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

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The "Law and Economics Yearly Review" is an academic journal to promote a legal and economic debate. It is published twice annually (Part I and Part II), by the Fondazione Gerardo Capriglione Onlus (an organization aimed to promote and develop the research activity on financial regulation) in association with Queen Mary University of London. The journal faces questions about development issues and other several matters related to the international context, originated by globalization. Delays in political actions, limits of certain Government's policies, business development constraints and the "sovereign debt crisis" are some aims of our studies. The global financial and economic crisis is analysed in its controversial perspectives; the same approach qualifies the research of possible remedies to override this period of progressive capitalism's turbulences and to promote a sustainable retrieval.

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CONTENTS

FOCUS ON GLOBAL PERSPECTIVES

The Capital Markets Union and the elusive goal of a 'genuine' Economic and Monetary Union

Rainer Masera*

ABSTRACT: *The objective of a European EMU of stable prices, open markets, shared prosperity, employment and sustainable growth was defined in a Summit meeting of 1969, and has been actively pursued as a primary goal of the Union ever since. Significant results have been achieved, but the 5 Presidents' Report (5PR) of June 2015 frankly admits that a 'genuine' EMU remains an unaccomplished endeavour: divergences create fragilities for the whole Union which must be rapidly corrected. A critical analysis of the results so far recorded in the euro zone comes also from other recent documents of the ECB and the IMF.*

The 5 Presidents indicate a roadmap covering the next decade to ensure a genuine EMU: they argue that progress must be simultaneously made towards economic, financial, fiscal and political union. All Unions are mutually interdependent and must develop in parallel. Financial Union, which comprises the launching and achievement of a Capital Markets Union (CMU), receives specific attention.

The aim of this paper is to offer a critical assessment of the Report, in the analytical framework of a system-wide perspective on financial and economic stability offered by the macro prudential policy approach. Purposely, the quantitative evidence presented to illustrate the shortcomings of the EMU building process so far comes exclusively from official documents/papers of the ECB, the EC and the IMF.

The "traverse" to the 4-Union EMU is especially complex partly because it goes beyond economic analysis and policy. The crucial role of CMU requires clarification, also in terms of the legal approach to be adopted. More generally, the intertwining of economic policies and the role of fallacies of composition/division must be analytically developed. The 5PR

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requires detailed specification of these medium-term processes to become operational and to achieve its declared goals.

Key words: Economic and Monetary Union, Banking Union, Capital Markets Union JEL classification numbers: E60, G01, E44, E51

1. The objective of a European EMU of stable prices, open markets, shared prosperity, employment, innovation and sustainable growth has been advocated and actively pursued for a long period. The official approach to EMU dates back to the Summit Meeting in the Hague in 1969. The Monetary Union was achieved at the end of last century, after the signing of two Treaties with a strong economic and fiscal content (Maastricht, 1992 and Amsterdam, 1997). The thirty years between 1969 and 1999 cover what I call here Phase 1 of EMU (Appendix 1).

The following fifteen years (2000-June 2015) span Phase 2, which refers to the operation and workings of the independent monetary policy of the ECB, the signing of many Pacts of economic nature, the build-up of the Great Financial Crisis (2007-2009) and a subsequent repair and recovery period, notably with the creation of the Banking Union (BU) (2013).

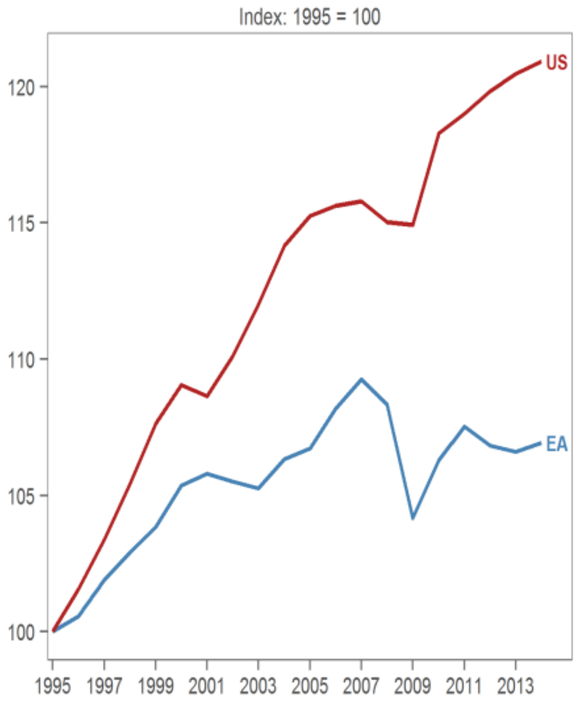
Much has been achieved and major difficulties were overcome during the past half century. But the track record, especially in Phase 2, makes it legitimate to ask whether the policies adopted, in particular during the operation of the euro, have been appropriate and, if not, what changes are required. In any event, the task of ensuring a true and genuine economic union overcoming the difficulties of monetary unification in a non-optimal currency area has not been accomplished. This strong proposition is, somewhat paradoxically, a conclusion which can be found in an official, highly important document of the EU: the "Five Presidents' Report" (5PR) of June 2015 (Juncker *et al*., 2015). This paper frankly recognises that the euro area, as of today, does not represent a genuine EMU, fulfilling the aspirations and expectations repeatedly expressed, since 1969, by the Council, the Commission and the European Parliament:

> «Europe's Economic and Monetary Union (EMU) today is like a house that was built over decades but only partially finished. When the storm hit, its walls and roof had to be stabilised quickly. It is now high time to reinforce its foundations and turn it into what EMU was meant to be: a place of prosperity based on balanced economic growth and price stability, a competitive social market economy, aiming at full employment and social progress. To achieve this, we will need to take further steps to complete EMU» (Juncker *et al.*, 2015 p.4).

2. An open admission of the lack of overall success of the euro area economic policies, after the creation of the common currency and, even more, after the Great Financial Crisis, comes from a EU official. Peter Praet, member of the Executive Board and Chief Economist of the ECB, recently produced quantitative evidence in this regard – notably in a comparison with the United States. The following four charts (Figures 1-4) are taken from his study (Praet, 2015). They do not require explanatory comments. They show not only the need to enact different policy actions and mixes for the euro area as a whole, but also the necessity to develop an effective policy framework to correct fundamental differences between strong and vulnerable countries in the area[1]. In particular, the evidence presented highlights that EMU growth should be anchored to sustainable expansion of domestic demand in the internal market, not on net exports (and on a depreciating Euro). It also clearly indicates that key accepted paradigms of the political economy of the Eurozone must be critically reviewed.

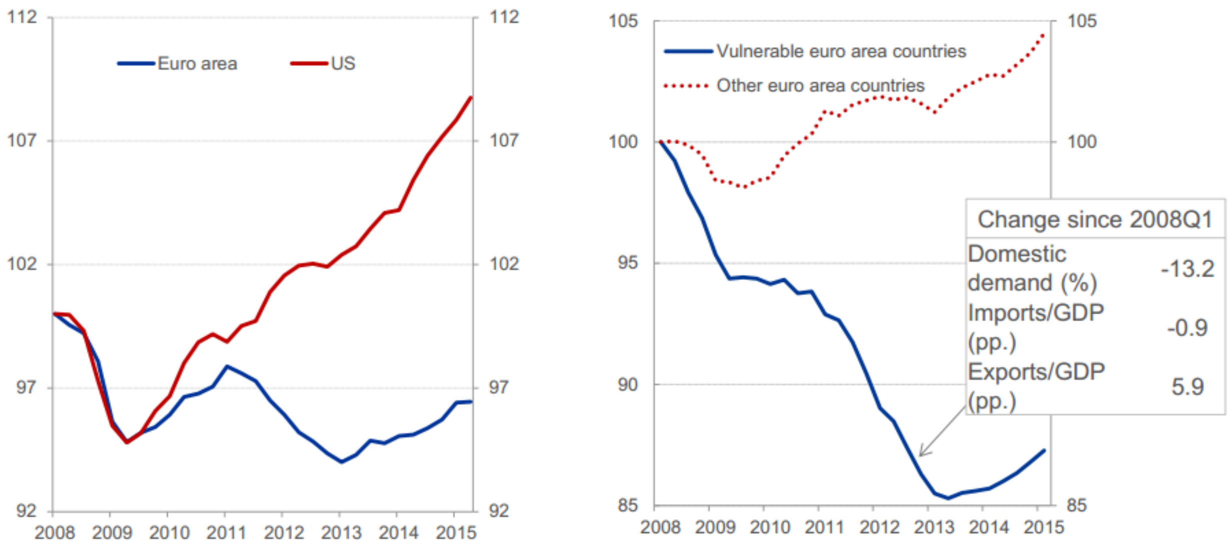
[1] "Vulnerable euro area countries" refers to CY, GR, IE, ES, IT, PT & SI.

Figure 1 – Total Factor Productivity.



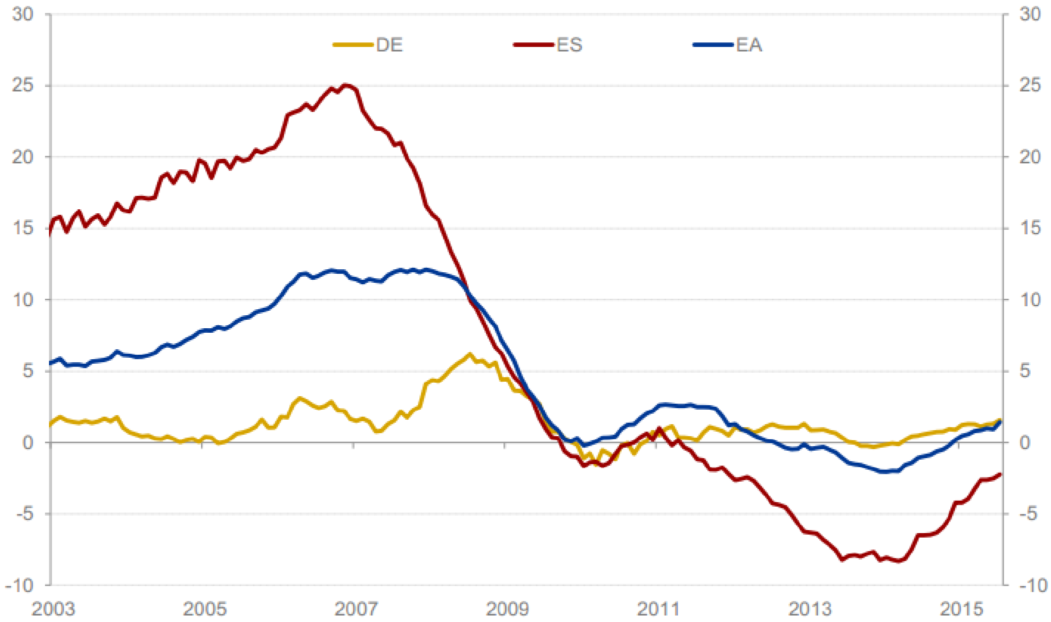
Source: Praet (2015).

Figure 2 – Real domestic demand.



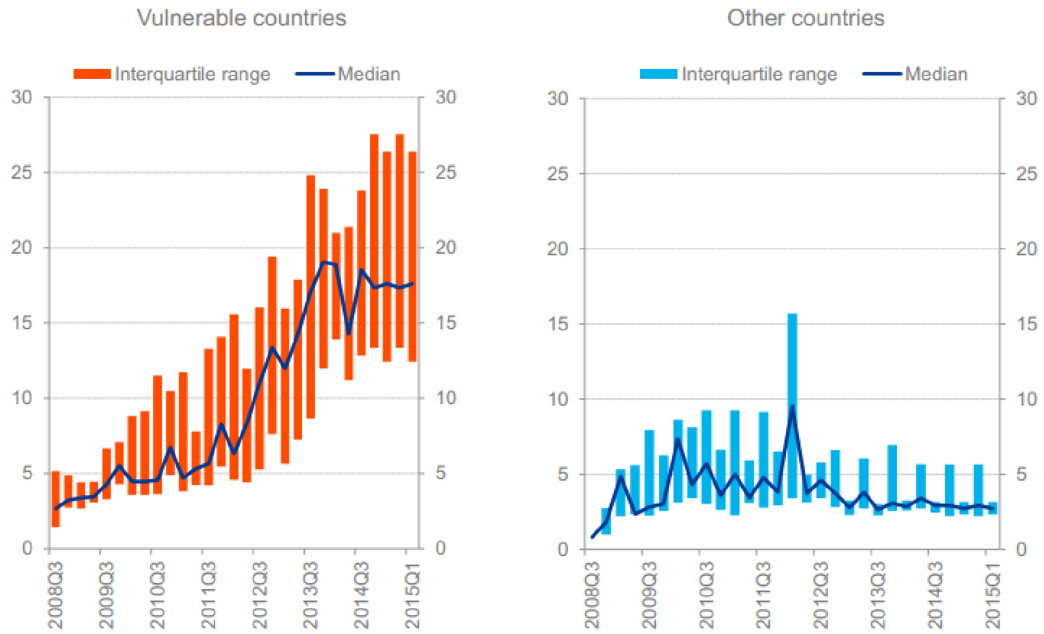
Source: Praet (2015).

Figure 3 – Bank loans to private sector.



Source: Praet (2015).

Figure 4 – Impaired loans of euro area banks (percentages of gross loans).



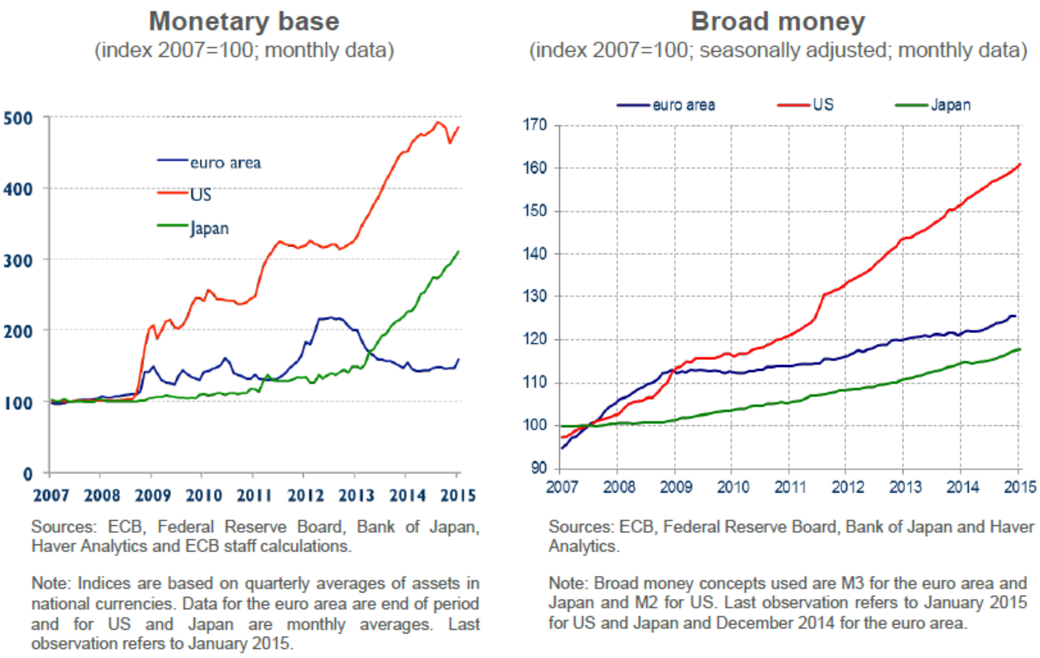
Notes: Based on an unbalanced sample of 32 euro area banks for vulnerable countries and 25 euro area banks for less vulnerable countries. The charts represents ratios of gross impaired customer and bank loans over gross loans.

Source: Praet (2015).

The charts provides clear evidence of: the unsatisfactory overall results of the economic policies adopted in the euro area after the creation of the single currency; the inability to correct structural differences between strong and vulnerable countries; the difficulties encountered in activating the bank credit supply process, notably after 2009[2].

As is well known, the ECB monetary policy framework was built on the heritage of the Bundesbank, and notably on the basis of a relative stability of the money supply process and hence on a reliable relationship between monetary base, M3 and inflation, for projected output changes (Issing, 2008). This simplified "monetarist" approach no longer holds. Here again, the evidence comes from the ECB itself (Constâncio, 2015).

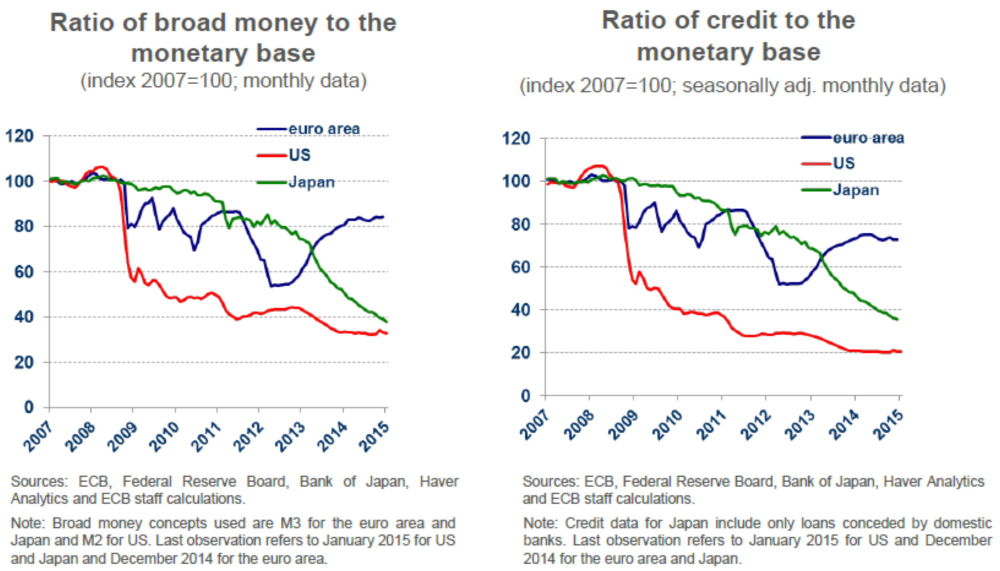
Figure 5 - Monetary base and broad money.



Source: Constâncio (2015).

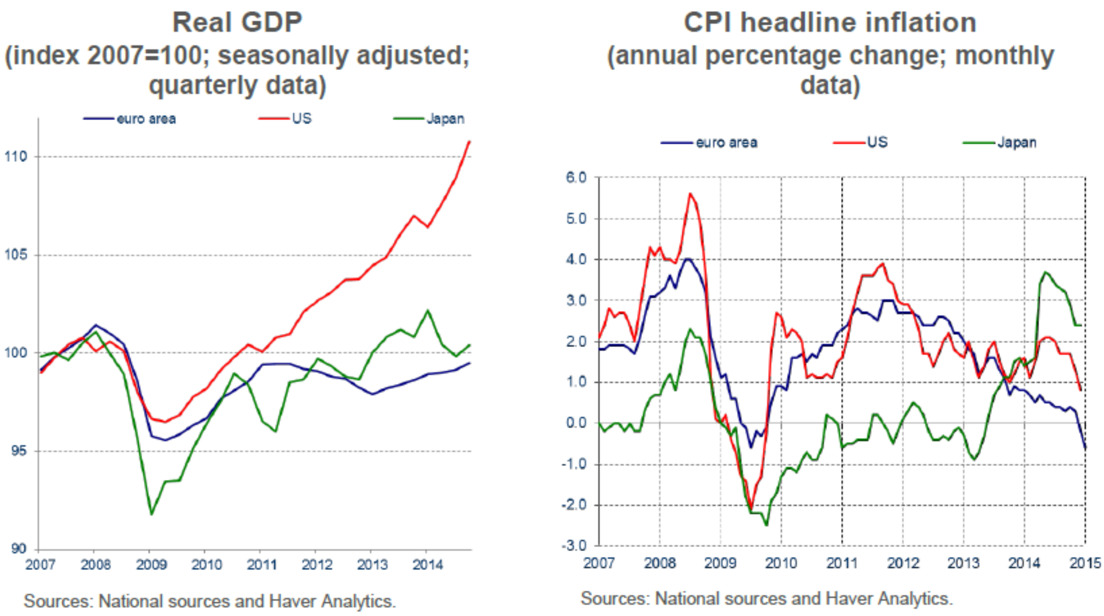
[2]For an analysis and explanation of these shortcomings in a macro prudential framework, see MASERA (2012).

Figure 6 – Ratios of broad money and credit to the monetary base.



Source: Constâncio (2015).

Figure 7 – Real GDP and CPI inflation.



Source: Constâncio (2015).

The evidence provided by Constâncio (2015) is also indicative of the inappropriate monetary/fiscal policy mix which led to the double dip in the euro area. The econometric results obtained from the Commission Eurozone model show clearly the negative impact of simultaneous fiscal consolidations from 2011 to 2013 (Table 1), and the perverse debt/GDP, negative growth loop, which was at the heart of the sovereign/bank crisis.

Table 1 - Fiscal policy: GDP losses in relation to baseline, resulting from simultaneous fiscal consolidations in seven euro area countries from 2011 to 2013 simulated by the EU Commission model QUEST.

	Impact on GDP 2013, (%)	Cumulative impact 2011-13, (% of 2013 GDP)
Germany	3.9%	8.1%
France	4.8%	9.1%
Italy	4.9%	9.0%
Spain	5.4%	9.7%
Ireland	4.5%	8.4%
Portugal	6.9%	15.3%
Greece	8.1%	18.0%

Source: Constâncio (2015).

The data collected do not identify the depressionary consequences of the enactment of CRR/CRD IV in the credit supply mechanism for the euro area (de Larosiére, 2013 and Masera, 2012 and 2015).

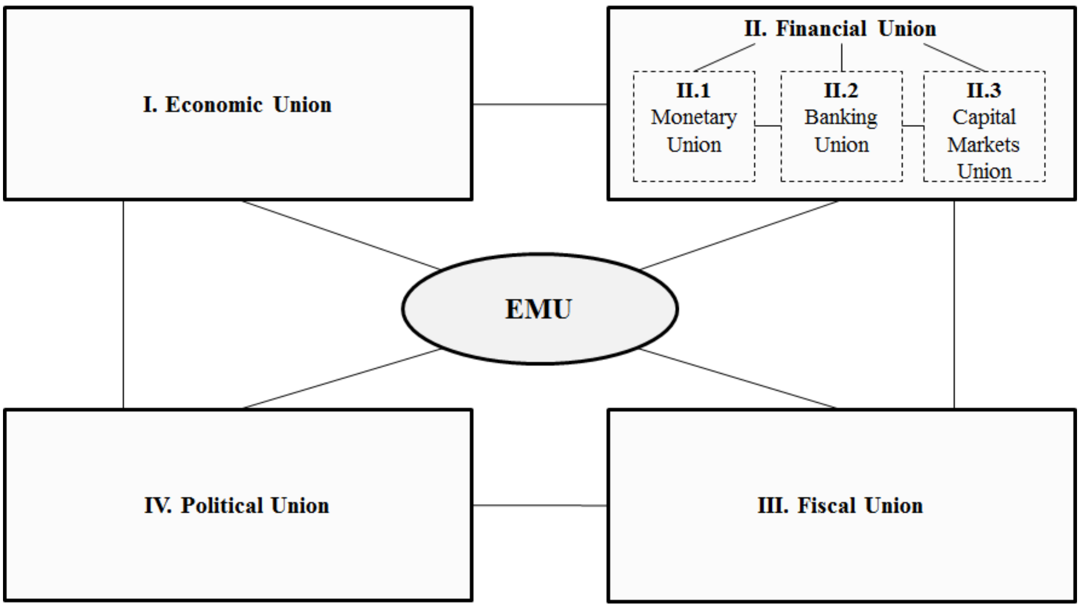
3. The 5PR states that the gradual evolution of the euro area towards a 'genuine' Economic and Monetary Union requires a shift from a system of rules and guidelines for national economic policies to further sovereignty sharing, with institutional changes and full political endorsement[3]. More specifically, it affirms that non-binding intergovernmental agreements should be superseded:

> «Instead of further ‛pacts’, concrete progress on the basis of EU law is needed to move towards an Economic Union of convergence, growth and jobs».

[3]Similar conclusions can be found in CAPRIGLIONE - SACCO GINEVRI (2015).

Two stages are identified to reach EMU. But, it would be only at the end of the Final Stage (by 2025) and once all steps are fully in place that a deep and genuine EMU would be created and would provide a stable and prosperous place for all the euro area. The (network) architecture of a genuine EMU envisaged in the 5PR is graphically depicted in Figure 8. It must be observed that complex adaptive systems based on strong interrelationships are robust during normal conditions. At times of stress, they can become fragile with statistical distributions shifting from Gaussian to power laws (Helbing, 2010).

Figure 8 – The Five Presidents' Four interdependent Unions to transform the euro area into a 'Genuine Economic and Monetary Union'*.



* «All four Unions depend on each other. Therefore they must develop in parallel and all euro area Member States must participate in all Unions for the euro area to gradually evolve towards a genuine Economic and Monetary Union… After many years of crisis, governments and institutions must demonstrate to citizens and markets that euro area will do more than just survive» (Juncker *et al.*, 2015 p.5).

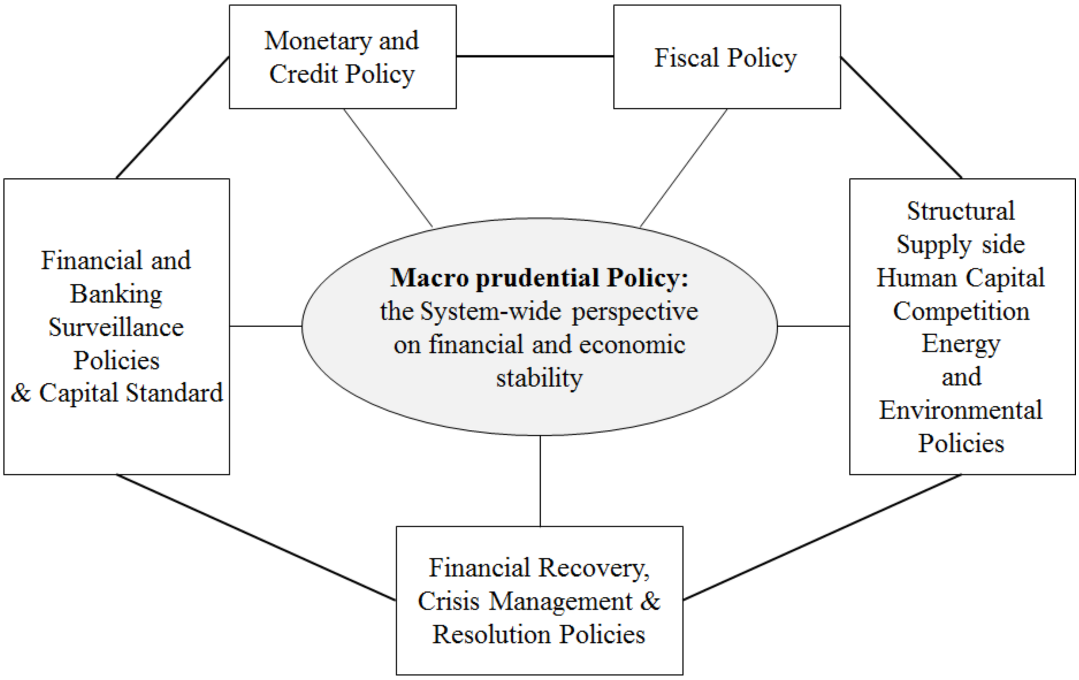
The “Union Approach” has its interest and validity, but – perhaps as a consequence of the brevity of the 5PR – has also evident shortcomings and points which need clarifications.

To start with, it does not address the fundamental issue of a recognition of the flaws of the analytical and policy paradigms which led to the Great Financial Crisis, and of the appropriate road to repair. In the second place, it diverts attention from a critical analysis of the policy actions taken after the crisis and does not provide satisfactory explanations for the unsatisfactory results documented by the ECB itself, summarised here in the data taken from Praet (2015) and Constâncio (2015). Finally, it neglects the need for an interactive macro prudential policy framework capable of identifying the links between monetary, credit, fiscal and structural policies and their fallacies of composition/division (Masera, 2015).

This is paradoxical because the 4/6 Union Model is itself based on these premises: «All Unions depend on each other and must develop in parallel…». Without a complete analysis of the theoretical framework and the policy interactions, especially under stress, the proposed Union model may convey the wrong impression that institutional and political changes would automatically lead to the goal of a genuine EMU.

The fragility under stress of complex systems has led to the development of macro prudential policies to cope with the system wide perspective on financial and economic stability. Priority was given to avoidance of systemic risks. The new framework has been adopted in similar ways both in Europe and in the U.S. (de Larosiére, 2009 and Dodd-Frank, 2010). A representation of the relationships between macro prudential and other economic policies in the new framework is offered in Figure 9.

Figure 9 – A complex system (network) representation of macro prudential and other economic policies.



Source: Masera (2015)

The macro prudential paradigm gives prominence to the prevention/containment of systemic risk and is characterised by the analysis of a double order of interconnections. First, reference is made to the links/mixes of different economic policies. Secondly, light is shed on the complex process interactions between the micro and the macro levels (with possible fallacies, but also synergies of composition). Finally, the conceptual framework of crisis as a medium-term process requires a corresponding approach to a coherent framework of political economy (Scazzieri, 2015).

4. The 5PR correctly underlines the need to ensure a true financial union in the euro area. This requires completion and integration of the Monetary and Banking Unions and construction of the CMU, covering the whole EU.

On Monetary Union, the Report is vague on important points, perhaps because it was thought that these issues would be taken care of by the ECB itself. Three key questions should however be mentioned: i) is the current institutional set-up appropriate for the ECB to fully cope with renewed instances of financial instability; ii) how can the de facto overlap between the ECB and the ESRB be corrected, should more independence/immediate power be given to the ESRB to cope with systemic risk; iii) what should be done to overcome the dangers of intertwining of monetary policy and capital standards (respectively under the responsibility of the ECB and the EC) in the shaping of the credit process? All these points have an obvious bearing also on the workings of the CMU.

With reference to Banking Union, the 5PR rightly recommends completing the Union by moving to a common back-stop to the Single Resolution Fund, and by reforming the European Deposit Guarantee Scheme, by gradually setting-up a common deposit insurance scheme. Both issues are crucially important and the medium-term process outlined in the Report should be fully endorsed[4].

We come now to the CMU itself (EC, 2015a): the priorities and the complexities of the launching are well recognised and analysed, but some critical issues require clarification, also to guide the Action Plan initiated by Commissioner Hill (EC, 2015b). The 5PR underlines that a primary function of a well-functioning, integrated and balanced CMU is to permit risk diversification across countries of the euro zone and of the EU. The other side of the coin of free, unimpeded movements of capital through banks, insurance companies and capital markets is, in fact, the reallocation of country-specific shocks across the whole area. This by itself reduces the burdens of fiscal policies which can used with clear limitations in the euro zone, given the institutional set-up of the various Compacts.

Financial Union and CMU have therefore two main positive features which explain why it is of paramount importance to ensure their rapid completion. The most common type of argument is represented by the need to ensure a level common playing field for the external finance of the corporate sector, and notably for growing innovative medium-sized companies sector and for the investment in infrastructure. This point was highlighted

[4]A proposal for an integrated European Deposit Guarantee Mechanism has been recently advanced by the Commission (EC, 2015c).

in Lord Hill's Action Plan. In the euro zone a very large share of credit flows is intermediated by the banking system: more balanced sources of finance are necessary. This implies a greater role for capital markets in the financing process of companies and, in particular, more equity finance. The United States offer clear evidence that highly developed economic system benefits from balanced and well-integrated relationships between credit markets and financial intermediaries. It must however be underlined that in the US, on the one hand, the largest banking/investment conglomerates play a fundamental role in the "market" sector (Cetorelli, 2013) and, on the other, local banks continue to account for a significant share of external finance of micro and small enterprises, largely because of a "tiered" approach to regulation and supervision of the banking system (Tarullo, 2015 and Yellen, 2014 and 2015). Due account should also be taken of the fact that in the U.S. official guarantee schemes for securitised bank loans, and notably for SMEs, have been and are being actively used (Fannie, Freddie and Small Business Administration) after 2008. These approaches are not part of the current CMU/BU schemes in Europe, as should be the case[5].

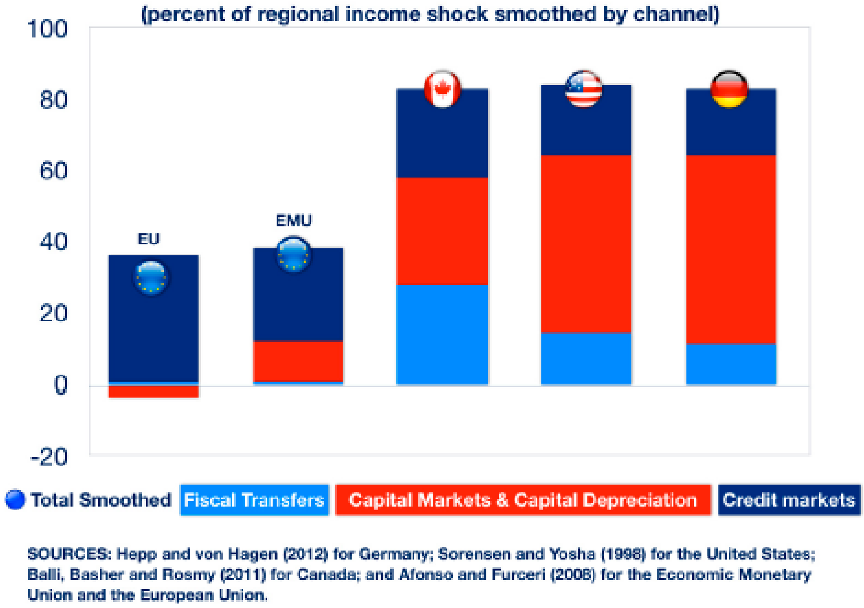
But, as already indicated, the Financial Union is also important as a cushion for asymmetric/country-specific shocks, which command three main types of response: from intermediaries, capital markets, fiscal shock-absorbers. Clearly, if intermediaries, markets and fiscal responses have mainly national features, the diversification of risks across countries is necessarily limited. There is therefore the need to encourage the development of a fully integrated CMU, but also to foster the development of truly pan-European intermediaries (as against national champions). Here again the US system of regulation and supervision should be carefully considered.

Beyond fiscal buffers at the national level, according to the IMF (Allard *et al*., 2013) in the euro area only 40% of country-specific GDP shocks is smoothed by cross-country risk-sharing insurance mechanisms: 30% comes from the operation of banking and credit markets and 10% from capital markets; there is no "federal" fiscal cushion. In the US,

[5]On these points see BASSANINI *ET AL*., 2014 and FEBAF, 2015b.

instead, the corresponding figures are 80%, 45% coming from capital markets, 20% from banking and credit markets and 15% by federal stabilisers (Fig.10).

Figure 10 – Risk sharing: Insurance against income shocks in EMU remains low.



Source: (Allard *et al*., 2013)

It is, therefore, clear that the development of a truly integrated, effective and efficient CMU has positive macroeconomic effects and fosters economic/financial stability, thereby preventing and/or limiting systemic risk.

A relevant open question concerning the creation of the CMU is whether a top-down (legislation based) approach should be followed or a bottom-up (market based) model should be adopted. A combination of the two schemes is naturally required[6], but it should be underlined that the Hill/EC Green Paper (February 2015) and the 5PR give very different answers. The EC favours a non-legislative model, apparently as requested by market operators. The Report indicates, instead, that the objective is to create a Single European Capital Markets Supervisory Authority, in analogy to the Banking Union (Single

[6]See, for instance, FEBAF (2015a).

Supervisory Mechanism, entrusted to the ECB). Even before this medium-term objective, many important changes to be rapidly achieved require legal action[7]:

> «A true Capital Markets Union also requires other improvements, some of which can only be achieved through legislation, such as simplification of prospectus requirements; a revived EU market of high quality securitisation; greater harmonisation of accounting and auditing practises; as well as addressing the most important bottlenecks preventing the integration of capital markets in areas like insolvency law, company law, property rights and as regards the legal enforceability of cross-border claims».

The lack of harmonisation of company and insolvency laws represents a crucial impediment to the full realisation of CMU, which feeds back on the Banking Union itself. A notable example is represented by the effective implementation of the Bank Recovery and Resolution Directive[8], especially with reference to the Intragroup Financial Support Framework (Lamandini, 2015).

The current EC Action Plan is based on a public consultation and an impact study, without setting apparently a time limit for the legal changes which are advocated in the 5PR. There is a clear risk of delaying the decision-making process at the EU and national levels.

5. It is obvious that a sound house must be built on good foundations, notably on solid cornerstones: the 5PR admits that this is not yet the case for EMU. The Report provides a time table and a road map to the final goal, but at the same time it creates a conundrum of joint decisions to be taken in various areas, and notably as regards the CMU

[7]The relevance of the choice between the two different approaches had been anticipated and rightly stressed by VÉRON (2014), who argued correctly in favour of addressing from a legal point of view the development of market segments, with policy initiatives graded according to impact and political difficulty.

[8]Directive 2014/59/EU and Council Implementing Regulation (EU) 2015/81 of 19 December 2014 specifying uniform conditions of application of Regulation (EU) No 806/2014 of the European Parliament and of the Council with regard to ex ante contributions to the Single Resolution Fund.

and the Political Union. The traverse is therefore especially complex because, beyond economic, monetary and financial issues, political decisions are required, which go over and above the Fiscal Union itself. But, as is indicated, it is only the Political Union which should provide the cornerstone for all the other Unions, by offering democratic accountability, legitimacy and institutional strength[9].

The complex network approach adopted in this study, notably in respect of the intertwining of economic policies in a macro prudential framework and the need to allow for fallacies of composition/division, is therefore stretched to the extreme. This is especially worrying because of the insufficient clarity on the macro prudential approach adopted in the Report and, more specifically, on the role and prerogatives of the ESRB. It must also be stressed that the decision model is extended to socio-political factors, which will require, even before the 10-year deadline indicated, institutional, legal and Treaty changes.

In conclusion, the ‘genuine’ EMU target requires success of common cooperative efforts in economics, law and politics over a relatively short time horizon, compared to the length of the two phases from 1969 to 2015.

[9]The ideas expressed in 1991 by the Chancellor Kohl to the Bundestag should be carefully reconsidered: «It cannot be repeated often enough. Political union is the indispensable counterpart to the economic and monetary union (EMU)… Recent history, and not just that of Germany, teaches us that the idea of sustaining an economic and monetary union overtime without political union is a fallacy».

Appendix 1 – The long road to Economic and Monetary Union (EMU) in Europe: 1969-2015, key steps.

Phase 1 (1969-1999)	
1969	Hague Summit decided that a plan should be drawn to create in stages an Economic and Monetary Union.
1970	Werner Report presented a plan for the attainment of EMU.
1972	Creation of the "snake" exchange rate agreement.
1979	Creation of the European Monetary System (EMS) and the European Currency Unit (ECU).
1985	The Single European Act set out a programme to create a unified economic area with freedom of movement of persons, goods, services and capital.
1988	The European Council confirmed the goal of EMU and mandated a Committee chaired by Jacques Delors to propose concrete stages leading to the Union.
1989	The Delors Report proposed that EMU should be achieved in three evolutionary stages, leading to strengthened economic and fiscal convergence and ultimately to the introduction of the Single Currency.
1991	Maastricht meeting of the European Council which drafted the Treaty on the European Union and on European fiscal convergence.
1992	Maastricht Treaty signed on 7 February.
1997	Treaty of Amsterdam signed on 2nd October. The Treaty contains the Stability and Growth Pact (SGP).
1998-99	Preventive and Corrective Arms of SGP.
1999	The ECB was created and the euro established with 11 initial participating national currencies.
Phase 2 (2000-June 2015)	
EU Treaties affecting EMU	

2001	Treaty of Nice
2007	Treaty of Lisbon
2012	Treaty establishing the European Stability Mechanism European Fiscal Compact
EU Pacts on economic commitments	
2005	SGP Amendment
2011	Europlus Pact Six Pack
2013	Two Pack
2014	SGP Review
2015	SGP Flexibility
Banking Union	
2013-14	Single Rule Book Capital Requirements Directive IV Capital Requirements Regulation Single Supervisory Mechanism Deposit Guarantee Scheme Directive* Bank Recovery and Resolution Directive Regulation (EU) No 806/2014*
Note	**To be completed*

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Risk, regulation, supervision and crises in the European Banking Union

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ABSTRACT: *This paper aims to analyse risk, regulation, supervision and crises in the framework of the European Banking Union, considering commercial banks and the evolution of the banking business.*

Identification, measurement and management of all the risks linked with the financial instruments and business areas constitute the premises for a sound management. This is the key and strategic issue for banks and financial intermediaries, involving positive results and therefore profits or negative results and therefore losses.

Financial crises, particularly severe in Europe over a long period of time starting in 2007, and related economic crises have given rise to non-performing loans spreading through European banks. This paper underlines the need to deal with and to solve this problem, which still has negative repercussions on the economic growth of the European Union mainly because it has meant fewer loans to the economy and especially to small and medium-sized enterprises.

The paper pays particular attention to the introduction and spreading of the so-called 'bad bank', which takes the bad assets and at the same time leaves the good assets in the previous bank in a sort of "cleaning up" of the asset side of the banks' balance sheets. The "cleaning up" and the full return to good banks represent the steps towards better conditions for the financing of the economy and economic growth. The greater the rates of return on investments for the good banks in the European Union the better will be the premises for lending.

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Regulation and supervision are typical aspects of the complexity and distinctive features of the banks. It is worth pointing out the over implementation of rules and constraints on the banking business and especially on capital levels, which are important from the point of view of covering losses but not from the point of view of a rational and sound management of banking risks and business areas.

In this context, the single supervisory mechanism and the single resolution mechanism, which has brought into operation the so-called 'bail-in' from the beginning of 2016*, are considered focusing weaknesses and critical aspects for the evolution of commercial banks, singling out confidence risks and instability risks. The financial crises have been the cause of many critical points and instability factors, and the application of the 'bail-in' can recreate financial instability. In the past years, states did spend a large amount of money for rescue purposes and now there is an incorrect use of state aid according to the European Commission interpretation, which considers many cases as state aid when they are not, in fact, state aid. This is misleading as it tends to increase the financial instability risks arising from the application of the bail-in.*

This paper examines risk management issues in the context of the bank and evolution of the banking business, by focusing on non-performing loans and bad bank to remove obstacles to economic growth on a European scale and, at the same time, on rules and single supervision for the removal of excessive restrictions and its inner irrationality on a European scale, identifying critical points and weaknesses.

Such circumstances show remarkable importance where banks' reinforcement is concerned, as well as their capacity to lending credit to the economy, which represents the point of return to satisfactory rates of economic growth in the European countries, particularly the weaker ones.

Therefore, this paper aims to analyse relationships between risk management, non-performing loans, regulation, supervision and banking crises in the framework of the European Banking Union, taking into account the bad

bank solution, and the bail-in resolution mechanism and focusing critical remarks and guidelines for the future.

1. In an increasingly global competitive context which presents several changes and financial innovations, banks are experimenting with risk management.

The net interest income reduction forces bank intermediaries to reinforce the non-interest income through a range of products which is wider and has a higher added value. This causes a broadening of instruments and business areas, with the consequent increase in risks and mutual interrelations.

It is therefore indispensable to have an adequate risk management function which can manage complex factors through processes able to transform risks into profit opportunities. There are, however, two unavoidable elements to take into account in order to achieve this target: competence and tools.

To take a closer look, these are two sides of the same coin as each propels the other. It is worth pointing out that mathematical and statistical knowledge is the *condicio sine qua non* for the carrying out of the tasks attributed to risk managers, but at the same time they have to be supported by adequate human resources. Competence and tools must perfectly align in order to maximise the benefits achievable from their synergies.

Financial engineering has achieved remarkable progress, originating tools for a real leap in quality in the results obtainable through risk management strategies. Among these, the main one is represented by derivatives which, despite their origins dating back a long way, still find wide usage in the bank of today. Their diffusion has been, to say the least, very impressive, as attested by the growth of the markets of reference.

As well as being used for different purposes, the aforementioned financial instruments play a key role in covering risks, there being several hedging techniques in use. In a bank context in which risk management represents the heart of all existing activities, derivatives find an almost natural collocation, to the point that their use has become an almost everyday procedure. Thus follow risk management policies which allow banks to carry on their risk-taking function over financial markets and, at the same time, to use these financial instruments to reduce their risk exposure.

Hence the need for adequate managing skills to prevent negative outcomes related to experimentation with derivatives, as the ratio of assets to capital, as is generally the case in the financial sector, will be very high. It implies the measurement of the leverage including fears of excess of hedging and therefore pursuing in the end not hedging objectives but speculation objectives, increasing and not reducing the range of risks.

2. Risk identification, measurement and management represent the heart of bank enterprises, and the ability to control them in a situation of asymmetric information is a fundamental bank function for the attainment of managing results[1]. Going further into what is meant by risk is not strictly necessary, but it is translated into a determining element to trace precisely the frame of reference for the bank.

In economic theory, risk tends to identify the variability of results around an expected value, and its existence relates to the presence of uncertainty. The latter constitutes a push towards progress, although progress through change generates uncertainty in return. Despite there being a close relation between

[1]See COLOMBINI, *Intermediari, mercati e strumenti finanziari. Economia e integrazione*, Turin, Utet, 2008; ID., *Financial crises. Where do we stand*?, "Law and Economics Yearly Review", 2, 2012; COLOMBINI - CALABRO', *Crisi finanziarie. Banche e stati. L'insostenibilità del rischio di credito*, Turin, Utet, 2011; ID., *Risk management e derivatives. Strategie bancarie*, "Banche e Banchieri", 4, 2010.

the concepts of risk and uncertainty, it is necessary not to confuse them. This labelling issue has been discussed in economic theory since the beginning of the twentieth century, and only around the 1920s was it given an exhaustive explanation by identifying two different types of uncertainty, characterised by their being measurable (measurable uncertainty) or unmeasurable (unmeasurable uncertainty)[2].

The verification of a phenomenon and the period of its manifestation are not known beforehand according to clear results, but can carry several values depending on a determined probability distribution. The calculation of probability has to lead to a result other than zero as it would represent a cost and not a risk, and at the same time different from 1 as it would mean a certain event.

Being able to estimate it and identifying as a matter of fact the possible event deviation from the expected value, we can talk about risk, otherwise about uncertainty. Along the same lines are the remarks of other economists, those who believe similarly that it is only risk to constitute an element of investigation in the economic discipline because of its being quantifiable, unlike uncertainty[3]. These assumptions can be seen as part of the neoclassical financial theory, which, since the 1970s, has been supposing the absolute rationality of economic agents, limited only by the lack of knowledge about the possible risk manifestations due to the randomness of events. The spread of studies around the theory of information re-assesses uncertainty, as it tries to take into account the effects of a limited human rationality within a system where the role of information and of its acquisition becomes pre-eminent.

Hence it follows that risk or stochastic variability pertains to the randomness of inner events, where instead uncertainty concerns the lack of knowledge or information. The distinction between risk and uncertainty can seem to be lacking practical outlines, but not if we take into account an interesting con-

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[2]See KNIGHT, *Risk, uncertainty, and profit*, Boston, Houghton Mifflin, 1921.

[3]See ARROW, *Alternative approaches to the theory of choice in risk-taking situations*, “Econometrica”, October, 1951; LUCAS, *Studies in business-cycle theory*, Cambridge (Massachusetts), MIT Press, 1981.

sideration according to which choices presuppose distribution of probability depending, at least partially, on subjective elements, so that even in the presence of the same event decisions taken are different according to the operator[4]. This is due not only to the different attitude to risk characterising each individual, but also to the different professional skills in identifying, measuring and managing a specific risk.

It is helpful to underline the importance of bank intermediaries which, thanks to both their resources and their skills, are better able than others to adequately manage risk-related issues.

The binomial risk-bank is something inseparable, which can result in a variety of results depending on the rate of accuracy of the risk assessment process by the risk management function. Despite the association of the common concept of risk solely with the negative side of event distribution - that is, concerning unfavourable situations - in reality the risk factor of a certain scenario can represent an opportunity of revenue compared only to financial, rather than pure, risks.

The importance of risk managers becomes even clearer, as not only can they prevent the destruction of value through correct risk management, but also create it until risk management becomes the real "profit engine" of the bank activity[5].

3. The true discriminating factor in identifying successful banks lies in the capacity to deal correctly with the evolution of risky phenomena, according to 89 percent of the senior banking executives of the major world banks[6].

In financial literature it is easy to find two different approaches to this theme: one refers to the organisational description of risk management func-

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[4]See ARROW, *Alternative approaches to the theory of choice in risk-taking situations*, *supra* note 3.

[5]See MASERA - MAZZONI, *Una nota sulle attività di risk e capital management di un intermediario bancario*, "Quaderno di Ricerca", 62, Rome, Ente Luigi Einaudi, 2007.

[6]See ERNST & YOUNG, *Basel* II. *The business impact*. *Global Basel* II *Survey*, "Research Paper", 2006.

tion, the other more related to the processes which the latter causes[7]. In reality, organisation and processes are two sides of the same coin, as it is only through their correct co-penetration that the best results can be achieved.

Risk management by a bank intermediary implies the function of risk management. Located in the organisation chart as an autonomous unit, the risk management function is related to the whole organisational structure in a transversal way, acquiring strategic information from the top management and gathering information from each single business unit to identify risk exposure, about the suitable levels of capital to allocate and about any critical issue relating to any of them. In the first instance we could define “top down” the processes affecting it, as in fact they are traced by the board of directors. Though not completely wrong, this consideration needs to be reformulated, because the definition of certain strategies implies the strict relation between the board of directors and risk management.

Strategies cannot avoid considering the capacity of risk managing on specific financial instruments and business areas, because otherwise it would be possible to start a determined operation in the wake of a great commercial idea without then being able to manage the critical issues related. It is a *modus operandi* which does not give sufficient value to the theme of risk, even though for years this has represented the way many banks work. The current context does not allow the top management to start any strategic operation without considering risk management peculiarities, both for the exponential increase in the range of risks and for the acquired awareness of correct risk management in the production of value.

The role attributed to the latter can be seen as that of a crossroads. It represents the main barycentre of the whole complex structure of the banking organisation chart[8].

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[7]See SCHROEK, *Risk management and value creation in financial institutions*, New York, Wiley, 2002.
[8]See BESSIS, *Risk management in banking*, New York, Wiley, 2015.

Its being autonomous allows the risk management function not to be linked to a specific business. This makes it possible to approach risk management from an integrated perspective. Setting a determined area to control each risk factor is not in fact farsighted because due to the possible correlations among the different factors, this would only cause more expense, and also lose its evaluative effectiveness.

In risk management, and in all related capital allocation issues, it is necessary to take into account the processes linked to the management of risk:

1. identification;
2. measurement;
3. monitoring and reporting;
4. management.

As may be readily guessed, the execution of strategies implies the preventive risk identification for their measurement and management[9]. This consideration might seem banal, but very often in operational practice it is from this first step that difficulties arise. Often the polyhedral nature of banking activity means that a single operation can be subject to several risks which can be confusing. The correct match between risks and business lines represents a key element to risk management success[10].

Each identified risk has to be classified according to event frequency and potential impact, this being an important reference parameter for the final passage: management itself. During identification and classification all data are gathered and organised into informative databases. This sets the following risk measurement, the heart of the whole process quantifying the risk exposure of the business units and of the bank as a whole. Usually the tendency is to make what risk managers do coincide with this activity, following for each one a particular logic which makes risk analyses which tend to follow during the life of a

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[9]See MIKES, *Risk management and calculative cultures*, “Management Accounting Research”, March, 2009.
[10]See MASERA, *Rischio, banche, imprese*, Milan, Il Sole 24 Ore, 2005.

bank homogenous and comparable. This is done with the introduction of *ex-ante* screening and *ex-post* monitoring.

Monitoring allows one never to lose track of the risk exposure of single business units, constantly allocating the correct amount of capital and identifying for each the most appropriate risk-return profile according to the targets fixed by top management.

It is necessary not to disregard the reporting phase which provides useful information to risk managers, with results coming from the adopted measurement system. This allows accurate assessment of the whole process and the correction of any gaps. As can be understood, risk management activity is something dynamic which needs to take shape according to market scenarios and related risk-events, following the bank business in its entirety[11].

4. Risk management plays a role of primary importance in the creation of value in bank intermediaries. As can be imagined, the focal issue in the understanding of the importance of such a complex - and thus so proportionally expensive - structure, is to identify the benefits.

To understand the logic connecting the production of value to risk management, it is necessary to consider the reason which prompts a bank intermediary to deal with risk management, and even more about the pursued targets. The latter are contained in the following categories:

1. adoption of the most appropriate strategy for risk management;
2. reduction of the variability of economic outcomes;
3. capacity for a suitable response to stakeholders' expectations.

The most appropriate strategy for risk management implies the link between risk management and the production of value which can come down to whether or not to hold a certain risk in the balance sheet. On this matter, with special regard to the capital level for supervisory purposes, being able to assess

[11]See CROUHY - GALAI - MARK, *The essentials of risk management*, New York, McGraw-Hill, 2014.

the convenience of holding a specific risk suggests to the bank the adoption of diametrically opposite managing strategies. The moment a specific critical issue is analysed, it becomes fundamental to understand its cost in terms of capital and - above all - the possible benefits.

This phase, despite being inserted in the risk identification, measurement and management process, involves elements of monitoring and reporting. It should be noted that a good deal of the costs to be borne with the acquisition of a certain risky position is related to its control *ex-post*. This further expense needs to be added therefore to the initial evaluation, and parameterised to the possible scenarios capable of influencing the position in question.

With regard to the supply of management skills, the overall cost of a risk-taking strategy needs to be estimated, and the more skills the bank proves to have with regard to that specific business risk, the lower the cost that will result. However, there are risks for which a taking strategy will turn out to be more expensive than a covering derivative strategy. In such contexts it is necessary to have recourse to the practice of hedging. One can understand that the dynamic modelling between risk taking and risk covering allows the activation of a flexible and dynamic managing policy, which can optimise capital and producing value[12].

Thus, risk identification and management, transfer and removing choices are related to the bank management strategic competences with regard to the financial instruments, business areas and operations to be considered central for the bank intermediary mission. The final decision is something which tends to incorporate both business strategy and risk strategy, which need to operate together in order to achieve the solution that best suits the bank in question.

Risk management activity, as empirical evidence makes clear, has a deep impact on the reduction of cash flow and profit volatility. The way strategies whose aim is the reduction of serious financial shocks arising from financial markets are set tends to ease the potential losses which, as well as eroding

[12]See CULP, *Risk transfer*: *derivatives in theory and practice*, New York, Wiley, 2004.

profit margins, cause instability in the worse scenarios, with heavy repercussions on investing strategies[13].

The fact that there are fewer resources available to lend credit means that the main bank activity is penalised, with all the effects that may result. As in a vicious circle, such a circumstance has repercussions on the profits and on the level of the bank's competitiveness. Not only does the bank experience a rise in the cost of the funds' raising for the market's confidence deterioration, but – in the search for a higher net interest income – tends to the increase of the bank's lending interest rates, with the effect of - once again - losing existing customers and not acquiring potential ones. The conclusion of all this is that the bank's level of competitiveness tends to decrease, and with it the production of value.

Therefore the effects of a mismanaged risk trigger mechanisms and impacts which are not limited to the current procedure, but basically produce effects - and this is the worst aspect - also in the medium and long term.

If there is not an adequate risk management system, not only do cash flows and profits erode due to the losses attributed to an underestimated risk, but it is also necessary to cascade a revision of the business strategies projected to intervals of a much larger scale. The reduction of cash flow and profit variability is a primary target which can be achieved only with a sound risk management.

There are a number of categories of stakeholders to whom risk managers, so to speak, need to find answers. Considering that the bank institution's target is value maximisation, the first to be affected by risk reductions are the shareholders. To confirm this, it is enough to consider that in rating each single bank's performance, more and more often risk-adjusted performance meas-

[13]See GATZERT - SCHMEISER - SCHUCKMANN, *Enterprise risk management in financial groups*: *analysis of risk concentration and default risk*, "Financial Markets and Portfolio Management", 3, 2008.

urement (RAPM) indicators are used, which identify in the risk adjustment the discriminating element in a comparison among different banks.

It would be pointless to consider on equal terms two banks which imply completely differing risks, because in this case we would not approach the logic at the base of different investing strategies played out by operators with different risk profiles. Even in this case an adequate risk management system becomes the determining factor to align shareholders' performance expectations to the actual achieved results.

As indicated, the reduction in profit volatility is a primary target for a bank that wants to be competitive in financial markets, so much so that many authors aim at this reduction to achieve the maximisation of value[14]. This aspect may not be equally important for all types of shareholders. For instance, especially for the so-called scalpers, a higher exposure to the bank risks would increase the profile risk-return and would better fit an investing logic which is purely speculative and oriented to the short term. With regard to this, considering a small portion of shareholders, it is to be believed that risk reduction and profit stabilisation are key elements for a correct response to the majority of shareholders' expectations.

The maintenance of a certain risk profile permits the achievement of a financial reputation to all stakeholders, a critical factor for success in banking. The activity in question arises from the idea of trust, and the lack of this, caused by an increase of default probabilities, can lead to a decrease in the standard business areas.

One might think, for instance, of a depositor who feels there is a problem in the financial solidity of his own bank, and even before ascertaining the possible seriousness of the situation, he hurries to the cashier's desk to withdraw what he has previously deposited. A correct and sound risk management represents the founding element of a bank which wants to enjoy a healthy relationship with all its stakeholders.

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[14]See ROUHY - GALAI - MARK, *The essentials of risk management*, *supra* note 11.

5. Models which can be framed into enterprise risk management (ERM) lead to an integrated risk approach, pursuing more effectively the following targets[15]:

a. more efficient capital allocation to single business units;

b. identification of the relations between various risks and the performances achieved by the various areas of banking business;

c. better planning and control of banking and financial products which include many and complex risks focusing the attention on an active monitoring of the interrelations.

Integrated risk management allows a relation between the concept of value and the concept of regulatory capital. Basel III application maintains a risk-based approach between allocation of capital and risk. This risk-based logic brings with it a re-think of the whole organisational and managing structure, which needs to be moulded in order to effect more manageable and flexible risk management actions. The strict link between the function in question and the internal audit needs to find its maximum expression in the ERM.

Risk becomes, as it were, the key variable retracing the whole organisational and management structure of the control procedures. Risk management and internal audit are two sides of the same coin onto which management and event control give continuous feedback between resources' cost and means' expense and their effectiveness. Such a relationship becomes the crucial element on which to base bank strategies and managing policies, especially in order to re-mould those controls which proved to be inadequate and/or reinforce them if they already successfully support the evolution of the intermediary's capacity of operation. The truly crucial element to achieve all this is something that goes beyond risk management function and processes. This is the spread-

[15]See BESSIS, *Risk management in banking*, *supra* note 8; NOCCO - STULZ, *Enterprise risk management*: *theory and practice*, "Journal of Applied Corporate Finance", 4, 2006.

ing of a "culture of risk" such as to ensure that its management is not just a problem for risk managers.

Starting from the board of directors, each single area of the bank management must follow risk-based logic, regardless of the fact that a specific function is set for this target. It is possible to produce data and information giving risk managers an exhaustive picture of the risk exposure of the intermediary in question. With regard to this, it becomes essential to have an integrated informative system and operators capable of adjusting it to changeable demands due to the evolution of different economic and operational contexts, for the success of the risk management process.

A continuous flux of information moving like a circulatory system delivers to the heart of the structure - the risk management function - all the necessary elements to put into effect an adequate risk management policy. Without information it is not possible to plan, let alone set quantitative studies to confine uncertainty, the same way neoclassicists intended it, to an *epsilon* percentage of the own entire exposure to stochastic variability. It is thus necessary to produce as much significant data as possible.

Hence, the fundamental role of human resources, so that each person's skills, from the board of directors to the front office, can become critical factors in the success of the process of risk identification, measuring and management. The professional capacity to put into place small precautions in order to eliminate further risk sources is crucial.

Identification, measuring and management of those risks which burden financial instruments and business areas of each bank carry substantial importance in a context of profit achievement strategies in the medium and long term, regardless the regulatory measures that need to be complied with.

6. Banks pursue the objective of expansion of on and off-balance sheet instruments and volumes over time in order to create the premises for profits and positive performance. Banking balance sheets have grown rapidly in a low

interest-rate environment and in the presence of a surge in innovative instruments[16].

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

The growth of the banking business has underlined the shift from commercial banking to investment banking, and therefore an increase in the range of risks and in total risk. The process of identification, measurement and management of risks is of crucial importance in creating and maintaining conditions for 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[17].

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

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

[16]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.

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

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.

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[18].

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[19]. Restoring rational choices in the context of commercial banks constitutes a requirement for medium and long period financial stability, with less importance awarded to growth of their capital.

Over time, the dealing and market making of securities and derivatives and proprietary trading have become increasingly important. There has also been a remarkable growth in derivatives, especially in the over the counter (OTC) market[20]. Since the beginning of the third millennium, securitisation

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[18]See COLOMBINI, *Intermediari, mercati e strumenti finanziari. Economia e integrazione*, *supra* note 1.

[19]See COLOMBINI, *Strumenti derivati e intermediari finanziari*, "Rivista Bancaria - Minerva Bancaria", 1, 1999; COLOMBINI, *Strumenti fuori bilancio negli intermediari bancari. La recente esperienza italiana*, "Rivista Bancaria - Minerva Bancaria", 4, 2004; COLOMBINI - CALABRO', *Risk management e derivatives. Strategie bancarie*, *supra* note 1.

[20]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.

markets have grown rapidly and created the shadow banking system, built up essentially by special purpose vehicles (SPVs) and structured investment vehicles (SIVs).

A large recourse to leverage and, at the same time, the development of the phenomenon of the shadow banking system[21] imply avoidance in capital requirements, in a bank context, through the constitution of off-balance sheet vehicles. These latter in particular run up debts on the market of commercial papers such as short-term securities, and use the achieved resources to purchase long-term securities, such as asset-backed securities (ABS). The difference between purchased securities return and the cost of financing through commercial papers, creates grounds for the attainment of profits to special purpose vehicles.

Changes and innovations in rules should be accompanied by adequate levels of controls on bank practices of regulatory avoidance through off-balance sheet 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]. 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 the irrationalities in the management of banks.

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

It is worth pointing out that the paralysis of asset-backed securities markets, due to the collapse of the real-estate market and of the underlying

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[21]See CLAESSENS - POZSAR - RATNOVSKI - SINGH, *Shadow banking: economics and policy*, "IMF Staff Discussion Note", December 4, 2012; GORTON - METRICK, *Regulating the shadow banking system*, "Brookings Papers on Economic Activity", Fall, 2010; STEIN, *Securitization, shadow banking, and financial fragility*, "Daedalus", 4, 2010.

[22]See POZSAR - ADRIAN - ASHCRAFT - BOESKY, *Shadow banking*, "FRBNY Staff Reports", 458, 2012; *Global shadow banking monitoring report* 2012, FSB, November 18, 2012; *Green paper shadow banking*, Brussels, European Commission, March 19, 2012.

asset characterising these securities, does not allow special purpose vehicles to raise funds to cope with their short-term commitments.

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

National responses to financial and economic crises, together with years of waste in public resource management, cause a rise in public expenditure and imbalance in the principal Western countries' public accounts, leading the way to sovereign debt crisis. Essentially this means credit risk for the country due to the non-payment of its debt maturity (debt default), or the intervention of an international financial authority, such as IMF, to adjust deadlines and amounts of those payments as defined in the debt contract (debt restructuring) [23] .

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[23]Regarding financial crises see, among others, ACHARYA - PHILIPPON - RICHARDSON - ROUBINI, *The financial crisis of* 2007-2009: *causes and remedies*, "ACHARYA V., M. 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*, "Annual Review of Economics", 2, 2010; ALLEN - CARLETTI, *An overview of the crisis*: *causes*, *consequences and solutions*, "International Review of Finance", 1, 2010; ARTETA - HALE, *Sovereign debt crises and credit to the private sector*, "Journal of International Economics", 1, 2008; BERNANKE, *The crisis and the policy response*, Speech, LSE, London, January 13, 2009; BLANCHARD - DELL'ARICCIA - MAURO, *Rethinking macroeconomic policy*, "IMF Staff Position Note", February 12, 2010; BOCCUZZI, *Towards a new framework for banking crisis management. The international debate and the Italian model*, "Quaderni di Ricerca Giuridica", 71, Rome, Banca d'Italia, 2011; BOLTON - JEANNE, *Sovereign default risk and bank fragility in financially integrated economies*, "NBER Working Paper", 16899, 2011; BROWN, *Beyond the crash*. *Overcoming the first crisis of globalization*, London, Simon and Schuster, 2010; CALABRIA, *Did deregulation cause the financial crisis*?, "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*, "Economic Policy", 62, 2010; COLOMBINI, *Crisi finanziarie e risk management. Rilievi critici*, "Rivista Trimestrale di Diritto dell'Economia", 4, 2011; COLOMBINI - CALABRO', *Crisi finanziarie. Banche e stati*. *L'insostenibilità del rischio di credito*, *supra* note 1; COOPER, *The origin of financial crises*. *Central banks*, *credit bubbles and the efficient market fallacy*, Petersfield, Harriman House, 2010; CRESCENZI, *Propagazione ed effetti della crisi finanziaria sull'economia reale*, "CRESCENZI (ed.), 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*

7. Financial crises imply the absolute importance of risk management, which becomes applicable to different sectors, both private and public.

Thus, the subprime mortgage financial crisis brings to light the inadequate credit risk management produced by the banking system, which initially originates negative consequences for the financial system and subsequently for the economic system.

Similarly, the sovereign debt crisis stresses the unbalanced public finance management characterised by the widespread use of debt, together with subprime mortgage financial crisis impact for public resources aimed to the rescue of banks and financial systems, raising critical issues due to the increasing level of credit risk borne by sovereign states which, at the same time, initially produces negative repercussions on public issues and, as a result, on the fluctuations in value of the financial instrument portfolios of financial intermediaries.

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big banks fail and what to do about it, Princeton, Princeton University Press, 2010; EICHENGREEN, *Ten questions about the subprime crisis*, “Financial Stability Review”, Banque de France, 11, 2008; ESTRELLA - SCHICH, *Sovereign and banking sector debt*: *interconnections through guarantees*, “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*, “CFS Working Papers”, 31, 2008; FRATIANNI, *Financial crises, safety nets and regulation*, “Rivista Italiana degli Economisti”, 2, 2008; FORNASARI, *I dati e gli insegnamenti della crisi finanziaria USA*, “Economia Italiana”, 1, 2009; GEITHNER, *Stress test. Reflections on financial crises*, New York, Penguin Random House, 2014; GOODHART, *The background to the* 2007 *financial crisis*, “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 (ed.), La crisi mondiale. Storia di tre anni difficili”, Rome, Luiss University Press, 2010; MASERA, *Financial turbulence and the capital standard paradigm: a sequel*, “MASERA (ed.), 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; 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*?, “PAGANETTO (ed.), 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.

The readjustment of public accounts produces a tax increase and/or a reduction in the public expenditure. It is right to stress that policies for the rebalancing of public accounts cause a recessive push economically, essentially in the period between 2007 and 2014 in the European context, implying a loss estimated in several percentage points of GDP, despite differences among European countries. It is a loss in wealth which becomes practically irrecoverable, and stresses a negative aspect: public accounts rebalancing operations in a financial and economic crisis context imply negative results economically.

In Europe, public accounts rebalancing policies generate economic recessions over several years, with a slow recovery phase which started towards the end of 2013. Economic recessions contribute over time to an increase of non- performing loans (NPLs) in a commercial banking context, causing the credit crunch. The economic consequences show that the credit crunch performed by banks on their customers hard tests the companies' investments, with the logical consequence of sharpening the forces of recession.

Credit crunch reduction is linked with NPLs divestiture processes and to processes for the creation of bad banks on an internal or external level for the recovery of better and optimal lending conditions for families and enterprises. The price applied in credit lending divestiture distinguishes between unsecured credit and mortgage credit, respectively being lower and higher.

A bad bank implies the creation of state-owned or private companies for the use of capital in bad assets purchase from troubled banks, cleaning up their balance sheets and assessing the congruity of their purchase price. Regarding this, a company constituted for bad banking activities implies either a definite public equity presence, feeding the list of public companies, or a definite private equity presence, thus feeding off-balance sheet vehicles.

A bad bank postulates the identification and the net partition between bad assets and good assets, simply because bad assets are separated and transferred into the assets of the constituted company, whereas good assets stay in the existing company's assets, introducing a clear distinction between bad bank and good bank.

A bad bank represents an intervention repeatedly carried out in those countries affected by the effects of the world financial crisis experienced since 2007. At the same time, it establishes an intervention which is being carried out in several countries around the world, because it introduces clarity and different ways of risk management activity, in the context of a recovered bank (good bank) and of a surviving bank (bad bank) which now incorporates all negative and problematic items from the past management of what used to be a single bank.

It is worth specifying that bad banking activity does not represent a sole right for bad banks, because, in the evolution of financial crises, central banks carry forward repeated purchases of government securities and toxic assets in the context of unconventional measures, thus contributing to the placement of government securities and of the recovery of the negative situation of bank balance sheets.

These are interventions which cause a considerable increase in the volume of assets and, at the same time, cast light and shadows over the central banks from the standpoint respectively of a hypothetical value increase or of a hypothetical value reduction due to the presence of financial instruments of high or low quality in their assets.

Applications of Basel III and additional corrections imposed by the European Central Bank (ECB) and by the European Banking Authority (EBA) simply lead to the bank capital reinforcement in the economic, financial and capital situation which is being pictured at the time of the period in question, without giving any "guarantee" for the increase of intermediated and production volumes and, at the same time, for the keeping or improvement of the surplus revenue over costs and the achievement of adequate levels of profits in the future.

Taking a closer look, the weakness of many banks makes economic recovery slower and more complex for single countries and on a European scale, because the presence in assets of non-performing loans and more so of toxic securities tends to the absorption of greater capital, thus comparatively reducing monetary resources allocated for lending to the economy. It is worth to point out the importance of rational decision-making in the selection and control of loans to customers.

On a European level, in order to reinforce economic growth, the creation of a number of bad banks for the ultimate cleaning up of balance sheets in each country is a measure to pursue, creating again more favourable conditions to loans, especially to small and medium-sized enterprises, and therefore to economic development.

The importance of a check-up of European banks' balance sheets needs to be stressed, identifying deteriorated credit levels and toxic securities, and, at the same time, the cleaning requirements - as it were - for single countries and on a global level, adopting private or public initiatives for the creation of bad banks and the restoration, by contrast, of good banks.

This fulfils financial stability targets and particularly targets for the foundation of the best conditions for economic development simply because good banks go back to performing their traditional task, that of raising and lending funds to the worthiest enterprises. Even in the worst hypothesis, where, in some cases, there might be the necessity of using public resources, the pursued economic outcomes would be superior by far to public resources expenditure.

Moreover, in past experiments the creation of bad banks - even when using public resources - does not necessarily produce a negative outcome for states, simply because the recovery of economic development causes a value re-adjustments even in bad assets, within bad banks. At the same time, also, the final net result can turn positive after some time.

8. The application of Basel III is inspired, as in the past, by prudential logic[24], stressing progressive corrections and inadequacies in regulatory measures in the European context.

The transition to Basel III shows that the previous Basel I and Basel II regulations proved to be inadequate and unable of preventing the birth and the effects of subprime mortgage financial crisis and the sovereign debt crisis, which produced serious repercussions on financial stability and economic growth.

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

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

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

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

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[24]Basle III has introduced higher and better levels of capital, in the framework of risk-weighted assets, and, at the same time, the liquidity risk and the leverage to be implemented progressively over time. It can thus be regarded as based on a prudential approach. That does not exclude additional capital corrections for the banks which are subject to inspections and stress tests on the basis of the European Central Bank (ECB) indications and also of the European Banking Authority (EBA) guidelines. Accordingly, this can be regarded as adopting a discretionary approach highlighting overlapping and excessive regulations, and uncertainties for banks in the EU.

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

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

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

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

Taking a closer look, capital ratios neither eliminate nor lower corporate risks, which can even endure increases; these merely create the premises for the reduction or the elimination of losses occurring in negative events.

Capital ratios meet the need for prediction and allocation of an adequate level of capital, essentially for negative impacts and losses caused by credit, market and operational risks. Capital is considered the main aid to commercial banking stability and solidity for three main reasons: absorption of asset value fluctuation, stabilisation of financing sources and absence of contractual remuneration constraints[25].

The main target for supervisory authorities is the setting of higher capital levels in relation to higher risk levels of financial instrument types, thus reducing

[25]See BERGER - HERRING - SZEGO, *The role of capital in financial institutions*, "Journal of Banking and Finance", June, 1995; PECCHIOLI, *Prudential supervision in banking*, Paris, OECD, 1987; PRINGLE, *The capital decision in commercial banks*, "Journal of Finance", September, 1974; TAGGART - GREENBAUM, *Bank capital and public regulation*, "Journal of Money, Credit and Banking", May, 1978.

the incentive for moral hazard risk. Indeed, the effects of capital ratios on moral hazard are not entirely uniform, diverging according to the theoretical model followed.

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

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

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

Reactions and behaviours of individual banks are very different, and this finds weak justification in the uniform and generalised capital ratios application for issues depending upon the lack of assessment of each instrument on the portfolio risk, and also to the identical weight assigned to different loans within the same class.

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

Each class incorporates diversity in the instruments and in the composition of customers, at the same time originating risk differences. In addition, the degree of correlation between different asset instruments is not taken into account, ignoring the postulates of diversification[26].

[26]See GRENADIER - HALL, *Risk-based capital standards and the riskiness of bank portfolios: credit and factor risk*, "Working Paper Series", 5178, Cambridge (Massachusetts), National

The different capacity of individual banks in creating a diversified lending portfolio is not taken into account[27].

An ideal system should consider the increase in risk to the portfolio for the introduction of assets instead of limiting itself to a mere capital addition, appreciating correctly the risk associated with different financial instruments.

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

It also needs to be specified that in the light of the theory of information asymmetries, the position of individual bank intermediaries for news and data collection and in the production of information is necessarily very different, thus feeding higher or lower costs. Significant are the ways of creating and keeping customer relations and the bank size in producing information and costs related to this, indicating strengths and weaknesses in the comparison and in the competition with other similar intermediaries.

Therefore classes are rather broad; they do not take into account the existence of diversification, do not take into account the benefits of methods of screening and monitoring, present substantial static elements and are essentially identified for the creation of conditions of control performed by supervisory authorities.

At the base of the internal models there is the value at risk (VaR), which constitutes the maximum potential loss over a financial instruments portfolio in

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Bureau of Economic Research, July, 1995; SANTOMERO, *The bank capital issue*, "WIHLBORG - FRATIANNI - WILLETT (eds), Financial regulation and monetary arrangements after 1992", Amsterdam, North-Holland, 1991; SHAEFER, *The design of bank regulation and supervision: some lessons from the theory of finance*, "PORTES - SWOBODA (eds), Threats to international financial stability", Cambridge, Cambridge University Press,1987.

[27] See COLOMBINI, *Intermediari, mercati e strumenti finanziari. Economia e integrazione*, *supra* note 1, p. 196.

a precise time interval, calculated assuming a determined probability. VaR considers the impact on the value of each single financial instrument of the variations in market factors, such as interest rates and exchange rates.

The internal model on credit risk, in the evolution of rules, introduces internal ratings for the appreciation of balance sheet assets and off-balance sheet instruments. This model reflects evaluations and calculations from individual banks and makes necessary the approval of supervisory authorities.

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

This model allows VaR calculation, identifying individual banks' credit risk exposure and, therefore, the amount of capital, following the indications provided by supervisory authorities for construction and operation.

Therefore, the identification of individual banks' best position in credit risk measurement and control does not imply a restriction in the role of supervisory authorities, always committed to an *ex-ante* and *ex-post* control of the characteristics and results of banks' internal models.

The internal model of market risks, in turn, postulates the best capacity of individual banks' risk appreciation in comparison with the standardised model drawn by supervisory authorities. The issue lies in the joint appreciation of setting and realisation expenses and consequent capital constraint on one side and benefits inherent in best management of risk on the other.

This model permits VaR calculation which identifies the market risk exposure for individual banks, and, therefore, the capital amount, complying with the indications provided by supervisory authorities for construction and operation. A central issue lies in the imposed requirements check which proves to be very complex, feeding outflanking possibilities and lack of capital growth. Such a circumstance raises the issue of introducing capital ratios for uniform application, and, at the same time, of a simple check by supervisory authorities[28].

The pre-commitment approach means a solution to the capital requirement issue, left unresolved by those models based purely on VaR application. Such a model allows the preventive definition of capital, necessary to cover negative impacts caused by market risks, calculating exactly the potential loss[29].

This model postulates the identification of the time period and the level of potential loss, and presupposes the application of bank penalties for those which encounter errors, essentially reflecting canons and internal needs. The introduction of penalties and time intervals for the check should create the necessary incentives for a correct and rational setting. The pre-commitment approach detaches itself from previous approaches and allows full freedom in individual banks' choice of parameters[30].

Moreover, the application of the pre-commitment approach presupposes the solution of some aspects, such as penalty modalities, check frequency and consequent penalties introduced by supervisory authorities, isolated or joint use of other models, possible link between potential loss predetermination and capital growth[31].

The process of financial innovation must also be taken into account, and, in particular, financial instruments for credit and market risk coverage, such as swaps, options and futures, have to be adequately included in the set of rules.

More generally, the different levels of trust and benefit of risk management raise different strategic answers, inherent in the changed balance sheet

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[28] See BLISS, *Risk-based bank capital: issues and solutions*, "Economic Review", Federal Reserve Bank of Atlanta, September-October, 1995.

[29] See KUPIEC - O'BRIEN, *A pre-commitment approach to capital requirements for market risk*, "Finance and Economics Discussion Series", 36, Washington (D.C.), Board of Governors of the Federal Reserve System, July, 1995; ID., *The pre-commitment approach*: *using incentives to set market risk capital requirements*, March, 1997; CONSIDINE, *Pilot exercise-Pre-commitment approach to market risk*, "Economic Policy Review", October, 1998;

[30] See SIRONI, *An analysis of banks market risk management and its implications for capital regulation*, "Working Papers", Milan, Bocconi University, October, 1996.

[31] See BLISS, *Risk-based bank capital: issues and solutions*, "Economic Review", Federal Reserve Bank of Atlanta, September-October, 1995

assets and off-balance sheet instruments for the reduction of potential loss and/or for the growth of capital which is suitable for their coverage.

The performance considers the achieved results in different business areas. It tends to the construction and analysis of a series of financial, capital and economic indicators, and in particular, the focus on profits.

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

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

The various Basel I, Basel II and Basel III tend to increase the compliance costs of individual banks, and, at the same time, of the organising of inspection work while disregarding the fact that banks differ greatly when small and medium in comparison with the largest. The issue for banks is the use of rational and rigorous methods for the management of business areas and correlated risks, from the viewpoint of producing profits in the short, medium and long term.

The focus on increasing capital is not the correct approach, because it uses a unitary attitude, the "one size fits all" approach[32] to banks which are deeply different in their various business areas and risk range. Rules essentially consider a loss coverage issue through an adequate capital level, and this is a very different matter from an actual ability of management the entire risk range.

[32]See BLISS, *Risk-based bank capital: issues and solutions*, *supra* note 28, p. 34: "The "one-size-fits-all" approach implicit in the standard model approach does not reflect the diversity of portfolios and strategies that exist. Neither is it likely to keep up with changing circumstances. Portfolio positions change rapidly, requiring real time monitoring".

The increase in capital demands imposed by regulation and supervision in corrective measures tends to the reduction of the capacity to lend to the economy, and does not introduce improvements to risk management.

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

It is in the coordination of ideas and actions on a European level that it becomes possible to improve the potential of financial and economic systems, reducing the global imbalance between creditor and debtor countries which can feed worrying geopolitical tensions.

During phases of increases in return rates demanded by the market over state issues in peripheral countries, the negative impact on public expenditure tends to aggravate the fragility of public budgets, creating a sort of vicious circle[33].

Implicit or explicit state guarantees for "too important to fail" banks and other financial institutions constitute liability items in the public budget. They can be regarded as put options in the context of contingent claims analysis (CCA), showing value fluctuations in connection with value changes in the assets of banks and financial intermediaries. It follows that financial crises intensify the intricate interconnections between states, banks and financial intermediaries,

[33] In this respect, the progressive adoption of measures for the improving of the financial crises in individual countries reduces tensions on financial markets. This finds its evidence in the reduction of the spreads between public bonds of individual countries and German bonds, using as the main parameter a ten-year maturity period.

ECB initiatives in providing liquidity to European banks and in experimenting with quantitative easing (QE) tend to consolidate peripherical countries' achieved results in the gradual reduction of spreads, which implies an inflow of liquidity to European banks and their support to the purchase of public bonds and also to lending credit to enterprises.

This fits into the abatement of the malignant spiral of increased costs of public refinancing and of public interest expenditure, because it goes in the opposite direction of cost reduction and public interest expenditure reduction.

leading to the application of implicit or explicit guarantees in the different countries[34].

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[35]. 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[36].

Improvements in risk management 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 against the onset of new financial crises in the future.

The application of the bail-in from 2016 in the context of the European bank crises is tending to the reduction of value of implicit guarantees but not to their nullification, state aid being an extreme remedy, always applicable to the "too-important-to-fail" banks, and therefore to the onset of a systemic risk.

9. The creation of the banking union in Europe, applying uniform criteria for supervision over banks through the single supervisory mechanism (SSM) and, at the same time, uniform criteria for the bank crisis resolution through the

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[34]See GRAY - MERTON - BODIE, *A new framework for analyzing and managing macrofinancial risks of an economy*, "NBER Working Paper", 12637, 2006.

[35]See SCHICH - LINDH, *Implicit guarantees for bank debt*: *where do we stand*?, "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*, "OECD Journal: Financial markets trends", 2, 2012; NOSS - SOWERBUTTS, *The implicit subsidy of banks*, "Financial Stability Paper", 15, Bank of England, May, 2012.

[36]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), "CGFS Papers", 43, BIS, July, 2011; *High-level expert group on reforming the structure of the EU banking sector*, *supra* note 17; SCHICH - LINDH, *Implicit guarantees for bank debt: where do we stand*?, *supra* note 35.

single resolution mechanism (SRM), is introduced in a single and reinforced supervision perspective.

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

Public debt reduction through privatisations with revenues designed to cut down the public debt, or the creation of a public real estate investment fund which leads to the purchase of assets disvested by the state or public entities, anticipating immediately resources to the state equally cutting down public debt, would constitute a structural change in a very positive key.

The single supervisory mechanism is carried forward by an integration between a supranational authority, the European Central Bank and national competent authorities (NCA) of individual countries of the European Union (EU), essentially following a single set of standards and requirements.

The single supervisory mechanism presupposes the ECB direct supervision over significant banks, and therefore of large dimensions, which are around 120 units, representing almost 85 percent of its total banking assets, and the NCA supervision over the less significant banks in collaboration with the ECB, and therefore of small and medium sizes, which are around 3500 units.

The single supervision postulates control over bank capital ratios on the basis of Basel III application, and control over economic, financial and capital trends to identify problematic situations in their initial phase and, at the same time, the development of asset quality review and of stress tests to identify weaknesses in the event of particularly adverse situations.

The single supervision is created by the European Central Bank and the national competent authorities of the individual countries in the EU for the performance of specific tasks of prudential supervision. Such tasks presuppose the testing of loans, investments and raising funds for the impact on costs and revenues, on liquidity, on capital and leverage.

The single supervision is carried on by the supervisory board. Hence the task and structure difference within ECB, between the conducting of the monetary policy and single supervision, which sometimes provides indications which do not conform particularly closely.

The single supervisory mechanism has become necessary because, on the basis of the recent financial and bank crises in Europe, simple coordination between single central banks has not proved to be satisfactory in the light of operations outside national borders, hence the need to ensure financial stability.

The creation of SSM has happened together with the SRM, managed by the single resolution board (SRB) and the single resolution fund (SRF), fed by the banks and the projected single scheme for deposit guarantee.

The substantial novelty in bank crisis management is represented by the bail-in[37], which implies the aid of shareholders and bank creditors including subordinated and straight bonds for the coverage of serious losses and the rescue of the bank in question. In the event of severe economic, financial and capital instability, account holders could run the risk of losing their deposits which exceed one hundred thousand, even if this is a rather remote hypothesis. States can intervene with their financial aid only in an extreme and residual hypothesis.

It needs to be emphasised that, in the case of a very large cross-border bank or in the event of a systemic crisis, the bail-in will not remove the need for public support of funds[38].

The bail-in presents critical aspects from different standpoints in the EU banking context. First of all, it is rather problematic, even for the most careful saver, to have the right indications to assess and correctly follow the bank's

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[37]See BART, *Regulatory capital requirements and bail in mechanisms*, "HAENTJENS - WESSELS (eds.), Research Handbook on Crisis Management in the Banking Sector", Cheltenham, Edward Elgar Publishing (UK), 2015; BOCCUZZI, *The European banking union. Supervision and resolution*, London, Palgrave Macmillan, 2016; SOMMER, *Why bail in? And how?*, "Economic Policy Review", Federal Reserve Bank of New York, March, 2014.
[38]See AVGOULEAS - GOODHART, *A critical evaluation of bail-in as a bank recapitalisation mechanism*, "Discussion Paper Series", 10065, CEPR, July, 2014.

economic, financial and capital evolution, there being an issue of informative asymmetry which is not resolvable[39].

In the second place, we need to consider the confidence crisis which hits savers in the event of crisis and bank failure, and which can become difficult to control, with negative repercussions[40].

In the third place, it is conceivable that the bail-in and the onset of crisis and bank failure tend to the contraction of the channel of banking bonds for the fund raising, thus causing significant damage to monetary resources flowing to the bank with medium-to-long term maturity and, therefore, used typically for medium-to-long term loans towards investments for EU small and medium-sized enterprises.

In the fourth place, the drying up of the channel of banking bonds has negative repurcussions on the bank's financial balance for the hypothesised lack of medium-to-long term monetary resources.

For the above reasons, the bail-in tends on one side not to burden the cost of the crises and bank failures on state budgets, and on the other to introduce aspects of financial instability.

For these reasons, the bail-in constitutes a set of rules which must be changed radically. The basic impression is that the critical aspects of the bail-in have been neither assessed nor simulated. It is enough to point out that, in the event of a confidence crisis by savers hit by the failure of a bank of significant size, the spread and extension to other banks could carry serious implications for bank intermediaries and financial markets, raising the issue of state intervention.

In the drafting of the bail-in there are economic and financial elements which seem to have been ignored. Thus in the event of crisis, or worse, of bank failure, the most immediate aspect and which, on the basis of what has been

[39]See COLOMBINI, *Intermediari, mercati e strumenti finanziari. Economia e integrazione*, *supra* note 1.
[40]See AVGOULEAS - GOODHART, *A critical evaluation of bail-in as a bank recapitalisation mechanism*, *supra* note 38.

concluded above, is of fundamental importance, leads to irrational choices carried out by the management, and in particular, by risk management. Towards shareholders and bank creditors, there have been from the start and will remain over time informative asymmetries which do not allow an accurate appreciation of the economic, financial and capital conditions of the bank in question.

Therefore, in a crisis or bank-failure event, the responsibility falls primarily on the administrators especially at the high bank levels which take choices regarding instruments, bank business, bank areas and risk management. Thus a sort of automatism should be introduced in the application of financial penalties by the supervisory authorities to the administrators especially at the top level of the bank in question to "fix" the damage on the basis of new and more severe rules, and at the same time, relating to the hypothesis of evidence of crisis and bank failure.

Due to the fact that recent financial crises have dramatically focused attention on the negative impact on banking and on the economy of crises and failures in the banking context, anticipation and creation of various precautionary funds fed through a percentage of administrators' high salaries to be used in the event of crisis or bank failure, and to be returned in the event of no crisis or bank failure, would represent a tool against any morally hazardous behaviour. Administrators especially at the top level are always responsible for crisis or failure, and therefore the bail-in should be heavier and more incisive on the category in question.

The bail-in has been introduced to ensure that, in future, banking crises have a lighter effect on taxpayers, and do not raise public expenditure. The modalities with which resolution authorities limit the development of liabilities which are truly aligned with future losses, affect the freedom of choice of a bank's management. Thus, the single resolution board defines the minimum requirement for own funds and eligible liabilities (MREL) for the various banks in the EU.

The application of the bail-in, considering the use of interbank deposit protection funds for individual countries as a state aid, lacks any economic and legal foundation, while there remain internal resources created by individual countries' banks for the resolution of problematic crises arisen within individual bank systems. Regarding this, the recent application of the new mechanism for the bank resolution to the four failed banks in Italy is emblematic. Furthermore, such prohibition of use, imposed on a European scale, produces negative effects on savers, extending the contribution they are asked for to the resolution of the bank, and thus acting on confidence crises and alarm elements among savers, who are still taxpayers even though a smaller number compared with the country's overall taxpayers.

There being a control and an imposition by supervisory authorities with regard to the volume of bonds compared to the potential level of losses, such a circumstance means an external restriction of the choices for the liability composition.

Bail-in repercussions of potential crises of confidence, of potential drying-up of the channel of banking bonds, of potential worsening of banks' financial balance, of potential reduction in investments' lending, imply critical elements and suggest a complete revision and a radical change.

It is worth pointing out that ECB alone cannot create strong premises for economic development in Europe, because political choices are necessary which could go towards structural economic reforms in the short term and towards much more solid integration, removing all sources of uncertainty affecting finance and economics[41].

[41]See, among others, ANDENAS - SUPINO, *Politics and finance with reference to the European institutional frame*, "Law and Economics Yearly Review", 1, 2015; CAPRIGLIONE - SACCO GINEVRI, *Politics and finance in the Europian Union*, "Law and Economics Yearly Review", 1, 2015; McCORMICK, *The influence of politics on regulatory and cultural change in the financial sector after the financial crisis: a UK perspective*, "Law and Economics Yearly Review", 1, 2015.

10. In this context, a few indications and remarks in the European banking, financial and economic system emerge:

- skills and tools are very important in the activity of risk management, considering the positive impact on profit pursuit or the negative impact on loss event;

- capital adequacy is to be taken into consideration for the choice of the composition of assets and for the absorption of losses produced only in the event of irrational choices, and, in particular, in the event of risk management presenting weaknesses in setting and management;

- credit risk in a banking context must be well managed and kept to low levels, acceptable in the light of related and yet still broad negative impacts for choices tending towards risk increase;

- the joint development of commercial banking and investment banking in banks provides opportunities for profit and, at the same time, for loss only in the event of irrational risk management;

- the dimension and length of economic crises are strictly related to the rise and effects of financial crises, thus to the requirement for adequate short-term initiatives in contrast to recessive economic pushes;

-the wide range of NPLs in banking due to the financial crises and related economic recessions generates the credit crunch towards enterprises, especially those of small and medium sizes, thus a need for the progressive reduction of NPLs essentially experiencing loan sales and EU-wide bad-bank creation, returning to more favourable conditions for loan granting and economic development;

- importance of uniform criteria for risk analysis and evaluation, and, especially, for credit risk through asset quality review, stress tests and inspections carried out by ECB single supervision through European banks;

- importance of public debt levels for individual states and therefore the demands for privatisations and selling public assets to cut down public debt, recreating margins to support the economy for the decrease of interest expenditure already being reduced in many countries due to the contraction of return and interest rates as a consequence of conventional and unconventional measures adopted in Europe – especially the quantitative easing of the ECB;

- reduction of rules and additional corrections with regard to the bank capital for the decrease in the costs of compliance;

- return of more freedom and discretion in the choices of European banks, with the introduction of a widespread pre-commitment approach in risk management contexts;

- importance of analysis and comprehension of the bail-in negative aspects, and therefore deep and radical change of the rules applied through the bail-in within the EU;

- political choices in the economic and financial field which take into account the importance of the timing of their adoption and consequent impact which, even if considered positive, tend all the same to fade when in the presence of indecision and uncertainties;

- the plainest example is given by economic recessions which have gripped as it were the majority of economies of various members of the EU for an overall period of eight years, including the subprime mortgage financial crisis and the sovereign debt crisis, starting in 2007 until 2014 and beyond, having found political answers in an economic and financial mode which were not particularly effective in the course of time and not very different from the German model of austerity, with obvious results in a European context.

Creative austerity*

Giuseppe Di Taranto** - Sabina Smailovic***

ABSTRACT: *The chief current problems for Europe, apart from possible decisions bearing on the Schengen Treaty and its costs, concern compliance with the rules on the government budget deficit (3 per cent of GDP) and the public debt (60 per cent). The annual budget constraint is attenuated by the possibility of flexible application for individual members, while the debt limit is harshened by the Fiscal Compact, which requires members to bring the ratio down below the 60 per cent threshold within 20 years.*

The Italian government's recent critical stance on a European Monetary Union more concerned with budgetary rigor, measured in percentage points, than with growth, gauged by more jobs and higher living standards, constitutes an important stimulus for rethinking the institutional architecture of the treaties and regulations in force.

The premises for the euro highlight the problems and constraints that would plague its proper implementation.

1. The Italian government's recent critical stance on a European Monetary Union more concerned with budgetary rigor, measured in percentage points, than with growth, gauged by more jobs and higher living standards, constitutes an important stimulus for rethinking the institutional architecture of the treaties and regulations in force. To better grasp the need for change, one need merely ask why, of the 200 or so countries that now make up our world, only the few that belong to the European Monetary Union are subject to such strin-

gent budget constraints and why the euro area is growing less than other regions, in particular the United States, the epicenter of the subprime mortgage crisis.

The chief current problems for Europe, apart from possible decisions bearing on the Schengen Treaty and its costs, concern compliance with the rules on the government budget deficit (3 per cent of GDP) and the public debt (60 per cent). The annual budget constraint is attenuated by the possibility of flexible application for individual members, while the debt limit is harshened by the Fiscal Compact, which requires members to bring the ratio down below the 60 per cent threshold within 20 years.[1] It is worth recalling that if the Union's objectives for inflation and long-term interest rates have been practically attained, owing in part to the recession caused by the sacrifices imposed by economic convergence, as regards the objective of fiscal sustainability four of the twelve original signatories of the Maastricht Treaty were running deficits larger than 3 per cent in 1991 (Portugal and Belgium, 7.2 per cent; Greece, 11 per cent; and Italy, 11.4 per cent), and at the end of that year five had debt ratios higher than 60 per cent (Belgium, 127 per cent; Greece, 82.2 per cent; Ireland, 94.4 per cent; Italy, 98.0 per cent; and the Netherlands, 73.7 per cent).

At the first of three scheduled monitoring exercises, at the end of 1993, the countries failing to comply with the deficit ratio were again Italy, whose deficit had come down to 10 per cent, Belgium, where it was unchanged, Austria (which joined the European Union on 1 January 1995, together with Sweden and Finland) at 4.2 per cent, and France, at 5.9 per cent.

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*Sections 1 and 2 are by Di Taranto, Section 3 by Smailovic.

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[1]See, DI TARANTO, *L'Europa tradita. Lezioni dalla moneta unica,* LUISS University Press, Rome, 2014, pp. 51-53.

At the second assessment, as of 31 December 1996 nine members were above the 3 per cent threshold and seven in violation of the 60 per cent debt ratio limit. And despite improvements on the deficit front, at the final verification, 31 July 1998, the debt ratio was above the limit in seven countries and had risen in a good many others: by 20.1 percentage points in Germany, 22.3 in France, and 31.8 in Greece. After the three assessments, 11 of 12 countries were admitted to the single currency. Greece was admitted under derogation, soon to be terminated.

The acceptance of these members, which ignored their public finance problems, was possible thanks to an interpretation of Article 104C(b) of the Treaty that had been adopted in the earlier exercises as well; namely, greater importance was assigned to the deficit than to the debt ratio. As in December 1991, when the Treaty had been signed but not yet ratified, five member states had debt ratios higher than 60 per cent, it was posited that there was no definite limit to the volume of the public debt, and that accordingly it was sufficient for the debt to be coming down towards the desired value at a satisfactory pace, with no specific timetable for attaining it.[2] This is the reading that has now brought, instead, the Fiscal Compact, which lays down rigid time and quantity standards for lowering the debt ratio to 60 per cent. Here, one of the linchpins of modern economic theory has been – willfully – ignored: the Ricardian equivalence proposition, set forth in the second decade of the 19th century and refined by R. Barro in 1974, which postulates that the public debt can increase as long as the additional tax revenue deriving from greater economic growth

[2]See, GUARINO, *L'Europa imperfetta. Ue: problemi, analisi, prospettive*, in Id., *Diritto ed economia. L'Italia, l'Europa, il mondo*, "I Quaderni di Economia italiana", No. 8, 2011, pp. 219-274; Id., *Eurosistema. Analisi e prospettive*, Giuffrè, Milan, 2006, pp. 126-141. See also DI TARANTO, *Le basi problematiche della moneta unica*, "Aspenia", No. 26, 2012, pp. 176-179; Id., *The Internationalization Process in Southern Italy*, "Review of EconomicConditions in Italy", 2011/2-3, pp. 495-517; Id., *L'Europa tradita. Dall'economia di mercato all'economia del profitto*, in F. Capriglione (ed.), *La nuova disciplina della società europea*, Cedam, Padua, 2008, pp. 21-63.

produced by larger deficits is enough to cover the interest payments principal repayments on the debt.

As for the deficit ratio, the rules allowed for overshoots in temporary, exceptional circumstances. Hence, the deficit requirement turned out to be a necessary and sufficient condition for convergence on the standards of admission to the single currency.

Italy, with its very high public debt, in order to qualify quickly applied the Ricardian equivalence, enacting a burdensome "Eurotax" and not following the UK's lead in "opting out" under the Maastricht Treaty clause that allowed member countries not to adhere immediately, pending further consideration.[3]

These premises for the euro highlight the problems and constraints that would plague its proper implementation.

What, then, were the criteria behind the 3 and 60 per cent limits? And what economists endorsed such limits in theory?

Before the advent of the euro, the 3 per cent deficit parameter was ascribed to the so-called "golden rule of fiscal policy," namely that government should not borrow to finance current spending and that the deficit should therefore not exceed public investment expenditure, which was around that level in a good number of countries. Or else it referred to the benchmark applied by West Germany. Or, yet again, it was said to correspond to the deficit at which a public debt of 60 per cent of GDP could be financed at an interest rate of 5 per cent. This third criterion, however, implies a balanced budget net of interest payments and thus conflicts with the medium-term objectives of the Stability and Growth Pact.[4] Yet the Delors Report, upon which the Maastricht Treaty was based, only spoke of the need to "impose effective upper limits on budget deficits of individual member countries"; it did not quantify them.

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[3] See, SAVONA, *Eresie, esorcismi e scelte giuste per uscire dalla crisi. Il caso Italia*, Rubettino, Soveria Mannelli, 2012, p. 46.
[4] See , MAGNIFICO, *Euro: squilibri finanziari e spiragli di soluzione*, LUISS University Press, Rome, 2008, p. 239.

Thanks to the French daily *Aujourd'hui*, we now know how the 3 per cent deficit ratio originated and how it was adopted by the technocrats of Brussels. Its inventor was Guy Abeille, a budget department functionary at the French Finance Ministry during the presidency of François Mitterrand. The standard was set "with no theoretical reflection whatever," Abeille has said. "Mitterrand needed an easy rule to use in order to turn down ministers who came to ask for money. … We needed something simple." At the time, in the early '80s, France was running a deficit of around 2.6 per cent, so "proposing 1 per cent would have been too hard, unfeasible," 2 per cent would have "put the government under too much pressure"; the figure was therefore fixed at 3 per cent. "3 per cent? It's a good number, a historic number, calling the Trinity to mind." And in fact the former head of the Bundesbank, Hans Tietmeyer, acknowledged that the standard was "economically not easy to explain." The most striking thing, as *Aujourd'hui* emphasizes, is that the Brussels technocrats adopted the same method in their recent determination of "another seeming, and equally false, Cartesian rule: the structural deficit ceiling of 0.5 per cent. Why not 1 per cent or 2 per cent? No one knows."[5]

There has been no lack of proposals for modifying these postulates. The European Economic Advisory Group advocates modulating the budget constraints depending on the size of the country's debt. Other scholars hold that there is a need for some deficit flexibility in accordance with national economic growth rates. And the list could be extended.[6] So far, however, nothing has changed – least of all the obstinacy of the Eurocracy.

The theoretical underpinnings of the 60 per cent debt ratio are traceable to what was called, in the '90s, "expansionary austerity," by now part of the mainstream neoclassical market model. Under the theory of expectations, the reduction of the sovereign debt thanks to fiscal consolidation through spending

[5]See, DI TARANTO, *Ragioni liberali per criticare certi eccessi dell'austerity*, "Il Foglio", 16 November 2012; V. Lops, *Parla l'inventore della formula del 3% sul deficit/pil: 'Parametro deciso in meno di un'ora, senza basi teoriche*, "Il Sole 24 Ore", 29 January 2014.
[6]See, MAGNIFICO, *op. cit.*, pp. 241-43.

cuts will stimulate growth, because the cuts are perceived as the signal of future tax reductions and hence higher expected incomes. But the recent crisis has demonstrated that “expansionary” austerity was, instead, recessionary. The International Monetary Fund, at first the most vehement of the Troika’s advocates of austerity, has now had to recognize that the fiscal multipliers have been higher during the recession than before: 1.5 instead of 0.5, meaning that a fiscal contraction of €1.00 had a recessionary impact of €1.50 on the economy, and not of €0.50, as the theorists of expansionary austerity had estimated.[7]

The thesis of a negative correlation between debt and growth has been recently resumed and sustained by Carmen Reinhart and Kenneth Rogoff of Harvard. Based on empirical studies, they show that in the long run countries with high sovereign debt – over 90 per cent of GDP, hence well above the more restrictive 60 per cent parameter laid down by the European treaties and regulations - have lower growth. The study has been taken as the scientific justification for the adoption of austerity policies within the euro area and for the rule requiring reduction of the public debt to 60 per cent of GDP, including by means of the Fiscal Compact and the incorporation of the balanced-budget principle in national constitutions.

But this empirical work on the correlation between debt and growth is flawed by spreadsheet errors, as was discovered by researchers at the University of Massachusetts and as Reinhart and Rogoff have admitted. What is more, it has been shown that there is in fact no “threshold effect,” such as a ceiling of, say, 60 per cent, and no direct causal nexus between debt and growth. Finally, the consequences vary from country to country, while empirical studies on the Reinhart-Rogoff model simply *postulate* that the relationship between debt and growth is the same independent of context. “The hypothesis could potentially

[7] See, DANIELE, *L’austerità espansiva e i numeri (sbagliati) di Reinhart e Rogoff*, “Economia e Politica”, 20 June 2013, http://www.economiaepolitica.it/index.php/primo-piano/lausterita-espansiva-e-i-numeri-sbagliati-di-reinhart-e-rogoff/. For Italy, PISAURO, *Il risanamento dei conti pubblici*, “Economia italiana”, No. 1, 2012, pp. 37-61; IMF, *World Economic and Financial Surveys. Fiscal Monitor*, October 2012, p. 53 ff.

produce misleading results, and studies using statistical techniques that *do not so postulate* cast doubt on the negative correlation between debt and growth in the advanced countries."[8]

2. The advent of the single European currency has resulted in a switch in the focus of currency speculation, from exchange rates – which were flexible after 1978 both under the old monetary snake and also, albeit within a fixed fluctuation band, under the European Monetary System – to the rates of interest on the public debt of different countries. In other words, speculators switched from currencies as the representation of the conditions of a national economy to the market's confidence in a State's sovereign debt. While the spread between ten-year Italian Treasury bonds and German Bunds was 600 basis points in 1991 when Germany was reunified, rose to 700 basis points with the speculative attacks on Italy in 1992, and remained over 300 basis points until 1996, not a single analyst cited this as proof of Italy's economic weakness relative to Germany. The spread then declined and with the advent of the euro recorded negative values from 1997 to 2007, marking the first but in many respects also the last success for the single currency. As Jacques Sapir has noted, it went unobserved – or ignored – that this was the only sphere in which some effective unification was achieved at the time: "Product prices remained quite diverse across the various euro-area countries, and the prices of shares listed in the various stock exchanges absolutely failed to converge. Worse still, the dif-

[8] See, PANIZZA - PRESBITERO, *Quel nesso da dimostrare tra debito e crescita*, "lavoce.info", 20 April 2013; REINHART - ROGOFF, *Growth in a Time of Debt*, "American Economic Review", Vol. 100, No. 2, 2010, pp. 573-578; T. Herndon, M. Ash, R. Pollin, *Does High Public Debt Consistently Stifle Economic Growth? A Critique of Reinhart and Rogoff*, PERI Working paper No. 322, April 15, 2013, For the full text, see: http://www.peri.umass.edu/fileadmin/pdf/working_papers/working_papers_301-350/WP322.pdf.

ferences in economic trends between the countries of the euro area continued to increase."[9]

The shortcomings of Europe's institutional architecture were then thrown into relief by the subprime mortgage crisis that broke out in the United States, the subsequent failure of major investment banks – first Bear Stearns, then Lehman Brothers – and Prime Minister Georgios Papandreou's declaration that Greece risked default. The resulting contraction of liquidity widened interest rate spreads vis-à-vis ten-year German bonds, spreads that hit their maximum during the summer of 2011 in Portugal, Ireland, Italy, Greece and Spain (the "PIIGS" countries) but also in Belgium. Actually, this constituted the realization of the conditions laid down by Germany for agreeing to Maastricht – the euro area had to arise as a community of financial stability, according to a decision of the German Constitutional Court, which consequently ruled out any form of mutualization of the sovereign debt of countries in difficulty. And given this line of thought, the European Central Bank, founded in 1998, could not act as lender of last resort, because its sole mandate was for monetary stability, interpreted narrowly as fighting inflation on the model of the Bundesbank.

Euro-area countries in difficulty, then, given the single currency, cannot mutualize their debt, or carry out competitive devaluations, or regulate interest rates. The sole instrument they can use to finance themselves is the free capital market – an instrument that even in 1999 Joseph Halevi had described as a boon to financial rents[10] – with a consequent increase in the public debt and the transformation of the liquidity crises into solvency crises. These in turn undermine investor confidence, threatening economic deterioration in the debtor states, insofar as the widening of spreads lowers the value of their government securities and means higher debt interest payments. It is no accident that the IMF has reconsidered its original position, admitted the damage done by the

[9]See, SAPIR, *Bisogna uscire dall'euro?*, Ombre corte, Verona, 2012, p. 24-39.
[10]See, GRAZIANI, *Lo sviluppo dell'economia italiana. Dalla ricostruzione alla moneta unica europea*, Bollati Boringhieri, Turin, 2001, p. 171.

policies of austerity imposed through the Troika,[11] and, together with the OECD and the European Parliament, recognized the need for some control on capital movements.

The yield on sovereign debt instruments is correlated with the exchange rate, inflation, insolvency risk and, solvency being equal, their degree of liquidity. So a German Bund is more attractive in the international capital market than an Italian BTP, which in turn is more attractive than analogous bonds issued by Greece or Cyprus. Thanks to the soundness and reliability of the German economy, the Bund would appear to serve as a sort of safe haven. With the advent of the single currency, the first of these factors – the exchange rate – was eliminated and variations in inflation expectations were reduced enormously, to far less than 2 percentage points above the rates in the three most virtuous countries as established by the Maastricht Treaty. And in fact until 2007 the average spread with respect to German government bonds was only 27 basis points for Italy, 28 basis points for Greece, and a mere 9 basis points for Spain. This means either that the markets had unlimited confidence in the financial soundness of all the euro-area countries or else that they had failed to comprehend one of the constituent elements of Maastricht, namely the no-bail-out principle, which ensures the stability of the single currency and absolutely precludes any transfer of funds between member states.[12]

Jean-Paul Fitoussi has rightly observed that "the consequences of foreign exchange speculation, while serious, are infinitely less grave than those of speculation on the stability of States. The economic and social consequences of a currency devaluation are incomparably less severe than those of a bank run."[13] In practice, the switch from speculation on exchange rates to speculation

[11]See, SAPIR, *op. cit.*, pp. 12-13, 16. For Italy, see "Growth and Financial Stability in Italy. Review of Economic Conditions in Italy", 2012, No. 1. In particulare, PISAURO, *The consolidation of the Italian economy*, pp. 31-54.
[12]See, SARRAZIN, *L'Europa non ha bisogno dell'euro*, Castelvecchi, Rome, 2013, pp. 77-78.
[13]See, FITOUSSI, *Il teorema del lampione o come mettere fine alla sofferenza sociale*, Einaudi, Turin, 2013, p. 122.

on sovereign interest rates coincided with the transfer of sovereignty from States to the supranational economy of finance. Whereas a national government can manage exchange rates by open market operations to regulate domestic liquidity through its own central bank or by competitive devaluation – or revaluation, as envisaged by the EMS – it is impossible for any country, alone, to ward off speculative attacks on its stability, given the enormous volume of capital that liberalization has injected into the market with the financialization of the economy. This is because the euro-area countries' public debt is denominated in a supranational currency over which they no longer wield the monetary policy powers just mentioned. On the contrary, the crisis is deepened, as the danger of a State's default depresses its bonds, widens the spread, and depreciates the assets of the banks that hold them. Unless government intervenes, there is the danger of a bank run – as in Greece – and the flight of capital to States with sounder sovereign debt. Obviously this mechanism weakens the poorer countries, through speculation, and further enriches the affluent.

In this regard, Thilo Sarrazin has observed that "a bank that holds government securities denominated in euros takes on an extra risk with respect to the securities of a State whose central bank can issue money" and that this threatens to undermine its solvency.[14]

3. Eight months have passed since Schengen's 30th anniversary: the European treaty signed on 14th June 1985 by Belgium, France, Germany, Luxembourg and The Netherlands. The abolition of borders and the subsequent free movement of persons within the Schengen area represent a major conquest for the members of the European Union, as well as a fundamental element on which the Union is based.

The values of solidarity and hospitality promoted by the EU are integral part of the Schengen's *Acquis,* which is currently applied by 26 countries (22

[14] See, SARRAZIN, *op. cit.*, pp. 24-41.

European Union members and 4 associated states).

However, the dream of a united and supportive Europe seems nowadays undermined as nationalism and xenophobia find increasing public approval in times of disastrous migrant crisis.

Saving one of the most important strongholds in European history and providing a concrete answer to the ever-increasing migration issues is crucial for the future of the "Old Continent".

It's not surprising to see nationalist movements stonewalling the arrival of refugees escaping from war, death and misery. Refusal and demonization of diversity are just part of their DNA.

Most worrying, democrats and liberals paved the way to isolationist policies, taking advantage of legitimate fears in the citizenry for the sake of arguable political campaigns.[15]

Hungarian Prime Minister Victor Orban caused public outrage last summer for its decision to build a barrier on the Serbian borders to prevent migrants from entering the country. Decisionist policies in Poland, Czech Republic and Macedonia echoed Mr. Orban determination with the announcement of drastic and violent solutions in an effort to hinder the refugees flow. The incapacity of the European Union to provide a univocal, well-balanced, answer to the crisis and its failure to develop a common sense of belonging for the EU members appear to be the real problem.

Legal gaps and European Union's lack of preparation in managing the phenomenon justify the adoption of restrictive measures and isolationist policies by moderate governments: blaming Orban's barbed wire while building invisible walls made of tighter border controls and questioning Schengen's validity.

As the crisis sharpens, Schengen's area shows signs of weakness while Austria, Denmark, France and Sweden restore borders[16] pointing their fingers

[15]See, ACCARDO, *Libera circolazione e immigrazione: trent'anni dopo, che cosa rimane di Schengen*, "Voxeurop", 19th June 2015.

at the presumed inability of Italy and Greece to patrol the European external frontiers. Recent studies show that over one million asylum-seekers crossed the EU borders: a remarkable number, especially if compared to 2014 data. Nevertheless, this figure seems more reassuring when confronted to EU total population. At this purpose, one million migrants accounts for 0,2%, therefore scaling down the crisis magnitude which cannot be compared to the situation Lebanon has to face, providing hospitality to one million migrants representing 25% of its population.[17]

Issues regarding the management and integration of people from different worlds in the economic, social and cultural context are undeniable as they represent the real challenge to a strong and unite Europe.

Integration and constructive exchange should be at the very heart of the "New Schengen". The Cologne matters show the urgent need for a balance between integration and social protection of UE's citizenry. Shutting eyes and doors is not a solution. Such a behaviour wouldn't be respectful of the work and hope with which Schengen was created. Incalculable damages would affect every EU citizen with a significant reduction in mobility rights that would mean living in a degenerated Europe, deprived of that common sense of belonging acting as inspirational principle.

However, Schengen suspension would need the approval of all the 26 member states and, in any case, would mean unsustainable costs for all the participants to the zone. Cost/benefits analysis on immigration show that abandoning Schengen would not bring any advantage.

The European crisis is serious and Mr. Donald Tusk, President of EU Council, gave a 2 months deadline to reform Schengen and find a long-term an-

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[16]See, CARLINO, *Porte sempre più chiuse per i migranti. Scontri a Kos contro gli hotspot*, "Euronews", 15th February 2016.

[17]See, LIBERTI, *Chiudere le frontiere in Europa ha conseguenze incalcolabili per tutti*, "Internazionale", 18th January 2016.

swer to the migrants issue. As time is pressing, a fast response is needed to tackle migration crisis.[18]

Greece is now experiencing hard times in balancing its economic and social efforts for both the migrant crisis and the financial issues regarding its debt, while Europe still fails in defining a suitable strategy for the current immigration problems.

As Turkey wriggles out of its duties concerning the strengthening of border controls to stem the migrant flow heading to Greece, Kos is witnessing fights between the embittered population and desperate migrants, exhausted by inhuman trips and uncertain perspectives.[19]

Schengen's suspension and the redefinition of Europe's real borders will not be an acceptable solution, as this will not help interrupting the migrant flow to the Hellenic coastline: blocking desperate migrants in an unprepared country will only result in a humanitarian emergency.[20]

In this catastrophic context, the European strategy and the relocation policy must be redesigned in order to avoid nationalisms and unsustainable economic and social costs. In addition to this, the uncertainty about the British referendum and the threat of a possible Brexit burden the crisis with an additional risk factor. Moreover, the commodity crisis and the ghost of recession, new and old EU discords, the Eastern "secession" and the possible return of Nation states cast a shadow over the unity of Europe.

To make the multi-speed Europe matters worse (a division which is nowadays less visible as Finnish economic conditions deteriorate), a rift between Western Europe and radical nationalist Eastern nations follows up.[21] Furthermore, the virtuous, unwavering Germany suffers from the impact of one

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[18]See, CORIAT, *2016: année critique pour l'Union européenne*, "Alternative économiques", 18th January 2016.

[19]See, GUETTA, *Compte à rebours en Europe*, "France Inter", 26th January 2016.

[20]See, PAPACHELAS**,** *Διπλή καταιγίδα στον ορίζοντα, "I Kathimerini", 17th February 2016.*

[21]See, CORIAT, *2016: année critique pour l'Union européenne*, "Alternative économiques", 18th January 2016.

million refugees on the job market, the instability of economic conditions and the uncertainty of electoral results.

Studies outline the possibility of an even worse migration flow in the future, as a consequence of climate change. Such a scenario makes the current refugees tragedy a mere testbed for Europe, which, if not capable of managing the crisis, will give in to more serious and hardly avoidable migration flows.[22]

An unanimous, sustainable and responsible solution, outcome of a well-balance mix of integration and citizenry safeguard, is highly necessary; as well as the redefinition of the refugee-sharing scheme with fairer models.

In response to the struggle among Ministers of the member states and Italy and Greece push for the application of EU solidarity principle, the European Commission published an agenda concerning the distribution of asylum-seekers from Syria, Eritrea and Iraq. The Commission agreed to redistribute migrants on the basis of population size (40%), national GDP (40%), unemployment rate (10%) and number of refugees hosted during the last 4 years (10%).

Denmark, United Kingdom and Ireland are excluded from the programme, as determined by the Treaty of Lisbon.

An alternative allocation method has been proposed by two researcher from the London School of Economics, basing their study on realistic and pragmatic criteria. The hosting capacity of destination countries is analyzed taking into consideration three dimensions: internal wealth, job market conditions and demographic rate. Internal wealth is estimated by GDP (PPP) per capita, as hosting costs are strictly correlated to the cost of living. The greater is the wealth of a country, the easier is for it to sustain the migrants-related financial costs. Bigger shares, therefore, must be allocated to the richest countries.

Job market and demographic rates – inasmuch as they can turn the migrant issue into a good economic and social development opportunity - are crucial for the definition of these shares. A quali-quantitative research is per-

[22] See, HALL, *The Challenge of Financing the Costs of Climate Change*, “The Governance Posts”, 25th January 2016.

formed to analyze the job market conditions, taking into consideration job vacancies. Countries with high education level will probably suffer from shortage of manpower and less qualified workers. Demographic structures with low birth rates will benefit from refugees (81% is under 35 years old and 55% is 25).

The 10% correction factor regarding previous hosting commitments is omitted as it has little influence on the results of the study. Moreover, economies of scale offset hosting costs. The outlined shares are highly divergent from the ones proposed by the Commission.[23]

Regardless of the results, it's interesting to note that many other redistribution plans are feasible and desirable for a real and supportive cost sharing in order to host refugees and save Schengen.

[23]See, BOVENS - BARTSCH, *Why the refugee quota system is unfair on poorer eastern and souther EU states*, "The London School of Economics", 28th January 2016.

Which democratic oversight on the Banking Union?
The role of the Euro-national parliamentary system[*]

NICOLA LUPO[**] - RENATO IBRIDO[***]

ABSTRACT: *The essay aims at analysing the instruments of democratic and parliamentary oversight on the European Banking Union. It argues that the role of the European Parliaments and National Parliaments, as envisaged in Regulation (EU) No. 1024/2013 of the Council, in Regulation (EU) No. 806/2014 of the European Parliament and of the Council and in the interinstitutional agreements between the European Parliament, on the one side, and, on the other, the European Central Bank or the Single Resolution Board (published respectively on 30th November 2013 and 24th December 2015), could be fruitfully analysed using the concept of the "Euro-national parliamentary system". It is developing traditional and innovative parliamentary instruments, at national as well at European level (especially the so called "banking dialogue"), that these new powers can be made accountable and that the new bodies of the "fragmented" Executive in the EU, set up within the Banking Union, will not increase the width of the "democratic disconnect".*

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[*] Although the contents of the article presented here is the result of a joint work, Nicola Lupo has written paragraphs 1, 2 and 3 while Renato Ibrido the others.

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806/2014. - 5.2. The Interinstitutional Agreement between the European Parliament and the European Central Bank. - 6. The National Parliaments' participation in the Banking Union governance. - 6.1. An "anatomy" of the National Parliaments' oversight powers in the Banking Union framework. - 6.2. The implementation of the National Parliaments' internal rules: comparing procedural philosophies. - 7. Conclusions

1. The setting up of the European Banking Union has been a strategic step of the European integration process[1]. By means of the Banking Union, further traditional functions exercised at national level, also by the central banks[2], have been pooled and will be mainly exercised at a European level.

As often happens, especially regarding crucial policies on the banking sector, the most relevant roles have been assigned to bodies and institutions neither elected by citizens nor directly deriving their legitimacy from Parliaments. Some powers are, indeed, reserved to the (National and European) Governments, but most of them are attributed to central banks of the ESBC, independent authorities and to other agencies that could be included in the "fragmented" Executive in the EU (as we will see in par. 3).

For this very reason the problem of democratic oversight on the European Banking Union is, at the same time, absolutely crucial and not easy to be solved. Democratic legitimacy and political accountability of the important decisions that can be taken by the institutions and bodies of the Banking Union and that might have clear and very relevant effects on European citizens, as savers, borrowers or taxpayers, depend on the capacity of Parliaments to exercise some form of oversight on these institutions.

[1]For an historical antecedents of the Banking Union project, see MOURLON - DRUOL, *Banking Union in Historical Perspective: The Initiative of the European Commission in the 1960s–1970s*, in *Journal of Common Market Studies*, 2016, 1 ff. On the European policy framework in the financial sector and post-crisis bank regulatory reforms, see CAPRIGLIONE – TROISI, *L'ordinamento finanziario dell'UE dopo la crisi*, Torino, Utet, 2014; ANGELONI – BERETTI, *Harmonising banking rules in the Single Supervisory Mechanism*, in *Law and Economics Yearly Review*, 4, 2015, 124 ff.

[2] On the problem of the separation between monetary policy and banking supervision, see, inter alia, GOODHART – SCHOENMAKER, *Should the Functions of Monetary Policy and Banking Supervision Be Separated?*, in *Oxford Economic Papers*, 4, 1995, 539 ff.; SABBATELLI, *La supervisione delle banche. Profili evolutivi*, Padova, 2009, spec. 166 ff.

As always happens, the pooling of functions at European level determines a potential dispersion of responsibility, as well as the need to identify the Parliament where forms of accountability and sometimes of political direction could be experienced. It will be shown (respectively, in paras. 4 and 5) that both the European Parliament and National Parliaments are called upon to play a role in this regard. Indeed, after the Monetary Dialogue, the Political Dialogue and the Economic Dialogue a new framework of democratic oversight powers and parliamentary information rights was introduced within the Banking Union governance.

That is why, particularly in this case, the analytical tool of the Euro-national parliamentary system – a way of reading the role of the many Parliaments that exist and operate in the EU – could be useful in order to clarify the mechanisms and the procedures allowing Parliaments to exercise one of their fundamental roles i.e. to oblige the Executives to publicly give account of the reasons for the decisions that they have taken and to discuss with representatives elected by the citizens the main directions they are going to follow while they make use of their powers.

2. There are many ambiguities and debates on what is and what should be the place of the many Parliaments that exist and operate in the EU democracy, and particularly on the respective functions of the European Parliament and National Parliaments[3]. These debates and ambiguities are particularly heated when they refer to functions that have been pooled following the intergovernmental method instead of the community method, as in these cases the role of the European Parliament as co-legislator and its scrutiny powers of the Commission tend almost inevitably to be by-passed. At the same time, it is far from easy for National Parliaments to oversee the action exercised by the Ex-

[3]For an updated picture see HEFFTLER – NEUHOLD – ROZENBERG – SMITH (eds.), *The Palgrave Handbook of National Parliaments and the European Union*, Basingstoke, Palgrave Macmillan, 2015.

ecutives at European level: at best, each one of them can oversee and sometimes even direct the behavior of its own Government, with reference to how it was able to pursue the national interest, but obviously it is not in any position to do the same thing at European level, checking whether or not the policies envisaged or enacted have actually achieved the European interest.

The analytical tool that has recently been proposed in this regard, in order to better grasp these peculiar features of EU democracy, and eventually to stimulate their evolution, is the "Euro-national parliamentary system"[4]. It assumes that the EU democracy is founded and characterized not only on the directly elected European Parliament, but also on the confidence relationships that, with the only exception of Cyprus, link each National Government to its Parliament (or with at least one Chamber thereof). Consequently, it tends to underline the relevance for EU democracy of the relationship between each National Parliament and its respective Government, explicitly acknowledged by article 10 TEU, when it states, after recognizing that the EU is founded on representative democracy and after recalling the role of the European Parliament, that "Member States are represented in the European Council by their Heads of State or Government and in the Council by their governments, themselves democratically accountable either to their national Parliaments, or to their citizens"[5].

In comparison to other widespread analytical tools, like the one of the "multilevel parliamentary field"[6], which has become remarkably widespread in

[4]See MANZELLA – LUPO (eds.), *Il sistema parlamentare euro-nazionale. Lezioni*, Torino, Giappichelli, 2014; LUPO, *Parlamento europeo e Parlamenti nazionali nella Costituzione "composita" dell'UE: le diverse letture possibili*, in CIANCIO (ed.), *Nuove strategie per lo sviluppo democratico e l'integrazione politica in Europa*, Roma, Aracne, 2014, 365 ff.; MANZELLA, *Parlamento europeo e parlamenti nazionali come sistema*, in *Rivista AIC*, 1, 2015, www.rivistaaic.it/parlamento-europeo-e-parlamenti-nazionali-come-sistema.html.

[5]On this point GRIGLIO – LUPO, *Parliamentary Democracy and the Eurozone Crisis*, in *Law And Economics Yearly Review*, 2012, 314.

[6]See CRUM – FOSSUM, *The Multilevel Parliamentary Field: a framework for theorizing representative democracy in the EU*, in *European Political Science Review*, 1, 2009, 249.

recent years[7], the "Euronational Parliamentary system" seems more useful and meaningful, as it adds a couple of new and relevant elements.

First, it includes in the picture not only all the Parliaments (European, National and even regional, if they exercise legislative powers), but also the Executives. In this way, it highlights the fact that, also thanks to the already mentioned confidence relationships existing in each Member State's form of government, among the main functions of each Parliament is the oversight of its Executive, or, better, of the part of the "fragmented" Executive in the EU that is in some way linked to it.

Second, in talking about a "system" instead of a "field", it shows that the relationships among Parliaments cannot be correctly defined as "having no clear relation of hierarchy, but linked to each other by a sense of common responsibility, shared norms, and a certain density of interaction". On the contrary, the relationships among Parliaments, and even more so those between each Parliament and its Executive, are designed and ruled by legal provisions and characterized by Euro-national procedures and often by a number of common institutions.

In other words, the 'system' of relationships outlined above is constituted by procedures, ruled by a composite parliamentary law, made up of EU as well as national provisions, and is based on the idea that the functions of representation, political direction and oversight are now necessarily shared between parliaments of different levels of government[8].

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[7]Among others, LORD, *The European Union: Parliamentary Wasteland or Parliamentary Field?*, in CRUM – FOSSUM (eds.), *Practices of Inter-parliamentary Coordination in International Politics: The European Union and Beyond*, Colchester, ECPR Press, 2013, 235; ERIKSEN, *The Normativity of the European Union*, London, Palgrave MacMillan, 2014, 98 ff.; ABELS – EPPLER (eds.), *Subnational Parliaments in the EU Multi-Level Parliamentary System: Taking Stock of the Post-Lisbon Era*, Innsbruck, Studien Verlag, 2015.

[8]See MANZELLA, *Verso un governo parlamentare euro-nazionale?* in MANZELLA –LUPO (eds.), No. 4 *supra*, 1 ff.. See also, although talking of a multilevel parliamentary field, WINZEN – ROEDERER-RYNNING – SCHIMMELFENNIG, *Parliamentary Co-Evolution: National Parliamentary Reactions to the Empowerment of the European Parliament*, in *Journal of European Public Policy*, 22, 2015, 75.

One of the advantages of this approach is that it should encourage Parliaments to cooperate not just for the pleasure of doing so, but because any form of interparliamentary cooperation would strengthen the setting up and the efficacy of parliamentary oversight on the "fragmented" Executive in the EU (the European Council, the Council, the Commission, and also the European Central Bank).

3. As stated, there is no one single unitary institution in the EU which can be described as the "European government". The executive power in the EU is indeed a "fragmented power", that is composed of supranational institutions (the Commission, the ECB, the agencies), institutions made up of National Governments (European Council, Council) and a galaxy of committees and working groups at a sectorial level[9].

However, far from weakening the EU Executive, its "fragmented" nature makes it "ultra-powerful", as long as traditional forms of parliamentary oversight and political responsibility are difficult to apply[10]. In taking part in the European integration process, National Governments have obtained, at least in part, what was deemed impossible in contemporary democracy: the exercise of powers without (almost any) responsibility.

On the one side this is the outcome of the fact that for the Government to blame someone else for the decisions they have actively concurred in taking and, on the other side, of the difficulty for National Parliaments and for (still mainly national) public opinion to correctly reconstruct the chain of political re-

[9]For the thesis of the EU's "fragmented executive", see MAGNETTE, *L'Union européenne: un regime semi-parlementaire*, in DELWIT – DE WAELE – MAGNETTE (eds.), *A quoi sert le Parlement européen?*, Bruxelles, Editions Complexe, 1999, 25 ff.; CURTIN, *Executive Power of the European Union. Law, Practices, and the Living Constitution*, Oxford University Press, Oxford, 2009, spec. p. 28 ff., Id. *Challenging Executive Dominance in European Democracy*, in *The Modern Law Review*, 1, 2014, 1 ff.

[10]See LUPO, *Il controllo parlamentare dei Governi degli stati membri nell'Unione europea, tra trasparenza e privacy*, in *Federalismi*, 3, 2015, 7.

sponsibility and, should it be necessary, to sanction those who have exercised their powers in an ineffective or incorrect manner[11].

Even the Banking Union governance is not exempt from the interactions between the "fragmented executive" in the EU and its parliamentary interface. Rather, the analysis of the supervision and resolution policies confirms that the ECB is not – as affirmed in a recent book[12] – a *counter-majoritarian* institution that can be assimilated to a constitutional court. The ECB is instead a component of the "fragmented executive", and indeed this "executive" role explains the competences of the European Parliament and the National Parliaments to oversee the decisions adopted by the ECB within the Banking Union governance.

The concept of "executive" shows at least two different meanings: in a negative sense, it could be defined as being in opposition with the other two powers which make up the traditional Montesquieu tripartite system; instead, in a positive sense it coincides with the bodies which carry out the function of execution[13].

From this point of view, the central banks seem to correspond with both definitions of "executive". Indeed, it is not a coincidence that the German Bundesbank is regulated by art. 88 GG., that is a provision included in the section of the Basic Law concerning "The Execution of Federal Laws and the Federal Administration"[14].

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[11]See HOBOLT – J. TILLEY, *Blaming Europe? Responsibility Without Accountability in the European Union*, OUP, Oxford, 2014.

[12]See MOROSINI, *Banche centrali e questione democratica. Il caso della Banca centrale europea (BCE),* Pisa, Edizioni ETS, 2014, especially 43.

[13]On the different meaning of "executive", see BOGNETTI, *Governo*, in *Enciclopedia delle scienze sociali*, IV, 1994, 405 ff.; SCHÜTZE, *European Constitutional Law*[2], Cambridge, CUP, 2015, 302 ff.

[14]See BIFULCO, *Bundesbank e Banche centrali dei Länder come modello del sistema europeo delle banche centrali*, in GABRIELE (ed.), *Il governo dell'economia tra crisi dello Stato e crisi del mercato*, Bari, Cacucci, 2005, 41 ff.

Moreover, the recent ECB refinancing operations and purchase programmes[15] highlight the “enlargement of functions” of the European Central Bank and could be considered as indirectly confirming the Alberto Predieri thesis: although the central banks are at the apex of a sectorial sub-system (the banking governance), they are actively involved in the political direction function, taking decisions with a general and intersectorial impact[16].

4. In December 2012, at the peak of the sovereign debt crisis[17], the EU decision-makers launched a “road map” to achieve a complete Economic and Monetary Union (EMU) through the setting up of a European Banking Union[18].

The Banking Union architecture is built on three different pillars: the Single Supervisory Mechanism (SSM), the Single Resolution Mechanism (SRM), and the Deposit Guarantee Scheme (DGS)[19].

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[15]On the ECB refinancing operations and purchase programmes, see MOSTACCI, *Alla maniera di Asghar Farhadi. Le operazioni straordinarie della BCE nelle dinamiche delle separazione*, in *DPCE*, l, 2015, 221 ff.; PISANESCHI, *Legittimo secondo la Corte di Giustizia il piano di allentamento monetario (OMT) della BCE. Una decisione importante anche in relazione alla crisi greca*, in *Federalismi*, 13, 2015; BASSAN, *Le operazioni non convenzionali della BCE al vaglio della Corte costituzionale tedesca*, in *Riv. dir. internaz.*, 2014, 361 ff.

[16]See PREDIERI, *Il potere della banca centrale: isola o modello?*, Firenze, Passigli, 1996.

[17]For a parallel between the recent financial crisis and the Great Depression of 1929, see CAPRIGLIONE, *Crisi a confronto (1929 e 2009)*, Padova, Cedam, 2009.

[18]With regard to the “constitutional impact” of the crisis, on the EU as well as on national legal orders, see CONTIADES (eds.), *Constitutions in the global financial crisis: a comparative analysis*, Farnham, Ashgate, 2013; DI GASPARE, *Diritto dell’economia e dinamiche istituzionali*, Padova, 2015, 257 ff.; TUORI – TUORI, *The Eurozone Crisis: A Constitutional Analysis*, Cambridge, CUP, 2014; BALAGUER CALLEJÓN, *Crisis económica y crisis constitucional en Europa*, in *Revista española de derecho constitucional*, 98, 2013, 91 ff.; CERRINA FERONI – FRANCO FERRARI (cur), *Crisi economico-finanziaria e intervento dello Stato: modelli comparati e prospettive*, Torino, Giappichelli, 2012; GRASSO, *Il costituzionalismo della crisi. Uno studio sui limiti del potere e sulla sua legittimazione al tempo della globalizzazione*, Napoli, Editoriale scientifica, 2012. Specifically on the impact on EU Constitution, denying that the responses to Eurocrisis determinined a “constitututional mutation” of the EU legal order, see (also for references to those who argued the opposite) DE WITTE, *Euro Crisis Responses and the EU Legal Order: Increased Institutional Variation or Constitutional Mutation?*, in *European Constitutional Law Review*, 3, 11, 2015, 434 ff. With regard to the role of the ECB during the crisis, see NAPOLITANO, *Il ruolo delle banche centrali nella gestione della crisi dell’Eurozona: osservazioni su alcuni aspetti istituzionali*, in ADINOLFI – VELLANO (eds.), *La crisi del debito sovrano degli stati dell’area Euro: profili giuridici*, Torino, 203, 66 ff.; RAFFIOTTA, *Il volto ambiguo della Banca centrale europea*, in MORRONE (ed.), *La costituzione finanziaria. La decisione di bilancio dello Stato costituzionale europeo*, Torino, 2015, 215 ff.

Moving from the SSM, Regulation No. 1024/2013 established an integrated and multilevel structure, transferring the direct supervision competences on the most systemically important banks to the ECB. The National supervising authority, instead, continues to carry out the supervision of "less significant banks"[20], although under the ultimate responsibility of the ECB[21].

The ECB's supervisory tasks are carried out by a Supervisory Board, which is composed of a Chairman, a Vice-Chairman, 4 representatives of the ECB and one representative from each national supervisory authority in the participating Member States. However, the ECB's Governing Council has the power to reject the Supervisory Board's decisions.

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[19]On the Banking Union project, see CAPRIGLIONE, *L'Unione bancaria europea: una sfida per un'Europa più unita*, Torino, Utet, 2013; BARUCCI – MESSORI (eds.), *Towards the European Banking Union: achievements and open problems*, Bagno a Ripoli, Passigli, 2014; CERRINA FERONI, *Verso il Meccanismo Unico di Vigilanza sulle Banche. Ruolo e prospettive dell'European Banking Authority*, in *Federalismi*, 17, 2014; PISANESCHI, *La regolazione comunitaria del credito tra European Banking Authority (EBA) e Banca centrale europea: prime osservazioni sul Single Supervisory Mechanism*, in MELICA – MEZZETTI – PIERGIGLI (eds.), *Studi in onore di G. De Vergottini*, III, Padova, Cedam, 2014, 2283 ff.; BOCCUZZI, *L'Unione bancaria europea. Nuove istituzioni e regole di vigilanza e di gestione delle crisi bancarie*, Roma, Bancaria, 2015; BUSCH – FERRARINI, *European Banking Union*, Oxford, OUP, 2015; CLARICH, *I poteri di vigilanza della Banca centrale europea*, in *Diritto pubblico*, 3, 2013, 975 ff.; ANTONIAZZI, *L'Unione bancaria europea: i nuovi compiti della BCE di vigilanza prudenziale degli enti creditizi e il meccanismo unico di risoluzione delle crisi bancarie*, in *Rivista italiana di diritto pubblico comunitario*, 3-4, 2014, 717 ff.; MANCINI, *Dalla vigilanza nazionale armonizzata alla Banking Union*, in *Quaderni di ricerca giuridica – Banca d'Italia*, 73, 2013, 10; CIRAOLO, *Il Regolamento UE n. 1024/2013 sul Meccanismo unico di vigilanza e l'Unione bancaria europea. Prime riflessioni*, in *Amministrazioni in Cammino*, 2014; QUAGLIA – HOWARTH, *The New Intergovernmentalism in Financial Regulation and European Banking Union*, in BICKERTON – HODSON – PUETTER (eds.), *The New Intergovernmentalism States and Supranational Actors in the Post-Maastricht Era*, Oxford, OUP, 2015, 146 ff.; DI MARCO, *Il controllo delle banche nell'UEM: la (problematica) nascita di un sistema integrato di vigilanza prudenziale*, in *Dir. Un. eur*., 3, 2013, 549 ff.; TORCHIA, *L'Unione bancaria europea: un approccio continentale?*, in *Giornale Dir. Amm.*, 2015, 1, 11 ff.; SCHIMMELFENNIG, *A differentiated leap forward: spillover, pathdependency, and graded membership in European banking regulation*, in *West European Politics*, 2016, 1 ff. For a comparison with the US experience, see KAISER, *Act of Congress: How America's Essential Institution Works, and How It Doesn't*, Vintage, 2014.

[20]At present, the ECB directly supervises the 120 biggest banking groups, covering almost 85% of the total banking assets of the Euro area. In particular, banks subject to direct supervision are those which have assets of more than € 30 billion or which account for at least 20% of their home country's GDP.

[21]Indeed, the ECB may decide to directly supervise the "less significant" banks if necessary to ensure consistent application of the supervisory standards.

With the introduction of the SSM, the role of the European Banking Authority (EBA) – within the European System of Financial Supervision (ESFS)[22] – is undergoing some important changes. In any case, the EBA – an agency already established with Regulation No. 1093/2010 – maintains the responsibility for the implementation of the Single Rulebook in the banking sector[23], participating moreover in the preparation of "bank stress tests".

Secondly, Regulation No. 806/2014 and Directive No. 59/2014 introduced the Single Resolution Mechanism, that is, an EU level system for the resolving of non-viable financial institutions.

On the one hand, the Single Resolution Mechanism is based on a distribution of tasks between an atypical European agency[24] – the Single Resolution Board – and the National authorities. The Board is directly responsible for the cross-border cases and for the significant banks, while the National authorities ensure the resolution of the other cases. However, the resolution scheme adopted by the Board enters into force only if, within 24 hours after its adoption by the Board, there are no objections from the Council (acting by simple majority) on a proposal by the Commission[25].

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[22]The ESFS is a system of micro (the European Supervisory Authorities, the European Banking Authority and the European Insurance and Occupational Pensions Authority) and macro-prudential authorities (the European Systematic Risk Board) created in 2010. On the relations between EBA and Banking Union (and their constitutional implication) see CERRINA FERONI, *Verso il Meccanismo Unico di Vigilanza sulle Banche. Ruolo e prospettive dell'European Banking Authority*, in *Federalismi*, 17, 2014; PISANESCHI, *Banca centrale europea, vigilanza bancaria e sovranità degli stati*, in *Federalismi*, 17, 2014.

[23] The Single Rulebook is a set of legal acts applied in all the EU which aims to harmonize the Member States' legislations, ensuring the same level of protection for consumers and an equal playing field for the banks in Europe. In particular, it includes the capital requirements directive IV (CRD IV), the capital requirements regulation (CRR), the amended directive on deposit guarantee schemes, the bank recovery and resolution directive (BRRD).

[24] The Single Resolution Board is formally an EU agency with a composition and independence which departs from the model of all other EU agencies, which are auxiliary bodies and are subordinate to the Commission. See MACCHIA, *The independence status of the Supervisory Board and of the Single Resolution Board: an expansive claim of autonomy?*, in BARUCCI – MESSORI (eds.), No. 19 *supra* 117 ff.

[25]"Immediately after the adoption of the resolution scheme, the Board shall transmit it to the Commission.
Within 24 hours from the transmission of the resolution scheme by the Board, the Commission shall either endorse the resolution scheme, or object to it with regard to the discretionary aspects of the resolution scheme in the cases not covered in the third subparagraph of this paragraph.

On the other hand, the SRM finds a fundamental component in the Single Resolution Fund (SRF). This common fund, which is financed with the contributions of the same banks of the Banking Union participant countries, will be used for resolving the failing credit institutions. At the same time, a precondition for accessing the fund is the application of the "bail-in" system. Indeed, in order to minimize the costs of the resolution of a failing entity borne by the taxpayers, Directive No. 59/2014 introduces some rules to avoid the application of the "bail-out" model. Precisely, the "bail-in" principles ensure that shareholders and creditors of the failing entity suffer appropriate losses and bear an appropriate part of the costs arising from the failure of the entity. Only if necessary will it be possible to resort to the Single Resolution Fund.

The SRF will be built up over a period of 8 years. However, in December 2013, a Statement by the Eurogroup and ECOFIN Ministers undertook to develop a common "backstop" and ensure "bridge financing" for the transitional phase, also through the resources of the European Stability Mechanism (ESM).

It is important to emphasize the asymmetry between the European System of Financial Supervision – which is a decentralized, multi-layered system of

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Within 12 hours from the transmission of the resolution scheme by the Board, the Commission may propose to the Council:
(a) to object to the resolution scheme on the ground that the resolution scheme adopted by the Board does not fulfill the criterion of public interest referred to in paragraph 1(c);
(b) to approve or object to a material modification of the amount of the Fund provided for in the resolution scheme of the Board.
The resolution scheme may enter into force only if no objection has been expressed by the Council or by the Commission within a period of 24 hours after its transmission by the Board.
The Council or the Commission, as the case may be, shall provide reasons for the exercise of their power of objection.
Where, within 24 hours from the transmission of the resolution scheme by the Board, the Council has approved the proposal of the Commission for modification of the resolution scheme on the ground referred to in point (b) of the third subparagraph or the Commission has objected in accordance with the second subparagraph, the Board shall, within eight hours modify the resolution scheme in accordance with the reasons expressed.
Where the resolution scheme adopted by the Board provides for the exclusion of certain liabilities in the exceptional circumstances referred to in Article 27(5), and where such exclusion requires a contribution by the Fund or an alternative financing source, in order to protect the integrity of the internal market, the Commission may prohibit or require amendments to the proposed exclusion setting out adequate reasons based on an infringement of the requirements laid down in Article 27 and in the delegated act adopted by the Commission on the basis of Article 44(11) of Directive 2014/59/EU" (art. 18, par. 7 Regulation No. 806/2014).

micro- and macro-prudential authorities with a competence for the whole EU – and the SSM/SSR. Indeed, the SSM and SSR rules find application only in the Eurozone and in those non-Euro countries that opt to join the Banking Union mechanisms.

However, it is undoubtedly significant (although in no way surprising) that in the new Juncker Commission, the portfolio concerning the Banking Union was conferred to Lord Hill, that is, to a commissioner coming from a state, the United Kingdom, which does not participate in the Banking Union.

Finally, Directive No. 49/2014 lays the foundation for the Deposit Guarantee Scheme. According to the Directive, Member States have to create a Deposit Guarantee Scheme financed with the sector bank contributions. In this way, should deposits be unavailable, it will be possible to reimburse a limited amount of deposits to depositors whose bank has failed.

5:5.1. The Euro-national parliamentary system research hypothesis finds a fundamental test in the recent trend towards the "parliamentarization" of the Banking Union governance[26]. Council Regulation (EU) No. 1024/2013 and Regulation (EU) No. 806/2014 of the European Parliament and the Council – despite some "pitch invasion" of the intergovernmental method – reserved several original oversight powers for the European Parliament (EP) and the National Parliaments (NPs) in the field of policies related to the prudential supervision of credit institutions and banking resolution. Although these powers are rarely configured as definitive and insuperable, they can nonetheless represent an an-

[26]The definition of the concept of "parliamentarization" is controversial. In any case, in this article, we will use this concept in a very broad meaning, that is to indicate the trend to empowerment of the parliamentary institutions within the European decision-making process: therefore including not only the European Parliament but also National Parliaments, Regional Parliaments and the instruments of interparliamentary cooperation, consistently with the approach of the Euro-national parliamentary system.

swer, regarding the banking policies pursued in the EU and in the Eurozone, to accountability and "democratic disconnect" problems[27].

Undoubtedly, these new forms of accountability do not substitute the tools which the European Parliament can exploit within the Monetary Dialogue and the Economic Dialogue. Pursuant to the first tool, the ECB shall address some periodical reports to the EP, which may adopt recommendations on the monetary policy of the ECB[28]. With regard to the Economic Dialogue, starting from the "Six-Pack" and "Two-Pack", some continuous interaction procedures have been introduced between the EP, Council, Commission, European Council and national institutions within the European semester[29].

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[27]According to LINDSETH, *Power and Legitimacy: Reconciling Europe and the Nation-State*, Oxford, OUP, 2010, the problem in Europe is not the "democratic deficit", in the sense of needing increased input legitimacy, but rather a "democratic disconnect". Indeed, the EU institutions are generally perceived as beyond the oversight of the national democratic and constitutional bodies, and this has a bearing on the scope of authority that Europeans believe supranational bodies can legitimately exercise. For the "*subsidiarity deficit*" thesis, see MACCORMICK, *Questioning Sovereignty. Law, State, and Nation in the European Commonwealth*, Oxford, OUP, 1999. For overview on the debate about the democratic deficit, see also RIDOLA, *The parliamentarisation of the institutional architecture of the European Union between representative democracy and participatory democracy*, in BLANKE – MANGIAMELI (eds.), *Governing Europe under a Constitution*, Berlin-Heidelberg, Springer, 2006, 415 ff.; CRAIG, *Integration, democracy and legitimacy*, in CRAIG – DE BURCA (eds.), *The evolution of EU Law*[2], Oxford, OUP, 2011, 13 ff.

[28]On the Monetary Dialogue, see AMTENBRINK – VAN DUIN, *The European Central Bank before the European Parliament: theory and practice after 10 years of monetary dialogue*, in *European Law Review*, 2009, 561 ff.; EIJFFINGER – MUJAGIC, *An Assessment of the Effectiveness of the Monetary Dialogue on the ECB's Accountability and Transparency: A Qualitative Approach*, in *Intereconomics*, 2004, 190 ff.; COLLIGNON, *Central Bank Accountability in Times of Crisis. The Monetary Dialogue: 2009-2014*, 2014, http://www.europarl.europa.eu. For the problem on the ECB democratic accountability, see AMTENBRINK, *On the Legitimacy and Democratic Accountability of the European Central Bank*, in ARNULL – WINCOTT (eds.), *Accountability and Legittimacy in the European Union: Legal Arrangements and practical experience*, Oxford, OUP, 2002, 147 ff.; AMTENBRINK, *The Democratic Accountability of Central Banks. A comparative study of the European Central Bank*, Portland, Hart Publishing, 1999; GORMLEY – DE HAAN, *The Democratic Deficit of the European Central Bank*, in *E.L. Review*, 1996, 95 ff.

[29]On the ambiguity of the "Economic Dialogue" concept, FASONE, *European Economic Governance and Parliamentary Representation. What Place for the European Parliament?*, in *European Law Journal*, 2, 2014, 164 ff., highlighting that "it is not clear what happens if the Economic Dialogue fails or if one of the institution does not fulfill its obligations. In many regards, its execution seems to be left to the voluntary commitment of the European Parliament, the Commission, the Council, the President of the European Council and the governments of the Member States". On the European Semester, see ARMSTRONG, *The New Governance of EU Fiscal Discipline*, in *European Law Review*, 5, 2013 601 ff.

To a certain extent, on the contrary, the parliamentary oversight powers established in the Banking Union framework seem to represent the partial re-production and enhancement of the format already experimented with the Monetary Dialogue and the Economic Dialogue.

In spite of a trend of literature to highlight the critical points rather than the merits of the Monetary Dialogue[30], some eminent scholars, in a "qualitative" evaluation of the relationship between the European Parliament and the ECB, underlined how the Monetary Dialogue has increased the transparency and the accountability of the ECB over time[31].

This element appears encouraging in view of the next steps of the BU. However, in this article any conclusion about the effectiveness of the oversight powers of the European Parliament and National Parliaments within the Banking Union governance will have only an open and provisional character. The period that has elapsed from the assumption of the prudential supervision competence by the ECB on 4 November 2014 is indeed too short. Moreover, as whole parts of the Banking Union project are incomplete or not fully implemented, in this phase the research can only take into consideration the fundamental data of the institutional practice in a minimum part.

As seen above, Regulations No. 1024/2013 and No. 806/2014 have transferred some relevant competences from national to EU level in the field of policies relating to the prudential supervision of credit institutions and banking resolutions.

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[30] According to the article 284, par. 3 TFEU "The European Central Bank shall address an annual report on the activities of the ESCB and on the monetary policy of both the previous and current year to the European Parliament, the Council and the Commission, and also to the European Council. The President of the European Central Bank shall present this report to the Council and to the European Parliament, which may hold a general debate on that basis. The President of the European Central Bank and the other members of the Executive Board may, at the request of the European Parliament or on their own initiative, be heard by the competent committees of the European Parliament". Although the art. 284, par. 3 TFEU requires only one meeting a year, the Monetary Dialogue takes place quarterly in the form of a meeting between the President of the ECB and the ECON Committee.

[31] See AMTENBRINK – VAN DUIN, No. 28 *supra*, which however highlighted some criticality of the Monetary Dialogue.

However, the EU has tried to balance this process of power transfer through the strength of the transparency and democratic accountability standards within the context of the supervision and resolution policies in the Eurozone.

In this framework, the ECB "shall be accountable to the European Parliament and to the Council for the implementation" of Regulation No. 1024/2013 (art. 20, par. 1), while the Single Resolution Board "shall be accountable to the European Parliament, the Council and the Commission" for the implementation of Regulation No. 806/2014 (art. 45, par. 1).

Therefore, the conferral of supervisory and resolution tasks from the Member States to the Union level in the field of the Banking Union is balanced by the promotion of the European Parliament oversight function, through the introduction of specific transparency and accountability standards. On the other hand, these new forms of accountability are not exempt from an "original intergovernmental flaw"[32].

First of all, the Regulation which transferred the prudential supervisory tasks to the ECB was adopted, in accordance with art. 127, par. 6 TFEU, following a special legislative procedure, within which the European Parliament was only consulted. This means that, without a more solid legal "umbrella", the Council could at any time make a clean sweep of the European Parliament and National Parliaments oversight powers within SSM governance (or, however, reshape these powers in a unilateral way). The fact that, in the current European political framework, this scenario appears unlikely does not change how things really stand, at least from a legal perspective.

Another sign of the "intergovernmental original flaw" can be traced back to the status of the "Agreement on the transfer and mutualisation of contribu-

[32] On the "*vizio d'origine "intergovernativo*" ("original intergovernmental flaw") of the new forms of accountability within the Banking Union, see IBRIDO – PECORARIO, *Unione bancaria e sistema parlamentare euro-nazionale*, in *DPCE*, 1, 2016, forthcoming.

tions to the SRF". Despite an initial outcry from the European Parliament[33], Regulation No. 806/2014, adopted in accordance with an ordinary legislative procedure *ex* art. 114 TFEU, transferred an essential part of the matter to an intergovernmental agreement (and therefore an international legal source), causing many protests by the European Parliament given that art. 114 TFEU, for the unanimous admission of the legal services of the three main institutions, constituted the most appropriate legal basis.

5.2 In any case, the European Parliament's oversight powers within the Single Supervision Mechanism are only partially defined by Regulation (EU) No. 1024/2013. Indeed, art. 20, par. 9 refers to an Interinstitutional Agreement between the European Parliament and the ECB for the concrete definition of the "practical modalities of the exercise of democratic accountability and scrutiny over the exercise of the tasks conferred on the ECB by this Regulation"[34].

In a similar manner, art. 45, par. 7 and 8 of Regulation No. 806/2014 established that the European Parliament and Single Resolution Board would set out an Agreement to define the European Parliament oversight powers of the activity of the Board.

The Interinstitutional Agreement between the European Parliament and ECB was published on 30 November 2013 in the Official Journal of the European Union. Instead, the European Parliament and Single Resolution Board concluded the second Agreement on 16 December 2015.

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[33] See the letter of 20 January 2014 from the European Parliament President to the President of the Commission on the Single Resolution Fund, in which Martin Schulz stood against the decision of the Council to take certain aspects out of Regulation No. 806/2014 and dealt with them through an intergovernmental procedure. With regard to the problem of the legal basis of the Single Supervision Mechanism, see TOSATO, *The legal basis of the Banking Union*, in BARUCCI – MESSORI (eds.), *Towards the European Banking Union: achievements and open problems*, No. 19 *supra*, 43 ff.

[34] Moreover, in December 2013 the Council of the European Union and the European Central bank signed a Memorandum of Understanding on the cooperation related to the Single Supervisory Mechanism. The Memorandum implemented the accountability and reporting obligation of the ECB to the Council and the Euro Group under Regulation (EU) No. 1024/2013.

The Interinstitutional Agreement between the European Parliament and ECB can be divided into 4 parts.

First of all, the Agreement defined some specific oversight procedures: a) the presentation of an Annual Report of the ECB at a public hearing of Parliament. The Report concerns the execution of supervisory tasks within the SSM[35]; b) the power of the ECON Committee of the European Parliament to convene the Chairman of the Supervisory Board for ordinary hearings, ad hoc exchanges of views and confidential meetings[36]; c) the duty of the ECB to reply in writing to

[35]"The ECB shall submit every year a report to Parliament ("Annual Report") on the execution of the tasks conferred on it by Regulation (EU) No 1024/2013. The Chair of the Supervisory Board shall present the Annual Report to Parliament at a public hearing. The draft Annual Report shall be made available to Parliament on a confidential basis in one of the Union official languages four working days in advance of the hearing (…) During the start-up phase referred to in Article 33(2) of Regulation (EU) No 1024/2013, the ECB shall transmit to Parliament quarterly reports on progress in the operational implementation of the Regulation (…) The ECB shall publish the Annual Report on the SSM website. The ECB's "information e-mail hotline" will be extended to deal specifically with SSM-related questions, and the ECB shall convert the feedback received via e-mails into a FAQ section on the SSM website" (art. I.1 of the Interinstitutional Agreement between the European Parliament and the ECB).

[36]"The Chair of the Supervisory Board shall participate in ordinary public hearings on the execution of the supervisory tasks on request of Parliament's competent committee. Parliament's competent committee and the ECB shall agree on a calendar for two such hearings to be held in the course of the following year. Requests for changes to the agreed calendar shall be made in writing.

–In addition, the Chair of the Supervisory Board may be invited to additional ad hoc exchanges of views on supervisory issues with Parliament's competent committee.

– Where necessary for the exercise of Parliament's powers under the TFEU and Union law, the Chair of its competent committee may request special confidential meetings with the Chair of the Supervisory Board in writing, giving reasons. Such meetings shall be held on a mutually agreed date.

–All participants in the special confidential meetings shall be subject to confidentiality requirements equivalent to those applying to the members of the Supervisory Board and to the ECB's supervisory staff.

– On a reasoned request by the Chair of the Supervisory Board or the Chair of Parliament's competent committee, and with mutual agreement, the ordinary hearings, the ad hoc exchanges of views and the confidential meetings can be attended by the ECB representatives in the Supervisory Board or senior members of the supervisory staff (Director Generals or their Deputies).

–The principle of openness of Union institutions in accordance with the TFEU shall apply to the SSM. The discussion in special confidential meetings shall follow the principle of openness and elaboration around the relevant circumstances. It involves the exchange of confidential information regarding the execution of the supervisory tasks, within the limit set by Union law. The disclosure might be restricted by confidentiality limits legally foreseen.

–Persons employed by Parliament and by the ECB may not disclose information acquired in the course of their activities related to the tasks conferred on the ECB under Regulation (EU) No 1024/2013, even after such activities have ended or they have left such employment.

written questions put to it by the European Parliament as promptly as possible, and in any event within five weeks of their transmission to the ECB[37]; d) the possibility for the European Parliament to access some categories of information in possession of the ECB[38].

Secondly, in the attempt to strengthen the standard of transparency in the selection process of the Chairman and Vice-Chairman of the Supervisory Board, the interinstitutional agreement of 30 November 2013 submitted their appointment to Parliament's approval, which is held at a public hearing of the candidates proposed by the ECB. If the proposal for the Chair is not approved, the ECB may decide either to draw on the pool of candidates that originally applied for the position or to re-initiate the selection process. From this point of

–The ordinary hearings, ad hoc exchanges of views and the confidential meetings can cover all aspects of the activity and functioning of the SSM covered by Regulation (EU) No 1024/2013.
–No minutes or any other recording of the confidential meetings shall be taken. No statement shall be made for the press or any other media. Each participant to the confidential discussions shall sign every time a solemn declaration not to divulge the content of those discussions to any third person.
– Only the Chair of the Supervisory Board and the Chair and the Vice-Chairs of Parliament's competent committee may attend the confidential meetings. Both the Chair of the Supervisory Board and the Chair and the Vice-Chairs of Parliament's competent committee may be accompanied by two members of respectively ECB staff and of Parliament's Secretariat" (art. I.2 of the Interinstitutional Agreement between the European Parliament and the ECB).

[37]"The ECB shall reply in writing to written questions put to it by Parliament. Those questions shall be channeled to the Chair of the Supervisory Board via the Chair of Parliament's competent committee. Questions shall be replied as promptly as possible, and in any event within five weeks of their transmission to the ECB.
– Both the ECB and Parliament shall dedicate a specific section of the websites for the questions and answers referred to above" (art. I.3 of the Interinstitutional Agreement between the European Parliament and the ECB).

[38]"– The ECB shall provide Parliament's competent committee at least with a comprehensive and meaningful record of the proceedings of the Supervisory Board that enables an understanding of the discussions, including an annotated list of decisions. In the case of an objection of the Governing Council against a draft decision of the Supervisory Board in accordance with Article 26(8) of Regulation (EU) No 1024/2013, the President of the ECB shall inform the Chair of Parliament's competent committee of the reasons for such an objection, in line with the confidentiality requirements referred to in this Agreement.
– In the event of the winding-up of a credit institution, non-confidential information relating to that credit institution shall be disclosed ex post, once any restrictions on the provision of relevant information resulting from confidentiality requirements have ceased to apply.
– The supervisory fees and an explanation of how they are calculated shall be published on ECB website.
– The ECB shall publish on its website a guide to its supervisory practices" (art. I.4 of the Interinstitutional Agreement between the European Parliament and the ECB).

view, these provisions present some analogies with the appointment procedure of the European Banking Authority Chairperson[39].

The European Parliament can use this sort of veto power also in relation to the ECB's proposal to remove the Chairman and the Vice-Chairman of the Supervisory Board from their office[40].

Moreover, in the case that the European Parliament sets up a Committee of Inquiry[41], the ECB, in accordance with Union law, shall assist a Committee of Inquiry in carrying out its tasks in accordance with the principle of sincere cooperation. Against this support, the European Parliament shall respect some confidentiality obligations[42].

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[39]According to the art. 48 of Regulation (EU) No 1093/2010 of the European Parliament and of the Council, the European Banking Authority Chairperson shall be appointed by the EBA Board of Supervisors, following an open selection procedure. However, before taking up his duties, and up to 1 month after the selection, the European Parliament may, after having heard the candidate selected by the Board of Supervisors, object to the designation of the selected person.

[40]"– The approval process shall comprise the following steps:
– The ECB shall convey its proposals for the Chair and the Vice-Chair to Parliament together with written explanations of the underlying reasons.
– A public hearing of the proposed Chair and Vice-Chair of the Supervisory Board shall be held in Parliament's competent committee.
– Parliament shall decide on the approval of the candidate proposed by the ECB for Chair and Vice-Chair through a vote in the competent committee and in plenary. Parliament will normally, taking into account its calendar, aim at taking that decision within six weeks of the proposal.
– If the proposal for the Chair is not approved, the ECB may decide either to draw on the pool of candidates that applied originally for the position or to re-initiate the selection process, including elaborating and publishing a new vacancy notice.
– The ECB shall submit any proposal to remove the Chair or the Vice-Chair from office to Parliament and provide explanations.
– The approval process shall comprise:
– a vote in Parliament's competent committee on a draft resolution; and
– a vote in plenary, for approval or objection, on that resolution". (art. II of the Interinstitutional Agreement between the European Parliament and the ECB).

[41]The main legal basis of the Committee of Inquiry is the art. 226 TFEU. According to this provision, the European Parliament may – at the request of a quarter of its members – set up a temporary Committee of Inquiry to investigate alleged contraventions or maladministration in the implementation of Union law. More detailed provisions about the European Parliament's right of inquiry are contained in the Decision 95/167/EC, Euratom, ECSC of the European Parliament, the Council and the Commission of 19 April 1995.

[42] All recipients of information provided to European Parliament in the context of investigations shall be subject to confidentiality requirements equivalent to those applying to the members of the Supervisory Board and to the ECB supervisory staff and Parliament and the ECB shall agree on the measures to be applied to ensure the protection of such information. Moreover, where the protection of a public or private interest recognised in Decision 2004/258/EC requires that confidentiality is maintained, European Parliament shall ensure that this protection is maintained and shall not divulge the content of any such information

Finally, according to the interinstitutional agreement, the ECB shall pre-emptively inform the ECON Committee with regard to the main contents of some categories of acts which the ECB drafts to adopt within the SSM[43]. This obligation is established also with reference to the Code of Conduct referred to in art. 19 of Regulation No. 1024/2013[44].

The European Parliament oversight powers defined by Regulation No. 806/2014 mirror, in great part, the powers established by Regulation No. 1024/2013 and by the Interinstitutional agreement of November 2013. Indeed, the Chairman of the Single Resolution Board shall submit an Annual report to the European Parliament, to participate at the public hearing of the ECON Committee (at least once a year), to hold confidential discussions behind closed doors with the Chairman and Vice- Chairman of the ECON Committee.

Moreover, the Single Resolution Board shall reply orally or in writing to questions addressed to it by the European Parliament within five weeks and shall support the European Parliament investigation[45].

Finally, the European Parliament confirms the appointment[46] and the removal[47] of the Chair, Vice-Chair and four other full-time members of the Single Resolution Board.

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[43]"– The ECB shall duly inform Parliament's competent committee of the procedures (including timing) it has set up for adoption of ECB regulations, decisions, guidelines and recommendations ("acts"), which are subject to public consultation in accordance with Regulation (EU) No 1024/2013.
–The ECB shall, in particular, inform Parliament's competent committee of the principles and kinds of indicators or information it is generally using in developing acts and policy recommendations, with a view to enhancing transparency and policy consistency.
–The ECB shall transmit to Parliament's competent committee the draft acts before the beginning of the public consultation procedure. Where Parliament submits comments on the acts, there may be informal exchanges of views with the ECB on such comments. Such informal exchanges of views shall take place in parallel with the open public consultations which the ECB shall conduct in accordance with Article 4(3) of Regulation (EU) No 1024/2013.
– Once the ECB has adopted an act, it shall send it to Parliament's competent committee. The ECB shall also regularly inform Parliament in writing about the need to update adopted acts". (art. V of the Interinstitutional Agreement between the European Parliament and the ECB).

[44]The Code of Conduct is a set of rules which establish proper practices for the ECB staff and management involved in banking supervision concerning in particular conflicts of interest.

[45]According to the art. 128 of the European Parliament Rules of Procedure, questions for oral answer with debate may be put to the Council or the Commission by a committee, a political group or at least 40 Members.

As seen in this overview, the European Parliament's oversight powers within the Banking Union appear variegated and heterogeneous: some of these can in fact be attributed to a passive function, like for instance, the right of the ECON Committee to receive a report of the Supervisory Board's meetings. In other cases, these powers have a more active nature, in which the European Parliament is called upon to give its own views. Sometimes, this active role can include powers of a positive type, such as, in particular, the comments that the European Parliament can transmit to the ECB regarding the drafting of acts. Otherwise, the European Parliament's active oversight function can include powers of a negative type. This is the case of the opposition power to the appointment of the Chairman of the Supervisory Committee.

The "*fil rouge*" of this cluster of powers can instead be traced back to the tension between the demands of publicity – which represents the traditional reason for the oversight function – and the necessity to preserve the confidentiality of the work of the ECB and the Single Resolution Board. This is a very important point, given that a surplus of publicity can compromise the efficacy of the supervisory and resolution action, proper market behavior and the very capacity of the European Parliament to obtain information[48].

From this point of view, the special regime of publicity established by the "confidential meetings" (art. I.2) is emblematic. These meetings may be at-

[46]The Single Resolution Board shall be composed of the Chair, four other full-time members and a member appointed by each participating Member State (representing their national resolution authorities). The Chair, the Vice-Chair and the four full-time members shall be chosen on the basis of an open selection procedure. In particular, the Commission shall submit a proposal for the appointment of the Chair, the Vice-Chair and the full-time to the European Parliament for approval. Following the approval of that proposal, the Council, acting by qualified majority, shall adopt an implementing decision to appoint these members.

[47]If the Chair or the Vice-Chair or a full-time member no longer fulfills the conditions required for the performance of his or her duties or has been guilty of serious misconduct, the Council, acting by qualified majority, and on a proposal from the Commission which has been approved by the European Parliament, may adopt an implementing decision to remove him or her from office.

[48]On the need to control the publicity of parliamentary committees' activity, especially after the transformations due to the internet, see FASONE - LUPO, *Transparency vs. Informality in Legislative Committees. Comparing the US House of Representatives, the Italian Chamber of Deputies and the European Parliament*, in *The Journal of Legislative Studies*, 3, 2015, 342 ff.

tended only by the President of the Supervisory Board, the Chairman and Vice-Chairman of the ECON Committee and two senior members of the ECB staff and the Parliament's Secretariat. No minutes of the proceedings or any other recording of the confidential meetings shall be taken. No statement shall be made to the press or any other media. Moreover, each participant at the confidential discussions shall sign a solemn declaration every time not to divulge the content of those discussions to any third person.

The binding nature and the "enforcement" of the interinstitutional agreement (and, even more so, of other typologies of agreements) in the framework of EU source of law are debatable[49]. In principle, the interinstitutional agreements are a species of the wider typology of atypical acts (that is, acts not provided for by art. 288 TFEU). However, the difficulties to define the position of these acts are increased by the fact that some of these agreements find a legal basis in the Treaties, while others may be deemed at the most only the expression of the principle of "mutual sincere cooperation" (art. 13, par. 2 TEU).

The two agreements that the European Parliament had to conclude within the Banking Union do not find the "umbrella" of art. 295 TFEU, which allows Council, Commission and European Parliament to adopt binding interinstitutional agreements. Therefore the legal basis of these agreements can be traced back only to the Regulations concerning the SSM and SRM (nevertheless with the additional "umbrella" of the already mentioned art. 13, par. 2 TEU).

6:6.1. Although less incisive in comparison with the tools of the European Parliament, the oversight powers that art. 21 of Regulation No. 1024/2013 and

[49]See HUMMER, *From "Interinstitutional Agreements" to Interinstitutional Agencies/Offices?* in *European Law Journal*, 1, 2007, 47 ff.; TOURNEPICHE, *Les accords intérinstitutionnels dans l'Union européenne*, Bruxelles, Bruylant, 2011; SBOLCI, *Conflitti tra istituzioni dell'Unione europea e accordi interistituzionali*, in *Riv. dir. internaz.*, 2, 2007, 344 ff.; STACEY, *Integrating Europe. Informal politics & institutional Change*, Oxford, 2010; FIENGO, *Brevi riflessioni in tema di natura giuridica ed efficacia degli accordi interistituzionali alla luce del Trattato di Nizza*, in *DPCE*, 1, 2002, 13 ff.

art. 46 of Regulation No. 806/2014 reserved for the National Parliaments also appear relevant. Rather, according to some scholars the National Parliaments' participation in the Banking Union governance exceeds the oversight function usually played by these bodies towards the National Central Banks[50].

First of all, like the European Parliament, the National Parliaments also receive the annual reports from the ECB and the Single Resolution Board. In turn, the National Parliaments can "react" to them, addressing their reasoned observations on the reports to the ECB and Single Resolution Board.

Secondly, through their own procedures the National Parliaments may request the ECB and Resolution Board to reply in writing to any observations or questions submitted by them.

Finally, the National Parliaments may invite the Chairman or a member of the Supervisory Board and the Chairman of Resolution Board to participate in an exchange of views together with a representative of the competent national authority. However, the terminology used by the Regulations is ambiguous: the reference to "exchange of views" rather than "hearings" – a tool which instead could be activated by the European Parliament and Euro Group – could be interpreted as the exclusion from the possibility to organize meetings with the same level of formality and publicity typical of the hearings in the National Parliaments' Rules of Procedure.

It is important to emphasize that the involvement of the National Parliaments is also the result of the contribution of these institutions within the political dialogue procedure. Some National Parliaments – this is the case, for example, of the Czech Republic and Denmark[51] – asked for an empowerment of

[50]See MANZELLA, *Parlamento europei e Parlamenti nazionali come sistema*, No. 4 *supra*, at 10.

[51]On 13 March 2013, a Resolution of the Senate of the Parliament of the Czech Republic observed that the "new tasks on the European Central Bank concerning policies relating to the supervision of banks leads to a significant concentration of power in the hands of one institution (…). It is, therefore, necessary to ensure that the ECB is, in the exercise of this function, subject to democratic control, not only by the European Parliament, but also, in particular (…) National Parliaments, because the responsibility for the stability of the financial system (including financial guarantees to depositors) will continue to lie with the Member States". Instead, on 10

the role of the National Parliaments within the Banking Union governance in the comments transmitted to the Commission[52].

Obviously, the catalogue of National Parliaments powers within the Banking Union should be interpreted also in the light of the oversight tools that each Chamber can activate on its own Government by virtue of the domestic constitutional law. As has been seen, indeed, the ECB and the SRB are accountable also to the Council. Consequently, according to the "Europeanization clause" of the national institutional framework contained in art. 10, par. 2 TEU, Member States are represented in the Council by their governments, themselves democratically accountable either to their National Parliaments, or to their citizens.

As clarified by the preamble of the two above mentioned Regulations, the involvement of the National Parliaments is aimed to counterbalance the potential impact that Banking Union measures may have on public finances, credit institutions, their customers and employees, and the markets in the participating Member States.

However, this catalogue did not confer oversight powers to all National Parliaments, but only to the Chambers of the Eurozone and also the Parliaments of the countries, not included in the Eurozone but which have established a close cooperation in the Banking Union field (the so-called, "'participating Member States"). This element introduces a relevant component of differentiation in comparison with the European Parliament: while the involvement of the National Parliaments in this field reflects the "variable geometries" of the "asymmetric Union", the European Parliament composition instead expresses

July 2013 the European Affairs Committee of the Danish Parliament presented an Opinion concerning the EU Commission proposal for a Regulation on the Single Resolution Mechanism. The majority was pleased that the proposal ensured that the Single Resolution Board must inform National Parliaments of its activities and answer questions submitted by the Parliaments. In this framework, the majority support the view that National Parliaments should be able to invite the Executive Director of the Single Resolution Board to participate in an exchange of views.

[52]On the "political dialogue", see, *ex multis*, D. JANCIC, *The Barroso Initiative: Window Dressing or Democracy Boost?*, in *Utrecht Law Review*, 2012, 78 ff.

the traditional indifference of this institution to the “differentiated integration” models[53].

According to one of the possible classification criteria[54] we can distinguish among four kinds of National Parliaments “European powers”: a) powers individually attributed to each Chamber; b) powers attributed to each National Parliament, thus requiring a double approval in the case of bicameral systems; c) powers attributed to a “group of chambers”, which require the achievement of some threshold; d) powers exercised in collective form, in the case with the involvement of the European Parliament.

Therefore, the National Parliaments’ powers within Banking Union governance can be classified in the first category. At the most, in some countries like Spain, where a bicameral Committee for the EU is provided, the National Parliaments can consider the possibility to exercise powers of the second type.

The question of the “individual” or “collective” nature of the National Parliaments’ oversight powers makes it possible to deal with a fundamental point. According to some scholars, the National Parliaments’ individual action integrates an indirect source of democratic legitimacy (affecting the domestic level in a way not so dissimilar to the “pluralist paradigm” identified by the *Maastricht-Urteil*). On the contrary, the National Parliaments’ collective action would ensure a *quantum* of legitimacy which is not mediated by the democratic resources of the Member States[55].

This interpretation, which may be too schematic, needs to be problematized. The border line between the “individual action” and “collective action” of the National Parliaments is indeed much more uncertain than may appear at

[53]See FASONE, *Il Parlamento europeo nell’Unione asimmetrica*, in MANZELLA – LUPO (eds.), No. 4 *supra* at 51 ff.
[54]See LUPO, *National parliaments in the European integration process: re-aligning politics and policies*, in CARTABIA – LUPO – SIMONCINI (edt.), *Democracy and subsidiarity in the EU National Parliaments, regional and civil society in the decision-making process*, Bologna, il Mulino, 2013, 107 ff.
[55]See KNUTELSKÁ, *Cooperation among National Parliaments: An Effective Contribution to EU Legitimation?* in CRUM – FOSSUM (edt.), *Practices of Inter-parliamentary Coordination in International Politics: The European Union and Beyond*, Essex, ECPR Press, 2013, 35 ff.

first sight. For example, how to frame these interparliamentary cooperation forms which aim to put the Parliaments in the best conditions for the activation of the European procedures on an individual basis[56]?

In fact, the chances of success of the new democratic accountability mechanisms largely depends on the predisposition of adequate interparliamentary cooperation forms – not expressly provided for by Regulations No. 1024/2013 and 806/2014. Without a doubt, the point is not to add a new and further body specialized on the Banking Union affairs to the already overcrowded family of interparliamentary cooperation bodies. The point is instead to exploit the already existing cooperation structures or however to activate fast informal cooperation channels among Parliaments. It suffices to imagine, for example, the opportunity to organize ad hoc meetings between the European Parliament ECON Committee and the National Parliaments' specialized Committees. From this point of view, the interparliamentary cooperation in the Banking Union field has at least three important advantages.

First of all, the exchange of information and good practice would make it possible to take care of the problem of the "informational asymmetry" which has been identified by eminent scholars as one of the main factors at the basis of the "executive dominance issue"[57].

Secondly, the cooperation in the Banking Union field could help to strengthen the connection and the complementarity among the European Par-

[56] On interparliamentary cooperation, see CRUM – FOSSUM (eds.), *Practices of Interparliamentary Coordination in International Politics. The European Union and Beyond*, Essex, ECPR Press, 2013; COOPER, *Parliamentary oversight of the EU after the crisis: on the creation of the "article 13" interparliamentary conference*, SOG Working Paper Series, 2014; DECARO – LUPO (eds.), *Il "dialogo" tra Parlamenti: obiettivi e risultati*, Roma, Luiss University Press, 2009; ESPOSITO, *La cooperazione interparlamentare: principi, strumenti e prospettive*, in MANZELLA – LUPO (eds.), *Il sistema parlamentare euro-nazionale. Lezioni*, No. 4 *supra*, 133 ff.; DICOSOLA, *I Presidenti di Assemblea nella cooperazione interparlamentare in Europa*, in GIANFRANCESCO – LUPO – RIVOSECCHI (eds.), *I Presidenti di Assemblea parlamentare. Riflessioni su un ruolo in trasformazione*, Bologna, il Mulino, 2014, 331 ff.

[57] See CURTIN, *Challenging Executive Dominance in European Democracy*, in *The Modern Law Review*, 1, 2014, 1 ff. and notably 15.

liament and National Parliaments, reversing the trend of these institutions to interpret their relationships in competitive terms[58].

Finally, a third advantage consists in the contribution which the interparliamentary cooperation can offer the National Parliaments' "Europeanization"[59]. In this framework, the cooperation appears able to increase the National Parliaments' awareness to work, also in this sector, within a systemic and interconnected European dimension, fostering a fruitful process of global interaction among National Parliaments' Rules of Procedures. In this way, the parliamentary oversight procedures in the Banking Union field can be "exchanged", developed, improved and integrated in their own national context.

6.2 As mentioned above, the setting up of new oversight powers needs an implementation of the National Parliaments' internal procedures. Regarding the power to address the observations to the ECB and the Board, the same Regulations No. 1024/2013 and 806/2014 require an upgrade of the National Parliaments' Rules of Procedure.

The main choice that National Parliaments are called upon to make will be that of defining the relations between the competent Committee for the banking sector and the Committee on European affairs. From this point of view, the German Bundestag experience and that of the French National Assembly seem to point to the existence of two opposing philosophies[60].

The German Bundestag – which significantly was the first Parliament to set up new oversight mechanisms introduced with Regulation No. 1024 of 2013

[58] See FASONE – LUPO, *Conclusion. Interparliamentary Cooperation in the Framework of a Euro-National Parliamentary System*, in FASONE – LUPO (eds.), *Interparliamentary cooperation in the composite European Constitution*, Hart, Forthcoming.

[59] On the concept of "Europeanization" see RADAELLI – EXADAKTYLOS, *New Directions in the Europeanization Research*, in EGAN – NUGENT – PATTERSON (eds.), *Research Agendas in EU Studies. Stalking the Elephant*, Houndmills, Palgrave Macmillan, 2010, 189 ff.; FABBRINI (ed.), *L'europeizzazione dell'Italia*, Roma-Bari, Laterza, 2003, 3 ff.

[60] On the relations between the European affairs committees and the sectorial standing committees, see FROMAGE, *Standing Committees in Interparliamentary Cooperation in the Post-Lisbon Era: Towards the End of the European Affairs Committees' Predominance?*, in FASONE – LUPO (eds.), *Interparliamentary cooperation in the composite European Constitution*, Hart, Forthcoming.

– gave precedence to the role of the Committee competent in such matters, namely the Budget Committee. On 8 September 2014, the President of the Supervisory Board, accompanied by the President of the German Financial Supervisory Authority was heard before the Committee in a 'closed-doors exchange of views'.

Unlike the German Parliament, in France the Committee specialized in EU affairs has maintained its role of "*dominus*" of European procedures, and in that capacity on 16 December 2014 it proceeded to the public hearing of the President of the Supervisory Committee and the Secretary General of the National Prudential Supervision and Resolution Authority. It is true that the Rules of Procedure of the French National Assembly do foresee a double membership (of sector Committee and European Affairs Committee). Nevertheless, this latter body did not even consider coordinating with the Budget Committee, for example, by means of the calling of a joint hearing.

The political implications at the basis of these different procedural choices cannot escape notice: in the Bundestag the interlocutors of the Supervisory Board were deputies specialized in finance, banking and insurance matters and the very choice to proceed "with closed doors" constitutes further proof of the will of the German MPs to obtain non generic information perhaps unsuitable to being made public to the markets. On the other hand, in the French National Assembly, the representatives of the Supervisory Committee were able to exchange views with a body with "transversal" competence and in fact the minutes of the meeting mirror the reality of an undoubtedly interesting debate but which is still focused on the "broad outlines" of the issues of banking supervision.

The German Bundestag was furthermore the first – and until now the only – Parliament to have organized a hearing of the President of the Single Resolution Board setting in motion the powers foreseen by Regulation No. 806 of 2014. Moreover, it is significant that this faculty was exercised not so much in the perspective of oversight of the activity of the SRB – a body that was only established a few months ago – as rather to ask the Board for an opinion with regard to the national legislative measures for the implementation of Regulation No. 806 of 2014 being examined by the Bundestag.

A further point concerns the role of the upper Chambers. At the moment, the only Upper Chamber to have exploited oversight powers in the context of the Banking Union is the Italian Senate. This is perhaps not fortuitous considering that the perfect Italian bicameralism does not penalize the competences of the Senate in policies regarding banking[61]. Nevertheless, on 23 June 2015, the Italian representative of the Supervisory Board, Ignazio Angeloni, intervened in the Finance and Treasury Committee during a fact-finding investigation already started by the Senate. Furthermore, the different formal framework that the Senate and the ECB gave to this meeting must be noted: while the President of the Finance Committee identified the juridical legal basis of the meeting in art. 48 of the Rules of the Senate (hearings of experts during fact-finding investigations), in its website the Supervisory Board referred to an "exchange of opinions" according to art. 21 of Regulation No. 1024 of 2013.

Following the coming into force of the Treaty of Lisbon, some National Parliaments – and in particular those of Spain, Ireland and Belgium – attributed the competence for establishing the new "European powers" appertaining to National Parliaments to a bicameral Committee. It is foreseeable that great part of these systems will choose to extend also the competences regarding the banking Union to such bicameral Committees. This is furthermore a solution that in our opinion presents a number of drawbacks: there is no doubt that the setting up of a bicameral Committee within the differentiated bicameral systems has the advantage of contributing to a rebalancing of the positions between the two Houses. And however, also in this case the sectorial Committee

[61] On the Europeanization of the upper Chambers, see KIIVER, *The Early Warning System for the Principle of Subsidiarity. Constitutional theory and empirical reality*, London – New York, Routledge, 2012, 62 ff.; ROMANIELLO, *Second Chambers in EU Affairs*, Roma, Pioda, 2015.

specialized in banking issues would end up being excluded from the dialogue circuit with the European institutions, thus accentuating competitive attitudes among National Parliaments and European decision-makers. The prudential supervision and resolution policies – it must be stated once again – represent matters that are far too technical to be assigned to bodies having "transversal" competence.

With specific reference to the implementation of internal Italian Parliament procedures, it is possible to anticipate four different scenarios.

A first path could consist of a Rules of Procedure reform which aims to introduce "ad hoc" tools for the implementation of art. 21 of Regulation No. 1024/2013 and art. 46 of Regulation No. 806/2014. Nevertheless, this is the most stringent solution from a formal point of view, and at the same time it is the most difficult to accomplish. In the light of the current obstacles met by the reform projects of both the Chamber and the Senate, a formal modification of the Rules of Procedure is indeed improbable, at least in the short term. After all, the idea of a maintenance and upgrade of parliamentary law rules through typical procedures seems to have gone out of fashion within the Italian Parliament[62].

A second solution, which basically retraces the path followed by the Chamber on the occasion of the implementation of the National Parliaments' European powers established by the Lisbon Treaty could consist in an opinion by the Committee on the Rules of Procedure (*Giunta per il Regolamento*). In this case, the Committees on the Rules of Procedure, with the exception of some adjustments, could limit themselves to applying the already existent procedures with an analogical interpretation (for example, equalizing the BCE and Single Resolution Board reports to the documents transmitted to the National Parliaments within the political dialogue). Otherwise, they could adopt an opinion

[62]See LUPO, *"Codificazione" dei precedenti o valorizzazione della Camera? I presupposti dell'ipotesi di riforma del regolamento della Camera e alcune possibili integrazioni*, in *Oss. fon.*, 1, 2014; POLI, *Dinamiche del sistema politico e formazione delle regole di diritto parlamentare: una tassonomia dei pareri delle Giunte per il Regolamento*, in *Oss. fon.*, 4, 2014.

with a more innovative character. However, the flippant recourse to "experimental procedures" through recommendations by the Committee on the Rules of Procedure was subject to severe criticism by scholars (especially with regard to the adoption of "experimental procedures" in violation of the "*nemine contradicente*" constitutional custom)[63].

The compliance of the internal procedures with the new National Parliaments' powers established in the Banking Union sector could also occur – this is the third scenario – on the basis of a Presiding Officer's decision, possibly together with the Presiding Officers of the Finance and EU affairs Committees. This model is quite similar to the one followed after the Lisbon Treaty, when the experimental procedure concerning the subsidiarity scrutiny was defined through a letter of the Presiding Officer to the Committee's Presiding Officer [64].

Finally, in the light of the "culture" of the Italian Parliament, it is not possible to exclude that, after having experimented the "zero option"[65] on the occasion of the implementation of the Lisbon Treaty innovations, the Houses would decide to pass to the "below zero option": keeping the current procedural framework intact, abstaining from the use of the new powers established in the Banking Union field and at the most sending the European authority informal letters of the Finance Committees (should it be necessary in agreement within their own Committee Board).

There is no point in adding that it would be a pity: this minimalist approach would not help either to increase the transparency and democratic accountability level within Banking Union governance or least of all to modernize

[63]Indeed, the experimental procedure introduced through a Committee on the Rules of Procedure recommendation represents a waive of the Rules of Procedure. See POLI, No. 62 *supra*, above all 16 ff.; FASONE, *Quale è la fonte più idonea a recepire le novità del Trattato di Lisbona sui Parlamenti nazionali?*, in *Oss. fon.*, 3, 2010, notably p. 6 ff.; IBRIDO, *"In direzione ostinata e contraria". La risposta della Corte costituzionale alla dottrina della sindacabilità dei Regolamenti parlamentari*, in *Rivista AIC*, 3, 2014, above all 13.

[64]See the letter of 6 October 2006 from the Senate President to the Presidents of the permanent Committee.

[65]According to the expression proposed by FASONE – GRIGLIO – PICCIRILLI, *The implementation of the Lisbon Treaty in the parliamentary rules of procedure. The Italian "zero-option" in comparative perspective*, paper – XIX *Annual Conference* del *Council for European Studies*, Boston, USA, Columbia University, 2012.

the Houses, which are nowadays called upon to Europeanize their organization and working modalities.

7. The evaluation of the National Parliaments' powers in the Banking Union governance is controversial: as seen, while some constitutional law scholars underline that these powers exceed the oversight function usually played by the National Parliaments towards the National Central Banks[66], other scholars consider the role of the National Parliaments in the Banking Union governance as insignificant[67].

Maybe, the truth is somewhere in-between: as the Monetary Dialogue experience has shown, the *ex post* parliamentary oversight powers can potentially activate fruitful discourse dynamics with the purpose of making the Banking Union governance more transparent, more participant and consequently, more legitimate. This dialogue does not exclude but, on the contrary, implies that the ECB and the Single Resolution Board have the last word with regard to competences which, already before their transfer at European level, were in many Member States taken away from the entitlement of democratically elected organs[68].

Nor is it possible to underestimate the potential importance of the new information rights conferred to the European Parliament and National Parliaments. As stated, also the enlargement of this category of parliamentary powers can represent a first answer to the problem of the "*informational asymmetry*". This is a problem which has been identified by scholars as one of the main factors at the bottom of "*Executive dominance issue"*[69].

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[66]See, for example, MANZELLA, *Parlamento europei e Parlamenti nazionali come sistema*, No. 4 *supra*, at 10.
[67]This is the position, for example, of CONTALDI, *Politica economica e monetaria (diritto dell'Unione europea)*, in *Enc. Dir. (annali)*, VII, Milano, Giuffrè, 2014, 811 ff.
[68]On the level of accountability and independence of the national supervisory authorities in Italy, Germany, France and United Kingdom before the Banking Union, see SICLARI, *Costituzione e autorità di vigilanza bancaria*, Padova, Cedam, 2007.
[69]See CURTIN, *Challenging Executive Dominance in European Democracy*, No. 57 *supra*, notably 15.

Developing the Monetary Dialogue format, the introduction of a sort of "banking dialogue" – and therefore the empowerment of democratic oversight and parliamentary informational rights in the banking sector –identifies a further indicator of the crossing (*rectius*, of the upgrade) of the old "communicating vases" paradigm. According to the doctrine inaugurated by the *Bundesverfassungsgericht* with *Maastricht-Urteil*, the devolution of powers at EU level is admissible insofar as this transfer is compensated by the transferring of the scrutiny and oversight powers by the National Parliaments to the European Parliament[70].

This conception of parliamentary democracy in Europe, long "ridden" by the European Parliament in order to lay claim to the strengthening of its own powers, tends to be overturned within a contest characterized by a plurality of parliamentary players in the EU institutional scenario. Besides the traditional channel of political representation offered by the European Parliament, the representative democratic principle established by art. 10, par. 1 TEU has to be nurtured also by the National Parliaments' contribution. Rather, it is on these last institutions that the attention of the scientific community is mainly focused today because they present a wider innovation and improvement margin: with the risk, however, of compromising the good functioning of the EU decision-making process in the case of the giving of a proper veto power to the National Parliaments.

In conclusion, the analysis of the democratic accountability mechanism introduced within Banking Union governance offers a confirmation of one of the most relevant aspects of the Euro-national parliamentary system theory: the considerable extent of the informal activities (or anyway a low degree of formalization) which precede or follow the adoption of formal decisions and the natural calling for the discreet usage of persuasion powers. In other words, that

[70] On the "communicating vases" paradigm, see MANZELLA, *Il parlamento federatore*, in *Quad. cost.*, 1, 2002, 35 ff. and notably 46 ff.

legal category of influence would be at issue which is something more than the consultation method and something less than co-decision[71].

On the other hand, it is not sufficient that Parliaments in Europe feel, in a more or less active manner, like a part of the system. Today it is also necessary that Parliaments "make the system". In other words, the European Parliament and National Parliaments should overcome the traditional preconception according to which an expansion of the European Parliament's position would entail a strengthening of National Parliaments in an inversely proportional way (and vice versa).

During the next months we shall see whether or not the players of the Euro-national parliamentary system choose to interpret their own role within Banking Union governance in the light of the "coexistence" method or in coherence with the opposite method of "cooperation": in the first case, the parliamentary bodies within the exercise of the oversight function will interact in the strictly indispensable measure to minimize the negative effects of the interference (therefore, remaining anchored to a competitive approach in interparliamentary relationships); in the second case, the European Parliament and National Parliaments will propose to make this same interference convenient for the own position and for that of the "system" as a whole.

[71]See, CAPUANO – GRIGLIO, *La nuova governance economica europea. I risvolti sulle procedure parlamentari italiane*, in MANZELLA – LUPO (eds.), *Il sistema parlamentare euro-nazionale. Lezioni*, No. 4 *supra*, 227 ff. and notably 258.

The Danish No to EU Justice and Home Affairs opt-in. The reasons behind

Thomas E. Jorgensen* and Alessandra Chirico**

ABSTRACT: *On the 3rd of December 2015, the Danish government held a referendum on stepping up Denmark's participation in EU police and judicial cooperation in criminal matters, asking its citizens to change the existing Danish opt-out from EU's collaboration on Justice and Home Affairs (JHA) to an opt-in model.[1] Denmark's opt-out from Title V of Part Three of the TFEU (area of freedom, security and justice), according to Protocol 22 of the Treaty of Lisbon, implies that the country does not take part at all in this policy. "In the negotiations of the Treaty of Lisbon, Denmark obtained an option to convert its opt-out into a flexible opt-in modelled on the Irish and British opt-outs",[2] which would have allowed it to opt in or out of legislation and legislative initiatives on a case-by-case basis. However, the referendum planned to approve the exercise of this option gave a clear response from the voters, who decided to uphold the opt-out with 53 % voting for a No to the opt-in model.*

This short article will attempt to: i) outline the background for the vote in the light of a broader political European and international landscape, which

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[1] The Justice and Home Affairs (JHA) opt-out was, at first, a consequence of the Danish referendum on the Maastricht Treaty in 1992. It was then formalised as a Protocol to the Treaties at the time of the Treaty of Amsterdam (in force in 1999), and was successively revised at the time of the Treaty of Lisbon (in force 2009). It currently appears as Protocol 22 to the Treaties, available at the following address: http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:12012E/TXT

[2] European Parliament Research Service, Judicial cooperation in civil matters, available at http://www.europarl.europa.eu/atyourservice/en/displayFtu.html?ftuId=FTU_5.12.5.html

takes into account increasing fears mainly related to the refugees' crisis; ii) present the arguments for voting Yes or No among the voters with a focus on national Danish politics, more and more tightening on immigration policies, as to the point of compromising the Schengen area; iii) sketch out the possible consequences of the No for Denmark and the European Union as such, both for the JHA's area and with respect to the management of the refugees' crisis in Europe.

SUMMARY: 1. Political background surrounding the Danish referendum on Justice and Home Affairs. - 2. Arguments for voting Yes or No among the voters with a focus on national Danish politics. - 3. Possible consequences of the No for Denmark and the European Union as such.

1. The core issue at the heart of the Danish referendum on JHA was whether to convert Denmark's current full opt-out on home and justice matters into an opt-out with case-by-case opt-in (or "selective opt-out") similar to the one held by Ireland and the United Kingdom. Furthermore, approval of the referendum was needed for Denmark to remain in Europol under the new rules. The main reason to change the opt-out model, in place for more than 20 years, was the planned change in the regulation on Europol, which is not compatible with the present opt-out model.[3] As rightly pointed out by Steve Peers, "with the entry into force of the Treaty of Lisbon, the European Parliament (EP) now has joint powers with the Council as regards the adoption of a Regulation governing Europol, and the Treaty now refers expressly to the importance of ensuring accountability to both national Parliaments and the EP. To expand Europol's powers further, while addressing the issues of governance, accountability and data protection, the Commission proposed a new Regulation[4]

[3] A short, but comprehensive analysis of the role played by Europol within the EU is provided by Steve Peers in his commentary *The reform of Europol: modern EU agency, or intergovernmental dinosaur?*, available at http://eulawanalysis.blogspot.be/2014/06/the-reform-of-europol-modern-eu-agency.html

[4] European Commission, *Proposal for a Regulation of the European Parliament and of the Council on the European Union Agency for Law Enforcement Cooperation and Training*

reconstituting Europol in 2013".[5] The general idea behind the reform of Europol is that of abandoning a model based on purely inter-governmental agreements, while moving to a more structured Community method. Such an institutional reform is based on the assumption (explicitly acknowledged by the European Commission) that "organised crime is a global threat to European citizens, businesses, state institutions as well as the economy as a whole. Criminals easily operate across borders, which creates a need for a consistent European–level action".[6] Hence, the need for the EU to continuously adapt its response in relation to the growing complexity of the situation, which is also, reflected in the development of specialised EU agencies, such as Europol. It is worth recalling that Europol handles different issues varying from criminal intelligence and combating serious international organised crime by means of cooperation between the relevant authorities of the member states, including those tasked with customs, immigration services, border control and financial police.

Concretely, a Yes to the opt-in model would have encompassed 22 specific legislative files in the areas of Criminal Law and Police Cooperation and Civil, Family and Commercial Law.[7] These legal acts included, *inter alia,* the cross-border Legal Aid Directive, the Cyber Crime Directive, the Directive on combating the abuse and sexual exploitation of children, and the Directive on trafficking in human beings.[8] Ten legal acts have been explicitly excluded from

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(Europol) and repealing Decisions 2009/371/JHA and 2005/681/JHA available at http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2013:0173:FIN:EN:PDF

[5]See, Steve Peers in his commentary *The reform of Europol: modern EU agency, or intergovernmental dinosaur?,* available at http://eulawanalysis.blogspot.be/2014/06/the-reform-of-europol-modern-eu-agency.html

[6]European Commission, DG Migration and Home Affairs, *Organised Crime and Human Trafficking* available at http://ec.europa.eu/dgs/home-affairs/what-we-do/policies/organized-crime-and-human-trafficking/index_en.htm

[7]"Legislative files Denmark will opt-into if referendum is positive", Ministry of Foreign Affairs ofDenmark,http://um.dk/en/~/media/UM/English-site/Documents/Politics-and diplomacy/liste%20over%20tilvalg%20engelsk.pdf

[8]Here is an overview of the legal act subject to referendum, also available at http://stm.dk/_p_14120.html

Police and criminal law:

-Directive 2014/41/EU, EUR-lex regarding the European Investigation Order in criminal matters

-Directive 2011/99/EU, EUR-lex regarding the European protection order the arrangement, including one on asylum and immigration policies, as the Prime Minister Rasmussen repeatedly stressed out during various press conferences, assumingly in consideration of the sensitivity of the issue.

2. In December 2014, most of the large political parties finally agreed to hold the referendum: this was to be done after the next general election, but no later than March 2016. At the end, it was moved up so that it would not interfere with the campaign for Britain's EU referendum (on a possible Brexit), due to be held before 2017.

According to the Danish constitution, any transfers of sovereignty to the international bodies must either have a 5/6 majority in Parliament, or be put to a

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-Directive 2011/36/EU, EUR-lex regarding preventing and combating trafficking in human beings and protecting its victims
-Directive 2011/92/EU, EUR-lex, regarding combating the sexual abuse and sexual exploitation of children and child pornography
-Directive 2013/40/EU, EUR-lex, regarding attacks against information systems
-Directive 2014/57/EU, EUR-lex, regarding criminal sanctions for market abuse
-Directive 2014/62/EU, EUR-lex, regarding the protection of the euro and other currencies against counterfeiting by criminal law Civil law and commercial law:
-Regulation 1346/2000, EUR-lex, regarding insolvency proceedings
-Regulation 1206/2001, EUR-lex, regarding cooperation between the courts of the Member States in the taking of evidence in civil or commercial matters
-Regulation 1896/2006, EUR-lex, creating a European order for payment procedure
-Regulation 861/2007, EUR-lex, establishing a European Small Claims Procedure
-Regulation 805/2004, EUR-lex, creating a European Enforcement Order for uncontested claims
-Directive 2008/52/EC, EUR-lex, regarding mediation in civil and commercial matters
-Regulation 593/2008, EUR-lex on the law applicable to contractual obligations (Rome I)
-Regulation 864/2007, EUR-lex on the law applicable to non-contractual obligations (Rome II)
-Regulation 662/2009, EUR-lex, establishing a procedure for the negotiation and conclusion of agreements between Member States and third countries on particular matters concerning the law applicable to contractual and non-contractual obligations
-Regulation 655/2014, EUR-lex, establishing a European Account Preservation Order procedure to facilitate cross-border debt recovery in civil and commercial matters Family law
-Regulation 650/2012, EUR-lex, regarding jurisdiction, applicable law, recognition and enforcement of decisions and acceptance and enforcement of authentic instruments in matters of succession and on the creation of a European Certificate of Succession
-Regulation 2201/2003, EUR-lex, regarding jurisdiction and the recognition and enforcement of judgments in matrimonial matters and the matters of parental responsibility
-Regulation 4/2009, EUR-lex, regarding jurisdiction, applicable law, recognition and enforcement of decisions and cooperation in matters relating to maintenance obligations
-Regulation 664/2009, EUR-lex, establishing a procedure for the negotiation and conclusion of agreements between Member States and third countries concerning jurisdiction, recognition and enforcement of judgments and decisions in matrimonial matters, matters of parental responsibility and matters relating to maintenance obligations, and the law applicable to matters relating to maintenance obligations.

referendum in the case that the government would like to enter an international collaboration that requires a transfer of sovereignty, but cannot muster a 5⁄6 majority.[9] In practice, however, the referendum method will always be the only viable political option in Denmark as there is a clear precedence of submitting major EU-related questions to a referendum (there have been six such referenda within the last 20 years),[10] and – importantly – due to the fact that the electorate in the numerous referenda regarding the EU has voted differently from the in general elections. Although most voters will vote for parties that are positive towards the EU, a substantial part will vote against further European integration when it comes to concrete issues, as the No to the Justice and Home Affairs opt-in clearly shows. Even if transfers of sovereignty could be done in Parliament, this would very likely be seen as by-passing the electorate.

In addition to the discrepancy between the political establishment and the electorate in EU matters, the political landscape in Denmark is quite complex by the standard of many other European countries. The Danish Parliament contains a large number of parties. Danish governments are usually coalitions between several parties, and they are almost always minority governments finding support for their policies with changing political partners. Moreover, the result of the general elections prior to the referendum, in June 2015, were unusually complicated. The last decade has seen substantial movements of

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[9]Danmarks Riges Grundlov § 20

[10]There are several academic publications about the referenda held in Denmark with respect to the EU. It is here worth recalling the research of LAURSEN, notably "Denmark and the Ratification of the Maastricht Treaty," in Finn Laursen and Sophie Vanhoonacker (eds.), *The Ratification of the Maastricht Treaty* (Dordrecht: Nijhoff; Maastricht: EIPA, 1994), pp. 61-86; “Denmark: The Battle for a Better Treaty,” in Finn Laursen (ed.), *The Amsterdam Treaty: National Preference Formation, Interstate Bargaining and Outcome* (Odense: Odense University Press, 2002), pp. 71-91; “Denmark: The Battle to Avoid a Referendum,” in Finn Laursen (ed.), *The Treaty of Nice: Actor Preferences, Bargaining and Institutional Choice* (Leiden: Academic Publishers Brill, 2006), pp. 57-81; “Denmark and the Constitutional Treaty: A Difficult Two-Level Game,” in Finn Laursen, ed., *The Rise and Fall of the EU’s Constitutional Treaty* (Leiden: Nijhoff/Brill, 2008), pp. 249-278; “The Danish Defence Opt-Out: Who Cares?” in Finn Laursen (ed.), *The EU as a Foreign and Security Policy Actor* (Dordrecht: Republic of Letters Publishing, 2009), pp. 319-342; “Denmark and Lisbon: How a referendum was avoided,” in Finn Laursen (ed.), *The Making of the EU’s Lisbon Treaty: the Role of the Member States* (Brussels: PIE Peter Lang, 2012), pp. 237-258.

voters between the established parties as well as the appearance of new parties. The present Parliament has nine different parties, with the two largest being the social democrats and the ultra-nationalist Danish People’s Party. Nevertheless, it is the liberal Venstre party that governs through a minuscule one-party minority government with only 34 seats in a Parliament of 179 seats, after having lost more than a fourth of the votes from the previous election. The referendum thus took place in a politically unstable environment with many of the parties of the political establishment being diminished, a much strengthened ultra-nationalist right wing, and a plethora of smaller parties including the free-market Liberal Alliance, two socialist parties (not counting the social democrats) and the green, alternative-living Alternativet. Although Denmark has as strong tradition of consensus politics built on compromises between many stakeholders, the present situation is no doubt a strain on the system.

With specific regard to the issue of Justice and Home Affairs, the electorate had an array of choices without much correlation to other political standpoints. Voters could heed arguments from one liberal party arguing for a No, while the other liberal party would argue for a Yes to the opt-in model. On the left side of the political spectrum, there were socialist recommendations to vote both Yes and No as well. Of the nine political parties in Parliament, six advocated for a Yes, three for a No.

The left wing campaign for a No, represented by the far left Red-Green Alliance (Enhedslisten), argued that more power to the EU would mean removing decisions too far away from the citizens. Also, the party reached back to a long tradition on the Danish left wing, arguing that integration with a 'backwards', conservative Europe would endanger the progressive Danish model of society.[11] Other EU member states were for instance described as: “ (...) countries where abortion and 'homosexual propaganda' are illegal and where

[11]See, JØRGENSEN (2008), *Transformations and Crises. The Left and the Nation in Denmark and Sweden 1956-1980*, Berghahn Books, p. 62.

the freedom of expression is severely limited."[12] The rest of the 'red bloc' centre left parties argued for a Yes using European police collaboration as the main argument: a Yes to the opt-in model would have guaranteed continued Danish participation in Europol, something that the vast majority of the electorate, as well as some parties arguing for a No (a seemingly paradoxical, but non-neglible detail), were very positive towards.

The right wing was more split on the issue. Although the right wing parties support the government, they were far from all following the government endorsement of a Yes. Again, this is not unprecedented in Danish politics: the 1986 referendum on the European Single Act was provoked by disagreement within the government bloc. The low-tax, free-market Liberal Alliance argued that a Yes would make it possible for a simple majority in the Parliament to enter binding collaborations with the EU, which future Parliaments could not decide to leave. Although possibly a rather theoretical point, similar considerations about entering agreements with no exit-options were visible in the debate about joining the Euro in the year 2000 (where the Euro was rejected again against the recommendation of the majority of political parties). The governing liberal party, Venstre, and its traditional junior partner, the Conservative Party, argued for a Yes, with similar arguments as the centre-left: an opt-in would have secured Danish participation in Europol. Lastly, and crucially, the far-right nationalist Danish People's Party argued strongly for a No, giving a prominent place to asylum policies. According to the party, lenient EU policies had led to the wave of refugees approaching Europe, and only some 'Eastern' member states had shown the willingness to secure the borders of Europe. The party did want to participate in Europol, but argued for a parallel agreement to be made after a possible No vote.[13]

[12] See, http://retsforbehold.eu.dk/da/jaellernej/partier/enhedslisten (translation TEJ).
[13] Information about the referendum and the arguments for and against the opt-in model can be found at http://retsforbehold.eu.dk/da/jaellernej/partier (in Danish).

Looking at the arguments without entering into the context of the developments occurred in the summer and fall of 2015, the Danish voter was presented a wide range of arguments from an array of political parties. While almost all could agree on the issue of Europol, there was no agreement whether this was at all endangered by keeping the opt-out model. While parties arguing for a No would still want Danish participation in Europol, they were also convinced that it would be possible to obtain a parallel agreement on this issue within the existing framework. It was hence up to the voters' trust in politicians whether to believe that the referendum was about Europol participation or not. It was indeed a question that could not be answered; no-one could say with certainty whether it would be politically possible to reach a parallel agreement, and it is still an outstanding question, which will be further looked at in this article.

The question of trust in politicians can have played a role particularly for the right-wing vote. The main party on the right advocating for a Yes, the governing Liberals, had been hit by a string of scandals regarding its leader, prime minister Lars Løkke Rasmussen, concerning among other things improper use of the party's funds for private purposes. As mentioned above, the party had had a disastrous election the same year, and did not wield much political clout or confidence among the electorate. On the other hand, the Danish People's Party has been riding on a wave of success, being the second-largest party in the Parliament. Before that, in the 2014 European elections, the party received the biggest number of votes by a considerable margin (27 % against the 19 % obtained by the closest competitor). In a survey from May 2015, the right-wing electorate was evenly split between the leaders of the Liberals and of the Danish People's Party as preferred prime minister after the elections.[14] There is reason to believe that a large part of the right wing electorate would trust the Danish

[14]See, POLITIKO, 14 May 2014, *"Thulesen Dahl side om side med Lars Løkke i popularitet"*, http://www.politiko.dk/nyheder/thulesen-dahl-side-om-side-med-lars-loekke-i-popularitet

People's Party over the Liberals and believe that a parallel agreement on Europol would in any case be possible.

The migrants' crisis and terror attacks occured in the summer and fall of 2015 did not make the situation less complicated. The move to the nationalist right by the Danish electorate has created a publicly accepted, but politically poisonous, discourse mixing anti-muslim, anti-EU, and anti-establishment elements. The present hard line against refugees, for example, envisaging measures like confiscating jewellery and valuables of those arriving, is a continuation of the nationalist demands for a return to an ethnically and religiously homogenous nation state with patrolled borders, and a roll-back of European integration. Such views, while already widespread in Denmark, were fuelled by the perceived threat of new arrivals, and they were tacitly or expressively supported beyond the ranks of the ultra-nationalists. The three main parties, the social democrats, the Danish People's Party, and Venstre, are unfortunately all keen to present themselves as hard-liners on refugees.

There is not yet published any comprehensive surveys about the reasons for the Danish No. Surveys in early 2015 saw a sizeable majority for a Yes, though there were big variations between different survey results, possibly due to the fact that voters were not yet acquainted with the issues at hand.[15] There is no reason to believe that the Danes were *a priori* against the opt-in model.

All this provided, another strong argument against further support to the EU (used in the campaign for a No vote) was that related to some heavy domestic concerns about the impact of thousands of refugees on social integration and on Denmark's welfare state. According to a poll reported by The Guardian "some 70% of Danes say immigration is their biggest political concern".[16] The British newspaper correctly points out that last September, the

[15] *Retsforbeholds-målinger peger i øst og vest*, Altinget 6 February 2015, http://www.altinget.dk/artikel/retsforbeholds-maalinger-peger-i-oest-og-vest
[16] *Danish PM counts on popular support in tackling refugees*, The Guardian, 28 January 2016, available at http://www.theguardian.com/world/2016/jan/28/lars-lokke-rasmussen-danish-pm-popular-support-tackling-refugees.

Danish government placed advertisements in Middle Eastern newspapers warning that "entry regulations for refugees had been tightened and unsuccessful asylum seekers would be swiftly returned".[17] In December, the Prime Minister even declared that the 1951 refugee convention might need to be revised. With this in mind, it is also worth recalling that he Danish PM paid a visit to the British PM in September 2015 (hence, at the core of its campaign on the referendum on JHA, to be held few months later) to meet and discuss with Cameron on the current refugees situation. What emerged from this meeting – as reported by the international press – was that the two leaders shared the same desire "to keep the EU from turning into a what Rasmussen has characterized as a "social union".[18] The concerns of the Danish PM mirrored the tangible fears of the Danes to have the solidity of their welfare system endangered by the refugees eventually imposed by the EU (with the system of national quotas), as the newly arrived refugees could be entitled to claim social benefits. On the occasion of the meeting with the British PM, Rasmussen explicitly declared to the journalists that : "the different member states should have some access to protect their own welfare model"[19]. Such a declaration could be seen as a message to the Danish electorate that their PM was (and still is) very much willing to shield national sovereignty.

With a more specific regard to the concrete arguments used for and against the opt-in model, it is worth recalling that in November 2015, a year ahead of the actual referendum, Gallup (the American consulting company, specialised in opinion-polls) made an exercise where a representative group was asked a number of questions about the referendum before and after having taken part in public debates about the issues that the vote would have covered. The survey prior to taking part in the debates showed a rather even distribution

[17]Ibid.
[18]*Løkke and Cameron find common ground on refugees and welfare*, The Local, 22 September 2015, available at http://www.thelocal.dk/20150922/lkke-and-cameron-find-common-ground-on-refugees-welfare.
[19]Ibid.

between those intending to vote Yes, those that would vote No, and those undecided. After the debates, 49 % would vote Yes, 40 % No, and only 11 % did not know. Before the debates, those inclined to vote Yes cited Europol and the general importance of European collaboration as the main reasons. Those who wanted to vote No were overwhelmingly concerned with the transfer of national sovereignty to the European level and had a general wish not to expand the powers of the EU. Interestingly, asylum policies were not at the centre of the concerns, and asylum policies were evenly cited as a reason to vote Yes and to vote No. After the debates, asylum policies hardly featured at all in the arguments for and against.[20] The survey after the debates clearly showed that almost all voters favoured a continued Danish participation in Europol (97 %), but that 59 % thought that Denmark should participate through a parallel agreement (only 23 % were against this solution).[21] It would seem that even at a time when the electorate was still relatively favourable towards an opt-in model, there was a preference for a model, which would limit the transfer of sovereignty to the European level.

Looking more broadly at public opinion before the referendum, the Eurobarometer survey from spring 2015 gives an impression of the general mood in Denmark compared to other European countries. The results show how Denmark has long overcome the crisis following 2008 and that many of the economic worries of other European countries should not be extrapolated to the Danish electorate. Tellingly, 83 % of the respondents in the Eurobarometer survey thought that the national economic situation was a good one, compared to 38 % in the Union as a whole.[22] However, the Danes were considerably more worried about immigration than other Europeans with 50 % of Danish

[20]See, FJELDSØE - HANSEN (2014), *Folkehøringen om retsforbeholder: Deltagernes* oplevelse, p. 10-11
http://retsforbehold.eu.dk/~/media/sites/euretsforbehold/mediemappe/rapport%20%20kmh%20 gallup.ashx.
[21]Ibid. p. 20.
[22]Eurobarometer (2015), *Public Opinion in the European Union*, p. 20

respondents mentioning this issue as opposed to 38 % of the whole sample.[23] Moreover, Danes were generally a little less positive towards the EU than the overall average with 39 % of Danish respondents being 'totally positive' towards 41 % in Europe as a whole. Generally, the Danish electorate were not particularly Eurosceptic, but they did have a particular worry about immigration, notably before the beginning of the refugee crisis in the summer of 2015 (the data was gathered in May 2015).

3. After the No result of the referendum, the political and legal consequences of maintaining the opt-out model had to be clarified with the European institutions. On December 11 2015, Lars Løkke Rasmussen met the Presidents of the European Commission and the Council, Jean-Claude Juncker and Donald Tusk, to evaluate, *in primis,* the possibilities for a continued Danish participation in Europol. The clear outcome of the meeting was that a Danish opt-out would be irreconcilable with full membership of Europol. This was confirmed to the Danish press directly by the spokesperson of Jean-Claude Juncker, who declared full participation impossible.[24]

As the reform of Europol will be implemented in the spring of next year, 2017 will be marked by the work of legal experts examining the actual possibilities for Danish participation.

However, the political aspect of the opt-out cannot be ignored. The Danish request for a parallel agreement will very likely be a broad one, as all political parties favour full participation in Europol. This request will have to be approved by the other 27 EU member states. Moreover, any agreement will have to be made on the legal basis provided by the European Commission, which under Jean-Claude Juncker has explicitly taken a more political role. It could well be imagined that the experts within the Commission would apply

[23]Ibid. p. 16

[24]"Danmark står til B-medlemskab af Europol", Jyllands Posten 11 December 2015 http://jyllands-posten.dk/politik/ECE8294601/Danmark-st%C3%A5r-til-B-medlemskab-af-Europol/

either a rigid or a flexible interpretation according to given political priorities. Here, we can only guess, but the priority would seem clear: the political and legal management of the Danish No will not only be about Denmark, but also about the United Kingdom European Union membership referendum, which is scheduled to take place in the UK before the end of 2017. Considering that this referndum may bring about the UK withdrawal from the European Union, reference to it is often shortened to Brexit (short for *British exit*).

The negotiations about a parallel agreement would show the possibility of an individual member state to pick and choose between different European policies. A wide-ranging parallel agreement could send the signal that a country could reap the benefits of European collaboration without being a full member. Such a signal would likely play into the hands of those that argue for a Brexit, as the negative consequences of the UK leaving the European Union could be remedied through bilateral parallel agreements. A similar situation has been seen in Switzerland, where a referendum to limit the free movement of labour triggered Switzerland being excluded from the European student mobility programmes and research funding, where Switzerland performs extremely well. The political signal was clear: a country (although not even member of the EU) should not be able to opt in where it sees benefits and opt out where it does not. Given the importance of a possible Brexit, this message will very likely have high priority for the Commission and for a number of member states. However, there are important differences between the two situations. Several - particularly EU-13 - countries have clear interests in the free movement of labour, as a considerable part of their citizens seek to work in other EU countries. These were directly affected by the Swiss referendum. Secondly, European research funding is a null-sum game, and excluding a high-performing participant would mean more funding for the rest. In the Danish case, all parties involved have a considerable interest in full participation in Europol, which will be stronger the more countries participate. No-one will benefit from a weak link in European police cooperation in Denmark, where criminals will be able to operate outside the Europol area, but within Schengen. At the same time, the only ’punishment’ possible will be to limit Danish participation in Europol, which again will weaken Europol to the detriment of all.

The argument of the common good of having a strong Europol with the widest possible Danish participation will then have to be weighed against the political signal towards the UK and the Brexit debate. One could imagine three separate cases: i) the UK will stay in the EU after the referendum in the summer of 2016, and the Commission will give its opinion on the legal basis for Danish Europol participation after that. Here, the political risk of giving the Danes a wide-ranging parallel agreement will have dissipated, and open the possibility of a generous parallel agreement; ii) an early UK referendum will result in the UK leaving the EU, and a Danish parallel agreement will be overshadowed by probably very rigid and bitter negotiations about future EU-UK relations. The outcome would very likely be a limited agreement; iii) the Commission will give a quick and highly negative opinion on the basis for Danish participation in Europol in order to show the British electorate that a leaving the EU will have serious consequences and that obtaining special agreements will be difficult.[25]

The Danish No to the opt-in model is thus tightly inter-twined with the bigger challenges facing European integration, like the refugee crisis, the future of Schengen, the strengthening of an EU paying more attention to its social dimension, and Brexit in particular. It could become another case of EU pragmatism through a wide parallel agreement, but might just as likely be a symbol of the price that European countries will have to pay if they want to distance themselves from the process of European integration.

[25]Europol Director Rob Wainwright already has pointed to the risks to the UK leaving Europol as a consequence of a Brexit
http://www.afp.com/en/news/brexit-could-leave-britain-vulnerable-europol

Bridging spending review and change management in Italian public administrations

Vincenza Esposito - Riccardo Mercurio - Marcello Martinez - Mario Pezzillo Iacono - Ernesto De Nito*

ABSTRACT: *In recent years, Italy launched a spending review process to pursue budgetary retrenchments through expenditure cutbacks at the central, regional, and local level. This paper tries to interpret a diverse set of spending review initiatives realized in Italy during the last three years as part of an extensive program of organizational development, through the framework of organizational change. In particular, the main goal of this work is to understand the spending review processes in terms of the levels of decision-making, sense making and learning changes developed by the public organizations analysed. The case studied show an incremental and pluralistic approach to organizational change, involving multiple mental models and actors that is useful to solve wicked problems.*

1. The social, institutional, economic and technological transformations of the last decades have invested heavily on the sector of public administration in all modern countries. On a global scale, great reform programs in the public sector are inspired more and more widely by models and principles already established in the

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field of private organizations. In them, the adhesion to certain relevant trends is clear such as the pervasiveness of information and communications technology, the constant pursuit of innovation, the weakening of the formal boundaries between policy makers, more and more involved in the search for forms of cooperation variables between different types of actors in the pursuit of specific public purposes.

One of the tendencies that unite more strongly the experience of public administration reform in Europe is that of rationalization and reduction of operating costs of their own organizational models, often labelled as *Spending Review* (SR). These reforms have two main purposes: to contain public expenditure and to increase the efficiency of public administrations.

The financial crisis of summer 2007 rapidly turned into an economic crisis of an international impact. The resulting measures of support and revitalization of the economies have very strong effects on public deficits and on the increase of public debt.

Instances of innovation, that have been carried out by public administrators and the pressing need for efficiency have triggered a process of thorough review of the organizational forms which today are applied with greater success in the government sector. In many cases, the SR has ceased to be an objective desperately pursued by the government, to be transformed into a working method, an approach (more or less conscious) to organizational change[1].

This paper tries to interpret a diverse set of SR initiatives realized in Italy during the last three years as part of an extensive program of organizational development (PA Performance project), through the theoretical framework of organizational change. In particular, the main goal of this work is to understand the spending review processes in terms of the levels of decision-making, sense-making and learning changes developed by the public organizations analyzed.

[1]See, MERCURIO (2007), *Approcci per lo studio del cambiamento organizzativo*, in *Studi Organizzativi*, 1, pp. 97-100

2. As a response to EU fiscal consolidation pressures, Italy along with the other Southern European countries has launched a spending review process to pursue budgetary retrenchments through expenditure cutbacks at the central, regional, and local level.

Current spending review process puts emphasis back on expenditure rather than on performance and outcomes and centrally introduces mandatory budgetary cutbacks. Through coercive isomorphism, this central way of operating will influence local evaluation practices to the extent to which fiscal consolidation becomes a strong pressure for the assessment of local public programs as well.

The spending review also and more importantly intends to promote efficiency in the utilization of available human and material resources. Therefore, the main aim of spending review is to increase efficiency of public expenditure in accordance to its objectives.

The modern SR interventions conducted in European public administrations share the overall aim of reducing operating costs, but are reflected in a more wide and varied program of development of the administrative system assuming, in the first place, the meaning of better use of the available resources.

Practical experience has shown that no “best” SR model exists, in terms of content and choices, but rather a “typical ideal” model of internal organization of the interventions themselves. The areas of action and the parameters for achieving the reductions of costs change in different interpretations of the SR. The need to interpret such actions through a program of change in which the right vision of organizational activities and expected results is combined with an equally correct interpretation of the conditions of the context, the expertise available and the cultural values that emerge in the specific organizational structure.

The existing organizational literature allows to conduct two parallel paths of study on these issues; the first, related to the evolution of the organizational models in the public sector. The second related to change management[2], i.e. the

[2]See REBORA - MINELLI (2007), *Il change management. Un modello di lettura e interpretazione*”, in *Studi Organizzativi*, 1, pp. 27-50

characteristics of the different strategic approaches to change the conditions that make these approaches more consistent, to the roles that must be guaranteed in the process of transitions and the resistance that the management will have to face[3].

3. The changing context in which public organizations operate matures the need to adapt, to ensure the delivery of innovative services of quality to groups of users carriers of diverse and increasingly sophisticated requests. The logic of productivity and efficiency of public action is complemented by the increasing demand to effectively guarantee the rights of individuals and to promote the development of community action with prudent planning and regulations[4].

For such evolutionary pressures, there is a need for the emerging of multiple theoretical paradigms, among which those of New Public Management[5], of Public Governance and of Public Service Motivation[6], which have established themselves.

During the eighties, the changes that occurred in the public sector of most OECD countries were fundamental for the birth of the line of study called NPM. The NPM has been defined as a vision, an ideology or a set of particular approaches and managerial techniques designed in the private sector and withholding particular utility also for the public sector. A set of operating principles that characterize this paradigm of studies. To begin with, the importance of ensuring the governance bodies the role and responsibility, not of providing public services, but to ensure that such services are provided in a competitive environment in the best possible way. In terms of more stringent management techniques, the NPM supports a clear orientation towards the client, in terms of the vision for the administrative process, the entrepreneurship manifested through the planning of objectives and the

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[3]See CHOI, RUONA (2011), *Individual readiness for organizational change and its implications for human resource and organization development*, in *Human Resource Development Review*, 10(1), pp. 46-73.

[4]See MANGIA - PEZZILLO IACONO - CANONICO - MARTINEZ - MERCURIO (2013), *The human side of organizational change: Compliance and management control systems in Italian public utilities*, in *Human Factors and Ergonomics in Manufacturing & Service Industries*, 23, pp. 47–57.

[5]See ARMSTRONG (1998), *A comparative analysis: New public management-the way ahead?* In *Australian Journal of Public Administration*, 57(2), pp. 12–24.

[6]See PERRY (1996), *Measuring Public Service Motivation: An Assessment of Construct Reliability and Validity*, in *Journal Public Administration Research and Theory*, 6 (1), pp. 5-22.

verification of results and the use of techniques that enrich decision-making processes through the involvement of citizens3.

Studies following the birth of the line of the NPM, but even more the maturing of some relevant experiences in Europe, made it possible to reflect on the limits of the same paradigm: the potential of the equipment and management principles cannot, by themselves, heal the quality gap of public choices, nor solve (in fact in some cases they intensify) the problem of the proper regulation of the relationship between politics and administration.

The paradigm of Public Governance (PG) was born in the nineties and came as a natural evolution of NPM, but also in a logic of development and public criticism of the managerialism that was growing both nationally and internationally5. The information contained in the White Book on governance of the European Commission helps to understand the characteristics of the ideal type of Good Governance proposed by the authors of the PG for the development of all public administrations6.

1) opening of the institutions, which should give more importance to transparency and communication in their decision making processes;
2) participation of the citizens in the elaboration and implementation of policies;
3) affirmation of responsibility, mainly in relation to the assumed roles in the decision-making processes;
4) priority pursuit of the principle of effectiveness of public actions;
5) coherence, modernity and integration of public policies and action plans.

Among the problematic aspects found in the experiences of change of governments more strongly instilled in NPM and PG is found the issue of motivation of civil servants. On this aspect emphasizes the cultural movement of the Public Service Motivation (PSM), formalized between the seventies and eighties and recently caught again the attention of scholars.

The PSM can be defined as the personal guidance that inspires the behaviour of a public servant, aiming to promote the general well-being of individuals and community. According to this theory, the main task of public management is to support its employees in understanding the reasons of gratification and satisfaction intrinsically associated with the implementation of work aiming to promote the public interest and to promote behaviours inspired by social justice, the spirit of sacrifice and civic duty. The paradigm of PSM stresses, thus, the significance of taking the most modern systems of personnel management, inspired by an appreciation of the skills and merits, in the system of matrix management methodology proposed by the government.

4. The traditional approach of the theories of Change Management has favoured the analysis of the typology of change, the modality of the government in the decision-making variables on the part of the management and the possible actions to be implemented that lead to transformation in the best possible way[7].

The change represents in these approaches some kind of an objective, voluntary and impartial, or rather an instrument useful for resolving a specific problem and favouring a better functioning of the organizations.

The so-called traditional approach, soon manifested obvious limits of applicability under conditions of uncertainty and has been largely superseded by contemporary debate on management. The latter therefore considered it reasonable to include among the elements under consideration not only the technical dimension, namely the model review management and production, but also the social aspect.

So, the organizational thought increasingly turns its attention more to the relations than to the organizational forms to the processes more than to the structure. The organizational problem triggered by change today essentially concerns the manner in which the entities interact with the environment and the ability to learn by the changes that affect it.

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[7]See HINNA (2009), *Organizzazione e cambiamento nelle pubbliche amministrazioni*, Roma Carocci Editore.

In this context, the phases leading to change do not always represent dramatic events; they are rather the product of a participatory and tacitly negotiated process. The change is no longer an occasional and isolated incident but becomes a structural dimension of the evolution of the organizations13.

This fact is even more relevant if we analyse the peculiarities of approaches to change in the public sector where the variables “soft” design (culture, values, leadership, power) can be traced and calibrated also compared to the general theme of the relationship between politics and administration.

In light of this new conceptualization, management literature emphasizes how organizations can change too quickly, and that the slower ones are the true processes of transition and that they require the application of all the suitable strategies to make such a transition less traumatic and with more participation.

In addition, Kotter[8], in more recent times, to respond to the issue of collective learning which generally characterizes the implementation of organizational transformations. From this point of view to conduct a transformation requires a shared leadership, no longer the preserve of a select few, but a permanent feature of the system, the dissemination of which will have to be favoured by continuous training and by a strong impetus for competition.

Excessive emphasis on management, in fact leads to an equally excessive focus on internal objectives and the real risk of bureaucratic forms of management in the paths of change, a result of blind procedures missing the big picture17. Such risk is expressed more strongly in contexts structurally oriented to the standardization of their practices, as occurs naturally in the public sector, inspired, among other things by the principles of transparency and uniform treatment of citizens.

In line with our theoretical approach, Wollmann[9] presents change in the public sector as an interchange between (radical) reform waves and intermittent incrementalism. Distinguishing public sector change management from generic

[8]See KOTTER (1995), *Why transformation efforts fail*, in *Harvard Business Review*, March-April, pp. 113-29.
[9]See WOLLMANN (2000), *Local Government Modernization in Germany: Between Incrementalism and Reform Waves*, in *Public Administration*, 78, 4, pp. 915-36.

change management, Rusaw[10] proposed four approaches to change in public organisations: 1) a means-end, rational, top-down planned change approach with examples of TQM and re-engineering, 2) an incremental, small-steps, decentralized, approach focused on visible results in the short-term that is most successful if there is no need for external approval, 3) a pluralistic approach involving multiple mental models and actors that is useful to solve wicked problems (shared policy-making), and 4) an individual approach, which is basically the learning model, involving changing the organisation through individuals and groups as well as formal and informal learning behaviour to improve service levels and invent new service systems.

5. We adopt a qualitative multiple-case study approach[11]. Indeed, this method is more suitable for obtaining an in-depth understanding of complex phenomena, especially when the focus is on the social processes involved, just as it is in our study. We carried out the analysis iteratively with a semi-grounded approach, thus we emphasise that our data informed the selection of theory presented upfront[12].

The data presented and discussed here represent the first processing of results of an extensive research project, conducted in the period 2012-2015 in the regions of Convergence Objective in collaboration with the Department of Public Administration of the Italian Government and the Formez PA, in context of the broader development program "Performance PA". The purpose of the project is to make available to regional and local administrations models, tools and experiences that ensure the sufficient management and allocation of resources and the improvement of the quality of services.

[10]See RUSAW (2007), *Changing Public Organizations: Four Approaches*, in *International Journal of Public Administration*, 30, 3, pp. 347-61

[11]See YIN (2003), *Case study research: Design and methods*, 3rd Edition, Beverly Hills, CA: Sage Publications.

[12]See VAN MAANEN - SORENSEN - MITCHELL (2007), *The interplay between theory and method*', in *Academy of Management Review*, 32(4), pp. 1145–1154.

The administration targets of the ministerial development program were 24 municipalities, provincial and regional authorities to which the following four types of change in course were proposed:

- reorganizing the macro-organizational structure;
- reviewing of administrative processes;
- promotion of property assets;
- management of associated services.

In the first phase of the study, it was decided to locate a sample of 12 institutions represented in diverse ways the types of promoted change. Only in those cases, a specific analysis of the processes and models of change implemented under the government program was conducted.

Multiple sources of information were used to gather data from each case, so as to allow a triangulation of information[13]: participant observation, in-depth face-to-face interviews with the public managers(s) and consultants, reports, and news from public sources.

The study was conducted by 12 mixed working groups composed of researchers, professionals, administrators and political representatives and the methodological solutions adopted were discussed in the setting of a scientific committee chaired by two of the authors of this paper. Three of the authors participated directly in working groups engaged alongside the three administrations for the duration of the ministerial program. In the case of the remaining nine administrations, interviews were conducted together by two of the four authors of this paper in order to reduce the ‘interviewer biases’ (such as, first-impression error, non-verbal influences or negative emphasis; Salazar, 1990), and on the basis of a semi-structured questionnaire aimed at stimulating a narrative approach in the dialogue with the interviewees.

Overall, in addition to the analysis of the documentation and direct observation, 12 meetings were conducted with the Scientific Committee, 120

[13]See PETTIGREW - WOODMAN - CAMERON (2001), *Studying organizational change and development: Challenges for future research*’, in *Academy of Management Journal*, 44, 4, pp. 697-713

interviews with directors, managers and political representatives and 12 shops with employees. The interviews, which were digitally recorded and transcribed, were carried out between July 2013 and November 2014.

6. The experiences of the SR conducted within the PA Performance project have taken different configurations depending on the interweaving of the choice of the contents of change (structure, processes, enhanced assets, and networking) and the temporal dimension in which it was placed (Table 1). In terms of process, however all the initiatives described here shared a planning which strongly inspires the concept of SR outlined here.

Firstly, projects of change have shared an important methodological trait: the creation of "mixed" working groups, composed of external consultants and internal resources and organization in which representatives of political and administrative bodies worked together with the employees and the managers of the structures involved.

Secondly, the approach to the definition of the interventions was always a definable approach "from below".

The local working groups interpreted and formally assumed the goals that they believed to be more consistent with the organizational conditions and the existing context through a phase of "consultation" between professional external professionals, managers and administrators.

The analysis carried out in the 12 selected cases eventually allowed to detect the following specific set of critical factors and resistance to change that occurred widely in the different phases of the individual change projects.

- The power of the dominant "model as is" and the isomorphism of models;
- The instability of the conditions of the context;
- Conflicts between high posts and political commitment;
- Lack of a strategic approach to change;

- Gap between existing skills and competences required for change management;
- The underlying distrust of the public opinion.

Such sets of critical factors could constitute an area of future investigation to complete the study on the process of the analysed transition.

Table 1) Types of SR interventions adopted by public administrations analysed

		TYPES OF ACTION			
TIME PER-SPECT IVE		Elimination of wasteful ex-		Management	Policy
	SHORT term				
	MEDIUM term			Reviewing the structure of org.. Operating process Seized property procedure Regulations. sanctions Mapping processes Public lighting Reorganizing SUAP Reviewing systems Offices and services regul. Associate management	Purchase control Department
	LONG term			Communal workmanship studio	Stray dogs Natural area development Enhancing municipal property Promotion of property assets

PA Performance project has allowed to show that the implementation and effectiveness of SR interventions cannot be achieved by simply adopting an "economic accounting", that is aimed to make cuts in specific cost items or the quantity of payable services offered by public administration.

In fact, such a perspective, although in some cases necessary or even essential, is by its very nature a high risk of rapid obsolescence.

A perspective of "economic accounting" normally tends to assert itself on an organizational and administrative framework over time that is measured and evaluated statically in a specific moment of time.

The main limitation of this stillness is the failure to consider that in public administrations, as in every kind or organization, can appear together relevant requirements of change and transformation of a regulatory, technological and technical type (for example related to ICT or the adoption of new types of systems), difficult to compose in a linear path with a distinct transformation.

The actions developed within PA Performance project show that once the economic analysis had highlighted possible areas of savings and efficiency, such needs emerged for change in organization and, perhaps an unexpected element, but extremely interesting, the opportunity to introduce solutions not necessarily of the contingent type and thus merely functional to the implementation of "cuts" or cost reductions.

The case analysed represent an incremental and pluralistic approach to organizational change, involving multiple mental models and actors that is useful to solve wicked problems.

The interaction between the members of the working groups composed by Formez consultants and local administrations staff, has been moving towards a reflection of the second level that is aimed at verifying the ability to activate performance control systems of the PA with a "double ring" more similar to learning systems than those for the assessment of the gaps.

It can be observed that even from the mapping shown in Table 1 the interventions of the SR have shown a greater potential impact and consequently in some cases have generated a greater inertial resistance, just when there was a requirement for modification of the underlying mechanisms traditionally adopted to adjust the organizational processes essential to the basic functioning of the organization of the different PA.

Table 2) Mapping the characteristics of the case analyzed

	DECISION-MAKING PROCESSES	SENSE MAKING PROCESSES	LEARNING PROCESSES
Municipality of Agropoli	High	High	Low
Trentova Bay	High	Low	Medium
Municipality of Battipaglia	Low	Medium	High
Municipality of Borgia	High	Low	High
Municipality of Catania	High	Low	Medium
Municipality of Mazara del Vallo	High	Medium	High
Municipality of Pompei	Low	Medium	High
Municipality of Villaricca	Low	Medium	High
Caudina Association (intercomunal kennel)	High	Medium	Low
Association of Caudina (municipal police)v	Medium	High	High
Calabria Region	Low	High	High
Puglia Region	Low	High	High

The different interventions, in fact show how the activation and the degree of success on the one hand and the impact of the proposed solutions on the other derive from the possibility to activate changes in the essential organizational processes: decision-making processes, processes of sense making (interpretation), learning processes[14].

Decision making processes affect the operation of organizations by means of manner, timing and procedures with which the PA defines its objectives and actions to be put in action for their pursuit. It is consolidated that in the PA are present simultaneously different types of decision making processes, such as those planned, the incremental ones, the negotiated ones, those based on improvisation and the ad hoc research for solutions.

[14]See WEICK (1995), *Sense-making in Organisations*, London, Sage.

Processes of sense making affect the functioning of organizations through the availability of cultural, technical, administrative models, and the corresponding systems of measurement and evaluation of performance. The underlying principle that affects the processes of sense making is that “you cannot improve what you cannot measure”. In addition, of course you cannot measure an event and organizational phenomenon if you are not equipped with appropriate frames or patterns of interpretation for it, such as new systems of performance control, whether qualitative or quantitative.

Learning processes affect the functioning of organizations as they allow, through the measurement of the results of administrative actions and the understanding of the possible actions, to improve the conditions (for example processes and structures) on which they depend.

The different interventions on the PA Performance project showed a heterogeneous combination of changing needs of these essential processes and a possible placement of the different cases, with a gradation of the impact that each of them has obtained, as presented in the table 2.

The table shows how various interventions have often produced different impacts that have generated a variety of critical issues, some of which have been addressed and resolved, others have influenced the timing of completion of the solutions proposed by the PA Performance project.

A significant impact on decision-making processes implies that, in the context of that specific project, it is necessary to face the difficulties connected to the need to reconfigure the procedures traditionally followed by the PA to make decisions. In these cases, just the implementation of an SR intervention could be (or in some cases has been) reduced by the decision-making difficulties that the different actors met in the selection and evaluation of the various alternatives.

A significant impact on the processes of sense making, on the other hand, involves having to deal with problems related to the adoption of new regulatory systems (new rules or regulations), new performance control systems or new responsibilities to provide the PA object in technical or professional framework adequate to interpret differently the possible effects of different interventions.

A high impact on the learning process instead implies having to deal with the serious problems encountered, related to the formation and development of new organizational, cultural procedures with which the PA is reduced to self-reflect on their operation and to seek possible improvements in the near future for the quality and the quantity of the services entrusted to them.

Central Banks' Monetary Policy Study

Galina Gospodarchuk[*] *- Sergey Gospodarchuk*[**]

ABSTRACT: *Existing theories and monetary policy models have been studied. Practical application issues have been discussed, including: limited monetary policy tools considered in the models; exchange rate targeting issues; required money supply volume planning/calculation challenges; interest rate targeting difficulties; inflation rate targeting issues. The European Union, the USA and Russia's modern monetary policy analysis has been executed. Conclusions about discrepancies of the declared and actually applied monetary policy tools of the central banks have been made.*

SUMMARY: 1. Existing monetary policy theories and models practical application issues. 2. Limited monetary policy tools considered in the models. 3. Exchange rate targeting issues. 4. Required money supply volume planning/calculation challenges. 5. Targeted interest rate determination difficulties. 5. Inflation rate targeting issues. 6. The European Union, The USA and Russia's modern monetary policy analysis. 7. Conclusions.

Monetary policy implemented by central banks has been one of the essential research topics for a long time. Most of them are focused on creation of monetary policy theory, model, or plan of action of the central bank. In this article we study problems of these researches and their practical application issues related to monetary policy implementation by central banks.

Several basic theories which set the monetary policy targets and methods for achieving them are currently known. Review of these theories can be found in [1,2,3]. Around 10 theories are the main, also there are some variations. Analysis of these theories reveals the presence of not only the weak points but also of fundamental

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problems which question the practical application possibility of that theories in principle. In the following sections we do not study these approaches in details as they are well-known and we do not propose anything new in them. We shall only discuss their problems.

1. Comparison of monetary theories by applied monetary policy tools shows a lot in common between them. There are only two main tools: money supply and interest rate. Different variants are proposed for the money supply depending on which aggregate to control: M0, M1, M2 aggregates or several of them. We should note that interest rate and money supply are integrally related. In the easiest case, the central bank directly controls the money in circulation, maintaining it on the planned level. This was proposed by M. Friedman (1953) [4] and B. McCallum (1988) [5]. In such case, interest rate shall make itself to balance the money supply and demand.

In the alternative variant of the central bank's policy, the interest rate is the target and money supply is being adjusted to provide balance for this rate on the money market. This concept in different variants is proposed by many authors, J. Taylor (1993) [6] is the most well-known among them. His equation is one of the simplest. A lot of more complex equations are based on it, including those used by central banks in the monetary policy. The idea to control interest rates was formed almost 100 years earlier, by K. Wicksell (1898). It is obvious that in the market economy the central bank cannot just simply lock the market rate on desirable level. It can change the rate only indirectly, by changing the money in circulation. In other words, the use of interest rate as the target value implies money supply management, as in the first case. Thus, the selection of one of the two methods means simply selection between direct or indirect money circulation management style.

Specific tools of the central bank's monetary policy are diverse. For example, central bank of each country has about 10 different types of short-term lending for commercial banks. But these tools are similar from the point of how they influence money supply, as they lead to the increase of monetary base and/or money supply.

Similar situation takes place with tools for reduction of the money supply by means of withdrawal of the excess money from the economy.

Central banks' supervisory responsibility is a bit aside. It is different because it is not part of the monetary policy tools. Nevertheless, it has a significant influence over the money supply due to money multiplier change. Regulatory requirements to the banks influence the accepted risks level, thus increasing or decreasing lending. This supervisory aspect is studied less because it is very difficult to quantitatively describe regulatory actions of the central bank (that is why they cannot be included in a model). Some regulatory measures are individually applied to the banks and are not subject to public disclosure (difficult to consider in the research, difficult to acquire information). The purpose of the supervisory activities is banking system stability and not the monetary policy. That is why it is not considered as a monetary policy tool.

The last tool is central bank's policy for exchange rate stabilization. It is executed by two ways: interventions on foreign exchange market and M2 aggregate control. The interventions require currency, which is sourced from international reserves of the country. They are limited by total amount, and the central bank cannot freely use them. Usually, the government or any other governmental institution approval is required, and they are available not in every country. The second method refers to the money supply management and that has already been discussed.

Thus, the central bank has only one monetary policy tool which it can use freely and independently: money supply management. Tasks, assigned by the scientists onto the central bank, should be related to its actual capabilities. Dissatisfaction with the central bank's actions which is lately growing due to the economic crisis speaks about the absence of understanding the central bank's real capabilities.

2**.** Historically, one of the first monetary policy ideas was the idea of the national currency stability maintaining in relation to other currencies (including gold). In those times these indices were part of the few which could be measured with sufficient accuracy. Imperfection of economic data collection systems made the price index, output volume and other similar indices impossible to use. Currently these indices are available with good accuracy, however exchange rates targeting ideas are still expressed. Their main disadvantage is that exchange rates also depend on the monetary policy of counterpart country. Exchange rate targeting makes to the fact that monetary policy of the country falls under the influence of the monetary policy and the economic situation of other countries and stops serving national interests. There is no effective solution of this problem. Even if the way to stabilize the rates is found, e.g. by political efforts, the foreign economic trends will influence the economy of this country. In particular, the attempts of many countries in 2015 to target the dollar exchange rate which has strengthened, led to two consequences: either the country should reduce the money supply causing the economic downturn, or the country preserved the soft monetary policy, supporting the dollar exchange rate by spending of international currency reserves. It is obvious that both ways are dead-end, that is why Russia has rather quickly abandoned the idea of exchange rate targeting.

3. This is the problem of theories which propose the central bank to directly control the money supply. Friedman proposed to fix the money supply growth rate. Later, McCallum proposed to adjust the money supply growth to the expected GDP growth and the change in money velocity. Friedman's idea was rather simple: the money supply should correspond to the gold volume in the economy so that the gold price would be stable. This supposed the money supply fixed growth rate of about 2% per year. Stabilization of gold price seems not very appropriate. Unlike Friedman, McCallum proposed to link the money supply to the economic output to achieve zero inflation. Money velocity and change of the product output were taken into consideration to increase the accuracy. Nothing new was proposed from that time. What are the problems of McCallum's approach and its derivatives?

Firstly, it is rather difficult to measure, let alone forecast the money velocity. It is different in different economy sectors, so weighted averaging with weighting for total turnover in each sector is required. These turnovers should be accurately measured. Furthermore, money velocity is influenced by different factors such as: duration of the business cycle, performance of bank payment systems, ratio between M1 and term deposits (depends on interest rates).

Secondly, it is difficult to forecast the transaction volume which should be serviced by the money turnover. Besides final consumption, it is required to consider all intermediate consumption which depends on the economic output and the number of intermediate stages of product redistribution.

Thirdly, in the modern economy, a significant part of money is circulating in the financial sector. The financial sector forms additional money demand depending on its condition. It has highly dynamic and difficult to forecast.

Fourthly, McCallum's model states that money supply volume is set via annual indices growth in the following way:

$$m = y - v + p,$$

where: m, y, v, p -logarithms of, respectively, money supply, output, money velocity and average price level growth.

Errors arising during assessment of indices will integrate over time, and total error will accumulate. In modern economy, growth rates is on the level of few percent. In the best case, accuracy of measurement shall make up the same few percent. But it is more realistic to expect errors of 10-20%. That is why, obtaining of values with satisfactory accuracy is almost impossible.

Thus, we observe difficulties during an attempt to calculate the "proper" money supply volume from individual indices. Due to the fact that this is done for provision of required inflation level, it is more viable to use feedback inflation control. In case of feedback it is necessary to monitor only one parameter - inflation itself. Thus, approaches of Friedman or McCullum cannot be practically implemented. Inflation feedback control is much simpler and can be a good candidate for practical implementation.

4. Interest rate targeting approaches are popular nowadays. In our opinion, popularity of these approaches is justified not by their practical effect, but easiness of inventing of new "recipes" for target interest rates. Source [2] gives 8 different calculation variants. In addition, central banks have developed their own target rate formulas. This information is available at the central banks' websites [7,8,9].

During interest rate targeting, problem of the required money supply volume calculation is bypassed as interest rates are used as the money excess or shortage indicator in the economy. But new challenges arise.

Firstly, equations for targets determination for interest rates are very complex, especially their modern versions. In particular, Taylor's equation (1993) [6] contains 2 initial indices (real GDP deviation from long term trend and inflation) and 3 empirical coefficients which can be selected quite randomly:

$$i = ap_t + by_t + c$$

a, b, c - coefficients (Taylor recommends *a*=1.5 *b*=0.5 *c*=1).

i, p_t, y_t - rate, inflation and real GDP deviation from long term trend (i.e. from the potential value).

Newer equation of Batini, Harrison, Millard proposed for the Bank of England contains 4 indices and 4 coefficients [7]. Bank of Russia's equation includes data smoothing operation, consideration of liquidity shocks [8]. Indices and coefficients calculation methods are weakly justified. In consequence this give us equations which are unreliable but allow to explain any Central Bank's monetary policy.

Absence of the economic basis under the abovementioned empirical coefficients makes their validity check impossible and promotes errors. Absence of necessity to strictly justify the economic sense and calculation procedure of each coefficient greatly contributes to growth of their amount in each future version of the equation. For example, different sources give different variants of the Taylor's equation which differ from his own version from [6] by coefficients values and by formula itself. [9] gives a so called "generalized" variant of the Taylor's equation in which target rate is expressed via deviations from equilibrium values:

$$i = (1-\theta_i)(r^* + \pi^*) + \theta_i + \theta_\pi(\pi - \pi^*) + \theta_q(q - q^*) + \theta_{\Delta q}(\Delta q - \Delta q^*)$$, where

r, π, q - interest rate, inflation and real GDP,

mark * means "equilibrium" value,

θ - model's set of coefficients.

Coefficient values in such equation will be totally different. Equilibrium values which should be *preliminary* known, i.e. they are to be preliminary calculated by some other model, are added to them. In fact, these values are transforming into additional empirical coefficients. This equation also gives no answer for the main question: what shall we do in case the long term (equilibrium) coefficient values will become unacceptable, e.g. long term trend for GDP will become negative?

Secondly, and this is very important, interest rates structure is diverse and the equation gives only one of the rates. Interest rates depend on loan term and risk level. Rate targeting is aimed at the inter-bank market rate. This is short-term risk-free rate. It does not show the situation with the availability of money to the real sector of economy which needs money for long-term periods and with non-zero risk. Interest rate for ordinary borrowers makes up from the risk-free rate and risk premium. Risk premium cannot be lower than the borrower's probability of default within a year. Otherwise, lending will be knowingly loss-making. Currently, a global economic downturn has led to the situation when probability of default of many borrowers is more than 10%, that is why their rate on credit will be higher than 10% even in case of zero risk-free rate. Thus, interest rate targeting in practical terms means absence of situation control.

Thirdly, the central bank itself can lend with the rate sufficiently different from key rate. For example, the key rate in Russia is set to 11% now. Short-term bank liquidity programs have interest rates of 11-12%, but anti-crisis lending to some large banks is provided at less than 1%. Interest rate structure in economy is various. Deposit rate in large banks is significantly lower than the key rate (6% in Sberbank for 3 months deposits). In less reliable banks the rates for 12-month deposits are near similar to the key rate. Credit rates are within the range from the key rate and to 25% for unreliable borrowers.

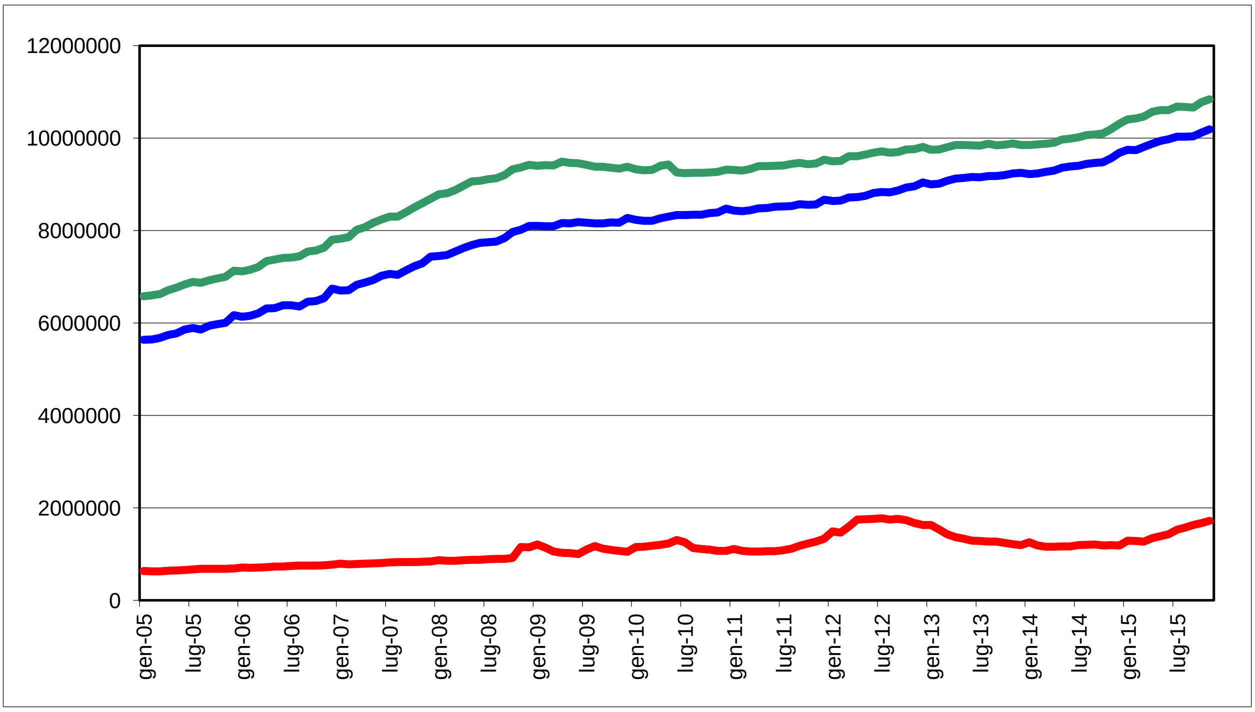
We see that recommendations for rates targeting are in a situation which is far from readiness to practical application. The fact that many central banks officially state usage of interest rate targeting does not change the situation. Decisions about the rate target level are actually made not according to the equations but by voting depending on possible side effects.

5. This approach is similar to the money supply volume control by means of interest rates targeting. The main problem of the practical implementation of this approach is that the total inflation is the sum of two factors. The first one is the monetary inflation. It arises due to the money supply growth and it is the process than can be controlled by the central bank. The second factor is nonmonetary inflation arising due to the cost of production growth by different reasons which are not directly connected to the money supply. They include tax increase, exchange rate growth and decrease in production. These reasons are out of the central bank's responsibility and cannot be fully controlled by its policy tools. Special hazard is the change in production. From one side it leads to a reverse change of fixed costs per production unit. From the other side it is directly dependent on the money supply change (as the money supply growth leads to demand and output volume growth). Thus, in case of money supply change, nonmonetary inflation (or deflation) will partially cancel the monetary inflation (or deflation), making the inflation targeting policy results unpredictable.

The studied practical implementation challenges show that monetary policy implementation on the basis of one or another theoretical approach is unreliable in terms of the obtained result. Monetary policy should provide the predictable result and for that it should be simple and understandable. What actions can be done by the central bank in a simple and understandable way?

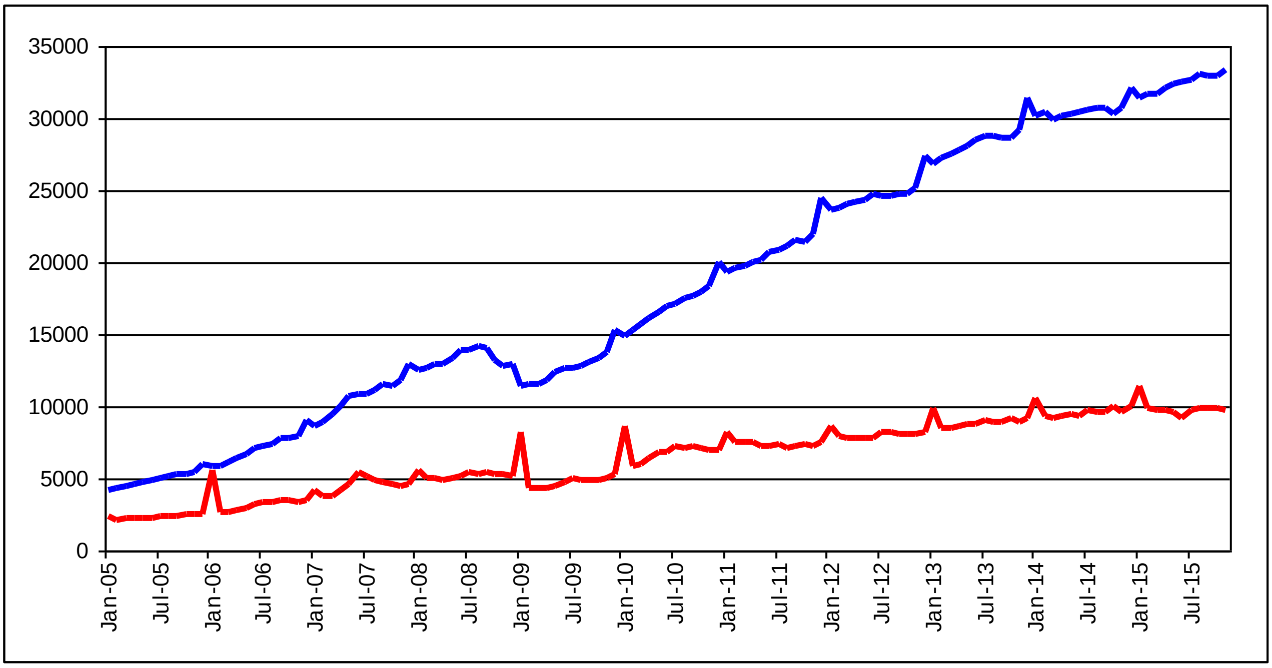
To answer this question we have studied the indices of the money and credit statistics of the European Union, the USA and Russia. As the source of information we have used the websites of corresponding central banks [10, 11, 12]. Money supply data (aggregates M1, M2, M3, cash) and monetary base have been studied. M3 aggregate have been studied only for the EU as it is not calculated according to the procedure of the Central Bank in Russia and corresponding long-term deposits are part of M2. Currently M3 is not reported for the US, apparently due to the fact that it includes a lot of components which are not part of the money, in the direct sense of this word. The data is not smoothed nor seasonally adjusted. Time period is from 2005 for the EU and Russia and from 2002 for the USA.

Diagrams 1, 2 obviously confirm that central banks of the EU and Russia are targeting money supply directly. Even exponential growth with the rate of 9.48% per year before the financial crisis of 2008 and 3.56% for the subsequent period can be seen in the diagram for the EU. Planned growth rate reduction is quite obvious - it is made because of concern of the increased inflation as one of the long-term consequences of the crisis. More even growth with average rate of 15.5% per year can be seen for Russia except for the downturn at the end of 2008. Downturn is caused by the fact that at that moment the Bank of Russia had not developed efficient tools for money supply stabilization against the acute bank crisis.



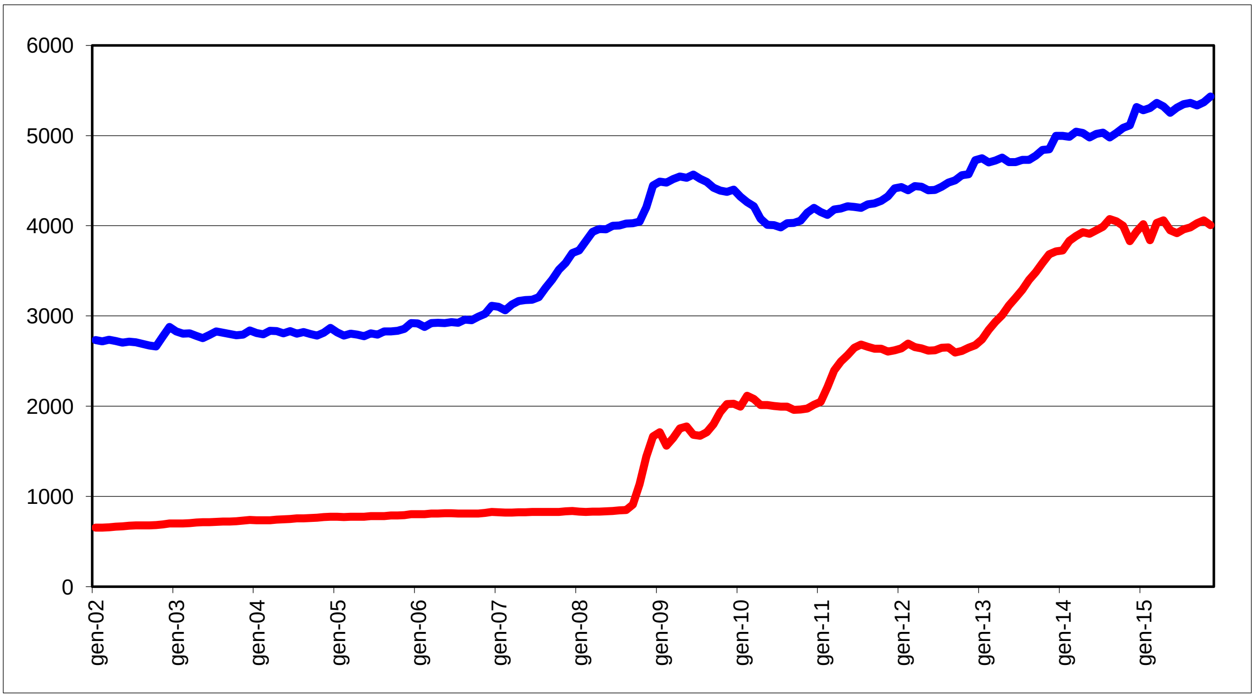
green: M3 aggregate, blue: M2 aggregate, red: M0 aggregate.

Diagram 1. Money supply and monetary base in the EU, mln. euros.



blue: M2 aggregate, red: M0 aggregate.

Diagram 2. Money supply and monetary base in Russia, billion rubles.



blue: M2 aggregate, red: M0 aggregate.

Diagram 3. Money supply and monetary base in the USA, billion dollars.

Money supply in the USA (diagram 3) is changing in a more complex way. Reasons for that are quite explainable: financial crisis carries a threat of not the devaluation of the national currency for the USA, but financial system malfunction. That is why the crisis response measures are firstly aimed towards refinancing loses of structurally important financial institutions. The diagram shows that the money supply quickly increased from July, 2007 to April, 2008. Average growth rate was 32.6% per year! Global crisis was not present at that moment but the problems with mortgage securities were beginning. Decision was made to combat the problem by increasing credit availability. During that period, monetary base has not been changing significantly. Credit granting was increasing due to relaxation in the regulatory requirements related to credit risks management. The main defect of the pursued policy was the absence of mechanism preventing money migration from consumer sector to other sectors of economy. As a result, when problems with mortgage securities started to widen, the money moved to the commodity market and forex. By the summer of 2008, the crude oil price had set the record of 147 dollars and dollar depreciated against other currencies.

Three quantitative easing attempts were undertaken to fight the crisis of 2008. At the monetary base diagram of the USA they look as 3 periods of rapid growth. QE1 was intended to overcome acute crisis. Main part of the infusion was made within first 3 months. Markets decline was stopped. Money supply downturn occurred after completion of QE1 and since 2010 its stable growth with the rate of 6.1% per year is observed. QE2 and longer and larger QE3 were held at that time but there was no significant M2 fluctuation. Hence, we conclude that M0 increasing within QE1,2,3 was aimed towards prevention of future losses. Money supply management on the principle of the negative feedback at which the Federal Reserve System reacts to the actual money supply value deviation from the planned level was used insignificantly. If the Federal Reserve was mainly focused on the achieved M2 values then much larger fluctuations of M2 could be observed.

Thus determination of feedback coefficients quantitative values used for M2 management is practically impossible because the main contribution is made by the proactive management.

Now we shall study the money emission by the central banks. Emission is implemented using the following tools:

1. Lending to commercial banks (including regular liquidity provision operations and special-purpose liquidity programs).

2. Purchases of nonmarket (low quality) assets by central bank, or lending, or repo operations with low-quality collateral.

3. Loans to government, including government's securities purchase.

Source of information about the extent of operations is the M0 monetary base value and the central bank's assets value from its balance[1]. We excluded from our study assets not related to emission, e.g. investment in precious metals, property, other assets. For the Bank of Russia we also excluded the article "Nonresidents' assets and foreign issuer securities" because it reflects the international reserves and not the emission.

In principle, all emission operations should lead to monetary base increase. Practically this can only be observed for the Federal Reserve of the USA. M0 and assets of the Fed are changing similarly and do not greatly differ from each other (diagram 4). As for the ECB and the Bank of Russia, the situation looks completely different, especially for Russia.

ECB assets change repeats the monetary base, however in 2-2.5 times larger by the absolute value (compare diagram 2 and 5). Also we note that money multiplier in the EU is enormously large - more than 10. This can be due to M0 understatement. Diagram 5 shows an interesting thing - ECB somehow managed to decrease assets and M0 during the period from beginning of 2013 to the middle of 2014. In other words, it has got back the funds allocated to fight the crisis of 2008. Assets which were held for refinancing are not so liquid to be sold in normal way within 1.5 years.

[1]Applicable to the EU, the system of ECB and national central banks is meant by the central bank; in statistical reporting this system is referenced as "Eurosystem".

It is more likely that there were one or several large investors which have replaced the ECB. In-depth assets structure analysis of the ECB balance shows that the first assets peak appeared due to activation of "Long-term refinancing operations" and "Lending to euro area credit institutions related to MPOs". Diagram 6. Second peak appeared due to the fast growth of securities holdings by the ECB. Thus, ECB has only pretended to overcome the crisis and after that it was again forced to provide money to banks to support them, but this time via different refinancing methods.

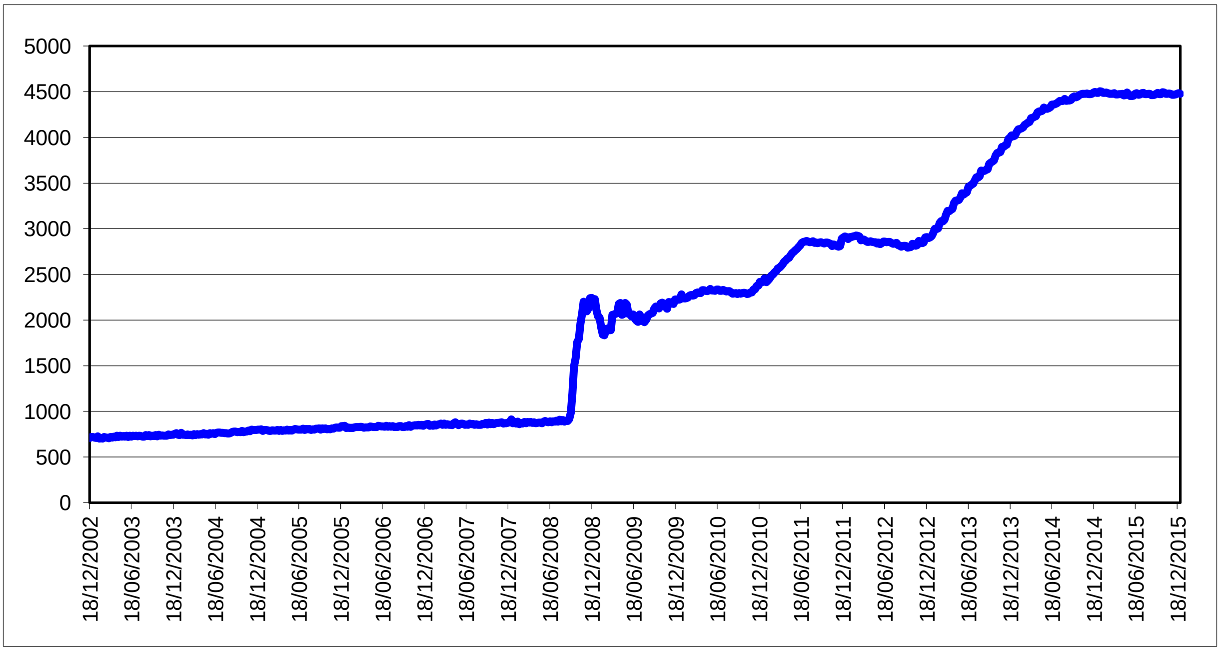


Diagram 4. The USA Federal Reserve assets (excluding gold), billion dollars

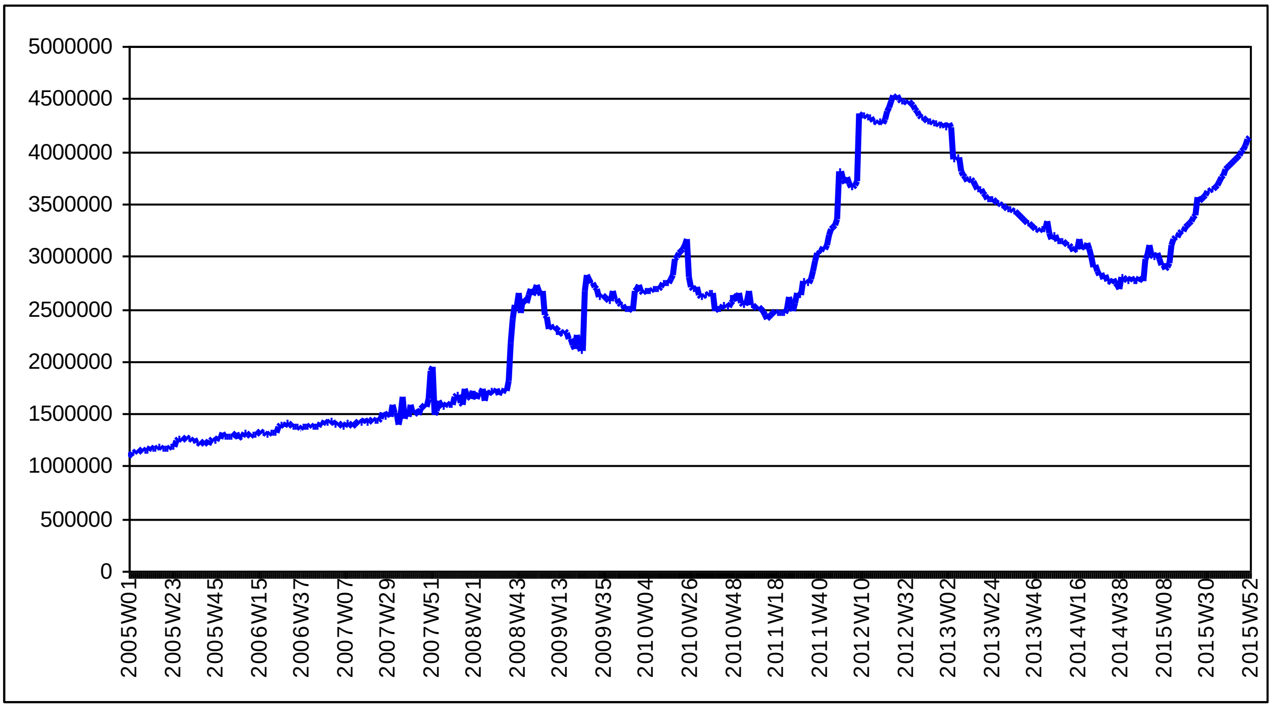


Diagram 5. ECB assets (excluding gold), mln. euros

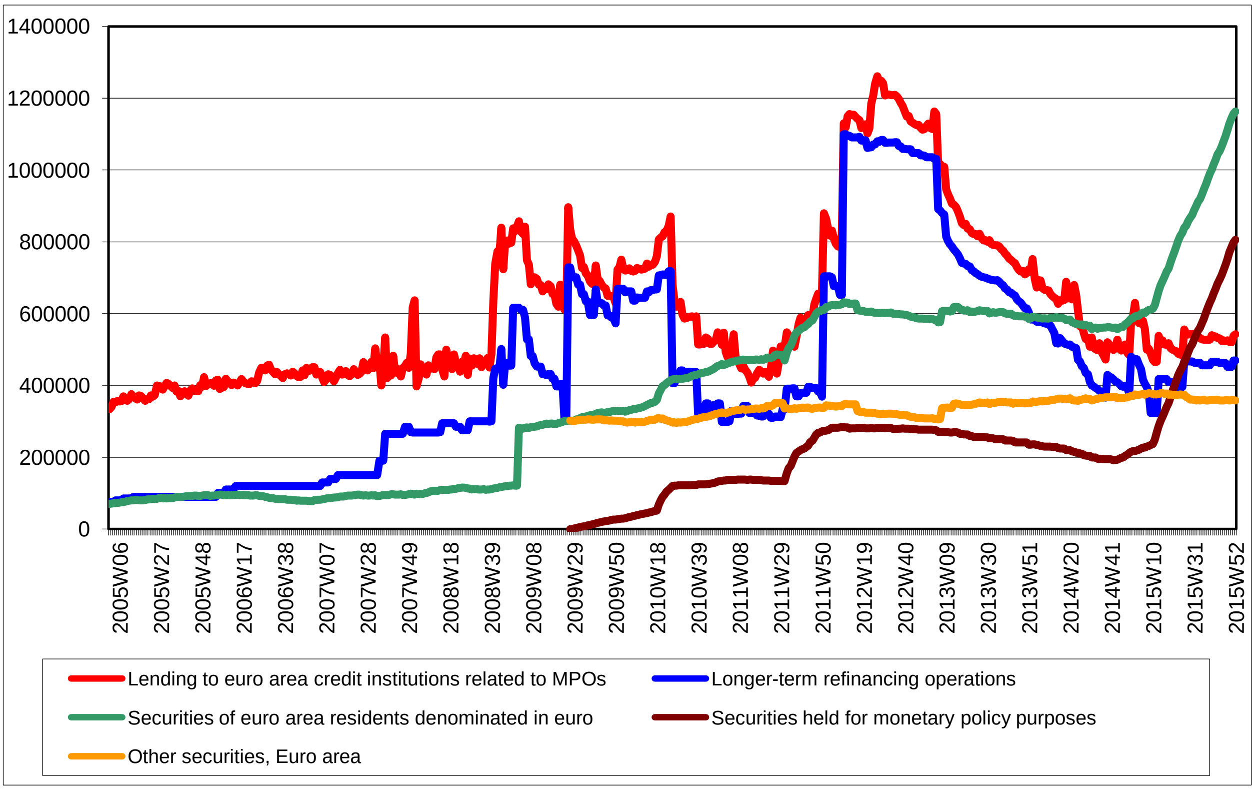


Diagram 6. Main components of ECB assets, mln. euros

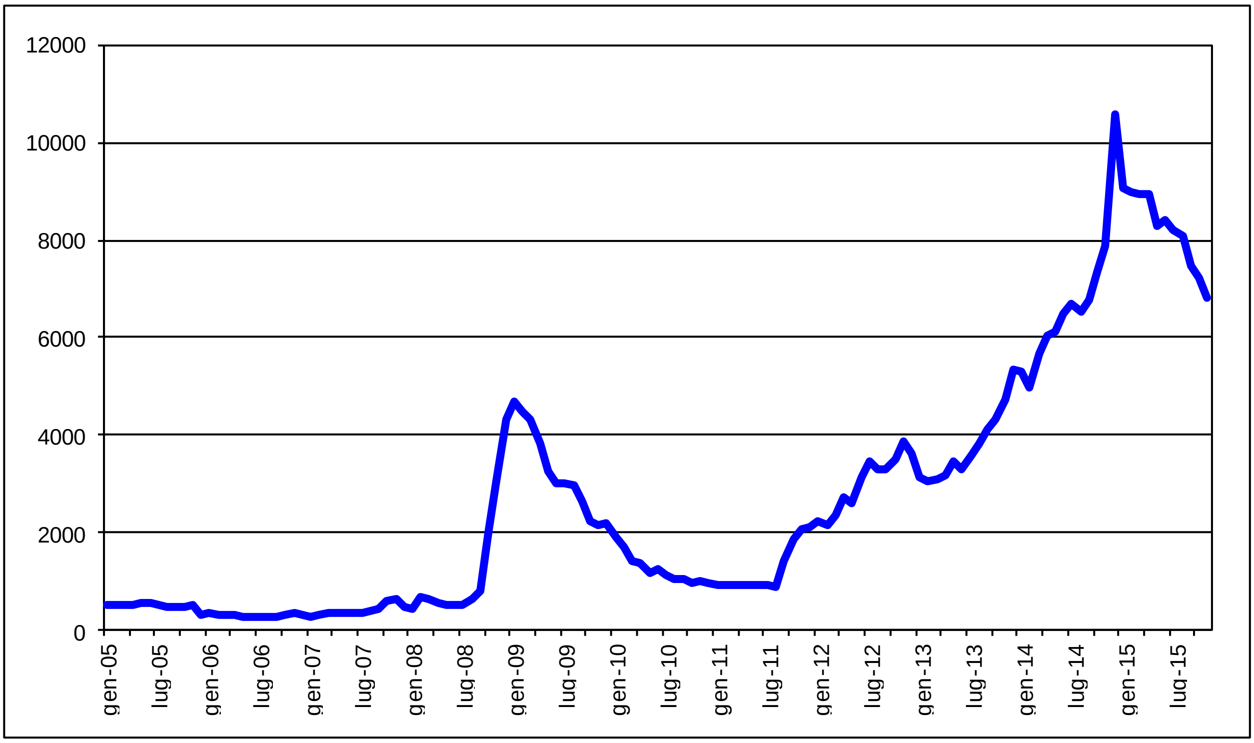


Diagram 7. Bank of Russia assets (excluding international reserves), billion rubles

Now lets look at Russia. Monetary base diagram in the wide definition (diagram 3) shows no crisis response measures. It smoothly increases if we do not consider peaks for January, which are due to long New Year holidays. Although, it is reliably known that the crisis response measures took place and about 1 trillion rubles (equivalent to 30 billion dollars) were used for the bank crisis of 2008. Analysis of the Bank of Russia's balance sheet reveals that these amounts are present and given in the articles "credits and deposits" and "securities". These assets are shown in diagram 7. Recipient of funds are banks and the government. Two peaks can be seen in the diagram 7. The first one is caused by crisis fighting of 2008. Emission made up to 2.5 trillion rubles (about 80 billion dollars). This debt was relatively quickly paid off, mostly because crude oil prices growth starting from 2009. New emission growth was observed from the middle of 2011. It was related to implementation of several infrastructure projects but in 2014 it added the fight with the new bank crisis. Emission reached 10.5 trillion rubles, i.e. almost 1/3 of the total money supply in the country.

As we see, central banks implement a rather powerful money and credit emission, and the bank system problems are its main driver. Long-term goal of monetary policy is the money supply targeting with provision of constant growth rate. Under normal situation, a central bank will reach this goal without significant monetary base growth. Crisis times require a significant emission to maintain money supply at target level.

As for the interest rates, in our opinion they do not play a significant role. It is commonly supposed that they manage the investor's risk appetite. However, the investor's behaviour is much more significantly dependent on the risk level in the economy and on the investment resources they possess.

6.

1. Really implemented monetary policy of the central banks comes down to money supply targeting.

2. The main tool for the monetary policy implementation is emission.

3. Complex economic models are not used in monetary policy implementation, although their implementation is widely declared and discussed.

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The fight against fraud: a critical review and comparative analysis of the Labour and Conservative government's anti-fraud policies in the United Kingdom

Umut Turksen[*] - *Nicholas Ryder*[**]

> *"There is clear evidence that fraud is becoming the crime of choice for organised crime and terrorist funding. The response from law enforcement world-wide has not been sufficient. We need to bear down on fraud; to make sure that laws, procedures and resources devoted to combating fraud are fit for the modern age".*[1]

ABSTRACT: *This paper concerns the fight against fraud, by questioning what financial crime is and the relevance of its countering. In this context, the critical review of the Labour and Conservative government's anti-fraud policies in the United Kingdom move from the assumption that initially international efforts to tackle financial crimes have concentrated mainly on money laundering and terrorist financing, even if any financial crime almost certainly has an adverse impact on the relevant economies. The Authors shows that UK has a strong history of utilising financial intelligence as part of its broader financial crime strategy, anyway they conclude that the policy adopted by the Conservative government towards fraud has been heavily influenced not by legislation, but by the imposition of record amounts of financial penalties, the introduction of deferred prosecution agreements, budgetary cutbacks, the creation of*

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[1]See, WRIGHT (2007), 'Developing effective tools to manage the risk of damage caused by economically motivated crime fraud', *Journal of Financial Crime*, 14(1), 17-27, at 18.

the National Crime Agency (NCA), the expanding remit of the Home Office and numerous broken promises.

1. Initially, international efforts to tackle financial crimes have concentrated mainly on money laundering and terrorist financing. This is largely due to the United States of America (US) led 'war on drugs' and the 'financial war on terrorism'. Fraud on the other hand has been placed lower in the list of public policy priorities and law enforcement efforts.[2] Following the turbulent times we have experienced since the global economic downturn first in 1997 (triggered by the Asian crisis) and later in 2008 (triggered by the bursting of the US subprime mortgage bubble), there is evidence that politicians are changing their stance in tackling a number of fraudulent and malfeasant activities particularly in the banking and financial services sectors. Fraud can be defined as "persuading someone to part with something",[3] which includes "deceit or an intention to deceive",[4] or an "act of deception intended for personal gain or to cause a loss to another party" [5] and it "involves the perpetrator making personal gains or avoiding losses through the deception of others".[6] The international and national profiles of fraud have increased significantly during the last two decades.[7] This is due, in part, to instances of corporate (white-collar) fraud

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[2]Levi described the UK government's attitude to fraud prior to 1979 as one of 'benign neglect'. LEVI, *Reforming the Criminal Fraud Trial: An Overview of the Roskill Proposals* (1986) *Journal of Law and Society*, 13 (1), 117. Fraud has not featured as a priority in law enforcement agencies' priority list. Only recently, in its 2015-16 Annual Plan, the UK National Crime Agency listed fraud as a priority. See National Crime Agency *2015-2016 Annual Plan* (National Crime Agency: London, 2015) p. 8.
[3]See, DOIG - ALAN. (2006), *Fraud*, Cullompton, Willan Publishing, at p.19.
[4]See ORMEROD - WILLIAMS, *Smith's law of theft* (Oxford, Oxford University Press, 2007) 9.
[5]Serious Fraud Office (n/d), '*What is fraud?*, http://www.sfo.gov.uk/fraud/what-is-fraud.aspx.
[6]Financial Services Authority (n/d), 'fraud', http://www.fsa.gov.uk/Pages/About/What/financial_crime/fraud/index.shtml.
[7] For an interesting discussion of the historical development of fraud see ROBB (1992), *White-collar crime in modern England – Financial fraud and business morality 1845-1929*, Cambridge, Cambridge University Press.

relating to the collapse of the Bank of Credit and Commerce International,[8] Barings Bank,[9] Enron [10] and WorldCom[11] as well as increase in law enforcement and monitoring against fraudulent activities in the national context. For example, in 2015 alone, there were 5 million reported cases of fraud in the UK.[12] Large-scale fraud has also occurred in the European Union (EU) following the collapse of Parmalat and Vivendi,[13] and Jerome Karivels fraudulent investments that cost SocGEN £3.7bn.[14]

As a result of the most recent financial crisis, mortgage fraud and tax evasion are additional major concerns and their extent is difficult if not impossible to determine. For example, the FBI estimated that the extent of mortgage fraud in 2006 was $4.2bn.[15] In 2007 the FBI described mortgage fraud as "an escalating problem",[16] yet the total amount of mortgage fraud related losses dropped to $813m.[17] Nonetheless, in 2008, the reported losses from mortgage fraud increased by 83.4 per cent to $1.4bn.[18] In its 2009 Mortgage Fraud Report, the FBI cited figures from CoreLogic, who estimated that the total amount of losses related to mortgage fraud had increased to $14bn.[19] CoreLogic estimated that the extent of mortgage

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[8]For an excellent discussion see ARORA, (2006), *The statutory system of the bank supervision and the failure of BCCI*, *Journal of Business Law*, August, 487-510.
[9]For a general commentary of the collapse of Barings Bank see PROCTOR (1997), *The Barings collapse: a regulatory failure, or a failure of supervision?*, *Brooklyn Journal of International Law*, 22, 735-767.
[10]Generally see HURST, (2006), *A post-Enron examination of corporate governance problems in the investment company industry*, *The Company Lawyer*, 27(2), 41-49.
[11]See SIDAK, (2003), *The failure of good intentions: the WorldCom fraud and the collapse of American telecommunications after deregulation*, *Yale Journal on Regulation*, 20, 207-261.
[12]BBC News, Crime figures: 'Five million' fraud cases in past year, 15 October 2015, http://www.bbc.co.uk/news/uk-34538183.
[13]ABARCA, (2004), *The need for substantive regulation on investor protection and corporate governance in Europe: does Europe need a Sarbanes-Oxley?*, *Journal of International Banking Law and Regulation*, 19 (11), 419-431, at 419.
[14]See, HAINES, (2009), *The National fraud strategy: new rules to crackdown on fraud*, *Company Lawyer*, 30 (7), 213.
[15]Federal Bureau of Investigation 'Mortgage Fraud Report 2006', May 2007, available from http://www.fbi.gov/stats-services/publications/mortgage-fraud-2006/2006-mortgage-fraud-report.
[16]Federal Bureau of Investigation 'Mortgage fraud report 2007', April 2008, http://www.fbi.gov/stats-services/publications/mortgage-fraud-2007.
[17] *Ibid*.
[18]Federal Bureau of Investigation 'Mortgage Fraud Report 2008', n/d, available from http://www.fbi.gov/stats-services/publications/mortgage-fraud-2008/2008-mortgage-fraud-report.
[19]Federal Bureau of Investigation '2009 Mortgage Fraud Report Year in Review', n/d, available from http://www.fbi.gov/stats-services/publications/mortgage-fraud-2009.

fraud in 2011 was $12bn.[20] In its 2012 mortgage fraud report CoreLogic, projected that that the level of mortgage fraud had increased to $13bn.[21] This statistical data is supported by research conducted by the Mortgage Asset Research Institute, who advised that "mortgage fraud is more prevalent now than in the heyday of the origination boom and that it will continue to rise".[22]

The United Kingdom (UK) has not been spared from large-scale instances of fraud. Examples include, Polly Peck,[23] the Mirror Group Pension Scheme,[24] Guinness,[25] the collapse of Barlow Clowes[26] and more recently the London Interbank Offered Rate.[27] The calculation of fraud, like the other types of financial crime, is fraught with methodological difficulties.[28] The National Fraud Authority (NFA) estimated that the extent of fraud in the UK increased from £52bn in 2011, £73bn in 2013.[29] In the same year, the volume of fraud in the financial and banking sectors was indicated as £5.4 billion. Yet, the Fraud Review stated that "there are no reliable estimates of the cost of fraud to the economy as a whole",[30] and it has been argued that "in monetary terms, fraud is on a par with Class A drugs".[31] The threat of fraud

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[20]See, CoreLogic *2011 Mortgage fraud trends report* (CoreLogic: Irvine, 2011) at 1.
[21]*Ibid*.
[22]See, CRESENEY - ENG - NUTTAL, '*Regulatory investigations and the credit crisis: the search for villains*' (2009), *American Criminal Law Review*, Spring, 46, 225-273, at 226.
[23]See, GALLAGHER - LAUCHLAN - STEVEN, (1996), *Polly Peck: the breaking of an entrepreneur?, Journal of Small Business and Enterprise Development*, 3 (1), 3-12.
[24]See, SARKER, (1996), *Maxwell: fraud trial of the century*, *Company Lawyer*, 17 (4), 116-117.
[25]See, SARKER, (1994), *Guinness – pure genius*, *Company Lawyer*, 15 (10), 310-312.
[26]Doig above, n 5 at 9-12.
[27]See, ASHTON - CHRISTOPHERS, *On arbitration, arbitrage and arbitrariness in financial markets and their governance: unpacking LIBOR and the LIBOR scandal*, (2015) *Economy and Society*, 44 (2) 188-217. Hereinafter 'LIBOR'.
[28]Attorney General's Office *Fraud Review – Final Report* (Attorney General's Office: London, 2006) at p.21. For a more detailed examination of the problems associated with determining extent of fraud see LEVI - BURROWS, (2008), *Measuring the impact of fraud in the UK: a conceptual and empirical journey*, *British Journal of Criminology*, 48(3), 293-318, at 297-298.
[29]National Fraud Authority *Annual Fraud Indicator 2013* (National Fraud Authority: London, 2013). Interestingly, the figure in 2010 was £30bn. See National Fraud Authority *Annual Fraud Indicator 2010* (National Fraud Authority: London, 2010) at 3. Also see National Fraud Authority *Annual Fraud Indicator 2012* (National Fraud Authority: London, 2012) at 3.
[30]See, LEVI - BURROWS above, n 30 at 297.
[31]See SARKER, (2007), *Fighting fraud - a missed opportunity?*, *Company Lawyer*, 28 (8), 243-244, at 243.

cannot be underestimated and it has been suggested that terrorists are increasingly using it to fund their illegal activities.[32] Haines noted that:

> "Historically, there was a lack of authoritative statistics in the area on the scale of fraud in the UK, poses a policy challenge for the UK government. Additionally, the criminal law and court procedure, which are at the heart of an effective anti-fraud strategy, were complex and largely ineffective … outdated and inflexible legislation prevented many large fraud cases from being brought to court at all".[33]

Therefore, two important questions must be considered. Firstly, what can be done to tackle fraud in the UK? Secondly, can any lessons be learnt from the contrasting policies over the last two decades? At a national level, the UK government has implemented a number of legislative measures that criminalise a wide range of fraudulent activities. For example, the Fraud Act 2006 was enacted after a 30-year campaign by the Law Commission in response to the problems with the Theft Acts (1968-1994). In addition to criminalising fraud, the UK has created several agencies to tackle fraud including the Serious Fraud Office (SFO), the NFA, the Financial Services Authority (FSA), the Financial Conduct Authority (FCA), the National Fraud Reporting Centre (NFRC) and the National Crime Agency (NCA). Accordingly, this article identifies the new trends and policies adopted by the Labour and Conservative governments towards the prevention of fraud and critiques their effectiveness.

2. The term financial crime is often used in common parlance and thus is one, which we assume we know its meaning, despite the fact that there is 'no internationally accepted definition'[34] of it. No research on financial crime can omit

[32]See, RYDER, (2007), *A false sense of security? An analysis of legislative approaches to the prevention of terrorist finance in the United States of America and the United Kingdom*, *Journal of Business Law*, November, 821-850, at 825.
[33]See, HAINES above, n 16 at 213.
[34]International Monetary Fund *Financial system abuse, financial crime and money laundering – background paper* (International Monetary Fund, 12 February, 2001, 5).

the seminal definition of white-collar crime provided by Sutherland in 1939.[35] He defined white-collar crime as "a crime committed by a person of respectability and high social status in the course of his occupation".[36] In his seminal paper, Sutherland stated that:

> "The present-day white-collar criminals, who are more suave and deceptive than the 'robber barons', are represented … many other merchant princes and captains of finance and industry, and by a host of lesser followers. Their criminality has been demonstrated again and again in the investigations of land offices, railways, insurance, munitions, banking, public utilities, stock exchanges, the oil industry, real estate, reorganization committees, receiverships, bankruptcies, and politics".[37]

One of the most important parts of this definition is that white collar crime is committed by people of a high social standing.[38] This is a view supported by Kemper who noted that white-collar crime refers to "illegal behaviour that takes advantage of positions of professional authority and power - or simply the opportunity structures available within business - for personal or corporate gain".[39] It is unsurprising that Sutherland's definition has been subject to a great deal of academic debate. For example, Bookman argued that Sutherland's definition of white-collar crime was too narrow [40] and Podgor went so far as to argue, "throughout the last 100 years no one could ever figure it [white collar crime] out".[41] White-collar crime has also been referred to as 'financial crime', 'economic crime' and 'illicit finance'. Examples of

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[35]See SUTHERLAND, (1940) *The White Collar Criminal'*, *American Sociological Review*, 5 (1), 1-12, at 1.
[36]See, SUTHERLAND, *White Collar Crime* (Dryden: New York, 1949) 9.
[37]See, SUTHERLAND above, n 37 at 2.
[38]See, BENSON - SIMPSON, *White-Collar Crime: An Opportunity Perspective, Criminology and Justice Series (*Routledge: New York, 2009) as cited in GOTTSCHALK, *Gender and white-collar crime: only four percent female criminals* (2012) *Journal of Money Laundering Control*, 15 (3), 362-373, at 362. For an excellent commentary on whether white collar criminals are privileged see BUELL, *Is the white collar offender privileged?* (2013) *Duke Law* 823-889, at 841-845.
[39]See, KEMPA, *Combating white-collar crime in Canada: serving victim needs and market integrity* (2010) *Journal of Financial Crime*, 17 (2), 251-264, at 252.
[40]See, BOOKMAN, *Convergences and omissions in reporting corporate and white collar crime*, (2008) *DePaul Business & Commercial Law Journal*, 6, 347-392, at 355.
[41]See, PODGOR, *White collar crime: a letter from the future* (2007) *Ohio State Journal of Criminal Law*, 5, 247-255, at 247.

white-collar crime include bribery and corruption, money laundering, insider dealing, fraud and market manipulation.[42]

In England and Wales, financial crime can be said to include 'any offence involving fraud or dishonesty; misconduct in, or misuse of information relating to, a financial market; or handling the proceeds of crime'.[43] This can therefore include the activities of money laundering and terrorist funding. The FSA offered a similar definition, stating that it is 'any offence involving money laundering, fraud or dishonesty, or market abuse'.[44] The European Union Commission does not appear to provide an actual definition of the term; but on looking at the EU secondary legislation, which has been issued, to counter financial crime, it would appear that the provisions therein only cover money laundering and terrorist financing.[45] The International Monetary Fund (IMF) goes further by stating that it 'can refer to *any* non-violent crime that generally results in a financial loss' (emphasis added).[46] This can therefore include tax evasion, money laundering and financial fraud, but essentially allows for anything, which causes a financial loss. It further states that where the loss involves a financial institution, then the term 'financial sector crime'[47] can also be used. Financial Abuse is another term, which is sometimes used synonymously with financial crime and is defined in the UK as:

> "Financial or material abuse, including theft, fraud, exploitation, pressure in connection with wills, property or inheritance or financial transactions, or the misuse or misappropriation of property, possessions or benefits"[48].

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[42]For a general discussion of these different types of white collar crime see HARRISON - RYDER, *The law relating to financial crime in the United Kingdom* (Ashgate: Farnham, 2013).
[43]Financial Services and Markets Act 2000, s. 6(3).
[44]Financial Services Authority 'Fighting Financial Crime', http://www.fsa.gov.uk/about/what/financial_crime.
[45]European Commission 'Financial Crime', http://ec.europa.eu/internal_market/company/financial-crime/index_en.htm. See in particular, the 4th Anti-Money Laundering Directive, 2014/56/EU of the European Parliament and of the Council of 16 April 2014, http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A32014L0056.
[46]International Monetary Fund above, n 36.
[47]*Ibid*., at 5.
[48]City of London Police *Assessment: Financial Crime against vulnerable adults* (Social Care Institute for Excellence November 2011, 2).

Under Section 44 of the Mental Capacity Act 2005, this therefore includes the offences of: theft, forgery, fraud by abuse of position, fraud by false representation, fraud by failing to disclose information and blackmail.[49] Another term which have been used by the US Department of Treasury and Her Majesty's Treasury in the UK[50] instead of financial crime include illicit finance.

A person, who has committed such offences must, therefore be able to be described as a financial criminal. Other perhaps more common terms of vernacular include that of the white collar criminal and the offender who has committed corporate crime, although as acknowledged by Croall there are also problems with how these terms are defined.[51] For example, whilst we might often regard the white collar criminal as someone who has high social status, is respectable, powerful and at management level, this is not always true; with many corporate crimes involving employees acting in the course of trade and business and with their offences relating to matters of hygiene and other health and safety issues.[52]

3. Even though financial crime is often thought to be victimless; this is far from the truth. As explained by the FATF 'criminal proceeds have the power to corrupt and ultimately destabilise communities or [even] whole national economies'.[53] The integrity of a nation's financial institutions can be eroded by those organised criminals who seek to maximise their illegal profits so that they are able to enjoy the so called champagne lifestyle,[54] and as further explained by Vaithilingam and Nair it can weaken the financial systems which are the main players in many global financial transactions.[55] Moreover, as Ryder argues, the effects of financial crime can ultimately threaten national security on the basis that terrorists need money and

[49] *Ibid*. p. 3.
[50] See, RYDER, *Financial Crime in the 21st Century* (Edward Elgar 2011).
[51] See, CROALL, *Who is the White-Collar Criminal?* (1989) *British Journal of Criminology* 29(2), 157.
[52] *Ibid*.
[53] Financial Action Task Force *Report on Money Laundering and Terrorist Financing Typologies 2003-2004* (Financial Action Task Force 2004).
[54] See, RYDER, *Financial Crime in the 21st Century* (Edward Elgar 2011).
[55] *Ibid*.

resources so that they can carry out their illegal activities.[56] The IMF additionally argues that financial system abuse,

> ". . . could compromise bank soundness with potentially large fiscal liabilities, lessen the ability to attract foreign investment, and increase the volatility of international capital flows and exchange rates . . . financial system abuse, financial crime, and money laundering may also distort the allocation of resources and the distribution of wealth."[57]

Financial crimes almost certainly have an adverse impact on the economies of countries. Further economic damage for a country may arise through the loss of reputation, which may prevent businesses conducting financial transactions and investing in that country. The impact of financial crime can also be seen on an individual level albeit the losses to individuals may be small, especially when compared to public sector and private sector losses. This may include a reduced flow of wealth between generations in families and a subsequent loss of tax revenue for the government through inheritance tax, subsequently creating real negative consequences for the public purse. For example, victims of financial crime who need care in their old age may no longer have the means to pay for it themselves and so become dependent on state funding. Also, where crime is perpetrated by a professional, such as a solicitor or financial professional, there may be harm to the reputation of individuals and organisations, leading not only to a decrease in confidence and trust,[58] but as emphasised by the IMF, can consequently result in a weakening of the entire financial system.[59] The impact of financial crime should therefore not be underestimated and can be every bit as significant as physical abuse. Deem, for example, suggests that victims of financial crime can suffer as much as those who have been victims of a violent crime.[60] Spalek notes that outrage and

[56]See, RYDER, above, n 56.
[57]International Monetary Fund above, n 36 at 9.
[58]See, City of London Police above, n 50.
[59]International Monetary Fund above, n 36 at 9.
[60]See, DEEM, *Notes from the field: observations in working with the forgotten victims of personal financial crimes* (2000) *Journal of Elder Abuse & Neglect* 12 (2), 33-48.

anger, as well as fear, stress, anxiety, and depression, were experienced by victims of the Maxwell pension fraud[61] and how many victims of this fraud thought that their husbands' deaths had been accelerated as a result of the said events.[62]

In short, financial crime requires governments to act as the implications of it touch nearly all aspects of public and private lives. Furthermore, the electorate no longer sees robust financial regulation and fighting fraud as secondary issues. Thus, these policy areas are a permanent feature of the recent manifestos of all major political parties in the UK.[63] With the victory in the general elections in 1997, the Labour government led by Tony Blair set off an ambitious mission to adjust to new global power shifts (e.g. global financial crisis in 1997, transfer of British sovereignty over Hong Kong to China) as well as sustaining, promoting, and expanding to open global economy so as to capture its perceived benefits.[64] As part of this strategy, a number of important legal developments pertaining to countering financial crime have also taken place during and after the Labour government's reign between 1997 and 2010.

4. Under the Conservative governments of the 1980s (Margaret Thatcher) and 1990s (John Major), concurrent with deregulation of financial services, there was a greater opportunity for fraud and other financial crimes. Following the general election victory in 1997, the Labour Government focused on legislative reform and criminalisation of fraudulent activity, thus the Labour government must be credited with adopting a robust and comprehensive strategy towards financial crime which predominantly created the current legal framework for countering fraud. For example, the successive Labour administrations oversaw the introduction of the

[61] See, SPALEK, *Knowledgeable consumers? Corporate fraud and its devastating impacts*, *Briefing 4*. (Centre for Crime and Justice Studies, 2007).
[62] See, SPALEK, *Exploring the impact of financial crime: a study looking into the effects of the Maxwell scandal upon the Maxwell pensioners* (1999) *International Review of Victimology*, 6, 213-20.
[63] Norton Rose Fulbright, 'UK General Election: Impact on financial services regulation', April 2015, http://www.nortonrosefulbright.com/knowledge/publications/127809/uk-general-election-impact-on-financial-services-regulation.
[64] See, CERNY - EVANS, *Globalisation and public policy under New Labour*, (2004) Public Policy, 25 (1), 51-65.

Proceeds of Crime Act 2002, which codified the UK's anti-money laundering legislation and created a new confiscation of the proceeds of crime regime. This was ably supported by the creation of the UK's first AML strategy document. Furthermore, following the ground breaking recommendations of the Fraud Review in 2006, the Labour government enacted the Fraud Act 2006 and created the National Fraud Authority, a strategic body that would develop and implement the UKs first counter-fraud strategy. Subsequently, fraud was propelled from its traditional tertiary position, behind money laundering and terrorist financing, to the top of the government's financial crime agenda.[65] Sarker takes the view that "a fresh crop of anti-fraud initiatives, reviews and legislation has sprung up, ostensibly demonstrating how fighting fraud is a top priority in the UK".[66] However, this is not a view shared by all commentators and it has been argued that "little has changed to reverse the perception of fraud as a low priority".[67] The Fraud Review (the Review) was commissioned by the Attorney General "to recommend ways of reducing fraud and the harm it does to the economy and society".[68] The Review considered three questions:

1. What is the level of fraud?
2. What is the appropriate role of the government in dealing with fraud?
3. How could government resources be spent to maximise value for money?[69]

The Review was unable to accurately outline the extent of fraud. In relation to its second task, it concluded that the government has two functions – to protect public money from fraudsters and to protect consumers and businesses against fraud. The Review recommended that the government should adopt a holistic

[65]The government announced that it intended to introduce a radical overhaul of the laws on fraud in its 2005 general election manifesto. Labour Party *Labour party manifesto – Britain forward not back* (Labour Party: London, 2005).
[66]See, SARKER above, n 33 at 243.
[67]*Ibid*.
[68]Attorney General's Office above, n 30 at 4.
[69]*Ibid*., at 4-5.

approach towards fraud and develop a national strategy. Furthermore, it recommended the creation of the NFA to develop and implement the strategy. It also suggested that a NFRC should be created so that businesses and individuals could report fraud. The NFRC has been operating since October 2009,[70] as 'actionfraud.org'.[71] The National Fraud Intelligence Bureau (NFIB) is the agency dedicated to analyse and assess fraud, employing analysts from both law enforcement and private sector. Fourthly, the Review suggested that a national police task force on economic crime should be established based on the City of London Police Force.[72] The main legislative developments during the Labour government's tenure are identified above.

5. Prior to the Fraud Act 2006, the statutory maze on fraudulent activities comprised of eight deception offences in the Theft Act (1968 and 1978) and the common law offence of conspiracy to defraud.[73] The offences created by Theft Act were difficult to enforce.[74] Therefore, it led to the introduction of the Theft Act 1978, which did little to rectify the fragmentation of the offences under the 1968 Act.[75] The Home Office noted that it "is not always clear which offence should be charged, and defendants have successfully argued that the consequences of their particular deceptive behaviour did not fit the definition of the offence with which they have been charged".[76] In 1998, the then Home Secretary Jack Straw asked the Law

[70] National Fraud Authority (2009), 'National Fraud Reporting Centre's '0300' line launches in the West Midlands', http://www.attorneygeneral.gov.uk/nfa/WhatAreWeSaying/NewsRelease/Documents/NFRC%20launch%2026%20Oct%2009.pdf.

[71] Action Fraud (n/d), 'Action Fraud', http://www.actionfraud.org.uk/.

[72] Attorney General's Office above, n 30 at 10. The effectiveness of this decision has been questioned. See for example RIDER, (2009), *A bold step?*, *Company Lawyer*, 30 (1), 1-2, at 1.

[73] The Theft Act was creation of the Criminal Law Revision Committee Theft and Related Offences, Cmnd. 2977, May 1966. Other noteworthy attempts to tackle fraud before the Theft Act were the Prevention of Fraud (Investments) Act 1958 and the Financial Services Act 1986.

[74] See generally KIERNAN - SCANLAN, (2003), *Fraud and the law commission: the future of dishonesty*, *Journal of Financial Crime*, 10 (3), 199-208.

[75] For a useful discussion of the law of theft see DOIG above, n 5 at 22-35. Wright concluded that the laws were "fragmented, disparate and over specific". See WRIGHT above, 3 at 18.

[76] *Ibid*. For a more detailed illustration of this problem see generally *R v Preddy* [1996] AC 815, 831.

Commission to examine the law on fraud.[77] In 1999 the Law Commission published a Consultation Paper, which distinguished between two types of fraudulent offences – dishonesty and deception.[78] The Law Commission concluded that while the concerns expressed about the existing law were valid they could be met by extending the existing offences in preference to creating a single offence of fraud.[79] The Law Commission published its final report in 2002 with the Fraud Bill.[80] The Fraud Act came into force on January 15 2007;[81] it overhauls and widens the criminal offences available in respect of fraudulent and deceptive behaviour.[82] The new offence, punishable by imprisonment of up to 10 years and/or an unlimited fine can be committed in three different ways – fraud by false representation,[83] fraud by failing to disclose information [84] and fraud by abuse of position.[85] Dennis argued that the Act "represents the culmination of a law reform debate that can be traced back more than 30 years".[86] Scanlan takes the view that the Fraud Act 2006 "provides prosecutors with a broad range offence of fraud".[87] This clearly represents a significant improvement on the statutory offences of the Theft Acts and the common law offences of conspiracy to defraud. Nonetheless, it is important to point out that since the manipulation of LIBOR prosecutorial agencies have targeted the

[77]Specifically the Law Commission were asked to "to examine the law on fraud, and in particular to consider whether it: is readily comprehensible to juries; is adequate for effective prosecution; is fair to potential defendants; meets the need of developing technology including electronic means of transfer; and to make recommendations to improve the law in these respects with all due expedition. In making these recommendations to consider whether a general offence of fraud would improve the criminal law". See HC Debates 7 April 1998 c.176-177WA.
[78]The Law Commission *Legislating the Criminal Code Fraud and Deception – Law Commission Consultation Paper no 155* (Law Commission: London, 1999).
[79]The Law Commission also published an informal discussion paper in 2000. See Law Commission *Informal discussion paper: fraud and deception – further proposals from the criminal law team* (Law Commission: London, 2000).
[80]For an analysis of the Law Commission's report see Kiernan and Scanlan above, n 76.
[81]The Fraud Act 2006 (Commencement) Order 2006, S.I. 2006/3500.
[82]For a detailed commentary and analysis of the Fraud Act see ORMEROD, (2007), *The Fraud Act 2006 – criminalising lying?*, *Criminal Law Review*, March, 193-219.
[83]Fraud Act 2006, s. 2.
[84]Fraud Act 2006, s. 3.
[85]Fraud Act 2006, s. 4.
[86]See, DENNIS, (2007), 'Fraud Act 2006', *Criminal Law Review*, January, 1-2, at 1.
[87]See, SCANLAN, (2008), *Offences concerning directors and officers of a company: fraud and corruption in the United Kingdom – the present and the future*, *Journal of Financial Crime*, 15(1), 22-37, at 25.

perpetrators not by using these offences under the Fraud Act 2006, but they have fallen back on the common law offence of conspiracy to defraud, which interesting the Law Commission wanted to abolish. For example, in August 2015 Tom Hayes was convicted of conspiracy to defraud LIBOR at Southwark Crown Court. He was originally sentenced to 14 years imprisonment,[88] but this was reduced to 11 years on appeal.[89] The SFO noted that "the jury were sure that in his admitted manipulation of Libor, Hayes was indeed dishonest. The verdicts underline the point that bankers are subject to the same standards of honesty as the rest of us".[90]

6. There is no single government department that plays such an active role in the UK, where the most prominent agency is the SFO. This was established following the 'era of financial deregulation' in 1980s, an era that resulted in London attracting "foreign criminals, including 'mademen' from the US Mafia, the 'Cosa Nostra', who were now in London taking advantage of the new climate of enterprise, offering securities scams, commodity futures trading frauds and other forms of investment rip-offs".[91] Bosworth-Davies noted that "almost overnight, London became the fraud capital of Europe and every con-man, snake-oil, salesman, grafter and hustler turned up".[92] To tackle these problems the SFO, an independent government department, was created with both investigative and prosecutorial powers.[93] The impetus for introducing the Criminal Justice Act 1987 and creating the SFO was the Fraud Trials Committee Report, commonly known as the 'Roskill Report'. The government established the independent committee of inquiry, in 1983. The Roskill Committee considered the introduction of more effective means of fighting fraud through

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[88] *R v Tom Hayes*, Southwark Crown Court, 03 August 2015.
[89] See *R v Tom Hayes* [2015] EWCA Crim 1944.
[90] Serious Fraud Office 'First LIBOR defendant on trial found guilty', August 5 2015, available from https://www.sfo.gov.uk/2015/08/03/first-libor-defendant-on-trial-found-guilty/, accessed February 25 2015.
[91] See, BOSWORTH - DAVIES, (2009), *Investigating financial crime: the continuing evolution of the public fraud investigation role – a personal perspective*, *Company Lawyer*, 30(7), 195-199, at 196.
[92] *Ibid*. Such dual power is not available to the police or the Crown Prosecution Service.
[93] See generally WRIGHT, (2003), *Fraud after Roskill: A view from the Serious Fraud Office*, *Journal of Financial Crime*, 11(1), 10-16.

changes to the law and criminal proceedings.[94] The Committee criticised the staffing levels of the agencies policing fraud, and that there was a great deal of overlap between them. Roskill concluded that "co-operation between different investigating bodies in the UK was inefficient, and the interchange of information or assistance between our law enforcement authorities was unsatisfactory".[95] The Roskill Committee made 112 recommendations, of which all but two were implemented.[96] Its main recommendation was the creation of a new unified organisation responsible for the detection, investigation and prosecution of serious fraud cases. The result was the SFO, which has jurisdiction in England, Wales and Northern Ireland, but not Scotland.[97] It is headed by a director, who is appointed and accountable to the Attorney General. Under the Act, the SFO has the ability to search property and compel persons to answer questions and produce documents provided they have reasonable grounds to do so.[98] The SFO has a budget of £44.6m per year, it employees 303 staff and has 86 active cases.[99] The SFO also considers the seriousness of the case and its complexity and will investigate investment fraud, bribery and corruption, corporate fraud and public Sector fraud.

The effectiveness of the SFO has been questioned following a number of high profile failed prosecutions. Mahendra describes the notorious failures of the SFO as reminiscent of "watching the England cricket team – a victory being so rare and unexpected that it was a cause of national rejoicing".[100] Indeed, Wright notes that "because the SFO operates in the spotlight, the beam falls on the unsuccessful as well as the victorious. Indeed it shines with blinding brightness on the ones that get

[94]The Committee was asked to "consider in what ways the conduct of criminal proceedings in England and Wales arising from fraud can be improved and to consider what changes in existing law and procedure would be desirable to secure the just, expeditious and economical disposal of such proceedings". See Fraud Trials Committee Report (1986) HMSO.

[95]*Ibid*, p.8.

[96]For a detailed commentary of the Roskill Commission see LEVI, (2003), *The Roskill Fraud Commission revisited: an assessment*, *Journal of Financial Crime*, 11(1), 38-44.

[97]Criminal Justice Act 1987, s. 1.

[98]Criminal Justice Act 1987, s. 2. It is important to note that the SFO has other investigative and prosecutorial powers under the Fraud Act 2006, the Theft Act 1968, the Companies Act 2006, the Serious Crime Act 2007, the Serious Organised Crime and Police Act 2005, the Proceeds of Crime Act 2002 and the Regulation of Investigatory Powers Act 2000.

[99]Serious Fraud Office *Achievements 2009-2010* (Serious Fraud Office: London, 2010) at p.3.

[100]See, MAHENDRA, (2002), *Fighting serious fraud*, *New Law Journal*, 152(7020), 289.

away".[101] The prosecutorial inadequacies of the SFO were highlighted by the 'Review of the Serious Fraud Office'.[102] The Review compared the performance of the SFO with the US Attorney's Office for the Southern District of New York and the Manhattan District Attorney's Office and concluded that "the discrepancies in conviction rates are striking".[103] The Review noted that between 2003 and 2007 the SFO's average conviction rate was 61%, whilst the conviction rates in the two aforementioned cases studies was 91% and 97% respectively.[104] In September 2007, the Crown Prosecution Service announced the creation of the Fraud Prosecution Unit, now referred to as the Fraud Prosecution Division,[105] which was established following the collapse of the Jubilee Line fraud trial.[106] The Unit limits its involvement to suspected instances of fraud exceeding £750 000, cases involving the corruption of public officials, fraud on government departments, fraud on overseas governments, complicated money laundering cases and any other matter that it feels is within its remit.[107] In October 2008, HM Crown Prosecution Service Inspectorate concluded that there "has been a positive direction of travel in terms of successful outcomes (convictions), which stood at a creditable 85% of the defendants proceeded against in 2007-2008; underlying casework quality, which is characterised by strong legal decision-making and active case progression; and the development of management systems and leadership profile".[108] Davies took the view that "it [the Serious Fraud Office] was not the great success that Roskill envisaged, and its activities were marked out by 20 years of professional jealousy and internal squabbling among its component teams".[109] Conversely, the performance of the SFO is hampered by the

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[101]See, WRIGHT above, n 95 at 10.
[102]See, DE GRAZIA, *Review of the Serious Fraud Office – Final Report* (Serious Fraud Office: London, 2008).
[103]*Ibid*., at pp. 3-4.
[104]See, DE GRAZIA above, n 104.
[105]Crown Prosecution Service (2009), 'DPP announces new head of Fraud Prosecution Division', http://www.cps.gov.uk/news/press_releases/136_09/.
[106]See, MASTERS, (2008), *Fraud and money laundering: the evolving criminalisation of corporate non-compliance, Journal of Money Laundering Control*, 11 (2), 103-122, at 104.
[107]*Ibid*.
[108]HM Crown Prosecution Service Inspectorate *Review of the Fraud Prosecution Service* (HM Crown Prosecution Service Inspectorate: London, 2008) at p.5.
[109]See, BOSWORTH-DAVIES above, n 93 at 198.

complexity of the crimes it investigates.[110] Raphael noted that the SFO is "always kept short of resources and instead of being a unified fraud office, was just another, more sophisticated, prosecution agency".[111]

One of the secondary agencies that tackles fraud is the FSA.[112] The FSA stated that its fraud policy can be divided into four parts – a direct approach,[113] increased supervisory activity,[114] promoting a more joined up approach[115] and Handbook modifications.[116] The FSA requires senior management to take responsibility for managing the risk of fraud and that firms are required to have in place effective controls and instruments that are proportionate to the risk the firm faces.[117] The FSA encourages firms to maintain their systems and controls, thematic work, improving the whistle-blowing arrangement, amending the financial crime material in the FSA Handbook and ensuring that the financial services sector, trade associations and the government continue to communicate the risk of fraud to customers.[118] To implement this policy the FSA has been given an extensive array of enforcement powers, some of which it has utilised to combat fraud. It is a prosecuting authority for both money laundering, and certain fraud related offences,[119] and has the power to impose a financial penalty where it establishes that there has been a contravention by an authorised person of any requirement.[120] The FSA fined Capita

[110]See, WRIGHT above, n 95 at 10.
[111]*Ibid*.
[112]Financial Services Authority *Developing our policy on fraud and dishonesty – discussion paper 26* (Financial Services Authority: London, 2003).
[113]This would have seen the FSA focusing its efforts on specific types of fraud or dishonesty which constitute the greatest areas of concern, and where they can make a difference.
[114]This would include, for example, considering the firms' systems and controls against fraud in more detail in our supervisory work, including how firms collect date on fraud and dishonesty.
[115]The third approach would involve the FSA liaising closely with the financial sector and other interested parties in order to achieve a more effective approach towards fraud prevention in the financial services sector.
[116]The final proposed method would include codification and clarification of the relevant fraud risk management provisions of the Handbook.
[117]Financial Services Authority 'The FSA's new approach to fraud – Fighting fraud in partnership speech by Philip Robinson', 26 October 2004, http://www.fsa.gov.uk/library/communication/speeches/2004/sp208.shtml.
[118] *Ibid*.
[119] See Financial Services Authority 'Fake stockbroker sentenced to 15 months', 13 February 2008, http://www.fsa.gov.uk/library/communication/pr/2008/011.shtml.
[120]Financial Services and Markets Act 2000, s. 206 (1).

Financial Administration Limited £300 000 for poor anti-fraud controls,[121] and in May 2007 fined BNP Paribas Private Bank, £350 000 for weaknesses in its systems and controls which allowed a senior employee to fraudulently transfer £1.4m out of the firm's clients' accounts without permission.[122] Furthermore, it has fined the Nationwide Building Society £980 000 for "failing to have effective systems and controls to manage its information security risks",[123] and Norwich Union Life, £1.26m for not "having effective systems and controls in place to protect customers' confidential information and manage its financial crime risks".[124] The FSA also has the power to ban authorized persons and firms from undertaking any regulated activity.[125] In 2008, the FSA had fined and/or banned 12 mortgage brokers for submitting false mortgage applications. In 2007, the FSA handed down only five bans. In 2008, the FSA has prohibited 24 separate brokers and issued fines in excess of £500 000.[126] In the first half of 2009, the level of fines imposed by the FSA has already exceeded this figure. In addition to imposing sanctions on fraudsters the FSA has also enabled victims of fraud to recover losses suffered at the hands of companies involved in share fraud activity.[127] The FSA has concentrated is financial crime policy on money laundering, largely at the expense of fraud, in order to meet its statutory objective to reduce financial crime. Its recent efforts to tackle fraud, especially mortgage fraud, have been fast tracked due to the problems associated with the global financial crisis. The FSA should have equally prioritised the different

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[121] Financial Services Authority 'FSA fines Capita Financial Administrators Limited £300,000 in first anti-fraud controls case', March 16 2006, http://www.fsa.gov.uk/pages/Library/Communication/PR/2006/019.shtml.

[122] Financial Services Authority *Financial Services Authority Annual Report 2007/2008* (London, Financial Services Authority, 2008) p 23.

[123] Financial Services Authority 'FSA fines Nationwide £980 000 for information security lapses', February 14 2007, http://www.fsa.gov.uk/pages/Library/Communication/PR/2007/021.shtml.

[124] Financial Services Authority 'FSA fines Norwich Union Life £1.26m', December 17 2007, available from http://www.fsa.gov.uk/pages/Library/Communication/PR/2007/130.shtml, accessed February 27 2016.

[125] Financial Services and Markets Act 2000, s. 56.

[126] National Fraud Strategic Authority *The National Fraud Strategy – A new approach to combating fraud* (National Fraud Strategic Authority: London, 2009) 16.

[127] In February 2010 the FSA recovered £270 000 for defrauded investors who were advised to buy shares in Eduvest plc. Financial Services Authority 'FSA returns £270 000 to victims of share fraud', February 23 2010, available from http://www.fsa.gov.uk/pages/Library/Communication/PR/2010/032.shtml, accessed February 26 2015.

types of financial crime it is required to tackle under FSMA 2000, and not exclusively concentrate its efforts on money laundering. Furthermore, there is a clear overlap between the investigative and prosecutorial responsibilities of the FSA and SFO.

The most recent agency created (under the Labour government's reign) to tackle fraud is the NFA.[128] The objectives of the NFA include creating a criminal justice system that is sympathetic to the needs of victims of fraud by ensuring that the system operates more effectively and efficiently,[129] to discourage organised criminals from committing fraud in the UK and to increase the public's confidence in the response to fraud. Rider stated that the NFA:

> "has an impressive list of strategic aims: tackling the key threats of fraud that pose the greatest harm to the United Kingdom; the pursuit of fraudsters effectively, holding them to account and improving victim support; the reduction of the UKs exposure to fraud by building, sharing and acting on knowledge; and securing the international collaboration necessary to protect the UK from fraud".[130]

The NFA's Interim Chief Executive Sandra Quinn boldly claimed that "we can respond quickly and effectively to the fraud threat".[131] This level of optimism was not shared by Davies who stated that the NFA "will last about as long as the unlamented Asset Recovery Agency".[132] An important measure introduced by the NFA was the publication of the National Fraud Strategy, which is an integral part of the government's fraud policy.[133] Under which, the NFA is required:

1. to tackle the threats presented by fraud,
2. acting effectively to pursue fraudsters and holding them to account,
3. improving the support available to victims,

[128]National Fraud Strategic Authority above, n 128.
[129]For a more detailed discussion of how this is to be achieved see The Attorney General's Office *Extending the powers of the Crown Court to prevent fraud and compensate victims: a consultation* (Attorney General's Office: London, 2008).
[130]See, RIDER above, n 74 at 1.
[131]National Fraud Strategic Authority above, n 128.
[132]See, BOSWORTH-DAVIES above, n 93 at 199.
[133]National Fraud Strategic Authority above, 128 at 3.

4. reducing the UK's exposure to fraud by building the nation's capability to prevent it, and

5. targeting action against fraud more effectively by building, sharing and acting on knowledge and securing the international collaboration necessary to protect the UK from fraud.[134]

Despite the fanfare announcement by the government that it had created the NFA, one fundamental question must be asked, has it actually made any difference towards the overall effectiveness of the UKs fraud policy. If we are to believe that the extent of fraud in the UK is somewhere between £14bn and £30bn, how is it possible for an agency to make any valuable dent in this statistic if it only has a budget of £29m over a three year period?

The effectiveness of these anti-fraud agencies must be questioned and can be contrasted with those in the US. There is a considerable degree of overlap amongst the SFO and FSA; both have extensive investigative and prosecutorial powers that seek to achieve the same objective. The failures of the SFO are well documented, whilst the FSA's effectiveness must be questioned because of its obsession with combating money laundering. It is recommended that a single financial crime agency should be established to co-ordinate the UKs fraud policy with extensive investigative and prosecutorial powers. Such an idea was first mooted by Fisher who recommended the creation of a "single 'Financial Crimes Enforcement Agency' to tackle serious fraud, corruption and financial market crimes".[135] This recommendation has been supported by the Conservative party who would establish an Economic Crime Agency that would do the work of the SFO, the Fraud Prosecution Service and the OFT. Following the 2010 general election, the coalition government outlined its desire to create a single agency to tackle financial crime. The government stated:

[134] *Ibid*.
[135] See, FISHER, *Fighting Fraud and Financial Crime A new architecture for the investigation and prosecution of serious fraud, corruption and financial market crimes* (Policy Exchange: London, 2010) at p.3.

> "We take white collar crime as seriously as other crime, so we will create a single agency to take on the work of tackling serious economic crime that is currently done by, among others, the Serious Fraud Office, Financial Services Authority and Office of Fair Trading".[136]

However, it is likely that the 'financial crisis' could scupper the government's plans to create such an agency.[137] The Fraud Advisory Panel writing in March 2010 took the view that due to the current climate the time is not right for an economic crime agency.[138]

7. The UK has a strong history of utilising financial intelligence as part of its broader financial crime strategy, a point clearly illustrated by the anti-money laundering reporting provisions of the Proceeds of Crime Act 2002 (PCA 2002) and the duty to report any suspected instances of terrorist financing under the Terrorism Act 2000. The Fraud Review noted that "fraud is massively underreported. Fraud is not a police priority, so even when reports are taken, little is done with them. Many victims therefore, do not report at all. Accordingly, the official crime statistics display just the tip of the iceberg and developing a strategic law enforcement response is impossible because the information to target investigations does not exist".[139] If a suspected fraud is committed against a bank it is reported to its Money Laundering Reporting Officer (MLRO). Subsequently, fraudulent activities are reported to SOCA. Conversely, decision lies with individual banks to determine whether or not to report the fraud to the police. In 2007, the Home Office announced that victims of credit card, cheque and online banking fraud are to report the matter to banks and financial institutions. However, the obligation to report allegations of fraud is not as straight forward, but nonetheless still important. The primary statutory obligation for

[136]See, HM Government *The Coalition: our programme for government* (HM Government: London, 2010) at p.9.
[137]See, LEIGH - EVANS, *Cost of new economic crime agency could prove prohibitive*, June 2 2010, available from http://www.guardian.co.uk/business/2010/jun/02/economic-crime-agency-scheme-cost, accessed February 26 2016.
[138]See generally Fraud Advisory Panel *Roskill Revisited: Is there a case for a unified fraud prosecution office?* (Fraud Advisory Panel: London, 2010).
[139]Attorney General's Office above, n 30 at 7.

reported instances of fraud is contained under the PCA 2002.[140] It is a criminal offence under the 2002 Act to fail to disclose via a SAR where there is knowledge, suspicion or reasonable grounds to know or suspect, that a person is laundering the proceeds of criminal conduct. Successful fraud is defined as money laundering for the purpose of this Act.[141] Furthermore, the Act specifies that members of the regulated sector are required to report their suspicions 'as soon as reasonable practical' to SOCA via their MLRO. There is no legal obligation to report unsuccessful or attempted frauds to the authorities because any attempted frauds will not give rise to any legal criminal proceedings that are available for money laundering, and fall outside the scope of the mandatory reporting obligations under the PCA 2002. Ultimately, the decision lies with the police whether or not an investigation will be conducted. The Home Office has advised that the police should only investigate where there are good grounds that they believe a criminal offence has been committed.[142] Given the cuts in the budget for police[143] and the increase in administrative workload for police officers, it is not surprising that the police has not been in the forefront for tackling financial crime.

Furthermore, members of the regulated sector are obliged to report fraud to the Financial Services Authority (FSA) in the following circumstances:

> "(1) it becomes aware that an employee may have committed a fraud against one of its customers; or
>
> (2) it becomes aware that a person, whether or not employed by it, may have committed a fraud against it; or
>
> (3) it considers that any person, whether or not employed by it, is acting with intent to commit a fraud against it; or

[140]Proceeds of Crime Act 2002, s. 330.
[141]It is important to note that the Proceeds of Crime Act 2002 applies to serious crime, which includes fraud.
[142]Home Office *Home office circular 47/2004 priorities for the investigation of fraud cases* (Home Office, London, 2004).
[143]See, RAWLINSON, *Three police forces still at risk of budget cuts, government admits*, December 13 2015, available from http://www.theguardian.com/uk-news/2015/dec/13/three-police-forces-still-at-risk-of-budget-cuts-government-admits, accessed February 3 2016.

(4) it identifies irregularities in its accounting or other records, whether or not there is evidence of fraud; or

(5) it suspects that one of its employees may be guilty of serious misconduct concerning his honesty or integrity and which is connected with the firm's regulated activities or ancillary activities".[144]

In determining whether or not the matter is significant, the firm must consider:

"(1) the size of any monetary loss or potential monetary loss to itself or its customers (either in terms of a single incident or group of similar or related incidents);

(2) the risk of reputational loss to the firm; and

(3) whether the incident or a pattern of incidents reflects weaknesses in the firm's internal controls".[145]

The FSA Handbook also provides that the FSA "the notifications under SUP 15.3.17 R are required as the FSA needs to be aware of the types of fraudulent and irregular activity which are being attempted or undertaken, and to act, if necessary, to prevent effects on consumers or other firms".[146] Therefore, "a notification under SUP 15.7.3 G should provide all relevant and significant details of the incident or suspected incident of which the firm is aware".[147] Furthermore, "if the firm may have suffered significant financial losses as a result of the incident, or may suffer reputational loss, and the FSA will wish to consider this and whether the incident suggests weaknesses in the firm's internal controls".[148] If the institution has suffered a significant financial loss, or may suffer reputational loss as a result of the fraudulent activity, the FSA will take into account whether the incident suggests weaknesses in the institution's internal controls. If the fraud is committed by representatives and other Approved Persons, the FSA has the power to withdraw its authorization and the possibility of prosecution.

[144] SUP 15.3.17R.
[145] SUP 15.3.18G.
[146] SUP 15.3.19G.
[147] SUP 15.3.19G.
[148] SUP 15.3.20G.

The UK's policy towards fraud gained momentum under the Labour government, a willingness shared by the current Conservative administration. Prior to the 2008 financial crisis, the priority was given to criminalisation of fraudulent activities. During the 2008 financial crisis the focus shifted to the risks in 'Casino' banking, as illustrated by well-known cases of Kerviel[149] and Adoboli.[150] Then the focus shifted to market stability and integrity. Today, as aptly identified by McCormick, the main concern is conduct safety[151] and regulation of the market. At the same time, it is possible to see the continuation of the criminal and strict liability approaches, not only in the form of the Bribery Act 2010 but also more recently the new criminal offence of reckless mismanagement of a bank pursuant to section 36 of the Financial Services (Banking Reform) Act 2013 which will come into force in March 2016.[152] Accordingly, senior executives in banks may be held responsible for regulatory breaches in their areas of responsibility unless they can demonstrate that they had relevant mechanisms in place and took reasonable steps to prevent such breaches – a major shift from the presumption of having to prove some degree of guilt.[153] These initiatives go some way in improving accountability, demonstrating the seriousness of the offence, and the incentives for compliance. However, there is still scope for improvement in the initiatives that have been introduced to tackle fraud. For example, the effectiveness of the criminalisation of fraud has been limited by the inadequacies of the Theft Acts and the common law offences, a position that has improved by the introduction of the Fraud Act. However, concerns still remain about the enforcement of these offences by the SFO and the CPS following the collapse of several high profile instances of fraud. It is simply too early to determine if the Fraud

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[149]See, STOTHARD, *Rogue trader Jérôme Kerviel to challenge SocGen damages case*, January 20 2016, http://www.ft.com/cms/s/0/2fb10f74-bf5e-11e5-846f-79b0e3d20eaf.html.

[150]*R v Kweku Adoboli* http://www.judiciary.gov.uk/Resources/JCO/Documents/Judgments/kweku-adoboli-sentencing-remarks- 20112012.pdf. For a detailed comparative analysis of counter economic crime law and policy in the US, UK and Australia see, PALMER, *Countering Economic Crime: A Comparative Analysis*, (Routledge, *forthcoming*, 2017).

[151]See, MCCORMICK, (2015) 'The influence of politics on regulatory and cultural change in the financial sector after the financial crises: a UK perspective', *Law and Economics Yearly Review*, Vol. 4 (1), 110-123.

[152]The maximum sentence following conviction is seven years imprisonment.

[153]*Ibid*.

Act has made any difference to the prosecution of fraudsters. The current government must be commended for recognising the need to create single economic crime agency. Yet, the reporting of instances of suspicious fraudulent activities is fragmented with a number of different reporting mechanisms available. This causes confusion, uncertainty and delay.

8. The policy adopted by the Conservative government towards fraud has been heavily influenced not by legislation, but by the imposition of record amounts of financial penalties, the introduction of deferred prosecution agreements, budgetary cutbacks, the creation of the National Crime Agency (NCA), the expanding remit of the Home Office and numerous broken promises.

With the NCA becoming fully operational in 2013, the regulatory and enforcement regime for countering financial crime has become more complex and costly.[154] This is because the Economic Crime Command (ECC), which sits within the NCA, duplicates some of the functions of the SFO and the FCA. These include *inter alia* seizure of assets, sharing of intelligence, and coordination of anti-money laundering operations. This complexity may be deepened in the future as the NCA intends to tackle fraud, corruption, bribery, insider dealing, and market abuse[155] all of which come particularly under the remit of the SFO and FCA. In terms of its effectiveness and value for money, the NCA was criticised by the Home Affairs Select Committee for not doing enough.[156] With its huge budget (compared to the SFO), the NCA managed to seize only £22 million worth of criminal assets[157] and struggled to cope with its workload.[158]

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[154]BBC News 'The budget of the NCA is reported as £500 million in 2014-15', February 17 2015, available from http://www.bbc.co.uk/news/uk-31499706, accessed February 26 2016.

[155]National Crime Agency *Annual Plan 2014-15* (National Crime Agency: London. 2014).

[156]Home Affairs Select Committee *Work of the National Crime Agency scrutinised'*, December 8 2015, http://www.parliament.uk/business/committees/committees-a-z/commons-select/home-affairs-committee/news-parliament-2015/national-crime-agency/.

[157]*Ibid.*

[158]The Guardian, 'Keith Vaz says National Crime Agency is more like Keystone Cops than FBI', December 8 2015, http://www.theguardian.com/uk-news/2015/dec/08/keith-vaz-says-national-agency-is-more-like-keystone-cops-than-fbi.

Financial Sanctions

One of the most commonly used counter-fraud measures that have been used since the 2010 general election has been the imposition of record breaking financial penalties. For example, the highest profile financial sanctions imposed since the financial crisis has been over the manipulation of the London Interbank Borrowed Rate and the Foreign Exchange Currency Market.[159] In 2012, the regulator concluded that Barclays Bank had manipulated the both the dollar LIBOR and the EURIBOR rates of interest after being asked by derivative traders and other banking institutions.[160] The regulator noted that Barclays had acted inappropriately by “making LIBOR submissions which took into account concerns over the negative media perception of Barclays’ LIBOR submissions”.[161] This is of particular relevance to link between the financial crisis and the illegal activities of Barclays. The regulator added that the concerns raised by members of senior management of Barclays resulted in “instructions being given by less senior managers at Barclays to reduce LIBOR submissions in order to avoid negative media comment”.[162] The regulator concluded that this conduct breached several of its Principles of Business and stated that Barclays had “fail[ed] to conduct its business with due skill, care and diligence when considering issues rose internally in relation to its LIBOR submissions”.[163] Barclays Bank Plc was fined £59.5m by the regulator and their conduct was strongly condemned by the HM Treasury Select Committee.[164] The second bank to be fined (£160m) due to its manipulation of LIBOR was UBS in December 2012.[165] The regulator concluded that between January 2005 and December 2010, UBS breached

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[159] It is important to also state that the regulator has also imposed financial penalties for other types of financial crime including money laundering, fraud and bribery.

[160] See, Financial Services Authority ‘Barclays fined £59.5 million for significant failings in relation to LIBOR and EURIBOR’, June 27 2012, http://www.fca.org.uk/news/press-releases/barclays-fined-595-million-libor-euribor.

[161] See, Financial Services Authority *Final notice to Barclays Bank Plc* (Financial Services Authority: London, 2012) at 3.

[162] *Ibid*.

[163] Financial Services Authority above, n 163 at 3.

[164] HM Treasury Select Committee *Fixing LIBOR: some preliminary findings* (HM Treasury: London, 2012) at 21.

[165] See, Financial Services Authority ‘UBS fined £160 million for significant failings in relation to LIBOR and EURIBOR’, December 19 2012, available from http://www.fsa.gov.uk/library/communication/pr/2012/116.shtml, accessed February 26 2016.

Regulations 3 and 5 of the Principles of Business when the bank engaged in illegal behaviour regarding the calculation of LIBOR and EURIBOR.[166] The Royal Bank of Scotland (RBS) became the third bank to be fined in February 2013 following the revelations of LIBOR rigging. At the time, taxpayers had 79% stake in the RBS following the bailout package in 2008.[167] The regulator fined RBS £87.5m for its conduct between January 2006 and November 2010.[168] The overall fine would have been £125m had it not been for a 30% discount granted by the regulator. The conduct of the banks employees was not limited to the UK, it occurred in Japan, Singapore and the US. According to the regulator, the illegal conduct was extensive and "219 requests for inappropriate submissions were documented – an unquantifiable number of oral requests, which by their nature would not be documented, were also made. At least 21 individuals including derivatives and money market traders and at least one manager were involved in the inappropriate conduct".[169] The regulator added that "the failures at RBS were all the more serious because of the attempts not only to influence the submissions of RBS but also of other panel banks and the use of interdealer brokers to do this … the extent and nature of the misconduct relating to LIBOR has cast a shadow on the reputation of this industry and we expect firms to take steps to ensure that this can never happen again".[170] The regulator imposed another financial penalty of £14m on ICAP European Limited in September 2013 for an embarrassing amount of misconduct that involved the firm's traders colluding with the UBS traders to manipulate the (Japanese Yen) JPY LIBOR rates and one trader receiving bonus or corrupt payments

[166]*Ibid*.
[167]See, TREANOR, *UK government starts Royal Bank of Scotland sell-off*, August 3 2015, available fromhttp://www.theguardian.com/business/2015/aug/03/uk-government-starts-royal-bank-of-scotland-sell-off-rbs, accessed February 13 2016.
[168]Financial Services Authority 'RBS fined £87.5m for significant failings in relation to LIBOR', February 6 2013, available from http://www.fsa.gov.uk/library/communication/pr/2013/011.shtml, accessed February 26 2016.
[169] *Ibid*.
[170]Financial Services Authority above, n 163.

for assisting in the manipulation.[171] In October 2013, Rabobank was fined by the regulator £105m for "poor internal controls encouraged collusion between traders and LIBOR submitters and allowed systematic attempts at benchmark manipulation".[172] The regulator added that "The FCA found over 500 instances of attempted LIBOR manipulation, directly or indirectly involving at least 9 managers and 19 other individuals based across the world. At least one manager was actively involved in attempted manipulation and facilitated a culture where this practice appeared to be accepted, or even endorsed by the bank".[173] In July 2014, Lloyds TSB was fined £104m by the regulator for breaches of the LIBOR and other benchmarks.[174] Additionally, Martin Brokers (UK) Limited was fined £630,000 for significant failings in relation to LIBOR.[175] The key question that must be addressed here is whether the financial penalties will deter future misconduct in the financial services sector? Evidence suggests that the impact of these fines on the financial services sector is extremely limited and that the financial services sector continues to be troubled by misconduct. This was soon illustrated the imposition of these record breaking financial penalties following the manipulation of FOREX. For example, in November 2014 the regulator fined five banks a total of £1.1bn for "failing to control business practices … in their foreign exchange trading operations".[176] In this instance, the regulator fined Citibank £225m, HSBC Bank Plc £216.3m, JP Morgan

[171] Financial Conduct Authority 'ICAP Europe Limited fined £14 million for significant failings in relation to LIBOR', September 25 2013, available from http://www.fca.org.uk/news/icap-europe-limited-fined, accessed February 26 2016.

[172] Financial Conduct Authority 'The FCA fines Rabobank £105 million for serious LIBOR-related misconduct', October 29 2013, available from http://www.fca.org.uk/news/the-fca-fines-rabobank-105-million-for-serious-libor-related-misconduct, accessed January 29 2016.

[173] *Ibid*.

[174] Financial Conduct Authority 'Lloyds Banking Group fined £105m for serious LIBOR and other benchmark failings', September 28 2015, available from https://www.fca.org.uk/news/lloyds-banking-group-fined-105m-libor-benchmark-failings, accessed February 25 2016.

[175] Financial Conduct Authority 'Martin Brokers (UK) Limited fined £630,000 for significant failings in relation to LIBOR', May 15 2014, available from http://www.fca.org.uk/news/press-releases/martin-brokers-uk-limited-fined-630000-for- significant-failings-in-relation-to-libor, accessed February 26 2016

[176] Financial Conduct Authority 'FCA fines five banks £1.1 billion for FX failings and announces industry-wide remediation programme', November 12 2014, available from https://www.fca.org.uk/news/fca-fines-five-banks-for-fx-failings, accessed February 26 2016.

Chase Bank £222.1m, RBS £217m and UBS AG £233m. Martin Wheatley, the then had of the regulator *boldly* claimed:

> "The FCA does not tolerate conduct which imperils market integrity or the wider UK financial system. Today's record fines mark the gravity of the failings we found and firms need to take responsibility for putting it right. They must make sure their traders do not game the system to boost profits or leave the ethics of their conduct to compliance to worry about. Senior management commitments to change need to become a reality in every area of their business".[177]

In May 2015, Barclays was fined by the regulator £284.4m for "failing to control business practices in its foreign exchange business in London".[178] The regulator condemned the actions of Barclays and stated that "this is *another* [authors' emphasis] example of a firm allowing unacceptable practices to flourish on the trading floor".[179] The regulator also imposed a financial penalty on Mark Stevenson in 2014 for manipulating gilt prices during quantitative easing.[180]

While we have only seen one criminal conviction and there is an increased number of enforcement action in the form of penalties, it is not clear if the strategy of the current government has had the desired effect of firstly bringing about a culture change and secondly, reducing financial crime in the industry. Arguably, public spending cuts (e.g. the SFO faced) also contributed to the limited success in countering financial crime.

Budgetary Cutbacks

One of the major criticisms of the response to white collar crime emanating from the financial crisis has been the lack of criminal prosecutions. During the height

[177] *Ibid*.
[178] Financial Conduct Authority 'FCA fines Barclays £284,432,000 for forex failings', May 20 2015, available from https://www.fca.org.uk/news/fca-fines-barclays-for-forex-failings, accessed February 14 2016.
[179] *Ibid*.
[180] Financial Conduct Authority 'FCA bans and fines trader £662,700 for manipulating gilt price during QE', March 20 2014, available from https://www.fca.org.uk/news/fca-bans-and-fines-trader-660k-for-manipulating-gilt-price-during-qe, accessed February 15 2016.

of the financial crisis, and whilst leader of the Conservative party, David Cameron boldly proclaimed that the City of London faced a "Day of Reckoning" and that severe penalties would be imposed for those bankers whose reckless activities causes the financial crisis.[181] During his 'Day of Reckoning' speech, David Cameron stressed the importance of punishment and deterrence and stated:

> "[the] most important step we must take in enforcing responsibility in the City is to make sure that when rules are broken, and culprits are found, they are properly punished. That's only fair - because those responsible must be held to account … around the world, bankers sat up and took notice not when global finance ministers issued some new communiqué on unauthorized speculative trading - it was when Nick Leeson was caught and put behind bars … The problem in Britain … is that there just doesn't seem to be the will to see appropriate justice done at the highest level. Not from the Government. And not much will evident in the FSA either. Despite the fact that the FSA itself admits: 'that the prospect of criminal proceedings acts as a significantly greater deterrent to those contemplating misconduct than does a fine of almost any size' it still prefers fines and mediation to the full application of the law. I welcome the recent comments by Jamie Symington of the FSA that they would 'bring more criminal prosecutions in the future'. But the truth remains that in the last twelve months, they have only brought four cases to trial. And only one of these has any connection to the current crisis - a mortgage advisor who lied and submitted forged documents in his application to become an FSA approved person. The other three all involved incidences of insider dealing that occurred before the debt crisis. This is not, at root, about more legislation. The laws are already there. Rather, it's about implementation and law enforcement".[182]

[181]See, PRINCE, *Cameron calls for criminal charges against bankers responsible for credit crunch*, December 15 2008, available from http://www.telegraph.co.uk/finance/financetopics/bernard-madoff/3775925/Cameron-calls-for-criminal-charges-against-bankers-responsible-for-credit-crunch.html, accessed February 14 2016.

[182]Conservatives 'David Cameron: A day of reckoning', 15 December 2008, http://www.conservatives.com/News/Speeches/2008/12/David_Cameron_A_day_of_reckoning.aspx.

A number of interesting points can be raised from this section of the speech. For example, David Cameron stated that when “rules are broken, and culprits are found, they are properly punished”. This raises a very important question, how many of those who are responsible for the financial crisis or contributed to it have been held accountable since the Coalition government was formed in 2010 and subsequently since 2015 when Conservative Party won the general election by majority? The answer at the time of writing is zero. For example, not one director of a bank has been disqualified by the DBIS under the Company Director Disqualification Act 1986. Cameron also claimed that “corporate America really understood the consequences of dodgy accounting not just when Enron collapsed - but when Jeffrey Skilling was given a twenty-four year jail sentence”. This part of the speech must be questioned as previously argued, there have been no high profile prosecutions let along convictions for those who contributed towards the financial crisis. Indeed, the only convictions we have seen in the US were two former Rabobank traders in November 2015.[183] US law enforcement and regulatory agencies have concentrated on imposing what were initially perceived as impressive financial penalties on the culprits and also pursuing deferred or non-prosecution agreements. Sadly, authorities in the UK have adopted a similar, rather limp approach. David Cameron added that:

> “the Serious Fraud Office has an important part to play too. But its effectiveness was called into question earlier this year in a review conducted by American prosecutor Jessica de Grazia. This has to change. The FSA and the SFO should be following up every lead, investigating every suspect transaction. And the government should be urging them on, because we need to make it one hundred percent clear: those who break the law should face prosecution”.[184]

In order for the SFO to “follow up” every lead it is essential that it is granted the appropriate levels of funding by the UK government. However, under the current

[183] United States Department of Justice ‘Two former Rabobank traders convicted for manipulating US dollar, Yen LIBOR interest rates’, November 5 2015, available from https://www.justice.gov/opa/pr/two-former-rabobank-traders-convicted-manipulating-us-dollar-yen-libor-interest-rates, accessed February 29 2016.
[184] *Ibid*.

government's watch, the SFO, like many other government departments and agencies, has had its budget cut as part of a glut of extensive austerity measures. For example, the annual budget of the SFO was £43.3m in 2008/2009 and £53.2m in 2009/2010. The figure was gradually reduced from £40.1m in 2010/2011; to £35.5m in 2011/2012; and to £33.8m in 2014/2015.[185] The decision to reduce the budget of the SFO, at a time where white collar crime has increased and the duties of the SFO have been expanded to incorporate the enforcement of the Bribery Act 2010, has been questioned and criticised. However, it is important to note that fraud is an extremely difficult criminal offence to detect, prosecute and expensive to enforce.[186] This was clearly illustrated by the 1994 SFO prosecution of Virani, in which 50% of the trial costs was associated with accountants who assisted with the prosecution.[187] The imposition of budgetary cuts on the SFO since 2010 adversely affected its investigations and prosecutions into the manipulation of LIBOR. The Wall Street Journal reported that the SFO were unable to accept the offer to investigate LIBOR in 2011, due to significant budget cuts. However, it has also been argued that the former Director of the SFO, Richard Alderman, refused to investigate LIBOR and handed it over to the FSA.[188] However, it is important to note that the government responded by increasing the SFO budget into the investigation of LIBOR.[189] Indeed, the Financial Times reported that the SFO had been given an additional £10.5m to

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[185]Serious Fraud Office *Serious Fraud Office Annual Report and Accounts 2011-2012* (Serious Fraud Office: London, 2012) at 7.

[186]For an excellent discussion of the practical difficulties in prosecuting fraud cases see LLOYD-BOSTOCK, *The Jubilee Line Jurors: does their experience strengthen the argument for judge-only trial in long and complex fraud cases?* (2007) *Criminal Law Review*, April, 255-273, JULIAN, *Judicial perspectives in serious fraud cases - the present status of and problems posed by case management practices, jury selection rules, juror expertise, plea bargaining and choice of mode of trial*, (2008) *Criminal Law Review*, 10, 764-783 and JULIAN, *Judicial perspectives on the conduct of serious fraud trials*, (2007) *Criminal Law Review*, October, 751-768.

[187]See, SAVLA, *Serious Fraud Office powers under section 2 of the Criminal Justice Act 1987 and Police and Criminal Evidence Act 1984*, (1997) *Journal of Financial Crime*, 4(3), 223-231, at 225.

[188]See, ADAMSON, *SFO's priorities* (2013) Tolley's Practical Audit and Accounting, 24(7), 81-82, at 81.

[189]See for example ANON, *SFO to launch criminal investigation into Libor scandal*', July 6 2012, http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/9381683/SFO-to-launch-criminal-investigation-into-Libor-scandal.html, and BINHAM - PARKER, *SFO secures cash for Libor investigation*, 06 July 2012, http://www.ft.com/cms/s/0/3b590260-c6cd-11e1-943a-00144feabdc0.html#axzz2XgX4w3hV.

fund its investigation into LIBOR.[190] In March 2013, the Director of the SFO, Sir David Green QC, announced that:

> "We have an agreement with HM Treasury that where any case costs over a certain percentage of our budget in any one year, we can have access to the reserve for a sum covering that cost, ring fenced for that case. Libor is the first example".[191]

The budgetary constraints are not solely responsible for the limited success rate of the SFO. Some of the problems belong to how the SFO operates. For example, in the case of Tchenguiz, it was revealed that owing to the investigation and search procedures adopted by the SFO, a settlement for damages was reached.[192] In another prolific case, involving the BAE, documentation pertaining to the SFO investigation was found in a cannabis farm. [193]

9. The UK fraud policy has gathered pace following the publication of the Fraud Review in 2006, but is still in a state of flux. The policy adopted is very similar to that adopted in the US, but the criminalisation of fraud can be contrasted with the approach in the US. The UK has a single Fraud Act, which criminalises different types of fraudulent activities and provides prosecutors with new powers to tackle fraud. The second part of its anti-fraud policy concerns primary and secondary agencies, and it is this part that is in need of fundamental reform. There is no single agency that takes a lead role in tackling fraud, there are simply too many agencies who

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[190]See, SHOFFMAN, *SFO given £10.5m for Libor probe*, February 20 2013, http://www.ftadviser.com/2013/02/20/regulation/regulators/sfo-given-m-for-libor-probe-uza6iEIER2ai2LZejszgLJ/article.html. It has also been argued that the SFO were initially granted an additional £3.5m of funding to investigate LIBOR. See Adamson above, n 315 at 81.

[191] Serious Fraud Office 'Inaugural fraud lawyers association, Inner Temple, speech by David Green CB QC Director, Serious Fraud Office', 26 March 2013, available from http://www.sfo.gov.uk/about-us/our-views/director's-speeches/speeches-2012/inaugural-fraud-lawyers'-association.aspx, accessed February 26 2016.

[192]See, WINNING, *SFO settles $500 million Tchenguiz damages claim*, Reuters, March 9 2011, available from http://uk.reuters.com/article/uk-britain-settlement-tchenguiz-idUKKBN0G00SD20140731, accessed February 25 2016.

[193]The Guardian, 'Identities of BAE Systems witnesses among data lost by Serious Fraud Office', September 13 2013, available from http://www.theguardian.com/law/2013/sep/13/bae-systems-lost-serious-fraud-office, accessed February 26 2016.

performing the same function, a position that has deteriorated by the fact that not one government department performs a similar function to the Department of Justice. For example, HM Treasury has been charged with developing and implementing the UKs policies towards money laundering and terrorist financing, yet it has very little to do with the UKs fraud policy. Furthermore, the Home Office, who has been charged with tackling the problems associated with organised crime, but does little to tackle fraud. Therefore, it is recommended that a single government department is given the task of tackling all types of financial crime, it seems logical that this task is given to HM Treasury, given its experience with money laundering and terrorist financing. Another example of the overlap between anti-fraud agencies relates to the fact that both the SFO and FCA have the ability to conduct investigations and initiate prosecutions. The NFA has been given a three-year budget of £29m to tackle an industry that is worth £30bn. Therefore, it faces an improbable mission to reduce the extent of fraud with a very small budget. This makes little or no sense. The UK government should develop unitary financial crime agency that incorporates the functions of the agencies outlined above. It is possible to argue that this process has already started with the merger of several agencies including the National Crime Squad, the National Criminal Intelligence Service and the Assets Recovery Agency into SOCA. The primary legislation that imposes reporting obligations is the PCA 2002, under which fraud is reported to SOCA. However, in some circumstances allegations of fraud are reported to banks, the police and the regulated sector reports to the FSA. The system needs clarification and it has not been assisted by the creation of the NFRC. In the US, allegations of fraud are reported to FinCEN, and it is suggested that the UK should adopt a similar reporting strategy and that all suspicious transactions relating to fraud should be reported to SOCA.

Holding induvial culprits to account has been difficult to achieve albeit there has been a few successful convictions of lower ranking employees. Yet, the political will and the public support to improve the current anti-fraud regime seem to be there. For example, the chairman of the Treasury Committee, Andrew Tyrie MP said that "The [2008 financial] crisis showed that there must be much greater individual responsibility in banking. A buck that does not stop with an individual often stops nowhere."[194] It is however, too early to determine, if and to what extend the recent statutory and regulatory changes will be instrumental in preventing financial crime.

[194]See, ARNOLD *ET AL*, *Two HSBC directors quit in protest over new conduct rules*, Financial Times, 07 October 2014, http://www.ft.com/cms/s/0/a237eb26-4e12-11e4-bfda-00144feab7de.html#axzz41BLLUz44.