

LAW AND ECONOMICS YEARLY REVIEW

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GOVERNMENT'S
POLICIES ON
GLOBALIZATION

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PRIVATE LAW REMEDIES FOR NON-PROFESSIONAL INVESTORS. THE ITALIAN CASE

Mads Andenas* - Anna Maria Pancallo**

ABSTRACT: *This article aims to examine the role of information and rules of conduct in the relationship between investors and intermediaries. The information flows have several purposes, since they fulfil the obligation to ensure the transparency about the quality and conditions of the services offered. Moreover, the article focuses on: the asymmetric relationship, the asymmetric agreement and the most recent innovations introduced by MifiD 2. The article also analyses the most recent contributions from doctrine and jurisprudence.*

SUMMARY: 1.Introduction - 2. Pre-contractual information: the first protection for investors -3. Rules of conduct of financial intermediaries - 4. The violation of the rules of conduct by the intermediary - 5. Particular aspects of MiFID II – 6. Conclusion

1. The increasingly complex and diverse financial markets offer a variety of financial products to investors. The objective of European legislation is to diminish the potential information deficit of the investor and protect against irrational decision making¹. However, many mis-selling scandals in the Member State of European Union – also in Italy - have caused a loss of trust in investment advisors².

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This paper is the result of a unitary approach and a common reflection by the two authors. However, paragraphs 1 and 6 can be attributed, in particular, to Mads Andenas while paragraphs 2, 3, 4 and 5 can be attributed to Anna Maria Pancallo.

¹See MOLONEY, *How to Protect Investors*, Cambridge University Press, 2010, 192; G. ALPA, *Gli obblighi informativi precontrattuali nei contratti di investimento finanziario. Per l'armonizzazione dei modelli regolatori e per l'uniformazione delle regole di diritto comune*, in *Contratto e impresa*, 2008, 908 ss.

²See SMITH, *The Age of Instability: The Global Financial Crisis and What Comes Next*, Profile Books, London, 2010; CAPRIGLIONE - SEMERARO, *Financial crisis and sovereign debt: the European Union between risks and opportunities*, in *Law and Economics Yearly Review*, 2012;

Unsuitable financial products as certain private protection insurance, private pension, high risk instruments or interest hedging products have been sold to investors³. This is the background for regulation of investment advice as an important part of investor protection in MiFID II.

In this article, the principles of investor protection will be set out. The principles and their application in the Italian legal system is the main part. This will include investor protection schemes in Italy and the factors affecting them.

In the last part of the article, we turn to of article 69 of MiFID II⁴. After the global financial crisis, the Commission started a process of review of MiFID I⁵ as part of the reforms aimed at creating a safer, sounder, more transparent and more responsible financial system. One main purpose of this reform process was to strengthen investor protection⁶. The European Union acknowledged the aim of investor protection and harmonized regulatory rules concerning investment advisors in MiFID I. The European Union endorsed investor protection by harmonizing the regulation of investor protection, for example investment advice or pre-contractual information. In the Markets in Financial Instruments Directive 2014 (MiFID II) further regulatory rules for financial advisors were laid down. The harmonization of the regulation of financial advisors seems to be concerned mainly with public enforcement. For the investors suffering loss, the question remained if

COLOMBINI - CALABRÒ, *Crisi globale e finanza innovativa. Irrazionale creazione, trasferimento e moltiplicazione del rischio di credito*, Torino, 2009; MASERA, *The great financial crisis. Economics, regulation and risk*, Rome, 2009.

³See ZEPEDA, 'Derivatives mis-selling by British banks and the failed legacy of the FSA', 2013, J.I.B.L.R. 209.

⁴See Directive 2014/65/EU, replacing Directive 2004/39/EG MiFID.

⁵See MiFID I established a regulatory framework for the provision of investment services (such as brokerage, advice, dealing, portfolio management and underwriting) by banks and investment firm and for the operation of regulated markets by market operators. It also established the powers and duties of national competent authorities in relation of these activities. The overarching objective was to further the integration, competitiveness and efficiency of EU financial markets, and specifically to abolish the requirement for all trading in financial instruments to take place on specified exchanges, thereby enabling EU wide competition between traditional exchanges and alternative venues.

⁶The Commission proposed, in the public consultation document, to introduce the principle of the civil liability of financial firms for the losses caused to clients for the breach of information requirements, suitability and appropriateness test, reporting requirements, best execution and client order handling. Commission, Public Consultation. Review of the Markets in Financial Instruments Directive (MiFID), 8.12.2010.

they can claim compensation payments in cases of infringement of regulatory law⁷.

2. The relationships between investors and intermediaries are based on a fundamental anomaly: they are asymmetric relationships, characterized by a gap in information, marking the distance between the saver and the financial dealer. For this reason, the EU legislator issued a series of directives to regulate matters where the need to protect the saver was greater. In addition, the correctness (the meaning of this duty will be clarified later on) of the intermediary's behaviour is one of the necessary conditions for the proper operation of the market. Already in 1961, George J. Stigler, economist, understood that imperfect and asymmetric information are one of the (potential) reasons of a market failure. For this reason, in order to reduce such asymmetries, the intervention of the legislator is needed.

The "asymmetric agreement" is a "*new category, where asymmetry - which can articulate into information, negotiating power, imposing power - is not limited to the individual (consumer, investor, saver) but also the small business. More in general, we refer to the party who is mainly exposed to the counterfeiting power of the counterparty.*"⁸».

It should also be noted that the information flows have several purposes, since they fulfil the obligation to ensure the transparency about the quality and conditions of the services offered (pursuant to Article 21 of the Consolidated Law

⁷See TISON, *The civil law effects of MiFID in a comparative perspective* in Grundmann and others (eds.), *Festschrift für Klaus Hopt De Gruyter* 2010, 2621; GRUNDMANN, *The Bankinter Case on MiFID Regulation and Contract Law* ERCL, 2013, 267; DELLA NEGRA, *The Effects of the ESMA's Powers on Domestic Contract Law* in Andenas/Deipenbrock (eds.), *Regulating and Supervising European Financial Markets*, Springer International Publishing 2016, 155; BUSCH, *Why MiFID matters to private law*, 2012, CMLJ 386; ID, *Why MiFID Matters to Private Law - The Example of MiFID's Impact on an Asset Manager's Civil Liability*, December 31, 2016, (www.papers.ssrn.com/sol3/papers.cfm?abstract_id=2900842); KRUIHOF, *A differentiated approach to client protection: the example of MiFID*. In: Grundmann S, Atamer YM (eds) *Financial services, financial crisis and general European contract law*. Kluwer Law International, Leiden, 2011, 105–163.

⁸See ALPA, *Il contratto in generale. Fonti, teorie e metodi*, Milano, 2014, 288 ss. See also the papers of: DI DONNA, *Obblighi informativi precontrattuali. I. La tutela del consumatore*, Milano, 2008, 174 ss.; ZOPPINI, *Il contratto asimmetrico, tra parte generale, contratti di impresa e disciplina della concorrenza*, in *Il diritto europeo dei contratti fra parte generale e norme di settore*, a cura di NAVARRETTA, Milano, 2007;

on Finance, hereinafter also “*T.u.F.*”- *Testo Unico della Finanza*) as well as the exact knowledge of the buyer's speculative intentions in view of an increasingly efficient allocation of resources. The transparency rule, as a principle, has been borrowed from the Anglo-Saxon experience and was introduced into the European system with the adoption of Directive 2004/39/EC (the so-called “*MiFID I*”), entered into force in Italy by virtue of the Legislative Decree No. 164 of September 17, 2007.

Therefore, the transparency criterion shall be evaluated as the obligation to provide the investor with all the information, which are necessary to understand the characteristics of the financial product; how the investment service operates and, in brief, it is a specification of the obligations of fairness and diligence. It should be pointed out that the principle of transparency did not belong to the Italian legal tradition⁹.

3. The existence of a specific regulation about the behaviour of intermediaries is one of the distinctive features of the legislation addressed to “brokerage activities” as well as investment services and activities. The provision of a body of rules of conduct aimed at defining the standards of behaviour of intermediaries is, indeed, a typical feature of the reforms implemented in some European regulations since the late 1980s. These bodies of rules have influenced the same EU regulation (for example Directive 93/22/EEC, the aforementioned Directive 2004/39/EC and Directive 2014/65/EU, the so-called “*MiFID II*”, which will be better analyzed in the last paragraph)¹⁰.

A well-developed and articulated regulatory body has been set up, in the regulation of the financial markets, to regulate the conduct of service providers in order to protect investors. In the course of events that have affected the Italian

⁹See BUONOCORE, *Problemi di diritto commerciale europeo*, in *Giur. comm.*, I, 2008, 3 ss.; CAPRIGLIONE, *Varietà dalla trasparenza alla best execution: il difficile percorso verso il giusto prezzo*, in *Banca, borsa e tit. cred.*, IV, 2009, 475 ss.; RORDORF, *La tutela del risparmiatore: nuove norme, problemi vecchi*, in *Dir. comm. soc.*, 2008, 269 ss.

¹⁰See SARTORI, *Le regole di condotta degli intermediari finanziari*, Milano 2004, *passim*.

market - but not only - in recent years, the relevance and scope of the discipline of intermediary behaviour has become more and more important. Before the entry into force of the MiFID I, the content of the rules of conduct differed in the various states of the Union, often with significant divergences. Indeed, it should be pointed out that the harmonization of the rules introduced by Directive 93/22/EEC had not been particularly pervasive. The provisions of MiFID I, which pursued the objective of maximum harmonization between Member States, were much more intense and detailed.

The Italian transposition rules follow the content of MiFID I, consistently with what has been established at a Community level, given the limited margins of autonomy recognized to Member States. Similarly, in respect of the implementation of MiFID II.

As already stated, following the adoption of MiFID I, the above-mentioned regulation has been hugely modified and, in many cases, there has been a decisive break point with the rules originally introduced in T.u.F.¹¹

The structure of the rules of conduct of intermediaries is structured in two main levels: general rules belong to the first level, which apply to all services and activities provided by the intermediary. The second level includes rules of behaviour, which are applicable to individual services or activities. Both in the first and second level, the sources are rules of primary and secondary rank. The latter are issued as regulations by the National Commission for Companies and the Stock Exchange (CONSOB).

Articles 21 and 23 of the T.u.F. belong to the so-called first level and define the guidelines of the relationship between the intermediary and the client. The central core of these rules is the care of the client's interests by the intermedia-

¹¹See ANNUNZIATA, *La disciplina del mercato mobiliare*, Milano, 2014, 125 s.; GABRIELLI – LENER, *Mercati, strumenti finanziari e contratti di investimento dopo la MiFID*, in *I contratti del mercato finanziario*, a cura di GABRIELLI e LENER, in *Trattato dei contratti*, diretto da RESCIGNO ed GABRIELLI, Torino, 2011, 40 s.

ry¹².

Article 21, which is the most important rule of conduct, can be articulated in: general obligations of correctness, diligence and professionalism; duties of information; rules about internal organization; rules about conflict of interest. With reference to obligations of correctness, diligence and transparency indicated in letter (a) of the said article, it should be pointed out that the law provision resumes and restates the principles already contemplated by common law rules. Nevertheless, this is not a mere repetition; the special law and the Italian Civil Code contribute to create one unique vision. As a matter of fact, the reference to diligence is to be understood as a reference to the professional diligence provided in Article 1176, second paragraph of the Italian Civil Code and it corresponds to the obligation of the intermediary to comply with all the rules of expertise prescribed by its appointment¹³. Correctness is to be understood as good faith in an objective way, that is to say, as an obligation to behave in a fair manner, taking care of the interest of the other party¹⁴. The transparency criterion, as anticipated, must be interpreted as the duty to provide the investor with all the information that are needed to understand the characteristics of the financial product and how to operate the investment service. It is, in brief, a specification of the obligations of fairness and diligence. Concretely, the duty of transparency is the need to provide clear and comprehensible information in order to reduce the obvious distance between the different positions of the parties. Moreover, it is not only the content of the agreement which shall be consistent with this obligation of transparency, but also the way in which the information is transmitted; Indeed, it has often been challenged to draft these agreements by using extremely small charac-

¹²See MAGGILOLO, *Servizi e attività di investimento*, in *Trattato di diritto civile e commerciale*, già diretto da CICU-MESSINEO-MENGONI, continuato da SCLESINGER, Milano, 2012,

¹³See ALPA, *Commento all'art. 21*, in *Commentario al testo unico delle disposizioni in materia di intermediazione finanziaria*, a cura di ALPA e CAPRIGLIONE, tomo I, Padova, 1998, 20 ss. who also states that this is an immediately binding norm despite the general character shown and that, more specifically, it can be considered a framework rule. See on that point of MIOLA, *Commento all'art. 21*, in *Testo Unico della Finanza*, diretto da CAMPOBASSO, Torino, 2002, 135.

¹⁴See BIANCA, *La nozione di buona fede quale regola di comportamento contrattuale*, in *Riv. dir. civ.*, 1983, I, 209.

ters¹⁵.

It should be noted that the Court of Milan, in its judgment dated 23 March 2012, No. 3513 stated that the general obligations of correctness, diligence and professionalism referred to in Article 21 of T.u.F., also apply to the so-called “*qualified counterparties*” referred to in Article 58 of the Regulation for Intermediaries (No.16190/2007). The Court of Milan have argued that, despite the fact that the provisions of this Regulation do not apply to this kind of customers, the intermediary cannot be exempted from the application of higher-grade rules, such as Article 21 of T.u.F.

Article 23 of T.u.F. provides for precise formal requirements, non-compliance of which causes the nullity of the agreement; then, pursuant to such article, in compensation cases, the burden of proof falls on the intermediaries, who must provide evidence that they have acted by adopting all the required diligence. In addition, a copy of the agreement must have been delivered to the customer¹⁶. The solemn form is one of the protection tools for the benefit of non-professional customers (Consob may introduce an exception to this principle, in relation to the professional nature of the client¹⁷) and Article 23 provides that this is a case of relative invalidity and that, as such, it can be relied upon solely by the investor. The contractual document is therefore an information tool for customers as well as a tool to verify the intermediary’s compliance with the rules¹⁸.

The form requirement is prodromal to the so-called “*Framework Agreement*”. As a matter of fact, under the prevailing approach, it is necessary to have a “framework agreement” which shall pre-exist to each investment transactions. There are those who argue that this is a regulatory agreement, that is to say, an

¹⁵See RORDORF, *La tutela del risparmiatore: nuove norme, problemi vecchi*, in *Dir. comm. soc.*, 2008, 270.

¹⁶See ALPA, *Commento all’art. 23*, in *Commentario al testo unico delle disposizioni in materia di intermediazione finanziaria*, a cura di ALPA e CAPRIGLIONE, tomo I, Padova, 1998, 256 ss. For recent case law, see judgments, TRIB. GENOVA, 5 maggio 2017, n. 1187; TRIB. LUCCA, 14 dicembre 2016, n. 2629; APP. CATANZARO, 21 marzo 2017, n. 518; CASS., 3 febbraio 2017, 2949; CASS., SS. UU., 2 dicembre 2016, n. 24645.

¹⁷In this context, it may be recalled the article 37 of Regolamento Intermediari.

¹⁸See LENER, *Forma contrattuale e tutela del contraente “non qualificato” nel mercato finanziario*, Milano, 1996, *passim*.

agreement dealing with future single agreements¹⁹. Conversely, there are those who argue that this is a kind of agreement having a progressive development consisting of two levels²⁰. The main approach believes that the framework agreement should be qualified as a mandate agreement, conferred to the financial intermediary²¹. The authors supporting this approach consider that the core of the transaction is, essentially, the brokerage agreement. Each transaction is considered as a single act of a complex transaction that finds its origin in the mandate conferred by the investor to the intermediary to act on his behalf in the financial market. The Italian Court of Cassation (*Corte di Cassazione*) has also adopted the advanced solution of the prevailing interpretation. As a matter of fact, the brokerage agreement is resembled to the mandate. Therefore, "*subsequent investment transactions are the implementation of the previous brokerage agreement*"²². In the light of these considerations, it is necessary to analyse the decision of the *Corte di Cassazione*²³ that stated that the client acting before the Court to declare the nullity of the single purchase order must necessarily expressly ask that nullity apply to the framework agreement. Such client cannot simply deduce the lack of written form for the single order, since this possibility is not contemplated by Article 23 of T.u.F. This approach must, however, also be seen in the light of the decision of the United Sections of the Court, which states that the nullity of protection may also be directly found by the Court, even if for a case different from that proposed by the parties²⁴.

The achievement of the scope of the efficiency and integrity of the financial markets cannot ignore a set of rules, which may differ depending on the quality (meaning expertise, experience and knowledge) of the person for whom the in-

¹⁹See CASS., 17 febbraio 2009, n. 3773, in *Danno e responsabilità*, 2009, 503; F. IUDICA, *La responsabilità degli intermediari finanziari*, Milano, 2011, 1 s.

²⁰See APP. GENOVA, 30 giugno 2006, n. 740, in *Giurisprudenza di Merito*, 2007, 1910.

²¹See GALGANO, *Il contratto di intermediazione finanziaria*, a cura di GALGANO e ROVERSI MONACO, *Le nuove regole del mercato finanziario*, in *Trattato di diritto commerciale e di diritto pubblico dell'economia*, 2009, 236 ss.

²²See CASS., SS. UU., 19 dicembre 2007, n. 26724; CASS., SS. UU., 19 dicembre 2007, n. 26725, in *I Contratti*, 2008, n. 3, 221 ss.

²³See CASS., 348/2012 e CASS. 7283/13

²⁴See CASS., SS. UU., 12 dicembre 2014, n. 26143.

vestment services are carried out (Article 6, paragraph 2 of T.u.F.). Hence, one of the most frequent discussions of the case law in recent years is the role of the customer's statement (better, customer's self-declaration) to belong to the category of qualified counterparties. Initially, the *Corte di Cassazione*²⁵ believed that the client's declaration exonerated the intermediary from the obligation to carry out further inquiries regarding the actual existence of the characteristics of "qualified counterparty" for the counterparty, unless there were divergent elements in the documentation (already) in its possession. Conversely, a more recent decision of the *Corte di Cassazione*²⁶ states that natural persons investors fall within the category of qualified counterparties if they prove of being in possession of professional qualifications set up for persons performing administrative, management and control tasks in brokerage companies. The intermediary shall compulsorily verify, upon the setting up of the relationship, that the investor has already performed those roles and tasks as indicated by the said investor, since the simple statement of the client is not sufficient to exclude the intermediary's responsibility. It is necessary that the intermediary verify the customer's statement.

Another important topic are brokerage agreements concluded by individuals not having the necessary legitimation to enter in the agreement. It is well known that to carry out investment activities and to provide services are under a statutory reserve and persons who are authorised to do so are listed in Article 18 of T.u.F. The *Corte di Cassazione*, when declaring the invalidity of certain agreements, stated that invalidity depends on elements that do not refer to the content and structure of the agreement. This is essentially a violation of a subjective right: the law prohibits participation in an agreement of a person who does not comply with the requirements²⁷.

²⁵See CASS., 26 maggio 2009, n. 12138.

²⁶See CASS., 1° giugno 2017, n. 13872; see also *ex multis* CASS, 13 maggio 2016, n. 15330; CASS., 21 aprile 2016, n. 14873.

²⁷See CASS., SS. UU., 19 dicembre 2007, n. 26724 e 26725, in *I contratti*, 2008, 221 ss., punto 1.7. See also a series of pronouncements, many of which preceded the issuance of MiFID, enunciated the same principle: CASS., 19 settembre 2006, n. 20261; CASS., 10 maggio 2005, n. 9767; CASS., 16 luglio 2003, n. 11131; CASS., 3 agosto 2005, n. 16281; CASS., 18 luglio 2003,

At present, the Italian courts have noticed the issue of the so-called “implicit derivatives” so that the reserved activity has come back again (albeit only partially). The Court of Udine²⁸ has recently decided on “hidden” derivatives within leasing contracts. In the case of 24 February 2015, the plaintiff sued the company with which he had executed the agreement, which, in his view, was void due to lack of legitimacy of the counterparty. In addition, the plaintiff claimed that he had received no information about the risks arising from the indexed clauses of the agreement. The judge's decision differs from the precedents of the same office²⁹, who, in similar cases, did not apply the T.u.F. on the assumption that only to the provisions of T.u.B., the CICR Resolution dated 4 March 2003 and the Circular of the Bank of Italy No. 229/1999 apply to the leasing agreement. Moreover, the precedents did not qualify the indexed terms as derivative financial instruments. The competent Court considered that the agreement contained financial derivative instruments (specifically, an option and a future). In consideration of the nature (and complexity) of the derivative, the client should have been informed of the type of derivative and its probabilistic scenarios. Neither does it seem persuasive to sacrifice the customer / saver’s information on the assumption that the cause of the mortgage or lease agreement prevails (as stated by the previous decisions of the Court of Udine). The judge, however, did not declare the agreement as null and void, but he only acknowledged damages. Other trial courts³⁰ stated the invalidity of certain clauses or the whole agreement, as in the case ruled by the Court of Turin³¹, who stated that, in interest rate swap transactions, the fact that, at the time of the conclusion of the agreement, the investor was not aware of the so-called “*mark to market*”, determines the radical nullity of the agreement.

n. 11247; CASS., 5 aprile 2001, n. 5052; CASS., 15 marzo 2001, n. 3753; CASS., 7 marzo 2001, n. 3272.

²⁸See TRIB. UDINE, 24 febbraio 2015, ined. Others follow the same methodological system and, of course, come to the same conclusion: TRIB. UDINE, 25 agosto 2015 n. 1179/2015; TRIB. UDINE, 1° settembre 2015, n. 1196/2015

²⁹See TRIB. UDINE sentences nn. 916/13 e 593/14.

³⁰See APP. TERNI, 3 maggio 2013; APP. MILANO, 18 settembre 2013; TRIB. TORINO, 17 gennaio 2014,

³¹See TRIB. TORINO, 17 gennaio 2014

As a matter of fact, all the elements of the risk and the scenarios that may derive from it, imply the cause of a derivative agreement and must therefore be previously fully defined and known, both by the weak counterparty and the intermediary. In the absence of this, the interest rate swap agreement must be considered null and void for lack of cause. An agreement characterized by the creation of mutual and bilateral risks, which remain unknown to one party, cannot be considered as having a worthy cause.

Conversely, the European Union Court of Justice has differently warned that foreign currency exchange transactions in the context of certain mortgage agreements are not financial instruments³². The *Ráckevei Járásbíróság* (Court of Racke, Hungary) asks the Court of Justice whether the granting of a loan in foreign currency, as in the case at hand, can be regarded as providing an investment service to which the provisions of Directive 2004/39 / EC apply. In that event, the Bank, and in particular the intermediary would have to comply with a series of obligations set out in the Directive. The Court notes the essentially ancillary nature of foreign exchange transactions and since the borrower only seeks to obtain funds for the purchase of a good or service and not to manage a foreign exchange risk or to speculate on the exchange rate of a foreign exchange, these transactions do not have the purpose of making investment services. These exchange transactions are also bound to an instrument (the mortgage agreement) which is not a financial instrument within the meaning of the Directive.

4. The judges of the United Sections, with the so-called “*twin decisions*” n. 26724 and 26725 of December 19, 2007, clearly distinguish between rules of behaviour and validity³³. The breach of the first kind of rules, unless otherwise pro-

³²See CORTE GIUST. UE, 3 dicembre 2015, n. 143, C-321/14

³³See Sezioni unite della Corte di Cassazione, 19 dicembre 2007, n. 26724 NAPPI, *Le sezioni unite su regole di validità, regole di comportamento e doveri informativi*, in *Giust. Civ.*; in *Nuova giur. civ. comm.*, 2008, 432, commented by SALANITRO; in *Foro it.*, 2008, I, 784, commented by SCODITTI; in *Dir. banca*, 2008, I, 691, commented by MAZZINI; in *Soc.*, 2008, 449, commented by V. SCOGNAMIGLIO; in *Corr. giur.*, 2008, 223, commented by MARICONDA; in *Contratti*, 2008, 229, commented by SANGIOVANNI; in *Danno resp.*, 2008, 525, commented by

vided by law, cannot cause the invalidity of the agreement. In order to reinforce this requirement, the Court mentions Article 2 of the Constitution pursuant to which the duty of every party to act with correctness is "immanent to the whole legal system".

The Civil Code has rigorously provided the remedy to be used, so that these violations can never cause the nullity of the agreement, because they do not affect the genesis of the agreement. This solution does not deny the mandatory nature of the rules regulating relationships in the financial market and the provisions providing for specific behaviour obligations. The Court holds that the mandatory nature of the provision is necessary but not sufficient to prove that its breach causes the invalidity of the agreements entered into by the intermediary with the client since the legislature did not expressly provide for the remedy of nullity in case of violation of the rule; the present case cannot be included in the context of the application of Article 1418 paragraph 1st and 2nd of the Civil Code.

Accordingly, an illegal conduct, held during the negotiations or while executing the agreement, can never cause the nullity of the agreement, even though violations are mandatory. In order to have a null and void agreement because of the violation of the rules of conduct, the legislator must have clearly provided for such nullity ("*expressis verbis*"). The judges state that the clear caesura between rules of conduct and validity is hugely marked in the Civil Code and it is clear from the fact that the violation of the obligation to behave in good faith and fairness - which is mandatory - the Civil Code provides for consequences that can also reverberate on the survival of the agreement (as in the case of annulment for fraud or for violence, resolution for failure to act or termination for *ultra dimidium* damage) or that determine pre-contractual or contractual liability³⁴.

BONACCORSI e di ROPPO e Cass., sez. un., 19 dicembre 2007 n. 26725 in *Giur. comm.*, 2008, II, 344, commented by GOBBO; in *Giur. it.*, 2008, 347, commented by COTTINO; in *Dir. fall.*, 2008, II, 1, commented by SARTORI; in *Resp. civ. prev.*, 2008, 547, con nota di GRECO; in *Banca borsa tit. cred.*, 2009, II, 133, con nota di BOVE, Cass. 14 dicembre 2010 n. 25222; DI DONNA, *Obblighi informativi precontrattuali*, *op. cit.*, 163 ss.

³⁴See ALPA, *Il contratto in generale*, *op. cit.*, 830 s.; DURANTE, *Intermediari finanziari e tutela degli investitori*, Milano, 2009, 304 ss.; BERSANI, *La responsabilità degli intermediari finanziari*,

There are no different trends or perspective changes on the principles set out in the aforementioned decisions, on which are also based the most recent judgments about this matter³⁵. A part of the doctrine questions the thesis supported by main jurisprudence, since, for example, in many cases the legislator foresees nullity in the hypothesis of violation of a c.d. rule of conduct³⁶.

It is necessary to determine exactly when the intermediary carries out its misconduct. It is necessary to ascertain whether the violation of the obligations of conduct has been carried out before or after the conclusion of the agreement.

It is necessary, first of all, to analyse the breach, made by the financial intermediary, of the rules of conduct before the conclusion of the agreement that refers to "pre-contractual" liability. The relevant in the Italian Civil Code is Article 1337, which requires the parties to behave in good faith. However, it is not so clear whether and to what extent the pre-contractual liability is a kind of liability in itself (meaning a pre-contractual liability) or is, at least in part, attributable to a 'contractual' or 'extra-contractual' liability. The prevailing jurisprudence, until recent times, held that pre-contractual liability was a kind of non-contractual liability³⁷.

The most recent jurisprudence considers that the qualifying element of pre-contractual liability is not the fault, but the breach of good faith that causes mutual protection obligations between the parties. Such responsibility is attributable to the kind of contractual liability, due to the qualified social contact that causes spe-

Torino, 2009, 240 ss.; AUTELITANO, *La natura imperativa delle regole di condotta degli intermediari finanziari*, in *I contratti*, XII, 2008, 1157 ss.; PEPE, *La giurisprudenza nella responsabilità degli intermediari finanziari*, in *Corr. Giur.*, I, 2008, 123 ss.

³⁵See CASS., 31 agosto 2017, n. 20620; CASS., 31 agosto 2017, n. 20617; CASS., 7 luglio 2017, n. 16861; CASS., 23 maggio 2017, n. 12937; CASS., 10 novembre 2015, n. 22950; CASS., 17 settembre 2013, n. 21255.

³⁶See NATOLI, *Regole di validità e regole di responsabilità tra diritto civile e nuovo diritto dei mercati finanziari*, in *Banca, borsa e tit. cred.*, 2012, 173; DI SABATO, *Società in generale, società di persone*, in *Trattato di Diritto Civile del Consiglio Nazionale del Notariato*, direct by P. PERLINGIERI, 2005, 72; G. PERLINGIERI, *L'inesistenza della distinzione tra regole di comportamento e di validità nel diritto italo europeo*, Napoli, 2013, 120 s.

³⁷See CASS. 5 agosto 2004, n. 15040; CASS. 16 luglio 2001, n. 9645; CASS. 29 luglio 2011 n. 16735; CASS., sez. II, 10/01/2013, n. 477; CASS., sez. I, 20/12/2011, n. 27648; CASS. 30 agosto 1995 n. 9157. Argument defended by authoritative doctrine: ALPA, *Il contratto in generale*, op. cit., *passim*.

cific obligations of good faith, protection and information pursuant to Articles 1175 and 1375 of the Italian Civil Code, and attributes exclusive importance to the objective aspect of the breach of the above-mentioned obligations³⁸. About compensation, to bring the pre-contractual liability under contractual liability, allows the injured to obtain a very high compensation, which is not limited to the simple "negative interest".

Violations may also be perpetrated after the agreement is concluded. As it has been said, the source of the obligations is the framework agreement, which is not an end in itself, being instrumental in a subsequent investment activity. One or more sale agreements may follow the master agreement. If the violations relating to investment or disinvestment transactions are carried out in accordance with the corresponding brokerage agreement, the intermediary's liability has a contractual nature, with a consequent duty of compensation and, if necessary, may cause the termination of the said agreement.

At present, given the very indefinite margins of contractual and pre-contractual responsibility - at least in the case law - it will be interesting to understand what effects the application of that principle will have in the financial field.

5. The MiFID II was adopted, in the context of the MiFID I's review³⁹, after the after the EU reforms driven by the G-20 regulatory agenda, on 15 May 2014⁴⁰. Its objectives are closely linked to the traditional objectives of the EU securities regulation, namely market efficiency, client protection and market integrity. However, the global financial crisis and the large scale of mis-selling have shaped some elements of this Directive. More strongly than its predecessor, the MiFID II em-

³⁸See CASS., sez. I, 12/07/2016, n. 14188.

³⁹See Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC OJ L 145, 30.4.2004, p. 1–44. See the "review clause" of Article 65 of the MiFID I

⁴⁰See Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU OJ L 173, 12.6.2014, p. 349. MiFID II/MiFIR had an initial application date of 3 January 2017 but due to implementation challenges they will start applying on 3 January 2018.

phasises the importance of protecting the individual investor in order to ensure the EU citizens's confidence in the efficient and safe functioning of the EU financial markets. The Markets in Financial Instruments Directive has incorporated such duties to be complied with by financial institutions when providing investment services to (retail) investors and subjected them to public supervision and enforcement. The development has generated tension between this "investor protection regulation"⁴¹ and traditional private law.

The MiFID II can affect also the interpretation of national private law duties via the national court's duty to interpret. It is submitted that national courts shall interpret the general duties of contract law (i.e. duty of pre-contractual good faith) the national private law in light of the wording and purpose of EU law

The MiFID aims to strengthen investor protection and is the causa of most national law regulatory schemes on financial advice in the European Union. Investment advice is defined in the MiFID II as "*the provision of personal recommendations to a client, either upon its request or at the initiative of the investment firm, in respect of one or more transactions relating to financial instruments*". This definition is specified in art. 52 of the MiFID implementing directive. The rules concerning investment advice can be found in Chapter 2 of the MiFID II. Most prominent are the rules in art. 25 (2) MiFID II, which provide that investment advice may only be given after fulfilling the "know-your- customer"⁴² requirements and that only suitable advice may be given. Next to that, there are reporting and disclosure rules, as the rule to disclose conflicts of interest in art. 23 MiFID II.

In the initial consultation document on the MiFID II the European Commission proposed to include the harmonization of the civil liability due to

⁴¹See MOLONEY, *The Investor Model Underlying the EU's Investor Protection Regime: Consumers or Investors*, EBOR 2012/2. See also: CHEREDNYCHENKO, 'Contract Governance in the EU: Conceptualising the Relationship between Investor Protection Regulation and Private Law', ELJ 2015/4.

⁴²See MCMEEL and VIRGO, *On Financial Advice and Financial Products*, 3rd edition OUP 2014, 11.33, 11.34

breach of certain MiFID II rules⁴³. This proposal was not included into the draft MiFID II, which might be explained by the difficulties that generally arise with the harmonization of private law in the EU⁴⁴. In particular the national authorities were concerned about disrupting national liability systems, while the industry feared higher indemnity insurance costs and was concerned about the practicability of a harmonized liability regime⁴⁵. For these reasons an article assuring civil liability for breaches of the regulatory regime was not included in the MiFID II. However, the growing regard for private enforcement as an effective matter of investor protection can be seen in art. 69 MiFID II. Art. 69 MiFID II states that “Member States shall ensure that mechanisms are in place to ensure that compensation may be paid or other remedial action be taken in accordance with national law for any financial loss or damage suffered as a result of an infringement of this Directive”. It is questionable how this rule should be interpreted. But the article could be interpreted extensively, meaning a direct obligation for Member States to enable private law remedies. This interpretation would certainly agree with the directive’s aim to promote investor protection. But an extensive interpretation is not systemically coherent with the above-mentioned article. The article’s heading is “supervisory powers”. This suggests that the article gives supervisors the powers to create private remedies but does not require judicial private law remedies. According to speaking of mechanisms that ensure that compensation may (and not must) be paid, supports this interpretation. However, the MiFID II innovations, and in particular, the “general provision” for the firm’s liability (Article 69(2) of the MiFID II), do not prevent Member States from maintaining their own private law remedies but aim to ensure that a minimum level of protection for the clients is

⁴³Public Consultation of the Commission, ‘Review of Markets in Financial Instruments Directive (MiFID)’ 8.12.2010, 63; Federico Della Negra, ‘The Effects of the ESMA’s Powers on Domestic Contract Law’ in Andenas/Deipenbrock (eds.), *Regulating and Supervising European Financial Markets*, (Springer International Publishing 2016) 155.

⁴⁴See TISON, ‘*The civil law effects of MiFID in a comparative perspective*’ in Grundmann and others (eds.), *Festschrift für Klaus Hopt* (De Gruyter 2010) 2621, 2622; Danny Busch, ‘Why MiFID matters to private law’ (2012) CMLJ 386, 387.

⁴⁵See DELLA NEGRA, ‘*The Effects of the ESMA’s Powers on Domestic Contract Law*’ in Andenas/Deipenbrock (eds.), *Regulating and Supervising European Financial Markets*, Springer International Publishing 2016, 155.

granted. Similarly, the MiFID II's innovations on conduct of business rules and product governance and their "spill-overs" on national private law should be seen as tools to ensure, that "the central role played by

financial services in the economy of the European Union" is supported by a regulatory framework capable of preventing systemic risks and ensure financial stability. As the MiFID II made it clear (Recital No 5), reducing the detriment caused to clients by mis-selling is a pre-requisite to achieve these objectives.

6. The MiFID II completes the regulation of European financial market. Simultaneously with the the Directive, the Regulation n. 600/2014/EU (so-called MiFIR) of the European Parliament and of the Council of 15 May 2014 came into force. It is intended to guarantee the most complete information regarding the product that the investor is going to buy. MiFID II shares the purpose of the 2004 MiFID and confirms the basic choices made there. The objective is the development of a single market for financial services in Europe, in which transparency and the protection of investors are ensured. Savers and investment firms have the right, respectively, to invest and provide investment services, cross-border; the legislator has simplified the procedures and has set identical conditions for all the States of the Union.

Under MiFID II, investor protection is the key. Financial institutions must act in the best interest of their client, and it is paramount that firms have a deep understanding of who is distributing the financial products they manufacture. Financial literacy is increasingly important in the population at large, as one central banker has expressed it: *"Including financial education into the school curriculum in an on-going manner would hold the key to making our future generations financially literate"*⁴⁶.

Many Member States and also the European Commission are promoting financial education policies. Financial education is the process through which con-

⁴⁶See Dr. K. C. Chakrabarty, Deputy Governor, Reserve Bank of India and Co-chair of the INFE Advisory Board

sumers improve their understanding of financial products, financial risks and the opportunities presented by the market, so that they can make informed decisions on their finances. The European Commission, the OECD, the Economic and Financial Affairs Council (ECOFIN) and the International Organization of Securities Commissions (IOSCO) have all sought to address the issue.

The CONSOB and the Bank of Italy have invested in financial education as a teaching subject in schools. Being prepared to better face the challenges of the future is a modern categorical imperative.

**THE CHOSEN METHOD OF HARMONIZATION IN EU CONSUMER
PROTECTION AND ITS IMPACT ON NATIONAL LAW IN POLISH
AND ITALIAN LAW IN THE LIGHT OF THE IMPLEMENTED
PROVISIONS OF DIRECTIVE 2014/17/EU ON CREDIT
AGREEMENTS FOR CONSUMERS RELATING TO RESIDENTIAL
IMMOVABLE PROPERTY**

Elisabetta Bani * - Beata Pachuca-Smulska **

ABSTRACT: The importance of affordable housing and the economic relevance for the families of buying a house as well as the need to create an efficient and transparent market in an important sector of the lending activity led the European Union to enact the Directive 2014/17/EU on credit agreements for consumers relating to residential immovable property. The article, after an examination of the EU on the consumer protection model, focused on the implementation of Directive 2014/17/EU in Italian and Polish law, not only in defining the concepts of “personal scope”, “consumer” and “creditor”, but in addressing, the thorny issues of foreign currency loan agreements, advisory services and independent advisors. The general rule of minimum harmonization is not always consistently applied, as maximum harmonization is required on the fields of the right to information, a uniform information set of information and the requirement of the Annual percentage rate of charge (APRC).

The minimum harmonization method, the prevailing one for the implementation of the Directive, confirms its validity, meeting the fundamental goals: to safeguard consumer protection in this specific market, and to attempt to create a

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This paper is the result of a unitary approach and a common reflection by the two authors. However, paragraphs 2, 3 and 6 can be attributed, in particular, to Elisabetta Bani, while paragraphs 1, 4, 5, 7 and 8 can be attributed to Beata Pachuca-Smulska.

single internal market for mortgage credits in the European Union, taking into consideration the fact that the real estate market is closely linked to the internal legal order of each country and has been shaped over the centuries, and therefore, the rules governing real estate loans are usually detailed and largely based on traditional domestic solutions.

SUMMARY: 1. Introduction. - 2. Genesis of the EU regulations on consumer loans in the real estate market. - 3. Purpose of Directive 2014/17/EU. - 4. Models of consumer protection in the EU financial market vs. implementation of Directive 2014/17/EU in Italian and Polish law. - 4.1. EU consumer protection model. - 4.2. Implementation of Directive 2014/17/EU in Italian and Polish law. - 4.3. Scope of Directive 2014/17/EU. - 4.3.1. Personal scope; 4.3.1.1. Consumer. - 4.3.1.2. Creditor. - 4.3.2. Material scope of Directive 2014/17/EU; 4.3.2.1. Credit agreement. - 4.3.2.2. Foreign currency loan agreement. - 4.3.2.2.1. Foreign currency loans in Poland. - 4.3.2.2.2. Use of foreign currency in the financial market in Italy. - 4.4. Regulation of Directive 2014/17/EU vs. foreign currency loans in the Polish and Italian regulations. - 5. Advisory services. - 5.1 Register of credit advisors - independent advisor. - 6. The right to information vs. full harmonization in the Directive 2014/17/EU. - 6.1. European Standardized Information Sheet. - 7. Annual percentage rate of charge (APRC). - 8. Conclusions.

1. On February 4, 2014, Directive 2014/17/EU on credit agreements for consumers relating to residential immovable property and amending Directives 2008/48/EC and 2013/36/EU and Regulation (EU) No 1093/2010¹ were adopted as a further step towards strengthening consumer protection in the financial services market. This is particularly important in the light of the practices followed by financial institutions prior to the global crisis in the US, but also in many Member States of the European Union. Despite the high level of consumer protection in the European Union, the crisis has exposed numerous gaps in the regulations that failed to guarantee adequate consumer protection². Directive 2014/17/EU is intended to strengthen the solutions adopted earlier, but also to introduce new

¹OJ L 60, 28.2.2014, p. 34-85.

²Cf. Opinion of the European Economic and Social Committee on 'Strengthening EU cohesion and EU social policy coordination through the new horizontal social clause in Article 9 TFEU' (own-initiative opinion) (2012/C 24/06), sections 1.2, 1.5, 2.1.1, 3.7.

ones that will guarantee better protection in the mortgage credit market. The Directive follows the minimum harmonization method. However, in order to increase legal certainty for consumers, the EU legal system provides for full harmonization of the right to information, which is one of the four fundamental consumer protection rights adopted worldwide as far back as in the 1960s³.

The adoption of full harmonization is intended to contribute to the promotion and development of cross-border activities in the mortgage credit market and, at the same time, to facilitate competition in this market. It is yet another attempt by the EU legislators to consolidate various types of credits offered to consumers.

The subjects of this publication are the provisions of the EU law and selected national regulations implementing the Directive, which was implemented into Polish law by the Act of 23 March 2017 on Mortgage Credit and on Supervision of Mortgage Credit Intermediaries and Agents⁴, and into Italian law by the Legislative Decree of 21 April 2016 no. 72 (“Decreto Mutui”)⁵.

The subject of the analysis is an attempt to assess how well implementation of Directive 2014/17/EU has been able to strengthen consumer protection in the mortgage credit market in two selected European Union countries: Poland and Italy. Research will be conducted from the perspectives of regulation subject to both full harmonization and to minimum implementation, in the indicated area. The two selected legal systems refer on the one hand to the regulation adopted in an ‘old’ EU Member State with a strong banking tradition as represented by Italy, and on the other to that of a relatively young EU Member State - Poland. The selection is not accidental: Italy belongs to the Eurozone, while Poland still has its own currency, which has strongly affected consumer decisions in the mortgage credit

³See also PACHUCA-SMULSKA, *Prawo do informacji i edukacji podstawą ochrony interesów konsumenta*, [in:] *Ochrona konsumenta w prawie polskim i Unii Europejskiej*, edd. B. Pachuca-Smulska, M. Królikowska Olczak, s. 42–47.

ALPA, *Il diritto all’educazione e all’informazione*, [in] (edd.). Alpa, Catricalà, *Diritto dei consumatori* II Mulino, 2016, s.180-194.

⁴Journal of Laws 2017, item 819

⁵Published on 20 May 2016, Gazzetta Ufficiale no. 117/2016

market. This has also been reflected in the regulation adopted in the Mortgage Credit Directive. The analysis will focus on two issues: the first concerns the information obligations towards consumers regarding foreign currency lending and the new rules on the same. The other concerns the principles of how intermediaries and advisers (agents and brokers) offer real estate loans to consumers. In this paper, the two basic areas of consumer protection will be assessed from the point of view of the implementation method applied and its impact on the development of the most effective model of consumer protection in selected Member States.

The authors do not aim to discuss all regulatory solutions adopted in Directive 2014/17/EU, but to focus on those institutions which, in their opinion, make an important contribution to the assessment of new regulations and to the assessment of the implementation carried out.

2. The fundamental role of mortgage credits in the EU economy was recognized by the European Commission in 2001. On 1 March 2001, the European Commission issued recommendations on which pre-contractual information should be provided to consumers by creditors prior to concluding a mortgage credit agreement⁶. This was the first of a series of measures proposed to strengthen consumer protection. The dynamically developing residential real estate market in Europe in 2004-2005 contributed to the development of the Green Paper on mortgage credits in the European Union⁷. The evolving real estate market has prompted the EU legislator to streamline the legal regulations governing mortgage loans, given the significant role of the real estate market in the European economy⁸.

⁶OJ L 69 of 10.3.2001

⁷Opinion of the European Economic and Social Committee of 15 December 2005 on the Green Paper: Mortgage Credit in the EU [COM(2005) 327 final - OJ C 65 of 17.3.2006].

⁸White Paper p. 2. With the balance of receivables from mortgage loans for housing purposes amounting to almost 47% of the EU's GDP, data from 2006. The importance of mortgage loans for the EU economy is also confirmed by the document 12905/13 of the Council of the European Union of 12 September 2013, which states that 70% of EU citizens own the apartments in which they live and that most of these apartments were purchased with the help of mortgage loans. Mortgage loans together account for more than 52% of the EU's GDP. <http://www>.

The European Commission has taken steps to harmonize the provisions governing mortgage credits by presenting a cross-border regulation in its 2006 Green Paper⁹. In this document, the Commission points out the minimum information requirements that should be provided for this type of credits, and the importance of adopting a single European-wide regulation on mortgage credits. The next year saw the publication of the White Paper presenting a proposal for integration of the real estate credit market in the European Union¹⁰. The financial crisis of 2007-2008 was a turning point in the financial market and a key factor in the final development of mortgage credit regulation. It was the collapse of the financial market that exposed its numerous problems and shortcomings. The crisis has shown that irresponsible behavior by market participants can undermine the foundations of the financial system, leading to a loss of consumer confidence with serious social and economic consequences. Practices by financial institutions have caused many consumers to lose confidence in the financial sector¹¹. The problem of mortgage credits has become global. In the United States, many properties of defaulting debtors have been taken over by banks. The situation of borrowers in the EU was not comparable, despite the existence of the single market, and loans, particularly those on the real estate market, were largely governed by national regulations. Borrowers in some European Union countries have experienced increasing difficulties in repaying their loans, which has led to an increase in arrears and, ultimately, to enforcement against real estate¹².

The European Commission's Communication "Driving European Recovery", presented on 4 March 2009, was an important step towards restoring consumer

parlament.gv.at/PAKT/EU/XXIV/EU/12/47/EU_124721/imfname_10415390.pdf (accessed on 1.07.2015)

⁹OJ C 65 of 17.3.2006

¹⁰Brussels, 18.12.2007, COM(2007) 807 final, see also: RUMI, *La direttiva 2014/17/UE sul credito relativo agli immobili residenziali*, [in:] *Le operazioni di finanziamento bancario, societario, sull'estero, al consumatore, strutturato, a mezzo garanzia, pubblico*, Francesco Galgano, Panzarini, Dolmetta, Patriarca (edd.). 2016, Bologna Zanichelli, v. 34, p.632.

¹¹See DI PORTO, *commentary to Art. 120-septies*, Commentario al Testo unico delle Leggi in materia bancaria e creditizia, diretto da Francesco Capriglione, vol. III, Quarta ed., Padova, Cedam, 2018, p. 1990, and the literature referred to therein.

¹²Recital 3 of Directive 2014/17/EU.

confidence. This document lists measures to repair the residential property financing market. The Commission is committed to establishing a sound basis for the rules on credit intermediation to ensure responsible and reliable market mechanisms and to restore consumer confidence¹³. The proposal of the Directive dated 31 March 2011¹⁴ and received a favorable opinion from the BCE¹⁵. In its Communication of 13 April 2011 “Single Market Act: Twelve levers to boost growth and strengthen confidence”, the Commission confirmed the solutions adopted to remedy internal market mechanisms, including in particular transparency of bank costs and more effective protection of borrowers in the mortgage credit market¹⁶.

The documents adopted by the European Commission confirm the special role of real estate loans due to their high costs and the desire of the consumer to own his own apartment. For most consumers, purchasing a property involves taking a long-term, expensive loan, and is one of the most important financial decisions in life, which determines a range of other circumstances. The purchase of real estate usually has an impact on where the borrower will live and work for the next dozen or several dozen years. A credit is also associated with interest rate risk, and nowadays, very often with currency risk and uncertainty in the labor market. These factors strictly determine the ability of the customers to fulfill their obligations to repay the credit installments, thus it is crucial for the consumer to make the right decision. For the above-mentioned reasons, new legal regulations oblige loan-providing entities to present full information on the loan and related risks. The consumer’s understanding of the information and risks presented requires appropriate preparation and, above all, basic financial knowledge. These circumstances have led to the preparation of a separate regulation for the EU mortgage credit market¹⁷.

¹³Commission Communication of 4 March 2009 to the Spring European Council, “Driving European recovery”, COM(2009) 114 final.

¹⁴COM (2011) 142 def. *A comment on the propale* in TOMMASI, *Unione Europea e contratti di credito relative ad immobili residenziali*, I contratti, 2001, p. 956.

¹⁵CON/2011/58 of 5 July 2011.

¹⁶Brussels, 13.4.2011, COM(2011) 206 final, p. 11

¹⁷An overview of the directive in DE GIOIA-CARABELLESE, *The Directive on Credit*

3. The mortgage credit market in the EU Member States is not uniform, nor are the citizens standard of living, or their respective expectations and housing needs. The new regulation is intended to harmonize the rules and create better conditions for consumer protection, notably through a broad right to information and opening the market to the free movement of capital and customers¹⁸.

The reason for the adoption of Directive 2014/17/EU is to organize the regulation of mortgage loans and create a more transparent, competitive single internal market. These objectives are to be guaranteed by consistent, fully transparent and, therefore, fair credit agreements relating to real property. The adopted regulation creates a basis for protection of the consumer as party to a credit agreement and lays down requirements for the lending entities. In order to address the causes of the financial crisis, the legislator is developing uniform quality standards and promoting good practice among credit providers: banks, financial institutions and credit intermediaries. The EU legislator introduces specific requirements to authorize the operations of financial institutions granting loans to operate, and sets out supervisory and prudential requirements for these entities¹⁹. The need to protect non-professional financial market participants raises no objections whatsoever; on the contrary, it is the responsibility of the State²⁰. In the

Agreements for Consumers Relating to Residential Immovable Property (Directive 2014/17): a Regulatory Explanation and a Private Law Analysis, European Business Law Review, 2018, p. 33 and in PELLECCCHIA, *La direttiva 2014/17 sui contratti di credito ai consumatori relative a beni immobili residenziali*, Banca borsa, 2016, I, p. 206.

¹⁸Weakness of the single financial market was confirmed by the 2011 Report, http://ec.europa.eu/internal_market/finservices-retail/docs/policy/eb_special_373-report_en.pdf (accessed on 5.05.2018)

¹⁹Cf. Recital 8 of Directive 2014/17/EU

²⁰It is derived directly from EU and Member States' internal legislation and case law: Article 169 TFEU, case law - see judgment of the Court of Justice on the supervision of credit costs, Case C-602/10; Article 76 of the Polish Constitution: 'Public authorities shall protect consumers, users and tenants from activities that endanger their health, privacy and safety, and from unfair market practices'. See also: Corte di Giustizia, Sentenza del 17/12/2015, Neptune Distribution c. Ministre de l'Économie, sulla tutela del consumatore e l'obbligo di fornire indicazioni nutrizionali e sulla salute dei prodotti alimentari (<http://www.Federalismi.it/AppIOpenFilePDF.cfm?artid=31076&dpath=document&dfile=29122015180027.pdf&content=Corte+di+Giustizia,+Sentenza+del+17/12/2015,+Neptune+Distribution+c.++Ministre+de+l%E2%80%99% C3%89conomie,+sulla+tutela+del+consumatore+e+l%27obbligo+di+fornire+indicazioni+nutrizionali+e+sulla+salute+dei+prodotti+alimentari+-+unione+europea+-+documentazione+-+>; accessed

area of the financial market, mortgage borrowers undoubtedly face greater risk than those taking out consumer loans. The decision to take out a loan for the purchase of residential property is made only a few times, at best, in the life of an average citizen. This is a decision requiring particular consideration in view of the multi-annual repayment period²¹. A mortgage loan does not mean only that the consumer will be bound by a contract with a bank, but also, and above all, she will be tied to a property and its location, which becomes the consumer's center of life. A credit-financed purchase of immovable property results in a number of restrictions for the consumer with regard to changing the place of residence, work and family relations. Establishing such real estate credit collateral - an apartment in which the borrower usually lives – means that this type of agreement requires special protection of the bank's customer²².

Moving from the *expresse* declarations of the text to a quick interpretation of the intents as they emerge from the rules, we can say that the Directive has two main macro-economic goals. On one side it tries to create in the consumers a climate of trust towards the financial system at large, supporting a relevant sector of the EU economy. The trust is built ensuring a (perhaps paternalistic) protection to the customer who is granted a number of rights, part of which will be discussed hereinafter, to be exercised during the negotiation and formation of the agreement, thus burdening the creditor and the advisor, if any, with rules of conduct²³. A by-product, which will not be discussed here, of this attitude in protecting the consumer, is the requirement for Member States to foster the financial education²⁴. On the other side of the coin, the Directive intends to prevent a systemic

on 5.5.2018).

²¹See PACHUCA-SMULSKA, *Prawo nabywcy do informacji jako podstawa ochrony jego interesów*, [in:] *Działalność deweloperska w praktyce obrotu gospodarczego*, edd. M. Królikowska-Olczak, A. Bieranowski, J. J. Zięty, Warsaw 2014, p. 29.

²²See also: TERESZKIEWICZ, *Obowiązki informacyjne w umowach o usługi finansowe. Studium instrumentów ochronnych w prawie prywatnym i prawie unijnym*, Warsaw 2015, p. 43.

²³See CALVO, *Le regole generali di condotta dei creditori, intermediari e rappresentanti nella Direttiva 2014/17*, *Corr. Giuridico*, 2015, p. 823.

²⁴See PATTI, *L'educazione finanziaria e la direttiva 2017/17/UE (sui contratti di credito ai consumatori relativi a beni immobili residenziali)*, *Contratto e impresa*, 2015, p. 1423.

risk, the increasing inability of the borrowers to repay the lenders²⁵.

A further goal, as evidenced by the rules including the refurbishment of existing houses and of the partly residential real estate in the scope of the Directive, might be identified more than in helping the purchase of the home in helping the spending within the Union²⁶.

Better protection of mortgage borrowers is therefore to be achieved by Directive 2014/17/EU. Member States were required to prepare by 21 March 2016 a regulation implementing the provisions of Directive 2014/17/EU, which requires, in accordance with Article 2(1) of Directive 2014/17/EU, the minimum harmonization, but under Article 2(2) it also introduces maximum harmonization with regard to the provisions of Article 14(2) and Annex II, Part A²⁷.

4: 4.1. According to Article 169(1) TFEU and Article 12 TFEU²⁸ (horizontal clause) as well as Article 38 CFR²⁹, the EU legislator is obliged to ensure that a high level of consumer protection is taken into account in all EU policies³⁰. However, despite such high requirements for consumer protection regulations, no one-size-fits-all model of consumer protection has been developed that would be common to all EU Member States. Each country builds its own model based on the existing provisions laid down in the Directives, which rely both on minimum and maximum harmonization, as well as on regulations that involve provisions requiring special attention and therefore, direct application.

Three basic models of consumer protection in the financial market can be

²⁵On the "dual nature" of the Directive PAGLIANTINI, *Statuto dell'informazione e prestito responsabile nella direttiva 2014/17/UE (sui contratti di credito ai consumatori relativi a beni immobili residenziali)*, Contratto e impresa – Europa, 2014, p. 523.

²⁶See PIRAINO, *Il patto marciano alla luce della disciplina del credito immobiliare ai consumatori*, Giur. it., 2017, p. 1746.

²⁷The method adopted for the integration of the European Union banking market is minimum harmonization, based on Article 114 TFEU (former Article 95 TEU). More on harmonization methods: D. Wojtczak, *Usługi bankowe w regulacjach Unii Europejskiej*, Warsaw 2012, p. 69-81, 108-122; A. Kunkiel-Kryńska, *Metody harmonizacji prawa konsumenckiego w Unii Europejskiej i ich wpływ na procesy implementacyjne w państwach członkowskich*, Warsaw 2013.

²⁸Treaty on the Functioning of the European Union

²⁹Charter of Fundamental Rights of the European Union

³⁰Article 38 of the Charter of Fundamental Rights of the European Union, ed. Wróbel 2013, published by D. Miąsik (Legalis)

identified in the European Union: French, Italian and Polish. The French model is consolidated and brings all consumer protection together in the Consumer Code³¹ (including financial market regulations, although it still refers to the provisions of the Code monétaire et financier)³². In the Italian model, which also sought to codify consumer protection in 2006, the Consumer Code was adopted. However, the regulation of consumer protection in the credit services market was laid down in the Consolidated Act on Banking Law (TUB)³³, the said solution being conducive to better protection of consumers in this market. The Polish protection model is, in comparison with those referred to above, the most scattered and is included in various legal acts³⁴, which does not foster effective consumer protection. These regulations are both of a private law nature (civil code) and a public law nature (the Act on Competition and Consumer Protection); regulations in selected areas are overlapping and intermingled.

4.2. Directive 2014/17/EU on credit agreements for consumers relating to residential immovable property and amending Directives 2008/48/EC and 2013/36/EU and Regulation (EU) No 1093/2010, the so-called Mortgage Credit Directive (hereinafter MCD)³⁵ introduced a number of essential amendments to the EU legislation in the area of consumer credits offered in the real estate market³⁶.

³¹Code de la consommation [https://www.legifrance.gouv.fr/affichCode.do?cidTexte= LEGITEX T000006069565](https://www.legifrance.gouv.fr/affichCode.do?cidTexte=LEGITEX T000006069565) (20.06.2018)

³²Text by Lemonier and Mariański.

³³Testo Unico Bancario: Decreto legislativo 1° settembre 1993, n. 385, Testo unico delle leggi in materia bancaria e creditizia, as amended..

³⁴Act of 23 April 1964 – Civil Code (consolidated text: Journal of Laws 2017 item 459, as amended) (Art. 384–385³); Act of 16 February 2007 on Competition and Consumer Protection (consolidated text: Journal of Laws 2017 item 229, as amended); Act of 30 May 2014 on Consumer Rights (consolidated text: Journal of Laws 2017 item. 683, as amended) (Art. 39–43); Act of 23 August 2007 on Combating Unfair Market Practices (consolidated text: Journal of Laws 2017 item 2070); Customer Credit Act of 2 May 2011 (consolidated text: Journal of Laws 2016 item 1528, as amended); Act of 5 August 2015 on Complaint Handling by Financial Market Entities and on the Financial Ombudsman (consolidated text: Journal of Laws 2017item 2270, as amended); Act of 23 September 2016 on Out-of-Court Settlement of Consumer Disputes (Journal of Laws 2016 item 1823).

³⁵OJ L 60, 28.2.2014, p. 34-85.

³⁶An examination of the definitions contained in the Directive 2008/48/EC vis-à-vis the ones in the Directive 2014/17/EU, as well as the notable variations between them, in FERRETTI, *Contratti di credito ai consumatori relativi a beni immobili residenziali: prime osservazioni sulla direttiva*

The amendments can be divided into two basic groups:

(a) provisions concerning pre-contractual and contract performance information to the consumer with respect to credit for the purchase of immovable property, with the aim of improving the level of counterparty protection and strengthening appropriate safeguards for the assessment of consumers' creditworthiness;

(b) provisions on sales and the conclusion of mortgage credit agreements, in particular through external entities operating outside the bank (agents and brokers).

The EU legislator has required Member States to transpose the MCD into national law by 21 March 2016, by introducing those laws, regulations and administrative provisions necessary to comply with this Directive according to the principle of minimum harmonization³⁷.

Member States were free to choose how to implement the MCD³⁸. In Poland, it was implemented with some delay, in a special Act of 23 March 2017 on Mortgage Credit and on Supervision of Mortgage Credit Intermediaries and Agents (hereinafter referred to as the Mortgage Credit Act)³⁹, with the intent to comprehensively strengthen consumer protection in this market. The title of the Act emphasizes both the regulation of the mortgage credit market, and the considerable importance and even the necessity to regulate credit intermediation. Due to the lack of uniform regulation of this market, no adequate basis was provided for protecting the weakest players in the market. Until the Mortgage Credit Act was is-

2014/17/UE, *Contratto e impresa – Europa*, 2014, p. 863.

³⁷The method adopted for the integration of the European Union banking market is minimum harmonization, based on Article 114 TFEU (former Article 95 TEU). More on harmonization methods: WOJTCZAK, *Usługi bankowe w regulacjach Unii Europejskiej*, Warsaw 2012, p. 69-81, 108-122; KUNKIEL-KRYŃSKA, *Metody harmonizacji prawa konsumenckiego w Unii Europejskiej i ich wpływ na procesy implementacyjne w państwach członkowskich*, Warsaw 2013.

³⁸Article 42 of Directive 2014/17/EU The method adopted for the integration of the European Union banking market is minimum harmonization, based on Article 114 TFEU (former Article 95 TEU). More on harmonization methods: WOJTCZAK, *Usługi bankowe w regulacjach Unii Europejskiej*, Warsaw 2012, p. 69-81, 108-122; KUNKIEL-KRYŃSKA, *Metody harmonizacji prawa konsumenckiego w Unii Europejskiej i ich wpływ na procesy implementacyjne w państwach członkowskich*, Warsaw 2013.

³⁹*Journal of Laws* 2017, item 819.

sued, a number of legal acts applied in the Polish legal system in the discussed scope⁴⁰. Apart from statutory regulations, recommendations of the Polish Financial Supervision Authority, which are not generally binding legal acts⁴¹, have pertained to mortgage credits and real estate financing credits. Due to the provisions of the Banking Law Act and the scope of influence of the Polish Financial Supervision Authority, the application of the said recommendations is limited to supervised entities. Art. 138(7) of the Banking Law Act provides that measures taken under supervision may not violate agreements concluded by the bank with customers, including those persons with the status of a consumer⁴².

In contrast to Polish law, the Italian legislator has chosen a model of implementation that integrates the Directive into the existing legal system, which requires folding the new regulations into the existing provisions. The Mortgage Credit Directive has been implemented into Italian law by the Legislative Decree of 21 April 2016, N. 72 (hereinafter “Decreto Mutui”)⁴³. It has introduced a number of amendments and additions to the Italian legal system. In particular, it introduced new provisions in the Consolidated Banking Act of 1 September 1993, TUB N. 385 (the so-called Testo Unico Bancario, hereinafter “TUB”), i.e. it supplemented the Act with a new Chapter I bis ‘Consumer Real Estate Loans’ as a part of Title VI “Transparency of Contract Terms and Conditions and Customer Relationships” (Articles from 120 quinquies to 120 noviesdecies). Despite the changes made to the current regulation, it was widely criticized. The scholarly debate in Italy is dominated by the view that the implemented directive is in line with the process

⁴⁰ Act of 23 April 1964 – Civil Code, Act of 6 July 1982 on Land and Mortgage Registers and Mortgages, Consumer Credit Act of 12 May 2011, Act of 29 August 1997 – Banking Law, Act of 21 July 2006 on Financial Market Supervision, Act of 5 August 2015 on Complaint Handling by Financial Market Entities and on the Financial Ombudsman (consolidated text: Journal of Laws 2017item 2270, as amended)

⁴¹Mortgage-backed loans are subject to Resolution No. 148/2013 of the Polish Financial Supervision Authority dated 18 June 2013 regarding the issuance of Recommendation “S” on good practices in the management of mortgage-backed credit exposures. A set of good practices concerning credit exposures financing real estate which are not secured with a mortgage is contained in Resolution No. 59/2013 of the Polish Financial Supervision Authority dated 26 February 2013 regarding the issuance of Recommendation “T” on good practices in risk management of retail credit exposures.

⁴²The rationale behind the bill – Polish Parliament paper 1210.

⁴³Published on 20 May 2016, Gazzeta Ufficiale no. 117/2016 (Decreto Mutui).

of partial fragmentation (“scissione parziale”) of the regulation in the area of transparency of banking regulations⁴⁴. Decreto Mutui also amended the Decree of 13 August 2010, No. 141 on the regulation of credit intermediaries (financial intermediaries and credit brokers, etc.), which was also incorporated into TUB and is included in Title VI bis on the regulation of financial advisors and credit intermediaries (Articles 128 quarter and 128 sexies TUB). In the case of Italy, many of the legislative solutions introduced by the Mortgage Credit Directive had already been in place⁴⁵.

The MCD, as well as the Mutui Decree and the Polish Act on Mortgage Credit and Supervision, lay down the principles of advertising and information to be provided to consumers prior to the conclusion of a contract, as well as rules on verifying of the borrower’s creditworthiness and evaluating the collateral that establish the borrower’s credit. They also provide the rules for remuneration and the professional qualifications of staff. In addition, the rules also apply to loans denominated in foreign currencies, consumer credit advisory services, sales of credit agreements as well as other financial products, and determine the consequences of their non-performance.

4.3: 4.3.1: 4.3.1.1. The discussed Directive does not define the consumer specifically, but refers to the definition in Article 3(a) of Directive 2008/48/EC of 23 April 2008 on credit agreements for consumers⁴⁶. According to Directive 2008/48/EC, a consumer is a natural person who, in transactions covered by this Directive, is acting for purposes which are outside his trade, business or profes-

⁴⁴See CIVALE, *La nuova disciplina del credito immobiliare ai consumatori*, http://www.diritto bancario.it/sites/default/files/allegati/civale_f_la_nuova_disciplina_del_credito_immobiliare_ai_consumatori_2016.pdf (accessed on 5.05.2018)

⁴⁵The provisions of the Directive already in force in Italy are as follows: Art. 5, Art. 9, Art. 12, Art. 25, Art. 28, Art. 29, Art. 30, Art. 31, Art. 32, Art. 34, Art. 35, Art. 38, Art. 41.

⁴⁶The Polish Consumer Credit Act (implementing Directive 2008/48/EC) defines the consumer in Article 5 and at the same time refers to the provisions of Art. 22⁽¹⁾ of the Civil Code. The definition of a consumer prior to the 2014 amendment was criticized by: B. Gnela, *Pojęcie konsumenta w prawie wspólnotowym i prawie polskim*, [in:] *Ochrona konsumenta usług finansowych*, ed. B.Gnela, Warsaw 2007, p. 33 ff.

sion⁴⁷. The problem arises in dual nature contracts where the contract is concluded for purposes which are partly related to his trade. When the economic purpose of a contract is not predominant, a natural person in the light of the preamble should be considered a consumer⁴⁸. The EU legislator proposes to assess the situation of the individual as a consumer in dual nature contracts on a case-by-case basis, which is often questionable, in particular as to how such an assessment should be made⁴⁹.

The Italian legislature provides in Article 120-quinquies TUB for the basic legal definitions adopted for the purposes of Chapter I bis - “Consumer Real Estate Loans” under Title VI TUB. In the definitions adopted specifically for this part of the regulation, the legislator has applied the general reference in item (a) to the Italian Consumer Code⁵⁰ which applies to unregulated matters and to all references, while in item (b) it introduces a definition of consumer for the purposes of Capo I bis, according to which a consumer means a natural person who is acting for purposes which are outside his trade, business or craft, and thus points out that special protection applies only to the consumers in the context of their consumer activity⁵¹. The Polish legislator does not directly specifically define a con-

⁴⁷Cf. Tiziana Rumi, *La direttiva 2014/17/UE sul credito relativo agli immobili residenziali*, [in:] *Le operazioni di finanziamento bancario, societario, sull'estero, al consumatore, strutturato, a mezzo garanzia, pubblico*, Francesco Galgano, Panzarini, Dolmetta, Patriarca (edd.). Bologna 2016, p. 633-634.

⁴⁸Recital 12 of Directive 2014/17/EU, similarly in Recital 17 to Directive 2011/83/EU. More on the notion of the consumer see: PACHUCA-SMULSKA, *Działalność deweloperska*, ed. J. Zięty, M. Królikowska-Olczak, A. Bieranowski, Warsaw 2014, p. 27-28

⁴⁹Such a solution should be assessed critically, sharing the view of W. J. Katner, *Wstępne uwagi na temat nowych przepisów o ochronie praw konsumenta w zakresie rękojmi i gwarancji przy sprzedaży*, *Ustawa o prawach konsumenta*, Warsaw 2015, p. 266, More on the definition of the consumer see: M. Sieradzka, *Konsument w świetle ustawy o prawach konsumenta – czy zmiany idą w dobrym kierunku*, *Ustawa o prawach konsumenta*, Warsaw 2015, p. 251.

⁵⁰Development of the consumer protection system in Italy, just like in Poland, is significantly influenced by the legal regulations in force in the EU. The adoption of EU law is confirmed by the Italian Consumer Code, in force since 23 October 2005, adopted in the form of Legislative Decree no. 206 on 6 September 2005. For more on this, see: P. Marchetti, L.C. Ubertazzi (edd.), *Commentario breve alle leggi su proprietà intellettuale e concorrenza*, Padua, Cedam, Sesta ed., 2016, p. 2663 ff. See also: B. Pachuca-Smulska, *Ochrona konsumenta we Włoszech w świetle implementacji dyrektywy 2011/83/UE o ochronie konsumentów*, edd. D. Karczewska, M. Namysłowska, T. Skoczny, [w:] *Ustawa o prawach konsumenta*, Warsaw 2014, s. 57-74.

⁵¹For more on this, see: ALPA, GAGGERO, *Commentary to Art. 121 TUB*, *Commentario al Testo unico delle Leggi in materia bancaria e creditizia*, diretto da Francesco Capriglione, vol. III, Quarta

sumer in Article 4(7) of the Act on Mortgage Credit and on Supervision of Mortgage Credit Intermediaries and Agents, but rather refers to the universal definition adopted for the entire Polish legal system, limiting the consumer to natural persons acting for purposes not related to the economy and defined in Article 22¹ of the Act of 23 April 1964 - Civil Code⁵². The provisions regulating consumer protection both in Poland and in Italy are to be interpreted on the basis of EU legislation and jurisprudence. According to Recital 12 of Directive 2014/17/EU, if it is a dual nature contract, the position of the consumer in the contract shall be assessed on a case-by-case basis. The need to assess each time whether a consumer or an entrepreneur is involved has been confirmed by the Court of Justice [on the entrepreneur (here: lawyer) treated as a consumer when concluding a credit agreement] - judgement of the Court of Justice of 3.9.2015, C-110/14⁵³. In Polish scholarly debate, two positions - a broad and narrow one - can be identified. B. Paxford takes a narrow view of the term, by considering a consumer as a natural person who carries out a legal act for a purpose directly outside his business or profession⁵⁴. The broader approach taken by M. Korpalski⁵⁵, however, points out that small entrepreneurs should enjoy consumer-specific protection because of information asymmetries and the fact that they are in a much weaker position in their

edizione, Padua, Wolters Kluwer, Cedam, 2018, p. 2121-2132. Cf. P. Cottafavi, *Commentary to art. 1*, in MARCHETTI, UBERTAZZI, *Commentario breve*, p. 2664–2665 and the jurisprudence referred to therein. Cf. also: DI PIRRO, *Le nuove procedure*, p. 25. [??] On the basis of the jurisprudence, the situation of a small entrepreneur is the subject of a number of judgments, including i.a. judgment of the Supreme Court of 25.07.2001 (10127/01), according to which the assessment of a natural person and his/her contract should be decided on a case-by-case basis. See also judgments of the Supreme Court of 14.4.2000, 4843/2000 and 15475/2004.

⁵²Art. 22¹ The consumer shall be deemed to be any natural person who performs acts in law with an entrepreneur, said acts not being directly connected with his economic or professional activity.

⁵³Legalis, *Horăbiu Ovidiu Costea v. SC Volksbank România SA.*, <http://eur-lex.europa.eu/legal-content/PL/TXT/PDF/?uri=CELEX:62014CJ0110&from=PL>. See also: P. Bogdanowicz, *Prawnik to też konsument*, <http://www.rp.pl/Rzecz-o-prawie/309199987-Prawnik-to-tez-konsument-stwierdzil-Trybunal-Sprawiedliwosci-UE.html>, accessed on 2.04.2018; A. Cholub, *Adwokat to też konsument, stwierdził Trybunał Sprawiedliwości*, <http://www.adwokat-cholub.pl/aktualnosci/49-adwokat-to-tez-konsument-stwierdzil-trybunal-sprawiedliwosci-unii-europejskiej.html>, accessed on 2.04.2018.

⁵⁴Cf. PAXFORD, *Legalis Ustawa o kredycie hipotecznym oraz o nadzorze nad pośrednikami kredytu hipotecznego i agentami. Komentarz*. Warszawa, 2018.

⁵⁵See KORPALSKI, "Nieprofesjonalista" czyli kodeks cywilny pomiędzy konsumentem a przedsiębiorcą, *Forum Prawnicze* 2012, issue 8, p. 23–24

relations with entrepreneurs and cannot negotiate the terms of their contracts. In case of loans for residential properties and micro-entrepreneurs, working within their own residential property is often the only option. The authors share this position. It is worth emphasizing recent systemic changes introduced into the Polish law, which provide a more comprehensive protection for the smallest entrepreneurs. New regulations have been introduced by the Business Constitution⁵⁶, which is designed to assist small and micro-entrepreneurs in particular in running their businesses. Despite these changes, the definition of a consumer from Article 22¹ of the Civil Code has not been changed.

4.3.1.2. The personal scope of ‘creditor’ according to Directive 2014/17/EU should apply to the creditor or credit intermediary who grants or promises to grant credit, irrespective of whether it is a legal or a natural person⁵⁷. In the preamble to Directive 2014/17/EU, the EU legislator indicates that it does not restrict the rights of Member States to designate as creditors only legal persons (or certain types of legal persons) under EU law⁵⁸. As a minimum harmonization measure, in the Polish legal system a model has been adopted wherein a mortgage lender in accordance with Article 4(8) may be an entity which is subject to the regulation included in the Banking Law Act of 29 August 1997⁵⁹. The legislator has adopted a closed list in which it indicates: a domestic bank⁶⁰, a branch of a foreign bank⁶¹, a credit institution⁶², a branch of a credit institution⁶³ as well as a coopera-

⁵⁶Business Constitution, four Acts: ustawa z dnia 6 marca 2018 roku, Prawo Przedsiębiorców, Journal of Laws Dz. U. poz. 646; Ustawa z 6 marca 2018, o Rzeczniku Małych i Średnich Przedsiębiorców, Journal of Laws Dz.U. 648;ustawa z dnia 6 marca 2018, o zasadach uczestnictwa przedsiębiorców zagranicznych i innych osób zagranicznych w obrocie gospodarczym na terytorium Rzeczypospolitej Polskiej, Journal of Laws Dz. U. 649; ustawa z 6.03.2018, o Centralnej Ewidencji i Informacji o Działalności Gospodarczej i Punkcie Informacji dla Przedsiębiorcy, Journal of Laws Dz. U. 647.

⁵⁷The definition of a credit institution results directly from Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms.

⁵⁸Recital 10 of the Directive opens up the possibility for a number of entities to grant credits which until now have not been able to become lenders.

⁵⁹Journal of Laws 1997 No 140 poz. 939

⁶⁰Art. 4(1)(1) of the Act of 29 August 1997 – Banking Law,

⁶¹Art. 4(1)(20) of the Act of 29 August 1997 – Banking Law.

tive credit union (SKOK), which in its scope of activity may grant mortgage loans to consumers. Thus, the personal scope is limited to entities supervised by the state (the Polish Financial Supervision Authority) on the basis of strictly defined rules. The restriction of the personal scope to creditors under Article 4(8) is confirmed by Article 5 of the Polish Act, which strictly prohibits entities other than those listed therein from carrying out this type of business activity. The new regulation prevents mortgage lending by other entities (i.e. loan institutions operating in the domestic market as well as non-banking loan companies operating in other Member States), which are not lenders within the meaning of the discussed regulation and cannot grant mortgage credit⁶⁴. The adopted solution prohibits the operation in the mortgage lending market of entities operating outside the strict supervision of the Polish Financial Supervision Authority (KNF) and related reporting requirements. This, in turn, is intended to safeguard financial stability and is also important in terms of the effectiveness of macroprudential tools⁶⁵. Restricting the personal scope is intended to minimize risks and strengthen the protection which is the objective of Directive 2014/17/EU. The restriction on the freedom of establishment introduced by Article 49 of TFEU is admissible insofar as it is justified on the grounds set out in Article 52(1) of TFEU, i.e. ‘overriding reasons of public interest’. As ‘overriding reasons of public interest’ which could justify a derogation from the freedom of establishment, the Court of Justice of the European Union has held i.a. consumer protection. It is also clear from the jurisprudence of the Court of Justice that national legislation may constitute a legitimate restriction on one of the fundamental freedoms if it is justified by reasons of an economic nature serving purposes of general interest. It should be noted that it is not possible to ensure a level of consumer protection in the non-banking sector that would be adequate to the situation of customers of banking entities operating in the finan-

⁶²Art. 4(1)(17) in conjunction with Art. 4(1)(21) of the Act of 29 August 1997 – Banking Law.

⁶³Art. 4(1)(18) of the Act of 29 August 1997 – Banking Law.

⁶⁴Polish Parliament paper 1210 part II, p. 263.

⁶⁵As applied under the Act of 5 August 2015 on Macroprudential Supervision of the Financial System and Crisis Management in the Financial System.

cial market. Banking entities are subject to specific public-law requirements, in particular of a prudential nature, which are imposed on banking entities and result from relevant EU law standards implemented in the national legal order, as well as from EU legislation directly applicable to such entities⁶⁶.

Contrary to the Polish solution, in the Italian system the creditor (*finanziatore*) is defined in Article 120-quinquies e) TUB in a broad way. The creditor shall be a body that, being authorized to provide professional financing in the territory of the Italian Republic, offers or enters into credit agreements, which basically means that banks (Articles 1.1 b) and 10 TUB) and supervised *finanziarie* intermediaries (Article 106 TUB) qualify.

Application of the minimum implementation allowed for the introduction of a more restrictive regulation into Polish law and thus a better adaptation to the national requirements, including more comprehensive consumer protection.

4.3.2: 4.3.2.1. Directive 2014/17/EU introduced in Article 4 a number of concepts important for the implementation of the new regulation, including a general definition of credit agreement. In the Italian system, the concept of credit agreement was introduced in Article 120 quinquies (1)(c) TUB. This term was defined more specifically by indicating directly the loan asset. A 'credit agreement' is defined in TUB as one by which the lender grants or undertakes to grant to the consumer a credit in the form of a deferred payment, a loan or another financial facility, where the credit is secured by a mortgage on real estate or other real estate property rights, or is taken to acquire or retain title to land or to constructed or planned property. This definition is open. The concept of credit agreement is clarified by the exemptions to Article 3 MCD, transposed into Article 120 sexies TUB.

In the Polish Act, no definition of credit can be found in the glossary. However, the notion is introduced in a separate provision of Article 3(1) of the Act on

⁶⁶Polish Parliament paper 1210 part II, p. 264.

Mortgage Credit, wherein the mortgage credit agreement is defined in a broad yet very precise manner. A mortgage credit agreement within the meaning of the discussed regulation is a 'contract whereby a creditor grants or promises to grant to the consumer a credit secured by a mortgage or another right related to residential immovable property, or intended to finance the purchase of immovable property not related to commercial activity or operation of an agricultural farm, to acquire or retain: (1) title to a residential building or residential premises constituting a separate immovable property, as well as their construction or conversion within the meaning of Art. 3 (6) and (7a) of the Act of 7 July 1994 – Construction Law (consolidated text: Journal of Laws 2017 item 1332, as amended); 2) cooperative title to the premises; 3) title to a land property or a part thereof; 4) share in the co-ownership of the residential building or residential premises constituting a separate immovable property, or share in a land property'. In Article 3(1)(2) of the Polish Act, the cooperative title to residential premises was included, which is known only in the socialist systems. This is a limited right in rem which comprises two basic rights: the right to use the premises and the right to dispose of one's right. The cooperative title to residential premises is transferable, it passes to the heirs and is enforceable. Since 31 July 2007 it has no longer been possible to establish a cooperative title to the premises⁶⁷. The extension adopted is in line with the Directive, as it meets its objective, which is to secure the place of residence of the consumer as a borrower, and the property is designed to satisfy the consumer's housing needs.

Until the adoption of the Act on Consumer Mortgage Credit, the concept of a mortgage credit agreement was not a statutory concept and resulted only from the position of the doctrine. The terms 'mortgage credit' or 'mortgage credit agreement' are not even used in the Act on Mortgage Bonds and Mortgage

⁶⁷The cooperative title to the premises was regulated by the Act of 15 December 2000 on Housing Cooperatives. Currently, work is under way to equalize this right with ownership. For more on this, see: IGNATOWICZ, STEFANIUK: *Prawo rzeczowe*. Warsaw: LexisNexis, 2012, p. 249-252.

Banks⁶⁸, while Article 2 of the Polish Act, like Article 3 of the MCD, provides for exemptions from the application of the mortgage credit agreement.

The material scope of Directive 2014/17/EU indicated by the legislator already in the title of the Directive clearly specifies that it applies to credit agreements secured by a mortgage or some comparable collateral and credit agreements intended to finance the acquisition or retention of residential property. The regulation refers to real estate which is to be used for housing purposes, and not for economic purposes. It also applies to the land on which the houses will be built. The regulation's material objective is fully achieved by each Member State, but is adapted to their respective legal systems as a minimum harmonization measure. Another issue is loans for the renovation of real estate used for housing purposes, which are also covered by Directive 2014/17/EU⁶⁹. According to the provisions, the scope of regulation under Article 3 of the MCD may take into account the needs of the national legislator. Residential property, to which the Directive applies, will *a priori* be used by the consumer for residential purposes. Therefore, it is no longer necessary to verify whether no economic activity is involved. However, in specific cases, reference should be made to the subject of the contract, the purpose of which is the purchase of property serving the consumer and their family as their place of residence⁷⁰. However, one should consider a situation where the consumer lives in the property but a part of it is used for business purposes, e.g. one room in the apartment is the place of office work or the garage partially serves as a repair shop. However, the main purpose of the purchased property is to satisfy the consumer's housing needs. In such a situation, according to the authors, the real estate is used primarily for the purposes indicated in the discussed regulation, and thus the borrower should be considered a con-

⁶⁸Article 12(1) of the Act of 29 August 1997 on Mortgage Bonds and Mortgage Banks (consolidated text: Journal of Laws 2016, item 1771), according to which one of the basic activities of mortgage banks is granting loans secured with a mortgage.

⁶⁹Art. 3(1) of Directive 2014/17/EU

⁷⁰Cf. Recital 13 of Directive 2014/17/EU.

sumer⁷¹. In its implementation of the Directive, the Italian legislator exercised its right to extend the material scope of the regulation to credit agreements relating to real estate other than residential property, extending it explicitly to garages or land, which are usually an integral part of residential property⁷².

However, it should be stressed that, in principle, unsecured credit agreements aimed at the restructuring of residential immovable property should not be subject to regulation⁷³. The EU legislator referred to them in Recital 18 of the Preamble and in Article 46 of Directive 2014/17/EU and made reference to the provisions of Directive 2008/48/EC. In the case of contracts for the renovation of residential property, credits are governed by the provisions of the Consumer Credit Directive 2008/48/EC. The renovation of a property is not part of the objectives of the loan, that is to say, it does not serve either to acquire or to retain property rights, even if it serves to increase the value of the residential property. Minimum implementation has also allowed Italy to adopt a broad definition of the subject of the contract⁷⁴, which consequently favors the use of the consumer mortgage to meet housing needs under other legal titles, such as real estate leasing or apartment rental⁷⁵.

4.3.2.2. A new concept in both EU and Member State legislation is that of a ‘foreign currency loan’. Although it is a well-known and practiced instrument, it was not legally defined in EU legislation until 2016⁷⁶. In the period preceding the financial crisis, there was a sharp increase in sales of loans denominated in foreign currencies in Europe. Borrowing in a currency other than the one in the country of

⁷¹See also the section on personal scope, cf. B. Pachuca-Smulka, *Ochrona praw konsumenta w świetle wybranych rozwiązań dyrektywy 2014/1UE w sprawie konsumenckich umów o kredyt związany z nieruchomościami mieszkalnymi*, [in:] *Sprzedaż konsumencka*, M. Jagielska, K. Podgórski, Warsaw 2015, p.

⁷²Art. 120-*sexies* TUB.

⁷³See Rec. 18 of the Preamble and Art. 46 of Directive 2014/17/EU, in Italy - Art. 120-*sexies* (1)(h) TUB.

⁷⁴Art. 120-*sexies* TUB.

⁷⁵Art. 120-*sexies* (1)(h) TUB.

⁷⁶In Polish law, Article 69(3) of the Banking Law includes a provision on a credit agreement denominated in or indexed to a currency other than the Polish currency.

residence became particularly attractive due to favorable financing conditions and large interest rate differentials⁷⁷. Foreign currency lending in the real estate market has been the most common form of consumer lending in the new non-euro area Member States, in particular in Hungary⁷⁸ and Poland⁷⁹. To a lesser extent, these loans were also granted in Croatia, Slovenia, Serbia and Romania. However, on the EU map there is one exception to this rule. Among the 'old' euro area Member States, the country with the highest proportion of such loans is Austria⁸⁰. Italy, on the other hand, has been affected to a very limited extent⁸¹. Foreign currency lending poses a risk of exchange rate fluctuations which may affect borrowers' ability to repay foreign currency-denominated debt. The use of such loans requires borrowers, lenders and intermediaries to properly assess the risk involved.

[mutui in ECU e in CHF]

Foreign currency loans pose a risk to every borrower because the loan value changes as a result of exchange rate fluctuations. As a consequence, the lender may not obtain the repayment of the borrowed funds, but evict real estate collateral. Another risk related to foreign currency loans is the risk of a decrease in the value of real estate, as expressed in the foreign currency, in particular below the loan amount. When loans are granted on a large scale, a problem with repayment may arise for a very large number of borrowers, and thus also for lenders. As a result of changes in exchange rates, systemic risk may occur. The significant risk associated with foreign currency loans has led the EU legislator to introduce new so-

⁷⁷See Recital 4 of Directive 2014/17/EU

⁷⁸See "The Economist" 2014, November 15, <http://www.economist.com/news/finance-and-economics/21632651-hungarys-government-gives-struggling-borrowers-break-forint-exchange> (accessed on 20 May 2018)

In Hungary, mortgage loans taken out between 2005 and 2007 in the form of indexation/valuation to the Swiss franc (CHF) or denominated in that currency were automatically converted into forint (HUF) in March 2015.

⁷⁹Central Europe and the Swiss franc, Currency risk, 15 January 2015 <https://www.economist.com/news/2015/01/15/currency-risk>

⁸⁰See the official position of the Austrian Financial Market Authority (Österreichische Finanzmarktaufsichtsbehörde, FMA) on foreign currency loans: Position der Finanzmarktaufsicht zu Fremdwährungskrediten und Informationen zur derzeitigen Lage, <https://www.fma.gv.at/de/sonderthemen/fremdwaehrungskredite.html> (accessed on 20 May 2018)

⁸¹ Statistical data indicated in the Banca di Italia document, Normativa secondaria di attuazione della Direttiva mutui (MCD), https://www.bancaditalia.it/compiti/vigilanza/normativa/consultazioni/2016/direttiva-credito-immobiliare/AIR_trasparenza.pdf (accessed on 12 May 2018).

lutions for better consumer protection, both by raising awareness of the risk involved through the need and even necessity for broad education, and by reducing exposure to currency risk⁸².

4.3.2.2.1. The issue of foreign currency loans in Poland⁸³ has its origins in 2000, when the Monetary Policy Council decided to increase interest rates to 19% (compared to 14% in September 1999)⁸⁴. Many borrowers started looking for more favorable sources of financing. At that time, the reference rate in Switzerland was only 1.75%. As a result, many borrowers decided to take out a loan in Swiss currency and counted on ever lower installments, which in the face of a long-term loan appeared to be an advantageous solution. The weakening franc and growing zloty also resulted in an artificial increase in creditworthiness and a chance to obtain a higher loan for those borrowers who had not previously had adequate financial capacity. Borrowers were encouraged to use loans in Swiss francs by sellers - credit 'pseudo-advisers'. This credit policy was negatively assessed by the Polish Financial Supervision Authority (KNF). In 2006, KNF issued Recommendation S obliging the borrower to read detailed information and sign a document confirming his/her awareness of credit risk before concluding such a loan agreement. On the other hand, the recommendation obliged banks to reliably and precisely inform their customers about possible risk⁸⁵. Despite the restrictions introduced, according to the statistics of the Polish Financial Supervision

⁸²Recital 4 and 30 of Directive 2014/17/EU

⁸³For more on this, see: JURKOWSKA-ZEIDLER, *Asymetria ryzyka a zasada sprawiedliwosci społecznej na tle problemu kredytów we frankach szwajcarskich*, Gdańskie Studia Prawnicze. Sprawiedliwość, ed. J. Zajadło, vol. XXXV, Gdańsk 2016, p. 131-153.

⁸⁴See http://www.nbp.pl/home.aspx?f=/dzienne/stopy_archiwum.html

More on the issue of foreign currency loans in Poland: TERESZKIEWICZ, *Neutral Third-Party Counselling as Nudge toward Safer Financial Products? The Case of Risky Mortgage Loan Contracts* Polish Yearbook of Law & Economics. Chapter 3, Vol. 6 (2015), ed. BEŁDOWSKI, literature referred to therein.

⁸⁵Recommendation S by the Polish Financial Supervision Authority resulted in a smaller number of loans in francs (97 thousand against 115.5 thousand in 2006). The trend desired by the Polish Financial Supervision Authority did not last long, in 2008 the price of Swiss franc was even PLN 1.95 and thus reached the lowest level in many years. http://www.knf.gov.pl/aktualnosci/2015/forum_bankowe_prezentacja.html This resulted in a situation where in 2013, the value of loans granted in CHF exceeded the value of loans granted in PLN.

Authority, in the third quarter of 2008, 63,845 loan agreements were concluded, almost all of them in Swiss currency. Despite a much smaller disproportion between the costs of loans in both currencies, in 2008 as many as 162 thousand loans were granted in francs⁸⁶, which at that time constituted 68.6%⁸⁷ of the structure of mortgage loans in Poland. In 2013, the value of loans granted in Swiss francs exceeded the value of loans granted in Polish currency⁸⁸. The release of the franc exchange rate by the Swiss National Bank on 15 January 2015⁸⁹ made the installments of such loans significantly more expensive. When granting a loan in a foreign currency, the Bank converts the loan at the currency purchase rate. When the borrower repays the loan, the bank uses the current selling rate of the currency in which the loan was granted⁹⁰. In case of loans denominated in a currency other than Polish and indexed loans, the spread is always a source of additional profits for the bank. Foreign exchange rates fluctuate constantly; the higher they are, the higher bank spread is charged⁹¹. Banks did not specify in their credit agreements how the FX spread was going to be determined. The lack of spread rules⁹² did not limit banks in any way and increased their profits at the expense of higher capital and interest repayments made by consumers⁹³. The situation of customers changed after the adoption of the so called anti-spread act⁹⁴. However,

⁸⁶See http://www.knf.gov.pl/aktualnosci/2015/forum_bankowe_prezentacja.htmlwe.

⁸⁷See http://serwisy.gazetaprawna.pl/finanse-osobiste/artykuly/782471,kredyty-we-frankach_szwajcarska-ruletka-w-ktora-zagrало-700-tys-polakow.html.

⁸⁸See https://www.knf.gov.pl/Images/prezentacja_Forum_Bankowe_11-03-15_tcm75-40763.pdf

⁸⁹See The Economist explains Why the Swiss unpegged the franc, 18 January 2015 <https://www.economist.com/the-economist-explains/2015/01/18/why-the-swiss-unpegged-the-franc> (accessed on 20 May 2018)

⁹⁰Cf. RUTKOWSKA-TOMASZEWSKA, *Ochrona prawna klienta na rynku usług bankowych*. Warsaw 2013, p. 291

⁹¹See more: PALECZNA, RUTKOWSKA-TOMASZEWSKA, *Uprawnienia kredytobiorcy zaciągającego kredyt denominowany lub indeksowany do waluty innej niż polska w świetle ustawy antyspreadowej*, *Ekonomia — Wrocław Economic Review* 24/1 (2018) *Acta Universitatis Wratislaviensis*, No 3832; s. 39 i n.

There is a view in the literature that the currency spread is an amount of commission on the sale of indexation currency that is not ascertained in the loan agreement. Cf. BURZYŃSKA, *Ustawa antyspreadowa*, [in:] W. Góralczyk, *Problemy współczesnej bankowości. Zagadnienia Prawne*. Warsaw 2014, p. 104).

⁹²See OFIARSKI, *Prawo bankowe. Komentarz*. Warsaw 2013, p. 489.

⁹³See Sroczyński, *Szok frankowy*. *Wiedzieliście*, http://wyborcza.pl/magazyn/1,143016,17302190,Szok_frankowy_Wiedzieliscie.html (accessed on 25 May 2018).

⁹⁴The Act of 29 July 2011 on Amending the Banking Law Act and Certain Other Acts (*Journal of*

this was not the end of problems for borrowers of foreign currency loans. The release of the franc exchange rate resulted in an increase in the amount of installments and serious difficulties with repayment for many households, which in early 2015 resulted in the emergence of a social group directed against banks, associating borrowers in foreign currencies, the so-called *'frankowicze'*⁹⁵. This began a wave of criticism of banks for granting loans denominated in or indexed to foreign currency. As a result, such practices were banned in several countries (including Poland). As a result, a large group of *'frankowicze'* decided to sue lenders; in some cases final judgments have already been passed. However, no uniform position has been adopted in jurisprudence⁹⁶. The doctrine is also divided on the assessment of foreign currency loans⁹⁷. The value of foreign currency loans is significant in the Polish banking system⁹⁸. Legislative work to address foreign currency loans granted before 2015 has been ongoing for several years, but so far no legal act has been adopted⁹⁹. Many borrowers bring legal action against the state, which in their opinion is obliged to safeguard consumer interests.

4.3.2.2.2. In Italy, the problem arose from the application of the foreign exchange risk clause, which is a financial instrument used by certain credit institutions. The clause was used not only in credit agreements, but also in other types of

Laws 2011 no. 165, item 984) For more on this, see: RUTKOWSKA-TOMASZEWSKA, Ochrona prawna klienta na rynku usług bankowych. Warsaw 2013, p. 291; BURZYŃSKA, Ustawa antyspreadowa, [in:] W. Góralczyk, Problemy współczesnej bankowości. Zagadnienia Prawne. Warsaw 2014, p. 100-108, M. Frysztak, Orzecznictwo sądowe w sprawach kredytów frankowych, [in:] SADLIK, Biała Księga kredytów we frankach w Polsce-historia i analizy. Warsaw 2015, p. 72-73.

⁹⁵See, <https://www.bankowebezprawie.pl> (accessed on 25 May 2018).

⁹⁶See the jurisprudence specified therein: <https://pomocfrankowiczom.pl/?cat=5> (accessed on 25 May 2018).

⁹⁷Analiza prawna wybranych postanowień umownych stosowanych przez banki w umowach kredytów indeksowanych do waluty obcej lub denominowanych w walucie obcej zawieranych z konsumentami, Raport Rzecznika Finansowego [Report of the Financial Ombudsman], Warsaw, June 2016 https://www.rpo.gov.pl/sites/default/files/Raport_RF_Kredyty_walutowe.pdf.

⁹⁸As on the end of December 2017 (latest data available) they amounted to ca. PLN 107.2 billion, while the total (nominal/accounting) equity of the system in the corresponding period amounted to PLN 204.3 billion. https://www.knf.gov.pl/?articleId=56224&p_id=18 (accessed on 29 May 2018).

⁹⁹See <http://www.gazetaprawna.pl/artykuly/1106124,szlachta-w-poniedzialek-podkomisja-frankowa-wznowi-prace.html> (accessed on 25 May 2018).

agreements, such as financial leasing agreements. The best known cases of using such solutions are Hypo Alpe Adria Bank and Barclays¹⁰⁰. Hypo Alpe Adria Bank included an index clause between euro and foreign currency exchange rate (Swiss franc LIBOR to the EUR exchange rate or Japanese yen LIBOR to the EUR exchange rate) in addition to the traditional structure in the financial leasing agreement. It was constructed in such a way that at each installment of the leasing fee, the amount of the lease was determined on the basis of the indexation clause, which entailed a serious risk of changes in exchange rates. For an unprofessional borrower, such risk can be difficult to understand and assess. It is therefore clear that the Bank, by including a currency clause in the agreement, sought to obtain additional financial means. The currency risk clause was drafted in such a way that it always benefited the creditor and not the customer. Key to the assessment of the Bank's FX risk clause was the judgment of the Udine Court¹⁰¹, in which it ruled that Hypo Alpe Adria Bank had committed a number of infringements. In particular, it failed to comply with its obligation to act conscientiously, fairly and transparently in the process of granting credit, which was designed to better serve the customers' interests. In addition, the Court found that there was a conflict of interest and a failure to comply with the obligations owed by the bank's employees who had not examined the customers' experience in investing in financial instruments. Clients were also not adequately informed about the nature of the risk and effects of the transaction. In the Court's opinion, the Bank failed to fulfill its obligations under the provisions of TUF (Article 6(2)(C), 21 TUF) and the implementation regulations issued by Consob no. 11522/98. Based on these assessments, the Court in Udine found that the exchange rate risk clause applied in the analyzed agreement was a serious breach of the law and obliged the Bank to repay the amounts unduly

¹⁰⁰ La clausola di rischio cambio nei contratti di leasing Hypo e l'analogia al mutuo Barclays Bank Plc; <https://www.tuconfin.it/la-clausola-rischio-cambio-nei-contratti-leasing-hypo-lanalogia-al-mutuo-barclays-bank-plc/> (accessed on 25 May 2018).

¹⁰¹ See, Judgement of the Udine Court n. r.g. 6459/2012, http://www.almaiura.it/allegati/214_UD314_2015.pdf

See also: judgement no. 263/2016 delivered on 29 February 2016.

collected¹⁰².

4.4. Recognizing the importance of the issue of foreign currency lending in some Member States, the EU legislator decided to regulate it in Directive 2014/17/EU, choosing the minimum implementation method to address it¹⁰³. The regulation of mortgage loans covers two basic issues. The first is the introduction of a legal definition of a foreign currency loan, while the second defines behavior when granting and performing a foreign currency loan agreement. The definition of a foreign currency loan is included in Article 4(28) of the Directive and, accordingly, in the Polish legislation in Article 4(23) of the Act on Mortgage Credit and in the Italian TUB in Article 120-quinquies n), referring, however, only to the 'concept of foreign currency'¹⁰⁴. According to the legal definitions, a foreign currency mortgage contract is a mortgage contract in a currency other than that in which the consumer receives income or has assets and in which the mortgage is to be repaid, or in a currency other than that of the Member State in which the consumer is domiciled. Detailed regulation of performance of a foreign currency credit agreement is included in Article 23 of the MCD. In this provision, the legislator specifically refers to the rules applicable to foreign currency lending. While the Italian legislator regulated this in Article 120-quaterdecies TUB, in the Polish Act it is included in Article 6. When implementing the MCD on specific foreign currency credit regulation, Member States were given the possibility to act by recognizing the right to conversion or by developing mechanisms to mitigate foreign currency risk. The Italian legislator has chosen to protect consumers through the first of the two options set out in Article 23 of the MCD and has recognized the right to con-

¹⁰²See, http://www.almaiura.it/allegati/214_UD314_2015.pdf, p. 3. (accessed on 29 May 2018).

¹⁰³See HOWELLS, TWIGG-FLESNER, WILHELMSSON, (edd.), *Rethinking EU Consumer Law*, Routledge London and New York 2018, p. 211.

¹⁰⁴For more on this, see: D. Maffei, *Direttiva 2014/17/UE: rischi di cambio e di tasso e valore della componente aleatoria nei crediti immobiliari ai consumatori*, in *Banca, Borsa e Titoli di Credito*, 2016, I, p. 190 ff.; R. Ferretti e A. Santoro, *Prime osservazioni sul decreto legislativo di recepimento della direttiva mutui*, www.dirittobancario.it. 2016 http://www.dirittobancario.it/sites/default/files/allegati/ferretti_r_e_santoro_a._prime_osservazioni_sul_decreto_legislativo_di_recepimento_della_direttiva_mutui_2016.pdf (accessed on 20 May 2018).

version¹⁰⁵. This right can only be exercised if certain conditions are met, in terms of the minimum exchange rate variation. In Poland, a more restrictive regulation was introduced than the one provided for in the Directive, which is reflected in Article 6(1) of the Act on Mortgage Credit. According to that provision, the creditor may grant the consumer a mortgage loan only in that currency or indexed to that foreign currency in which the consumer receives the majority of their income or in which the latter holds the majority of the funds or other assets valued in the currency in which the mortgage is granted or to which the loan is indexed. An unambiguous regulation of foreign currency loans in the Polish legal system became a necessity. This is to prevent foreign currency loans from being granted to entities that should not take such a risk. Already at the stage of applying for a foreign currency loan, the consumer is obliged to provide the creditor with documents confirming that he or she meets the above-mentioned requirements (e.g. a certificate of income or a bank statement confirming his/her savings). At the same time, the lender is obliged to indicate a specific foreign currency in the application (Article 10(1)(7) of the Act on Mortgage Credit). This restricts the availability of mortgage credit in a foreign currency with which the consumer has nothing to do.

The EU legislator ensures that consumers are protected from the very beginning when the procedure of selling a foreign currency mortgage loan is started. The solutions adopted protect the consumer already at the stage of advertising and pre-contractual information obligations under Article 11(2)(j) MCD, as also confirmed in Article 120-octies (2)(m) TUB and in Article 7(2)(9) of the Polish Act. According to these provisions, prior to granting a foreign currency loan, the consumer should be provided with basic information which should 'clearly, concisely, comprehensibly, but also intelligibly indicate that any fluctuations in the exchange rate may have an impact on the amount which the consumer may be obliged to

¹⁰⁵Art. 23(1) MCD and Art. 120 *quaterdecies* TUB. https://www.bancaditalia.it/compiti/vigilanza/normativa/consultazioni/2016/direttiva-credito-immobiliare/AIR_trasparenza.pdf (accessed on 25 May 2018).

Cf. AZZARRI, I «prestiti in valuta estera» nella direttiva 2014/17/UE sui «contratti di credito ai consumatori relativi a beni immobili residenziali», ODCC 1/2015, p. 187-226.

pay'¹⁰⁶. The measures introduced are intended to ensure that the consumer understands the information provided and is therefore also aware of the exchange rate risk which is assumed by signing a foreign currency credit agreement¹⁰⁷. The objective of introducing such a broad information obligation is to implement the principle of transparency. At the same time, it educates the borrower-consumer and encourages him/her to take informed economic decisions¹⁰⁸.

5. One of the most important problems revealed by the financial crisis was the lack of regulation of advisory services in the financial services market. This prompted the EU legislator to introduce a detailed regulation of consumer mortgage credit consultancy. Very often, loans for the purchase of real estate were granted to borrowers who were not sufficiently creditworthy. Poor advice has caused a lot of damage to consumers and reduced confidence in creditors and credit intermediaries. By the regulations introduced, the EU legislator aims to rebuild this trust¹⁰⁹. It is therefore important that uniform rules are in place in all Member States to ensure that intermediaries and advisors are genuinely independent¹¹⁰.

The EU legislator has already pointed out the need to regulate credit advice in Recitals 63 to 65 of the MCD. The text of the preamble signals the need to regulate consultancy as a service which meets certain standards and aims to provide the consumer with an offer of products which meet their needs. The key im-

¹⁰⁶Commentary on foreign currency loans by URBANI, *Commentary under Article 116*, in the Commentary to the consolidated text - banking and finance, chaired by Capriglione, Padua, 2012, Volume III, p. 1683 ff. In the wording of Article 120-octies TUB (Sabbatelli, *Commentary under Article 120-octies*, in the Commented Contract Code, cit., p. 3509 ff.) Obligation of transparency of the information provided.

¹⁰⁷See Ferretti e Santoro, *Prime osservazioni sul decreto legislativo di recepimento della direttiva mutui*, Diritto bancario, 27 May 2016, <http://www.dirittobancario.it/approfondimenti/credito/prime-osservazioni-sul-decreto-legislativo-di-recepimento-della-direttiva-mutui> (PDF p. 2).

¹⁰⁸See Cf. Massa, *Le finalità delle disposizioni normative in tema di pubblicità e marketing*, in *I mutui ipotecari nel diritto comparato ed europeo Commentario alla direttiva 2014/17/UE*, Ed. P. Sirena, Milan 2015, p. 249, (<http://elibrary.fondazione-notariato.it/pdf/I-2015.pdf>, accessed on 24 May 2018).

¹⁰⁹See DOTTORE, RIO, *Commentary to Art. 22*, [in:] *I mutui ipotecari nel diritto comparato ed europeo Commentario alla direttiva 2014/17/UE a cura di P. Sirena*, p. 401.

¹¹⁰See BENANTI, *Commentary to Art. 15*, [in:] *I mutui ipotecari nel diritto comparato ed europeo Commentario alla direttiva 2014/17/UE a cura di P. Sirena*, p. 340.

portance of advisory services and their impact on the consumer is demonstrated by the separation in the MCD of Chapter 8 exclusively dedicated to these services in Article 22 MCD. Art. 22(6) MCD introduces an obligation for Member States to limit the personal scope of advisory services to creditors, credit intermediaries or appointed representatives only¹¹¹. The new provisions are key for establishing professional and independent consultancy in the credit services market. Previously, in Poland, consultancy had not been regulated in detail, which led to many abuses. In Italy, the credit advice market was regulated in TUB, but not all of the regulatory solutions corresponded to those which should have been introduced by MCD. Article 22 MCD corresponds to Article 120 - terdecies TUB, which regulates advisory services on real estate loans offered to consumers and indicates that this is a completely optional service, independent of lending activities and should therefore be remunerated separately.

5.1. Advisory services are enumerated already in the title of the Mortgage Credit Act, which indicates the particular importance of this form of activity for consumer protection. It was therefore decided to regulate the consultancy activity in detail and to limit it to the entities holding a relevant authorization. Since 22 July 2017, entities conducting advisory activity have been required to obtain a permit from the Polish Financial Supervision Authority (KNF). In accordance with Article 48(1)¹¹², this activity requires a permit from KNF and an entry in the register of credit intermediaries. An application for a permit shall be submitted by an entrepreneur carrying out the activity of mortgage loan intermediation. KNF shall, ex officio, make an entry in the register of credit intermediaries, which shall be in force as of the date of authorization. There is an exception to the above rule: a so-called “tied credit intermediary”, who provides advice in connection with one or more lenders. Article 57(1) of the Polish Act lays down that a tied mortgage credit in-

¹¹¹See DOTTORE, RIO, *Commentary to Art. 22*, [in:] *I mutui ipotecari nel diritto comparato ed europeo Commentario alla direttiva 2014/17/UE a cura di SIRENA*, p. 401 ff.

¹¹²The Act of 23 March 2017 on Mortgage Credit and on Supervision of Mortgage Credit Intermediaries and Agents (Journal of Laws item 819).

termediary may carry on business without authorization, if it is acting on behalf of only one lender, but that in order to carry on its business, it must be entered in the register of credit intermediaries. The application for registration of such a credit intermediary is submitted by the lender (Article 57(7) of the Mortgage Credit Act). Restrictions of advisory activity introduced in Poland in the form of authorizations and supervision by KNF are to guarantee a high level of services provided by credit advisors. The Italian TUB, on the other hand, regulates the activities of independent credit advisors in Article 128-sexies, under which professional activity of credit intermediary is reserved only to those entities which are registered in a special list maintained by an 'authority' (*Organismo*)¹¹³ and regulated in Article 128-undecies. An entity entered in the register may only carry out activities provided for in that register, for which it is remunerated solely by the customer. The independence of such an intermediary is safeguarded by the absence of connections with the parties and the prohibition of simultaneous inclusion in the list of financial agents and credit intermediaries (Article 128-octies TUB).

The definition of advisory services adopted in the Directive and implemented in national laws indicates the need to tailor the offer to the consumer. The basis for the regulation is the principle of putting the customer's interest first¹¹⁴. Numerous problems in the financial market were caused by the fact that mortgage loan sellers referred to themselves as 'advisors' or 'credit advisors'. The title of 'advisor' was misleading for the consumer, who believed, according to the literal understanding of the term, that they could count on the assistance of an independent professional in choosing the best credit option. In most cases, the consumer was assisted by a seller representing one or more creditors and it was the interests of the latter that the seller-advisor actually represented. At the same time, in accordance with the Directive, Article 25(2) of the Polish Act stipulates that the term 'advisor' is prohibited for entities that are tied to the creditor. The

¹¹³The activity of the independent authority '*Organismo*' is supervised by the Bank of Italy.

¹¹⁴Art. 4(21) MCD, see also Art. 120-quinquies (1)(i) TUB. LUPOLI, *La Direttiva 17/2014, il mercato dei crediti immobiliari e la consulenza al credito*, in *Banca, Borsa e Titoli di Credito*, 2016, II, p. 234 and Art. 4(26) of the Mortgage Credit Act.

provisions introduced are intended to better protect the consumer and prevent them from being misled when advisory services are provided, for example, by entities tied to the lender. There is a concern that the tied entity may present to the consumer an offer that is most advantageous for the offering party on account of the commission received, and not most advantageous for the consumer on account of the services provided. This is explicitly regulated in Article 25(3) of the Polish Act, whereby the title of ‘independent advisor’ may be used only if the conditions set forth therein are met. Polish law allows this term to be used in the name or advertisement only if the adviser does not receive commission or other remuneration in cash or another agreed form of profit from the creditor. In addition, both the ‘independent credit advisor¹¹⁵’ and the ‘tied advisor¹¹⁶’ are required to provide the consumer with at least three offers best suited to the consumer’s situation and to recommend one in accordance with Article 27(2) and (3) of the Polish Act. Pursuant to Article 27(2) of the Mortgage Credit Act, a creditor, a tied mortgage credit intermediary or an agent of the tied mortgage credit intermediary shall be required to submit to the consumer at least three offers of mortgage credit agreements, together with an information sheet. Recommended offers of mortgage credit agreements pursuant to Article 27(3) shall take into account the specific needs, financial situation and personal circumstances of the consumer. Following the EU regulation, the institution of an independent credit advisor is regulated in Article 128-sexies (2 bis) TUB. At the same time, in Article 26 of the Polish Act, in accordance with Article 22(2) of the MCD, a catalogue of information that should be provided by the creditor, mortgage credit intermediary or agent in connection with the services provided to the consumer has been specified. The entity providing advisory services is obliged to present the consumer with a full market offer and to indicate any costs that the consumer will be obliged to incur. The same obligations are imposed on the creditor or credit intermediary by Article

¹¹⁵Sejm print no. 1210 Governmental project the Mortgage Credit Act and the supervision of mortgage brokers and agents. Justification. p. 23-24.

¹¹⁶Ibidem.

120-terdecies (4) of the Italian TUB¹¹⁷. A precondition for the preparation of an individual offer by an advisor is that they obtain a complete set of information taking into account the consumer needs, objectives, preferences, personal and financial situation. Article 27(4) and (6) provides for rules on acting in the best interest of the consumer and informing them of potential risks and risk assumptions taken into account in the preparation of the recommendation (in particular, specific risks such as those arising from the use of a foreign currency loan). Article 7(1) of Directive 2014/17/EU (just as the provision of Article 19(1) of MiFID) requires creditors to act ‘honestly, fairly, transparently and professionally, taking account of the rights and interests of the consumers’. This provision puts the creditor in the position of the customer’s *quasi* financial advisor, approaching the introduction of the principle of the priority of interest of the customer over the interest of the creditor, which is becoming increasingly present in many regulations¹¹⁸. Consequently, the actual coverage of the bank’s obligations under Directive 2014/17/EU shows a greater degree of customer protection than under the Consumer Credit Directive. The principle of the priority of customer interest over creditor interest has implications for the information obligations adopted in Directive 2014/17/EU and is best reflected in the European Standardized Information Sheet (ESIS) and the APRC.

Attention is drawn here to Article 22(5) of Directive 2014/17/EU, which allows Member States to impose an obligation on entities providing advisory services to warn the consumer if the credit agreement is likely to present a particular risk to the consumer because of the latter’s financial situation. This opportunity was used in the Polish Act, whose Article 27(6) imposes an obligation on the creditor, intermediary and agent to warn the consumer as indicated in Directive

¹¹⁷Cf. SOLINAS, *Commentary to Art. 15*, [in:] *I mutui ipotecari nel diritto comparato ed europeo Commentario alla direttiva 2014/17/UE a cura di P. Sirena*, p. 347.

¹¹⁸See TERESZKIEWICZ, *Obowiązki informacyjne w umowach o usługi finansowe. Studium instrumentów ochronnych w prawie prywatnym i prawie unijnym*, Warsaw 2015, p. 135 ff. Cf. differences between advisory services specified in MCD and MIFID II, BENANTI, *Commentary to Art. 15*, [in:] *I mutui ipotecari nel diritto comparato ed europeo Commentario alla direttiva 2014/17/UE a cura di SIRENA*, p. 340.

2014/17/EU. In the Polish Act, the rules on advisory services in the mortgage credit market have been regulated comprehensively and precisely. However, it is only through the practical application of the solutions adopted in the law that their effectiveness can be properly assessed. The Italian literature on the subject is critical of national solutions on advisory services, as resulting from the Mortgage Credit Directive. The critics claim that the legislator failed to seize the opportunity to make the regulation more specific and strengthen consumer protection, while defining the responsibilities of credit advisors in a manner consistent with the provisions of MIFID II¹¹⁹. The solutions adopted are also criticized in Poland. Despite their correct implementation, they may remain a dead letter used by the creditor to justify actions taken rather than safeguard real consumer protection when the product is selected¹²⁰. Polish and Italian regulations introduce administrative penalties for failure to comply with formal requirements by advisors. Unfortunately, they do not include sanctions for acting to the detriment of a customer, to the detriment of a lender, or for obvious factual errors. The basis for the assessment of the advisor's activity is only fulfillment of the formal requirements specified in the Act. According to the authors, compliance with formal requirements does not go far enough to guarantee real consumer protection. In order to assert their rights, consumers must take civil action and provide relevant evidence.

However, it is essential that the consumer is properly informed and educated, is aware of their rights and distinguishes between an independent advisor and a seller tied to the creditor.

¹¹⁹See https://www.pltv.it/news/consulenza_credizia/tipologie-e-modalita-dellattivita-di-consulenza-dei-mediatori-credizi (accessed on 30 May 2018), La nuova disciplina del credito immobiliare ai consumatori, CIVALE, <http://www.dirittobancario.it/approfondimenti/credito/la-nuova-disciplina-del-credito-immobiliare-ai-consumatori> (accessed on 30 May 2018), Credito immobiliare ai consumatori: prime problematiche applicative, diritto bancario, MAZZARINI, http://www.diritto_bancario.it/sites/default/files/allegati/mazzarini_g._credito_immobiliare_ai_consumatori_prime_problematiche_applicative_2016.pdf (accessed on 30 May 2018).

¹²⁰For more on this, see Opinion for the Senate Committee on Budget and Public Finance on the Act on Mortgage Credit and on Supervision of Mortgage Credit Intermediaries and Agents, Paper no. 433 of 13 March 2017: Krzysztof Oppenheim, Opinion on the Act on Mortgage Credit and on Supervision of Mortgage Credit Intermediaries and Agents - Paper no. 433.

6. In order to increase legal certainty for consumers, the EU legislator has opted for full harmonization of the right to information¹²¹. Other provisions, however, do not require maximum harmonization and give national legislators more leeway. As it has already been pointed out, the basic method of implementation for this directive is minimum harmonization. This allows Member States to go further than the minimum requirements of Directive 2014/17/EU for other provisions, and to maintain or introduce more stringent consumer protection regulations, provided that they are consistent with the rules in force in the Member States introduced by EU law¹²². The technique of full harmonization, on the other hand, means that the EU legislator introduces an imperative regulation that the Member States must comply with. The EU legislator decided that full implementation should cover the right to information¹²³ as provided for by Directive 2014/17/EU as a fundamental consumer protection right in the European Union, which aims to redress the information asymmetry between the professional creditor and the weaker party to the agreement, i.e. the consumer. According to the legislator, the information provided to the consumer must be comprehensible and complete in order to compensate for their lack of professional knowledge and weaker position in the market¹²⁴. The reasons set out above have led to the application of full harmonization, as specified in Article 2(2) of Directive 2014/17/EU¹²⁵, and concern the provisions of Article 14(2)¹²⁶ and Annex II¹²⁷ with regard to stand-

¹²¹Art. 2 of Directive 2014/17/EU.

¹²²Art. 2(1) of Directive 2014/17/EU.

¹²³See PACHUCA-SMULSKA, *Prawo do informacji jako podstawa ochrony konsumenta*, in: *Ochrona konsumenta w prawie polskim i Unii Europejskiej*, ed. by M. Królikowska-Olczak and B. Pachuca-Smulska, CH Beck, Warsaw 2013, p. 38-62, and the literature referred to therein.

¹²⁴For more on this, see: RUTKOWSKA-TOMASZEWSKA, *Naruszenie obowiązków informacyjnych banków w prawie umów konsumenckich*, Warsaw 2009, p. 21 and PAGLIANTINI, *Statuto dell'informazione e prestito responsabile nella direttiva 2014/17/UE (sui contratti di credito ai consumatori relativi a beni immobili residenziali)*, *Contratto e impresa – Europa*, 2014, p. 523.

¹²⁵Pursuant to Article 2(2) of Directive 2014/17/EU, the solution based on the principle of maximum harmonization is provided i.a. in Directive 2007/64/EC and Directive 2008/48/EC of the European Parliament and of the Council of 23 April 2008 on credit agreements for consumers and repealing Council Directive 87/102/EC, OJ L 133, 22.5.2008, p. 66 (hereinafter: Directive 2008/48/EC).

¹²⁶In Italian law Art. 120-novies (2)(3)(4)(6)(a) TUB, in Polish law Art. 11(2).

¹²⁷See also Recital 7 of Directive 2014/17/EU. In Italian law Art. 120-novies (6)(a) TUB -

ard pre-contractual information provided by means of the European Standardised Information Sheet (ESIS), and Article 17(1) to (5), (7) and (8) of the Mortgage Credit Directive with Annex I as regards a common, consistent Union standard for the calculation of the annual percentage rate of charge (APRC)¹²⁸.

6.1. Of the range of information provided to the consumer, pre-contractual information is essential for efficient protection, as it is on this basis that the consumer decides whether or not they are interested in concluding the contract under certain conditions with a particular creditor¹²⁹. The crucial importance of pre-contractual information has led the legislator to standardize and clarify it using the ESIS form¹³⁰ in accordance with Article 14(2) and Annex II of Directive 2014/17/EU¹³¹.

Content of the ESIS form, as set out in Article 14(8) of Directive 2014/17/EU, shall remain unchanged. Where Member States adopt additional requirements in their national law going beyond the scope of the ESIS form, such information should be included in a separate document accompanying the ESIS in accordance with EU requirements¹³². It is worth noting that Directive 2014/17/EU refers to the content of the European Standardised Information Sheet (ESIS), but

European Standardised Information Sheet (PIES – Prospetto informativo europeo standardizzato).

¹²⁸The Standardised Information Sheet (ESIS) included in Annex II to the Directive comprises fifteen sections, the fourth of which defines the APRC. In Italy, it is regulated by Article 120-quinquies (3) (Calco del tasso annuo effettivo globale TAEG), in Poland by Article 11 of and Annex II to the Mortgage Credit Act.

¹²⁹On the importance of the pre-contractual information RUMI, *Profili privatistici della nuova disciplina sul credito relative agli immobili residenziali*, I contratti, 2015, p. 70. On the same issue, with reference to directive 93/13/CE, see the Court of Justice of the European Union of 20 September 2017, in *Andircinc v. Banca Romanescu*, C – 186/16.

¹³⁰See also Recital 7 of Directive 2014/17/EU (European Standardised Information Sheet).

¹³¹The Directive 2001/48/EU imposed the predecessor of the PIES, the SECCI (Standard European Consumer Credit Information) on which see MAFFEIS, *Direttiva 2014/17/UE: rischi di cambio e di tasso e valore della componente aleatoria nei crediti immobiliari ai consumatori*, in *Banca borsa*, 2016, I, p. 190. The existence of the former SECCI, of the current PIES and of the KIID (Key Investor Information Document) introduced by the Directive 2009/48/CE, so called UCITS IV, shows a trend. As the financial rules underlying a financial transaction become more complex a short document on the fundamental issue governing the relationship becomes necessary, to focus the attention of the (potential) customer and let her decide on firm grounds.

¹³²In the Polish Mortgage Credit Act this is stipulated under Article 12, in Italy - under Art. 120-novies (3) TUB.

does not refer to the formal requirements for it being provided¹³³.

In both Polish and Italian law, the minimum information requirements introduced by the Directive differ from those previously adopted for banks. They resulted from earlier EU and national regulations, and internal regulations of banks. In particular, the transposed Directive has led to an increase in the information made available to customers in the ESIS form, by including some data which had not been required before. This scope has been extended to include, among others, information on accepted guarantees, available currencies, additional services or consultancy¹³⁴.

The choice of mortgage credit and the subsequent signing of the contract is a complex process in which the consumer should be assisted by the new ESIS form. Making a final decision in this respect is very difficult because a mortgage contract binds a consumer to a bank and a property for many years. The bid selection process can be divided into three successive stages. The first concerns the provision of information by the creditor on the scope of the credit agreements offered. This information is of a general nature and is addressed to a wide range of consumers¹³⁵. Then, if the consumer is interested in the creditor's offer, the former is obliged to provide the latter with detailed information on their needs¹³⁶, which is necessary for the preparation of a customized offer. The prerequisite for the reliable preparation of personalized information is the provision of complete and accurate information on the customer's needs and financial situation by the customer themselves¹³⁷. However, the customer is not the only source of infor-

¹³³See, https://www.bancaditalia.it/compiti/vigilanza/normativa/consultazioni/2016/direttiva-credito-immobiliare/AIR_trasparenza.pdf.

¹³⁴Ibidem.

¹³⁵See Recital 38 and Art. 13 MCD.

¹³⁶Art. 20 MCD.

¹³⁷Lenders, in order to ensure that they obtain fair data from their clients, may take advantage of protection provided for in Article 297(1) of the Criminal Code. The Criminal Code in Art. 297 (1) provides for the following: Who, in order to obtain for themselves or for someone else, from a bank or organizational unit conducting a similar economic activity pursuant to an act, or from a body or institution disposing of public funds - credit, cash loan, surety, guarantee, letter of credit, grant, subsidy, confirmation by the bank of the obligation resulting from a surety or from a guarantee or similar cash benefit for a specified economic purpose, a payment instrument or a public procurement contract, submits a forged, falsified, untrue or unreliable document or an

mation for the creditor. The lender has access to a number of databases on borrowers¹³⁸. At the same time it is worth noting that the preparation of a personalized form and the subsequent offer will be closely linked to the information to be obtained by the lender or the adviser from the customer themselves. For this reason, the legal solution adopted in the Mortgage Credit Directive imposes liability for concluding the contract on both party. The consumer will only obtain a relevant offer if the information provided by them is true and professionally verified. The correct assessment of the consumer's creditworthiness is based on cooperation and trust between the consumer and the creditor¹³⁹.

The EU legislator did not explicitly specify the moment of handing over the ESIS form to the consumer, which puts an end to the pre-contractual stage. Directive 2014/17/EU indicates merely that this takes place between the moment when the consumer informs the creditor about their needs, financial situation and preferences, and the moment when the consumer is obliged to conclude the credit agreement. It follows from the provisions that submission of the ESIS to the consumer may take place prior to or simultaneously with a binding offer being prepared and issued by the lender. In accordance with the rules adopted in Directive 2014/17/EU, the consumer shall receive the European Standardised Information Sheet (ESIS/PIES) 'immediately'. Unlike the Directive, the Italian legislator uses the phrase 'without undue delay' to describe the term¹⁴⁰. It should be noted, however, that the Italian legislator did not exercise the right provided for in Article 14(4) of Directive 2014/17/EU, which requires the creditor to ensure that the ESIS (PIES) form must be communicated before a binding offer can be made. The Polish legislator, on the other hand, decided to specify the time limit for submitting the ESIS

untrue written statement concerning circumstances significant for the purpose of obtaining the said financial support, payment instrument or contract, shall be punishable by a custodial sentence for a term of between 3 months and 5 years.

¹³⁸See STANGRET-SMOCZYŃSKA, *Zdolność kredytowa w ujęciu prawnym prawa polskiego*, Warsaw, CH Beck, 2016, *Legalis*, § 3. Źródła uzyskiwania informacji przez kredytodawcę dla oceny zdolności kredytowej.

¹³⁹Art. 120-undecies (1) TUB; Cf. G. Falcone, *Prestito „responsabile” e valutazione del merito creditizio*, *Giur. comm.*, 2017, I, p. 147.

¹⁴⁰Art. 14(1) in conjunction with Art. 20 of Directive 2014/17/EU, in Italy - Art. 120-novies TUB; see Recital 44 and Article 14(1)(a) MCD.

form in Article 11(4) of the Mortgage Credit Act. It obliges the creditor or intermediary to provide a personalized form immediately once they have received the required information from the consumer on the latter's needs, financial and personal situation, preferences and objectives. The form should be submitted to the consumer no later than before the consumer submits an application for mortgage credit¹⁴¹.

Another important problem from the point of view of national regulation that needs to be identified is the institution of the creditor being bound by the offer submitted. Two issues are relevant in this area. The first concerns the principle of the creditor being bound by the offer, and the other - the time for the consumer to reflect on the choice of the appropriate offer. In the event of the lender being bound by the offer, there is a concurrence of special and general provisions; in Italian law this matter is addressed in Article 1329 of the Civil Code, in Polish - in Article 66 of the Civil Code in conjunction with Article 66²(2) of the Civil Code, and in German - in Article 145 of the Civil Code. This issue is also regulated by the UNIDROIT Principles (Article 2.1.4), the principles of European Contract Law (Article 2:202, paragraph 3) and the Vienna Convention (Article 16, paragraph 2). The existing regulations may lead to problems with their proper interpretation¹⁴². The standards in the Mortgage Credit Directive shall be viewed as *lex specialis* in relation to the general principles governing the offer in the civil law regulations. From a consumer perspective, not only the principle of the creditor being bound by the offer is important, which makes it possible to compare offers, but it is also crucial to be allowed sufficient time for reflection. For this reason, it is very important that the creditor determines the time available for the consumer to take the decision before they finally commit themselves to taking out the credit. The consumer should be provided with comprehensive information concerning their rights, in particular the right of withdrawal. In the European Standardised Information

¹⁴¹Cf. Recital 44 - the EU legislator does not explicitly indicate when the form should be provided.

¹⁴²See: CIVALE, *La nuova disciplina del credito immobiliare ai consumatori*, http://www.diritto bancario.it/sites/default/files/allegati/civale_f_la_nuova_disciplina_del_credito_immobiliare_ai_consumatori_2016.pdf (accessed on 15.06.2018).

Sheet, pursuant to Article 14(6) of Directive 2014/17/EU, the creditor shall give the consumer at least 7 days to reflect on the assessment of the credit agreement. This term also applies in Italy in Article 120-novies (3) TUB. On the other hand, the Polish legislator introduced an innovative solution in Article 11(5) of the Mortgage Credit Act, extending the validity of the offer contained in the form to 14 days. Of course, the entity granting the credit may indicate a longer term of form validity (i.e. the period when they are bound with the offer) than that specified by the Polish or Italian legislator. If, within that period, the consumer submits an application for a mortgage loan, the offer contained in that form shall be binding on the creditor. Therefore, in such a case, the creditor will not be able to offer the consumer any (worse) mortgage credit conditions than those contained in the form.

The Mortgage Credit Directive has set a minimum time limit for the consumer to decide, as failure to clarify this time limit in the Consumer Credit Directive has caused a number of practical problems, in particular lenders have urged consumers to take prompt credit decisions¹⁴³. During the time taken to reach a decision, the consumer can and should consult with the creditor, who is obliged to clarify any doubts that may arise in connection with the form and documentation provided. The standardised form is intended to enable the consumer to compare offers made by different creditors, both in the national and in the single European market. Recital 41 of Directive 2014/17/EU draws attention to the need for the form to be drafted in a language that is simple and comprehensible to the consumer. For this reason, different wording is introduced in the ESIS form to identify the same institutions as mentioned in the Mortgage Credit Directive. An example of such simplification is the use of the phrase “total amount payable by the consumer” in Directive 2014/17/EU (Article 4(14)), whereas the ESIS form, section 3, introduces a notion of “total amount to be reimbursed”¹⁴⁴ which is more transparent to non-professional market participants.

¹⁴³See: Directive 2008/48/EC of 23 April 2008 on credit agreements for consumers and repealing Council Directive 87/102/EEC.

¹⁴⁴Cf. Paxford, Legalis, Commentary to Art. 14 Ustawa o kredycie hipotecznym oraz o nadzorze nad pośrednikami kredytu hipotecznego i agentami.

The Directive provides that the form is to be provided to the consumer as a hard copy or on a durable medium¹⁴⁵, and that Member States may not introduce any provision for the information to be provided to the consumer in any other way.

The ESIS is divided into 15 sections which indicate the main features of the credit agreement, such as the amount, currency, duration, type of applicable interest rate, frequency and number of payments, amount of each installment, an 'illustrative amortization table' which, in line with the transparency provisions, must be set out in the credit agreement form. Such a table should also contain the information needed to assess the calculation of the amount of credit repayment either: (a) at a fixed rate over the entire period, or (b) with a deferred interest payment option (i.e. if interest is not expected to be fully repaid in installments and is instead added to the total amount of the outstanding credit). In the context of information on interest rates and other costs, the total effective annual percentage rate of charge (APRC) is important in order to give an immediate indication of the total cost of the credit to the consumer. The ESIS also contains information on early termination of the agreement and other regulated areas, such as credit portability, or rights such as the use of a reflection period and complaints to the creditor. In addition to these elements, the form also contains some indications that are intended to clarify the economic impact of the contract and to draw attention to risks. The ESIS, although drawn up on the basis of an assessment of the individual characteristics of consumers, has only an informative value with regard to the content of the future mortgage credit agreement. In fact, the terms and conditions set out therein do not contain a binding contractual offer to the creditor. The conditions set out in the ESIS may change during the negotiations and the binding offer to the borrower, which accompanies the ESIS, usually differs from the offer made previously.

From the point of view of consumer protection, an important innovation

¹⁴⁵Article 120-novies (1) TUB.

adopted in Directive 2014/17/EU is the obligation to provide consumers with information on any fees they incur for credit intermediaries¹⁴⁶. The consumer will know how much of their credit will benefit the employee or advisor representing the creditor. Until the new regulation was introduced, the benefits obtained by intermediaries and *quasi* advisors rather than the interest and welfare of the client had often been the reason why a specific product was recommended by an advisor. The solution introduced aims to eliminate these harmful practices. Mandatory information obligations include the “right to know” the amount of commissions or other benefits resulting from advice¹⁴⁷, which is never actually free of charge. These solutions are innovative and make it easier for the consumer to assess the reasons for the intermediary offering products of certain creditors¹⁴⁸. The provision of an ESIS form by the creditor does not give rise to an obligation to provide advisory services to the consumer on credit agreements for immovable property. It is necessary to distinguish between the provision of ‘advice’ concerning credit agreements or non-standard information provided by the creditor and the credit intermediary - and provision of paid advisory services on home credit agreements for consumers¹⁴⁹. The issues related to provision of advice on mortgage credit to consumers are regulated both by the ESIS form, which applies full harmonization, and by the provisions covered by and discussed in the part concerning minimum harmonization.

The individual form specifies the financial or legal consequences of a borrower’s non-performance of a contract, e.g. late payments, default or failure to respect the obligations set out in the ESIS. The creditor should indicate (in the form) in a prominent way the sanctions or consequences of the customer’s non-performance of the contract¹⁵⁰.

¹⁴⁶Recital 47 of Directive 2014/17/EU.

¹⁴⁷Art. 15(2) of Directive 2014/17/EU.

¹⁴⁸See also: TERESZKIEWICZ, *Obowiązki informacyjne w umowach o usługi finansowe. Studium instrumentów ochronnych w prawie prywatnym i prawie unijnym*, Warsaw 2015, p. 41.

¹⁴⁹Recital 63 Providing advice in the form of a personalised recommendation is a distinct activity which may but need not be combined with other aspects of granting or intermediating credit.

¹⁵⁰Annex II A and B to Directive 2014/17/EU.

According to Annex II to Directive 2014/17/EU, the consumer should be informed about the possibility of early repayment and about the costs of such an operation, including the fees related thereto. The early termination of a credit agreement in the event of early repayment entails compensation for the creditor and the ESIS should contain such information. The creditor shall indicate how the compensation is calculated and shall indicate the maximum amount thereof. If it is not possible to clearly indicate the amount of the fee, its calculation shall be done using different scenarios. Although the ESIS does not set out detailed rules for such calculations, it does oblige the creditor to provide information about them to the potential borrower¹⁵¹.

The form is prepared for a specific date on the basis of information provided by the client, and on the current financial market conditions. The information contained in the form, with the exception of the interest rate and other costs, is valid until the date indicated in the document. After the expiry date of the form, the information contained therein should be amended in line with the current market situation¹⁵².

7. Directive 2014/17/EU introduces a uniform standard for the calculation of the annual percentage rate of charge (APRC)¹⁵³. The APRC is calculated in accordance with the mathematical formula set out in Annex I to the Directive and in the ESIS form in Section 4. Annex I is based on the 'internal rate of return' formula, which is well known from financial literature¹⁵⁴. The aim of the introduced uniform rules for calculating the APRC is to make the consumer aware of the 'total amount to be reimbursed'. It is the sum of the credit amount and the total cost of the

¹⁵¹Annex II A and B to Directive 2014/17/EU.

¹⁵²Art. 14(6) Directive 2014/17/EU.

¹⁵³In Italian law it is regulated in Art. 120-quinquies (3) TUB, while in Polish - in Art. 19 of the Mortgage Credit Act. 'Annual percentage rate of charge' (APRC) means the total cost of the credit to the consumer, expressed as an annual percentage of the total amount of credit, where applicable, including the costs referred to in Article 17(2) and equates, on an annual basis, to the present value of all future or existing commitments (drawdowns, repayments and charges) agreed by the creditor and the consumer. Art. 17 of Directive 2014/17/EU.

¹⁵⁴Cf. BREALEY, MYERS, *Principles of corporate finance*, (4 edition) McGraw-Hill, Inc. 1991, p. 79.

credit to the consumer, expressed as an annual percentage defined by the creditor. Where the borrowing rate is variable during the lifetime of the credit, the consumer should be informed that the amount given is illustrative and may vary in relation with the variation in the borrowing rate¹⁵⁵.

Undoubtedly, the advantage of the adopted formula is to include all cash flows (both drawdowns of credit tranches, repayment of credit installments, as well as all other fees and commissions) and the formula itself is relatively manipulation-proof. At the same time, it may not be very intuitive, and therefore even incomprehensible to an average consumer, which will require a certain educational role from financial institutions. Annex I to Directive 2014/17/EU provides guidance for the calculation of the APRC and specifies the mechanisms for its calculation in situations where cash flows or interest rates may vary (the former due to customer preferences, the latter due to the market environment). Adopting a standard formula for calculating the APRC based on (all) cash flows significantly limits the possibility of manipulation and misleading the customer in advance. At the same time, the introduction of uniform rules for calculating the annual percentage rate of charge (APRC) across the single market is a solution that allows consumers to compare multiple offers and choose the most advantageous one. When deciding to take out a loan, consumers should take into account their income and unforeseen life situations requiring them to make a financial commitment. The choice of the best offer is possible only if the consumer is aware of all the fees and costs related to the credit and can confront them with their capacities and needs as well as with the presented offers. This is to be done by means of the ESIS and APRC¹⁵⁶.

8. The analysis presented confirms the validity of the minimum harmonization method as the prevailing one for the implementation of the Mortgage Credit

¹⁵⁵Art. 17(6) of Directive 2014/17/EU.

¹⁵⁶See PACHUCA-SMULSKA, *Ochrona praw konsumenta w świetle wybranych rozwiązań dyrektywy 2014/17/UE w sprawie konsumenckich umów o kredyt związany z nieruchomościami mieszkalnymi*, [in:] *Sprzedaż konsumencka w teorii i praktyce. Problemy węzłowe*. Ed.: Monika Jagielska, Elżbieta Sługocka-Krupa, Krzysztof Podgórski, Rafał Biskup, CH Beck, Warsaw 2016, p. 114-130.

Directive in the EU legal system. This method meets the fundamental objectives of the Directive: to safeguard consumer protection in this market, and to attempt to create a single internal market for mortgage credits in the European Union. However, these objectives can only be achieved by strengthening the consumer's right to information by means of full harmonization. Maximum harmonization does not apply to all the provisions of the Directive, but only to the most essential important ones, and to a minimum extent. These provisions pursue the primary objective of protecting the consumer, namely the consumer's right to pre-contractual information, by introducing a uniform personalized information sheet which gives the consumer the best opportunity to compare the presented offers.

Creation of a single internal market for mortgage credits in the European Union is a difficult task to achieve. The real estate market is closely linked to the internal legal order of each country and has been shaped over the centuries.

Therefore, the rules governing real estate loans are usually detailed and largely based on traditional domestic solutions¹⁵⁷. This *status quo* is confirmed by the comparative legal analysis of Polish and Italian provisions – while each state builds regulations on the basis of EU solutions, each of them does so drawing very strongly on its own legal tradition and both long-term and recent experience.

¹⁵⁷See HOWELLS, TWIGG-FLESNER, WILHELMSSON, (edd.), *Rethinking EU Consumer Law*, Routledge London and New York 2018, p. 231.

EU STATE AID LAW IN THE BANKING SECTOR: THE STORY OF A REVELATORY CHANGE

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ABSTRACT: *Every cloud has a silver lining. The financial crisis of 2008 and the related sovereign debt crisis of 2010 forced the European institutions not only to give new impetus to the process of formation of the Banking Union, but also to realize that State aid law can become the quintessential legal tool for the pursuit of policy objectives of interest to the Union. This article traces the changes in State aid law during the crisis and in its aftermath to give a sense to how State Aid law is called upon to strike a balance between opposing but legitimate needs.*

SUMMARY: 1. Introduction. – 2. What do Banks in Difficulty need? – 3. To aid or not to aid: that is the question. – 3.1 The Contagion Mechanism and the Mortal Loop: Why National and European Institutions need to aid banks in trouble. – 4. State aid law before the outbreak of crises. – 4.1 Opposite objectives balanced by Article 107. – 4.2 The conditions under which public support for banks is State aid. – 4.3 The balancing test to assess compatibility. – 4.4 The procedure. – 5. The ordinary State aid rules applying to ailing firms. – 6. The financial collapse and the prompt reaction of the European Commission: Six Communications in a row. – 6.1 The rescue phase: timely disbursement of huge amounts of money. – 6.2 The restructuring phase: banks cannot dwell on hope for better times. – 6.3 Safeguards to limit the impact of State aid. – 6.4 Nevertheless, Crisis Communications were still to all intents and purposes an element of State aid rules. – 7. The current 2013 Banking Communication and the way forward under the BRRD and the SRM. – 8. Concluding remarks.

1. In common parlance, the word “crisis” has a negative meaning, as it refers to a time of intense difficulty and danger. However, its etymology reveals a positive nuance. The word crisis derives from the Greek verb *krino*, which means to separate, to list and, in the broadest sense, discern, judge, evaluate. Hence, a time of crisis may also be a time of reflection, evaluation, or discernment, a

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necessary premise for a phase of improvement, rebirth, and flourishing.

Also the financial crisis and the subsequent sovereign debt crisis, which hit the European Union between 2008 and 2013, may be framed in these terms. On the one hand, while plunging Europe into the worst economic crisis ever since the 1930s,¹ they have demonstrated the fragility not only of some banks, but also of the Eurozone and entire financial system. On the other hand, first, they forced European and national institutions to fully realize that global financial markets need integrated regulations and mechanisms of supervision, control, and governance.² Indeed, it is no coincidence that the crises spurred the creation of the Banking Union,³ which now allows the consistent application of EU banking rules in the participating countries,⁴ to ensure a more transparent, unified, and secure market for banks.⁵ Second, on a smaller scale, both crises gave the

¹See CAPRIGLIONE, *Crisi a confronto (1929 e 2008). Il caso italiano*, Padova, 2009.

²See CAPRIGLIONE, *Globalizzazione, crisi finanziaria e mercati: una realtà su cui riflettere*, in COLOMBINI, PASSALACQUA, *Mercati e banche nella crisi: regole di concorrenza e aiuti di Stato*, Napoli, 2012, pag. 3-4 e AMOROSINO, *Le banche e la crisi economica: concorrenza, regolazioni ed aiuti di stato*, ibidem, pag. 469.

³To put the Economic and Monetary Union on a more solid footing, the European Council has agreed to create the Banking Union. At the moment, it includes two pillars: (i) the Single Supervisory Mechanism (SSM), a new system of banking supervision comprising the European Central Bank (ECB) and the national supervisory authorities of the participating countries; and (ii) the Single Resolution Mechanism (SRM), which is meant to ensure the efficient resolution of failing banks, by casting minimal costs on both taxpayers and the real economy. Within the Eurozone the SRM implements the Bank Recovery and Resolution Directive (BRRD). See, respectively, Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, OJ L 287, 29.10.2013, pag. 63-89; Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010, OJ L 225, 30.7.2014, pag. 1-9; and Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council Text with EEA relevance, OJ L 173, 12.6.2014, pag. 190-348. For sure, the Banking Union is based also on a third pillar, a European deposit insurance scheme, which however is not in force yet.

⁴This Single Rulebook is the set of rules providing legal and administrative standards to regulate, supervise, and govern the EU financial industry. It includes rules on capital requirements, recovery and resolution processes, and a system of harmonized national Deposit Guarantee Schemes.

⁵The literature on Banking Union is huge. See, *ex multis*, IBRIDO, *L'Unione bancaria europea. Profili costituzionali*, Torino, 2017; BOCCUZZI, *L'unione bancaria europea. Nuove istituzioni e regole di vigilanza e di gestione delle crisi bancarie*, Roma, 2015; CAPRIGLIONE, *L'Unione*

European Commission the opportunity to better understand that EU State aid law is a living tool, functional to the achievement of EU goals, even when the European project is overwhelmed by adverse vicissitudes.

Between 2008 and 2013, indeed, EU State aid law was the only supra-national legal instrument available to the Commission to dictate the common reasons, conditions, and procedures under which each Member State could employ taxpayers' money to provide public support to banks in difficulty.⁶ Thus, the Commission relied on it to achieve a complex balance between opposing objectives: the "traditional" need to promote budget discipline, while preserving the integrity of the internal market and minimizing competitive distortions between subsidized and unaided banks from the same or different Member States; and the need, arisen from crises, to restore financial stability and remedy the serious disturbance of national economies caused by crises. Therefore, over those years, the Commission gained a significant experience that still informs today the Bank Recovery and Resolution Directive and the Single Resolution Mechanism.⁷

In order to provide a thorough account of how the Commission used State aid law to tackle the 2008 financial crisis and the subsequent sovereign debt crisis, the paper is structured as follows. To set the scene, paragraph 2 briefly describes the kind of public support that distressed banks may need, while paragraph 3 explains the facts and reasons that, between 2008 and 2013, led Member States

bancaria europea: una sfida per un'Europa più unita, Torino, 2013. In relation to the SRM, see in particular, TROIANO, UDA, *La gestione delle crisi bancarie. Strumenti, processi, implicazioni nei rapporti con la clientela*, Torino, 2018; ROSSANO, *La nuova regolazione delle crisi bancarie*, Milano, 2017; GRECO, *La tutela del risparmio alla luce della nuova disciplina di risoluzione delle banche*, in *Banca Impresa e Società*, 2016, pag. 77; DI BRINA, *La crisi della banca e degli intermediari finanziari*, in CAPRIGLIONE, *Manuale di diritto bancario e finanziario*, Padova, 2015; and CAPRIGLIONE, TROISI, *L'ordinamento finanziario dell'UE dopo la crisi. La difficile conquista di una dimensione europea*, Milano, 2014; GUARRACINO, *Dal meccanismo di vigilanza unico (SSM) ai sistemi di centralizzata di risoluzione delle crisi e di garanzia dei depositi: La progressiva europeizzazione del settore bancario*, in *Rivista trimestrale di diritto dell'economia*, 2012, pag. 202.

⁶See GRAY, DE CECCO, *Competition, Stability and Moral Hazard: The Tension between Financial Regulation And State Aid Control*, in LAPRÉVOTE, GRAY, DE CECCO, *Research Handbook on State Aid in the Banking Sector*, Cheltenham, 2017, pag. 21.

⁷See previous footnote 3.

to use taxpayers' money to accommodate such a support notwithstanding its distortive effects on competition and budgetary discipline. As the Treaty on the Functioning of the European Union (TFEU), alongside with several pieces of secondary legislation and a wide range of guidelines, envisages a set of provisions – exactly State aid law – that precisely govern cases where Member States use public resources to help private firms, paragraph 4 discusses the goals and the scope of State aid law. In this way, the paper intends to pursue three objectives: (i) to show the drawbacks that State aid produces at the European level to explain why no Member State can make a reckless use of public resources to save firms in trouble, even when it comes to banks; (ii) to illustrate how State law was enforced before the bursting of the crises, as so to appreciate the scale – not so broad, indeed – of the changes that the Commission made to tackle those crises; and (iii) to explain that, in its essence, at least from the second half of the 1990s onwards, the law on State aid has been called upon to strike a balance between the protection of competition, the defense of the integrity of the single market, and the protection of a prudent use of public resources against the pursuit of other objectives of equal common interest, such as financial stability. Furthermore, to give an account of the ordinary rules informing State aid law, paragraph 5 discusses the criteria already in place before the crisis in order to manage the case of public support for firms in distress. Against this backdrop, hence, not only can paragraph 6 afford the discussion of the sector-specific and exceptional State aid rules that the Commission adopted to handle the financial and sovereign debt crises, but also paragraph 7 can introduce the last reform of State aid law that the Commission codified in the 2013 *Banking Communication*,⁸ to keep on devoting specific attention to the banking sector, while employing more ordinary rules to manage the cases of banks in difficulty. Paragraph 8 concludes.

⁸Communication from the Commission on the application, from 1 August 2013, of State aid rules to support measures in favor of banks in the context of the financial crisis, OJ C 216, 30.7.2013, pag. 1–15 (hereinafter, *2013 Banking Communication*).

2. Suppose a bank becomes too illiquid to fulfill its obligations to its depositors and other creditors and/or suppose that bank sees the market value of its assets fall below the market value of its liabilities. Also imagine that, in both cases, the bank is not able to collect the liquidity and capital necessary to stem insolvency and losses, neither through its own resources nor through the funds coming from its owners, shareholders, or creditors. In such a situation, the bank – which in the EU jargon is called “a bank in difficulty”⁹ – will almost certainly fail in the short or medium term, unless a public institution decides to use taxpayers’ money to support it.

As the practice indicates, to prevent a bank in difficulty from leaving the market, national governments adopt various measures, non-structural and structural ones.

Non-structural interventions, such as liquidity assistance or loan guarantees, aim to improve, on a temporary basis, the access that beneficiary banks have to finance, in order to prevent bank runs and the flow of credits to the real economy. States can act directly, lending public funds to troubled banks¹⁰ or opening a line of credit to them,¹¹ thereby exposing themselves to the risk of net losses should banks not repay the loan. Or, States can act indirectly by guaranteeing newly issued debt instruments, which beneficiary banks will use to

⁹This concept derives from the notion “undertaking in difficulty”, which is now included in Communication from the Commission, Guidelines on State aid for rescuing and restructuring non-financial undertakings in difficulty, OJ C 249, 31.7.2014, pag. 1, but traces back to 1999. Then, the corresponding community guidelines on State aid for rescuing and restructuring firms in difficulty, OJ C 288, 09/10/1999, pag. 2, specified the notion of a «firm in difficulty», by stating that a firm is in difficulty where it is unable, whether through its own resources or with the funds it obtains from its owner/shareholders or creditors, to stem losses which, without outside intervention by the public authorities, will almost certainly condemn it to go out of business in the short or medium term. A very similar definition is included in the 2004 *R&R Guidelines* discussed in the following paragraph 4.4.

¹⁰See, e.g., State aid NN 68/2009 – *Hungary Liquidity scheme for banks*, 14.1.2010, § 4 (deciding for the compatibility of a liquidity scheme in the form of loans to financial institutions established in Hungary). Less often, the liquidity measure may take the form of State deposits – see State Aid 38994 (2014/N) – *Liquidity support to Bulgarian banks*, 29.06.2014, § 28 (deciding for the compatibility of a liquidity scheme pursuant to which the Republic of Bulgaria provided State deposits to credit institutions established in Bulgaria).

¹¹See, e.g., State aid 33917 (2011/N) – *Spain Recapitalization and Liquidity support for Banco de Valencia, S.A.*, 21.11.2011, § 58 (also deciding for the compatibility of the *ad hoc* liquidity assistance granted to Banco De Valencia by the Fondo de Reestructuración Ordenada Bancaria).

raise funds from the market, or by lending government bonds,¹² which beneficiary banks will use as collateral to borrow liquidity from the central bank.¹³ In both cases, therefore, States undertake to assume the liabilities of distressed banks, should they prove to be defaulting.

Structural interventions, such as recapitalizations and asset relief measures, are instead meant to produce lasting effects, by addressing capital shortfalls¹⁴ and improving balance sheets.¹⁵ Namely, pursuant to recapitalization plans, States inject new funds into distressed banks, by purchasing their capital and debt instruments at a price above the market price.¹⁶ In a complementary way, by means of capital measures, States free the banks in distress from the assets that could lead to losses. To this end, they either purchase those assets via a vehicle owned, funded, or guaranteed by the State – the so-called “Bad Bank” or “Asset Management Company” – at a transfer price above the market value of the assets,¹⁷ or they leave the impaired assets under the ownership and the balance sheet of the bank, while committing to indemnify it, if the cumulative credit losses

¹²See, e.g., State Aid N 507/2008 – *UK Financial Support Measures to the Banking Industry in the UK*, 13.10.2008, §§ 23-24 and 66 (deciding for the compatibility of, among the others, the short-term liquidity that the Bank of England provided to the entire British banking industry).

¹³During the crisis, the first solution was widespread among banks of Member States with strong creditworthiness. Differently, in Member States with low creditworthiness, investors were reluctant to subscribe those newly issued debt instruments, even if they were guaranteed by the State. Thus, banks retained these debt instruments on their balance sheets to use them as collateral to obtain financing from the central banks.

¹⁴As the *2013 Banking Communication* recalls, capital shortfalls may emerge from inspections of supervisory authorities, which may run a capital exercise, a stress-test, or an asset quality review. For example, the rescue package designed for the Banco de Valencia became necessary because, after an inspection of the Bank of Spain, the Banco de Valencia failed to raise capital from its key shareholders or from other private sources to meet the required ratios – see State aid 33917 (2011/N) – *Spain Recapitalization and Liquidity support for Banco de Valencia, S.A.*, 21.11.2011, §§ 7-13.

¹⁵Indeed, public asset relief measures free the beneficiary bank from the need to register either a loss, or a reserve for a possible loss, on its impaired assets and, thus, free a share of the regulatory capital for other uses.

¹⁶See LUJA, *State Aid and the Financial Crisis: Overview of the Crisis Framework*, in *European State Aid Law Quarterly*, 2009, pag. 152.

¹⁷More in detail, usually, as the transfer price falls below the book value of the asset, the beneficiary bank however undergoes a write-down of the asset in question. On the other hand, if the real economic value of the asset purchased is higher than the transfer price, the State may benefit from a potential upside.

on a well-identified set of assets exceed a certain amount.¹⁸

To be sure, there are many reasons for favoring either of the above measures. Mainly, if a bank is a sound institution experiencing a temporary illiquidity crisis, it may “only” need a guarantee on its liabilities or other forms of liquidity support. Instead, if a bank has adopted a reckless business model, also due to a wrong corporate governance,¹⁹ it may need to clean its balance sheet, by increasing equity and improving the quality of its assets, and it may also need to undergo a serious restructuring plan, meant to change its management and business model.

However, one issue remains crucial: the mere fact that a bank in difficulty needs help does not entail that public institutions must rush to cover it. In other words, one should not take for granted that the private needs of banks in difficulty deserve public protection:²⁰ any public support may indeed trigger perverse and distortive effects.

3. National governments and authorities may choose to subsidize private companies to achieve a good array of legitimate public goals. However, no aid is free of charge.

First, a policy promoting public support for firms in difficulty, including banks, is not fully consistent with the model of market economies that conceives the market as a selection mechanism, which awards firms capable of meeting

¹⁸Therefore, the State partially bears the downside risk linked to the asset, but has no upside other than the fee revenue.

¹⁹See ROTONDO, VATTERMOLI, *Gli aiuti alle imprese bancarie in difficoltà*, in *Banca Borsa e Titoli di Credito*, 2000, pag. 240 and CESARINI, *Il ruolo delle banche: controllo del rischio di credito e collocamento di strumenti finanziari*, in *La crisi finanziaria: banche, regolatori, sanzioni*, in Atti del Convegno Courmayeur, 2010, pag. 23.

²⁰In this regard, the case of liquidation aid represents an exception. Those aid do not lie at the heart of any conflict, indeed. First, they are granted not for the sake of the bank in difficulty, but to help Member States to carry out a controlled winding-up, when it is clear the bank in question cannot be restructured successfully. Therefore, they do not refer to any conflict between private interests and public values. Second, these aid do not refrain, but facilitate the exit of a non-viable bank. Thus, they are consistent with the functioning of the market, while usual State aid interfere with it. For these reasons, these liquidation State aid do not fall within the scope of the paper, although the Commission has expressly dealt with them both in the 2008 *Banking Communication*, §§ 43-50, and in the 2013 *Banking Communication*, §§ 65-88. As to these Communications, see the following paragraph 6.

consumer needs and excludes firms that are not efficient and innovative enough to withstand competition from their rivals.²¹ In other words, States that subsidize banks, especially to keep them remain on the market, distort the functioning of the very same market, as they prevent those firms from responding to their commercial choices, even when it is clear that there is no entrepreneurial merit in adopting an unsustainable business model or in the impossibility of raising new capital from investors.

By the same token, it is not surprising that State intervention increases the moral hazard of companies. By loosening the cause-effect relationship between entrepreneurial choices and their market consequences, State support for firms in distress reduces their *ex ante* incentives to pursue efficiency and innovation, while allowing overly risky or otherwise inefficient behavior and the surveillance of inefficient industry structures.²² Namely, the knowledge/awareness that the State will intervene to save firms in difficulty²³ – banks included, especially when they are deemed to be too big, too interconnected, or too complicated to fail²⁴ – may incentivize risk-taking and imprudent behavior that puts banks themselves at risk as well as diminish the importance of due diligence on the part of depositors who

²¹See PESARESI, *Diritto della concorrenza e crisi di impresa*, in COLOMBINI, PASSALACQUA, *Mercati e banche nella crisi: regole di concorrenza e aiuti di Stato*, Napoli, 2012, pag. 156.

²²See CARBONETTI, *La gestione delle crisi bancarie in Italia: prospettive e problemi di una riforma*, in BELLI, MINERVINI, PATRONI GRIFFI, PORZIO, *Banche in Crisi 1960-1985*, 1987, pag. 176 (arguing that the risk of bank run incentivizes banks to operate in a prudent and careful way).

²³See ATANASIU, *State aid in central and Eastern Europe*, in *World Competition* 2001, pag. 257; KORNAI, MASKIN, ROLAND, *Understanding the soft budget constraint*, in *Journal of economic literature*, 2003, pag. 1095.

²⁴See KNIGHT, *Mitigating moral hazard in dealing with problem financial institutions: Too big to fail? Too complex to fails? Too interconnected to fail?*, in LA BROSSE, OLIVARES-CAMINAL, SINGH, *Financial crisis management and bank resolution*, 2009, pag. 257. The doctrine is indeed understood to mean that, if a bank is big, complex, or interconnected enough, it will receive financial assistance to the extent necessary to keep it from failing, although this this last, that may induce banks to disregard inefficiencies and undertake overly risky behaviors. This is why maintaining a vague policy in relation to large banks that will be rescued ensures sufficient incentive for risk-averse behavior of economic agents – see MOLYNEUX, *Banking crises and the Macro-economic context*, in LASTRA, SCHIFFMAN, *Bank failures and bank insolvency law in economies in transition*, 1999, pag. 5.

should assess the safety and soundness of their banks.²⁵

In addition, the model of market economies takes as a benchmark the scenario in which rivals compete one each other on equal footing or – better – a scenario in which no firm takes advantage from any support other than its own resources, business acumen, and good luck. If only a few firms could benefit from "exogenous" help, as it happens in cases of selective State measures, not only the market mechanism would not be revealing their different levels of efficiency and innovation, but even non-aided firms would lose the incentive to compete fiercely.

Finally, and irrespective of any conceptualization of the functioning of the market, any State measure produces a, direct or indirect, impact on the coffers of the State. In other words, State measures do not neutralize losses and debts: they collectivize them, transferring them from the balance sheets of private firms, banks included, to the balance sheets of the State.²⁶ Accordingly, any decision to support private firms in difficulty has a twofold cost in terms of public financing: it involves not only the use of taxpayers' money, but also the increase in public debt or its removal from the pursuit of other public interest objectives.

In summary, hence, any State intervention puts at risk the proper functioning of the market and puts the National budgetary discipline to the test. If, then, one considers public support in the framework of the formation of the European single market and the Eurozone, State intervention not only takes the technical name of "State aid", but also produces further distortive effects.

In the first place, State intervention may jeopardize the integrity of the

²⁵See DOWD, *Moral Hazard and The Financial Crisis*, in *Cato Journal*, 2009, pag. 141; ANTZOULATO, TSOUMAS, *Institutions, Moral Hazard, and Expected Government Support of Banks*, in *Journal of Financial Stability*, 2014, pag. 161. More in general, as to the many sources of moral hazard in the banking sector, see GROSSMAN, *Deposit insurance, regulation, and moral hazard in the thrift industry: evidence from the 1930s*, in *The American Economic Review*, 1992, pag. 800; HELLMANN, MURDOCK, STIGLITZ, *Liberalization, moral hazard, and prudential regulation: are capital requirements enough?*, in *The American Economic Review*, 2001, pag. 147; and HALDANE, SCHEIBE, *IMF Lending and Creditor Moral Hazard*, May 2004, Bank of England Working Paper No. 216, available at SSRN: <https://ssrn.com/abstract=598905>.

²⁶See *Mutatis mutandis*, this idea recalls that of "socialization of losses" that informed the law and mechanisms on banking resolution before the BRRD and the SRM came into force. See, on this point, CAPRIGLIONE, *La nuova gestione delle crisi bancarie tra complessità normativa e logiche di mercato*, in TROIANO, UDA, *La gestione delle crisi bancarie. Strumenti, processi, implicazioni nei rapporti con la clientela*, 2018, pag. 7.

internal market, by inducing subsidy races. In other words, if a Member State helps banks in difficulty, those banks enjoy a competitive advantage over their rivals located in other Member States. This not only jeopardizes the level playing field that should be inherent in the European internal market, which is supposed to be a free market answering to the above mentioned model, but also induces the other Member States to react and support their own firms, in turn.

In the second place, also the fact that some Member States have deeper pockets than others – or, better, a margin of action in the use of tax payers' money greater than the one of some other Member States – harms the integrity of the single market and reproduces national barriers. Indeed, if some banks can receive more public funds than others, the level playing field (inherent) in the internal market is impaired, that is, the possibility for European banks to compete on equal footing is undermined.

Finally, given the fiscal rules underlying the euro area, if a Member State seriously deteriorates its public debt to support its banks, the sustainability of the whole monetary union can be jeopardized due to the degree of interdependence and integration among markets using this same currency.²⁷

In summary, it is not surprising that, since the drafting of the Treaty of Rome, the founders of the now European Union have provided for some rules aimed at controlling the aids that member States may grant to private firms.²⁸ On the other hand, one should wonder why, despite all the above drawbacks, national governments and European institutions have chosen to support troubled banks during the financial crisis and the subsequent sovereign debt crisis.

3.1. While the bankruptcy of an ordinary firm tends to favor its own competitors and potentially strengthens the economy as a whole by eliminating

²⁷See MEROLA, *La politica degli aiuti di Stato nel contesto della crisi economico finanziaria: ruolo e prospettive di riforma*, in COLOMBINI G., PASSALACQUA M., *Mercati e banche nella crisi: regole di concorrenza e aiuti di Stato*, Napoli, 2012, pag. 219.

²⁸See BACON, *European Union Law of State Aid*, Oxford, 2017; PESARESI, VAN DE CASTEELE, FLYNN, SIATERLI, *EU Competition Law. State aid*, Deventer, 2016; and QUIGLEY, *European State Aid Law and Policy*, Oxford, 2015.

an inefficient economic agent, the default of a bank may weaken both its competitors and the market itself. It may put other banks in difficulty, jeopardize the stability of the overall financial system, determine a credit crunch that, in turn, slows down the economic growth, and even threaten the sustainability of sovereign debts.²⁹

This contagion mechanism (also named “domino” or “snowball effect”) is rooted in the special nature of the banking activity as well as in the complex structure of current banks.³⁰ Indeed, the essence of the banking activity is borrowing capitals in order to provide liquidity, lend money on the inter-bank market, and secure payment systems.³¹ Therefore, banks bear a severe asset-liability mismatch that finds no correspondence in the balance sheets of ordinary firms: irrespective of the specific business model or corporate governance system adopted, each bank has a low capital-to-assets ratio, a low cash-to-assets ratio, and a high short-term-debt-to-total-debt ratio.³² Furthermore, current banks are large and interconnected.³³ Not only can the volume of their business may shoot up to values that far exceed the higher turnover of large industrial firms; also they engage in a range of regulated and unregulated activities,³⁴ trade in global markets, stand at the heart of the monetary policy transmission chain³⁵ and

²⁹See NIGRO, *La gestione delle crisi bancarie nell'ordinamento comunitario*, in *Diritto della banca e del mercato finanziario*, 1990, pag. 280 and PORZIO, *La disciplina giuridica dell'esercizio del credito*, 1991, pag. 358.

³⁰See GOODHART, HARTMANN, LLEWELLYN, ROJAS-SUAREZ, WEISBROD, *Financial regulation: why, how and where now*, London, 1998, pag. 10-12.

³¹See DE HAAN, OOSTERLOO, SCHOENMAKER, *Financial markets and institutions. A European Perspective*, 2012; HUPKES, *Form follows function. A new architecture for regulating and resolving global financial institutions*, in *European Business Organization Law Review*, 2009, pag. 371; CARLETTI, HARTMAN, SPAGNOLO, *Bank Mergers, Competition, and Liquidity*, ECB Working paper 292, 2003.

³²See KAUFMAN, *Bank failures, systemic risk, and bank regulation*, in *Cato Journal* 1996, pag. 17

³³See SCIASCIA, *Recovery and resolution in the EU: Devising a European Framework*, in CHITI, VESPERINI, *The administrative architecture of financial integration. Institutional design, legal issues, perspectives*, Bologna, 2015, pag. 93.

³⁴See LASTRA, PROCTOR, *The Actors in the Process: of Supervisors, Regulators, Administrators, and Courts of Justice*, in LASTRA, *Cross-Border Bank Insolvency*, Oxford, 2011, pag. 74.

³⁵See DAVIES, *Liquidity Safety Nets for Banks*, in *Journal of Commercial Law Studies*, 2013, pag. 287.

control the access to credit for ordinary firms and households.³⁶

Moreover, the contagion mechanism is what has swiftly turned a speculative bubble regarding the U.S. subprime market, a relatively small spot in the whole financial system, into a global crisis, the worst ever happened since the 1930s. Namely, in 2007 a steep reduction/fall in the prices of U.S. housing led to a significant devaluation of the related securities, as well as countless mortgage delinquencies and foreclosures. Due to the high degree of integration and interdependence among financial products, which were – and still are – removed from the scope and control of any supranational regulation or political oversight,³⁷ even the major European banks were exposed to these serious downsides/drawbacks. Therefore, in a blink of the eye, the crisis reached the other side of the Atlantic Ocean: between the summer of 2007 and the summer of 2008, many large creditors of European financial institutions refrained from rolling-over their credit lines and short-term debts, with the ultimate effect of spreading grim concerns about the solvability of EU banks.³⁸

Yet, the financial system seemed to resist until the collapse of Lehman Brothers on 15 September 2008 together with the serious crisis of AIG, the U.S. insurance giant, turned such early signs of the crisis into a full-blown panic. Across the Atlantic Ocean, the loss of confidence in banks' solvability dried up the market of interbank lending and, consequently, made access to liquidity progressively more difficult even for sound and healthy banks. Investors massively liquidated their investments, stock markets went into a tailspin, and a bulk of large-scale interconnected institutions had to uncover their own inefficiencies and poorly

³⁶See KNIGHT, *Mitigating moral hazard in dealing with problem financial institutions: Too big to fail? Too complex to fail? Too interconnected to fail?*, in LA BROSSE, OLIVARES-CAMINAL, SINGH, *Financial crisis management and bank resolution*, 2009, pag. 257; PSAROUDAKIS, *State aid, central banks and the financial crisis*, in *European company and financial law review*, 2012, pag. 194.

³⁷See CAPRIGLIONE, *Regolazione europea post-crisi e prospettive di ricerca del diritto dell'economia: il difficile equilibrio tra politica e finanza*, in *Rivista trimestrale diritto e procedura civile*, 2016, pag. 540-548 and CAPRIGLIONE, *Globalizzazione, crisi finanziaria e mercati*, cit., pag. 3 and 10 (considering regulation failure among the factors triggering the financial crisis).

³⁸See COLOMBINI, CALABRÒ, *Crisi finanziarie. Banche e Stati*, Torino, 2011; OECD, *Competition and Financial Markets*, 2009.

performing assets, which turned to be ultimately unable to sustain their risky investment strategies. To all this, a severe credit crunch, affecting both business investment and household demand, could only be to the detriment of the real economy, which entered into recession.

The public impact of the private difficulties of banks was thus evident and manifest: in other words, beyond any doctrinal discussion, in 2008, it was clear that the default of a bank could not be treated as private matter for shareholders and creditors. It had a public dimension, so that national governments could not witness such a baleful scenario without doing anything. Since the early days of the crisis and during the subsequent months, they tried to restore confidence in the financial sector, the long-term viability of their banks and, accordingly, the ability of their ordinary firms to access finance. Namely, they begun using taxpayers' money to put in place the above mentioned measures and, in particular, those meant to remedy to the liquidity crisis not only for the benefit of banks, but also of ordinary firms needing credit access to develop their business.

However, as in a perfect storm, from the 2009 onwards, these costly domestic measures increased the sovereign distress of the EU Member States whose public finances were already quite deteriorated. In a few months, the governments of Greece, Portugal, Ireland, Spain, and Italy saw their sovereign risk premiums rise to shooting up to unprecedented (and unbearable) levels, precisely because of their efforts to deal with the faults of private banks. At the same time, the recessionary impact of the continuing credit crunch triggered by the crisis led to a reduction in the GDPs of these Member States and, accordingly, to a decrease of their tax revenues, with the ultimate result of further weakening their solvency.³⁹ In summary, the crisis also infected the public finances of some EU member States and had a perverse effect on the national banks themselves that those governments were originally supposed to help. Involved in a “deadly

³⁹For the impact of the credit crunch and its consequences on the real economy, which in turn triggered the sovereign debts crisis, see CAPRIGLIONE, *Globalizzazione, crisi finanziaria e mercati: una realtà su cui riflettere*, cit., pag. 12-13; and CAPRIGLIONE, TROISI, *L'ordinamento finanziario dell'UE dopo la Crisi*, cit., pag. 23-24.

embrace” (also named “diabolic” or “mortal” loop), domestic financial institutions saw their credit risk drop down again due to the low market value of the debt bonds that they held precisely to support their solvency.⁴⁰

It was thus that a crisis born in the private sector on the other shore of the Atlantic Ocean, due to the reckless management of too sophisticated financial instruments free from any supranational control, turned into a sovereign debt crisis that put a strain on the resistance of the EU, further fueling a widespread (and never dormant) Euro skepticism.⁴¹

Moreover, as so it was that European institutions understood⁴² that they need to arrange an effective response to the financial and sovereign debt crises with State Aid law,⁴³ the only supra-national tool that⁴⁴ – at the time, absent Eurobonds⁴⁵ and other coordinated mechanisms as the one now envisaged – was available together with monetary policy.⁴⁶

Clearly, though, State Aid law had not been designed to tackle these crises:

⁴⁰See SEMERARO, CAPRIGLIONE, *Crisi finanziaria e dei debiti sovrani. L’Unione Europea fra rischi ed opportunità*, Torino, 2012, pag. 28; FARHI, TIROLE, *Deadly embrace: sovereign and financial balance sheets doom loops*, January 2016, available at <https://www.nber.org/papers/w21843>.

⁴¹See CAPRIGLIONE, *Eurosclosi e globalizzazione (contro un possibile ritorno all’euroscetticismo)*, in *Rivista trimestrale diritto dell’economia*, 2010, pag. 1.

⁴²To be sure, they have not been as quick and effective as the corresponding U.S. authorities. See on this point CAPRIGLIONE, TROISI, *L’ordinamento finanziario dell’UE dopo la Crisi*, cit., pag. 19-20.

⁴³In addition to the rules for the banking sector, the Commission adopted the Temporary Framework for State aid measures to support access to finance in the current financial and economic crisis, OJ C 16, 22.1.2009, pag. 1. It gave Member States additional possibilities to tackle the effects of the credit squeeze on the real economy. The first measures were approved at the end of 2008 and regarded German companies: N 661/08 – *KfW-run loan component of the German Konjunkturprogramm* and N 668/08 – *Federal Framework “Small amounts of compatible aid”*.

⁴⁴At the heart of the financial crisis there is an issue that goes beyond the scope of this paper: the gap between the global dimension of banking activity and the national, at most European, domain of binding rules and of the range of interests on the policy agenda. See, in this regard, CAPRIGLIONE, *Globalizzazione, crisi finanziaria e mercati: una realtà su cui riflettere*, cit., pag. 7-9; and GOODHART, LASTRA, *Border Problems*, cit., pag. 705.

⁴⁵Eurobonds would in fact serve to create a solidarity mechanism for the distribution of sovereign debts at European level. See on this issue and the further instruments that could be used to handle financial crisis hitting the Union, CAPRIGLIONE, TROISI, *L’ordinamento finanziario dell’UE dopo la Crisi*, cit., pag. 45-50.

⁴⁶Indeed, the European Central Bank (ECB) decided for an unprecedented reduction of the interest rate, a vigorous support to credit, and the so-called “Securities Market Programme”. See, on this point, CAPRIGLIONE, *Globalizzazione, crisi finanziaria e mercati: una realtà su cui riflettere*, cit., pag. 13-14.

it had to face this challenge with its own goals and rules – some of which had the priceless merit of recalling what was said above, namely that no public support for a bank in difficulty is free of charge; others had to be changed to make such public support effective and useful.

Hence, in the following paragraphs, State Aid law will be reviewed, with a twofold intent: (i) to explain that, in its essence, at least from the second half of the 1990s onwards, State law has always been called upon to strike a balance between conflicting goals and interests; and (ii) to illustrate how State aid law was enforced before the outbreak of crises, to appreciate the extent of the changes that the Commission made to tackle them.

4. In its essence, State Aid law is a living instrument, a tool of economic policy that, over the years, has been constantly changing to keep pace with the significant vicissitudes undergone by the European project.⁴⁷ The single market has grown geographically due to the inclusion of new Member States, which have joined the Union loaded with their policies and public institutions. More and more industries have been liberalized, going to swell the ranks of companies potentially benefiting from State aid. The possible forms of aid have become increasingly complex and sophisticated due to the degree of articulation achieved by the market economy. But, above all, over the years, both the objectives pursued by the State aid policy and the constraints imposed on it have changed.⁴⁸

The structure Article 107 serves this trade-off well enough. On the one hand, its first paragraph includes the prohibition, which applies if and only if an undertaking within the meaning of EU law receives, on a selective basis, an economic advantage, which is imputable to the State and is financed, directly or indirectly, through public resources, and which is likely to distort competition and affect trade between Member States. On the other hand, the second and third

⁴⁷See PIERNAS LOPEZ, *The Concept of State Aid under EU Law: From Internal Market to Competition and Beyond*, Oxford, 2015, pag. 45.

⁴⁸See BIONDI, RIGHINI, *An evolutionary theory of EU State Aid Control*, in CHALMERS, ARNULL, *The Oxford Handbook of European Union Law*, Oxford, 2015, pag. 672-673

paragraphs of Article 107 set forth two kinds of derogations.⁴⁹ Namely, Article 107(2) identifies *de jure* derogations, that is, State measures that are deemed automatically compatible with the internal market;⁵⁰ Article 107(3) lists discretionary derogations⁵¹ and – for what is more here – its letters (b) and (c) respectively mention aid to «remedy a serious disturbance in the economy of a Member State» and aid «to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest».⁵²

Therefore, the State aid prohibition is not absolute. The Treaty itself provides for certain scenarios where the drawbacks caused by State measures are outweighed by the objectives of common EU interest that they pursue, so as to prove that State aid policy is a matter of balance between the possible negative and positive effects of any State measure.

4.1. Until the 1980s, the Commission applied State aid law in a few cases, because not only was the process of market integration at the beginning, but also

⁴⁹To be sure, the Treaty provides for other exceptions as well: Article 106(2), which deals with undertakings delivering services of general interest, and Articles 107(3)(e) and 108(2), which grant the Council the power to create lawful categories of State aid.

⁵⁰The text of the provision reads that, «[t]he following shall be compatible with the internal market: (a) aid having a social character, granted to individual consumers, provided that such aid is granted without discrimination related to the origin of the products concerned; (b) aid to make good the damage caused by natural disasters or exceptional occurrences; and (c) aid granted to the economy of certain areas of the Federal Republic of Germany affected by the division of Germany, in so far as such aid is required in order to compensate for the economic disadvantages caused by that division».

⁵¹See, e.g., Case C-225/91, *Matra SA v Commission*, ECLI:EU:C:1993:239, § 24 and Case C-409/00, *Spain v Commission*, ECLI:EU:C:2003:92, § 94. See, furthermore, ROSSANO, *Gli aiuti di Stato alle banche e le ritrattazioni della Commissione: tra distorsioni della concorrenza e (in)stabilità finanziaria*, in *Rivista trimestrale di diritto dell'economia*, 2016, pag. 14; FERRARO, *L'evoluzione della politica sugli aiuti di Stato a sostegno dell'accesso al finanziamento nell'attuale situazione di crisi economica e finanziaria*, in *Diritto dell'Unione Europea*, 2010, pag. 337; and ANTONUCCI, *Gli aiuti di stato e il ruolo della Commissione del consiglio delle comunità europee*, in *Il consiglio di Stato*, 2004, pag. 110.

⁵²Whereas in relation to *de jure* derogations, the Commission will be required only to declare their lawfulness, in relation to discretionary derogations the Commission will have to assess their compatibility with the internal market. To this end, the Commission must interpret Article 107(3) narrowly and on the basis of the features of the specific case at stake. See, e.g., Case C-156/98, *Germany v Commission*, ECLI:EU:C:2000:467, § 49 and Joined cases T-102 and 120/07, *Freistaat Sachsen and Others v Commission*, ECLI:EU:T:2010:62, § 134.

the oil crisis and the collapse of the Bretton Woods system made State measures be a popular tool in the hands of national governments.⁵³ The first and sparse decisions adopted during the 60s and early 70s concerned mainly aid to the steel and coal industries, to shipbuilding, agriculture, textiles, and a few cases of rescue and restructuring.⁵⁴

However, from the 1980s onwards, the Commission devoted much more resources to State aid enforcement, precisely because of the 1987 *Single European Act*,⁵⁵ which was meant to add new momentum to the European integration process for the creation of the free single market, and because of the 1992 *Maastricht Treaty*,⁵⁶ which imposed new budgetary constraints on the public finances of the Member States, also to reduce State Aid as a percentage of (the) European GDP.

But the *Maastricht Treaty* did something more than that. It clarified that a reasonable and rationalized use of public funds had to be redirected towards objectives of common interest. It is true that at the beginning of 1990s, the Commission identified the superior community interest with market integration and with a rigorous – sometimes abstract – protection of competitive rules,⁵⁷ as so that its analysis of State measures was essentially focused on their negative effects. However, from the mid-1990s onwards,⁵⁸ especially after the 1997 *Treaty of Amsterdam*, and definitively with the 2007 *Treaty of Lisbon*, which ruled competition out of the EU goals,⁵⁹ the Commission adopted a more balanced approach and recognized that also other interests connected to employment,

⁵³See TOSATO, *L'evoluzione della disciplina sugli aiuti di Stato*, in SCHEPISI, *La "modernizzazione" della disciplina sugli aiuti di Stato*, Torino, 2011, pag. 4.

⁵⁴See BIONDI, RIGHINI, *An evolutionary theory of EU State Aid Control*, cit., pag. 684.

⁵⁵Single European Act, OJ L 169, 29.6.1987, pag. 1-28. See, in the same vein, the 1985 *White Paper – Completing the Internal Market*, COM (85)310 final, 14 June 1985, §§ 19 and 158.

⁵⁶Treaty on European Union, OJ C 191, 29.7.1992, pag. 1-112.

⁵⁷See TOSATO, *L'evoluzione della disciplina sugli aiuti di Stato*, cit., pag. 7.

⁵⁸Community guidelines on state aid for small and medium-sized enterprises (SMEs), [1996] OJ C 213/4; Community framework for state aid for Research and Development, [1996] OJ C 45/5; Guidelines on aid to employment, [1995] OJ C 334/4; Framework on training aid, [1998] OJ C 343/10.

⁵⁹See TUFANO, *La disciplina degli aiuti di Stato: dal controllo all'enforcement*, in SCHEPISI, *La "modernizzazione" della disciplina sugli aiuti di Stato*, Torino, 2011, pag. 35

health, environment, and social cohesion should have played a role in State aid enforcement.⁶⁰ Therefore, without disregarding budget discipline and the need for an effective and transparent use of taxpayers' money, the Commission started giving more room to the positive effects of State measures, in particular as regards innovation, research, and the optimization of human capital.⁶¹

Thus, over the years, State aid law has ceased to be a residual piece of legislation for depressed industries and unfortunate geographic areas,⁶² to become the pivot of a fully-fledged economic policy, called upon to strike a transparent balance between the protection of competition, the integrity of the internal market, and the rational use of public resources, on the one hand, and the will to accommodate the ever-growing needs of the complex European social economy, on the other.⁶³

During the crisis, financial stability – and therefore the intent to prevent the failure of a single bank from threatening the financial system as a whole, the real economy and public debt – has become one of the objectives of the European Union. Therefore, in those years, the European Commission had to understand how much of the other values – from the integrity of the single market to the budgetary discipline, passing through the protection of competition – could have been sacrificed to defend financial stability.⁶⁴

In the following paragraphs we will see that the evolution of events has conditioned this response.

4.2. Article 107(1) applies if some conditions are met. First, the beneficiary

⁶⁰See SCHEPISI, *La modernizzazione della disciplina sugli aiuti di Stato secondo l'Action Plan della Commissione europea: un primo bilancio*, in SCHEPISI, *La "modernizzazione" della disciplina sugli aiuti di Stato*, Torino, 2011, pag. 17

⁶¹See TOSATO, *L'evoluzione della disciplina sugli aiuti di Stato*, cit., pag. 10

⁶²See TUFANO, *La disciplina degli aiuti di Stato nell'Unione Europea: dal controllo all'enforcement*, cit., pag. 381.

⁶³See BIONDI, RIGHINI, *An evolutionary theory of EU State Aid Control*, cit., pag. 671; and DIVERIO, *Le misure nazionali di sostegno al mercato bancario: un'applicazione à la carte della disciplina europea degli aiuti di stato alle imprese?*, in *Diritto del commercio internazionale*, 2017, pag. 630.

⁶⁴2013 *Banking Communication*, § 7.

of the measure at stake must be an undertaking. It is true that Article 107 addresses Member States and their use of their taxpayers' money.⁶⁵ However, one of the reasons why Article 107 exists is to prevent Member States from distorting the selective mechanism that should underpin the internal market and that should ensure an undistorted business competition, provided that business competition is precisely the rivalry among undertakings. Therefore, any aid must be conceptualized of as a *vertical* measure affecting *horizontal* business relations, as it comes from a Member State, but it impacts on the rivalry among undertakings. As to the EU notion of undertaking, then, the Court of Justice has repeatedly stated that an undertaking is any entity or economic unit engaged in an economic activity,⁶⁶ that is, in an activity that consists in offering goods or services on a given market.⁶⁷ In other words, an undertaking is any agent that develops its activity consistently with the market rationale. On the contrary, State aid law cannot be applied if the beneficiary of the State intervention carries out a solidarity-laden activity⁶⁸ or deals with a matter that is a prerogative of the State.⁶⁹ To be sure, the issue whether the offer of certain products or services falls within the domain of public powers not only depends on the political and economic principles endorsed by the specific Member State concerned, but also

⁶⁵See ANTONUCCI, *Gli "Aiuti di stato" al settore bancario: le regole di azione della regia della Commissione*, in TROIANO, UDA, *La gestione delle crisi bancarie*, Milano, 2018, pag. 438.

⁶⁶See, e.g., Case C-41/90, *Klaus Höfner e Fritz Elser contro Macrotron GmbH*, 1991, ECLI:EU:C:1991:161, § 21. In the same vein, C-159/91 e C-160/91, *Poucet – Pistre*, 1993, ECLI:EU:C:1993:63, § 17; C-244/94, *Fédération française des sociétés d'assurances*, 1995, ECLI:EU:C:1995:392, § 14; C-55/96, *Job Centre II*, 1997, ECLI:EU:C:1997:603, § 21; C-180/98, *Pavel Pavlov*, 2000, ECLI:EU:C:2000:428, § 74; C-309/99, *Wouters*, 2002, ECLI:EU:C:2002:98, § 46; and C-264/01, C-306/01, C-354/01 e C-355/01, *AOK Bundesverband*, 2004, ECLI:EU:C:2004:150, § 46.

⁶⁷See, e.g., Case 118/85, *Commissione v Italy*, 1987, ECLI:EU:C:1987:283, § 7; Case C-180/98, *Pavel Pavlov*, 2000, ECLI:EU:C:2000:428, § 75; Case C-309/99, *Wouters*, 2002, ECLI:EU:C:2002:98, § 47.

⁶⁸See, e.g., Case C-159/91 e 160/91, *Poucet*, ECLI:EU:C:1993:63, §§ 18-19; Case C-237/04, *Eni risorse*, ECLI:EU:C:2006:197, § 31; and Case C-222/04, *Cassa di Risparmio di Firenze*, ECLI:EU:C:2006:8, §§ 120-121.

⁶⁹See, e.g., Case 107/84, *Commissione v Germany*, ECLI:EU:C:1985:332, §§ 14-15; Case C-364/92, *SAT Fluggesellschaft*, ECLI:EU:C:1994:7, §§ 30-31; Case C-343/95, *Diego Calì & Figli*, ECLI:EU:C:1997:160, §§ 22-23, and Case C-113/07 P, *SELEX*, ECLI:EU:C:2009:191, § 72.

vary over time.⁷⁰ Just consider, for example, that until the 1980s it was questioned exactly whether banking activities were purely market-oriented and, accordingly, whether banks were undertakings within the meaning of EU law.⁷¹ However, in 1977, the 2008 *Banking Directive* expressly held that banks are undertakings and,⁷² in 1981, the Court of Justice clarified in the *Züchner* case that banks perform economic activities,⁷³ subjected to EU antitrust law.⁷⁴ Accordingly, the Court made room to the idea that also banks could be “beneficiary undertakings” of State aid and this is the first reason why aid ranging from recapitalization schemes to restructuring plans may fall within Article 107(1).

Second, in order to be characterized as a State aid, a State measure must favor certain undertakings or the production of certain goods. True, this requirement may seem trivial. Indeed, where the aid at stake is granted to an individual undertaking, it is presumed. However, in case of interventions that apply broadly, to more than one undertaking, the selectivity requirement is what serves to distinguish general measures of fiscal or economic policy,⁷⁵ which do not

⁷⁰For example, whereas ensuring internal and external security, the administration of justice, or the conduct of foreign relations intrinsically are prerogatives of the State, in some Member States, the provision of social security or healthcare services as well as the offer of education and research activities may be classified, at least partially, as economic activities.

⁷¹See SCHENA, PEZZOTTA, *Commissione europea e politiche antitrust nel settore bancario*, in *Rivista italiana di diritto pubblico comunitario*, 2005, pag. 1188 and URBANI, *L'impresa bancaria italiana nella prospettiva del mercato unico europeo*, Padova, 2005, pag. 113.

⁷²See Article 1, First Council Directive 77/780/EEC of 12 December 1977 on the coordination of the laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions, OJ L 322, 17/12/1977, pag. 30-37.

⁷³Case 172/80, *Gerhard Züchner c. Bayerische Vereinsbank*, ECLI:EU:C:1981:178, § 7, reading that «although the transfer of customers' funds from one member State to another normally performed by banks is an operation which falls within the special task of banks, particularly in connection with international movements of capital, that is not sufficient to make them undertakings within the meaning of article [106(2)] of the treaty unless it can be established that in performing such transfers the banks are operating a service of general economic interest with which they have been entrusted by a measure adopted by the public authorities».

⁷⁴See, e.g., PANZERA, *Disciplina comunitaria della concorrenza e sistema bancario italiano*, in *Banca borsa e titoli di credito*, 1990, pag. 152; MENGOZZI, *La disciplina comunitaria sulla concorrenza ed attività bancaria*, in *Banca impresa e società*, 1992, pag. 15 e GHEZZI, MAGNANI, *Banche e concorrenza*, 1999, pag. 131-134 (where further references).

⁷⁵See, in this regard, 2008 *Banking Communication*, § 51, which reads «where a Member State/central bank reacts to a banking crisis not with selective measures in favor of individual banks, but with general measures open to all comparable market players in the market (e.g. lending to the whole market on equal terms), such general measures are often outside the scope of the State aid rules and do not need to be notified to the Commission. The Commission considers for

fall within the scope of Article 107(1), from aid schemes, which instead are subject to State aid law. Aid schemes – that, for what matters more here, have been quite common during the financial crisis because they help simplifying aid granting⁷⁶ – are indeed general plans on the basis of which single undertakings, that verify some general conditions, have the right to access the aid for an indefinite period of time and/or for an indefinite amount, without being subject to any further condition.⁷⁷ Now, these schemes may fall within Article 107(1) if their rationales do not justify any distinction between the banks that access them and the banks that are somehow excluded from them, although they are in a legal and factual situation that is comparable to that of the beneficiary undertakings.⁷⁸

Third, to be deemed as a State aid, the measure at stake must constitute a “un-market-like” advantage for the beneficiary undertaking. In other words, the measure must lead to an improvement in the economic and/or financial position of the undertaking,⁷⁹ which the undertaking would not have received under normal market conditions.⁸⁰ After all, even in market economies, States are allowed to act as economic agents (entrepreneurs, investors, or creditors) who, for example, sell land or assets, supply goods, participate in the capital of

instance that activities of central banks related to monetary policy, such as open market operations and standing facilities, are not caught by the State aid rules».

⁷⁶Indeed, aid schemes relieved the Commission of the administrative burden of considering each request on a case by case basis, particularly in a scenario when each approval may well have been fraught with political considerations and national interests.

⁷⁷See HANDBOOK ON COMMUNITY STATE AID RULES FOR SMES, 25 February 2009, pag. 6, available at http://ec.europa.eu/competition/state_aid/studies_reports/sme_handbook.pdf.

⁷⁸To ascertain whether the selectivity requirement occurs, the Commission undertakes a quite convoluted three-prong test – see, e.g., Case C-106-107/09 P, *Commission and Spain v Government of Gibraltar and United Kingdom*, ECLI:EU:C:2011:732, § 74; Case C-487/06 P, *British Aggregates v Commission*, ECLI:EU:C:2008:757, § 82; Case C-88/03, *Portugal v Commission*, ECLI:EU:C:2006:511, § 54; and Case C-143/99, *Adria-Wien Pipeline and Wietersdorfer & Peggauer Zementwerke*, ECLI:EU:C:2001:598, § 41. Furthermore, see BIONDI, *State Aid is falling, falling down: an analysis of the concept of “aid” in the acquis of the EU Courts*, in *Common Market Law Review*, 2013, pag. 1719.

⁷⁹See, e.g., Case C-206/06, *Essent Netwerk Noord and Others*, ECLI:EU:C:2008:413, § 79; Case C-280/00, *Altmark Trans and Regierungspräsidium Magdeburg*, ECLI:EU:C:2003:415, § 84; Joined Cases C-34/01 to C-38/01, *Eni risorse*, ECLI:EU:C:2003:640, § 30; and Case C-451/03, *Servizi Ausiliari Dottori Commercialisti*, ECLI:EU:C:2006:208, § 59.

⁸⁰See, e.g., Case C-533/12 P, *SNCM and France v Corsica Ferries France*, ECLI:EU:C:2014:2142, § 30 and Case C-39/94, *Syndicat français de l'Express international (SFEI) and others v La Poste and others*, ECLI:EU:C:1996:285, § 60.

undertakings, or grant firms loans. The gist of State Aid law is not preventing States from acting on the market, but is imposing States acting on the market to do it as if they were private economic agents. Therefore, when States act on terms which would be acceptable to commercial actors, Article 107 is not engaged.⁸¹ Instead, Article 107 applies when «State aid ... is non-commercial in the sense that the State steps in where the market [or where a rational economic agent] would not».⁸² Indeed, any State aid has the potential to undermine the market mechanism precisely because it contrasts with the normal course of the market, by transferring to undertakings resources that otherwise they would have not obtained at all, or that would have obtained at less convenient or profitable conditions. Thus, the Union courts have developed three similar tests – the *market economy investor test* that applies in cases of public investment,⁸³ the *private creditor test* that governs cases of debt renegotiation,⁸⁴ and the *private vendor test* that holds for cases of sale⁸⁵ – to distinguish the scenarios where States act as rationale private agents interested in maximizing their profits from those where States use taxpayers' money to pursue other non-market oriented goals. During the financial crisis, the Commission had no difficulty in showing that Member States acted irrespective of any market rationale.⁸⁶ Sometimes, the financial

⁸¹See e.g., Case C-303/88, *Italian Republic v Commission of the European Communities*, ECLI:EU:C:1991:136, §§ 19-20.

⁸²See, Opinion of AG Sir Gordon Slynn, 2.4.1987, Cases 67, 68 and 70/85, ECLI:EU:C:1987:177, pag. 251, which reads that, «[t]he State may have its reasons for doing so but they are not commercial in the ordinary sense of the word. Thus the State may subscribe for shares in a company or lend money, but when it does so to an extent or on terms which would not be acceptable to the commercial investor, it is granting aid which falls within Article [107] if the tests of that provision are satisfied».

⁸³See, e.g., Case C-142/87, *Belgium v Commission ('Tubemeuse')*, ECLI:EU:C:1990:125, § 29 and Case C-305/89, *Italy v Commission ('ALFA Romeo')*, ECLI:EU:C:1991:142, §§ 18 and 19.

⁸⁴ See, e.g., Case C-525/04 P, *Spain v Commission*, ECLI:EU:C:2007:698, § ECLI:EU:C:2007:698 and Case C-73/11 P, *Frucona v Commission*, ECLI:EU:C:2013:32; C-256/97, *DMTransport*, ECLI:EU:C:1999:332, § ____.

⁸⁵ See, e.g., Joined Cases T-268/08 and T-281/08, *Land Burgenland and Austria v Commission*, ECLI:EU:T:2012:90, § ECLI:EU:T:2012:90.

⁸⁶State aid N 507/2008 – *UK Financial Support Measures to the Banking Industry in the UK*, 13.10.2008, § 39, which clearly reads that, «both recapitalization and the guarantee would not have been provided by a market economy investor. Regarding the capitalization, the Commission recalls that a market economy investor expects a reasonable return on his investment. However, if a firm is in difficulty or acts in an industry experiencing particular difficulties it is normally not justified to assume a reasonable return. For the current scheme this is confirmed by the fact that the State is

products guaranteed had no economic value and thus were devoid of any meaning for a private investor;⁸⁷ sometimes the Commission assumed that dysfunctionalities of the market as such prevented the existence of a private investor, even if the remuneration of the particular financial instrument adopted was in line with market rates.⁸⁸

Fourth, the measure at stake must be *both* imputable to the State⁸⁹ and financed, directly or indirectly, through public resources.⁹⁰ More precisely, and as said before, first Article 107(1) does not target the actions of private economic agents: it addresses States and the way in which they intervene in the market. Therefore, to qualify as State Aid, the measure in question must be *attributable to* the State. Clearly enough if, for example, the aid results from a piece of national legislation⁹¹ or consists in the action of a public administration, imputability is assumed.⁹² By contrast, in all the other cases, even when the measure is adopted by a public undertaking, imputability must be assessed by looking at the circumstances and the context of the case.⁹³ Second, it has long been established that the nature of a measure cannot be appreciated separately from the way in

only investing because no market economy operator was willing to invest on similar terms (this is illustrated by the mechanism of the scheme). Regarding the guarantee, the Commission is convinced that in the current circumstances of financial crisis no private investor would have granted such a significant guarantee on senior debt of the participating banks». In the same vein, see State aid NN 51/2008 – *Guarantee scheme for banks in Denmark*, 10.10.2008, § 32.

⁸⁷See, e.g., State aid C 9/08 (ex NN 8/08, CP 244/07), *Sachsen LB*, 24.04.2009, § 74 (addressing the case of mortgage-backed commercial papers, whose demand had practically dried up, so that there was no longer any effective market for that type of investment).

⁸⁸Clearly on this point, *Restructuring Communication*, § 14, which reads that « In the current crisis governments have recapitalized banks on terms chosen primarily for reasons of financial stability rather than for a return which would have been acceptable to a private investor».

⁸⁹ Case C-482/99, *French Republic v Commission*, ECLI:EU:C:2002:294, § 24 and Joined Cases C-182 and 217/03, *Kingdom of Belgium and Forum 187 ASBL*, ECLI:EU:C:2006:416, § 127.

⁹⁰ Case C-379/98, *PreussenElektra*, ECLI:EU:C:2001:160, § 58 and C-345/02, *Pearle and Others*, ECLI:EU:C:2004:448, § 35.

⁹¹Differently, if the measure directly derives from a piece of EU legislation and leaves a Member State without any choice or leeway, the measure at stake cannot be deemed an aid of the *State*. See Case C-460/07, *Puffer*, ECLI:EU:C:2009:254, § 70.

⁹²Case C-182 and 217/03, *Belgium v Commission*, ECLI:EU:C:2006:416, § 128.

⁹³See, in this regard, Commission Notice on the notion of State aid as referred to in Article 107(1) of the Treaty on the Functioning of the European Union, OJ C 262, 19.7.2016, pag. 1–50, §§ 42–43.

which it is financed.⁹⁴ Accordingly, a measure is not a State aid unless it is financed through public resources, that is, unless it entails a *burden* on the public finances.⁹⁵ Any different interpretation, indeed, would have broaden too much the scope of the prohibition.⁹⁶ For example, it is not a State aid an *ad hoc* liquidity measure that is taken at the central bank's initiative *and* is not backed up by any counter-guarantee of the State. In such a situation, indeed, the State's coffers are not charged, even indirectly, with the onus of the liquidity support.⁹⁷ Differently, still today it is questioned whether the use of deposit guarantee schemes (DGS) actually amount to the disposition of public resources.⁹⁸

Fifth, the measure at stake must be capable of distorting competition and affecting trade among Member States. These conditions, although often analyzed together,⁹⁹ address two different issues.¹⁰⁰ As for the distortion of competition, the case law of the Court of Justice does not require any sophisticated market analysis: it is enough that the State measure puts the rivals of the beneficiary at a

⁹⁴See, e.g., Case C-261-262/01, *van Calster and Cleeren*, ECLI:EU:C:2003:571, §§ 46-49.

⁹⁵See Opinion Advocate General Jacobs, Case C-379/98, *PreussenElektra*, ECLI:EU:C:2001:160, §§ 137-145.

⁹⁶And this notwithstanding the letter of Article 107(1) which provides for an alternative: *either* that the aid is granted by a Member State *or* that it is financed through State resources.

⁹⁷See *2008 Banking Communication*, § 51, which lists the other conditions that a liquidity measure must meet not to be characterized as a State aid. Namely, the beneficiary institution must be solvent at the moment of the liquidity provision; the liquidity provision must not be part of a larger aid package; the facility is fully secured by collateral to which haircuts are applied, in function of its quality and market value; and the central bank charges a penal interest rate to the beneficiary». In the same vein, see also the current *2013 Banking Communication*, § 62.

⁹⁸ See Case T-98/16, *Italy v Commission*, ECLI:EU:T:2019:167 (affirming the principle according to which a DGS's preventive and alternative measure do not constitute State aid, unless the Commission adequately proves that the public authorities exercises actual control over the operations). See further GIGLIO, SETOLA, *La disciplina degli aiuti e le crisi bancarie italiane*, in *Mercato Concorrenza Regole*, 2002, pag. 217-218; DIVERIO, *Le misure nazionali di sostegno al mercato bancario: un'applicazione à la carte della disciplina europea degli aiuti di stato alle imprese?*, cit., pag. 610; ARGENTATI, *I salvataggi di banche italiane e l'"Antitrust" europeo*, in *Mercato concorrenza regole*, 2016, pag. 109 and ARGENTATI, *Sistemi di garanzia dei depositi e crisi bancarie: c'è aiuto di Stato?*, in *Mercato concorrenza regole*, 2015, pag. 315; and AA.VV., *The role of the CJEU in shaping the Banking Union: notes on Tercas (T-98/16) and Fininvest (C-219/17)*, Banca d'Italia, Quaderni di Ricerca Giuridica, n. 85, May 2019.

⁹⁹Joined Cases T-298/97, T-312/97 and others, *Alzetta Mauro and others v Commission*, ECLI:EU:T:2000:151, § 81.

¹⁰⁰Case C-372/97, *Italy v Commission*, ECLI:EU:C:2004:234, § 44 and Case C-148/04, *Unicredito Italiano*, ECLI:EU:C:2005:774, § 55.

competitive disadvantage.¹⁰¹ Instead, as for the interstate commercial clause, case law does not require a threshold or a percentage below which the State measure is assumed not to affect trade between Member States – a fact, the last one, that for example has justified the application of Article 107(1) even to minor domestic banks.¹⁰² Differently, to better administer its resources, the Commission has identified a *de minimis* threshold below which the State measure is supposed to have a negligible impact on trade and competition and, accordingly, does not require any notification.¹⁰³

4.3. As mentioned above, the rules on State Aid control do not prevent Member States from supporting businesses. Rather, they ensure that any of the aid granted pursues a European goal capable of outweighing the distortions that it causes. And, in doing so, they contribute to realize many other objectives: they protect the functioning of the market, by ensuring equity and a level playing field; they help rewarding the most competitive firms, thereby increasing overall European competitiveness; they direct the use of public funds towards objectives of common interest that otherwise would not be realized, such as major infrastructure projects or investments in renewable energy; and they encourage the efficient use of taxpayers' money,¹⁰⁴ while maximizing the resources available from limited national budgets targeting many essential purposes, such as the educational system, the health system, national security, social protection and others.

In practice, then, irrespective of the specific provision of Article 107(3) requiring approval,¹⁰⁵ every Commission decision on the compatibility of a State

¹⁰¹Case 730/79, *Phillip Morris*, ECLI:EU:C:1980:209, § 11.

¹⁰²For a critique to this approach, see ANTONUCCI, *Gli "Aiuti di stato" al settore bancario: le regole di azione della regia della Commissione*, cit., pag. 444.

¹⁰³See, Commission Regulation (EU) No 1407/2013 of 18 December 2013 on the application of Articles 107 and 108 of the Treaty on the Functioning of the European Union to *de minimis* aid, OJ L 352, 24/12/2013, pag. 1.

¹⁰⁴*SAM Communication*, § 14

¹⁰⁵To be sure, in 1999, the so-called Enabling Regulation was enacted – see Council Regulation (EC) No 994/98 of 7 May 1998 on the application of Articles 92 and 93 (now 107 and 108

measure balances its positive impact, that is, whether it is able to realize a commonly agreed, politically desirable, goal of communitarian interest,¹⁰⁶ against its potentially negative effects, such as competitive distortions and inappropriate use of taxpayers' money.¹⁰⁷

More specifically, since the 2005 *State Aid Action Plan (SAAP)*,¹⁰⁸ the Commission has followed this approach, often referred to as the “balancing test”,¹⁰⁹ not only in its decisions, but also in its guidelines, including those that dealt with the financial crisis after 2008. Thus, it has tried to support “less and better-targeted aid”, with the ultimate goal of increasing efficiency through

respectively) of the Treaty establishing the European Community to certain categories of horizontal state aid, OJ L 142, 14.5.1998, pag. 1. Thus, the Commission was entitled to adopt regulations identifying certain categories of aid as compatible and exempting them from previous notification by the Member States, provided they respect a number of criteria defined in such regulations. Nowadays, therefore, compatibility is assessed on the basis of case practice, horizontal and sectoral guidelines and a block exemption regulation – the General Block Exemption Regulation (‘GBER’). Since 2008, it has captured in one single legislative text all the criteria for exempting aid from notification and harmonized, as far as possible, all horizontal aspects applying to the different aid areas concerned. See, Commission Regulation (EC) No 800/2008 of 6 August 2008 declaring certain categories of aid compatible with the Common Market in the application of Articles 87 and 88 of the Treaty (General block exemption Regulation), [2008] OJ L 214/3. It consolidated five existing state aid regulations adopted by the Commission since 2001: aid to SMEs; research and development aid in favor of SMEs; aid for employment; training aid; and regional aid. In addition, the GBER block exempted another five categories of aid: environmental aid; innovation aid; research and development aid for large companies; aid in the form of risk capital; and aid for enterprises newly created by female entrepreneurs.

¹⁰⁶Case C-730/79, *Philip Morris Holland*, ECLI:EU:C:1980:209, §§24-26 and Case C-301/87, *French Republic v Commission*, ECLI:EU:C:1990:67, §49.

¹⁰⁷See 2005 State Aid Action Plan, § 11 where the Commission states that, «state aid should only be used when it is an *appropriate* instrument for meeting a well-defined objective, when it creates the *right incentives*, is *proportionate* and when it *distorts competition to the least possible extent*» (emphasis added) and *Commission’s State aid modernization programme* COM (2012) 209, § 18.

¹⁰⁸To be sure, not only did the SAAP introduce the balancing test, also it promoted three other reforms: «the increasing complexity and number of documents progressively adopted by the Commission over time have created [1] a need to streamline state aid policy, focus attention on the most distortive types of aid and make state aid control more predictable and user-friendly, thereby minimizing legal uncertainty and the administrative burden both for the Commission and for Member States. [2] There is also a need to strengthen the commitment of Member States to their obligation to enforce state aid rules. [3] Finally, there is a need to increase transparency and advocacy about state aid policy to allow undertakings, the academic world, competition specialists, consumers and the broader public to get involved and act against unlawful aid, in particular before national judges» – see SAAP, § 17.

¹⁰⁹See DELL’ATTI, *Gli aiuti di stato alle banche in tempo di crisi*, in *Concorrenza e Mercato*, 2012, pag. 570; BRANCASI, *La tutela della concorrenza mediante il divieto di aiuti di stato*, in *Diritto Pubblico*, 2010, pag. 195; ZIMMER, BLASCHZOK, *The Role of Competition in European State Aid Control during the Financial Market Crisis*, in *European Competition Law Review*, 2011, pag. 9.

focusing on most important and potentially distortive cases,¹¹⁰ while supporting domestic investments in research, economic growth, and job creation. In other words, thanks to the balancing test, the Commission has been working to improve the effectiveness and credibility of State aid rules,¹¹¹ while preserving and consolidating its political – and hence discretionary – role in determining whether the State interventions under scrutiny were not only compatible with the single market, but also consistent with EU goals.¹¹²

In particular, since the 2012 *State Aid Modernization Communication (SAM Communication)*,¹¹³ the Commission has given another breakthrough in its compatibility assessment and has not aligned it to the Europe 2020 objectives.¹¹⁴ Thus, the Commission has tried to stimulate Member States to spend their often scarce public resources to facilitate and not to replace private spending, in areas which are considered the engines of the European social economy and where the markets are indeed failing, on their own, to deliver the necessary growth.¹¹⁵ To this end, the Commission has created the notion of “good aid”, that is aid «which is well designed, targeted at identified market failures and objectives of common interest, and least distortive».¹¹⁶ Next, it has promoted the “*big on big and small*

¹¹⁰ This happened by endorsing two strategies. On the one hand, SAM meant a significant move towards more exemptions for projects which create fewer competitive concerns. On the other hand, SAM introduced several safeguards, such as monitoring, evaluation of large aid schemes and transparency of aid awards.

¹¹¹ See SCIAUDONE, *Gli aiuti di Stato tra regolamentazione ‘orizzontale’ e crisi dei mercati*, in SCHEPISI, Torino, 2001, pag. 140.

¹¹² At the same time, the Commission gave space to Member States and national judges. See SCHEPISI, *La modernizzazione della disciplina sugli aiuti di Stato secondo l’Action Plan della Commissione europea: un primo bilancio*, cit., pag. 19

¹¹³ See <https://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:52012DC0209>. The State aid modernization communication had three main objectives: "(a) to foster sustainable, smart and inclusive growth in a competitive internal market; (b) to focus Commission ex ante scrutiny on cases with the biggest impact on the internal market while strengthening the cooperation with Member States in State aid enforcement; (c) to streamline the rules and provide for faster decisions".

¹¹⁴ This is the European Union’s ten-year growth and jobs strategy, launched in 2010 as a response to the financial and economic crisis that has hit Europe since 2008. See Communication from the Commission, EUROPE 2020—A strategy for smart, sustainable and inclusive growth, COM(2010) 2020 final of 3 March 2010.

¹¹⁵ See PESARESI, *Diritto della concorrenza e crisi di impresa*, cit., pag. 164.

¹¹⁶ Communication from the Commission on EU State Aid Modernisation (‘SAM’), COM (2012) 209 final, 08.05.2012, para 12.

on small” approach,¹¹⁷ to improve an efficient use of its own resources.¹¹⁸ Furthermore, it wanted to ensure equal treatment for Member States with different financial pockets.¹¹⁹ Finally – and for what matter more here – in the SAM the Commission has formalized the balancing test and spelled out its practice, by codifying a set of seven common principles applicable to the compatibility assessment of all kinds of aid.¹²⁰ Therefore, today, to be compatible with the internal market, an aid: (a) must aim to achieve a well-identified goal of common interest, such as educational system promotion, health system development, national security defense, sustainable growth, competitiveness, social and regional cohesion, environmental protection, or cultural diversity advancement; (b) has to be *necessary* and *well-designed*, either to bring about a market improvement that the failed market cannot deliver on its own or to target another non-economic object; (c) must be an *appropriate* tool for dealing with the problem as opposed to other policy instruments that could turn out to be more effective or less distortive; (d) must be *proportionate* to address the issue at stake, without requiring any exceeding amount of resources or time; (e) must give the beneficiary undertaking enough *incentives* to ultimately get rid of the aid,¹²¹ with the parallel effect of promoting effectiveness in public spending; (f) cannot bring about any *undue negative effects* on competition or trade; and finally (g) must be

¹¹⁷See BLAUBERGER, *From negative to positive integration? European State aid control through soft and hard law*, Max Planck Institut für Gesellschaftsforschung. Discussion Papers, 2008.

¹¹⁸To this end, the Commission has restated almost all of the substantive rules that govern the compatibility assessment, ranging from the guidelines on energy and environment to those of broadband, regional aid, aviation, or research, development and innovation. Furthermore, the Commission has revised the Enabling Regulation to adopt an enlarged GBER, whose scope now extends to block exemptions of all categories of aid that are considered ‘good’, have limited impact on the internal market, and for which the compatibility criteria are consolidated. Nowadays, new categories include aid for culture, natural disasters, sport, transport to remote regions and aid for certain agriculture, forestry, and fisheries issues. See Commission Regulation (EU) No 651/2014 of 17 June 2014 declaring certain categories of aid compatible with the internal market in application of Articles 107 and 108 TFEU, OJ L 187, 26.6.2014, pag. 1.

¹¹⁹See PESARESI, *Diritto della concorrenza e crisi di impresa*, cit., pag. 164.

¹²⁰SAM *Communication*, § 18.

¹²¹Clearly on this point, *Restructuring Communication*, § 14, which reads that, «[l]ong-term viability [...] requires that any State aid received is either redeemed over time, as anticipated at the time the aid is granted, or is remunerated according to normal market conditions, thereby ensuring that any form of additional State aid is terminated».

transparent as so to guarantee easy access to all material acts and pieces of information concerned for the Commission, Member States, and the beneficiary undertakings to cooperate.¹²²

Therefore, three conclusions follow from what just said. First, the idea that State aid law can work to channel and coordinate public spending towards a clear objective of EU interest,¹²³ such as financial stability,¹²⁴ rebuts the argument that, during the crisis, the Commission rubber-stamping State measures can be dismissed easily, although it decided for incompatibility only in a few cases.¹²⁵ Second, the analysis carried out under Article 107(3) requires that the Commission exercise significant discretionary power to limit Member States' sovereignty in intervening in the market. The scope of such power, as it results from the specific criteria employed, is what distinguishes a rigorous from a lenient approach on the part of the Commission.

Indeed, to ensure uniformity across the European Union, Article 108 TFEU entrusts only the European Commission with the power to carry out a comprehensive review as to whether a State measure falls within the scope of

¹²²See DELL'ATTI, *Gli aiuti di stato alle banche in tempo di crisi*, cit., pag. 570.

¹²³See MEROLA, *La politica degli aiuti di Stato nel contesto della crisi economico finanziaria: ruolo e prospettive di riforma*, cit., pag. 222 (addressing this activity as a form of "grandfathering"). For a critical opinion, see OSTI, *La riforma degli aiuti di Stato e il nuovo approccio economico della Commissione*, in SCHEPISI, *La "modernizzazione" della disciplina sugli aiuti di Stato*, Torino, 2001, pag. 57 (arguing that State aid law should do anything other than protecting competition).

¹²⁴In the same vein, GRAY, DE CECCO, *Competition, stability and moral hazard: the tension between financial regulation and State aid control*, cit., pag. 27-29.

¹²⁵See, e.g., State aid 33927 (2012/C) (ex 2011/NN) – *Guarantee scheme protecting the shares of individual members of financial cooperatives*, 19.07.2012, §§ 52-64, where the Commission found that a Belgian guarantee scheme for shareholders of financial cooperatives did not fall within Article 107(3) (b). In particular, first the Commission doubted that the activities of the financial cooperatives sufficiently match with those of a typical financial institutions. Thus, the Commission concluded that the Belgian scheme could not be covered by the 2008 *Banking Communications* to then verify that the Belgian scheme could not meet general conditions of appropriateness, necessity, and proportionality. Furthermore, see the already mentioned *Tercas case* – State aid 39451 (2015/C) (ex 2015/NN) – *State support to Banca Tercas – Italy*, 27.02.2017. The gist of the case has nothing to do with the compatibility of the aid with EU law (see §§ 87-91, where the Commission declared to miss the information necessary to assess compatibility), but with the existence of the aid as the Italian mandatory deposit guarantee scheme (that is, Fondo Interbancario di Tutela dei Depositi – FITD) intervened beyond the pay-out function to depositors to grant support to the bank in difficulty.

Article 107(1)¹²⁶ and meets the conditions set forth in Articles 107(2) and 107(3).¹²⁷ For sure, it happens in accordance with a specific procedure.

4.4. Irrespective of whether the requested authorization is based on Article 107(2) or Article 107(3),¹²⁸ the Member State proposing to grant aid shall notify the proposal to the Commission for approval.¹²⁹ And it must do it in advance of providing the aid. In other words, it must wait for the Commission's decision before implementing the measure.¹³⁰

In particular, each notification triggers a preliminary investigation, during which the Commission may request information and Member States have strong

¹²⁶ See, e.g., Case C-452/10 P, *BNP Paribas and BNL v Commission*, ECLI:EU:C:2012:366, § 100; Case C-83/98 P, *France v Ladbroke Racing and Commission*, ECLI:EU:C:2000:248, § 25, and Case C-487/06 P, *British Aggregates v Commission*, ECLI:EU:C:2008:757, § 111.

¹²⁷In particular, when taking into account all the relevant circumstances of the case under scrutiny, the Commission must focus on the potential effects of the aid – see Case C-173/73, *Italy v Commission*, ECLI:EU:C:1974:71, § 13 – as they can be appraised on the date on which the Commission takes its decision; see, e.g., Case C-334/07 P, *Commission v Freistaat Sachsen*, ECLI:EU:C:2008:709, § 50; Joined Cases C-182/03 and C-217/03, *Belgium and Forum 187 v Commission*, ECLI:EU:C:2006:416, § 137; and Joined Cases C-341/06 P and C-342/06 P, *Chronopost and La Poste v UFEX and Others*, ECLI:EU:C:2008:375, § 95. Differently, the Commission shall not focus on the form of the aid. For example, already in the early days the Court made clear that the notion of aid is wider than that of subsidy. See Case C-30/59, *De Gezamenlijke Steenkolenmijnen in Limburg v High Authority of the ECSC*, ECLI:EU:C:1961:2, pag. 19. Neither shall it elaborate any discretionary assessment of its social, economic, or political justifications. See, e.g., Case C-241/94, *French Republic v Commission*, ECLI:EU:C:1996:353, §§ 20-21 and Case C 310/85, *Deufil GmbH & Co. KG v Commission*, ECLI:EU:C:1987:96, § 8. Furthermore, the Commission may consider also facts and elements already analyzed in a prior decision as well as the obligations which that decision may have imposed on the Member State concerned. However, the Commission is not bound by its earlier decisional practice. See, e.g., Case C-138/09, *Todaro Nunziatina & C.*, ECLI:EU:C:2010:291, § 21.

¹²⁸Differently, the notification is not required where the proposed measure meets the conditions of a block exemption, a legal tool that the Commission has increasingly employed over the years precisely to lower the number of individual cases.

¹²⁹If the aid is granted without the Commission's permission, it will almost always automatically be deemed to be unlawful and challenged in national courts. Furthermore, the beneficiary undertaking may be ordered to pay it back. See, in this regard, ROBERTI, *Gli aiuti di stato nel diritto comunitario*, Padova, 1997, pag. 20 and SHEPISI, *La modernizzazione della disciplina sugli aiuti di Stato secondo l'Action Plan della Commissione europea: un primo bilancio*, cit., pag. 17.

¹³⁰There are a few exceptions to mandatory notification, for example: (i) aid covered by a Block Exemption (giving automatic approval for a range of aid measures defined by the Commission); (ii) *de minimis* aid not exceeding €200,000 per undertaking over any period of 3 fiscal years (€100,000 in the road transport sector) or (iii) aid granted under an aid scheme already authorised by the Commission.

incentives to fully collaborate.¹³¹ Indeed, from the time the Commission believes to have received all the needed pieces of material information, the Commission has two months to take one of the following decisions: (i) that there is no aid within the meaning of Article 107(1) and the measure notified can be implemented; (ii) that the aid is compatible with Article 107(3), because its positive effects outweigh its distortions and, hence, it may be implemented; or (iii) that serious doubts remain as to the compatibility of the notified measure and, accordingly, the Commission must open an in-depth formal investigation under Article 108(2).

Also in this instance, the measure may not be implemented until the investigation is concluded. Moreover, there is no legal deadline to complete an in-depth investigation and its actual length depends on many factors, including the complexity of the case, the quality of the information provided and the level of cooperation from the Member State concerned.

Therefore, whatever the decision reached at the end of the formal investigation,¹³² it is quite clear that the ordinary State aid procedure takes months, during which no public support can be granted. It is therefore clear that such a procedure cannot meet the pressing needs of firms in difficulty, let alone the systemic ones of banks in difficulty.¹³³

5. Where the firm receiving public support is unable to recover through its own resources or by raising the funds it needs from the market and where the aid granted is precisely meant to prevent that firm from exiting the market, such a State intervention is one of the most dangerous. It contradicts the *raison d'être* of market economies, because it prevents the market from excluding a firm that is

¹³¹See, e.g., Case C-372/97, *Italy v Commission*, ECLI:EU:C:2004:234, § 81 and Case C-364/90, *Italian Republic v Commission*, ECLI:EU:C:1993:157, § 20.

¹³²There are mainly three possible outcomes: (i) a positive decision, where the measure is no aid or the aid is compatible with the internal market; (ii) a conditional decision, where the measure is found compatible, but its implementation is subject to the conditions stated in the decision; or (iii) a negative decision, where the measure is incompatible and cannot be implemented.

¹³³See PESARESI, *Diritto della concorrenza e crisi di impresa*, cit., pag. 164.

not efficient and innovative enough to resist its rivals.¹³⁴

Nevertheless, even before the bursting of the financial crisis, the European Commission has recognized that, under the conditions set out in its *R&R Guidelines*,¹³⁵ in some exceptional circumstances, Member States may disregard market selection and use rescue and restructuring aid to support firms in difficulty.¹³⁶

Better, when it was still politically incapable of preventing the provision of rescue and restructuring interventions, the Commission found a way – its own way – to scrutinize them and try to reduce their distortive effects on competition.¹³⁷ Via the *R&R Guidelines*, it established that rescue and restructure interventions deserve to be authorized pursuant to Article 107(3)(c) for two reasons at least. First, because they contribute to solve employment or regional problems, protect the economic viability of small and medium-sized suppliers/distributors operating with the firms in trouble, and prevent the existence of anticompetitive market scenarios.¹³⁸ Second because, without such aid, distressed firms would be unable to promote any public policy objective or support the development of economic

¹³⁴See KOKKORIS, *The special nature of banks and its challenges for competition policy*, in LEPREVOTE, GRAY, DE CECCO, *Research handbook on State aid in the banking sector*, Cheltenham, 2017, pag. 4

¹³⁵OJ C 244, 1.10.2004, pag. 2.

¹³⁶Firstly enacted in 1994 – see Community guidelines on State aid for rescuing and restructuring firms in difficulty, OJ C 368, 23.12.1994, pag. 12 – the *R&R Guidelines* have been periodically revised. Two amendments occurred between 1994 and 2004: Community guidelines on State aid for rescuing and restructuring firms in difficulty, OJ C 283, 19.09.1997, pag. 2 (following the 1994 policy indications except as regards the agricultural sector, for which the 1997 text introduced various amendments); and Community guidelines on State aid for rescuing and restructuring firms in difficulty, OJ C 288, 09/10/1999, pag. 2 (framing the rules more strictly). For the analysis of 1994 *R&R Communication*, see ROTONDO, VATTERMOLI, *Gli aiuti di Stato alle imprese bancarie in difficoltà*, cit., pag. 247; GIGLIO, SETOLA, *La disciplina degli aiuti e le crisi bancarie italiane*, in *Mercato Concorrenza Regole*, 2002, pag. 213; NICOLAIDES and KEKELEKIS, *When do Firms in Trouble Escape from State Aid Rules*, *European State Aid Law Quarterly*, 2005, pag. 17; ANESTIS, MAVROGHENIS, DRAKAKAKIS, *Rescue and Restructuring Aid: A Brief Assessment of the Principal Provisions of the Guidelines*, *European State Aid Law Quarterly*, 2004, pag. 27-34. Furthermore, for the most recent version of the *R&R Guidelines*, see PETZOLD, *Rescue and Restructuring (R&R) Guidelines – Thoughts and Comments on the Commission's Draft*, *European State Aid Law Quarterly*, 2014, 289.

¹³⁷See GIGLIO, SETOLA, *La disciplina degli aiuti e le crisi bancarie italiane*, cit., pag. 216 (proposing indeed to change such approach).

¹³⁸Differently, rescue and restructuring aid will never be justified «to keep a firm artificially alive in a sector with long-term structural overcapacity or when [the firm] can only survive as a result of repeated State interventions» – see 2004 *R&R Guidelines*, § 8.

activities compatible with the communitarian interests.

To be sure, *rescue aid* need to be understood as temporary – not exceeding six months – and reversible subsidies, meant to remedy acute liquidity crises or technical insolvency, with minimum competitive distortions. Therefore, not only have they to consist in loan guarantees or loans for the amount and time strictly necessary to either reimburse/terminate the loans/loan guarantees or to work out a solution for the firm in difficulty – a restructuring or a liquidation plan – also they must be granted at an interest rate comparable to that applied for loans to healthy firms.¹³⁹

Instead, *restructuring aid* are supposed to restore, in the shortest period possible, firms' long-term viability and thus need to consist in measures internal to the firm, such as capital injections, debt reductions, and reorganization projects, meant to be appropriate and strictly necessary, that is not only able to actually solve the structural problems that caused the firm's distress, but also capable of keeping their amount and intensity at minimum.¹⁴⁰ Therefore, to be compatible with the internal market, the first restructuring aid need to be linked to a reliable plan, of a reasonable duration and based on realistic and generally acknowledged assumptions as to the future operations of the firm and the market's developments,¹⁴¹ which the Commission had to approve and to which the Member State concerned commits itself.¹⁴² Secondly, the beneficiary undertaking must be called to share the financial burden of the restructuring aid. In other words, «[a]id beneficiaries [are] expected to make a significant contribution to the restructuring plan from their own resources, including the sale of assets that are not essential to the firm's survival, or from external financing at market

¹³⁹2004 *R&R Guidelines*, §§ 15 and 25.

¹⁴⁰*Ibidem*, §§ 17, 35, 36 and 43.

¹⁴¹In particular, the Commission requires that the beneficiary firm elaborates a restructuring plan that «must take account, *inter alia*, of the present state of and future prospects for supply and demand on the relevant product market, with scenarios *reflecting best-case, worst-case and intermediate assumptions and the firm's specific strengths and weaknesses*» (emphasis added). See 2004 *R&R Guidelines*, § 36.

¹⁴²*Ibidem* §§ 34-35.

conditions».¹⁴³ And this for two reasons: on the one hand, such a commitment by the part of the beneficiary undertaking ensures that the markets (owners, creditors) believe in the feasibility of the return to viability within a reasonable time period; on the other hand, it ensures that the restructuring aid is limited to the minimum required to restore viability.¹⁴⁴ Third, in order to minimize the effect on competitors and competition, the restructuring aid has to be accompanied by proportionate compensatory measures, such as divestiture of assets, reductions in capacity or market presence, and reduction of entry barriers on the markets concerned. In addition, granted that the Commission will be always be allowed to add further obligations meant to deal with the specific case at stake, the beneficiary firm is not authorized to use the public funds received to engage in aggressive, market-distorting activities or new investments that are not linked to the restructuring process.¹⁴⁵ Fourth, as a matter of procedure, the Commission must be put in a position to make certain that the restructuring plan is being implemented properly, through regular detailed reports provided by the Member State concerned.¹⁴⁶

In addition, the 2004 *R&R Guidelines* specifies that both rescue and restructuring aid have to obey to the “one time, last time” principle, according to which Member States cannot not repeatedly grant rescue or restructuring aid. Indeed, consistently with the rationale of any market economy, no firm can be put in the position to survive competition thanks to the ongoing assistance of the State. To be sure, the Commission envisages as well three main exemptions to this principle: where the restructuring aid follows a rescue aid as part of a single restructuring operation; where a lawfully granted rescue aid was not followed by a restructuring aid, but after at least five years, this need raised due to exceptional

¹⁴³*Ibidem*, § 43. Furthermore, in para 44 the Commission specifies the contributions required to deem the contribution appropriate: «at least 25 % in the case of small enterprises, at least 40 %, for medium-sized enterprises and at least 50 % for large firms. In exceptional circumstances and in cases of particular hardship, which must be demonstrated by the Member State, the Commission may accept a lower contribution».

¹⁴⁴2004 *R&R Guidelines*, §§ 7 and 43.

¹⁴⁵*Ibidem*, §§ 39-40 and 45-46.

¹⁴⁶*Ibidem*, § 49.

and unforeseeable circumstances for which the undertaking is not responsible; or where exceptional and unforeseeable circumstances occurred for which the undertaking is not responsible.¹⁴⁷

Finally, the 2004 R&R *Guidelines* provided for a shorten procedure for rescue aid, according to which the Commission could take a decision in one month from the receipt of a complete notification of the necessary information.¹⁴⁸

In summary, hence, the 2004 *R&R Guidelines* answered to a specific vision: in exceptional circumstances, taxpayers' money can be quickly used to rescue and restructure firms in difficulty, only as long as those measures realize rigorous and effective plans, the costs of which are partially cast upon those who contributed to the distress.

6. There was a time when the EU banking sector was a strong and prosperous industry, experiencing a rapid credit growth, low risk premiums, abundant availability of liquidity, high leveraging, soaring asset prices, and the development of bubbles in the real estate sector.¹⁴⁹ At that time – that is, until the 1990s – the Commission did not need to develop any sector-specific rule on State aid to manage financial institutions in difficulty. When some individual banks were in distress, the Commission treated them as ordinary firms and followed the above-mentioned ordinary *R&R Guidelines*,¹⁵⁰ which it actually kept applying in the very early days of the crisis.¹⁵¹

¹⁴⁷Ibidem, §§ 5, 72 and 73.

¹⁴⁸Ibidem, § 30.

¹⁴⁹See TESAURO, *Disciplina comunitaria degli aiuti di Stato e imprese bancarie*, in *Diritto del commercio internazionale*, 1991, pag. 411.

¹⁵⁰ See, e.g., *Crédit Lyonnais*, OJ L308, 21.12.95, pag. 92 and L221, 8.8.98, pag. 28; *GAN Group*, OJ L78, 16.03.98, pag. 1; *Société Marseillaise de Crédit*, OJ C49, 19.12.1997, pag. 2 and OJ C 249, 08.08.1998, pag. 11; *Banco di Napoli*, OJ L 116, 4.5.99, pag. 3; *Banco di Sicilia e Sicilcassa*, OJ L256, 10.10.00, pag. 21; *Bankgesellschaft Berlin*, OJ L 116, 4.5.2005, pag. 1; and State aid, C 50/2006 (ex NN 68/2006, CP 102/2006) implemented by Austria for *BAWAG-PSK*, 27.06.2007. For a detailed analysis of some of these cases see ROTONDO, VATTERMOLI, *Gli aiuti di Stato alle imprese bancarie in difficoltà*, cit., pag. 250.

¹⁵¹See C 9/2008 *Restructuring aid to Sachsen LB*, Germany; C 10/2008 *Restructuring aid to IKB*, Germany; C 43/2008 *Restructuring aid to West LB*, Germany; N 366/2008 *Rescue aid to Roskilde Bank*, Denmark; NN 44/2008 *Rescue aid to Hypo Real Estate*, Germany; NN 41/2008 *Rescue aid to Bradford and Bingley*, UK.

However, times are a changing and against the bursting of the crisis the Commission needed to take important steps to preserve the possibility of playing a role in the government of the crisis.¹⁵² And it took them. After a very early moment in which it witnessed Member States' initiatives, the Commission was not ousted,¹⁵³ as it could have been under Article 108(2) TFUE.¹⁵⁴ Nor did it suspend the application of State aid rules to the financial sector.¹⁵⁵ Rather, the Commission organized a coordinated and harmonized counter-attack to restore financial stability, while not only protecting competition, the integrity of the internal market, and public finances, but also avoiding regulatory competition among Member States.¹⁵⁶ In particular, as the crisis unfolded fully, the Commission realized that its action would have been effective as long as it would have been flexible enough to accommodate the different needs of beneficiary banks and Member States as well as the different, albeit very close, moments of the crisis:¹⁵⁷ from the initial moment where the Commission focused on banks' liquidity and customer confidence and thus used the *2008 Banking Communication* to mainly

¹⁵²See FORTUNATO, *Aiuti di Stato e mercato creditizio tra orientamenti comunitari e interventi nazionali*, in *Dir. banc.*, 2010, pag. 393; GEBSKI, *Competition first? Application of State aid rules in the banking sector*, in *Competition Law Review*, 2009, pag. 90; TUFANO, *Il ruolo della Commissione nella governance europea: quali prospettive?*, in *Diritto unione europeo*, 2012, p. 133.

¹⁵³See MEROLA, *La politica degli aiuti di Stato nel contesto della crisi economico finanziaria: ruolo e prospettive di riforma*, cit., pag. 224.

¹⁵⁴The provision reads that, «[o]n application by a Member State, the Council may, acting unanimously, decide that aid which that State is granting or intends to grant shall be considered to be compatible with the internal market, in derogation from the provisions of Article 107».

¹⁵⁵By practice, the Commission extended the material scope of the *Crisis Communications* beyond credit institutions, to include also insurance companies of systemic relevance – see *Quinn Insurance*, C(2011) 7266 12.10.2011 and *Ethias*, C(2010) 3249 20.05.2010 – and in-house banks – see *Aide* C(2013) 4791 29.07.2013. In 2013, the *Second Banking Communication* acknowledged this practice – see §§ 25-26.

¹⁵⁶Indeed, the Commission has been very clear in explaining the need for coordinated actions in *Impaired Asset Relief Communication*, §§ 13-14.

¹⁵⁷See CAPRIGLIONE, TROISI, *L'ordinamento finanziario dell'Ue dopo la crisi*, Torino, UTET, 2014, pag. 121 ss; CANEPA, *La regolazione al tempo della crisi tra salvaguardia del mercato unico e «flessibilità» delle regole sugli aiuti di Stato*, in *Banca Impresa Società*, 2016, pag. 445; PESARESI, *Diritto della concorrenza e crisi di impresa*, cit., pag. 161-162; CROCI, *L'impatto della crisi finanziaria sugli aiuti di Stato al settore bancario*, in *Il Diritto dell'Unione Europea*, 2014, p. 735 s.; LIBERATI, *La crisi del settore bancario tra aiuti di Stato e meccanismi di risanamento e risoluzione*, in *Rivista Italiana Diritto Pubblico Comunitario*, 2014, pag. 1340 ss. GIGLIO, *Gli aiuti di Stato alle banche nel contesto della crisi finanziaria*, in *Mercato Concorrenza Regole*, 2009, pag. 30.

govern the cases of State liquidity support and State guarantees on banks' liabilities, to the intermediate phase where the real economy had to be defended from credit crunch by paying more attention to public capitals injections via the *Recapitalization Communication*,¹⁵⁸ up to the final phase where, with the ultimate intent of restoring the long-term viability of the overall financial system, the Commission issued the *Impaired Assets Communication*¹⁵⁹ to specify the rules for purchasing and/or ensuring deteriorated and toxic credits.

After all, as Commissioner Kroes clarified, State aid law were not a part of the problem, but «a part of the solution», to protect financial stability, restore banks' long run viability, avoid spill-over effects on the rest of the economy and, in summary, provide «a Europe-wide response to a Europe-wide problem».¹⁶⁰

Soft law helped the Commission to guarantee such a swift and flexible performance, while also ensuring transparency, consistency, and legal certainty – three features that State aid needed to have to avert any panic or unconscious action on the part of private agents or Member States.¹⁶¹ Indeed, between 2008 and 2011, the Commission issued six Communications (often referred to as the *Crisis Communications*) that, as a whole, set out the goals of the State aid policy applied to the financial sector and explain the conditions under which banks may

¹⁵⁸Communication from the Commission — The recapitalization of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition (Text with EEA relevance) *OJ C 10, 15.1.2009, p. 2–10*. To be sure, the *2008 Banking Communication* already addressed recapitalization schemes – see *2008 Banking Communication*, §§ 34-42. However, as the nature, scope, and conditions of these measures varied considerably during the first months of the crisis irrespective of the guidelines set forth in October 2008, the *Recapitalization Communication* offered a more detailed guidance as to whether specific forms of recapitalization would be acceptable under State aid rules, to restore financial stability, ensure lending to the real economy, and deal with the risk of insolvency – see *Recapitalization Communication*, §§3-6.

¹⁵⁹*OJ C 72, 26.3.2009, pag. 1–22*. Indeed, as the injections of public capitals allowed between the end of 2008 and the very beginning of 2009 did not prove to be enough to restore investors' confidence in banks' creditworthiness, the financial institutions in distress used the capital buffer so obtained to clean their balance sheets, instead of lending money to the real economy. Such an unexpected credit crunch triggered an economic slowdown and produced a further and more extensive deterioration of the credits that banks in distress hold. Therefore, to help banks cope with the increasing disruption of credit markets, the Commission decided that the *Impaired Assets Communication* would have helped Member States to coordinate their actions in taking charge of the deteriorated and toxic credits of banks.

¹⁶⁰Neelie Kroes, *Dealing with the current financial crisis*, SPEECH/08/498.

¹⁶¹See PESARESI, *Diritto della concorrenza e crisi d'impresa*, cit., pag. 162.

legitimately have access to public support. Indeed, in EU law, communications serve to clarify the boundaries of the Commission's discretionary power, for its own the sake, that is, to allow the Commission resist any political pressure for heterodox decisions, and for the sake of the recipients of those decisions, who may legitimately expect that the Commission always acts accordingly to its priorities and guidelines. To be sure, while constraining Commission's leeway, communications do not prejudice the interpretation that the Court of Justice does of Treaty provisions and are not legally binding upon Member States. Thus, any failure to comply with the rules of State aid communications does not, in itself, constitute a valid reason for concluding that the aid is incompatible with the internal market.¹⁶²

6.1. Read in hindsight, the *Crisis Communications* show, first of all, that the Commission was well-aware of the pressing and unusual circumstances it was called to face. Indeed, in order to facilitate timely decision-making, it created an economic crisis group to act as the first point of contact for all Member States interested in granting public aid to their banks and enabled the Competition Commissioner to approve, in agreement with the President and the Commissioners responsible for the internal market and economic affairs, State aid measures without involving the whole Commission.¹⁶³ In addition, soon in the *2008 Banking Communication*,¹⁶⁴ the Commission soon made two commitments in its 2008 Banking Communication: to collaborate with Member States to design

¹⁶²Case C-526/14, *Kotnik e altri*, ECLI:EU:C:2016:570, §§ 41-44. See furthermore, Advocate General Wahl, *Kotnik Opinion*, ECLI:EU:C:2016:102, §§ 37, 38, 41 e 44. See furthermore REGANELLI, *Gli aiuti di stato alle banche nel contesto della crisi finanziaria – il commento*, in *Giornale di diritto amministrativo*, 2016, pag. 773; and LUCCHINI, MASCIANESE, DE ANGELIS, DI BENEDETTO, *State aid and the banking system in the financial crisis. From bail out to bail in*, JCLP, 2016, pag. 1. For a more general perspective, CINI, *The Soft Law approach: Commission Rule-making in the EU's State Aid Regime*, in *Journal of European Public Policy*, 2001, pag. 192.

¹⁶³See CANEPA, *La regolazione al tempo della crisi tra salvaguardia del mercato unico e «flessibilità» delle regole sugli aiuti di Stato*, in *Banca Impresa Società*, 2016, pag. 454-455; and WENER, MAIER, *Procedure in crisis?*, in *European State Aid Law Quarterly*, 2009, pag. 177

¹⁶⁴Communication from the Commission on the application of State aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis, OJ C270, 25.10.2008, pag. 8 (hereinafter, *2008 Banking Communication*).

compatible State measures and to take connected decisions as soon as possible.¹⁶⁵

Even more importantly, the Commission conceived the *Crisis Communications* as a temporary emergency framework justified by the premise that practically, during the crisis, all banks had to be first rescued and, then, at a later stage, subject to a viability, restructuring, or liquidation plan(s).¹⁶⁶ Thus, it conceptualized almost all State interventions as if they were two-phased: the rescue phase, meant to stabilize banks by immediately providing them with huge amounts of liquidity and capital, and the restructuring phase, meant to actually restore the long-term viability of banks by redesigning the composition of their assets, their business models or their corporate governance.¹⁶⁷

To this end, in line with the *2004 R&R Guidelines*, first the Commission introduced the “temporary approvals”, a new procedural type of no objection decisions, which limited the compatibility assessment to the delayed restructuring phase of the aid. Namely, if the aid at stake met a minimum set of conditions, temporary approvals guaranteed legal certainty to State measures meant to stabilize a bank in the rescue phase in a very short time, even within 24 hours and over a weekend.¹⁶⁸

Second, by distancing itself from the *2004 R&R Guidelines*, the Commission enlarged the scope of rescue measures. It allowed Member States to adopt general rescue aid schemes – established by a declaration, legislation, or contractual regime – not only for SMEs and liquidity support, but also for large banks and structural aid, such as recapitalization and impaired asset relief

¹⁶⁵*Ibidem*, § 53.

¹⁶⁶*2013 Banking Communication*, § 23.

¹⁶⁷In particular, the Commission referenced the fully-fledged assessment of the restructuring plan to six months after the recapitalization aid was granted – see *2008 Banking Communication*, § 44 – or to three months after the acceptant to impaired asset relief plan – see *Impaired Assets Communication*, Annex V – and confined possible doubts to the starting of a formal investigation pursuant to Article 108(2). See also LIBERATI, *La crisi del settore bancario tra aiuti di Stato e meccanismi di risanamento e risoluzione*, cit., pag. 1356-1357.

¹⁶⁸See VESTERDORF and NIELSEN, *State Aid Law of the European Union*, London, 2008, pag. 91.

measures.¹⁶⁹ Furthermore, the Commission accepted that the scheme could last more than six months. Therefore, for this kind of aid, the Commission suspended the usual case-by-case approach to allow rapid and lasting interventions towards as many banks as possible,¹⁷⁰ which also relieved the Commission of a significant administrative burden, particularly in a scenario where any approval could well have been fraught with political considerations and national interests.

More in general, due to the exceptional circumstances it had to govern,¹⁷¹ the Commission decided that State aid should last as long as it was necessary and that a bank could benefit for more than one aid. For example, under the *2008 Banking Communication*, schemes of liquidity support that, in principle, should have covered a period longer than six months and up to two years, could be further extended, subject to the Commission's approval, if the financial market crisis so requires.¹⁷² Likewise, the *Restructuring Communication* admitted that, while restructuring plans should last as short as possible, the crisis justified a longer time horizon, also to avoid perverse effects, such as a further decline in the value of the banks' assets due to sudden fire sales.¹⁷³ Even more importantly, the Commission abandoned the "one-time-last-time" principle.

Thus, during the crisis, the Commission hardly ever considered aid incompatible with the internal market and, in the most difficult months, until the end of 2009, of the eighty-one decisions adopted, only six were made conditional after a formal investigation.¹⁷⁴ More specifically, consider that in a few months of 2008, the Commission approved eleven guarantee schemes (Denmark, Finland, France, Ireland, Italy, Latvia, the Netherlands, Portugal, Slovenia, Spain and

¹⁶⁹See JAROSZ-FRIIS, KERLE, GALAND, *Banking*, in PESARESI, DE CASTEELE, FLYNN, SIATERLI, *EU competition law. State aid*, Deventer, 2016, pag. 1124.

¹⁷⁰*2008 Banking Communication*, §§ 4-5. Clearly enough, general schemes do not prevent *ad hoc* interventions, especially in cases of banks of systemic relevance.

¹⁷¹*2008 Banking Communication*, § 10.

¹⁷²*Ibidem*, § 52.

¹⁷³*Restructuring Communication*, § 15.

¹⁷⁴See KOKKORIS, *The special nature of banks and its challenges for competition policy*, cit., pag. 13;

Sweden);¹⁷⁵ two recapitalization schemes (France and Italy);¹⁷⁶ one asset purchase scheme (Spain);¹⁷⁷ and four holistic schemes containing two or more of the above elements (Austria, Germany, Greece, United Kingdom).¹⁷⁸ Furthermore, the Commission also approved a number of individual cases, including recapitalization, guarantee and liquidity cases: ING, KBC, Parex, SNS Reaal, Bayern LB, Fortis, Dexia, Nord LB, and guarantee for IKB, Carnegie Sweden, Aegon, Fortis Bank and Fortis Bank Luxembourg.¹⁷⁹

6.2. In addressing these extraordinary circumstances, the Commission was aware that the exceptional measures referred to above, whether structural or not, were meant to address the acute symptoms of the crisis and could not tackle its true causes. In other words, the Commission soon understood that banks and Member States should not be left free to use the crisis to hide the dysfunctions and specific problems inherent in financial markets and individual banks. Rather, they should be forced to employ State aid as an “opportunity” to make the

¹⁷⁵See, respectively, NN 51/2008 – *Guarantee scheme for banks in Denmark*; N 567/2008 – *Finnish guarantee scheme*; N 548/2008 – *Financial support measures to the banking industry in France (refinancing)*; NN 48/2008 – *Guarantee scheme for banks in Ireland*; N 520a/2008 – *Guarantee scheme for Italian banks*; N 638/2008 – *Guarantee scheme for banks*; N 524/2008 – *Guarantee scheme for Dutch financial institutions*; NN 60/08 – *Guarantee scheme for credit institutions in Portugal*; N 531/2008 – *Guarantee scheme for credit institutions in Slovenia*; NN 54b/2008 – *Spanish guarantee scheme for credit institutions*; N 533/2008 – *Support measures for the banking industry in Sweden*.

¹⁷⁶See, respectively, N 613/2008 – *Financial support measures to the banking industry in France (recapitalization)* and N 648/2008 – *Recapitalization scheme*.

¹⁷⁷See, NN 54a/2008 – *Fund for the Acquisition of Financial Assets in Spain*.

¹⁷⁸See, respectively, N 557/2008 – *Aid scheme for the Austrian financial sector*; N 512/2008 – *Aid scheme for financial institutions in Germany*; N 560/2008 – *Aid scheme to the banking industry in Greece*; and N 507/2008 – *Aid scheme to the banking industry in the UK*.

¹⁷⁹See, respectively, 87 N 528/2008 – *Measure in favor of ING (recapitalization), Netherlands*; N 602/2008 – *KBC Recapitalization, Belgium*; NN 68/2008 – *Support measures for JSC Parex Banka, Latvia*; N 611/2008 – *SNS Reaal/New capital injection by the Dutch authorities, Netherlands*; N 615/2008 – *Guarantee and recapitalization for Bayern LB, Germany*; N 574/2008 – *Measures in favor of Fortis, Belgium/Luxembourg/Netherlands*; NN 45-49-50/2008 – *Guarantee on liabilities of Dexia, Belgium*; N 655/2008 – *Guarantee for Nord LB, Germany*; N 639/2008 – *Guarantee for IKB, Germany*; NN 64/2008 – *Emergency rescue measures regarding Carnegie Investment Bank, Sweden*; N 569/2008 – *Measure in favour of Aegon, Netherlands*; NN 42-46-53A/2008 – *Restructuring aid to Fortis Bank and Fortis Bank Luxembourg*. For a comment on some of these cases, see PASSALACQUA, *Aiuti di Stato al settore finanziario nell'amministrazione dell'emergenza*, in COLOMBINI G., PASSALACQUA M., *Mercati e banche nella crisi: regole di concorrenza e aiuti di Stato*, Napoli, 2012, pag. 252-253.

changes necessary to restore investors' confidence, credit flow to the real economy, and also – when necessary – also to remedy to the hazardous and inefficient decisions that had brought about the risk that the State aid aimed at containing.¹⁸⁰

Therefore, since October 2008, and consistently with the approach followed in the *R&R Guidelines*, the Commission did not to fully disregard a long-term vision. Rather, it almost always conceived of a phase, where beneficiary banks could either exit the market, or return to operate in it without any State support.¹⁸¹ Namely, not only did the first three *Crisis Communications* required that,¹⁸² where a financial institution has received State aid, the Member State should submit a viability plan or a more fundamental restructuring plan,¹⁸³ in order to confirm or re-establish individual banks' long-term viability in the absence of any State support;¹⁸⁴ in the second half of 2009 the Commission issued a

¹⁸⁰*Recapitalisation Communication*, § 44. See, in particular, SOLTÉSZ, VON KOCKRITZ, *From State aid control to the regulation of the European banking system – DG Comp and the restructuring of banks*, in *European Competition Journal*, 2010, pag. 285 (arguing that the Commission has turned from a supervisor of national State aid measure into a supervisor of restructuring efforts of individual banks); and AHLBORN, PICCININ, *The application of the principles of restructuring aid to banks during the financial crisis*, in *European State Aid Law Quarterly*, 2010, pag. 47.

¹⁸¹With an exception, however. The Commission indeed allowed liquidity support for longer than six months without triggering the restructuring obligation, recognizing that the need for such support may stem from liquidity stress in the market and not from intrinsic weakness of individual banks. See, *2008 Banking Communication*.

¹⁸²See *2008 Banking Communication*, §§ 28-29 with reference to guarantee schemes and § 35 with reference to recapitalization schemes; *Recapitalization Communication*, §§ 28-29 and 44; and *Impaired Asset Relief Communication*, §§ 48-59 and, in particular, §§ 53-59. Though endorsed in the relation to any aid, the long-run perspective is crucial for structural aid, consisting either in capital injections or asset relief measures. In those cases, indeed, the very same measures are meant to produce long-run effects. Therefore, if misused, they may definitively weaken the structure of financial markets.

¹⁸³In particular, see *Recapitalisation Communication* § 40 and *Impaired Assets Communication*, Annex V, for the distinction between viability and restructuring plans. The former trigger where a limited amount of aid has been given to banks which are fundamentally sound. In this case, indeed, Member States are required to submit a report to the Commission on the use of State funds comprising all the information necessary to evaluate the bank's viability, the use of the capital received and the path towards exit from reliance on State support. The viability review should demonstrate the risk profile and prospective capital adequacy of these banks and evaluate their business plans. Differently the latter refer to situations where a distressed bank has been recapitalized by the State, or where a bank benefiting from asset relief has already received State aid in whatever form that contributes to coverage or avoidance of losses (except participation in a guarantee scheme) which altogether exceeds 2 % of the total bank's risk weighted assets.

¹⁸⁴See DELL'ATTI, *Gli aiuti di stato alle banche in tempo di crisi*, cit., pag. 586.

specific communication on the matter, the *Restructuring Communication*.¹⁸⁵ Precisely meant to help beneficiary banks to develop their restructuring plans, this Communication clarified that any restructuring measure should include an in-depth review of the bank's strategy and activity, including, for example, a focus on core business, a reorientation of business models, the closure or divestment of business divisions/subsidiaries, changes in the asset-liability management and other changes.¹⁸⁶

Likewise, as is clear from the *Impaired Assets Communication*, the Commission set forth a set of rules to oblige banks to come to terms with their own problems once and for all. For example, it limited the enrolment window for impaired assets schemes to six months¹⁸⁷ and required banks applying for an asset relief measure (or adhering to an asset relief scheme) to: (i) be fully transparent and rigorous in quantifying their asset-related needs; (ii) submit such an evaluation to the certification of independent experts and to the validation by the competent authority; and (iii) undergo a full review of its activities and balance sheet, with a view to assessing the bank's capital adequacy and its prospects for future viability.¹⁸⁸ Thus, while supporting banks and Member States, the Commission tried to block opportunistic behaviors.

More in general, during the crisis, the Commission has always “worked” to get rid of the very same exceptional measures it has been granting. Not only did it make the aid costly via burden sharing and remuneration rules;¹⁸⁹ not only did it create exit incentives to induce private investors to redeem State capital,¹⁹⁰ but it also used the *First and Second Prolongation Communications*¹⁹¹ to convey a simple

¹⁸⁵OJ C 195, 19.8.2009, pag. 9-20.

¹⁸⁶*Restructuring Communication*, §§ 7 and 9-11. On this point, ROSSANO, *Gli aiuti di Stato alle banche e le ristrutturazioni della Commissione: tra distorsioni della concorrenza e (in)stabilità finanziaria*, in *Rivista trimestrale di diritto dell'economia*, 2016, pag. 15.

¹⁸⁷*Impaired Assets Communication*, § 26.

¹⁸⁸*Impaired Assets Communication*, §§ 19-20.

¹⁸⁹See *infra*, paragraph 6.3.

¹⁹⁰*Recapitalization Communication*, §§ 31-34.

¹⁹¹Actually, the *First Prolongation Communication* of 2010 prolonged until 31 December 2011 the *Restructuring Communication*, which was the only one with an expiring date. The Second

message: although in 2010 and 2011 the crisis that was not fading away yet to call for an extension of the duration of the emergency measures so far designed, still some rules had to be tightened up. For example, the Commission increased the exit incentives to favor a gradual phasing out of the public funds to restore a viable banking system.¹⁹² Likewise, as regards State guarantees, the Commission introduced an increased guarantee commission as well as the obligation to present a profitability plan for the beneficiaries of the new guarantees. In addition, the Commission tightened the rules on pricing of capital injections in the form of equity and introduced the obligation to always remunerate the State for hybrid capital instruments. Furthermore, in relation to structural aid, the Commission established that, as from 1 January 2011, any recapitalization or impaired asset measure had to trigger a restructuring obligation, irrespective of the size of the aid.

In summary, not to be overwhelmed, the Commission has addressed the crisis with a comingling of a bottom-up and a top-down approach: on the one hand, it granted State aid to cater for the turbulent events and the many and differentiated needs coming from the bottom; on the other hand, it has not only guided the State measures as part of its ongoing and regular reviews, but – from the top – it has also imposed certain constraints on the amount, duration and characteristics of the State aid granted.¹⁹³

6.3. The Commission used the *Crisis Communications* also to confine the impact of State aid.¹⁹⁴ In particular, in order to keep the amount of aid at

Prolongation Communication, which provides guidance on guarantees and equity, extended the crisis rules and linked the restructuring of banks to sovereign crisis.

¹⁹²This approach began with the tightening of the conditions for new public guarantees through a fee increase and closer scrutiny of the viability of heavy guarantee users; in addition the price was to be closed to market conditions to reflect individual bank's creditworthiness with the final intent of reducing competitive distortions.

¹⁹³2008 *Banking Communication*, § 41; *Recapitalization Communication*, §§ 40-44.

¹⁹⁴See DE KOK, *Competition policy in the framework and application of State aid in the banking sector*, in *European State aid Law Quarterly*, 2015, pag. 224 (using the Dutch cases ABN AMRO, ING, AEGON, and SNS REAAL, to discuss the effectiveness of the structural and behavioral measures meant to limit the impact that State aid measures had on competition).

minimum and to limit the moral hazard of individuals, banks, and Member States, the Commission affirmed – better, reaffirmed – the liberal principle underlying the market mechanism: all economic operators involved in the crisis should have been accountable for their choices and actions. In relation to individuals, the Commission provided for several burden-sharing rules to make the holders of private capitals to some extent responsible for the banks' distress.¹⁹⁵ In other words, the Commission asked them to contribute as much as possible to the public support. For example, in relation to loans guarantee – the most popular kind of aid granted – the Commission excluded that public funds could be used to guarantee the liabilities of subordinated creditors and shareholders, while they had to cover retail and wholesale depositors, as well as the debts of retail clients and short and medium-term debt instruments.¹⁹⁶ Likewise, in relation to asset purchase meant to offer banks the time necessary to devise a restructuring or liquidation plan, the *Impaired Assets Communication* required shareholders to bear losses at least until the regulatory capital adequacy limits were reached.¹⁹⁷ To be sure, it must be acknowledged that in the first few months, when the systemic nature of the crisis was evident, these burden-sharing rules have been applied at their minimum, also because the Commission did not set any *ex ante* threshold for State aid.¹⁹⁸

In relation to banks, until the *First Prolongation Communication*, the Commission tried to differentiate its rules by distinguishing between two categories of banks: illiquid but otherwise fundamentally sound financial institutions, whose viability problems were inherently exogenous and linked to the crisis rather than to inefficiency or excessive risk-taking; on the other financial

¹⁹⁵See DIVERIO, *Gli aiuti di Stato al trasporto aereo e alle banche. Dalla crisi di settore alla crisi di sistema*, 2010, pag. 150 and 165.

¹⁹⁶2008 *Banking Communication*, §§ 19-23. This has first been established in the decision concerning the rescue of the bankrupt Danish bank Roskilde, whose main creditors were large German banks. See, in this regard, Commission, Authorisation for State aid pursuant to Articles 87 and 88 of the EC Treaty Cases where the Commission raises no objections, OJ C12, 17.01.2009, pag. 1-4.

¹⁹⁷*Impaired Assets Communication*, § 23.

¹⁹⁸2013 *Banking Communication*, §§ 16-18.

institutions characterized by endogenous problems, such as losses stemming from inefficiencies, poor asset-liability management or risky strategies, on the other.¹⁹⁹ Namely, in the *2008 Banking Communication*, the Commission clarified that State aid for illiquid but sound banks raise minor concerns and,²⁰⁰ thus, it provided recapitalization schemes only for them.²⁰¹ To be sure, in the subsequent *Recapitalization Communication*, the Commission extended the recapitalization schemes to non-sound banks,²⁰² but subordinated their granting to the adoption of in-depth restructuring measures, based on a plan – the viability plan – to be approved by the Commission separately from the recapitalization scheme within six months from it.²⁰³ In the *Impaired Assets Communication*, then, the Commission issued several guidelines depending on the risk profile and viability of the beneficiary bank:²⁰⁴ if the beneficiary banks were either in distress or having already received State aid, restructuring measures had to follow. Finally, in the *Restructuring Communication* it confirmed that Member States were asked to submit either viability or restructuring plans according to whether the beneficiary banks were sound or in distress.

As regards States, in the *Impaired Assets Communication*, for some Member States, this measure should be limited to systemically relevant banks and

¹⁹⁹See *2008 Banking Communication*, § 14, for the introduction of this distinction that – to be sure – was a complicated one, because it was difficult to find out the *dies a quo* one sound bank started to be affected by the crisis.

²⁰⁰*Ibidem*, §§ 1-2, 14, and 33.

²⁰¹*Ibidem*, § 34, which indeed talks about «[a] second systemic measure in response to the ongoing financial crisis would be the establishment of a recapitalization scheme which would be used to support financial institutions that are fundamentally sound but may experience distress because of extreme conditions in financial markets». However, in dealing with restructuring plans, § 35 reads that the Commission takes into account « both the distinction between fundamentally sound financial institutions solely affected by the current restrictions on access to liquidity and beneficiaries that are additionally suffering from more structural solvency problems linked for instance to their particular business model or investment strategy and the impact of that distinction on the extent of the need for restructuring». This should mean that recapitalization schemes were available also to banks in distress.

²⁰²*Recapitalization Communication*, §§ 43-45.

²⁰³*Recapitalization Communication*, §§ 13; 17. In addition, expressly on this point, FORTUNATO, *Aiuti di Stato e mercato creditizio fra orientamenti comunitari e interventi nazionali*, in G. Bianchi (a cura di), *Diritto, mercato ed etica. Dopo la crisi. Omaggio a Piergaetano Marchetti*, Milano, pag. 387.

²⁰⁴*Impaired Assets Communication*, § 17.

must however be severely constrained, due to their current budgetary constraints and/or the size of their banks' balance sheet in relation to GDP.²⁰⁵ In the *First Prolongation Communication*, when the sovereign debt crisis unfolded fully, the Commission envisaged different values of sovereign guarantees depending on the quality of public finances of the Member State concerned.²⁰⁶

Furthermore, to make State aid costly and thus less attractive, the Commission required that all banks contributed adequately to cover the costs of the aid granted. For example, in relation to guarantee measures, it indicated that the remuneration due to the State should have been as close as possible to the market price of the guarantee, with several assumptions providing additional remuneration for the State.²⁰⁷ Likewise, in relation to recapitalization aid, the Commission laid down some criteria to ensure that the pricing of the instruments chosen to inject capital into ailing banks, ranging from shares and warrants to asset acquisitions, had to be market-oriented and provide an incentive for the bank to redeem the State as soon as the crisis was over.²⁰⁸ Else, in relation to impaired assets relief measures, the Commission wanted ensuring an adequate participation – even a compulsory one²⁰⁹ – on the part of the beneficiary banks, by requiring the inclusion of specific clauses meant to make the bank (and thus its early shareholder) pay.²¹⁰ Finally, in relation to restructuring plans, the Commission set aside the *R&R Guidelines'* requirement that the banks' own contribution to the costs of restructuring should meet the 50% threshold.

In the same vein, that is, with the ultimate aim of discouraging banks from

²⁰⁵*Impaired Assets Communication*, §§ 10-12.

²⁰⁶See JAROSZ-FRIIS, KERLE, GALAND, *Banking*, in PESARESI, DE CASTEELE, FLYNN, SIATERLI, *EU competition law. State aid*, Deventer, 2016, pag. 1126.

²⁰⁷*2008 Banking Communication*, § 25-26.

²⁰⁸*2008 Banking Communication*, §§ 38-40 and *Recapitalization Communication*, §§ 10, 20, 22-30, 31-32.

²⁰⁹*Impaired Assets Communication*, § 8.

²¹⁰*Impaired Assets Communication*, §§ 24 and 50. In particular, § 24 reads that, «[w]here it is not possible to achieve full burden-sharing *ex ante*, the bank should be requested to contribute to the loss or risk coverage at a later stage, for example in the form of claw-back clauses or, in the case of an insurance scheme, by a clause of 'first loss', to be borne by the bank (typically with a minimum of 10 %) and a clause of 'residual loss sharing', through which the bank participates to a percentage (typically with a minimum of 10 %) of any additional losses».

relying on public support, the Commission ruled out the possibility of taxpayers' money being used to pay dividends or to allow new stock option plans for managers.²¹¹ Then, depending on circumstances, the Commission agreed to modulate this principle, in relation to the responsibilities of shareholders and executives. For example, when addressing the case of recapitalization schemes for sound banks, the *Recapitalization Communication* states that «it would be important to allow for dividend payment where this represents an incentive to provide new private equity to fundamentally sound banks». Differently, referencing to the case of recapitalization schemes for not-sound banks, the same communication includes a prohibition of dividend payments not only during the aid, but also during the subsequent restructuring period.²¹²

Finally, to protect the “traditional” objectives of the State aid law, namely, the protection of competition, market integrity and budgetary discipline the Commission made State aid conditional on the respect of several safeguards, behavioral and structural ones. First, all the *Crisis Communications* ensured that no aid would come at the cost of distorting/distort competition between aided and non-aided banks, between banks from different Member States and between aided banks.²¹³ Thus, they all imposed beneficiary banks behavioral standards, which were meant to prevent any sort of abuse or exploitation of the obtained State aid. For example, both the *2008 Banking Communication* and the *Recapitalization Communication* banned beneficiary banks from advertising their State-supported status or leveraging the public funds to undertake aggressive practices vis-à-vis their competitors.²¹⁴ In addition, the *Restructuring Communication* imposed behavioral safeguards along with structural ones: first, it prevented the beneficiary banks from offering (predatory) conditions that cannot be compensated by non-aided banks and from providing credit at non-market-

²¹¹2008 *Banking Communication*, § 27.

²¹²*Recapitalization Communication*, §§ 33 and 45.

²¹³See GIGLIO; Crisi finanziaria e aiuti di Stato alle banche in difficoltà, in SCHEPISI, *La “modernizzazione” della disciplina sugli aiuti di Stato*, Torino, 2001, pag. 133

²¹⁴2008 *Banking communication*, § 27 and *Recapitalization Communication*, §§ 36-37.

oriented commercial terms,²¹⁵ second, it recommended that the State aid could not be used for the acquisition of competing firms.²¹⁶ Second, to protect the integrity of the single market, the *2008 Banking Communication* and the *Recapitalization Communication* required that guarantee schemes did not exclude any eligible player on the basis of non-objective and discriminatory criteria, as so to avoid asymmetries between banks working in the same Member State or across-borders.²¹⁷ Likewise, the Commission tried to limit negative spillovers among Member States, where the introduction of asset relief measures by a first-mover Member State results in pressure on other Member States to follow suit and risks launching a subsidy race between Member States.²¹⁸ Finally, to limit the impact on public finances and to prevent subsidy races, the *Impaired Asset Communication* established that government support through asset relief (and other) measures should not be large enough to raise concerns about the sustainability of public finances such as over-indebtedness or financing problems.²¹⁹

In short, seen with the benefit of hindsight, the *Crisis Communications* have identified a series of weights and counterweights so that aid, even if granted in very rapid times and under the pressure of the crisis, did not induce opportunistic behavior and did not definitively compromise competition, the single market, and public finances. Thus, the financial crisis and the subsequent sovereign debt crisis offered the Commission the opportunity to practice a great deal with the idea that State aid law must arise not only from the reconciliation of different interests, but also from the identification of the specific rules – weights and counterweights – that in practice design that reconciliation.

6.4. One might think that the *Crisis Communication* took so much distance

²¹⁵*Restructuring Communication*, §§ 40-44

²¹⁶*Restructuring Communication*, §§ 35-38.

²¹⁷*2008 Banking Communication*, § 18 with reference to guarantee schemes and § 37 with reference to recapitalization schemes.

²¹⁸*Ibidem*, § 13b.

²¹⁹*Ibidem*, §§ 10 and 11.

from the ordinary rules on State aid that they could no longer be considered as an emanation of Article 107. In reality, it is not so.

First, due to the systematic nature of the crisis, they were adopted under Article 107(3)(b).²²⁰ True, before the bursting of the crisis, this provision had hardly been applied,²²¹ not even as a legal basis for the aid granted during the 1974 energy crisis or for the aid supporting the reunification of the eastern German Länder.²²² Yet, it was the right provision to choose for two reasons, at least. By its very nature, Article 107(3)(b) remarks the exceptional nature of the aid and thus references to the idea that such aid is temporary and shall be ceased when the emergency is over. In addition, Article 107(3)(b) gave the Commission the possibility of escaping the case law previously established under Article 107(3)(c) to handle the cases of banks in difficulty.²²³

Furthermore, although more detailed and precise than the *R&R Guidelines*, and although different in relation to some key rules necessary to manage the emergency, the *Crisis Communications* have reaffirmed some ordinary principles informing State aid law for firms in difficulty: mainly that – as aforesaid –

²²⁰On this point see, *ex multis*, FORTUNATO, *Aiuti di Stato e mercato creditizio tra orientamenti comunitari e interventi nazionali*, cit., pag. 380 and 382; FERRARO, *L'evoluzione della politica sugli aiuti di Stato a sostegno dell'accesso al finanziamento nell'attuale situazione di crisi economica e finanziaria*, cit., pag. 335.

²²¹Article 107(3)(b) was applied only to support the privatization program launched in Greece in the 1990s for the recovery of the entire national economy and the aid deemed necessary to allow the same State to join the exchange rate mechanism of the European monetary system. See Commission Decision 88/167/EEC, 7 October 1987, concerning Law 1386/1983 by which the Greek Government grants aid to Greek industry, OJ L 76, 22.03.1988, pag.18. To be sure, the application of Article 107(3)(b) to banks in difficulty had never been excluded as a matter of law – see Commission Decision, 20 May 1998, *concerning aid granted by France to the Crédit Lyonnais group*, OJ L 221, 8.8.1998, pag. 28–80. Think in addition to Northern Rock saga: the decisions that regarded this bank in 2007 and 2008 had been adopted pursuant to Article 107(3)(c). See NN 70/07, 05.12.2007 and NN 1/2008, 02.04.2008. Differently, the Commission adopted the other decisions that regarded the restructuring plan of Northern Rock – that is, its nationalization, the sale of the good bank to the Virgin Group and the creation of an Asset Management Company that remained on the books of the UK government – pursuant to Article 107(3)(b). See C 14/08, 07.05.2009 and 28.10.2009. See further, on this case, GIGLIO, *Gli aiuti di Stato alle banche nel contesto della crisi finanziaria*, cit., pag. 25-28.

²²²C301/96, Germania c. Commissione. On this topic, see LIBERATI, *La crisi del settore bancario tra aiuti di Stato e meccanismi di risanamento e risoluzione*, cit., pag. 1340.

²²³See MEROLA, *La politica degli aiuti di Stato nel contesto della crisi economico finanziaria: ruolo e prospettive di riforma*, cit., pag. 227; LIBERATI, *La crisi del settore bancario tra aiuti di Stato e meccanismi di risanamento e risoluzione*, cit., pag. 1344

restructuring aid should lead to the restoration of viability of the undertaking in the longer term without State aid and that restructuring aid must be accompanied, to the extent possible, by adequate burden sharing and by measures to minimize distortions of competition, which in the long run would substantially weaken the structure and the functioning of the relevant market.²²⁴

But even more clearly, the structure of these Communications did include the cornerstones of State aid law or, at least, the quintessential features that have been distinguishing State aid law since the adoption of the 2005 SAAP and that, during the years of the crisis, were transposed into the 2012 SAM Communication.²²⁵ First of all, they all clarify that any aid must meet the *balancing test*: on the one hand, they have to work to restore financial stability or ensure lending to the real economy, elected as the superior EU goals that deserve to be pursued, on the other hand, they cannot bring about any excessive distortions of competition or any irresponsible use of tax payers' money. Indeed, the Crisis Communications not only focused on the *appropriateness, necessity, and proportionality* of State aid, to establish that it should have been limited, both in time and scope, to the minimum necessary to achieve a well-specified objective. Thus, State aid could not be discriminatory: it could not give an undue competitive advantage to one bank over banks in other Member States, over other banks within its Member State, and over non-aided banks.²²⁶ Furthermore, it needed to be clearly designed, well-targeted, and proportionate to what was strictly necessary²²⁷ to effectively achieve their legitimate purposes, without imposing

²²⁴Case T-457/09, ECLI:EU:T:2014:683, §§ 179-224, where the Court noted that the conditions imposed under Article 107(3)(b) may, under the circumstances, be either stricter (§ 222) or more lenient (§ 223) than those applied under the *R&R Guidelines*. Furthermore, see GEBSKI, *Competition first? Application of State aid rules in the banking sector*, in *Competition Law Review*, 2009, pag. 103 (considering the Crisis Communications a piece of *lex specialis* of the *lex generalis* included in the *R&R Guidelines*).

²²⁵See JAROSZ-FRIIS, KERLE, GALAND, *Banking*, cit., pag. 1124.

²²⁶Clearly on this point, *Recapitalization Communication*, §§ 8-9 and *Impaired Assets Communication*, §§ 8-9 and 16.

²²⁷See FORTUNATO, *Aiuti di stato e mercato creditizio fra orientamenti comunitari e interventi nazionali*, cit., pag. 391.

undue distortions or burden.²²⁸ Finally, they all impose transparency on Member States and beneficiary banks, so as to facilitate an intense and plain collaboration with the Commission.²²⁹

7. The general principles included in the *2012 SAM Communication* also inform the *2013 Banking Communication*,²³⁰ that is, the Communication currently in force, which replaced the *2008 Banking Communication*, provided guidance on compatibility criteria for liquidity support, adapted and complemented the *Recapitalization and Impaired Assets Communications*, supplemented the *Restructuring Communication*, and provided guidance on the compatibility requirements for liquidation aid.²³¹

Acknowledging the fragility of the economic recovery and the persistence of tensions in sovereign debt markets, the *2013 Banking Communication* still provides a safety net for banks in difficulty,²³² allowing the application of Article 107(3)(b) as long as a genuine crisis situation puts financial stability at risk. However, it also recognizes that the changes already experienced by the banking

²²⁸*2008 Banking Communication*, § 15.

²²⁹Pursuant *Impaired Assets Communication*, Member States must make asset relief measures conditional on full transparency and disclosure of impaired assets and must identify and value the credits eligible for asset relief, as so to allow the Commission to analyze each case, also with the help of external experts. Likewise, the *Restructuring Communication* required the information is necessary to devise sustainable strategies for a return to viability and thus to determine whether the proposed restructuring measures are apt to restore a beneficiary's long-term viability.

²³⁰SA.41503, *Panellinia Bank*, §§ 68-69.

²³¹*2013 Banking Communication*, § 24. On it see, *ex multis*, IFTINCHI, *State aid and the financial sector: the evolution of the legal framework of State aid law*, in LEPREVOTE, GRAY, DE CECCO, *Research handbook on State aid in the banking sector*, Cheltenham, 2017, pag. 54; CLARICH, *Sostegno pubblico alle banche e aiuti di Stato*, in *Giurisprudenza Commerciale*, 2017, pag. 702. FIORDIPONTI, *Aiuti di Stato al settore bancario: rischio di instabilità, concorrenza e tutela degli investitori*, in *Rivista di diritto dell'impresa*, 2017, pag. 589; SCIPIONE, *Crisi bancarie e disciplina degli aiuti di Stato. Il caso Italiano: criticità applicative e antinomie di una legislazione di emergenza*, in *Innovazione & Diritto*, 2017, pag. 284; MARCUCCI, *Aiuti di Stato e stabilità finanziaria. Il ruolo della Commissione europea nel quadro normativo europeo sulla gestione delle crisi bancarie*, in CHITI, SANTORO, *L'Unione bancaria europea*, 2016, pag. 300; and CROCI, *L'impatto della crisi finanziaria sugli aiuti di Stato*, in *Il diritto dell'Unione Europea*, 2014, pag. 733.

²³²The scope of the *2013 Banking Communication* covers insurance companies as well – *ibidem*, § 26. In doing so, the Commission has stated the practice followed between 2008 and 2013, when it treated insurance companies as banks. See LIBERATI, *La crisi del settore bancario tra aiuti di Stato e meccanismi di risanamento e risoluzione*, *cit.*, pag. 1349.

system together with the consequences of the sovereign debt crisis that erupted in 2010 justified a different approach, focusing on three main issues: (i) the necessity to restore banks' long-term viability;²³³ (ii) the need to make capital holders increasingly responsible for the problems of their own banks, provided that those problems were not immediately caused by external and systemic factors, such as the sovereign debt crisis, but resulted from the faults of those banks, such as excessive risk-taking business models; and (iii) the commitment to defend the integrity of the single market,²³⁴ both against the centripetal forces of the more creditworthy Member States, which can afford "deeper pockets" to support their banks,²³⁵ and against the greater risks of the less creditworthy Member States, which were exposed to speculative manoeuvres.²³⁶ Therefore, the 2013 *Banking Communication* makes the granting of State Aid subject to stricter conditions than those set out in the past.²³⁷

First of all, the Commission clarifies that it will no longer consider recapitalization or impaired asset relief measures as if they were rescue aid granted on a temporary basis. Thus, by reverting to the principles of the 2004 *R&R Guidelines*, the Commission establishes that the approval of structural aid will only be granted after it accepts a restructuring or liquidation plan.²³⁸ And, as any restructuring plan requires a complex case-by-case assessment, also recapitalization schemes will also no longer be accepted, unless the beneficiary banks are micro-banks,²³⁹ mainly because aid to small banks tends to affect competition less than aid granted to larger banks. In other words, via the 2013

²³³The very same structure of the 2013 *Banking Communication* demonstrates the different approach of the Commission. If in the early days of the crisis, the 2008 *Banking Communication* focused on guarantees on debts to face the liquidity shortage, the 2013 *Banking Communication* devotes many efforts to govern not only recapitalizations and impaired assets relief measures, but also restructuring plans.

²³⁴2013 *Banking Communication*, § 11, which expressly refers to «major asymmetries across Member States which could further fragment the single market and cause financial instability, impeding recovery within the Union».

²³⁵2013 *Banking Communication*, § 9. See also 2011 *Prolongation Communication*, § 14.

²³⁶2013 *Banking Communication*, § 13.

²³⁷2013 *Banking Communication*, §§ 1-6.

²³⁸2013 *Banking Communication*, §§ 34 and 50.

²³⁹2013 *Banking Communication*, §§ 54-55.

Banking Communication the Commission conveyed a simple – although questionable – message: five years after the beginning of the crisis, there was no need to keep on addressing State aid to banks as if it were an emergency tool. In the physiology on the system, banks' large capital shortfalls cannot surprise supervisors any more. Rather, they should be «established in a capital exercise, stress-test, asset quality review or an equivalent exercise»²⁴⁰ and, accordingly, detected by the competent supervisory authorities early enough²⁴¹ to enable Member States to negotiate and agree with the Commission on the required restructuring or liquidation plans.²⁴²

Consistently, in the 2013 *Banking Communication* the Commission also designs a pre-notification procedure to be followed after a capital shortage has been detected:²⁴³ first, Member States are invited to submit a capital raising plan, containing in particular the capital raising measures that the bank intends to undertake²⁴⁴ and the burden-sharing measures casting upon the shareholders and subordinated creditors of the bank; second, the Member State will submit a thorough asset quality review of the bank and a forward looking capital adequacy assessment, as so to enable the Commission to determine precisely the (residual) capital shortfall of a bank that needs to be covered with State aid; third, once the total amount of State aid necessary is determined, the Member State can draw up and discuss with the Commission the restructuring plan, which will continue to be assessed under the *Restructuring Communication*. Altogether, hence, this approach to structural State measures not only ensures that the amount of aid is more limited and accurately targeted on the basis of the identified sources of the bank's problems,²⁴⁵ but also that State aid arrives last.

²⁴⁰2013 *Banking Communication*, § 28.

²⁴¹This is consistent with the preventive approach underpinning the SRM – see, in this regard, CAPRIGLIONE, *La nuova gestione delle crisi bancarie tra complessità normativa e logiche di mercato*, cit., pag. 10 and ff.

²⁴²See JAROSZ-FRIIS, KERLE, GALAND, *Banking*, cit., pag. 1126.

²⁴³2013 *Banking Communication*, §§ 28-31 and 32-34 for a specific description of the ways whereby the Member State can coordinate its action with that of the Commission.

²⁴⁴2013 *Banking Communication*, §§ 35-36

²⁴⁵2013 *Banking Communication*, § 23 and 24(d).

Furthermore, to avoid any managerial abuse of the aid, the 2013 *Banking Communication* provides for the application of stricter remuneration policies, such as a cap on remuneration of executive pay or severance payments.²⁴⁶ In addition, consistently with the principle that anybody must be accountable for his/her deeds as so to limit moral hazard and prevent perverse incentives, the 2013 *Banking Communication* specifies that «if recourse to State aid could have reasonably been averted through appropriate and timely management action, any entity relying on State aid for its restructuring or orderly winding down should normally replace the Chief Executive Officer of the bank, as well as other board members if appropriate».²⁴⁷

In the same vein, the 2013 *Banking Communication* acknowledges that some Member States enforce stricter *ex ante* burden-sharing requirements than other Member States did, with the ultimate result that the integrity of the single market is undermined.²⁴⁸ Therefore, the 2013 *Banking Communication* enhances and unifies the burden sharing regime,²⁴⁹ to avoid discrimination on the basis of Member States' fiscal capacity, the Communication specifies that the Commission will only authorize the aid after the bank's shareholders, hybrid capital holders, and subordinated debt holders absorb the losses incurred. In particular, the latter two categories are required to contribute to reducing the capital shortfall to the maximum extent possible, whereas any cash outflow in their favor must be prevented to the extent legally possible and at the earliest stage possible.²⁵⁰ Differently, the Commission will not require contributions from senior debt holders, such as deposit holders, whether insured or uninsured, bonds and all

²⁴⁶2013 *Banking Communication*, §§ 38-39.

²⁴⁷2013 *Banking Communication*, § 37. On this, though in the context of the BRRD and SRM, see CIRAULO, *La Banca di Italia ed il potere di rimozione degli esponenti aziendali tra vigilanza prudenziale e disciplina della crisi*, in *Banca Impresa Società*, 2016, pag. 51 e ANTONUCCI, *I poteri di removal degli esponenti aziendali nell'ambito del Single Supervisory Mechanism*, in *Banca Impresa Società*, 2016, pag. 21.

²⁴⁸2013 *Banking Communication*, § 18.

²⁴⁹LIENERNEYER, KERLE, MALIKOVA, *The New State aid Banking Communication: The Beginning of the Bail-In Era Will Ensure a Level Playing Field of Enhanced Burden-Sharing*, in *EStAL* 2014, pag. 277

²⁵⁰2013 *Banking Communication*, §§ 19, 41, 44 and 47-48.

other senior debts.²⁵¹ Furthermore, with such an enhanced burden sharing regime the Communication reduces competitive distortions:²⁵² the idea that anybody should be accountable for his/her deeds is consistent with the market-based selection mechanism.

Overall, according to the 2013 *Banking Communication*, to distribute the cost of capital shortfall between taxpayer's money and private banks,²⁵³ the latter must meet three requirements before gaining public resources: first, the bank in difficulty has to demonstrate that it has executed a capital raising plan to minimize the public intervention; second, if the capital obtained in that way are not sufficient to cover the capital shortfall, then shareholders and subordinated creditors must bail-in;²⁵⁴ third, in order to preserve the capital generating potential for the second step in full, a bank has to prevent all outflows of capital and junior debt from the moment on in which it becomes aware (or should have been aware) of the possibility that it may need to resort to State aid. Thus, as said above, any State aid must be delayed as much as possible in order to allow for appropriate private solutions.

To be sure, the 2013 *Banking Communication* takes into consideration rescue aid granted on a temporary basis. In particular, it admits them not only for guarantee schemes in favor of banks without a capital shortfall,²⁵⁵ but also for recapitalization and impaired asset measures for banks with a capital shortfall.²⁵⁶ However, the Commission clearly qualifies the latter as exceptions to the rule and, accordingly, condition them to many strict requirements: (i) that, in the

²⁵¹2013 *Banking Communication*, § 42.

²⁵²2013 *Banking Communication*, § 20.

²⁵³See LIBERATI, *La crisi del settore bancario tra aiuti di Stato e meccanismi di risanamento e risoluzione*, in *Rivista Italiana Diritto Pubblico Comunitario*, 2014, pag. 1350.

²⁵⁴On this matter, though in relation to the BRRD and the SRM, see ROSSANO, *Nuove strategie per la gestione delle crisi bancarie: il bail-in e la sua corretta applicazione*, in *Federalismi*, 2016, pag. 1; PRESTI, *Il Bail-in*, in *Banca Impresa e Società*, 2015, pag. 339; GUIZZI, *Il bail-in nel nuovo sistema di risoluzione delle crisi bancarie. Quale lezione da Vienna?*, in *Il Corriere Giuridico*, 2015, pag. 1485; and DI BRINA, *“Risoluzione” delle banche e “bail-in” alla luce dei principi della Carta dei diritti fondamentali dell’UE e della Costituzione nazionale*, in *Rivista trimestrale di diritto dell’economia*, 2015, pag. 206.

²⁵⁵2013 *Banking Communication*, § 23.

²⁵⁶State aid SA.38228 (2014/N) – *Restructuring of Abanka Vipava Group – Slovenia*, 13.08.2014.

notification, the Member States concerned show that such measures are necessary to preserve financial stability; (ii) that the associated competent supervisory authorities confirm that a current (not a prospective) capital shortfall exists, which would force the supervisor to withdraw the institution's banking license immediately if no such measures were taken; (iii) no less distortive measures, such as private capital or State guarantee measures, would solve the problem; (iv) that such measures comply with the rules governing remuneration and burden-sharing as set out in the 2013 *Banking Communication* and in *Recapitalization Communication*, the 2011 *Prolongation Communication* and, where applicable, the *Impaired Asset Communication*. Furthermore, following the authorization of the rescue aid, the Member State must however submit a restructuring plan in line with the *Restructuring Communication* within two months of the date of the decision temporarily approving the aid. The restructuring plan will be assessed on the basis of the *Restructuring Communication*, taking into account the principles of burden-sharing described in the 2013 *Banking Communication*.²⁵⁷

Likewise, in relation to liquidity support, as before, Member States may continue to grant liquidity support to banks also via schemes, mainly because such support is of reversible nature.²⁵⁸ The most notable change that the 2013 *Banking Communication* has introduced for liquidity support is that aid cannot be granted to banks with a capital shortfall, which in contrast need to require an individual authorization.²⁵⁹ This notification will then trigger the obligation to submit a capital raising plan, in line with the otherwise voluntary pre-notification procedure, or even a restructuring plan, if a quantitative threshold is met.²⁶⁰

In summary, if we tried to place the balance between the many interests, private and public, that a bank in crisis urges along a scale, whereas the *Crisis Communications* have been more concerned with preventing the above

²⁵⁷2013 *Banking Communication*, §§ 50-53.

²⁵⁸*Ibidem*, §§ 56-57.

²⁵⁹*Ibidem*, § 58.

²⁶⁰*Ibidem*, § 59d.

mentioned contagion mechanism from spreading, the *2013 Banking Communication* shifts this balance towards the containment of moral hazard and towards the protection of competition, integrity internal market and public finances. And in doing so, the 2013 Communication paves the way to the Banking Union and the regime established via the SRM and BRRD,²⁶¹ which however can only be the subject of another research.

8. Often those who approach the topic of State aid law for the banking sector during the crisis years are tempted to dwell on the relationship between competition and financial stability. The conviction that the law on State aid has the protection of competition as its sole and principal end is in fact widespread and – for sure – well grounded. Consequently, equally widespread and reasonable is the belief that in the years of the crisis, the ideal conflict between financial stability and competition has been won by the former, as if it was established that, when it comes to banks in difficulty, the defense of financial stability had to prevail over the preservation of competition.²⁶²

Now, this reading is certainly not wrong. Still, there is room for considering it partial or, at least, excessive with respect to: (i) the emphasis with which State aid rules for the banking sector are described as a *contortion* of ordinary State aid rules; (ii) the idea that *from now onward*, in the financial industry, the protection of financial stability would always be preferable to that of competition; and (iii) the very same idea that the relationship between financial stability and competition should be understood in *hierarchical terms*, so as to understand which of those two interests is pre-ordinated to the other.

²⁶¹See KOKKORIS, *The special nature of banks and its challenges for competition policy*, cit., pag. 15; DIVERIO, *Le misure nazionali di sostegno al mercato bancario: un'applicazione à la carte della disciplina europea degli aiuti di stato alle imprese?*, cit., pag. 605.

²⁶²See, e.g., BLAZSEK, *Competition law and State aid for failing banks in EU and its specific implications for CEE Member States*, in *Yearbook of Antitrust and Regulatory Studies*, 2016, pag. 145. A similar though distinguished issue is how the protection of competition should be accommodated in a regulated industry. On this point see, e.g., the recent HELLOWIG, *Competition policy and Sector-specific regulation in the financial sector*, 2018, Max Planck working paper, available at www.ssrn.com

In the matter of State aid law, the years of the crisis have brought to maturity – have fully revealed – an idea that started circulating in the new millennium, namely that the EU law on State aid is the instrument by which the Commission decides if, when, and how to intervene in the internal market – rightly conceived as a single market – to pursue several and opposite objectives of community interest. In other words, if in the past we used to discuss the intervention of National States in the national markets, now that the process of European integration has almost come to fruition and a single European market exists, we should complete the reasoning by discussing how the Commission, in lieu of National States, decides to intervene in the European market. So then, as for a national State the protection of competition is an important but not exclusive goal, it should not come as a surprise that, even for the European Commission, competition cannot be the only possible objective deserving protection. Therefore, beyond any due consideration about the (questionable) democratic legitimization of the Commission, the fact that during the crisis the Commission had preferred to pre-ordinate the protection of financial stability to the protection of competition should not sound as a profound and exceptional upheaval of EU State aid law, a sort of *debacle* of the “liberal soul” of the European Union. Rather – and at most – it should nurture a more technical question – that is, whether State aid law should still be placed among the rules that, in the Treaties, deal with competition only – that, to be sure, has nothing to do with the financial crises. That question is rooted in the modernization of State aid law: it traces back to the years when State aid law has been called to defend not only competition and the integrity of the internal market, but also to pursue other goals, such as budget discipline or environmental protection, which are not in themselves a matter of competition law.

As to the conflict between financial stability and competition is concerned, the years of the crisis have not shown any ultimate answer or definitive arrangement between the two. Rather, they have demonstrated that the coexistence of financial stability and competition depends on the circumstances

or, better, on the rules governing those circumstances. In other words, it is well known that the theoretical and empirical literature about the effects of competition in the banking sector is huge. However, it is also well-known that such literature does not converge towards a shared and single opinion on the optimal balance between financial stability and competition.²⁶³ Therefore, there is scope for policy decisions to take place; and, as the experience shows also in connection to other fields of EU law,²⁶⁴ policy decisions take shape through the rules that, from time to time, institutions apply *under the circumstances*. As a consequence, it makes no point in arguing that from now onward the Commission will favor financial stability over competition, whenever a bank will be in difficulty. Rather, one must accept what has happened over the last ten years: that is, that State aid rules for the financial sector may change to answer the specific needs and wants of banks, Member States, and the European Commission itself.

But the story of State aid rules in the banking sector still reveals something more. As aforesaid, each of the above Communications has designed an intricate system of rules, so that State aid can be granted, causing the least possible damage to competition, the integrity of the single market, and public finances. Therefore, on the one hand, answering the question whether the protection of financial stability prevails over the protection of competition is not very significant. Rather, it is necessary to understand in what terms the coexistence

²⁶³The literature on this issue is huge. For the studies showing the trade-off between stability and efficiency see, e.g., KEELEY, *Deposit insurance, risk and market power in banking*, in *American Economic Review*, 1990, pag. 1183; VIVES, *Competition policy in banking*, in *Oxford Review of Economic Policy*, 2011, pag. 479; KAPSIS, *Competition law and policy for the EU banking sector in a period of increased economic uncertainty*, in *International Journal of Law and Management*, 2012, pag. 284; CEJINAR, DUKE, *Competition policy and the banking sector. The need for greater international competition*, in *European Competition Law Review*, 2013, 583. By contrast, for the idea that competition may support financial stability, see OECD, *Competition and Financial Markets*, 2009; BECK, DEMIRGUC-KUNT, LEVINE, *Bank concentration and crises*, in *Journal of Banking and Finance*, 2006, pag. 1581. Finally, see ACHARYA, GROMB, YORULMAZER, *Imperfect competition in the interbank market for liquidity as a rationale for central banking*, *American Economic Journal: Macroeconomics*, 2012, pag.184-217 for the idea that any competition policy in the banking sector is actually neutralized by the moral hazard resulting from the “too big to fail” policy.

²⁶⁴That is the state of affairs also when it comes to the equilibrium between competition and innovation. In the end, antitrust authorities do not have to state principles, but to govern single cases. See on this point MAGGIOLINO, *Intellectual Property and Antitrust Law*, 2011.

between financial stability and competition is identified. In fact, while some combinations of rules, such as those drawn by the *Crisis Communications*, end up being more "indulgent" towards the less efficient and innovative banks, other combinations of rules favor the selective mechanism inherent in the market, as the rules of the *2013 Banking Communication* actually do. In other words, it is hard to think of a context that, completely disregards either safeguards and compensatory measures to protect financial stability, or the above mentioned contagion mechanism, to protect the selective mechanism inherent in the market. On the other hand, it remains true that only the examination of how this combination of specific rules – weights and counterweights – that in practice reveals the impact of the approach that the Commission has actually chosen to follow.²⁶⁵ But also this deserves to be the subject of another research.

²⁶⁵See GRAY, DE CECCO, *Competition, stability and moral hazard: the tension between financial regulation and State aid control*, cit., pag. 27 (arguing that the sources of, and cures for, bank in distress can vary so widely that universal rules are unhelpful).

ARTIFICIAL INTELLIGENCE AND AUTOMATION IN FINANCIAL SERVICES: THE CASE OF RUSSIAN BANKING SECTOR

Ilya A. Goncharenko * - Andrea Miglionico **

ABSTRACT: *This article discusses the impact of innovation in the Russian banking sector. This innovation, often referred to as FinTech, comprises cryptoassets, artificial intelligence and RegTech (i.e., applications of digital technology by regulation and compliance actors). The aim of the article is to examine the importance of the new frontiers of technologies in financial services like smart contracts, peer-to-peer lending and crowdfunding platforms. In this context, the article analyses the evolution of artificial intelligence in Russia with emphasis on robotics and automated mechanisms implemented in the financial firms. It also provides an overview of the initiatives of the Central Bank of Russia and their main effects in the payment system. The implications of machine learning and automation are discussed in terms of monetary policy, prudential regulation and investor protection.*

SUMMARY: 1. FinTech in banks: risks and challenges. – 2. RegTech on banking compliance. – 3. The role of automation in the payment system. – 4. The regulatory framework of artificial intelligence in the Russian banking services. – 5. Implications of financial technologies in the Russian banks. – 6. Conclusion.

1. Financial technologies (FinTech) aim to support regulation in the finan-

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cial markets with the use of algorithm and computer systems.¹ FinTech also aims to reduce regulatory and compliance costs by enhancing operational efficiency and product development. This is evident in specific areas of financial services such as prudential regulation, customer protection, disclosure mechanisms, market integrity and competition.² A case in point of the application of FinTech is represented by the banking sector. FinTech encompasses risk management and minimises reputational risk, legal risk and operational risk in the financial market: it provides innovative solutions to improve the regulatory framework and the compliant behaviour of financial firms (e.g. natural language processing and cognitive computing).³ However, the adoption of cloud-based systems and data mining techniques in FinTech underlines the problem of the necessary intervention of supervisors to avoid fraudulent activities and ensure data protection and privacy.

For example, the UK Financial Conduct Authority (FCA) has launched automated practices – i.e., “sandbox” – to develop technologies in performing compliance programmes, particularly in sectors such as anti-money laundering (AML) and ‘know your customers’ (KYC).⁴ This section examines the impact of FinTech – automating regulation and supervision – in the financial market and considers whether the current rules are amenable to algorithmic treatment and what will be the impact on the quality of regulation and the exercise of judgement by the supervisory authority. In this context, the main aspects are international compliance using technology to address the challenge of making single contracts comply with multiple regulatory jurisdictions, and suitability of the current statement of rules and regulations for automation. Automating regulatory compliance does not apply

¹See DOUGLAS W ARNER, JANOS NATHAN BARBERIS AND ROSS P BUCKLEY, ‘The Evolution of Fintech: A New Post-Crisis Paradigm’ (2015) 47 *Georgetown Journal of International Law* 4, 1271.

²See BUTLER and O’BRIEN, ‘Understanding RegTech for Digital Regulatory Compliance’ in Theo Lynn, John G. Mooney, Pierangelo Rosati and Mark Cummins (eds), *Disrupting Finance FinTech and Strategy in the 21st Century* (London: Palgrave 2019).

³See LEWAN, ‘The Role of Trust in Emerging Technologies’ in Robin Teigland, Shahryar Siri, Anthony Larsson, Alejandro Moreno Puertas and Claire Ingram Bogusz (eds), *The Rise and Development of FinTech* (London: Routledge 2018) 111-112.

⁴Financial Conduct Authority, ‘Regulatory sandbox’, available at <<https://www.fca.org.uk/firms/regulatory-sandbox>> (accessed 27 June 2019).

mechanically, therefore it is relevant to investigate to what extent the UK Prudential Regulation Authority (PRA) can modify the rules. The use of algorithmic regulation to guarantee fairness and appropriateness of insurance, ensuring there is contractual certainty to avoid poor outcomes for customers is a key aspect as well as the use of technology to guarantee quality, suitability and competition in insurance products e.g. at point of sale for consumer durables. Interesting point is whether FinTech affects firms' compliance functions – i.e. if technologies improve or they blindly rely on the algorithm and if the algorithm is not perfectly designed may lead to problems – and whether the use of FinTech automatically excludes certain classes of consumers.

The prudential sourcebook for the UK financial industry offers evidence to discuss the extent to which these aspects can be addressed through principles and to examine which elements of regulation can potentially be most easily automated.⁵ Specifically, it is relevant to consider whether the statements of these elements of regulation are 'algorithm ready', i.e. they are presented in a way that would allow automated software-based compliance and reporting compliance.⁶ This means to investigate under what circumstances should we entrust 'x', 'y', 'z' tasks to algorithmic decision-making and under what circumstances should we entrust 'a', 'b', 'c' issues to human decision making. A further issue concerns the generation of new risks that derive from the use of FinTech. It is worth considering the role of supervisory judgement and how it will be affected by the introduction of FinTech applied to banking sector and whether automation will reduce or support the role of judgement and the application of principles in banks.⁷

FinTech aims to provide clarity and create a shared understanding around rules and data through virtual platforms: rules are transformed into code, auto-

⁵FCA, 'Prudential sourcebook for Banks, Building Societies and Investment Firms' (June 2019), available at <<https://www.handbook.fca.org.uk/handbook/BIPRU.pdf>> (accessed 16 June 2019).

⁶See NICOLETTI, *The Future of FinTech: Integrating Finance and Technology in Financial Services* (London: Palgrave 2017) 261-262.

⁷See COLAERT, 'RegTech as a response to regulatory expansion in the financial sector' (16 July 2018) Oxford Business Law Blog, available at <<https://www.law.ox.ac.uk/business-law-blog/blog/2018/07/regtech-response-regulatory-expansion-financial-sector>> (accessed 26 June 2019).

mating the process can allow regulators to request data and for firms to quickly and simply share it without the need to interpret.⁸ While machines can process data far more quickly than humans, they typically rely on more limited types of information. The challenge is how investors ensure that the machine has enough information about the world within which it is operating and how machines make critical decisions.⁹ In this context, it is important to explore whether regulation is machine readable into programmes when process data and computer code can ensure adequate consumer protection. Arner et al. argue that the focus of FinTech should be to transform financial regulation as well as achieve efficiency gains.¹⁰ Lastra and Allen observe that FinTech tools are an essential component in the regulatory response to virtual currencies and associated developments, such as ‘smart contracts’.¹¹ Although machines may be more reliable than humans, new risk can be generated into systems.¹² Financial institutions face substantial difficulties to comply with regulation in different jurisdictions, therefore the question arises whether the current statements of regulatory provisions are suitable for automation.

The range of digital technologies used in financial services is very broad, including for example household and small business lending, online and mobile payments, insurance, capital market transactions, wealth management and regulatory reporting and compliance. Likewise, a wide range of digital initiatives seek to promote ‘financial inclusion’, i.e. widening access to banking and

⁸See DHAR and M STEIN, ‘FinTech Platforms and Strategy’ (2017) 60 *Communications of the ACM* 10, 32-33, available at <<https://cacm.acm.org/magazines/2017/10/221331-fintech-platforms-and-strategy/abstract>> (accessed 29 June 2019).

⁹See Marshall W Van Alstyne, Geoffrey G Parker and Sangeet Paul Choudary, ‘Pipelines, Platforms, and the New Rules of Strategy’ (April 2016) 94 *Harvard Business Review* 4, 54-55.

¹⁰See Douglas W Arner, János Barberis and Ross P Buckley, ‘FinTech, RegTech, and the Reconceptualization of Financial Regulation’ (2016) 37 *Northwestern Journal of International Law & Business*, 371.

¹¹See LASTRA and GRANT ALLEN, ‘Virtual currencies in the Eurosystem: challenges ahead’ European Parliament, Monetary Dialogue, July 2018, available at <http://www.europarl.europa.eu/cmsdata/150541/DIW_FINAL%20publication.pdf> (accessed 26 June 2019).

¹²See Ross P. Buckley, Douglas W. Arner, Dirk A. Zetsche and Rolf H. Weber, ‘The road to RegTech: the (astonishing) example of the European Union’ (2019) 20 *Journal of Banking Regulation*, 2-3.

insurance services both for vulnerable households and small businesses.¹³ Access to technology enacts financial inclusion that “denotes banks’ provision of basic financial services at affordable costs to those that need and qualify for them”.¹⁴ With the advent of FinTech, it has been said that lenders will have more information to assess the credit quality of borrowers and to make decisions on whether (and how much) to lend more quickly.¹⁵ This raises the following points: (1) impact of FinTech on financial industry structure, organisation and business models; (2) household and business attitudes to financial services and adoption of FinTech; (3) promoting financial inclusion using financial technology in low and middle-income countries (for example the use of mobile phone payments and the promotion of financial inclusion in East Africa)¹⁶; (4) the consequences of new forms of data and algorithmic processing in financial services; and (5) regulatory applications of FinTech, for example, how it might be used to support regulatory objectives and whether it can be used to manage financial instability.

Stakeholders and policymakers are paying close attention to developments in FinTech, both because of the perception that they should support domestic capacity in what is a nascent and rapidly growing new industry with potential global impact, and because digital technology can address some of the perceived shortcomings of the traditional financial services industry (e.g. lack of consumer protection, weaknesses in governance, gaps in compliance and improved provision to previously underserved regions). As mentioned, issues arising from digital technology and financial inclusion are wide ranging and require regulatory attention, especially in the context of AML, combating the financing of terrorism (CFT) and KYC requirements. These issues underline several economic, regulatory,

¹³See GABOR and BROOKS, ‘The Digital Revolution in Financial Inclusion: International Development in the Fintech Era’ (2017) 22 *New Political Economy* 4, 423-424.

¹⁴See LEE, ‘Financial Inclusion: A Challenge to the New Paradigm of Financial Technology, Regulatory Technology and Anti-Money Laundering Law’ (2017) 6 *Journal of Business Law*, 473-474.

¹⁵See HODGE, ‘The Potential and Perils of Financial Technology: Can the Law adapt to cope?’, The First Edinburgh FinTech Law Lecture, University of Edinburgh, 14 March 2019, available at <<https://www.supremecourt.uk/docs/speech-190314.pdf>> (accessed 28 June 2019).

¹⁶It is referred to mobile payments technologies in emerging markets, mostly relating to the successful MPesa network in East Africa.

legal and social concerns (cybercrime, data protection, privacy, adequate dispute settlement mechanisms and crisis management procedures).¹⁷ FinTech highlights challenges in the regulatory framework in terms of the interpretation of “smart contracts”, attribution of responsibility for the acts and omissions of robots and enforcement of contractual obligations. Further, FinTech raises major data issues that relate closely to the accompanying think piece on data infrastructure.¹⁸ Identity, security, data privacy and their regulation are all central concerns for financial services firms. Enhancing the appropriate public policy on financial data and the availability of ‘open data’ for use by other financial firms, investors and other ‘stakeholders’ represent the main challenges for market actors.

2. Regulatory technology (RegTech) can be considered as the new paradigm of supervision and enforcement in the financial sector. The emergence of RegTech – the use of financial technologies to automate regulation and reduce the costs of regulatory compliance – represents a major opportunity for addressing the inefficiencies of financial regulation.¹⁹ RegTech aims to enhance the effective implementation of principles among financial institutions: for example, it facilitates the monitoring of bank capital rules with the use of automated machines.²⁰ The extent to which compliance with regulation can be automated and carried out by machines raises the question whether manual intervention is still required.²¹ The supervisory authorities are exploring RegTech platforms to expedite regulatory and management controls and mechanisms for enforcement of private con-

¹⁷See ACEMOGLU, OZDAGLAR and TAHBAZ-SALEHI, ‘Systemic Risk and Stability in Financial Networks’ (2015) 105 *American Economic Review* 2, 564–565.

¹⁸See ROMĂNOVA and KUDINSKA, ‘Banking and Fintech: A Challenge or Opportunity?’ in Simon Grima, Frank Bezzina, Inna Romănova and Ramona Rupeika-Apoga (eds), *Contemporary Issues in Finance: Current Challenges from Across Europe*, Contemporary Studies in Economic and Financial Analysis, Volume 98 (Emerald 2016) 21–22.

¹⁹See SILVERBERG, PORTILLA, FRENCH, VAN LIEBERGEN and VAN DEN BERG, ‘Regtech in Financial Services’ (2016), available at <https://www.iif.com/system/files/regtech_in_financial_services_solutions_for_compliance_and_reporting.pdf> (accessed 12 June 2019).

²⁰See TRELEAVEN, ‘Financial Regulation in FinTech’ (2015) 3 *University College London Journal of Financial Perspectives* 3, 114–115.

²¹See VAN LIEBERGEN, ‘Machine Learning: A Revolution in Risk Management and Compliance?’ (2017) 45 *Journal of Financial Transformation*, 60–61.

tracts. However, the application of technological solutions to reduce compliance costs and avoid gaps in supervising financial activities may interfere with the manual intervention of regulators.²² The adoption of RegTech in automating regulation and supervision, particularly in sectors such as anti-money laundering and ‘know your customers’, implies a shift from principle based to rules-based regulation.²³ RegTech can promote more substantive compliance processes, ensure information disclosure and contractual certainty and predictability as an incentive to prevent risk-taking and can reduce discretion, particularly in terms of an adequate level of enforcement of principles.²⁴

Further, RegTech eliminates the possible risks of compliance failures that consist, on the one hand, of creative compliance (i.e. where although the letter of the norm is adhered to, it is sometimes interpreted over-generously) and, on the other, of over-compliance (i.e. over-regulation or additional burdensome levels of enforcement). RegTech can be well-functioning on the basis of trust and fairness behaviours, which means confidence, transparency and cogent acts and it can strengthen substantive compliance that represents the key objective for fostering responsive regulation. In promoting a new compliance culture RegTech encompasses risk management but it also reduces reputational risk, legal risk and operational risk in banking industry and banking products.²⁵ Firms and financial institutions have recognised the importance of RegTech particularly as regards internal controls, where the relationship between administrators, managers and investors finds its best expression in a species of self-imposed rules designed to reduce the reputational risks posed by non-compliant behaviours. It has been argued that

²²See SITARAMAN, ‘Regulating Tech Platforms: A Blueprint for Reform’ (April 2018), “The Great Democracy Initiative 2018”, Vanderbilt University Law School, Legal Studies Research Paper Series 18-64, available at <<https://greatdemocracyinitiative.org/wp-content/uploads/2018/03/Regulating-Tech-Platforms-final.pdf>> (accessed 14 June 2019).

²³See GESLEVICH PACKIN, ‘RegTech, Compliance and Technology Judgment Rule’ (2018) 93 *Chicago-Kent Law Review*, 207-208.

²⁴See KAVASSALIS, STIEBER, BREYMAN, SAXTON and JOSEPH GROSS, ‘An Innovative RegTech Approach to Financial Risk Monitoring and Supervisory Reporting’ (2017) 19 *The Journal of Risk Finance* 1, 39-40.

²⁵See KIM, YOUNG-JU PARK and CHOI, ‘The Adoption of Mobile Payment Services for Fintech’ (2016) 11 *International Journal of Applied Engineering Research* 2, 1058–1061.

‘RegTech could make compliance easier: rather than writing rules in legal English the regulator could write rules in machine-readable English or prescribe particular software applications’.²⁶ Opportunistic behaviours by market participants could be avoided by means of the regulatory technologies – e.g. blockchains and smart contracts – as a measure falling within the category of internal self-controls, which could limit the need to regulate by statutory law and reduce mandatory disclosure costs.²⁷

RegTech can be used to prepare regulatory reports (e.g., market conduct annual statements). The FCA launched an initiative for ‘Model Driven Machine Executable Reporting’ to prove that if parts of their handbook were coded (so they became machine readable) this could streamline regulatory reporting and not only save ambiguity (but not judgement) time and costs associated with this compliance activity but also allow more uniform and accurate reporting and allow both regulatory and industry participants to identify and manage associated risks.²⁸ In substance, whilst the disclosure regime reduces the costs of capital and information, RegTech enables perfect alignment of manager and investor interests. On this view, the parameters of the regulatory technologies become not only a legal norm, but predominantly, a social norm; on the one hand, it is a legal norm for verifying that the corporate management has complied with the rules, on the other, it is social norm designed to transform risk prevention into benefits for investors and consumers.²⁹ RegTech not only assumes a normative value but also constitutes a useful measure for enforcing principles. The role of RegTech, as an *ex ante* legal measure to prevent the risks of statutory enforcement loopholes, be-

²⁶See MICHELER and WHALEY, ‘Regulatory Technology – Replacing Law with Computer Code’, LSE Working Papers 14/2018, 8, available at <<http://eprints.lse.ac.uk/89550/1/Micheler%20SSRN-id3210962.pdf>> (accessed 29 June 2019).

²⁷See H Y. CHIU, ‘A New Era in Fintech Payment Innovations? A Perspective from the Institutions and Regulation of Payment Systems’ (2017) 9 *Law, Innovation and Technology* 2, 190-191.

²⁸FCA, ‘Model driven machine executable regulatory reporting TechSprint’ (20 November 2017), available at <<https://www.fca.org.uk/events/techsprints/model-driven-machine-executable-regulatory-reporting-techsprint>> (accessed 27 May 2019).

²⁹See CARNEY, ‘New Economy, New Finance, New Bank’, Speech given at the Mansion House, London, 21 June 2018, available at <www.bankofengland.co.uk/speeches> (accessed 25 June 2019).

comes an important link between the rules-based and principles-based regulatory approaches by conveying these types of regulation into the risk-based regime.³⁰

3. FinTech holds the promise of addressing fundamental problems of resource misallocation and social and economic inequity in financial services.³¹ Supporting the continuing ‘information technology revolution’ in financial services, especially in addressing barriers such as the constraints of legacy systems and need for co-operation, e.g. on standardisation and on effective digital identity solutions, is the new challenge of regulators.³² However, there is little consensus amongst practitioners and policymakers on how technological change can shape the industry in the longer term, both in terms of industrial structure and regulation.³³

For example, processes for KYC compliance are costly and time-consuming with extraordinary fines for non-compliance. By implementing RegTech solutions such as a distributed shared ledger, a business can rapidly verify the identity of its clients and assess potential risks of illegal intentions for the business relationship.³⁴ RegTech can increase the speed of client on-boarding, reduce risk as a distributed shared ledger acts as an immutable assured audit trail of all KYC processes, enhance the customer experience (as little customer input is needed for on-boarding), and bring efficiency gains as RegTech enables businesses to scale higher

³⁰See KRÖNER, ‘API Deep Dive: Who Will Thrive in an Open Banking World? Why Meeting Regulatory Requirements Is Not Enough for Banks to Remain Relevant’ (2018) 2 *Journal of Digital Banking* 3, 198-199.

³¹See MADER, ‘Microfinance and Financial Inclusion’ in David Brady and Linda M. Burton (eds), *The Oxford Handbook of the Social Science of Poverty* (Oxford: OUP 2016) 844-45.

³²See SÁNCHEZ, ‘The Information Technology Revolution and the Unsecured Credit Market’ (2018) 56 *Economic Inquiry* 2, 914-915.

³³See POLLARI, ‘The Rise of Fintech: Opportunities and Challenges’ (2016) *The Australasian Journal of Applied Finance* 3, 15.

³⁴Distributed ledgers operate through the maintenance of multiple shared copies of the database which avoids single point attack or failure as with existing large legacy IT systems. Distributed ledger technologies can be used to allow governments to collect taxes, deliver welfare benefits, issue passports and control immigration, maintain land registries as well as manage the supply of goods and services and ensure the integrity of government records and services. For an overview, among others, Kern Alexander, *Principles of Banking Regulation* (Cambridge: CUP 2019) 342.

customer volume more efficiently.³⁵ In this context, Natural Language Generation (NLG) can be used to automate the generation of regulatory AML reports, e.g., suspicious activity reports (SARs).³⁶ Large institutions generate thousands of SARs every year, so AML compliance costs can be substantial. NLG enables compliance teams to automatically identify the most interesting and important information trapped in structured data and produce language that provides situational context, explanations and potential next actions. With advanced NLG systems, like ‘Narrative Science Quill’, the SAR Narrative can be automatically generated, while communicating the key ‘who, what, when, and where’ aspects of the suspicious activity and can also be tailored to meet the needs of the intended audience.³⁷

In terms of fraud insights, artificial intelligence (AI) can be used to reduce occurrences of fraud (internal and external) using Natural Language Processing (NLP) to uncover hidden patterns and anomalies in large quantities of text (outlier and drift detection) to flush out suspicious claims.³⁸ NLP can be used to extract regulations and identify regulatory and control requirements (i.e. legislation/regulation ‘gap’ analysis tools). Telephone conversations, face-to-face meetings and written correspondence provide invaluable information for optimising regulatory compliance, risk management, customer care and sales.³⁹ There are many practical implementations of neural networks and other automated meth-

³⁵See LOOTSMA, ‘Blockchain as the Newest Regtech Application— the Opportunity to Reduce the Burden of KYC for Financial Institutions’ (2017) 36 *Banking & Financial Services Policy Report* 8, 16-17.

³⁶A typical SAR has five components; the first four can be auto populated by many case management systems, however the last portion, the SAR Narrative, cannot. See Max Gotthardt, Dan Koivulaakso, Okyanus Paksoy, Cornelius Saramo, Minna Martikainen and Othmar M. Lehner (eds), ‘Current State and Challenges in the Implementation of Robotic Process Automation and Artificial Intelligence in Accounting and Auditing’ (2019) 8 ACRN *Oxford Journal of Finance and Risk Perspectives*, Special Issue Digital Accounting, 32-33.

³⁷See <https://narrativescience.com/products/quill/> (accessed 10 July 2019).

³⁸For example, IDVision is a RegTech company developing a set of solutions to verify consumer identities to establish identity with greater confidence by verifying against a broad set of personal and digital data and authenticate consumers, securing every point of the customer’s journey by validating the claimed identity is who they say they are. In literature, among others, see Mikko Riikkinen, Hannu Saarijärvi, Peter Sarlin, Ilkka Lähteenmäki, ‘Using artificial intelligence to create value in insurance’ (2018) 36 *International Journal of Bank Marketing* 6, 1145-1146.

³⁹Recordsure is a RegTech company currently pioneering tools that automate the assessment of a conversation and identify potential compliance risks: insurers could analyse up to 100 per cent of customer calls rather than the fraction of calls typically analysed by humans.

ods of data analysis for applications in credit, investment and trading decisions, sometimes with substantial industry impact (e.g. the rise of algorithmic and high-frequency trading in equity markets).⁴⁰ Using technology-based computation to improve regulation, for example in detecting insider trading, is conducted primarily by private firms. Ensuring that the above-mentioned systems and controls are independently assessed and tested for effectiveness at an appropriate frequency - and ensuring there is a clear allocation of responsibilities in the first and second line for monitoring compliance - are the main challenges regulators may face. In this way, every firm is responsible for interpreting regulation and implementing its requirements. Shifting the responsibility for converting regulation into code to a central body raises questions about the legal basis of the coded regulation and liability questions about who is responsible if there are errors in the conversion.

Regulators are only at the first stages of using technology in financial regulation, a major aspect of their work involving efforts to translate parts of the regulatory rule-book into machine-readable form.⁴¹ While this provides a ‘proof of concept’, it is relevant to identify what parts of the current range of regulations can be translated into a machine-readable form that can then be enforced algorithmically for rethinking regulatory process to make it more suitable for automated compliance.⁴² For example there is widespread industry interest in using a shared third-party for KYC regulations to share identity information; but it appears that these can make limited progress as long as responsibility for compliance remains solely that of the firms that use them with no possibility of regulatory and legal indemnity.⁴³

The burden of regulatory compliance may though still be a major barrier to

⁴⁰See CHABOUD, CHIQUOINE, HJALMARSSON and VEGA, ‘Rise of the Machines: Algorithmic Trading in the Foreign Exchange Market’ (2014) 69 *The Journal of Finance* 5, 2045-2046.

⁴¹See BENNETT, ‘The financial industry business ontology: Best practice for big data’ (2013) 14 *Journal of Banking Regulation* 3-4, 256-257.

⁴²See BAXTER, ‘Adaptive Financial Regulation and RegTech: A Concept Article on Realistic Protection for Victims of Bank Failures’ (2016) 66 *Duke Law Journal* 3, 570-571.

⁴³See MOYANO and ROSS, ‘KYC Optimization Using Distributed Ledger Technology’ (2017) 59 *Business & Information Systems Engineering* 6, 411-412.

technology-based entry into financial services. However, RegTech can increase competition in the financial services to the benefit of consumers by lowering barriers to entry in the market for personal current account and payments systems (technological change in bank delivery channels e.g. through ATM, telephone or online banking or on the network economics of card payments).⁴⁴ It can be argued that the new generation of financial technologies is an opportunity for rethinking and substantially improving the entire framework of financial regulation. However, the disadvantages of using RegTech are the initial cost, risk of error in the system, risk of over-reliance and increased systemic risk if all firms follow similar artificial intelligence solutions that lead to highly homogeneous market behaviour.

Next section discusses the implications of AI and automation in the Russian banking sector: the analysis shows how commercial banks in Russia are implementing financial technologies in their internal governance to deal with frauds and cyberattacks.

4. Russian legislation gives two specific definitions of artificial intelligence (AI): (1) “artificial intelligence” is simulated (artificially reproducible) intellectual activity of human thinking⁴⁵; (2) “component artificial intelligence” is a simplified version of artificial intelligence implemented in the subject-information form, allowing simulation of individual components of natural intellectual thinking.⁴⁶ Even though both definitions backdate to 2009, the issue of AI raised concerns in the Russian banking sector.

President Vladimir Putin pointed in the annual message to the Federal Assembly⁴⁷ on February 2019 that “we already have examples of successful innovative companies. We need to have much more of those including in such spheres as

⁴⁴See ANAGNOSTOPOULOS, ‘Fintech and regtech: Impact on regulators and banks’ (2018) 100 *Journal of Economics and Business*, 7-8.

⁴⁵“GOST P 43.0.5-2009. National standard of the Russian Federation. Information support for equipment and operator activity. Process of information exchange in technical activities. General provisions” (established and enacted by an Order of Rostechregulirovaniye dated 15.12.2009 N959-st), available at <<http://www.consultant.ru>> (accessed 01 July 2019).

⁴⁶Ibid.

⁴⁷Official name of both chambers of the Russian Parliament.

artificial intelligence”.⁴⁸ Russian President also suggested to start a full-scale programme in the AI sphere at a national level. Therefore, the issue of AI is becoming one of the mainstreams in Russia for the years to come. This has been a major objective in the council “On development of technology in the AI sphere” where it was pointed by the President on May 2019. The results of this council were approved by the Russian President through several orders⁴⁹:

- Ministry of Digital Development, Communications and Mass Media of the Russian Federation together with Sberbank of Russia PLC and Gazprom oil PLC, public company Management Company for the Russian Foundation of Direct Investment shall provide for the expert society to review a draft National strategy for the development of technology in the AI sphere in the Russian Federation;
- Russian Federation Government shall provide for a draft National strategy for the development of technology in the AI sphere in the Russian Federation, conciliated with the interested state bodies, to be submitted in an established order together with a draft Presidential Decree on approving this strategy;
- Russian Federation Government shall conclude agreements of intent between Russian Federation and interested state corporations and companies with state participation, including Sberbank PLC, State corporation RosAtom, State corporation RosTech, Rostelecom PLC and Russian Railways public company for the purposes of developing specific high-tech directions;
- within the framework of national programme “Digital economy of the Russian Federation” to establish a federal project aimed at fulfilling national strategy to develop technology in the AI sphere in the Russian

⁴⁸Russian Federation President’s Message to the Federal Assembly dated 20 February 2019, available at <<http://www.consultant.ru>> (accessed 25 May 2019).

⁴⁹List of orders as a result of a council “On development of technology in the AI sphere” (approved by the Russian President on 12.06.2019 N Pr-1030), available at <<http://www.consultant.ru>> (accessed 20 June 2019).

Federation, which would include a three years plan of activities;

- Together with Moscow city Government and Sberbank of Russia PLC to consider creating a territory within Moscow to operate under experimental legal regime and to have conditions necessary to develop and implement technology in the AI sphere.

Most interestingly the Central Bank of Russia is not involved in the mentioned process but Sberbank (the biggest commercial bank in the Russian Federation) deals with financial innovation. In 2017 Chairman of the Bank of Russia Mrs Nabiullina commented at the XV International Banking Forum that digital technology was a third factor of competition, together with an increased financial affordability, decrease of costs to process information and to channel sales, increased clients satisfaction and access to new markets.⁵⁰ Nabiullina argued that digitalization was a powerful trend, which would only build up making Russian financial market more and more exterritorial and hence competitive. Thus, only the banks with developed technological platforms and business models focused on the use of AI elements, high level of robotization of business processes, remote client servicing in minimum response time mode would gain market advantages and conversely, the banks – “latecomers” in the digital revolution risk to lose clients and, as a result, income.

Currently the Central Bank of Russia tends to consider AI only from the point of view of threats of cyberattacks, as it is not that important which technology would develop in the future: automation or robotization. It is more important for the Central Bank of Russia to understand which technology and methods can be used by an intruder (for instance to withdraw money). If they see that criminals learn to quickly withdraw money through a particular channel, then the Central

⁵⁰Chairman of the Bank of Russia Mrs Elvira Nabiullina’ speech at the XV International Banking Forum on 14.09.2017, available at <http://www.cbr.ru/press/st/press_centre/nabiullina_170914/> (accessed 05 July 2019).

Bank would build up additional security measures in that very direction.⁵¹ Nevertheless, the Central Bank admitted in its Report on development of banking sector and banking supervision in 2018⁵² that from the point of view of opportunities and challenges while developing banking technologies financial technology and innovation become an integral part of the banking sector by changing banks' operational processes, services they offer and mechanisms to interact with their clients, that they use. At the same time banking services actively switch for a digital space, which creates several risks for the banks also from the point of view of a growing number and complexity of cyberattacks. In 2018 there were the following trends in the Russian banking sector:

- digital transformation of the banking sector in the part of internal processes and channels to interact with the clients;
- increased competition from new financial market players, including FinTech companies and large technology companies;
- the use of AI technology to collect information about clients, to ameliorate services and render personalized services;
- increased importance of big data analysis, including the use of machine learning technologies;
- increased investment into cybersecurity.⁵³

5. As mentioned earlier a pioneer for using AI in the banking sphere in Russia is Sberbank which is at the forefront of deploying digital technology and it is transforming its in-house technological platform and creating a major, industrial-scale IT system. The bank has nine innovative laboratories operating in key areas such as AI and machine learning, virtual and augmented reality, blockchain, robot-

⁵¹First deputy Head of Department for information security at Central Bank of Russia, Artem Sychev's interview to IA "TASS", 21.06.2019, available at <http://www.cbr.ru/press/int/sychev_tass_2019-06-21/> (accessed 05 July 2019).

⁵²Central Bank of Russia's Report on development of banking sector and banking supervision in 2018, available at <http://www.cbr.ru/content/document/file/72560/bsr_2018.pdf> (accessed 03 July 2019).

⁵³Ibid.

ic technology, robotization and gamification.⁵⁴

Firstly, Sberbank develops specialized automated systems to work with toxic assets.⁵⁵ They carry out R&D projects on their own and exchange experience from other Russian commercial banks on a regular basis. Another sphere of AI development in Sberbank is automation of the insolvency procedures. They have joined efforts with their partner – “Pravo.ru” company – to make an affordable and convenient service in this area. This product is already created and offered to the clients under name Bankro.TECH. Currently it allows to aggregate information about insolvency procedure from all possible public sources, to present it in a structured and easy to analyse form and transmit it to all users, who need it. On a basis of the collected data, the system automatically makes registers of creditors, builds schedules of court sessions, form necessary documents for the insolvency procedure. It also allows participants to the processes to communicate, for example, to hold remote meetings of the creditors committee.

Insolvency procedure is quite formal, it is implemented according to the Bankruptcy Law⁵⁶, and most of the steps are confirmed by decisions or rulings of the courts. There are several courts and since there is a register of insolvency information, resources of the Federal Tax Service, the site of arbitration courts where decisions are published, Bankro.TECH allows to work with all the relevant data. Sberbank’s system automatically receives information from all sources, determines which document relates to which case, understands the meaning of the documents, extracts data from them and properly sorts it. In addition, attention in Sberbank’s service is paid to building the logic of the process itself, it is a work flow system in which one can build work plans (or use the built-in standard plans)⁵⁷.

⁵⁴See <<https://www.sberbank.com/about>> (accessed 7 July 2019).

⁵⁵Interview with Mr Maxim Degtyarjev, Vice-President of Sberbank, Head of the Department for work with toxic assets, “Banking review” N4 [2019].

⁵⁶Federal Law of the Russian Federation dated 26.10.2002 N127-FZ (last amended on 03.07.2019), “On insolvency (bankruptcy)” available at <<http://www.consultant.ru>> (accessed 07 July 2019).

⁵⁷Interview with Mr Maxim Degtyarjev, Vice-President of Sberbank, Head of the Department for work with toxic assets, “Banking review” N4 [2019].

In terms of automation, Sberbank allows it to free up its employees from performing routine operations and to redirect it to solving more complex interesting tasks where it is necessary to apply the knowledge that robots do not have at this moment. In routine tasks, robots have surpassed a man by quality. There are tasks that a machine fulfills worse than a man. For example, text recognition: the average accuracy of recognition is about 85%. Where the system is not sure, it points it out and the document is passed over to people for further recognition but Sberbank continues to train the system in order to improve accuracy.⁵⁸

Sberbank has already embedded robots into some of its banking processes. For example, Sberbank has a robot-collector - a complex software package that includes several functions. Robot makes calls to customers, talks to them, represents itself, asks who it is talking to, identifies the individual, notifies the person of a debt, asks about the reasons for the debt to occur, requests to repay the debt, registers a consent or refusal. There are several models that work in this complex: speech recognition, when the system translates a set of sounds into a set of characters; understanding the meaning of a message embedded in this text; selecting a desired response and, finally, speech generation. There are standard phrases in a conversation that are prerecorded, and there are phrases that are generated by machine in due course of such conversation.⁵⁹ Interesting to note that Sberbank does not warn a customer that he/she is talking to a robot, as some people are not ready to communicate with a machine. Key task of the bank in the process of communication with the client is to recover the debt in a way that is comfortable for both bank and client. After a communication with Sberbank's employee or a robot, the bank conducts a customer satisfaction survey.

Sberbank robot has both male and female voices. They teach models to detect whom a person is more comfortable to talk with: a man or a woman, more rigid or soft tone. In general, there are quite a lot of mathematical models in Sberbank systems on the basis of which AI determines which client should be called

⁵⁸Ibid.

⁵⁹Ibid.

and at what time, and also determines the probability of a successful call depending on the client's profile. An entire pool of overdue loans is screened through a sieve of a whole family of models that determine what needs to be done with this particular client at the current moment. Roughly speaking, a model is launched at night then in the morning the bank gets the result of analysis, which instructs the bank to send SMS to one client today, to call a second client, that a bank employee shall come out to a third client and find out what is going on at spot and that it is time to sue a fourth client.⁶⁰

Sberbank's robot involved in dealing with overdue loans makes around 140,000 calls per day. This is a huge number of calls from which Sberbank has freed its operators. Though they still have a call center, where people handle difficult conversations. At first, they were only entrusted to make first calls notifying of an overdue payment, which were the easiest ones. However, Sberbank already tests repeated calls, conversations about several loans simultaneously. Such a system may further be adapted to suit other market segments like collection agencies, utility services, insurance companies etc. But not everything may be modeled or robotized. There is a relatively big part of work, including the work with papers for court cases, which indeed may be automated, but there is work, which so far cannot be passed over to robots. For example, negotiations on conditions of restructuring, complicated situations, where a bank fails to come to an agreement with a man to repay a debt. Basic Key Performance Indicators (KPI) for Sberbank is a level of repayment. They currently manage to return about 99% of the overdue debt from individuals. In the corporate field the level of return for the default loans, where a delay exceeds 90 days, is more than 60% now, which Sberbank considers to be a very good rate.⁶¹

In the banking sector AI is also used to evaluate the work of employees and to help them. Sberbank has an intelligent management system that analyses the work of each employee: whether he/she deviates from the process, how does

⁶⁰Ibid.

⁶¹Ibid.

his/her effectiveness change. What is more important, that after the analysis, the system gives recommendations on what exactly needs to be improved and how to do that based on the best practices. Depending on the type of deviations, different periods and different stages of escalation are set. General principle is the following: if an employee's performance does not change, then the situation is escalated to his/her manager. The manager has recommendations on how to help an employee to work better, what needs to be explained to him/her, maybe the manager shall carry out a transaction together with him/her. If the manager does not react, then the situation is escalated to a next level. In addition, deviations are divided into typical for certain categories of employees and specific. This allows also to analyse the processes: if some similar deviations happen, then perhaps the process itself is initially built inadequately, and the task would be to find these problems in the process and fix them.

Further, robotics for Sberbank is a comprehensive tool that increases the efficiency of all processes, both internal and external, accelerates them, provided that such processes are correctly built from a methodological point of view. But Sberbank is not the only one among Russian commercial banks that implements AI. The lag in the implementation of these technologies may cause a serious damage to competitive positions, but so far it is possible to catch up with the leaders without an exorbitant level of investment.⁶² As expected, banks specializing in servicing individuals prevail among the leaders in the field of AI and machine learning but there are also universal credit organizations there. Leading banks have adapted their IT platforms to the needs of AI, have gathered strong teams, organized the work with data, and accumulated experience of using advanced machine learning algorithms. Russian banking sector, because of the efforts of the leaders, does not lag a global trend - banks become more like technology companies, but subject to strict regulation. Among the leading banks in the field of AI one can name the following Russian banks: Tinkoff bank, MTS bank (affiliated with MTS

⁶²See VOLKOV, "Banks teach the machines", "Banking review" N12 [2018].

mobile operator), Moscow Credit Bank and others.⁶³

Russian banks often use solutions based on AI in the assessment of credit risk and related areas (debt collection, detection of fraudulent transactions), though the leaders are not limited to this. Credit scoring in one form or another is largely practiced by the Russian banks. Another very popular direction, where banks use AI is marketing, including forming individual proposals for the customers. Only one Russian bank had a working solution in the field of automation of call centers, a similar situation is in the field of information security.

Russian banks expect the greatest financial effect from the use of AI technologies in such areas as detection of fraudulent transactions, debt collection and credit scoring. Less promising is automation of call centers using chatbots, monitoring compliance with the Law N115-FZ⁶⁴, marketing and algorithmic trading. Russian banks expect significant results from the use of AI in personnel management, tracking the information background in relation to the bank, remote customer identification.⁶⁵

Russian banks consider the following problems to limit the use of AI in Russian banks:

- 1) noncompliance with security policies;
- 2) low probability of model validation by the regulator as a basis for IRB-approach;
- 3) difficulties in interpreting the results when using nonlinear models;
- 4) data and information systems fragmentation/lack of necessary infrastructure;
- 5) lack of competencies of the bank's employees;
- 6) high cost of solutions.⁶⁶

At the same time, the shortage of personnel with required skills often

⁶³Ibid.

⁶⁴Federal Law dated 07.08.2001 N115-FZ (as amended on 03.07.2019) "On countering the legalization (laundering) of proceeds from crime and the financing of terrorism", available at <<http://www.consultant.ru>> (accessed 7 July 2019).

⁶⁵See VOLKOV (note 62).

⁶⁶Ibid.

comes to the fore in public speeches of bankers. Therefore, having overcome the obstacle in a form of data fragmentation, banks would face an acute shortage of personnel capable of processing this information. The growing interest of the Federal authorities and the Bank of Russia in digitalization now exacerbates the problem with personnel, but in the future can create a more favorable regulatory environment, which is very important for the banks that implement AI technologies.

6. Russia stimulates a wide range of AI R&D projects among regular companies for the purposes of economy modernization. From the point of view of state support, R&D projects in the AI sphere are encouraged by granting tax reliefs in Russia. Specifically, all R&D projects fulfilled by taxpayers allow a deduction of 100% of the actual project costs from a Russian income tax on enterprises⁶⁷ taxable base, which is not very stimulating bearing in mind a flat rate of this tax - 20%. However, in order to promote research in the AI, Russian Federal Government included some R&D areas related to AI into its Ordinance⁶⁸ allowing a deduction of 150% of the actual project costs for the income tax purposes, for instance:

- 1) development of methods and software for intelligent decision support systems;
- 2) research and cognitive modeling of intelligence;
- 3) development of unified flexibly adjustable operating systems for adaptive information and control computing systems with elements of artificial intelligence;
- 4) development of technologies for monitoring the condition of rocket and space technology products and control of critical objects in real time using artificial intelligence methods and others.

⁶⁷Translation of this tax from Russian is “tax on organizations’ income”, it is regulated by Chapter 25 of the Tax Code of the Russian Federation.

⁶⁸Russian Governmental Ordinance dated 24.12.2008 N 988 (last amended on 18.05.2019) “On establishing a list of R&D areas the costs of which may be included by taxpayer into other expenses in accordance with item 7, section 262, second part of the Russian Tax Code at the amount of actual costs multiplied by a coefficient of 1.5”, available at <<http://www.consultant.ru>> (accessed 20 June 2019).

The Russian Federal Government offers subsidies from the Federal budget as a form of state support to the leading companies which develop products, services and platform solutions on a basis of “end-to-end” digital technology.⁶⁹ For the purposes of determining an amount of a federal subsidy the maximum costs of a leading company to realise a project shall be limited to approximately 3.4 million Euro (250 mln roubles).⁷⁰ Similar federal subsidies are granted to the leading research centers to support their programs of activities fulfilled for the purposes of developing and realizing road maps to build promising “end-to-end” digital technologies.⁷¹ Such significant incentives are aimed at increasing a number of entities involved in AI R&D projects thus boosting chances for positive outcome. Currently government aims to introduce AI into various sectors of economy:

- health sector. For instance, creation of centralized digital platforms for the diagnosis of diseases, including the use of AI⁷²;
- agriculture⁷³;
- car manufacturing. For example, developing new products and services in the sphere of steering and AI and bringing them to market before 2025 (introduction of an “AI system car” definition into current legislation)⁷⁴;

⁶⁹Ordinance of the Russian Federation Government dated 03.05.2009 N 549 “On state support to the companies - leaders in developing products, services and platform solutions on a basis of “end-to-end digital technologies” (together with “Rules for providing subsidies from the Federal budget as a state support to the companies - leaders in development of products, services and platform solutions on a basis of “end-to-end digital technologies”, “Regulations on carrying out competitive selection to provide state support to the companies - leaders in the development of products, services and platform solutions based on “end-to-end digital technologies”), available at <<http://www.consultant.ru>> (accessed 20 June 2019).

⁷⁰ Ibid.

⁷¹Ordinance of the Russian Federation Government dated 03.05.2019 N551, available at <<http://www.consultant.ru>> (accessed 4 July 2019).

⁷²Item 27(19), Chapter IV “Targets, main objectives and priorities for health development in the Russian Federation”, Decree of President of the Russian Federation dated 06.06.2009 N 254 “On Strategy for health care development in the Russian Federation for the period until 2025”, available at <<http://www.consultant.ru>> (accessed 4 July 2019).

⁷³Ordinance of the Russian Federation Government dated 25.08.2017 N 966 (as last amended on 06.05.2019) “On establishing a Federal scientific and technical program to develop agriculture in 2017-2025”, available at <<http://www.consultant.ru>> (accessed 4 July 2019).

⁷⁴Directive of the Russian Federation Government dated 28.04.2018 N831-R (as amended on 22.02.2019) “On approval of a Strategy to develop automotive industry of the Russian Federation for the period until 2025”, available at <<http://www.consultant.ru>> (accessed 4 July 2019).

- railroads: for instance, creation and implementation of dynamic control systems for transportation process using AI⁷⁵;
- higher education: for example, the quality of students' coursework is planned to be evaluated automatically using semantic analysis tools based on AI methods.⁷⁶

In conclusion, it can be argued that a wide implementation of AI technology in the Russian banking sector is a growing trend. Even though currently banks are taking cautious steps to implement financial technologies their competitiveness in the nearest future vastly depend on the results of their progress in the AI sphere.

⁷⁵Directive of the Russian Federation Government dated 19.03.2019 N466-r “On establishing a development program for Russian Railroads PLC until 2025”, available at <<http://www.consultant.ru>> (accessed 4 July 2019).

⁷⁶Letter by the Ministry of Education and Science of the Russian Federation dated 29.04.2019 N MH-737/MB “On providing information on final qualification papers by the graduates of higher educational institutions 2018”, available at <<http://www.consultant.ru>> (accessed 7 July 2019).

LIMITATIONS OF RIGHTS OF LAND PLOT OWNERS: WHERE IS THE BOUNDARY BETWEEN REASONABILITY AND ABUSE?

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- Elena Sergeevna Boltanova ***

ABSTRACT: *The article proves that expansion of the list of the grounds for withdrawal of land plots for public needs (or limitation of rights of private owners by establishing public easements) caused by the processes of urbanization and globalization has not led to creation of an adequate system of guarantees of human rights. In this regard, the authors propose a range of measures to increase public participation in decision making as well as creation of a new legal framework of “private-public” interests and legal entities expressing them and performing a range of public functions, however, having also their own interests that often do not coincide with either private (those of land owners) or public (those of residents of settlements) interests. These legal entities must not be granted the authorities to make decisions limiting the rights of private land owners.*

SUMMARY: 1. Introduction. – 2. The Category of “Limitation of Rights of Owners of Land Plots”: Content and Correlation with the Related Legal Concepts. – 3. Issue of Distinguishing between Private and Public Interests in the Context of Termination/Limitation of the Right of Private Ownership of Land. – 4. Withdrawal of Land Plots for Public Needs: the Mechanism of Search for a Balance between Private and Public Interests. – 5. Limitation of the Right of Private Ownership by Establishing Public Land Easements: Issue of Search for a Balance of Interests. – 6. Conclusion.

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1. Constitutions of the most countries of the world stipulate that the people is the bearer of sovereignty, and human rights determine the sense and content of activity of public authorities. However, human rights (even taking into account their undoubted value) are not absolute and have many natural limits (for example, prohibitions for owners to use their land plots to the detriment of neighbors). Moreover, property rights of citizens are often subject to various limitations caused by the need to pursue and protect public interests. The said circumstances require further search for a balance between private and public interests, especially in respect to issues of exercising the right of private ownership of land plots as immovable property items.

This problem exists not only in Russia, a country with just forming democracy, but also in quite developed countries of the world, including the USA. Such problems and even their aggravation in recent years require continuation of scientific discussions about the criteria of reasonability of limitations of human rights by which public authorities should be guided when making decisions on involuntary withdrawal of land plots for public needs or limitation of owners' rights by establishing easements. Undoubtedly, such a model will have strongly pronounced national features. Nevertheless, the methodology of search for a balance between private and public interests when terminating/limiting the right of ownership of land plots can be of interest to the scientific community, businessmen and legislators of all countries of the world, including the USA, countries of Eastern Europe and the post-Soviet space.

Taking into account the set goal, we divide this article into four sections. In the first one, we will try to define the terminology and establish the correlation between the concepts of "limits" and "limitations" of the right of ownership of land plots. In section 2 we will study the issue of the content of private and public interests and their consideration when terminating/limiting the right of land ownership. In the third section we will examine the peculiarities of involuntary withdrawal of private land plots for public needs. Finally, in the fourth section we will consider (in terms of public easements) the grounds and the procedure for limitation of rights of private

owners of land plots (without their withdrawal) discussing the reasonability of these procedures.

2. The issue of terminology is the basis of any research regarding national peculiarities of legal regulation of property relations. In respect to Russia, it is impossible to discuss the issue of guarantees of the right of private ownership of land without identifying the correlation of the concepts of “limitations”, “limits” and “prohibitions”. However, there is no unanimity of opinion on this issue in the modern Russian scientific legal doctrine.

Several approaches to interpreting the concept of “legal limitations” are distinguished in the Russian science of constitutional law: 1) limitation as a measure of the scope of a right (a freedom); 2) limitation as a deviation from legal equality; 3) limitation as a change of the content of rights and freedoms of man and citizen. Legal limitations manifest themselves in two main forms: either as an absolute prohibition of a certain right (a freedom) caused by objective or subjective circumstances of various types or as reduction of options of possible, allowed conduct (in terms of a certain right or a freedom) through establishment by public authorities of various types of limits (relating to territories, time, subjects, etc.) of such conduct.¹ We should note that this author equates the categories of “prohibition” and “limitation” defining one through the other one. Moreover, the second form of limitations (which, in our view, will be just limitation) is defined by the author through the category of “limits” of conduct. The latter point of view is quite common in legal science.

A.F. Kvitko believes that “limitation of a right (freedom)” should be understood as “statutory limits (boundaries) of exercise by a man (a citizen) of rights (freedoms) expressed in prohibitions, invasions, duties, liability, existence of which is determined (predetermined) by the need to protect constitutionally recognized values,

¹See ASHIKHMINA, *Constitutional legal mechanism of limitation of rights and freedoms of man and citizen in the Russian Federation*: abstract of the thesis of candidate of juridical sciences (Moscow, Academy of Management of the Ministry of Internal Affairs of Russia, 2009) 12-13.

and the purpose of which is to ensure the required balance between interests of person, society and state".² Consequently, in this approach, limitations are the limits of a legal right consisting also in prohibitions. However, equation of prohibitions, limitations and limits of legal rights seems to us not completely justified. They are categories that are related but do not coincide totally, both in private and public law.

As noted by V.S. Nersesyants, limitation is a sanctioned temporary reduction or decrease, regarding both the matter and the time of using a benefit which is the subject of a legal right. In this case, it is not the benefit itself that is limited, but the conditions of the subject's claim to it.³

In respect to the right of private ownership of land, its limitations can not consist in withdrawal of some or other authorities from its content (although it is a very common position),⁴ since in this case the very legal right will be transformed. Being limited, a certain authority is not excluded from the content of the ownership right, but can not be exercised to the full extent. Since the authority that is subject to limitation is not excluded but is still in the content of the ownership right, when the limitation is cancelled, we observe restoration of the possibility to exercise it to the full extent rather than new acquirement of this authority. This is the main difference of limitations from boundaries of the ownership right.

The boundaries (limits) of the ownership right indicate which authorities are not there in the ownership right; limitation – which of the authorities included in the content are constrained (restricted) regarding their exercise. Therefore, limitations of the ownership right inherently relate only to exercise of rights rather than to the rights themselves.⁵ This fact is also mentioned by T.V. Deryughina. In her opinion,

²See KVITKO, *Constitutional legal fundamentals of limitation of rights and freedoms of man and citizen in the Russian Federation*: abstract of the thesis of candidate of juridical sciences (Moscow, Moscow University for the Humanities, 2007) 10.

³See NERSESYANTS, *Progress in law (historical experience and prospects)*. In: *Theory of state and law*. Textbook (Moscow, Bek, 1995) 287.

⁴See MOROZOVA, *Principles, limits, grounds of limitation of human rights and freedoms according to the Russian legislation and international law*, 7 *State and Law*, 24 (1998).

⁵See KUDRYAVTSEVA, *Limitations of land ownership rights according to the Russian pre-revolutionary law*, 3 *Science of law*, 59 (1997).

limitations and limits are aimed at establishing the boundaries of rights, but the target object of limitations is emergence, exercise and termination of rights, and limits of exercise affect the mechanism of use of rights. Limitations of rights are established to prevent violation of essential rights and legitimate interests of man, society and state, these goals are strictly enshrined by the federal law. Exercise limits are for the most part aimed at balancing private interests of specific holders of legal rights. Limitations of rights must be strictly stipulated by the federal law, while exercise limits arise not only from laws but also from contracts and other transactions.⁶

We fully share this theoretical approach. Indeed, limits and limitations are not coincidental categories, although in fact they are closely interrelated. Both in private and in public law, these categories perform various (even if related and very similar) functions, differing in their place in the mechanism of legal regulation, content, procedure of establishment, etc. From the point of view of legal technique, inclusion of Article 10 dedicated to *limits* of exercise of civil rights in the Civil Code of the Russian Federation is very effective. According to this Article, exercise of civil rights exclusively with the intention to cause harm to another person, actions bypassing the law with an unlawful purpose, as well as other deliberately unfair exercise of civil rights (abuse of rights) shall not be allowed. In its turn, the correlation and interaction of the legal categories of “prohibition” and “limitation” manifests itself as follows. When the legislator wants to make one or other activity mandatorily impossible, he sets a prohibition. Prohibitions in law indicate the full duty of a subject to refrain from actions causing significant harm to the interests of an individual and a society, which bears the risk of incurrance of liability, and limitations are partial or complete restriction of legal rights, in addition, as a result of limitation, legal rights themselves do not disappear. In other words, in contrast to categorical prohibition, limitations of the right of private ownership signify only decrease (reduction) of possibilities of its subject to

⁶See DERYUGINA, *Theoretical issues in the field of exercise of legal civil rights*: abstract of the thesis of doctor of juridical sciences (Moscow, Academy of national economy under the Government of the Russian Federation, 2011) 9-20.

exercise the right to use or dispose of a plot, permanently or temporarily (for example, limitations of owners' rights in emergency situations).⁷ After cancellation of the circumstances giving rise to establishment of limitations of legal rights they are restored to the full extent (for example, after elimination of the consequences of natural disasters the requisitioned land plot is returned to the private owner).

Limitations must be established only in public (economic, environmental, social, cultural, military, etc.) interests, but not in the interests of private persons (although such a conclusion can be often observed in scientific literature),⁸ since the latter will mean abuse of rights. This is why a private land easement rather than a public easement shall be established to ensure private interests.

One of the types of limitations of the ownership right will be rules on involuntary termination of the right of ownership of land plots,⁹ as well as on reservation of plots for public needs,¹⁰ which restrict the possibility of owners to exercise authorities to use and dispose of a land plot. Since limitations do not generate new rights, they can include public easements, which allow a public subject to implement protection of public interests to the full extent in this way rather than imply emergence of the public subject's right of limited use of a land plot of another person.¹¹

The category of "limits" of exercising the right of private ownership of land plots will be different from both limitations and prohibitions. The limits of legal rights both in public and in private law denote the scope and boundaries of pursuing legal rights initially inherent in a person. The limits of owner's rights arising out of proper-

⁷See POMERLYAN, *Issues of limitation and exercise of rights of man and citizen under an emergency regime*, 6 *Law and education*, 114-117 (2001).

⁸See KRYLOV, *Concept and attributes of limitations of legal civil rights*, 4 *New Legal Thought*, 31 (2008).

⁹Legal Encyclopedic Dictionary / Chief Editor O.E. Kutafin (Moscow, Great Russian Encyclopedia, 2003) 383.

¹⁰See ARAKELIYAN, *Reservation and withdrawal of land plots in the mechanism of legal regulation of property relations (civil and legal aspect)*: abstract of the thesis of candidate of juridical sciences (Krasnodar, Kuban State Agrarian University, 2007) 26 p.

¹¹See LUZHINA, *Limitations and encumbrances of rights to immovable property in Russia and France*: abstract of the thesis of candidate of juridical sciences (Moscow, Russian Academy of justice 2006) 9-10; REZNIK, *Public land easement under Russian civil law*: abstract of the thesis of candidate of juridical sciences (Kazan, Kazan State University, 2007) 17.

ties of the object of a right are equally obvious. For example, establishment of the intended purpose¹² and permitted use¹³ of land plots are not limitations of ownership rights¹⁴, since any item of immovable property has its individual features which determine the possibilities of its use. Consequently, a ban on construction of residential buildings on agricultural land (or apartment buildings in industrial areas of cities) is not a limitation of rights of owners of land plots, it just establishes the limits of their legal right of ownership. Another typical example of limits but not limitations is the impossibility for a municipality to sell a land plot subject to limited circulation to a citizen in an auction, or to withdraw a land plot from a private owner for municipal needs in terms of lack of land use and development rules, a local level of urban planning documentation, in a municipality.

Thus, limitation of the right of private ownership of land is a restriction of possibilities of the owner to use and dispose of the property (plot) belonging to him that is stipulated by the federal law and caused by the need to pursue the public (social, environmental, etc.) interest rather than by his unlawful acts. This definition of content-related parameters of the object of our research allows proceeding to discussion of the following facet of this issue, connected with the need to find a balance between two types of interests.

3. It is necessary to study this issue because establishment of limitations of human rights may not be arbitrary, it must be justified by the need to protect public interests. However, the content of public interests in different historical periods in

¹²In Russia, the Land Code divides all land into seven types (categories), including agricultural land, land of settlements, industry and another special purpose, specially protected areas and objects, land of the forest fund, etc. Within each category of land, there is an established unique set of rights and duties of owners of land plots to use and protect such land, as well as a list of land plots that are limited or withdrawn from the civil circulation.

¹³This legal framework is used mainly within the category of land of settlements, the territory of which is divided into territorial zones as a result of urban development zoning. There are urban planning regulations determining parameters and types of permitted use of land plots established for each territorial (residential, industrial, etc.) zone.

¹⁴However, this position is very common. Ref., for example: TURITSYN, A.V. *Limitation of freedom of owners' discretion in selection of ways to exercise the right of ownership of agricultural land plots*, 6 Yurist-Pravoved, 130-132 (2009).

law of different countries and peoples, as well as the mechanism of guarantees of citizens' rights, did not coincide. Traditionally, Statements of the Roman jurist Ulpian are traditionally considered as the beginning of the discussion about the correlation between private and public interests. He attributed public law to the position of the Roman state, and private law to the benefit of certain persons, noting that there is the good in a public relation and the good in a private relation.¹⁵ The fact that the boundary between private and public interests is rather notional was mentioned by dozens of European and Russian legal scholars of the 19th-20th centuries, including R. Iering,¹⁶ V.K. Kavelin,¹⁷ G.F. Shershenevich¹⁸ and many others. The first conclusion that they made could be formulated as follows: it is impossible to clearly distinguish private interest from public, there is no wall between them. However, even if such a wall is built somewhere, it will bring not those benefits expected by its builders.

Another fundamentally important conclusion consists in the fact that the interest is the material foundation of rights, and its main purpose is to express the needs of citizens and the society, to find the balance between them.

In the modern legal science, a number of authors understand "interest" as a need (conscious intention) expressing the desire of a certain subject to use a specific social benefit.¹⁹ Accordingly, "private interest is the interest pursuit of which is determined by the own will of the subject within the limits established by the community, an integral social entity, which includes this subject. Public interest will be the interest pursued according to the will of this community".²⁰

Therefore, the nature of the needs reflected by the interest, and the charac-

¹⁵The Digest of Justinian: Translation from Latin / Managing Editor L.L. Kofanov (Moscow, Statute, 2002) 82-83.

¹⁶See IERING, *The struggle for the law* (Moscow, Spark, 1991) 8.

¹⁷See KAVELIN, *Selected works on civil law* (Moscow, JurInfoR, 2003) 76.

¹⁸See SHERSHENEVICH, *Textbook of Russian civil law* (Moscow, Spark, 1995) 1-2.

¹⁹See KIYKO, *Private and public law principles in civil law regulation of the state property in the economic turnover of Russia*: abstract of the thesis of candidate of juridical sciences (Volgograd, Volgograd Academy of the Ministry of internal Affairs of Russia, 2004) 16.

²⁰See PERSHIN, *Private-legal interest: concept, legal formation, implementation*: abstract of the thesis of candidate of juridical sciences (Nizhny Novgorod, Nizhny Novgorod Academy of the Ministry of Internal Affairs of Russia, 2004) 22.

teristics of the subject, the holder of such interest (an individual or a social group) are of fundamental importance within the category of “interest”. Based on the foregoing, we believe that any private land interest is a need of citizens and legal entities, owners (lessees) of land plots, to exercise freely their authorities to use and protect the land in order to obtain material or non-material benefits. Accordingly, public land interest is a set of private needs (of citizens and their associations) in a certain locality, consisting in the willingness to exercise certain collective property or non-property land rights. Meanwhile, it is obvious that different associations of citizens can have their own public interests formed according to territorial (microdistrict, quarter) or subject (construction of schools, stadiums, shopping malls) criteria. Different public interests may be not coincident, since construction of a stadium may meet the interests of residents of a metropolis but conflict with the interests of residents of a certain microdistrict.

More complex types of conflict of public interests are equally common, when one group of citizens wants to construct a casino in a city quarter, another one – a mosque (or a Christian church), and the third one – a shopping mall with a parking lot. Accordingly, whatever decision is adopted by local authorities, conflict of public interests of different groups of population of a city is often anyway inevitable, which leaves open the question of where the boundary between private and public interests is, what the difference between them is, and which of two public interests should be given preference.

In respect to Russia and its legal system, this kind of common (also for other countries of the world) conflicts of public interests are often aggravated by the policy of state authorities, which, in order to achieve immediate political or economic “victories”, adopt ineffective decisions that have long-term adverse economic, environmental or other effects. A typical example of such a kind of decisions was mass withdrawal of land plots from citizens for construction of stadiums and other sports facili-

ties required for the 2014 Olympics and the 2018 FIFA World Cup.²¹ The problem here consisted in the fact that it is hard to consider sport as public interest,²² since many citizens are indifferent to it (preferring theater or hippodrome). Therefore, such decisions meet the needs and interests of only a *part* of the population. It appears that the interests of the owner (lessee) of a land plot (and in case it is a plot where an apartment building is situated – the interests of holders of shared ownership of such a plot) will be private. Accordingly, public interest is the interest of residents of the entire country (in case of construction of an ordnance factory), a certain municipality or its part (microdistrict, quarter) in case of construction of communal or transport infrastructure facilities.

But what to do in a situation when such an object meets the interests of only a *part* of residents of the municipality, as we see in the example of stadiums? The answer lies in the need to develop a new legal framework, which is not yet in the law, and which is little discussed in the legal doctrine. The proposals available in the legal doctrine of Russia, for example, concerning development of the category “socially important” or “social” interests not coinciding with public interests,²³ are very interesting but they are evaluative categories without clear parameters. This is why we suggest relying upon the category of “subject of interest” and formulating a new legal framework on its basis – “private-public interests”.

In the Russian legal science, the issue of distinguishing between legal entities of private and public law has been discussed for many years. The main difference between them consists in the social essence of such organizations, although it is recog-

²¹2 special federal laws were adopted, they established a special procedure for withdrawal of private land

²²Similar problems with withdrawal of private land for construction of stadiums (even without organizing a football championship) we observe also in some states of the USA. Ref.: CHEN, S. *Keeping Public Use Relevant in stadium eminent domain takings: The Massachusetts Way*, 40 *Environmental Affairs*, 453-485 (2013).

²³See GRUSHEVSKAYA, *Imperativeness in the Russian civil law*: abstract of the thesis of candidate of juridical sciences (Krasnodar, Kuban State Agrarian University, 2010) 8-9; POLESHCHUK, A.S. *Constitutional legal fundamentals of social control in the Russian Federation*: abstract of the thesis of candidate of juridical sciences (Moscow, Moscow University of the Ministry of Internal Affairs of Russia, 2012) 28 p.

nized that many legal entities of private law perform a social mission to a greater or lesser extent. Moreover, attention is drawn to the close relationship between legal entities of public law (for example, federal public enterprises) and public authorities.²⁴ This theory appears important, especially if it is supplemented with another element – the category of “private-public legal entities”, which was first proposed by S.A. Charkin.²⁵

The peculiarities of these types of legal entities (state corporations, state companies, the Skolkovo Innovation Center) will be the fact that they are the owners of the state property transferred to them,²⁶ as well as that they perform particular social public functions. For example, by virtue of Art. 3-5 of Federal Law No. 244-FZ of 28.09.2010 (as amended on 27.10.2018) “On the Skolkovo Innovation Center”, this center is the owner of land plots on which infrastructure facilities are located, leases them out and performs a range of public functions inherent in local government bodies (street lighting and naming, road construction, etc.).

In addition, most of such “private-public” legal entities perform functions that are not connected directly with support of daily living needs of the population (space exploration, subsurface use, scientific research, etc.). Moreover, in reality this group of legal entities often have its own interests that may be not coincident with either private or public interests (of residents of municipal entities). Despite this fact, the Land Code of the Russian Federation stipulates a set of additional authorities for such subjects, for example, to initiate and participate in the procedures for involuntary termination of the right of private ownership of citizens as well as to limit the rights of private owners by establishing public land easements. There is no official exhaustive list of such private-public legal entities today, but it is obvious that it includes state corporations, state companies, the Skolkovo Center, subsurface users and natu-

²⁴See CHIRKIN, *Public and private interests of legal entities performing public functions*, 1 Russian Law Journal, 10-14 (2013).

²⁵See CHARKIN, *Land legal relations as an interbranch legal category: monograph* (Moscow, Publishing House Yurait, 2012) 225.

²⁶These are their differences from legal entities of public law (for example, unitary enterprises), which are not granted the right of ownership of the property assigned to them by the owner.

ral monopolies.

In this case we do not claim that all their activity to terminate and limit the rights of private owners of land plots is abuse of power and rights. It is certainly not the case. However, it is apparent that interest of this group of subjects is very complex and requires understanding and proper legal regulation. A particular problem consists in the fact the conflict may involve public interests of residents of neighboring municipal entities. For example, in the Russian Federation, there is an acute problem of removal of production and consumption waste from large cities with its placement in landfills in neighboring regions and municipalities. Accordingly, the following question arises: how to regulate the conflict, on the one hand, of a private interest (of a person that may be even not affected by withdrawal of a plot for construction of a landfill, but it is sufficient that the landfill will be constructed near, which will reduce the value of the plot and possibilities of its use) and a public interest of residents of the village close to which the landfill for placement of waste will be constructed, and, on the other hand, of a public interest of residents of a metropolis which have to take their waste somewhere. At the moment, the Russian legislation does not contain effective procedures that allow solving this problem. From a formal point of view, by virtue of p.2, Art.16 of the Urban Development Code of the Russian Federation, an area planning scheme project of a subject of the Russian Federation²⁷ is to be agreed with higher state executive authorities of the subjects of the Russian Federation having a common border with the subject of the Russian Federation ensuring drafting of such a scheme project, in order to meet the interests of said subjects of the Russian Federation in terms of establishment of zones with special requirements of area use in their territories (sanitary protection zones, protective, water protective zones, flood zones, etc.) in connection with the planned placement of facilities of regional significance, which may have a negative impact on the environment in the territories of the said subjects of the Russian Federation. In reality

²⁷Area planning scheme is a type of urban planning documentation containing available and planned types of area use at local, regional and federal levels.

population of municipalities do not have any leverage opportunities regarding this situation, which leads to mass protests.

Settlement of this issue consists not so much in improvement of legislation itself as in enhancement of the effectiveness of already available procedures, including approval of urban planning documentation, as well as development of environmental federalism – horizontal interaction of subjects of the federation, the interests of which are equally important.²⁸ However, in this case construction of landfills in the suburbs of Moscow will be possible after achievement of agreement with residents of Moscow region and their authorities. In this case, undoubtedly, Moscow will have to construct waste treatment plants for the neighbors rather than to pile the waste on the ground.²⁹ It will entail additional expenses of the budget of Moscow but preserve the health of residents of Moscow region and will not reduce the value of their plots.

Therefore, a means of arrangement of public interests of different groups of population (or residents of different settlements and microdistricts) is development of conciliation procedures (approval of urban planning documentation, organization of public hearings), establishment of horizontal interaction between regions and municipalities, which is now hardly observed in Russia, as well as development of a new doctrinal framework of “private-public interests”, which reflect activity of a certain group of legal entities that express interests of some population groups (sports fans, shareholders of oil companies, etc.).

In our view, *private-public interests* are the needs of certain types of legal entities partially owned by the state that are stipulated by federal laws, connected with subsurface use, construction of residential buildings, sports facilities and other im-

²⁸We will not dwell here on the concept of environmental (cooperative) federalism, fully studied in Russian and American legal science. Ref.: VOLKOV, P.V. *Theoretical and legal issues of federalism: federal power relations*: abstract of the thesis of candidate of juridical sciences (Nizhny Novgorod, Lobachevsky State University, 2004) 36; BUTLER, H.N., HARRIS, N.J. *Sue, settle and shut out the states: Destroying the environmental benefits of cooperative federalism*, 37-2 *Harvard Journal of Law and Public Policy*, 579-628 (2014).

²⁹Another conflict around garbage dumps in Moscow region begins in Ruzsky District <<https://www.sularu.com/news/10002/11019>>.

movable property items and met by means of involuntary withdrawal/limitation of the right of private ownership of land. In contrast to private-public interests, which are shared only by a number of social groups, “classic” public interests are aimed at creating the life-sustaining environment for the entire population of a particular territorial unit (municipality, region) and include placement of facilities of engineering and transport infrastructure, defense and security, power industry, environmental security, protection of cultural heritage sites, performance of international treaties, etc.

4. As we have already mentioned above, the category of “interest” has an abstract nature, however, it becomes much more concrete when the concept of “public needs” is formulated on its basis. Procedures for involuntary withdrawal of private land plots to meet them are very common in the world practice and can be observed in many countries of Europe,³⁰ Asia,³¹ Africa³² and America.³³ The content of these procedures is determined by national legal traditions and may not always comply with the universally recognized principles and rules in the area of human rights.

In Russia, after adoption of the Land Code in 2001, the procedures for withdrawal of private land plots for state needs have complied with the world standards for a long time. The situation began to change when authorities decided to simplify and accelerate the procedures for withdrawal of private land for construction of stadiums and other sports facilities for the 2014 Olympics. Afterwards such procedures were extended to withdrawal of land plots for construction of the “new Moscow” (development of new territories attached to the metropolis), as well as construction of stadiums for the 2018 FIFA World Cup. The idea of limitation of guarantees of pri-

³⁰See VOLOVICH, SHCHUROV, *Issues of withdrawal of land plots for state or municipal needs. Part 1*, 3 Property relations in the Russian Federation, 65-80 (2011).

³¹See KRASSOV, *Land law in countries of the Middle East: monograph* (Moscow, Norma, 2018) 34, 121, 191.

³²See KRASSOV, *Land law in countries of Africa: monograph* (Moscow, Norma, 2018) 254, 261, 378.

³³See BAUDE, *Rethinking the Federal Eminent Domain Power*, 122-7 *Yale Law Journal*, 1741-1789 (2013).

vate owners' rights, having begun with construction of local facilities, was subsequently extended to the entire territory of Russia, and the Land Code was supplemented with a special chapter regulating in detail the new (simplified) procedures for withdrawal of private land plots.

As noted in this regard by O.A. Zolotova, it means that there is unification of a special procedure for withdrawal of land for state needs, which consists in establishment of reduced terms for adopting management and judicial decisions; a simplified method of forming land plots and issuing their cadastral certificates; an extrajudicial procedure for withdrawal of land plots from state and municipal institutions and unitary enterprises; a special procedure for compensation for the cost of withdrawn land.³⁴

In this case the very expansion of the list of the grounds for withdrawal of private land plots for public needs is not something unacceptable, since objective complication of social relations in the field of land use (especially in cities) requires also an adequate response from the legislator. However, in this case there is no formation of an equally complex system of *guarantees of rights of private land owners*, which requires discussion and correction. To determine the boundary between reasonability and abuse when making decisions on involuntary withdrawal of private land plots for public needs, public authorities, in our view, should be obliged to be governed by the following principles:

1) *principle of proportionality*. This principle means that withdrawal of private property for public needs according to the simplified procedures stipulated by Chapter VII.1 of the Land Code of the Russian Federation is allowed only to satisfy public (but not private or private-public) interests, and the need to withdraw a specific plot must be *proved* by a public authority in court. There is already such judicial practice in Russia. For example, the commercial court held a resolution of a local government body on withdrawal of land plots for municipal needs invalid, since no documents

³⁴See ZOLOTOVA, *Special procedure for withdrawal of land for state needs*, 12 Russian Law Journal, 113-118 (2012).

proving the exceptional need to place facilities exactly on the disputed land plot had been presented. An agricultural land plot was supposed to be withdrawn from a closed joint-stock company to place facilities for development of the mineral raw material base of local industry enterprises and for implementation of investment projects. Meanwhile, the Land Code of the Russian Federation does not stipulate withdrawal of land plots for state or municipal needs *in order to attract investors to supplement the budget of a municipal district* and to create new jobs. This is why in this case the local authorities had no legal grounds for withdrawal of the land plot.³⁵

We observe similar attempts to withdraw land from the owners for private-public needs also in the judicial practice of the USA. For example, after some decisions limiting rights of private owners (*Berman v. Parker*, *Poletown Neighborhood Council v. City of Detroit*, *Hawaii Housing Authority v. Midkiff* and a number of others),³⁶ in 2005, the Supreme Court of the United States adopted a very ambiguous decision in the case of *Kelo v. City of New London*, having changed (expanded) the interpretation of a “social purpose” of property. The court held that a public authority may withdraw private property to transfer it to another private owner for the *purposes of economic development*, having stated that economic growth, which is used by the society due to new private initiatives, may be an acceptable “social purpose”. This opened the door for developers of planning of shopping malls and other similar construction projects which suggest withdrawal by the government of any private property that can stand in the way of their plans.³⁷

Analyzing the case of *Kelo*, we should note that the decision to implement the project of reconstruction of New London adopted by the city council implied that the plot would be provided not to an ordinary legal entity but to Pfizer, which “was a pri-

³⁵Resolution of the FCC of the Volga District of 15.06.2009 in case No. A 65-19967/2008. In: Legal Reference System “Consultant Plus”, accessed 30.04.2019.

³⁶See GHILINA, *Concept of eminent domain and its application in judicial practice of the USA*, 3 Bulletin of Tver State University. Series “Law”, 8-17 (2016); MICHELS, *Kelo v. City of New London: is the Response to Curb the Effect of the Supreme Court Decision Going too Far?* 37 Seton Hall Law Review, 530-534 (2007).

³⁷See SOMIN, *The grasping hand: Kelo vs New London and the limits of eminent domain* (Chicago: Univ. of Chicago press, 2015) 356 p.

vate organization under the control of the city government”.³⁸ This is a typical case of private-public legal entities within our concept, although there is no such a framework in the USA.

The problem in this case consisted in the fact that there was no official definition of “economic development” in the USA laws at that moment, and laws of the states contained very vague interpretation of this term. As a result, the main conclusion from the case of *Kelo* was that afterwards executive authorities could carry out involuntary withdrawal of immovable property from a private owner for development of private enterprises, even if this this property did not have any other social purpose than development of the local economy. Meanwhile, after this ruling of the Supreme Court, 45 states reviewed their laws in order to protect private property better, having limited authorities of the government associated with involuntary withdrawal of private property, although, for example, in a number of states (Maryland) these changes have not been introduced.³⁹ Immediately after the case of *Kelo* seven state high courts took measures to protect rights of homeowners from the threat of involuntary withdrawal. The high courts of Ohio, Oklahoma, Pennsylvania, Missouri, New Jersey and Rhode Island have all ruled in favor of owners and against eminent domain for private gain.⁴⁰

For example, in Oklahoma in 2006 withdrawal of land for construction of a water supply system in the interests of an electrical energy plant was prohibited.

It appears that this practice indicates that the problem of abuse of private-public interests is typical both for countries with developed democracy (the USA) and countries where it is not so developed (Russia), which confirms the rightness of

³⁸See BARKACS, BARKACS, *Kelo v. City of New London: is eminent domain for economic development public use or public abuse*, 10-1 Proceedings of the Academy of Legal, Ethical and Regulatory Issues, 1-3 (2006).

³⁹See BUZBY, *Farming the Slums: Using Eminent Domain and Urban Agriculture to Rebuild Baltimore's Blighted Neighborhoods*, 38-2 William & Mary Environmental Law and Policy Review, 492-494 (2014).

⁴⁰See WALSH, C. *Kelo Case - A home lost for what???* <<https://thatwoman.wordpress.com/category/eminent-domain/>> (access date 22.05.2019).

K. Marx that stated that it is economy that determines both politics and law.⁴¹ However, our conclusion consists in the need of further development of the corresponding legal tools rather than in rejection of legal regulation of economic relations. Otherwise, judicial practice will be still controversial, adopting, on the one hand, decisions within the spirit of *Kelo*, and, on the other hand, decisions similar to those by the state supreme court of Michigan, which recently overruled one of the previous decisions and held under the state constitution that a local government could not withdraw land in order to turn it over to a private developer, even if the initiative would advance the public interest by creating many jobs and expanding the tax base.⁴²

In our view, fair settlement of this issue requires formation of clear legal principles by which public authorities could be governed when making decisions. The European Court of Human Rights made an attempt to formulate one of these principles.

For example, in the Judgment in the case of Gladysheva v. Russia (Application No. 7097/10) of December 6, 2011, the Court states that any interference with property must not only be lawful and pursue a legitimate aim but also satisfy the requirement of *proportionality*. The Court notes that a fair balance must be struck between the demands of the general interest of the community and the requirements of the protection of the individual's fundamental rights, the search for such a fair balance is inherent in the whole of the Convention. The requisite balance will not be struck where the person concerned bears an individual and excessive burden.⁴³ Search for such a balance had been conducted by the ECHR also before. For example, in the case of Sporrang and Lonroth v. Sweden in the Judgement of September 23, 1982, the Court states that establishment of restrictions on development of an area of citizens from 1954 to 1979 by the municipality of Stockholm (despite the fact that

⁴¹See MARX, Contribution to the Critique of Political Economy. Preface. In: Marx K. Engels F. Selected Works. Volume 1 (Moscow, ProMedia, 2008) 335-336.

⁴²See BYRNE, *Condemnation of Low Income Residential Communities Under the Takings Clause*, 23 Journal of Environmental Law, 131 (2005).

⁴³Bulletin of the European Court of Human Rights. 2012. No. 6.

this area was not withdrawn for public needs and developed) is a violation of the rights of the citizens to freely use their property without fair compensation for inflicted damages.⁴⁴

Therefore, one of the elements of the principle of proportionality must be not just interest (an economic need of a particular society group) but an exclusive social necessity (need) of an indefinite number of persons residing in the municipality or its part, satisfaction of which is impossible without withdrawal of a specific private land plot. The importance of this criterion is well observed in terms of two Russian procedures: withdrawal of land plots and immovable property items under agreements on development of built-up areas (carried out within the framework of the program for resettlement of citizens from dilapidated and hazardous housing), and the renovation program of Moscow, when the citizens were resettled from quite decent houses in the city center to the outskirts to transfer commercially attractive land for construction of shopping malls and luxury housing.⁴⁵

While in the first case the factor of “exclusiveness” consists in the impossibility to live in an unfavorable environment, in the second case we observe just a typical case of abuse of rights and prevalence of private-public interests.⁴⁶ This kind of examples is not limited only to Moscow. In particular, V.P. Kamyshansky fairly doubted that the necessity for demolition of 58 thousand single-storey houses located in the total area of about two thousand hectares in Krasnodar in 2006 corresponds exactly to municipal needs.⁴⁷ The decision of the authorities of Detroit on withdrawal of an

⁴⁴European Court of Human Rights. Selected judgements: In 2 v. / Managing Editor V.A. Tumanov (Moscow, Norma, 2000) 808 p.

⁴⁵Housing renovation program – what is the threat of resettlement under the new law <<https://videomotret.ru/watch/programma-renovatsii-zhilya-chem-grozit-pereselenie-po-novomu-zakonu/aBmdXRbjnZE>> (accessed 28.04.2019).

⁴⁶This conclusion about the correlation between private and private-public interests is proved also by the fact that resettlement of citizens from dilapidated and hazardous housing to new apartments never raises protests; the renovation program in Moscow caused mass protests of citizens who did not want to leave their homes. Ref.: Protest against renovation in Moscow grows into a spontaneous procession <<https://belsat.eu/ru/programs/protest-protiv-renovatsii-v-moskve-pereros-v-stihijnoe-shestvie/>> (accessed 28.04.2019).

⁴⁷See KAMYSHANSKY, KAMYSHANSKY, ARAKELIYAN, *Reservation and withdrawal of land plots for municipal needs*, 1 Law, 64-73 (2007).

entire district (465 acres of homes for 4,200 residents, as well as several schools and churches) can be called equally disputable; it was made to provide General Motors with a land plot complying with its specifications for construction of a new plant.⁴⁸

At the same time, the principle of proportionality must, in its turn, have natural boundaries (limits) that allow, in particular, considering the demands of citizens for compulsory provision of another land plot for the withdrawn one, instead of receiving monetary compensation, as unreasonable.⁴⁹ Therefore, the principle of proportionality must signify inadmissibility of arbitrary limitation of land rights, including withdrawal of land for private-public needs according to a simplified procedure.

2) *principle of establishing limits of authorities of private-public legal entities to withdraw private land plots.*

Thus, there is no exhaustive list of private-public legal entities (and their interests) in Russia at the moment, however, many of them are expressly mentioned in the Land Code (subsurface users, natural monopolies, etc.). Their special authorities consist in the possibility to participate in the procedures for withdrawal of land plots for state or municipal needs. For example, they may submit requests to public authorities suggesting withdrawal of a private land plot; the land plot may even become private property of private-public legal entities (in this case they pay compensation to the former owner).

In our view, emergence of such rules in the Land Code of the Russian Federation indicates a sharp decline in guarantees of the right of private ownership of land, while many private-public legal entities express private-public interests rather than public ones. Accordingly, we consider equation of their interests with the interests of the entire society as a violation of property rights of people. This issue can be settled

⁴⁸See BYRNE, *Condemnation of Low Income Residential Communities Under the Takings Clause*, 23 *Journal of Environmental Law*, 139 (2005).

⁴⁹Ref.: Ruling of the Constitutional Court of the Russian Federation No. 2963-O of 19.12.2017 “On Refusal of Acceptance for Consideration of the Complaint of the Citizen Ivan Yurievich Bekhtold about Violation of his Constitutional Rights by Provisions of the Civil Code of the Russian Federation and the Land Code of the Russian Federation”. In: Legal Reference System “Consultant Plus”, accessed 30.04.2019.

by means of two actions: determination of a list of private-public needs (they arise out of private-public interests); regulation of special procedures. In our view, the list of such needs must include demolition of dilapidated and hazardous housing (slums) and construction of modern houses in their place (under agreements on development of built-up areas); construction of sports facilities; subsurface use; construction of private roads and hospitals, etc.

The main criterion of difference of public from private-public needs is the degree of their general utility (in the interests of all citizens, if they are roads or electric networks; in the interests of some citizens, if they are stadiums); the purpose of use (direct generation of profit (renovation) – for private-public needs; lack of such a purpose for public needs – military facilities); the form of ownership to which a land plot is transferred – state or municipal (for public needs); private (for private-public needs).

Use of such criteria will allow arranging many conflict situations arising in practice, related to promotion of tourism (and replenishment of the budget), and requiring withdrawal of land plots from private owners to ensure access to the beach;⁵⁰ expansion of the list of city land for its use for agricultural purposes;⁵¹ distinction between public (communications networks in cities) and private-public infrastructural needs (pipelines for oil trade).

In terms of the procedure, we should note that a decision on withdrawal of private land plots (like now) must be adopted by public authorities subject to availability of urban planning documentation and full compensation for the market value of the withdrawn land plot and all inflicted damages. In addition, we think it is important to extend the period of notice on withdrawal of land plots and establish mandatory public hearings the results of which must have a legal significance in this

⁵⁰See TENAGLIA, *Chandler v. County Commissioners of Nantucket County: Why the Massachusetts Statute Authorizing Takings by Eminent Domain for Highway Purposes Should Not Serve as a Mechanism for Conservation*, 21 Pace Environmental Law Review, 15-17 (2003).

⁵¹See PETERS, *Creating a Sustainable Urban Agriculture Revolution*, 25 Journal of Environmental Law and Litigation, 240 (2010).

case.⁵² Moreover, it is necessary to enshrine the mechanism of liability of private-public legal entities, if they have not developed the land plot within the established period, as well as the need to obtain a certificate of a regional Commissioner for Human Rights in respect of the project requiring withdrawal of private land.

3) *principle of adequacy of compensation for withdrawn land property*. The issue of fair calculation of compensations for owners of withdrawn property plays an important role in the procedure for withdrawal of land plots for public and private-public needs. Unfortunately, at the moment there are a number of problems with the understanding of “fair compensation”, and courts almost always take the side of the plaintiff (authority) and completely ignore expert calculations of the defendant (citizen). Analysis of the wide judicial practice shows that in “political” cases associated with mass withdrawal of land plots from citizens and their associations (for example, in connection with the Olympic Games in Sochi in 2014), judicial authorities did not take into account arguments of citizens about undervaluation of their property. For example, the court referred to item 26 of Article 15 of the Federal Law “On Organization of the XXII Olympic Winter Games and XI Paralympic Winter Games of 2014 in Sochi, Development of Sochi as a Mountain Climate Resort and Introduction of Alterations to Certain Legislative Acts of the Russian Federation” of December 1, 2007, and stated that the repurchase price of the land plots and (or) immovable property items located on them, as well as *the amount of losses subject to compensation in connection with the withdrawal, might not exceed the amounts determined in the valuation report*,⁵³ drawn by a state unitary enterprise.

Cases when courts, calculating compensation, ignore *all losses* of citizens associated with withdrawal of land plots are not less common. The situation is aggravated also by the fact that before upcoming withdrawal local government bodies

⁵²At the moment in Russia public hearings are organized to discuss some types of urban planning documentation, however, their results are not mandatory and are often ignored.

⁵³Ruling No. BAC-10286/13 of August 21, 2013 “On Refusal to Submit the Case to the Presidium of the Supreme Commercial Court of the Russian Federation”. In: Legal Reference System “Consultant Plus”, accessed 25.04.2019.

sometimes artificially underestimate the cadastral value of a land plot, on which calculation of compensation is based.

It is noteworthy that in a number of countries the issue of adequate (fair) compensations has been settled more effectively. For example, addenda to the State Constitution adopted in the State of Michigan (USA) stipulate that in case of withdrawal of private property authorities shall prove that withdrawal is not performed in order to transfer property to private persons for the purpose of economic development or growth of tax revenues. In addition, 125 % of the market value of the withdrawn land plots and other immovable property shall be paid to their owners,⁵⁴ which is actually compensation for moral harm suffered by the person as a result of the property withdrawal.⁵⁵ Moreover, this compensation will facilitate the search for a new home and the change in the usual way of life. It is especially relevant for low-income citizens affected by these procedures. It is also necessary to enshrine such an additional guarantee as the possibility for citizens to independently choose the audit organization performing assessment of the value of land plots, which will allow evaluating the withdrawn plots objectively and paying fair compensation,⁵⁶ as well as to create a system of special land (environmental) courts, which could consider this category of disputes in a competent manner.⁵⁷ Equal value and timeliness of payment of compensation for the property (land) withdrawn for public needs is a very important element of this principle, since the gap between adoption of a decision on withdraw-

⁵⁴See RUKHTIN, *Involuntary withdrawal of land and other immovable property in Russia, the USA and Great Britain / under the editorship of V.P. Kamyshansky. Monograph* (Moscow, Arctic- 4 D, 2007) 118.

⁵⁵In the Russian legal science, it is proposed to establish 150% compensation. Ref.: AFANASIEVA, S.D. *Constitutional and legal institution of withdrawal of land plots for public needs: comparative analysis of experience of the Russian Federation and the United States of America: abstract of the thesis of candidate of juridical sciences* (Moscow, National research University «Higher school of Economics», 2015) 14.

⁵⁶See GOLOVANOV, *Withdrawal of land plots for state and municipal needs – issues of legal regulation*, 10 *Property relations in the Russian Federation*, 113 (2013).

⁵⁷See MELNIKOV, *International experience of judicial protection of land rights and land courts in Russia*, 8-19 *Amazonia Investiga*, 278-286 (2019).

al and payment of compensation can significantly reduce the value of a land plot.⁵⁸

Therefore, the grounds for involuntary withdrawal of private land plots to public (state or municipal) ownership or private ownership of legal entities specifically mentioned in the law must comply with the principles of proportionality, adequacy of compensations, as well as limitedness of authorities of private-public legal entities. Meanwhile, the very development of procedures for withdrawal of private land plots is inevitable in the era of globalization, which is caused, in particular, by the needs of development of engineering and transport infrastructures. However, an equally complex and multilevel system of guarantees of human rights must correspond to the increasing grounds for withdrawal of private property. Otherwise, the balance between private and public interests will be disturbed.

5. The Russian legal doctrine and legislation stipulate the possibility of not only withdrawal of private property for public needs but also limitation of rights of private owners to promote particular public interests. Such a legal framework was called “public easement”. Initially, its difference from a private easement consisted in the fact that a private easement was intended to promote the interests of certain citizens and legal entities; a public easement – the interests of an indefinite range of persons (residents of a settlement or its part).⁵⁹

At the moment, there is no consensus of scholars regarding the position of a public easement among the related legal categories and phenomena. For example, A.V. Kopylov believes that public easements have nothing in common with easements known to Roman private law. They are “only limitations of ownership rights by

⁵⁸Ref.: Resolution of the Constitutional Court of the Russian Federation No. 9-II of February 11, 2019 “In the Case Concerning the Review of the Constitutionality of Part 5 of Article 13 of the Federal Law “On Peculiarities of Regulation of Certain Legal Relations in Connection with Accession of Territories to the Subject of the Russian Federation – the City of Federal Significance Moscow and on Introduction of Alterations to Certain Legislative Acts of the Russian Federation” in Response to Complaints from the Citizens A.K. Kachkovsky and A.G. Fedosov”. In: Legal Reference System “Consultant Plus”, accessed 30.04.2019.

⁵⁹See POZDNYAKOVA, *Establishment of easements on land with linear structures*, 4 Agrarian and Land Law, 57-58 (2009); KALINICHEV, *Land easement in the Russian legislation*: abstract of the thesis of candidate of juridical sciences (Moscow, Russian State Social University, 2007) 25 p.

virtue of law”.⁶⁰ On the contrary, T.V. Deryughina thinks that an easement “differs from limitation of the ownership right in purposes of establishment; subject content; objects; content; compensatory nature”; “a public easement does not belong to the category of rights of limited use of another person’s property, limitations of the ownership right, but occupies its own position in the system of real rights”.⁶¹ A third group of authors believes that a public easement is a limit of the ownership right rather than its encumbrance.⁶² In our view, the first point of view appears more preferable due to a great similarity of the procedures and legal consequences of establishment of public easements and limitations of the ownership right. A public easement can not be considered as a type of real rights because of the lack of attributes of “inseparability” of an easement from the dominant land plot and the “value of will” of the owner.

Study of the said differences inevitably raises the question of which interests are reflected by the public servitude established in Russia: private, public or private-public? In contrast to the classic ideas about an easement (including public one), implying only the possibility to use another person’s property, the public land easement provided for in the Land Code of the Russian Federation allows the possibility of construction in terms of the easement. Initially such limitations were stipulated for development of road service on federal roads. Then this list was supplemented with the rules providing the possibility to construct various linear structures in terms of an easement for organization of the 2014 Olympic Games⁶³ (and after also the 2018 FIFA World Cup), as well as in case of accession of new territories to Moscow. It is the differences of the frameworks used in the latter laws from the classic easement that

⁶⁰See KOPYLOV, *Real rights to land in Roman, Russian prerevolutionary and modern civil law* (Moscow, Statute, 2000) 62.

⁶¹See DERYUGINA, *Civil law regulation of the institution of easement in Russia*: abstract of the thesis of candidate of juridical sciences (Volgograd, Volgograd Academy of the Ministry of Internal Affairs of Russia, 2002) 6.

⁶²See KRASNOVA, *Certain aspects of the doctrine of easement in modern Russian law*, 3 *Property relations in the Russian Federation*, 7-8 (2017).

⁶³The timeless nature of many “sports easements” exceeded the term of the Olympics themselves, which in their turn, were interesting only to a part of the population, but led to violation of rights of many private owners.

led to the proposal to “reject using the term “easement” and use the wording “limitations of the ownership right for the purpose of placement and (or) operation of infrastructure facilities””.⁶⁴

We should agree with the latter proposal. Considering the issue about the legal regime of linear structures and the legal status of persons placing them, we come to a conclusion that in most cases linear structures (such as gas and other pipelines, power lines and some other facilities) belong to private persons, and only due to the social, public significance, monopolistic nature of the corresponding type of activity, relations *regarding their operation* are under particular control of the state and subject to special legal regulation.

In our view, use of many such facilities reflects private-public interests, however, the entire coercive apparatus of the state is used to promote them. In addition, it is noteworthy that before September 2018 Article 23 of the Land Code of the Russian Federation had not stipulated establishment of a public easement for construction of linear structures. This circumstance did not prevent interested organizations (gas, electricity, water supply, etc.) from requesting establishment of a private easement, and the courts from establishing exactly a private easement, although now the same needs are elevated to public ones.⁶⁵ In our view, since private persons are the owners of such facilities, the state must not establish special preferences for all of them regarding involuntary limitation of the private owners’ rights.

In other words, with consideration of the general principle of inadmissibility of arbitrary intervention by anyone in private affairs, which is addressed to all subjects of law and is a guarantee of the freedom to exercise rights and freedoms of person and citizen, the state may not establish an obvious statutory priority of interests of

⁶⁴See AFANASIEV, *Easement in civil law of the Russian Federation: theory and practice of application*: abstract of the thesis of candidate of juridical sciences (Moscow, Russian Academy of advocacy and notary, 2017) 13.

⁶⁵Ruling of the Supreme Court of the Russian Federation No. 306-ЭС17-22992 of 14.02.2018; Ruling of the Supreme Court of the Russian Federation No. 308-ЭС16-9476 of 17.08.2016; Ruling of the Supreme Court of the Russian Federation No. 308-ЭС16-14553 of 02.11.2016. In: Legal Reference System “Consultant Plus”, accessed 30.04.2019.

the future owners of private linear structures (even if their operation has a public significance) over the legitimate interests of the owners of private land plots. However, what can we see?

The current land legislation of Russia in terms of regulation of public easements does not comply with the principles of adequacy and justice, it is not aimed at the search for a balance between private and public interests, because it stipulates reduction of the term and the cost of services for registration of linear structures. A significant part of linear structures is constructed in violation of the established procedure (or the procedure for registration of rights or the procedure for technological connection of consumer facilities). Public easement was proposed to solve the existing problems as the main way of emergence of rights to land plots for placement of linear structures. Agreeing that there are public purposes during placement of most linear structures, we should note that their achievement threatens private interests of owners and does not allow speaking about a balance of interests of owners of land and linear structures.

By virtue of Article 39.37 of the Land Code of the Russian Federation a public easement may be established for placement of transmission facilities, heating networks, water supply networks, sewerage networks, communication lines and installations, linear structures of gas supply systems, oil pipelines, their integral technological parts, if the said facilities are facilities of federal, regional or local significance, or are necessary to organize power, gas, heating or water supply for population and water sewerage, linking (technological connection) to engineering networks. In contrast to the previously effective legislation, now the procedure for establishment of a public easement excludes public hearings that were an important element of the mechanism of promoting rights and legitimate interests of owners of land plots, buildings and structures, although the Constitutional Court of Russia admitted that public hearings provide everyone who can be affected by a supposed decision of an authority and an official with the possibility to participate in its discussion regardless of having

special knowledge or belonging to particular organizations and associations.⁶⁶

In connection with the new rules, land and urban development decisions on placement of linear structures in terms of public easements are largely not open and will be adopted without participation of citizens (including owners of immovable property). Issues of placement of facilities of regional and federal significance remain without discussion by the public, because the corresponding documents related to territorial planning are not the subject of social discussions (public hearings).⁶⁷

Moreover, the Government of the Russian Federation may establish cases where preparation of territorial planning documents is not required for construction or reconstruction of linear structures (it. 5, P. 3, Art. 41 of the Urban Development Code of the Russian Federation). In certain cases, social discussions or public hearings on a territorial development plan or an area demarcation plan may be not organized (P. 5.1, Art. 46 of the Urban Development Code of the Russian Federation). In addition, the grounds for construction of linear structures are programs for integrated development of communal infrastructure systems of settlements, urban districts, investment programs of subjects of natural monopolies, organizations of the utilities complex, which do not require social discussions or public hearings either. Therefore, there is violation of one of the principles of the land legislation providing for participation of citizens, social organizations and religious organizations in settlement of issues related to their rights to land (submit. 4, it. 1, Art. 1 of the Land Code of the Russian Federation), as well as one of the basic principles of the urban development activity legislation proclaiming participation of citizens and their associations in implementation of urban development activity and promotion of the freedom of such participation (it. 5, Art. 2 of the Urban Development Code of the Russian Federation).

⁶⁶Ruling of the Constitutional Court of the Russian Federation No. 931-O-O of 15.07.2010 “On the Complaint of the Citizen Olga Olegovna Andronova about Violation of Her Constitutional Rights by Provisions of Articles 39 and 49 of the Urban Development Code of the Russian Federation, Article 13 of the Law of Saint Petersburg “On Urban Development Activity in Saint Petersburg”, Articles 7 and 8 of the Law of Saint Petersburg “On the Procedure for Organization of Public Hearings and Provision of the Population with Information when Implementing Urban Development Activity in Saint Petersburg”. In: Bulletin of the Constitutional Court of the Russian Federation. 2011. No. 2.

⁶⁷Only general layouts of urban districts and settlements fall within their scope in Russia.

New rules of the Land Code about public easements violate another fundamental provision enshrined not only in the Civil Code but also in the Constitution of the Russian Federation, the principle of inviolability of the ownership right.

Violation of this principle can be illustrated with the use of some new provisions of the Land Code of the Russian Federation. First, rules of the Land Code admit that establishment of a public easement may lead not just to a significant difficulty in using a land plot (its part) and (or) the immovable property located on it but also to the complete impossibility to use the object for a certain period. The term of the difficulty in using/impossibility to use (in case of such circumstances) is a necessary element of an application of an interested person for establishment of a public easement, a decision on establishment of an easement, an agreement about the corresponding easement. The maximum term comprises 3 months for certain types of use of land plots (housing construction, private households, gardening) and 1 year as a general rule. For a whole year (!), the owner as a result of construction, reconstruction, placement of linear structures on his land plot (or its part) may be deprived of the authority of possession and use, actually having a “bare ownership right”, although this concept is not used in the Russian science of civil law

However, even after “active” urban development actions on the land plot there is a new structure, and limitations of the rights of the owner of the land plot (in fact it means deprivation of the possibility to possess and use the corresponding part of the land plot) remain effective.

Second, violation of rights and legitimate interests of owners of immovable property is also indicated by the rules that if they fail to sign a public easement agreement within 30 days, and to challenge the decision on establishment of the public easement in court, the owner of the public easement that has made a notarial deposit for the public easement, shall be entitled to exercise the public easement, including performance of the required (including construction) works.

It means that now the property side of limitation of use of land plots (the main thing is to compensate the owner for his inconvenience) is preferable in the Land

Code of the Russian Federation to such an extent that the very essence of the ownership right is negated. Following one of the constitutional provisions on advance and, probably, equivalent compensation, the Land Code violates another basic provision on the necessity of availability of constitutionally protected purposes and their compliance with the nature of limitations. Probably, understanding this, in it. 5, Art. 39.39 of the Land Code of the Russian Federation the legislator prohibited (excluding some exceptions) establishment of public easements for placement of linear structures on land plots belonging to citizens and intended for individual housing construction, gardening, private households. In the Russian judicial practice, it is possible to find interesting cases, decisions which indicate how ambiguously the nature of “public needs” is defined when an easement is established. For example, the court rejected establishment of a public easement on plots determined in the development plan and the quarters area demarcation plan for placement of roads, in connection with the applicant’s failure to provide evidence of interests of the local population therein”.⁶⁸ It appears that in this way the court made a distinction between private-public interests (of legal entities) and public interests (of the population of the municipality).

Therefore, by its legal nature, an easement is not aimed at (and does not imply) termination of the right to use the encumbered part of the land plot, while exercise, material implementation of the right to develop land provided to the dominant owner by the Land Code of the Russian Federation – to construct a *surface* facility – leads to an actual impossibility to use the developed part of the land plot by its owner.

Construction of buildings (road service facilities) as well as various structures by the dominant owner in general contradicts easement relations, and availability of the relevant rules is the result of a political decision. This is why in the scientific literature it is fairly noted that enshrining of a legal framework of public easements in the

⁶⁸Ref.: Appellate Decision of Perm Krai Court of 12.11.2012 in case No. 33-10282. In: Legal Reference System “Consultant Plus”, accessed 02.05.2019.

Land Code of the Russian Federation is unjustified and looks like a desire of the legislator to settle public law issues with the use of a set of private law tools not intended for this purpose.⁶⁹

Meanwhile, we should note that in most cases linear structures are under or above the earth's surface and their availability, for example, in confined urban built-up areas is needed objectively. The nature of development, the length of linear structures (often location on a significant number of land plots having different owners) determine the complexity of registration of other rights to land plots (for example, lease). Consequently, in the long term, development of a new type of real rights, which would correspond to the possibility to use a land plot of another person for construction of linear or similar structures to a greater extent must be the task of the legislator (in order to ensure a balance between private and public interests). Probably, it is the right of development discussed in legal science and provided for in one of draft laws on alteration of the Civil Code of the Russian Federation.⁷⁰ However, even now it is necessary to correct rules of the Land Code of the Russian Federation in terms of transferring the burden of initiating court proceedings (with all arising procedural consequences) from owners of private land plots to the other party (private-public legal entities interested in construction of linear structures), as well as to prohibit economic activity on land plots of other persons before obtaining the consent from their owners or court decisions.

Such measures will allow getting closer to achievement of a balance between private and public interests, will create the basis for elimination of the "skewness of interests", their disharmony. In addition, we should note that we mean not so much the conflict of private and public interests as the conflict of private and private-public interests – the legitimate interest of one private person (the owner of immovable property) and the interests of another private person (the owner of a public ease-

⁶⁹See KOZLOV, *Land easement in the current Russian law*, 9 Issues of Russian and international law, 264 (2016).

⁷⁰See POPOVA, *Right of site development in the modern civil law*: abstract of the thesis of candidate of juridical sciences (Moscow, Moscow Academy of Economics and Law, 2016) 28 p.

ment) under the cover of public interest. Meanwhile, only public interests and (or) rights of third parties are acceptable to limit inviolability of the right of private ownership.

In our view, up to reformation of the land legislation, even now it is necessary to take two important legislative measures. First, expanding public participation (as in case of withdrawal of land plots for public needs) in discussion of urban planning documentation (area planning schemes), as well as making the results of social (public) hearings on establishment of public easements mandatory. Moreover, it is necessary to revoke a range of legislative decisions mentioned above, including establishment of a ban on construction of facilities on a part of a land plot encumbered with a public easement.

Second, for purposes of and procedures for establishment of public land easements, it is necessary to distinguish public from private-public interests and needs. The experience of the USA is of interest in this sense, there in cases about attempts of involuntary limitation of rights of private owners with an easement for laying of pipelines the court made a distinction between oil pipelines as common carriers and private carriers by defining private carriers as pipelines serving the sole purpose of moving the owner's oil from its own wells to its own refinery, even if the movement crossed state boundaries.⁷¹

It appears that also in Russia it is necessary to separate private-public interests (construction of oil pipelines can hardly be recognized as public interest)⁷² from "classic" public interests (construction of roads, supply of population with water or electricity). Accordingly, the current framework of public easement must not apply to private-public interests – in order to promote them, a private easement without any participation of public authorities must be established.

⁷¹See JENSEN, *Eminent Domain and Oil Pipelines: A Slippery Path for Federal Regulation*, 29-2 Fordham Environmental Law Review, 321-328 (2017).

⁷²See GARTINA, *Civil law regulation of land easements in the Russian Federation: issues of theory and practice*: abstract of the thesis of candidate of juridical sciences (Moscow, Institute of legislation and comparative law under the Government of the Russian Federation, 2009) 20-21.

6. Unreasonable denial, termination or limitation of the right of private ownership signifies refusal of the state to respect rights and freedoms of man and citizen. The trends of transition from the tasks of protection of private property to almost socialist ideas about the priority of widely understood public interest over private one existing in Russia and the USA give rise to concern and require discussion and adjustment. Meanwhile, the very need to limit human rights is beyond doubt – otherwise, egoism of one owner can leave a whole city microdistrict (quarter) without light and water. The problem is that expansion of the state powers to intervene in private property, which is inevitable in terms of urbanization and globalization, has not led to proportional growth and complication of guarantees of human rights that allow determining the balance between private and public interests and block the abuse of regulatory powers by public authorities.

Settlement of such a complex issue can not be simple and particularly universal for all countries of the world. However, trends of limitation of rights of private owners are inherent in many countries of the world regardless of their degree of democracy development (which exists in the USA but is still absent in Russia). It means that also arrangement of the system of guarantees of human rights will be subject to particular regularities common for all countries.

In respect to Russia, it signifies the need to develop the system of social (public) hearings, to form the concept of private-public interests (and legal entities expressing them), with exclusion of the latter from the field of state support in the form of involuntary withdrawal of private land plots for public needs and establishment of public easements. Compilation of a clear and exhaustive list of private-public and public needs, despite all the drawbacks of such a decision from the point of view of standards of the legal technique, nevertheless, in the specific conditions of Russia, can have a positive effect, clearly determining parameters and types of state intervention in private affairs, thereby establishing additional protection of rights of private owners from arbitrary limitations, including by means of private, rather than public, easements.

When distinguishing between public and private-public interests, it is necessary to consider the factor of “directness” of promotion of public interests (for example, oil trade is an important task, however, the main benefit from it is received by oil companies but not citizens), as well as the factor of “direct life necessities” of population (which excludes stadiums).

Creation of an appropriate system of guarantees of withdrawal/limitation of private land plots will provide a stimulus to development of the national economy and attraction of investments, which is very important for development of Russia.

TRANSNATIONAL LEGAL ISSUES IN IMPACT INVESTING: REGULATING THE ACTIVITIES OF SOCIALLY ORIENTATED ENTERPRISES

Conor Talbot *

ABSTRACT: *The article studies the existing and potential legal structures for facilitating impact finance investing. The first sections provide an introduction and background to relevant theories of the firm and motivations for adding non-financial concerns into a business's decision-making. The article then defines and distinguishes impact investing from grants and other forms of funding before identifying a gap for legal structures for impact investing transnationally. The second half of the article is focussed on describing and comparing existing legal structures that have been developed globally before concluding with some findings and remarks on the future direction of legal developments in the area.*

SUMMARY: 1. Introduction. – 2. Background and literature review. – 3. Need for impact investing. – 4. Need for legal structures for impact investing. – 5. Different legal structures developed to date. – 6. Concluding remarks.

1. In a globalised world where cross-border investing is increasingly prevalent, modern legal scholars and practitioners are constantly confronted with the increasingly multi-jurisdictional nature of legal practice. In the commercial sphere, this has necessitated the development of sophisticated corporate governance principles which are, in essence, designed to assure financiers that they will get a

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return on their financial investment¹. This chapter goes a step further to examine the legal issues that arise when investors are not solely interested in receiving a monetary return on their cross-border investment. In doing so, it examines some of the most important legal structures that have evolved to provide corporate governance solutions to non-traditional investors and, in particular, asks whether the emergence of community enterprises could present an optimal solution for the specific needs of such investors.

This chapter starts from the underlying assumption that the role of good governance is to provide legitimacy to managers such that investors feel protected from management consuming private benefits of control². In other words, it is ultimately the protection of outside investors (investors other than management or controlling shareholders) that drives a business's corporate governance³. A second assumption is that, in all types of investing, the investors' culture and background influence the investees' governance not only through managerial decision-making but also by influencing legal institutions and structures, which can become path-dependent results of the influences of the prevailing investing culture⁴. This chapter, therefore, explores how emerging corporate governance structures have struggled to adapt to a specific type of investing culture, that of transnational impact investing.

2. Traditional theories of the firm dictate that companies should care only

¹See SHLEIFER, R. VISHNY, *A survey of corporate governance*. *Journal of Finance*, 1997, 52(2), pp. 737–783.

²See LIPTON, LORSCH, *A modest proposal for improved corporate governance*. *The Business Lawyer*, 1992, 48(1), pp. 59–77; AGUILERA, JACKSON, *The cross-national diversity of corporate governance: Dimensions and determinants*. *Academy of Management Review*, 2003, 28(3), pp. 447–465.

³See LA PORTA, LOPEZ-DE-SILANES, SHLEIFER, VISHNY, *Investor protection and corporate governance*. *Journal of Financial Economics*, 2000, 58(1–2), pp. 3–27; LA PORTA, LOPEZ-DE-SILANES, POP-ELECHES, A. SHLEIFER, *Judicial checks and balances*. *Journal of Political Economy*, 2004, 112(2), pp. 445–470.

⁴See CUMMING, FILATOTCHEV, KNILL, MITCHELL REEB, SENBET, *Law, finance, and the international mobility of corporate governance*. *Journal of International Business Studies*, 2017, 48(2), pp.123–147; DAVID, *Why are institutions the carriers of history? Path dependence and the evolution conventions, organizations, and institutions*. *Structural Change and Economic Dynamics*, 1994, 5(2), pp. 205–220.

about profits and let the government of the day deal with externalities. For instance, examining the emerging trend of social responsibility initiatives in companies in the 1970s, Friedman pointed out the incongruity of how such schemes allowed managers to spend someone else's money (in particular that of the shareholders, but also of customers and employees) for social causes with only a vague mandate to decide which social cause to support⁵. However, viewed from the perspective of society as a whole, more recent economic theory indicates forcefully that social welfare might not be maximised if certain externalities are not brought into a business's equation at all, with authors generally concluding in favour of the merits of aiming for the maximisation of stakeholder-value rather than that of shareholders alone⁶. Meanwhile, from the owner-investor's perspective, another study from Allen et al shows that stakeholder-oriented societies actually have higher company values than shareholder-oriented societies⁷. The increasing amounts of money invested according to socially responsible principles is proof of this increased interest, although significant debate remains about the motivations underlying these decisions. In this vein, commentators typically point to the signalling effect that can, in a positive sense, increase a company's market reputation⁸ or ability to attract motivated workers⁹, and in a more defensive sense, help the company respond to pressure from social and environmental lobbyists¹⁰. Perhaps more relevant in the context of this chapter, Goss and Roberts determined that socially responsible conduct had an effect

⁵See FRIEDMAN, *The social responsibility of business is to increase its profits. The New York Times Magazine*, 13 September 1970.

⁶See RENNEBOOG, TER HORST, ZHANG, *Socially responsible investments: institutional aspects, performance, and investor behaviour. Journal of Banking and Finance*, 2008, 32(9), pp. 1723–1742.

⁷See ALLEN, CARLETTI, MARQUEZ, *Stakeholder capitalism, corporate governance and firm value. EUI Working Papers*, 2009, available at: http://cadmus.eui.eu/bitstream/handle/1814/10678/EUI_CO_2009_10.pdf?sequence=1&isAllowed=y.

⁸See FOMBRUN, SHANLEY, *What's in a name? Reputation building and corporate strategy. Academy of Management Journal*, 1990, 33(2), pp. 233–258; A.L. FRIEDMAN, S. MILES, *Socially responsible investment and corporate social and environmental reporting in the UK: an exploratory study. British Accounting Review*, 2001, 33(4), pp. 523–548.

⁹See BREKKE, NYBORG, *Moral hazard and moral motivation: corporate social responsibility as labor market screening. Memorandum*, 2004, available at: <http://hdl.handle.net/10419/63093>.

¹⁰See BARON, *Private Politics, Corporate social responsibility, and integrated strategy. Journal of Economics and Management Strategy*, 2001, 10(1), pp. 7–45.

on the interest rates companies pay for bank debt, such that companies perceived to have a low degree of social responsibility pay up to 18 basis points more for their loans than companies that are perceived to have a positive social engagement¹¹. Thus, we can see that the motivation to add non-financial concerns into a business's decision-making has been perplexing commentators for some time but, nevertheless, the demand for doing remains perhaps stronger than ever today.

3. There is a plethora of existing research highlighting the lack of finance at the earlier (riskier) stages of an enterprise's development, in particular for socially engaged enterprises. Koh et al, for instance, found that most investors surveyed expressed a strong preference for investing in the later stage, certainly after commercial viability had been established and preferably once market conditions were well prepared for sustainable scaling¹². Kohler et al, likewise, stress the bottleneck that flows from how socially engaged initiatives are restricted in their search for investment to the small cohort of mission-aligned investors that are already committed to supporting those particular types of enterprises¹³. This means that the investment pie is limited and investees compete with each other for a slice, rather than being able to increase the pie by attracting investment from fresh sources. This problem is even more acute in the early stages of the development cycle of these enterprises, whereby they are dependent on a finite pool of grant funding that often runs out before the business is either sustainable or able to qualify for debt finance.

Impact investing is commonly identified as a potential solution for this funding

¹¹See GOSS, ROBERTS, *The impact of corporate social responsibility on the cost of bank loans. Journal of Banking & Finance*, 2011, 35(7), pp. 1794-1810; GIRERD-POTIN, JIMENEZ-GARCES, LOUVET, *The link between social rating and financial capital structure. Finance*, 2011, 32(2), pp. 9-52.

¹²See KOH, KARAMCHANDANI, KATZ, *From blueprint to scale. Monitor Inclusive Markets*, 2012, available at: www.mim.monitor.com/blueprinttoscale.html.

¹³See KOHLER, KREINER, SAWHNEY, *Coordinating Impact Capital: A New Approach to Investing in Small and Growing Businesses. Aspen Network of Development Entrepreneurs*, 2011, available at: <https://www.scu.edu/media/institutional-pages/news-amp-events/Coordinating-Impact-Capital.pdf>.

gap. For the purpose of this paper, we take impact investing to mean investments made into companies, organisations, and funds with the intention to generate social and environmental impact alongside a financial return¹⁴. Importantly from a governance perspective, impact investing must be distinguished from grants which are simply donations of funds with no expectation of financial returns since impact investors still seek returns¹⁵. The interest in impact investing, especially in a cross border context where investors may be physically located far from the investee and with limited daily oversight of the investee's activities, is that allows for a better level of delegation and entrustment on the part of the investor which, in turn, allows investees to embark on more complex projects which may include a blend of profit-motivated and socially motivated (impact) investors. To ensure the social objectives remain paramount, impact investors' stakes must be structured such that they hold rights capable of counterbalancing the other owners' tendencies to overemphasise profits. Generally, the rate of impact investors' stakes amongst the cohort of owners is in proportion to the value of social output, such that pure non-profit status may be optimal for the highest valued social projects, but this does not discount the possibility of blending social and return-based incentives within a single project or enterprise¹⁶. Therefore, while impact investing is sometimes simply described as being investing with good intentions, a more rigorous assessment would be that the defining characteristic of impact investment is that the goal of generating financial returns is unequivocally pursued within the context of setting impact objectives and measuring their achievement¹⁷.

Other terms, such as sustainable or sustainably responsible investing, are

¹⁴See further, GLOBAL IMPACT INVESTING NETWORK, *What you need to know about impact investing*. GIIN, 2018, available at: <https://thegiin.org/impact-investing/need-to-know/#what-is-impact-investing>.

¹⁵See NOVAK, DE AMICIS, MOZETI, *Impact investing market on Twitter: influential users and communities*. *Applied Network Science*, 2018, 3(1), p. 40.

¹⁶See CHOWDHRY, DAVIES, WATERS, *Investing for impact*. *Review of Financial Studies*, 2019, 32(3), pp. 864–904.

¹⁷See BREST, BORN, *When Can Impact Investing Create Real Impact?* *Stanford Social Innovation Review*, 2013, 11(4), pp. 22-27.

often used in the business organisation literature on this topic with the common thread being an attempt to describe enterprises that strive to pursue desirable non-financial impacts, although Dorfleitner and Utz point out that sustainability means something different in every case¹⁸. Similarly, social enterprises are organisations committed to social and/or environmental returns as part of its core business while seeking profit or return on investment. According to the structure made popular by the work of Muhammad Yunus, the legal structure of such social enterprises may be for-profit or non-profit, but they must aspire to financial sustainability¹⁹.

Generally, however, these terms are consistent in referring to the integration of certain non-financial concerns, such as ethical, social or environmental, into the investment process²⁰. Such terms should, however, be distinguished from the term corporate social responsibility (CSR) which is used in the academic literature to describe a company's ethical and responsible behaviour which is shaped by the extent to which companies integrate social and ecological topics into their corporate governance. Thus, the two sets of terms describe similar concepts but at different levels: by implementing CSR, companies establish a basis to attract socially responsible investors or, viewed from the other perspective, shareholders can use their influence to impose CSR rules and frameworks on the investee company²¹.

4. The fundamental legal issue being explored here stems from the fact that traditional corporate governance systems were designed by and for traditional investors, and thus revolve predominantly around securing the financial position of

¹⁸See DORFLEITNER, UTZ, *Safety first portfolio choice based on financial and sustainability returns*. *European Journal of Operational Research*, 2012, 221(1), pp. 155–164.

¹⁹See YUNUS, *Building Social Business: The New Kind of Capitalism that Serves Humanity's Most Pressing Needs*, Public Affairs Publishing, New York, 2011.

²⁰See SANDBERG, JURAVLE, HEDESSTROM, HAMILTON, *The heterogeneity of socially responsible investment*. *Journal of Business Ethics*, 2009, 87(4), pp. 519–533.

²¹See SPARKES, COWTON, *The maturing of socially responsible investment: a review of the developing link with corporate social responsibility*. *Journal of Business Ethics*, 2004, 52(1), pp. 45–57.

investors in a given enterprise²². Impact investors, on the other hand, have faced the need to develop new forms of documentation and deal structures that attempt to align their capital to the business models, including financial and social objectives, of their investees²³. This is clearly not ideal, since traditional investment structures evolved over time in a balanced way to protect a defined set of interests. Attempting to incorporate another perspective into the standard equation, being that of the need for social outcomes, requires a re-calibration of the balance typically reached for traditional investments and results in over-stretching existing mechanisms. For example, lenders may seek ways to provide for longer principal amortisation schedules or grace periods, agree to forego prepayment penalties or offer prepayment discounts²⁴. Equity investors, meanwhile, attempt to compromise by aligning the timing and amount of dividend payments and redemption rights with the business models of their investees, for example, by staging dividend payments and redemption-based exits or linking such payments to the investee's revenues or amount of cash on hand²⁵. Thus, while tapping into private sources of finance clearly has the potential to help solve society's toughest problems, new methods of social impact investing are required which truly harness entrepreneurship, innovation and capital to power social improvement.

From a legal perspective, impact investors are similar to any other cross border legal actor in search of the requisite degree of legal certainty to underpin a

²²The literature on the theory of the firm is voluminous. For a representative background of legal discussions, see BAINBRIDGE, *Director Primacy: The Means and Ends of Corporate Governance*. *Northwestern University Law Review*, 2003, 97(2), pp. 547-550 (arguing that the firm is a nexus of contracts); ULEN, *The Coasean Firm in Law and Economics*. *Journal of Corporation Law*, 1992-1993, 18(1), pp. 301-330; A. Wolfe, *The Modern Corporation: Private Agent or Public Actor?* *Washington and Lee Law Review*, 1993, 50(4), p. 1673 (noting that "the nature of corporations has always been contested").

²³See SALTUK, EL IDRISI, BOURI, MUDALIAR, SCHIFF, *Spotlight on the Market: The Impact Investor Survey*. *Global Social Finance*, 2014, available at <http://www.thegiin.org/binary-data/2014MarketSpotlight.PDF>.

²⁴See SANTA CLARA UNIVERSITY, *Demand Dividend: Creating Reliable Returns In Impact Investing*. *GIIN*, 2013, available at <http://www.scu.edu/socialbenefit/impact-capital/upload/Demand-Dividend-Description.pdf>.

²⁵See BURAND, *Resolving Impact Investment Disputes: When Doing Good Goes Bad*. *Washington University Journal of Law & Policy*, 2015, 48(1), pp. 55-89.

given transaction. The principle of legal certainty is of fundamental importance for law and society in general, and when an investor is putting its money on the line, being able to rely on established legal principles with a level of certainty attaching to them is vital in stabilising expectations and providing a framework for subsequent legal interactions. So, although the structures described in the sections to follow are not all fully mature, the debate and commentary on each model is important in order to help certainty in the domain become fully realised, both at the national and transnational level²⁶.

5. As a growing number of investors seek opportunities to generate social impact, there are not enough investment opportunities that meet their risk-return expectations, thereby limiting access to the enormous pools of capital managed by institutional investors²⁷. As described above, merely tweaking or adjusting traditional investment structures to encompass social impact amongst other motivations amount to investors compromising and effectively weakening those mechanisms in order to facilitate the investee's circumstances. Accordingly, innovation is necessary to create new financial instruments and strategies that appeal to institutional investors while addressing the needs of sustainable development. Therefore, certain structures have come to be developed which, rather than aligning impact investors' financial return expectations to the investee's business model, allow impact investors embed social impact goals directly into the contractual provisions underpinning the recipients of their investments from the outset. The investees and investors thus jointly seek to ensure what is called "mission lock" through the choice of legal form or governance provisions, and recent years have seen the emergence of new legal forms of corporate entities that can be utilised by organizations seeking to generate

²⁶See FENWICK, SIEMS, WRBKA, *The Shifting Meaning of Legal Certainty in Comparative and Transnational Law*, Hart Publishing, Oxford, 2017.

²⁷See DAVIS PLUESS, GOVAN, PELAEZ, *Conditions for Scaling Investment in Social Finance. Business for Social Responsibility*, 2015, available at: https://www.bsr.org/reports/BSR_Conditions_for_Scaling_Social_Finance_2015.pdf.

financial returns as well as positive social benefits²⁸. On a firm by firm level, these can take the form of restrictive internal governance provisions whereby certain fundamental changes can only be “unlocked” through a vote of the requisite number of shareholders/members or using golden shares as a way to harness the deep pockets of financial capital, without jeopardising the entity’s social mission²⁹. However, more radical or far-reaching proposals are required to shape the future of impact investing in a more definitive manner. The following sections describe innovative legal structures which build on the existing notions of, first, multi-beneficiary funds with socially-defined characteristics and, second, individual corporate entities with limitations on their scope of activities.

Impact Funds, Social Bonds and Crowdfunding

Impact funds are venture capital and growth equity funds with dual objectives of generating a financial return and generating a positive externality. Clearly, the development of these types of funds is demonstrative of the belief that private capital has the scale required to fundamentally address global social and environmental challenges, and that innovative mechanisms are required because existing financial instruments and intermediaries are designed to maximize financial returns for the providers of capital rather than generate positive externalities. Impact funds are distinct from investing in social enterprises (directly or via other vehicles such as philanthropic funds) in that impact funds intend to earn financial returns in addition to addressing a social and/or environmental concern.

An implication of having dual objectives is that such funds face a constrained investment opportunity set relative to financial investors, who have a sole objective of generating financial return and an unfettered choice of investments. It follows that financial investors should have better expected returns than impact investors in an

²⁸See PLERHOPLES, *Delaware Public Benefit Corporations 90 Days Out: Who’s Opting In?* *UC Davis School of Law Business Law Journal*, 2014, 14(2), pp. 247-280.

²⁹See HOGAN LOVELLS, BIG SOCIETY CAPITAL, *Going for Gold: How golden shares can help lock in mission for social enterprises*, 2015, available at: https://www.hoganlovells.com/~media/hogan-lovels/pdf/publication/4878744v1golden-share-report-final-formlwdlib01_pdf.pdf.

efficient market. A further major problem for the emergence of these types of funds is the trend of legal and regulatory restrictions to impose strong fiduciary standards on investors. For instance, the traditional interpretation of the fiduciary duty of an investment fund manager in the U.S. restricts the consideration of noneconomic benefits to situations where the financial value is at least as good or better than the alternative choices³⁰. Barber et al find that a relaxation of this and similar requirements could increase the demand for impact investing³¹. However, it would clearly require a paradigm shift in the traditional relationship between money managers and their clients.

A social bond is a type of bond that raises capital to finance projects with one or more social objectives. They are commonly referred to as an offshoot of the larger and more established market for green bonds, which are dedicated to financing low-carbon, climate-resilient 'green' projects. More specifically, Social Impact Bonds (SIBs) are financial products aimed at gathering private funding used to support social programs in order to allow governments to use a market-based mechanism to finance welfare initiatives whose successful implementation is expected to address a specific social issue and consequently reduce future public expenditure. From an efficiency perspective, it is important that they are structured as pay-for-success assets, meaning that the private capital generates returns only if the funded project meets its objectives. They are usually employed to fund particularly innovative, and therefore risky, projects that otherwise would find it difficult to attract support from public funding³². As such, SIBs are not true financial bonds but rather future contracts on social outcomes and can be issued either as debt capital or, more often, as equity

³⁰See, e.g. EMPLOYEE RETIREMENT INCOME SECURITY ACT (ERISA). *United States Code*, 1974, 29(18), pp. 1001 et seq.

³¹See BARBER, MORSE, YASUDA, *Impact Investing*. SSRN Working Paper, 2018, available at: <https://ssrn.com/abstract=2705556>.

³²See DEL GIUDICE, MIGLIAVACCA, *Social impact bonds and institutional investors: an empirical analysis of a complicated relationship*. *Nonprofit and Voluntary Sector Quarterly*, 2018, 48(1), pp. 50-70.

in the form of donations³³. As regards the legal structure, the SIB mechanism revolves around a financial intermediary that organises the issuance, designs the features of the financial instruments, and sets up a legal entity independent of the parent corporation to issue financial instruments and receive financial resources from outside investors. SIBs have attracted increasing attention from scholars, policy makers, and investors. However, notwithstanding good intentions and policy makers' enthusiasm, SIBs have failed to attract significant private capital, and recent commentary indicates that institutional investors will be more likely to participate in SIBs only when means are found to resolve the remaining agency problems.

Crowdfunding is viewed as a promising source of finance for sustainable enterprises by offering entrepreneurs an alternative to traditional finance channels³⁴. Crowdfunding caters well to innovative, opaque, small firms and makes use of social networks in the funding process³⁵. The main benefit is that it lowers the transaction costs for entrepreneurs to collect small investment amounts from a dispersed set of investors and is becoming an increasingly sizable source of funding for start-ups and other bottom-up initiatives in the economy³⁶. As the method matures though, it is becoming unclear whether crowdfunding provides access to the wisdom of the crowd, or whether in fact it simply opens an investment project to a wider audience of underinformed potential investees alongside the usual "in-crowd" of the entrepreneur's family and friends. To be truly efficient, the wider group of crowdfunders would need to compensate for their lack of familiarity with the entrepreneur by a greater reliance on information about the project. However,

³³See JOY, SHIELDS, *Social impact bonds: the next phase of third sector marketization? Canadian Journal of Nonprofit and Social Economy Research*, 2013, 4(2), pp. 39-55.

³⁴See TOXOPEUS, K. MAAS, *Crowdfunding Sustainable Enterprises as a Form of Collective Action*, in *Designing a Sustainable Financial System*, ed. by T. Walker, S. Kibsey, R. Crichton, Palgrave, London, 2018.

³⁵See VISMARA, *Equity retention and social network theory in equity crowdfunding. Small Business Economics*, 2016, 46(4), pp. 579–590.

³⁶See WARDROP, ZHANG, RAU, GRAY, *Moving mainstream: the European alternative finance benchmarking report. University of Cambridge*, 2015, available at: https://www.jbs.cam.ac.uk/fileadmin/user_upload/research/centres/alternative-finance/downloads/2015-uk-alternative-finance-benchmarking-report.pdf.

Bernstein et al's study finds that the quality of decision making of crowdfunders, when aggregated across all types, leaves a lot to be desired especially when compared to professional venture capital investors who are more likely to rely also on financial due diligence and an alignment of goals between venture and investor³⁷.

a. Società Benefit, Sociétés d'Impact Sociétal and Community Interest Companies

Turning from more general funds-based concepts to specific corporate structures, certain European legislatures have responded to the demand by formulating specific corporate entities in national legislation. For instance, since 2015 Italian company law has provided for a specific legal status for companies, called "*Società Benefit*"³⁸, which was designed to combine the goal of profit with the purpose of creating a common benefit for society in a transparent, responsible and sustainable way³⁹. The *Società Benefit* amounts to a legal tool to ensure long term mission alignment even during expansion phases through capital raises and leadership changes⁴⁰. In practice, to attain the status, a company must amend its articles of association including in the object clause the aims of common benefit that it intends to pursue. This means that the company will not only pursue the purpose of profit, but also the specific purpose or purposes of common benefit that it has inserted in its articles of association.

In an attempt to lend a sense of coherency to the cohort of companies opting of the status, the legislation prescribes the notion of a common benefit as the

³⁷See BERNSTEIN, KORTEWEG, LAWS, *Attracting early stage investors: evidence from a randomized field experiment*. *Journal of Finance*, 2017, 72(2), pp. 509-538.

³⁸ Law No. 208 of 28 December 2015, available at: <http://www.gazzettaufficiale.it/eli/id/2015/12/30/15G00222/sg>; English version available at: <http://www.societabenefit.net/wp-content/uploads/2017/03/Italian-benefit-corporation-legislation-courtesy-translation-final.pdf>; see further: B LAB EUROPE, *Società Benefit: English information*, 2019, available at: <http://www.societabenefit.net/english-information/>.

³⁹See HILLER, SHACKELFORD, MA, *The Firm as Common Pool Resource: Unpacking the Rise of Benefit Corporations*. *Kelley School of Business Research Paper*, 2016, available at: <https://ssrn.com/abstract=2874654>.

⁴⁰See PELATAN, RANDAZZO, *The First European Benefit Corporation: blurring the lines between 'social' and 'business'*. *ESELA Annual Conference*, 2016, available at: <https://www.bwblp.com/file/benefit-corporation-article-june-16-pdf>.

creation of positive effects (or the reduction of negative ones) vis-à-vis individuals, communities, territories and the environment, cultural and social heritage, entities and associations as well as other stakeholders. Given the broad criteria, the legislature entrusts the national competition authority with the task of overseeing whether the relevant companies are indeed pursuing the stated goals. From that perspective, investors enjoy a further comfort of knowing that the investee company faces the risk of being fined under unfair commercial practice and misleading advertisement legislation where they fail to pursue the aims stated in their foundational documents.

Looking further back in time, the United Kingdom's Community Interest Company ("CIC") regime was first introduced by the Blair government in 2005 to provide a legal vehicle for non-charitable social enterprises⁴¹. Behind the introduction was a recognition of the practical fact that the heavy regulation and requirement for volunteer boards meant that being a charity is not the best route for many social entrepreneurs. Thus, a major advantage of CICs is that directors can be paid a salary, creating a feasible manner for founders to retain strategic control of the enterprise's mission in a financially sustainable way. Although fundamentally structured along the lines of a typical limited company, in that they can issue transferable shares, the social mission is ring-fenced through a prohibition on uplift in any share buy-backs which prevents any value from being extracted from the company.

This legislative initiative formed part of a larger set of public policy measures that aimed to create a more enabling environment for the accelerated growth of social entrepreneurship in the UK. As regards the relationship with the State, the thinking behind the initiative was that the State would act as catalyst, customer and champion of the emergent sector. True to the regulatory tradition of UK governments of the era, the CIC regulator operates as a "light-touch" oversight body whose main

⁴¹See CHO, *Benefit Corporations in the United States and Community Interest Companies in the United Kingdom: Does Social Enterprise Actually Work?*. *Northwestern Journal of International Law & Business*, 2017, 37(1), pp. 149-172.

role is to certify the social purpose of the proposed CIC before it can be registered. The legislative definition of the social purpose requirement, and its subsequent interpretation, is so broad as not to pose a substantive barrier on the types of activities realistically foreseeable under the structure. Rather, the social nature of the CICs was indirectly ensured by the value-extraction limitations noted above and the regulator's function is more that of a data collector allowing the State to monitor the type and scale of CICs functioning in the territory, in turn allowing the State to optimise its other interventions in society.

Likewise in Luxembourg, the tradition of welfare state activism through social entities appears to have emerged in the realm of providing social services that otherwise would have to be delivered by the State directly⁴². Bearing witness to the broad aims of the initiative, the legislation underpinning the *Société d'Impact Sociétal* ("SIS") involved not only policymakers but also the University of Luxembourg, Chamber of Commerce and various research centres as well as representatives of social- and solidarity-economy organisations. Again, a core aim of the initiative was to provide legal certainty through providing a structure for erstwhile *associations sans but lucratif* which were formally forbidden to engage in commercial activities through strict eligibility rules for public subsidies.

Since a SIS can only be established through the form of a *société anonyme*, *société à responsabilité limitée*, or a *société cooperative*, there is a clear regulatory burden associated with this option. Furthermore, the constitutive statutes must include elements not usually found in an off-the-shelf limited company such as performance indicators for measuring the achievement or otherwise of the declared social objective. A split between so-called "impact shares" and "profit shares" is envisaged whereby impact shares do not receive dividends while profit shares do retain this right. In order to set a certain floor to its social nature, the share capital of

⁴²See CLIFFORD, HEHENBERGER, FLETCHER, HARLING, *European Impact Investing Luxembourg: Social Impact Measurement in the framework of a Société d'Impact Sociétal*. *European Impact Investing*, 2015, available at: <http://www.impact-investing.eu/download/128/eiil-social-impact-measurement-in-the-framework-of-the-sis-regulatory-framework-bwb-report-final.pdf>.

a SIS must consist of at least 50% of these special impact shares. On the other end of the scale, where a SIS's share capital is composed exclusively of impact shares, it will be fully exempt from corporate income tax, municipal business tax and net wealth tax and any cash donations are deductible as special expenses, akin to donations made to qualifying not-for-profit organisations.

From a regulatory and supervisory perspective, a SIS is submitted to the control of a special commission specifically created to oversee ongoing compliance with the minimum SIS requirements. Given the tax advantages mentioned above, the equivalent of which are not directly present under the UK system, it emerges that the Luxembourg supervisory authority has a more anti-abuse mandate as opposed to the mere data collecting function exercised by its counterpart in the UK.

From a financing point of view, it is clear that the SIS system was envisaged to provide a maximum degree of transparency. Thus, indirect means of finance such as shareholder loans are prohibited, although a SIS can access normal arm's-length financing. This desire for transparency comes at the price of a further administrative burden in that a SIS's annual accounts must be submitted to an independent auditor (*réviseur d'entreprise agréé*) to ensure that no complex instruments or shareholders' loans have been issued.

As an exercise in regulatory politics, the development of the CIC legislation and practices can perhaps best be explained based on the logic of collective action, whereby the largest interest groups – in this case the central government and combined local authorities – lobbied most effectively, resulting in legislation that serves those interests more so than the local social entrepreneurs. By evolving into a mechanism for the State to effectively exit certain areas of traditional social intervention, the CIC formed a crucial part of the small-government movement at the heart of New Labour politics in the UK. It remains to be seen whether the Società Benefit or SIS regimes, with their similar foundations but a stronger regulatory oversight, will be likewise skewed towards traditional public service functions in practice. In conclusion, this area of the law and regulatory practice suffers from the

struggle to lend a fixed and meaningful value to the notion of “embeddedness” as a core underlying characteristic of a social enterprise. This is something that is widely noted in studies of the social enterprise movement and is perhaps epitomised by the ease with which CICs can fulfil the social criterion in the registration process, which represents a design attribute which has allowed CICs to be utilised for purposes that stray away from true social entrepreneurship.

6. Ultimately, impact or ethical investors must deal in the same asset class universe as conventional investors: they can invest in equity, fixed income products, and alternative investments, with most such investors tending currently to use discretionary mandates for their asset management in order to influence the identities of the final investee entities.⁴³ In turn, non-financial concerns can be integrated into the investment process, mainly through positive and negative screening, shareholder activism and community development investing. Since some of the types of community development or socially directed investments mechanisms described in this piece deliberately accept below market returns in order to help others, authors such as Bugg-Levine and Emerson argue that the separation between financial return and contribution to charities leads to a “waste of capital and talent”⁴⁴. From whence emerges the idea of impact investing, whereby positive impact on social and environmental challenges is executed while optimizing financial returns. Impact investing is becoming more and more important in the investment practice, but require the continued evolution of delivery mechanisms such as funds that can direct investments into growing economies or market segments that do not yet have sufficient access to capital markets.⁴⁵ Once one adds a cross-border

⁴³See EUROSIF, *European SRI Study*, 2010, available at: http://www.eurosif.org/wp-content/uploads/2014/04/Eurosif_2010_SRI_Study.pdf.

⁴⁴See BUGG-LEVINE, EMERSON, *Impact Investing: Transforming How We Make Money While Making a Difference*, Jossey-Bass Publishing, San Francisco, 2011.

⁴⁵See DORFLEITNER, LEIDL, PRIBERNY, *Microcredit as an asset class: structured microfinance*, in *Mobilising capital for emerging markets: what can structured finance contribute?*, ed. by Doris Kohn, Springer, Berlin, 2011.

element, however, these mechanisms must add better and stronger legal reinforcements for both the financial and non-financial interests of the investors. Going forward, transnational law will have a significant influence on how these structures evolve. For instance, one can expect impact investors to have a preference for arbitration due to the fact that most impact investments are taking place in emerging markets, where the efficiency and impartiality of judicial systems may be viewed with scepticism by foreign investors. In many developing countries, even if there is a functioning and reputable judicial branch, courts may experience significant backlogs, which can add to lengthy delays in resolving disputes.

As outlined above, impact investors appear to be taking a variety of approaches to mitigate or avoid the possible risks of impact investing. In many cases, the most effective and practical approach to managing these risks may be to look beyond the four corners of the investment documentation but the underlying investment documentation still will need to include some form of dispute resolution mechanism. Furthermore, while investors and investees may not be inclined to instruct lawyers to tailor dispute resolution provisions to the specificities that shape their particular investment, merely using boilerplate dispute provisions from commercially-oriented agreements will rarely mesh well with the novel structures or terms designed to reflect the transacting parties' social motivations.

In conclusion, we should also note that there is significant diversity within the impact investing community from philanthropic investors to angel, early-stage and equity investors each with their own specific set of needs and interests that need to be reflected in the legal structures. As even global investment banks begin to operate in this field, impact investing seems set to become more and more mainstream. Creating scalable and reliable legal structures will be a crucial step to broaden the base of investors active in the area and, perhaps, finally allow us to drop the word "impact" before investment and thereby making such methods the new standard practice.