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

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FOCUS ON GLOBAL PERSPECTIVES

REGULATORY GOVERNANCE OF ALTERNATIVE INVESTMENT FUND MANAGERS

Mads Andenas - Iris Chiu*

ABSTRACT: *This article analyses the rules of governance set by the EU legislator with regard to Alternative Investment Fund Managers, as a regulatory response to the financial crisis. In fact, the Commission is of the view that alternative investment funds may pose systemic risk because other financial institutions, such as banks, may be exposed to them and thus be subject to the macro-prudential and micro-prudential risks of hedge fund behaviour. The authors focus on the prudential and risk management regulation, in order to verify if it is able to protect the investor and the market's integrity. Although the AIFM Directive has responded to the financial stability and systemic risk rationales for regulating alternative investment funds, the prudential regulatory regime may be too standardised with the UCITS and MiFID regimes, lacking consideration of some of the unique features of AIFMs, and also too procedural in nature, allowing AIFMs considerable discretion in determining their own levels of safety and soundness. In conclusion, the authors do not believe that mandatory disclosure to regulators adequately supports systemic risk oversight.*

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1. The de Larosière Report[1] recommends that the regulatory net be extended to the parallel banking system, which includes alternative investment funds such as hedge and private equity funds. Transparency is required of the activities in this sector to be able to assist in systemic risk oversight and appropriate regulation may be necessary in the interests of maintaining financial stability. The comprehensive regulatory reforms in EU financial regulation following the global financial crisis may be criticised as a form of regulatory creep,[2] but on the other hand, they are based on the rejuvenation of the financial stability objective in financial regulation. Although these funds have been acknowledged as having little part to play in the causes leading up to the global financial crisis, the extension of regulatory reach to alternative investment funds has been argued to be necessary in the de Larosière Report as 'appropriate regulation must be extended, in a proportionate manner, to all firms or entities conducting financial activities which may have a systemic impact ... even if they have no direct links with the public at large'.[3] The Report is of the view that hedge funds, in particular, could pose a systemic risk by virtue of their investment activities and scale, or their connections with other financial institutions. The European Commission's proposal to regulate alternative investment funds also outlines that alternative investment funds were not at the forefront of the global financial crisis, but that they could generate systemic risk in the future.[4]

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[1] See DE LAROSIÈRE and OTHERS, *Report by the High Level Group on Financial Supervision in the EU*, Brussels, 25 February 2009, available at *ec.europa.eu*. Compare also the mandate of the *Financial Stability Board* by the G20 to succeed Financial Stability Forum at an international level, to cover all systematically important institutions including hedge funds or more broadly the 'shadow banking system'. See DALHUISEN, *Transnational and Comparative Commercial, Financial and Trade Law*, 5th edn., Oxford: Hart Publishing 2012, vol III, ch 2, ch 1.1.6; NORTON, *NIFA II or "Bretton Woods II": The G-20 (Leaders) summit on managing global financial markets and the world economy – quo vadis'*, in *Journal of Banking Regulation*, 2010, p. 261.

[2] See WILSON, *"Mission creep" fears surround EU watchdogs*, in *The Telegraph*, London, 5 September 2010, available at *www.telegraph.co.uk*; FERRAN, *The Regulation of Hedge Funds and Private Equity: A Case Study in the Development of the EU's Regulatory Response to the Financial Crisis*, February 2011, in *ECGI Law Working Paper No 176/2011* available at *ssrn.com*.

[3] See DE LAROSIÈRE and OTHERS, *op. cit.*

[4] See COMMISSION, *Proposal for a Directive for Alternative Investment Fund Managers*, COM (2009) 207 final. This view is supported by some academic commentators, see for example PEARSON -

In the European Commission's perspective, alternative investment funds may give rise to systemic risk due to their connections with other financial institutions, their trading activities and investment strategies such as short selling, and the scale of potential investor losses if they should fail.[5] These three key factors are discussed below.

First, the Commission is of the view that alternative investment funds may pose systemic risk because other financial institutions, such as banks, may be exposed to them and thus be subject to the macro-prudential and micro-prudential risks[6] of hedge fund behaviour. The macro-prudential risks refer to the risks that follow the typically pro-cyclical behaviour of alternative investment funds. Such pro-cyclical behaviour could lead to an extensive build-up of leverage in exuberant times, which could then cause widespread financial stress and instability if deleveraging should become necessary.[7] The practice of taking on leverage by hedge funds has been widely documented[8] and their role in exacerbating a situation of stress is quite undisputed. Further, it is suggested by

PEARSON, *Protecting Global Financial Market Stability and Integrity: Strengthening SEC Regulation of Hedge Funds*, 33, in *North Carolina Journal of International Law and Commercial Regulation,* 2010, 1.

[5] The systemic risk dimension necessitates the institution of a regulatory regime, and Andreas Engert argues that such a regime should be harmonised internationally and not just at the EU level in order to prevent regulatory competition from undermining it. See ENGERT, *Transnational Hedge Fund Regulation*, in *European Business Organisation Law Review,* 2010, p. 330, whose article examines self-regulation, regulatory competition and transnational harmonisation as possible options for governing hedge funds, concluding after an even-handed assessment that transnational harmonisation meets best the needs of enforcement and systemic risk monitoring.

[6] See further BANK OF ENGLAND, *The Role of Macroprudential Policy*, in *Bank of England Discussion Paper,* November 2009, available at *www.bankofengland.co.uk*. In essence it concerns the adjustment of regulation to better reflect the various stages in the credit cycle. The term 'macro-prudential supervision' has been used for some time, see ANDENAS and PANOURGIAS, *Applied Monetary Policy and Bank Supervision by the ECB*, in Joseph J. Norton and Mads Andenas (eds.), *International Monetary Law and Financial Law in the New Millennium*, London: BIICL 2002, p. 130; DALHUISEN, *Transnational and Comparative Commercial, Financial and Trade Law*, 5th edn, Oxford: Hart Publishing, 2012, vol III, ch 2, ch 1.1.6.

[7] See COMMISSION, *Proposal for a Directive for Alternative Investment Fund Managers*, COM(2009) 207 final, para. 1.1.

[8] In the US especially, as earlier commentators post the LTCM collapse and later commentators agree on the exacerbating capacity of leverage used by hedge funds, GIBSON, *Is Hedge Fund Regulation Necessary?*, 73, in *Temple Law Review,* 2010, p. 681; OESTERLE, *Regulating Hedge Funds*, 1, in *Entrepreneurial Business Law Journal,* 1; SAMI, *A Comparative Analysis of Hedge Fund Regulation in the United States,* 29, in *Northwestern Journal of International Law and Business,* 275, 2009; WAGNER, *Hedge Funds: The Final Frontier of Securities Regulation and a Last Hope for Economic Revival*, 6, in *Journal of Law, Economics and Policy,* 2009, 1; THOMPSON, *Why We Need a Superfund for Hedge Funds,* 79, in *Mississippi Law Journal,* 2010, p. 995; OVERMYER, *The "Foreign Private Adviser" Exemption: A Potential Gap in the New Systemic Risk Regulatory Architecture*, 110, in *Columbia Law Review,* 2010, p. 1185.

some commentators that hedge funds could also contribute further stress to a situation of asset price decline; they account for almost a third of all daily trading activity in the US and unwinding their positions could become very stressful for the market in terms of the sudden and massive withdrawal of liquidity.[9] Hedge funds account for a significant amount of trading volumes despite the fact that the amount of assets under management remains globally small compared to pension and mutual funds.[10] Micro-prudential risks may come from hedge funds' internal risk management and valuation procedures that are less than robust. Although the collapse of most hedge funds need not be systemically significant,[11] the above-mentioned concerns about linkages – especially due to leverage, the withdrawal of liquidity, and the potential exacerbation of asset price collapses due to the difficulty in valuing illiquid hedge fund positions[12] – could entail wider stress on the rest of the financial sector.

Next, the Commission highlights that alternative investment funds may be inadequately robust in protecting and being accountable to their investors. Although shortfalls in investor protection and investor losses may not necessarily trigger systemic risk, widespread investor losses could have an impact on liquidity in the markets. Further, if investor losses result from the exposure of pension funds or insurance companies,[13] these losses may be indirectly borne

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[9] See THOMPSON, *op. cit.*

[10] See OPPOLD, *The Changing Landscape of Hedge Fund Regulation: Current Concerns and a Principle-Based Approach*, 10, in *University of Pennsylvania Journal of Business and Employment Law* 833, 2008, suggests that up to half of global equity trading is undertaken by hedge funds.

[11] The International Financial Services London (IFSL) highlights, in its 2010 Hedge Funds Report that, during the global financial crisis, assets under management declined by 30% for hedge funds and more than 1000 funds were wound up. See IFSL, *Hedge Funds 2010*, London, April 2010, *in IFSL Research Report*. Hence, the collapse of most funds is of insufficient systemic impact, see SNEERINGER, *The Lesson of Goldstein v. SEC: If At First You Do Not Succeed, Regulate Again?*, 36, in *Capital University Law Review,* 2008, p. 1173,; SHADAB, *The Law and Economics of Hedge Funds: Financial Innovation and Investor Protection*, 6, in *Berkeley Business Law Journal*, 240, 2009. However, fears of systemic risk led to a bailout for LTCM in 1998 and the Bear Stearns hedge funds in 2007, see CRUTCHFIELD GEORGE - DYMALLY - BOSS, *The Opaque and Under-Regulated Hedge Fund Industry: Victim or Culprit in the Subprime Mortgage Crisis?*, 5, in *New York University Journal of Law and Business,* 2009, p. 359.

[12] See KAAL, *Hedge Fund Valuation: Retailization, Regulation, and Investor Suitability*, 28, in *Review of Banking and Financial Law*, 581, 2009; SKLAR, *Hedges or Thickets: Protecting Investors from Hedge Fund Managers' Conflicts of Interest*, 77, in *Fordham Law Review,* 2009, p. 3251

[13] Widely documented in the US, see PIERRE-LOUIS, *Hedge Fund Fraud and the Public Good*, 15, in *Fordham Journal of Corporate and Financial Law,* 21, 2009; HALL, *The Elephant in the Room:*

by individual savers and the wider public may thus be brought into exposure with alternative investment funds. In this way, any shortfalls in investor protection in the alternative investment fund market could arguably have an impact on a systemic or social scale.

Further, the Commission is of the view that the use of strategies by hedge funds, such as short selling, and the general opacity in hedge fund strategies, which may involve market abuse, are reasons for greater regulatory scrutiny of hedge funds. These risks are largely to be overcome by mandatory disclosure regimes, in the Regulation on Short Selling and Certain Aspects of Credit Default Swaps 2010,[14] as well as in the Directive for Alternative Investment Fund Managers that will be discussed in detail shortly. The general transparency of alternative investment funds is also thought to be important for systemic risk oversight.[15]

The Commission is also particularly concerned about hedge funds building stakes in companies to carry out activism in order to make short-term gains in 'value extraction'.[16] Hedge funds can also take positions which lead them to vote against the common welfare of their investee companies, as in cases where an acquisition may be imminent.[17] Finally, the Commission is of the view that private equity funds may load investee companies with debt and subject them

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Dangers of Hedge Funds in our Financial Markets, 60, in *Florida Law Review,* 2008, p. 183; JONNA, *In Search of Market Discipline: The Case for Indirect Hedge Fund Regulation*, 45, in *San Diego Law Review,* 2008, p. 989; SKLAR, *op. cit.*

[14] See COMMISSION, *Proposal for a Regulation of the European Parliament and of the Council on Short Selling and certain aspects of Credit Default Swaps*, COM/2010/0482 final, and Regulation (EU) No 236/2012 of the European Parliament and the Council of 14 March 2012 on short selling and certain aspects of Credit Default Swaps (OJ L 86/1)

[15] See WAGNER, *op. cit.*

[16] See CHIU, *Foundations and Anatomy of Shareholder Activism,* Oxford: Hart Publishing 2010, ch. 3.

[17] See discussion of the Mylan Laboratories episode, OPPOLD, *The Changing Landscape of Hedge Fund Regulation: Current Concerns and a Principle-Based Approach,* 10, in *University of Pennsylvania Journal of Business and Employment Law,* 833, 2008; SAMI, *A Comparative Analysis of Hedge Fund Regulation in the United States*, 29, in *Northwestern Journal of International Law and Business*, 275, 2009. Empty voting was first discussed as a potential concern in HU - BLACK, *Hedge Funds, Insiders, and Empty Voting: Decoupling of Economic and Voting Ownership in Public Companies*, 13, in *Journal of Corporate Finance,* 2007, p. 343; HU - BLACK, *Empty Voting and Hidden (Morphable) Ownership: Taxonomy, Implications, and Reforms*, 61, in *Business Lawyer,* 2006, p. 1011.

to stressful debt management,[18] including redundancies. Such behaviour may affect a significant economic population where buy-outs relate to public companies that are important employers. The practices of alternative investment funds, especially in relation to leverage management, could generate social costs, such as job or asset stripping of the general corporate sector.

Not all of the Commission's regulatory objectives relate to systemic risk oversight and maintaining financial stability. Some issues are actually longstanding issues relating to market failures in investor and stakeholder protection.[19] However, the resurgence of public regulatory power in financial regulation has provided the opportunity for a range of different issues to be dealt with at the same time and to be ultimately legislated. It has however been critically commented[20] that some of these concerns are overstated, for example, in relation to the leverage employed by hedge funds as well as concerns relating to market manipulation or abusive forms of shareholder activism. The regulatory regime for alternative investment fund managers will now be critically explored.[21]

2. The regulatory regime in the EU for alternative investment fund managers, the Alternative Investment Fund Managers Directive ('AIFM Directive'), covers managers of hedge and private equity funds, as well as unregulated collective investment schemes marketed in the EU, whether the funds are themselves established in the EU or elsewhere.[22] Article 2(3) contains some absolute exemptions from the Directive, including sovereign wealth funds, pension

[18] See, for example, discussed in ORDOWER, *The Regulation of Private Equity, Hedge Funds, and State Funds*, 58, in *American Journal of Comparative Law*, 2008, p. 295.

[19] For a balanced overview of the reasons for regulating alternative investment fund managers, see FERRAN, *After the Crisis: The Regulation of Hedge Funds and Private Equity in the EU*, in *European Business Organisations Review*, 380, 2011.

[20] See AWREY, *The Limits of Hedge Fund Regulation,* 5, in *Law and Financial Markets Review*, 2011, p. 119.

[21] For an overview of the AIFM Directive, also see WYMEERSCH, *The European Alternative Investment Fund Managers Directive*, in Eddy Wymeersch (ed), *Alternative Investment Fund Regulation,* Alpen aan den Rijn: Wolters Kluwer, 2012, at ch. 18, p. 433 ff.

[22] See EUROPEAN PARLIAMENT and COUNCIL DIRECTIVE 2011/61/EU of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010 [2011] OJ L174/1 (AIFM Directive), art 2(1).

schemes, fund management by central banks, supranational or national institutions, and securitisation special purpose vehicles. Member states are responsible for authorising the operation of alternative investment fund managers and are given discretionary powers to exempt fund managers who are managing leveraged funds less than 100 million euros in assets or unleveraged close-ended funds with assets less than 500 million euros.[23] The AIFM Directive is generally a maximum harmonisation measure but it cannot avoid providing for specific instances of discretionary exercise of power for national regulators, such as under Article 3 where exemptions may be made.

The UK has an active market in non-UCITS collective investment schemes aimed at retail investors, which will now have to be subject to the AIFM Directive.[24] The AIFM Directive is aimed at the wholesale investment sector, but Member States may allow marketing of alternative investment funds to retail investors, subject to more stringent rules and upon notification to the Commission and to ESMA.[25] It is nevertheless noted that the decision to allow retail marketing under more stringent national rules does not require the approval of the Commission or ESMA, and hence regulatory divergences in this area may continue to exist. It may be argued that each national regulator is able to assess the needs of the retail market and, as such, this responsibility need not be centralised. Indeed, the lack of centralisation at the EU level need not be adverse to consumer protection. However, as alternative investment funds are entitled to an EU passport for marketing, as will be discussed later in this Article, would such funds be marketable to another EU retail market? The Directive does not seem to forbid this and there are no provisions allowing host Member States to

[23] See AIFM Directive, art 3, calculated on an annual basis, as per ESMA's technical advice to the European Commission. See ESMA, *Final Report: ESMA's Technical Advice to the European Commission on Possible Implementing Measures of the Alternative Investment Fund Managers Directive*, 16 November 2011, ESMA/2011/379 available at *www.esma.europa.eu*.
[24] See FCA, *Handbook* (as of 30 April 2013, formerly FSA Handbook) COLL 1.2.2. See background discussion in FSA, *Implementation of the Alternative Investment Fund Managers Directive*, 2012, DP12/01 available at *www.fsa.gov.uk* and *Implementation of the Alternative Investment Fund Managers Directive*, CP12/32, 2012, ch. 2.23, available at *www.fsa.gov.uk*.
[25] See AIFM, *Directive*, art 43.

exercise further discretion with respect to the marketing of the fund to their own retail market. Will the initial approval of the fund by the home Member State be able to take into account concerns any host Member State may have in relation to the latter's retail market? As one of ESMA's key missions is to develop consumer protection policy,[26] it is questioned whether such decentralisation of oversight of marketing regimes for non-UCITS collective investment schemes is in the interests of consumer protection. Further, large scale failures in consumer protection could become an issue for systemic risk.[27]

Article 6 provides that authorisation for alternative investment fund managers (AIFM) is required in order for them to manage one or more alternative investment funds (AIF) whether or not such AIF is established in the EU or in another jurisdiction. The core management function may be supplemented by additional functions as may be approved.[28]

3. The imposition of prudential and risk management regulation on alternative investment funds may be justified by the post-crisis emphasis on the financial stability objective and the need for systemic risk monitoring and control. However, there is arguably also a European integration agenda behind the current legislative provisions. This section will now examine the prudential and risk management provisions in the AIFM Directive in order to critically understand the nature of governance in these provisions and the dilemmas between competing rationales in financial regulation in the EU.

Capital adequacy requirements are imposed in respect of initial capital, own funds, and additional own funds, in relation to potential liability for profes-

[26] See EUROPEAN PARLIAMENT AND COUNCIL REGULATION (EU) 1095/2010 of 24 November 2010 establishing a European Supervisory Authority (European Securities and Markets Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/77/EC [2010] OJ L331/84 (ESMA Regulation 2010), art 9.
[27] See GERDING, *The Subprime Crisis and the Link between Consumer Financial Protection and Systemic Risk,* 5, in *Florida International University Law Review,* 2009, p. 93.
[28] See AIFM, *Directive*, art 6(4).

sional negligence.[29] The initial capital requirements for an AIFM, which is internally managing its AIF, is set at 300,000 euros, while the initial capital requirements for an AIFM that is externally managing one or more AIFs is set at 125,000 euros. Internally managed hedge funds are generally 'funds of funds' which invest in a portfolio of hedge funds. Where funds of hedge funds are concerned, the opacity of investing in fellow hedge funds, the pervasive lack of due diligence, the layers of fees upon fees of hedge funds and the requirement to commit substantial amounts to each fund, are factors that have not necessarily helped funds of hedge funds manage risk or perform better.[30] The higher initial capital requirement may reflect the inherent riskiness of funds of hedge funds.

Where the portfolio of an AIFM exceeds 250 million euros, an extra 0.02 per cent of own funds must be set aside for capital adequacy, a requirement that is consistent with that applied to UCITS.[31] However, Member States may allow up to 50 per cent of such own funds to be provided for in the form of a guarantee by a credit institution or an insurance undertaking registered in the EU or in a third country whose prudential regulations are equivalent to those of the EU.[32] This is a curious discretionary power, as linkages could then be encouraged between banks and insurance institutions and alternative investment funds, on top of other relationships in leverage and prime brokerage. This also means that banks and insurance companies may be liable to top up the capital adequacy of hedge funds if capital runs low. It is queried whether this provision is sound given that one symptom of systemic risk is the potential contagion effect among financial institutions due to linkages. If the guarantee exposures become significant or concentrated, this could be a source for systemic concerns. The authors caution that there may be unintended consequences in providing that AIFMs could seek recourse to guarantees provided by banks or

[29] See AIFM, *Directive*, art 9.
[30] See KAT - PALARO, *Replication and Evaluation of Fund of Hedge Funds Returns*, in *Alternative Investment Research Centre Working Paper No 28,* 2006, available at *ssrn.com*.
[31] See AIFM, *Directive*, art 9(3).
[32] See AIFM, *Directive*, art 9(6).

insurers in order to maintain solvency. Adequate capitalisation of AIFMs may mitigate failures of AIFMs, but it may be undesirable to involve banks and insurers in capitalising AIFMs. The authors query whether the legal integration impetus has slightly overtaken the needs of financial stability underlying the micro-prudential regime for AIFMs here.

Article 9(7) further provides that additional own funds will be required of alternative investment funds, for the purposes of addressing the risks of liability for professional negligence in fund management.[33] ESMA has prescribed 0.01 per cent of the value of the portfolios managed by the AIFM in additional own funds to cover professional liability risk.[34] Such own funds may however be replaced by professional indemnity insurance of an equivalent value.[35] This measure arguably foresees the possibility of increased civil litigation against hedge funds by professional investors as a form of market discipline.[36] The authors are of the view that such market discipline is generally a positive development. In light of the investor protection requirements in the AIFM Directive that will be discussed below, and the increased transparency and accountability to investors, investor litigation is likely to be more highly supported than before as a measure of fund accountability. As much as litigation

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[33] Professional liability is identified as negligence *vis-à-vis* clients, or in respect of business disruption, or in respect of business losses caused by fraud or dishonesty where senior management has negligently failed to maintain adequate internal controls or risk management. See ESMA, *Final Report: ESMA's Technical Advice to the European Commission on Possible Implementing Measures of the Alternative Investment Fund Managers Directive*, ESMA/2011/379 available at *www.esma.europa.eu.*

[34] See ESMA, *Final Report: ESMA's Technical Advice to the European Commission on Possible Implementing Measures of the Alternative Investment Fund Managers Directive*, ESMA/2011/379 available at *www.esma.europa.eu*. This is now adopted by the European Commission, see Commission Delegated Regulation (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 14.

[35] The coverage of liabilities and amount covered are also prescribed in ESMA, *Final Report: ESMA's Technical Advice to the European Commission on Possible Implementing Measures of the Alternative Investment Fund Managers Directive*, ESMA/2011/379 available at *www.esma.europa.eu*. This is now adopted by the European Commission, see Commission Delegated Regulation (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 15.

[36] See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 12 that sets out the circumstances under which professional liability may be incurred.

entails legal risk for hedge funds, it also allows bottom up reflexive governance forces to work in the regulatory landscape. However, the exposure of insurance companies to the capital adequacy needs of alternative investment funds in providing professional indemnity insurance should be considered from the perspective of whether systemic risk may be exacerbated. If there is concentration in the market for insurers of hedge funds, as was the case with AIG and credit default swaps, systemic risk concerns could ensue. Further, systemic risk concerns could also arise if insurance companies end up taking on a significant volume of such business.

The authors are of the view that the nature of regulation in areas of organisation and structure of investment firms and funds generally reflects the treatment of risk management regulation as an extension of prudential concerns. This approach is taken in the AIFM Directive as well. Part 3 will make this argument in greater detail and explore the proliferation of risk management regulation in relation to investment firms generally in the post-crisis era.

In the AIFM Directive, Article 18 provides for general principles of organisational soundness, such as sound administrative and accounting procedures, control and safeguard arrangements for electronic data processing and adequate internal control mechanisms. These are largely similar to general organisational requirements imposed for all investment firms under the Markets in Financial Instruments Directive 2004,[37] suggesting that regulatory harmonisation is an important driver behind organisational and risk management regulation in the AIFM Directive. ESMA recommends[38] that sound organisational arrangements refer to clear decision-making procedures and re-

[37] See EUROPEAN PARLIAMENT and COUNCIL DIRECTIVE 2004/39/EC 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 [2004] OJ L145/1 (Markets in Financial Instruments Directive, MiFID), art 13.

[38] See ESMA, *Final Report: ESMA's Technical Advice to the European Commission on Possible Implementing Measures of the Alternative Investment Fund Managers Directive*, ESMA/2011/379 available at *www.esma.europa.eu*. This is now adopted by the European Commission, see Commission Delegated Regulation (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 57.

porting lines, employment of competent staff and staff training, adequate internal control mechanisms, sound accounting policies, information flows, adequate record keeping, business continuity policies and regular review, and senior management oversight of key issues such as investment strategies and risk profile. Requirements under MiFID, such as the institution of a permanent and effective compliance function, have also been imported,[39] as has the permanent internal audit function.[40] The boosting of internal control within financial institutions is a key theme in post-crisis reforms, as regulators seek to address the financial stability regulatory objective by enhancing regulatory standards and supervision as well as improving overall internal monitoring within firms.

Further, the AIFM Directive requires the functional separation of risk management from portfolio or other operational functions of the AIFM.[41] This does not mean that risk management must be departmentally separate, as this may be disproportionate to the scale, size and complexity of the fund. However, the risk management function must be permanent and free from conflicts of interest.[42]

The risk management function is responsible for developing an adequate policy to identify the prudential risks AIFMs face and the appropriate measures that need to be taken to secure the prudential position of AIFMs so that they

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[39] See ESMA, *Final Report: ESMA's Technical Advice to the European Commission on Possible Implementing Measures of the Alternative Investment Fund Managers Directive*, ESMA/2011/379 available at *www.esma.europa.eu,* 101. This is now adopted by the European Commission, see Commission Delegated Regulation (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 61.

[40] See ESMA, *Final Report: ESMA's Technical Advice to the European Commission on Possible Implementing Measures of the Alternative Investment Fund Managers Directive*, ESMA/2011/379 available at *www.esma.europa.eu,* 104. This is now adopted by the European Commission, see Commission Delegated Regulation (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 62.

[41] See AIFM, *Directive*, art 15.

[42] See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), arts 39, 42 and 43.

are in compliance with regulation.[43] The risk management function must also develop qualitative and quantitative risk-taking limits[44] that are consistent with the risk profile disclosed to investors.[45] Article 15 also requires that risk management in relation to assessing and evaluating the AIF portfolios be documented, subject to due diligence and annual review by senior management.[46] These provisions are rather prescriptive in nature and represent a shift from the more meta-regulatory position taken under MiFID. These provisions may portend the shape of reforms in risk management regulation as MiFID is currently undergoing revision.

The next aspect of prudential oversight of AIFMs is regulatory monitoring of the amount of leverage employed by AIFs. AIFMs must establish a maximum amount of leverage to be employed for each AIF.[47] This prescriptive requirement clearly shows that regulators are concerned with the implications of hedge funds' use of leverage and how it may create future systemic risk effects. However, Awrey warns that interventions into leverage could cause premature systemic effects, exactly the consequence regulators wish to avoid.[48]

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[43] See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 40, 45.

[44] In respect of market, credit, liquidity, counterparty and operational risks as identified in ESMA, *Final Report: ESMA's Technical Advice to the European Commission on Possible Implementing Measures of the Alternative Investment Fund Managers Directive*, ESMA/2011/379 available at *www.esma.europa.eu*, 67. This is now adopted by the European Commission, see Commission Delegated Regulation (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 44.

[45] See ESMA, *Final Report: ESMA's Technical Advice to the European Commission on Possible Implementing Measures of the Alternative Investment Fund Managers Directive*, ESMA/2011/379 available at *www.esma.europa.eu,* 62. This is now adopted by the European Commission, see Commission Delegated Regulation (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 44(3).

[46] See ESMA, *Final Report: ESMA's Technical Advice to the European Commission on Possible Implementing Measures of the Alternative Investment Fund Managers Directive*, ESMA/2011/379 available at *www.esma.europa.eu,* 67. The responsibility to review is found in Commission Delegated Regulation (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 41.

[47] See AIFM, *Directive*, art. 15(4).

[48] See AWREY, *op. cit.*

On the whole, the regulatory regime for AIFMs prescribes in greater detail than under MiFID the operations and responsibility of internal control in order to enhance the prudential oversight of AIFMs. This approach however remains meta-regulatory in nature as AIFMs are still responsible for determining the risk limits, the risk management policy and how functional and hierarchical separation is to be achieved.

Even if internal control, such as compliance, internal audit and risk management, were made independent from the operational and business units of the AIFM, regulators should perhaps be healthily sceptical of the governance that can be provided by these 'internal partners' in governance. Organisation studies have shown that internal control functions, such as the internal audit, are starting to achieve a distinctive culture and purpose from the organisation they are situated in. Nevertheless, depending on management practices and pressures, they may still be influenced by general organisational and management culture.[49] In some organisations, taking on a role in internal control is part of an employee's rotating experience in the whole organisation[50] or regarded as a relatively minor or peripheral unit.[51] Hence, it remains to be seen if internal control functions may effectively develop a distinct identity and purpose and provide the governance that assists in meeting regulatory objectives. Regulatory supervision is likely to be necessary in monitoring the internal control functions themselves.

Except for the management of unleveraged close-ended AIFs, Article 16 of the AIFM Directive provides that AIFMs must have liquidity management sys-

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[49] See PFISTER, *Managing Organizational Culture for Effective Internal Control*, Berlin & Heidelberg: Physica-Verlag, 2009, generally; MACEWAN WRIGHT, *Internal Audit, Internal Control and Organizational Culture*, DPhil thesis, Victoria University 2009, available at *vuir.vu.edu.au*, with empirical research into three case studies where internal audit personnel were interviewed and the organisational cultures of the relevant firms investigated. See also HALA, *If Capitalists were Angels – An Interview with Sherron Watkins on the Fall of Enron*, 60, in *Internal Auditor*, 38, 2003, on how organisational and management culture compromised internal controls.

[50] See MESSIER JR and OTHERS, *The Effect of Using the Internal Audit Function as a Management Training Ground on the External Auditor's Reliance Decision*, 86, in *The Accounting Review*, 2011, p. 2131.

[51] See, for example, PICHET, *What Governance Lessons Should Be Learnt from the Société Générale's Kerviel Affair*, 3, in *La revue française de gouvernance d'entreprise*, 2008, p. 117.

tems and procedures and must regularly stress test their systems and procedures. ESMA specifies that AIFMs should establish a liquidity policy to manage the liquidity risks arising from different profiles of assets and to monitor the liquidity risks of each AIF under management.[52] Liquidity management includes setting limits the compliance with which needs to be maintained and monitored, and carrying out appropriate and regular stress-testing of each AIF's liquidity positions.[53]

Liquidity buffers have been argued to be an important tool in mitigating risk where capital adequacy requirements may place stress on financial institutions having to liquidate assets in a declining price situation.[54] Further, even if a crisis is more of a 'capital' crisis than a liquidity crisis, liquidity buffers could provide a cushioning period that may affect market confidence less adversely.[55] However, another commentator is of the view that liquidity buffers are only effective against relatively minor liquidity squeezes.[56]

Compared to the rather prescriptive liquidity standards under the international leadership of the Basel Committee,[57] the liquidity management provisions in the AIFM Directive seem more open-ended in nature, leaving AIFMs to determine the appropriate liquidity levels to maintain. As AIFMs have

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[52] See ESMA, *Final Report: ESMA's Technical Advice to the European Commission on Possible Implementing Measures of the Alternative Investment Fund Managers Directive*, ESMA/2011/379 available at *www.esma.europa.eu*, 76. This is adopted in Commission Delegated Regulation (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 47.

[53] See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 48 which deviates slightly from ESMA's advice, see ESMA, *Final Report: ESMA's Technical Advice to the European Commission on Possible Implementing Measures of the Alternative Investment Fund Managers Directive*, ESMA/2011/379 available at *www.esma.europa.eu*, p. 80.

[54] See CIFUENTES - FERRUCCI - SONG SHIN, *Liquidity Risk and Contagion*, 3, in *Journal of the European Economic Association*, 2005, p. 556.

[55] See LASTRA - WOOD, *The Crisis of 2007-09: Nature, Causes, and Reactions*, 13, in *Journal of International Economic Law*, 2010, p. 531.

[56] See RATNOVSKI, *Liquidity and Transparency in Bank Risk Management*, in *IMF Working Paper*, 2007, available at *papers.ssrn.com*.

[57] See BASEL COMMITTEE ON BANKING SUPERVISION, *Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring*, Basel: BIS 2010, available at *www.bis.org*, now amended by BASEL COMMITTEE, *Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools*, Basel: BIS 2013, available at *www.bis.org*.

different and more focused business models than universal banks, a slightly decentralised approach to setting liquidity management rules may be more nimble and appropriate for national regulators. However, if the illiquidity risks of AIFMs pose systemic risk, as discussed above, this also means that there needs to be dynamic and continuous regulatory supervision of liquidity management at the national and EU levels. Allen and Carletti,[58] for example, argue that banks hoarding liquidity in situations of stress may protect themselves but may adversely affect other deficient but solvent banks. Hence, the balance between hoarding and lending needs to be dynamically considered in a wider context by regulators, as individual institutions would not be able to take this collective view.[59] It is unclear if the AIFM Directive envisages liquidity monitoring for such broader concerns or is taking a narrower perspective in relation to the risks to the fund as such.

Article 13 provides that AIFMs should establish remuneration policies and practices 'that are consistent with and promote sound and effective risk management'. Financial sector remuneration policies have now become a matter of prudential concern. The Geneva Report on Financial Regulation produced in 2009[60] reflects upon the global financial crisis and possible causes and reforms and points out that inappropriately structured remuneration packages gave rise to incentives on the part of bank staff to take excessive risks. Bank/financial institution remuneration packages are argued to have contributed to weak risk management[61] in financial firms and where the same flaw appears in many financial institutions, this results in systemic risk effects in economic systems.[62] The connection between remuneration policies and risk management is now le-

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[58] See ALLEN and CARLETTI, *The Role of Liquidity in Financial Crises*, September 2008, available at *ssrn.com*.
[59] See CIFUENTES - FERRUCCI - SONG SHIN, *op. cit.*
[60] See BRUNNERMEIER and OTHERS, *The Fundamental Principles of Financial Regulation*, Geneva Reports on the World Economy, London: Centre for Economic Policy Research 2009.
[61] See COMMISSION, *Green Paper on Corporate Governance in Financial Institutions*, COM(2010) 284 final, para 3.1.
[62] See BRUNNERMEIER and OTHERS, *op. cit.*

galised in the Capital Requirements Directive 2010.[63] Ferranini and Ungureanu argue that 'The short-term approach in banks' remuneration policies contributed to [the global financial crisis], undermining the safety and soundness of banks.'[64]

The scope of application of Article 13 extends to 'senior management, risk takers, control functions and any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers, whose professional activities have a material impact on the risk profiles of AIF they manage', consistent with the above-mentioned Capital Requirements Directive 2010 and the UK Remuneration Code in SYSC 19A applying to other financial institutions. Detailed remuneration rules for AIFMs are set out in Annex II of the AIFM Directive, which also by and large dovetail the requirements in the Capital Requirements Directive 2010. Nevertheless, the authors query whether the streamlining of remuneration policy regulation across banks, financial institutions and AIFMs is necessary.

On the one hand, it may be argued that since remuneration policies are regarded as affecting the character of micro-prudential regulation, a consistent approach should be taken in all parts of the financial sector in the EU. This would be in line with the comprehensive vision for EU legal integration set out in the de Larosière Report. However, remuneration policies in AIFMs may be less of a systemic issue than in universal banks and other financial institutions, as AIFM remuneration may be subject to some investor oversight. As AIFMs are by and large exclusively marketed to professional investors (unless Article 41 applies), professional investors may be able to influence remuneration policies if

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[63] See EUROPEAN PARLIAMENT AND COUNCIL DIRECTIVE 2010/76/EU of 24 November 2010 amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies [2010] OJ L329/3 (Capital Requirements Directive 2010), art 1(3) and Annex I pt 1 (amending European Parliament and Council Directive 2006/48/EC of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) [2006] OJ L177/1 (Capital Requirements Directive 2006), art 22 and Annex V pt 11 respectively).

[64] See FERRANINI - UNGUREANU, *Executive Pay at Ailing Banks and beyond: A European Perspective*, 5, in *Capital Markets Law Journal*, 2010, p. 197, p. 202.

it is perceived that such policies affect investment returns on the relevant AIFs managed. There is perhaps room to argue that transactional governance between investors and AIFMs could affect how much AIFMs are rewarded. This is to be distinguished from remuneration policies in universal banks, for example, where shareholders still struggle to influence pay.

Further, as AIFMs generally have a vested interest and their incentives are aligned with the investors' (to pursue investment performance), generous remuneration policies may be perceived as providing the right incentives for investor protection. There is arguably potential for reflexive bottom-up forces that can be exerted by investors in establishing the appropriate levels of remuneration of the AIFM in relation to each AIF.[65] Article 22(2)(e) and (f) state that information on total and aggregate remuneration should also be provided to investors.[66] Such information should be presented in relation to each AIF.[67] In this area, investors are likely to be interested in the transfer of wealth to AIFMs and so information including a breakdown by AIF would be helpful in facilitating investor-led governance. The authors are of the view that a convincing connection still has to be made for any systemic impact of AIFM remuneration policies in relation to each AIF. Indiscriminate convergence in remuneration regulation should not be sought for legal integration as an end in itself.

AIFMs must provide information to Member State regulators regarding their investment strategies and Member State regulators may restrict the use of

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[65] See MALAGUTI, *Private-Law Instruments for Reduction of Risks on International Financial Markets: Results and Limits of Self-Regulation*, 11, in *Open Economies Review*, 2000, p. 247; BRADLEY, *Private International Law Making for the Financial Markets*, 29, in *Fordham International Law Journal*, 2005, p. 127.

[66] This is supplemented by COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), arts 107-108.

[67] See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 107(3), deviating from ESMA's advice, see ESMA, *Final report: ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive*, ESMA/2011/379, p. 227, available at *www.esma.europa.eu*.

certain strategies in relation to any AIFs managed by the AIFMs.[68] The power to impose restrictions upon AIFMs in managing AIFs is discretionary in nature, but the Commission has set out in a supplemental Regulation[69] the considerations upon which the discretion may be exercised. These conditions generally relate to concerns for financial stability and the materialisation of systemic risk. This is representative of the pre-emptive governance which post-crisis reforms seek to introduce in the interests of monitoring systemic risk and financial stability. Short selling restrictions may be imposed from time to time by regulators, as may restrictions upon leverage (e.g. Article 25(3)), as these are often seen to be connected to systemic risk. Wymeersch however cautions that the imposition of discretionary leverage limits by national regulators upon particular funds may cause distortions in the market and inconsistency in practice in the EU.[70]

Where private equity funds are concerned, leverage is key to making private equity deals possible in the first place,[71] but the leverage is not taken at the fund level, but by the companies to be invested in. Article 25(3) seems only to deal with fund level leverage and hence does not *prima facie* deal with the investee company's leverage. In the latter case, arbitrary regulatory intrusions may be inappropriate. However, excessive leverage, usually borne by the company, and not the fund, may cause undue hardship to stakeholders, such as employees, if the company hits hard times. The restrictions upon leverage in Article 25(3) possibly only relate to hedge funds; private equity funds, even if they employ leverage at fund level, are not likely to have a systemic impact due to their close-ended nature. Moreover, as will be discussed later, stakeholder pro-

[68] See AIFM, *Directive*, art 8(4).

[69] See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 112(3).

[70] See WYMEERSCH, *The European Alternative Investment Fund Managers Directive*, in Eddy Wymeersch (eds.), *Alternative Investment Fund Regulation*, Alpen aan den Rijn: Wolters Kluwer, 2012, at ch18, p. 454.

[71] See PAYNE, *Private Equity and its Regulation in Europe*, 12, in *European Business Organization Law Review*, 2011, p. 559.

tection in companies invested by private equity funds does not address the issue of leverage.

Article 17 is a reactive provision to the key cause of the financial crisis: investments in complex securitised debt obligations. Article 17 disallows AIFMs to invest in securitised products where the originator of such products does not retain at least a 5 per cent net economic interest in the underlying securities or financial instruments. Further, AIFMs must undertake due diligence concerning the credit policy of the originator of securitised obligations[72] and must ensure that they have a thorough understanding of those positions and have implemented formal policies and procedures appropriate to the risk profile of the relevant AIFs under management. [73] These investments should also be subject to regular stress testing and review, and to be reported to senior management.[74]

These direct interventions into portfolio management by AIFMs probably showcase the most intrusive aspects of the new pre-emptive governance architecture. However, as this Article will go on to discuss, robust supervisory monitoring requires adequate information surveillance, but the reporting obligations in the AIFM Directive seems to have become excessively focussed on investor protection and are comparatively lighter in terms of returns for regulators. This discrepancy should arguably be addressed in light of the systemic risk monitoring that regulators need to carry out in order to consider if any of the pre-emptive powers mentioned in this section should be exercised.

[72] See ESMA, *Final report: ESMA's technical advice to the European Commission on possible implementing measures of the Alternative Investment Fund Managers Directive,* ESMA/2011/379, p. 91, available at *www.esma.europa.eu*, adopted in COMMISSION DELEGATED REGULATION (EU), 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 52.

[73] See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 53.

[74] See ESMA, *Final, op. cit.,* 93 - 96, adopted in COMMISSION DELEGATED REGULATION (EU), 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 53(2)-(6).

Article 20 subjects the outsourcing of risk management or portfolio management by AIFMs to approval by Member State regulators. Such outsourcing must be justified with objective reasons.[75] The AIFMs that intend to delegate functions must also ensure that the outsourcee's has sufficient expertise and resources and the persons who effectively conduct business have adequate experience, knowledge and skills, as well as good repute. [76] Written arrangements must also be put in place between the home state regulator for the AIFM and the supervisory authority for the outsourcee so that information exchange and coordinated supervisory activities can be carried out.[77] The AIFM must also satisfy its home regulator that that outsourcing will not impede effective supervision of the AIFM.[78] The sub-delegates and further delegates of outsourcees are *mutatis mutandis* subject to the same rules as above.

AIFMs need to ensure that delegation does not affect their obligations to comply with the regulatory regime or their duties to their investors, and that the arrangements between the AIFMs and their outsourcees would not affect the due and expedient discharge of the AIFMs' functions.[79] Delegation should also be managed such that the AIFM retains oversight of the delegated functions, ensuring continuity and quality in the performance of tasks, information reporting from the delegate, the protection of confidential information and the introduction of a contingency plan for disaster recovery. AIFMs are however not

[75] Set out in COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 76, as based on ESMA's advice, see ESMA, *Final, op. cit.,* p. 122. The criteria are set out in Box 65, p. 126, relating mainly to cost saving and expertise.

[76] See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 77, adopting ESMA, *Final, op. cit.*, pp. 129 - 130.

[77] See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 78(3).

[78] See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 79.

[79] See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 75.

allowed to outsource portfolio or risk management functions to the same institution that undertakes its depositary functions or where conflicts of interest may be present unless well managed.[80]

Where an AIFM delegates so excessively that it becomes only a letter-box entity, Member State regulators may consider the AIFM no longer to be the actual fund manager of the AIFs and may require the outsourcee to be subject to the regulatory regime instead.[81]

Outsourcing could create layers of supervisory complexity for regulators but it is often efficient in market practice to do so. Regulatory control of outsourcing and delegation is arguably used by regulators to maintain effective information surveillance over AIFMs. However, regulatory oversight seems to concentrate on the establishment of the outsourcing agreement, while AIFMs are responsible for ongoing monitoring of the outsourcees/delegates. The AIFMs' ongoing monitoring of outsourcees and review of risk is imposed as a duty, but curiously these procedures are not part of the regular reports that must be sent to regulators under Article 24.[82] Hence, there is a risk that although the AIFM Directive provides a framework for AIFMs to monitor and review outsourcees/delegates, the implementation of that framework may become self-regulatory. It is proposed that disclosure to regulators be bolstered in terms of AIFMs' ongoing monitoring and review of their outsources /delegates, especially if outsourcing involves risk management which is regarded as an important part of prudential regulation.

[80] See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 80.
[81] See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 82 provides for the circumstances where an AIFM should be regarded as having become a letter-box entity.
[82] Supplemented by COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 110, in which there is no mention of reporting on outsourcing activities.

On the whole, the prudential and risk management regulation imposed on AIFMs features a fair amount of discretionary implementation by AIFMs. This is a meta-regulatory framework and should be supplemented by a fair amount of regulatory supervision. Regulators have to be mindful that dynamic and continuous supervision needs to be carried out in order to prevent meta-regulatory mechanisms from becoming self-regulatory. However, the authors are of the view that reporting to regulators seems a little thin to support the extent of regulatory supervision that may be required. We query whether regulators would devote significant resources to policing AIFMs or in fact leave much enforcement to market discipline. If the latter approach is to be relied on, then the regulation of the AIFM will evolve into a largely investor protection measure, perhaps de-emphasising the financial stability narrative that underlined its conception. Further, the authors are also of the view that the regulatory regime is highly influenced by the impetus for legal integration, securing legal harmonisation with the MiFID or UCITS Directives. Such harmonisation, such as in the regulation of remuneration policies, may not always be warranted as the regulation of AIFMs could be tailored to unique aspects of the AIFMs that relate to financial stability concerns.

The levels of leverage and counterparties involved in the leverage exposure of AIFs managed by AIFMs are, as mentioned above, regarded as important to systemic risk monitoring.[83] Hence Article 24(4) and onwards of the AIFM Directive requires that AIFMs provide regulators with information on levels of leverage, breakdown of leverage, the five largest sources of borrowed cash or securities for each managed AIF, and other information that may be periodically required. Where leverage exceeds three times the net asset value of an AIF, Member State regulators are to consider such AIFs as employing substantial leverage and should monitor the relevant AIFMs more regularly by requiring

[83] See, for example, GIBSON, *Is Hedge Fund Regulation Necessary?*, 73, in *Temple Law Review*, 2000, p. 681; OESTERLE, *Regulating Hedge Funds*, 1, in *Entrepreneurial Business Law Journal*, 2006, 1; SAMI, *op. cit.*

half-yearly or quarterly reporting depending on the size of assets under management.[84] Member State regulators must also provide information to ESMA and the ESRB for systemic risk analysis and oversight.[85] Moreover, Member State regulators are empowered to impose restrictions[86] upon the use of leverage in appropriate cases, after informing ESMA and the ESRB.

Besides the leverage reporting mentioned above, AIFMs are required to make regular reports to Member State regulators as regards the profiles of the AIFs they manage, the principal instruments and markets traded in and, in particular, the liquidity profiles, results of regular stress testing, risk profiles and risk management policies, and the annual report containing details of financial performance of the AIFs managed.[87] The nature and management of assets in AIFs is perceived by regulators to be important to systemic risk, as trading activities affect liquidity in the markets. The disclosures made to regulators by AIFMs generally concern micro-prudential and balance sheet information, as these are usually regarded as most relevant to the financial soundness of firms. ESMA views the reporting of regulatory information to be crucial in identifying any systemic risk build-up[88] and in triggering the exercise of power to impose regulatory controls, such as to limit leverage under Article 25(3).[89] Where an AIFM manages total assets exceeding 100 million euros, or 500 million euros for close-ended funds of funds, the AIFM is subject to half-yearly reporting. Where an AIFM manages total assets exceeding 1 billion euros, or manages an AIF whose assets exceed 500 million euros, the AIFM is subject to quarterly report-

[84] See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 111.
[85] See AIFM, *Directive*, art 25(3)-(5).
[86] Discussed above under "*Restrictions on Investments or Investment Strategies*".
[87] See AIFM, *Directive*, art 24, supplemented by Commission Delegated Regulation (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 110.
[88] See ESMA, *Final, op. cit.,* p. 212.
[89] See ESMA, *Final, op. cit.,* pp. 214 - 215.

ing to the relevant Member State regulator.[90] Private equity funds are subject only to annual reporting.[91] The varying intensity of reporting requirements imposed on AIFMs reflect the systemic interest in the potential impact from failure of larger AIFMs. Awrey[92] queries whether the reporting regime adds anything more to the existing fabric of regulation in the UK to which hedge fund management activities are already subject. The authors also query whether the reporting requirements are too narrow in scope when compared to the range of information to be provided to investors, as will be discussed below. The information related to investor protection, such as valuation, may be useful in understanding asset profiles and could be useful in identifying signals of asset price problems.

Summing up the authors' views on the regime for prudential regulation in the AIFM Directive and the supplemental Commission Regulation, although the AIFM Directive has responded to the financial stability and systemic risk rationale for regulating alternative investment funds, the prudential regulatory regime tends to rely heavily on convergence with the UCITS and MiFID regimes. There is room for regulatory monitoring and discretionary powers to be exercised, especially in relation to the use of leverage, but it is queried as to how much regulatory resources would be devoted to supervising AIFMs in light of the regulators' likely reliance on market discipline, an issue which will be discussed below. The next Section will discuss the investor protection provisions and will argue that this seems to be the focus of the AIFM Directive. Although market failures in investor protection are linked to financial stability, we query whether the approach taken in the AIFM Directive is excessively focused on transactional and relational aspects (a historically dependent approach charac-

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[90] See COMMISSION DELEGATED REGULATION(EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 110(3).

[91] See COMMISSION DELEGATED REGULATION(EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 110(3)(d).

[92] See AWREY, *op. cit.*

terised by addressing agency problems and information asymmetry). We agree that involving the wholesale investment sector in the provision of more governance and discipline is a positive move, but we are concerned that regulators may become excessively entangled in investor rights and AIFM liability issues when the starting point for extending regulation to AIFMs relates to financial stability concerns. This may affect regulatory scrutiny for systemic risk issues and may undermine the move towards mobilising market discipline through investor actions. Further, the legal integration objective also looms large in the form of the AIFM passport, which has become an issue of contention and a target for industry lobbying. We are thus concerned that the regulatory regime has not been framed with its key objectives in mind.

4. The AIFM Directive has also taken the opportunity to enhance investor protection, said by commentators[93] to be inadequate if left to freedom of contract. Although investor protection concerns, such as valuation and side letters, were subject to critique prior to the global financial crisis, there was a lack of regulatory action until the post-crisis reforms. It seems to the authors that many of the improvements in investor protection introduced by the post-crisis reforms are not a response to the old arguments of market failure (which fell on deaf ears in the pre-crisis years too). Enhanced investor protection has in fact ridden on the back of the revitalisation of the financial stability objective in financial regulation[94] and has taken on a new, more protective, flavour. Even if enhanced investor protection could play a part in the overall systemic well-being of the financial sector,[95] investor protection is a different regulatory ob-

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[93] See, for example, KAAL, *Hedge Fund Valuation: Retailization, Regulation, and Investor Suitability*, 28, in *Review of Banking and Financial Law*, 581, 2009; SKLAR, *Hedges or Thickets: Protecting Investors from Hedge Fund Managers' Conflicts of Interest*, 77, in *Fordham Law Review*, 2009, p. 3251.
[94] See DUNCAN - CURTIN - CROSIGNANI, *Alternative Regulation: The Directive on Alternative Investment Fund Managers*, 6, in *Capital Markets Law Journal*, 2012, p. 326.
[95] As suggested in COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 17(1) that a

jective and could come to dominate the regulatory regime for AIFMs. Further, the conferment of investor rights could rejuvenate market discipline against AIFMs and create the effect of framing the regulatory interest over AIFMs as centred upon investor protection. We query whether regulators would increasingly rely on market discipline in enforcing the regulatory regime over AIFMs. If so, then the regulatory character of the AIFM Directive will change over time and financial stability monitoring may become de-emphasised.

Article 12 of the AIFM Directive lays down six general principles of conduct of business, that are fleshed out in detail by the supplemental Commission Regulation based on ESMA's technical advice.[96]

AIFMs owe legal duties in care, skill and diligence, to employ resources effectively for the performance of due functions, to manage conflicts of interest, to act in the best interests of investors, to comply with all regulatory requirements and to treat investors fairly.

The care and skill required on the part of AIFMs relate to acting honestly, fairly and with due skills.[97] Although these terms are widely-worded, the Commission Regulation that supplements the AIFM Directive refers to the following attributes: (a) the adequacy of the collective knowledge, skills and experience on the part of senior management; (b) sufficient time commitment by senior management; (c) the qualities of honesty, integrity and independence of mind on the part of senior management; and (d) devotion of time and resources to adequate training of staff.[98]

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failure of AIFMs to act in investors' best interests may adversely affect the stability and integrity of the financial markets.

[96] See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), arts 16-29, and ESMA, *Final, op. cit.*

[97] See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 21.

[98] See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), arts 21 and 22.

Diligence must be demonstrated in the selection and continuous monitoring of transactions undertaken in fund management and an adequate understanding of the assets invested in. Written policies and effective implementing arrangements must be put in place to discharge the duty of due diligence.[99] AIFMs are imposed with duties of due diligence in the following particular respects: (a) investing in assets of limited liquidity[100] and (b) selecting appropriate counterparties and prime brokers.[101] It is however noted that the duty of due diligence is not extended to the selection of outsourcees or to the valuation process, both of which may be related to investor protection. However, it may be argued that the valuation process is a highly prescribed one and failures to carry out valuation properly may still be subject to civil enforcement. The lack of attachment of the duty of diligence to valuation may not prejudice investors.

On the enforcement of the duties of care, skill and diligence, it is questioned whether regulators and courts will take an approach that focuses excessively on adherence and implementation of written policies. The requirement to put in place written policies on diligence, as mentioned above, allows compliance to be defined in very procedural terms. There are benefits and drawbacks to this. The UK's experience is that a procedural approach may allow regulators to take pre-emptive enforcement action[102] based on findings of unsatisfactory procedures, whether or not investor losses or complaints have ensued. However, this also means that regulatory inquiry may not go beyond looking at procedures and the spirit of diligence must thus be presumed from

[99] See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 18, adopting ESMA, *Final, op. cit.*, 42 (Box 11).

[100] See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 19.

[101] See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 20.

[102] FSA Enforcement against Wheatcroft Fox, July 2011.

procedural compliance. Instituting procedures may create its own perceived legitimacy[103] and shape regulatory acceptance of proceduralisation as adequate regulatory compliance. This problem is called 'legal endogeneity' and is discussed by Edelman[104] in relation to proceduralisation undertaken to comply with employment law. Further, a procedural approach could even affect judicial interpretation of diligence in civil law cases, as per the problem of legal endogeneity raised by Edelman and others.[105] Where UK case law is concerned, the court is unwilling to hold investment managers negligent for failure to predict general return patterns and risk materialisation, unless the investment manager falls below the reasonable standard of an investment banker.[106] Instituting standardised procedures could assist the industry in constructing a framework of what the industry perceives as 'reasonable standards' of care. The industry could thus be in a position to determine for itself the parameters of diligence.

UK courts also currently uphold contractual exclusions where financial institutions disavow having an advisory relationship with their professional clients, since professional investors rightly classified would have a certain amount of knowledge and sophistication in investment matters.[107] It is uncertain how the duty of diligence would be interpreted in such limited contractual relationships.

Further, the principles found in the AIFM Directive concentrate on post-sale diligence in fund management. But care, skill and diligence issues may occur at the stage of sale or distribution. The courts in the UK are keen to uphold investors' responsibilities for assessing risks at the point of sale and will not too

[103] See POWER, *Organised Uncertainty*, Oxford: Oxford University Press 2007.
[104] See EDELMAN and OTHERS, *When Organizations Rule: Judicial Deference to Institutionalized Employment Structures*, 117, in *American Journal of Sociology*, p. 888, p. 2911.
[105] See EDELMAN and OTHERS, *op. cit.*
[106] See *CRSM v Barclays Bank Ltd* [2011] EWHC 484 (Comm), [2011] *All ER* (D) 189 (Mar).
[107] See *CRSM v Barclays Bank Ltd* [2011] EWHC 484 (Comm), [2011] *All ER* (D) 189 (Mar).

easily attribute any subsequent losses in investments to negligent advice at the point of investment.[108]

On 'acting in the best interests' of investors, the Commission Regulation supplementing the AIFM Directive defines this duty as one of preventing malpractices that prejudice investors and to ensure that investors are not overcharged.[109] ESMA's initial advice[110] on the interpretation of this duty is based on the Markets in Financial Instruments Directive 2004[111] 'gold standard' of best execution and expeditious and proper client order handling. However, such an interpretation is rather narrow in scope and perpetuates the legal endogeneity problem mentioned above. Best execution is often developed in written policies, and an emphasis on establishing policies as compliance encourages a form of procedural compliance which could be narrow-minded in nature. The Commission Regulation has however enacted specific provisions[112] to ensure that AIFMs are under a duty of best execution in the context of portfolio management, and that they should execute client orders fairly and expeditiously.[113] The criteria for best execution in MiFID[114] is adopted in the Commission Regulation, viz the objectives of the investment, the characteristics of the financial instru-

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[108] See *CRSM v Barclays Bank Ltd* [2011] EWHC 484 (Comm), [2011] *All ER* (D) 189 (Mar); *Camarata Property Inc v Credit Suisse Securities (Europe) Ltd* [2011] EWHC 479 (Comm), [2011] All ER (D) 145 (Mar).

[109] See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 17.

[110] See ESMA, *Final, op. cit.* 44-45.

[111] European Parliament and Council Directive 2004/39/EC 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 [2004] OJ L145/1 (Markets in Financial Instruments Directive, MiFID), art 21; Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirement and operating conditions for investment firms and defined terms for the purposes of that Directive [2006] OJ L241/26 (MiFID Commission Directive), arts 44 ff.

[112] See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 27-29.

[113] See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 25.

[114] The MiFID template as referred to above also applies to European Parliament and Council Directive 2009/65/EC of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities [2009] OJ L302/32 (UCITS recast Directive), arts 25-26.

ments to be traded, the characteristics of the order and the characteristics of the execution venue.

On treating all investors fairly, AIFMs are to ensure that their treatment of one or more investors does not result in an overall material disadvantage to other investors. However, hedge funds have always been engaged in the use of side letters, which are preferential terms individually negotiated with investors.[115] The AIFM Directive now subjects the use of side letters to transparency measures and *ab initio* disclosure to all investors,[116] but does not prohibit them. Hence, the Commission Regulation, read subject to the parent Directive, should not affect the use of side letters. But the wide wording in relation to material disadvantage may still entail questions as to whether very differential levels of treatment may be subject to civil enforcement. Top-down regulation of side letters is unwarranted given that the practice has subsisted for a considerable amount of time and that professional investors should be engaged in considering the level of protection they may be offered when participating in investments with unequal treatment. In fact, ESMA considers it overly prescriptive to set out which practices may be *ex ante* considered to be fair or unfair, recognising that discretionary application by national authorities is preferable.[117] It will be curious to see how the UK regulator will implement this provision. Even if the UK regulator has developed enforcement jurisprudence[118] in applying its 'Treating Customers Fairly' principle, this relates exclusively to retail investors and hence a different set of considerations would have been applied. It is uncertain as yet under what circumstances wholesale investors will be regarded as having been treated 'unfairly' where greater levels of knowledge and bargaining power exist.

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[115] See McVEA, *United Kingdom*, in Eddy Wymeersch (eds.), *Alternative Investment Fund Regulation*, Alpen aan den Rijn: Wolters Kluwer, 2012, p. 343, p. 372.
[116] See AIFM, *Directive*, art 12(1).
[117] See ESMA, *Final, op. cit.* 51.
[118] See GEORGOSULI, *The FSA's "Treating Customers Fairly" (TCF) Initiative: What is so Good About it and Why it May Not Work*, in *38 Journal of Law and Society*, 2011, p. 405, even argues that the enforcement of this provision results in highly self-regulatory behaviour in terms of customer redress.

The introduction of new regulatory duties for AIFMs in EU law has opened up new possibilities for civil enforcement in Member States as well as liability for breach of European Union law. At a national level there will be a general tort liability and actions for breach of regulatory duties such as are facilitated under section 150 of the UK Financial Services and Markets Act. In practice, however, there is very limited case law in the UK and Europe as only 'private persons' are allowed to sue.[119] In spite of some out of court settlements, civil liability does not play a sufficiently significant role in providing market discipline for financial institutions.[120] Should the position be reformed so that wholesale sector investors such as institutions can bring civil actions in the breach of regulatory duties against AIFMs? However, courts are likely to have to grapple with causation issues (i.e. whether any breach of duty therefore causes investor loss) given that there is no default presumption of causation between breach and loss. Where courts find that investors would have persisted in a particular course of behaviour – such as buying, holding or selling – then ultimate losses on investment may not be attributed to particular breaches of duty.[121]

Investor litigation can be a useful force in providing a form of bottom-up governance, complementing regulatory governance in reflexive ways. Individual shareholder actions will not be restricted by limited resources and the priorities of regulators. Regulators could be subject to capture, political intervention and challenges in balancing a suite of regulatory objectives. Regulatory controls may be based on assumptions and predictions that remain static and may not catch up with the dynamics of change in the financial sector. Public regulatory power

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[119] See for example, *Zaki and Ors v Credit Suisse (UK) Ltd*, [2011] EWHC 2422 (Comm) where breaches of regulatory duties in investment advice were alleged and upheld.

[120] The UK Financial Services Act 1986 limited civil liability for breach of the regulatory duties under the act so that only 'private investors' could bring an action. Practically no actions were brought. Professional investors, including other financial institutions, would have had the financial resources to bring actions and private investors could have 'piggy backed' individual actions or used the case law that would have developed. Mass or class actions were not developed, again due to fears of US style litigiousness and floodgate problems. This is yet another example of calibrating civil liability such that it plays no role in the protection of private investors.

[121] See *Camarata Property Inc v Credit Suisse Securities (Europe) Ltd* [2011] EWHC 479 (Comm), [2011] All ER (D) 145 (Mar).

may also be limited in resources, and insufficiently incentivised to follow through with enforcement, opting for settlements.[122] Bottom-up reflexive forces of discipline allows other actors in the regulatory space, such as aggrieved investors, to provide governance. Regulators could observe and learn from these effects in order to engage with a governance paradigm that is dynamic in nature.[123]

Fears surrounding investor litigation often seems to be based on a worry about undesirable 'floodgates'[124] and the overly-litigious experience of the United States regarding issuer litigation.[125] This explains why a proposal to expressly beef up investor litigation against investment funds in the UK Financial Services Bill 2010 was dropped in the final version of the Act.[126] The authors suggest that reflexive bottom-up forces of governance, such as investor litigation, have an important role to play.

However, there are a few major drawbacks in enrolling investor litigation as a force for governance. One is that civil enforcement may not be successful in providing credible levels of market discipline as the nature of the regulatory duties seems focused on procedural approaches which could encourage box-ticking compliance and judicial affirmation for legal endogeneity. The need to

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[122] Sees KLÖHN, *Private Versus Public Enforcement of Laws – A Law & Economics Perspective*, available at *ssrn.com*.

[123] See LOBEL, *The Renew Deal: The Fall of Regulation and the Rise of Governance in Contemporary Legal Thought*, 89, in *Minnesota Law Review*, 2004-2005, p. 342,; WRIGHT - HEAD, *Reconsidering Regulation and Governance Theory: A Learning Approach*, 31, in *Law and Policy*, 2009, p. 192.

[124] See DAVIES, *Davies Review of Issuer Liability*, HM Treasury, March 2007. Assumptions about 'floodgates' and American style litigiousness have resulted in civil liability regimes in the UK and Europe that have simply not been used. See for more general arguments in favour of extended civil liability, MARKESINIS - FEDTKE, *Authority or Reason*, in *European Business Law Review*, 2007, 5; ANDENAS, *Liability for Regulators and Public Authorities*, in *European Business Law Review*, 2007, 1.

[125] See ROSE, *Reforming Securities Litigation Reform: Restructuring the Relationship between Public and Private Enforcement of Rule 10b-5*, 108, in *Columbia Law Review*, 2008, p. 1301. There is controversy over the net positive effects of wider civil liability in the United States compared with the UK and the rest of Europe. This kind of analysis does not take account of the very limited role of civil liability in Europe and the very many different mechanisms in the US that facilitate liability there, not the least in civil procedure with juries and mass actions of different kinds, many of which where developed in legislation to create effective remedies.

[126] After strong industry pressure, just as in the case of the Financial Services Act 1986 and at all the intermediate stages. The arguments were the same now and then. No lessons seem to be learnt from the experiences with the existing regimes where there has been no effective remedy for private investors in civil liability. The UK statute will not prevent liability under EU law.

provide legal harmonisation in interpreting AIFMs' duties, which has resulted in legal prescriptions that are highly procedural in nature, may in fact entail weak forms of compliance and enforcement. Further, the mobilising of bottom-up reflexive forces may undermine the legal harmonisation project in the EU, [127] and it is queried whether courts would be extremely cautious. Finally, bottom-up reflexive governance may end up substituting for regulatory governance and regulators may lose sight of the main financial stability objective. The authors do not think that this is a reason to weaken the potential of market discipline. However, the regulatory framework for civil enforcement as should be appropriately designed so that market discipline will be strengthened and beneficial effects for financial stability can also be captured.

The AIFM Directive seems to encourage civil actions as a form of investor discipline and the discussion on depositaries below reinforces this impression. Encouraging civil actions may reflect the contemporary regulatory need for co-governance and partnership with other actors in the regulatory space, especially given that the wholesale sector is well-resourced to contribute some form of governance. However, in order to make market discipline credible and robust, the authors suggest that more reforms are needed in relation to empowering institutions to sue and in limiting the extent of procedural prescription attached to each duty so that more room can be left for judicial interpretation to suit the circumstances of each case.

The AIFM Directive[128] requires AIFMs to identify, prevent, manage and disclose conflicts of interest. This framework for dealing with conflicts of interest is identical to the one under MiFID.[129] The criteria in the AIFM Directive for

[127] EU law on liability for breach of EU rights could provide a new basis for market discipline here. However, the ECJ has been cautious in providing private investors, such as depositors, with EU rights that are protected in this way in a case about liability for omissions by the legislator and the banking supervisor. Concerning the EU law aspects of the BCCI litigation in the UK, see ANDENAS, *Liability for Supervision*, *Euredia*, 2000, p. 379.
[128] See AIFM, *Directive*, art 14.
[129] See MiFID, art 18; MiFID Commission Directive 2006, arts 21-22.

determining whether a conflict of interests exists are identical to those under MiFID.[130]

It is to be noted that the AIFM Directive and its supplemental Commission Regulation adopt a procedural approach in regulating the management of conflicts of interests, that is to say, AIFMs are required to maintain written policies for management of conflicts of interest,[131] monitor the efficacy of implementing such policies[132] and make appropriate disclosure to investors.[133] Such a procedural approach is also mindful of the scale, size and complexity of the AIFMs' operations.[134] This approach is essentially a form of meta-regulation that allows AIFMs to apply discretion in identifying the potential conflicts of interest and determining how to manage those. The Commission Regulation provides that the procedures established by AIFMs should "prevent or manage" conflicts of interest,[135] but the authors query whether the regulatory regime really imposes an obligation to "prevent" which is more challenging than "managing" conflicts of interest. The prevention of conflicts of interest may mean that AIFMs should refrain from taking on certain transactions and hence limits transactional freedom. But an obligation to 'manage' would not impede so much upon transactional freedom. The authors are of the view that the regu-

[130] See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 30. Extensive examples are however provided in ESMA, *Final, op. cit.*, 53 - 55, including the AIFM investing in a company that has obtained a loan from one of the AIFM, the appointment by the AIFM of an adviser or broker that may be related to one of the AIFM, etc.

[131] See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 31, adopting ESMA, *Final, op. cit.*, 55.

[132] See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 35.

[133] See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 36.

[134] See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 31(1).

[135] See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 33.

latory tenor is geared towards "management" and not "prevention" of conflicts of interest as such. The permissive quality of this approach to regulating conflicts of interest has wider implications.

Article 14(2) states:

Where organisational arrangements made by the AIFM to identify, prevent, manage and monitor conflicts of interest are not sufficient to ensure, with reasonable confidence, that risks of damage to investors' interests will be prevented, the AIFM shall clearly disclose the general nature or sources of conflicts of interest to the investors before undertaking business on their behalf, and develop appropriate policies and procedures.

This provision seems to indicate that, as a last resort, disclosure and leaving it to investor governance may be a way out. This is a divergence from MiFID's position which is keen to ensure that disclosure does not become a 'way out' for investment firms and that firms demonstrate engagement with conflicts of interest by developing an intelligent and considered policy and reviewing it regularly.[136] It is thus queried whether conflicts of interests are to be policed by investors who, empowered by disclosure, may exert forms of governance. Policymakers may assume that professional investors in AIFs are better placed to understand, negotiate and exert governance in the management of conflicts of interest that are disclosed to them. However, it could also be argued that the imposition of regulation inevitably undermines transactional solutions, as regulation has the effect of replacing and centralising transaction costs and removes the impetus towards private solutions.[137] Hence, it is queried whether investors would be actively alert to having to engage with this issue or would rely on regulatory supervision and enforcement for protection. Moreover, it is uncertain whether disclosure of conflicts of interest will cause investors to consider how they may exert governance for their protection. Investors may find it diffi-

[136] See MiFID, art 18.

[137] See WILLIAMSON, *Strategizing, Economizing and Economic Organization*, 12, in *Strategic Management Journal*, 1991, p. 75.

cult to assess the potential impact of conflicts of interest on their interests and the behavioural tendency of the availability heuristic[138] may prevent investors from questioning AIFMs. The efficacy of investor-led governance is dubitable in this area. The Commission Regulation also imposes on AIFMs the duty to report to senior management[139] if the procedures put in place by AIFMs are not sufficient to prevent damage to investors' interests. It seems that there is scope for regulators to call senior management to account if investors are adversely affected by inadequate management of conflicts of interests by AIFMs.

Further, in terms of proscriptive duties imposed on AIFMs, the MiFID regime against inducements[140] also applies to the AIFM Directive.[141] The inducements regime under MiFID requires that third party payments be made or received by the fund manager only if they do not impair service to clients and add value to such service. Such inducements must also be disclosed to clients. In the area of inducements, it seems that compliance with the requirement that inducements not impair service to clients would not be satisfied by mere disclosure to investors.

In sum, the approach of the AIFM Directive to investor protection is rather meta-regulatory in nature. Many duties are imposed on AIFMs, but adherence to these duties generally requires the AIFMs to establish a policy over which they have considerable discretion in setting parameters and determining implementation. Further, it is uncertain whether regulators or investors

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[138] The availability heuristic is the human behavioural tendency to filter out which risks are salient and which are not. The 'salience' of risks may be affected by many psychological and sociological conditions that affect perception. Hence, one of the effects of this heuristic is to discount the impact of possibilities that are more remote or unimaginable or difficult to perceive. See MULLAINATHAN - THALER, *Behavioral Economics*, September 2000, in *MIT Department of Economics Working Paper No 00-27*, available at *papers.ssrn.com*; KAHNEMAN - SLOVIC - TVERSKY, *Judgment Under Uncertainty: Heuristics and Biases*, Cambridge: Cambridge University Press 1982, 3; SUNSTEIN, *Precautions against What? The Availability Heuristic and Cross-Cultural Risk Perceptions*, 57, in *Alabama Law Review*, 2005-2006, p. 75.

[139] See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 34.

[140] See MiFID, arts 11-12; MiFID Commission Directive 2006, arts 25-26, on inducements.

[141] See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 24.

are to police AIFM behaviour, as investors could rely on regulator enforcement while regulators may view that the availability of investor civil actions and professional indemnity insurance for AIFMs should make market discipline the primary source of governance. It is unclear whether robust enforcement will be substantively difficult against AIFMs as many duties are framed in a procedural manner and AIFMs that adopt a box-ticking approach could be regarded as compliant. It is also unclear how courts would interpret the ambit and discharge of these duties and how contractual limitations would be upheld. There is scope for enrolling investor discipline as a form of governance by allowing civil litigation to be pursued in respect of breaches of such duties. However, it remains uncertain whether investors would be motivated to play such a role. Finally, it is questioned whether civil litigation will be more successful riding on the back of successful regulatory enforcement, as case law in the UK suggests.[142] Section F will further discuss the prospect of investor litigation as a form of market-based governance in the wholesale sector.

Article 21 now requires AIFMs to appoint an independent external depositary for each AIF managed, to be situated in the jurisdiction where the AIF is based, whether in the EU or in a third country, or in the home Member State of the AIFM where a non-EU AIF is concerned. An exception applies to closed-end private equity funds. As these funds only hold non-listed company shares, it is not necessary for a separate depositary to be appointed. The depositary provisions seem to be a response to the Lehman fallout[143] in the global financial crisis, which resulted in a large number of civil actions being brought in respect of money or asset recovery. Further, the appointment of independent depositaries may mitigate the incidences of ponzi scheme frauds such as the Madoff scheme. The depositary provisions arguably have in mind investor protection for ease of recovery, but there is also a systemic risk element that intends to pro-

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142 See *Rubenstein v HSBC* [2011] EWHC 2304 (QB), [2011] 2 CLC 459.

143 See, for example, *Lehman Bros International v CRC Credit Fund* [2009] EWHC 3228 (Ch), [2009] WLR (D) 371; revd [2010] EWCA Civ 917, [2011] Bus LR 277.

mote orderly resolution of money or asset returns held in custody. However, it has been commented[144] that the depositary provisions, whilst they make sense for hedge funds, are “nonsensical” when applied to private equity funds, which have been shoehorned into the same category of alternative investment fund management in order to be subject to the need of having a harmonised and one size fits-all regulatory regime.

Where the depositary is in a third country (where the AIF is situated), Article 21(5)(b) provides that the depositary will only be acceptable to the home regulator of the AIFM if the third country regulator responsible for the depositary has information exchange and cooperation arrangements with the home regulators (including on tax matters). The third country regulator must also have an equivalent regulatory regime for prudential supervision and dealing with financial crime and be expressly made subject to the delegation restrictions and provisions on civil liability to investors. The third country regulatory regime must also be substantively equivalent to the EU regulatory regime where prudential regulation, regulation of conduct of business and enforcement are concerned.[145]

The independent external depositary is to be separate from the prime broker and other entities whose dealings with the AIFM may lead to a conflict of interest. The depositary will therefore focus on custodial functions and effective reconciliation of accounts and registers. Under Article 21(7), the depositary has a cash flow monitoring function,[146] a custodial function over clearly defined financial instruments (including lending and collateral arrangements),[147] a

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[144] See AWREY, *op. cit.*

[145] See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 84.

[146] See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), arts 85-86, adopting ESMA, *Final, op. cit.*, 150, on information flows between the AIFM and depositary and the depositary’s procedures to ensure cash flow monitoring and reconciling of accounts.

[147] See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating

function to ensure that all information from the AIFM is received to verify the booking of subscription payments made by investors,[148] a function to ensure that subscription and redemption orders are duly reconciled by the AIFM,[149] a function to oversee valuation procedures implemented by the AIFM,[150] a general obligation of oversight of the AIFM's procedures,[151] and a duty of diligence to oversee any third parties to whom the depositary delegates any functions.[152] The oversight duty will likely elevate depositaries' functions to the status of an independent gatekeeper. In order to facilitate the due discharge of depositaries' regulatory functions, the Commission Regulation that supplements the AIFM Directive provides for certain standardised mandatory features in the contractual arrangements between depositaries and AIFs. [153] These provisions ensure that depositaries have access to information and that AIFMs carry out their responsibilities. Further, reporting by prime brokers to depositaries will be made mandatory so that the depositary has a full picture of accounts at the close of each financial day.[154] These provisions show that EU policymakers intend to en-

conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), arts 88-90, adopting ESMA, *Final, op. cit.,* 157-158 on how custodial functions should be carried out, including verifying ownership procedures and maintaining registers for different types of assets.

148 See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 87, deviating from ESMA's advice, ESMA, *Final, op. cit.*, 154.

149 See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 93, adopting ESMA, *Final op. cit.*, 164.

150 See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 94, adopting ESMA, *Final op. cit.*,, 167-169.

151 See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 92.

152 See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), arts 98-99.

153 See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 83, adopting ESMA, *Final op. cit.*, p. 141.

154 See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating

rol depositaries in the governance landscape for AIFMs. The enrolment of depositaries into the governance landscape shows that regulators perceive the need to enhance governance and oversight in the wholesale sector, but doubt if significant regulatory resources should be committed to policing a sector where sophisticated parties may also supply monitoring and governance. The duty imposed on depositaries to maintain general oversight of AIFMs may constitute a form of governance over AIFMs, but is nevertheless framed in a procedural manner. Depositaries are required to establish adequate procedures and arrangements to verify the AIFMs' operations and asset positions, procedures for reporting and escalation where irregularities are detected and demonstrate that there are sufficient information flow arrangements in place between themselves and the AIFMs. The procedural requirements may not be difficult to discharge, although whether or not they are substantively efficacious for monitoring AIFMs remain to be seen. However, the governance role of alternative private sector actors in governance should still be monitored by regulators, or else ineffective, non-existent forms of governance or collusive arrangements in the industry may ensue. The governance role of depositaries is flanked by regulatory enforcement on the one hand and potential civil enforcement on the other hand, as depositaries are subject to almost strict liability[155] in terms of their custodial duties.

Would civil enforcement play a more significant role in supporting the governance role of depositaries? This could be a form of smart regulation if depositaries undertake gatekeeping functions for investor protection and are motivated to do so since they may be subject to civil liability to investors. Regulators may not be able to keep an eye on depositaries if they are not in the same jurisdiction.

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conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 91, adopting ESMA, *Final op. cit.*, p. 163.

[155] See WYMEERSCH, *The European Alternative Investment Fund Managers Directive,* in Eddy Wymeersch (eds.), *Alternative Investment Fund Regulation,* Alpen aan den Rijn: Wolters Kluwer, 2012, at ch18, p. 465.

Civil liability may now be incurred by the depositary to the AIF and to the investors in each AIF. The express provision of civil actions for the benefit of investors[156] against the depositary is arguably a robust investor protection measure. This regime seems to hold out the promise of orderly resolutions in money and asset recoveries for investors and could be a measure that mitigates systemic risk. Further, by opening up depositaries to civil actions by investors, regulators also carve out this area of wholesale sector problem-solving for the wholesale sector itself. This measure may portend two advantages for regulators. First, regulatory resources need not be implicated in solving wholesale sector fallouts if investors are themselves empowered to bring civil action. Second, by carving out an area for private enforcement, regulators may be able to limit the spillovers from the wholesale sector. One of the issues in the Lehman fallout was that, even if many civil actions for money or asset recovery were brought by wholesale sector participants and hence Lehman could have been a wholesale sector issue as such, the lack of orderly resolution and payout regimes caused a spillover to the rest of the investment banking sector in terms of loss of market confidence and chaotic behaviour.

The depositaries' civil liability may however be subject to an exception. ESMA has clarified that the exception to liability laid down in Article 21(12) is to be interpreted in 3 stages: namely, that the loss has been caused by an external event, the event is beyond the control of the depositary even with reasonable efforts and the loss is also beyond the control of the depositary even with rigorous and comprehensive due diligence.[157] In order to set reasonable parameters around the civil liability of depositaries, investors' actionable loss must be a permanent loss of rights based on deprivation of ownership,[158] excluding insol-

[156] See AIFM, *Directive*, arts 21(11) and (13).
[157] See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 101, adopting most of ESMA, *Final op. cit.*, 179.
[158] See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating

vency or administration and all cases where legal proceedings could be taken to recover ownership. This will prevent depositaries from being sued the moment an AIFM goes under. The 'reasonable efforts'[159] of depositaries are interpreted as having procedures to identify external events of stress and putting in mitigation mechanisms. Further, depositaries that have delegated custodial functions may be able to secure a contractual discharge from liability based on a prior written agreement with its delegate.[160] Such discharge would be available if the delegation is necessary, to comply with a national law for example, and is limited to precise and concrete circumstances only. [161] Contractual discharge cannot operate as a blanket discharge of liability.

It may also be argued that the depositary requirements encourage AIFMs or AIFs to be established in jurisdictions where the private market infrastructure for depositaries in the financial sector is well developed, such as in London. Further, the stringent requirements in terms of duties imposed on depositaries discussed above may also mean that jurisdictions with more developed and mature financial institutions may be more likely to support the operating environment required for AIFMs. There is also a need to consider if the potential concentration of such activities in a few jurisdictions may pose challenges to systemic risk.

Valuation is an issue at the heart of investor protection as investments in alternative investment funds such as private equity funds are often difficult to value if there are no market price references available. ESMA also requires that an AIFM not invest in a particular type of asset unless the valuation methodology for it has been identified.[162] Payne comments that private equity funds may

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conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 100, adopting ESMA, *Final op. cit.*, 179-180.

[159] See ESMA, *Final op. cit.*, 182.

[160] See AIFM, *Directive*, art 21(13).

[161] See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 102, adopting ESMA, *Final op. cit.*, 187.

[162] See ESMA, *Final op. cit.*, p. 112.

find it harder and costlier to comply with the valuation requirements as they deal with private companies with no market price.[163] Hence, how far can regulation go in achieving a satisfactory form of investor protection in the wholesale sector, bearing in mind that such investors may also be willing to engage in higher levels of risk in order to pursue higher returns?

The AIFM Directive provides for the valuation function to be exercised properly and independently.[164] Excessive prescription for the valuation process or methodology is not possible as it would be limited by contractual stipulations in each AIF enforceable in the jurisdiction of the incorporation or establishment of the AIF and by the laws applicable in the jurisdiction of the AIF. However, a framework for valuation has been put into place by the Commission Regulation that supplements the AIFM Directive. The framework provides for the fair, appropriate and consistent application of documented valuation procedures, and where models are used, such models need to be fully explained and justified.[165] Valuation procedures and models should also subject to senior management oversight and input from risk management, and regularly reviewed.[166]The valuation methodologies need to be able to calculate individual asset values.[167] Valuations need to be carried out whenever the net asset value of the fund needs to be calculated for redemption purposes, or at least yearly.[168]

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163 See PAYNE, *Private Equity and its Regulation in Europe*, 12, in *European Business Organization Law Review*, 2011, p. 559.
164 See AIFM, *Directive*, art 19.
165 See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), arts 67-69, see also ESMA, *Final op. cit.*, p. 113.
166 See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 70.
167 See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), arts 71-72, adopting ESMA, *Final op. cit.*, p. 115.
168 See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 74, adopting ESMA, *Final op. cit.*, p. 119.

The 'independence' of the valuation function is to be achieved either by the appointment of an external valuer – who is professionally registered and is able to furnish professional guarantees of competence in performing the valuation function – or by the establishment of a valuation function in the AIFM that is functionally separate from portfolio management, remuneration setting and other functions, in order to ensure its independence and freedom from undue influence.[169] Where the valuation function is not external, the Member State regulator may require that the internal but independent valuation function be verified by an external valuer or auditor.[170] An external valuer must also be a professional that is registered and subject to regulation, and must furnish an adequate professional guarantee.[171]

Article 19(10) of the AIFM Directive provides that AIFM liability to investors will be unaffected by the appointment of an external valuer but the external valuer may itself become liable to the AIFM for negligence or intentional failure to perform tasks. It may be queried whether the external valuer owes a duty of care to the AIF investors. One might argue that the valuer can reasonably foresee its valuation will affect the AIF investors, or least the group seeking redemptions to which the valuation pertains. However, the jurisprudence in *Caparo Industries v Dickman*[172] concerning auditors may present impediments to the valuer's duty to AIF investors. In that case, auditors for a company were sued for negligence in verifying mistaken financial accounts, therefore causing loss to a shareholder who consequently offered a high price in a takeover offer. The House of Lords stated that the takeover offeror could not sue on the basis that the auditors did not owe a duty of care to the shareholders at large. Instead, the duty would only be owed in situations of sufficient proxim-

[169] See AIFM, *Directive*, art 19(4).
[170] See AIFM, *Directive*, art 19(9).
[171] See AIFM, *Directive*, art 19(5), and the content of such guarantees must comply with Commission Delegated Regulation (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 73.
[172] [1990] UKHL 2, [1990] 2 AC 605.

ity between auditors and shareholder, where the shareholder informs the auditors, in advance, of his purpose in consulting the financial statements. If there is no prior knowledge or proximity where investors are affected by a valuation, could *Caparo* weaken investor discipline against valuers?

On the whole, however, the AIFM Directive provides for many avenues of investor-led governance and civil litigation as a means of exerting governance and asking for redress against AIFMs and depositaries. Empowering and rendering responsible wholesale sector participants – such as depositaries, valuers and wholesale sector investors – is necessary as there are constraints on regulatory resources in enforcing wholesale sector investor protection. However, in the interests of regulatory monitoring for financial stability risks, the authors will propose a framework for regulators to have a form of involvement in the outworking of investor-led governance in section F.

The provisions on disclosure to investors should support the governance role envisaged in the AIFM Directive for investors. We now turn to consider these provisions.

Article 22 of the AIFM Directive provides that an annual report of financial performance should be made available to investors upon request. The provision is minimal as some AIFs established as corporations would be subject to company law reporting in the jurisdiction of the AIF. Article 22 merely provides a right for investors to have at least annual access to such information. The Commission Regulation supplementing the AIFM Directive elaborates on the items that are required in annual reporting but seeks to introduce only a minimum form of harmonisation.[173] Annual reports may of course contain more, and qualitative information too.[174] Article 22(2)(e) and (f) provide that information on total and aggregate remuneration should also be provided to investors. The authors argued earlier in this Article that further classification of

[173] See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), arts 104-105.
[174] See ESMA, *Final op. cit.*, p. 225.

such information by AIF may be relevant to stimulating investor scrutiny/governance.

Article 23 deals with pre-investment disclosure and periodic ongoing disclosure post-investment. A list of items is prescribed as pre-investment disclosure for AIFs: a description of investment objectives, investment strategy and investment restrictions; levels of leverage and use; how changes to investment policies may be made; the main features of contractual terms, applicable law and investor rights; the identity of the AIFM, its depositary, its auditors, external valuers where applicable and other service providers, such as its prime broker and the main features of contractual arrangements with the prime broker; delegation of functions; liquidity and risk profiles and management; valuation policies; redemption procedures and rights; all fees and charges; the most recent annual report; net asset value; and historical performance, where applicable. Although the pre-crisis position on the wholesale end of the financial market relies on transactional governance, leaving intermediaries and professional investors to bargain freely, Mendales[175] argues that complete freedom to bargain does not necessarily facilitate effective investor scrutiny and protection, if investors rely on professional intermediaries for information and advice. Hence, post-crisis, the regulatory standardisation of disclosure of key investor protection items and risk profiles has been brought in. Such standardisation may help facilitate investor scrutiny and governance, as investor scrutiny is now based on comparable and standardised information. Regulatory standardisation does not mean that investor scrutiny is replaced by regulatory enforcement; professional investors have resources to impose market discipline, via civil litigation for example. The AIFM Directive is arguably trying to strike a balance between recognising where regulatory intervention may be needed for investor protection, without overdoing investor protection where investor governance can be brought to bear.

[175] See MENDALES, *Collateralized Explosive Devices: Why Securities Regulation Failed to Prevent the CDO Meltdown, and How to Fix it*, in *University of Illinois Law Review*, 2009, p. 1359.

Article 23(4)-(5) provides for post-investment periodic disclosure of how each AIF is managing its liquidity. Disclosure items include percentages of illiquid assets (in particular whether redemption rights may be affected if investments are made in illiquid assets), the management of risks by each AIF, amounts of leverage, use of leverage and any changes thereto. The periodic disclosure required relates generally to fair treatment of investors, and revolves around whether side letters and arrangements are in place, and whether there may be changes in liquidity positions that may affect redemption rights.[176] Periodic reporting also includes risk management techniques and the risk profiles of the AIFs.[177]

Regular disclosure is also imposed on AIFMs to inform investors of issues in relation to the leverage levels employed by AIFs.[178] On leverage, ESMA has provided prescriptive guidelines on the computation of leverage, not leaving it to discretionary Value-at-Risk methods preferred by the industry.[179] Leverage is to be reported to investors in accordance with those standards.

Reporting prudential issues to investors may engage them in individually considering their investment decisions, but such investor protection may sometimes be contrary to systemic risk concerns. The authors are doubtful whether investor governance over prudential issues is the appropriate approach. The likely investor action or reaction to any misunderstood prudential disclosures is redemption or flight and hence regulators should monitor the systemic impact

[176] See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 108, also see ESMA, *Final op. cit.*, pp.77-78, p. 80.

[177] See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 108, adopting ESMA, *Final op. cit.*, p. 230.

[178] See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 109.

[179] See COMMISSION DELEGATED REGULATION (EU) 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), arts 7-8, adopting ESMA, *Final op. cit.*, pp. 192 - 211.

of investor governance in this area. On the whole, the disclosure provisions may be inadequate for the new investor protection regime in the AIFM Directive. There is an excessive focus on pre-sale disclosure that harks back to the days when disclosure was meant to address market failures and information asymmetries. Moreover, pre-sale disclosure may not significantly alter the irrational exuberance and herding tendencies in investing behaviour[180] in good times. Post-sale disclosure, which is more important for the new regime of investor protection and civil litigation, should relate to the causes of action relevant to civil litigation, such as the discharge of duties, valuation activities and how these are undertaken, and management of conflicts of interest. Instead, post-sale disclosure relates largely to prudential issues, such as liquidity and leverage. It is not suggested that such information is not important. Rather, the authors propose (a) that post-sale disclosure should support possible causes of investor civil action in order to make the prospect of investor governance possible and (b) that although information relating to leverage and liquidity is important, it is uncertain what investor governance in relation to these issues would bring to the overall governance landscape. In particular, the potential systemic impact of chaotic investor behaviour at any sign of bad prudential news should be considered.

Articles 27-30 of the AIFM Directive deal with the operations of private equity funds acquiring significant stakes and/or control of non-listed companies. Article 27 provides for mandatory disclosure of acquisition of stakes from 10 per cent onwards, and subsequently at the thresholds of 20%, 30%, 50% and 75%. These notifications must be made to shareholders, employee representatives or

[180] For a selection of behavioural literature in investing, see GILOVICH - GRIFFIN - KAHNEMAN (eds.), *Heuristics and Biases: The Psychology of Intuitive Judgment*, Cambridge: Cambridge University Press 2002; KAHNEMAN - TVERSKY (eds), *Choices, Values and Frames*, Cambridge: Cambridge University Press, 2003; SCHILLER, *Irrational Exuberance,* Princeton, NJ: Princeton University Press 2000; SHEFRIN, *Beyond Greed and Fear,* Oxford: Oxford University Press, 2009; *Papers at the Lewis & Clark Law School Business Law Forum: Behavioral Analysis of Corporate Law: Instruction or Distraction?,* 10, in *Lewis & Clark Law Review,* 2006; STOUT, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28, in *Journal of Corporation Law,* 2008, p. 635; PRENTICE, *Whither Securities Regulation?*, 51, in *Duke Law Journal,* 2002, p. 1397.

the body of employees, and to Member State authorities. Article 28 further provides that the AIFM must set out its policies on managing conflicts of interest between the AIFM, AIFs and the target company concerned; the policies for internal and external communication regarding employees; its future intentions regarding the company and likely repercussions on employment and material changes to the business and shareholding. These mandatory requirements of disclosure are principally intended to provide important stakeholders, such as employees, with timely access to information. Any exertion of stakeholder power or governance will however largely depend on contractual provisions and the laws of the target company's jurisdiction.

Article 29 provides that AIFMs must ensure that each AIF that has acquired control of a non-listed company be subject to annual reporting, presenting a fair review of the company's business, including important and material events over the previous financial year, the company's likely future development and any acquisitions of own shares. This report should be made available to employees of the company. This provision may be compared to the best practice recommended for private equity funds by the Walker Review 2007 in the UK.[181] The Walker Review however focuses on public companies that have become private after being acquired by private equity funds and recommends that private equity funds disclose financial information, fund management objectives, plans for the acquired company and impact on employees, the environment and other stakeholders (such as suppliers, customers and community). This requirement would not apply unless the target company has a certain social impact by virtue of its economic size and employment capacity.[182] The limited parameters of the Walker recommendation reflect the need for disclosure based on the social interest of accountability where employment and the impact on stakeholders may be relatively more significant. However, Ar-

[181] See WALKER WORKING GROUP, *Guidelines for Disclosure and Transparency in Private Equity (Final Report)*, available at *walker-gmg.co.uk*.
[182] Market capitalisation of at least £300 million (or £500 million where acquisition is made largely on-market) or 1000 equivalents of fulltime employees.

ticle 29 widens the disclosure obligation to all AIFMs where an AIF gains control of a non-listed company. This provision may be said to be introducing an even level of stakeholder protection however small the non-listed company that is acquired. The authors are of the view that increasing stakeholder protection and governance is generally a positive move, as these reflexive bottom-up forces can motivate financial sector actors, such as AIFMs, to take into account of a broader set of risks and social concerns.[183]

Article 30 provides for prohibitions to be imposed on AIFMs to stop them supporting, or voting to support, asset stripping of acquired companies in the form of distributions, capital redemptions or share buybacks for a period of 24 months after the acquisition of control of the company. This interference with the private proprietary right to vote[184] is perhaps based on consideration of stakeholder interests and the social cost of activities carried out by private equity AIFs. The accountability and stakeholder-focused provisions concerning private equity funds in these Articles are not directed at investor governance but at stakeholder protection.

Regulatory prescriptions to provide for stakeholder protection are welcome, as stakeholders have often felt disempowered and excluded from business restructuring processes following private equity takeover of companies and there is at least a role for regulation to address any externalities that may be imposed on them. However, it is to be noted that although stakeholder protection is prescribed in the disclosure provisions and the provisions prohibiting asset stripping, stakeholders are not provided with governance power in the form of legal recourse. This means that stakeholders must rely on regulatory enforcement to ensure compliance or redress non-compliance with these

[183] See AHDIEH, *The Visible Hand: Coordination Functions of the Regulatory State*, 95, in *Minnesota Law Review*, 2010, p. 578.
[184] See *Northern Counties Securities Ltd v Jackson & Steeple Ltd* [1974] 2 All ER 625; *Her Majesty's Commissioners of Inland Revenue v Laird Group Plc* [2003] UKHL 54, [2003] 1 WLR 2476 [35]: "It is customary to describe [a share] as "a bundle of rights and liabilities", and this is probably the nearest that one can get to its character, provided that it is appreciated that it is more than a bundle of contractual rights. ... These rights, however, are not purely personal rights. They confer proprietary rights in the company though not in its property".

provisions. It is queried why stakeholders are not given direct governance power in the form of civil actions since the range of stakeholders (e.g. employees) is relatively identifiable and does not threaten to expand indefinitely. The post-crisis governance landscape relies almost exclusively on expert actors in the private sector to provide governance. This strategy may be elitist, narrow-minded and disempowering for a significant body of constituents whose concerns and voices may be diverse and valid.

5. Articles 31-40 of the AIFM Directive deal with the marketing and passport provisions applicable to EU AIFMs or non-EU AIFMs authorised by a Member State, in relation to the management of EU AIFs or non-EU AIFs. The passport provisions are regarded as the 'carrot' counterpart to the regulatory regime for AIFMs in the AIFM Directive and serve to further the inexorable legal and market integration project in the EU.

Where an EU AIFM managing EU AIFs is concerned, marketing is allowed in the home Member State, as well as in other Member States, on the basis of the passport for the EU AIFM.[185] The passport process shall involve notification of host Member States by home Member States, similar to the operation of the passport for prospectuses and investment firms, with the establishment of branches requiring further information to be provided to the home Member State in respect of the organisational structure and activities of the branch.[186]

Where an EU AIFM manages a non-EU AIF, it is permitted to manage without marketing in the EU if the AIFM complies with all but Articles 21 (depositary separation) and 22 (annual reporting to investors) of the AIFM Directive and the third country in which the non-EU AIF is established maintains appropriate cooperation arrangements for exchange of information with the EU home Member State.[187] However, the home Member State may permit marketing on

185 See AIFM, *Directive*, arts 31, 32.
186 See AIFM, *Directive*, art 33(2).
187 See AIFM, *Directive*, art 34.

its territory without a passport only if all provisions of the AIFM Directive, but for Article 21 on depositary separation, are complied with by the EU AIFM, and provided that custodial functions, functions relating to reconciliations and monitoring of money flow are vested in separate entities external to the AIFM.[188] The home Member State must however be satisfied that the third country in which the non-EU AIF is established fulfils certain conditions: it must have appropriate cooperation arrangements for exchange of information with the EU home Member State; adequately discharge international obligations in combating financial crime and money laundering; and have signed an agreement with the home Member State that fully complies with the standards laid down in Article 26 of the OECD Model Tax Convention, ensuring effective exchange of information in tax matters, including multilateral tax agreements. EU AIFMs may only market non-EU AIFs if the AIFM complies with all the obligations imposed in the AIFM Directive and the third country, in which the non-EU AIF is established, fulfils all the cooperative conditions previously mentioned.[189] The host Member States to which such an EU AIFM wishes to market non-EU AIFs may however disagree with home Member State approval in relation to the adequacy of third country cooperation and anti-money laundering arrangements and could refer the matter to resolution by ESMA.[190] The marketing of non-EU AIFs is to be delayed by two years after the AIFM Directive passport goes live for EU AIFs in 2013.[191]

A non-EU AIFM may manage an EU AIF or non-EU AIF and attain certain passport marketing rights if it is authorised by a Member State which will be its home Member State of reference. The home Member State of reference is determined by considering where most of the AIF concerned will be established and where the largest amount of assets managed is located. Where the non-EU AIFM intends only to market in one Member State, that Member State will be-

[188] See AIFM, *Directive*, art 36.
[189] See AIFM, *Directive*, art 35.
[190] See AIFM, *Directive*, art 35(2).
[191] That is, non-EU AIFs will be marketed from 2015.

come the home Member State of reference.[192] The non-EU AIFM must comply with all of the provisions of the AIFM Directive, unless compliance conflicts with another mandatory law applicable to the non-EU AIFM, thus excusing the non-EU AIFM. But such respite from AIFM Directive compliance is only possible if the third country, to which the non-EU AIFM is also subject, imposes an equivalent rule having the same regulatory purpose and offering the same level of protection to the investors of the relevant AIF.[193] The non-EU AIFM may only be authorised if it establishes a legal representative in the Member State of reference, to act as a contact point for regulators in supervisory activities,[194] and if the third country, in which the non-EU AIFM is established, fulfils all the cooperative conditions previously mentioned. The EU home Member State of reference must effectively be able to exercise supervisory functions over the non-EU AIFM.[195] A home Member State of reference may exempt a non-EU AIFM from complying with provisions of the AIFM Directive,[196] or allow the non-EU AIFM to continue its operations despite changes to its marketing strategy,[197] but these exemptions are subject to notification to ESMA and receipt of ESMA's advice. A Member State regulator is not bound to comply with ESMA's advice, but must give its reasons for non-compliance, and these may be published by ESMA.[198]

Where a non-EU AIFM is authorised and markets to a host Member State, the host is entitled to disagree with the home Member State of reference's determination (in relation to the adequacy of information exchange arrangements, or anti-money laundering regimes, the appointment of a legal representative or

[192] See AIFM, *Directive*, art 37(4).
[193] AIFM, *Directive*, art 37(2).
[194] AIFM, *Directive*, art 37(3).
[195] AIFM, *Directive*, art 37(7).
[196] AIFM, *Directive*, art 37(9).
[197] AIFM, *Directive*, art 37(11).
[198] AIFM, *Directive*, art 37(9) and (11).

the effectiveness of the home Member State's supervisory discharge) and such disagreements will be referred to ESMA.[199]

Where a non-EU AIFM is duly authorised, it may manage AIFs without a passport from its home Member State of reference, as long as it complies at least with the annual reporting and disclosure requirements to investors under Articles 22-24. Where private equity funds are concerned, the non-EU AIFM must comply with Articles 26-30 on appropriate stakeholder and regulatory notifications, annual reporting and prevention of asset-stripping. The third country, in which the non-EU AIFM is established, must also have appropriate cooperation arrangements for exchange of information with the EU home Member State of reference and adequately discharge international obligations in combating financial crime and money laundering.[200] Member State regulators overseeing such non-EU AIFMs may impose more stringent rules in marketing.

Where a non-EU AIFM is duly authorised, upon compliance with the AIFM Directive, the passport rights in marketing the EU AIFs it manages are automatically acquired,[201] including the right to establish branches with the provision of additional information (as applies to branches of EU AIFMs).[202] Where the duly authorised non-EU AIFM wishes to market non-EU AIFs it manages, marketing rights will only be granted if the third country, in which the non-EU AIF is located, fulfils all the cooperative conditions previously mentioned..[203]

ESMA is empowered to conduct peer reviews of Member State regulators' authorisation and supervision of non-EU AIFMs to determine supervisory efficacy and convergence.[204] ESMA may issue guidelines for Member State regulators, based on these peer reviews, on a comply-or-explain basis.

The provisions on marketing and passport rights are likely to compel more AIFs to establish onshore rather than offshore. They are also likely to push

[199] AIFM, *Directive*, art 37(7).
[200] AIFM, *Directive*, art 40.
[201] AIFM, *Directive*, art 38.
[202] AIFM, *Directive*, art 39bis.
[203] AIFM, *Directive*, art 39.
[204] AIFM, *Directive*, art 37a.

non-EU AIFMs to raise their game in order to meet the AIFM Directive requirements, even if these AIFMs choose to limit marketing to one jurisdiction and forego any passporting opportunities. This is most likely to affect American hedge funds with management offices in London. National regulators have some discretion to exempt, and they use this discretion, but are watched carefully by ESMA. A jurisdiction like London is likely to experience tensions in between complying with the EU supervisory convergence agenda and promoting its attractiveness and competitiveness as an international financial centre.

The treatment of non-EU AIFMs and AIFMs managing non-EU AIFs does not bar these entities from being able to offer investment opportunities and operate in the EU.[205] However, they must be capable of coordinated global supervision. These entities are further encouraged to adopt the AIFM Directive standards in order to enjoy marketing rights, so providing an opportunity for EU standards to reach out as a major force for international convergence.[206] The role of the AIFM Directive in facilitating dialogue on international convergence could be helpful in fostering global coordination, perspectives and systemic risk oversight of alternative investment fund activities. However, policymakers should be mindful of compromising prudential requirements in view of promoting access or fostering market integration. The needs of systemic risk oversight should be assessed carefully when the AIFM Directive comes up for review.[207]

The next section will discuss how investor governance in civil litigation – a major governance feature of the AIFM Directive – works and how it may be enhanced.

6. The AIFM Directive encourages investor governance with respect to conduct of business and accountability of AIFMs. In a decentred governance landscape, this is the post-crisis regulatory strategy of seeking governance po-

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[205] Subject to non-EU AIFs being allowed to be proposed in the EU from 2015 only.
[206] See BOLLEN, *Setting International Regulatory Standards for Hedge Funds: Parts 1 and 2*, 26, in *Journal of International Banking Law and Regulation*, 2011, p. 59, p. 105.
[207] Four years after it comes into force: AIFM, *Directive*, art 64.

tential from ‘other experts’, as a countervailing form of governance *vis-à-vis* financial intermediaries themselves.[208] Will investors take on this governance role? Are there sufficient self-interest incentives for investors to do so? In the UK, the Hedge Funds Standards Board was set up in 2009 to encourage best practice in the accountability of hedge fund managers to investors under the Large Report.[209] The Large Report (which presents the code of best practices administered by the Hedge Funds Standards Board) provides investor disclosure similar to that under the AIFM Directive, but there is no evidence of investor discipline by litigation so far in the UK. Perhaps investor discipline takes place in the form of exit from investment, rather than by way of expensive litigation. The only case of litigation[210] by a pension fund against its investment manager for underperformance was settled out of court. Hence courts have not had an opportunity to examine issues relating to sophisticated investors and fund managers (apart from issues framed as pre-sale advisory failures).[211] Whether investors can be motivated to discipline AIFMs is therefore very much open to question. Further, current jurisprudence from the court demands that investors prove causation of loss which could be rather tricky,[212] as a regulatory breach need not be the proximate cause for loss. Stringent positions on causation may discourage investor litigation.

That said, investors in hedge funds, particularly institutional investors are arguably both resourced and motivated to monitor the governance and performance of AIFs and AIFMs. For example, institutional investors are calling for

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[208] See WILKE, *Governance in a Disenchanted World*, Cheltenham: Edward Elgar, 2009.
[209] See HEDGE FUND WORKING GROUP (led by Sir Andrew Large), *Hedge Fund Standards: Final Report*, January 2008, available at *www.hfsb.org*.
[210] Unilever Superannuation Fund sued Mercury Asset Management in the UK in 2001 for underperforming its benchmark. The case was settled for £70m in compensation.
[211] See *Camarata Property Inc v Credit Suisse Securities (Europe) Ltd* [2011] EWHC 479 (Comm), [2011] All ER (D) 145 (Mar); *CRSM v Barclays Bank Ltd* [2011] EWHC 484 (Comm), [2011] *All ER* (D) 189 (Mar).
[212] See *Camarata Property Inc v Credit Suisse Securities (Europe) Ltd* [2011] EWHC 479 (Comm), [2011] All ER (D) 145 (Mar)**.**

better governance[213] in the AIFs, usually structured as offshore companies, in relation to the appointment of skilled and independent directors to the Boards of these AIFs. The Boards of AIFs are expected to exercise oversight of AIFMs (who have contractual relationships with their AIFs) in such a way as to protect investors' interests as shareholders in the AIF. However investor governance in this area is exercised informally rather than visibly through civil forms of litigation such as derivative litigation against the Boards of AIFs.

The authors are of the view that visible forms of market discipline such as civil litigation could be effective, and in a landscape where such forms of market discipline have not flourished, regulators could provide an enabling framework to encourage such market discipline, and also remain involved to a certain extent in order to avoid the ills of civil litigation, much of which has been documented in American literature in relation to private securities litigation.

The authors advocate a 'structured approach' to the empowerment of bottom-up reflexive governance forces, such as investor litigation, in order to address the balance between investor protection, decentred governance potential in the private sector and the needs of wider systemic concerns and financial stability from the public good perspective.

A 'structured approach' is proposed in accordance with Ben-Porath's ideas on how paternalistic regulatory governance may nevertheless co-opt individual choice and responsibility.[214] Ben-Porath discusses how regulatory governance may be necessary in setting welfare goals, as these may not be adequately provided if left to individual free will and markets. However, the attainment of such welfare goals need not be achieved in a top-down command and control fashion. Regulators could design choice sets and facilitative environments to steer towards these welfare goals. These insights could be relevant to the relationship between regulatory governance and investor-led governance

[213] See SZILAYGI - WEI CHONG, *The Board of Directors in Hedge Fund Governance*, 2011, available at *www.aeaweb.org*.
[214] See BEN-PORATH, *Tough Choices: Structured Paternalism and the Landscape of Choice*, Princeton, NJ: Princeton University Press, 2010.

where AIFMs are concerned. The authors advocate a pre-vetting role for the regulator, in respect of civil litigation that may be commenced or considered by AIF investors, coupled perhaps with reporting to ESMA for monitoring purposes.

In relation to the undesirable effects of the litigious enterprise in American style class securities litigation against issuers, Rose argues that the US regulator, the Securities Exchange Commission (SEC), should be involved in pre-vetting the merits of the litigation in order to make an appropriate cost-benefit analysis before an action is allowed to proceed. This would be in addition to preliminary proceedings in court.[215] As the AIFM Directive extends the possibility of civil actions for regulatory breaches, it could be argued that the regulator has an interest in these actions and the ensuing jurisprudence interpreting the scope and meaning of the regulatory breaches. A role for the regulator in pre-vetting investor litigation may thus be warranted. It is proposed that wholesale sector investors should submit possible civil actions to dialogue with the regulator in order to obtain such approval. Approval could also be formalised as a mandatory requirement that must be met before the commencement of investor civil proceedings against AIFMs. The regulator's approval however need not mean substantive approval of the merits of the case, but may simply act as a mechanism for filtering out obviously vexatious or ill-motivated litigation, promoting litigation that serves as a force for discipline.

The pre-vetting mechanism arguably does not obstruct the regulatory objective of investor protection and may in fact provide an initial form of legal advice as to the viability of proceedings. Further, the fostering of interaction between the wholesale sector investment community and the regulator may promote diversity of influence in a governance landscape that has hitherto been dominated by the industry. Regulator pre-vetting may encourage investor civil litigation to operate as a force for discipline and help avoid the pitfalls often discussed in relation to US securities litigation in terms of rent-seeking by lawyers

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[215] See ROSE, *op. cit.*

and inflicting unnecessary costs upon other shareholders. Such proceedings may also act as a substitute for the expenditure of regulatory resources in enforcing regulation, achieving a form of 'smart' regulatory governance for regulators whose resources are inevitably constrained. Further, having regulatory oversight of bottom-up reflexive forces may prevent regulators from taking a back seat in supervision and enforcement in the wholesale sector and provide regulators with information that could feed into wider systemic monitoring and oversight.

One of the authors argued in an earlier paper that investor civil litigation could be channelled to specialist Tribunals dealing with financial services matters.[216] The UK Upper Tribunal[217] could be developed to have a primary role in developing financial regulation jurisprudence. Regulator-vetted actions could be heard and decided by the Tribunal and made appealable to the Court of Appeal on issues of law. The Tribunal could be in an appropriate position to frame investors' rights and AIFM duties, developing specialist jurisprudence in statutory interpretation, as these issues of fund-client relations framed in traditional private law actions of contract and negligence are increasingly being dovetailed with regulatory duties anyway.[218]

7. The regulatory regime in the AIFM Directive reflects a mixture of objectives, from concerns about systemic risk, to investor protection and empowering investor-led governance, to market integration in the EU. The mixture of objectives reflects the difficult political process that has been taken to allow the regulatory regime to materialise. Ferran[219] points out that many voices at both European and international levels have pointed out the need for hedge funds to be regulated but the remoteness of regulation was due to the

[216] See H-Y CHIU, *The Nature of a Financial Investment Intermediary's Duty to his Client*, 28, in *Legal Studies*, 2008, p. 254.
[217] Upper Tribunal for Tax and the Chancery.
[218] See H-Y CHIU, *op. cit.*
[219] See FERRAN, *After the Crisis: The Regulation of Hedge Funds and Private Equity in the EU,* in *European Business Organisation Law Review*, 2011, p. 380.

power of industry resistance. The crisis provided an opportunity for the political resistance to give way but the ultimate regulatory regime is fraught with compromises and a fundamental lack of clarity about its goals. She opined that "[f]rom its inception, the EU's post-crisis agenda with respect to the regulation of alternative investments was … dogged by lack of clarity about the underlying goals."[220] However, the authors are of the view that it is understandable that the regulatory regime encompasses many objectives and approaches, but that the mixture of objectives has confused the use of regulatory strategies.

First, we are concerned that the key objective of supervisory oversight for systemic stability, which has justified regulatory extension to the alternative investment fund sector, is being compromised. Article 37(9) allows non-EU AIFMs to be exempted from AIFM Directive provisions at the discretion of a Member State, and under ESMA scrutiny. These provisions uphold deviations from the AIFM Directive based on minimum compliance with investor protection provisions, but this means deviations may also be made in relation to micro-prudential or risk management regulations. Concerns in relation to financial stability and systemic risk oversight should entail the even application of micro-prudential or risk management regulation across all AIFMs operating in the EU, whether they are EU AIFMs or non-EU AIFMs duly authorised. It is queried whether a uniform approach to micro-prudential and risk management provisions would not be preferable if the concern is that AIFMs may have an impact on systemic risk. Nevertheless one could argue that much of the regulation of internal control and liquidity management is meta-regulatory anyway, and so would regulatory supervision of the prudential position of exempt non-EU AIFMs necessarily add much to systemic risk monitoring? Further, even if regulators have the power to impose leverage limitations and restrictions on investment in securitised products, it is doubted that regulators will exercise

[220] See FERRAN, *op. cit.* pp. 380 - 397.

such powers as the imposition of such restrictions may send unduly worrying signals to investors and precipitate self-fulfilling prophecies for AIFMs.

As the AIFM Directive is keen on enrolling investor governance, it is uncertain whether a backseat will be taken with respect to conduct of business supervision, affecting the regulatory approach to prudential supervision as well. If regulators rely on investors to share in the monitoring, as investor disclosure includes leverage and liquidity matters, the authors very much doubt that investor governance is ideal in respect of prudential issues, as investors' views on prudential issues will be narrow and not systemic in perspective.[221] Further, prudential issues may either be perceived as having no immediate impact or their impact misunderstood causing behavioural tendencies such as panic. The authors advocate that regulators should clearly take on responsibility for monitoring prudential issues and systemic risk related concerns in relation to AIFMs. Further, is the AIFM Directive too concerned about the objective of allowing market access on reasonable terms for non-EU AIFMs and the management of non-EU AIFs? The objective of market access and integration may affect systemic risk governance; there is a need for vigilance.

It is uncertain whether the AIFM Directive will actually enhance investor protection in the wholesale sector if reliance is placed on bottom-up civil litigation to address this issue. The lack of market discipline in the wholesale sector has been a market failure. It is not clear whether the AIFM Directive adequately turns this market failure around to create a form of credible governance. The AIFM Directive has standardised many investor protection provisions, such as depositary, valuation and disclosure requirements, and the duties of care, skill, diligence and fairness. These duties are however subject to procedural prescriptions and so procedural compliance may suffice to show that AIFMs' duties have been duly discharged. The authors are concerned that judicial interpretation of the duties and their discharge may be trammelled. Further, it remains to be

[221] See SCHWARZ, *Systemic Risk*, 97, in *Georgetown Law Journal*, 2008, p. 193, p. 206.

seen whether the AIFM Directive's disclosure regimes adequately support investor litigation and whether investor litigation may be impeded by a lack of incentives (as discussed in relation to conflicts of interest above) or hurdles in court (as discussed concerning conduct of business and valuation). There are outstanding issues in respect of how easily investors may be able to call gatekeepers, such as depositaries and valuers, to account. Will regulators have to devote resources to supervision and enforcement in order to protect wholesale sector investors?

The AIFM Directive has taken minimal interest in using prime brokers as possible parties that could exert governance upon AIFMs. The Hedge Fund Standards in the UK have envisaged that the appointment of more than one prime broker by large hedge funds could serve governance purposes of multilateral scrutiny and monitoring.[222] However, King and Maier[223] argue that, prime brokers have the ability to impose certain controls and undertake monitoring of hedge fund risks, but that they are unlikely to do so, left to their own devices, as the competition in the market entails incentives to race to the bottom in order to attract hedge fund engagement. They argue that instead regulation should be increased for prime brokers, so that direct regulation over prime brokers provides indirect governance over hedge funds through transactional controls that prime brokers would have to implement. Direct regulation of prime brokers may also provide regulators with key information on leverage and asset allocation that could be important for an overall picture of systemic stability. The AIFM Directive has not taken steps to enrol the help of prime brokers in regulation, nor does it regulate them more stringently in their relations with AIFMs, preferring a regime which focuses on investor governance and regulatory oversight.

It is also to be noted that the voluntary Hedge Fund Standards mentioned above require hedge funds to institute systems of risk management against

[222] See HEDGE FUND WORKING GROUP, *op. cit.*
[223] See KING - MAIER, *Hedge Funds and Financial Stability: Regulating Prime Brokers will Mitigate Systemic Risks*, 5, in *Journal of Financial Stability*, 2009, p. 283.

market abuse and to prohibit inappropriate shareholder activism, such as using borrowed stock to vote. Only the issue of AIFMs exercising voting rights is cursorily dealt with in the Commission Regulation supplementing the AIFM Directive.[224] It could be argued that the general scrutiny of hedge fund strategies by regulators could allow regulators to monitor use of activism strategies and impose limitations on inappropriate forms of activism that may have an adverse impact on the wider corporate sector.

In general, the AIFM Directive is not the centralised top-down regulatory regime once feared. However, it is highly debatable whether the various objectives in financial regulation have been adequately balanced in this regime. Although the AIFM Directive has responded to the financial stability and systemic risk rationales for regulating alternative investment funds, the prudential regulatory regime may be too standardised with the UCITS and MiFID regimes, lacking consideration of some of the unique features of AIFMs, and also too procedural in nature, allowing AIFMs considerable discretion in determining their own levels of safety and soundness. The authors do not believe that mandatory disclosure to regulators adequately supports systemic risk oversight. There may also have been undesirable compromises made in view of market access interests in the passport provisions. Investor protection has become the highlight of the AIFM Directive, but we query whether the AIFM Directive has taken a historically dependent approach by addressing agency problems and information asymmetry. We agree that the wholesale investment sector should play a more important role in governance and discipline, but we are concerned that the regulatory regime has not done enough to credibly mobilise investors and may yet take a regulatory backseat in view of the governance that is expected to be exercised by investors. There is still room for the AIFM Directive to

[224] See COMMISSION DELEGATED REGULATION (EU), 19.12.2012 supplementing Directive 2011/61/EU of the European Parliament and of the Council with regard to exemptions, general operating conditions, depositaries, leverage, transparency and supervision (19 Dec 2012), art 37.

be reviewed and shaped in response to its key objective, which is financial stability.

BANK GOVERNANCE. LESSONS FROM THE FINANCIAL CRISES

Fabiano Colombini*

ABSTRACT: *This paper aims to examine bank governance by focusing on the process of risk screening and risk monitoring, in the framework of critical observations based on the recent experiences of financial crises during the 2007-2014 period. Improvement of risk management is a key issue not only for the current situation and for evolution of lines of business, but also for the survival of banks in the context of financial markets and financial systems. Therefore, suggestions for improving risk management and bank governance in order to restore public confidence are put forward.*

1. The OECD principles define corporate governance as involving relationships between a company's management, its board, its shareholders, and other stakeholders. Corporate governance also provides the instruments for setting the objectives and, at the same time, monitoring performance[1].

Bank governance is related to decision-making at the level of the board of directors and top management. Additionally, it concerns internal and external mechanisms designed to ensure that decisions are taken in line with the objectives of the bank and its shareholders[2]. It should be noted that corporate

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[1] See OECD, *Principles of corporate governance*, Paris, OECD, 2004.

[2] See MULBERT, *Corporate governance of banks after the financial crisis. Theory*, *evidence*, *reforms*, in *ECGI*, *Law Working Paper*, 2010, p. 151.

governance is different in banks as compared to other firms and has played an important role in the origin of financial crises[3].

Bank governance has emerged as one of the most critical issues in the cause and evolution of financial crises. In the light of weaknesses in the conduct of banks, emphasis has been placed on improving their management and organizational structures[4]. In this context, central banks have contributed to improving and modernizing corporate governance by introducing a clear separation of roles and responsibilities between the board of directors and executive management.

The separation of shareholder ownership from management control in modern banks has given rise to agency problems. These occur when the principal (shareholders) is in a weak position of information asymmetry and therefore monitoring and controlling the agent (managers) is very difficult. Managers can further their own interests at shareholders' expense and shareholders can mitigate conflicts with managers by implementing incentive-compatible mechanisms[5].

Banks have a greater range of stakeholders than nonfinancial firms, moreover, their business is more opaque and complex, which may lead to sudden rapid shifts[6]. The business is also composed of balance and off balance sheet items, giving rise to shocks and the need to select and monitor both sides in order to evaluate the real situation.

Transitions from one line of business to another and from balance to off balance sheet and vice versa, as well as shocks in values of items on balance and

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[3] See BECHT – BOLTON - ROELL, *Why bank governance is different*, in *Oxford Review of Economic Policy*, 3, 2012; CAPRIGLIONE, *Banking governance within company interests and prudential regulation* (*European regulation and specific Italian rules*), in *Law and Economics Yearly Review*, 2014, vol. 3, part 1; MACEY - O'HARA, *The corporate governance of banks*, in *FRBNY, Economic Policy Review*, April 2003.

[4] See KIRPATRICK, *The corporate governance lessons from the financial crisis*, in *Financial Market Trends*, 1, 2009; McCORMICK - MINTO, *Governance of banks in an era of regulation change and declining public confidence*, in *Law and Economics Yearly Review*, 2014, vol. 3, part 1.

[5] See MACEY - M. O'HARA, *op. cit.*

[6] See MEHRAN – MORRISON - SHAPIRO, *Corporate governance and banks*: *what have we learned from the financial crisis*?, in *FRBN, Staff Reports*, June 2011.

off balance sheet, constitute a distinctive characteristic of banks and highlight their tendency to exert a significant influence on the market.

Shifts and shocks in the banking sector can be particularly important in the framework of bank governance. This also underlines the role of supervisory authorities, showing the need for attention to risk selecting and risk monitoring. Moreover, the question of the rise of the total risk for financial systems should also be carefully examined.

Financial crises revealed corporate governance failures in the banking sector, both in the United States and Europe. Boards of financial intermediaries failed to identify, measure and monitor the range of risks or monitor executive salaries or supervise conflicts of interest. Since corporate governance determines banks' behaviour towards employees, clients, and shareholders[7], such a failure can have adverse consequences.

In the light of the 2007-2014 period of financial crises, corporate governance of banks today aims to restore public confidence or public trust.[8]

This paper proposes to examine bank governance by focusing on the process of risk screening and risk monitoring and its impact on financial crises. It is a key issue for the current situation and evolution of lines of business. At the same time, it is crucial for the survival of banks in the context of financial markets and financial systems.

The paper also addresses the aspects involving risk transfer viability at a micro and macro level, additionally examining commercial and investment banking and the related banking models in terms of the impact on risk management and corporate governance.

2. Financial crises can be analysed in the framework of crises involving financial markets, crises affecting financial intermediaries, sovereign debt crises

[7] See JASSAUD, *Reforming the corporate governance of Italian banks*, in *IMF*, *Working paper*, September 2014; STULZ, *Governance*, *risk management*, *and risk-taking in banks*, in *ECGI Working Papers Series in Finance*, June 2014.

[8] See McCORMICK - MINTO, *op. cit.*

and currency crises. Careful examination of the issues involved shows that financial crises are the result of interrelations among a number of circumstances: adverse trends on the financial markets, adverse situations affecting financial intermediaries, tensions focusing on public debts and turmoil in the exchange markets.

Financial crises have effects that ripple through financial markets, financial intermediaries, financial instruments, states and central banks, thus highlighting correlations and interdependencies as well as financial instability[9]. In short, financial crises have repercussions of marked intensity that are projected in the short, medium and long term over financial systems and, at the same time, over economic systems. For example, the subprime mortgage financial crisis calls for state aid measures in support of crisis-ridden financial intermediaries; the sovereign debt crisis implies the need for action to restore balance in the public finances; the economic crisis necessitates economic stimulus initiatives which diverge from the measures suggested in the previous two cases and may indeed be in conflict with them.

Accordingly, there emerges the importance of a scale of priorities concerning the volume of public resources required. Decisions on priorities must take into account the margins for public expenditure without causing excessive imbalance in the public budgets.

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

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[9] See COLOMBINI - CALABRO’, *Crisi finanziarie. Banche e stati. L’insostenibilità del rischio di credito*, Turin, Utet, 2011.

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

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

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

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

Bailout plans to address the subprime mortgage financial crisis and expansionary policies designed to tackle the economic crisis have led to a marked deterioration in the public finances. However, the dramatic condition of the public finances should be ascribed not merely to the above described exceptional measures, but also to unbridled public expenditure that has risen to unsustainable levels.

The most critical elements affecting the public finances involve the following aspects: rising pension and health care expenditure due to an aging population; fairly high expenditure on the national, regional and local level in matters pertaining to political affairs; intensity of tax evasion; amount of the public debt and its composition in terms of maturities and apportionment between residents and non residents; private debt levels and degree of solidity of the banking systems.

The elevated levels of public indebtedness create the premises for the sovereign debt crisis, leading to an increase in the returns that the markets demand on bonds issued by states perceived as being at risk and thereby bringing about an increase in spreads between the bonds of an individual state and those of the German state. This, in turn, exacerbates the fragility of the budgets of such states and makes it difficult, if not impossible, to intervene with measures aimed at economic recovery[10].

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[10] On the subject of financial crises see, among others, ACHARYA – PHILIPPON - RICHARDSON - ROUBINI, *The financial crisis of 2007-2009*: *causes and remedies*, in Acharya and Richardson (eds.), *Restoring financial stability: how to repair a failed system*, New York, Wiley, 2009; ADRIAN - SHIN, *The changing nature of financial intermediation and the financial crisis of 2007-2009*, in *Annual Review of Economics*, 2, 2010; ALLEN - CARLETTI, *An overview of the crisis*: *causes*, *consequences and solutions*, *International Review of Finance*, 1, 2010; BERNANKE, *The crisis and the policy response*, in *Speech, LSE*, London, January 13, 2009; BLANCHARD - DELL'ARICCIA - MAURO, *Rethinking macroeconomic policy*, in *IMF Staff Position Note*, February 12, 2010; BOCCUZZI, *Towards a new framework for banking crisis management. The international debate and the Italian model*, in *Quaderni di Ricerca Giuridica*, 71, Rome, Banca d'Italia, 2011; BOLTON - JEANNE, *Sovereign default risk and bank fragility in financially integrated economies*, in *NBER Working Paper*, 16899, 2011; CALABRIA, *Did deregulation cause the financial crisis*?, in *Cato Policy Report*, 4, 2009; CAPRIGLIONE - SEMERARO, *Crisi finanziaria e dei debiti sovrani. L'Unione Europea tra rischi e opportunità*, Turin, Utet, 2012; CASSIDY, *How markets fail. The logic of economic calamities*, New York, Farrar, Straus and Giroux, 2009; CLAESSENS - DELL'ARICCIA - IGAN - LAEVEN, *Cross-country experiences and policy implications from the global financial crisis*, in *Economic Policy*, 62, 2010; COLOMBINI, *Crisi finanziarie e risk management. Rilievi critici*, in *Rivista Trimestrale di Diritto dell'Economia*, 4, 2011; COLOMBINI - CALABRO', *op. cit.*; COLOMBINI, *Interview*, in *Pezzuto I., Predictable and Avoidable.*

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

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

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Repairing Economic Dislocation and Preventing the Recurrence of Crisis, Experts' Insights for Improved Governance, Gower, 2013; CRESCENZI, *Propagazione ed effetti della crisi finanziaria sull'economia reale*, in Crescenzi (eds.), *La crisi mondiale. Storia di tre anni difficili*, Rome, Luiss University Press, 2010; DAVIES, *The financial crisis. Who is to blame*?, Cambridge, Polity Press, 2010; DOWD - HUTCHINSON, *Alchemists of loss. How modern finance and government intervention crashed the financial system*, Chichester, Wiley, 2010; DUFFIE, *How big banks fail and what to do about it*, Princeton, Princeton University Press, 2010; EICHENGREEN, *Ten questions about the subprime crisis*, in *Financial Stability Review*, Banque de France, 11, 2008; ESTRELLA - SCHICH, *Sovereign and banking sector debt*: *interconnections through guarantees*, in *OECD Journal: Financial Markets Trends*, October, 2011; *Financial crisis inquiry report. Final report of the National Commission on the causes of the financial and economic crisis in the United States*, January 2011; FRANKE - KRAHNEN, *The future of securitisation*, in *CFS Working Papers*, 31, 2008; FRATIANNI, *Financial crises, safety nets and regulation*, in *Rivista Italiana degli Economisti*, 2, 2008; FORNASARI, *I dati e gli insegnamenti della crisi finanziaria USA*, in *Economia Italiana*, 1, 2009; GOODHART, *The background to the 2007 financial crisis*, in *International Economics and Economic Policy*, February, 2008; HALDANE, *Why banks failed the stress test*, Bank of England, February 2009; HUBBARD, *The failure of risk management*: *why it's broken and how to fix it*, Hoboken (NJ), Wiley, 2009; MARCONI, *Le origini e la diffusione della crisi finanziaria*: *evidenze teoriche ed empiriche*, Crescenzi (eds.), *La crisi mondiale. Storia di tre anni difficili*, Rome, Luiss University Press, 2010; MASERA, *Financial turbulence and the capital standard paradigm: a sequel*, "MASERA (eds.), *The great financial crisis. Economics, regulation and risk*, Rome, Bancaria Editrice, 2009; MISHKIN, *Over the cliff*: *from the subprime to the global financial crisis*, in *NBER Working Paper*, 16609, 2010; PEZZUTO, *Predictable and avoidable. Repairing economic dislocation and preventing the recurrence of crisis*, Farnham (Surrey), Gower, 2013; REINHART - ROGOFF, *This time is different*. *Eight centuries of financial folly*, Princeton, Princeton University Press, 2011; SHILLER, *The subprime solution. How today's global financial crisis happened and what to do about it*, Princeton, Princeton University Press, 2008; SORKIN, *Too big to fail*, New York, Viking, 2009; SPAVENTA, *Economists and economics*: *what does the crisis tell us*?, in PAGANETTO (eds.), *Global crisis and long term growth: a new capitalism ahead*, Milan, McGraw-Hill, 2010; STIGLITZ, *Freefall. America, free markets, and the sinking of the world economy,* New York, Norton, 2010; WOLF, *The shifts and the shocks*. *What we have learned, and still have to learn, from the financial crisis*, London, Penguin Press, 2014.

the context of the euro zone countries, triggering potential contagion among countries viewed as weaker on the financial plane and therefore more fragile on the plane of speculation.

Careful evaluations should be conducted in seeking to devise the best approach for overcoming financial crises and economic crises. More specifically, attention should be paid to identifying the specific problems, estimating the costs and formulating rational choices. Failure to assess these aspects results merely in wasteful use of public resources that provides no solution either for the problems raised by the subprime mortgage financial crisis or for the problems deriving from the sovereign debt crisis. In other words, the complex interactions are not addressed and definitive solutions are basically postponed to an indefinite future[11].

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

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

[11] See JOHNSON - KAK, *The price of salvation*, in *FT.com Economists' Forum*, September 25, 2008.

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

Bank governance has revealed many weak points in the risk screening and risk monitoring and particularly the credit risk which postulates radical changes.

3. The subprime mortgage financial crisis, together with the subsequent sovereign debt crisis, has had notable consequences in terms of transfer of monetary resources from subjects and sectors in surplus to subjects and sectors in deficit. This process comes about through two channels: on the one hand, by direct credit, which in turn presupposes the search for a counterparty in order to ensure preference satisfaction and an agreement on conditions, thereby giving rise to and fuelling the activity of the financial markets (direct circuit); on the other hand, by indirect credit, which presupposes a lengthier and mediated transfer of resources, giving rise to and fuelling the activity of the financial intermediaries (indirect circuit)[12].

On account of the ever greater integration between financial markets, financial intermediaries and financial instruments, the financial crisis has dealt a severe blow to the direct circuit, thereby generating uncertainty and volatility in the financial markets and, consequently, in the instruments traded. It has also had an equally severe impact on the indirect circuit, as a result of the difficulties encountered by financial intermediaries in managing the credit risk and,

[12] See COLOMBINI, *Intermediari, mercati e strumenti finanziari. Economia e integrazione*, Turin, Utet, 2008.

consequently, the drastic loss of value that undermines their loan portfolios and financial instrument portfolios.

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

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

On closer examination, credit risk transfer onto financial markets, where the main figure both in the field of sales and also of purchasing is represented by financial intermediaries, assumes the extended meaning of an increase in the burden of risk weighing upon the financial system, due to the numerous inter-relations among financial intermediaries[13]. Basically, the problem can be traced partly to unorthodox practices in granting loans to a very poor quality customer base, and partly also to the subsequent experimental practices of risk transfer taken to excessive levels, as well as to failure of the supervisory authorities to exercise proper control.

It is worth noting that the subprime mortgage financial crisis underscores the fact that systematic recourse to credit risk transfer can have adverse effects in a context characterised by marked integration between financial markets,

[13] See SHIN, *Risk and liquidity*, Oxford, Oxford University Press, 2010.

financial intermediaries and financial instruments. The transferred risk aggravates the overall risk level, which becomes unsustainable and severely affects those who are driving the process and, consequently, the financial intermediaries that stand at the origin of the process.

Risk management and the related practices of risk transfer are fully viable only in financial systems where the individual financial sectors (typically, banking, investment trusts and insurance) pursue rational approaches to risk management, ensuring that credit risk or other risk factors do not increase to levels that become intolerable and unsustainable for the financial systems[14]. This postulate was not applied when the subprime mortgage financial crisis arose; furthermore, the supervisory authorities, above all in the American context, did not intervene.

It follows that the practice of experimenting with risk transfer and, consequently, of risk shifting from internal to external should not be taken to levels that could threaten the survival of financial systems. Precise rules should be laid down, together with the exercise of rigorous and systematic control by the supervisory authorities.

There can be no doubt that if the regulatory setup is flawed or inadequate, or monitoring action is not performed at well defined and reasonably spaced temporal intervals, the problem of bank governance will remain unsolved.

Exposure to subprime mortgages prior to the onset of the subprime mortgage financial crisis was a characteristic of a number of different types of financial intermediaries in the United States, testifying to interest in the market segment under consideration. This was an interest based essentially on purely commercial motives and on the aim of increasing the volumes, with the

[14] Commercial banks likewise adopt speculative strategies on derivatives, increasing their range of risks and exposure and, at the same time, their leverage and hence their vulnerability to fairly substantial adverse fluctuations in their assets. A similar observation can be made with regard to the investment banks' experiment with speculative operations on derivatives, which involve increasing the level of risk. Speculation by means of derivatives is regarded as a solution for growth of profits, but careful attention should always be paid to the associated risks.

presumption of a growth of profits in the short run. However, the expansionary impact of risk on the systemic level was totally underestimated.

If the management policies of a given financial sector become "irrational", as was the case with the policies adopted by the banking system, above all by American banks, then the safety net consisting in risk management strategies implemented by all the economic actors, whether financial or industrial, is drastically compromised. This is due to the fact that the intense links between firms, financial instruments and financial markets lead to rapid and amplified expansion of the range of risks[15].

Government intervention has succeeded in containing the harsh impact of the subprime mortgage financial crisis, but in so doing it has created the premises for the sovereign debt crisis that has given rise to repeated fluctuations and volatility in the prices of the bonds of numerous countries. Such a phenomenon, in turn, has adverse repercussions for the balance sheets of the financial intermediaries: already suffering as a result of the loss of value in their subprime mortgage-linked assets, the financial intermediaries also find themselves facing a reduction in the value of the portion of their assets composed of sovereign bonds.

In the American context, the subprime mortgage financial crisis constitutes the most prominent component of the financial crises, whereas in Europe it is the sovereign debt crisis that represents the main component, although interactions and signs of interdependency with the other component are not lacking[16].

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[15] See COLOMBINI - CALABRO', *Risk management e derivatives. Strategie bancarie*, in *Banche e Banchieri*, 2010, 4.

[16] A considerable number of measures have been implemented by national governments, the European Central Bank (ECB), the International Monetary Fund (IMF) and the Federal Reserve (FED) aimed at reducing financial crises. In this context, the framework to identify the three main areas of intervention is as follows: economic policies for balancing the public finances through reduction in expenditure and/or increase in fiscal taxation, and the establishment, by European states, of the European Stability Mechanism (ESM), in other words a permanent "European state bailout fund" which should bring a degree of stability into the euro area. The ECB pursues the priority aim of price stability using a number of different monetary policy instruments, both of a conventional and unconventional type, restoring conditions for an increase in prices on bond markets and stock markets and a reduction in the cost of

Bank governance indicates weaknesses in selecting, measuring and managing the range of risks and improving is necessary in these different practices.

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

The systematic use of this practice has negative repercussions on the two classical banking activities: screening and monitoring. Screening and monitoring reduce or, in a very optimistic assumption, completely eliminate the problems, respectively, of information asymmetry ex ante and, therefore, of adverse selection, and the problem of information asymmetry ex post and, therefore, of moral hazard.

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financing for states, banks and firms; additionally, it has contributed to reducing the spread between the yield on bonds of the weaker countries and those of the German country.

The IMF pursues aims of financial stability and prevention and management of internal financial crises. Its instruments are essentially short-medium term financing of countries that are unable to raise funds on financial markets at fair prices, together with the imposition of structural adjustments and economic reforms.

The FED pursues several objectives, such as: control of inflation, economic growth, employment, financial stability, interest rates and exchange rates control. During the onset and evolution of financial crises, the FED tends to use a wider range of instruments and thus demonstrates greater capacity to cope with and overcome financial crises in comparison with the ECB, in pursuit of a monetary stimulus to the economy and, at the same time, to public financing.

Financial markets, in the components involving money markets, bond markets, stock markets and derivatives markets, reflect the initiatives, behaviour and choices of central banks. A central bank's approach can contribute to increasing trends in these various sectors through concrete action and/or intention of buying sovereign securities. However, conventional and unconventional instruments employed by central banks have the effect of rapidly increasing the volumes in their balance sheets and, consequently, the risk level as well, especially, the credit risk, as clearly emerges from observation of the 2007-2014 period.

Screening and monitoring activities, together with the information content of bank loans, the uncertainty of return and of the value of their assets, and the "certainty" of remuneration and of the value of their liabilities, as well as the specific nature and depth of financial transformation, underline the importance of banks and, at the same time, highlight their differences in comparison with other financial intermediaries[17].

A considerable number of banks have undertaken the development of business areas which are parallel to the classical areas of raising and lending funds. Many of these developments frequently involve high leverage areas, as in the case of derivatives[18]. Restoring rational choices and trust in the bank governance constitutes a requirement for medium and long period financial stability, less importance being awarded to growth of their capital.

In this perspective, the Basle III regulation, based on prudential criteria, and the measures prescribed by the European Banking Authority (EBA), based on discretional criteria, lead to overlapping rules[19], underlining instability factors within financial markets, purely discretional compensation mechanisms in comparison with Basle III, exacerbation and failed solution of the complex bank-state linkages and inadequacy of regulatory measures in Europe[20].

The important role of commercial banks in financial systems must not be jeopardised by reckless commercial strategies aiming to increasing profits in the short term which, at the same time, induce some banks to embrace high levels

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[17] See COLOMBINI, *op. cit.*

[18] See COLOMBINI, *Strumenti derivati e intermediari finanziari*, in *Rivista Bancaria - Minerva Bancaria*, 1999, 1, COLOMBINI, *Strumenti fuori bilancio negli intermediari bancari. La recente esperienza italiana*, in *Rivista Bancaria - Minerva Bancaria*, 2004, 4, COLOMBINI - CALABRO', *op. cit.*

[19] Basle III has introduced higher and better levels of capital, in the framework of risk-weighted assets, to be implemented progressively over time. It thus can be regarded as based on a prudential approach. In contrast, the EBA has introduced additional capital corrections, formulating estimates on the value of the sovereign bonds in bank portfolios: accordingly, this can be regarded as adopting a discretionary approach. However, a number of problems can be pointed out and several critical aspects should be highlighted: overlapping regulations, timing, and the mistaken approach towards banks whereby banking intermediaries are viewed, via an analogical process, as similar to investment trusts which must, on a daily basis, satisfy the obligation to assess the value of their assets and disclose the information to the market.

[20] See MASERA, *The Basel III global regulatory framework: a critical review*, in *Rivista Trimestrale di Diritto dell'Economia*, 2011, 3.

of risk that could compromise management of banks. It is also necessary to re-examine the corporate governance models of banks, envisioning changes in the top management that would allow the entry of professionally competent figures capable of assessing the risk-return relation in the medium and long term[21].

Credit risk transfer, which has contributed to increasing volumes of mortgages, has incontrovertibly represented a key element in interpreting the subprime mortgage financial crisis. By increasing volumes of mortgages, it has set the stage for real estate speculative bubbles. Yet risk transfer became a constant and marked approach in risk management, resulting in a worsening of credit risk screening and monitoring. This in turn implied a progressive multiplication of credit risk spreading throughout the financial systems and thus creating doubts with regard to sustainability.

Changes and innovations in rules should be accompanied by adequate levels of controls on bank practices of regulatory avoidance through off balance sheet instruments (OBSIs). For banks, the shadow banking system represents one of the main ways in which vast quantity of risk generated and transferred is rendered opaque[22]. Thus it is important to bring greater transparency into financial intermediaries' balance sheets, above all as regards OBSIs, which, in the light of financial crises on a global scale, highlight irrationalities in the management of banks.

The tremendous growth in practices of origination, transfer and multiplication of the credit risk calls for a revision in the bank governance, which must be required to take into account sustainability on the level of individual

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[21] See BEBCHUCK – COHEN - SPAMANN, *The wages of failure: executive compensation at Bear Stearns and Lehman* 2000-2008, in *Harvard Law School Discussion Paper*, 2010, p. 657; BOCCUZZI, *Gli assetti proprietari delle banche. Regole e controlli*, Turin, Giappichelli, 2009; FERRARINI - UNGUREANU, *Economics, politics and the international principles for sound compensation practices. An analysis of executive pay at European banks*, in *ECGI Law Working Papers*, 2010, p. 169; MASERA, *La crisi finanziaria e i modelli di corporate governance delle banche: implicazioni e prospettive*, in *Bancaria*, 1, 2009.

[22] See POZSAR – ADRIAN - ASHCRAFT - BOESKY, *Shadow banking*, in *FRBNY Staff Reports*, 2012, p. 458; *Global shadow banking monitoring report* 2014, FSB, October 30, 2014; *Green paper shadow banking*, Brussels, European Commission, March 19, 2012.

banks which is important for their survival and, particularly, on the level of financial systems which is still more important for their survival.

Considering the marked integration among financial intermediaries, financial markets and financial instruments as well as the interrelations among world economies, the credit risk level arising in a bank, a given financial sector or a given financial system provokes an impact on all the others, increasing the credit risk level on a global scale.

Irrational criteria for creation, transfer and multiplication of the credit risk which affect a given financial sector or a given financial system can lead to global financial and economic crises[23]. It is essential to implement fair and rational risk management practices in order to avert the eventuality of risk escalating to unsustainable levels either for the individual financial system or on a global scale. Thus financial intermediaries, industrial firms and public agents should be characterised by rational criteria of risk management and therefore by good corporate governance.

5. Banks pursue the objective of expansion of on and off balance sheet instruments and volumes over time in order to create the premises for positive performance and profits. Bank balance sheets have grown rapidly in a low interest rate environment and in presence of a surge in innovative instruments[24].

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

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[23] See COLOMBINI - CALABRO', *op. cit.*
[24] See RICHARDSON – SMITH - WALTER, *Regulating Wall Street: The Dodd-Franck Act and the new architecture of global finance*, New York, New York University Stern School of Business, 2010.

securities, derivatives, investment trusts and real estate investment trusts, pension funds and insurance policies (investment banking).

Over time, the dealing and market making of securities and derivatives and proprietary trading have become increasingly important. There has also been a remarkable growth in derivatives, especially in the over the counter (OTC) market[25]. Since the beginning of the third millennium, securitisation markets have grown rapidly and created the shadow banking system, built up essentially by special purpose vehicles (SPVs) and structured investment vehicles (SIVs).

The growth of the banking business has underlined the shift from commercial banking to investment banking, and therefore an increase in the range of risks and in total risk. The process of identification, measurement and management of the range of risks is of crucial importance in creating and maintaining conditions for profits and solvency. The above mentioned shift is evident when looking at the assets side, the liabilities side and income sources as the share of net interest income falls and non-interest income rises[26].

This structural shift in the banking business can offer an explanation for the subprime mortgage financial crisis. The universal model in the banking sector combines commercial banking with investment banking and can be regarded as a critical issue for managing risks at a sustainable level for the individual institution and for the whole financial system.

The universal model in Europe has been called into question and a number of helpful proposals have been put forward. The so-called Vickers Report makes the recommendation that a robust ring fencing should be built, separating investment banking from commercial banking, in order to reduce structural complexity and to ensure that banks are better equipped to devise

[25] Regarding macroeconomic implications of derivatives, see SAVONA, *Sugli effetti macroeconomici dei contratti derivati. Dieci lezioni*, Rome, Luiss University Press, 2010; OLDANI, *Governing global derivatives. Challenges and risks*, Aldershot (Hampshire), Ashgate, 2008.

[26] See *High-level expert group on reforming the structure of the EU banking sector* (chaired by Erkki Liikanen), Final Report, Brussels, October 2, 2012.

solutions in the event of crises. Ring-fencing means that most of a bank's investment banking and related risks will be separated from commercial banking and related risks[27]. The main point is that since investment banking and the related risks traditionally involve a higher risk level than is the case with commercial banking, their separation insulates the ring-fenced bank and sets it in a better position in the event of difficulties. Emphasis should be placed on the need to hold sufficient capacity so that any losses can be absorbed, and to increase levels of bank capital in order to build a more robust banking system. It is also important that there should be strong support for moves designed to increase competition in the UK banking system thereby stimulating new entrants to compete on a level playing field[28].

These reform proposals including ring-fencing, loss-absorbency and competition will be implemented in the UK. The government is committed to ensuring that the new industry-funded switching service is operational by 2019.

The Volcker Rule prevents the use of deposits, insured in the USA by the Federal Deposit Insurance Corporation (FDIC), for proprietary trading activities. The Volcker Rule will take into effect in July 2015. This is similar to the rule concerning ring-fenced banks, which will be prevented from engaging in proprietary trading once the financial reform has been implemented in the UK .

The so-called Liikanen Report introduces a distinction between significant trading activities and commercial banking. According to this report, banks with significant trading in excess of a certain threshold should separate their investment banking activity from commercial banking. Banks in excess of the threshold would have to create a separate legal entity to transfer the trading assets. The trading entity would have to be economically independent and easily separable, meeting prudential regulatory requirements on a stand-

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[27] See *High-level expert group on reforming the structure of the EU banking sector*, *op. cit.*; *Banking reform: delivering stability and supporting a sustainable economy* (chaired by John Vickers), HM Treasury, BIS, June 2012.

[28] See *Banking reform: delivering stability and supporting a sustainable economy, op. cit.*

alone basis[29]. The lines of financial change of financial rules are under consideration by public authorities in the EU.

Such reforms aim to curtail the impact of implicit guarantees of states towards the banking sector in the UK, the USA and the EU. It is difficult to quantify the value of implicit guarantees, which varies over time; a decrease in implicit guarantees can be explained by declining sovereign strength, by more effective bank failure resolution regimes and practices or by lower perception of the systemic risk[30]. It should be noted that implicit guarantees imply an undesirable close link between the value of banks and sovereign debt. They also imply a significant funding cost advantage for banks that benefit from them, giving rise to competitive distortions, excessive risk-taking, and misallocation of resources[31].

Therefore financial reforms of the banking system which lead to improvements in risk management through separation between investment banking and commercial banking can be regarded as reducing the value of implicit guarantees and thus reducing the close link between the value of banks and sovereign debt. This can represent a positive premise in the bank governance against the onset of new financial crises in the future.

6. The analysis carried out here underlines the importance and centrality of credit risk management in the bank governance which is defined by the board of directors and implemented by the executive management at several levels of decision-making. This was a major aspect involving the subprime mortgage financial crisis in the framework of financial instruments (loans, asset-backed

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[29] See *High-level Expert Group on reforming the structure of the EU banking sector*, *op. cit.*

[30] See SCHICH - LINDH, *Implicit guarantees for bank debt*: *where do we stand*?, in *OECD Journal: Financial Market Trends*, 1, 2012; SCHICH - KIM, *Developments in the value of implicit guarantees for bank debt*: *the role of resolution regimes and practices*, in *OECD Journal: Financial markets trends*, 2, 2012; NOSS - SOWERBUTTS, *The implicit subsidy of banks,* in *Financial Stability Paper*, 15, Bank of England, May 2012.

[31] See COMMITTEE ON THE GLOBAL FINANCIAL SYSTEM, *The impact of sovereign credit risk on bank funding conditions* (Study group chaired by Fabio Panetta of the Bank of Italy), in *CGFS Papers*, 43, BIS, July 2011; *High-level expert group on reforming the structure of the EU banking sector*, *op. cit.*; SCHICH - LINDH, *op. cit.*

securities, derivatives) created by banks, but it also plays a crucial role in the sovereign debt crisis in the context of financial instruments created by states (sovereign debts).

Financial crises have been a feature of financial systems for roughly the last eight years (2007-2014) and have been addressed through a number of fiscal restriction measures, mainly in Europe, and expansionary monetary measures especially in the USA.

The presence of spreads discriminating between the yield on public securities of some countries (such as Spain and Italy) and those of Germany has negative repercussions not only on the cost of public refinancing but also on the cost of credit to private and public firms, thus creating an obstacle to investments and economic growth.

This protracted period of crisis management has severely impaired economic growth, with a more marked negative impact in the European context as compared to America.

The crises, failures and industrial breakups have prompted the central banks in Europe and the USA to take action in order to counter the adverse effects. But it should be borne in mind that the extended time span of the crisis reflects the lengthy and difficult decision-making procedures that come into play when choices have to be made on different levels, above all on the political level. In particular, a fundamental point should be stressed: the long-drawn-out financial crisis has led to a sequence of restrictive measures in the fiscal field in different European countries, and such measures, in turn, have set the stage for economic recession and missed wealth-production opportunities. Further adverse effects thus arise from the negative impact on employment and especially on youth employment, with increasing unemployment rates in the various economies.

The way forward in the line of restoring standard financial conditions in Europe must include: credible economic strategies, steadier interventions of the ECB and structural reform plans in the medium and long run[32].

In the weak countries of Europe affected by financial crises, it becomes of fundamental importance to draw up and implement economic growth strategies using all available instruments.

The potential interventions by the ECB can be regarded as instruments capable of lowering the spreads among yields. Recently, the quantitative easing (QE) set up by the ECB in the EU for the purchase of public securities implies an expansionary monetary policy, in pursuit of a monetary stimulus to the economy and, at the same time, to public financing in the future.

A structural reform plan should be pursued by those countries that are particularly affected by financial crises, with the aim of strengthening their position in the medium and long term.

Therefore, in the evolution of financial crises some progress towards financial stability has indeed been achieved, but some steps still remain to be taken.

An improvement in corporate governance of banks can contribute to restoring public confidence and, at the same time, to recreating financial stability in line with better premises of financing small and medium sized businesses. This is very important in the context of economic growth in every country and particularly in the weak countries of European Union.

7. The evolution of financial crises, risk management and bank governance calls for great progress in the field of financial stability. The analysis carried out in this paper allows the basic elements to be singled out:

1) credit risk should not rise to elevated levels, as the impact of increasing credit risk affects the sustainability of financial sectors and financial systems;

[32] See GOODHART - KAPOOR, *Has the euro crisis turned a corner*?, in *Wall Street Journal*, September 19, 2012.

2) bank risk management in connection with the transfer and multiplication of credit risk, and state risk management designed to address both the origination and management of credit risk as well as fluctuations of yields and spreads and of maturities, should be comprehensively overhauled. There should be a radical break with the past, implementing rational criteria for selection of loans and financial instruments and for good governance;

3) in the light of the repercussions of bank crises on states and vice versa, a clear-cut separation between banks and states should be imposed;

4) the range and volumes of instruments of individual states, of central banks and of the IMF imply the need for diversified capacity in countering and managing financial crises;

7) in the future, once the financial crises triggered by banks and financial intermediaries have been eliminated, the restoration and maintenance of balanced conditions in the public finances will have positive repercussions on banks and financial intermediaries, allowing stability in asset values and a lesser increase in the sovereign securities portfolio. Such an outcome will recreate better premises for the granting of loans to the economy in terms both of volumes and interest rates;

8) the main routes to a solution and at the same time to prevention of financial crises in the future are essentially as follows: separation of commercial banking from investment banking, stronger intervention capacity of the ECB, reduction in public debt; credible strategies for economic growth and structural reform plans; a move towards fiscal union, financial union and also political union together with the monetary union on the EU level;

9) improvements in risk management, to be achieved through the separation between commercial banking and investment banking, can be regarded as reducing the value of implicit guarantees and thus reducing the close link between the value of bank and sovereign debt. This creates a positive

premise for bank governance against the onset of new financial crises in the future;

10) the prevention of new financial crises is linked to restoring and maintaining rational criteria both in state finances and in the related risk management practices and, at the same time, to restoring and maintaining rational criteria in financial intermediary lending and investment and in the related risk management practices in line with good corporate governance.

RECOVERY PLANNING:

A NEW VALUABLE CORPORATE GOVERNANCE FRAMEWORK

FOR CREDIT INSTITUTIONS

Luca Amorello - Sacha Huber*

ABSTRACT: *Since the outset of the 2008 financial crisis, policymakers realized the need to implement a new regime for banks and financial institutions restructuring. as a result, a change of attitude in the legal construction of the banking crisis management seems to have taken place. amid the newly established tools thought to deal with the insolvencies of banks, ex-ante regulatory instruments aimed at preventing banks from defaults by stabilizing their financial sustainability play a prominent role.*

This holds true especially with regard to "recovery planning" which sets out a range of recovery actions and strategies able to restore the ongoing business of credit institutions at early stage in the events of financial distress. this paper argues that recovery planning may be deemed as a valuable corporate governance instrument for credit institutions.

Recovery plans are indeed capable to positively affect the risk management organization of the firm and provide additional incentives to scrutinize excessive risk-taking behaviors, thereby leading to the establishment of more efficient governance practices and an higher degree of protection for bank's stakeholders.

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SUMMARY: 1. Introduction. - 2. Early experiences in recovery planning. - 3. The European framework of recovery planning: from the financial stability board's standards to the application of the EU bank recovery and resolution directive. - 4. Which role for recovery plans in banks' governance? - 5. Concluding remarks.

1. Since the outset of the 2008 financial crisis, policymakers realized the need to implement a new restructuring regime for banks and financial institutions. The crisis' experience showed that initiating a normal insolvency proceeding over an insolvent or quasi-insolvent credit institution could bring about severe repercussions for the financial system and real economy as a whole by spreading the risk of financial contagion through the disruption of the liquidity channel and the impairment of the banks' core functions.[1]

In order to restore the financial viability of credit institutions the toolkit used by policymakers to reconcile effective strategies and cope with adverse scenarios of severe stress globally, required the implementation of innovative ex-ante and ex-post regulatory instruments associated with and aimed at providing an orderly discipline for the recovery and resolvability of credit institutions. On one hand, ex-ante regulatory instruments are thought to prevent credit institutions from default by requiring certain measures to be taken for stabilizing their financial sustainability. On the other hand, ex-post regulatory instruments are deemed corrective mechanisms to be triggered whenever a default can no longer be avoided[2]. Hence, starting from the G-20 "*Key Attributes of Effective Resolution Regimes for Financial Institutions*"[3] and going through the

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[1] See, *inter alia*, IVASHINA - SCHARFSTEIN, *Bank Lending During the Financial Crisis of 2008*, EFA 2009, in *Bergen Meetings Paper*, July 2009; MORA, *Can Banks Provide Liquidity in a Financial Crisis?*, in *Economic Review*, Federal Reserve Bank of Kansas City, Third Quarter; VAN RIXTEL - GASPERINI, *Financial crises and bank funding: recent experience in the euro area*, BIS Working Papers, No. 406, Bank for International Settlements; BOLOGNA, *Is there a role for funding in explaining recent US banks' failures?*, in *Banca d'Italia, Questioni di Economia e Finanza*, No. 103, October 2011; CORNETT - MCNUTT - STRAHAN - TEHRANIAN, *Liquidity Risk Management and Credit Supply in the Financial Crisis*, in *Journal of Financial Economics*, Vol. 101, Issue 2, 2011, pp. 297 – 312.

[2] See THOLE, *Bank Crisis Management and Resolution - Core features of the Bank Recovery and Resolution Directive*, 22 July 2014, available at *ssrn.com.*

[3] See FINANCIAL STABILITY BOARD, *Key Attributes of Effective Resolution Regimes for Financial Institutions,* October 2011, available at *www.financialstabilityboard.org.*

implementation of the EU Bank Recovery and Resolution Directive (BRRD), a change of attitude in the legal construction of the banking crisis management seems to have taken place. As a matter of fact, the ex-ante regulatory instruments are framed within a prevention regime that is now integrated into the bank's corporate governance adequacy assessments performed by the supervisory authorities within their supervisory tasks[4].

"Living wills" and "contingencies plans[5]" offer a fruitful example of such new toolkit. However, among these new instruments, a prominent role is played by the recovery planning whose intent is to ensure - through the drawing up and maintenance of updated recovery plans - the timely implementation of a series of recovery actions to restore the regular business of credit institutions should conditions of severe financial distress occur. While at the national level some jurisdictions within the European Union had already stipulated specific rules on recovery planning that greatly differ among them[6], at the EU level the Bank Recovery and Resolution Directive (BRRD) has achieved the harmonizing goal of a level playing field for the establishment of this new preventive regime.

2. This article argues that recovery planning is capable to elicit better governance practices for banks and investment firms. On one hand, the recovery plans, by developing specific financial distress scenarios and strategically forecasting early remedies to address possible financial contingencies of credit institutions, may play an important role in strengthening the risk governance

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[4] See EBA, *Guidelines for common procedures and methodologies for the supervisory review and evaluation process (SREP)*, EBA/GL/2014/13, 19 December 2014, under which *"[t]o assess internal governance and institution-wide controls, competent authorities should consider any findings and deficiencies identified in the assessment of recovery plans and recovery planning arrangements [...]. Similarly, findings from the assessment of SREP elements, including internal governance and institution-wide control arrangements, should inform the assessment of recovery plans"*.

[5] For a critical insight on "living wills" and "contingencies plans" *see*: FEIBELMAN, *Living Wills and Pre-Commitment*, in *American University Business Law Review*, Vol. 1, No. 1, 2011; GESLEVICH PACKIN, *The Case Against the Dodd-Frank Act's Living Wills: Contingency Planning Following the Financial Crisis*, in *Berkeley Business Law Journal*, Vol. 9, Issue 1, 2013; AVGOULEAS - GOODHART - SCHOENMAKER, *Living Wills as a Catalyst for Action,* DSF Policy Paper Series, No. 4, May 2010.

[6] See EBA, *Discussion Paper on a template for recovery plans* (EBA/DP/2012/2).

framework and its management. On the other hand, recovery planning by disclosing accurate information on credit institutions about their governance structure to the market, to third-parties and allowing regular feedbacks by the supervisory and resolution authorities on its recoverability in times of financial distress, can be considered as a powerful instrument to discipline managers' behaviour in normal times.

On 18 May and 7 December 2010, the Council of the European Union endorsed a comprehensive roadmap outlining actions in order to:

(i) reinforce the EU supervisory framework;

(ii) further bolster the EU regulatory framework;

(iii) promote financial market integrity;

(iv) significantly enhance the EU framework for crisis prevention, management and resolution; and

(v) develop a comprehensive EU-wide framework for closer policy coordination on financial stability[7].

Among the major elements of such roadmap, the Council advocated for a rapid implementation of detailed and proportionate recovery and resolution plans by end-2010. Additionally other possible tools are available to reduce the impact of failure, at least for systemically important financial institutions (SIFIs)[8]. Following the conclusions of the Council, the European Commission adopted on 6 June 2012 the proposal for the recovery and resolution directive that sowed the seeds of the EU BRRD finally issued on 15 May 2014.

Nonetheless, specific rules and guidelines containing key-features for the establishment of recovery plans for banks and investment firms have been published by single European countries in anticipation of any EU comprehensive intervention. After being solicited by European Institutions and the International Monetary Fund (IMF) within the context of financial assistance programs, some

[7] See COUNCIL OF THE EUROPEAN UNION, *Council conclusions on crisis prevention, management and resolution*, 3054th ECONOMIC and FINANCIAL AFFAIRS Council meeting Brussels, 7 December 2010.
[8] See COUNCIL OF THE EUROPEAN UNION, *Council*, *op. cit.*

countries have vowed to reform their own resolution regimes, while others - as UK and Germany - have decided to release a first regulatory draft for recovery plans due to their involvement in the international work of the Financial Stability Board[9].

In Germany, recovery plans were deemed as instruments of contingency planning for emergencies relating to time-critical activities within the framework of risk management under Sec. 25a of the German Banking Act[10]. While the contingency plans were designed to stipulate the communication channels to be used in the event of emergency and be provided to the affected employees, the recovery plans had to ensure restoration of the normal operations within an appropriate period of time[11]. In November 2012, the Federal Financial Services Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht,* BaFin), in asking national SIFIs to develop and implement recovery plans by the end of 2013, lunched a public consultation on a first draft circular regarding minimum requirements for the contents of recovery plans (*Mindestanforderungen an die Ausgestaltung von Sanierungsplänen* – MaSan), which aimed at providing first guidance for writing up such plans[12]. BaFin finally published the final Circular on 25 April 2014[13]. Further, the ring-fencing Act (*Risikoabschirmungsgesetz*), having the purposes to protect client deposits and help solving the too-big-too-fail issue, entered into force on 12 August 2013[14]. This Act contained provisions on recovery and resolution planning for credit institutions that may pose a potential systemic risk. In particular, it required these banks to formulate recovery plans and implement them within their administra-

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[9] See EBA, *Discussion Paper on a template for recovery plans* (EBA/DP/2012/2).
[10] Pursuant to Sec. 25 (a) of the German Banking Act credit institutions *must:* "*(1) have in place suitable arrangements for managing, monitoring and controlling risks and appropriate arrangements by means of which the institution's financial situation can be gauged with sufficient accuracy at all times; (2) have a proper business organisation, an appropriate internal control system and adequate security precautions for the deployment of electronic data processing*".
[11] See BAFIN, Circular 12/2012 - *Mindestanforderungen an das Risikomanagement - MaRisk*, AT 7.3, 14 December 2012.
[12] See BAFIN, Consultation on "*Mindestanforderungen an die Ausgestaltung von Sanierungsplänen - MaSan*", 2 November 2012.
[13] See Circular 3/2014, available at *www.bafin.de* (only in German).
[14] See FEDERAL LAW GAZETTE (BGBl.) I 2013, p. 3090.

tive procedures in order to improve their ability to overcome a crisis[15]. Under these new provisions, recovery planning had to include *(i)* a strategic analysis of the company, *(ii)* a general presentation of the available recovery actions that could be undertaken by the management body to stabilize the credit institution's financial position including an impact analysis and an evaluation of their feasibility, *(iii)* a description of different stress scenarios that could occur and their impact on the credit institution, *(iv)* a range of recovery indicators triggering the execution of the recovery options and *(v)* an internal and external communication plan. Most of the key-components of these plans are now embedded in the EU BRRD framework regarding the recovery planning. Therefore, it's not a case that German recovery innovations have been crucial for the developments of the European framework on banking crisis management, making Germany a pioneer in the area of preventive regulatory measures against banking failures.

In anticipation of the European BRRD intervention, the UK Prudential Regulation Authority (PRA), in December 2013, published rules on recovery and resolution planning for deposit-taking firms and PRA-regulated investment firms (PS8/13)[16]. According to the PRA's policy statement "*PRA expects firms to maintain recovery plans, outlining credible recovery actions that they could implement in the event of severe stress to restore their business to a stable and sustainable condition*". Credit institutions subject to the supervision of the PRA had to devise plans containing a comprehensive range of options setting out actions that should be triggered in a number of both idiosyncratic and market-wide stress scenarios in order to improve effectiveness and consistency of the institution's recoverability. These new rules were supplemented by a supervisory statement (SS18/13)[17], which set out in more detail what the firms must

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[15] See BAFIN, *Annual Report 2013*, 17 June 2014.
[16] See PRA, Policy Statement PS8/13, *Recovery and Resolution Plans*, December 2013.
[17] See PRA, Supervisory Statement SS18/13, *Recovery Planning*, December 2013.

consider in filling the content of their recovery planning. Building blocks of this new comprehensive recovery framework were:

(i) a complete list of recovery options and an overview of the full range of further possible alternatives that might be taken;

(ii) a description of each recovery option, including the firm's assessment of the probable success and a quantitative estimate of each option's benefits;

(iii) the identification of a range of triggers whose achievement activates the implementation of the recovery plan;

(iv) a clear description of the escalation and decision-making process; and

(v) a communication plan to ensure that stakeholders (both internal and external) are given timely and appropriate information during the firm's recovery process was required[18].

The French Authority of Prudential Control (now *Autorité de contrôle prudentiel et de résolution* - ACPR), also in anticipation of the BRRD framework, published on 26 July 2013 the new banking reform on ring-fencing and regulation of certain banking activities[19] which introduced, amongst others, preventive recovery and resolution measures to counter likely banking failures[20]. In particular, credit institutions and investment firms whose balance sheet exceeds certain thresholds fixed by governmental decree[21] are required to develop recovery plans (*plan préventif de rétablissement*) that set out specific actions to be taken in the event of significant financial distress. According to the wording of the law, the ACPR must assess the recovery plans periodically to verify if the re-

[18] See PRA, Supervisory Statement SS18/13, *Recovery Planning*, December 2013.
[19] See JORF n°0173 du 27 juillet 2013 page 12530, *LOI n° 2013-672 du 26 juillet 2013 de séparation et de régulation des activités bancaires*.
[20] See JORF n°0173 du 27 juillet 2013 page 12530, *LOI n° 2013-672 du 26 juillet 2013 de séparation et de régulation des activités bancaires*, art. 26; now article L613-31-11 of the *Code monétaire et financier*.
[21] See JORF, *op. cit.*

covery measures specified could be effective in the related scenarios[22]. Further, such plans must be updated on a yearly-basis[23].

Although regulations at high level on recovery planning have been a domain of a few EU countries only, it is important to note that several national prudential and resolution authorities over the last years have requested major banks to develop recovery and resolution plans despite the absence of a proper national regulatory framework[24]. One striking example is Banco Santander, the biggest bank in the Eurozone by market capitalization, which has since 2009 been working closely with Bank of Spain to establish its own contingency plans in order to preserve its going concern[25].

3. All national reforms providing regulatory frameworks for recovery planning were first responses to the auspices of the Financial Stability Board (FSB) which, in its *Key Attributes of Effective Resolution Regimes for Financial Stability* ("*Key Attributes*") endorsed by the G-20 Leaders at the Cannes Summit in November 2011, established international standards for recovery and resolution regimes. These new standards "*call on jurisdictions [...] to put in place an on-going recovery and resolution planning process to reduce the potential for failure and promote resolvability as part of the overall supervisory process*"[26]. More in detail, the *Key Attributes* urged all jurisdictions to require G-SIFIs and any other firm assessed by national authority as potentially dangerous for financial stability in the event of its failure to formulate robust and credible recovery plans. The recovery plans should identify a fan of credible options and measures to restore the financial viability of the credit institution. Such options should be

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[22] See JORF, *op. cit.*
[23] See JORF, *op. cit.*
[24] According to the FSB's Chairman Mark Carney, until November 2014 fewer than half of FSB jurisdictions have adopted recovery and resolution planning for all systemic domestically incorporated banks. *See*: FSB's Chairman Mark Carney, *Letter to G20 Leaders on Financial Reforms: Completing the Job and Looking Ahead*, 7 November 2014.
[25] See HOUSE OF COMMONS TREASURY COMMITTEE, *Too important to fail–too important to ignore*, Ninth Report of Session 2009–10, Vol. I, 22 March 2010, Ev. 74.
[26] See FSB, *Key Attributes of Effective Resolution Regimes for Financial Stability*, supra note 4, p. 3.

capable to overcome idiosyncratic and market-wide stress events and should outline specific scenarios that address capital shortfall and liquidity pressures. Further, the timely implementation of the recovery plans are to be ensured through the definition of clear backstops and escalation procedures, identifying both quantitative and qualitative criteria[27] that would trigger without undue delays the implementation of the options by the credit institutions. Triggers for recovery plans are to be embedded into the overall risk management framework of the credit institution and must be aligned with any existing liquidity or capital contingency plan triggers[28]. More relevant, the recovery planning has been thought to be subject to appropriate risk governance processes in the firm, including being subject to accurate review of the Board[29].

As noted above, the European Union responded to the call of the FSB by carrying out the Conclusions of the Council of the European Union on Crisis Prevention, Management and Resolution of 18 May and 7 December 2010 through the adoption on June 2012 by the European Commission of the proposal for the Recovery and Resolution Directive.

However, in order to fill the interim period before the Commission's proposal on recovery and resolution was implemented at EU level and foster consistency and convergence of best practices in recovery planning, the European Banking Authority (EBA) presented on 15 May 2012 a discussion paper[30] on the essential elements of the recovery plans. Taking into consideration the FSB's *Key elements* and the experience of national authorities in Europe, the EBA provided a preliminary overview on a possible template for recovery plans covering fundamental issues and providing a non-exhaustive lists of information

[27] See FSB, *Key Attributes of Effective Resolution Regimes for Financial Stability*. The *Key Attributes* provide some guidance on the definition of qualitative and quantitative triggers. In particular, quantitative triggers focus mainly on the extent or speed of change in different elements such as, amongst others, ratings downgrades, credit risk limits, equity ratios, collateral requirements, rise in public debt and GDP forecasts. Qualitative triggers include instead: requests from counterparties for early redemption of liabilities, difficulties in issuing liabilities at current market rates, an unexpected loss of senior management, and adverse court rulings.
[28] See FSB, *Key Attributes of Effective Resolution Regimes for Financial Stability*.
[29] See FSB, *Key Attributes of Effective Resolution Regimes for Financial Stability*.
[30] See EBA, *Discussion Paper on a template for recovery plans* (EBA/DP/2012/2), 15 May 2012.

that credit institutions have to communicate to competent authorities. Purpose of the discussion paper was to profile an harmonized, but flexible, toolkit that could be applied in all national jurisdictions which were until then characterized by widespread fragmentation of the rules on recovery planning. According to the EBA's document, the recovery template was designed to gauge the robustness of the options available for the financial entity to counter a crisis and assess whether the nature of these options was sufficiently varied to deal with a broad variety of shocks[31]. After publishing the discussion paper, EBA recommended on 23 January 2013 major EU-cross border banking groups to develop their own recovery plan by the end of 2013[32]. This recommendation required credit institutions to submit recovery plans to the respective competent authorities whose content - discussed within a college of supervisors - was to be drafted in accordance with the FSB's *Key Attributes* and the EBA's template.

The role of the EBA in recovery planning has been further amplified by the Directive 2013/36/EU (*Capital Requirement Directive,* CRD) of 26 June 2013, where the European legislator clearly stated that EBA should assess and coordinate initiatives, in accordance with Regulation (EU) No 1093/2010, on recovery plans with a view to promoting convergence in that area. In addition, where a recovery plan is being drafted, EBA should contribute to and participate actively in the development and coordination of effective and consistent recovery and resolution plans in accordance with Regulation (EU) No 1093/2010[33].

One can argue that the CRD represents the earliest EU legal framework for recovery planning. Indeed, article 74(4) required all national competent authorities to ensure that credit institutions prepare, maintain and update recovery plans for the restoration of an institution's financial situation following a significant deterioration[34]. Even more important, the requirement to put in

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[31] See EBA, *Discussion Paper on a template for recovery plans* (EBA/DP/2012/2), 15 May 2012.
[32] See EBA, *Recommendation on the development of recovery plans* (EBA/REC/2013/02), 23 January 2013.
[33] See Recital (34) and article 74(4) of CRD.
[34] Article 74(4) of CRD.

place recovery plans falls within the broader obligation for credit institutions to define robust internal governance arrangements which, according to the wording of the provision, must include:

(i) a clear organizational structure;

(ii) well-defined, transparent and consistent lines of responsibility;

(iii) effective processes to identify, manage, monitor and report the risks credit institution might be exposed to;

(iv) adequate internal control mechanisms, including sound administration and accounting procedures; and

(v) and remuneration policies and practices that are consistent with and promote sound and effective risk management[35].

Because of that, the CRD suggests the acknowledgement of the recovery plans as regulatory tools to be incorporated within the wider range of corporate governance instruments available for banks and investment firms.

Yet, as already pointed out, the accurate EU legal framework on recovery planning is to be found in the EU BRRD of 15 May 2014. This Directive - and the corresponding regime stipulated by the Regulation (EU) No 806/2014 on the Single Resolution Mechanism and a Single Resolution Fund[36] - sets out an harmonized Union-wide framework for crisis prevention, management and resolutions of credit institutions, investment firms, holding companies and banking groups. The economic foundation of an harmonized framework of banking crisis management across EU countries has been widely recognized by the European legislator. Indeed, while the "*absence of common conditions, powers and processes for the resolution of institutions is likely to constitute a barrier to the smooth operation of the internal market and hinder cooperation between national authorities when dealing with failing cross-border groups of*

[35] Article 74(1) of CRD.

[36] According to Recital (18) of the Regulation (EU) No 806/2014 "*In order to ensure a level playing field within the internal market as a whole, this Regulation is consistent with Directive 2014/59/EU. It therefore adapts the rules and principles of that Directive to the specificities of the SRM and ensures that appropriate funding is available to the latter*".

institutions [...], *differences in resolution regimes may affect the funding costs of institutions differently across Member States and potentially create competitive distortions between institutions*"[37]. It follows that the BRRD represents one of the farthest step to acknowledge the principle of market economy according to which if a credit institutions fails, its shareholders should be hierarchically first to absorb risks and losses.[38] In line with this understanding, the Directive recognizes the *"no creditor worse off principle"* under which no creditor must incur greater losses than it would have incurred if the institution had been wound up under normal insolvency proceedings[39]. Fully in accordance with the international standards and the growing convergence of national and international best practices[40], the Liikanen Report[41], whose main purpose was to develop regulatory proposals for strengthening the structure and the resilience of the EU banking sector, also highlighted the importance of the BRRD proposal stating that it would have enhanced "*the likelihood that banks can be wound down in an orderly fashion and without impact on other market participants*"[42].

The new EU banking recovery and resolution regime provides a set of preventive instruments in order "*to intervene sufficiently early and quickly in an unsound or failing institution so as to ensure the continuity of the institution's critical financial and economic functions, while minimizing the impact of an institution's failure on the economy and financial system*[43]".

Essential component of this new ex-ante market-oriented[44] toolkit is the recovery planning. In fact, according to Title II, Chapter I, Section II of the BRRD, credit institutions are now required to prepare, maintain and update at least

[37] See Recital (9) of BRRD.
[38] See DEUTSCHE BUNDESBANK, *Europe's new recovery and resolution regime for credit institutions*, Monthly Report, June 2014, p. 31.
[39] See Recital (5) of BRRD
[40] See BINDER, *Resolution Planning and Structural Bank Reform within the Banking Union*, 18 December 2014, in *European Banking Union. Prospects and challenges*, in Castaneda – Karamichailidou – Mayes - Wood (eds.), Routledge, 2015, p. 9.
[41] See HIGH-LEVEL EXPERT GROUP on reforming the structure of the EU banking sector, chaired by LIIKANEN, *Final Report* (so-called *Liikanen Report*), Brussels, 2 October 2012.
[42] See LIIKANEN, op. cit., p. 82.
[43] See Recital (5) of BRRD.
[44] See BINDER, *supra* note 41.

annually recovery plans that set out measures to be taken for the restoration of their financial position following a significant deterioration. These plans must comprise appropriate conditions and procedures to ensure the timely implementation of recovery actions as well as a wide range of recovery options[45]. Further, different scenarios of severe macroeconomic and financial stress relevant to the institution's specific conditions, including system-wide events and stress specific to individual legal persons and to groups, are to be included[46]. The management body of the credit institution has the duty to assess and approve the recovery plan before submitting it to the competent authority for reviewing[47]. The layout of the plans must be based on a variety of information summarized in Section A of the Annex to the Directive[48] and further specified by the final EBA Regulatory Technical Standards (RTS) on the content of recovery plans[49] and the EBA Guidelines (GL) on the range of scenarios to be used in recovery plans[50]. More precisely, key elements of recovery plans must include:

- *(i)* information on governance;
- *(ii)* a strategic analysis;
- *(iii)* an analysis of any material changes to the institution, group or recovery plan since the previous version of the recovery plan submitted to the competent authority;
- *(iv)* a communication and disclosure plan; and
- *(v)* an analysis of the preparatory measures set out in the recovery plan to restore credit institution's capital base, reduce risk and leverage, restructure liabilities and business lines, maintain continuous access to financial markets infrastructures, ensure the smooth functioning

45 See Art. 5(1) of BRRD.
46 See Art. 5(6) of BRRD.
47 See Art. 5(9) and 6(1) of BRRD.
48 See art. 5(5) and Annex, Section A of BRRD.
49 See EBA, *Draft regulatory technical standards on the contents of recovery plans* (EBA/RTS/2014/11), 18 July 2014.
50 See EBA, *Guidelines on the range of scenarios to be used in recovery plans* (EBA/GL/2014/06), 18 July 2014.

of essential operational systems and facilitate the sale of assets and business lines[51].

Recovery plans must also include an array of indicators, which may identify the points at which appropriate actions referred to in the plan are to be taken[52]. These indicators have qualitative or quantitative nature relating to the institution's financial position and must be capable of being monitored easily[53]. Furthermore, the range of scenarios to be included in the recovery plans must be based on events that are most relevant to the institution or group concerned and must ensure coverage of at least one system-wide event, one idiosyncratic event and a combination of system-wide and idiosyncratic events[54].Recovery plans *should* not assume access to extraordinary public financial support or expose taxpayers to the risk of loss, but they may provide for the use of central bank facilities identifying those assets that are to be qualified as collateral[55].

Pursuant to article 6 of the BRRD, supervisory authorities must review the satisfaction of the recovery plan's compliance with the requirements outlined in the Directive and assess whether the implementation of the arrangements proposed in the plan is likely to maintain or restore the viability and financial position of the credit institution or of the group; and whether the plan and specific options within the plan are likely to be implemented quickly and effectively in situation of financial distress, avoiding to the maximum extent possible any significant effect on the financial system[56]. To ensure that supervisory authorities take a common approach in assessing the recovery plans presented by credit institutions, EBA has published on 18 July 2014 Regulatory Technical Standards (RTS) on common criteria for such assessments[57].

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[51] See Art. 4 and 6, EBA/RTS/2014/11. See also Annex, Section I of BRRD.
[52] See ANNEX, *Section I*, lett. (20) and Art. 9(1) of BRRD.
[53] See Art. 9(1) of BRRD.
[54] See Title II (8) and (9), EBA/GL/2014/06.
[55] See Recital (31) and art. 5(4) of BRRD.
[56] See Art. 6(2) of BRRD.
[57] See EBA, *Final Regulatory Technical Standards on the assessment of recovery plans* (EBA/RTS/2014/12), 18 July 2014.

Supervisory authorities must communicate the recovery plan to their respective - newly established - resolution authorities in order to identify any actions, which may adversely impact the resolvability of the credit institution and make recommendations with regard to those matters[58]. Besides, the BRRD provides a specific discipline if a credit institution fails to submit proper recovery plans or if a recovery plan does not adequately remedy the deficiencies and the potential impediments to resolvability identified in the authorities' assessments.[59]

As last point, articles 7 and 8 of the Directive regulate recovery planning of banking groups. The requirements assigned for group's recovery plans are similar although the structure of the assessment procedure is more sophisticated[60].

4. As already pointed out, the purpose of recovery planning is not to forecast the factors that could prompt a crisis. Rather, they aim at identifying those measures and strategies useful to counter financial distress of credit institution and assess whether the options available are sufficiently robust and varied to deal with a wide range of stress scenarios[61]. However, one of the key features of the recovery framework is that the BRRD explicitly recognizes recov-

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[58] See Art. 6(4) of BRRD.

[59] See Art. 6(5) and (6) of BRRD. More precisely, *"[i]f the institution fails to submit a revised recovery plan, or if the competent authority determines that the revised recovery plan does not adequately remedy the deficiencies or potential impediments identified in its original assessment, and it is not possible to adequately remedy the deficiencies or impediments through a direction to make specific changes to the plan, the competent authority shall require the institution to identify within a reasonable timeframe changes it can make to its business in order to address the deficiencies in or impediments to the implementation of the recovery plan"*. Furthermore *"If the institution fails to identify such changes within the timeframe set by the competent authority, or if the competent authority assesses that the actions proposed by the institution would not adequately address the deficiencies or impediments, the competent authority may direct the institution to take any measures it considers to be necessary and proportionate, taking into account the seriousness of the deficiencies and impediments and the effect of the measures on the institution's business, the competent authority may [...] direct the institution to: (a) reduce the risk profile of the institution, including liquidity risk; (b) enable timely recapitalization measures; (c) review the institution's strategy and structure; (d) make changes to the funding strategy so as to improve the resilience of the core business lines and critical functions; (e) make changes to the governance structure of the institution"*.

[60] See Artt. 7 and 8 of BRRD.

[61] See EBA/RTS/2014/11.

ery plans as corporate governance arrangements within the meaning of Article 74 of the CRD[62].

There is no general accepted definition of corporate governance for banks. The law and economics literature argues about the differences between governance of banks and that of non-financial firms[63] and over the last decades many scholars developed different understanding of the role that corporate governance should play within the banking industry[64]. However, because of the peculiar functions and business of credit institutions from those of industrial firms and the stringent prudential regulation of capital and risk, the banking industry witnessed the emergence of particular governance practices and works on sound corporate governance for banks and investment firms[65]. To fill any such gaps and avoid uncertainties, the Basel Committee on Banking Supervision issued an overall definition of corporate governance for banks under a supervisory approach. In its final "*Principles for Enhancing Corporate Governance*[66]" the Basel Committee states that "*from a banking industry perspective, corporate governance involves the allocation of authority and responsibilities, i.e. the manner in which the business and affairs of a bank are governed by its board*

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[62] See Art. 5(1) of BRRD.

[63] See MEHRAN – MORRISON - SHAPIRO, *Corporate Governance and Banks: What Have We Learned from the Financial Crisis?*, in *Federal Reserve Bank of New York Staff Reports*, no. 502, June 2011, according to which *"two key differences distinguish the governance of banks from that of nonfinancial firms. The first is that banks have many more stakeholders than nonfinancial firms. The second is that the business of banks is opaque and complex and can shift rather quickly"*. See also MÜLBERT, *Corporate Governance of Banks after the Financial Crisis - Theory, Evidence, Reforms*, in *ECGI - Law Working Paper* No. 130/2009, August 2010; LEVINE, *The Corporate Governance of Banks: A Concise Discussion of Concepts and Evidence*, in *World Bank Policy Research Working Paper* No. 3404, September 2004; HOPT, *Corporate Governance of Banks after the Financial Crisis*, in Wymeersch – Hopt - Ferrarini (eds.), *Financial Regulation and Supervision, A post-crisis analysis*, Oxford University Press, 2012; BECHT – BOLTON - ROELL, *Why bank governance is different*, in *Review of Economic Policy*, Volume 27, Number 3, Oxford, 2012, pp. 437 – 463.

[64] See, *inter alia*, MACEY - O'HARA, *The Corporate Governance of Banks*, in *Economic Policy Review*, Vol. 9, No. 1, April 2003.

[65] See MÜLBERT, *supra* note 64. Main works on banks' corporate governance are: BASEL COMMITTEE ON BANKING SUPERVISION, *Enhancing corporate governance for banking organisations*, February 2006; OECD, *Principles of Corporate Governance*, C(2004)61, April 2004; OECD, *Policy Brief on Corporate Governance of Banks in Asia*, June 2006; OECD, *Policy Brief on Improving Corporate Governance of Banks in the Middle East and North Africa*, November 2009;

[66] See BASEL COMMITTEE ON BANKING SUPERVISION, *Principles for enhancing corporate governance*, October 2010, available at *www.bis.org*. See also the definitions provided by the new Consultative Document, *Guidelines Corporate governance principles for banks,* issued by the Basel Committee on Banking Supervision on October 2014, available at *www.bis.org*.

and senior management, including how they: (i) set bank's strategy and objectives; (ii) determine the bank's risk tolerance/appetite (iii); operate the bank's business on a day-to-day-basis; (iii) protect the interests of depositors, meet shareholder obligations, and take into account the interests of other recognized stakeholders; and (iv) align corporate activities and behaviour with the expectation that the bank will operate in a safe and sound manner, with integrity and in compliance with applicable". These principles on corporate governance for banks are currently under revision[67] but the core functions and the role of corporate governance in the banking sector remain untouched.

In light of these principles, a primary objective of the banking corporate governance framework is to emphasize the key components of risk governance as risk culture[68], risk appetite[69] and their relationship to the bank's risk-bearing capacity[70]. Under this perspective, one of the critical task of the management board becomes to strengthen the bank's risk governance through the establishment of, *inter alia*, policies, procedures and processes designed to ensure that credit institutions, having regard to its nature, size and complexity, may have effective capabilities to identify, aggregate and monitor their risk profiles[71]. This risk identification and monitoring must include quantitative and qualitative analysis that are able to ensure a complete and accurate reflection of exposures and may allow timely action to address and mitigate risks under a variety of stress scenarios[72]. A sound banking corporate governance framework

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[67] See BASEL COMMITTEE ON BANKING SUPERVISION, *Consultative Document "Guidelines Corporate governance principles for banks"*, October 2014, available at *www.bis.org*.

[68] See, amongst others, MIHET, *Effects of Culture on Firm Risk-Taking: A Cross-Country and Cross-Industry Analysis*, in *IMF Working Paper* No. 210, 2012; African Development Bank, Proposal for a Definition of the Bank's risk appetite, risk dashboard and enhancement of Credit Risk Governance, April 2011.

[69] For a better understanding of the concept see FSB, *Principles for An Effective Risk Appetite Framework*, Consultative Document 17 July 2013.

[70] *Idem*.

[71] For an evaluation of the different risk profiles of credit institutions see EBA, *Guidelines for common procedures and methodologies for the supervisory review and evaluation process (SREP)*, EBA/GL/2014/13, 19 December 2014.

[72] See BASEL COMMITTEE ON BANKING SUPERVISION, *Guidelines Corporate governance principles for banks*, *supra* note 58, available at *www.bis.org*. See, in particular: Principle 7, paragraphs 110 - 124.

thus would require a series of internal procedures, methods and tools, within the risk management function, that may help to perform effective risk assessments trough the collection of a wider variety of internal and external data and allow immediate adjustments when the risk-taking behavior of the credit institution overcomes its sustainability.

Contextualizing this background, the recovery planning plays a pivotal role. The recovery plans are not just a set of ambiguous documents that must be submitted on the basis of a regulatory automatism. Instead, they outline a new internal procedure that is integrated within the overall governance framework of the credit institution and is designed to enhance the understanding of the bank's business structure[73]. Such a recovery planning procedure is able to strengthen the regulatory incentives that already exist for banks' shareholders and managers to challenge and resolve governance problems. For example, these plans may require structural changes in the organization of the credit institution. By designing relevant stress scenarios and providing assessments of these events and contingencies on key elements of the business structures, such as capital, liquidity, business model, profitability, payments and settlement operations and reputation, recovery planning may affect the strategic decisions of managers, soliciting the credit institution to take appropriate corrective actions to ensure a constant bank's soundness[74]. Further, for a successful execution of the recovery plans, the management body may be obliged to take preparatory measures that involve changes of the institution organization, governance and personnel[75].

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[73] See BINDER, *supra* note 45.

[74] See on the issue: ERNST - YOUNG, *Progress in financial services risk management, A survey of major financial institutions*, 2014, available at *www.ey.com*, pp. 53 - 54. In this publication some managers pointed out that "*recovery process is a beneficial management exercise*" and may encourage top management to consider what they should be doing to simplify the structure of the firm.

[75] For example, according to BINDER, *supra*, if *"the planning process reveals a group's dependence on a centralized IT infrastructure provided by a group member, resolution action with regard to other members of the group may be confronted with severe impediments if these services are not available. Such findings could then inform preparatory action by both the banks and the relevant authorities to help mitigate these problems in advance"*.

Even more relevant for our purpose, the economic literature has recognized a trade-off between poor governance and excessive risk-taking[76], while the 2008' financial crisis showed how this trade-off *may* ultimately result in unexpected losses and systemic risk. Against this backdrop, the recovery plans is capable to provide an ex-ante discipline for the management body. Managers now have to spend sufficient time and acquire a deep knowledge of the risks to which credit institution may be exposed[77]. Further efforts have to be invested in the definition of possible actions that may strengthen the efficiency of the recovery actions[78]. Further, in order to maintain strength and efficiency against those risks, the management body should have a comprehensive understanding of the entire organization and a full consideration of the operational and financial linkages among the bank's core business lines, material entities, and critical operations[79]. But, if these circumstances are correct, this means that the recovery planning process is able to affect the overall firm's risk preferences in corporate investments and may also deter harmful conducts[80]. Indeed, recovery plans can be thought as new regulatory caps that force top management to constrain excessive risk-taking behaviors and avoid those actions that may disrupt the viability and effectiveness of the recovery options.

Another purpose of the recovery plans is to equip both the supervisory and resolution authorities and the bank's management itself with relevant and updated information[81]. In this perspective, the assessment process carried out by the authorities is to be deemed as an external monitoring mechanism of the governance arrangements which may further help the establishment of more

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[76] See, *inter alia*, JOHN – LITOV - YEUNG, *Corporate Governance and Risk Taking*, in *The Journal of Finance*, Vol. 63, Issue 4, pp. 1679 – 1728, August 2008; LAEVEN - LEVINE, *Bank Governance, Regulation, and Risk Taking*, NBER Working Paper No. 14113, June 2008; STULZ, *Governance, Risk Management, and Risk-Taking in Banks*, in *ECGI Finance Working Paper* No. 427/2014, June 2014.

[77] See BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, *Consolidated Recovery Planning for Certain Large Domestic Bank Holding Companies*, in *Division of Banking Supervision and Regulation*, SR 14-8, 25 September, 2014 available at *www.federalreserve.gov*.

[78] See BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, *Consolidated*, *op. cit.*

[79] See BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, *Consolidated*, *op. cit.*

[80] See THOLE, op. cit., *supra* note 3.

[81] See THOLE, *op. cit., supra* note 3.

efficient corporate governance practices. Such external monitoring function completes the overall corporate governance framework by proving regular feedbacks on the viability of the arrangements put forward to constraint bank's exposures and restore its financial position. The BRRD requires periodical and updating communication between the authorities and the credit institution. Then, recovery planning blueprints the emergence of a new dialogue between bank's management body and supervisory and resolution authorities. This dialogue ensures that firm's actions and strategies take into account the broadest range of factors that may affect stakeholders and the overall financial system. It is not a case then that the monitoring function of the recovery planning process has been ultimately recognized in the *Supervisory Review and Evaluation Process* (SREP) which requires supervisory authorities, when assessing the existence of deficiencies in the internal governance and the institution-wide controls, to verify the completeness and the credibility of the recovery plans, as well as the suitability of the recovery planning arrangements[82].

As a last point, it is worth mentioning that the disclosure of the relevant information needed to formulate the recovery plans may result in a primary source of relevant information even for market participants and third parties which now have a new valuable instrument to assess the degree of firm's exposures and the nature of those vulnerabilities that may arise in times of financial distress. This ancillary function of third-party information provider increases confidence of market participants and transparency of banks' operations, structure, and financial performance, providing at last a higher degree of protection for both shareholders and creditors of the banking firm.

5. When the global financial crisis exposed the vulnerabilities of the corporate governance arrangements in banks and financial institutions, scholars and practitioners reacted focusing on the role that preventive regulatory

[82] See EBA, *Guidelines for common procedures and methodologies for the supervisory review and evaluation process (SREP)*, EBA/GL/2014/13, 19 December 2014.

measures may play in the governance of credit institutions. In particular, the continuing shift in the banking resolution framework - from an ex-post regulatory approach to an ex-ante regulatory intervention[83] - has been fertile ground for the construction of new tools and processes that may help the smooth functioning of firms, as well as the overall stability of the whole financial system. This change of perspective seems to be capable of affecting the corporate governance practices of credit institutions and some of these innovative key instruments and processes could now be used to address the weaknesses related to the bank's day-to-day management. This is the case of the new recovery planning framework, initially developed by some countries within their own national banking legislation and now harmonized at EU level through the implementation of the FSB's standards and the EU BRRD. Not only does such new framework provide an effective range of recovery options and strategies that may tackle banking failures at an early stage thereby preventing the need of an insolvency proceeding, but it also complements the risk governance arrangements of banks and investment firms. Through the drawing up of periodical recovery plans top management now has the duty to improve the organization of risk management by taking a more informed role in the assessments of the different bank's profiles. In order to design an effective and consistent set of arrangements and measures for a quick recovery, this planning process requires a deep knowledge and a better understanding of risks, strategies and core functions of the credit institution. Further, the inclusion of a variety of different scenarios, indicators and triggers for recovery actions in the recovery plans represents a further regulatory incentive for banks to scrutinize those excessive risk-taking behaviors that may ultimately result in ruinous financial distress. This responsiveness parallels the external monitoring function of the recovery planning, carried out by the supervisory and resolution authorities. This monitoring process may act as a substitute in the event of poor governance

[83] See THOLE, *op. cit., supra* note 3, pp. 3 - 6.

by the management body. It allows either for continuous assessments of impediments and weaknesses in the recovery framework or for further actions, which are deemed to preserve the ongoing business of the bank and the efficient implementation of its corporate governance arrangements.

The harmonization process at EU level carried out by means of the BRRD is still under review. The EU Commission and the EBA have different responsibilities in leading these new reforms and further regulatory developments are expected in the next few years. However, this legal framework has set out the foundations for a possible convergence in the recovery actions outlined in the recovery plans. This could imply in the next future the establishment of "standardized" recovery options and common strategies that may bring about more convergence in the risk governance practices and in the corporate governance arrangements of banks and financial institutions across Europe. Under this perspective, further research on the issue remains inescapable.

CORPORATE GOVERNANCE IN THE EUROZONE

Matthias Lehmann - Enrico Leone*

ABSTRACT: *This paper concerns the regularion of corporate governance in the Eurozone. Taking into account the results of a comparative research on the European models, this analysis focuses on the composition and selection of boards. The authors expect that the new role of the ECB will impose a cultural change, not only with regard to the corporate governance, but also throughout the Eurozone banking system.*

1. As a result of the recent implementation of provisions set forth in Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 ("CRD IV") in each European member state and their interpretation in accordance with the guidelines of the European Banking Authority (EBA) [1], European banks will be required to review their corporate governance and adopt new criteria for the selection of board members.

The purpose of this article is to provide a brief analysis of the main challenges facing the banking industry in the Eurozone and the role of the European Central Bank.

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[1] See EUROPEAN BANKING AUTHORITY, *EBA Guidelines on Internal Governance (GL 44)*, 27 September 2011

A wealth of studies and theories[2] on the causes of the financial crisis, which started in the United States in 2008 and which has being spreading its negative effects to the global banking industry during the last years, suggests that one of the key factors which determined the success, survival or disappearance of a given credit institution was the performance of its corporate governance[3].

Institutions operating in the same markets and regions, and sharing the same regulatory framework experienced quite different outcomes depending on their corporate governance which, in turn, determined the adoption of high or less risk-taking strategies.

Until recently, the corporate governance of banks was regulated by codes of conducts and very general non-binding rules. This inadequate legal framework, together with the unclear role of the competent authorities, allowed ineffective risk management practices and short-term prospects for the management in many credit institutions. These deficiencies also included insufficient board oversight of senior management, an opaque internal organisation and the creation of business and structures subject to inefficient risk management.

In order to improve the governance system of banking institutions, in 2010 the Basel Committee of Banking Supervision (the "Basel Committee") decided to intervene by issuing the banking sector with principles and guidelines designed to guarantee sound management of credit institutions and to tackle such failures as could re-create conditions for the ineffective risk management of a bank[4].

In addition, and more important, the Basel Committee agreed that each supervisor should perform a comprehensive evaluation of the supervised banks' overall corporate governance policies and practices and evaluate the implementation of those principles and standards.

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[2] See MEHRAN - MORRISON - SHAPIRO, *Corporate Governance and Banks: What Have We Learned from the Financial Crisis?*, Federal Reserve Bank of New York, June 2011.

[3] See WALKER *A review of corporate governance in UK banks and other financial industry entities – Final Recommendations*, 2009.

[4] See BASEL COMMITTEE ON BANKING SUPERVISION, *Principles for enhancing corporate governance*, Bank for International Settlements, October 2010.

In general, the Basel Committee's regulatory initiative resulted in an improvement of the overall governance of credit institutions established in the relevant jurisdictions and increased attention to the board's selection and structure has been seen since 2010. The steps taken by credit institutions, which in turn now demonstrate a better understanding of the fundamental factors concerning corporate governance, as well as the fact that supervisors have now enhanced their oversight activity, are encouraging changes. Nevertheless, the improvements seen still appear to be insufficient and the current legal framework is considered to be still in need of further correction[5].

With specific regard to Europe, the recommendations of the Basel Committee were implemented through the CRD IV, which introduced in each Member State the "*principles and standards to ensure effective oversight by the management body, promote a sound risk culture at all levels of credit institutions and investment firms and enable competent authorities to monitor the adequacy of internal governance arrangements*" [6].

The implementation of these principles and standards has been carried out following the principle of proportionality and, therefore, will be applied relative to the size, complexity, structure, economic relevance and risk profile of the supervised credit institution. No indications have been given by the Directive on a specific management structure credit institutions are required to adopt.

With regard the latter aspect, two types of management structure controlling the executive and supervisory functions of a credit institution are used across Europe and acknowledged by the European legislator: the one-tier system and the two-tier-system. Within a credit institution which adopts a one-tier system, a single board typically performs both the management and the supervisory tasks, within a credit institution which adopts a two-tier system, the management and supervisory functions are performed by separate boards.

[5] See FINANCIAL STABILITY BOARD (FSB), *Thematic Review on Risk Governance*, 2013.
[6] See Recital 54 of CRD IV

Regardless of the type of management structure adopted, the effectiveness of corporate governance will be determined mainly by the cross-check activity of which any of the individuals involved in the management of the credit institution are required to be part[7].

2. The Board should be structured in such a way that the board itself and senior management are able to perform their duties and take their decisions following efficient and risk weighted processes.

Therefore, the board's overall duties also include the distribution of the key responsibilities and authorisations within the board itself and the terms of the mandate to the senior management and those in charge of control functions. In other words, an efficient governance system should be designed to allow the board to adopt a model which guarantees a constant dialogue and interaction between management and supervisory functions and which mirrors the size, complexity and risk of the relevant credit institution.

Even if the adoption of a well designed management scheme by the board represents an important element for the successful governance of any company, this in itself cannot be enough, in particular in the case of credit institutions. An effective management structure needs also to be supported by a sound corporate culture and an adequate management selection criterion.

Firstly, a well balanced management body of itself does not guarantee a sound corporate governance if the tasks performed by each member of the board do not conform to sound corporate culture and values. The "tone at the top" and the promotion and implementation of positive corporate values has been shown to have a direct effect on the risk attitudes of the board, senior management and the staff of a bank.[8]

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[7] See EUROPEAN BANKING AUTORITY, *op. cit.*

[8] See, *e.g.*, LANGEVOORT, *Chasing the Greased Pig down Wall Street: A Gatekeeper's Guide to the Psychology, Culture, and Ethics of Financial Risk Taking*, 96, in *Cornell L. Rev*. 1209, 2010-2011, p. 1215 ff.; LIPTON - NEFF - BROWNSTEIN - ROSENBLUM -EMMERICH - FAIN, *Risk Management and the Board of*

Therefore, identifying clearly acceptable and unacceptable behaviours as well as methods to stimulate internal discussions and escalation of problems to a higher level within the institution positively increase both risk management performance and the safe management of the bank.

Corporate culture and values represent the basis on, and from, which the board, the body responsible for managing the risk in general, will elaborate the risk appetite statement (RAS), an analysis based on quantitative and qualitative considerations of the business model of the relevant bank. The RAS analyses and determines both the risks that the credit institution is intending to assume in order to achieve its business targets and those which are outside these limits. This analysis will not be limited to a general evaluation of the bank's risks but will need to review from a practical prospective the effectiveness of the risk management for each business line. In this regard, the RAS defines and predetermines responsibilities for risk control functions and management. Different risk control procedures would be established depending on the size, structure and complexity of a bank.

Second, the performance of the board will be conditioned by the expertise and experience of its members. Consequently, the selection of the members of the board and the definition of the criteria for the composition of the board generally represent an important stage in the life of any credit institutions and it is understandable that this has been the subject of attention by the European legislator.

In this regard, Article 91(1) of CRD IV requires board members to have at all time "*sufficiently good repute and possess sufficient knowledge, skills and experience to perform their duties*". The selection procedure should determine whether candidates have a combination of the relevant knowledge, skills and experience, which in turn needs to be evaluated taking into consideration the size, complexity and risk profile of the specific credit institution. Proof of an immaculate record of integrity and good repute is also fundamental.

Directors, in *Bank and Corporate Governance Law Reporter*, 45, no. 6, February 2011, pp. 793 - 794; AWREY - BLAIR - KERSHAW, *Between law and markets: Is There a Role for Culture and Ethics in Financial Regulation?*, 38, in *Delaware Journal of Corporate Law*, 191, 2013.

These requirements must be met by members of the management body from their appointment to the moment at which their mandate ends.

In addition to the above personal circumstances, board members are required to commit sufficient time to allow them to perform the relevant functions.

The European legislator has recognised that being a "*fit and proper person*" will no longer be sufficient as it will also be necessary to determine whether the candidate is actually capable of committing to such a burdensome function. CRD IV has already set out some circumstances that are assumed would jeopardise the satisfactory performance of a board member's role. Under Article 91(3) of CRD IV, circumstances which might impede such performance include the concurrent appointment of the candidate to other directorships exceeding the limits indicated by the directive itself as well as any conflict of interest which could affect in the performance of his/her duties.

In the case of "*significant credit institutions*"[9], the standards to be met are even stricter. This is explained by the fact that these institutions are capable of creating systemic risk, thereby threatening financial stability in the Eurozone. The EU legislator therefore requires that the selection of the board must be performed through transparent and open appointment procedures by a "nomination committee" composed of non-executive members of the board. This nomination committee will identify candidates and evaluate their knowledge, skills and experience. Furthermore, the nomination committee will be in charge of assessing the ongoing activity and performance of each board member from his or her appointment together with those of the board in general.

In the process of identifying selection criteria for board members, the committee is also required to evaluate the balance of knowledge, skills, diversity and experience of the management body. This provision is not only intended to guaran-

[9] See Article 2, point (20) of the Regulation (EU) No 468/2014 of 16 April 2014 of the European Central Bank establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities (SSM Framework Regulation)

tee the presence of underrepresented genders in the management body but also to avoid the so called "groupthink" which characterised the composition of the boards of some of the banks which suffered the highest losses during the crisis.

3. Diversification in the composition of the board on the basis of age, gender, geographical provenance as well as educational and professional background, including employee representatives, has shown to guarantee a more varied view of the different aspects of the business and has proven to be more effective from a risk prospective. A number of economic studies have shown that women are less prone to exaggerated risk taking than men, that older people's choices are often safer than those of younger people, and that even marital status can affect decision-making.[10] They have drawn on insights from psychology, sociology and anthropology, using what is commonly called a 'behavioural approach' to economics.

In addition, potential candidates should not be in the position that any conflict of interest might jeopardise their objectiveness and result in undue influence as a result of their personal or professional relationships with other persons or entities (including shareholders).

Non-executive members have an important role in the control activity since they are required constructively to challenge the strategy of the credit institution and the performance of the senior management as well as to ensure that efficient controls and systems of risk are in place.

While a well thought through process for selecting the appropriate members for a managing body is a precondition for a successful and effective board, this alone is not sufficient to ensure its good functioning.

The skills and knowledge of board members must be maintained and enhanced through induction programmes at the beginning of their mandates - the board should allocate resources to organise ongoing training on those subjects which,

[10] See, *e.g.*, LANGEVOORT, *op. cit.*; JIANAKOPLOS - BERNASEK, *Financial Risk Taking by Age and Birth Cohort*, 72, in *Southern Economic Journal*, 2006, pp. 981 - 1001; YAO - HANNA, *The Effect of Gender and Marital Status on Financial Risk Tolerance*, 4, in *Journal of Personal Finance*, 1, 2005.

from time to time, are relevant to the bank, especially for those members who have less risk-related and regulatory experience[11].

From November 2014, the supervision of compliance by credit institutions in the Eurozone with the new banking governance rules, as well as any EU laws and regulations has been conferred on the ECB which, under the legal framework of the Single Supervisory Mechanism (SSM), will exercise direct or indirect supervision over-sighting the supervisory activity of the National Competition Authorities (NCAs) over such Eurozone credit institutions.

The introduction of a common supervisory system is aimed at restoring confidence in the European banking sector, creating the conditions to strengthen European credit institutions, making sure that banks avoid in taking excessive risks and assuring a consistent approach at Eurozone level.

In order to achieve the above mentioned targets, under the legal framework of the SSM, the ECB is assigned the direct supervision of about 120 "*significant credit institutions*[12]", which account for approximately 85% of the assets in the Eurozone banking sector. The ECB's direct supervision is carried out through the Joint Supervisory Teams, which comprise staff from both the ECB and the NCAs of the countries in which the credit institutions are incorporated and their banking subsidiaries or their significant cross-border branches are established. The day-to-day supervision of the 3,400 remaining banks (the "*less significant credit institutions*[13]") will remain under the responsibility of the NCAs with the oversight of the ECB[14].

The structure of the SSM shows the clear intention of the European legislator to combine the local expertise and experience of the NCAs with centralised control and coordination by the ECB. In particular, the ECB has been assigned a central role in

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[11] See CAPRIGLIONE – CASALINO, *Improving Corporate Governance and Managerial Skills in Banking Organisation*, International Journal of Advanced Corporate Learning (iJAC), vol. 7, no. 4, Austria, 2014.

[12] See Article 2, points (16) and (22) of Regulation (EU) No 468/2014 of 16 April 2014 of the European Central Bank establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities (SSM Framework Regulation).

[13] See Article 2, point (20) of the SSM Framework Regulation.

[14] See the ECB is in charge of developing guidelines and principles to harmonise the supervisory approach of the NCAs across the Eurozone when supervising the Less Significant Credit Institutions.

the Eurozone banking supervision to guarantee the consistent implementation of rules and standards in the different countries of the Eurozone as well as performing an oversight function on the supervisory activity of the NCAs for “less significant credit institutions”.

The central position of the ECB and its mandate to create a consistent implementation of the European rules should help combat any attempt to interpret the rules in a way which is influenced by local factors or interests and national bias.

With particular reference to the corporate governance of banking institutions, the new supervisory framework is expected to bring into line the different approaches which characterised banking supervision over the past years in the European Union, and, in particular, within the Eurozone countries.

In this regard, comparative research on the characteristic of the management bodies in Europe has indicated that the composition and selection of boards before the crisis showed remarkable differences depending on in which country a bank was incorporated[15].

This was not only because of the peculiarities of the legal system of the jurisdiction in which the supervised entity was incorporated, but also because of the different approaches taken in different jurisdictions by board members of banks and by regulators. In many cases, factors and interests which should have not been relevant in determining the strategy of a credit institution had an undue influence on the decisions of its management and resulted in poor choices and inefficient models from both a business and a risk prospective[16].

The role assumed by the ECB in November 2014 combined with the legal framework on banking governance introduced by CRD IV, which in the last couple of years has been implemented in the national legislation of the European member states, appears to be able to address some of the issues which led to the financial cri-

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[15] See ARNABOLDI - CASU, *Corporate Governance in European Banking*, in *Working Paper Series*, 2011, Cass Business School, City University, London.
[16] See JASSUAUD, *Reforming the Corporate Governance of the Italian Banks*, in *IMF Working Paper*, WP/14/181, 2014.

sis and have resulted in an improvement of the performance of management bodies of the banks within the Eurozone.

In this regard, the supervisory activity of the ECB and its approach will certainly have a remarkable impact on the corporate governance of each significant credit institution as, under article 98(7) of CRD IV its review will include various aspects of the management body life including: a) the "*fit and proper assessment*" considered above, b) the governance arrangements within the Supervisory Review and Evaluation Process (SREP), which allows the review of the effective composition of the board and the committees in relation to the size, complexity, business model and potential risks for a specific credit institution on the basis of objective and independent criteria; and finally c) the decision by the ECB on exemptions regarding the number of non-executive directorships a board member can hold.

4. The standard defined within the SREP will be then applied for the supervision of the NCAs and, consequently, the approach decided at ECB level is expected to be replicated at national level for the *less significant credit institutions*.

The creation of standards does not imply that the ECB intends to adopt the same criteria towards every credit institution. The principle of proportionality will impose diversification in the way in which the SREP is implemented, not only on the basis of the distinction between significant and less significant banks, but also depending on the nature, complexity, scale, business model and risk profile of the supervised banks[17]. Moreover, complete regulatory harmonisation may also have unintended consequences. Financial institutions with a similar board structure and corporate culture will tend to diversify their portfolio in a similar way. 'Herd behaviour' of this kind increases the probability of multiple bank failures in the event of an unfavourable change in circumstance that results in widespread economic disrup-

[17] See EBA, *Guidelines on common procedures and methodologies for the supervisory review and evaluation process*, EBA/GL/2014/13, 19 December 2014.

tion.[18] In the end, a uniform corporate banking structure and culture may render the financial system in the EU more vulnerable instead of making it more stable. Hence some degree of variation is necessary.

On the basis of a number of public statements and speeches[19] from members of the ECB's executive board, it may be predicted, then, that the new role of the SSM will impact significantly on the corporate governance model of many credit institutions in the Eurozone. In particular, the ECB is expected to adopt generally a more intrusive approach towards the activity of the boards of credit institutions and a severe review of their selection and performance.

We can expect, for example, that criteria around the "*fit and proper*" assessment will impose stricter requirements and that credit institutions will be forced to carry out a number of pre-selections before being able to determine whether or not a candidate meets ECB's standards; or the current composition of many boards will no longer be considered acceptable because of the unsatisfactory balance of expertise. More important, the new role of the ECB will hopefully impose a cultural change, not only with regard to the corporate governance of credit institutions, but throughout the whole Eurozone banking system, eliminating local approaches and obviating national biases. This step forward would create the conditions for a raising of the standards of the Eurozone banking industry and a consequentially improved capacity of credit institutions to face the global competition.

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[18] See BEALE - RAND - BATTEY - CROXSON - MAYE - NOWAK, *Individual versus systemic risk and the Regulator's Dilemma*, 108, in *Proceedings of the National Academy of Sciences of the United States of America*, 12647, 2011.

[19] See NOUY, *Marking the inauguration of the ECB's new supervisory responsibilities*, Frankfurt am Main, 20 November 2014; LAUTENSCHLÄGER, *Start of the Single Supervisory Mechanism: from the comprehensive assessment to day-to-day supervision*, Frankfurt, 18 November 2014, available at *www.bankingsupervision.europa.eu.*

BLAMELESS BEHAVIOUR, MANAGEMENT AND PERFORMANCE OF EUROPEAN PUBLIC TOP MANAGERS

Nunzio Casalino - Adam Steinhouse*

ABSTRACT: *Skills, blameless behaviour and performances of public top managers are critical for the success both of the general performance of public administration and of public administration reform attempts. With national policy making becoming increasingly complex and ever more exposed to international co-ordination, as is the case in all EU Member States, the need is all the greater for top public managers with a broad perspective and the ability to co-ordinate their work with both national and international institutions. The European Senior Civil Servant project was an innovative model of trans-national networking and the exchange of best practice, thanks to the active involvement of European schools and institutes of public administration. This essay identifies the benefits and effectiveness of the introduction of a mix of methodologies, including the use of e-learning, and concludes that this mix could improve the training process of all European senior civil servants.*

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The manuscript is the result of joint observations of the two authors. They contributed equally to this work.

1. Many reforms in public administration in the past have led to changes in the role, position, organisation and steering of senior civil servants or public top managers. Owing to decentralisation and globalisation, and to the introduction of other management philosophies, their responsibilities and the competences required of them have changed. Competition with the private market, the increased importance of customer and/or citizen orientation, better quality public services[1], the need for permanent change all demand strong strategic and operational top management[2].

Senior civil servants have to develop into leaders. They should be able to lead innovation and change, to communicate effectively and work in permanent dialogue with all stakeholders[3], to manage the human and financial resources and processes[4], and to achieve the agreed results.

Reaction and learning are studied as major indicators of training outcomes; however, these variables are not the appropriate indicators of the final desired outcome of training programs. An appropriate evaluation of training outcomes[5] is made by measuring changes in job performance[6] and relating it to measurements of achievement of learning goals.

The civil servants' learning must turn from the traditional education methods to modern education methods. Therefore, this article tries to identify and describe the benefits of the introduction of a mix of methodologies to improve the training process of European senior civil servants/top managers[7]. It describes the results and the organisational impact of a course programme combining one month of e-learning

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[1] See DEMMKE, C., & HENOKL, T. 2008. *What are Public Services Good at?*, Study commissioned by the Slovenian EU presidency.

[2] See BERENSCHOT, B.V. 1998. *A Comparison of Personnel Development for Top Managers in Fourteen OECD Member Countries*, The Hague.

[3] See CROSSAN, M.M., LANE, H.W., & WHITE, R.E. 1999. *An organizational learning framework: from intuition to institution*, in *Academy of Management Review*, Vol. 24, No.3, pp. 522-537; MARENGO, L., & DOSI, G. 2005. *Division of labour, organizational coordination and market mechanisms in collective problem solving*, in *Journal of Economic Behaviour & Organization*, 58(2), pp. 303-326.

[4] See DEWHURST, F.W., & CEGARRA, J.G. 2004. *External communities of practice and relational capital,* in *The Learning Organization International Journal*, Vol. 11, pp. 322-331.

[5] See ROSE, H.C. 1998. *A plan for training evaluation,* in *Training and Development Journal*, n.5, p. 23-26.

[6] See DODGSON, M. 1993. *Organisational learning: a review of some literatures,* in *Organisation Studies*, Vol. 14, No.3, pp. 375-394.

[7] See FLYNN, N. 1995. *The Future of Public Sector Management. Are There Some Lessons from Europe?,* in *International Journal of Public Sector Management*, Vol. 8, pp. 59-67.

courses and one week of in-class courses. For each didactic module, the e-learning phase provided general training contents to reinforce participants' background as a pre-requisite for in-class sessions. If we think of life-long training for civil servants, one of the most important points is to find an effective learning method. Learning is not simply a matter of adding one piece of knowledge to another; there are many ways of learning, which must take into account specific needs and approaches[8].

Training is required to improve the knowledge, skills and attitudes of civil servants at all levels, including central, regional, departmental, bureau and sectional[9]. To obtain these skills, officials can participate in training activities at schools of administration, executive leadership academies or other training organisations approved by human resource departments. In the ESCS - European Senior Civil Servant project, an analysis of the main drivers to introduce a real change in the field of public administration[10] was undertaken. We looked at the political, economic, social, legal and environmental contexts of public administration in order to develop and implement an accurate training strategy. The following factors were identified to improve the training activities:

Political factors:

- commitment to create a modern European public administration to support social and economic development;
- new relationships[11] established between national civil servants in the EU context;

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[8] See KUPERUS, H., & RODE, A. 2008. *Top Public Managers in Europe. Management and Working Conditions of the Senior Civil Servants in the European Union Member States*, European Institute of Public Administration/Institut Européen d'Administration Publique, Maastricht, the Netherlands/Pays-Bas.

[9] See STEINHOUSE, A. 2013. *Skills for the 21st Century, in Sustainable Growth in the European Union: The Role of Education and Training*, European Commission Directorate-General for Education and Culture, Luxembourg, pp. 76-78.

[10] See ARMENIA, S., CANINI, D., & CASALINO, N. 2008. *A System Dynamics Approach to the Paper Dematerialization Process in the Italian Public Administration*, in *The Interdisciplinary Aspects of Information Systems Studies*, D'ATRI, A., DE MARCO, M., CASALINO, N. (Eds), Physica-Verlag, Springer, Heidelberg, Germany, pp. 399-408.

[11] See GOLINELLI, G. M., PASTORE, A., GATTI, M., MASSARONI, E., & VAGNANI, G. 2011. *The firm as a viable system: managing inter-organisational relationships*. in *Sinergie rivista di studi e ricerche*, (58).

- reform and institution building of which learning and development is an important sub-component;
- absence of a civil service-wide human resource strategy and policy as a framework for learning and development.

Economic factors:

- resource constraints owing to the new macro-economic situation;
- an expected cut in national and European funds.

Social factors:

- higher incentives for self-development;
- opportunities for civil servants to meet international best practices in public administration;
- implementing real change management;
- lack of embedded management culture in public administrations;
- transferability of public administration approaches to other situations;
- exchange of knowledge and individual experiences between civil servants;
- low status and acceptability of training and viewed as additional to day-to-day work.

Legal and environmental factors:

- traditions of a law-based approach to public administration;
- primacy of regulations in determining public administration competences;
- lack of dedicated training infrastructure.

The ESCS - European Senior Civil Servant project featured a pilot phase of one year in order to demonstrate the effectiveness of the overall system (applications, contents and organisational aspects) and to promote the use of e-learning in the field of EU public administration. A scientific committee of experts was established to define guidelines for the project. The purpose of the project was to stimulate co-operation and the exchange of best practices in Europe, and to build and test an innovative model of trans-national networking, thanks to the active involvement of European schools and institutes of public administration.

2. In general, there are two types of employment systems: career-based and position-based. The career-based civil service system aims at building a coherent civil service with top executives who share the same culture, which makes working together and communication across government organisations easier and suitable[12], also favouring internal mobility.

The position-based civil service system aims to provide a wider choice of candidates, including those with specialist skills, which promotes competition, cultural renewal, and adaptation in the civil service. This system enables decentralisation, recruitment to specific competence needs in different activities, differentiation of pay and other employment conditions in accordance with the market situation, and the achievement of a strong performance-orientation.

Meanwhile, an increasing number of EU Member States are starting to combine elements of both these systems. They can be considered as mixed or hybrid systems, because the configuration of the civil services of some Member States shows a mix between the two types of system.

In reality, these employment models differ in nuance between Member States, and the grouping of countries according to one or other model can be difficult. Nonetheless, the main characteristics usually remain the same: in the career-based system, a group of candidates is recruited for a career in the civil service, and in a position-based system, candidates are selected for a particular position[13]. In a hybrid

[12] See RICCIARDI, F., ROSSIGNOLI, C., & DE MARCO, M. 2013. *Participatory networks for place safety and liveability: organisational success factors*, in *International Journal of Networking and Virtual Organisations*, 13(1), pp. 42-65.
[13] See CASALINO, N., & DI PERSIO, F. 2004. *Integrating medical services, training and education: the HERMES project platform*, in *ATL - Advanced Technology for Learning Journal*, ACTA Press Anaheim - Calgary - Zurich, Vol. 1, Issue 2, pp. 71-80.

model both these elements can be present in the recruitment of civil servants. Member States were divided among the three employment models based on these criteria.

Furthermore, in many Member States the recruitment procedures and career systems for the specific target group of senior civil servants differ from the general or main employment system. To improve these aspects, the Member States with a career-based employment system are moving in the direction of a position-based system for positions in order to select candidates to a greater extent on the basis of merit and performance for short-term appointments and from outside the own organisation, corps or pools. Member States with position-based systems are tending to move elements of the system towards the career-based system in order to ensure some kind of career path for the best employees and to strengthen the corporate identity of the group[14]. Collective recruitment of young trainees or internal longlists and shortlists of candidates for specific positions have been introduced and combined with the open recruitment of external applicants for specific positions.

Based on the information collected from EU Member States, several common features of the senior civil service in EU Member States can be identified which go some way to explaining the movement of convergence from one system to another.

The main common elements of employment are as follows:

- selection is less based on duration of service;
- fixed-term contracts/appointments;
- performance assessment;
- internal and external applicants;
- mobility between public organisations and between public and private organisations;

[14] See REXED, K. 2007. *The Pros and Cons of Career and Position-based Systems*, in *Good governance for development in Arab countries initiative*, Rabat.

- selection of candidates in accordance with their managerial skills and experience[15];
- willingness to attract or retain promising employees by offering a career path;
- in-service training, e.g. on leadership, in order to strengthen corporate identity.

This means that Member States with a career-based system are choosing to limit the selection of top public managers based on duration in service, and to increase the amount of fixed-term contracts and appointments, to use performance assessments, and to open positions to external applicants with managerial skills and experience[16]. At the other end, Member States with position-based systems are willing to retain the best managers and to try to find a way of offering them a career perspective and in-service development. Similar tendencies can also be seen among Member States with a hybrid system.

3. As a basis for the definition in this study, we adopted the OECD definition: "A Senior Civil Service is a structured and recognised system of personnel for the higher non-political positions in government. It is a career civil service providing people to be competitively appointed to functions that cover policy advice, operational delivery or corporate service delivery[17]. The service is centrally managed through appropriate institutions and procedures, in order to provide stability and professionalism of the core group of senior civil servants, but also allowing the necessary flexibility to match changes in the composition of Government by using appropriate due processes."

[15] See BOCCARDELLI, P., GRANDI, A., MAGNUSSON, M.G., & ORIANI, R. 2009. *The Value of Managerial Learning in R&D*, in *Strategy in Transition*, 132.
[16] See CAPRIGLIONE, F., & CASALINO, N. 2014. *Improving Corporate Governance and Managerial Skills in Banking Organizations*, in *International Journal of Advanced Corporate Learning (iJAC)*, Austria, vol. 7, issue 4, pp. 17-27.
[17] See OECD GOV/PGC/PEM. 2008. *The Senior Civil Service in National Governments of OECD Countries*, Paris.

However, several elements of this definition are misleading in that not all of them are always a part of the description in EU Member States. For example:

(a) A structured personnel system: in some EU countries, there is no structured system for higher (civil service) positions; therefore, this element should be excluded from the definition.

(b) A recognised personnel system: a recognised system can mean several kinds of recognition. The emphasis in this study should be both on the formal and informal recognition from the authorities, and a common understanding of the organisation of such a group.

(c) Higher non-political positions: by only mentioning 'higher non - political positions', the reader cannot understand that the focus is on management functions, which is the focus of this particular study, and not, for example, on advisors or other non-management functions.

(d) A centrally-managed service: the centralised management is only the case in very few EU Member States and, if mentioned in the definition, would exclude all the other models of organisation.

With regard to the above-mentioned points, the following definition of senior civil service will be used in this particular study, focusing on management: "Senior Civil Service is a system of personnel for high and top level management positions in the national civil service, formally or informally recognised by an authority[18], or through a common understanding of the organisation of such a group. It is a framework of career-related development providing people to be competitively appointed to functions that cover policy advice, operational delivery or corporate service delivery".

A global trend can be seen in public administration for countries to consider making their civil services more productive and efficient and managing them in a

[18] See CAPRIGLIONE, F. 2004. *Freedom of Establishment and Provision of Services*, in *European Business Law Review*, Kluwer Law International, vol. 15, issue 3, pp. 447-461, London, UK.

more business-like manner[19]. Civil service managers play a vital role in national developments and are required for their ability to acquire special leadership skills. Owing to this particular role of senior civil servants, they should have a special status as well as special recruitment and pay conditions in addition to other support arrangements within the civil service; and on account of their different profile to that of other civil servants they need a different employment and support framework in which to work in to guarantee their better performance[20].

Normally, the senior civil service contains several levels of managers and they have to manage effectively organisational change in public administration. Therefore, they need to have a vision and strategy, strong leadership competences and people management skills, in addition to political and environmental awareness. Mid-level managers have to deal mainly with day-to-day management within the organisation and need at least general management skills[21] (e.g. HRM, finance and communication, team and relation- building). Depending on their functional level and also on their role, different competences and skills are necessary for specific positions[22]. All levels need to be increasingly result-oriented, in order to ensure the effective and efficient organisation of processes in the public administration and to involve all stakeholders.

As the focus of this study is on senior civil servants at the highest level, emphasis will be put on their leadership and competences. The top managers of public administrations in EU Member States and the European Commission work within a European context with an increasingly multicultural labour force. Competences related to this European context and diversity could well be needed for the success of future leaders.

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[19] See OECD GOV/PUMA. 2003. *Managing Senior Management: Senior Civil Service Reform in OECD Member Countries*, in *Background note*, Paris, p. 5.

[20] See OLSEN, J.P., & PETERS, B.G. 1996. *Lessons from Experience: Experiential Learning in Administrative Reforms in Eight Democracies*, Oslo, Scandinavian Univ. Press.

[21] See FONTANA, F., & CAROLI, M. 2013. *Economia e gestione delle imprese*. McGraw-Hill.

[22] See CASALINO, N., D'ATRI, A., & FADDA, C. 2005. *Organisational impact and exploitation of the results of an Italian research project for e-health and medical training*, in *Proceedings of ECIS 2005 - European Conference on Information Systems*, Regensburg, Germany.

4. The European Senior Civil Servant (ESCS) project aimed at improving competences, networking skills and knowledge for those officials who have regular exchanges with their European counterparts or those interested in working in the public administration of another EU Member State. This type of mobility scheme enhances career development and provides a unique experience in an international and highly professional environment. The ESCS project was operated by the Scuola Superiore della PA (SSPA, currently SNA - Scuola Nazionale dell'Amministrazione) and financed by the Italian government. It was an initiative implemented within the framework of the Agreement entitled "The promotion of coordinated initiatives to implement the Lisbon 2000 objectives for training senior civil servants from the Italian State and other European Union countries" and it followed the positive experience of the Patent Project funded by the Leonardo da Vinci programme of the European Commission, which aimed at shaping a European shared framework for the training of senior civil servants in order to promote mobility and mutual understanding.

The partners included some of the most important European schools and institutions such as:

- the Scuola Superiore della Pubblica Amministrazione - SSPA (Italy), currently SNA - Scuola Nazionale dell'Amministrazione;
- the National Centre for IT in Public Administration - CNIPA (Italy), currently AgID - Agenzia per l'Italia Digitale;
- the Université Paris 1 Panthéon-Sorbonne (France);
- the Ecole Nationale d'Administration - ENA (France);
- the Bundesakademie für öffentliche Verwaltung im Bundesministerium des Innern - BAköV (Germany);
- the National School of Public Administration - EKDDA (Greece);

- the Kormányzati Személyügyi Szolgáltató és Közigazgatási Képzési Központ - KSZK (Government Centre for Public Administration and Human Resource Services) (Hungary);
- the Krajowa Szkola Administracji Publicznej - KSAP (Poland);
- the National School of Government (UK).

On the basis of the "scientific curriculum of the European senior civil servant", developed by a scientific committee of experts, a pilot training programme for civil servants of EU member countries was implemented and tested. The first pilot training course was held at the Reggia Palace in Caserta, with a class composed of 30 participants from the partner countries. The class comprised senior middle-rank civil servants from European national public administrations wishing to sign up for mobility initiatives within European Union countries. The training programme was defined to reach the following learning outcomes:

- shared knowledge[23], key skills and competences needed to collaborate with EU colleagues;
- specific knowledge of each country. The pilot course focused on 4 countries (IT, PL, UK, F);
- each module was taught by the partner school which had developed it.

Training was delivered in English by high-level lecturers and experts from different European backgrounds. A final certificate, recognised and validated[24] by the project partners through a memorandum of understanding, and bearing their respective logos, was delivered at the end of the course by the Italian Minister for Reform and Innovation in Public Administration.

The SSPA adopted a basic e-learning platform and a blended learning method. Both e-learning and traditional classroom teaching have their respective advantages and disadvantages, and the appropriate teaching mode is dependent on different

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[23] See PRENCIPE, A., & TELL, F. 2001. *Inter-project learning: processes and outcomes of knowledge codification in project-based firms*, in *Research policy*, 30(9), pp. 1373-1394.

[24] See STEINHOUSE, A. 2011. *Academic–Government Partnerships: A Pragmatic View, in Franco–British Academic Partnerships: The Next Chapter*, FRASER, M. & LANE, P. (Eds), Liverpool University Press, pp. 222-223.

training courses and training objects[25]. The civil servants' training covered both basic theoretical contents and case studies[26], and was suitable for a blended learning approach. The main objectives of the course were:

Long-term objectives

- Enhance civil servant's mobility within European Union countries;
- Strengthen collaboration between EU national administrations.

Medium-term objectives

- Develop shared knowledge, key skills and competences among middle rank civil servants of national public administrations;
- Create a basis for the possible future participation in the Leonardo Da Vinci programme financed[27] by the European Commission.

Short-term objectives

- Develop the scientific curriculum of the European senior civil servant;
- Set up a training programme for civil servants of EU member countries, based on the scientific curriculum. The training course might be re-proposed in the future by the partner Schools;
- Follow the positive experience of the Patent Project (Public Administration Training European Network for the Harmonisation of Training Approach) funded by the Leonardo Da Vinci programme of the European Commission.

Global horizontal issues such as sustainable development and climate change, access and diversity were addressed within different working groups.

5. The choice to adopt a blended approach, based on in-class training and e-learning, gave extremely positive and efficient results and was highly rated by partici-

[25] See METALLO, C., AGRIFOGLIO, R., FERRARA, M., CASALINO, N., & DE MARCO, M. 2012. *Why should people use wiki in academic environments? An empirical analysis of undergraduate students, in Visualization*, in *Imaging and Image Processing/783: Modelling and Simulation/784*, *Wireless Communications*. ACTA Press.

[26] See CASALINO, N. 2014. *Learning to Connect: a Training Model for Public Sector on Advanced E-Government Services and Inter-Organizational Cooperation*, in *International Journal of Advanced Corporate Learning*, iJAC, 7(1), pp. 24-31.

[27] See LEMMA, V. 2013. *The Derivatives of Italy*, in *Law and Economics Yearly Review*, Queen Mary University, London, UK, p. 480.

pants[28], who were invited to assess the quality of the training through *ex ante*, *in itinere* and *ex post* evaluation forms. The results of these evaluations provided a very useful basis to improve and implement other ESCS courses in the next years.

To fulfil the objectives of the project, we tried to design and implement a training model of teaching, transferable and repeatable in different European contexts, in order to enable public top managers to acquire the shared knowledge[29] and the necessary country-specific background to start working in a public administration in another EU member State.

The system methodology consisted on the implementation of four different subsystems: courses, teaching administration, tutoring and overall system management, as shown in figure 1.

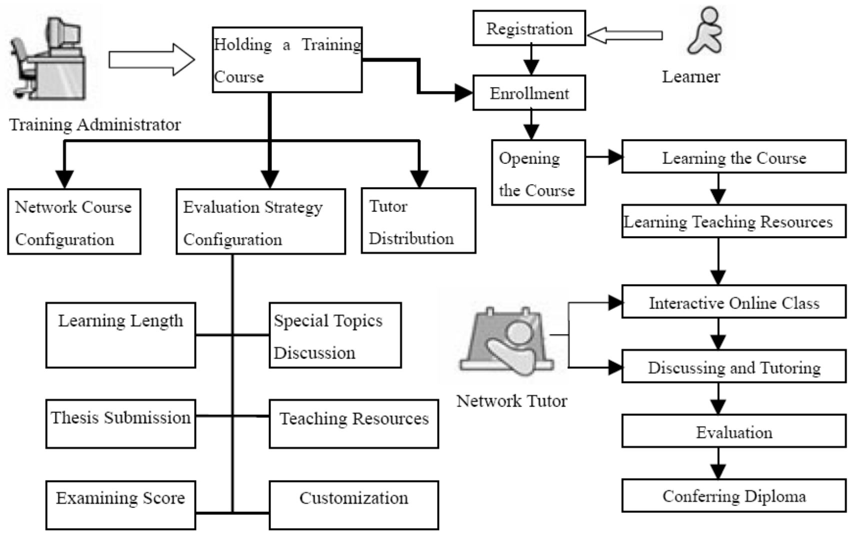

Figure 1: Process chart of ESCS.

The mixed backgrounds and nationalities of the audience and the lecturers were an important asset. The e-learning part was delivered through a platform, created with the collaboration of CNIPA, the Italian Centre for ICT in Public Administration, and accessible through the SSPA website (platform address: http://sna.gov.it/www.sspa.it/index-p=2583.html).

[28] See CASALINO, N., BUONOCORE, F., ROSSIGNOLI, & C., RICCIARDI, F. 2013. *Transparency, openness and knowledge sharing for rebuilding and strengthening government institutions*, in *WBE 2013*, vol. 10 IASTED-ACTA Press Zurich, Innsbruck, Austria.
[29] See NONAKA, I., & TAKEUCHI, H. 1995. *The knowledge Creating Company*, Oxford University Press, UK.

Figure 2: ESCS learning platform.

The learning platform adopted for this purpose was based on the Learning Management System (LMS) “Moodle”. With only a few modifications, this integrated system[30] was adapted to the public managers’ needs.

The e-learning contents included mainly text material. Before the beginning of the course, the tutor sent to each participant an e-mail containing the access ID and password as well as all the necessary instructions for accessing the platform. User accounts were created by the platform administrator for participants, lecturers, staff and tutors. The language chosen for communication between participants, lecturers and tutors was English. The tutor followed the progress made by each participant in the e-learning course and maintained direct and regular contact with them by e-mail.

A pre-assessment quiz, an intermediate questionnaire and a final test were prepared in order to assess participants’ knowledge before, during and after the e-learning. The tests were performed on-line by the participants. Regular contact between the tutor and the users was maintained in order to exchange several information related to the overall implementation of the pilot course, to the individual protected access[31] to the platform by each participant and to the tuning of the e-learning contents and platform. Moreover, a forum was created for each module in order to enable participants to interact with the tutor and the teaching staff on spe-

[30] See PRENCIPE, A., DAVIES, A., & HOBDAY, M. 2003. *The business of systems integration*. Oxford University Press.
[31] See BASKERVILLE, R., & LEE, A. 1999. *Distinctions among Different Types of Generalizing in Information Systems Research*, in *New Technologies in Organizational Processes*, New York, Kluwer Academic Publishers.

cific contents. The contents of the platform were interactive[32], with full tutorial assistance available for users, who had the possibility to interact via a “forum café” and a “technical forum”.

There was also a "news forum" for useful information. As far as the functionality of the platform was concerned, interaction modalities proved to be quite efficient and immediate and the quick and simple description of the resources provided through a video tutorial was quite useful. From the evaluation questionnaires, it emerged that the e-learning contents were rated, on the whole, as efficient, exhaustive, relevant and consistent with the in-class contents.

Following the blended learning approach, the in-class part of the course aimed at providing a more in-depth insight of the topics tackled in the e-learning part. A third level included country specific parts. For these sessions, participants were divided into three groups in different classrooms. In-class training was organised into six-hour teaching days. Participants were asked to fill-in evaluation questionnaires at the end of each training day and at the end of the course in order to produce an exhaustive feedback on the overall course organisation and the knowledge acquired.

6. As shown by the overall active participation during the implementation of the course, the selection procedure proved to be valid and it would be advisable to adopt the same methods in the future.

Possible improvements in this respect may include for instance more complete information on the course and selection procedures (indicating clearly the selection criteria) through the central website. It was possible to identify some suggestions for improving the learning methods such as:

- the e-learning contents could be completed with other material based on different media (software or links to relevant websites presenting statistics or economic data of interest[33], slides or data to be examined during the in-

[32] See DE MARCO, M. 2004. *Le metodologie di sviluppo dei sistemi informativi*, Franco Angeli, Milan.
[33] See LEMMA, V. 2013. *On Banking and Ethics. Banche e Etica*, Padova, Cedam.

class sessions, videos presenting in-depth analysis or practical cases) available in streaming or download mode. The resources needed in this respect are quite reasonable for very good results in terms of quality, processing and connection times;

- a better way to contact the tutor for a more immediate interaction (in the current version, the tutor could be contacted only by e-mail);
- extension of the length of the e-learning course to two months. Many participants claimed in their evaluation questionnaires to have faced time pressures to follow thoroughly and carefully the e-learning modules;
- introduction of more immediate communication tools[34] in order to establish a direct line between tutor, participants, staff and lecturers (chat, wiki, etc.) and obtain a major involvement (full immersion);
- introduction of a scheduling function or “to do list” in order to provide information related to training activities or deepening;
- improvement of the monitoring and reporting features (progress report) in order to provide participants with a detailed list of topics/lessons and the scores obtained in tests and exercises;
- elimination of the automatic transfer of messages from the technical forum to the whole list of platform users (spam effect).
- daily in-class training could be re-organised to lay greater stress on practical exercises;
- splitting the group of participants into country-specific sub-groups left a sense of incompleteness to some delegates, who expressed the need to have a final plenary session for a general review of the topics. Many participants were in fact interested in gaining an insight into all three countries studied.

[34] See AGRIFOGLIO, R., METALLO, C., VARRIALE, L., FERRARA, M., CASALINO, N., & DE MARCO, M. 2013. *Assessing Individual Learning and Group Knowledge in a Wiki Environment: An Empirical Analysis*, in KLEMENT, E.P., BORUTZKY, W., FAHRINGER, T., HAMZA, M.H., & USKOV, V. (Eds), *WBE 2013 conference*, IASTED, ACTA Press Zurich, Innsbruck, Austria.

Participants appreciated the practical approach adopted as well as the use of case studies, exercises, role-playing and team working activities. The methodology of the project involved a mix of public administration objectives, information systems[35] and organisational aspects.

The main modules adopted for the online and in-class training activities were:

European Integration and EU institutions:

- The historical origins of the EU;
- EU policy areas and EU enlargement;
- EU legal framework;
- EU decision making procedures;
- EU effective networking and lobbying.

EU Legal Framework and Country-specific:

- Political institution and legal framework;
- Public administration and coordination;
- Political role and legislative process;
- Coordination with EU laws;
- Public administration: legal power and civil service legal status;
- Policy making decision and implementation;
- Civil servant role in the process of implementation;
- Explanation of professional skills for government.

Managerial tools and behaviour:

- Change management;
- Motivating and coaching people;
- Cross-cultural and diversity management.

Ethics:

- Introduction to ethical reasoning;

[35] See ROSSIGNOLI, C. 2009. *The contribution of transaction cost theory and other network-oriented techniques to digital markets*, in *Information Systems and E-business Management*, 7(1), pp. 57-79.

- Typical cases of ethical conflict[36] in public administration.

Statistics:

- How to read a statistical document;
- How to perform statistical comparisons;
- How to perform statistical analyses.

Economics – general training:

- Principles of EU economic policy;
- European monetary integration;
- Current issues of economic policy in the EU;
- Competition policies in the EU and its member States;
- The Lisbon process;
- Countries economic outlook;
- Key institutions;
- Institutions and regulatory framework;
- Policy issues.

The evaluation was made after the e-learning modules, during and after the in-class modules. Participants were asked to indicate how far they agreed or disagreed with the following statements:

- if they learned new ideas or skills (or both) by attending the blended course;
- if they learned something that they could definitely use in their day-to-day work;
- if they learned something new from talking to other colleagues;
- if they learned things which could help them in the long term.

Participants were asked also to rate the training course modules in their features:

- relevance of the topic covered;
- in-depth analysis of the topic;
- effectiveness of the presentations;

[36] See CAPRIGLIONE, F. 1997. *Etica della finanza e finanza della etica*. Laterza, Bari.

- efficiency and relevance of didactical tools;
- balance between theory and practice;
- involvement in the didactical activity;
- training materials/hand-outs used;
- interaction with other course participants.

After the pre-assessment phase, the learning results were very enthusiastic and the rate of the attendance was very high.

The main aspects emerging from daily evaluation forms were the positive rating of the topics and the benefit of the modules. The final questionnaire aimed at evaluating the overall satisfaction, the attainment of the course objectives and of personal training goals[37]. As a whole, participants gave a very positive feedback. Other questions more strictly related to the course organisation and the services provided (course administration, venue, catering and accommodation) were also included. These aspects were rated positively by participants and they give to coordinator other suggestions to improve learning experience and contents.

7. It is generally accepted that, in order to compete in today's complex and rapidly changing world, civil servants will need continuous access to learning resources throughout their entire working lives. Increased competition and financial limitations increase the pressure for flexible learning[38] to become an essential ingredient of educational policy. The purpose of the ESCS project was to develop shared knowledge, to update knowledge, to improve skills and competences among middle rank civil servants of EU member state public administrations in order to increase collaboration and mobility within European Union countries. Flexible learning methods,

[37] See SITKIN, S.B. 1992. *Learning through failure: the strategy of small losses*, in *Research in Organisational Behaviour*, Vol. 14 No.1, pp. 231-266.

[38] See RUMBLE, G. 2000. *The Globalisation of Open and Flexible Learning: Considerations for Planners and Managers*, in *Online Journal of Distance Learning Administration*, 3, 3, State University of West Georgia, pp. 1-15.

usually, give more attention to the learning process[39], the ability to learn, the need to learn rather than the acquisition of knowledge itself[40]. Therefore, they need active learners to solve problems, analyse information, and take decisions.

One of the solutions is to provide civil servants with blended learning courses and self-teaching packages to enable them to acquire more competencies and added capacities to adapt to the changing work environment.

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[39] See STEINHOUSE, A. 2014. *The relationship between the UK civil service and research: Reforms from Blair to Cameron*, in *Télescope, Actes du colloque - Quelles recherches pour quelle action publique? Les défis d'une prise de décision mieux informée*, Quebec City, 27 September 2013, pp. 101-112.

[40] See ROSSIGNOLI, C. 1996. *Il ruolo dell'IT e del facility management nel conseguimento del vantaggio competitivo*, in *Problemi di gestione dell'impresa*, 21.

MEDIA AND WOMEN OBJECTIFICATION IN ITALY: AN ANALYSIS OF IMPLICATIONS IN THE GOVERNANCE CONTEXTS

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ABSTRACT: *The exposure to media images, consisting in thin-and-beautiful women, significantly affects the way of thinking and acting of women and men in the community, reinforcing the existing gender stereotypes. Likewise, women, comparing themselves to standardized media models (slenderness and beauty), show dissatisfaction with their body and reductions in self-esteem, self-efficacy and self-concept. In Italy the debate on this issue is still open with an increasing focus on the negative effects by mass media on women image, in terms of their sexual objectification. The purpose is to analyze the two phenomena, media representations and gender stereotypes, adopting the theoretical framework of objectification. More specifically, our purpose is to investigate the relationship between these topics for women involved in the governance systems with a specific attention to the Italian context.*

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1. Media play a key role in everyday life of each person by creating frames and images, which simplify the interpretation of the context. Consequently, people evaluate themselves and others according to the media frames, which become an integral part of individuals' taken-for-granted assumptions, affecting their beliefs, values, attitudes and behaviors.

Most studies in the United States have shown that the exposure to media images consisting in thin-and-beautiful women significantly affects the way of thinking and acting of women and men in the community, reinforcing the existing gender stereotypes[1]. Likewise, women tend to compare themselves to standardized media models (slenderness and beauty) with dissatisfaction with their body and reductions in self-esteem, self-efficacy and self-concept.

In Italy the debate on this issue is still open with an increasing focus on the negative effects by mass media on women image in terms of their sexual objectification. More specifically, in magazines, TV, and movies women are shown as "glossy, aesthetically perfect and young" beyond the actual age, assuming mainly representing roles in the entertainment areas. In details, men manage 63 percent of the Italian TV programs, and women are often involved only in marginal roles supporting the anchorman. The prevalent image of women divulgated by Italian media consists in an "artificial beauty condition" achieved by typical techniques of surgery or excessive dietary restrictions.

The self-objectification experience may produce different consequences on female workers at work. Some of them suffer from the appearance anxiety and consequently they become more preoccupied of their physical appearance than of

[1] See YAMAMIYA, Y., CASH, T.F., MELNYK, S.E., POSAVAC, H.D., & POSAVAC, S.S. 2005. *Women's exposure to thin-and-beautiful media images: Body image effects of media-ideal internalization and impact-reduction interventions*, in *Body image*, 2, pp. 74-80; MILKIE, M.A. 1999. *Social comparisons, reflected appraisals, and mass media: The impact of pervasive beauty images on Black and White girls' self-concepts*, in *Social Psychology Quarterly*, pp. 190-210; LAVINE, H., SWEENEY, D., & WAGNER, S.H. 1999. *Depicting women as sex objects in television advertising: Effects on body dissatisfaction*, in *Personality and Social Psychology Bulletin*, 25, pp. 1049-1058; COLTRANE, S., & ADAMS, M. 1997. *Work–family imagery and gender stereotypes: Television and the reproduction of difference*, in *Journal of vocational behavior*, 50, pp. 323-347.

empowering their professional skills and competences. The beauty sometimes is perceived as the main resource to access to work positions and powerful relationships.

The ongoing exposure to media representations of the sexualized female body may also produce a lowered self-esteem and self-efficacy of women at work leading to reduce their level of aspiration, hesitating to take up a leadership role and significant job opportunities.

Starting from the role of media in the Italian context, in creating and reinforcing negative social and cultural assumptions about women in the Italian context, this study aims to deeply investigate how women experience these distorted representations, assuming attitudes and behaviors that contribute to activate discriminant processes against themselves at workplace, especially in high organizational positions considered crucial in the definition of governance systems. Our focus is on women who operate in top management teams or leadership positions in the organizations.

In Italy, the debate on women in leadership positions is still very lively, also considering the recent law introduced to promote the access of women on boards of directors of publicly listed companies and state-owned companies. The law, known as Golfo/Mosca n. 120, represents the first “affirmative action” aimed to support the women’s managerial career in Italian organizations.

Starting from these brief considerations, we consider the objectification theory as the theoretical framework in our current analysis to explain how media representations and gender stereotypes are related, with significant consequences for women at governance positions.

Thus, this is a theoretical study that aims to analyze the phenomena of media representations and gender stereotypes for women adopting a wide approach through the theoretical framework of objectification. More specifically, our purpose is to investigate the relationship between these topics for women usually not involved in the governance systems with a specific attention to the Italian context that represents a very interesting area for its peculiarities.

The paper is structured as follows: section 2 is focused on the analysis of the objectification theory, outlining its main determinants and applications as evidenced in the existing literature more focused on the difficulties and concrete barriers faced by women s at workplace, especially at top management and leadership positions.

Section 3 evidences the main implications of the objectification theory in terms of gender stereotypes. Finally, section 4 outlines some final considerations.

2. According to the objectification theory[2], the ongoing exposure to the soci-ocultural belief that women are to be judged as objects leads women to internalize others' views of themselves. More specifically, the theory argues that when engaged in this process, which is termed self-objectification, women and girls tend to adopt observers' perspective of their physical, addressing their attention to monitoring and assessing these observable body characteristics.

The mass media play a key role in the Italian culture, contributing to the sexual objectification of women also and mostly at workplace. The artificial beauty standards divulgated by media lead to think that successful women at work are always beautiful, thin and young. This is evident in the numerous Italian TV movies where women in leader roles, such as detectives, physicians, lawyers, and so on, always appear aesthetically attractive and have active sexual lives. On the contrary, women who look unfeminine are often chosen in Italian TV programs for self-mocking and comic roles that ironically emphasize their unattractive look and their low exiting experiences of living and working. Unattractive professional women do not represent common guests in most popular Italian TV programs, and their witness is requested just in charity programs to fight disease or to stimulate awareness of humanitarian issues.

In women's perspective, there is no doubt that they are subject to a great deal of pressure to conform to the ideal of feminine beauty supported by the Italian cul-

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[2] See FREDRICKSON, B.L., & ROBERTS, T.A. 1997. *Objectification theory*, in *Psychology of women quarterly*, 21, pp. 173-206.

ture. The self-objectification and, in particular, the objectification experience may produce different consequences on female workers in any organizational contexts, especially concerning their role and functions in the governance settings. Some of them suffer from the appearance anxiety and consequently they become more pre-occupied of their physical appearance than of empowering their professional skills and competences. The beauty sometimes is perceived as the main resource to access to work positions and powerful relationships, by participating actively to the governance systems. The ongoing exposure to media representations of the sexualized female body may also produce a lowered self-esteem and self-efficacy of women at work leading to reduce their level of aspiration, hesitating to take up a leadership role and significant job opportunities.

In addition, the objectification of women by media obviously affects men in the social and work context. Especially male employers tend to be affected adopting mostly the beauty and slenderness criteria in the recruitment and career advancement processes. Consequently, women responding to these beauty and slenderness criteria have more chance to be recruited and promoted, achieving significant career goals, at the expense of women with concrete work skills and professional experiences.

3. In women's perspective, there is no doubt that they are subject to a great deal of pressure to conform to the ideal of feminine beauty supported by the Italian culture. The self-objectification and objectification experience may produce different consequences on female workers reinforcing or creating gender stereotypes that are used to justify the assignment of social roles operating to the disadvantage of women. This is the case of gender stereotypes that often disadvantage women in the work setting, especially at top management and leadership positions, because they are based on the beliefs that women are less able than their male colleagues for management positions, because of the lack of those masculine characteristics that are

traditionally associated with effective managers[3]. Stereotypes refer to “beliefs about the characteristics, attributes, and behaviours of members of certain groups”[4]. Considering the context of corporate governance, the existence of gender stereotypes makes difficult for women to express their potential and provide a real contribution to the decision-making process within boards of directors. Moreover, stereotypes pressure makes more difficult for board members to trust each other’s judgment and expertise, with negative consequences on board ability to cooperate and combine their contributions in the creative and synergistic ways.

Some scholars have explained that differences in communication behaviors might determine much of the subtle biases against women. Indeed, women tend to show more socio-emotional communication behaviors, compared to men who seem more dominant and assertive[5]. Because the communication behaviors are presumed to be an indicator of competences[6], communication styles of women are perceived as non-standard and unconventional, leading to underestimate their capabilities and to exclude them from the group’s activities.

Psychological research evidences that stereotypes often operate in an unaware way, also when gender diversity policies are introduced to overcome prejudices and discriminations at workplace. According to the Ironic Effect theory[7], pressures for “not” applying prejudices may involuntary increase the level of prejudice among employees[8]. When people try to suppress thoughts, two parallel processes are triggered: operating and monitoring processes. The operating process is conscious and requires

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[3] See POWELL, G.N., BUTTERFIELD, D.A., & PARENT, J.D. 2002. *Gender and managerial stereotypes: have the times changed?*, in *Journal of management*, 28, pp. 177-193.

[4] See HILTON, J.L., & VON HIPPEL, W. 1996. *Stereotypes*, in *Annual review of psychology*, 47, pp. 237-271.

[5] See ARIES, E. 1987. *Gender and communication*, in *Review of personality and social psychology*, Vol. 7, pp. 149-176.

[6] See FERNANDEZ, J.P. 1991. *Managing a diverse work force: Regaining the competitive edge*. Lexington, MA, Lexington.

[7] See WEGNER, D.M. 1994. *Ironic processes of mental control*, in *Psychological review*, 101, p. 34.

[8] See KULIK, C.T., PERRY, E.L., & BOURHIS, A.C. 2000. *Ironic evaluation processes: Effects of thought suppression on evaluations of older job applicants*, in *Journal of Organizational Behavior*, 21, pp. 689-711; MACRAE, C.N., BODENHAUSEN, G.V., MILNE, A.B., & JETTEN, J. 1994. *Out of mind but back in sight: Stereotypes on the rebound*, in *Journal of personality and social psychology*, 67, p. 808; MONTEITH, M.J., SHERMAN, J.W., & DEVINE, P.G. 1998. *Suppression as a stereotype control strategy*, in *Personality and Social Psychology Review*, 2, pp. 63-82.

higher efforts of cognitive activation than monitoring process that is unconscious and automatically enabled by call for thought suppression[9]. Because of the contemporary responsibility for many concurrent tasks and decisions, managers are often affected by cognitive and psychological pressures to reach contemporary different goals. Consequently, pressures to avoid prejudices overload these individuals and so their monitoring processes take over and precedence to operating rational process[10], triggering repeatedly and paradoxically the undesirable thoughts of stereotypes[11].

4. In Italy gender diversity debate is particularly heated, as outlined by the large diffusion of affirmative actions or equal opportunity programs, prescribed by laws to promote women's recruitment and promotion within organizations.

Starting from the role of media in the Italian context, this study has investigated how women can become victims of gender stereotypes, which are conceived as relevant effects of the media representations of women. The objectification theory adopted in this paper provides the theoretical framework to explain this link between media representations and gender stereotypes for women considering the Italian context.

Despite the popularity and divulgation of diversity management programs within organizations, also promoted by laws, discriminations and prejudices against women are still widespread. Indeed, women are however penalized in their job and career opportunities, and very often, they are not involved in the governance systems, although the laws impose to the companies the adoption of non-discriminatory policies, by applying the equal opportunity criteria at workplace.

In summary, because of the negative implications of the media representations of women in terms of gender stereotypes explained through the objectification theory, sometimes the diversity management programs are only formal initiatives, a

[9] See WEGNER, D.M. 1994. *Ironic processes of mental control*, in *Psychological review*, 101, p. 34.
[10] See again WEGNER, D.M. 1994. *Ironic processes of mental control*, in *Psychological review*, 101, p. 34.
[11] See BODENHOUSEN, G.V., & MACRAE, C.N. 1998. *Stereotype Activation and Inhibition*, in WYER R.S. (ed.), *Stereotype Activation and Inhibition. Advances in Social Cognition* 11, Mahwah, NJ: Lawrence Erlbaum, pp. 1-52.

“window dressing” for organizations, where women do not have concrete possibilities to participate into the decision-making processes, more specifically the governance systems within organizations.

We argue that, in order to promote the concrete recruitment and participation of women in the governance systems, overcoming any gender stereotypes arising mainly from the media representations, diversity policies are necessary but not sufficient. In fact, in this scenario effective diversity training initiatives, such as role-playing, mentoring, and networking, become crucial for the development of attitudes to diversity by the overall workforce. In this perspective, such initiatives support women but also men to overcome the gender stereotypes resulting from the influence of the media frames and images.

SHARING CORPORATE GOVERNANCE:

THE ROLE OF OUTSOURCING CONTRACTS IN BANKING.

Valerio Lemma - John A. Thorp*

ABSTRACT: *This paper analyses the effects of outsourcing policies on banking corporate governance. The analysis of the regulatory framework shows that EU rules set a minimum size for a credit institution, to be guaranteed by the government bodies and the senior management of the bank. In this context, the research focuses on the role of contracts between the and ancillary services undertakings. These contracts apply bank's outsourcing strategies, and then shall ensure the provision of services, according to the duty of safe and sound management required by supervising authorities. Therefore, the research will take into account the Anglo-Saxon approach to the banking outsourcing, because outsourcing is not an option, but the consequence of certain market conditions. The authors reach a specific conclusion highlighting that the principles set by the European regulation appear to be designed to prevent that outsourcing translates into an 'escape from responsibility', and then that competent authorities shall make further steps towards a proper configuration of supervisory practices on outsourcing.*

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proach to the banking outsourcing. - 8. The perspective of the European supervision (ECB, EBA and National authorities). - 9. Conclusions.

1. A credit institution is a business entity that enters the financial market in order to match the demand for and the supply of capital, by intermediation procedures originating risks with a direct impact on its equity. Indeed, the essence of banking can be found in the ability of banks to connect entities that have resources in surplus with others that, in order to satisfy their needs, are willing to remunerate a temporary leasing of money. This activity implies the overcoming of barriers that hamper the meeting of demand and supply with obstacles referable to the asynchrony of deadlines, to the asymmetry of risk profiles, and to the existence of geopolitical difficulties. Banks are under the public supervision because both the relevance of the interests involved in their activities, and the effect of this business on the monetary policies.

Under this premise, we must shall asses the scope of governance relations that banks can develop. On this point, there is an interesting perspective, related to the forecasting of the 'outsourcing wave' in the banking sector. The results of this analysis will clarify if there is a limit to the organizational structure required to perform the credit intermediation activities, provided by Directive no. 2013/36/EU and other relevant regulations.

In particular, we shall understand whether and how the 'outsourcing agreements' affect the mechanisms, processes and relations by which banks are directed, having regard to the circulation of information, the evaluation of creditworthiness, and the internal controls. At the end of this investigation, we will be able to address the impact of these contracts on the corporate governance of a bank, bearing in mind that the services provided by the outsourcers directly refer to areas related to the functioning of the board of directors and the board of auditors.

2. A credit institution cannot be considered only as an entity that originates a set of contracts, whose function is the money transfer from the depositors to the borrowers. Under this assumption it seems not to be lawful the provision of banking services by minimizing the organizational structure beyond certain limits, *id est* by outsourcing all the activities required to collect savings, arrange the maturity transformation process, provide loans, and manage risks.[1]

In order to carefully analyse the *legal profiles* of the economic player's organization, we have to start by considering the results of the studies that highlighted the primary role attributed by the legal system to ethics within the economic relationships. Therefore, any model of corporate governance must be compatible with the internal procedures and the prerogatives of the open market.[2] Hence, the need for corporate governance structures to support the different managers in charge of banking. In this context, we should consider the link between the rightfulness of the *agree* and the organization of the credit business. Some recent interventions were made to this business by the European regulator, in the attempt to rebalance role and powers of the 'ancillary services undertakings', which supply *services* (to the intermediaries) according to the outsourcing model, being independent (from the senior management) but responsible (for the outsourcing).

The European regulation links the banking execution modalities to the structural profiles of the credit institutions. Hence, the choice of supervisory authorities to adopt specific corporate governance and internal control measures, in view of the proper functioning of any credit institution.[3]

There is no doubt that the attention paid by the legislator to the organizational structure is designed to overcome certain limitations of the regulatory supervision (at times focused on the mere verification of the mathematical models provided by the

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[1] See LEMMA, *Commento sub art. 13 d. lgs. 385 del 1993*, in *Commentario al Testo Unico delle leggi in materia bancaria e creditizia*, Padova, 2012, p. 183, on the function of the Bank's register provided by European regulation since art. 3, Directive no. 77/780/EC.
[2] See ALPA, *Presentazione*, in *Banche e etica,* edited by Sabbatelli, Padova, 2013, p. XIV.
[3] See CAPRIGLIONE, *Commento sub art. 10 d. lgs. 385 del 1993*, in *Commentario al testo unico delle leggi in materia bancaria e creditizia*, Padova, 2012, p. 115.

capital adequacy rules, i.e. the Basel Accords). The same conclusion should be achieved with regard to the efficiency of the governance models and of the logistic choices necessary for the pursuit of the banking (considered as the core business of a credit institution).

Therefore, we feel the need to analyze the supervisory mechanisms in order to understand which of these are able to verify the *adequacy* of the company's size, according to the need for an efficient delivery of banking services. This, with the obvious consequence of admitting that public intervention can predetermine (or at least limit) the cases in which a credit institution outsources certain operations, through which it achieves its own banking activity.[4]

That said, it appears necessary to identify the requirements adopted by the European Legal Framework in order to ensure that the production processes chosen by the managers are able to combine the banks' need for solidity with the growing levels of efficiency and profitability (set as objectives by ownership and management).[5]

This approach allows us to understand how the definition of a minimum size (of a bank's internal organization) should not be included among the restrictive interventions, but among the supervisory actions aimed at identifying a rational balance between the tendency to reduce costs and the need to avoid that the banks are left without any contents (becoming vehicles and no-longer business entities).[6]

That explains the content of Directive 2013/36/EU, which sets the regulation for credit institutions, in addressing the definition of art. 4, paragraph 1, point 1, of the (EU) Regulation no. 575/2013. This regulation defines the bank according to its activity (lending) and its structure (which must present adequate levels of profes-

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[4] See AUBERT - PARTY - RIVARD, *A tale of two outsourcing contracts. An agency-theoretical perspective*, in *Wirtschaftsinformatik*, 2003, p. 181 ff., for a study on the management of the relationships,

[5] See FENG - YAO - JIANG, *Analysis of the Market-Based Adjustable Outsourcing Contract under Uncertainties*, in *Production and operations management*, 2013, p. 178 ff. for an analysis of the market-based adjustable contracts for customized goods or services that have emerged in outsourcing practices.

[6] On the role of incentives, see OSEI BRYSON - NGWENYAMA, *Managing risks in information systems outsourcing: An approach to analysing outsourcing risks and structuring incentive contracts*, in *European Journal of Operational Research*, 2006, p. 245 ff.

sionalism). In this contest, the centrality of the management body is based on the previous and proved options of the main Member States, whose task is to identify the bodies or members - of the management body - which are responsible for the banking activities to be carried out, according to national legislation.[7]

Therefore, the EU rule places one or more "management bodies" at the center of the governance; these bodies are entrusted (by the statutory by-laws) with the power to decide the strategy of the bank, its goals, together with the task to supervise and monitor the decisions of the senior management. Hence, the express provision intended to include within this body 'the persons who effectively direct the business of the institution'. This clarifies the European regulator's will to allocate those who are in charge of the management power in a single assembly, according to an effectiveness criterion that will promote the transparency of the organization, its supervision and, consequently, the imputation of the responsibilities (art. 3, para 1, points 7-8, Dir. 2013/36/EU).

The provision according to which 'the competent authorities shall grant authorization to commence the activity of a credit institution only where at least two persons effectively direct the business of the applicant credit institution' (art. 13, dir. 2013/36/EU) appears to be of singular importance. If on the one hand the minimal measure identified (two people), overcomes the longstanding problem of the monocratic direction of a company, on the other it stands at a level too contained to ensure that the body operates accordingly to the known collegiality criteria (that appear necessary to establish a reasonable debate, able to allow to take appropriately weighted decisions).

Following this approach we can also understand the reasons of the option to include within a single category, called "senior management", the individuals with executive functions and which are responsible for the daily management of the institution, reporting to the management body (art. 3, para 1, dir. 2013/36/EU). It goes

[7] As we will see, this provision must be related to the analysis on the relation between the government body and the outsourcers (having regard to the agreed contracts); see SPENCER, *International outsourcing and incomplete contracts*, in *Canadian Journal of Economics*, 2005, p. 1107.

without saying that the explicit reference to individuals suggests that the same are placed in a direct employment relationship with the bank, having to exclude that these functions could be outsourced outside of the bank's economy.

This is how the European regulator identifies an essential core of individuals that, in giving content to the head of corporate governance, must necessarily be included within the bank, setting the community (of individuals), which substantializes the intermediation activities that characterize the business purpose of the institution in question.[8] It is clear how the organization (that assists this community in banking) is entrusted to private self-regulation**,** which must be adopted within the limits specified by the technical standards developed by the EBA and approved by the Commission, as well as by the conditions laid down by the Member States (art. 8, dir. 2013/36/EU).

It should be stressed that the European regulation requires Member States to provide that the 'program of activities' (which accompanies the application for bank's authorization) must indicate both the type of operations provided and the organizational structure of the credit institution (art. 8, dir. 2013/36/EU). Therefore, the latter is the document in which the subjects that request authorization must clearly indicate the activities that they intend to carry out within the company and those which, instead, will be outsourced. In this program, the levels of disclosure of the outsourcing contracts (and of the characteristics of the service providers) appear to be of central importance; that is the information that the individuals are required to provide to the supervisory authority, which may take elements (from these) in order to evaluate which controls fall within its powers (i.e. belong to the safe and sound management).[9]

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[8] See HARRIS - GIUNIPERO - HULT, *Impact of Organizational and Contract Flexibility on Outsourcing Contracts*, in *Industrial Marketing Management*, 1998, p. 373 ff.

[9] See AMOROSINO, *Commento sub art. 14 d. lgs. 385 del 1993*, in *Commentario al testo unico delle leggi in materia bancaria e creditizia*, cit., 2012, p. 191 ff.

3. It is now appropriate to analyse the "ancillary services undertaking" concept, as considered by the European banking legal order. The clarification of the problems underlying these services will allow the evaluation of the parameters that a credit institution must use in order to adapt its business (this considering the recent financial crisis).[10]

More specifically, it is necessary to assess the scope of the EU law when referring to "an undertaking the principal activity of which consists of owning or managing property, managing data-processing services, or a similar activity which is ancillary to the principal activity of one or more institutions" (art. 4, paragraph 1, point 18, of EU Regulation no. 575/2013 and art. 3, paragraph 1, point 17, of Directive 2013/36/EU).

We are looking at a definition intended to comprehend a wide range of subjects, which are included within the perimeter of public supervision, taking into account the type of work performed and its "ancillary" character in relation to banking. Instead, the reference of the ownership structure of the institution does not come to mind.

It goes without saying that these ancillary activities can be reserved (in the case of the provision of payment services, electronic money issuance and, in some ways, credit rating evaluations).[11]

Furthermore, the possibility (for the competent authorities of a Member State) to verify the information regarding the ancillary businesses erases any doubt on the subjection of the businesses in question to supervision (accordingly to art. 118 of Directive 2013/36/EU), even when these are not *subjective proliferations* re-conducible to the banking group.[12] This interpretation is also confirmed in art. 124 of Directive 2013/36/EU, where it is stated that "in the case of financial holding companies, mixed financial holding companies, financial institutions or ancillary services under-

[10] On the origins and on the consequences of the crisis, see CAPRIGLIONE, *Crisi a confronto (1929 e 2009): il caso italiano*, Padova, 2009, *passim*.

[11] In this regard, it should be noted that the interpretation key is the position of a real estate fund responsible for the ownership and the management (through the fund manager) of the bank's ancillary properties, given the difficulty to include this subject within the juridical definition of business identified in EU Regulation n. 575/2013.

[12] On this point, see CAPRIGLIONE, *Ordinamento finanziario italiano*, Padova, 2010, p. 130 e ss.

takings, the collection or possession of information shall not imply that the competent authorities are required to play a supervisory role in relation to those institutions or undertakings standing alone". Undeniably, the legislation clarifies that public supervision extends itself to these firms because of the servicing relationship that connects them with banks.[13]

It should be borne in mind that EU Regulation n. 575 of 2013 (art. 4, point 27) describes an ancillary business undertaking included within the financial consolidation of a credit institution as a "financial sector entity", with obvious consequences on the application of the supervision requirements. Significant, on this matter, is the legislation set out in art. 15 of this Regulation and, in particular, the specific conditions set for the promotion of the ancillary businesses in case of derogation by the competent supervisory authority, with regard to the subject of own funds, on a consolidated basis, for groups of investment firms.

The intention is to avoid that the outsourcing of business functions impacts on the calculation of the elements of the Common Equity Tier 1 (which, therefore, will have to deduct any contingent liability towards ancillary companies that would otherwise be consolidated), as well as the calculation of the minimum core capital (having to consider the full value of the participations, of the subordinated credits, and of other instruments relating to these companies). This justifies the need for monitoring the capital and the funding sources of all the companies included in the banking group, identified by the European Regulator, which comes to impose the adoption of specific internal controls to the EU investment firms (art. 15, paragraph 1, last paragraph of the EU Regulation n. 575/2013).

In light of the foregoing, it appears to be clear that and the outsourcing of functions to ancillary entities may affect the organizational structure of the bank, and then the application of the prudential rules provided by the EU legislation. Hence the importance attributed to the authorization (provided by the supervisory authorities),

[13] See HONESS - CHANCE, *Outsourcing - A legal perspective on contract critical success factors*, in *Information security technical report*, 1996, p. 57 ff.

which marks the perimeter of the entities that cooperate for a proper banking performance.[14] Therefore, it should be highlighted that the legislation does not exclude the possibility of a proportional consolidation (even through the use of the so-called «equity method»), where this is not an obstacle for the effective protection of the savings collected by the intermediary (art. 18, EU regulation 575/2013).[15]

Similarly, this also applies to the option, of the competent authorities, to exclude an undertaking from the consolidation in the cases where: (i) 'it is situated in a third country where there are legal impediments to the transfer of the necessary information'; (ii) 'it is of negligible interest only with respect to the objectives of monitoring credit institutions'; (iii) 'the consolidation of the financial situation … would be inappropriate or misleading as far as the objectives of the supervision of credit institutions are concerned', on the understanding that, in case of the involvement of several undertakings, 'collectively they are of non-negligible interest with respect to the specified objectives' (art. 19, EU regulation n. 575/2013).

Even the regulation regarding the capital requirements for credit risk appears to be in line with the objective of preventing that the subjective proliferation and the outsourcing of business functions allow an arbitrage in the application of the capital adequacy rules. Significant, in this regard, is the provision according to which institutions may treat equity exposures to ancillary services undertakings in accordance with the treatment of «other non credit obligation assets» (art. 155, EU regulation n. 575/2013).

A different legal framework is outlined, in which banking, revised in its structure, is primarily defined in reference to the paradigm of capital adequacy, even while taking into consideration the ancillary companies. In fact, the discipline concerning "management bodies" and "senior management" appears to be only partially adequate to avoid the pursuit of *unbridled* outsourcing policies and, consequently,

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[14] See MAUGERI, *Esternalizzazione di funzioni aziendali e "integrità" organizzativa nelle imprese di investimento*, in *Banca borsa e titoli di credito*, pt. 1, 2010, p. 439 ff.

[15] Hence, the justification for the extension of the legislation in question also to the cases in which the exercise of consolidated supervision appeared appropriate because of the relative importance of the single activities in the various countries (and, therefore, applies the principles of art. 111, Dir. 2013/36/EU).

the *emptying* of the company structure. Therefore, it is essential to identify a balance point in the relationship between "banking business", "organization" and "individual". In order to protect the stability of credit institutions, this balancing shall ensure that the exercise of intermediation activities refers to an *agere* able to connect the efficiency levels (of the business) to a minimum size of the organizational social structure **(**adequate to ensure the bank's solidity).

4. Strategies**,** models and rational decision-making processes are the components of the internal governance of a bank that, according to the European legal framework, must ensure its safe and sound management.

The legislation calls for a promotion of an organizational structure in which the operational guidelines and responsibilities are well defined, transparent and consistent. In particular, effective processes are required (for the identification, management, monitoring and risk reporting), as well as adequate structures (for the execution of administrative and accounting tasks, together with the internal audit).[16] These components are subject to public supervision (from the request for the authorization to pursue banking operations) and, therefore, they have to be presented to the competent authority – from the early stages of the authorizing procedure – in complete and proportionate (to the nature, scale and complexity of the risks that characterize the plan indicated in the "activity program") modalities.[17]

Clearly art. 74 of Directive 2013/36/EU is in this way oriented. This article relates organization to the "remuneration policies and practices", in order to ensure that corporate decisions promote sound and effective risk management. The regulator has been dealing with this issue for some time, in relation to the senior management and to the danger that certain strategies (weighted on short-term volumes or measurements) could undermine the bank's solidity. However, this issue can

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[16] See RAY - TAO - OLKHOVETS – SUBRAMANIAN, *A decision analysis approach to financial risk management in strategic outsourcing contracts*, in *EURO J Decis Process*, 2013, p. 187 ff.

[17] See, on the press, the Italian Montepaschi case, *Banca Monte dei Paschi di Siena outsources key administrative services*, in *Dow Jones*, 2 December 2013

arise new questions if considered in reference to the outsourcing phenomenon. Indeed, after a control on the internal personnel (exercising important tasks for the bank) remuneration policies, we should expect that the principles contained in directive 2013/36/EU (together with the EBA orientations and the principles announced by the Commission[18]) should be extended until they condition the outsourcing prices (i.e. the calculation methods for the money owed by the Bank to the outsourcer).[19]

Hence, there is the need for rules able to set a price (for the "service" in question) able to adequately remunerate the employers providing it, even if their activities are carried out outside the bank's subjective perimeter.[20]

On a regulatory perspective, the responsibilities of the body appointed to the strategic supervision of the bank come to mind. This body is called for evaluating in particular if the information regarding the remuneration of the outsourced functions should be brought to the knowledge of the "remuneration committee" (set in art. 95 of Directive 2013/36/EU).[21] Obviously, this information should also be transmitted to the competent public authorities that, accordingly to art. 75 of Directive 2013/36/EU, collect data on the operating procedures of the credit institution, in order to ensure a complete observation of the "trends" in the industry.

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[18] See also Recommendation 2009/384/EC of the Commission, of the 30th of April 2009, on the retribution policies in the financial services sector.

[19] See KENYON, *Optimal price design for variable capacity outsourcing contracts*, in *Journal of Revenue and Pricing Management*, 2005, p. 124 ff., where a solution method is proposed. The resulting linear (and quadratic) mixed integer optimisations can be solved numerically using standard software. According to the Authors interpretation, the solution yields Pareto-efficient outcomes with respect to the Provider and the Client. The frontier of Pareto-optimal designs serves as an appropriate space for practical contract negotiation.

[20] Therefore, the criteria used to determine this price shall promote a sound and prudent risk management, avoiding the encouragement to recruit risks exceeding the level tolerated by the credit institution, also in order to avoid conflicts of interests and other hazards that may occur in the long term. This, even with regard for every distinction between fixed base remuneration (that should reflect, in this case, the standing and the guarantees given by the ancillary business) and the variable remuneration (due for services that go beyond the minimum concluded in the contract); see. Art. 92 and Art. 94 Directive 2013/36/EU. On this point, see ADELEYE - ANNANSINGH – NUNES, *Risk management practices in IS outsourcing: an investigation into commercial banks in Nigeria*, in *International Journal of Information Management*, 2004, p. 167 ff.

[21] According to the article cited in the text, this shall allow the latter to detect (and, where appropriate, report) any differences between the functions that cooperate (from the inside to the outside) for the conduct of banking.

On this matter, we must consider also the practice to outsource the development of policies and strategies (that should be responsibility of the management bodies of the credit institution) to high-standing operators.

In general, the approach to this particular consulting activity (adopted by the external operators) is open to conflicting interpretations. In this case, the intervention of a merchant bank (able to help the bank to evolve to the best market practices) appears to be appreciable and sharable. However, there is also the evidence of the risk that – for this reason – the bank would follow the industry standards without developing a personal operating profile (able to produce a competitive advantage for the credit institution itself).[22] Hence, we feel the need to reconnect such a service to a 'reserved activity paradigm', in order to prevent that the decision-making process (in which a bank's strategies and business plans are elaborated) is entrusted to a non-supervised body.[23]

From another perspective, we must consider the tasks that the special regulation imposes to the management body for the organization and the mitigating of "risks the institution is or might be exposed to, including those posed by the macroeconomic environment in which it operates in relation to the status of the business cycle." (art. 76, Dir. 2013/36/EU). In fact, if there is an active participation of this body to the setting of risk taking policies, then there shall be specific 'reporting lines' to a 'risk committee' (established within it, and mandatory when the bank reaches a certain operational size).

In this context, the intervention of an outsourcer must satisfy the criteria that, on the one hand, prevent a discharge of responsibility (by the bank) and, on the other, enhance the position of independence of the external operators from the operating functions. These criteria suggest also to provide agreements able to ensure

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[22] See TEIXEIRA DE ALMEIDA, *Multicriteria decision model for outsourcing contracts selection based on utility function and ELECTRE method*, in *ScienceDirect*, 2007, p. 3570 ff.

[23] This statement is in line with the standard approach of Mifid Directive, where the investment advices have been regulated; see SCIARRONE ALIBRANDI, *Il servizio di consulenza in materia di investimenti: profili ricostruttivi di una nuova fattispecie*, in *Scritti in onore di Francesco Capriglione. Le regole del mercato finanziario*, Padova, 2010, p. 597 ff.

the ancillary company the resources and the powers which, in general, are provided by the European standard for the exercise of such tasks.

With particular reference to the outsourcing of internal controls, it seems possible to argue that the organization will have to ensure that the bodies entrusted with control functions: (i) are independent from the business units subject to their interventions; (ii) have the necessary authority and - as far as possible - (iii) are paid accordingly to the achievement of the objectives linked to their functions, independently from the results obtained by the business areas subject to their control. Otherwise, the outsourcing policy could try to pursue efficiency objectives through a mere regulatory arbitration (which appears inconsistent with the obligations imposed by art. 92, dir. 2013/36/EU).

Generally speaking, it should be noted that the *outsourcing* choices should be oriented towards an effective management of the credit institution, having regard also for the separation of the duties within the organization. There is no doubt, in fact, that they represent one of the highest degrees of independence between the holder of the function and the organizational structure of the bank. However, this set-up must preserve the overall responsibility in the hands of the management body (which is, therefore, also responsible for the approval and monitoring of the implementation of the strategic objectives).

5. At operational level, the integrity of the accounting and financial reporting systems, together with the monitoring of the process of (internal and external) communication, remains in the hands of the bank's organization. This set-up outlines a network of functions and information linked to the bodies responsible for corporate governance, even if it extend its links to the internal auditors (who may use the information contained therein for the achievement of their own institutional purposes).[24] At the same time, this network is subject to controls by the competent

[24] See CASALINO – MAZZONE, *L'esternalizzazione della funzione sistemi informativi nelle banche. Una strategia di outsourcing*, in *Mondo Bancario*, *Futura 2000*, Italy, anno 49, n. 5, pp. 37-49, 2008.

authorities, called to order by the European regulation to carry out a review of practices implemented by credit institutions to comply with Directive 2013/36/EU and Regulation (EU) No. 575/2013.

Hence, we need to focus on the outsourcing of relevant functions. With regard to the of 'research and development' department, we must highlight that it is in charge of to the innovation of banking and, in particular, of the revising of the maturity transformation procedures (and the use of financial instruments). In fact, it should be borne in mind that some scholars have indicated such function as the center of imputation of numerous choices that have contributed to the spread and the triggering of the recent financial crises.[25] The results of this analysis shows the opportunity to regulate these functions, in order to place the burden of managing the risk of amplifying shocks (endogenous or exogenous) in the hands of the managers. Therefore, this result does not suggest to restate the calculation of regulatory capital, but to avoid future 'drifting projects', in order to increase the levels of prudence in important sections of the financial market.[26]

The business model adopted by a bank has central importance for the purpose of such supervision, as the option for operations *originate to hold* or *originated to distribute* influence the choice of the technical criteria for the prudential evaluation of the corporate organization.[27] This option, in fact, places the management body in front of an alternative: keeping (within the assets of the current bank) or transferring (to third parties) the credits originating from lending. In the first case, we can find services relate to the asset management (sometimes owned by outsourcers), whose function is outsourced (in whole or in part). In the second case, the ancillary activity will focus on the financial products and on the contracts used for the sale of the assets, as well as on the application of the most advanced techniques of credit enhancement or maturity transformation (developed by specialized outsourcers).

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[25] See BRESCIA MORRA, *Innovazione nei prodotti finanziari e ordinamento del credito*, in *Scritti in onore di Francesco Capriglione. Le regole del mercato finanziario*, cit., 2010, p. 551 ff.
[26] See LEMMA, *Crisi finanziaria e stabilità dei fondi immobiliari*, in *Scritti in onore di Francesco Capriglione. Le regole del mercato finanziario*, cit., 2010, p. 1228 ff.
[27] See Art. 98, paragraph 1, lett. i, dir. 2013/36/EU.

These solutions, at first glance, appear oriented towards improving the 'production function' (or rather: intermediation formula) of the bank. However it should be noted that these solutions raise specific problems in terms of the allocation of managerial decisions (and, therefore, of customization of the banking business). In fact, the use - approved by the management body - of a model owned by third parties involves specific organizational consequences, both for the dependence that establishes between the service provider and the credit institution, and for the outsourcing of functions that qualify the essence of the banker.

More specifically, the option for the OTD model projects the bank towards the border between the regulated market and the illegal movement of capital: the «shadow banking system». This is a field that is configured in residual terms, in comparison to the banking and financial system, where the supervisor's focus should control that the outsourcing process does not amplify the risks that qualify the original situation.[28]

This suggests the need to identify governance principles for the cases in which a bank, after outsourcing services related to securitized loans, provides implicit support to securitizations (originated by it). It goes without saying that the intervention of an outsourcer[29] should not place some stages of the movement of capital outside the banking system (in a logic that still appears respectful of this system), but must support a trading system designed to develop within the economy of a credit institution (and, therefore, in a context of capital adequacy and prudential supervision).

Therefore, special internal rules may provide specific interventions (also by the internal audit) to avoid that outsourcing does not translate into a significant proliferation of the risks (according to art. 98, paragraph 3, dir. 2013/36/EU).

Reaching a first conclusion, it can be said that in the outsourcing process, the intervention of an ancillary services undertaking should produce easily measurable

[28] See LEMMA, *The Shadow banking system*, London, 2015, *passim*.
[29] See CASALINO - MAZZONE, *Externalization of a banking information systems function. Features, regulatory and critical aspects*, in *The Interdisciplinary Aspects of Information Systems Studies*, D'ATRI, DE MARCO, CASALINO (Eds.), Physica-Verlag, Springer, Heidelberg, Germany, 2008, pp. 89-96.

quantitative improvements (in terms of cost reduction or increase of the output).[30] However, the intervention of an outsourcer (which produces one or more phases of the tasks necessary for the conduct of banking) follows contractual rules (predetermined at the time of the commitment) that are not re-conducible to traditional forms of business relationship. It is clear that the provisions of any outsourcing contract replace those of the relationship that qualifies the direct employment of a worker in charge of the same tasks. So, in the outsourcing, the relationship (between the management bodies of the bank and the executors of the services) will have equal - bilateral character, having to necessarily find appropriate discipline in the contract that the management must conform to the provisions of the supervisory authorities.

6. There is no doubt that the contracts (agreed between the bank and the ancillary service undertakings) implement the rules required to apply the strategies of outsourcing chosen by the management bodies and by the senior management of the credit institution. These contracts are particularly significant in the analysis of the outsourcing processes, and in the control of the banking business.[31] Indeed, once chosen to entrust some stages of the bank's production cycle to external companies, the establishment of contractual regulations shall not limit the supply (by third parties) and the use (by the bank) of the services (outsourced), but shall define the outsourced activities as part of an organizational structure that must be compliant with the indications contained in the authorization provided by the supervisory authority.[32]

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[30] See DOMBERGER - FERNANDEZ – FIEBIG, *Modelling the price, performance and contract characteristics of IT outsourcing*, in *Journal of Information Technology*, 2000, p. 107 ff.
[31] See JIANG – YAO, *Valuate Outsourcing Contracts from Vendors' Perspective: A Real Options Approach*, in *Decision Sciences*, 2008, p. 383 ff.; YAOA - JIANGB - YOUNGB - TALLURI, *Outsourcing timing, contract selection, and negotiation*, in *International Journal of Production Research*, 2010, p. 305 ff., where the Authors examine outsourcing contracts subject to irreversible outsourcing investment and cost uncertainty, by considering three common outsourcing contracts (fixed-price, cost-plus, and gain-sharing) and address issues of when to outsource and which contracts to select.
[32] See CERA, *Esternalizzazioni di gestione, mandato generale e rappresentanza legale nelle società per azioni*, *Rivista di diritto privato*, 2013, p. 327 ff.

Clearly, in outsourcing of one or more business units, the contract must not only consist in the agreement between two parties who wish to establish and regulate (between each other) a legal relationship, but it must also consist in a tool that extends its economic function to areas of public oversight competence. So that, in the application of the outsourcing strategies, the bank should consider the limits that the supervisory system imposes to the exercise of private enterprise, in order to compose the interests that qualify the present case, and to reach a voluntary collaboration that is in line with the *quantum* authorized by the supervisory authority.

Consequently, in these agreements, the *stare pactis* extends its efficacy beyond the legal sphere of the contracting parties, as the rules that they have voluntarily established influence the stability of the intermediary and, therefore, the correct movement of capital (entrusted to it by the market). Therefore, to *consensus* and the *formation* of this contract must follow not only the pursuit of individual interests (cost reduction or efficiency of procedures and, therefore, the maximizing of profit), but also an economic balance that preserves the purposes and the more general interests that characterize the sector in question.[33]

In this context, we understand the reason because the contents of these agreements must be brought to the attention of the supervisory authority, in order to disclosure the specific characteristics of the supervised party. This is a duty of loyalty and transparency that is one of the prerequisites for the smooth operation of the internal market (advocated by recital no. 6 of Directive 2013/36/EU), which “requires not only legal rules but also close and regular cooperation and significantly enhanced convergence of regulatory and supervisory practices between the competent authorities of the Member States”.

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[33] See FENG - XIAOYUAN LU, *The Role of Contract Negotiation and Industry Structure in Production Outsourcing*, in *Production and operations management*, 2013, p. 1299 ff., where the Authors attempt to further understand the strategic impact of low-cost outsourcing on manufacturers’ profitability by investigating the contractual form of outsourcing agreements and the industry structure of the upstream supply market, by considering a two-tier supply chain system, consisting of two competing manufacturers, who have the option to produce in-house or to outsource to an upstream supplier with lower cost.

The object of the (outsourcing) contract and the one of the (provider) obligation are, therefore, the pillars of a private regulatory system that allows (a credit institution) to carry out certain functions outside the banking entity, for reasons of convenience (or managerial politics) re-conducible to the private autonomy. This suggests that the proper definition of contractual settlement (and the banks obligation resulting from it) is essential to limit the risks of dysfunctions. Otherwise, the contract may be considered null and under the circumstances, the obligation might be considered settled, or resolved.[34]

All the disputes (between the bank and the outsourcer), in fact, has effects on the validity of the requirements at the base of the authorization to exercise banking and, therefore, on the levels of responsibility of the leaders of the credit institution. Hence, we identify the need to provide special form and content requirements, in order to allow the formation of the consensus and the establishment of an agreement resulting in a 'synallagmatic contract', brought to the attention of the supervisory authorities and appropriate to clearly define the obligation of the other (non-banking) party.

Therefore, this is a complex set of rules, in which the subjection of the contract to the control of the judicial authority - conceivable in cases of dispute between the parties - raises specific concerns. This applies, in particular, to the possibility to ensure that the *favor* for equal relations between private individuals (for example, in the presence of an obligation to contract, unfair competition or abuse of position) will not be subordinated to other interests (i.e. the protection of savings, credit control, the preservation of monetary policies and, ultimately, price and market stability).

Beyond that, it will be necessary to evaluate the incidence of the banking regulation on the effects of outsourcing contracts with regard to third parties. In following the traditional criterion of the interests (and not the one of the participation in the

[34] See QIU - YU, *International Outsourcing and Imperfect Contract Enforcement*, in *Asia-Pacific Journal of Accounting & Economics*, 2012, p. 315 ff.

formation of the contract), in fact, we rise doubts about the 'relativity of contracts' (i.e. the identification of those who remain essentially external to the contract and those who are invested in terms of direct effects, reflections or consequences). In addition, these doubts become observable when referring to the outsourcing of customer management or to the securitization of bank assets services. In these cases, it seems possible to suppose that customers will (frequently) come to feel the effects of the innovations caused by outsourcing, because of obvious (positive or negative) externalities associated with the intervention of an ancillary business.[35]

According to this, we notice that the outsourcing contracts signed after the registration of the bank must take into account the *quantum* of business authorized and, therefore, the contents of the 'program of initial operations' (together with those of the statute and articles of association).[36] Otherwise there would be a contrast that cannot be considered to be free of juridical consequences. We are not referring (only) to the Italian provision of art. 1418 civil code, but (also) to the specific indications on prudential supervision, contained in art. 64, dir. 2013/36/EU, where it is established that 'competent authorities shall be given all supervisory powers to intervene in the activity of institutions that are necessary for the exercise of their function, including in particular the right to withdraw an authorization'.

In this regard, we must take into account also the provision of art. 65, dir. 2013/36/EU. According to this article, the authorities have all the powers to collect the information necessary for this purpose, as well as the opportunity to exercise them (through surveys or inspections) also toward third parties, whose credit institutions 'have outsourced operational functions or activities'.

In fewer words. In the difficult historical moment that banks are going through, the negotiating events of the outsourcing processes impact on the economic and legal balance of the credit institution. Sometimes, the contracts that underlie it

[35] See BOND, *Input Quality, Relational Contracts And International Outsourcing*, in *Pacific Economic Review*, 2008, p. 391 ff.
[36] See IMF, *Italy: detailed assessment of compliance with Basel core principles for effective banking supervision*, Washington D.C., 2004, p. 32

can reflect the uncertainties and concerns arising from the instability of the capital market; however it is not possible to admit agreements not adequate to support the challenges set by the changing taking place (and by the new centrality of banking compared to the recovery of the real economy).

In this context, the necessary correspondence between the correctness of the negotiation phase and the responsibility of the ancillary service undertakings (to which follow professional standards and disclosure requirements adequate to ensure the protection of savings)[37] should be included in the text of the agreement. Only in the presence of such correspondence it can be said that outsourcing arises between ‘service’ and ‘contract’, with duties of conduct that will reflect the complexity of the contributions owed by the service providers. Otherwise, the contractual text should provide analytical provisions on the content of the service, which do not perfectly comply with the peculiarities of the banking sector.[38]

7. The UK Banking act of 2009 shows a regulatory approach that reflects the findings of most-advanced organization theories, given that the outsourcing policies open up powerful ways of business. They has helped managers to analyse complicated situations and discover the effective means of dealing with the challenges placed by the capital markets.

While, in banking, the high level of regulation can suggest that there is only one approach to the relation with the service providers, in fact, there are many organization settings and they do not always fit nearly together. Scholars often justify this diversity by pointing out the complexity of any business organization and the different techniques of dealing an outsourcing agreement. This means that, in the

[37] See ALPA, *Gli obblighi informativi precontrattuali nei contratti di investimento finanziario*, in *Scritti in onore di Francesco Capriglione. Le regole del mercato finanziario*, cit., 2010, p. 699 ff.

[38] See TUCCI, *Il rapporto intermediario/cliente fra servizio e contratto*, in *Scritti in onore di Francesco Capriglione. Le regole del mercato finanziario*, cit., 2010, p. 828.

common law context, we encounter a large and complex phenomenon, with perceptual equipment that suggest to supervising it in a holistic way.[39]

Sometimes, outsourcing is not an option, but the consequence of certain market conditions.[40] We refer to the results of the integrated analysis of horizontal and vertical links to operators acting within and outside the firm's perimeter. Even if these analysis shows qualitative evidence (from interviews with investment bank analysts), we should consider that the option of outsourcing (of certain stages of business processes and offshoring parts of the value chain) to providers placed in low-wage countries are possible only if the relevant processes can be linked to the departments which remains in the bank. This is more evident in the case of UK industry, where the world-wide English language helps the banks to approach the emerging countries (of the commonwealth and, in particular, the Republic of India).[41]

However, British authorities are aware that international outsourcing (to lower-wage countries) can best be understood through models that explain the vertical organization of credit intermediation.[42]

Since both the theorists and supervisors expect further developments in this field, we must take into account the possibility of a greater international outsourcing wave that can also increase the thickness of markets and reduce the transactional costs (given the enforceability of the contracts in the foreign countries).[43] This means

[39] See HATCH, *Organization theory*, London, 1997, p. 7. See also LI, *Relational Contracts, Growth Options, and Heterogeneous Beliefs: A Game-Theoretic Perspective on Information Technology Outsourcing*, in *Journal of Management Information Systems*, 2014, p. 319 ff., where the Author suggests that, because salient forms of relational bonuses are often not adopted, relational incentive provision is likely more pervasive than what we can observe.

[40] See GROTE – TAUBE, *When outsourcing is not an option: International relocation of investment bank research - Or isn't it?*, in *Journal of International Management*, 13, 2007, p. 57 ff.

[41] See AMITI - WEI, *Fear of service outsourcing: is it justified?*, in *IMF Working Paper* 04/186, 2004. See also RAVI - JAIN – SHARMA, *An Analysis Of Business Process Outsourcing Strategies Of Public And Private Sector Banks In India*, in *International Business & Economics Research Journal,* 2011, p. 1 ff., on the recent trends of Business Process Outsourcing (BPO) strategies and practices among banking institutions in India.

[42] See WANG - NIU – GUO, *The Comparison of Two Vertical Outsourcing Structures under Push and Pull Contracts*, in *Production and operations management*, 2014, p. 610 ff., where the Authors compare the two outsourcing structures under a push contract (whereby orders are placed before demand is realized) and a pull contract (whereby orders are placed after demand is realized), finding out that the equilibrium production quantity is higher under control than under delegation for the push contract whereas the reverse holds for the pull contract. Both the OEM and the CM prefer control over delegation under the push contract.

[43] See FEDERICO, *Outsourcing versus integration at home or abroad and firm heterogeneity*, in *Empirica*, 2009, p. 47 ff.

that the supervising authorities shall focus on the choice of bank's organizational form. This also explains the reason of the prevalence of firms choosing different organizational form, rather than focusing on a traditional organizational model.

8. In these times of crisis, many banks suffer competitive pressure due to the need to conquer new market share, to meet the growing expectations of customers, to maximize shareholders' value. Similarly, it is to be said about the need to comply with a wavering and increasingly stringent regulation.

This pressure suggests, to the management, the research of innovative solutions in the outsourcing market, where numerous companies offer services to support the banking business. These services are not only able to reduce costs, but also to take advantage of the experience and of the economies (of scale) that allow all outsourcers to deliver 'tailored services' to quickly respond to market challenges.

This suggests a reality in which the outsourcing process does not translate into a homogenization of the services (according to the 'one size fits all' theory),[44] even when the bank asks for an entire operation, a corporate function (e.g. contract centre or mortgage operation) or an operative branch (i.e. a full end to end business process). Thus, the evolution of the banking sector - from the prevalence of the 'in-house service provision' model to another centred on the intervention of a 'specialist third party provider' - questions the regulator and the supervisory authorities about their capability of evaluating the holistic framework of this new banking system.

In this context, the industry of ancillary services does not escape the controls of the new European system of financial supervision, since - according to the deductions of the De La Rosiere Report - the inadequate configuration of banking corporate governance is one of the causes that have contributed to the worsening of the financial crisis. Hence, we feel the need to understand the role of the ESRB and the EBA, together with the tasks of the ECB and other competent authorities. Many, in fact, are the intervention profiles necessary to protect the general interests that, in this

[44] See MASERA, *CRR/CRD IV: the Trees and the Forest*, in *Does one size fit all*, Bologna, 2014, p. 9 ff.

case, are affected by the services provided by outsourcers; this analysis will take into account not only the protection of savings and price stability (from macro and micro-prudential risks), but also the consumer rights (i.e. transparency, disclosure and privacy).

On this point, it should be noted that the ESRB has prompted the need to examine "the systemic implications of so-called misconduct risk in the banking sector, i.e. the risk that banks are subject to fines and other sanctions due to violation of good conduct rules". These risks are related to rare events, in relation to which the growing level of sanctions creates "uncertainty about the business model, solvency and profitability of banks". We must consider that these risks tend to produce systemic effects (for their intersubjective, pro-cyclical character and anti-market confidence).[45] Hence our intent to analyze the definition (together with EBA) of "a minimum methodology for banks to apply when calculating potential misconduct costs under stress".[46]

Come to mind the contents of the 'Guidelines on Outsourcing', of the 14th December 2006, prepared by CEBS on the basis of the best practices in the industry. Despite the alleged compatibility with the MiFID regulation (and certain overlaps), the problems caused by the absence of 'harmonisation at the EU level in the area of outsourcing undertaken by credit institutions' were already at that time perceived and, therefore, the "different supervisory approaches … developed across the EU to address the potential risks arising from this practice".[47] Current practices and common elements of policy had been chosen, by CEBS, to promote an appropriate level

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[45] See DRAGHI, *Hearing before the Committee on Economic and Monetary Affairs of the European Parliament - Introductory statement*, Brussels, 17 November 2014, who - as Chair of the ESRB - said that "The systemic nature of this risk derives from a number of factors. In many cases, misconduct issues arise across markets and also at systemically important banks. The costs typically rise in times of crisis and as such have a procyclical impact. Finally, misconduct can damage confidence in financial markets and institutions, which is vital for the proper functioning of the financial system".

[46] See DRAGHI, *Hearing*, cit., on the perspective of "a robust, rigorous and comparable assessment across banks and a consistent approach and appropriate contingency planning across jurisdictions. Misconduct risks should also be adequately captured in future EU-wide stress tests".

[47] See CEBS, *Guidelines on Outsourcing*, 14 December 2006, pp. 1 - 2; if, on the one hand, some Member States had, at that time, adopted 'formal outsourcing regimes', others remitted this subject only to private enterprise (with obvious negative effects on the consistency of national legal frameworks).

of convergence in the internal market about the “authorised entity’s use of a third party … to perform activities that would normally be undertaken by the authorised entity”.[48]

Despite this, the attribution of responsibility on the “outsourcing institution’s senior management” is of central importance. This is why it was explicitly stated that “outsourcing arrangements can never result in the delegation of senior management’s responsibility” (Guidelines 2-3). At operational level, the possibility that “an authorised entity may not outsource services and activities concerning the acceptance of deposits or to lending”, unless the service provider was authorized by the supervisor (Guideline 4) resulted to be precluded. An *appendix* to these rules was the duty to avoid that outsourcing strategies undermine the functioning of the bank or its management bodies. Following of this approach, the CEBS suggested that “the outsourcing institution should have a policy on its approach to outsourcing, including contingency plans and exit strategies”, having to manage the risks related to the service entrusted (Guidelines 6-7).

In the above construction is also noted the establishment of a “formal and comprehensive contract” and of a “written agreement on the responsibilities of both parties and a quality description” configured as “a mixture of quantitative and qualitative performance targets, to enable an outsourcing institution to assess the adequacy of service provision” (Guideline 8 - 9).[49] The same has to be said for the relationships with supervisory authorities, which should have “access to relevant data held by the outsourcing service provider and, where provided for by the national law, the right … to conduct onsite inspections at an outsourcing service provider’s premises” (Guideline 11).

However, we must also have regard for the “EBA Guidelines on Internal Governance”, which deal with the outsourcing issue together with the regulation of the

[48] See CEBS, *Guidelines on Outsourcing*, cit., p. 2

[49] See LU - NG – TAO, *Outsourcing, Product Quality, and Contract Enforcement*, in *Journal of Economics & Management Strategy*, 2012, p. 1 ff., where de Authors question if outsourcing compromise product quality or sound contract enforcement alleviate this concern. They also offer a simple model to illustrate how outsourcing leads to lower product quality and how contract enforcement helps mitigate this problem.

"management body". In fact, this body has to "approve and regularly review the outsourcing policy of an institution", as the same impacts on the activities and on the risks that a bank must face (such as operational, reputational and concentration risk).[50] According to the Euro-system's regulatory framework, a bank that outsources is responsible for the effects that the activities carried out produce (in the relationships with customers or with supervisory authorities).

In this regard, the orientation of the ECB appears to be significant, because the latter – considering the impact of outsourcing to the banking structure – claims that "bank supervisors seem to deal with outsourcing risk by encouraging precautionary measures on the part of banks and service providers, and some convergence of supervisory approaches and practices in relation to outsourcing is under way".[51]

Concluding on this point it can be said that – in the last decade – the European supervisory system has moved towards the management of a phenomenon that – as was noted in 2005 be the "Basel Committee on Banking Supervision" – "is increasingly used as a means of both reducing costs and achieving strategic aims".[52]

9. This analysis lead us to reflect on the perimeter of subjectivity in banking, which – according to a broad interpretation – could be enlarged to also cover the ancillary services undertakings and their role in providing outsourced activities. There is no doubt that the principles set by the European regulation appear to be designed to prevent that outsourcing translates into an 'escape from responsibility' or into a speculative use of the model Originated to Distribute, *i.e.* becomes an operating technique that ends up reducing the dimensions of the credit institution to minimum measures, not compatible with the stability requirements that qualify the current banking industry.

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[50] See *EBA Guidelines on Internal Governance*, London, 27 September 2011, p. 31
[51] See ECB, *Report on EU Banking Structure*, November 2004, p. 27 ff. and p. 31.
[52] See Basel Committee on Banking Supervision, The Joint Forum - Outsourcing in Financial Services, February 2005, p. 1.

However, the baseline of our analysis showed a substantial compatibility of the main outsourcing policies with the principles of savings collection[53] and lending.[54] On this point, we must refer to the experiences gained through the involvement of financial promotion agents or promoters (independent from the bank), as well as the use of credit rating agency's assessments. These experiences have highlighted the costs and benefits of entrusting external subjects with certain relevant functions in the performance of banking activities.[55]

Therefore, we verified the impact of the outsourcing on the integrity of the banking business in reference to the number of outsourcers, and the compliance of the organizational structure with the contents of the authorization for the reserved activity (provided by supervisory authorities). Hence, we had identified the need to intensify the controls on the corporate governance of the entities that have outsourced the essential stages of credit evaluation and decision-making processes (in addition to those purely executive). Warnings, in this regard, seem to come from the European guidelines mentioned in our investigation. Indeed, the most recent EU legislation provides for certain formal duties, which seem to be able to steer the banking industry towards safer and sounder outsourcing policies. However, this does not preclude that the operation of the service providers – where new regulatory measures do not apply - may be a cause for the alteration of the circulation of capitals, penalized by an excessive fragmentation of the production cycle.

It is evident that the ESFS, the ECB and the national authorities are in charge of making further steps towards a proper configuration of supervisory practices in this industry, in order to set up a banking model that is able to take advantage of external service providers without emptying itself of its contents and safeguards, required to protect the savings raised from the public.

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[53] See LENER, *Profili generali della raccolta (bancaria) del risparmio*, in *Scritti in onore di Francesco Capriglione. Le regole del mercato finanziario*, cit., 2010, p. 527 ff.
[54] See TROISI, *Le Agenzie di Rating*, Padova, 2013, p. 129 ff.
[55] See LISTON - BYRNE - BYRNE – HEAVEY, *Contract costing in outsourcing enterprises: Exploring the benefits of discrete-event simulation*, in *Int. J. Production Economics*, 2013, p. 97 ff.

SHADOW BANKING, BANKING UNION

AND CAPITAL MARKETS UNION

Marina Brogi[*]

ABSTRACT: *This paper analyses the development of shadow banking and considers the challenges it poses for regulators and supervisors vis-à-vis latest developments regarding i) the Banking Union, which led to the Single Supervisory Mechanism that became operational in November 2014, and ii) the Capital Markets Union that is one of the most important projects of the Juncker Commission. The focus is on the inter-connections between the various elements of the financial system and their impact on systemic risk in the perspective that the financial system is a fundamental infrastructure of the economy and should be structured in order to contribute to growth and job creation.*

1. The financial system (made up of intermediaries and markets) is one of the fundamental infrastructures of any economic system, therefore in assessing the contribution of shadow banking and the banking and capital markets union we should use the prism of growth and job creation.

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The difficulties in stimulating growth, in a context of extremely low inflation, have led the ECB to implement an accommodating monetary policy that implies

1. low yields, which means that asset managers, insurance companies etc. are turning to loans to increase their returns and that banks are struggling to maintain their profitability from traditional banking
2. further liquidity injections by the ECB in the coming months
3. weak and weakening euro, that might drive savers to turn to other currencies.

Low yields and ample liquidity are two conditions that may favour a further rise in shadow banking.

The weak and expected-to-weaken-further euro may pose specific immediate challenges for the capital markets union as investors leave euro-denominated asset classes.

2. The term “shadow banking system” was allegedly[1] coined by Paul McCulley of Pacific Investment Company Management (PIMCO) in August 2007 at the U.S. Federal Reserve’s (Fed’s) annual symposium in Jackson Hole, Wyoming, who defined shadow banks as “levered-up intermediaries without access to either Federal Deposit Insurance Corporation (FDIC) deposit insurance or the Fed’s discount window to protect against runs or stop runs. But since they don’t have access to those governmental safety nets, shadow banks do not have to operate under meaningful regulatory constraints, notably for leverage, only the friendly eyes of the ratings agencies.”

This term was subsequently widely used since the beginning of the financial crisis, as a result of the increasing volume of banking activities performed outside the regulated banking system. Despite its extensive use, there is no straightforward and generally-accepted definition of “shadow banking”.

[1] See IMF, *What is Shadow banking?*, in *Finance and Development*, June 2014.

Poszar (2008) defines shadow banking as “the network of highly levered off-balance sheet vehicles”. In a more recent definition, Pozsar et al. (2010) shadow banks are “financial intermediaries that conduct maturity, credit, and liquidity transformation without access to central bank liquidity or public sector credit guarantees”.

Kodres (2013) gives a simple but effective definition of shadow banking system describing it as “many financial institutions that act like banks (but) are not supervised like banks”.

The first ‘official’ definition was provided by the Financial Stability Board (FSB) in 2011: the shadow banking system as “a system of credit intermediation that involves entities and activities outside the regular banking system”.

In the inaugural release of the Global Shadow Banking Monitoring Report issued in 2012 using end-2011 data, the FSB sets out a two step-approach in defining the shadow banking system as a driver for systemic risk and as a development of regulatory arbitrage that could undermine the benefits of financial regulation. It combines a macro perspective, related to the structure of the financial institutions, and a micro perspective, focused on the features of the financial instruments that compose the “non-bank credit intermediation”.

In particular, in 2014 the FSB distinguishes two different measures of the shadow banking system: the so called Monitoring Universe of Non-Bank Financial Intermediation (MUNFI) that is composed by the global financial assets of non-banking institutions (Other Financial Institutions – OFIs[2]), and a narrower measure that deducts from the global financial assets of the OFIs all the financial assets not involved in credit intermediation, financial assets that are prudentially consolidated into a banking group and financial entities whose activities do not exhibit risks associated with shadow banking.

[2] OFIs comprise all financial institutions other than those included in the sectors Monetary Financial Institutions – MFIs and the Insurance Corporations and Pension Funds ICPFs, see BAKK-SIMON - BORGIOLI - GIRON - HEMPELL - MADDALONI - RECINE - ROSATI, *Shadow banking in the euro area: An overview*, in *ECB Occasional Paper no.133*, 2012.

The fact that shadow banking does not have a universally-acknowledged definition stems from the relevantly recent attention paid to this phenomenon and from the different regulatory systems which may influence what is considered shadow banking in different jurisdictions. But especially it reflects the complexity and the continuously-evolving and innovative nature of financial activities performed outside the banking sector also as a reaction to the regulatory requirements imposed on banks.

3. As a result of the financial crisis new, more binding regulations were imposed on banks and thus presumably favoured a further expansion of shadow banking. Shadow banking activities are basically interlaced with core credit operations of banking institutions and insurance companies, creating a source of systemic risk for the financial system at large. The first step in appraising the value and the riskiness of the shadow banking activities is to classify its main components.

The Global Shadow Banking Monitoring Report of the Financial Stability Board based on the data of the Global Financial Stability Report published by the International Monetary Fund[3] estimates the size of the shadow banking system.

MUNFI assets considerably increased in the period of observation (2002-2013), reaching approximately €67 trillion ($75.2 trillion) in the 20+Euro Area (EA) group[4]. The trend is strongly positive in 2013, up by €4.3 trillion ($4.8 trillion) with a 7% growth rate from the value of 2012.

Comparing these values with the level of GDP, *20+EA-group* shadow banking activities represent 120% of GDP in 2013, with a considerable expansion from 114% in 2012.

[3] See IMF, *Global Financial Stability Review*, October 2014.

[4] The *20+EA-group* comprises 20 individual jurisdictions (Argentina, Australia, Brazil, Canada, Chile, China, Hong Kong, Indonesia, India, Japan, Korea, Mexico, Russia, Saudi Arabia, Singapore, Switzerland, Turkey, United Kingdom, United States, South Africa) plus the Euro Area (Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Lithuania, Luxemburg, Malta, Holland, Portugal, Slovakia, Slovenia, Spain).

The Euro Area, the United Kingdom and the United States represented 80% of total global MUNFI assets in 2013 with about €22 trillion ($25 trillion) in the EA and the US and €8.3 trillion ($9.3 trillion) in the UK.

The 2013 EA annual growth rate is on the *20+EA-Group* average level (7%), but there are several differences between the various components. For instance, the 2013 UK annual growth rate is about 1%, after being strongly negative (-8%) in the previous year. In the most emerging market jurisdictions, the average growth rate is higher than the *20+EA-Group* average level and exceeded 20% in 2013.

Despite the lack of a generally acknowledged definition, we can infer that shadow banking refers to all the non-banking instruments that imply credit intermediation and maturity and liquidity transformation. Hence, it is useful to examine the trends of two different types of activities: (i) money market funds and repurchase agreements and (ii) securitisations.

3.1 Money Market Funds (MMFs) are mutual funds that invest in short-term financing instruments such as government securities, short-term bonds, repurchase agreements, commercial papers, and other money funds. For these reason MMFs are widely used as banking activities in maturity and liquidity transformation, and represent an alternative to bank deposits, with more attractive yields.

Between December 2013 and June 2014, the average maturity, and in particular the average life, of EU prime MMFs assets rose considerably (+3% and +14%). Daily liquidity levels fell by 10%, while weekly liquidity increased 2%. These mixed developments in average MMFs liquidity probably reflect efforts by MMFs to restore profitability by accepting marginally more maturity risks within their portfolios.[5]

MMFs are an important source of short-term financing for financial institutions and non-financial institutions, and lead to a high level of interconnection that could distress the banking system in a crisis event. In order to preserve the integrity and stability of the financial system the European Commission proposed a regulation on 4

[5] See ESMA, *Trends Risks Vulnerabilities*, No. 2, 3 September 2014

September 2013 defining a framework that will make the MMFs more resilient to future financial crisis and at the same time secure their financing role for the economy.[6] The International Organization of Securities Commissions (IOSCO) also developed several recommendations regarding MMFs.[7]

In both cases the recommendations propose to introduce common standards for the regulation and management of MMFs to ensure a minimum level of weekly and daily liquidity and to guarantee diversification, high quality, and good credit standing of the MMFs investment. These standards are organized in principles regarding valuation, disclosure, credit ratings and liquidity management.

This harmonisation process is aimed at enhancing the soundness and the integrity of the MMFs, preserving the role of MMFs as a financing tool and minimising the effects of a new crisis. Investors and issuers as well will benefit from the proposed framework: investors will be more aware of the risk they are going to take, and issuers will be able to operate in a more stable environment.

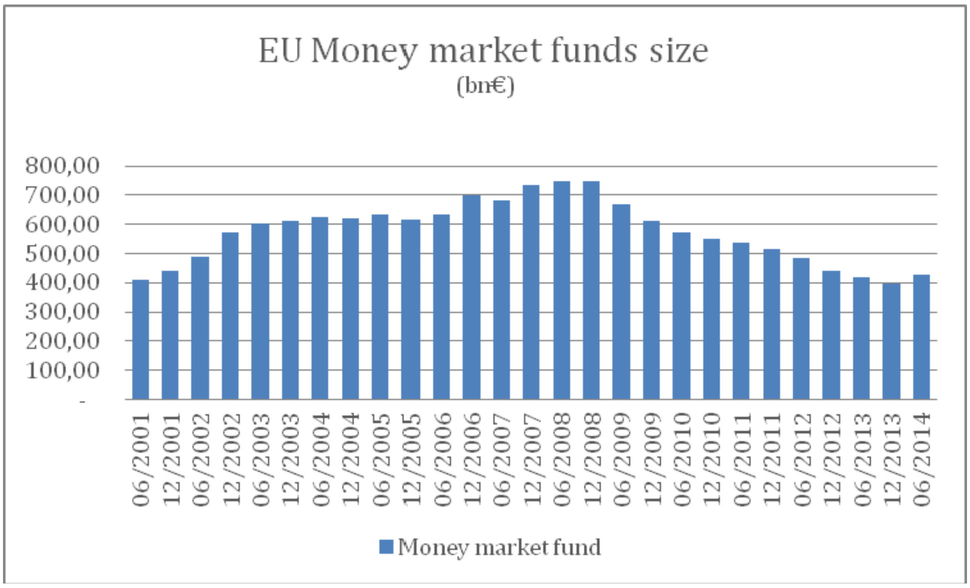

Figure 1 – Author's elaboration on ECB, Statistical Data Warehouse

[6] See EUROPEAN COMMISSION, *Regulation of the European Parliament and of the Council on Money Market Funds*, Proposal, 4 September 2013.
[7] See IOSCO, Policy Recommendations for Money Market Funds, 1 October 2012.

A repurchase agreement is a bilateral contract involving a cash borrower (REPO seller) that agrees to sell securities to a cash lender (REPO buyer) buying them back at specified price and date, with interest (REPO rate) paid over the period of the agreement. REPOs are widely used for maturity transformation, because the maturity of the agreements are typically shorter than the maturity of the underlying asset. Dealers use REPOs to borrow from lenders or from Money Market Funds in order to finance their own assets and post haircuts (cash collateral) at least at the same amount of the value of the borrowed securities. Lenders investing in REPOs are typically pension funds, insures of sovereign wealth funds that operate in order to gain additional revenues from their portfolios.

The repo activity revealed by the latest survey of the International Capital Market Association (2014) suggest a growth of the European repo market and shows an increase in market leverage that might concern regulators. The size of the total European REPOs market in the first half of 2014 was €5,78 billion (€2,97 billion REPO and €2,81 billion reverse REPO), rising by 5% from the previous semester (December 2013) and by almost 20% from the previous 5 years (June 2009).

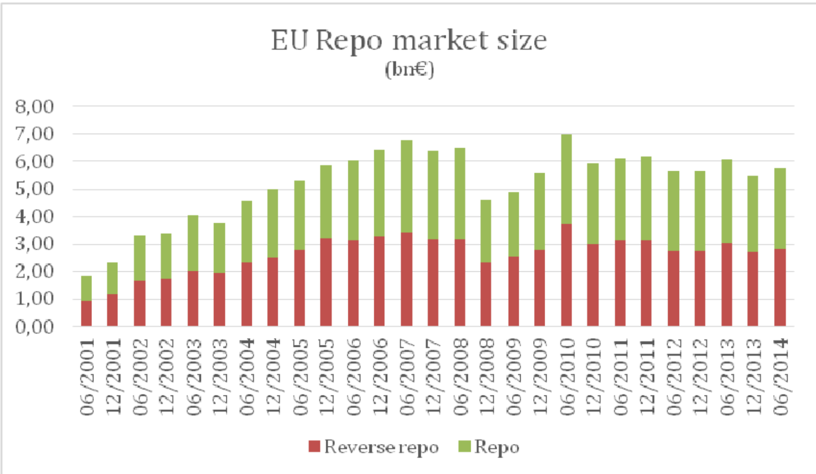

Figure 2 - Author's elaboration based on International Capital Market Association (2014), European repo market survey, Number 27, September[8]

[8] "The total value, at close of business on December 10, 2014, of repos and reverse repos outstanding on the books of the 67 institutions which participated in the latest survey was EUR 5,499.6 billion. This represents a return back almost to the level seen in December 2013. It is still much higher than the crisis trough of EUR

3.2 The activity of the European securitisation[9] market (Figure 3) increased in 2008 as banks retained securitisations to pledge as collateral with central banks in order to obtain financing during the financial crisis[10].

The European Central Bank analyses[11] the European market of securitisation due to its riskiness and the high level of shadow-transactions that it implies. In December 2009 the ECB started a "*Public Consultation on the Provision of ABS Loan-Level Information in the Eurosystem Collateral Framework*" to raise the level of disclosure in European securitisation market and to ensure an adequate risk assessment of ABSs because investors did not correctly evaluate the risks of the underlying securitised asset pools since these innovative instruments became increasingly complex as they increased their weight in the financial markets.

The availability of loan-by-loan information on the underlying assets backing the ABSs is necessary as of 2011[12] in order to use them as collateral with the ECB. In September 2014[13] the ECB tightened the reporting requirements for certain types of asset-backed-securities.

In the same perspective the Basel Committee on Banking Supervision (BCBS) and the Board of the International Organization of Securities Commissions (IOSCO)

4,633 billion in December 2008 but much lower than the pre-crisis peak of EUR 6,775 billion in June 2007.", International Capital Market Association (2015), European repo market survey, Number 28, February.

[9] "Securitization activity is at the heart of shadow banking, as it allows credit originators to sell pools of credit to other institutions, thereby transferring the credit risk." ADRIAN - ASHCRAFT, *Shadow Banking: A Review of the Literature*, Federal Reserve Bank of New York, Staff Reports, in *New Palgrave Dictionary of Economics*, October 2012.

[10] See Basel Committee on Banking Supervision (BCBS) and Board of the International Organization of Securities Commissions (IOSCO) (2014), Criteria for identifying simple, transparent and comparable securitisations, Consultative Document, 11 December.

[11] See MERSCH, *Speech* by the Member of the Executive Board of the ECB at the IMN Global ABS Conference, Barcelona, 11 June 2014: "[...] in recent months the ECB has put a great deal of public focus on reviving the European ABS market. Why are we so interested in this particular market segment? There are three parts to the answer: price stability, financial stability, and the stability of our balance sheet".

[12] See ECB, *Loan-by-loan information requirements for CMBSs and SME transactions*, April 2011

[13] "As of 1 October 2014, auto loan, leasing, consumer finance and credit card ABSs for which the mandatory level of compliance with reporting requirements has not been attained and for which the data provider has neither given an explanation for that non-compliance nor provided an action plan for achieving full compliance, will become ineligible for use as Eurosystem collateral. [...] These decisions will help secure a smooth transition to full compliance while ensuring a level playing field between different classes of ABSs at different stages of the compliance process.", ECB (2014), ECB modifies loan-level reporting requirements for some asset-backed securities, September.

(2014), have recently identified 14 "*Criteria for identifying simple, transparent and comparable securitisations*". [14]

A higher level of disclosure has the purpose of restoring the weakened confidence in the securitisation markets and increasing both the number of investors and the value of the investments.

This concise classification and quantification of the shadow banking activities provides a first level analysis of the value and the riskiness of the main components of the shadow banking system. The relevance of appraising the size of the shadow banking activities lies in the close relationship between traditional and shadow banking.

Shadow banks conduct liquidity and maturity transformation in a comparable way as the traditional banking intermediaries do, but the main difference between this two credit sources is the higher level of complexity of the shadow operations, besides opaqueness. Traditional banking intermediaries perform credit intermediations especially with deposits and held to maturity loans, shadow banks decompose this process into a wholesale funding and securitisation based lending intermediation with a higher level of complexity.

[14] "The purpose of these criteria is not to serve as a substitute for investor due diligence but rather to identify and assist in the financial industry's development of simple and transparent securitisations.", Basel Committee on Banking Supervision (BCBS) and Board of the International Organization of Securities Commissions (IOSCO), Criteria for identifying simple, transparent and comparable securitisations, Consultative Document, 11 December 2014.

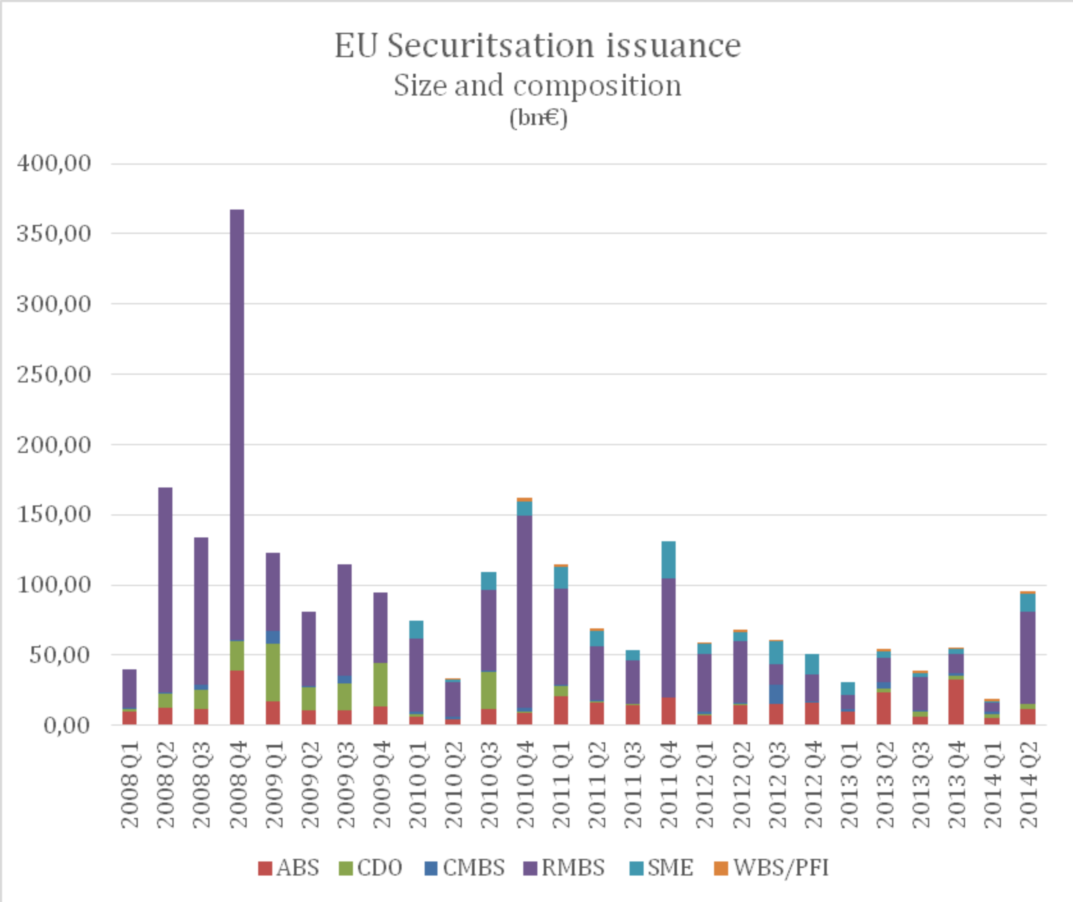

Figure 3 - Author's elaboration based on Association for Financial Markets in Europe (AF-ME), Europe Securitisation Data Reports, 2008-2014

Asset Backed Securities (ABS), Collateralized Debt Obligations (CDO), Commercial Mortgage Backed Securities (CMBS), Residential Mortgage-Backed Security (RMBS), Small and Medium Enterprises (SME)

Whole Business Securitization (WBS), Project Finance International (PFI)

4. Shadow banking represents an innovative and significant source of liquidity and financing for the real economy, which is to be further researched and understood.[15]

[15] See GIOVANNINI AND OTHERS, *Restarting European Long-Term Investment Finance: A Green Paper Discussion Document*, 30 January 2015

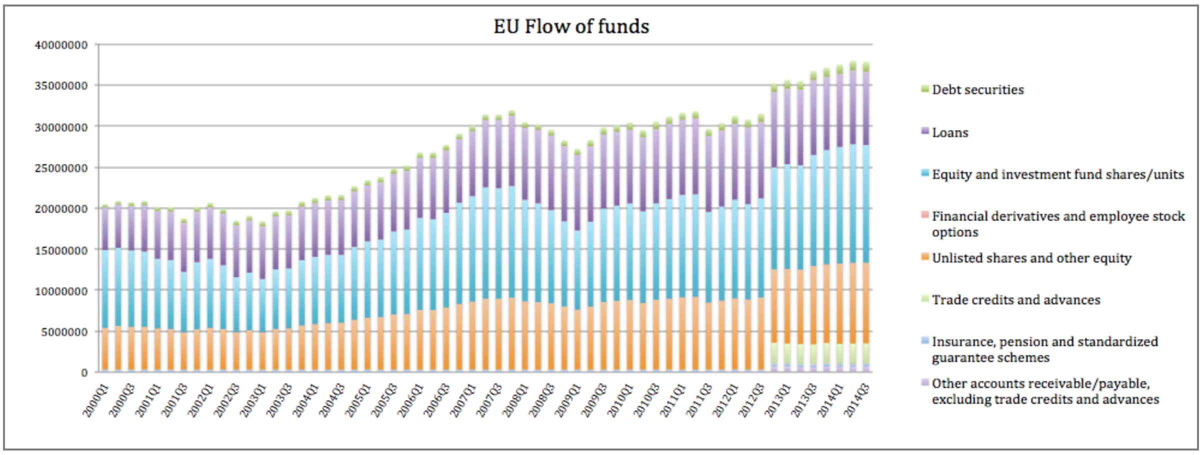

Figure 4 - Author's elaboration on based on EU Flow of funds, Euro area non-financial accounts data from ECB, Statistical Data Warehouse

Giovannini A. et al. (2015) find that for the EU28 countries, there is an increase in the level of equity between 2007 and 2013, but this value remains below 40% of total assets.

The outstanding value of long-term financing instruments rises from 46% of GDP in 1999 to 76% at the beginning of 2014. In particular, the outstanding value of long-term bonds rise from 5% of GDP in 1999 to 11% of GDP in 2014, while long-term loans increase from 42% to 66% of GDP over the same period. As concerns short-term instruments the outstanding value is stable around 25%. By comparing the relative weights of external and internal financing instruments, the authors conclude that firms' debt financing has been instable over the period of observation, and equity remains a stable source of finance in the EU28.

Irrespective of how you consider shadow banking, be it 'non-bank financial intermediation, i.e. credit intermediation outside the conventional banking system … which means there is no safety net' as the FSB calls it or 'non-bank banking/lending or as it has been called capital market lending' as defined by others in order to decide whether shadow banking should be a concern we need to address a two main questions: can more lending, non-bank lending to be precise, contribute to growth? And can it contribute to growth without increasing risk?

The answer is that it depends. If companies are postponing investment because they cannot raise enough debt, since capital constrained banks, due to their legacy of non-performing loans, are not lending creditworthy companies then it may be that shadow banking can be a useful complement of traditional banking

But even if there is a problem in the credit supply side, in order for non-bank lending to be a positive complement which does not increase risk, non-bank lenders must maintain sound and prudent management, which ultimately means that non-banks must achieve adequate liquidity and solvency conditions

Conversely, more credit is not the answer for companies which are already highly geared. Actually, more collateralised lending not only increases the risk of default of such companies but it also leaves non-guaranteed borrowers worse off.

Interconnectedness is of course another problem, shadow banking is closely connected to banking since banks provide liquidity to non banks. The shadow banking system can be considered as internal or external activity. The financial holding companies run internal shadow banking activity using regulatory loopholes to minimize regulatory costs and increase leverage for example throughout commercial paper. External shadow banking activity is the bank's role of liquidity provider to other actors there are not banks, connecting non-financial institutions in the money market, pension funds and hedge funds, throughout repos. Moreover, banks often distribute the money market funds or the other funds which invest in loans, thus leading to reputational risk should something go wrong.

In general, shadow banking if totally unregulated exposes the financial system to runs, contagion, excessive credit growth and pro-cyclicality.

5. The crisis confirmed a number of well-known risks and which we should indeed consider when assessing the pros and cons of shadow banking:

a) mismatching is a problem. If the maturity of assets exceeds the maturity of liabilities, any entity, be it a bank, a company or an investment fund a liquidity problem arises

b) excessive leverage or, in other terms insufficient equity, that turns a liquidity problem into a solvency problem. Moreover, deleveraging is difficult, when trying to sell assets on the market, normally the assets which can be sold easily and without losing money are the ones which produce income in subsequent years, they are the better cash/earnings generators. So it may very well be that deleveraging ends up in fixing today's balance sheet at the expense of tomorrow's statement of income

c) deequitisation, long-term investing needs long-term financing, ideally equity financing. Since equity is a permanent source of funding for a company it is the ideal source of funding for investment. Loans, even long-term loans or bonds, must be reimbursed at maturity and at maturity either the company finds new sources of funds (i.e. is granted new loans, issues bonds or raises new equity) or it must reduce its assets. And if it cannot liquidate part of its assets this might lead to default

d) procyclicality – collateralised debt tends to be procyclical and bubble prone.

6. Creating a Capital Markets Union for the EU 28 countries is one of the objectives of the European Commission. The Commission published a green paper[16] that builds on the short term priorities set out in the Investment Plan for Europe such as reviving the markets for high quality securitization and simplifying the Prospectus directive by consulting on how those priorities should be implemented. To put it as Steven Maijor, the ESMA chair, said in a conference hosted by the Italian Presidency in November last year, the Capital Markets Union should maximise the benefits of capital markets and non-bank financial institutions for the real economy and thereby contribute to foster growth.

[16] See EUROPEAN COMMISSION, *Building a Capital Markets Union*, Green Paper, 18 February 2015.

The Capital markets union may indeed contribute to growth, especially if it leads to more capital, meaning equity capital, for companies, and especially start-ups and SMEs.

It may also be worth noting that the Capital Markets Union is yet to be accomplished as concerns regulations applied by securities markets in the 28 EU countries. It is particularly urgent, and as such it is reassuring that it is high in the European Commission’s agenda, because it not just about rules. From an investor perspective one could argue that the Capital Markets Union or even a Global Capital Market Union is de facto here already. A European investor may buy securities issued and traded almost in any market. With a weak euro and expectations of an even weaker euro in the future, non-euro denominated assets will be increasingly appealing.

Shadow banking may indeed be a blind spot in the Banking and Capital Markets Union if some of its intrinsic risks are not addressed.

7. Just a few concluding but non conclusive comments, in that they conclude my remarks but do not propose recipes for success, just some food for thought on three issues – shadow banking and growth, challenges for regulators and the need for a grand plan to favour more capitalised companies – which may prove to be particularly important for the future.

1) Shadow banking and growth

Non-bank intermediation may contribute to growth and investment without undermining stability if it is not a way of circumventing regulation and capital adequacy provisions.

Moreover, a longer intermediation chain and direct risk taking by investors, through lending via insurance companies and investment funds may help share risk and contribute to growth provided it does not lead to more risk i.e. by sharing risk more leverage is achieved by companies which cannot sustain it then it may be detrimental to sustainable growth.

Low interest rates could lead to more leverage, leaving firms more vulnerable to temporary reductions in their profitability and to higher interest rates when the latter will rebound.

Perhaps ensuring that the managers of the investment funds/insurance companies entering the loan market have skin in the game, i.e. their pay-offs are aligned with those of their investors, and be affected by both downside and upside risk, can curtail risk-taking to an appropriate level.

2) Challenges for regulators

Going forward we can identify a number of oxymora and paradoxes, difficulties in striking the right balance between necessary regulation aimed at protecting investors and excessive regulation which may hamper growth.

Of course more regulation provides incentives for a further expansion in the shadow banking system.

In the aftermath of the crisis, regulation was aimed at restoring investor confidence, now regulation must pursue the objective of maintaining investor confidence which is of course related to investor protection and orderly markets.

- compliance with regulation is expensive and may hamper financial markets competitiveness, however it is at the core of investor protection, orderly markets, financial stability so it’s very difficult to strike the right balance
- rules should be simple and clear . Perhaps bans, temporary or permanent, might prove to be more effective than cumbersome transparency requirements, e.g. the temporary ban on the placement to retail investors of contingent convertibles introduced by the Financial Conduct Authority in the UK

- regulating financial firms which do not collect deposits but may in any case be subject to runs, such as in the case of the US. The Financial Stability Oversight Council has already designated insurers (such as AIG and Prudential Financial Inc.) and the financial arms of large corporations (such as GE capital) as systemically important and as such potentially subject them to tougher capital rules and other new regulations.

If shadow banks are unregulated this increases systemic risks. Vulnerabilities deriving from shadow banking may lead to contagion if banks provide the liquidity backstops and/or are involved in the distribution of products issued by non-bank lenders. Moreover, shadow banking may end up transforming credit risk in the books in market risk deriving from securities received in repurchase agreements, reputational risk from placement of products, and so on.

- create a favourable context for good securitisations, that may imply lower interest rates for borrowers

  - skin in the game
  - can be used as collateral with the central bank
  - marketable instruments so they can be sold on the market (provided the market exists) marketable instruments are an improvement *coeteris paribus*, i.e. if the same amount of risk remains. On the contrary if the longer intermediation chain enables higher risk levels, i.e. higher leverage, then securitisations may increase risk.

Of course as long as the market is sufficiently liquid, a securitised loan is less risk than a non-marketable loan in the books of a bank, however its credit risk depends on the characteristics and ultimately the financial structure of the borrower. In other words, a packaged/securitised loan, is still a loan for the company, so it will ultimately need to be reimbursed. If we are to pursue a ‘safer and sounder’ financial system which supports growth, a plan for more equity is necessary.

3) a plan to favour more capitalised companies

more risk capital in companies not only makes them more resilient, it is a pre-condition for sustainable growth.

Growth and innovation need investments and investments ultimately need equity, so fiscal incentives aimed at favouring higher equity levels, either via retained earnings or capital increases on the market and IPOs are important complements of a sounder financial system, safer banks and a successful capital market union.

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THE «IN OR OUT» DILEMMA IN THE EU

Francesco Capriglione[*]

ABSTRACT: *This paper highlights the difficulties that, in this moment, penalize the EU, by emphasizing the failure in achieving of a common belonging within the Member States. We take into account the realization that perhaps it has come to the sad moment in which the Europeanization process is at risk of implosion. The Author has no doubt, however, it is still possible hoping the recovery of the 'European dream'. He reach this conclusion by evaluating the positive response to the well-known 'French drama' of January 2015 of the European people, who finally has decided to speak up not only with the common currency.*

1. In recent times, the European regressive process has challenged a long list of hopes and expectations for the creation of a "common home". In fact, it points out a situation characterized by cultural differences, as well as by the persistence of domestic logic linked to the failure in achieving adequate homogenization forms within the European regional context.

It appears to be increasingly popular the belief that the intensification of economic and financial connections between the European countries (that has developed in over half a century of increasing interaction between them) has not been sufficient to create the identity bond which is required in order to achieve an integration among the populations of those countries. There was a lack of the

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conditions necessary for the development of a sense of belonging to a single social and political reality, circumstance needed in order to connote and legitimize the presence of a State/Nation. The dream of building up the “United States of Europe” has faded away: it seems to be destined to loosing itself in the mists of a dark conservation, focused on the “primacy of the interest” and far from the “values” that are foundation of modern civilization.

The market and its rules of strict reference to “affordability” – although being able both to promote development and, therefore, to bring undoubtable benefits to the community in question – is considered, by many, inadequate to congruently accomplish the ambitious goals it is required to achieve, in the last century, by the founding fathers of the European Community. Their ideal – aimed at the achievement of a «unification» constructed through a process of gradual harmonization – is considered being impaired by the lack of concreteness; in particular, because of its limits related to the substantial inability of the European legal system to knock down the “barriers” of diversity and overcome the “contrasts” resulting from centuries of tough wars, opening the way to sharing, cohesion and solidarity.

From another perspective, the competition logic, although aimed at equalizing the interests, has allowed the persistence of certain inequalities connected to (or rather: resulting from) previous situations of economic subordination; which hasn’t been, therefore, resolved in the “panacea” (desired by many) that should have rectified old afflictions, correcting shameful trends of *mala gestio* and corruption which, unfortunately, afflict some EU countries. An insecure future, of probable disaggregation looms on the horizon! The danger of a reversal of the path followed so far becomes more and more concrete; inversion in which – up against the unheard request for the change (aiming at alleviating the lines of an unbearable austerity) of the European management policies – a broader affirmance of the Eurosceptic orientations and of the forces that aim at implementing a solution in the continuity of a process, in some ways now disapproved and that, however, is not wanted or cannot be considered further, becomes feasible.

We are in the presence of a phenomenal reality that finds its epicentre in the post-crisis stagnation; hence, the realization that perhaps it has come to the sad moment in which the Europeanization process is at risk of implosion. At the basis, the doubt of having given life to an "institutional misunderstanding" spreads, represented by the reference to a unification project built only on currency, considered to be adequate to last in time despite resulting undocked by a contextual political unification. In other words, we realize that we have disowned the crucial role that only a political aggregation is able to play in re-conducing to unicity, both positions and interest that are traditionally distant.

2. Rediscovering the founding values of an encounter between the countries linked by a common history, by a religious faith attributable mainly to Judeo-Christian roots, by a shared aspiration for equality and freedom (considered in its wider significance) is the essential requirement of an operative commitment, which aims at solving the current difficult situation (by which are strongly penalized the relations between EU Countries). Considering carefully, alternatives to overcome the context of deep distress in which a large part of the population of the "old continent" are forced to live in, don't seem to exist; it follows that only by finding an identity of «European citizenship» it becomes possible to get out of the passiveness at the basis of the "geopolitical crisis" that upsets the EU and, therefore, to hypothesize the end of the serious "financial turmoil" that for many years has caused imbalances and disaster to the latter.

Being united in diversity! Hope for the achievement of a *unitary status* that doesn't know any distinctions within the European populations, wish for a "new humanism" that doesn't have any prejudices and that is ready to give up any previous, established negative comparisons between the different Countries: this is the categorical imperative that must be imposed to continue believing in the European dream. The awareness of the difficulties connected to the proceeding towards forms of real convergence must be of guidance in this journey; forms to which should be able to follow the realization of a fusion within a continent whose member countries should be finally willing to dismiss the usual critical attitudes, essentially dictated by the auto-reference and/or by the assumption of an hegemonic attitude.

There is no doubt, however, that within this mindset a perspective is outlined, a plan that may seem to be doubtable for that concerning its feasibility; a perspective that could, therefore, easily result in a visionary *wishful thinking*, developed by a nostalgic dreamer that does not want to give up a project in which he has always believed in. However, this is a doubt that is disowned in front of events that mark history, that stir up feelings, that bring people closer in a renewed sense of brotherhood, which pushes them to ease the pain through the research for common responsive strategies and innovative responses defending their freedom.

In particular, we are referring to the sad event of the barbaric terrorist attack that at the beginning of 2015 was brought to the capital of France, injuring not only Paris, but also the whole of Europe.

To the violent massacre that caused anger and pain throughout the western world followed a response by all the French citizens and those of other EU countries that denotes great maturity. The wakes held in many European capitals (from Paris to Berlin, from Rome to London), the words "*Je Suis Charlie*" that appeared on many walls and on thousands of posters in the squares of numerous cities, the parade (that took place in Paris the 11th of January 2015) of a massive representation of the Heads of State and eminent exponents of western politics tell us that – as it sometimes happens – in front of traumatic events conditions that call for unity, cohesion and solidarity are determined. The "sacrifice" of those who died to defend their freedom of opinion can become a catalyst in creating a common feeling within the EU; therefore, it creates an ideological push towards recognizing the need to restart and complete the Europeanization process that, for different reasons, today seems to have lost its propulsive charge essential in order to reach to its conclusion in political key.[1]

[1] See MAURO, *Una nuova stagione*, available at *www.repubblica.it*, where it is stated «and the political Europe was for once through the streets of Paris in this defense of democracy by citizens that are aware that they have

In this regard, the warning that appeared on many press headlines must be considered significant; warning that, for European safety, emphasizes the need to identify a rational response to the fanaticism of the hooded assassins that attacked the newsroom of the satirical weekly paper Charlie Hebdo. This, without falling into the "trap" of an opposite fanaticism that will result in «xenophobic impulses», but answering «with the United States of Europe and the political strength of the largest consumer market in the world that finally has decided to speak up not only with the common currency».[2]

something to fight for and to believe in because it is something that is worth it. Really, as the premier Valls has said in a boulevard named after Voltaire, yesterday in Paris can be a turning point for Europe, the beginning of a new season».

[2] See, also, NAPOLETANO, *L'anima e la ragione*, available at *www.ilsole24ore.com.*