPRIGLIONE, *The use of «derivatives» by Italian local authorities in public finance management. Still an issue,* in this Review *infra*.

to use liquidity provided by the derivatives in order to broaden their political consensus). It is clear that the aforementioned intervention of Ministry of Economy and Finance also prevents this *bad-practice*, in order to avoid an unfair and hidden increase of the local authorities' debt.

3. In such a fast-moving regulatory environment, financial companies attempt to adopt the institution-based view (IBV) within their organizations even through the tool of *functional compliance*. This term traditionally refers to the collection of internal procedures designed to prevent and detect violations of applicable laws, regulations, rules and ethical standards. Constituting an important component in the process of creating business value, the specific function of *compliance* may be defined as "a state of conformity or identity between an actor's behaviour and a specified rule[42]" and may be alternatively meant as avoidance of punishment or as obedience to a precept. Crucial factors such as changing financial markets, incentives to innovation, international projections have made compliance a key resource for the success of any form of business: it helps in promoting internal audits, it establishes behavioural benchmarks aimed at preventing unlawful conduct, it signals the impact that new regulatory scenarios can have on the operational activities of the organization, it may reduce the severity of penalties when violations of law occur and it assists corporate structures in the slavish application of

[42] See RAUSTIALA - SLAUGHTER, *International Law, International Relations, and Compliance*, in *The Handbook of International Relations*, edited by Walter Carlnaes, Thomas Risse and Beth Simmons, Sage Publications, Ltd., 2002.

the rules to be respected. Managing rules and conforming to existing institutional arrangements, could represent nowadays an incredible source of competitive advantage since being unprepared to such a circumstance may cause *compliance costs* hard to recover.

According to PwC's State of Compliance 2013 Survey, the compliance function wears a role of growing importance in a transnational business environment: chief compliance officers (CCOs), in the attempt of providing more value for money spent, pay great attention to this aspect since compliance failures are the biggest source of reputational risk: a deficient compliance program may determine negative publicity, harmful money distractions and low performance. In discharging their duties, CCOs should verify that corporate policies are conforming with codes of business conduct, anti-discrimination and employment laws, environmental and health and safety laws, anti-bribery laws, antitrust and competition laws, and securities laws. As you might guess, this business function takes on particular relevance for companies operating in an international context, which should be accordant to stringent and complex legal mandates worldwide.

The relevance of this tool has been clearly established by the compulsory requirements, for banks and other financial intermediaries, to bring their own compliance function. This explains why, in Italy, there is a specific obligation to prevent the so-called *non-compliance risk* defined as "the risk of incurring judicial or administrative sanctions, material financial loss or reputational harm as a result of violations of statutory provisions (laws or regulations) or self-regulatory codes (e.g. bylaws, codes of ethics, corporate governance codes)[43].” This requirement should be assimilated especially by those business realities forced to reason with international breadth. In such a way, the regulator aims to avoid damages to property or reputation as a result of an incorrect application of institutional, fiscal and regulatory the precepts[44].

In the case of financial derivatives, compliance became progressively crucial for banks and other intermediaries since different jurisdictions elaborate their own regulation. In EU, the legal framework is referred to as “European Market Infrastructure Regulation” (EMIR) while in USA Title VII of the “Dodd-Frank Wall Street Reform and Consumer Protection Act” (enacted for pursuing similar disciplinary aims). If we think that those two sets of rules have different reporting requirements, types of obligation applicable to end-users, or standards for trade repositories, we easily understand the critical role of the compliance function in the international capital markets, especially regarding the trading of OTC derivatives (agreed between US and EU banks).

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[43] See BANK OF ITALY, Supervisory Regulations, *The Compliance Function*.

[44]Using the worlds of the Basel Committee on Banking Supervision (2005) “Compliance laws, rules and standards generally cover matters such as observing proper standards of market conduct, managing conflicts of interest, treating customers fairly, and ensuring the suitability of customer advice. They typically include specific areas such as the prevention of money laundering and terrorist financing, and may extend to tax laws that are relevant to the structuring of banking products or customer advice. A bank that knowingly participates in transactions intended to be used by customers to avoid regulatory or financial reporting requirements, evade tax liabilities or facilitate illegal conduct will be exposing itself to significant compliance risk”.

4. As is known, the institution-based view does not evaluate institutions as mere control variables but treat them as independent superstructures by focusing "on the dynamic interaction between institutions and organizations and considers strategic choices as the outcome of such an interaction[45]". However, defining the level of institutional quality within a country, a region or in general within a community may be a very difficult exercise.

Kaufmann, Kraay and Mastruzzi [46] constructed six indicators providing a punctual assessment of different aspects of a country's institutional quality: such parameters measure different aspects of a nation's institutional life going from democratic accountability and civil freedom to government stability, from bureaucracy capability to fiscal effectiveness, from property rights protection to the degree of bribery. We will use such variables as different perspectives from which closely analyse financial derivatives and their institutional origins.

In terms of (a) *voice accountability*, we assume that democratic

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[45] Mike W. Peng et al. (2009) define the Institution-Based View as "a Third Leg for a Strategy Tripod", trying to bridge in this way the well-known shortcoming of attention to the contexts, which is typical of the two leading "more elderly" theories of strategy: the industry-based (Porter, 1980) and resource-based (Barney, 1991) views. As we largely know the former perspective is basically market-oriented while the latter interprets the potential competitive advantage as mainly springing up from resources and capabilities endogenously generated. Adding a third appendix to this consolidated theoretical framework is to admit that "institutions matter" in the sense that they directly and massively impact on economic performance within countries and industries.

[46] See KAUFMANN, *The worldwide governance indicators: methodology and analytical issues*, Policy Research Working Papers Series 5430, The World Bank, 2010.

infrastructures enhance financial development and, consequently, boost financial innovation. Civil and political rights are supposed to reduce political power, secure individual positions and thus incentive investments and transactions. Democracy promotes the efficiency of financial markets, by lowering transaction costs. However, democratic systems may generate an agency conflict problem between elected representatives and electing population: the higher is the level of trust that the citizens of a country have in the selection process of their own politicians, the greater is the commitment of governors in administrating public money. The active role of democratic electors may influence risk management choices and, intuitively, mitigate the use of dangerous and not always transparent means as derivatives are. Concerning (b) *political stability*, individuals are supposed to invest, hedge or speculate with their own money when property rights are granted. Those rights are secured only when a government is expected to last and is asked to reinforce individual and civil protection [47]. However, the capability of a government to not be destabilized or overthrown by violent actions or unconstitutional means could not be enough for promoting the use of financial instruments. (c) *Government effectiveness* must stand since elected political forces may be inefficient or irresponsible, recording delays in the formulation and implementation of policy. A proper public management may incentive private initiatives by permitting fair competition and by disciplining rent

[47] See OLSON, *Dictatorship, Democracy, and Development*, in *The American Political Science Review,* Vol. 87(3), 1993, pp. 567-576.

seeking behaviours. Moreover, fair elections and democratic systems need to be institutionally legitimized through adequate and well-functioning legal frameworks.

Institutional factors such as (d) *regulatory quality* and (e) the *rule of law* are without doubt the most incisive elements on the use of derivatives. In general, both financial and non-financial firms operating in efficient legal environments are more likely to use derivatives since contract enforcement lowers transaction costs. The efficiency of legal framework and the trust in the judicial system guarantee the security of contracts between private agents and, consequently, the entering into derivatives contracts. Law enforcement controls (f) *corruption* and prevents illegal misappropriation of money harmful for the development of the financial sector.

Very often financial intermediaries tend to exploit cross-sectional institutional voids in order to gain profits from the sale of derivatives in countries with deficient legal systems. Globalisation pushes international banks to "cross the border" and to reap benefits from regulation asymmetries. Banks and other financial intermediaries try to build up a market share abroad by trading innovative derivatives with domestic partners. Their final aim, however, is very often to elude tighter and prudential regulation by operating in countries with unprepared local supervisors. Financial globalization rendered *systemic* the risk borne by the operators involved who are generally more interested in profits rather then in the stability of the markets. The financial crisis started in 2008 demonstrated how interconnected the global financial system is and how much a *global* institutional reform for avoiding another international financial crack is deemed necessary. According to the IBV approach, the last crisis was more intrinsically *institutional* rather then purely economic. The mistake was not financial but regulatory: it was not Wall Street but the wide myopia of policy-makers to lead to catastrophe.

In a period of great institutional changes - as is the one in which we live nowadays - derivative regulation is the vivid example of how a healthy market could not exist without a strong institutional framework. And for strong institutional framework we mean a mixture of proper legal means and political common sense. This is instrumental to understand that what happens on the markets, whether or not regulated, may have a *social* as well as financial cost. Integrated economies, globalizing markets and convergent legal systems require a holistic vision since no economic efficiency can be reached without a real institutional effectiveness.

Let's consider financial derivatives once again. When policy makers and worldwide rulers reduced their intervention in the field of derivative regulation, the *over the counter* market proliferated since deregulation[48] made both hedging and *speculative* contracts easily enforceable. In the light of this, it is partially incorrect to blame for the financial distress the

[48] Traditional legal constraints on OTC speculation were progressively removed. This dismantling of laws led to the legalization of speculative OTC trading in derivatives. Such a removal, as Prof. Lynn A. Stout asserts, eliminated prudential rules according to which those "derivative contracts that couldn't be proved to hedge an economic interest in the underlying were deemed nothing more than legally unenforceable wagers".

greed of any Wall Street trader who, being professional *gambler*, plays his game according to the rules imposed upon. Now, since institutions are "the *rules* of the game in a society, or more formally, are the humanly devised constraints that shape human interaction[49]", it is evident that, where normative control lacks, no instrumental rationality may exist. Responsible for evaluating the social welfare consequences of uncontrolled derivatives exchange are not margin-oriented traders but politicians and rulers, whose main task should be to prevent that an unproductive and unwarranted risk would be further added to the system. Until there will be absence of adequate regulation at the global level, the normative incongruities among countries will allow international operators to use derivatives in order to earn profits that, in hindsight, have an institutional rather than economic derivation. After all, derivatives force the capital markets and institutions of capital markets force intermediaries to compete with derivatives.

5. According to the previous paragraphs, it is clear how institutional factors may cause the use – and the abuse - of derivatives. This is why we examined how the institutional changes following the last financial crisis produced enormous effects on derivatives market and on their regulation. The necessity of re-regulating the OTC derivatives has not been fully satisfied by EMIR and other set of rules mentioned above. This pushes

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[49] See NORTH, *Institutions, Institutional change, and economic performance*, Harvard University Press, Cambridge, 1990.

several countries to discuss standards, practices but overall rules for disciplining the (ab)use of these financial instruments.

The guarantees of an effective contractual enforcement as well as the efforts to reduce the excess of information asymmetries between the different actors of the transaction may produce a path towards a viable and efficient development of financial derivatives. Moreover, these types of financial tools have been originally developed to cover from the excesses of a specific risk exposure. Notwithstanding, the heterogeneity of institutional and regulatory frameworks has allowed a use of derivatives as a tool to develop abnormal returns even in financial markets with flat returns. Since the international financial system is globally interconnected, the implementation of measures that, being not uniformly applicable, may maintain the possibility of regulatory arbitrage for financial players in a market like the one of derivatives that has been defined for different purposes.

These misuses and abuses of financial derivatives have been mainly determined by the lack and the inefficiencies in the institution-based arrangements in some countries and markets. Therefore a more comprehensive and efficient regulation as well as the development of more effective legal and institutional systems may reduce the likelihood that derivatives might be adopted for aims different from the risk edging.

We can conclude that transparency cannot be achieved in the absence of legal guarantees, operational efficiency cannot be attained in the absence of regulatory effectiveness, and temporary profit cannot be converted into permanent wealth in the absence of clarity about the methods of creating the wealth itself.

THE ROLE OF FINANCIAL DERIVATIVES IN THE EU PROCEDURE ON EXCESSIVE DEFICIT AND DEBT

Gabriele Semeraro*

ABSTRACT: *In view of the forthcoming revision of the EU Protocol on Excessive Deficits, the role of financial derivatives in the monitoring procedure is examined, taking into account the recent approval of the new European System of Accounts (ESA10) and the developments in accounting standards, as well as other possible reasons to change. Special attention is deserved by the borderline between financial derivatives and debt instruments, that in some cases may be blurred. Attempts to overcome such difficulties may involve a significant increase in the range of contracts giving rise to liabilities included in the debt. Beyond a certain limit, this may in turn result in weakening, rather than strengthening, the reliability of the indicator. Information and transparency on financial derivatives should anyway be improved, possibly using other forms of harmonised reports.*

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1. The tasks of budgetary surveillance, assigned to the European Commission by the Treaty on the Functioning of the European Union, are performed according to the regulation called "Protocol on the Excessive Deficit Procedure". The first version of this Protocol dates back to 1993 ((EC) No 3605/93 of 22), while the last text, currently under revision, was approved in 2009[1]. The Protocol attaches a clear and detailed definition to the concepts of government "deficit" and "debt" referred to by the Treaty, as well as other important statistical concepts. The notion of relevant deficit identified in the Protocol corresponds to the "net borrowing", as defined in the European System of Accounts (or ESA95)[2]. This definition is very complex, since it is not based on simple cash indicators, specific to the monitoring on government finance (e. g. the borrowing requirement). Indeed, the notion of deficit is based on the balancing item of capital accounts, i.e. the difference between the sum of all government revenues and the sum of all government current and capital expenditures, according to national accounting rules (to be applied to non-government sectors as well). In this calculation, entries should be recorded on an accrual basis, and several components, not directly observable, should be inputed.

On the other hand, the concept of stock defined in the Protocol, i.e. the government debt, is probably the simplest available. Government debt is

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[1] COUNCIL REGULATION (EC) No 479/2009 of 25 May 2009 on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community

[2] COUNCIL REGULATION (EC) No 2223/96 of 25 June 1996 on the European system of national and regional accounts in the Community

constituted by the liabilities of general government in currency and deposits, debt securities, and loans. All data are measured at face value, without corrections for accrued interest, and financial derivatives are explicitly excluded from the list. Reference to the European System of accounts is only made for clear identification of the units belonging to the government sector and the financial instruments included in the list.

Since the beginning of the European single monetary policy, the role of financial derivatives has been controversial. The first version of the Protocol, like the current one, made reference to the accounting rule of the ESA95, approved in 1996. The ESA95 Regulation included interest and other property income in the government revenues, without making any explicit reference to financial derivatives. Few years later, a worldwide debate on international statistical standards for national accounts and balance of payments clarified the treatment of "interest payments" under two important categories of derivatives: i.e. swap and forward rate agreements (FRA). Taking for granted that derivatives are not financing instruments, it was clarified that flows of payments attached to them cannot be considered as the remuneration for the provision of cash for financing needs. Therefore, what is often (and legally) referred to as "interest payments" in swap and forward rate agreement contracts, should no longer be recorded as interest, or property income, in the system of national accounts. As a result, in December 2001, it was necessary to amend the ESA95, in order to re-establish consistency with other international standards. In principle, this would also imply a corresponding change in the deficit used for the purposes of the Protocol on Excessive Deficits, to be updated in order to exclude swap and FRA payments.

Perhaps, this change in treatment of derivatives would have been more easily accepted, if included in the ESA 95 from the beginning (i.e. from mid nineties). At the time of the change, the situation was different. Since the end of the nineties, several European sovereign borrowers, including France, Germany, Italy and the Netherlands, decided a significant recourse to derivative contracts, in some cases creating a specific debt management agency, in charge of deciding how to fund the government borrowing requirements and provide insurance against changes in market conditions. While transferring their national monetary sovereignty, the governments were increasingly involved in debt management operations, and their planned debt and deficit figures were connected with use of derivatives. Debt managers had argued that the use of swaps was an integral part of debt management, possibly resulting in a reduction of the cost of the debt and/or leading to a change in the maturity profile of the debt. Following years of accurate planning and fine tuning of expenditures and revenues, an ex-post change in “the rules of the game” would have been harmful and not justified. The legal solution that was in the end agreed was called “the swap exception”: the ESA 95 was updated, only for the purposes of national accounts and general economic analysis; but the Protocol on Excessive Deficits remained unchanged, foreseeing a deficit corrected for re-inclusion of interest on swaps and FRA,

Even though fully justified by reasons of time-consistency of rules, the “swap-exception” was not favourable in terms of credibility and reputation.

While not recognised in the stock of debt, financial derivatives were still able to impact on deficit. In case of change in prices or exchange rates for foreign currency debt, the corresponding holding gains could be used to improve deficit figures, leaving debt unchanged. This exception contributed to raise criticisms by several authors, suggesting the idea of EU rules prone to "creative accounting", used to disguise deficit figures[3]. Even though originated from a short-term, contingent problem of start-up, the swap exception is still in place. The first full revision of the European System of Accounts ended in May 2013, with the approval by the EU Parliament and Council of the ESA10 Regulation[4]. While confirming the definition of net borrowing already used in national accounts, the new ESA eliminated the Appendix V, defining the alternative notion of interest to be used for the purposes of the Protocol on Excessive Deficits. Even though not directly implied in legal terms, it is very likely that the swap exception disappear in the forthcoming Protocol, to be approved by the EU Council.

2. As already seen in the case of swaps and FRA, cash payments under derivative contracts should not be interpreted as lending of funds impacting on debt, as well as components denominated "interest" should not be seen as

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[3] See for example VON HAGEN - WOLFF, *What do Deficits Tell US about Debts? Empirical Evidence on Creative Accounting with Fiscal Rules, CEPR Discussion Paper*, n. 4759, 2004, and MILESI - FERRETTI, *Good, Bad, or Ugly? On the Effects of Fiscal Rules with Creative Accounting*, *Journal of Public Economics*, 2004, n.88, pp. 377-394.

[4] See REGULATION (EU) No 549/2013 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 21 May 2013 on the European system of national and regional accounts in the European Union.

property income paid to a "lender". However, an important difference in the implementation of ESA95 was identified in this regard by the EU Commission (Eurostat), between "off-market swaps" and "par-swaps". For example, in a "plain vanilla" interest rate swap, one party agrees to pay a fixed rate over a notional value defined in the contract; while the other party agrees to pay a variable rate on the same notional amount, plus a spread depending on market conditions. Rates and spreads are adjusted in order to balance (or make equal) the expected value of the two legs of the contract. This means that, at the beginning of the contract, the market value of expected future settlements is zero, and remains zero until market conditions change, without any actual payment between the parties. A swap contract with zero market value at inception is a "par-swap", to which all general rules already seen should easily apply.

On the other hand, swap contracts have been observed, where future payments are clearly unbalanced at inception, and an upfront payment is then necessary in order to compensate the counterparty ("off-market swaps"). According to Eurostat's analysis, and in line with the literature[5], off-market swaps might result in borrowing of fund *not included* in the definition of debt. An off-market swap should then be divided into two parts: the upfront payment should be classified as a financial loan, included in debt; whereas the remaining part is swap, with nil original market value. Future payments will be separated accordingly, distinguishing the principal and interest on the loan

[5] See PIGA, *Do Governments Use Financial Derivatives Appropriately? Evidence from Sovereign Borrowers in Developed Economies*, in *International Finance,* vol. 4(2), Wiley Blackwell, Summer, 2001, pp. 189-219 ff.

component, to be amortised over the life of the instrument, from the remaining component, interpreted as settlements under the par swap[6].

This restrictive treatment, even though not easy to apply, has been so far preserving the measurement of debt in relation to several contracts entered to by governments at the beginning of the monetary union. An interesting question is how to treat cases of unbalanced contracts created in the contest of restructuring of old contracts, as observed in several countries, often in association with changes in market conditions resulting from the EU sovereign debt crisis. For example, an originally plain-vanilla swap, now facing a negative market value due to occurred changes in prices, is substituted by a new contract. The new swap has the same final maturity, but distributes the current negative value on the spreads to be applied to remaining settlements. Apart from restructuring choices, similar cases may also be originated by the entry of force of a swap foreseen by a *swaption* contract: i.e. an option granting the right to enter into an underlying swap, against the payment of a premium paid in the past to the seller of the option.

On the one hand, it might be argued that the new contract is just an update of the previous one under new market conditions, and that government debt should not be increased, as long as no new upfront payment (i.e. no actual lending of funds) is made. On the other hand, it could be observed that, in legal terms, the previous swap does no longer exist and a new, off-market swap is created; absence of cash payment might also be seen as the net outcome of an

[6] See EUROSTAT, *Manual on Government Deficit and Debt - Implementation of ESA95,* Publications Office of the European Union, Luxembourg, November 2013.

upfront received (thanks to the obligation to pay future, unbalanced flows), and immediately used to close the previous contract in loss.

Both approaches have a clear economic rationale. The latter, more extreme, treatment might be seen as more rigorous, but it may imply unwanted side effects. In order to be applied consistently, it would require clear rules to distinguish cases of substantial restructuring from cases where the economic substance of the contract remain basically the same (and there is, e.g., just a change in one of the parties or a marginal update in parameters). Once the link with observable lending of fund is weakened, it becomes necessary a general review of all other cases of derivatives not included in debt. Beside swaps and FRA, other kinds of financial derivatives might be involved. Other examples may refer to option contracts, that might be designed in order to "bet" on a future event that is very likely to occur, implying an almost certain future repayment. In these cases, by properly setting parameters, it would be possible to create financial derivatives that are close substitutes for debt instruments, but currently excluded from government debt.

In the end, the stock of debt might be significantly increased; but this does not necessarily mean an increase in its quality. Imputed off-market swaps (resulting from restructuring without new upfront payment) might significantly change their value before maturity, with significant impact on payments to be made. Inclusion in debt would ignore critical differences in contracts, like the right to unilaterally close the contract before maturity. In the end, this extension may blur the soundness and straightforwardness of debt calculation, without providing an accurate measurement of governments' exposure to risks.

3. Increased attention deserved by use of financial derivatives by government units is fully in line with the size of the involved assets, as well as possible consequences as prices change. The need for better information should be addressed via proper technical instruments, not necessarily corresponding to those already in use in the context of the EU budgetary surveillance. Indicators like government debt and net borrowing are not designed for the purpose of monitoring exposure to derivative contracts. While some update and maintaining in their definition is often needed, they remain aimed at measuring ex-post lending of fund between sectors; their size has an important impact on the overall financial risk incurred by the government sector, but they are not themselves measures of risk. The definition of debt, as adopted in the EU Protocol on Excessive Deficit Procedure, is broadly appropriate in order to capture components of direct lending of funds that may be included in derivative contracts. Further extending this definition in order to capture other forms of implicit lending may weaken the link with the observable cash basis, hamper the role of debt as a simple indicator of performance, and still result into an inappropriate measurement for the overall exposure to financial risks.

Rather than changing the nature of the Maastricht indicator, a possible alternative is to increase the quality of information on derivatives through a dedicated survey or other forms of reports, in order to allow for a specific assessment based on the nature, maturity, existence of unilateral termination clauses, and other characteristics.

This would perhaps increase transparency of government accounts more than an increase in the stock of debt[7].

[7] For a similar reasoning on other forms of contingent liabilities, see SEMERARO, *Should Household Wealth and Government Liabilities Include Future Pension Rights?*, in De Bonis and Pozzolo (Eds), *The Financial Systems of Industrial Countries,* Springer-Verlag, Berlin, 2012.

ESMA SUPERVISION. SPECIFICITY OF THE INTERVENTION IN THE DERIVATIVES MARKETS

Alessandro Engst – Angela Troisi*

ABSTRACT: *This paper analyzes the issues related to 'advanced finance' and European Securities and Markets Authority (ESMA)'s power of supervision. The focus is on the new mechanisms of cooperation between the Authorities of each member State, in order to guarantee an adequate level of stability in the international markets. Moreover, particular attention is paid to the introduction of specific obligations in terms of clearing (through central counterparts - so called CCP) and of reporting (to trade repositories) imposed by the Regulation (UE) n.648/2012 (the so-called EMIR Regulation).*

In particular, the research is about whether a local government falls within the scope of application of EMIR. This is relevant with regard to certain member States, in particular Italy, where the use of derivatives by local authorities has resulted at times in transactions characterized by speculative purposes. In conclusion, the recovery of an optimum balance of financial markets and the overcoming of criticalities brought by the recent financial crisis are not yet a

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done thing. This is the set of evaluations that should frame the analysis relating to derivative transactions.

SUMMARY: 1. Derivatives activity and issues related to the 'advanced finance' – 2. The European financial system after the recent crisis: systemic profiles and supervisory authorities. – 3. The European Securities and Markets Authority (ESMA): tasks and supervisory functions. – 4. *Continued*: A few specific operative profiles. – 5. Supervision of OTC markets. – 6. *Continued*: ESMA's peculiar intervention powers. – 7. The supervision on the derivatives of local governments. – 8. Conclusions.

1. In recent times, the Italian financial system has been characterized by a climate of instability, which has reduced the spectrum of a sound and prudent *agere* on the part of credit intermediaries and, as a result, of investor protection[1]. In fact, all sides have felt the growing need of curbing some of the disruptions that at times characterize the operations carried out by the actors specialized in 'advance finance' strategies.

[1] See VISCO *, Indagine conoscitiva sul decreto legge recante disposizioni urgenti per la crescita, l'equità e il consolidamento dei conti pubblici*, in a hearing at Camera dei Deputati, December 2011, in which it is explicited the necessity to characterize strategic mesures able to reform the actual national reality, as well as insure "higher growth ratios" on the market in comparison to last years registrations; DE POLI, *Crisi finanziaria globale e fattori comportamentali*, in *Analisi Giuridica dell'Economia*, 2012, No.1, p. 49 and following, in which the author underlines that "financial markets appear (…) systems (…) susceptible of react either to rational behaviors as well as others, irrational, this means that the *disclosure* techniques will have to at least be adapted, carefully, to the effective conditions of the markets".

As underlined by an authoritative scholar[2], the possibility of putting into practice logics of pure speculation has acted as a catalyst for the rise of moral hazard mechanisms on intermediaries and, more generally, on all operators dealing with market negotiations. Hence, a *modus operandi* that is not grounded to behavioral ethic principles, which have traditionally ensured the order of the market[3], has imposed itself.

A consideration should be given also to the current economic situation that had many negative repercussions on the profitability of banking institutions, in particular with respect to the quality of the employments and the relevant financial exposures[4]. Moreover, significant losses have affected the trading of derivative contracts, a substantial part of which has been carried out on the so-called *over the counter* markets and, therefore, in a context of operative opacity

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[2] See IRTI, *L'ordine giuridico del mercato,* Bari, 1998.

[3] In particular, the evaluation of the macroeconomical risks takes specific importance, which effects tend to reflect first, on the entire financial market, second on the growth opportunities of individuals and national entrepreneurs reality. For an analysis of the actual socio-economical context, see BANCA D'ITALIA, *Rapporto sulla stabilità finanziaria*, No. 2, November 2011. Doctrine, see CAPRIGLIONE, *CriIsi a confronto (1929 e 2009). Il caso italiano,* Padova, 2009, p. 37 and following; ID., *Etica e finanza alla luce della recente crisi* finanziaria, in *Rivista elettronica di economia, diritto e* management, 2011, p. 9 and following; PELLEGRINI, *La con-flittualità in ambito bancario a seguito della crisi finanziaria*, in *Rivista Trimestrale di Diritto dell'Economia*, No. 2, 2011, p. 187 and following; ALPA, *Quale modello di governo dell'economia in Italia?*, in *Econ. Dir. terziario,* 2011, No. 1, p. 7 and following

[4] According to the monthly report redacted by ABI on September 2012, the amount of the losses is increasing in comparison to the precedent months. The report between net losses and total functions has increased, in fact, 3,34% in July, placing the latters above the estimated value of June 2012 (3,31%) and the value registered in July 2011 (2,7%). Such report is available at www.abi.it.

and lack of regulation[5]. Not without reason in fact, the value of said financial products has affected the integrity of banks' balance sheets, which have suffered the effects of the fluctuating trend recently reigning over global markets (a reality that is well-known in Italy through the events of Monte dei Paschi di Siena) [6].

In this regard, reference is made to certain categories of derivative contracts that, since lacking of actual hedging purposes (in relation to credit exposures arising from underlying financial assets), are aimed at realizing short-term (even very short-term) speculative objectives.

Moreover, the risk of such operations is greatly increased with the degree of strategic discretion granted to the contractual counterparts which operate in the OTC markets. Such markets are in fact characterized by a lack of specific

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[5] In this regard, it has been observed that on 16 August 2012 enter into force the new EMIR(*European Market infrastructure Regulation*) Regulation No. 648/2012, aimed to discipline the OTC markets, increasing the operative transparency grade. More in particular, such regulation (published on 4 November 2010 and definitively approved by the European Parliament on 29 March 2012) introduces new and more pressing informational, compensation and conduct obligations which will permit to minimize the systemic risk and the uncertainty of the negotiations on such markets. Moreover, such discipline is applicable to central counterparties (and related direct participants), to financial counterparties, as well as data repertories on negotiations. Doctrine see, ANTONUCCI, *Considerazioni sparse in tema di strumenti finanziari derivati creati da banche*, in *Banca, borsa, tit. cred*., 2004, II, 204 and following; CAPRIGLIONE, *I «prodotti» derivati: strumenti per la copertura dei rischi o per nuove forme di speculazione finanziaria?*, 1995, I, 359 and following.

[6] It is estimated that the overall potential losses recently became 27,7 from 26 bln Euro, with an incidence of 52 Mil for each banking operator. Significant is the CDS situation on Sovereign debt, which quotations suffer periodically the risk of default that actually characterize some of the biggest Countries economically advanced. Data available on www.bancaditalia.it. For such argument see, CAPRIGLIONE - MONTEDORO, *Brevi note sulla vicenda MPS e sul ruolo delle cd. fondazioni bancarie*, available on www.apertacontrada.it, 2013/02/07.

behavioral rules, as well as adequate technical aids capable of addressing (i.e. mitigate) the credit risk that lies on the majority of the transactions carried out.

Lastly, the peculiar effects (of patrimonial and financial nature) resulting from the circulation of the credit default swaps (CDS) correlated to the creditworthiness of the States and, therefore, to their bankruptcy risk, should not be underestimated[7].

Such derivative instruments - sometimes leading back to liquidity management strategies adopted by financial intermediaries - expose financial sector members to the risks deriving from systemic tumultuousness and therefore, to potential negative repercussions (whose field of action cannot be limited into a microstructural size).

Such specific issues have contributed to create a strong need for the adoption of adequate reforms which led to the G20 commitment agreed in Pittsburgh in September 2009, in response of which the Dodd Frank Act has been enacted in the US and the European Market Infrastructure Regulation (EMIR) has been enacted in the European area[8]. In fact, the rise of cross-border

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[7] Recent negotiations in CDS are considered such a factor of detriment of the stability of the financial market and, particularly, of the crisis situations of some Eurozone Countries. In November 2012 the regulation (UE) No. 236/2012 is in force, which forbids the short sales "naked" and to take speculative positions on CDS of sovereign issuers (articles 13 - 14). For in-depth analysis see, SERVIZI DI BILANCIO DEL SENATO, *Sostenibilità del debito sovrano e titoli derivati*, nota breve No. 7, June 2011.

[8] The need of a reform at an European level appears coherent with what hoped in 2008 and recently reaffirmed by the *Financial Stability Board*. In particular, in his September 2013 Report "*Overview of Progress in the Implementation of the G20 Recommendations for Strengthening Financial Stability*" the *Financial Stability Board* highlighted that «*over the past five years, FSB members have agreed and are implementing a broad range of policy reforms that address the*

transactions, along with the development of global operative logics and the identification of relevant macro systemic risks, constitute the requirements for the creation of a supervisory system that would be uniform in all member States with the intent of ensuring a 'coordinated and common action'[9] throughout the EU.

2. The conclusions reached in 2009 by the working group led by J. de Larosiére have drawn attention to the need of finding new mechanisms of cooperation between the Authorities of each member State, in order to guarantee an adequate level of stability in the international markets[10]. The abovementioned working group has therefore identified specific forms of supranational control able to 'prevent a new financial crisis in the future'[11] and also to reinstate trust in the orderly execution of market transactions.

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major fault lines that caused the crisis. We are building more resilient financial institutions and markets, using substantially strengthened common international standards that have been designed to be applicable to different national circumstances. We are addressing the problem of too-big-to-fail. At the same time, we are working to prevent regulatory arbitrage».

[9] See GUARRACINO, *Supervisione bancaria europea. Sistema delle fonti e modelli teorici*, Padova, 2012, p. 34.

[10] See TROIANO, *L'architettura di vertice dell'ordinamento finanziario europeo*, in AA.VV. *Elementi di diritto pubblico dell'economia*, Pellegrini, Padova, 2012 p. 541 and following, and in particular p.550 where there are described the weak points of the pre-crisis regulation, on which focused the attention of the group managed by Larosière. In particular it regards, "limited focalization of the national surveillance authorities on *macro-prudential* profiles", on the risky "forms of regulatory arbitrate", as well as the non-sufficiency of the "prerogatives and resources of the *third level committees*" conductible to the Lamfalussy procedure.

[11] Even in the document 2009/C318/11 is highlighted the necessity of "attribute an official mandate to a European organism in charge of the surveillance of the financial system under the macroprudential profiles and to signalize eventual systemic risks". At the same time, it is stressed out the exigency of "set out a new microprudential system…(able to identify)

Hence, the creation of an ‘integrated network’ of supervision, created by assigning to autonomous national and European supervisory bodies various control functions in respect of the risks (of macro and micro operative origin) to which operators of the banking, financial and insurance sectors are exposed. A renewal of the existing regulation in the financial European system has been accomplished, along with a real ‘review of the supranational architecture’, which sets the basis for a future reunification of monetary functions (attributed to the ECB following the Maastricht Treaty in 1992) and supervisory functions on the same Authority (i.e. The European Central Bank) [12].

This leads to the setting up of a supervisory system based on two main pillars: on one side, the configuration of a macroprudential control carried out by the European Systemic Risk Board (ESRB) and, on the other side, a collaboration model based on supervision carried out by specific European agencies (EBA, ESMA and EIOPA), which closely liaise with national Authorities in supervising the same sectors over which they each have competency[13].

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common ground rules for surveillance (and to eliminate) the differences in the application between countries”.

[12] See CAPRIGLIONE – SEMERARO, *Crisi finanziaria e dei debiti sovrani. L’Unione Europea tra rischi ed opportunità*, Torino, 2012, p. 78 and following particularly p.80, where it is stressed out that “the communitarian orientations go…in the direction of accoutrement in Europe of the essential part of the competences which give content to public surveillance on the economies’ action ”; SARCINELLI, *L’Unione bancaria europea*, in *Banca Impresa Società*, 2012, No. 3, p. 333 and following, the Author highlight that “the attribution of the unified baking surveillance to the ECB, Eba and national authorities of the countries non- adherent to UEM”.

[13] See RUDING, *From National to European Regulation: Towards European Financial Supervisory Authorities*, CEPS Policy Briefs No. 209, available on papers.ssrn.com; GODDARD – MOLYNEUX – WILSON, *The financial crisis in Europe: evolution, policy responses and lessons for the future*, in *Journal of Financial Regulation and Compliance*, 2009, 17. 4, p. 362 and following;

A centralized cooperation at EU level has in fact been started with the goal of safeguarding the integrity and the stability of the financial markets and, at the same time, minimizing the technical and operative differences that characterize the regulatory approach taken by each national supervisory body[14]. In fact, the Directive 2010/78UE (so-called *Omnibus*) defines the fundamental criteria necessary to guarantee an optimal level of convergence between said authorities, with particular emphasis on the supervisory functions performed in certain sectors of the economic and financial system.

POSNER, *Is a European approach to financial regulation emerging from the crisis*, in VV AA., *Global finance in crisis. The Politics of international regulatory change*, HELLEINER – PAGLIARI – ZIMMERMANN, New York, 2010, p. 108 and following; MASCIANDARO, *Politicians and financial supervision unification outside the central bank: Why do they do it?*, in *Journal of Financial Stability*, 2009, Vol. 5.2, p. 124 and following.

[14] See TROIANO, *L'architettura di vertice dell'ordinamento finanziario europeo*, in AA.VV. *Elementi di diritto pubblico dell'economia*, op.cit., p. 543 where it is highlighted that the system precedent to the SEVIF "has demonstrated itself exposed to the risk of an ongoing fragmentation of the disciplinary regimes… given the distance… between general principles fixed by communitarian legal acts and the possible declination, in conformity to such principles, identifiable at a national regulation level". Moreover, . BAGLIONI – BONGINI – LOSSANI – NIERI, *Verso l'Unione bancaria europea: disegno istituzionale e problemi aperti*, in *Banca Impresa Società*, 2012, No. 3, p. 313 and following, and particularly p.314, where it is specified that "many are the reasons why it is opportune a transfer of sovereignty in relation to the banking surveillance. First of all, the integration between European countries (moreover the ones sharing the same currency) provide that all such countries were regulated by the same rules in the financial context and that the latters were applied in the same way: in order to assure the full uniformity it is useful to have a unique surveillance authority. In second place, in Europe are active banks of big and international dimension it should be helpful that such institutions interact with a unique subject, instead of a plurality of national authorities. The centralization of controls, is the premise in order to put in common the sources necessary to manage the banking crisis".

With particular regard to the ESRB, it is worth underlining that the specificity of the relevant functions of macroprudential nature has allowed the European regulator to focus the attention on the importance of the "systemic risk", as well as on its influence on possible perpetuations of financial tensions.

The definition under article 2 of Regulation (EU) No.1092/2010 underlines indeed the characteristics of such a risk. Reference is made to the heterogeneity of the relevant negative implications (which reflect both on the internal financial market and the real economy) and to the "domino-effect" that comes from it (which causes the involvement of numerous categories of operators in situations of particularly high economic and financial turbulence) [15].

The ESRB is supported, at a microprudential level, by competent authorities: EBA for the banking sector, ESMA for financial markets and EIOPA for the insurance and pension sectors[16]. They are given specific tasks, powers and intervention tools, all targeted to the promotion of "common procedures for regulation, supervision and disciplinary action"[17]. These are supervisory bodies specialized in providing technical guidelines, as well as recommendations on economic and financial matters, without reference to decisions of political and/or institutional nature. The guidelines of such bodies are addressed to the

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[15] In fact, the lawmaker defined the systemic risk as "risk of perturbation of the financial system that can have serious negative consequences for the internal market and the real economy". In order to clarify, that "all types of intermediary, financial markets and infrastructures are potentially important in a certain measure for the system", where it is evident the referral to a risk notion that exonerate the interpret from the individuation of subjective application limits.

[16] See Reg. (UE) No. 1093/2010, Reg. (UE) No. 1094/2010, Reg. (UE) No. 1095/2010.

[17] See TROIANO, *L'architettura di vertice dell'ordinamento finanziario europeo*, in VV.AA. *Elementi di diritto pubblico dell'economia*, p. 558.

national competent authorities and to the financial institutions, which trough the ordinary '*comply or explain'* principle are able to autonomously identify the optimal process of adopting the indications received from the above supervisory bodies.

3. The Regulation (EU) No. 1095/2010 entrusts the European Securities and Markets Authority (ESMA) with supervisory functions on financial instruments traded within EU and, more generally, on the markets active in the Union. The establishment of such Authority addresses the need, pushed from several sides, to rebuild investors trust in the financial system and the coherence of the economic and financial supranational structure[18]. The regulator aims indeed at both overcoming the crisis that in recent times has affected the majority of the member States and defining the structural conditions able to support the development of an efficient and fully operative financial European system (i.e. able to absorb possible shocks of macroeconomic nature)[19].

Therefore, we are in the presence of operative logics that give pre-eminent importance to the international cooperation (to be carried out through direct forms of communications between State bodies, EU bodies and global

[18] Reference is made, in particular, to the conclusions of 19 June 1009 of the European Council where it is stressed the necessity to constitute a European surveillance system in order to increase the uniformity and quality of the supranational regulation apparatus destined to rules l'*agere* of the internal market partecipants.

[19] In fact, the *considerando* No. 33 of the mentioned Regulation highlights as "the crisis demonstrated that the actual system of cooperation between national authorities which tasks are limited to single member States it's insufficient in case of financial institutes that operate on a trans-frontier level".

networks), as well as to the minimization of the cost deriving from turbulences in the different national fields.

In fact, article 29 and following of the abovementioned Regulation underline the key role that the European regulator assigns to ESMA with respect to the spread of a ‘common supervision culture’, the establishment of specific ‘general coordination’ functions between the different EU authorities and, lastly, the implementation of international relations (bilateral and multilateral) with non-member Countries.

In particular, ESMA’s tasks - as specified in the mentioned Regulation (EU) No. 1095/2010 - are not limited to the issuance of recommendations and guidelines “with a view to establishing consistent, efficient and effective supervisory practices within the ESFS, and to ensuring the common, uniform and consistent application of Union law” (article 16), but they also include the organization and conduct of reviews of some or all of the activities of competent authorities” in order to verify “the adequacy of the resources” of the different national authorities, as well as “the degree of convergence” identifiable in their actions (article 30).

It can be inferred that ESMA’s supervision is carried out both in the initial phase of collaboration between the various (national and supranational) bodies, and thereafter through the *ex post* control of the actual operations and/or the non-compliance with the indications given by the same Authority. This, in a logic of *continuous* intervention, which is supported by mechanisms of (bilateral and multilateral) exchange of information, data and news between ESMA, the other competent authorities and the members of the economic and financial sector[20].

4. From a technical perspective, the division of ESMA's tasks into four segments (the safeguard of financial stability, the investor protection, the establishment of criteria for the convergence of member States regulatory frameworks and, lastly, the supervision over the financial markets) reflects the high degree of specificity of its control functions[21]. In fact, the exercise of the supervisory tasks finds adequate support in certain procedural practices and technical standards that are developed by such Authority with the intent of

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[20] Article29 of the Reg. (UE) No.1095/2010 states that between the competencies of ESMA there are: a) to provide opinions to the competent authorities; b) promote the efficient exchange of information (…) among competent authorities c) contribute to develop uniform standards of diligence and high quality; d) examine the application of the technical norms of regulation; e) establish programs of sectorial formation and inter-sectorial, ease the exchange of employees, support the competent authorities to intensify the recourse to regimes of detach and to other instruments.

[21] More in general, in the annual Report 2011 published by ESMA are listed the main characteristics that distinct the related surveillance functions. Such Agency is, therefore, described as a "European" Organism (which acts for the interests of the Union, giving at the same time attention to specificity of the different member States), "independent" (from the communitarian institutions, the national authorities and the different operators which participate in the financial market), "cooperational" (in spite of the participation to the national and supranational authorities' web which monitor in the European regional context) "responsible" (in line, so, respecting the traditional transparency and correctness canons in respect of the market and other institutions), "professional" (as a result of the high technical levels of quality and competence), at last, "effectiveness"(in referral to the optimization logics adopted in the resources management and realization of policies in favor of the financial markets investors' protection)"; See annual Report 2011, p. 8, available at www.esma.europa.eu.

creating common conditions on the markets and the completion of the European *Single Rulebook* on economic and financial matters.

Moreover, it is worth mentioning that ESMA periodically carries out investigations (including procedures of *analysis over the impact of the regulation*[22]) aimed at controlling EU securities markets trend, with particular reference to their stability and the development of their operative trends. It can be deduced that ESMA's activity is not limited to a mere recognition of the degree of stability of the EU financial system; in fact, it tends to take on a purposive character by means of the implementation of perspective evaluations with elevated technical and strategic value concerning medium-long term market developments.

ESMA's activity appears therefore consistent with the protection of the "quality of public policies" [23]. At the same time, it guarantees the constant

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[22] More in particular, the European regulator provided specific obligations in relation to analysis of impact of the regulation, as well as activities of consultation (with the so called group of the interested parties, which represents market operators, institutions and investors).

[23] See, CASSESE, *La qualità delle politiche pubbliche, ovvero del metodo nel governare*, Intervento in occasione della presentazione del Rapporto 2012-2013 di "Italiadecide", Camera dei Deputati, 11 February 2013. Available on www.osservatorioair.it, where it pointed out that "to talk about public policies means to talk about methods of government" and, therefore, of the "democracy working", which "requires knowledge, consultations, public discussion of the addresses indicated by the governors". It is important that the Author analytically describes the concept of "public policies", intending "the result of a long sequence, of which principal phases are the following: election of public policies, what nowadays it's call formation of the agenda; preparation of the project, with the formulation and decision of the policy (contained in a law or in other act); its concrete actuation executively; the examination of the results obtained after the execution of the policy; eventual correction or reformulation, on the basis of the analysis of the results". It is, therefore, constituted a "circular" mechanism which display

correspondence between supranational supervisory actions and market's interests and, in particular, the need of minimizing the distortions that sometimes come from *market failures* or *regulatory failures* in the financial system[24].

To conclude on this point, it can be said that ESMA concentrates its attention on specific operational segments of the financial market, being that its analysis focus on subjects whose definition is considered crucial for the global stability of the European financial system. More specifically, ESMA tends to resolve structural and contingent issues, among which are those arising from certain operational approaches at times used in the context of financial engineering (e.g. securitizations, derivatives, etc.), which are highly risky and aimed at pursuing purposes not always in line with sound and prudent management and

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its weakness in each of the phrases above described. See PATRONI GRIFFI, *Fasi, contenuti, fini della semplificazione normativa*, in *Rassegna parlamentare*, 2009, No. 1, p. 229 and following.

[24] See, ZATTI, *Il problema della responsabilità politica nelle "reti di regolatori" indipendenti del mercato*, published on www.apertacontrada.it, 9 November 2012, where the Author detects the relation between law and market. As a result, it is noted that "the market is itself a regulatory system. Therefore, to regulate the market could mean either wishing to modify it for political reasons or to defend it from the political intrusion in the spontaneous functioning of its natural mechanism. In both scenarios, being regulatory "systems", the effects produced by one of those will affect the other one in an inevitable *feedback* process". For a reconstruction of the value of the regulation of international markets see BALDWIN – CAVE – LODGE, *Understanding Regulation. Theory, Strategy and Practice*, Oxford, 2012; GRAVANO – TIVELLI, *La qualità della legislazione in Italia. Stato dell'arte e prospettive*, in *Iter legis*, 2009, No. 5-6, p. 143 and following, where it is pointed out that "the quality of the regulation (is) an element of fundamental importance in order to evaluate the ability of national ordainment to attract enterprises and investments, particularly foreign, avoiding dangerous conditions of competitive disadvantages"; DE BENEDETTO - MARTELLI - RANGONE, *La qualità delle regole*, Bologna, 2011.

transparency principles[25]. More specifically, such Authority carries on evaluations that have an impact on the efficiency and the quality of the regulation (already enacted and/or to be implemented) within the European Union[26]. In particular, reference is made to ESMA's tasks in relation to short sales, financial information, efficiency of market microstructures and, lastly, regularity of clearing mechanisms in the OTC markets[27].

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[25] In addition, the progressive establishment of strategies of credit risk diversification (among others securitization processes and, more generally the application of techniques known as "*originate to distribute*") that, as well as increase the volatility factors in the markets, generated many distortions in the savings allocation mechanism in the entire financial system. See MAXWELL – SHENKMAN, *Leveraged Financial Markets. A comprehensive guide to high-yield bonds, loans, and other instruments*, New York, 2010.See, BAFFI – PARISI, *Il mercato dopo la crisi finanziaria del 2008*, in AA.VV. *Capitalismo prossimo venturo. Etica Regole Prassi*, p. 319, where the 2007 crisis is considered as resulting from an inefficient interaction of some factors of the actual financial system.

[26] See, ESMA annual report 2011, p. 14, where it is stressed out that "in a difficult market situation context, the ESMA has taken the fundamental role of coordinating ne surveillance of the EU markets, which intended the active control of developments and risks and an action of co-ordination carried out by the national competent authority".

[27] Furthermore, ESMA dedicates peculiar attention to some categories of participant of the European financial market, like credit rating agencies and investment funds (either for the entities that are ascribable in the UTICS discipline, and for the one subject to the AIFM Directive). All of this, in view of safeguarding adequate investor protection standards and transparency of the products related in any way to investment funds. Under another profile, the ESMA actually represents the only Organism to which have been attributed specific surveillance functions on the credit rating agencies operating in a regional European context. With the Reg. (UE) n. 513/2011, integrating and amending Reg. (CE) n. 1060/2009, it was possible to identify specific tasks on authorization and surveillance of the latter Authority in relation to *raters* specialized in the elaboration (and diffusion) of judgments on the credit merit of firms, public bodies, privates and Sovereign States. This is due to the fact that the recourse to credit rating has obtained an important acceleration with the diffusion of progressed finance products and, more in particular, the introduction of sophisticated

5. The crisis experienced over the last few years has acted as a catalyst for the identification of new supervisory forms over OTC markets[28]. In particular, the European Council held on 2 December 2009 has evidenced the need of strengthening the measures aimed at facing the credit risk on the subjects operating in OTC markets, as well as guaranteeing a higher transparency, efficiency and integrity of relevant transactions dealing with derivative products.

The introduction of specific obligations in terms of clearing (through *central counterparties* - so called CCPs[29]) and of reporting (to *trade repositories*[30])

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techniques of index structuring and negotiable instruments which are instrumental to the satisfaction of the financial needs of the market operators.

[28] See, BRI, *Indagine triennale delle banche centrali sui mercati dei derivati OTC condotta sotto l'egida della BRI nell'aprile 2013,* where it is pointed out that "the daily average negotiation on non-regulated markets of derivatives on interest rates were $ 2,3 trillions in April 2013, up from $ 2,1 and 1,7 trillions of April 2010 and April 2007 respectively. The more used instruments were the swap, with a daily volume of $ 1,4 trillion, followed by the forward rate agreement, with %o,8 trillion. The growth of the activity in the derivatives market on interest rates is due to financial institution different from the declaring intermediaries. In respect of the Survey 2010, the negotiation between intermediaries and non-financial clients has reduced its volumes, also the actions among intermediaries, down in 2013 of 35% of the total turnover, the smallest quota ever registered since the beginning of the data collection on derivatives on interest rates in 1995".

[29] The clearing obligation was introduced progressively with respect to products and market participants categories. On 24 July 2012 CFTC announced the first classes of swap subject to the compensation obligation, precisely two classes of credit default swap and four classes of swap on rates to be compensate through a registered central counterparty, a progressive approach will be applied based on categories of market participants (90/180/270 days to conform to the obligation of compensation). A similar approach will be applied to other classes of activity.

[30] Intending every "legal entity which collects and stores in a centralized manner the registrations on derivatives" (Art. 2, point 2, Reg. UE n. 648/2012).

imposed by the European Market Infrastructure Regulation (EMIR) (Regulation (UE) n.648/2012) addresses both the definition of a safer and standardized operational context and the protection of an adequate level of information concerning transactions in the OTC markets.

More in particular, EMIR (which has entered into force on 16 August 2012) imposes to all financial counterparties (and also to non-financial counterparts operating beyond specific thresholds[31]) the clearing, through central counterparties[32], of all OTC derivative contracts[33], as well as the provision of specific risk mitigation techniques for those contracts that are not cleared through central counterparties. As a consequence, EMIR imposes supervisory models over the amounts of monetary exchange ordinarily realized on the OTC markets.

It is noteworthy that the European regulator has intended to entrust ESMA with a leading role, assigning to the same the task of instituting adequate regulatory measures, with the aim of mitigating the systemic risk of OTC markets. In fact, EMIR entrusts the ESMA with the task of providing recommendations and guidelines, such forms of intervention being meant to set

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[31] Equal to Euro 3 billion of notional for derivatives on interest rates and of Euro 1 billion of notional for the CDS. See, about , Article 11 of the technical norms of the Delegated Regulation 149/2013.

[32] For Article 2 of such Regulation central Counterparty means ”a legal entity interjected among counterparties of contracts negotiated on one or more financial markets acting as a buyer in respect of each seller and as a seller in respect of each buyer”.

[33] Reference is made, in particular, to derivative contracts stipulated on commodities, credit, equity, interest rate and foreign exchange. In relation to floating rate derivatives are considered the categories having as subject: Fixed-floating (IRS), floating-floating (basis swap), Forward Rate Agreement (FRA), Overnight Index Swap (OIS) and Options.

forth a common regulatory framework for all member States and prevent operative distortions and possible regulatory arbitrages.

ESMA's activity is mainly dedicated at identifying minimum levels of contractual standardization and liquidity, seeking the adequacy of the same with respect to each (negotiated) derivative product. In addition, ESMA is entrusted with specific tasks relating to the diffusion of information and data sufficient to guarantee to the operators the possibility of determining the price of each contract in a fair and reliable way.

A complete evaluation of the technical procedures of such supervisory functions, highlights how all such forms of control can be reduced to a system of "rules and evidence", which, despite its usefulness under an informative on financial operational perspective, would result significantly limited with respect to the necessary inputs required to the reinstatement of sustainable market balances. The limit of the legislation is then clear: in establishing the competencies of the authorities of the European financial regulation, the legislation has maintained a static vision that has not been able to catch the dynamics implied in a competitive approach and therefore, in the evolutionary process of the credit activity.

A more complete regulatory intervention could have facilitated the possibility of reconducting, under ESMA's supervision a closer examination on the concrete nature of derivatives transactions, so to allow such authority to carry out, from time to time, an analysis that could verify the actual impact on the stability of the relevant intermediary, and more generally, the impact on the entire sector, which is unequivocally affected by the possible negative effects of those derivatives which have a mere speculative nature, or even just of dubious executive fairness[34].

6. In addition, among ESMA's supervisory functions over OTC markets it shall be included its membership in the college entrusted with the authorization of central counterparties operating in the EU (*i.e.* those companies interposing themselves between the counterparties to the contracts and becoming the buyer to every seller and the seller to every buyer). Based on article 18 and following of EMIR, the opinion of such college (composed of, *inter alia*, ESMA, national competent authorities and European central banks) represents a requirement for the actual establishment of new clearing companies within the EU[35].

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[34] Furthermore, it is worth noting that ESMA dedicate peculiar attention to some categories of participant of the European financial market, like credit rating agencies and investment funds (either for the entities that are ascribable in the UTICS discipline, and for the one subject to the AIFM Directive). All of this, in view of safeguarding adequate investor protection standards and transparency of the products related in any way to investment funds. Under another profile, the ESMA actually represents the only Organism to which have been attributed specific surveillance functions on the credit rating agencies operating in a regional European context. With the Reg. (UE) n. 513/2011, integrating and amending Reg. (CE) n. 1060/2009, it was possible to identify specific tasks on authorization and surveillance of the latter Authority in relation to *raters* specialized in the elaboration (and diffusion) of judgments on the credit merit of firms, public bodies, privates and Sovereign States. This is due to the fact that the recourse to credit rating has obtained an important acceleration with the diffusion of progressed finance products and, more in particular, the introduction of sophisticated techniques of index structuring and negotiable instruments which are instrumental to the satisfaction of the financial needs of the market operators.

[35] It is worth noting that, according to Article 14 of the Reg. (UE) n. 648/2012, the companies wishing to provide compensation services on the EU territory, will have to file a request to the competent national authorities. There is no, therefore, a direct reference to the ESMA

With specific reference to the diffusion of information and data concerning the trading on OTC markets, it should be noted that EMIR entrusts ESMA with tasks related to the registration and supervision on the "*trade repositories*" (see article 55), i.e. those companies that centrally collect and maintain the records and the information relating to derivative contracts.

Such reconnaissance appears to be consistent with the regulation laid down by the European regulator with reference to the supervision over rating agencies (and the relevant mandatory registrations to the CEREP data register[36]). The establishment of entities that handle information at a centralized level (information pertaining to transactions volumes, amounts of money exchanged, as well as types of derivatives executed) matches with a logic of accountability that usually guarantees the efficiency of the market and the investor protection.

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supervision, even if such reference is made for the surveillance powers in relation to rating agencies.

[36] More in particular, in the ESMA report "*Credit Rating Agencies Annual Report 2012*", p. 20, specifies that «*CEREP was made publicly available in February 2012 and updated statistics have been released in June 2012 and in October 2012. It has been welcomed by market participants and is perceived as a useful mechanism for retrieving information on CRAs' activity and rating performance. CEREP has recorded more than 400.000 user requests since it went live. Access statistics have been recorded from numerous countries, with the EU, US, Switzerland, Japan and China accounting for the highest concentration of users. CEREP users proved to have an even interest among all rating statistics provided by CEREP, with a slight preference for statistics in the Rating Activity, as compared to the statistics of the Default Rates and Transition Matrices screens. Access requests have been recorded on all CRAs reporting to CEREP. ESMA has responded to CEREP related queries from various market actors, including public institution officials, academics and investment banks representatives*». Available on www.esma.europa.eu. See, on this argument TROISI, *Le agenzie di rating. Regime disciplinare e profili evolutivi*, Padova, 2013, p. 70 and following.

Despite evident steps forward, the matter under analysis still appears to be defined. In fact, it is worth noting that the continuous updates provide the grounds for further amendments of the regulatory scenario actually defined by EMIR. It is not a coincidence that recently ESMA has decided to extend reporting obligations also to those subjects operating on regulated markets[37]. The aim is clear: submit all derivative contracts to the same transparency principles and, consequently, established a common control carried out by the same supranational body.

Such systemic structure appears to be fully understandable, given the actual need of mitigating the high degree of risk that in recent years the numerous types of financial products have evidenced (regardless of the characteristics and management techniques of the market on which such products are traded). In particular, reference is made to the diffused skepticism towards a *modus operandi* of certain financial intermediaries which adopt logics of poor transparency and fairness, logics that are often the reason grounding a distort use of some types of contracts, among which the *swaps* (and all relative combinations), that are often used to implement speculative strategies aimed at obtaining high profits in short term.

One can ask whether or not the intervention of the European regulator is sufficient to resolve the criticalities that have risen on the market in recent years. On this matter, the role given to ESMA has to be taken in consideration. Although it guarantees some forms of transparencies on the OTC markets, this

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[37] See, *Questions and Answers Implementation of the Regulation (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories (EMIR)*, available on www.esma.europa.eu.

authority’s tasks are far from creating a solid and efficient supervisory system in connection with the trading of derivative contracts. Specifically, although the regulator gives great importance to the impact of the systemic risk over the market trends[38], the regulatory provisions examined above seems, so far, not to be adequate to face a possible *domino effect* between the various operators involved.

The responsibility for the identification of new and greater possibilities of intervention sits with the BCE, or at least with the ESRB, which, as already mentioned, performs its functions with respect to the analysis and management of events (economic and financial) of macro systematic nature. Such an approach would lead to a broader spectrum of supervisory tasks recognized to the ESRB, so as to make it competent in the formulation of advices (and recommendations) in the sphere of derivative contracts as well (in accordance with article 16 of EU Regulation No. 1092/2010). Hence, the hypothesis of a possible review of the organizational structure of the European framework, whose scope could involve modifications on ESMA’s field of action, in ways not yet foreseeable. It is undoubtable that, along those lines, it would be plausible to have new forms of cooperation between ESMA and ESRB (the latter being

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[38] Indeed, the *considerando* No. 21 of Reg. (UE) No. 648/2012 specifies that «in determining whether a class of OTC derivative contract is to be subject to clearing requirements, ESMA should aim for a reduction in systemic risk. This includes taking into account in the assessment factors such as the level of contractual and operational standardization of contracts, the volume and the liquidity of the relevant class of OTC derivative contract as well as the availability of fair, reliable and generally accepted pricing information in the relevant class of OTC derivative contract».

entrusted with the monitoring of risks relating to derivative transactions on financial stability).

7. In a context like the one described above, representing a move towards a more integrated European supervision aimed at reaching a true level playing field for EU financial actors, it is worth mentioning the peculiarity of the issues related to the supervision on derivative transactions entered into by local governments.

In general, EMIR provides some specific exemptions that apply with reference to certain public entities: the entities that are not subject to EMIR provisions are the “Union public bodies charged with or intervening in the management of the public debt” and the “public sector entities”, as identified by Directive 2006/48/EC, where they are owned by central governments and have explicit guarantee arrangements in place provided by said central governments[39].

In the light of the above, local governments which are not charged or do not intervene in the management of public debt, and which cannot be considered as “public sector entities” must be considered as “non-financial counterparties” provided they are undertakings in the sense that they carry out economic activities in the market.

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[39]In particular, it is specified that «the Regulation shall not apply to a) the members of the ESCB and other Member States’ bodies performing similar functions and other Union public bodies charged with or intervening in the management of the public debt; b) the Bank for International Settlement».

[39] See, *infra* in this Review, CAPRIGLIONE, *The Use Of «Derivatives» By Italian Local Authorities In Public Finance Management. Still An Issue*.

The analysis about whether a local government falls within the scope of application of EMIR is particularly relevant with regard to certain member States, in particular Italy, where the use of derivatives by local authorities has resulted at times in transactions characterized by speculative purposes, notwithstanding that a specific and punctual regulation was in place in order to ensure that derivatives were used only for hedging and debt restructuring purposes.

Such a distortion of the use allowed by the Regulator has brought up the need to find a remedy to avoid heavy repercussions of such *modus operandi* on public finance balance and this led to the provision of a ban for the use of derivative contracts by Italian regions, provinces and municipalities; a ban which has been lastly, permanently, confirmed by the recent Italian Stability Law[40][41].

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[40] The prohibition for Italian regions and local authorities from entering into contracts relating to derivative financial instruments has been introduced by Article 62 of Law Decree No. 112 of 25 June 2008, as converted into law by Law No. 133 of 6 August 2008 and subsequently replaced by Law No. 203 of 22 December 2008 (the Italian Budget Law for the year 2009). Such provisions were aimed at prohibiting the entering into derivative financial instruments for the Italian regions and local authorities until the entry into force of a specific regulation by the Ministry of the Economy and Finance and in any event for a period of one year from the date on which the mentioned Law Decree No. 112 of 25 June 2008 entered into force.

[41] In particular, Point 572 of the mentioned Stability Law for the year 2014 specifies that "Article 62 of Law Decree No. 112 of 26 June 2008, converted with amendments by Law No. 133 of 6 August 2008, and further amendments, is amended as follows: a) at Paragraph 2, after the words: «and at the local authorities» the following words are included: «of Article 2 of the consolidated text mentioned under Legislative Decree No. 267 of 18 August 2000,» and after the words: «reimbursement of principal in one shot at maturity» the following words are included: «and debt securities and other liabilities in foreign currency»; b) Paragraph 3 is replaced as follows: «3. Save as provided in the following paragraphs, local authorities mentioned under Paragraph 2 are prohibited from: a) entering into the financial derivatives

In this respect, upon consideration that those financial instruments can be useful if used by local authorities for proper debt management purposes, the hope is that the Italian Regulator might address again the matter, even more if, as might be wished, this kind of transactions would be made subject to integrated European regulation and supervision.

8. In the light of the above considerations, we can conclude that the functions entrusted to the abovementioned authorities seem to be coherent with the intent of the European regulator to ensure adequate forms of protection *vis-à-vis* the depositors, the investors and the companies operating within the EU. The regulatory framework appears indeed in line with the safeguard of the global integrity of the economic and financial system; a result that meets the needs of the new technical and operational assets of the markets and of the single credit intermediaries.

In general, there is a strengthening of the cooperation, on an international level, between economic actors; a further effect of such a process is indeed the limitation of market abuses and the prevention of opportunistic behaviors of subjects supervised by the single member States authorities[42].

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contracts mentioned under Paragraph 3 of Article 1 of Legislative Decree No. 58 of 24 February 1998; b) renegotiating the derivatives contracts existing at the time of entry into force of this provision; c) entering into facility agreements which include derivatives components".

[42]See CAPRIGLIONE – SEMERARO, *Crisi finanziaria e dei debiti sovrani. L'Unione Europea tra rischi ed opportunità*, cit., p. 83, whereby the Author highlights the importance of the new regulatory framework also in the light of the benefits that the whole financial markets may obtain in terms of reduction of the «uncertain regulatory situations and consequent restraint of the *moral hazard* of the operators». Under a technical perspective, please refer to ESMA

The recovery of an optimum balance of financial markets and the overcoming of criticalities brought by the recent financial crisis are not yet a done thing. This is the set of evaluations that should frame the analysis relating to derivative transactions. In particular, it has been described how the EU regulator has intervened by entrusting ESMA with specific supervisory functions in respect of these financial instruments. It has also been noted how that, for the time being, such supervisory functions do not allow to guarantee a complete control over the possible negative effects arising from credit and counterparty risks; therefore, the overall regulatory framework analyzed above should be intended as a first step toward a more complete discipline, aiming at the mitigation of said risks.

Yearly Report for 2011, whereby it is evidenced that the convergence between the regulatory praxis adopted at an European level may avoid regulatory arbitrages, which «can compromise the integrity, the efficiency and the regular functioning of the markets and, at last, the financial stability as well». See ESMA Yearly Report for 2011, p. 12, available at www.esma.europa.eu

FINANCIAL DERIVATIVES. REGULATION AND DISPUTES IN THE ITALIAN LEGAL ORDER

Mirella Pellegrini [*]

ABSTRACT: *In this paper, the main features of over-the-counter derivatives are examined together with the rules applicable in case of so-called negotiation "per conto altrui" (that means as a simple seller of financial instrument on behalf of the issuer or owner). In this regard, the questions and following litigation on trading in derivatives concerned essentially the operations in direct counterpart not traded on regulated markets that have been characterized by evident problems of illiquidity and opacity.*

As a consequence, the reference to the behavioral norms that the legal system requires to intermediary in the execution of investment services and that have been subject to revision as a result of the transposition of MiFID directive.

In the attempt to identify remedies that protect the investor from errors in risk assessment assumed on trading these financial instruments (remedies able to prevent a misuse of derivatives and able to come beyond the information transparency) it draws to the attention the behavioral finance and the probabilistic risk assessment.

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SUMMARY: 1. Introduction - 2. Concept of derivatives, regulations and operational procedures - 3. Over-the-counter (OTC) derivatives - 4. Derivatives disputes - 5. The applicability of the adequacy principle to the transaction - 6. Additional measures against improper use of derivatives: behavioural finance and probabilistic risk assessment

1. The negotiation of OTC derivatives is considered by the majority of academics and financial operators as one of the causes that made the financial crisis explode with devastating effects both in the United States and Europe[1].

Such financial instruments, at the heart of numerous (and not only the most recent) financial scandals[2], have caused huge losses to the investing public as well as to companies in which they were traded[3]; it is logical in this context

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[1] See, among others, BORIO, *The Financial Turmoil of 2007*-?: *a preliminary assessment and some policy considerations,* 2008, www.bde.es; COLOMBINI, *La crisi finanziaria e la riforma Obama,* in *Riv. trim. dir. econ*. 2010, n.3, pp. 201 ff. See CAPRIGLIONE – SEMERARO, *Financial crisis and sovereign debt: the European union between risks and opportunities*, in this *Review*, 2012; FRIEDMAN, *Two Roads to Our Financial Catastrophe*, N.Y. Rev. Books, Apr. 29, 2010, p. 27; ROE, *The Derivatives Market's Payment Priorities as Financial Crisis Accelerator*, March 2011, on papers.ssrn.com

[2] The distribution of derivative contracts goes back in time (CHANCE, *A Chronology of derivatives*, in *2 Derivatives Quarterly*, 1995, p. 53); here we limit ourselves to remembering the succession of scandals related to negotiation in derivatives pushed the English legislator to prohibit negotiations at the end of the XVIII century (see Barnard's act): See OLDANI, *The financial derivatives*, Milan, 2010, pp. 47 ff. On American finance scandals in recent years see PARNOY, *Infectious Greed,* New York, 2009.

[3] In Italy, the third largest bank (Monte dei Paschi di Siena), due to some derivatives traded not in accordance with existing regulations, found itself in the well-known position of having to resort to state assistance. see RINALDI, *Derivati e crollo MPS*, Radioie, 23/1/2013.

that the same have been defined as "weapons of financial mass destruction[4]". It is precisely because of the improper use of such financial instruments which has enabled a dispute without precedence, begun by companies (and local authorities) that have signed such contracts: the matter in question is, therefore, of considerable practical impact.

The common element of the scandals mentioned above is not their being attributable to the derivatives "as such" (i.e. financial products intrinsically difficult to apply) but rather the distorted use of the same that has been made (not in accordance with regulatory requirements), or the fact that the operators have ended by excessively taking advantage of the leverage that derivatives enable. From here a general orientation critical of derivatives, a position that cannot be accepted *tout court,* as derivatives can presumably play a role, even a positive one, on the financial markets.

It can certainly be said that the data developed on the distribution of derivative contracts in global finance have long been the subject of reflection and guide the recruitment of taking corrective action in the present matter[5].

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[4] See BUFFETT, *Derivatives are Financial Weapons of Mass Destruction*, available at www.investorwords.com.

[5] Specifically, between 2008 and 2009, namely after the outbreak of the financial crisis, the notional value of derivatives negotiated over the counter, OTC, in the financial world continued to grow... The estimated value of financial derivatives is estimated to be 12 times higher than the global GDP somewhere over 600 trillion dollars). See *Rivelazione sui prodotti derivati over-the-counter,* on www.bancaditalia.it. This investigation carried out on the initiative of the Committee on the Global Financial System foresees the biannual disclosure of the statistics on OTC derivatives on the basis of a sample of banks and financial intermediaries working more in this sector. Such a disclosure is based on the recommendations of the Report

From the outset it was realized that more stringent rules were needed, designed to prevent risky behaviours (rules that are appropriate to ensure a fair distribution of resources in a competitive healthy environment)[6]. This has led to a tendency (particularly emphasized in the current historical moment) to abandon traditional forms of self-regulation of intermediaries[7], in favour of an increase in public control and sometimes of a ("re") adjustment that has the proposed object of encouraging an effective application of the regulations and to guarantee the protection of the diverse public and private interests that underlie the functioning of the financial markets[8].

The real problem that arises in substance is the one relating to the distinction between good and bad in this category of financial instruments that should absolutely not be demonized, but evaluated case by case to make sure they do not assume a speculative function, in other words aimed at reducing or

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Proposals for improving global derivatives market statistics, presented by the above-mentioned Committee in July 1996.

[6] On the effect of the limits of regulations – and above all the lack of clarity of the latter on the recent crisis see SICLARI, *Crisi dei mercati finanziari, vigilanza regolamentazione*, in *Riv. trim. dir. pubbl*., 2009, pp. 45 ff.; BERNANKE, *Speech at the Council on Foreign Relations,* Washington *D.C.* 10th March 2009; TRICHET, *The EBC's response to the crisis*, Paris 20th February 2009; CAPRIGLIONE, *Misure anticrisi tra regole di mercato e sviluppo sostenibile*, Torino, 2010.

[7] See PELLEGRINI, *Autoregolazione e controllo,* in *Elementi di diritto pubblico dell'economia,* e-dited by Pellegrini, Padova, 2012, pp. 241 ff.

[8] See FERRARINI – GIUDICI, *Financial scandals and the role of private enforcement: the Parmalat case,* ECGI, in *Law working paper* n.40/2005, May 2005.

delaying the concrete realization of the loss caused by a contract previously signed[9].

2. We need to move from the idea which according to the derivative contract takes as its object the transfer from subject A to subject B of a «risk » inherent in an «underlying asset». In the derivative – and here lies its essence – the "risk" is not a mere contract accessory (as each contract has its own risks), but rather identifies the main object of the same. So we can define the derivative as the contract whereby risk is given a price.

This category, which seems in itself very heterogeneous, has an element in common. The object of the derivative is represented by spread trading; not by chance, it has been highlighted in literature that "what the contracting party buys is not the underlying liability but the difference in value that this will acquire in time [10].

Under Italian law (which, as is known, adopts Community legislation), the expression «derivative contracts» frequently quotes from art.1, paragraph 2 , section D), E), F), G), H), J) of Legislative Decree No. 58/1998 (from here on TUF), which essentially qualify them along the same lines of financial instruments. The Bank of Italy[11] defines them as "the contracts based on elements of other negotiations such as bonds, currencies, interest rates, exchange rates, stock

[9] See CAPRIGLIONE, *I prodotti "derivati": strumenti per la copertura dei rischi o per nuove forme di speculazione finanziaria?,* in *Banca, borsa, tit. cred.,* 1995, pp. 359 ff.

[10] See GIRINO*, I contratti derivati*, Milano, 2010, pp. 16 ff*.*

[11] Art. 3, *Istruzioni di vigilanza per le banche*. See CAPUTO NASSETTI, *I contratti derivati finanziari*, Milano, 2007.

indexes etc." whose value 'comes', therefore, from that of the underlying assets. Derivatives are, for example, *future contracts, options, swaps, forward rate agreements"*.

It must be stressed that, in addition, such contracts are professionally traded exclusively with regards to the public by financial intermediaries; consequently, it does not amount to one type of contract, but rather a category of contracts.

In this respect, it is significant that, in the cited regulations, a definition of derivative contract cannot be found**.** Indeed, the TUF limits itself to a non-exhaustive list of the forms such instruments (contracts) can take, which – for their characteristics – are qualified as «derivatives» (art.1, paragraph 3, TUF)[12].

Despite being open to criticism in terms of legal certainty, this regulatory option is significant in actual fact when one considers that derivative contracts are developed first in financial practice, and only later «transposed» into law.

Such option has specific importance if one considers that several different types of contract have been developed in international practice, in addition to those set down by law (which can certainly be included in the class of derivatives).

All in all, a rigid legislative definition of derivative contract is not compatible with the operational reality on which derivatives are usually based;

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[12] These are: options, standardized predetermined financial contracts (futures), swaps, agreements for future interest rate exchanges, other derivative contracts relating to securities, currencies, interest rates, yields, other derivatives, financial indexes or financial measures which may be settled physically or in cash etc.

in fact, such definition would inevitably be doomed to crash with the rapid changes in financial engineering and to be considered obsolete in a few years.

In addition, this already very large legal category is open. It is for this reason that the list of derivatives does not constitute a closed number. Indeed, art.1, paragraph 2 *bis* of TUF grants a proxy authority to the Minister of Economy and Finance to identify other potential derivative contracts. In this way, the operating system acquires flexibility: the new derivative contracts, created on the basis of advanced financial techniques, may be incorporated into the legal order without the need for further specific legislative provision, but only after recourse to ministerial regulation.

Finally, it should be noted that the derivative contracts in an international field often repeat predefined schemes and models from third-party organisations; in this regard, it is particularly relevant the action taken by ISDA (International Swap Dealers Association for swap contracts, established in 1985 by some American operators), which subsequently changed its name from "Swap Dealers" to "Swaps and Derivatives". This change was made to focus more attention on their efforts to improve the more broad derivatives markets and away from strictly interest rate swap contracts.

This association (which in 1987 formulated the first *Master Agreement* aimed at regulating the operations in question) draws up standard agreements designed to regulate principal contractual aspects, leaving the task to the contracting parties to agree on the financial elements of the individual contract[13]. In this way, space is given to the so-called OTC derivatives, which will be discussed in the next paragraph. The need to contain the implicit costs related to the establishment of any new OTC derivative transaction and, at the same time, to have an instrument that can mitigate the related risks, including systemic risks, has given a decisive impetus to the development of the ISDA *Master Agreement.* In this logical context lies the recent issue of the ISDA *Protocol* 2013, a document that contains information on specific operative modes to comply with the recent Emir Regulation (see below) and the relevant implementing technical standards[14].

3. Problems in derivatives trading have essentially concerned direct counterparty transactions that are not negotiated on regulated markets and that are characterized by serious illiquidity and opacity problems.

It is necessary to point out that, in order to guarantee transparency, the orderly execution of trading and the investor protection, as well as to mitigate the spread of litigations between intermediaries and investors in Italy, in 2009 Consob, as national supervisory authority, issued a recommendation concerning

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[13] See CAPALBO, *Profili civilistici del rischio finanziario e contratto di swap,* Milano, 1999, p.23. On ISDA, see RADICATI DI BROZOLO, *Il contratto modello di swap del ISDA*, in *Diritto del commercio internaz.*, 1988, p. 539; DE BIASI, *Un nuovo master agreement per strumenti finanziari, in Banca borsa tit. cred.*, 2001, pp. 664 ff. In the case of swap contracts, as happens in that of new atypical contracts (not nominated yet), we see the emergence of models and forms being developed by multinational trade associations and international organizations, to facilitate the work of the economic operators.

[14] Referring to the publication by ISDA, respectively 8th November and 11th October 2013, of two new Protocols called ISDA 2013 ICE Brent Protocol and ISDA 2013 Discontinued Rates Maturities Protocol.

the obligation of the intermediary to behave correctly and transparently during the placement of " illiquid financial instruments"[15] (i.e. instruments difficult to disinvest in a reasonable lapse of time) to retail investors.

At the same time it has been underlined that particular attention should be reserved to OTC derivatives trading (swap overall), because these instruments "usually do not allow the definition of a real price but rather the identification of a set of financial parameters defining the transaction value" which is hardly quantifiable.

In the absence of a legal definition (both in national and in European legal order), legal doctrine has tried to define the expression "*over the counter trading"*, taking into account that the changes provided by the transposition of the MiFID directives (39/2004/CE) seem to have redefined its contents[16].

In the light of the research results, it can be said that this specific case (i.e.*"over the counter trading"*) is characterized by the following elements: parties involved in the transaction, trading platform, rules regulating the admission of securities to trading and the rule**s** governing the negotiation.

Belonging to the first element is the financial intermediary (generally counterparty of the derivatives contract) who can trade "on own account" (as

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15 It refers to Communication 2 March 2009, no. 9009104 that can be consulted on the web site www.consob.it; as an example, it considers bank bonds, over-the-counter financial derivative instruments, financial and insurance products (united and index limited) as illiquid financial instruments, which present restrictions or limitations to the disinvestment, at significant price conditions. On this issue see PICCININI, *La trasparenza nella distribuzione di strumenti finanziari derivati ed il problema della efficacia delle regole informative,* in *Contr. e impresa,* 2010, pp. 505 ff.

16 See SEPE, *La contrattazione "over the counter",* in *Riv. trim. dir. econ.,* 2011, pp. 45 ff.

issuer or owner of the offered financial instrument), or “on account of third parties” (as simple seller of the financial instrument on behalf of the issuer or of the owner). This explains why the intermediaries' activity (banks or investment firms) during the placement of over-the-counter derivative instruments (OTC) to local authorities or companies, is essentially that of providing a trading service on their account, that is playing the role of direct counterparty with costumers[17].

With reference to trading platform, it should be noted that OTC trading is the one performed outside regulated markets (in particular the official stock markets), which are subject to specific authorization requirements and supervision.

However, the transposition of the MiFID directives has introduced relevant regulatory innovations in Europe in the direction of overcoming the distinction between regulated and non-regulated markets. In particular, in order to avoid competitive asymmetries, all available trading platforms (regulated markets, multilateral trading systems or MTF and systematic internalizers) have been rationalized and they are now under control systems (also authorization systems) which are, to a great extent, equivalent (best execution, written form, pre- and post trading transparency).

These operational innovations have remarkably delimited the OTC area. From such innovations, there remain excluded (therefore they must be considered as OTC) those trading operations taking place outside the above-

17 See ROSATI, *Indagine conoscitiva sulla diffusione degli strumenti di finanza derivata e delle cartolarizzazioni nelle Pubbliche Amministrazioni,* hearing, 18 March 2009, on www.consob.it.

mentioned platforms, which means realized in an informal way, through bilateral relations between the parties, both *in the presence of the parties* and *by telephone,* but also by electronic means (*i.e*. when specialized *providers* make *booking* systems available to financial operators who can use these systems to insert their bid-offer on securities quotations, which can be displayed and accepted by system users[18].

The other identifying feature is usually the fact that, unlike trading platforms under supervision, OTC derivatives require neither specific rules regulating the admission of securities to trading nor rules concerning the trading mechanisms themselves.

This obviously does not mean that a set of rules to be observed is lacking. Indeed - also when referring to a direct OTC trading between an intermediary and a customer - during the negotiation the intermediary is always obliged to respect conduct rules concerning the provided service (on own account trading, orders execution, orders reception and transmission); rules that the Community guidelines have graded according to the status of the counterparty that can be retail investor[19], professional investor[20] or eligibile counterparty[21]. From such distinctions, different schemes of protection derive[22].

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[18] See SEPE*, La contrattazione "over the counter", cit*.

19 Retail investors are neither professional investors nor eligible counterparties (art.4, paragraph 1, sect.12, MiFID directives). To these investors, the standard protection regulation established by MiFID directives applies. art. 19 and ff.

20 In order to identify the category of "professional investor", see Annex II, directive 2004/39/EC

21 Eligible counterparties (described as investors in recital n. 40 directive 2004/39/EC), thus defined in relation only to specific services, are divided into subjects classified as such by MiFID

Basically, the so-called "OTC trading" phenomenon applies to an extended and varied range of operations (including rather different cases)[23], in which the key features are the "one-to-one" mode, in terms of trade negotiation (rather than a multilateral one) and regulations, and the absence of a "market" public regulation to regulate the transaction[24].

This operational situation has apparently not been overcome by the provisions set out in the recent Regulation 648/2012/EU (European Market Infrastructure Regulation, EMIR), which identifies a European common framework concerning the regulation of derivatives traded outside regulated markets (through mandatory clearing and reporting of the OTC contracts to the central counterparties), in order to reduce the systemic risks connected to

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directives and subjects that, on the basis of a possible option exercised by Member States, satisfy pre-determined requirements (art.24, paragraph 3, MiFID directives and art.50 directive 2006/73/EC). This classification as eligible counterparty does not compromise the subject's right to request, in general terms or for every single operation, a treatment as a professional investor or, expressly , as a retail investor. In this case, the request is subject to intermediary's approval.

22 For example, according to the best execution principle, this system may be departed from (in addition to "execution only" cases) only with reference to those operations executed on behalf of investors characterized by an "eligible counterparty status" (art. 58, sect.3, Consob Reg.).

23 Within this notion fall operations ranging from the sale of financial instruments (either derivatives or not) by the bank to its customer to the so-called financial transactions between intermediaries of systemic importance.

24 See SEPE, *cit*.; MAFFEIS*, Intermediario contro investitore: i derivati over the counter,* in *Banca borsa tit. cred.,* 2013, pp. 779 ff.

derivatives, and in which certain limitations to the discretionary nature of the counterparties on OTC markets are introduced[25].

However, it is of major importance to maintain the connection to the specific case (typical of OTC trading) that prevents a general and unambiguous regulation of this subject.

Beyond what so far mentioned, it is important to consider that, according to the recent provisions by the European Regulator, financial operators committed to bilateral OTC trading – where neither standardization nor mandatory clearing requirements from an appointed *clearing house* are involved – shall satisfy main capital adequacy requirements.

To summarize, also by virtue of the recent EU regulations, over-the-counter contracts are and may still be non-standardized contracts; at a practical

25 See Regulation (EU) n. 648/2012, adopted on July 4th, 2012, formally came into force on August 16th, 2012. It intends to regulate “OTC” derivatives (i.e. derivatives individually traded between two counterparties and not exchanged on regulated markets), imposing new stringent requirements on all operators, whose effective entry into force is planned according to a schedule of staggered deadlines. The main point is the introduction of mandatory clearing to the central counterparty and a mandatory reporting to the companies called “trade repositories”. All financial counterparties must comply with these requirements, as well as non-financial counterparties whose operations exceed a certain monetary threshold . Entities/Subjects operating as central counterparty are companies authorized by the national competent authorities, after consulting a college that includes Esma (European Security and Market Authority) (artt.14 ff.). A new supervisory function is conferred to Esma, with particular focus on the activity carried out by trade repositories and CCPs. In particular, according to artt.55 and ff, Esma keeps a register listing all trade repositories operating on OTC markets on the regional European territory. Once registered, Esma can require from trade repositories (and related third parties) every information linked to their activities (art.61) and can carry out on-site inspections (art.63). It can also apply administrative penalties (ex art.65) in case of technical infringements (as provided for in Annex I).

level, the possibility of a complete standardization seems unthinkable, as they are often generated to meet the investor's specific requirements and therefore conceived as “tailor-made” products.

4. Particular attention should be paid to the problem concerning litigations which may arise in case the relationship between the intermediary and the retail investor presents elements invalidating the contract.

This is not the appropriate context to focus on the broad debate regarding the possibility admitted by law to consider retail investors as professional investors (the so-called upgrading) and to waive any form of protection granted to the former (thus also to waive any intermediary's obligation to comply with the conduct rules imposed by the EU secondary regulation on investment services) by simply presenting a self-certification, as permitted by the regulations in force prior to the Mifid directives[26].

The present study is therefore confined to specify the constraints imposed on the intermediary by the assessment of the level of financial expertise and experience of the requesting party; being such assessment aimed at identifying the requirement whereby the operator can disapply conduct rules

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[26] For an overview into the opposing positions emerging in case law as concerns the evaluation of investors' self-certification as professional investors (and therefore evaluating such declaration as ground for potentially exempting the intermediary from checking the investors' competence and experience to include them among professional investors) see respectively, on the one hand: Milan Court, 12th october 2007 in *Nuova Giur. Civ*. 2008, I, p. 222, commented by RUGGIERI; Mantova Trib., commented by MOTTI; Novara Trib., 18th january 2007, in *Banca borsa tit. cred*. 2008, pp. 57 ff., commented by LEMMA, *L’ ”operatore qualifica-to”, nelle operazioni in derivati*.

(which is only granted by the law when the investor can consciously take decisions in terms of investments)[27].

Leaving aside in-depth analyses on derivatives litigations, we intend here to remind that public authorities and companies (but also private investors, yet within certain limits) have frequently been offered financial instruments by banks with the goal – at least originally – of providing hedging against risks.

It should be emphasized that the original operational objective of these transactions is to be considered a commendable one, even though an observer – yet only a keen one - might have envisaged a *dangerous* development of the relationships established to that purpose, due to several features of such financial instruments. Besides their riskiness, the shortage of liquidity characterizing this type of transactions is also relevant; hence the need for a negotiation (directly carried out by the bank) aimed at solving the difficulties of the so-called weak negotiating party.

Conversely, the circumstance negatively influencing the reconstruction of derivative operations is that these contracts – based on the protection needed by each single investor – do not have an organized secondary market and – as previously mentioned – are usually traded over the counter; that is in a context characterized by scarce transparency, illiquidity and prone to develop conflicts of interest (due to the intermingling of offer and counseling which characterizes

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[27] See Bari Trib., 15th july 2010, in *Banca borsa tit. cred*., 2012, II, 786; Milano Trib., 19th april 2011, *ibid.*, 2011, p. 748, commented by GIRINO, *Sviluppi giurisprudenziali in materia di deriva-ti* over the counter, pp. 794 ff.; Napoli Trib. 30th October 2011, n. 11706, available at www.dirittobancario.it.

them); being these preconditions capable of undermining the liability of the intermediaries to attend to the investor's interest.

It is fairly evident that, in the context of a written formal agreement, investors have often signed (without hesitation) a certification whereby they have claimed to have a certain financial experience without being aware of the protection they are renouncing by doing that.

This is where the wide-ranging dispute concerning the operations in question comes from; the details of which are well-know, as much as the significant contribution given by the Supreme Court of Cassation concerning the Italian legal order[28.] The guidelines set forth by the Supreme Court can contribute to solve the problem here at stake, if its invitation is accepted to give adequate relevance to the principle whereby integrity, transparency and good faith must be ensured to qualified operators too, as judicial proceedings have recently confirmed[29].

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[28] The Supreme Court intervened on this matter in 2007 by emphasizing that the (*virtual*) nullity "of the contract subsequent to the infringment of the intermediary's conduct rules…, in the absence of any specific provisions, general principles or systematic rules, is not justified" (whereas, depending on the case, either a «pre-contractual liability» or a breach of «contractual» obligation can be assumed, which legitimizes a claim for compensation or even, in case of exceptionally grave breach, for a termination of the agreement). See Supreme Court of Cassation, Ss. Uu., 19th december 2007, nn. 26745 and 26725, in *Danno e responsabilità*, 2008, pp. 525 ff., commented by Roppo – Bonaccorsi. See Supreme Court 26th may 2009, n.12138, on www.ilcaso.it.

[29] Case law has made clear that art.21 of TUF - claiming the "integrity of the market" - is a mandatory rule, therefore a binding one, which also applies to qualified operators . See Milan Trib., 23th march 2012, n.3513, on www.dirittobancario.it; and also previously Milano Trib., 19th april 2011, n.5443; Verona Trib., 20 settembre 2012, in *Il Corriere giuridico*, n.8-9, 2013, pp. 1094 ff.

In such context, it its clear that the defence of investors in litigations involving derivatives should proceed to a detailed reconstruction of the modes in which the transaction was carried out (also including to this purpose the negotiating phase), in order to identify suitable elements to represent the "deceptions" envisaged by art.1439 of the Italian Civil Code, and consequently a negligent behavior in terms of communication[30].

Furthermore, it should be noted that - besides Civil Law – the rules of conduct imposed by the law on the intermediary in dealing with investment services are also relevant and, as known, they have been reviewed following the application of the Mifid directive.

It follows that selling 'derivatives financial instruments' to customers can be framed within the wider context of providing the public with investment services, which is regulated by primary UE legislation (in Italy art.21 ff., TUF) and completed by secondary legislation (implemented in Italy by Consob Regulation No.16190 of 2007 art.27 ff.). It is worth remembering that the cornerstone rule regulating the intermediary/investor relationship is art.21 of TUF, which prescribes some *general criteria* among which the principle whereby the intermediary must act diligently, correctly and transparently in the interests of customers and the integrity of the market (art.21, paragraph 1, lett.a) acquires particular prominence. Hence the intermediary's duty to receive the necessary information from customers, to operate in such a way that they are always adequately informed (art.21, paragraph 1, lett.b) and to ensure a transparent

[30] See DE POLI, *Note minime su strumenti finanziari e mezzi di tutela dell'investitore*, in www.dirittobancario.it, June 2012, p.8.

conduct during each stage of the negotiation, namely pre-contractual phase, completion and implementation, by providing exhaustive, objective and clear information on the crucial elements concerning the transaction, the service and the financial instruments. The article also prescribes that the intermediary must have adequate resources and procedures, including internal control mechanisms, to ensure an efficient provision of services (art.21, paragraph1, lett.d). Still referring to conduct, it adds a final requirement, namely the adoption of "every reasonable measure to identify the conflicts of interest that may arise with the customers or between customers... (through)... adequate organizational measures, so as to prevent such conflicts from negatively affecting the customers' interests" (art.21, paragraph 1-*bis*, TUF).

In actual fact, recent experience has shown that financial intermediaries trading in OTC derivatives have *exclusively* acted like invertors' counterparty (*rectius*: they have behaved in conflict with them), whereas they should have *cooperated* with the investors, without renouncing to their profitability according to special provisions [31].

This also emerges from the provisions set forth in articles 21 and 23 of TUF concerning intermediation contracts[32], which apply to both the negotiating phase and the contract completion.

[31] See MAFFEIS, *cit.*

[32] In accordance with art.23 of TUF, contracts shall be in writing. If otherwise, they are void. Furthermore no action lies for payment of a gambling/gaming or betting debt, nor can an action lie for recovery where the debt has been paid voluntarily following a game or bet not involving fraud (art.1933 of the Italian Civil Code).

In such regulatory context, there acquires particular relevance the requirement according to which intermediaries should not pursue their own interest disregarding the customers'. If otherwise, the intermediaries would infringe art.21 of TUF and would be consequently held responsible. The EU regulator has imposed a strict discipline on intermediaries as regards conflicts of interest[33], considering that primary and secondary legislations already require them to refrain from such a conduct.

5. As regards OTC derivatives, Consob (already mentioned in the 2009 Communi-cation) pointed out that intermediaries are required to observe the requisite of "adequacy" of the transaction; this thesis is based on the consideration that the activity of assistance that they provide to customers (i.e. at the stage of structuring transactions according to the investor's profile risk), is embodied in the provision of advisory services (Article 1, paragraph 5 *septies*, t.u.f., transposing Article 52 of Directive 2006/73/EC)34. Therefore, we can understand the obligation imposed by the Authority on the intermediaries to adopt procedures apt to assess the suitability of the transaction recommended,

[33] See KRUITHOF, *Conflicts of Interest in Institutional Asset Management: Is the EU Regulatory Approach Adequate*? on www.ssrn.com; ANTONUCCI, *Regole di condotta e conflitti d'interesse*, in *Banca borsa titoli cred*., 2008, I; ENRIQUES, *Conflicts of Interest in Investment Services: The Price and Uncertain Impact of MiFID's Regulatory Framework*, on www.oxfordscholarship.com, pp. 11 ff.

[34] On the new configuration, as a result of the EU Guidelines, the criterion of the adequacy of operations, see PELLEGRINI, *Regole di comportamento e responsabilità degli intermediari*, in *I contratti dei risparmiatori*, edited by Capriglione, Milano, 2013.

suggesting suitable financial products in terms of effectiveness and efficiency, taking into account also the cost of alternative opportunities[35].

On a closer look, apart from the guarantees concerning profile information, it is mostly about guaranteeing the intermediary's organization and internal operations (commercial policy, pricing methods, monitoring of the operation over time); therefore, they are not in the perceptual availability of the customer, who is in a position neither to know and appreciate them, nor to monitor the actual compliance.

It is the Supervisory Authority's duty to control and possibly to take appropriate sanctioning measures, (being the *enforcement* the real test for the protection of the customer) also in order to avoid any possible recourse to civil and criminal courts.

However, repressive interventions may not be timely and investors may be damaged anyway. It is therefore necessary to identify preventive measures that go beyond the mere "disclosure" for the protection of the customer.

In this regard, case law has shown that transparency is not a sufficient protection for those investors who are not able to "critically evaluate" the information provided, beyond their supposed "expertise" (as they often lack the competence that only the intermediary has). This suggests that making the protection of the customer effective is not only a problem of "asymmetric information," but also of "cognitive asymmetries"36, i.e. the seller’s knowledge

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[35] See the ESMA, Guidelines, 6th july 2012, on suitability requirements, on ww.esma.europa.eu

[36] See GREENWALD - STIGLITZ, *Asymmetric information and thenew theory of the firm: financial constraints and risk behaviour*, in *American Economic Review*, 80, May 1990, pp. 160 ff.

of the product[37]; it is an obligation of the latter to assist the customers in consciously choosing investment products, in order to prevent them "unpleasant surprises".

6. Trading in derivatives in a context of recession - which is what characterizes some EU countries at present, such as Italy - poses the problem of finding additional measures for the protection of investors, as the economic recovery cannot occur regardless of it. As already pointed out elsewhere, there is a reciprocal relationship between intermediaries' fairness and proper functioning of the market, since the former represents a *condicio sine qua non* to gain savers' confidence in market mechanisms and, therefore, indirectly ends up being a condition for its proper functioning[38].

As regards the need to identify corrective measures to prevent the occurrence of situations that can seriously damage (and sometimes beyond repair) the relationships between intermediaries and investors, the results of scientific research on 'behavioural economics" can be useful; in fact, they provide an additional instrument to ensure a stronger protection of the investor, especially if retail.

Particularly, there emerges the possibility to use the information provided by social sciences (according to which the proper use of the *investor education* instrument can improve the investors' understanding of the financial products' characteristics) in view of an appropriate correction of the cognitive

[37] See on this point SEPE, *cit*., paragraph 3.

[38] See PELLEGRINI, *Le controversie in materia bancaria e finanziaria*, Padova, 2007, spec. Chap.V, wide bibliography ibid.

errors (debiasing) experienced by some customers who are either little cautious or unaware of the complexities they face in their actions[39].

Behavioural finance[40] - which deals with the results achieved in empirical studies - provides important information on the subject, pointing out that the decision-making processes of individuals are frequently influenced by different factors, which are not only rational but also emotional[41]. Actually, dealing with investigations to verify whether the investor's decision-making process has been influenced by external factors (or at least if the will to negotiate has somehow been altered) means pursuing market balance in innovative ways, based on the reliability of negotiations freely carried out by the contracting parties.

It is more recent and still very limited the line of investigation concerning the subjective difficulties experienced by investors in making their own choices before a wide range of operational alternatives (with respect to the same type of risk).

To clarify the context in which the various operational options offered by the market are located, it is getting more and more widely believed that it

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[39] See LINCIANO, *Errori cognitivi e instabilità delle preferenze nelle scelte di investimento dei risparmiatori* retail*. Le indicazioni di* policy *della finanza comportamentale***,** in *Quaderni di Finanza - Consob*, 2010, n.66, p. III.

[40] Studies of behavioral finance date back to the 1970s (see KAHNEMAN - TVERSKY, *Prospect Theory: An Analysis of Decision under Risk*, *Econometrica*, 1979, 47, p. 263 ff.; SHEFRIN, *Do Investors Expect Higher Returns from Safer Stock than from Riskier Stocks?*, in *Journal of Psychology & Financial Markets,* 2002, 2, 4, pp.176 ff.). See also AA.VV., *La finanza comportamentale e le scelte di investimento dei risparmiatori. Le implicazioni per gli intermediari e le Autorità*, in *Quaderni di Finanza - Consob*, 2011, n.68, p.6.

[41] See ROSSANO, *Le "tecniche cognitive" nei contratto di intermediazione finanziaria*, Napoli, 2011, *passim*.

would be appropriate to make it mandatory for banks to report the information contained in the 'probabilistic scenarios' when selling financial products (including derivatives) to savers.

Hence the growing interest in the so-called *risk-based approach*, whereby risks are assessed and illustrated to the investors with the aim of enabling the latter to a correct risk perception; this goal can be achieved by providing a report that clearly and objectively represents how likely the derivative is to improve its situation.

To confirm the validity of this approach it is sufficient to think how easy it is to let the investor believe that a product can produce high profitability (which is sometimes true), but without specifying what and how much this is likely to occur (being such information in possession of the issuer who does not mention about it in order to sell a specific financial instrument)[42].

This informative method shows its full effectiveness in gambling, whereby the probability of winning or losing the amount invested can be assessed.

Therefore the probabilistic method shows the exact extent of the risk taken (i.e. the possibility of loss)[43].

Applying the probabilistic method to some derivatives (for example, with regard to the past, those traded by local authorities), it turns out that the probability (calculated at the date of contract subscription) for the derivative to

[42] See PATRONI GRIFFI, *I contratti derivati: nozione, tipologia e peculiarità del contenzioso*, www.dirittobancario.it, October 2012.

[43] See PATRONI GRIFFI, *op. cit*.

perform financial coverage is very scarce, or even not non-existent in some cases.

On this point, we agree that assessing the instrument's conformity to its function in probabilistic terms can be a valid method of inquiry for legal proceedings involving derivative contracts. If the instrument is not “genetically” able to perform the function for which it is meant (i.e. financial coverage, as in the case of derivative contracts traded by local authorities), then we are faced with either an insufficient or an unlawful cause to enter into a contract; hence the nullity of the same[44].

Let us now take into account the case of OTC derivatives placed to private customers. If, on the basis of the above-mentioned method, the contract does not seem to carry out any of the functions typical of the negotiations in question (with the consequence that the specific case cannot be identified as “derivative financial instrument"), the investor should be entitled to terminate the contract, or to rely upon the “exception of the gambling and betting” and to declare the contract void for lack of cause (resulting from a defect in the *alea* of the contract whose typical characteristic is in fact that of being aleatory)[45].

In conclusion, the identification of techniques ensuring transparency – as concerns the risks faced by the investors trading in financial products - may represent a step forward in the search for solutions to progressively fill the informational asymmetries characterizing the intermediary-investor

[44] See PATRONI GRIFFI, *op. cit.*, p.23.

[45] See previous note, *ibidem*.

relationship; hence the recovery of the confidence in the financial system and, therefore, the preservation of its good functioning.

It is therefore necessary to reserve increasing opportunities for financial education, considering the investors' frequent inability to make choices that prove to be optimal for them. At the same time, it is clear that increasing attention needs to be devoted to the methods of intervention developed by cognitive sciences (which are able to identify suitable instruments for measuring the reactions of individuals faced with potentially risky situations). In other words, special attention should be paid to the operating models developed by the sciences that – even if apparently distant from the scope of finance and economics - can make a contribution to the solution to the long-standing problem of the protection of savers-investors[46].

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[46] We agree with those who claim that this should not take away from investors the entire responsibility on the choices made "even through the use of indiscriminate rules ...of compensation or personal liability"; see MORERA - MARCHISIO, *Finanza, mercati, clienti e regole… ma soprattutto persone*, in *Anal. giur. dell'economia,* 2012, p. 35 (on the inalienable right of the citizen to be wrong see LOSS, *Fundamentals of Securities Regulation*, Boston and Toronto, 1983, p. 36). In this way, as we have pointed out in the past (see PELLEGRINI, *Le regole di condotta degli intermediari finanziari nella prestazione dei servizi di investimento*, in *L'ordinamento finanziario italiano*, edited by Capriglione, Padova, 2010, II, p.856), we would give a too strict interpretation of the new regulations and this would possibly lead to an increasing number of measures to protect the weaker party. To such an extent, it would alter the market logic and its competitive mechanisms.

On the basis of the *antiantipaternalistic* approach to the regulation of financial markets see SUNSTEIN - THALER, *Libertarian paternalism is not an oxymoron*, *The University of Chicago Law Review*, 2003, p. 1159 ff.; according to this approach, public intervention should aim to correct errors by acting on the circumstances that favour their emergence (so-called *debiasing through law*, see Jolls - Sunstein, *Debiasing through Law*, in Journal of Legal Studies, 2006, 35, p. 199 ff.). On some "correction techniques" aimed at making individuals aware of the most

This may be the shortcut, though limited, that the authorities in the field (and the operators) should pursue in the attempt to reinterpret in an innovative and concrete way the "duty to act in the best interest of the investor", which has been present in the European regulations for quite a long time.

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common mistakes, see FISHOFF, *Debiasing,* in *Judgment under Uncertainty: Heuristics and biases*, edited by Kahneman, Slovic, Tversky, New York, Cambridge, University Press, 1982.

THE USE OF «DERIVATIVES» BY ITALIAN LOCAL AUTHORITIES IN PUBLIC FINANCE MANAGEMENT. STILL AN ISSUE

Francesco Capriglione*

ABSTRACT: *The 2008 financial crisis and its aftermath have prompted academics and policy makers to question issues related to the public finance management and, more specifically, to the usage of financial derivatives by local authorities.*

This paper can be placed within the debate on whether derivatives may or not contribute to a healthy allocation of public resources. It meets the need to investigate the extent to which those derivatives transactions entered into by the Italian local authorities before being prohibited by the regulator in 2008, have been executed in conformity with their related disciplining provisions; a still actual issue if one consider the wide number of legal disputes in subiecta materia.

In Italy, the need to prevent local administrations from postponing forward in time the financial burden of debt has driven the regulator to establish strict guidelines that could not be disregarded by intermediaries involved in the aforementioned transactions. Firstly, the scope of derivative transactions has been limited only to debt restructuring and, secondly, it was required to avoid both complex contractual forms, with the contextual request of a plain vanilla

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structure, and payment flows present values with an increasing profile. Thus, it is deemed necessary to analyse the remedies to challenge derivatives non-compliant with the ad hoc regulation: from the declaration of voidness (under Article 1418 of the Italian Civil Code) to the local authorities' self-repealing authority (potere di autotutela) and to the possibility to settle the dispute. This work reaches the conclusion that the interpretative approach adopted by the Italian Corte dei Conti leaves no doubt about how to use derivatives in the public finance management.

If you want to see the rainbow,
you have to learn to love
the rain.
Paulo Coelho

1. Among the many problems related to the effects of the recent financial and sovereign debt crisis are those linked to the use of financial derivative instruments made by Italian local authorities (provinces, municipalities, metropolitan cities, mountain communities and island communities and consortia of local authorities and regions), since the nineties until 2008, when they were temporarily prohibited by Article 62 of Law Decree No 112 of 25 June 2008 (converted with amendments by Law No 133 of 6 August 2008)[1] and then permanently prohibited by the recent 'stability law' for 2014. [2]

In particular, it is worth considering the public debt management techniques laid down by Law No. 448 of 28 December 2001 (*i.e.* the 2002 Budget Law), pursuant to which «in order to contain the cost of debt and to monitor fiscal developments» (Article 41, first paragraph) Regions and local authorities were allowed to access to capital markets. A large number of derivative transactions have been executed thereafter, from 2004 subject to compliance with an *ad hoc* regulation governing the structure and the execution of these transactions (*i.e*. Decree of Ministry of Finance No 389 of 1st December 2003 and Circular of Ministry of Finance dated 27 May 2004, containing certain guidelines for the interpretation of the abovementioned Decree).

These kind of interventions in the capital markets have not always been made by Regions and local authorities by strictly adhering to the aforesaid

[1] This provision has been subsequently amended, for the first time, by Article 3, paragraph 6, of Law No. 203 of 22 December 2008, and then by the Law Decree No 39 of 28 April 2009, converted with amendments by Law , No 77 of 24 June 2009.

[2] See the Law of 27 December 2013 No 147, which contains measures regulations that - even though they may appear operations with sectorial relevance - they have not changed the essence in an '*omnibus* measure', unlike the old 'balance laws' of the past.

regulatory requirements; a number of transactions can be found, in fact, where such public entities did not fully comply with the provisions of the abovementioned regulation. A broad interpretative debate has thus started, quite often resulting in legal disputes, many of which are still being defined. Hence, the need of a second reading of the relevant special provisions in the light of the purposes followed by the regulator when laying down the relevant provisions, which have been punctually highlighted and underlined in the indications provided by the MEF[3] and the Corte dei Conti (*i.e.* Italian court of auditors).

It is worth pointing out, in this regard, that the Corte dei Conti – which has in the Italian legal system the role of 'accounting court', carrying on ex ante and ex post controls with the aim of ensuring a proper management of public resources[4] – has provided certain guidelines which dispel any doubt about the interpretation of the relevant applicable provisions.

[3] See ITALIAN MINISTRY OF ECONOMY AND FINANCE (Ministero dell'Economia e delle Finanze), *Report on administrative and accounting audit in the City of Benevento*, performed by the State General Accounting Department, 20 December 2007.

[4] In order to properly evaluate the quantitative and qualitative assessment made by the Corte dei Conti on public expeditures, see CARAVITA DI TORITTO *Sulla vocazione del nostro tempo per una riforma della corte dei conti e la ricostruzione unitaria delle sue funzioni* in *Federalismi.it*, 2012, fasc. n. 9, p. 7. See also previous analysis on this argument such as: DELLA CANANEA, *I controlli sugli enti territoriali nell'ordinamento italiano: il ruolo della Corte dei conti*, in *Le Regioni*, 2009, pp. 855 ff.; RISTUCCIA, *La Corte dei conti quale strumento di governance*, in *Democrazia e diritto*, 2011, issue n. 3/4, pp. 39 - 53.

In evaluating a number of cases submitted to it concerning derivatives entered into by local authorities[5], the Corte has indeed pointed out which are the proper conditions to be met by local authorities when executing derivative transactions in order to comply with the regulation. Certain punctual exegetical indications have been therefore provided by the Corte to properly interpret the regulatory framework laid down by the Italian regulator in the early 2000s.

Lately, however, following the financial crisis and the related worsening of the problems of the current economic situation, this accounting body – though not in its jurisdictional function – has provided some remarks which *prima facie* could be seen as a different, more restrictive approach, compared to the interpretative guidance previously provided by the Corte.

In drawing the attention on the incidence of derivatives on the public finance balance, such remarks highlight the need to further investigate the matter under consideration in order to provide opportune clarifications and eliminate any doubt about the actual *mens legis* under the relevant regulatory provisions. Furthermore, this will allow finding the knowledge criteria upon which certain disputes still pending before domestic and international courts could be properly solved.

2. By identifying the investigation relevant for the purpose of this analysis, it needs to dwell on the cause that characterizes the essence and the ways in which the derivative transactions shall be structured. Obviously, we do

[5] See, among others, the judgments of the Corte dei Conti, Section. Reg Control for Campania, numbers. 14 and 17 of 2008.

not examine here the normative notion of "derivative financial instrument", upon which long held talks legal doctrine, outlining the activity relating to such figure (as far as the Italian legislative and regulatory framework is concerned) as reserved for companies and investment banks; hence, the applicability of the discipline provided for by Article 21 of the Italian Financial Act (*Testo Unico in materia di intermediazione finanziaria*).[6]

With reference, in particular, to the identification of the structural elements of the transactions carried out by the local authorities, it should be noted that this type of contract falls in the macro-categories of reference for the contents of the (derivative) transactions ordinarily executed.[7] It follows that, having regard to such structural feature, the *cause* of the contract, in line with prevailing case law, identifies the immediate, actual and direct interest protected by the contract: it provides, therefore, the real justification for the entering into such contract (as a result in the absence of the *cause* the contract must be deemed null and void).[8]

In the light of this premise, the purpose pursued by the parties through the execution of derivatives takes specific importance; with respect to local authorities such a purpose must consist essentially in the *hedging* and the

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[6] See from the past GABRIELLI, *Operazioni in derivati: contratti o scommesse?*, on *Contratto e impresa*, 2009, pp. 1136 f.; MAFFEIS, *Contratti derivati*, on *Banca e borsa*, 2011, I, p. 604 ss.; SCOGNAMIGLIO, *Profili di costituzionalità dei limiti all'utilizzo degli strumenti finanziari derivati da parte degli enti territoriali*, note to C. Cost. 18 febbraio 2010, n. 52, on *Banca e borsa*, 2011, II, pp. 18 ff.

[7] See on this point BARCELLONA, *Strumenti finanziari derivati: significato normativo di una «definizione»*, on *Banca e borsa*, 2012, I, pp. 547 ff.

[8] See on this point the informations contained in Cass. 8 maggio 2006, n. 10490.

restructuring of debts contracted previously. Not surprisingly the doctrine is keen to stress that the relevant regulation requires that derivative transactions entered into by local authorities must be made only in relation to liabilities actually owed by them.[9]

Hence, the need to point out that such instruments, without prejudice of the contractual terms relating to the underlying debt, express their raison *d'etre* in correlating the contents of the new agreement (which, by this way, is put in place) to the modality in which the subject must fulfil the existing obligations. This leads to the configuration of an *independent* cause of the derivative: this makes different the relationship created by means of such derivative with the prior debt position, with which a sort of nexus of contracts is arranged.

We can deduce that the use of derivatives by local authorities should not lead to situations which, through the restructuring of their past borrowing transactions, pursue the purpose of finding «resources to be used in the ordinary management».[10]

This, of course, though without precluding the possibility of using derivatives to deal efficiently with the cash flows dynamics, in order to avoid negative implications deriving from the structure of the payments (i.e. if the flows paid by the local authority are not perfectly aligned with those received by it).[11]

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[9] See FANTETTI, *L'annullabilità in autotutela dei contratti derivati*, on *La Responsabilità Civile*, 2012, p. 42.

[10] See Corte dei Conti, Sec. meeting within the control, *Gli strumenti di finanza derivata nelle regioni e negli enti locali*, on *Il Foro it*., 2009, c. 157.

[11] See FSA, *Liquidity swaps guidance consultation*, 2011.

From another perspective, we observe that the derivative entered into by the local authorities, being aimed at the production of an advantage, carry out their function by interacting on a merely profit-based perspective. This, in the sense that «each party is obliged to pay an amount (the rate that has provided on the notional principal amount that will accrue for the entire life of the contract) hoping to compensate such amount with the one it will receive from the other party».[12]

In conclusion we may affirm on this point that the cause of such contract is identified in the exchange of payments, «the amount of which is determined on the basis of different reference parameters».[13] More precisely in relation to this *ratio*, which characterizes derivatives, it can be identified the objective pursued by the regulator (in determining the structural requirements of the contract), *i.e*. the purpose of preventing the financial burden of debt local authorities to be postponed forward in time.

Of course, the events of these derivative contracts may change with the passage of time whenever (due to the fluctuations of market interest rates) can be found counterparties available to offer new contractual terms. Hence the possibility to carry out a «*novation*» of the original agreement between a local authority and a financial intermediary, whereas - in the presence of offers considered economically viable - the banking institution that originated the relationship is replaced and a new derivative contract is entered into.

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[12] So Tribunale di Bologna, December 14 2009, on *Giurisprudenza commerciale*, 2011, pp. 196 ff., with note of CAPUTO NASSETTI, *Contratto swap con ente pubblico territoriale con pagamento upfront*.

[13]See CAPUTO NASSETTI, *I contratti derivati finanziari*, Milano, 2007, p. 47.

3. The identification of the normative framework that allowed Italian local authorities to engage in derivative transactions must constitute the proper starting point for every inquiry aimed to establish their legitimacy to carry on such an activity. Hence, in fact, the conformity of the transactions under analysis to the applicable regulation (which, taking into account the peculiarities of the entities in question, delimited into well defined areas the access by local authorities to such financial instruments) can be inferred.

This moment of analysis regards not only to the clarification of the technical and legal aspects that distinguish the above mentioned instruments (contractual cause and type of derivative), but also the specification of financial and actuarial characters (*i.e.* the exclusion of the profile of ascending values) that qualify the dynamics of payment flows, typical of the contracts allowed by the regulation in force at that time.

Needless to say that, above this in-depth analysis, one should take into account the composite ways through which derivative contracts materialize. We refer, in particular, to the possibility to attribute diverse negotiating options to a unique decision-making intent (*i.e.* the hedging and debt restructuring purpose) and, therefore, to the uniqueness of the arising contractual typology. In fact, as we will point out later, in the field under consideration is possible to identify an association of more operational schemes in a sole contractual relationship; and that, by expectedly overcoming their *autonomous* evaluation in order to have a systematic analysis of the aggregate.

As has been indicated at the beginning, the 'normative framework' under which it was allowed to Italian local authorities to execute transactions in derivatives is summarized both in the Law No 448 of 2001 (budget law 2002) which, at Article 41, rules «the finance of local authorities», and in the Ministerial Decree December 1, 2003, No 389, governing the «rules concerning the access to capital markets by provinces, municipalities ... in accordance with Article 41, paragraph 1, of the Law of 28 December 2001, n. 448»; whereas significant interpretative criteria for a correct application of those rules are contained in the circular of May 27, 2004 of the Ministry of Economy and Finance[14].

The disciplinary framework was indicative of the intention of the regulator to put special protections to the assumption of risk positions on the part of the local authorities because of the central role that they wear in the context of the State system. Specifically, the legislation in question marked impassable limits to the *agere* of such institutions, which were only authorized to engage in operations of debt restructuring, to be performed in simplified procedures (*i.e.* capable of avoiding that the presence of complex operational schemes that might cause forms of rising bearable risks and, therefore, be detrimental to the stability of the institutions in question).

In line with this criterion of interpretation are, moreover, directed the evaluations made by the Italian Corte dei Conti, united Chambers, concerning «the fact-finding investigation on the use and diffusion of derivative financial

[14] See *supra* paragraph 1, where it is reaffirmed that, as a result of regulatory interventions, nowadays it is prohibited to local authorities to enter into derivative contracts.

instruments and securitization in the public administrations[15]». And indeed, in explaining that the transactions in question must always be grounded upon an evaluation being «at the same time, financial and economic» the Corte has pointed out the criteria according to which, *in subiecta materia*, it is required to examine the «risks that the local authority assumes with the new indebtedness transaction» (whence the possibility of justifying the renegotiation of the «passivity in the presence of changed market conditions such as, in particular, the variation in interest rates, in descending direction with respect to those characterizing the original debt»).

There is no doubt that, in legitimizing the local authorities to entering into derivative contracts, the regulator has taken care of delegating to the Ministry of Economy and Finance the coordination of the access to the capital market by the subjects taken in account by Article 41 of Law No 448 of 2001. For this purpose, specific forms of information exchange had been predetermined, as well as the specification of the forms of use of derivatives, both the first and the second then punctually identified in the mentioned Ministerial Decree December 1, 2003, No 389, and in the related explanatory Circular of 27 May 2004.

4. It follows that the Ministerial Decree No 389 identifies the sources of law of derivative transactions allowed to local public authorities during the past. Specifically, it is relevant the ruling of Article 3 in which are assessed the

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[15] See the Audition on 18 February 2009 in front of the VI Committee of the Senate of the Republic.

operational criteria from which one can deduce the intent of the regulator to prevent the use of derivatives for purposes other than hedging and restructuring. This interpretive approach is already clearly inferable from the analysis of the provision of Article 1 relating to the «currency swaps»; and it is, then, more markedly pointed out in the rulings contained in the remaining parts of that provision in which one may identify the contents of the various and numerous transactions to be potentially carried out.

In this regard, it is deemed necessary to specify that for *hedging* purpose we mean the ability, consequent to entering into the derivative, to assume a position of opposite sign compared to that assumed in the primary underlying contract, from which derives the risk to be hedged. From here, it results the general characteristic of the derivative products to allow a reduction in the exposure (of a pre-existing portfolio) to financial variability. Therefore, the purpose of such transactions relies upon the implementation of appropriate forms of protection aimed to avoid that currency and/or interest rate changes affect the finance of local authorities.

For *debt restructuring*, as it will be later explained in greater detail, we mean the change of the economic and financial parameters of an existing transaction (from which derives the debt position in relation to which the relevant derivative is created); and this by means of the prior variation of either interest rate or principal components. These are transactions that, intervening on the active management of debt, allowed the local authorities to modify their debt positions, providing a «new amortization plan that varies the deadlines for the restructuring of capital», as has been specified by the Italian Corte dei Conti[16].

Within the framework outlined by the provision in question, particular importance can be attributed to certain derivatives to which the rule devotes specific attention. We refer to transactions that, in addition to those provided by the first paragraph of Article 3 and those given in the previous Article 2, provide the following derivatives:

a) «*interest rate swap*» between two people who mutually undertake to regularly exchange interest flows connected to the main parameters of the financial market, according to modes, timing and conditions established by contract. It is, also in this case, a hedging operation tending to avoid any adverse effects of fluctuations in interest rates or conversely to allow m local authorities to reap benefits from those variations by resorting to appropriate restructurings. The derivative takes the form of an exchange of flows parameterised on different interest rates, such flows being referred to the same notional value for the same temporal lag.
b) The purchase of a «*forward rate agreement*», contract in which two parties define the interest rate that the forward's buyer agrees to pay on an established capital at a specified future date. This transaction is an agreement whereby one party is obliged, against a compensation, to liquidate an amount calculated at a certain rate of interest - other than the one current at the time the contract was stipulated - on a predefined

[16] See the deliberation of reg. Sec. Emilia Romagna, n. 14 of 2012, pp. 7-8.

capital and for a certain future period of time. Usually, the contract is regulated by setting off the flows of interest related to nominal figures, which in practice are not exchanged. By entering into one or more «*forward rate agreement*» contracts, one can both protect himself against a possible rise in interest rates and better plan his own financial position, avoiding uncertainties related to changes in the market (*i.e.* transforming future, variable, short and medium term rates from uncertain to certain).

c) The purchase of an «*interest rate cap*», transaction whereby the buyer is covered in case of increases of the aforementioned rate beyond a specified level. The cap option identifies a contract in which the buyer acquires, with the payment of a premium, the right to collect the positive differences existing between the variable interest rate (assumed as below) and the level of the cap (represented by the rate defined at the time of negotiation). In other words, it sets a maximum limit to financial costs, beyond which the option intervention ensures the coverage from losses.

d) The purchase of interest rate «*collar*» with which the buyer is guaranteed a level of rate oscillating within a predetermined minimum and maximum. The option collar is formed by the combination of two different option positions: the purchase of a *cap* option and the sale of a *floor* option. As above said, a collar allows the purchaser to safeguard from any loss resulting from increases in the yield curve over the threshold specified in the contract[17].

e) «*Other derivative transactions containing combinations of the transactions mentioned in the preceding paragraphs*», able to permit the conversion from fixed to floating rate and vice versa upon the achievement of a 'threshold value' or after passing a specified period of time. The combinations are operational strategies composed by the aggregation of several derivative contracts that, usually, refer to the same underlying. They can be used in the event of strong market movements because they ensure coverage from either sudden increases or rebates. It is clear that the integration of several contractual arrangements creates a financial product that, at technical and economic level, presents a risk/reward profile very far from that attributable to the individual, various components of the contract.

f) «*Other derivative transactions aimed to debt restructuring*», only if they do not provide for a maturity subsequent to the one associated with the underlying liability. These transactions are permitted where the flows received thereunder by the relevant local authorities are equal to those paid in the underlying liability and do not imply, at the time of their completion, an 'increasing profile of the present values of the single

[17] Related to the purchase of the cap option is the selling of the floor option that leads to a contract in which the seller earns the payment of a premium against the obligation to pay any differential to be eventually generated between the floor rate and the lower interest rate (variable). It, therefore, provides the seller with financial resources to be devoted to cover the cap costs.

> payment flows', with the exception of a possible 'discount or premium', to be regulated in the moment of perfecting the transactions, not exceeding 1% of the notional amount of the underlying liability.

This last provision certainly has an operational latitude broader than that provided in the preceding paragraphs of this provision, being to it ascribable the wide range of interventions that can redefine - synthetically - the structure of financial liabilities previously get into; and this, of course, with regard to the overall flow dynamics (*i.e.* both with regard to the reimbursement plan of the principal and the payment of interests). It should be emphasized, moreover, that – in the light of the “non- standardized” feature typical of derivative contracts (wherefrom the validity of a negotiating scheme designed to include any type of contractual relationships) - the regulator, in enabling local authorities to carry on these transactions, put a number of constraints which, by affecting the structural configuration of those instruments, confine the scope of the contractual typology under analysis within the specific ways indicated by them.

5. Particular consideration must be expressed with regard to the simplified or complex character that the derivative can show within the transaction that comes into existence. It constitutes, in fact, a relevant point of the special regulation examined above the clarification that the signing of contracts to hedge the risk was permitted (to local governments) providing that they were placed in «plain vanilla form»; regulatory orientation, directed to

avoid that local authorities could be put in difficulty by combinations (not easily intelligible) of financial engineering.

It is clear that the regulator had the intent to prevent that the local authorities could assume the financial risks typical of an intermediary 'seller of derivatives product'. Therefore, it has been adopted a prudential approach aiming at limiting the purchase of those instruments only in cases where they are simple, standard, typed if not by law, at least in contractual practice[18].

The Circular of 27 May 2004 explains in unequivocal manner what is meant by 'plain vanilla' form with respect to each class of derivative transactions provided in subparagraphs (a) to (d). In particular, by commenting Article 3 of Decree No 389, the circular affirms that (i) for the transactions of type interest rate swap it is intended complied the plain vanilla feature when is excluded any forms of optionality, (ii) for the type forward rate agreement, cap and collar this structure implies the simple purchase by the local authorities of the options provided for therein (with the exclusion of the sale of that options) and (iii) with specific regard to the type collar, the plain vanilla form is complied with when in the operation is provided the purchase of a cap option and the simultaneous sale of a floor option, "in order to finance the protection from rising interest rates provided by the purchase of the cap".

[18] In other terms, it is a contractual scheme in which «the liquidation of differential resulting from the difference between amounts deriving from the application of the two rates ... should be carried out periodically to coincide with the deadlines by which the parties are required to honour their debts», see ACCINNI, *Operatività in derivati e profili di responsabilità penale*, in *Rivista delle società*, 2008, p. 451.

The reference to a simple contractual formula excludes *in re ipsa* the possibility of combining with the hedging function of the derivative a trading function that, on substance, resolves into a speculative sort (be pursued where a reason for short-term profit through real bets on changes in interest rates). This, of course, should not be confused with the legitimate opportunity to amend the contract by adding clauses that, in some way, enrich the original transactional scheme. In such cases, the local authorities may not otherwise alter the character of the simplified structure of the derivative and, therefore, it must in any case remain within the scope of Article 3, paragraph 2, of Decree No. 389/2003.

Of course, there are many and varied reasons that may induce the parties to integrate, with particular clauses, the derivative contract. In this regard no doubt whatsoever can be proposed if it identifies a purpose of restructuring and hedging (to be understood, therefore, with regard to the possibility of modifying the modulation of principal repayment, the type of interest rates; ultimately to the determination of costs relating to the transaction).

By contrast, as has been just indicated, is precluded the right to innovate the structure of the derivative, by placing the figure outside of the types punctually provided in the Decree No. 389/2003. Therefore, still remains the need that the derivatives entered into by local authorities refer to an operational form which, even though composite, has to unfold in a transparent manner, both in terms of the components that give life to the derivative (*i.e.* cap and collar), and with regard to their dynamics (which should be instrumental in reducing the costs of debt).

It is evident that the task of the interpreter is to be able to distinguish the cases in which the combination between different operations (for example: swap-collar) rises a *simplified derivative* (*i.e*. the potential to reduce the financial burden of a local authority) compared to those in which be a feature of a complex transaction.

More specifically, it will rely on whenever an interaction between the technical forms in question is related to the purpose (the banking intermediary) to stimulate the propensity of local governments towards instruments presented in a manner that enhance the income function rather to that of hedging which should be ordinarily oriented.

This orientation reflects, moreover, the indications made by the general doctrine on the subject of structured bonds. These, in fact, denote risk profiles similar to those of complex derivatives, given the difficulty for investors to perceive immediately the limits and, therefore, the dangers.[19]

6. From an overall analysis of the legal issue at hand, the provision set forth by Article 3, second paragraph, letter f), of the Decree No. 389/2003 appears to play a peculiarly pivotal role. Such provision outlines a contractual model which, in pursuing specific goals of economic convenience of the local authorities, is characterized by a crucial role awarded to (the parties') empowerment in defining the features of the derivative instrument.

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[19] See LA SALA and BRUNO, *Dall'obbligazione plain vanilla all'obbligazione strutturata*, in *Le Società*, 2009, pp. 689 ff.

Indeed, as already highlighted above, the provision under letter f) contemplates the possibility that the contracting parties, for the purpose of restructuring their indebtedness, may carry out "other derivative transactions" (other than those described in the preceding letters), the main features of which are accurately detailed by law. In particular, after specifying that the abovementioned transactions shall not set "the final maturity later than the date on which the underlying liabilities become due", the lawmaker pointed out that such transactions "are permitted whenever the cash flows *received* there under by the interested entities are equal to those *paid* under the underlying liabilities". Moreover, a precondition required by law is that such transactions, as at the relevant signing date, do not *entail* "an increasing profile of the present values of the single payment flows".

The lawmaker clearly took into account (and, consequently, meant to regulate in accordance with the modalities set out in the relevant regulation) a transaction structured on two *legs*: a first leg, consisting in the "cash flows paid" by the bank (with which the derivative is entered into) and received by the public administration; a second leg, represented by the "payment cash flows" activated by the local authority towards the abovementioned financial intermediary. In such respect, the regulation is extremely clear: the cash flows to be paid by the bank to the public administration shall be equal to those of the repayment plan for the underlying liabilities, while the cash flows to be paid by the local authority to the bank may be determined between the parties without any limitation, save for the prohibition regarding the *increasing profile* of the (actual values of the) same, as mentioned above.

Such set of rules also includes a provision concerning the possibility – exceptionally awarded to parties – to contemplate a "discount or premium to settle at the time the transactions are entered into" for an amount "not higher than 1% of the notional amount of the underlying liabilities". While the examination of such latter contractual aspect will be carried out in the following paragraph, it seems useful to prioritize the analysis of the meaning and scope of application of the above-mentioned rules concerning the modalities for the exchange of cash flows.

In light of the foregoing, it appears clear that our analysis shall be focused on the verification of the operating practice targeted by the lawmaker (or, more precisely, on the correct meaning of the expression "other derivative transactions", which is utilized by the above-described set of rules). Subsequently, our analysis shall concern the calculation modalities which consent the identification of a possible increasing profile of the "present values of single payment flows". Obviously, such latter aspect of the analysis shall avail itself of (or, more precisely, shall consist of) actuarial assessments entailing the need to refer, on the one hand, to the amount of the «interest rates» applied in such contexts (*i.e*. fixed rate versus variable rate), and, on the other hand, to the «additional fixed amounts» swapped between the parties (regardless of the issue relating to the "fair" initial value of the derivative).[20]

In this regard, focusing our analysis on the first aspect referred to above, it must be observed that the circumstance that the transactions examined

[20] As to such issue, see CARLEO - MOTTURA C. - MOTTURA L., *Sul "valore" di un derivato. Argomentazioni in margine alla disputa tra amministrazioni pubbliche e banche*, in *I contratti*, 2011, pp. 383 ff.

herein are the *other ones* referred to in Article 3, second paragraph, letter a) to d) of the Decree No 389/2003 shall not be interpreted as qualifying such transactions as a mix of operating modalities aimed at achieving *only* the hedging of interest rate risks. Should the meaning of Article 3, second paragraph, letter f) be limited to such interpretation – so that the transactions referred therein be limited *only* to a combination of transactions identified in the preceding letters – such provision would be given a scope of application different from the one actually intended by the lawmaker (and, in addition, such provision would represent a substantial repetition of the provision set forth in Article 3, second paragraph, letter *e*).

Indeed, the notion of *referability* (as it is utilized in the wording of Decree No 389) does not imply the *exclusivity* of the operating modalities, *i.e*. the *univocal reference* to certain operating modalities. On the contrary, the provision in question – thus opposing any possible interpretation aimed at identifying the derivatives entered into by local authorities within a limited number of contractual types – meant to introduce an "open" category of permitted transactions (the structural features of which shall obviously entail a strict correlation with the targeted restructuring of the underlying liabilities).

Consequently – since it must be excluded that the lawmaker's intention was to merely duplicate the contractual type referred to under letter e) – the provision set out under letter f) shall be interpreted extensively, to the effect that it shall encompass an additional element not already included in the other provisions; hence the possibility to interpret such provision as making reference to payment flows which include principal and interest.

As to the second aspect of our analysis, it must be observed that, in practice, the broad scope of application of the regulation relies in the possibility (for the parties) to reschedule the amortization of the underlying liabilities by using the technical modalities they deem most advisable. In other words, parties are awarded complete freedom to negotiate the determination of the modalities through which implementing the features of the derivative instrument, save for the need to comply with the prohibitions set out under applicable regulations (*i.e*. the prohibition of a final maturity set later than the date on which the underlying liabilities become due, and the prohibition of an increasing profile in the present values of the single payment flows).[21]

Consequently, the parties may freely decide, for instance, that the derivative instrument be structured on the basis of a specific (limited) number of predetermined (fixed) rate installments, in consideration of a larger number of indexed (variable) rate installments; in the case at hand, such structure would clearly allow a part of the cash flows exchanged between the bank and the local authority to be paid to the latter in the initial phase of the transaction. Obviously, having regard to such example, the above-referred operating dynamics of the derivative instrument cannot be regarded as a financing transaction (which would be prohibited by the regulation), since such dynamics do not entail any new liabilities for the public administration entity, but rather the possibility for the public administration entity to anticipate the enjoyment

[21]See, in this respect, FRANCAVILLA, note to the research conducted by the *Corte dei Conti* on *The issues regarding the distribution of derivative financial instruments,* Chamber of Deputies, Finance Commission, 3 March 2005.

of certain benefits deriving from the derivative instrument, thus directly ascribable to the very essence of the transaction set out under letter f).

Indeed, in the case at hand, the additional liquidity available to the local authority derives from the reduction of the financial burden rather than from the granting of a loan. Accordingly, the intention to introduce any *loan element* in the contract – which, where regarded as the precondition of a possible repayment obligation of the public administration entity, would consist in a sort of financing (thus departing from the hedging cause of the derivative instrument) – shall be excluded.[22]

Considering that the derivative instruments at hand are aimed at 'restructuring the indebtedness' of local authorities, payment flows there under shall include both principal and interest amounts; in this regard, as already mentioned above, please see the provision set out under Article 3, second paragraph, letter f), of Decree No 389/2003. The opposite interpretation does not appear to be grounded on the circumstance that the Corte dei Conti, in this respect, makes reference to an «obligation to reimburse principal and/or interest»[23], as if such formulation could not be interpreted so that the expression «and/or» may entail an addition of elements. In this regard, it must be recalled that, in the Italian legal framework, the meaning of the above-

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[22] In these circumstances the derivative instrument appears intended to efficiently manage the liquidity of the contracting entities; as accurately highlighted by legal authors (see RUGGIERO, *Energia e rischi: le sfide*, in AA.VV., *Derivati ed energia: la gestione dei nuovi rischi globali*, co-ordinated by Oldani, Milano, 2012, p. 138), such goal certainly differs from any financing rationale and shall be regarded as particularly worthy in the event of a contingent crisis.

[23] See CORTE DEI CONTI, research conducted on «*The issues regarding the distribution of derivative financial instruments*», *cit.,* p. 7.

referred conjunction (i.e. «and/or») is generally deducted from the specific context in which the same are utilized (which means, in the case at hand, that the meaning of such conjunction shall be deducted from the context of the debt restructuring process, thus inclusive of both principal *and* interest).

Finally, it must be observed that the above considerations are further confirmed by the circumstance that the term 'cash flow' – as utilized in the regulation under exam – refers to a payment to be considered in the context of the 'evolution of the contractual relationship' and, accordingly, inclusive of all the components (for principal and for interest) which are relevant for the calculation of the overall amount due by the local authority to the financial intermediary. Accordingly, with respect to such transactions, it is not possible to identify an obligation to make a '*net payment*', as resulting from the interpolation of the 'cash flows' paid by local authorities and those received by the same authorities (which, on the contrary, are regulated separately). Indeed, regardless of the circumstance that such interpretation does not comply with the terms and conditions set out in the regulation, one cannot omit to consider that such interpretation merely takes into account a *balance* between the different financial cash flows (principal plus interest) to which parties are entitled in the course of the contractual relationship.

In conclusion, as to such aspect, it may be stated that the lawmaker, when establishing the prohibition regarding the increasing profile, intended to make reference to the part of the transaction concerning the payments to be made by the local authority, and connected the performance thereof to the other part of the derivative transaction, concerning the payments to be made by the financial intermediary – hence the above cited principle whereby the cash flows *received* by the public entity shall be equal to those *paid* in relation to the underlying liabilities. It is clear that the regulation meant to exclude the possibility to consider a *stand alone* derivative instrument (in connection with the underlying liabilities), since only the compliance with both the rules described above, considered in their joint rationale, allows to avoid that the financial burden of the indebtedness be shifted on future financial years.

7. As anticipated, the provision under letter f) mentioned above contemplates the possibility that an (upfront) 'premium' be awarded to the local authority which has entered into the derivative instrument by the financial intermediary acting as counterparty under the derivative transaction. However, such premium shall be of a limited amount, which means no higher than «1% of the notional amount of the underlying liabilities»; such rule obviously represents a limitation aimed at restraining the possibility to use such premium. In particular, as clarified in the Circular dated 27 May 2004, aimed at explaining the provisions set out in the Decree No 389/2003, the above-referred premium consists of a *discount* meant to «allow the restructuring of the liabilities in the event of market conditions different from the ones of the time on which such liabilities were entered into».

The *rationale* of such provision shall be identified, on the one hand, in the intention to compensate a possible position of initial disadvantage on the part of the contracting public administration entity, and, on the other hand, in the goal to allow such entity to carry out an efficient management of its 'liquidity' (which goal could be compromised by a market situation that has evolved from the one of the time on which the notional amount of the derivative had arisen). A clear confirmation of the foregoing derives from certain detailed indications of the Corte dei Conti which underlines that, by reason of the upfront premium, «during the initial period of the contract, the entity will cash in a net payment flow», which – defined in accordance with the limitations mentioned above – will be meant to «avoid transactions merely intended to satisfy liquidity needs».[24]

In this regard, it is not a coincidence that the provision under letter f) sets forth that the possible premium agreed between the parties shall be paid «at the time on which the transactions are entered into». It is clear how such clarification, in highlighting the connection between the upfront premium and the possibility for the local authority to anticipate certain benefits deriving from the transaction, ties the function of such premium to the performance of the derivative (and, more specifically, to the identification of the cash flows paid by the local authority to the financial intermediary).

The targeted goal of the regulation shall be regarded as being coherent with the one concerning the «limitation of indebtedness cost», since liquidity management is a pivotal factor in the definition of the plan for the payment of the entity's liabilities; in particular, liquidity management does not conflict with the goal to avoid that the overall '*burden*' of the transaction, calculated on the

[24] See CORTE DEI CONTI, *Report on the Financial Management of the Regions,* financial years 2011 - 2012, vol. I, p. 80.

basis of the *present value* thereof, is postponed in time through an increasing trend.

In addition, the upfront premium represents an exception (restrained within the limit of 1% of the underlying notional amount) to the prohibition concerning the increasing profile of payment flows present values. The inclusion of the premium within the structure of the derivative contract (as described above) and, accordingly, the nexus of the premium with the features characterizing the contract appears to confirm such assumption. Accordingly, in the event that the derivative instrument is not characterized by an increasing profile in payment flows present values, the payment of a premium of the type indicated by the regulation under exam shall be regarded as not being made.

In light of the foregoing, it appears that the payment of an upfront premium, to the extent that it complies with the limitations characterizing the contractual scheme of a derivative instrument, does not alter the function thereof. As a consequence, one may agree with the position expressed by court law whereby the payment of an upfront premium «does not change the rationale of the contract»,[25] without prejudice, nonetheless, for the need that parties establish such premium by contract and that the payment of the relevant amount be made «simultaneously with the execution of the [derivative] contract», as correctly pointed out by the Corte dei Conti.[26]

As a result thereof, in any such case in which no discount is contemplated at the time on which a derivative transaction is entered into, then no embedded

[25] See Tribunale di Bologna, December 14 2009, *cit.*

[26] See CORTE DEI CONTI, Report to the Italian Parliament on the *Management of local entities' finance in the years 2003 and 2004.*

premium may be deemed to have been agreed between the parties based on the modalities established for the settlement of the payments due under the derivative instrument.

Such circumstance may be verified with respect to the situation mentioned as an example in the previous paragraph, concerning the cases in which parties agreed to a structure of payment flows characterized, during the initial phase of the derivative, by certain semi-annual payments at a fixed rate (lower than the rate of the underlying notional amounts), which would then be followed by other floating rate semi-annual payments for the residual duration of the transaction. In such cases it would certainly be wrong to regard the liquidity originating as a result of the above-cited difference among the applicable rates as being an upfront premium; indeed, even though such situation would *de facto* determine an advantage for the public administration entity, such advantage should not be identified as a 'premium', given the absence of the legal preconditions which, based on the applicable regulation, would characterize the adoption and operation of such legal instrument.

8. The interpretative orientation expressed in the preceding sections finds its affirmation in the guidance of the Corte dei Conti, which - considering the context in which it is permitted the use of derivatives by local authorities - has made a significant contribution to the clarification of the present issue.

Indeed, the Corte dei Conti – on the exercise of its control on public finance (according with Article 100, paragraph 2 of the Italian Constitution) and guaranteeing the respect of jurisdictional system in matters of public accounting (and other specified by law, in accordance with Article 103, paragraph 2 of the Italian Constitution) – has carried out a detailed analysis of the 'derivatives' put in place by local governments in order to verify compliance with applicable regulations. Significant in this regard, must be considered the considerations that, in some cases, have been sent to it by the MEF (Ministry of Economy and Finance) which, at times, during the inspection, he was able to observe clear violations of the special discipline mentioned above.[27]

More precisely, to describe the transactions permitted according to the Decree No 389, the Corte dei Conti has underlined in many occasions that the above mentioned letter *f*), second paragraph of Article 3, refers to transactions «aimed at the restructuring of the debt, i.e. aimed at modifying the amortization plan».[28] Decisive for the purpose of a complete reading of this rule is the remark in which it is confirmed that the provision in question regulates the «other derivative transactions, resulting from the combination of the above or otherwise aimed at the restructuring of the debt, i.e. aimed at modifying the amortization plan»; clarification that legitimizes the use of this type of derivatives «provided that.. [they] do not imply a maturity later than that of the original contract and an increasing profile in the present values of the cash

[27] See, for example, the *note* of 12 October 2007 issued by MEF – Department of the Treasury – sent to the President of the Corte dei Conti in which it is communicated, according to Art. 1, paragraph 737 of Law 27 December 2006, no. 296, that the Municipality of Benevento, on 7 August 2007, stipulated a contract of *interest rate swap* with selling of *cap*, in violation of existing legislation; note cited in the epigraph of ruling No. 14/2008 of Regional Section of Audit for Campania of Corte dei Conti.

[28] See among others the ruling no. 14 of 2008 mentioned in the footnote n. 27.

flows, that means a repayment profile of the liabilities in which the burden of repayment of principal and/or interest is concentrated towards the maturity».[29]

It is clear that the Corte dei Conti considers that a variation of the «burden of repayment of principal and/or interest» carried out by means of the derivative comply with the regulatory provisions under analysis, for this way confirming the possibility to report the function of the derivative to the objective of the debt restructuring (considered in all its components). In this logic the Corte proceeded, in various cases submitted to it for examination, to verify the «full correlation» between the executed contract and the «plan of the liabilities resulting from the transaction»; it has, therefore, assessed analytically the technical procedures that characterize the regulation of 'cash flows' and, therefore, evaluated whether the derivatives «belong to the plain vanilla type», to recognize compliance with these regulations or to push the Municipal Councils «to take all the necessary initiatives for the adoption of corrective measures»[30].

Worthy of mention are the considerations made by this body in relation to the legal validity of the derivative, linked to the lack of an «increasing profile of the present values of the single payment flows, with the exception of a discount or premium to be regulated at the time of the completion of the transactions not exceeding one per cent of the notional amount of the underlying liabilities».[31] This, in conscious recognition of not being sometimes

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[29] See the «*Indagine Conoscitiva sulle problematiche relative alla diffusione di strumenti finanziari derivati*», Chamber of Deputies, Finance Commission, 3 March 2005, p. 7.

[30] See CORTE DEI CONTI, Sez. Reg. Audit for Campania, Ruling No. 14 of 2008, *cit*., p. 10.

[31] See CORTE DEI CONTI, Sez. Reg. Audit for Campania, Ruling No. 14of 2008, *cit*., p.11.

able to carry out a technical financial audit «regarding the compliance with the above mentioned regulatory provisions» (for material unavailability of quantitative data relating to the relevant transactions). Hence the conclusion - reached by the Corte dei Conti - that the use of derivatives by local authorities should not be directed to achieve, through the restructuring of their previous indebtedness, the purpose of finding «resources to be used in the ordinary management».[32] This, of course, without claiming any form of prohibition in respect of the possibility of using derivatives to cope efficiently with cash flows dynamics, in order to avoid negative implications arising from the structure of the payments (i.e. if the flows paid by the local authority are not perfectly aligned with those received by it).[33]

To complete this argument, it should be pointed out, however, that one of the regional sections of the Corte dei Conti - as a result of the financial crisis and the sovereign debt that has hit Italy together with other EU countries[34] - has directed toward a strict interpretation of the mentioned provision under letter *f*), perhaps in line with the *spending review* approach determined by the

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[32] See CORTE DEI CONTI, Sez. riunite in sede di controllo, *Gli strumenti di finanza derivata nelle regioni e negli enti locali*, in *Il Foro it*., p. 157, 2009.

[33] See FSA, *Liquidity swaps guidance consultation*, 2011.

[34] See, among others, MASERA, *La crisi globale: finanza, regolazione e vigilanza alla luce del rapporto de Larosiere*, in *Rivista trimestrale di diritto dell'economia*, 2009, pp. 147 ff.; VISCO, *La crisi finanziaria e le previsioni degli economisti*, Lecture on being presented as a Master in Public Economics, University of Rome "La Sapienza", 4 March 2009; CAPRIGLIONE, *Misure anti-crisi tra regole di mercato e sviluppo sostenibile*, Torino, 2010; COLOMBINI, *Crisi finanziarie. Banche e Stati*, Torino, 2011; CAPRIGLIONE and SEMERARO, *Financial crisis and sovereign debt: the European Union between risks and opportunities,* in *Law and Economics Yearly Review*, 2012, part. I, pp. 50 ff.

current economic condition; such a restrictive logic, of course, reflects in the proposition of new limits to public finance.

Indeed, in representing the event that contractual structures of derivatives are designed to «have an immediate cash flow», the Regional Section of Audit for Veneto of Corte dei Conti suggests the similarity between a case of this kind and that «associated with the entering into of a loan»[35]. More specifically, with respect to the function of the *upfront*, it is underlined how the rule provides that this «must be regulated simultaneously with the start date ... of the transaction» implies «the prohibition of further adjustments, such as in case of upfront is fractioned or deferred during the semesters».[36]

It is clear that the Corte dei Conti with such assumption intended to prevent any imbalance of payments which, of course, cannot occur in cases where it is found the absence of an increasing profile of the present value of payment flows. This interpretation of the legislation in question does not involve transactions carried out in full compliance with the special discipline, where the most rigorous evaluation process expressed seems related, as previously mentioned, to recover a correct behaviour in the management of local authorities' indebtedness.

9. For the sake of completeness the legal position of the local authorities in the negotiations relating to the transactions in question must also be

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[35] See CORTE DEI CONTI, *Indagine sul fenomeno degli strumenti finanziari derivati nelle provincie e nei comuni del veneto*, 2010, pp. 20 ff.

[36] See CORTE DEI CONTI, *Indagine sul fenomeno degli strumenti finanziari derivati*, *cit.*, p. 21.

considered, in order to following identify the remedies allowed under the Italian legal framework to avoid the negative consequences arising from derivatives that do not comply with the special regulation.

It is necessary to point out that the legal capacity of local authorities under private law is governed by the provisions of Article 1 of the Law of 7 August 1990, No 241, which provides that "for the adoption of not authoritative acts the public administration acts according to the rules of private law, unless otherwise provided by law". As regards, in particular, the legal capacity of local authorities to enter into derivative contracts, that is also governed by the provisions of Law 448/2001 and, therefore, those of Decree No 389, both regulating derivative contracts entered into by local authorities.

Despite their full contractual capacity, in the execution of such contracts local authorities were often in a weaker position *vis-à-vis* their counterparties (*i.e.* the banks with which the derivatives were entered into). Indeed, the increasing financing autonomy, by interacting on the relationship between market rules and public law rules, becomes a limiting factor to the action of such public entities. It results, in fact, a relational context in which the lack of information affecting the local authorities (due to the asymmetries notoriously characterizing the markets' operations) prevents them from acquiring the knowledge necessary to carry out activities qualified by sophisticated technicalities, with the result of performing them in ways that are not in line with the regulatory provisions adopted to protect the public interest.

Yet, it goes without saying that the progressive recognition of the full legal capacity of local authorities (see Article 11 of Italian civil code) implies that the latter, when are faced with transactions with structural irregularities, may seek recourse to the ordinary courts to obtain the annulment of the above contractual relationships which do not comply with the mentioned regulatory requirements. Of course, public authorities may invoke the nullity of the contract governing the *derivative* only in cases where, pursuant to Article 1418, first paragraph, of the Italian Civil Code, the contract is "contrary to mandatory rules, unless the law provides otherwise".

Leaving aside the debated issue of the identification of the scope of that provision, it should be reminded that the Corte Costituzionale, while affirming the “mandatory” nature of the rules governing “contracts related to derivative financial instruments”, has clarified that their dispositive content regards "essentially the procedures for the conclusion, the form and content of the individual contracts", emphasizing also their "clear protective purposes" of the "legal rights of persons having access to this type of financing".[37]

Therefore, those provisions whose breach - as indicated by the doctrine - is, usually, considered a requisite for a request of declaration of non-compliance by the intermediary with the behavioral duties provided by the applicable special regulation, must be taken into account[38]. There is no doubt that, in line with the prevailing interpretation, it can be concluded that the legislator wanted

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[37] See CORTE COSTITUZIONALE, 18 February 2010, n. 52, published in *Banca e borsa*, II, 2011, pp. 1 ff., with comment by GIRINO, *Natura e funzione della disciplina dei servizi di investimento e qualificazione degli strumenti derivati nella giurisprudenza costituzionale*.

[38] See PELLEGRINI, *Le controversie in materia bancaria e finanziaria*, Padova, 2007, p. 335.

to refer to violations relating to "intrinsic elements of the agreement" that is to say "related to the structure or content of the contract"[39].

Therefore, the existence of business conducts not in line with the rules of correct behavior – *i.e.* stability, efficiency and competition, from which the legal analysis derive the possibility of increasing the efficiency and the proper functioning of the market[40] – not necessarily translate into a conflict with “mandatory rules”, which determines the nullity of the contract. As correctly observed, the nullity of the contract, in fact, can be excluded on the basis of textual and extra-textual criteria related to the *ratio* of the rule infringed, and in particular to the manner in which the contract affects protected interests[41].

That implies that the verification of the existence of possible reasons of invalidity of the contracts that we are dealing with should be done on the basis

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[39] For the relevant case law see the judgment *Corte di Cassazione*, sez. I, 29 September 2005, n. 19024, *Mondo Bancario*, 2006, n. 1, p. 53, with comment by LEMMA, *Violazione delle regole di condotta nello svolgimento dei servizi di intermediazione finanziaria e tutela giurisdizionale.* This judgment recognizes the application of the “virtual nullity” only when the breach of mandatory rules concerns intrinsic elements of the contract, namely its structure or content. In that respect see VILLA, *Contratto e violazione di norme imperative*, Milano, 1993, *passim*; BRECCIA, *Il contratto in generale*, in *Trattato di diritto privato,* diretto da Bessone, XIII, Torino, 1999, p. 113; QUADRI, *«Nullità» e tutela del «contraente debole»*, in *Contratto e impresa*, 2001, p. 1143 ss.; ROPPO, *La tutela del risparmiatore tra nullità e risoluzione (a proposito di Cirio bond & tango bond),* in *Danno e responsabilità*, 2005, p. 624; ALBANESE, *ibidem*, p. 366; GIROLAMI, *Le nullità di protezione nel sistema delle invalidità negoziali: per una teoria della moderna nullità relativa*, Padova, cap. IV, 2008.

[40] See *inter alia* ALPA, *La disciplina della concorrenza e la correttezza nell’attività commerciale*, in *Economia e diritto del terziario*, 2002, n. 2, p. 359; DENOZZA, *Le regole della globalizzazione tra (pretesa) efficienza e (finti) mercati: il caso di modelli di corporate governane*, in *Giur. comm.*, 2006, I, p. 167; ROSSI, *Il gioco delle regole*, Milano, 2006.

[41] See PELLEGRINI, *Le controversie in materia bancaria e finanziaria, cit*., p. 266.

of the verification of the possible contrast between the structural elements of the transaction and the provisions of the Decree 389/2003. In particular, the nullity of derivatives contracts entered into by local authorities could be declared only in case of a clear contrast between the case under judicial scrutiny and the provisions governing the matter (i.e. when the relevant transactions are different from those mentioned in article 3, second paragraph, letters from (a) to (f) of Decree 389/2003).

In line with that conclusion appears, furthermore, the well-known judgment of the Corte Suprema di Cassazione, No 26724 of 19 December 2007, where it has been specified that the non-compliance with the above duties of conduct cannot induce the nullity of the intermediation contract nor of the resulting individual acts, pursuant to Article 1418 , paragraph 1, of the Italian Civil Code[42]. It is hence clear that the nullity of financial intermediation contracts performed in breach of mandatory rules can be declared only in cases where it regards intrinsic elements of the contract.

It is evident that the Corte di Cassazione – although adhering to a market based approach that promotes transparency of transactions and correctness of the operators, in view of the efficiency of system – wanted to narrow down the possible invalidity of financial intermediation contracts to limited hypothesis[43]. We are faced with, in fact, an approach focused on the "structure" and the "content of the contractual regulation outlined by the negotiating parties", only

[42] The text of the judgment is published in *Nuova Giur. Civ. comm*., 2008, n. 4, pp. 432 ff.

[43] See CAPRIGLIONE, *Intermediari finanziari, investitori mercati,* Padova, 2008, p. 56.

the violation of the related discipline (and not also the non-observance of rules of conduct) could eventually trigger the application of the "virtual nullity" [44].

That being said, it must be regarded as misleading with respect to the guidance given by the Corte di Cassazione to affirm that the judgment referred to above allow to infer tout court the existence of a nexus between the mere non-compliance with the "key financial terms" (not necessarily related to structural elements of the contract) and the nullity of the derivative.

In light of the above – in the case of contracts relating to derivative transactions not in line with the applicable special rules – the means of protection of the local authorities implemented by invoking the nullity under Article 1418 of the Italian Civil Code appear reductive. Not surprisingly, the frequent application by the lower courts of that norm has led the Corte di Cassazione to consider the so called "relative nullity" as peculiar instrument "judicial regulation of contractual discretion"[45]. Moreover, the firm criticism – raised in the case law and by doctrine, almost unanimous – to a general use of

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[44] For further references see TUCCI, *La violazione delle regole di condotta degli intermediari tra "nullità virtuale", culpa in contraendo e inadempimento contrattuale*, in *Banca e borsa*, 2007, II, pp. 648 ff.; GALGANO, *Il contratto di intermediazione finanziaria davanti alle Sezioni unite della Cassazione*, in *Contratto e impresa*, 2008, p. 3.

[45] See Corte di Cassazione, judgment of 20 April 1994, n. 3775, *Corriere giur.*, 1994, p. 566, with comment by CARBONE; Corte di Cassazione, judgment of 28 March 1996, n. 2885, *Foro it.*, I, c. 235; Corte di Cassazione, judgment of 11 February, n. 2855, with comment by BARALDI, *Il governo giudiziario della discrezionalità contrattuale*, in *Contratto e impresa*, 2005, p. 501 ss. Against the application of the nullity due to the breach of mandatory rules pursuant to article 1418, first paragraph, civil code see, *inter alia*, Tribunale di Milano, judgment of 29 June 2005, n. 8671, *Giur. merito*, 2006, n. 3, p. 612; Tribunale di Torino, judgment of 21 March 2005, *Giur. it.*, 2005, p. 1862; Tribunale di Roma, judgment of 11 March 2005, *Corr. merito*, 2005, p. 877; Tribunale di Viterbo, judgment of 7 March 2004, *Banca e borsa*, *cit.*

that form of intervention confirms the doubts that in such a way the public interest can be appropriately satisfied.

The peculiarity of the matter under analysis – and, therefore, the need to pay particular attention to the protection of the underlying interests – leads to consider carefully the possible recourse to instruments other than ordinary jurisdiction. That recourse – according to what can be assessed and predicted following certain significant positions assumed by the administrative judges – seems to allow to local authorities – as explained more extensively in the next paragraph – a wider margin of protection; it can be foreseen the possibility of finding preparatory solutions to the realization of a reasonable balance in the identification of limits to the action of the regulator in the technical and operational choices[46].

11. The search for alternative remedies against the risks for local authorities arising from the wide use of complex operational techniques – and, in particular, from debt restructuring implemented through derivatives contracts – leads to consider with favor the possibility allowed to local authorities to activate measures designed to achieve the restoration of the public interests that have been jeopardized. Reference is made to the feasibility of protective action in which the safeguard of the general interest of the Public Administration (regarded in reference to the different components of the organization of the State) is achieved in ways other than the research of a

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[46] See REVIGLIO, *Vi è ancora bisogno dello Stato nel XXI secolo?*, *Economia pubblica*, n. 5, 2002, pp. 13 ff.

judicial solution to the possible dispute regarding a relationship of questionable formal legal compliance[47].

More specifically, relevance should be given to remedies that, whilst not having jurisdictional nature, allow the reinstatement of legality, by adequately reconciling the interests at stake[48]. It is clear that – beyond the perspective of a substantial approach to justice – in cases of possible choice among alternative remedies it emerges a unique proximity between "autonomy of the administration" and "justice function", whence a possible equality between them[49], which leaves, however, unaffected the constitutional principle of the "reserve of jurisdictional function" provided for in article 102 of the Italian Constitution.

On that premise, specific relevance assumes the general provisions set forth in Articles 21-*octies* and 21-*nonies* of Law No 241 of 1990 which provides for the repealing, also *ex officio*, of unlawful administrative acts adopted by public entities, as well as the provision of Article 21-*sexies* of the same law, that allows the unilateral termination (i.e. self-repealing) of contracts entered in to by public administrations in cases provided by law or by the same contract. The

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[47] It is clear that the protection of the general interest is related to the proper functioning of the market, which benefits from the possibility of counteracting violations of special rules that produce dysfunctions in the negotiations, in this respect see D'AGOSTINO – MINENNA, *Il mercato primario delle obbligazioni bancarie strutturate. Alcune considerazioni sui profili di trasparenza e correttezza del comportamento degli intermediari*, in *Riv. politica economica*, 2001, n. 9, p. 51.

[48] See MONTEDORO, *Esigenze di tutela e rimedi giuridici*, in AA.VV., *Le tecniche di tutela nel processo amministrativo*, edited by Caringella, Garofoli, Montedoro, Milano, 2006, p. 4.

[49] See KELSEN, *Lo Stato come integrazione*, edited by Cabiddu, Milano, 2001, in particular, p. 182.

scope of these rules is significantly broad as they encompass the defect of "violation of law", "abuse of power" or "incompetence", ruling out the possibility of annulment only in cases in which is "obvious that its ruling content could have not be different from that actually adopted".

Local authorities must be considered, therefore, entitled to use their power of internal review (so-called *autotutela*) when – in case of contracts entered into on the basis of specific administrative resolutions – it results the lack of "any advantage" due to recurrence of one of the invalidity causes just mentioned above. More precisely - as it can be inferred from a recent decision of the Council of State with respect to a resolution giving the mandate to a third party to provide for the restructuring of the debt of the Province of Pisa – the power of internal review should not be exercised in order to simply avoid an agreement "economically unbalanced", but rather a result of the not correct assessment of the "economic advantage" legitimating the restructuring of the debt operation, in accordance with Article 41 of the above mentioned Law 448/2001[50].

There is no doubt that the right to self-repeal, by using the power of internal review, the administrative acts providing for the execution (by public entities) of derivative contracts is directly linked, in interpretation of the mentioned Judge, to the "cause" of such contracts. That in the sense that the legal and logical basis for the exercise of the power of internal review are represented by the existence of a negotiating environments that – being in

[50] See judgement of the Consiglio di Stato 27 Novembre 2012, sez. V, n. 05962/2012, on the appeal presented by Depfa Bank Plc versus the Province of Pisa.

contrast with the applicable legal provisions (or, at least, deviating from their structural features) – are not able to achieve the objectives that characterize their essence.

In other words, the legitimacy of use of the remedy at issue is strictly connected to the possible attenuation (or rather: the fading away) of the public interest being targeted by the regulator (i.e. in the case of local authorities, the restructuring of the debt); a fact that occurs in case of absence, or alteration, of the elements characterizing the mentioned contractual relationships (the presence of which is associated with the existence in the transaction of "a minimum margin of advantage").

For the purposes of the possible use in the subject matter of the local authorities' power of internal review, the possible "subjective changes" in the contractual relationship are also relevant, changes that sometimes occur over the term of derivative contracts. Indeed, that kind of changes can be associated with changes in the original content of the transactions at issue. It is what can be observed, for example, in many cases of "novation agreement" – a legal institute notoriously aimed at replacing the framework of the transaction[51] - whose adoption frequently results in arranging a derivative structure

[51] See AA.VV., *The Government Contracts reference book*, Third Edition, CCH, Riverwoods, USA, 2007, p. 401, where it is specified that the expression is used to mean «a legal agreement executed by a contractor (transferor), a successor in interest (transferee), and the government, by which the transferor guarantees performance of the contract, the transferee assumes all obligations under the contract, and the government recognizes the transfer of the contract and related assets. Under the common law, a novation is an agreement where a contracting party accepts a new party in place of the prior party […]. However, in government contract a novation is merely an assignment of contract (with the prior party retaining all obligations in the event the new party fails to perform)».

significantly different from that initially envisaged in the contract, that due to the novation contemplate new parties.

Leaving aside here the analysis of the various and complex implications of the *ius variandi* in contracts entered into by public administrations[52], there is no doubt that where structural changes of derivative transactions are implemented the public interest is exposed to possible imbalance. In fact, even if intermediaries are animated by the intention to behave properly, fundamental inadequacies (for example, with regard to the quantification of hidden costs) often occur, which occasionally have an impact on the same identification of the contract's objectives.

It results a situation in which local authorities may be encouraged to critically review the expected realization of economic advantages and, therefore, the same will to continue to keep the derivative "alive". In those cases – which, of course, being varied feature a wide range of possible relational positions – public bodies, depending on the degree of involvement of the responsibility assumed, may decide not to proceed by way of authoritative powers (i.e. by using their power of internal review), opting instead for an agreed solution.

Any settlement agreement – which could be reached in that respect –, being based on a preliminary investigation, incorporates an assessment that

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[52] On the power of public administrations to unilaterally modify the contractual relationship during its performance see CERULLI IRELLI, *Amministrazione pubblica e diritto privato*, Torino, 2011, pp. 240 ff. For a comparative analysis see GRAIG, *Specific Powers of Public Contractors*, in NOGUELLOU – STELKENS (eds.), *Droit Comparé des contracts publics, Comparative Law on Public Contracts*, Bruxelles, Bruylant, 2010, pp. 174 ff.

allow to identify in the content of the “settlement agreement” (and, more precisely, in the monetary amounts eventually paid by the local authorities to their counterparties) the recognition of a sort of “compensation” for having adhered to the contract without a prior fair estimation of its content.

As a result, it comes to a method of termination of the liabilities of public bodies that – even if meant to avoid further financial costs (and, primarily, the displacement of the costs of derivative transactions to future generations) – proves, among other things, a previous lack of attention in the behavior of the same public bodies.

12. The above considerations - showing the complexity of the circumstances which have been faced local authorities when entering into derivative transactions - highlight the need to ensure that in the future is avoided any form of management of public debt which make use of “financial creativity” mechanisms.

The intrinsic difficulty which characterizes the derivatives and the possibility that these instruments can be misused by intermediaries and investors (for speculative rather than for hedging purposes) have induced the Italian regulator to restrict derivative transactions, firstly limiting the scope only to debt restructuring and secondly by prohibiting new transactions.

There is no doubt the operational practice - despite the constraints imposed by the regulator - may alter the function of derivatives, overflowing in a drift in which it is affected the balance between finance and politics. The public interest - in a logic that appears contrary to fundamental ethical principles - is subjugated to the dominance of finance; the rules put in place for the protection of local authorities are not capable to contrast those of financial markets that, on their objectivity, prevail in presence of a politics which tend to hide, … to postpone the financial burden of preexisting debt transactions.

In this context, as has been underlined by the Corte Costituzionale, there is a need to recognize primary relevance to the maintenance of «the economic equilibrium of regional and local finance»; thus the significant emphasis ascribing «to the impact of derivatives on the overall performance of the market»[53].

On the other hand, given the endemic financial weakness of the local authorities, an admissible legal remedy could be represented in the right - when the effects of the derivatives may become excessively burdensome for the local authorities - to provide the cancellation, by way of *self-repealing*, of the contract. Another consideration comes from the instability of the contractual relationship throughout the lifetime of financial derivatives, due to changes of the initial agreement that may be implemented by parties: in such cases the objective of achieving additional profits may introduce new risk elements that, most of the time, result in harm to the local authorities.

So there is a need – acutely felt in the Italian system – to seek a greater equity through a rebalancing of derivative positions established in the past by local authorities, who acted in a manner that was not necessarily suited for their special features. Therefore, it is inescapable to secure public entities on a stable and continuous basis from possible dangers linked to the use of derivative

[53] See CORTE COSTITUZIONALE, February 18, 2010, no. 52, as above.

instruments, preventing local authorities from activating new contracts as well as from changing - during the duration of the instruments - the conditions initially agreed with financial intermediaries.

It should be noted, in this respect, that there is matured awareness of the adverse effects arising from the perverse connection between the financial practices described in this article and the political logic which persisted in Italy for a long time.

In particular, this relates to the incentives provided by the political class to the use of a method for the management of public finance which is not intended to achieve a strict limitation of debt exposure by local authorities, but rather is based on a structural failure of liability rules.

In the light of the above considerations, it is clear why the recent Stability Law for the year of 2014 (Law No 147 of 2013) has modified Article 62 of the Decree No 112 of 25 June 2008, converted with amendment by the Law No 133 of 6 August 2008. By effect of this law, legal clarity has been achieved about the prohibition «to make new contracts relating to financial derivative instruments as determined by Article 1, third paragraph of the Consolidated Law on Financial Intermediation (TUF)»; it have been also introduced specific obligations for the management of debt-restructuring operations concerning the outstanding debt contracted by public entities.

The above mentioned law - giving new interest to the analysis of a subject which in the last years appeared to be confined to the judicial area of courts - could mark a key turning point in the management of the public finance. It also becomes clear the impact of this law on the overall discipline of the financial activity, coming into consideration the strict relation between civil legal system and the related regulation of market[54].

Politics, in fact, is oriented toward a critical revision of the *favor* granted until recently to the public sector for the restructuring of its own liabilities, particularly referred to the bodies of their own organizational *apparatus*. It is legitimate to ask whether this is the prelude to a substantial renovation directed to limiting the dominant role of speculative finance in Italy? It is possible to affirm that the impact of Law may be considered as such as having broken the perverse combination of politics and finance, which in many cases has carried out distortions in the allocation of public goods and the impossibility of starting a sustainable economic recovery, unfettered from the so-called *strong powers*?

These are not easy questions to answer. Any attempt to do so implies the determination upstream of socio-cultural changes, perhaps still distant and still relegated to the area of *wishful thinking*![55] What is positive, however, to be inferred from the legislative measures indicated above is the acknowledgment of the need to proceed in a different direction than in the past; it is the acquired

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[54] The relation between "contract and market framework" has been a matter of concern for a long time by the Italian legal doctrine, which has explored most of all the scope of such relation in the banking and financial environment; see among others, BUONOCORE, *Contratto e mercato*, in *Giur. comm.*, 2007, I, pp. 380 ff.; OPPO, *Contratto e mercato*, in *Varie diritto. Scritti giuridici*, vol. VII, Padova, 2005, pp. 193 ff. and previously, *Principi*, in *Trattato di diritto commerciale*, Buonocore, Torino, 2001, Sez. I, Tomo I, *passim*; IRTI, *Diritto e mercato*, in A-A.VV., *20 anni di antitrust: l'evoluzione dell'Autorità Garante della Concorrenza e del Mercato*, by Rabitti Bedogni e Barucci, Torino, 2010, pp. 39 ff.; GUARRACINO, *Globalizzazione, mercato e contratto: la tutela del risparmiatore al tempo della internazionalizzazione dei sistemi economici*, in AA.VV., *I contratti dei risparmiatori*, edited by Capriglione, Milano 2013, pp. 617 ff.

[55] See CAPRIGLIONE - SEMERARO, *Financial crisis and sovereign debt: the European Union between risks and opportunities, cit*., pp. 65 ff.

awareness of need to abandon the logic which for decades has led the public finance management in a way with less attention to the public interest (in which it falls the protection of future generations).

DERIVATIVE FINANCIAL INSTRUMENTS

AND BALANCED BUDGETS:

THE CASE OF THE ITALIAN PUBLIC ADMINISTRATION

Michela Passalacqua*

ABSTRACT: *The present paper aims to examine whether derivative contracts concluded by the Public Administration enable to assess the real financial commitment on the authority's budget, due to their intrinsic features and the current legal framework. The author claims that, on the whole, they cannot be easily reconciled with the obligation to ensure balanced budgets and public debt sustainability, as provided for by the reformed Articles 81 and 97 of the Italian Constitution.*

Therefore, it is to be hoped that there be an intervention by the legislator to regulate the use of these financial contracts by all public authorities, as well as companies with public shareholding. In the author's opinion, there are two possible regulatory options: either to introduce a ban on these innovative financial instruments for any public body, or to accurately regulate this issue, by ensuring the disclosure of necessary information to render derivatives thoroughly compatible with the constitutional principles aimed at protecting the stability of public finances.

SUMMARY: 1. Balanced budget and sustainability of public debt in the Italian Constitution. – 2. Public accounting rules and derivatives. – 3. Balanced budget and derivatives. – 4. Whether public bodies, other than local authorities, and local government-owned corporations can contract derivatives. – 5. Conclusions.

«*Which of a weak or niggardly projection*
Doth, like a miser, spoil his coat with scanting
A little cloth»
William Shakespeare, *The Life of King Henry the Fifth*, Act II, Scene IV

1. The substantial Italian public debt is mainly due to the decision made by the members of the Constituent Assembly not to extend the obligation of providing financial coverage to the budget law[1] (Article 81, paragraph 4 of the Constitution, prior to the reform of 2012).

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[1] See BRANCASI, *Le decisioni di finanza pubblica secondo l'evoluzione della disciplina costituzionale*, 8 August 2009, in *www.astrid-online.it*, pp. 4 ff.; ID., *L'introduzione del principio del c.d. pareggio di bilancio: un esempio di revisione affrettata della Costituzione*, in *Quaderni costituzionali*, 2012, p. 108.

The aforementioned article stated that «every other» expenditure law – other than budget law – shall «indicate» the measures to be employed to face such expenditures[2], thus complying with the obligation of financial coverage.

The members of the Constituent Assembly have therefore underestimated that the largest part of the Italian public expenditure would originate from the budget law approved yearly by the Parliament. As a matter of fact, because being able to record the revenues-expenditures imbalance, it allowed recourse to debt[3], whose maximum amount would be later established by the Finance Act presented on an annual basis starting from 1978.

However, by passing judgement no. 1/1966, the Constitutional Court accepted – as consistent with the Constitution – the practice of covering expenditures also through Treasury's debt, which thus increasingly turned to the financial market to find further resources in addition to tax revenues.

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[2] But it did not specify «to supply» the means by which to cover the expenditures, as provided in the original wording proposed in the Second Subcommittee on the Constitution by the Honourables Mortati and Vanoni, which was however not approved by the Constituent Assembly.

[3] For these reasons, we cannot endorse the arguments of the doctrine which supported the principle whereby a balanced budget is already encoded in this paragraph 4 of Art. 81 of the Constitution; in the sense that the inability of the Budget Law to introduce new taxes or charges, together with the obligation of the other expenditure laws to indicate the funding, should ensure a balanced budget (DI GASPARE, *Innescare un sistema in equilibrio della finanza pubblica ritornando all'art. 81 della Costituzione*, in *www.amministrazioneincammino.luiss.it*, 2005, p. 2; BOGNETTI, *Costituzione e bilancio dello stato: il problema delle spese in deficit*, in *www.astrid-online.it*, 2009, pp. 15 ff.; GIANNITTI, *Il pareggio di bilancio nei lavori della costituente*, 2 August 2011, in *www.astrid-online.it*).

However, the parliament has recently amended the Constitution of 1947 by reforming the aforementioned Article 81, which now states that an «equilibrium» between revenues and expenditures needs to be ensured.

Presumably, the balanced budget introduced by the legislator aims to orientate the revenues-expenditures ratio to be allocated in the budget by «taking into account favourable and unfavourable phases of the economic cycle»[4], in accordance with the EU regulations on public budgets[5].

The goal of this constitutional amendment is also to grant the Parliament a certain degree of autonomy and to enable it to approve budget deficits in bust phases of the cycle, provided that future budget surpluses shall follow during the boom phases of the same cycle, so as to ensure a sort of balance over the cycle by compensating cyclical deficits and surpluses[6].

Secondly, this amendment is intended to set a limit to the Parliament's power to finance public expenditures through borrowing. As a consequence, limits to the legislator's authority of resorting to the financial market by issuing national government securities to find resources for public expenditures have been introduced.

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[4] See Article 1, paragraph 1 of Constitutional Law no. 1 of 20 April 2012; the passage in which it modifies Article 81, paragraph 1 of the Constitution.

[5] See paragraph 3 of the Treaty on Stability, Coordination and Governance (Fiscal Compact), signed on 2nd March 2012 by the leaders of the entire Euro area and eight other EU Member States, which entered into force on 1st January 2013.

[6] For more information, see PASSALACQUA, *Presupuesto con igualdad entre ingreso y gasto e intervención pública: el equilibrio propuesto en la revisión de la Constitución italiana*, in *Cuadernos de Derecho Pùblico*, no. 38, septiembre-diciembre, 2009, p. 213, available at revistasonline.inap.es.

It has been furthermore acknowledged in the Constitution the requirement of extending the principle of balanced budgets to Regions, local entities and any public administration[7], which are now required to ensure «balanced budgets and sustainability of public debt»[8]. The new constitutional formulation aims to carefully vet public debt according to principles of asset and financial sustainability.

Extending to local entities the obligation to balance the budget has obviously required the modification of the so-called *golden rule* (see Article 119 of the Constitution); i.e. the possibility of Regions and local entities of resorting to borrowing to support productive expenditures, namely investments. On this point, it is essential to remember that over 70% of public investments in Italy are made by local entities, namely Municipalities and Provinces[9].

Concerning this issue, a midway solution has been pursued in order to reconcile the much-desired balanced budget and the possibility for the territorial autonomies to meet those expenditures representing a potential enrichment for future generations (such as expenditures for infrastructures or to promote knowledge economy), and consequently for the country. Therefore,

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[7] Or rather, all public authorities – economic and non-economic – forming the Italian public administration, assuming that not every Italian public entity has budgetary autonomy and authority to contract indebtedness. This innovation has been approved by the Court of Auditors (the national judge of the accounts) which has evaluated it as respectful of international rules of national accounts (ESA 95), see Court of Auditors, sez. riun. contr., *Elementi per l'audizione in materia di introduzione del principio del pareggio di bilancio nella Carta costituzionale*, 26th October 2011.

[8] Articles 2 and 4 of Constitutional Law no. 1/2012, quot., amending respectively Art. 97, paragraph 1 and Art. 119, paragraphs 1 and 6 of the Constitution.

[9] Source: Court of Auditors.

the obligation being understood to ensure the balance of current expenditures, local administrations are allowed to incur debt to meet investment expenditures, as long as they can provide «a description of their amortization schedules and on condition that all local entities of each Region respect a balanced budget»[10].

In fact, unlike in the past, also due to the current economic-financial crisis, the Italian Constitutional Court has given quite a stern judgement on some Regional budget laws even before the aforementioned reform (in force since 2014), as it advocates they should comply with financial coverage, as provided for by Article 81, paragraph 4 of the Constitution (original version) concerning expenditure laws[11].

In particular, according to the Constitutional Court, budget laws should be regarded as expenditure laws and, as such, should meet a hedging requirement by means of a prior check of the resources available, in order to ensure a trend towards a balance between revenues and expenditures.

2. As previously mentioned, public administrations – including Italian ones – have been admitted to the financial services available in the regulated

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[10] Article 4 of Constitutional Law no. 1/2012, quot.

[11] See CONSTITUTIONAL COURT, 28th March 2012, no. 70 (relating to the Budget Law of the Campania Region); Id. 18th June 2008, no. 213 (concerning the provisional budget of the Sardinia Region); Id., 31st October 2007, no. 359 (on the variation to the budget of the Sicily Region).

markets and have traded in derivative financial instruments too, since the second half of the 20th century[12].

The Finance Law approved in 1984[13] authorized the then Ministry of the Treasury to realize operations of external debt restructuring[14]; later, the restructuring of domestic public debt will also be authorized[15]. By virtue of the public administration's legal capacity in terms of civil law[16], which authorizes it to implement contracts, the same administrative body believed that the Ministry could proceed to debt restructuring also through debt swap operations, provided that they serve the institutional purpose of minimizing debt (principle of legality).

Since 1994, the local authorities have been likewise authorized by law to issue debenture loans with the subscription of derivatives, in particular warrants[17], and later to trade in swaps to repay debt[18]. In the following years, the state regulations progressively extended the authorization for local

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[12] See PIGA, *The history of swaps in public debt management*, in *Derivatives and Public Debt Management*, Zurich, Isma, 2001, pp. 38 ff.

[13] Article 8, last paragraph, Law no. 887, 22nd December 1984. See also, Article 3, paragraph 1, letter c, Decree of the President of the Republic no. 398, 30th December 2003.

[14] To be intended as debt denominated in foreign currency.

[15] Article 2, paragraph 165, Law no. 662 of 28th December 1996.

[16] It is a general principle of national law.

[17] Article 35, paragraph 5, Law no. 724/1994.

[18] Article 41, paragraph 2, Law no. 448 of 28th December 2001.

autonomies to use derivatives until 2008[19], when interventions in the opposite direction occurred.

More specifically, the public administrations have shown interest in resorting to derivatives both for the purpose of restructuring their ever-increasing debt and in relation to the funds granted to make investments, because such financial instruments can serve a hedging function of the contracts subscribed. On the contrary, the legal order has always prevented public authorities from using derivatives to make profit.

In short, Italian administrations – both central and local ones – have used derivatives in order to manage their exposure to the market risks taken in the financial markets they addressed to raise the necessary funds for their activities[20].

The Italian regulations on this matter grant the State and local entities to trade in derivatives (see *infra* § 3) – where still allowed – by considering the latter as instruments for the management of an existing risk and not as a means of new risk-taking. More specifically, unlike the past, the local entities can no longer collect up-front payments upon concluding derivative contracts; ie. imprest payments, which shall constitute indebtedness if previously contracted. Nonetheless, following verifications on some local entities' accounts, some critical issues seem to emerge on this point; in that, the local entities have very

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[19] For a more accurate reconstruction of the regulatory framework see CAPRIGLIONE, *The use of «derivatives » by Italian local authorities in public finance management. Still an issue,* in this *Review*, 2013, II.

[20] Source: Senate of the Italian Republic, Finance and Treasury Committee, *Survey on the diffusion of financial derivative instruments and securitisations in the public administrations*, 11th March 2010.

frequently allocated revenues from derivatives to finance their current expenditures[21].

The real problem is that derivatives can also serve a speculative purpose[22] affecting the very reason for subscribing the contract. This may result in insolvency risks due to various factors mostly connected with the general market trends and aggravated by the circumstance that the default of one or more contracting parties can in turn influence that of the others. In other words, derivatives generate systemic risk, against which the parties do not have any kind of hedging strategy.

It is therefore common for a contracting party, either private or public, to suffer a financial loss exceeding the capital invested.

Such occurrence has raised remarkable doubts on the suitability of using derivative financial instruments by the public administration. As a consequence, the legislator has adopted stern measures against the ever-increasing costumes of using derivatives by the local administrations[23] and the Constitutional Court has passed rather severe judgments on the conduct of certain regional administrations (see *infra* § 3).

This phenomenon has indeed become quite relevant. In the late 2000s, the Italian Municipalities and Provinces used to manage over half of their debt

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[21] Source: Court of Auditors, sez. reg. contr.

[22] See CAPRIGLIONE, *I prodotti "derivati": strumenti per la copertura dei rischi o per nuove forme di speculazione finanziaria*?, in *Banca, borsa, tit. cred.*, 1995, pp. 359 ff.

[23] Mainly Regions, Provinces and Municipalities.

by means of this type of operations[24]. Yet, generally speaking, it should be noted that the local self-governments' total debt is globally far lower that the national one[25]. It is no coincidence that, in absolute term, the amount of derivatives traded by the Ministry of Economy is much higher[26].

On the other hand, the use of derivatives by public administrations seems to be hardly compatible with the regulations of public accounting, since derivatives are characteristically connected to other activities, either financial of real – the so-called underlying assets (such as securities, commodities, interest rates, indexes and other derivatives) – on which a derivative's price is based.

On the basis of the definitions provided by the European directives, the Italian doctrine ranks derivatives in financial derivatives, commodities derivatives and credit derivatives[27]. On this point, it is essential to remember that credit derivatives allow the transfer of credit risk but, unlike financial derivatives, do not aim at the acquisition of a spread. The result is that there are

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[24] Source: Court of Auditors, sez. riun. contr., *Survey on the diffusion of financial derivative instruments and securitisations in the public administrations*, 18th February 2009, p. 20.

[25] In 2007, for example, the total debt of Municipalities and Provinces amounted to 55.39 bn euros.

[26] By 6th April 2012, the total notional of exposure in derivatives, issued by the Italian Republic to hedge debt, was equal to about 160 bn euros, compared with securities in issue for 1,624 bn euros by 31st January 2012. Source: Court of Auditors, *Relazione scritta del procuratore generale*, *Cerimonia di inaugurazione dell'anno giudiziario 2013*, 5th February 2013, which shows the response to the parliamentary question, no. 2/01385, which took place during the public hearing of 15th March 2012 at the Chamber of Deputies; available at www.leg16.camera.it.

[27] For more explanations see BARCELLONE, *Strumenti finanziari derivati: significato normativo di una «definizione»*, in *Banca Borsa tit. cr.*, 5, 2012, pp. 541 ff.

numerous diverging interpreta-tions on the legal nature of contracts[28]. According to the most convincing opinion, derivative contracts are claimed to have the negotiation of a risk as their object, which falls behind the legal sphere of both contracting parties. In fact, as we have seen, some contracts do not contain any reference to spread despite being defined as derivatives by the legislator.

In this context, the administrations have negotiated financial derivatives – used for a better management of their debt – in the attempt to control market risks and reduce borrowing costs. Such contracts are intended to create a spread between the value of the entity negotiated upon the issuing of the contract and the value it will acquire on the maturity date previously arranged[29].

These spreads – which periodically accrue interests – require recording in the administration's budget. The problem is that such amounts cannot be determined upon the issuance of a contract, since they depend on the uncertain future market-trends.

Consequently, their budgeting becomes a complex operation, because it concerns financial resources whose flow will not be stable over time, but will rather be bound to change in a fairly aleatory way.

Therefore, the amount to be recorded in the estimated budget might be positive (gain), when accrued in favour of the local entity, or negative (loss), when accrued in favour of the financial intermediary.

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[28] For an analysis see BARCELLONE, *Strumenti finanziari derivati: significato normativo di una «definizione»*, quot.

[29] See the Constitutional Court's interpretation no. 52 of 18th February 2010.

The point is that the Italian legal order does not include any written rule whereby the entities can unambiguously budgetize these spreads.

Paradoxically, even the European legislation has not promptly intervened yet, since Eurostat decisions until 2008 did not include any binding forecasts in this respect for the Member States[30;] and there are not any shared accounting principles for the public sector on a European level yet. Nor has the Italian national law adopted the International Public Sector Accounting Standards (IPSAS) issued by the Public Sector Committee (PSC) of the International Federation of Accountants (IFAC)[31].

Such a shortcoming in the regulations may give rise to opportunistic attitudes in the public administrations, which aim to account for such operations in the most convenient way for them.

In any case, the Italian public administrations are required to follow the principles of sound financial management, inspired to prudential rules, integrity, comparability and transparency of public budgets.

Conversely, should the public authorities be less rigorous in their accounting, the balance of the future budgets might be compromised (on this notion, see the following paragraph).

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[30] See *Guidance on accounting rules for EDP Financial derivatives*, 13th March 2008, which responds to the question on how to deal with the flows given by swaps or options in accounting procedures.

[31] On this very subject, IPSAS 15 on «disclosure and presentation» of financial instruments – including derivatives – applies.

Such general principles were valid even before the constitutional amendment (see *supra* § 1) and, on the basis of interpretations[32], prescribed the administrations to carry out an accurate financial analysis on the future trend of the contract, upon approval of the yearly budget plan. Should a derivative generate a cash flow comparable to indebtedness, this positive cash flow would be either allocated to investment expenditures, as provided by Article 119 of the Constitution, or earmarked to pay back the financial intermediary in case of future negative flows.

Therefore, the administrations should have always adopted virtuous policies in employing these special revenues. In case of a positive assessment, they shall exclusively direct these cash flows to pay back the interests on the notional debt. On the contrary, they shall allocate the temporary revenues to the budget surplus reserved to the payment of negative cash flows in the future. Finally, if disbursements are to be faced in the administration's assessment, a special allocation for current expenditures shall be planned in proportion to the size of the financial loss.

The Court of Auditors is only partly responsible for overseeing the accounting regularity of these operations.

As a matter of fact, on a monthly basis, the national legislation[33] requires the Ministry of Economy to forward the Court of Auditors a copy of any derivative contracted by the local entities, which shall have in turn mandatorily

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[32] See Court of Auditors, sez. riun. contr., *Survey on the diffusion of financial derivative instruments and securitisations in the public administrations*, *cit*.

[33] Article 62, paragraph 7, Decree Law no. 112 of 25th June 2008 and Article 41, paragraphs 2 *bis*-2 *ter*, of the Law no. 448 of 28th December 2001.

notified the Ministry. Conversely, there are no transparency rules prescribing the Ministry to forward the Court of Auditors the derivatives contracted by the central administration. Nor are there similar information systems applying to the other non-local public administrations. The Directorate General of Ministry of Economy is simply required to send the Court of Auditors «a six-monthly report on the Treasury's liabilities emphasizing the appropriateness of the decisions taken»[34].

Finally, it should not be overlooked that the control operated by the Court of Auditors seems to be little effective considering that it is very hard to assume damages to the State, given the difficulty in applying rules of administrative liability to harmful events for the public finances that are hardly predicted, even with the best stochastic rules[35].

It clearly emerges that the implementation of a real European economic governance can hardly be reconciled with the context here described. As part of the Six Pack, the directive 2011/85/EU (the so-called Directive on national budgetary frameworks) states that the availability of complete, reliable and comparable budgetary data among the Member States is crucial to pursue a budgetary surveillance on a EU level.

In accordance with Article 16, paragraph 3 of the aforementioned directive, the European Commission is currently assessing the suitability of the International Accounting Standards applicable to the Member States' public

[34] Article 3, Ministerial Decree, 10th November, 1995.

[35] Towards a critique of the mathematical models in predicting risks, see PASSALACQUA, *Diritto del rischio nei mercati finanziari. Prevenzione, precauzione ed emergenza*, Padova, Cedam, 2012, pp. 140 ff.

sector (IPSAS), aiming to create a single set of accounting standards on any level of the public administration within the European Union[36].

3. Recently, the Constitutional Court has proved to be considerably severe in judging the use of financial derivatives by local autonomies, as they are believed to hinder debt control by these very administrations.

In more detail, following the appeal filed by some Regions, the Supreme Court has intervened on the legitimacy of state regulations limiting the use of derivatives. In 2008, a decree was passed and repeatedly modified, which introduced a provisional ban for the local entities on entering into contracts involving derivative financial instruments[37]. This ban was bound to expire upon issuance of a Ministerial Regulation aimed at more accurately regulating this subject-matter, which however has not been issued so far[38].

Actually, the Constitutional Court regards financial derivatives as 'dangerous' to the public finances, as they contain an evident non-predictable market risk falling beyond the parties' intention (see *supra* § 2) and facing the

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[36] Commission Report to the Council and the European Parliament, *Towards implementing harmonised public sector accounting standards in Member States. The suitability of IPSAS for the Member States*, 6th March 2013, COM/2013/0114 final.

[37] Article 62, paragraph 6, Decree Law no. 112 of 25th June 2008, then amended by Article 3, paragraph 1, of Law no. 203 of 22nd December 2008.

[38] See CAPRIGLIONE, *The use of «derivatives» by Italian municipalities in public finance management. Still an issue*, *cit.*

administrations with inappropriate financial costs, unforeseeable at the time the contract was concluded[39].

Thus, the use of contracts with strong aleatory components for investment operations does not seem to be compatible with the standards of a good accounting practice.

The restrictions imposed by the state regulations onto the local entities, as concerns the use of derivatives, end up by ensuring also the protection of the assets of the public bodies.

Case records have fully demonstrated that – besides setting unfavourable conditions onto the entities in the first place – derivative contracts, when renegotiated following debt restructuring, involve further risk-taking, as they shift over the period the costs deriving from even more unfavourable conditions, compared to the initial ones.

In short, the renegotiation of derivatives is characterised by a high degree of uncertainty, which can endanger those public financial resources the entities could use for collective needs; and thus for the general interest of the community.

Furthermore, the rules applying to each derivative contract are bound to necessarily and directly influence those economic balances that are meant to be ensured on a regional and local level.

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[39] See CONSTITUTIONAL COURT, 18th February 2010, no. 52, quot.; Id., 28th March 2012, no. 70, *cit.*

As a consequence, such negotiations appear to be dangerous also because they can prejudice the financial interest represented by balanced public budgets.

In light of the all reasons here provided, Article 62 of Decree-Law no. 112/2008 requires (only) local entities to enclose a report – in addition to final balance and budget plan – detailing the financial costs and liabilities, respectively estimated and undertaken, which originate from derivative contracts or contracts including a derivative component.

The regulation does not merely require a brief or general description of the derivatives contracted by the public administration, but it rather demands a detailed definition of any expenditure occurred and an estimate of the future ones, on the basis of the mathematical models adopted in connection to the financial markets trend. By doing so, the legislator compensates for a lack of clear accounting rules on cash flows deriving from the contracts; which therefore lays the foundations for a sound and prudential financial management of the public administration.

According to the Constitutional Court, such forecast aims to preserve balanced budgets; in that – as it imposes the compliance with financial as well as economic elements (the nominal value of the contract on the whole) – it also requires the entities to provide essential information to define public debt on a national level and enables them to make sure that budget planning and management comply with the rules of a sound accounting practice[40].

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[40] See CONSTITUTIONAL COURT, 28th March 2012, no. 70, *cit.*

Hence, the goal of the Court is to extend the hedging requirements to derivatives by equating them to multi-year expenditures with variable and complex components, in accordance with a constant approach of the Supreme Judge[41].

Consequently, in relation to the derivatives contracted by the public administration, the hedging strategies need to be thoroughly and exhaustively presented in the aforementioned report, which shall also provide accurate information in order to adopt coherent contractual options and effective controls (within the competence of the Ministry of Economy).

This represents a guarantee for the balances of both current and future financial years.

Actually, the report is intended to disclose the activities recorded in the budget and it therefore enables the assessment of their future impact on both the entity's assets and the future financial balances.

Given the significant impact these multi-year aleatory contracts may have on structural elements of the Regional finances, if the local autonomies failed to provide the above-mentioned report, a conflict would inevitably arise with the trend to preserve the balance of the budget forecast for the current and future financial years. In particular, all this should be considered in terms of precautionary measures against potential inadequate decisions, which might be favoured by the lack of clear and strict reference standards.

[41] See decisions no. 68 of 2011, no. 141 and no. 100 of 2010, no. 213 of 2008, no. 384 of 1991, no. 283 of 1991, no. 69 of 1989, no. 17 of 1968, no. 47 of 1967 and no. 1 of 1966.

The Court's interpretation turns out to be very important to limit any incautious conduct shown by the Regions in assessing the risks connected to the derivatives formerly traded. In fact, the Court will declare unconstitutional any Regional budget law lacking a report containing the above-mentioned elements on the derivatives contracted, for violating the hedging principle.

Such an approach should motivate also the local entities to respect the rule of enclosing a report, at least in consideration of the interpretation and assessment the Supreme Court may give of the controls operated by the Court of Auditors.

No wonder the legislator has eventually introduced in the Stability Law 2014[42] the permanent ban on purchasing derivatives for the local entities, unless they are interest rate caps concerning loan agreements; that is a derivative guaranteeing the buyer against interest rates rising over the threshold agreed on.

In fact, the legislator's intervention appears to be short-sighted and not in line with the constitutional reform imposing balanced budgets and public debt sustainability on any public administration, including non-local ones (*supra* § 1)[43].

Despite the Court's warnings, the legislator has failed to extend the ban on purchasing derivatives to every public entity, either national or non-local in any case, and therefore to solve an interpretative issue that may damage financial stability (see *infra* § 4 for more details). In addition to that, it has not been taken

[42] Art. 1, paragraph 572, Law no. 147 of 27th December 2013.

[43] See also Article 13 of Law no. 243 of 24th December 2012, *Provisions for the implementation of the balanced budget principle in accordance with Article 81, paragraph 6 of the Constitution*.

into account the opportunity of introducing strict rules to the numerous government-owned corporations, which can almost surreptitiously undermine the solidity of the national public accounts (see *infra* § 4).

What is more, the real problem is that the new regulation does not require any public administration – not even local ones, which are once again allowed to purchase interest rate caps starting from 2014 – to carry out an economic assessment of the derivative proposed prior to purchase, also in consideration of the entity's initial financial portfolio.

In accordance with the constitutional requirement to ensure balanced budgets and public debt sustainability, it is crucial to guarantee greater transparency of the contracts involving public authorities by illustrating the scenarios of real world probabilities, according to the methodology suggested by the National Companies and Stock Exchange Commission (Consob)[44].

On top of that, the constitutional amendment does not bind the financial intermediaries to explicitly provide the derivative's fair value upon subscription, nor to indicate the implicit cost of the derivative operations.

On the whole, any regulation allowing a public administration to enter into contracts that may potentially generate hidden charges and increase debt is not

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[44] See GIORDANO - SICILIANO, *Probabilità reali e probabilità neutrali al rischio nella stima del valore futuro degli strumenti derivati*, Quaderni Consob, August 2013; see also BAXTER - RENNIE, *Financial Calculus. An Introduction to Derivatives Pricing*, Cambridge, Cambridge University Press, 1996; CHENG YONG TANG – SONG XI CHEN, *Parameter estimation and bias correction for diffusion processes*, in *Journal of Econometrics*, 2009, no. 149, pp. 65 ff.; HUMPHREYS - NOSS, *Estimating probability distributions of future asset prices: empirical transformations from option-implied risk-neutral to real-world density functions*, Bank of England working paper, 2012, no. 455.

consistent with the Italian Constitution. This is because future expenditures – for which no hedging is available yet – may arise to the detriment of the financial balance. Any hidden charge – in terms of lost profits and losses – is against the principle of debt sustainability, which is based on the virtuous cycle between accumulated debt and owned wealth; as it undermines the possibility for the public entity to pay back its debt upon contact expiration[45].

4. As previously mentioned (s*upra* § 2), it is now a while that, under Italian national law, doctrine[46] and case law[47] have agreed on public bodies' full legal capacity in terms of civil law.

As a consequence, in the absence of prohibitions or restrictions imposed by the law, they are allowed to conclude any contract, typical or atypical[48], aiming to interests worthy of protection, on condition that they are not

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[45] This principle can be drawn from Article 4 of Law no. 243 of 24th December 2012, *cit.*

[46] See AMORTH, *Osservazioni sui limiti dell'attività amministrativa di diritto privato*, in *Arch. dir. pubb.*, 1938, pp. 455 ff.; PERICU, *Note in tema di attività di diritto privato della pubblica amministrazione*, in *Ann. Genova*, 1966, I, p. 166; ROMANO, *L'attività privata degli enti pubblici. Problemi generali, la capacità giuridica privata*, Milano, Giuffrè, 1979, pp. 143 ff.; MERUSI, *Il diritto privato della pubblica amministrazione alla luce degli studi di Salvatore Romano*, in *Dir. amm.*, 2004, 4, pp. 649 ff.

[47] It has been established in case law since the well-known pronunciation of the Council of State, sect. VI, 12th March, 1990 no. 374. See also Council of State, sect. III, 11th May 1999 no. 596; Council of Administrative Justice of the Sicily Region, 4th November 1995, no. 336 and Council of State, sect. V, 1st March 2010, no. 1156.

[48] See Council of State, sect. V, 7th September 2011, no. 4680, as well as, in the doctrine, DUGATO, *Atipicità e funzionalizzazione nell'attività amministrativa per contratti*, Milano, Giuffrè, 1996.

incompatible with the institutional objectives, to the satisfaction of which the law established them.

More recently, like for private individuals regulated by civil law, this entitlement is no longer established through interpretation, but through a clear provision of positive law, as supported by Article 1, paragraph 1 *bis* of the Act on administrative procedure (Law 241/1990), introduced in 2005, which states «When a public administration issues non-authoritative acts, it operates according to civil law unless otherwise provided by the law[49]». This provision implies that any public administration can generally carry out agreements, such as contracts, which no one in Italy has ever doubted for over the past half-century.

Following a first general examination, any public body can apparently conclude derivatives for the Italian national law in the absence of special provisions of State law[50], which are currently applied only to the local authorities (*supra* § 3). We only have to remember here the case of the Ministry of Treasury.

Actually, this issue needs a more comprehensive examination, also to investigate how the constitutional reform on balanced budgets here illustrated might contribute to the hermeneutic solution of the problem.

There can be no doubt that any public administration may decide to conclude a contract, when it is considered to be the best instrument to achieve the public interest pursued by the administration itself. By no means could an

[49] Note that by explicit provision of art. 1 quot., this is a general principle.

[50] It should be remembered that in Italy only the central government has legislative power in matters of civil law.

administration resolve to conclude contracts that are in conflict with the interest pursued, unless under the penalty of infringing the law and therefore of declaring voidable the act at stake. As a consequence, the contract itself would be void for infringement of mandatory rules.

As stated by the far-sighted doctrine, public authorities began in fact to employ the legal instruments of civil law not much as alternatives to authoritative acts, but rather because of the «inadequacy of public legal instruments in specific cases; in short, the use of contracts was a matter of good administration»[51].

The functional use of contracts to pursue public interest is ensured by a series of public procurement rules – the first among all the other rules of administrative proceeding – established by European law for the choice of the contractor.

Public accounting rules – intended to protect financial interest – are within the same set of rules, which are now fully recognized in articles 81 and 97 of the Constitution. This is true at least of the authorities governed by public law, other than the State, for which budgetary constraints were not parameters taken into explicit account previously.

It should not be forgotten that there is a strong link between public contracts and public accounting, since any contract has consequences on a financial level.

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[51] With these terms TRIMARCHI - BANFI, *Il diritto privato dell'amministrazione pubblica*, in *Dir. amm.*, 2004, 4, pp. 661 ff.

According to the Italian national law, contracts involving expenditures charged to the central or local (not regional[52]) administration are indeed ineffective, or without obligation for the authority, until an authorization according to the law and an accounting commitment are recorded in the appropriate section of the public body's balance forecast[53].

Consequently, a public authority is bound by a contract only in case a regular expenditure commitment applies.

Such expenditure commitment requires in turn to certify the existence of a financial coverage. Should this requirement be lacking, the related contract remains ineffective for the administration[54].

In conclusion, the ineffectiveness of the contract derives from the lack of financial coverage of the administrative provision.

In the author's opinion, claiming the invalidity of the contract would be more questionable under the current law. The resolution to conclude the

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[52] A state law regulating the matter is missing. See *supra* note 50.

[53] See the Royal Decree of 18th November 1923 no. 2440, *New provisions on the administration of the assets and the State Accounts*, the Royal Decree of 23rd May 1924, no. 827, *Regulations for the administration of the assets and the State Accounts*, the Decree of the President of the Republic 20th April 1994, no. 367, *Regulations for simplifying and accelerating the disbursement and accounting procedures*, the Law of 31st December 2009, no. 196, *Public finance and accounting Law*, article 191 Decree of 18th August 2000, no. 267, *Consolidated law on local government*.

[54] Since 2009, the government has granted the Court of Auditors a power of «a priori» audit of the legality of every employment and consultancy contract awarded by any administration, whatever their value. These contracts take effect upon completion of the checks, or otherwise, within thirty days of receipt by the control office without being remitted to the examination of the control section of the Court (see Art. 3, paragraph f *bis* – f *ter*, Law 20/1994 introduced by Decree-Law 78/2009).

contract would be ineffective but valid, thus inadequate to identify a validity defect in the contract.

So public authorities, other than local ones, could definitely enter into derivative contracts before the reform of articles 81 and 97 of the Constitution, since the fact that they fell outside the common negotiating models on public accounting provided for by law did not preclude them.

It is nonetheless true that, as demonstrated in the previous paragraphs, contracts containing derivative components can generate risks in the form of «hidden» debt[55].

Obviously, nor the obligation on the public authority to indicate in the resolution the exact content of an atypical contract can remedy this[56].

Strictly speaking, the respect of the rules of public procedure in choosing the contracting party should ensure the satisfaction of the authority's financial interest. Therefore the authority is required to adopt the most economical solution – or at least the most advantageous – offered by the markets, as the one capable of minimizing costs and possibly maximize benefits in terms of quality of the performance.

On the other hand, given the financial commitment the contract entails, accountancy rules oblige the authority to subordinate the resolution to contract to the budget availability.

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[55] It is also expressly declared by the Court of Auditors, *Relazione scritta del procuratore generale*, *Cerimonia di inaugurazione dell'anno giudiziario 2013*, 5th February 2013, *cit.*

[56] This obligation has been long theorized in the doctrine, see for instance DUGATO, *Atipicità e funzionalizzazione nell'attività amministrativa per contratti*, *cit.*, pp. 153 ff.

Yet, if such contract does not enable to assess the real financial commitment on the authority's budget, due to its intrinsic features, one can infer that, on the whole, it cannot be easily reconciled with the constitutional obligation to ensure public debt sustainability.

In this case, one might wonder whether the lack of strict regulatory limitations on the capacity of authorities – other than local ones – to enter such contracts could mean that the authorities are entirely free to conclude derivative contracts.

It is apparently harder to support this solution when the pursuance of public finance targets (i.e. budgetary constraints) becomes a general principle of European law, even before being a constitutional rule of a national law. Is this not inevitable that, once this principles have been adopted, the authority's capacity to enter into contracts turns out to be further limited?

In the opinion of the writer, this should be so any time the authority's contractual activity fails to comply with the above-mentioned principles at the top of the hierarchy of sources, because of the specific features of the contract type chosen.

If we adopt a different reasoning, we will continue to consider the targets of balanced budgets and public debt sustainability as mere government guidelines, indirectly protected through public procurement on the one hand – which should ensure the authority to trade at the lowest market costs – and through hedging rules on the other.

However, such conclusion is not convincing, since accountancy rules on their own are not fit to protect the administration from financial risks that do not immediately surface as costs.

As previously stated, on the basis of positive law, the afore-mentioned public finance targets have become general principles of the administrative action, on a constitutional and European level. The authorities shall therefore follow them in the pursuit of their activities as a priority and such restrictions shall constitute limits to their activity. These rules of public finance prove to be binding in themselves; as a result, the authority's contracting activity shall be legitimate only if reconcilable with budgetary discipline, namely the respect of the requirement of financial coverage aimed at ensuring balanced budgets and debt sustainability.

In the author's opinion, it follows that authorities should not be permitted to conclude, at least, any derivative contract whose structural features prevent from thoroughly establishing the financial commitment to which the authority is exposed. In other words, the authority's legal capacity in terms of civil law has its limit in the financial and asset sustainability. This means that the authority shall be prevented from entering into any contract obliging it to financial charges whose amount can hardly be calculated or which, in any case, cannot be calculated on the basis of the estimated maximum potential risk to which the authority is exposed.

In essence, should one disagree on this point of view, on account of the lack of regulations restricting the capacity of a public authority – other than local – to conclude derivatives, the authority's capacity to ensure balanced budgets and public debt sustainability would be considerably reduced.

Evaluating whether the constitutional reform may have affected the capacity of private companies with public participation to conclude derivatives is far more complex.

In actual fact, by analogy with what the Ministry of treasury has already been granted, a budget law dating back to 1996 (Dini government) explicitly allowed public bodies with economic interests and joint-stock companies with a majority of public shareholding to trade derivatives «for their domestic and external indebtedness»[57].

Such indebtedness, nevertheless, has been submitted to the authorization of the Ministry of Treasury.

Following the local self-government reform of the Italian Republic (2001), we raise doubts about the applicability of the rule to private companies with participation of local authorities.

We are once again faced with the problem of the authority's capacity of concluding this kind of contracts. As a matter of fact, it is a phenomenon which can gain substantial relevance for the stability of public accounts, if we just think that private companies with participation of local authorities total 5.000[58], according to recent statistical surveys.

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[57] See article 2, paragraph 165, Law of 28th December 1996, no. 662, *cit.*

[58] To be more precise 4874, see ASSONIME, *Principi di riordino del quadro giuridico delle società pubbliche*, Roma, September 2008, p. 8.

The formal status of joint-stock company certainly prevents from equating them *tout court* to public authorities, in virtue of the national administrative law.

However, due to the interference with the European law, the very notion of public authority has assumed a variable structure according to where it applies.

Unfortunately, it is rather difficult to infer from the national law what the boundaries of the notion of public authority are, in order to apply the rules of public finance.

Even more worrying is the fact that the aforementioned provision to implement the reform of articles 81 and 97 of the Constitution (Art. 2 Law no. 243/2012) has not seized the opportunity to clarify this point. In order to illustrate to which public authorities the balanced budget and debt sustainability applies, the above provision confines itself to consider public authorities as companies included in the public administration's consolidated income statement, as identified by the National Institute of Statistics (Istat)[59].

More specifically, the Istat identifies the authorities to include in the consolidated income statement in accordance with the ESA95 Community Regulation. Yet, the regulation once more raises the still unsolved interpretative question on public procurement, as concerns the correct identification of a clear-cut notion of body governed by public law.

[59] Article 1, paragraph 2, Law no. 196/2009, *cit.*

According to the ESA95 regulation, any «for-profit» company controlled by local authorities should remain excluded from the institutional sector of the public authorities. It is far more complex to clearly infer which they are.

Not to mention the fact that the activity carried out by Istat is merely clarifying and not constitutive. This means that the public status of a company cannot be unambiguously determined by merely reading the list of companies included (at least to apply the rules of public finance). In addition, the sole analysis carried out by the Institute does not seem to be particularly representative of a company's real status. Even though such analysis is conducted by the State statistical authority, the result also depends eventually on the companies involved, whether they fulfil or not the requirement to provide the data requested for the survey of the national statistical programme. It is to be feared that the ambition of each authority (to either depart from or approach the notion of public authority), may determine the authority's selection of data to be forwarded.

In conclusion, for all the reasons presented in the first part of this paragraph, any non-profit company controlled by local authorities, such as – in the author's opinion – companies delivering public services to be included in the public administration's consolidated income statement in accordance with ESA95, should refrain from entering into derivative contracts, as they are subject to be included in the administrative system subordinate to the rules of public finance.

5. In the last decade, the Italian legislation concerning derivatives contracted by the public administration has probably paid too much attention to regulating the use of innovative finance by the local administrations. Inexplicably, it has been neglected the adoption of a coherent and uniform legislation to regulate the use of structured finance by any subject managing public finances, and therefore capable of affecting the stability of the public finance.

As a consequence, there is considerable concern for public accounts to be exposed to inappropriate risks, even due to the mere lack of an adequate information and control system.

The interpretation of the amended article 97 of the Constitution here suggested is an attempt to make up for the legislator's inertia and it reaches as far as assuming the existence of a constitutional ban on any public administration assuming obligations for indefinite and/or indefinable amounts, which may therefore exceed the financial resources available resulting from the entity's balance forecast or its financial capacity.

This prohibition could not derive from the provision previously in force, that is the principle of sound administration, later implemented in the principles of profitability and efficiency contained in article 1 of Law no. 241/1990, because such legislative framework only required a profitable use of the public resources.

At most, it could be implied form the original constitutional provision that failing to provide the financial coverage of any expenditure beforehand is a violation of the principle of sound administration.

The current regulation does not only require the administrations to proactively operate to achieve a balanced budget, but also to ensure future debt sustainability, namely the availability of financial and capital resources to pay off the debts incurred. In short, the active pursuance of balanced budgets and debt sustainability are among the interests of any administration, under penalty of illegitimacy of their activities.

For all the reasons here illustrated, these new constitutional provisions question the lawfulness of contracting derivatives for the public administration, firstly because they may result in losses greater than the capital invested and prejudice the entity's financial capacity as they bear systemic risk, and secondly because the future capital costs for the administration can hardly be estimated from the contractual clauses regarding a risk that is unrelated to the parties' conduct and intention.

Finally, in this new context, the decision to authorize such contracts might be considered illegitimate for being detrimental of the overriding interests proposed above.

This seems to reinforce the hypothesis of considering void any contract based on that resolution for violating overriding rules (Art. 1418, Civil Code).

In conclusion, an urgent intervention by the legislator is clearly needed to regulate the use of these financial contracts by all public authorities, as well as companies with public shareholding. There are two possible regulatory options: either to introduce a ban on these innovative financial instruments for any public body, or to accurately regulate this issue, by ensuring the disclosure of necessary information to render derivatives thoroughly compatible with the constitutional principles aimed at protecting the stability of public finances.

THE DERIVATIVES OF ITALY

Valerio Lemma [*]

ABSTRACT: *This paper analyses government's funding programs taking into account both debt and derivatives. The focus on Italian case allows to show how the use of derivatives can influence the referential variables set by Maastricht Treaty. This is why the contract terms and conditions of Italy's use of derivatives could deny the rationale of European monetary union and the transparency of the internal market regulation.*

In particular, OTC derivatives set up a bilateral layout of the relationship between State and financial intermediaries, instead of a multilateral one (as in character of financial markets). Therefore, this relationship is still exposed to the counterparty risk that is reduced by the recent European process of market regulation.

In conclusion, the analysis of the legal framework does not dispel the doubt that an abuse of derivatives can, on the one hand, move forward (to next generations) the financial burden of sovereign debt and, on the other hand, falsify the accounting and the financial organization of the State. On the

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contrary, it is clear that the lack of transparency is not in line with public ethics and does not satisfy the need of democratic control of public finance.

SUMMARY: 1. Public finance between 'debt' and 'derivatives'. - 2. Italy's use of derivatives… - 3. …according to national and European regulatory framework. - 4. Efficiency and transparency of public finance management - 5. Public ethics and OTC derivatives: underlying doubts.

«*Do not pretend that things will change*

if we always do the same».

A. Einstein, 1930

1. Innovative financial instruments allow Governments to support public policy by accessing to capital markets under different conditions, even by entering into derivative transactions.[1] Recently, pursuant to sovereign debt crisis, these transactions seem to be more and more significant.[2] On the other hand, there is a specific matter of concern since Public Administrations, dealing

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[1] See Decree no. 91997 of Dec. 19, 2013, so called «Decreto cornice 2014», containing directions to implement financial operation to manage sovereign debt. (articles 4 and 5).

[2] See CAPRIGLIONE, *Crisi finanziaria e dei debiti sovrani*, Torino, 2011 p. 22 and Id., *L'Unione Bancaria Europea*, Torino, 2013, p. 9. See also GELPERN, *Domestic Bonds, Credit Derivatives, and the Next Transformation of Sovereign Debt*, in *Chicago-Kent Law Review,* 2008; GODERIS - WAGNER, *Credit Derivatives and Sovereign Debt Crises,* in SSRN.com, No. 826644, rev. 2010, where it is wrote that «the new markets for credit derivatives allow for buying protection on sovereign debt». Furthermore, see WILLIAMS – CALICE - CHEN, *Liquidity Spillovers in Sovereign Bond and CDS Markets: An Analysis of The Eurozone Sovereign Debt Crisis*, in *Paolo Baffi Centre Research Paper* , 2011, no. 105

with financial intermediaries, could conclude financing relationships within the «shadow banking system» (and, therefore, under unsatisfactory levels of transparency and inefficiencies in the price-setting process of the abovementioned derivatives).

In this context of equal bargain power (between National Authorities and intermediaries), it is important to verify the regular circulation of capitals and its guarantees, ensuring a fair cost-benefit allocation and an efficient access to credit (of Sovereign States). In fact, in the invitation to treat, there is a freedom able to damage the State's asset because of both the information asymmetries between creditor - debtor and the bilateral contract's hazard (*i.e.* the counterparty credit risk, given its implications on the bargain's *consideration*).

Government's use of these contracts generates questions on its effects on public finance, according to the implementation of the settlement's synthetic techniques at the base of derivatives (and the limited effects of the equitable estoppel principle). These questions are related to the circumstance that any benefit of the abovementioned transactions comes from financial market's trends.[3]

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[3] See BRAILSFORD – HEANEY - BARRY, *Use of Derivatives in Public Sector Organizations*, in *Accounting and Finance*, 2005, pp. 43 ff. who «develops and tests a model explaining public sector derivative use in terms of budget discrepancy minimization. The model is different from private sector models. Private sector models do not readily translate into the public sector, which typically faces different objectives. Hypotheses are developed and tested using logistic regression over a sample of Australian Commonwealth public sector organizations. It is found that public sector organization derivative use is positively correlated with liabilities and size consistent with the hypotheses concerning budget discrepancy management».

After the crisis, we must take into account the effects of the financial stability mechanism established by ECB.[4] Now, it is necessary to verify the effectiveness of the protections placed by the legal order against the risk that certain over-the-counter transactions, closed by States and international merchant banks, can damage the first ones. This is particularly true when these transactions are arranged without a central 'counterparty' (so called CCP) able to guarantee the performances promised by financial intermediaries.[5]

In this context, the experiences of Italian Republic seem to be relevant because the financial crisis of this Millennium has not been able to involve its stability (although the relevance and the increasing profile of its government debt). In order to understand the reasons of the imbalance between the rate used in the relevant derivative transactions and the one applicable to the recent placements of Italian Government securities (made in 2013), we must underline that the actual weighted average interest rate seems to be affordable (around 2.08% in 2013) and it shows the possibility to overcome the emergency (arising from the boost of the interest rates started in 2011). [6] This is why our analysis takes into account also the refinancing activity of the operations about to expire (under sustainable terms) and, in particular, the need to halve the sovereign debt before 2030.

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[4] See LEMMA - HAIDER, *The Difficult Journey Towards European Political Union: Germany's Strategic Role*, in *Law and Economics Yearly Review*, 2012, pp. 390 ff.

[5] *I.e.* a legal person that interposes itself between the counterparties to the contracts traded on one or more financial markets, becoming the buyer to every seller and the seller to every buyer.

[6] This is confirmed in the *Programma trimestrale di emissione - I trimestre 2014*, edited by Minister of Economy and Finance, Roma, Dec. 23, 2013, on www.dt.mef.gov.it

Under this perspective, there is the doubt that Italy's access to derivatives' market was aimed to reach goals additional to the mere reduction of financing costs (linked to interest rates volatility or to the capability to refinance the expiring operations). And so, Italy's intention to create legal relations - under derivative contracts - links the bargain, the agreement and the consideration to these additional goals, by using financial engineering tools. Our concern is that any of these innovative financial instruments has reached only accounting effects (aimed to show the Government's convergence to the Maastricht criteria), instead of the reduction of costs and risks. [7] Several facts feed this concern. First, Italy has operated outside (*rectius*: beyond) the regulated markets (lacking in transparency); secondly, the Government has accepted several risks (including the market liquidity risk and the settlement risk due to the absence of a CCP); thirdly, there are specific doubts on the disclosure of these transactions with EU institutions and other European bodies.

Under these circumstances, what is important is the competitive pressure arised in the market for sovereign debt's securities because of the downgrading of unsolicited credit ratings that influenced the economical convenience of their yields (and then the financial burden of public policy). [8]

In order to understand the impact of derivatives on the complexity of Italy's economic and financial condition, we need to select few 'markers' in order to address the benefit and the limits of the operations under analysis. If

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[7] See, in general, ALPER - FORNI - GERARD, *Pricing of Sovereign Credit Risk: Evidence from Advanced Economies During the Financial Crisis*, in *IMF Working Paper*, No. 24 of 2012, *passim*

[8] See TROISI, *Le Agenzie di Rating*, Padova, 2013, pp. 87 ff. on the role of *unsolicited* sovereign ratings.

the lack of certainty - which limited knowledge where it is impossible to exactly describe the existing state of Italy's use of derivatives - is one of that, it is possible to that the uncertainty arises from the OTC operations. This is true given that Government's access to shadow banking is itself a contradiction: from one aspect, OTC transactions do not limit the risk taking of Public Administration, and from another aspect, there are no specific requirements about the qualification of the counterparty, the object of the derivative agreement, the benefit of the operation.

2. Nowadays, mass media pay specific attention to the contractual activities between Italian Republic and international merchant banks. In particular, the debate focused on certain financial instruments which - according to media interpretation of the facts - were aimed not to cover the exposure to interest and exchange rates underwrote in the Nineties, but to have cash in advance and then to allow the Italian Government to get ready for the Euro kick-off.[9]

Eloquent, on this point, is the Financial Times' statement that «Italy risks potential losses of billions of euros on derivatives contracts it restructured at the height of the Eurozone crisis, according to a confidential report by the Rome Treasury that sheds more light on the financial tactics that enabled the debt-laden country to enter the euro in 1999».[10]

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[9] See GRECO, *Tesoro, perdite potenziali di 8 miliardi. L'origine è nei derivati degli anni '90*, in *Repubblica.it*, June 26, 2013.

[10] See DINMORE, *Italy faces restructured derivatives hit*, in *Ft.com*, June 26, 2013; futhermore this article wrote that «while the report leaves out crucial details and appears intended not to

We need to consider also that, in contradiction of this statement, Italian Minister of finance which provided clarifications and explanations useful to understand that «the interest rate risk hedging tools currently managed do not entail losses». He also stated that «it is absolutely groundless the hypothesis that the Italian Republic has used derivatives at the end of the nineties to determine the conditions required for the entry into the euro».[11]

This response appears in line with the information given by Monti's Government (in 2012). The latter has pointed out that Italy's financing policy is aimed to minimize costs and risks, even by increasing the average duration of sovereign debt.[12] We need to consider that this information is based on financial data completely clear in meaning (*i.e.* a notional amount of derivatives on Italy's government debt equal to Euro 160 billions).[13]

So, in Italy, there are clear criteria regulating the use of derivatives. The Treasury department, though being aimed to facilitate debt's management,

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give a full picture of Italy's potential losses, experts who examined it told the Financial Times the restructuring allowed the cash-strapped Treasury to stagger payments owed to foreign banks over a longer period but, in some cases, at more disadvantageous terms for Italy».

[11] See *Press Release no. 103 of June 26, 2013* where it is also clarified that «The transactions executed at the time were always recorded correctly, following the usual practice, in accordance with accounting principles both national and European. The checks carried out systematically by Eurostat starting from the second half of the nineties, including those resulting from the introduction - in several stages - of new guidelines on derivative financial instruments, have always confirmed the compliance of these transactions' accounting».

[12] See ROSSI DORIA, *Informazioni circa l'incidenza degli strumenti finanziari derivati nell'ambito della complessiva esposizione debitoria dello Stato italiano - n. 2-01385*, in *Resoconto stenografico dell'Assemblea*, March 15, 2012, pp. 88 ff.

[13] Against Euro 1.624 billions of securities and so equal to the 10 per cent of their value; see ROSSI DORIA, *Informazioni…*, *op. cit.*, pp. 89 - 90

takes position against any speculative activity which does not cover a real liability, but engages in risky financial transactions trying to profit from - short or medium term - fluctuations in the capital market.[14]

However, as recently pointed out in a prescient article by Dinmore, we cannot ignore the lack of transparency in the derivative operations. This critique involves the circumstance that «Italy does not disclose its total potential exposure to its derivatives trades».[15] It is relevant that «early last year Italy was prompted to reveal by regulatory filings made by Morgan Stanley that it had paid the US investment bank €2.57bn after the bank exercised a break clause on derivatives contracts involving interest rate swaps and swap options agreed with Italy in 1994».[16]

In brief, more then the doubts on the economic viability of these operations,[17] specific negative consequences results from Italy's use of derivatives, due to the bilateral negotiation of these contracts, settled out of regulated markets and so without any standard practice of *accountability* or *disclosure*.

On this point, the following statement made by Minister of Finance does not settle this debate. According to the Italian national authority «the transactions executed at the time were always recorded correctly, following the

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[14] See the position assumed by the 'Sezione giurisdizionale per il Lazio' of 'Corte dei Conti', Sentence no. 1044/2011 of July 11, 2011 on the liability for *mala gestio*.

[15] See DINMORE, *Italy faces restructured derivatives hit*, *cit.,* which precised that «The experts contacted by the FT, who declined to be named, noted that the report revealed just a six-month snapshot on a limited number of restructured contracts».

[16] See DINMORE, *Italy faces restructured derivatives hit*, *cit.*

[17] See FRISONE, *Le insidie degli swap plain vanilla*, in *Il Sole 24 Ore*, of Nov. 9, 2013, p. 24

usual practice, in accordance with accounting principles both national and European.[18] These principles - as we will investigate in the following paragraph - aims to quantify the total amount of sovereign debt, even in the ‘excessive deficit procedure0 set by Maastricht Treaty (and now governed by Article 126 of the Treaty on the Functioning of the European Union).

Without mentioning anything else, the contract terms and conditions of Italy’s use of derivatives deny the rationale of EU internal market regulation. And because of its OTC activity, the Public Administration did not benefit of the organizational set-up which support the matching between supply and demand (based upon precise rules of business management, fulfilment guarantees and circulation of the relevant data). [19]

Furthermore, *in subiecta materia*, there is a bilateral layout of the relationship State-financial intermediaries, instead the multilateral one in character of financial markets. This is one reason this relationship is still exposed to risks erased by the European process of market integration (*e.g.*, the settlement risk).[20] Even though other benefits, any bilateral transaction precludes - at least - to take advantage of the opportunities that qualifies the trading systems organized *around* a central counterparty. [21] It is obvious that

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[18] See *Press release n° 103 del 26 giugno 2013* of Minister of Economy and Finance.

[19] This is the direction suggested by Consiglio di Stato, sez. V, 12 aprile 1958, n. 216, in *Giust. Civ.,* 1958, II, p. 137 ss., with a comment of SANDULLI, *Osservazioni in materia di pubblici mercati.*

[20] See CAPRIGLIONE, *Intermediari finanziari investitori mercati*, Padova, 2008, pp. 207 ff on MiFID Directive n. 2004/39/CE on the regulation of capital markets.

[21] See AWREY, *The Dynamics of OTC Derivatives Regulation: Bridging the Public-Private Divide*, in *Oxford Legal Studies Research Paper*, 2010, who «explores both the private and social costs

the absence of any multilateral trading facility may produce anti-competitive effects, given the difficulties in observing adequate levels of transparency and completeness of the information. That is the principal obstacle against the reduction of transaction costs, the fair matching between supply and demand and then the adequacy of prices.[22]

It would be a mistake, however, to address this analysis on the effect of the abovementioned derivative transactions on the stability of Italian financial system (and, moreover, on their relevance in the fulfilment of the *conditionalities* in economic policies introduced by European Treaties).[23] To understand this assumption, we must note the difficulties in assessing the convenience in joining the Euro (whence the impossibility to calculate the whole utility of the above-mentioned derivatives). Despite this, there are no doubts that the decision to adopt the European single currency produced positive externalities, due to the solution of the vulnerability of the Italian Lira (frequently under international speculative attacks).

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and benefits of OTC derivatives and the respective strengths and weaknesses of public and private systems of ordering in pursuit of the optimal mode of regulating OTC derivatives markets».

[22] See CAPRIGLIONE, *Intermediari finanziari investitori mercati*, op. cit., pp. 214-215

[23] See SAVONA - OLDANI, *Derivatives, Fiscal Policy and Financial Stability*, in *ICFAI Journal of Derivatives*, 2005, Vol. 2, No. 3, p. 7 ss.; OLDANI, *Trading of Derivatives by Public Administrations: A Project of Accounting Transparency,* in SSRN.com, Paper no. 1486069 del 2009; and MERUSI, *Governo della moneta e indipendenza della Banca centrale nella federazione monetaria dell'Europa*, in *Il Diritto dell'Unione Europea*, 1997, pp. 89 ff.

Finally, there is a specific question on the role plaid by the European bodies in the supervision of Member States' use of derivatives: [24] did the willing of an Economic and Monetary Union as wide as possible influence the control? [25] To this question is also linked the problem of the stability of the legal order introduced by Maastricht Treaty, because there is the risk that the use of derivatives has facilitated the application (to Euro) of Countries that - according to their effective economical conditions - were not able to meet the European criteria (or, at least, to recover their economy from a financial crisis under these constrains, as Italian experience is showing).

3. In order to understand the concern expressed by the specialized press on Italy's use of derivatives, we must focus on the juridical configuration of sovereign debts outlined in the European regulation. Among the laws of EU, we cannot identify a set of rules banning these transactions, nor strict criteria to assess their value for money. On the contrary, there are accounting principles to verify if the use of derivatives aims to influence the referential variables of the

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[24] See PELIZZON - SUBRAHMANYAM - TOMIO - UNO, *Sovereign Credit Risk, Liquidity and ECB Intervention: Deus Ex Machina?*, in *SSRN.com*, 2013, No. 2345656, where it is analyzed «the interaction between credit risk and liquidity, in the context of the intervention by the European Central Bank (ECB), during the Euro-zone crisis».

[25] It is remarkable that «in August 2012 the European Central Bank (ECB) announced the possibility of conducting outright open market operations in secondary sovereign bond markets to safeguard an appropriate monetary policy transmission and preserve the singleness of the monetary policy. In September 2012 the ECB announced the technical features it had decided upon for such operations, named Outright Monetary Transactions»; See *Open market operations*, edited by ECB, on www.ecb.europa.eu

‘excessive deficit procedure’, under the guidelines set by the protocol that lays down the details of Article 104c of the Treaty of Maastricht. [26]

According to this, we must take into account article 126 of the Treaty on the functioning of the European Union, which charges European Commission with the task of monitoring the development of the budgetary situation and of the stock of debt in the Member States with a view to identifying ‘gross errors’.[27] Hence, this article focuses on both the dynamic elements (and then profits or losses) and the static elements (*i.e.* the final amount in stock). Therefore, EU rules make EC responsible, firstly, to consider if an excessive deficit in a Member State exists or may occurr and, accordingly, to address an opinion to the Member State concerned (and to inform the Council; art. 126, para. 5).

It is important, however, to observe the setting of «European system of accounts» used by members of the European Union (as recently updated, *i.e.* «ESA 2010»).[28] In this context, the relevant amount of government debt is limited to «the consolidated gross nominal value of the liabilities of the general government sector».[29] It means that this debt must be «constituted by currency

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[26] See *Protocol on the excessive deficit procedure* attached to Maastricht Treaty; and the related analysis of MAGNIFICO, *Le politiche di bilancio nell'Unione monetaria europea*, in *La Comunità Internazionale*, 2010, pp. 351 ff.; DELLA CANANEA, *Autonomie regionali e vincoli comunitari*, in *Rivista giuridica del Mezzogiorno*, 2007, p. 7

[27] See STARITA*, Il Consiglio europeo e la crisi del debito sovrano*, in *Rivista di diritto internazionale*, 2013, pp. 385 ff.; DONATI, *Crisi dell'euro, "governance" economica e democrazia nell'Unione Europea*, in *Rivista AIC*, 2013, pp. 13 ff.

[28] See HAGEN - WOLFF, *What Do Deficits Tell Us About Debts? Empirical Evidence on Creative Accounting with Fiscal Rules in the EU*, in *CEPR Discussion Paper*, 2004, No. 4759

[29] See *Ammontare Titoli di Stato e Debito Pubblico al 31.12.2012*, Note of Minister of Economy and finance on www.dt.mef.gov.it

and deposits, securities other than shares – excluding financial derivatives», in addition to loans (as defined in ESA 95).[30] It is clear that financial derivatives cannot be included in the calculation of government debt as there is no «nominal value identical to that of other debt instruments».[31]

A further point I want to emphasize is that derivatives are referable to the «financial transaction» taken into account by Council Regulation (EC) No 2223/96 of 25 June 1996 on the European system of national and regional accounts in the Community. In this system, a contingent asset is also a financial asset in cases where «the contractual arrangement itself has a market value because it is tradable or can be offset on the market». Otherwise, a contingent asset is not recorded.[32]Under this provision we can assume the relevance of the choice to create a sub-category (F.34), which consists of all transactions in financial derivatives that is financial assets based on or derived from a different underlying instrument.[33]

This explains the need to limit any discretionary accounting of derivatives, which arises from the over the counter trading of them and, then,

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[30] See *Ammontare Titoli di Stato e Debito Pubblico al 31.12.2012*, cit.; See also QUADRIO CRUZIO - ROTONDI, *Disavanzo pubblico e impresa pubblica nel pensiero di Ezio Vanoni*, in *Economia pubblica*, 1993, p. 407

[31] See *SEC 95 Manuale*, edited by EC, Lussemburgo, 2002, p. 198; in this context it is also stated that «There is no specific definition of government debt in the ESA95, but general provisions on institutional sectors (including the general government, see Part I) and on financial liabilities and their valuation rules», *ibidem*, p. 197

[32] See Regulation EC 2223/96, Chapter. 5, Para 5.05

[33] See Regulation EC 2223/96, Chapter. 5, Para 5.65

from the absence of a quoted price. [34] The same also explains the research - made by European institutions - of regulatory models able to support the calculation of Member States' deficit, as well as to promote a government's spending review on a regular basis. Indeed, these are the foundations of new - and higher than in the past - levels of integration in the European policies.

These topics have been investigates by European Commission, which promoted specific changes to Regulation (UE) no. 648/2012 on OTC derivatives, central counterparties and trade repositories. Following this analysis, the Commission concluded that central banks and public bodies charged with the management of government debt should be exempted from the clearing and reporting obligation applicable to OTC derivatives, pursuant to the rules on OTC derivatives introduced in Japan and the United States of America. [35] It is clear that this choice does not limit EU central banks' power to perform their tasks of common interest (made by Regulation UE no. 648/2012). Consequently, in our analysis, we must verify if these rules allows a fair management of the sovereign debt and then if the government's use of derivatives is compatible with the fast-moving EU single market for capitals and financial services.

Hence, we can point out the further need to analyze any other piece of law as a unit, taking into account that the adoption of legal tools applicable to

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[34] See SGARLATA CHUNG, *Municipal Securities: The Crisis of State and Local Government Indebtedness, Systemic Costs of Low Default Rates, and Opportunities for Reform*, in *Albany Law School Research Paper*, 2013

[35] See *Considerandum n. 2*, of Regulation EU no. 1002/2013

any national system has a positive effects on the stability of the European market.[36]

Therefore, we must underline the option - made by EU regulation within the 'excessive deficit procedure' - of recording streams of interest payments resulting from swap arrangements as property income (where the repayments of principal are recorded as transactions in the appropriate underlying instrument within the financial account).[37] This is not a surprise. Indeed, if the harmonization is the thread of the European legislative process, then it will be clear that a certain set of rules regulating the stability of economic policies the first is not yet been adopted. Hence, any step forward will fix an accurate principle able to avoid accounting arbitrages due to the national treatment of the Member States' use of derivatives.

On the other hand, it is useful to clarify that, among the derivative agreements, cross-currency swaps have their own neutral position. In the event of an international funding program made by a Member State whose currency is the Euro, the foreign offering of sovereign debt denominated in another currency cannot be precluded by the EU legislation. [38] In this case, however, the Member State can avoid the foreign currency risk with cover operations (even

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[36] See SAVONA, *Politica economica e new economy*, Milano, 2002, p. 184

[37] As provided by Regulation (CE) 2223/1996, para 5.139; see MINK and RODRIGUEZ-VIVES, *The measurement of government debt in the economic and monetary union*, 2004, on www.bancaditalia.it

[38] See AMATATSU - BABA, *Price Discovery from Cross-Currency and FX Swaps: A Structural Analysis*, in *BIS Working Paper No. 264*, 2008 on «the relative role of price discovery between two long-term swap contracts».

through derivative agreements).[39] This is why the 'excessive deficit procedure' validates the derivatives linked to real underlying securities, whereby their purpose is worth protection (because of the *management* of currency aspects of an existing liability).

This is the direction given by Regulation (EC) no. 3605/93 by introducing an univocal criterion: only a swap (to national currency) based upon an existing securities denominated in a foreign currency can be recorded in the calculation of sovereign debt (by fixing the underlying liability at the exchange rated agreed in the derivative).[40] Under this approach we can assume that the same accounting standard should be extended to other derivatives related to currency (such as *futures* or *options*). On the contrary, the payment flows related to speculative *cross-currency swaps* (*i.e.* the ones without any reference to an existing liability) should be excluded from the aforementioned calculation.[41]

Given this, it is a fair guess (it is actually a certainty) that risks lie lighter on the technical structure of currency derivatives based on existing liabilities rather than on the speculative ones. In particular, in the first case, it is easier to understand if the agreement aims to move forward the financial burden related

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[39] See *Linee Guida della Gestione del Debito Pubblico 2014*, edited by Minister of Economy and Finance, p. 19 on www.dt.mef.gov.it

[40] See *Manual of SEC 95*, *cit.,* p. 211

[41] This, accordingly to art. 1, para 5 of Regulation EC no. 475/2000 amending Regulation (EC) No 3605/93 on the application of the Protocol on the excessive deficit procedure annexed to the Treaty establishing the European Community where it is stated that « Government debt is constituted by the liabilities of general government in the following categories: currency and deposits (AF.2); securities other than shares, excluding financial derivatives (AF.33) and loans (AF.4), as defined in ESA 95».

to the reimbursement of the underlying securities. This justifies the choice to take into account these derivatives and, consequently, the possibility that these swaps can be settled in any moment and with any duration (within the issuing and the expiring date of the underlying debt) and they can provide payments lower than the original flaws (in capital and/or interests). In this respect, it is possible to agree one only derivative to cover jointly several underlying securities (with economies of scale).

What's more. Under the existing EU laws, Member States' governments have the possibility to use derivatives in order to reduce the total cost of sovereign debt by assuming market risks and, in particular, the cross-currency risk. Besides the abovementioned rules and constraints, only a strict supervision on public policy will be able to verify the activity of central banks and national bodies charged with the management of public debt. This will be one of the main tasks to the «European Summit» (informal meeting of the head of state and government of the Euro countries, technically supported by the Eurogroup, art. 12, SCG Treaty) and to the «Conference of Representatives» (composed by deputies that participate at the relevant committees of the European Parliament and national Parliaments, in order to discuss budgetary policies and other issues on stability coordination and governance, art. 13, SCG Treaty).

4. For a long time, the European regulation concerning national funding programs shows a *liberal* approach to the integration process. Consequently, under the framework set by the Treaty of Maastricht, Member States had not been forced to develop homogenous public policies (given the only need of

avoiding any damage to the interests of other Countries). Now, this individualistic (*rectius*: atomistic) approach seems to be override by the choice - made by Euro States - to regard their economic policies as a matter of common concern, according to the rules set by SCG Treaty.[42]

Therefore, there are two different points of view: (i) the first related to the essence of the derivatives (and then to their purpose of use any market trend or their accounting effect able to show the formal compliance to Maastricht convergence criteria); (i) the other related to the ethic profiles of their negotiation (and then the fulfilment of transparency and correctness rules). Both these perspectives allow understanding if the use of derivatives (made by Public Administration) is under the democratic control *or not*.

Hence, the clarification of the Italian Treasury's goals will - at least - remove any doubt about the compliance of its derivatives with EU legal order. [43] We report, in particular, to the choice to «protect against market risks, mainly foreign exchange and interest rate risks» the sovereign debt; this protection - in Minister's opinion - comes from a «lengthening the public debt overall duration, in order to hedge from a potential rise in interest rates, paying fixed and receiving floating».[44]

In this perspective, it is clear the intention to develop an «insurance strategy» by interest rate swap (IRS) and options on interest rate swaps (so called *swaptions*). This intention, however, had been putted aside by the actual interest rate trends, which - in the last period - are lower then the *minimums*

[42] See GUARINO, *Diritto ed economia. L'Italia, l'Europa, il mondo*, Roma, 2011, pp. 219 ff.

[43] See the aforementioned Decree no 91997 of Dec. 19, 2013.

[44] See *Press Release no 103 of June 26 2013*, *cit.*

forecasted at the time of the adoption of the Euro (and then in absence of the negative effect, *i.e.* high interest rates on sovereign debt).

Consequently, only assuming an aprioristic position, we can justify all the expenses related to these interest rate swaps.[45] In this case, probably, the fear of adverse scenarios exceeded the possibility to forecast the real market trends. Then, this set of problems goes beyond our background, focusing on the legitimation of the ruling class (that underwrote these derivatives) to restrict next generations' freedom.

With respect to the circulation of information about Italy's use of derivatives, there is no doubt that it is not sufficient to feed any cognitive process. Then, there are not the minimal conditions for creation of a secondary market for the derivatives underwrote by the Public administration. [46] On this point we must take into account the choice - made by the State - of operating beyond the standard rules stated - by Itself - to guarantee the efficient circulation of capitals under effective financial services (*i.e.* directive no. 2004/39/CE and legislative decree no. 164/2007). In particular, the option for a bilateral negotiation of these agreements do not satisfy the needs of the «*information economy*».[47]

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[45] See BRIGO - MASETTI, *A Formula for Interest Rate Swaps Valuation under Counterparty Risk in presence of Netting Agreements*, in SSRN.com, no. 717344, 2005 where it is examinated «how to handle counterparty risk for Interest Rate Swaps (IRS)»; see also SMITH, *Valuing Interest Rate Swaps Using OIS Discounting*, in *Boston U. School of Management Research Paper*, 2012, n. 11

[46] We are referring to the duty of reporting stated by article 8, Decree no. 91997, *cit.*

[47] See VARIAN, *Microeconomics*, New York, 2010, pp. 667 ff.

In this context, we must highlight that there are not transparency rules for the publication of the details of completed transactions in derivatives and for the disclosure of current opportunities to trade in them (in a secondary market), as provided in the European system of investors' protection. It is necessary to ensure that transparency of transactions is achieved (and that common rules laid down for that purpose apply) when public bodies charged with the management of public debt operate in the capital market. As is known, OTC derivatives have private pre-contract negotiations and that any relevant information, customarily, is reserved to the parties.

Furthermore, after the Financial Crisis (of this Millennium), UE has added to its legislative framework new rules aimed to reduce the risks coming from derivatives agreements (and, in particular, to the hazards linked to the complex network of interdependence able to increase the uncertainty in any period of market tension). [48] Member States should not use derivatives outside these conditions and, more in general, EU laws should not admit exceptions for the public administration. [49]Also the conclusions of European Council of Dec. 2 2009 had pointed out the need to reduce counterparty risks by implementing efficient and reliable clearing and payment systems, regulated by and under common financial supervision of European System of Financial Supervision and European Banking Union.

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[48] We are referring to Communications from the Commission of July 3, 2009 «Ensuring efficient, safe and sound derivatives markets» and of Oct. 20, 2009 «On derivatives markets: future policy actions».

[49] See the conclusions of Pittsburgh meeting of G20, Sept. 26 2009 and of Toronto meeting of G20, June 2010.

On the contrary, most of the rules set to increase the transparency and to reduce the risks does not apply to Member States.

Even before the aforementioned crisis, market experience showed the lack of incentives to centralize the payment system, this is why the option of specific duties for clearing and recording has been introduced by Regulation (EU) no. 648/2012 with regard to certain OTC derivatives (art. 4, Reg. cit.).

Given that the above-mentioned duties does not apply to «the members of the ESCB and other Member States' bodies performing similar functions and other Union public bodies charged with or intervening in the management of the public debt» (art. 1, para. 4, lett. a, Reg. cit.), we must take into account this reduction of the subject matter and scope. On the one hand, the will of Member States to protect their prerogatives seems to justify this rule; on the other hand, instead, the latter does not reduce the possibility that Public Administration undertakes specific risks. Obviously, this approach will not erase the negative effects coming from the use of derivatives in the public funding programs.

It is clear that if there is no mandatory clearing and reporting of OTC derivative agreements, any Member State can close a wholesale transactions at non-public prices and, therefore, under conditions different from the ones governing the operation of regulated markets. Consequently, there is the possibility of competitive asymmetries able to influence the price of the derivatives negotiated without a full *pre-trade disclosure* (within so called «*dark pools*»).[50]

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[50] See FLEMING -JACKSON - LI - SARKAR - ZOBEL, *An Analysis of OTC Interest Rate Derivatives Transactions: Implications for Public Reporting*, in *FRB of New York Staff Report No. 557*, 2012,

We observe a specific market structure and a legislative framework for Member States's use of derivatives. This is not aimed to satisfy the need of protection of the Public Administration. It is true that the negotiation of these financial instruments take place under inadequate levels of information and inefficiencies in the price setting. Hence, the freedom provided to central banks and public bodies charged with the management of government debt exposes public finance to the full risk of a financing activity that lacks of transparency.

5. Previous paragraphs describe a developing situation. If, in the beginnings, Italy has chosen to perform OTC transactions (in derivatives) in order to improve the dynamics of sovereign debt, now it is clear the risk that these transactions go beyond the limit fixed to public funding program.

According to our research, it looks like a safe management of sovereign debt should use the opportunities provided by derivatives in order to balance the economic flows of public policy. However, the analysis of the facts does not clarify the doubt that Italy's use of derivatives can, on the one hand, move forward (to next generations) the financial burden of sovereign debt and, on the other hand, falsify the accounting and the financial organization of the State.[51]

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which «examines the over-the-counter (OTC) interest rate derivatives (IRD) market in order to inform the design of post-trade price reporting. Our analysis uses a novel transaction-level data set to examine trading activity, the composition of market participants, levels of product standardization, and market-making behavior».

[51] See BUCHHEIT - GULATI, *How to Restructure Greek Debt*, 2010; ID., *Greek Debt - The Endgame Scenarios*, 2012, entrambi in SSRN.com, no. 1603304 and no. 1807011; BUITER, *The 'Sense and Nonsense of Maastricht' Revisited: What Have We Learnt about Stabilization in EMU?*, in *CEPR Discussion Paper No. 5405*, 2005.

Only a question remains with me. How EU will manage the recent developments in Member States' use of financial innovation?[52] Of course, this question produces problems about the democratic control regime to adopt. Indeed, we are within a framework where several governments had not yet found an unifying element to legitimate the political union. In particular, there is the need to set the accountability of EMU and its mechanisms.[53]

In this context, the validity of financial activity (and funding programs) of any Member State is related to the fair implementation of national public policies (in line with the general directions expressed by people's will). Hence, the relationship between State and market (*rectius*: between a Member State and financial intermediaries within the internal market) does not produce its effect only between these two parties, but it influences common interests of the European Union (as a whole).

Focusing on Italy, we must conclude that the Public Administration performs its funding programs in competitive capital markets without using the

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[52] See *Europe in the World*, Lecture by President of the European Council Herman Van Rompuy at Regent's University in London, Sept. 18 2013, where it is clarified that «for the countries of Europe, the question is how to deal with these long-term trends and sudden accelerations. How can we continue to defend our interests and values, our societies, in today's world? »

[53] See DRAGHI, *Opening speech at the European Banking Congress "The future of Europe"*, Frankfurt am Main, Nov. 22 2013, who said «We need to secure the economic recovery, reduce fragmentation in the euro area and continue the process of institutional and structural reform. To achieve this, it is essential that we do not retreat into purely national perspectives, with a narrow view of our interest. We must keep our European perspective – and stand up for our common interests. … The first is the monetary policy. Monetary policy with a single currency will always have different effects in different places. But it is essential to understand that the ECB, by its mandate, must act for the euro area as a whole. And in doing so, it makes the best contribution to prosperity for European society at large».

powers of sovereign authority over any private counterparty. This is true both for debt and derivatives. However, it is clear that these funding programs cannot be conducted in conflict with social usefulness (as stated in article 41 of Italian Constitution).

After all, in accessing to capital markets, the State is in the weak position of the debtor. In such a way, it is affected by the well-known negative effects of an unregulated market. This is true both in terms of financing costs and the difficulties in re-negotiate (or trade) any disadvantageous (derivative) transactions.

Sovereign States' access to unregulated markets calls into question the relationship between financial activity and public policy. [54]As we have seen, this is subject to the risk that derivatives are agreed only to elude the duties coming from the EMU membership. Hence, there are questions wider than the compliance to the applicable regulation or to the public accounting standards.

It is clear that the trading of derivatives in the shadow banking system does not reflect the European approach to capital markets regulation. Furthermore, this general practice – even if adopted by Member States – cannot influence the European legal order, which is subject to the strict discipline promoted by the Mitteleurope's attitude. This is why, after the sovereign debts' crisis and the implementation of a new system of national public policies (as stated by SCG Treaty), there is the opportunity that the integration process will promote virtuous conducts able to homogenize the financial market.

[54] See GARA - LAGOS, *The Over-the-Counter Theory of the Fed Funds Market: A Primer* , in *FRB of New York Staff Report No. 660*, 2013 for «a dynamic over-the-counter model of the fed funds market».

SWEET AND LOWDOWN: A "RESOLVENCY" PROCESS AND THE EUROZONE'S CRISIS MANAGEMENT FRAMEWORK

Cristoph G. Paulus – Ignacio Tirado•

ABSTRACT: *The massive crisis lingering in the Eurozone for almost 4 years now has been confronted by an enhanced integration of fiscal policies and regulations, an increase in the control mechanisms by EU institutions, and by the creation of ex post crisis management instruments to deal with the severe financial trouble of the sovereigns. These ex post instruments, embodied in the European Stability Mechanism (ESM) and regulated in its Treaty of creation (TESM), constitute a limited solution to the problems posed by the distress of the Eurozone countries. It is the present article's purpose to examine to which degree, if at all, this mechanism is reconcilable with a more ambitious approach, that includes a more elaborated and structured procedure: the Resolvency Model.*[1] *Accordingly, we begin by contextualizing the current institutional setting*

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[1] The choice was made for one of the present authors' former deliberations: see PAULUS, *Die Eurozone und das größere Thema eines Staateninsolvenzrechts*, in Kodek/Reinisch (eds.),

of the Eurozone´s Crisis Management Framework; after which we shall briefly summarize the main characteristics of the European Stability Mechanism. Once the description of the current situation shows us where we stand, we purport to explain the Resolvency model in some detail. In this context, we will try to spot the parallelisms and differences between the two approaches in order to examine if there are possibilities to reconcile the two of them. The task is carried out not as a mere intellectual exercise but with an eye on the practical feasibility – in particular with respect to an amalgamation of the two approaches. We believe that the ESM and the Resolvency system are complementary in an important number of tasks and competences. However, we do not consider the current ESM model, as a stand-alone solution, to be fully adequate. We conclude that many of the ESM's shortcomings would be solved by the introduction of the Resolvency model. One of the main problems of the current ESM system is its excessive exposure to political influence. Be it by means of the adoption of a Resolvency model, or by any other set of amendments, the ESM ought to be transformed into a technical instrument to enhance the efficient development of the Eurozone as a whole, stripped of political influence and the individual interest of countries.

Staateninsolvenz, Wien 2011, 9 et seq.; *ibid., Prolegomena für die Schaffung eines Resolvenzrechts für Staaten*, in Kadelbach (ed.), *Nach der Finanzkrise*, 2012, 105 et seq.; *ibid., Lehren aus den vergangenen Krisen und neue Ansätze zur Staatenresolvenz*, in Giegerich (ed.), *Internationales Wirtschafts- und Finanzrecht in der Krise*, 2011, 135 et seq.; *ibid., Rechtliche Handhaben zur Bewältigung der Überschuldung von Staaten*, RIW 2009, 11 et seq.; *ibid.,* Geordnete Staateninsolvenz – eine Lösung mit Hilfe des Vertragsrechts, ZIP 2011, 2433 et seq.; *ibid.,* Gläubiger oder neutrale Instanz – wer soll das schlingernde Schiff steuern?, ZSE, 2012, 30 et seq.; *ibid., Sovereign Defaults to be Solved by Politicians or by a Legal Proceeding?,* in *Law and Economics Yearly Review*, Vol. 1, Part 2, 2012, 203 et seq.

SUMMARY: I. Sovereign insolvency in the heart of Europe: from curiosity to self-awareness – II. The resolvency model in a nutshell. Analysis of consistency of both models – II 1. The design of the Resolvency Court – II 1.1. The Resolvency Model and its design of the Court – II 1.2. The proposal and the current situation – II 2. The rules of the Resolvency Court - II 2.1. Commencement of the procedure - II 2.1.1. The opening of Resolvency proceedings – II 2.1.2. The commencement of proceedings and the TESM – II 2.3. The plan (PSI)- II 2.3.1. The plan and the Resolvency model – II 2.3.2. The content and approval of the PSI under the current regime – II 2.4. Financial assistance- II 2.4.1. Financial assistance under the Resolvency process - II 2.4.2. The ESM's natural province: financial assistance to troubled sovereigns – II 2.5. The implementation of the plan – II 3. Binding creditors - III. Concluding remarks. Can the ESM and resolvency model coexist? Should they?

I. Sovereign insolvencies have existed for centuries, even in the heart of Europe[2]. In recent decades, the economic development of most Western European states, however, had turned the possibility of a national default into a matter of historical analysis or, if referred to non-European countries, into an alien issue that generated interest merely as a matter of curiosity. Business schools across Europe taught their students to assess investment risks against the benchmark of risk-free national bonds, and even the wise central-bankers of the Basel Committee envisaged no need to reserve capital against the portfolio

[2] For a historical overview of sovereign and financial crises, see ROGOFF - REINHART, *This Time is Different. Eight Centuries of Financial Folly,* Princeton Univ. Press, 2009, *passim.* See also, DAS - PPAPAIANNOU - TREBESCH*, Sovereign Debt Restructurings 1950-2010: Concepts, Literature Survey, and Stylized Facts*, WP/12/203, available at www.imf.org.

of sovereign debt: it was a safe bet. Since 2010 we know that things are very different. Reality bites, and Europeans have learnt it the hard way.

The insolvency of nations brings about a number of political, sociological, legal and economic problems that conform a puzzle extremely difficult to solve. Leaving aside the sociopolitical side of the conundrum (very much beyond the scope of this paper), the legal and economic issues raised by a sovereign state's inability to satisfy its obligations as they fall due resemble, to a certain extent, the collective action problems posed by corporate insolvencies in the market, with particular intensity concerning the organizational issues with creditors and the need to control dissidents (hold outs) [3]. The problems generated by the insolvency of a state have traditionally been confronted by a number of uncoordinated, untimely ad hoc actions and measures (negotiations with creditors at the London and Paris clubs, bilateral negotiations, extemporaneous IMF interventions, etc.) that have most often produced inefficient results. In order to amend this, a number of actions have been adopted and models

[3] Although collective action problems are similar in both the corporate and the sovereign worlds, there are elements that differentiate them drastically: in the latter case, the sovereign's ability to collect taxes and generate revenues mandatorily extracted from third parties, or the inaccessibility of creditors to the sovereign's assets (at least to those being in the sovereign's territory), stand out as relevant differences; in the former case, the legislative possibility to impose rules restricting – if not eliminating – hold-out strategies must be underlined.

proposed, that have graphically been clustered in two main groups:[4] the statutory (public law) approach and the contractual (private law) approach [5].

- All the proposals within the statutory approach share the creation of some kind of procedural structure by a legal instrument (a convention, a treaty, or national laws) and the existence of a court or similar authority to guide the process. The majority of the proposals are either inclusive of all claims or at least of all claims held by foreign creditors; they provide for a stay of actions/executions; and they envisage solutions to obtain financing during the development of the procedure[6]. Out of all, one

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[4] There are some further proposals that do not fit exactly into this either-or-scheme, see, e.g., BOGDANDY - GOLDMANN, *Restrukturierung von Staatsschulden als Ausübung internationaler öffentlicher Gewalt*, ZaöRV 73, 2013, pp. 61 ff.

[5] An excellent summary of the different approaches, see PANIZZA - STURNZENEGGER - ZETTELMEYER, *The Economics and Law of Sovereign Debt and Default*, in *Journal of Economic Literature,* 2009, 47:3, pp. 651 ff. Also, ROGOFF - ZETTELMEYER, *Bankruptcy Procedures for Sovereigns: A History of Ideas, 1976-2001*, IMF Staff Papers 49, nr. 3, 2002; and PAULUS, *A Statutory Proceeding for Restructuring Debts of Sovereign States*, *Recht der Internationalen Wirtschaft* (RIW) 2003, p. 401.

[6] Other relevant proposals (only to mention some examples) are the procedure proposed by Prof. Steven Schwartz following the structure of US Bankruptcy Code's Chapter 11 (*Sovereign Debt Restructuring: a Bankruptcy Reorganization Approach*, in *Cornell Law Review* 85, pp. 956 et seq.), the proposal put forward by Bolton and Skeel, based on local courts and protective of ex ante insolvency entitlements (*Inside the Black Box: How should a Sovereign Bankruptcy Framework be Structured*, in *Emory Law Journal,* 53, pp. 763 ff.), the approach defended by Prof. Raffer to follow a US Bankruptcy Code's Chapter 9 type of solution (*Applying Chapter 9 insolvency to international debts: an economically efficient solution with a human face*, in *World Developments* 18 (2), pp. 301 ff.), or the International Debt Framework designed by Berensmann and Schroeder (*A proposal for a new international debt framework for the*

proposal stands out: the IMF'S Sovereign Debt Restructuring Mechanism (SDRM). The SDRM, which provided for a (more or less) full Chapter 11-type insolvency procedure, was as close as the world has been to adopting a statutory approach solution. In the end, however, the proposal was never implemented.

- Some argue that it was –precisely- the preference for a contractual, partial solution that derailed the SDRM. The contractual approach to sovereign insolvency consists, mainly, on the inclusion of collective action mechanisms in bond issuances. The famous collective action clauses (CACs) seek to make debt restructuring possible by replacing the contract-law classic unanimity rule by a majority-based decision making process, that would be binding on all creditors (of the restructured bond). Although there are many different types of CACs, and proponents of these contractual solutions often include other complementary measures (more akin to those envisaged in the statutory approach), this approach is both subjectively and objectively limited in its scope, and also demands some sort of legislative intervention.

Both approaches have their pros and cons. It seems difficult to deny that the comprehensive approach (i.e., a statutory solution) would provide more certainty to markets and an orderly, efficient solution would be easier to attain.

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prevention and resolution of debt crisis in middle-income countries, *Discussion Paper 2/2006, Deutsches Institut fuer Entwicklungs-Politik*).

But it is also true that a contractual approach is much easier to implement. In practice, no full insolvency system has ever been put in place, while CACs have been common practice in bonds issued under New York and London laws. Following the aphorism that “perfect is the enemy of the good”, Governments seem to have contented themselves with the partial solution, perhaps convinced that the amount of political consensus needed for a full statutory solution was –and is- out of reach.

Undoubtedly, this sort of *Realpolitik* has been applied in Europe. If the crisis of the Eurozone members is good for anything then it would be its generation of awareness among European political decision makers that a sovereign default is not reserved exclusively to developing countries. But it took a while for the awareness to kick in. The reactions of the member states were divided into two – for quite some time overlapping – periods: the first one (and longer one) was dominated by panic reaction to save what was savable, in particular their own banking sectors, which included the creation of temporary rescue mechanisms and a number of interim/insufficient measures; the second one saw a shift in the handling of the crisis towards the construction of more stable mechanisms to deal with similar crises in future times. In the course of the latter stage, politicians did not have to start from scratch. As we mentioned above, the European decision makers could examine a number of proposals from the official sector, from practice and from academic writings. They were able, thus, to balance pros and cons of the statutory approach and of the contractual solution, which had put an end in 2003 to the discussion about the SDRM, as well as some more refined and comprehensive proposals from private sector writers. And yet, the outcome of these deliberations is well known by now: the creation of the European Stability Mechanism (ESM), an institution which has striking similarities with the IMF [7] and which is meant to offer a protective umbrella for the member states in financially critical situations, but little more. The Governments of the EU have decided to sideline the unique opportunity to go for the politically more difficult but also more efficient and enduring solution, and to create a instrument of interim financial assistance, with capacity to impose economic policy measures, providing for the mandatory inclusion of CACs in future bond issuances [8]. In other words, the EU has opted for the contractual solution and, at the same time, it has replicated an institution that already existed (the IMF), possibly with a view to politically control rescues within the Eurozone.[9] We have found no other explanation to the measures adopted: retaining political power. An analysis of the main elements of the ESM in the next section of this paper will show precisely that the European rescue mechanism may subjugate technical decisions under the rules of political will.

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[7] See BERGHTALER, *The Relationship Between International Monetary Fund Law and European Union Law: Influence, Impact, Effect, and Interaction,* in Wessel/Blockmans (eds.), *Between Autonomy and Dependency,* 2013, p. 159, p. 187.

[8] Note that the German transformation statute §§ 4a et seq. Bundesschuldenwesengesetz – irritatingly – speaks about “may“ (“kann”) rather than “shall“; on this see PAULUS, *Jüngste Entwicklungen des Resolvenzrechts*, Wertpapier-Mitteilungen (WM) 2013, pp. 489 ff.

[9] Reportedly, political reasons were behind the rejection of a legal procedure resembling an insolvency proceeding; in particular France was allegedly said to be in strong opposition to any such plan.

The European Stability Mechanism (ESM) was established by the European Council Decision 2011/199/EU; and it commenced its work on January 2013.[10] This new institution – succeeding the European Financial Stability Facility (EFSF) and the European Financial Stabilization Mechanism (EFSM) [11] that were set up in the course of the ongoing Euro crisis[12] – is designed to cope with the same kind of problems which the Euro zone experienced in the last few years with Greece, Ireland, Portugal and Cyprus.

The ESM conforms an institutional framework under the umbrella of which more or less the same actors as before will be active. Its mandate is envisaged in art. 3, according to which the purpose of the ESM is *"to mobilise funding and provide financial assistance, under strict economic policy conditionality, to the benefit of ESM Members which are experiencing or are threatened by severe financing problems, if indispensable to safeguard the financial stability of the euro area as a whole."*

Article 12 TESM lays down the general principles, where reference is made to the instruments to provide financial assistance and it is established that all sovereign bonds issued after January 2013 shall

[10] See www.esm.europa.eu.

[11] See REGLING, *Aufgaben und Herausforderungen der EFSF*, in Pache/Schwarz (eds.), *Grundlagen, aktuelle Entwicklungen und Perspektiven der Europäischen Währungsunion*, 2012, pp. 42 ff.

[12] See, for instance, HOFMANN – KONOW, *Die neue Stabilitätsarchitektur der Europäischen Union, Zeitschrift für Gesetzgebung,* 2012, p. 138, p. 153.

include CACs [13]. Although in rather cryptic way, the TESM regulates the inclusion of private sector involvements (PSI), which should be "exceptional" and take place when the respective sovereign's debt sustainability cannot be achieved otherwise. If the PSI becomes inevitable accordingly, the respective sovereign has to present *„"(a) credible plan for restoring debt sustainability and demonstrating sufficient commitment to ensure adequate and proportionate private-sector involvement. Progress in the implementation of the plan will be monitored under the programme and will be taken into account in the decisions on disbursements."*

Following the practice of other international lenders of last resort, and in line with the principles of corporate insolvency concerning post-commencement financing, the ESM claims priority for its own loans (i.e., financial assistance), albeit in a somewhat oblique manner. Recital 13 TESM states that *"[L]ike the IMF, the ESM will provide financial assistance to an ESM Member when its regular access to market financing is impaired. Reflecting this, Heads of State or Government have stated that the ESM will enjoy preferred creditor status in a similar fashion to IMF, while accepting preferred creditor status of the IMF over the ESM".* It must be noted that such priority is

[13] As to the literature on CACs just see BAUER – CAHN - KENADJIAN, *Collective Action Clauses and the Restructuring of Sovereign Debts, 2013*; BRADLEY – GULATI, *Collective Action Clauses for the Eurozone: An Empirical Analysis,* available at papers.ssrn.com HOFMANN - KELLER, *Collective Action Clauses,* ZHR 175 (2011), pp. 684 ff.; WEIDEMEIER - GULATI, *A People's History of Collective Action Clauses,* available at papers.ssrn.com

not even recognized in an article, but rather in the explanatory recitals of the Treaty. This seems to mirror the “virtual” priority traditionally awarded to the IMF by nations –and accepted by creditors- of rescued countries, despite there being no explicit and binding legal instrument to support it (concerning creditors). It should be noted that this special treatment undermines the *pari passu* principle (*par condicio creditorum*) which is unfortunate, too, in the context of a insolvency-like model as the one proposed in this paper [14]. The private sector gets degraded thereby to a mere „payer“ (or rather „loser“) – a position which, in the long run of time, is all but a great investment stimulus.

We believe that the combination of mandatory CACs in bonds and an international lender of last resort (a key player, but one that already existed: the IMF) provides an insufficient solution to the problems posed by the financial crisis of the Member States of the Eurozone. The model only includes a remedy for a portion of the claims (bonds), envisages no protection for the debtor country’s assets during the process and lacks an institutional organization and

[14] See also PAULUS*, WM, cit.,* 2013, p. 455. There might be another pitfall connected with such a privilege: After the ICSID decision in the case Abaclat and Others v. Argentina, ICSID Arbitral Tribunal 4.8.2011, Case No. ARB/07/5 (available at italaw.com) the connection between a general restructuring instrument and an individual Bilateral Investment Treaty has been established. Those treaties usually come with a “fair and equitable treatment” clause, which possibly is violated by such a privilege, see HOFMANN, *Greek Debt Restructurings and Abaclat v. Argentina,* available at blogs.law.nyu.edu

clear procedural rules. In light of this, and as experience has shown[15], the crisis management mechanism created by the EU is, by itself, inapt to stave off market fears. Without a clear, comprehensive framework, uncertainty remains. We believe that a formal insolvency procedure would provide an enduring solution to the crisis of sovereign member states, complete the current legal framework for economic governance and crisis management in the Eurozone, and thereby enhance legal certainty for investors.

We are also persuaded that this is the correct moment to aim for such an ambitious measure. The EU framework is being overhauled, the number and depth of the reforms has never been seen; the extreme suffering of European citizens has made them somewhat dormant, ready to accept any solution that once and for all relieves their pain; the situation is unique. It might well be that it is now or never.

In the following paragraphs we will put forward a model of insolvency of sovereigns. It will be described and contrasted with the current crisis management framework. We will argue that a combination of the current status with some complementary changes to generate the insolvency procedure would conform an adequate legal and institutional framework to control future financial crisis within the EU.

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[15] This is not contradicted by the relative calm existing now and for the past months in the European states under threat (namely, Italy and Spain). Such "calm" – which might precede a storm unchained any minute- would seem to respond to the ECB's public support of national bonds (Draghi's famous words: "we will do whatever it takes to save the euro, and – believe me - it will be enough"). After all, the ESM existed before those words were uttered, and the bonds of the Mediterranean nations were out of control.

II. The Resolvency[16] Proceeding proposal shares with many others the commonality of establishing a court-like institution as it was meant to be with the IMF's SDRM (Sovereign Debt Tribunal –SDT-). The said court would be in charge of managing, monitoring, and directing the proceeding. The specific peculiarity of this approach lies with the fact that, on the one hand, the assets that are indispensable for the execution of the sovereign's tasks remain entirely unaffected, and, on the other, that the responsibility of the Resolvency's success or failure rests completely on the parties involved. Like a US Bankruptcy Code Chapter 11 proceeding – or like all of its many copies around the Globe – the Resolvency proceeding is nothing but an invitation to the parties to negotiate. What the parties do with this invitation and how they act after its acceptance or rejection is their business. But they have the chance to come to a common ground that serves as the basis for the future relations between debtor and creditors.

In order to achieve this, the following three steps need to be taken: (1) A Resolvency Court would have to be set up (nature, structure, place and member selection mechanics); (2) rules determining the basic elements of the procedure and the functioning of the court would have to be designed by this Court and implemented; and (3) provide for the inclusion of a "Resolvency clause" in all credit related agreements and instruments so that all contractual claims against the sovereign are submitted to the Resolvency procedure and the Resolvency Court.

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[16] The neologism is chosen (a) to avoid the negative connotations afflicted traditional terms such as "insolvency", "bankruptcy", "faillite", etc., and (b) to stress the point that the only goal of such proceeding is to bring the sovereign back to solvency.

In the following sections, we purport to describe the main elements of the Resolvency model. It must be borne in mind that it is designed as an open model, one of degree, which will acquire one final shape or another depending on the political will behind its implementation. The extent to which countries are willing to give up their harness over the economic situation and establish a full, adequate mechanism to solve financial crises of Eurozone members will define the shape of the Resolvency proceeding and the Resolvency Court's rights and duties will be elaborated to a higher or lesser degree. The description of the main elements of the Resolvency model shall be then contrasted with an analysis of its compatibility and consistency with the current status as defined by the TESM and the EU's Crisis Management Framework.

1.1 The first step that needs to be taken concerns the setting up of the main institutional framework for the system, namely the creation of the Resolvency Court [17]. Experience from the IMF's proposed SDT shows that its design is a most important issue (and this includes the nature of the court, its members and even its placement). The court has to be independent and to look independent. It has to offer a structure that is acceptable to its constituents.

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[17] There do exist prominent models for such a tribunal (outside of and in addition to ICSID) – see, ID., *The Iran-United States Claims Tribunal*, see GIBSON/ - DRAHOZAL, *Iran-United States Claims Tribunal Precedent in Investor-State Arbitration*, Suffolk Univ. L.S., Legal Studies Research Paper Series 07-15, April 3, 2007; but see also the less prominent pendant for the restructuring of the Saddam-era debts of Iraq Schulden, cf. *Deeb*, Project 688: The Restructuring of Iraq's Saddam-Era Debt, Cleary Gottlieb Restructuring Newsletter Winter 2007, pp. 3 ff.

Thus, given the complexity and peculiarity of the tasks related to a sovereign debt restructuring, it would seem hard to assign them to any existing (supranational) court. Since what is at stake is only to a minor degree solving legal issues, the main thrust of work will rather be a combination of a multitude of concerns of economic, political or sociological nature, and each one of them additionally in a national context as well as in an international context. Accordingly, the judges must ideally have legal and economic background combined with political experience. Therefore, it appears to be advisable to establish the Resolvency Court as a new institution.

The Court should consist of a president and its staff; and this would be the only permanent part of the institution. The judges themselves, in contrast, need not be put in office on a constant basis; it suffices when and if they are pooled. Given the desirable result that they should rapidly develop expertise, the pool of potential judges should be limited right from the outset – maybe to 17, 20 or 30 persons. The members of that pool would remain in their professional positions and act as judges only when and if the president of the Resolvency Court appoints them for a particular case, as a part of the three-judges-panel. The advantage of this approach is that it reduces the tribunal's current costs; they are to be paid – by the debtor sovereign – only when acting as judges. The selection of the pool of judges must be guided by diversification criteria that meet the complex needs of the task: so, for example, the judges ought to be from different nationalities, offer varied professional profiles and expertise, and the main elements of their background are to be identified.

Concerning the Resolvency Court's location, it would seem inacceptable to connect it in any manner with any of the existing financial institutions such as the European Central Bank, or, by the same token, with any of the Brussels institutions as they are (or appear to be) guided by specific interests.[18] Under these circumstances, it would be preferable to have a special and independent chamber established at the European Court of Justice in Luxembourg. However, it is to be feared that this amendment would take considerable time (and possibly a change in the founding Treaties of the EU). Accordingly, under the present circumstances it might be an advisable solution to have the Resolvency court connected with the Permanent Court of Arbitration in The Hague,[19] or even, outside of the area of the EU Member States, at the Bank for International Settlements (BIS) in Basel.[20]

1.2 The current crisis management system set up by the TESM places the ESM and EU institutions at the core of the sovereign debt restructuring solution. As will be discussed below, the ESM provides financial assistance to the troubled sovereign and is the focal point for the debtor's restructuring plan. As a consequence, and bearing in mind the hard criticism received by the IMF's SDRM proposal, it is only reasonable that the Resolvency Court would not be

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[18] As one of the main criticisms to the SDRM, many argued that the IMF was given an excessive role, acting as lender and hosting the court.

[19] Not only that such an idea was actually circulated at the time of its foundation – i.e. some 120 years ago –, a similar concept was also discussed only very recently by the Dutch government.

[20] See also GITLIN - HOUSE, *Sovereign Debt Forum – Expanding Our Toolkit Handling Sovereign Crises*, available at www.cigionline.org.

lodged within the ESM or the EU institutions involved (European Commission, European Central Bank and even the European Supervisory Authority). The said institutions would occupy instrumental positions in the procedure, but always at a functional level and subject to the procedural framework established by the Resolvency Court. In our opinion, the implementation of a new Court would make it necessary to modify – in part – the system envisaged in the TESM for the solution of controversies. According to art. 37 TESM,

> *"1. Any question of interpretation or application of the provisions of this Treaty and the by-laws of the ESM arising between any ESM Member and the ESM, or between ESM Members, shall be submitted to the Board of Directors for its decision.*
> *2. The Board of Governors shall decide on any dispute arising between an ESM Member and the ESM, or between ESM Members, in connection with the interpretation and application of this Treaty, including any dispute about the compatibility of the decisions adopted by the ESM with this Treaty.(…)*
> *3. If an ESM Member contests the decision referred to in paragraph 2, the dispute shall be submitted to the Court of Justice of the European Union. The judgement of the Court of Justice of the European Union shall be binding on the parties in the procedure, which shall take the necessary measures to comply with the judgment within a period to be decided by said Court."*

No changes would need to be made regarding the interpretation of the TESM or the inner regulations of the institutions: questions would continue to be addressed to the Board of Directors and controversies solved by the Board of Governors in the first instance, and by the European Court of Justice in appeal. The system makes good sense: a senior body to solve the technical questions, an internal first instance to avoid undue delay in the decision making process and, ultimately, conferring the final word on the interpretation of the Treaty on the Highest judicial authority within the EU.

But things might be quite different concerning the *application* of the Treaty *whenever versed upon a specific case*. In other words, the Board of Governors and the ECJ could continue to solve general controversies concerning the interpretation of the Treaty, so long as they did not refer to a specific case of ongoing assistance to a Eurozone member. The Resolvency Court would have to be given jurisdiction to solve these controversies, in order to avoid having two parallel jurisdictions (as to the issues that would have to be decided by the Resolvency Court, see below 2). The change would not be as relevant as it might seem at first instance. The amendment would only refer to the issues posed by the sovereign debtor (or by another Member State of the ESM); but it would not imply any change concerning the possibility to appeal decisions of the ESM by any other party involved in the procedure (namely, the creditors). As art. 37 TESM stands now, no creditor or third party can directly challenge the application of the TESM.

2. The Resolvency Court would have to set up its own rules of procedure.[21] They would provide for a procedure that resembles to a limited degree the ordinary reorganization procedures in corporate insolvency (i.e. a Chapter 11-type of proceeding), of course, keeping in mind the material differences between a company and a sovereign.[22] In the following subsections, we will only go over the main elements of the procedure.

> A more detailed analysis would have to go through more elements of the Resolvency Model. Its rules must provide for a streamlined, efficient formal procedure. In order to achieve this result, correct procedural rules ought to be designed. After all, it is the invaluable advantage of a legal procedure to give guidance in and to structure chaotic situations – an advantage that becomes fully visible when one creates the hypothesis of the existence of such procedural guidance already in spring 2010. In brief,[23] these rules should regulate – at least – the following issues: opening reason, right to apply, structure of the draft plan, competences of the court, creditors and their organization, effects of commencement, negotiations, voting, confirmation of the

[21] Regarding the permissibility of such autonomous rule-setting, cf. just art. 30 par. 1 of the ICJ Statute; art. 16 of the Statute of the International Tribunal for the Law of the Sea; or art. 3 par. 2 of the Claims Settlement Declaration of the Iran-US-Tribunal.

[22] These differences result more or less from the fact that a state is endowed with sovereignty and is, thus, untouchable by the *rigor iuris* of commercial insolvency law. By adhering to the contractual approach, the entire proceeding is dependent on the sovereign's (voluntary) acceptance.

[23] In more detail, see *Paulus*, A Resolvency Proceeding for Sovereigns, forthcoming 2014, § 5 B II 3.

plan and consequences therefrom, remedies against the plan, time factor, plan fulfillment, and costs.

Out of this list, two procedural issues deserve particular emphasis: time and interruptions. The time factor is of eminent importance in any restructuring and, accordingly, in any Resolvency proceeding as well. Therefore, it is key to take this facet into consideration and to provide for rather strict time-frames in order to prevent strategic abuse by either side in prolonging or abbreviating the procedure to one's own benefit. However, it is to be assumed that, in most cases, it will be the debtor country that pushes for acceleration, given that the earlier the plan is accepted the earlier the state can begin with the realization of the Resolvency measures. Based on this assumption the focus of timing rules should be in disciplining the creditors. Those rules could be, for instance, the right to ad hoc-interventions of the judges or fixed time frames after which the majority requirements could change.[24]

Another element of great importance concerns dispute resolution mechanisms within the proceedings. The details could be elaborated by taking inspiration from existing commercial insolvency jurisdictions such as Austria or the US. They confer far-reaching competences upon their insolvency courts regarding the resolution of disputes between the parties. The concentration (in the commercial context labeled as

[24] When and if the debtor state should abuse such time frame the court could be allowed to prolong the deadlines.

„vis attractiva concursus“[25]) serves the purpose of the proceeding's acceleration and streamlining. In addition to the dispute resolution, one might also think about permitting the judges to serve as mediators or conciliators.

2.1.1 The Resolvency Model is based on the assumption that it must be the debtor alone that has the exclusive right to file an application. This is the same approach taken by the IMF's SDRM, and it is not only in line with the utmost respect to national sovereignty, but also provides a legal framework that has bigger chances of success than its alternatives. Allowing for a petition by creditors (or indeed a third party) might unnecessarily tie the hands of the sovereign debtor, undermining the latter´s will to collaborate. Moreover – and probably most importantly – the likelihood of such option's general political acceptance is minimal at best.

However, for the Eurozone it appears to be imaginable to give the right to trigger the proceeding to a supranational institution (such as, for example, the European Council). But such action would have to be taken within the new governance and crisis management frameworks, following substantial default of the sovereign´s obligation under the new EU system. And it would demand an overhaul of the system. Too much ado for – arguably – an unnecessary result. Besides, and as it will be argued below, an

[25] See just PAULUS, *Insolvenzrecht*, 2009, para. 47.

adequate interpretation of the current legality might suffice to impose a PSI on a sovereign of the Eurozone, given the necessary requirements.

Another issue connected with the commencement rules concerns the access to the procedure, namely, when and under which conditions the Resolvency proceeding is to be commenced. Traditional corporate insolvency opening criteria (imminent insolvency, illiquidity, over-indebtedness) are, as such, considered inadequate for sovereign defaults and a Resolvency proceeding. With a view to stave off the problems caused by the definition of a strict entry-gate to the procedure for sovereign debtors, the Resolvency system opts for lenient access criteria. It is questionable if there is any need at all to pin down precise opening grounds, the reason being that it might well suffice to provide a subsequent abuse control instead.[26] There would seem to be no incentives for a sovereign to resort to a Resolvency proceeding without adequate, sufficient justification. The Resolvency model assigns the court with the significant tasks of examining the justification of an opening reason and the potential abuse of the petitioning sovereign. The court has, accordingly, to review the debtor's justification given in its plan for the commencement of the proceeding and whether or not the preliminary plan is fair and equitable. It seems unlikely that a sovereign will risk a rejection by the Court, for such outcome would make the

[26] See PAULUS, *Rechtlich geordnetes Insolvenzverfahren für Staaten, Zeitschrift für Rechtspolitik* (ZRP) 2002, p. 383, p. 385.

troubled nation look for alternative solutions, with the subsequent loss of time and reputation – a purposeful unpleasant alternative to abusing the procedure.

> Note that conferring this task to the court underscores the care and attention needed for the selection of the judges that are to be integrated into the pool. High level political, economical and legal knowledge is indispensable for such an examination, since what is to be verified is the debtor's claim that all existing sources of income and other means have been considered and reasonably rejected. The options here at stake are innumerable: (further) privatizations[27] might be as possible, necessary, and reasonable as increasing certain taxes; saving options might be available by cutting salaries in the public sector (for instance, cutting back the 13th month's salary); certain commodities might have not been (fully) exploited, or the gold reserves could be sold, etc. To get an idea of the width of the possibilities, it could be helpful to study the conditionality catalogs of the IMF or the World Bank that these institutions have previously set up for borrowing states.[28]

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[27] Regarding the privatisations particularly of present Greece, see the very informative deliberations by KARGMANN - POTAMITIS, *A New Approach to Privatisation: An Unexplored Option for Greece in Privatising Troubled State-Owned Enterprises*, International Corporate Rescue 2011, p. 389.

[28] It is more than likely that cooperation of the judges is necessary at this point of the proceeding also both with Eurostat and IMF; since these institutions have unique sources of information for the debtor's economy.

2.1.2 On the face of it, the ESM seems to fit in nicely with the scheme of the Resolvency system. In particular, the ESM would be perfectly suited to directly conduct – or assist in the execution of – the analysis of the situation of the sovereign debtor. That way, the ex post assessment to be conducted by the Resolvency Court would be backed by the entire machinery set up by the TESM, including – possibly, as stated by the Treaty – the participation of the IMF. This would relieve the Court of the most burdensome of its tasks, one that it could hardly execute alone, without the assistance of other public or private institutions versed on macro-economic analysis.

The participation of the ESM would also stave off the risk of manipulation by the debtor country, since it would count on (i) all the information and the track record on the troubled sovereign existing following the application of the EU rules on transparency and homogenization of national budgets [29]; (ii) all the reports and warnings issued by the Eurozone authorities following the monitoring competences envisaged in the new economic governance framework [30]; and (iii) the additional information requested *ad hoc* by the ESM

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[29] See, especially, EC, Council Directive 2011/85/EU of 8 November 2011 on requirements for budgetary frameworks of the Member States, [2011] OJ, L 306/41, particularly art. 12 et seq.

[30] This would include the EC, Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, 2 March 2012, online: European Council, european-council.europa.eu, [TSCG] as well as the so-called "Six Pack": EC, Regulation (EU) No 1173/2011 of the European Parliament and of the Council of 16 November 2011 on the effective enforcement of budgetary surveillance in the euro area , [2011] OJ, L 306/1; EC, Regulation (EU) No 1174/2011 of the European Parliament and of the Council of 16 November 2011 on enforcement measures to correct excessive macroeconomic imbalances in the euro area , [2011] OJ, L 306/8; EC, Regulation (EU) No 1175/2011 of the European Parliament and of the Council of 16

or its agents (in accordance with the mechanics of the ESM) or by the Resolvency Court, if considered necessary [31]. Evidently, the same information would be also available for the Court without the participation of the ESM, but there would still be a need for a technical interpretation of a set of complex data that no other institution is in a better position to conduct than the machinery of the ESM.

An element that merits further consideration concerns the sufficiency of the current mandate of the EU institutions to assist in the tasks of a Resolvency procedure. The decision of the European Council of 24/25 March 2011, wherefrom the TESM originated, included the unanimous decision of the EU Member States to allow the European Commission and other EU institutions to collaborate with the ESM. It is unclear if that mandate, alone, would be enough to consider the institutions as empowered to act – through the ESM – in assistance of the Resolvency procedure; either in the verification of the sovereign debtor's reasons to access the Resolvency procedure or, as it will be explained below, in the tasks concerning the restructuring plan.

November 2011 amending Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies , [2011] OJ, L 306/12; EC, Regulation (EU) No 1176/2011 of the European Parliament and of the Council of 16 November 2011 on the prevention and correction of macroeconomic imbalances , [2011] OJ, L 306/25; EC, Council Regulation (EU) No 1177/2011 of 8 November 2011 amending Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure , [2011] OJ, L 306/33.

[31] Indeed one of the basic principles of all insolvency courts is to have the ability to issue mandatory orders to obtain as much information as needed concerning the debtor's status.

Having said this, there are other issues concerning the access to the procedure that would need coordination and, possibly, a change in the approach of the ESM. In a nutshell, the system envisaged in the TESM confers upon the ESM the possibility to intervene through different mechanisms depending on the economic situation of the debtor: illiquidity, when the ESM would be prepared to provide cautionary assistance; a sustainable crisis, where the ESM would, under certain requirements, make available to the debtor all its lending instruments; and non-sustainable crisis, in which the ESM would seem to require a PSI in exchange for its financial assistance.

> The situation is actually far from clear[32]. Famously, recital 12 TESM states that "[I]n accordance with IMF practice, in exceptional cases an adequate and proportionate form of private sector involvement shall be considered in cases where stability support is provided accompanied by conditionality in the form of a macro-economic adjustment programme." This confusing statement, on the one hand, limits the PSI to "exceptional cases", while, on the other, it makes express reference to the IMF practice. But the IMF practice is far from uniform, having changed its approach since its initial "PSI for all" of the 80s to the more cautious approach in the 2000s. Furthermore, the IMF has very recently issued a comprehensive paper in which the

[32] See also OLIVARES - CARMINAL*, The EC Crisis Prevention Mechanisms: A Road to Salvation … or Perdition?*, International Corporate Rescue 2013, p. 324.

PSI is not described as an exceptional remedy at all [33]. The confusion can only increase if one interprets the said recital (and not to forget, it is no article, only a recital) together with the guidelines provided by the Conclusions of the European Council's decision of 24-25 March 2011. The said decision states that "An adequate and proportionate form of private sector involvement will be expected on a case by case basis (…) The nature and extent of the involvement will be determined on a case by case basis and will depend on the outcome of a debt sustainability analysis (…)." It must be noticed that the Conclusion *does* *not make the PSI dependent on the sustainability analysis, but only its "nature and extent"*, in other words, the content of the private sector restructuring. Then the text goes on to differentiate between those cases in which the debt is sustainable, when the lenders will be "encouraged" to "keep their exposures" with the debtor; and the situations where no recovery is possible without a direct restructuring of the debt, when negotiations for it will need to be undertaken. With all this in hand, the question is unavoidable, when will the PSI be imposed by the ESM?[34]

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[33] See the IMF paper *Sovereign Debt Restructuring – Recent Developments and Implication for the Fund's Legal and Policy Framework*, released on 26 April 2013. It is available at www.imf.org. The paper includes as a possible solution the Resolvency Model.

[34] The question is all the more topical after the Cyprus crisis resolution with its PSI. On this incident, just see Orphanides, What happened in Cyprus?, Policy Letter Series No. 6, Center of Excellence SAFE, 2013, 6, available at safe-frankfurt.de.

In any case, and for the sake of the argument, let us assume that the reference to the IMF is to be taken as a need to meet the requirement of „unsustainability of debts“ for a PSI to happen, meaning – roughly – that the debt burden has become too high to reduce the principal amount and that the sovereign is captured, thus, in the *debt trap* [35]. This would imply that no PSI would be required in exchange for ESM financing in cases where the sovereign is insolvent (i.e., unable to ordinarily pay its debts as they fall due and with impaired access to the markets); the PSI would only necessarily happen, then, <u>in the most severe cases of over-indebtedness</u>. Or, as the TESM states, under "extraordinary circumstances".

Here is where the ESM design and the Resolvency procedure would crash. There would be two different procedures, with disparate effects and unequal requirements. That constitutes the most fertile ground for forum shopping. As things stand now, the creation of the Resolvency Court, with a more open access to a PSI, would not be easily compatible with the ESM approach. Politically audacious sovereigns might want to skip ESM-no-PSI solutions in order to solve their problems earlier and more efficiently; this might pose a problem with the ESM intervention in the Resolvency procedure, since the Luxembourg-based institution would be asked to collaborate with the solution of a crisis that it would have confronted in a different manner. This

[35] A full explanation of what the IMF understand for unsustainable debt can be found at www.imf.org. The EC's conclusions of 24/25 March 2013 also includes a brief definition in footnote: "In line with the IMF, debt is considered sustainable when a borrower is expected to be able to continue servicing its debts without an unrealistically large correction to its income and expenditure".

could create problems of coordination and even generate litigation, which might delay an adequate solution. Conversely, and in line with what seems to be the approach taken by the governments of the troubled states of the Eurozone in the current crisis, the sovereign might try to do anything to unnaturally avoid the PSI (a PSI that might prove itself unavoidable anyway, further down the painful road of the crisis [36]). This approach is – arguably – even worse than the previous one. Private debt is made progressively public and until full insolvency eventually happens anyway. Then, the Resolvency procedure would have to fight a much tougher bull, and with drastic consequences for both private investors and the citizens of the Eurozone.

The solution to this conundrum would require the clarification and coordination of the access mechanisms to both procedures. The PSI under the ESM mechanism would have to be in line with the entry access to the Resolvency procedure; in other words, all PSIs would have to be worked through the Resolvency process. This solution would be only natural, since the ESM does not envisage a mechanism for PSIs; it simply states when they have to take place and mandates the troubled sovereign to conduct negotiations. But no procedure is envisaged. And this is what the Resolvency court would provide, together with an adequate framework for a negotiation of the agreement. Besides, and more generally, the ESM would have to be provided with rules that

[36] A very clear example of this can be found in Greece, where the delay in the PSI caused the losses of the private sector investors to be much higher. For reference, see the saga on Greece written by BUCHHEIT – GULATI, *How to restructure Greek Debt*, available at papers.ssrn.com; *Greece: The endgame scenarios*, available at papers.ssrn.comand, *The Greek debt exchange: an Autopsy*, at papers.ssrn.com.

legally define their participation in the Resolvency system, in order to avoid conflicts and unnecessary delays.

> More generally, consideration could be given to re-thinking the entire PSI strategy by the ESM[37]. The task of the ESM as a lender to assist countries with sound economies but with a temporary shortage of liquidity makes all sense; but, absent exceptional situations (natural disasters, wars, etc.), serious problems of liquidity are a sign of insolvency and a pure bail out makes little sense. It is the gap between temporary illiquidity and – sustainable – insolvency that needs to be filled. Avoiding the PSI until the sovereign is caught in the debt trap implies the unjustified conversion of private creditors into public debt, with the former being fully repaid. Troubled Governments increase hugely their exposure to the ESM (and other institutions) while the private investors, who took the risk with all information in hand (an amount and quality of information that can hardly be mirrored in any investment in private corporates) are paid in full. This constitutes an unjustified windfall for financial investors, who benefit from the market when investments are successful, but do not suffer the consequences of misjudgments. That is playing the

[37] We are aware that the lack of a fiscal and banking union as well as the fact that the ECB does not work as a fully fledged central bank constitutes a framework that might present problems when purely market-based institutions (i.e., the PSI as an ordinary solution) are applied. However, the Union seems to be moving in the direction of higher integration, and the model presented here would be yet another piece of that process.

market game only to their benefit. This is naturally made at the expense of the suffering of the citizens of the Eurozone, who end up paying a bill for a meal they never ordered let alone eaten (since the TESM makes it very clear that ESM assistance will only be provided in exchange for "strict conditionality"). Further, this approach generates perverse moral hazard problems by creditors, who will alter their investment decisions based on the ESM's expected behavior – being the ESM a "permanent" mechanism, the "permanent Bail out" is guaranteed. And this alters inadequately the price of the national bonds, which no longer reflects the real risk of default [38]. Finally, the idea that PSIs doom countries, which take decades to re-access international markets in ordinary conditions thereafter remains to be proven. Experience offers reasons to reach a different conclusion: markets are much more attentive to the economic situation of a sovereign in a given moment than they do to past demeanors.[39]

[38] For a most famous defence of this argument, see, for all, SINN, *A New Crisis Mechanism for the Euro Area*, CESIfo, Munich, 2011, pp. 71 ff. In favor of an extension of PSIs in Eurozone crisis, see also DULLIEN - SCHWARZER, *Dealing with Debt Crisis in the Eurozone. Evaluation and Limits of the European Stability Mechanism,* SWP Research Paper, Oct. 2011, available at www.swp-berlin.org; also CHRISTOVA, *The European Stability Mechanism: Progress or Missed Opportunity?,* in *Baltic Journal of European Studies*, Sept. 2011, pp. 41 ff.; or the previous paper of one of the author's, TIRADO, *Sovereign Insolvency in the Eurozone: Public and Private Law Remedies,* in *Annual Review of Insolvency Law,* 2012, pp. 712 ff.

[39] Leaving aside the extreme example of Argentina as a particularly rough debtor, specific research has shown that capital markets' memories are definitely shorter than cataclysmic predictions tend to warn, see BORENSZTEIN - PANIZZA, *The Costs of Sovereign Default*, IMF Staff Papers vol. 56, No. 4, 2009; PANIZZA – STURZENEGGER - ZETTELMEYER, *The Economics and Law of Sovereign Debt and Default,* J. of Econ. Lit. 2009, pp. 633 ff.

2.2.1 In the Resolvency proceedings, creditors – and this means, generally speaking, the vast majority of creditors[40] - of the respective sovereign are to be recognized and clustered into classes that are to be formed in compliance with rational and verifiable criteria.

Concerning the task to verify creditors' claims, the devil is here, too, in the details. Some difficult questions need to be solved, such as (i) which claims are to be included in the Resolvency proceeding (only foreign claims or also the domestic ones); (ii) the definition of the debtor (i.e., if only claims against the State or also those against the national bank, subnational entities or state owned enterprises are to be included); or (iii) if only contractual claims must be considered or also those based on other grounds[41]. Unlike the partial and fragmented solutions offered by the restrictive approach of the Paris Club and the London Club, the Resolvency procedure would strive to achieve an all-encompassing proceeding, that covers as many claims as possible. As a result, this approach would try to include all foreign or domestic claims (possibly including the domestic tax- or wage claims); and all claims existing against entities that have no separate legal existence in themselves as legal entities (as

[40] This is in order to prevent a segmentation as it is done by the Paris Club or its London equivalent. It should be noted (since it is usually forgotten in the respective discussions at least among lawyers, economists and politicians) that financial institutions such as banks are also creditors, cf. PAULUS, *Staatspleiten und Bankenpleiten: eine gewollte Mesalliance*, KTS 2013, 155 et seq. (forthcoming in English in Texas International Law Journal 2014 under the title: Some Thoughts of a European about the Interrelationship of Sovereign Debts and Distressed Banks).

[41] For this, see just HAGAN, *Designing a Legal Framework to Restructure Sovereign Debt,* 36 Geo. J. Int'l L. 299, pp. 347 ff. (2004-2005).

for those which have such separate existence, the general insolvency law will be applicable). Conversely, if, as stated below, there should be a restriction to contractually founded claims because for the time being the Resolvency Court's competence can be founded only on contract, the claims included in the proceedings must be limited to those contractually originated.

> Like any other collective action mechanism aimed at the solution of a debtor's insolvency, Resolvency proceedings aspire to have a universal nature and encompass all of the debtor's claims. However, the nature of the debtor and the size of the body of creditors makes it advisable to restrict participation to some extent. In order to avoid the transaction costs, delays and complications that would stem from the need to negotiate a plan with thousands of creditors of all sizes and origins, limits could be established according to the nature of the claim (i.e., including only financial or industrial claims), the size (amount owed by the sovereign), or a combination of both (for example, including all financial claims –banking claims and bond holders – and all operational claims beyond a certain amount). Or it could be left open to a case by case analysis, to be decided by the Court based on the characteristics of the nation's economy and the structure of its body of creditors. This solution would be in accordance with ordinary corporate restructuring practice, where it is often the case that certain operational creditors (suppliers, workers) are paid in full in order to maximize the return of the rest of creditors.

> Alternatively, the various creditor classes that are to be created right at the outset of the proceeding need to be represented by a particular trustee for each one of those classes. This is an approach familiar from many Debenture Bond Acts which provide for such representative in order to streamline the procedure.

2.2.2 There being no formal procedure, the operation of the ESM does not touch upon the issue of the creditors of the sovereign. In case a PSI is to be negotiated, the TESM leaves it to the troubled Member State to carry out the process, and no mention is made as to the creditors concerned by the debt restructuring. In light of this, the ESM would not interfere in any way with the activity of the Resolvency procedure.

The TESM does however include a reference to the organization of creditors when, in article 12.3, it provides for the inclusion of CACs in all bond issuances occurring in 2013 and thereafter.[42] Amongst other objectives, the inclusion of CACs is supposed to provide an adequate framework for a restructuring of the debt. While this can only be endorsed, the fact that the TESM only includes rules for bond issuances shows the limited scope of the ESM's proposed solution. Precisely the wider approach of the Resolvency court is – arguably – one of its main advantages over a non-insolvency approach such

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[42] The regulation of the CACs as envisaged in the model Euro CAC (available at europa.eu) provides rules that are relevant to the nature of the creditors included in a PSI. For example, it includes rules to disenfranchise certain public creditors, which means that those are to be taken as part of the creditor structure.

as the ESM one. Collective action clauses may assist in reaching an agreement with bond-holders, but a good portion of the debt would be left untouched. This is particularly serious in Member States where subnational debt is high,[43] since the smaller the public institution, the more likely it is that a good portion of the indebtedness will be structured via loans. The Resolvency approach would allow for a wider restructuring and as a result it is bound to be more effective.

2.3.1 One of the milestones of the Resolvency model is the simultaneous presentation of a preliminary restructuring plan, drafted by the debtor itself, with the petition to start the proceedings. The plan would be expected to consist of two parts: one describes in detail how the debtor imagines the reshaping of its economy, the other one presents the (requested) restructuring of its debt (i.e. the plan must explain not only which concessions are requested by the creditors but also which contributions the debtor itself is ready to undertake) [44]. That plan is preliminary insofar as it may be subject to manifold changes, adaptations, and amendments in the course of the subsequent procedure and its discussions with creditors.

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[43] On the Spanish crisis see TIRADO, *Restructuring Subnational Debt vs Internal Bail-out in Spain*, in Paulus (ed.), *A Debt Restructuring Mechanism for Sovereigns – Do We Need a Legal Procedure?* (forthcoming in 2014).

[44] The comprehensiveness of the approach distinguishes the present proposal from the CAC approach (taken in abstract, as a stand alone solution; i.e., if one is to compare the Resolvency model with a country/area that includes CACs as the only solution to sovereign distress); the latter addresses solely the issue of the sovereign's debt side but not the generally equally indispensable restructuring of the economy and the official sector. As will be seen below, this distinction would not apply fully concerning the mechanisms set up by the TESM.

It will be one of the Resolvency Court's (i.e. the freshly appointed panel of three judges) first tasks to examine the feasibility, fairness and reasonableness of this draft plan, which serves also as a kind of entry control to the procedure and staves off the risk of abusive behavior by the debtor.

The debtor and her creditors have got to sit at the same table and to discuss the proposed plan. In order to reduce the mass of creditors and in order to enable meaningful discussions, the appointment of special representatives would be a possibility to consider – as they are foreseen, for instance, in many modern Debenture Bond Acts, or in many bond-issuances under New York or UK Law (cf. supra at 2.2.1). As a matter of fact, it is most likely that the parties involved in these discussions will negotiate toughly; it is to be assumed that every side will strongly argue for its own benefit. A Resolvency regulation is well advised, however, to abstain from any substantive prescriptions; the result should be left – at least as a rule of thumb – to the balance of powers. It should be noted that, in the Resolvency model, the power to impose conditions, amendments or improvements on the debtor's side of the plan is given to the creditors – which, after all, is just a fair compensation for their prospective losses. In contrast, under the ESM regime such power is confined to the fellow member states (which, admittedly, may be creditors at the same time) that, in the formulation of the conditionality, are likely to pursue their own economy's interests rather than the best possible outcome for the debtor state.

As advanced in the previous paragraphs, another essential feature of the Resolvency model lies with the fact that the discussion about and final voting on the plan will be done by groups of creditors. Even if the consent of each single group should be needed, such group formation implies that not every single creditor needs to concur; it rather suffices that the (qualified) majority of 75%[45] of the creditors within one group do so – thereby equating the ESM CACs requirement with those of the Resolvency model. Thus, if there should be only a simple majority within a group be required, the consent of 50% + 1 would be sufficient.

Irrespective of the foregoing, the Resolvency Court will be assigned with the task to moderate the negotiations and to check the legitimacy of the group formation, i.e. whether or not objective, coherent criteria have been applied. The goal of this latter task serves the additional purpose to prevent the debtor state to strategically bind all creditors together in one group which is likely to reject the plan. Accordingly, this task is one further piece of the puzzle to discipline the debtor state to not abuse the proceeding.

The Resolvency model seeks to strike a balance between the debtor and its creditors. Without an accepted plan, the debt situation of the debtor remains unchanged and, therefore, the crisis lingers. As a consequence, the debtor is dependent on the consent majority of creditors and is, accordingly, under a certain disciplining pressure. This dependency on creditors is a kind of

[45] As a matter of fact, the exact amount of the required percentage is dependent on political will; alternatively on strategic calculation, since hold-out creditors' businenss can thereby be alleviated or aggravated. The less securities need to be purchased on the secondary market the easier (and cheaper) is it to build up a blocking minority. Accordingly, 90 % would be risky – particularly given the increased (and growing) readiness of creditors to litigate for full compensation - whereas 50 % would probably be too low. In this context it should also be noted that the hold-out "business plan" can be thwarted by allowing the debtor state to form the groups independently from bonds; such an ex ante-uncertainty, too, makes it harder to prepare for the restructuring case.

compensation for the exclusive right of the debtor to pull the trigger for commencing the procedure. In order to mitigate this dependency to a certain extent, the Resolvency model would allow for the reduction of the requirement of unanimity regarding the groups' consent (attention! not the voting requirements within any one of the groups). One could also think along the lines of the so-called „cram down rule", which allows under certain circumstances a plan to be accepted when and if the (simple or qualified) majority of groups do concur. As to the content, the model does not exclude that different groups are treated differently. It would, thus, be possible to put small creditors into a separate group that receives 100% satisfaction whereas the other groups with, e.g., institutionalized creditors accept a „haircut" of 50%. The flexibility of potential solutions in this context might be as large as the contractual freedom allows for adaptations to the individual case.

If, alternatively, the necessary majority for the plan's acceptance is not achieved, a second chance should be granted for improving repair; i.e. re-negotiations should be possible, although just for a limited period of time. When and if this second attempt also fails, the institutions of the European Union (unlike the situation of other over-indebted sovereigns) could possibly provide for a whole range of sanctions up to the exclusion of that particular sovereign from the Union – which would likely be the most severe of such sanctions. However, the failure of the plan's acceptance could likewise be in one (or more) of the creditors' sphere of responsibility, namely when some creditors with a blocking minority „hold out" of the agreement with a view to obtain an unjustified windfall. Due to the court's moderation powers, a situation like that could be sanctioned by withdrawing that creditor's voting right or to interpret its vote as a „yes" after special investigation of the result's fairness and reasonableness. But, needless to say, in order for the Court to apply such extraordinary measures, there should be objective reasons to believe that the negative vote was grounded on fraudulent reasons. Thereby, both sides could be disciplined.

If the plan is, thus, accepted the court must confirm the plan by examining the legal correctness of the proceeding. Given this requirement, it is advisable to have the court be present all the time during the negotiations. As expressed above, the judges should play certain functions as moderators.

2.3.2 In the current context of the Eurozone, the plan proposed by the debtor would necessarily be restricted by all the data, analysis, reports and, generally, the track record of the crisis since its inception. The data to be used by the debtor would have to be in compliance with the EU Governance Management Framework, and, foreseeably, the state of severe financial distress would have been preceded by warnings issued under the Macroeconomic Imbalance Procedure and a cross-circulation of explanatory reports, strategic plans and, even, imposed sanctions. The data, thus, will have been well fixed by the moment the restructuring plan is to be presented with the petition to start a Resolvency procedure. This will undoubtedly assist the Resolvency Court in the initial analysis of the appearance of adequacy of the preliminary proposal.

The situation will be even more pre-determined in the – presumably common – case when the petition to open a Resolvency process has been preceded by a request of assistance from the ESM. This could be the case if, for instance, the sovereign debtor had requested precautionary financial assistance or any of the other financial instruments before a PSI was decided. In all those cases, the help from the ESM will only happen in exchange for strict conditionality (which, to be sure, could also consist of applying for a resolvency proceeding), following a detailed assessment and a signed Memorandum of Understanding (MoU). Although, per se, the MoU would not have to be binding on the Court, it would constitute an analytical piece that could not be ignored. The government of the sovereign might want to argue against the previous plans (after all, if the debtor has had to resort to the Resolvency Court because the initial plans did not work), but at least the analysis of the causes would be hard to contradict (in which case the argument would concentrate on the way forward). In any case, and as it will be stated in the next section, with the current crisis management framework in place, the debtor – and the Court – would have to take into consideration the opinion of the ESM and its agents (European Commission, European Central Bank and, possibly, the IMF) concerning the content of the plan (with particular regard to the part of the plan that verses upon a restructuring of the debtor's economy), or the ESM might not provide further financial assistance.

The "creditors' side" of the plan cannot be isolated from the side that concerns the restructuring of the debtor's economy. When the calculations are made and the decisions of economic policy adopted, the amounts and the design will necessarily have to take into consideration the size of the debt, which is, precisely, what needs to be discussed with creditors. On the face of it, the prospect of the content of the plan´s debt restructuring being to a certain extent conditioned by the figures and calculations stemming from a previous MoU and/or by the technical analysis conducted by specialized institutions would seem positive. It would provide very relevant information for both the debtor sovereign and its creditors. However, the way the Crisis Management Framework seems to want sovereign debt restructurings done raises important concerns.

For the Resolvency model, and apart from the inevitable information and events mentioned above, it is of the essence that there remains plenty of space for negotiation. The Resolvency system aims to create a level playing field for the parties to reach an agreement that is satisfactory – to the extent possible – for all parties. And yet, there are hints that the PSI under the intervention of the ESM (and agents) would be pre-determined not only by previous policies, but also by considerations beyond the specific problem posed by the insolvency case.

> The EC's Conclusions of 24/25 March 2011 establish the criteria that should guide a debt restructuring with participation of the ESM. According to the said Conclusions, the "granting of financial assistance will be contingent on the Member State having a credible plan and demonstrating sufficient commitment to ensure adequate and proportionate private sector involvement" (i.e., no "adequacy" and "proportionality", no assistance). The adequacy of the PSI seems to be tied with the debtor adhering to the principles of

"Proportionality" (i.e., the proposal ought to be proportionate to its debt sustainability problem); "*Transparency*" (i.e., sharing of information and engaging in open dialogue with creditors); *"Fairness"* (i.e., creditors will be consulted on the design of the restructuring, and "measures reducing the net present value of the debt will be considered only when other options are unlikely to deliver the expected results"); and, finally, *"Cross-border coordination"* (i.e., "the risk of contagion and potential spillover effects on other Member States and third countries will be duly taken into account in the design of measures to involve the private sector").

No problem arises concerning the first two principles: the "pain" to be suffered by creditors ought to follow a bona fide, transparent negotiation, and it should be limited to what is strictly necessary to allow the sovereign back to full solvency. The "Fairness" principle seems confusing. On the one hand, it is hard to differentiate the need to "consult creditors" on the design of the restructuring from the previous Principle, which demands engaging in an open dialogue with creditors (who, ultimately, will have to agree with the proposal). Further, it is dubious what is meant by "reducing the net present value", since both a rescheduling and a write off of the debt would reduce the net value. If what is meant is to establish a preference for a rescheduling over a "haircut", the limitation seems difficult to understand (for, ultimately, they are the same; and, if what is meant is that damage should be limited to the extent possible, then the principle is redundant, since that rule had been already included in the “Proportionality” principle).

But the *main problem* lies with the “Cross-border coordination” rule. This Principle is effectively curtailing the design of a debt restructuring by the need to protect third parties (not even the creditors involved). In other words, the ESM is offering help so long as what could be needed to solve the crisis does not affect other countries’ part of the ESM; i.e., it is an incomplete mechanism. The situation is serious and by no means remote. Imagine the insolvency of one of the large member states of the periphery, and a body of creditors formed to a large deal by financial institutions of one of the main countries of the core of the Eurozone. The PSI would not be designed as it should following an independent technical analysis, because that could pose a problem for the financial institutions of the third country. In other words, the citizens of the troubled sovereign would have to endure more pain than they need in order to safeguard the interests of – ultimately – the citizens of a third country (because we can assume that the effect of a severe haircut would end up being transferred to the nationals of the country of nationality of creditor-financial institutions via a national rescue or a restructuring of the sector). This leads necessarily to the decision making process of the ESM. And a quick look at the majorities needed to grant financial assistance and the allocation of shares between the nations shows that any mid-sized nation – let alone the bigger countries – forms a blocking minority.

On the content of the creditors' side of the plan (i.e., the conditions of the debt restructuring), the Resolvency process should stay away from the limitations stated above. The restructuring ought to be freely negotiated with creditors and the amount and nature of the measures should be linked to objective, market-based criteria. As stated above, PSIs should be treated as a normal development of the functioning of markets and foster an adequate price determination of the country's bonds and debt. As a consequence, the discounted price of the bonds or the quotation of CDSs are measures that would have to be taken into consideration to determine the adequacy of the plan's content.

The mechanics of the ESM do not regulate the majorities needed to approve a restructuring plan, and, therefore, it would seem to be neutral with regard to the system of majorities envisaged in the Resolvency model. However, the TESM provides for the mandatory inclusion of CACs in (nearly) every bond issuance after 1 January 2013. Although the use of CACs is not necessarily tied to the activity of the ESM, it is foreseeable that the vast majority of bond restructurings in the Eurozone will take place with the involvement of the ESM. Again, this creates the need to coordinate both systems. The parallel, uncoordinated existence of both regimes would not seem possible: the "open" determination of majorities envisaged in the Resolvency model would be hampered by the existence of a set of majorities in bond issuances; this might create a problem of forum shopping, that would end up pushing the Resolvency system to adopt a set of majorities that is equal or more debtor-friendly than the set of majorities included in the CAC. Alternatively, the debtor would always prefer a CAC regime that would make the restructuring easier. The situation would be inadequate: it would *de facto* eliminate the “open solution” envisaged in the Resolvency model, defeating its purpose; it would create coordination problems (how could the debtor know, *ex ante* -i.e., before adopting the decision to file for a Resovency case or to aim for a limited bond restructuring- that the Court would agree to the desired majorities?); and it could foster instability in financial markets, by pushing majorities down in excess.

The problem could be easily solved by incorporating to the Resolvency procedure the system of majorities foreseen for bond restructurings in CACs. That would eliminate the forum shopping problem and increase the certainty of the Resolvency model. As an alternative, the elimination of CACs would work equally well (for that matter at least).

> The need to mirror both regimes does not only affect the percentages needed to reach a majority, but also all other rules concerning the counting of the votes to reach the necessary threshold: especially important would be the aggregation rules, the rules on cross-series modification and the rules on disenfranchising.

2.4.1 Undergoing financial distress and with closed or impaired access to the markets, the debtor that resorts to the Resolvency procedure will be in dire need of fresh money. In order to be able to continue executing the ordinary activities of a sovereign government, the debtor country will be expected to conduct negotiations with potential new lenders, that need not be connected with the ongoing talks with existing creditors. The Resolvency model considers the IMF as the primary, natural option in many cases. Alternatively, depending on the general acceptability of and the reaction of the capital market to the commencement of the Resolvency proceeding, there might be even a – slender – chance that the debtor is able to get money from the capital market (bonds or loans) at tolerable interest rates; after all, research has shown that the announcement (i.e. the open recognition) of a sovereign default is usually the turning point for output losses.[46] In either case the lender might be interested to participate in the plan negotiations, and the Resolvency process would so allow. This might not only enhance the chances of reaching an adequate, bespoke solution, but also increase the disciplining effect on the debtor.

2.4.2 Given the current context, the financial assistance during the Resolvency procedure would naturally be in the hands of the ESM. Even if one can question the adequacy of the current design of the ESM, the doubts are referred to its sufficiency as a stand-alone solution or to its approach to the involvement of the private sector, not concerning the ESM's role as "lender of last resort". The ESM would be expected to provide financial assistance to the sovereign undergoing a Resolvency process for as long as necessary to execute the plan and allow the debtor back to full market access. Thus, assistance

[46] See YEYATI - PANIZZA, *The Elusive Costs of Sovereign Defaults*, in *J. of Developm. Econ.,* 2010, doi: 10.1016/j.jdeveco.2009.12.005.

should be available during the procedure leading to the plan and, if necessary, during the stage of execution of the plan.

Two elements need to be considered to ensure consistency in the functioning of the ESM within a Resolvency model. The first issue concerns the interest rate at which the financial assistance would be provided. When regulating the pricing policy, the TESM calls for the coverage of the costs and the inclusion of an “appropriate margin”. As with ordinary IMF practice, the margin would seem to be explained as a tool to avoid moral hazard by the debtor sovereign. This approach ought to be reconsidered. Troubled sovereigns that have undergone rescue programs by the ESM (or previous, similarly designed, mechanisms) have seen their financial costs soar. Sociopolitical approaches in the shape of “uncomfortable” interest rates must be sustained upon solid reasons or they look suspiciously like sanctions that undermine the coherence of an already weak and fragile Union. Such justification exists not in the case of the Eurozone. There exist controls and enforcement mechanisms capable of staving off the risk of moral hazard; and even the mechanics of the ESM would seem to make an ex-post relaxation of the conditionality difficult: the financial assistance is provided in tranches, the disbursement of which will only happen following full compliance with the reform plan.

Another element that would need coordination between both regimes concerns the ESM’s possibility to deny financial assistance to a debtor. In other words, what needs to be decided is if the ESM would have to approve the plan that the debtor presents in the context of the Resolvency process (by approving, we mean having the last word on it). We do not regard this possibility as desirable, the reasons being: (i) the ESM is a lender of last resort, which means that, apart –possibly- from the IMF, there are no alternatives, so the possibility to deny financial assistance at will would in fact be conferring upon the ESM a veto power; (ii) we have described above the limitations of the approach adopted by the ESM, and the strong likelihood that political decisions interfere with technical measures; and, especially, (iii) the existence of an independent court is not compatible with a different institution having powers above it (in formal proceedings, the Court is sovereign). If the ESM and the Resolvency Court are to coexist, the opening of Resolvency proceedings should generate a pre-eminence of the Court, that should have the final word. As any lender, the ESM has the right to establish conditions for the loan, but they must be based exclusively on technical grounds, within the contexts of what is reasonable. Beyond that, the Court ought to decide. Under a formal proceeding for the insolvency of sovereigns, the ESM may have a key role to play as financial assistance provider and technical instrument of the procedure, but it cannot be "king": the role should then be in the hands of the Court.

2.5 Once the plan is accepted by the prescribed majority vote and the Court has ultimately issued an order certifying the legality of the process, this Court order will be the basis for all subsequent legal changes and obligations arising from the plan. The reschedulings and „haircuts" of the creditors' claims are effective as of this exact procedural moment. As of that time, the debtor state, too, is obliged to begin –or continue – with all those measures which must be undertaken pursuant to the plan (for instance, cutting back of salaries, privatization operations, exploring new -or increasing existing- taxing sources, etc.[47]).

Under the Resolvency model, the role of the judges continues after the plan has been accepted. From then on they have to supervise the execution of the plan – in particular, whether or not the debtor sticks to its contractual duties. As stated above, it is a realistic assumption that, following the approval of the plan and the subsequent debt reduction, the debtor might become somewhat hesitant or less enthusiastic to comply with obligations of the plan imposed on him. The judges' sanctioning power should be, amongst others, the possibility to revoke the plan when and if the debtor materially violates its obligations. The consequence of the annulment of the plan would be that the *status quo ante* be re-established and all claims reinstated as they had been before the plan acceptance.

The TESM assigns the EC, in liaison with the ECB and, if possible together with the IMF, the monitoring of compliance with the conditionality attached to the financial assistance granted (art. 13.7 TESM). This competence could well be kept within the context of a Resolvency proceeding, with respect to the plan presented by the debtor sovereign to restructure its debt. As stated above, the plan would have a side that would correspond with the conditionality referred to in the TESM. In case a breach in the plan was detected, the Resolvency Court would be informed and decisions adopted depending on the circumstances. The

[47] Some of these operations have already been mentioned supra. This is not so surprising in sight of the possibility that the political chances for their realization might be greater when done in the context of the Resolvency plan – i.e. after the creditors' consent to do their part for the sovereign's restructuring.

control by the EC and ECB – and maybe the IMF – would help avoid the debtor's moral hazard problem (as would the ESM's disbursement of financial assistance in tranches). With minor regulation, both systems are in this regard compatible.

3. All loan and bond agreements of a sovereign should be amended by a contract clause which establishes that, in case of default and a subsequent petition of the debtor sovereign, the Resolvency Court will be in charge of the proceeding. Given the present state of the art (or the common understanding of that state) it seems advisable to stay away from a purely statutory approach and to prefer its contractual counterpart; after all, the TESM, art. 12 par. 3, too, has made CACs mandatory for all Eurozone countries. Needless to say, this proposal would need some legal instruments passed: a law/regulation that provides for the mandatory implementation of the said clause, for future debts/issuances; and, if the solution was to be aimed to tackle the current crisis, laws ought to be passed to retroactively amend the contracts. Difficult as it might be, it must be borne in mind that the legal amendment refers to the jurisdiction of a court, leaving unaltered the material rights of the parties.

IV. In the previous sections we have explained the main elements of the Resolvency model in abstract as well as how such model would fit with the ESM as it exists now.

> We have examined if at all and, if so, to which degree the two concepts could possibly be harmonized. The exercise was justified

given that, after all, a number of similarities do exist in both concepts. For instance, the ESM is an institution with its own legal standing that has, pursuant to art. 23 par. 1 TESM, its seat in Luxembourg; the procedure is dependent on the application debtor's presentation of a „credible plan" for restoring debt sustainability (art. 12 par. 2 TESM); the ESM is in charge of restoring the country's public debt to a sustainable path (art. 12 par. 2 TESM); it shall cooperate closely with the IMF, (recital 6); the ESM shall undertake a rigorous analysis of the public-debt sustainability (recital 4); the private sector can possibly be included (art. 12 par. 2 TESM); CACs are to be included in future debt instruments (art. 12 par. 3 TESM); and the institution shall be granted a preferred creditor status (recital 10). All these are elements which are, more or less, also to be found in the present proposal of a Resolvency proceeding.

However, it is our opinion that the ESM, as a stand-alone solution, conforms an inadequate solution to the current and possible future financial crises of sovereign states within the Eurozone. We believe that the solution lies with the reformulation of some of the characteristics of the ESM, complemented with the inclusion of a fully-fledged solution in the shape of a Resolvency Court.

In its current form, the ESM is neither well-focused nor does it provide for a sufficient mechanism to tackle insolvency crises of sovereign states.

-*Lack of correct focus*: the ESM is meant to constitute a permanent, complete instrument to confront the severe financial crises of the Member States of the Eurozone, but it does not count on a full regulation, it lacks an adequate institutional setting and, especially, it is open to huge political influence. Instead of being solely – or, at least, primarily – based on technical analysis and its decisions adopted by independent bodies, the main actions are to be freely decided by the countries, owing to a system of majorities that confers a veto power upon the larger countries, despite the existence of possible conflicts of interest. The design and functioning of the ESM resembles more that of any international institution (UN type, or, unfortunately, other EU type) than one permanent instrument to tackle financial crises in an integrated economic zone with a monetary union. The best example of this dysfunctional approach and the lack of adequate regulation is to be found concerning the threshold for the initiation of a PSI. As stated above, there are very few hints as to when a PSI is to be adopted ("exceptional circumstances"), and the hints that exist are all but scary (the "cross border coordination" principle). It is not possible to know when a PSI will take place; and, as a result, solutions are bound to be adopted "too late, too little", and following inadequate maneuvers [48]. It is unclear to what extent the MoU may determine the content of the PSI (*ex ante* awareness of the level playing field is indeed essential for market

[48] It suffices to look back and see when the PSI was adopted in Greece: once the financial institutions of core EU countries had got rid of the initial exposure.

participants to adopt sound investment decisions). The current situation places in the hands of the most powerful nations the possibility to block a technically sound solution to a nation's sovereign: it is not difficult to imagine that the larger countries, with the largest financial systems, will be ready to deny a PSI that jeopardizes their own financial sector. The conflict becomes clear if one makes a comparison with the corporate insolvency sector. The current regulation of the ESM is as if the representative of the interests of the main creditors of a corporate (say, the Banking Association of Country X) could block a restructuring of the debt that would save the business by imposing the shareholders of the – limited liability – corporation the payment of additional capital (the shareholders being, of course, the insolvent sovereign's ailing tax payers). We believe that the decisions on whether a debt ought to be restructured should follow exclusively technical reasons and be based on an analysis of the situation of the insolvent sovereign (not of third parties).[49] Moreover, consideration could be given to changing the approach to PSIs, that should be the norm, rather than the exception. Timely PSIs would provide for efficient, fair solutions (those who invested in the sovereign with full information should account for part of the losses), that could complete the macroeconomic scenario of a well-

[49] On the need for compliance with the rule of law requirements see PAULUS, *A Standing Arbitral Tribunal as a Procedural Solution for Sovereign Debt Restructurings*, in Braga - Vincelette (eds.), *Sovereign Debt and the Financial Crisis – Will This Time be Different?*, 2010, pp. 317 ff.

functioning monetary union (since the bonds of each nation would reflect the real risk of the investment [50]).

-*Insufficiency*: The ESM does not include any solution concerning the restructuring of debt, beyond the TESM´s mandatory inclusion of CACs. The solution is thus unduly limited to the restructuring of bonds. This would not only make a restructuring less efficient (*rectius,* less wide-encompassing) but it may also generate dysfunction in the bond-markets, with some investors moving back to other types of financial vehicles in order to limit the risk of restructuring. But, more importantly, the ESM as a stand-alone solution does not include some of the main features of insolvency proceedings: organizational efficiencies through representatives, or bodies of creditors; or, especially, the absence of a stay of executions over the insolvent sovereign's property outside the debtor's territory. In the absence of such type of stay, the moneys advanced by the ESM through financial assistance may end up in the pockets of hold out creditors [51].

[50] See, again, SINN, *A New Crisis Mechanism for the Euro Area*, CESIfo, Munich, 2011, pp. 71 ff. The TESM quotes the IMF's approach as the one to follow in this regard. The recent paper of the IMF on the subject matter changes its previous approach, and seems much more keen on PSIs as part of an integral solution to sovereign crisis. See the paper *Sovereign Debt Restructuring – Recent Developments and Implication for the Fund's Legal and Policy Framework*, released on 26 April 2013. It is available at www.imf.org.

[51] In order to avoid this problem, a reform in the TESM was proposed as an efficient solution by BUCHHEIT - GULATI - TIRADO, *The Problem of Holdout Creditors in Eurozone Sovereign Debt Restructurings",* available at papers.ssrn.com.

In light of the above, we believe that the Eurozone's Crisis Management Framework needs to be overhauled. It is necessary to amend the TESM in order to remove its current shortcomings and make it an independent, technical rescue mechanism. But this would not be enough. It needs to be completed with a sort of resolvency procedure that (i) ensures independent judgment, (ii) takes into consideration the main claims against the debtor (not only bonds), (iii) provides for a streamlined system of creditor organization and voting, and (iv) offers full asset protection during the development of the procedure and – with limitations – through the implementation of the plan. Such a procedure would have to be *"de minimis"* and need reduced limited infrastructure and cost. The Resolvency model fits those requirements.

> The main difference, however, between ESM and a Resolvency proceeding is that the former concept leaves considerable room for political intervention whereas the Resolvency proceeding is guided primarily by the „blindness" of a legal procedure. Once set in motion, the action would be in the hands of neutral judges with little if any potential for influence from the political side.

The introduction of a Resolvency would by no means imply the removal of the ESM. Quite the contrary, the ESM would play a key role under the proposed new regime. It would have to be "reprofiled", and turned into an institution that (i) provides precautionary financial assistance to troubled-but-solvent sovereigns; that (ii) ensures sufficient funds to the sovereign during the restructuring period, until the sovereign has regained access to the markets; and that (iii) provides technical assistance in the adoption of the technical decisions that need to be adopted during the process (both concerning the restructuring of the economy and the shaping of the PSI). The ESM would be part of the Resolvency process (the coexistence of both systems could generate forum shopping problems), and it would have to be subordinate to the Resolvency Court, or else, forum shopping would arise and political independence would be impossible to achieve. After all, concerning legal interpretation of the system, the ECJ would always have the last word. In order to do this, the regulation of the Resolvency system would have to be accompanied with a consistent reform of the TESM.

A final reminder: the foregoing model consisting of an amalgamation of the ESM and the Resolvency systems would unfold its potential (primarily of disciplining the stakeholders and secondly of providing predictability and transparency) only when and if it is already implemented. From then on, the relevant actors could adjust their behaviour and attitudes to the new setting for future events. As with any new legal instruments that gets introduced in the "legal market", there will be here, too, confusion and incompatibilities. They are usually mitigated by providing transitional rules for a certain period of times ("Übergangsregelungen") that are likely to be needed in our proposal as well.

ROLE THE CHINESE GOVERNMENT PLAYS

IN THE INTERNATIONALIZATION OF THE RMB

Liu Yamei *

ABSTRACT: *The rise of the Chinese currency RMB, also known as Yuan, has certainly captured everyone's attention and aroused considerable debate on whether it is the choice of the market or the outcome of the Chinese government's endeavor. Some people may question whether the Chinese government intervenes too much in market activities in order to promote the internationalization of the RMB or if it wisely acts as a booster to complement the market, the invisible hand, to work more efficiently. A currency's internationalization is normally accompanied with both gains and losses, and that's why some countries hold back from internationalizing their currencies to avoid potential losses, which sometimes could be substantial. Forced by "dollar trap" pressure and triggered by the 2008 crisis, China decided to embark on the track of internationalization of the RMB after weighing potential gains and losses. Having been a leading force of internationalizing the RMB, the Chinese government has played a significant role in the process and has guided the country to achieve notable progress through making practical strategies, enacting favorable policies; pushing forward economic and financial reforms, as well as coordinating with international communities*

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at the state level. With the deepening of internationalization of the RMB, the Chinese government needs to reposition itself as a coordinator rather than a commander-in-chief. Chinese policymakers should realize that the pursuit of internationalization of its currency needs to be on a market-oriented basis with well designed routes and strategic thinking.

SUMMARY: 1. Introduction. 2. Concept of internationalization of the RMB. 3. Motivation of the Chinese government to internationalize the RMB. 4. Role of the Chinese government in promoting its currency's internationalization. 5. Conclusion.

1. Internationalization of the RMB has accelerated since China launched a pilot program to use the RMB as the pricing and settlement currency in cross-border trade in July 2009. This was seen as the initial step China took in promoting its currency to be recognized and used internationally. The Chinese Yuan has for the first time joined the ranks of the most traded currencies, leaping to ninth in foreign-exchange turnover, ranking 8 steps higher than the previous BIS survey, in 2010[1]. Offshore RMB assets reached 1.4 billion Yuan (USD $230 million) by April 2013[2]. And, the RMB overtook the Euro in October of this year, becoming the second most used currency in trade finance, while

[1] See survey data from *Bank for International Settlements*, April 2013.

[2] See statistics released by *China's State Administration of Foreign Exchange*, April 2013.

taking a market share of 8.66%, which is a substantial growth from a share of 1.89% in January 2012[3].

Despite the fact that the substantial rise of RMB was limited in Asia and the level of RMB internationalization remains low, many economists share the view that RMB will inevitably take its part as a new competitor of the existing dominant international currencies in the world monetary system in the foreseeable future. There are now some who believe that the Chinese Yuan will eventually overtake the American dollar, becoming the world's dominant currency.

The Yuan's rise has certainly caught much attention and stirred debate on whether it is the choice of the market or the outcome of the Chinese government's endeavor. *Some people may question whether the Chinese government intervenes too much in the market activities in order to promote the internationalization of the RMB or if it wisely acts as a booster to complement the market, the invisible hand, to work more efficiently.* Some Chinese officials claim that it is not the government's policy to specifically promote the RMB, yet many scholars believe that China has made it a national strategy to push for its currency to be used internationally. Is international-lizing the RMB a national strategy? If so, why would Chinese policymakers venture to expose China's vulnerable financial system in an unpredictable world financial market? And, if that choice has been made, what role should the government play in the process of promoting the RMB's international use?

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[3] See SOCIETY FOR WORLDWIDE INTERBANK FINANCIAL TELECOMMUNI-CATION, *RMB now 2nd most used currency in trade finance, overtaking the Euro*. 03 Dec 2013, available at www.swift.com

2. An international currency, according to Peter B. Kenen, is one that is used and held beyond the borders of the issuing country, not merely for transactions with that country's residents but also, and importantly, for transactions between non-residents. "Internationalization of the RMB refers to the process of RMB performing functions of currency worldwide, becoming major pricing and settlement currency in trade, and becoming financial transaction currency and government's international reserve currency"[4]. To evaluate the degree of the internationalization of the RMB, the International Monetary Institute at Renmin University of China produced a new concept—internationalization index of the RMB in its annual report on the Internationalization of Renminbi, through six indicators from the three functional areas of international currencies, namely, international settlement, financial transactions, and official foreign exchange reserve[5]. The figure that represents the index implies the degree of the internationalization of the RMB. For example, they calculated the RMB internationalization index of the fourth quarter of 2012 as 0.87, a very moderate figure, but a sharp increase from 0.58, that of the first quarter of 2011. The progress of the index from 2011 to 2012 is shown in Figure 1. The index figure shows that even though the level of

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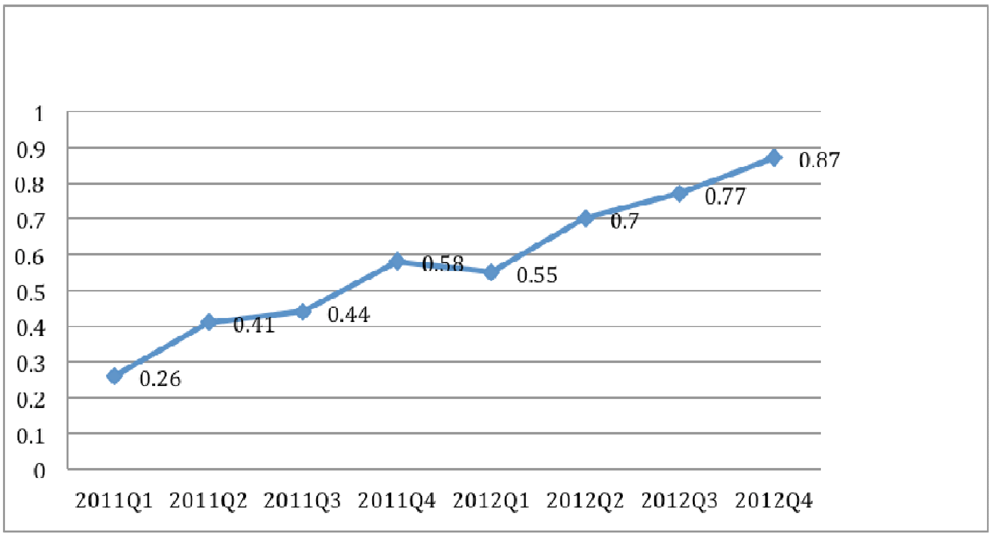
[4] See INTERNATIONAL MONETARY INSTITUTE AT RENMIN UNIVERSITY OF CHINA, *Annual Report on the internationalization of Renminbi*, Renmin University of China Press, 2013, pp. 1 ff.

[5] See INTERNATIONAL MONETARY INSTITUTE AT RENMIN UNIVERSITY OF CHINA, *Annual Report on the internationalization of Renminbi,* Renmbin University of China Press, 2012 pp.2 - 16.

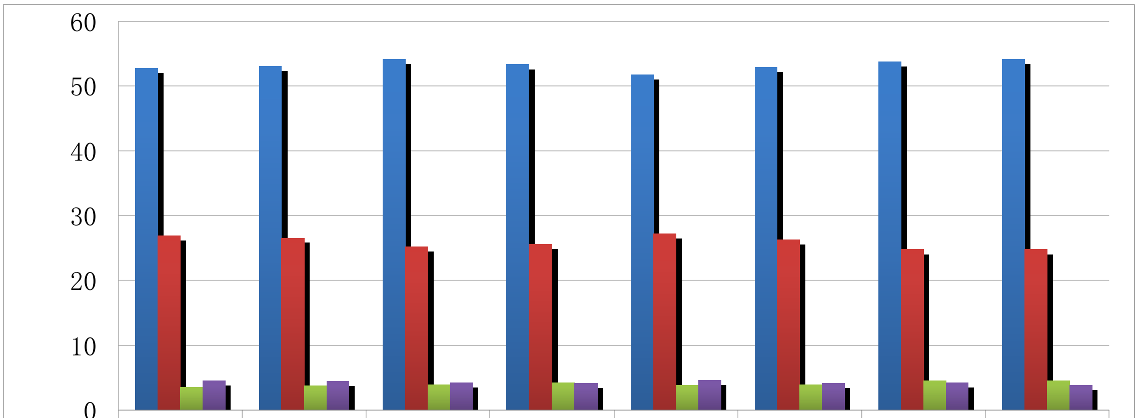
internationalization of the RMB substantially increased last year compared with the previous year, it is still a very low number.

Figure 1: RMB Internationalization Index



Source: International Monetary Institute at Renmin University of China, *Annual Report on the internationalization of Renminbi*, Renmin University of China Press, 2013, pp. 13 ff.

Figure 2: The Internationalization Index of World's Major Currencies



	2010Q1	2010Q2	2010Q3	2010Q4	2011Q1	2011Q2	2011Q3	2011Q4
USD	52, 79	53, 02	54, 16	53, 37	51, 81	53	53, 76	54, 18
EUR	26, 95	26, 57	25, 19	25, 6	27, 27	26, 27	24, 86	24, 86
JPY	3, 59	3, 8	4	4, 31	3, 86	4, 03	4, 58	4, 56
GBP	4, 64	4, 46	4, 34	4, 24	4, 73	4, 21	4, 34	3, 87

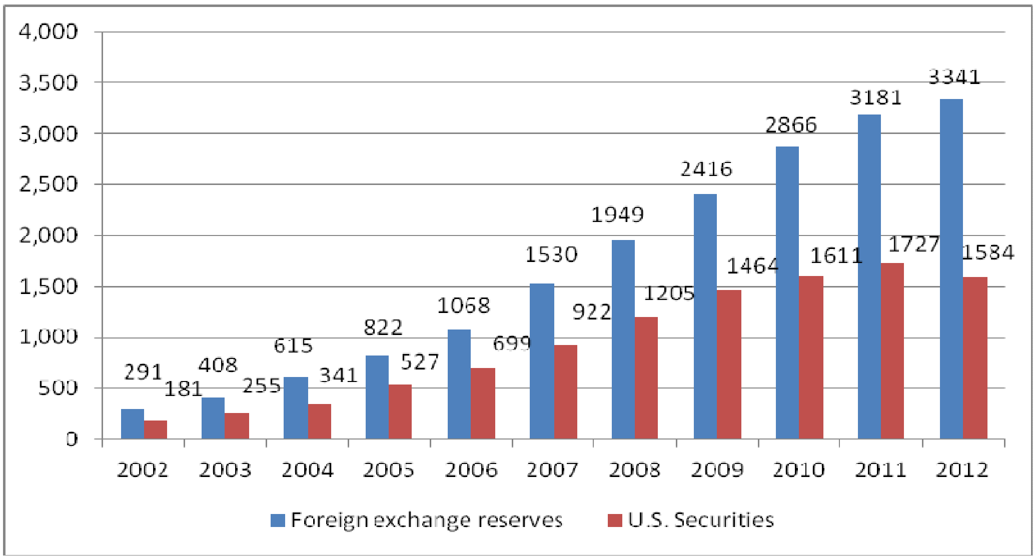
Source: Adapted from International Monetary Institute at Renmin University of China, *Annual Report on the internationalization of Renminbi*, Renmbin University of China Press, 2002

Compared with the US dollar, the world's leading currency, whose internationalization index of the same period is 54.18, the degree of the internationalization of the RMB is almost invisible as shown in Figure 2. Though the RMB has surpassed the Euro as the 2nd most-used currency in trade finance, the degree of internationalization of the RMB lags far behind the Euro, Japanese Yen and British Pound, whose internationalization indexes were 24.86, 4.54 and 3.87 respectively, for the same period.

3. Based on historical precedents, promoting the country's own currency is not an optimal choice during the rising economies period. The state that issues an international currency may enjoy significant benefits but may bear substantial costs as well. To avoid the potential costs, some states hold back from internationalizing their currencies.

The 2008 global financial crisis has forced China to confront the risk from the US dollar dominance. As the biggest holder of foreign exchange reserves in the world, more than 70% of which are US-dollar denominated assets, China was at great risk to the huge capital loss as a result of the US government's debasing of the US dollar. The crisis revealed systemic risks of the US dollar dominating the international monetary system. Reducing reliance on the US dollar and diversifying the international reserve currencies were shared as common understanding among the international community and became the driving force behind the Chinese government making its decision to promote Internationalization of the RMB as a means of reducing China's reliance on the US dollar, the dominant global currency, and pulling itself out from the so called "dollar trap". It was more like a self-protective or self-defensive endeavor, rather than a proactive internationalization move by the Chinese government. At that particular moment, China's objective was to protect its US denominated assets from being eroded by the quantitative easing monetary policy of America, not intending a planned push for the RMB to replace US dollar. With the accumulation of its holdings of US dollar denominated assets, China's reliance on the US dollar has become even more severe. Statistics by the U.S Treasury Department show that as of September of 2013, China's holdings of Treasury securities, the largest category of China's holdings of U.S. securities, reached upwards of nearly $1.3 trillion, USD.

Figure 3: China's Foreign Exchange Reserves and Holdings of U.S. Public and Private Securities: 2002-2012 ($ billions)



Source: U.S. *Treasury Department, Report on Foreign Portfolio Holdings of U.S. Securities as of June 30, 2012*, April 2013.[6]

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[6] Data on foreign exchange reserves are end of year values while data on holdings of U.S. securities are through the end of June.

With the long-term credit rating of the United States being downgraded from AAA to AA+ by Standard and Poor's in August of 2011, China's concerns over its American debt holdings were intensified. The quantitative easing utilized by the Federal Reserve as a means of stimulating the economy in recent years, boosted the U.S. money supply thereby devaluating China's holdings of the U.S. dollar assets. Chinese policymakers hope to reduce their hedge risks arising from the current US dollar dominated monetary system, through internationalization of the RMB, which is echoed among some western scholars[7].

Obviously China's pursuit of the internationalization of the RMB at this stage is more than merely escaping from the US dollar trap. In addition to the immediate benefits which include reducing trade costs and foreign exchange risks, enhancing trade development, boosting cross-border transactions, etc., globalizing the RMB is considered by academia as an external force utilized by Chinese policymakers to push forward financial reform at home. David Pilling maintains that it may be because Chinese market reformers hope the internationalization of the RMB will force domestic reform, like China's access to the World Trade Organization pushed domestic reform in the 1990s[8]. This point of view, to a certain extent, explains why China promotes its currency's international use while its financial system remains vulnerable. Pan Liying does not quite agree with the view that China's endeavor of opening up, including

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[7] See RANJAN - PRAKASH, *Internationalization of Currency: The case of the Indian Rupee and Chinese Renminbi*, 18 May 2010, available at www.rbi.org.in

[8] See PILLING, *The Renminbi won't replace the dollar anytime soo*n, 5 September 2012, available at www.ft.com

the opening of the capital account, would be able to push forward the domestic reform as an external force. She argues that China's entry to the WTO has not, in a real sense, forced reform in the financial system. However, "crisis" instead of "opening up" propels reform, and in return, reform gives rise to opening up[9]. Crisis breeds change. The 2008 crisis made China realized the vulnerable position of its financial system under the current international monetary system and the risks brought by its heavy reliance on the U.S dollar, which forced its policymakers to start the RMB internationalization. With the acceleration and the expansion of the RMB internationalization, the defects of China's economy and vulnerability of the domestic financial system have all been exposed, which has made it determined to reform the model of the country's economic development, economic structure and the financial system as well. Reform in turn would enhance the internationalization of the RMB and gradually a virtuous cycle will be formed. Shen Jianguang stresses that the internationalization of the RMB will lead to "four key transformations of the Chinese economy: 1. from an export-oriented economy to an economy focused on domestic demand; 2. from low-end manufacturing to moving upward on the value-added chain and establishing a strong service sector; 3. from being reliant on FDI, to the "go abroad" strategy of Chinese enterprises; 4. from policy-oriented, towards a more market-oriented financial market".[10] Once China achieves the goal of the above transformations, which lay the economic

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[9] See YINGLI, *Driving Force of the Internationalization of the RMB: the Government or the Market?* in *[China's] First Financial Daily*, 21 October 2013, available at www.yicai.com

[10] See JIANGUAN, *RMB internationalization and China's Economic Transformation*. 24 April 2012, available at www. Cf40.org.cn

foundation and institutional guarantees, it will to a great extent overcome the defects existing in its economy, the internationalization will be more of a natural outcome of the market choice rather than a campaign led by the government.

Increasing the political influence in the international community by promoting the RMB's international use is regarded as another factor for China to achieve the aim of its currency internationalization. Historical precedents prove that the internationalization of a currency, without an exception, increased the issuing country's political influence, for example, its influence in international organizations and among the neighboring countries. Political economy study has confirmed that the international use of a currency enhances a country's power, particularly its international monetary power[11]. "Broad international circulation may become a source of status and prestige, a visible sign of elevated rank in the community of nations." [12]. Subramanian notes that a country that is large in output, trade, and finance is a natural contender for reserve currency status."[13] Being the world's second largest economy, second largest trading country and the biggest holder of the world's foreign exchange reserve, both political and economic influence of China have been expanding, particularly in Asia. If China wants to increase its political power at the global level, it needs to start in Asia and push for the RMB to be regionalized within

[11] See ANDREWS, *International Monetary Power*. New York: Cornell University Press, 2006

[12] See COHEN, *Currency and State Power,* Back to Basics: State Power in a Contemporary World, Oxford, Oxford University Press, 2013

[13] See SUBRAMANIAN, *Renminbin Rules: Conditional Imminence of the Reserve Currency Transition,* working paper series produced by Peterson Institute for International Economics, September 2011

Asia to increase China's geopolitical influence[14]. At the international level, through internationalization of the RMB, China seeks to have its voice in the international monetary system and the RMB will have the opportunity to compete fairly with the US dollar and the Euro in international markets.

Internationalization of the RMB is regarded by some western scholars a correction to the current world international financial architecture. The RMB's internationalization will, to some degree, balance the current global monetary architecture which is dominated by the US dollar. China has been making efforts to contribute to the transformation of the current uni-polar monetary architecture into a multi-polar monetary architecture, in which there are several leading international currencies including the RMB, to minimize its reliance on the U.S. dollar. Special Drawing Rights has been considered a solution, though still controversial, to replace the US dollar as the reserve currency.

The potential costs of the internationalization of the RMB are also obvious, since the internationalization is inevitably accompanied with a higher level of capital account liberalization. But rapid opening of the capital account, and full convertibility of the RMB, in a country whose financial system is very fragile, could trigger crisis to its economy. The internationalization of the RMB could also weaken the effectiveness of the monetary and macroeconomic policies of the country, and it could challenge the risk control capabilities of the financial institutions that have not been well prepared. The fragile financial system, over monetization, shallow financial market, inflexible economic

[14] See OTERO-IGLESIAS, *The internationalization of the Renminbi: the Prospects and Ris*ks, in *Elcano Royal Institute Analysis* (73/2011), 18 April 2011, available at www.realinstitutoelcano.org

structure and the lack of competitiveness of the financial institutions will undoubtedly hinder the Chinese government from taking steps toward the internationalization of the RMB[15].

4. However, having realized the pitfalls of internalizing the RMB, the policymakers of China seem even more determined to promote its currency's internationalization. Frankel observes that it's quite different from the historical circumstances of the rise of the three earlier currencies, for the Chinese government has been actively promoting the international use of its currency[16]. Cohen analyzes that China has begun a determined campaign to promote Yuan as an international currency by strategically using power resources to widen RMB's foreign use[17]. Hyong-kyu Chey noted that the Chinese government is enthusiastically pushing ahead with Renminbi internationalization[18]. Chen Yulu[19], member of the People's Bank of China Monetary Policy Committee, whose views may better represent the Chinese policymakers' thought, argues that the internationalization of the RMB is seen as a symbol of China's rise that combines both the state's hard power and soft power, and is also regarded as

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[15] See HAIHONG - YONGDING, *The Internationalization of the RMB*, International Economic Review, 2010(1), pp.46 - 64

[16] See FRANKEL, *the Rise of Renminbi as International Currency: Historical Precedents*, 10 October 2011, available at www.voxeu.org

[17] See COHEN, *The Yuan Tomorrow? Evaluating China's Currency Internationalization Strategy,* New Political Economy, iFirst, 2012

[18] See CHEY, *Theories of International Currencies and the Future of the World Monetary Order*, International Studies Review, 2012, pp.51 - 77

[19] President of Renmin University of China, also editor in chief of the Annual Report on the Internationalization of Reniminbi, 2012 & 2013

the mainstay for China's integration into the international community, thus maintaining the Chinese economy's prosperity, which makes it one of the most significant national strategies of China in the 21st century[20.] In a prudent and cautious way, China has embarked on the track of internationalizing its currency and has achieved substantial progress since it first launched the pilot cross-border trade settlement using the RMB in 2009. The RMB has been increasingly used in international trade as settlement currency, between China and other countries, limited use as a store of value in RMB-denominated bank deposits in Hong Kong, and as an investment vehicle through the issuance of RMB-denominated financial products. BIS statistics in April show that trading in the Chinese currency has more than tripled over the past three years, to $120 billion a day in 2013 (Daily U.S. dollar trading in 2013 averaged $4.65 trillion), making the Yuan one of the most-traded international currencies. Though China has made its decision, promoting the internationalization the RMB has been controversial among Chinese authorities and international academia. The core issue arousing most of the debate is the liberalization of the capital account under which the RMB is able to be fully converted. The low degree of convertibility is the key obstacle lying ahead of the internationalizing of the RMB. There seems to be a dilemma for the Chinese policy makers: to give up capital control or to give up internalizing the RMB? Obviously neither would be entirely the case, at least in the short run. There is a strong voice among the international academia, even in China itself that says it's out of the question for

[20] See YULU, *Three-Step Development Strategy for the Internationalization of the RMB,* People's Daily Overseas Edition, 18 April 2013l

the RMB to realize internationalization without the liberalization of the capital account, because without full convertibility the RMB would be difficult to be accept for a wider range of purposes, by both residents and non-residents. But some maintain that opening up the capital account and the free convertibility of the RMB in a certain sense would not necessarily be the prerequisites of the RMB's internationalization in the short term and it is possible for China to continue to advance towards the internationalization of the RMB while it progressively loosens its control on the capital liberalization. The second argument is more like what policymakers prefer to make, and actually is being practiced now. Is it realistic to push further ahead with the internationalization of the RMB in an economy with a comparatively low degree of capital liberalization?

Capital liberalization, according to the IMF criterion, does not necessarily mean the complete free convertibility of various types of cross-border capital and liquidity, but a kind of efficient management over a state's convertibility and liquidity. Historical precedents show that most states chose to open their capital account in a steady pace, in that it flows rapidly and abundantly but can be hard to manage. For example, Germany started to loosen its capital outflow in 1958 but had not liberalized its capital inflow until 1981. It took a decade or two for Britain and Japan and other developed countries to complete liberalization of their capital accounts. China has been taking a prudent attitude in liberalizing its capital account since 1996 when it opened its current account convertibility. Presently the degree of China's capital liberalization has reached 60% of the IMF criterion. In China's 12th Five-year Plan it indicates, "To expand the RMB cross-border use and to gradually realize RMB convertibility in capital accounts."[21] The recently published Communiqué of the 3rd plenary session of the 18th CPC Central Committee stresses to accelerate interest rate liberalization and capital account convertibility, and to improve market-based exchange rate formation mechanisms for the RMB, with liberalized and improved financial market as the backdrop[22]. It sends a strong message to the world that Chinese policymakers have decided to take bolder steps towards the capital account convertibility by changing the wording from "gradually realize" to "accelerate". Under the guidance of the communiqué, China is expected to move faster to liberalize its capital account so that a more liberal and healthier financial environment is created to agree with the internatio-nalization of the RMB. But there will remain a certain degree of capital control in the next few years. If China waits until then, when the free market interest rate and exchange rate mechanism is completely ripe, the right time for economic development and the RMB's internationalization would have been missed. Although In the long run, the ultimate goal of internationalization of the RMB is to make the RMB an international reserve currency, which is greatly dependent on the RMB's convertibility. In the short run, international-lizing the RMB may proceed concurrently without capital account being completely liberalized because a certain degree of separation exists between the fully convertible capital account and RMB internationalization. With the fully convertible current account and not fully convertible capital account, the RMB's function as clearing

[21] See *China's 12th Five-year Plan for National Economic and Social Development for detailed information*

[22] See *Communiqué released by the 3rd Plenary session of the 18th CPC Central Committee*

and settlement currency can partly come into play in the international trade between China and other countries. This function of the RMB proved to perform quite well in international trade situations, which makes the RMB one of the top ten most traded currencies this year. The increase of trade volume helps China play a larger role in a market dominated by the US dollar, and to a lesser extent, the Euro, which in turn pushes ahead the process of the country’s capital liberalization.

Even though capital convertibility is not an absolute prerequisite in the short term, China has been making great efforts to promote the change in the current economic mode in order to gradually improve the environment for the RMB to go global. Among the measures and steps it takes, the establishment of well-developed offshore markets is undoubtedly the most notable and significant move. Currency internationalization goes hand in hand with the development of the offshore RMB market. Without a well-developed offshore market it would be very difficult to internationalize a currency. For example, the internationalization of US dollar is inseparable with the development of the European-based dollar offshore market, as well as expansion of American banks’ foreign business. Chinese policymakers believe that with its unique status as a prominent international financial center and a rich experience in performing offshore financial business, Hong Kong is no doubt the best of choice of being the first offshore RMB center. In August 2011, vice Premier Li Keqiang, officially claimed that the Chinese Central Government supports Hong Kong to be China’s offshore financial center. By issuing the RMB abroad through Hong Kong, the RMB is able to achieve self-reliance overseas by means of deposit, loan, stocks and bonds business. Since the pilot project of allowing cross-border settlement using the RMB was initiated in 2009 (with continued improvement in various aspects including supporting policies, the number of pilot areas, the business scope and participants), the use of the RMB for settlement in the cross-border trade has boosted the rapid growth of the offshore RMB market in Hong Kong. As of September of 2013, RMB trade settlement handled by banks in Hong Kong amounted to 2,616.6 billion RMB, an increase of 36% compared with the same period in 2012[23]. The expanding trade of China has promoted Hong Kong's position in international banking markets through a wider RMB deposit base, and increased the holding of the RMB by central banks as foreign exchange reserves. In addition to the cross-border trade settlement, other offshore RMB related businesses also developed rapidly. Although the offshore RMB market may lead to deviation between offshore market exchange rates and onshore market exchange rates, as well as speculation and arbitrage behavior, Chinese policymakers believe the highly liberalized Hong Kong RMB offshore market will provide precious experience, either negative or positive, for them to test the effect of the internalization the RMB. Therefore in this sense, the Hong Kong RMB offshore market is regarded as a significant experimental field to test how the RMB is received internationally and what that implies for onshore markets. The operation of the Hong Kong RMB offshore market allows the Chinese government more time and

[23] See HONG KONG MONETARY AUTHORITY, *Briefing to the Legislative Council Panel on Financial Affairs on 15 November 2013*, available at www.hkma.gov.hk

experience to develop the Shanghai financial center as a hub where eventually China will realize the full convertibly of the RMB.

To create a more liberal financial environment is the allowance of full convertibility of the RMB within the newly established Shanghai Free Trade Zone (FTZ). This is considered another notable move taken by the Chinese government. RMB convertibility within the Shanghai FTZ will enable the Chinese government to gradually liberalize the RMB at the national level. The authorization of the Shanghai FTZ agrees with Shanghai potentially becoming one of the major centers for the RMB trade. As the use of the RMB expands rapidly over time, particularly in Asia, there appears room for more than one offshore RMB center, each of which possesses its own strength. In April 2012, the City of London initiative on London as a center for RMB business was launched, and London became the second offshore RMB center after Hong Kong. A recent survey shows London has an increasingly strong position as a global centre for RMB trading. Driven by cross-border trading and portfolio diversification needs, and with its status as a regional trading hub and an international financial center, Singapore is almost ready to be the next offshore RMB center. Meanwhile, Shanghai is expected to be the city to facilitate the RMB internationalization, as an onshore center. It is interesting that in the process of the establishment of offshore RMB centers, the curve of the role of government appears to be a downward sloped line, yet that of the force of market is the opposite. In the initial period of RMB international-lization, Hong Kong's offshore RMB center was a more likely choice of the state with particular historical obligations, involving more government influence and support, while

London and Singapore are more likely choices of market forces, where RMB business expands globally.

5. After weighing benefits and cost, China is determined to push ahead with internationalizing the RMB, and has achieved notable progress in terms of expanding the use of the RMB in the cross-border trade settlement, developing offshore markets with Hong Kong as the leading force, promoting free currency convertibility and gradually liberalizing capital account within the Shanghai Free Trade Zone, etc. So far potential risks have not been significantly exposed because the process has not yet moved deep enough. When the process goes deeper, the road to "Rome" may not be easy. And the deeper it goes, the smaller the role should the government play, in that a currency's internationalization is basically a choice of the market. The government's role tends to be more important in the initial and declining phase of internationalization of its currency, when the country's economic attractiveness is not strong enough to qualify it as a top currency, as Eichengreen states[24]. However, based on the international experience, rather than government intervention, internationalization to a significant degree is an outcome of market force. Having been the leading force of promoting internationalization of the RMB, the Chinese government has played an important role in making practical strategies, enacting favorable policies, pushing forward economic and financial reforms, and coordinating with international communities at the state

[24] See EICHENGREEN, *Globalizing Capital: A History of the International Monetary System (Second Edition)*, Princeton, Princeton University Press, 2008

level. It has been acting to some extend like a commander in chief. With the deepening of the internationali-zation of the RMB, the Chinese government needs to reposition itself as a coordinator to complement with market forces, creating a preferential environment to enhance financial liberalization and reform. China should pursue its goal of internationalizing its currency on a market-oriented basis with well designed routes and strategic thinking. Yi Gang, vice governor of China's central bank, may well have explained the orientation that China is heading towards, when he said, "Whether the pace of the internationalization is a little bit quicker or slower, it is always and completely the choice of the market.[25]" Ultimately, a stable and thriving Chinese economy is the best foundation on which to reach the goal of RMB' internationalization.

[25] See Yi Gang's interview with Xinhua Agency, *China to Pursue Renminbi Internationali-zation on Market-Oriented Basis: Central Bank Vice Governor.* 28 January, 2013, available at en-glish.peopledaily.com.cn