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

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CONTENTS

FOCUS ON GLOBAL PERSPECTIVES

THE EU SEEKING A NEW BALANCE BETWEEN REGULATORY HARMONIZATION, ECONOMIC CONVERGENCE AND SOVEREIGNTY

Francesco Capriglione*

ABSTRACT: *The paper addresses the delicate issue of 'governance of complexity', which characterizes the present historical moment marked by economic and political uncertainties. The limits of the European federalist conception are taken into account, which are the basis of a recovery of the traditional figure of the nation state, which is in conflict with the objective under the constitution of a "unity" of States.*

The lack of aggregating capacity of the "convergence" formula and the progressive transfer of sovereignty of the Member States is then highlighted. We see a climate of general disappointment due to the failure to implement the European 'federalist' project, based on sharing and solidarity between different peoples and countries. Populist movements were born in a context of widespread disappointment for the missed realisation of the European 'federalist' project, which should have been based on sharing and solidarity among different people and countries.

In this context, specific emphasis has been put on the populist approach proposed by Italian politicians in order to shape a 'new model of democracy', giving way to a reality in which the affirmation of Eurosceptic nationalism reflects a critique of European technostructures aimed at overcoming the current Democratic-representative frameworks and creating an unprecedented form of direct deliberative democracy, operating from the bottom.

The outlined situation of growing difficulties does not exclude, however, that even today there are valid reasons for the existence of the EU: maintaining conditions of peace and democracy, eliminating frontiers within the Schengen ar-

*Editor-in-chief.

ea, promoting economic and cultural development among the Member States.

SUMMARY: 1. Introduction. – 2. The issues raised by a global reality. – 3. Governing the complexity ... – 4. *Continued*: ... and the challenge of renewal. – 5. The limits of the European federalist conception ... – 6. *Continued*: … the establishment of single currency ... – 7. *Continued*: ... and the transfer of sovereignty. – 8. The inadequacy of the European governance and the rise of populist movements. – 9. The affirmation of the sovereign ideology: a future full of unknown factors… – 10. *Continued*: … the Italian case. – 11. Conclusions.

1. In our current historical period, faced with several issues associated with a global situation affecting economic choices and political decisions and influencing the social determinants of the most advanced Countries, scholars from different disciplines look critically at the processes through which the reality, subject to their observation, unfolds. Legal scholars, in particular, wonder about the permanent validity of those 'categories' which, in the past, allowed to systematically frame the intersubjective relations and the foundations of the dominant state conception.

The well-known studies of Marc Augè comes back to mind and, especially, the analysis, carried out with increasing intensity from the end of last century, concerning the significant changes in the world economic situation induced by the information technology revolution.[1] The shortening of the distances, the reduction of goods and people transportation costs, the emergence of a 'new bourgeoisie' lacking of territorial anchorage, adheres to the lifestyles of 'liquid modernity'[2] and is capable of moving from one place to another of the planet, living in 'non-places or anonymous places' which are standardised all over the globe (airports, hotels, etc.), constituted - in the past - the subject of original studies that, however, could not benefit from a thorough understanding of the real effects of a *change* whose relevance was tangible, without even succeeding in fully grasping its implications.

[1]See MARC AUGÈ, *I non luoghi*, Milano, 1996.
[2]See BAUMAN, *La modernità liquida*, Bari, 2002.

After several lustrums from those studies, re-proposing a reflection on said topic today means shifting the focus of the analysis from the examination of the causes that set the abovementioned process in motion to the evaluation of the outcomes (more precisely: the developments) of the global dimension that characterizes the post-modern reality. The observation of political and juridical events that tend to result in epochal changes of intersubjective relations - and, therefore, of social and economic relations - today raises a number of questions. These questions require responses consistent with the founding criteria of a liberal democratic system that - as European history shows - is the outcome of a strenuous achievement which cannot be erased by the turmoil deriving from a more fanciful rather than rational progressivism.

2. We are dealing with a systemic context characterized by 'diversity' resulting, on an economic level, in an increased competition and an increasing power of the markets. Thus, the latter often end up affecting not only the development of the business sector, but also the political decisions made by the States.

Non-negligible risks that accentuate the dangers of possible financial distress scenarios have been identified, such as those that marked the recent crisis occurred in 2007 and continued in the following years. This phenomenon, with regard to Europe, has been exacerbated by a widespread aversion to the «euro» (sometimes blamed for the negative effects of an austerity linked to strict observance of the parameters underlying the 'single currency').

In addition to the above, it is worthy to take into account the evident limits of the international institutions - whose role is characterized by interventions that often denote a merely formal character (and, as far as Europe is concerned, such interventions are far from the logic of cohesion and solidarity that, instead, should have distinguished them)- as well as some extraordinary events, from terrorist attacks, fostering fear and insecurity, to increasing flows of irregular immigration (which gives rise to a path of hope fuelled by illusory expectations of well-being), destined to accentuate inconsistent actions taken by Member States, which hin-

der the process of common unification and development.

It follows a situation that denounces *uncertainties* in several respects: from the clash between the major economic powers (USA and China), due to the protectionist measures and the trade war imposed by the Trump presidency (which leads to possible criticism of colbertism by theorists of free trade),[3] to the identification of new types of obstacles to the exercise of financial activity. In fact, with the latter innovations involving the intermediation formula that is no longer linked to the *agere* of credit institutions alone, but rather to the development of a new kind of capitalism, the so-called digital platforms profoundly transform all the traditional reference paradigms.[4]

From a general point of view, the loss of identity is rooted at various levels and is due to different reasons. In the EU, a Member States' search of remedies followed, which, on the one hand, gave rise to progressive despoliation of their sovereignty (bearing in mind the unitary European governance), and on the other hand, determined a reaffirmed need for the national State (which, however, appears to be inadequate to face challenges that go beyond its borders). The latter is regarded, in a nostalgic way, as the best place (expression of *ethos* and *etnos*) to guarantee the rights and overcome social issues, where the European Charter of Fundamental Rights, on which the European law is founded, appears to be destined to reduce its original significance, with inevitable consequences on the traceability of the principles of democracy that characterize the rule of law.[5]

As regards, in particular, some countries, the significant socio-political changes of recent times seem destined to mark a turning point in the definition of the 'form of government' constantly used. This can be observed, for instance, in

[3]The name *colbertism* refers to the mercantilist theories that draw inspiration from the political action of the French minister Jean-Baptiste Colbert who in the 17th century introduced mandatory criteria into the economic governance (including: the reference to the currency quantitative data, the need to increase exports and reduce imports, etc.) to create *surplus* in the balance of payments. Thus, a movement originated that embodied the requests of the "new bourgeoisie" that, in the following period, would have always encountered greater fate.

[4]See SRNICEK, *Capitalismo digitale. Google, Facebook, Amazon e la nuova economia del web*, Roma, Luiss Press, 2017, *passim.*

[5]See ALPA, *CESL, diritti fondamentali, principi generali, disciplina del contratto*, in *Nuova giurisprudenza civile commentata*, 2014, II, page 153 ff.

Italy where the formation of a transversal government based on a contract - which has united different ideologies (willing to converge for the sole purpose of achieving a 'majority position') - gives content to a *bizarre* change that tends to imitate the past, after having criticized (more precisely: shaken) its characterizing elements. A sense of puzzlement distinguishes the transition to the new, which gives a glimpse of the possible end of liberal democracy.

It is clear that such events are destined also to be reflected in the economic and financial relations both from the points of view of correlating their development to the aims of internal politics and of conforming their contents to the possible changes in the relations with other EU States. Hence, the obvious consequence of the need to proceed with a renovation of the fundamental principles regulating the matter in question. This is an investigation whose relevance is linked to the fact that, on a forward-looking basis, reconstructive hypotheses of the EU are also taking shape, whose realization would certainly result in a general subversion of the consolidated principles on which, for over half a century, the European evolutionary process has been based.

3. As a result, in a context characterized by *complexity*, the research must be oriented towards the identification of the factors making it possible to start a process leading to an innovative definition of the reference socio-political models.

In the financial sector, the difficulty of reconciling the coordination of prudential policies, referred to the competent sector authorities, with the system stability has come across - in post-crisis times - the implications of an operational and relational change in contrast with the aim of conservation of the balances. And, indeed, - despite the very stringent nature of the legislation used by the EU to remedy the turmoil that has hit, in particular, some Member States - there has been an uneven resilience, which has accentuated previous *differences*. As a consequence, inequality has spread, leading to criticism and dissent.

Some countries, in particular, during the crisis years have suffered from such a severe recession the return to the normalcy state of the economic system

has been delayed. The latter was burdened by an extremely rigid regulation, which was followed by unemployment, poverty and a general sense of *resentment* by the civil society.[6]

The legal framework, created in order to face the crisis and remedy the related 'breakdowns', is regarded with increasing distrust. In the face of the failure of some banks, cause of costly losses by savers, doubts, shared at an European level, have been raised about the adequacy of the new legislation, designed to harmonise the supervisory techniques with the so-called SSM, as well as to prevent banking crises by providing with the so-called SRM specific criteria to be observed when managing them.[7] In fact, having a regulatory framework that, on the one hand, appears to be focused on the dimension of 'big size' banks - aimed at shifting supervision to the top of the European institutions (primarily the ECB) - and, on the other hand, turns out to be leaning towards the containment inside the entity in crisis itself of the negative effects deriving therefrom - in some cases involving even the savers[8] - is hardly convincing.

Considerable doubts follow in relation to the results of the search, carried out within the EU, for a rational balance between the harmonization to be achieved with the single rule book and the exact changes to the forms of banking control and the crisis management of credit institutions based on the «Functional connection between supervisory tasks and central bank tasks».[9]

At the same time, the prospect of a sort of «identity crisis» of the national supervisory authorities seems likely, following the legislative measures which de-

[6]See CAPRIGLIONE, *Mercato regole democrazia*, Torino, 2012, page 89 ff.
[7]See *infra* paragraph 6.
[8]Reference is made to the well-known principle of *bail-in* which avoids that the public sector bears bank failures, by innovating the previous mechanism of "socialization of losses", destined to redistribute the related burden to be borne by the entire population and, thus, making it scarcely significant; see, *inter alia*, PRESTI, *Il bail-in*, in *Banca Impresa Società*, 3, 2015, page 356; DI BRINA, *"Risoluzione" della banche e "*Bail-in*" alla luce dei principi della Carta fondamentale dell'UE e della Costituzione nazionale,* in *Riv. trim. dir. econ.*, 4, 2015, page 184 ff.; ROSSANO D., *La nuova regolazione delle crisi bancarie*, Milano Assago, 2017, page 95 ff.; RULLI, *Contributo allo studio della risoluzione bancaria*, Torino, 2017, page 40 ff.
[9]See SCIASCIA, *La regolazione macroprudenziale: un'introduzione,* text of the lecture held at the 2nd level Master Programme «*Regolazione dell'attività e dei mercati finanziari*», LUISS- G.Carli, Roma, September 22nd, 2018.

prived them of their original status with the loss of supervision. Certainly, such institutions have undergone a significant downsizing of their functions and a reduction of their appeal, which in the past had qualified their role. In the face of such identity crisis, it is sometimes possible to find a resigned attitude of national authorities which is indicative of the difficulties that arose in the exercise of their action. This behaviour - for instance - could be observed in Italy, during the adoption of the reform of cooperative credit banks, when the Supervisory Authority promoted and supported aggregation processes among the members of such category, related to morphological changes in the subjectivity of banks provided for by the Italian legislator in the last two years.[10]

From a different point of view, a significant change in the banking intermediary activity is being considered, which is reflected in the mitigation of the security and profitability guarantees on savings entrusted by savers/investors to credit institutions. The downsizing of such operating mode appears to be due to multiple causes: from the reduced spread between the rates of deposits and those of loans, to the concurrent activity carried out by insurance companies, as well as some particular types of funds and alternative collective asset management companies.[11] Hence, an innovative financial reality is emerging, whose characters - while highlighting the sunset of the '*bank-centered*' system and the growing assertiveness of the phenomenon known as shadow banking system (comprehensive of the *agere* carried out outside the banking rules)[12] - have not yet found a complete definition. As a matter of fact, the trust relationship of the operators towards the

[10]See, *inter alios*, CAPRIGLIONE, *Approvata la legge di conversione del d.l. n. 18/2016. Un'opzione normativa poco convincente***,** in *dirittobancario.it* of April 11th, 2016; SABBATELLI, *La riforma delle banche di credito cooperativo*, Bari, 2017, *passim*; SACCO GINEVRI, *La nuova regolazione del gruppo bancario*, Milano Assago 2017, chapter IV.

[11]See CAPRIGLIONE, *Nuova finanza e sistema italiano*, Milano Assago, 2016, page 11 ff.; see also the response by the Bank of Italy and the Italian Institute for Insurance Supervision ('*IVASS*') to the document of the Italian Banking Association (*"Abi*'), the Italian National Association for Insurance Companies ('*Ania*') and the Italian Association for Consumer Credit and Mortgages (*'Assofin*') of October 22nd, 2015 on «insurance policies combined with credit facilities», to be found on *www.cheleo.it/media /documenti _pdf/directory_nuova/doc_2015/ Bankit_ risposte% 20 su% 20polizze%20abbinate%20a%20finanziam enti.pdf*.

[12]See FINANCIAL CRISIS INQUIRY COMMISSION, *Shadow Banking and the Financial Crisis, Preliminary Staff Report,* May 201; FSB, *Global shadow banking monitoring report*, 2015; in the literature see LEMMA, *The Shadow Banking System*, Palgrave Macmillan, 2016, page 2.

market has changed; where a careful reinterpretation of the classic «sound and prudent management» clause, and evaluation criteria for the conduct of the intermediaries, are necessary.[13]

In addition to the above, the political forces of the EU countries are facing new challenges , posed by the governability of technological transformations - digitization, automation, artificial intelligence, etc. - destined to radically change the medium-long term economic policy decisions. In fact, the information technology 'revolution', involving all the economic and social sectors in a horizontal way, interacts not only with the structure of the markets, but also with the entrepreneurial strategies, the methods and the investment programs. It appears to be destined to change the same competitive logic, in view of the current and prospective change in the demand factors. Furthermore, it radically affects the role of labour in the productive function and, therefore, of the economic, social and political relations we have known so far.

It should be noted that, *inter* alia, the current regulatory framework has proved to be inadequate in offering suitable solutions to reconcile the positive results of IT innovation with the need to assess and control potential risks. It is no coincidence that, several years ago, a distinguished scholar, perceiving the innovative scope of information technology, hypothesized the necessity to create a 'new law' (Cyberlaw), able to cope with the change induced by such process.[14]

As a matter of fact, the technological revolution, in terms of concreteness, accentuates and accelerates a phenomenon that has been underway for some time in the identification of the regulatory criteria of the economic and financial phenomena. In fact, by increasing the intensity and the speed of exchanges, it fosters the transition from a model in which the *agere* (understood as the will to en-

[13]See. CAPRIGLIONE, *Commentary under article 5 of the Italian Banking Consolidated Act* ('TUB'), in AA.VV., *Commentario al testo unico delle leggi in materia bancaria e creditizia*, Padova, 2018, I, page 45 ff.

[14]See the introductory report held at the conference entitled "*Cyberlaw. Problemi giuridici connessi allo sviluppo di Internet*", organised in July 9th, 1998 by the Italian National Council for Economy and Labour ('*Cnel*') with the sponsorship of the Council of the Bar Association of Rome.

ter a business relationship) refers to well-defined seats and subjects - a model that in the past had given content to the qualifying essence of the law of contracts, in general, and of those underlying financial intermediation, in particular - to a model in which such relations are standardized, objectified and omitted in favour of the more general need to preserve the functioning of space (now virtual) in which they take place. Thus, we are witnessing a sort of depersonalization of the contractual relationships which, with a premonitory intuition, illustrious scholars, already at the end of the last century, defined as directed «not towards a community, but towards an anonymous mass of users».[15]

Ultimately, the impact of the technological process is not limited to the market reality, nor is it reflected solely on the change in the mechanistic techniques of contractual relations. The changes due to this process go beyond the financial innovation, which results in a change in the type and variety of available products. In fact, they become a benchmark for the identification of the forms adopted by capitalism in the era of *globalization*.

In this respect, it is relevant the fact that the adoption of sophisticated models linked to the use of *digital technology* has provided impetus to a global dimension of the economy, based on the free movement of capital and on the possibility of implementing investments without borders. Hence, the reference to 'rules' of *soft law*, whose application, potentially transnational, goes beyond the place where they are produced. This represents a disciplinary hypothesis that has been recently presented to the UN with regard to the elaboration of a set of principles, to be applied internationally, which can facilitate the restructuring of sovereign debt, by replicating oriented studies which should not be merely aimed at individuating how to ameliorate the efficiency of the financial system, by means of technologies but to reduce costs and increase productivity.

On the contrary, this form of analysis, by investigating the topic on the sole perspective of the management of services for banking activity (and therefore

[15]So writes OPPO, *Disumanizzazione del contratto*, in *Riv. dir.civ.*, 1998, I, page 525 ff.

conditioned by the acquisition and elaboration of data, and their related digital platforms) would prove itself rather limited.

In order to properly interpret the phenomenon, it is pivotal to consider how it currently operates: as a heterogeneous, diversified, ecosystem, where functional goals expand dynamically and adapt on the basis of the specific normative framework considered.[16]

The current banking *praxis* is detaching from the traditionally implemented techniques, subordinating the expansion of the sector to the challenges that innovations create. More generally, as far as the EU panorama is concerned, this transition seems to represent not only one of the most significant effects of globalization, but also able to threaten the pre-existing institutional European framework in general - also in consideration of the limits of a non-cohesive and non-integrated of its integration process - and, more specifically, the financial system.

4. In such a context, some Member States are facing an *impasse,* deriving from the effects of past unknown events and the subsequent regulatory provisions, which are both profoundly different from what the current regulatotion provides for. Overcoming such an obstacle is, nowadays, a pressing need. Furthermore, achieving a financial equilibrium is intuitively obstructed by the persistent political instability: propaganda and illusionary promises which characterized the past political experience of some Member States (*in primis* Italy and France) shall be gradually replaced by a concrete program of investments, aiming at promoting growth. This operation must be conducted, if necessary, even through the negotiation with the European institutions, by obtaining the authorization to overcome the parameters of the 'stability pact'.

In light of this approach, the different goals that are required to tackle innovation can be pinpointed. On the background, it is necessary to rethink the traditional relationship between technical expertise and politics in order to identify

[16]See MINTO, *FinTech and the "Hunting Technique": How to Hit a Moving Target*, in *Open Review of Management, Banking and Finance*, May 2017.

the most adequate strategies for the creation of a virtuous circle and to ultimately sustain growth. Furthermore, the activation of operative openings by the European Commission will increase the occupation rate, development, equity, and democratic revisions. It is, therefore, essential to understand how the explication of the connection between politics and finance is strictly intertwined with the socio-economic equilibrium of the EU and the balanced progress of all its Member States.

In order to do so, it is necessary to revise the management of economic processes and to disregard the excess that characterized intergovernmental strategies, which led to divergences and inequalities amongst Member States (given the prominence it gave to inner national interests).[17] At the same time, the use of technical strategies (despite what the latest policy interventions of the ECB suggest) should be limited to an integrative resource, in order to prioritize the clarification of the existing contradictions within the European framework. The technical strategies cannot, as a matter of fact, activate the processes of harmonization and cohesion amongst Member States, which must be achieved only by means of politics.[18]

It is essential to overcome the dysfunctions arising from a system, that has been radically disconnected from the political process - creating a gap amongst the different institution of the EU. Such a goal is pivotal if we want to actually "change" the geopolitical condition of Europe and promote economic convergence amongst Member States.

The pursuit of stability of the European system, under both the economic and political perspective, must be conducted through a radical renovation of the political strategy of the EU, enhancing solidarity, sharing, and effective cohesion.

The ultimate intent of politics is avoiding the birth of conflicting positions:

[17]Nevertheless, in 2014, the shortcomings of an Euro-national parliamentary system were still very clear, even in opposition to the problems of the intergovernmental approach. Cfr. MANZELLA, *Verso un governo parlamentare euro-nazionale?*, in AA.VV, *Il sistema parlamentare euro-nazionale*, Manzella and Lupo (eds.), Turin, 2014, pp. 16-17.

[18] Cfr. CAPRIGLIONE - SACCO GINEVRI, *Politica e Finanza nell'Unione Europea*, Padova, 2015, p. 142.

in the light of an ever-growing globalized economy, operating as a self-referential paradigm, these positions are likely to weaken the EU resistance (and the defenses) against the new "global directorate" jointly formed by the United States, China, and Russia through commercial relations and exchanges.[19]

The EU must not abandon its role as a primary force on the international scene: EU is - and shall always be - an aggregate of countries with significant relevance in terms of industrial production, exportations, and GDP, that should not be underestimated in its role as a global economic actor.

Accordingly, the next May 2019 European elections represent an opportunity to respond to the anti-European movements that are spreading through all over Europe. These elections can show that European populations still believe in the positive outcomes of a political strategy which, regaining its fundamental function, points towards consistent common actions, and cohesion amongst countries in the name of solidarity.

In order to avoid marginalization in the new asset of forces amongst global superpowers, EU must overcome its current fragmentation. The changes intervened in the European governance after *Brexit*[20] should lead to the complete failure of the 'integration process' that animated the hopes and dreams of Member States since 1957, due to the decisional void and the lengthy functioning of European institutions leading institutions and their bureaucratic apparatus. Henceforth, 2019 elections can mark a profound - and much needed - division between euro-skeptical narratives (and their opposition to a common project amongst Member States) and the affirmation of a joint systemic order to promote the creation of a "New Union" on liberal basis. It goes without saying that only by embracing the second option it will be possible not only to overcome all the perplexities surrounding the need of new checks and balances within the European system,

[19]See RAMPINI, *Un G3 con Usa, Russia e Cina. L'interesse di Trump è per uomini forti, non diritti umani*, available at *https://video.repubblica.it/dossier/trump-presidente/rampini-un-g3-con-usa-russia-e-cina-l-interesse-di-trump-e-per-uomini-forti-non-diritti-umani.*

[20]See CARAVITA, *Brexit: keep calm and apply the European Constitution*,in *federalismi.it*, 29 June2016, p. 4; CAPRIGLIONE, *Brexit: an anti-historical divorce which can change the EU*, in *Law and economics yearly review*, 2016, I, p. 4 ss.

but also to ensure sufficient interaction amongst member states, backing up a strong and competitive social market economy (according to the goals set in Art. 3 TEU) with democratic values.

5. A further aspect worthy of deeper investigation is the critical examination of the organizational model adopted by the EU - as well as the reasons that hindered the continuation of the foreclosure process that was inaugurated with the constitution of the European Community. Firstly, the profound heterogeneity existing at the time - and, still, nowadays - within the European territory must be considered: differences amongst Member were even more intensified by the *one-size-fits-all* approach that characterized convergence programs over time. This led to a minority of 'virtuous states' displaying hegemonic tendencies, in opposition to other countries stuck in bureaucratic shortcomings and political delays: such a difference represented a major obstacle to equal development of the generality of EU Member States.

Lately, the ontological limits of the EU were further stressed by the difficulties encountered - especially in the Mediterranean area - in facing the 2007 economic crisis, and the (desirable) switch towards a more cohesive system was not realized: on the contrary, the previous relational consistency gradually fell apart, and the integration process seemed unable to be more than a mere legal harmonization - even oriented towards economic development.

The interventions adopted in order to counteract the abovementioned financial crisis are, someway, symptomatic of these problems. As a matter of fact, the EU did not develop a strategy aimed at the adoption of reasonable measures in order to counteract the causes of the crisis. On the contrary, the EU restricted its approach to establishing measures in order to limit the effects, by blocking their spread. The resulting regulatory technique choice was the imposition (by EU main organisms) of austerity measures on Member States that were actually in

need of financial support.[21]

These directives were very distant from the fundamental principles of the social market economy and from the promotion of a highly competitive market. Furthermore, these measures revealed the objective of tackling the crisis through a s.c. *export-led recovery* strategy.

According to this approach, austerity measures - by reducing labour costs - , are supposed to improve the responsiveness and competitivity of enterprises in the export area, making them better suited for the foreign demand. This will ultimately encourage new enterprises and businesses to invest in such a competitive environment.[22] In spite of this narrative, though, the (often already precarious) life conditions of many populations were exasperated. This led to critical backlash, oppositions, and to the birth of euro-skeptical and anti-European trends, as a response to the excess of stringent interventions.

As a reaction to this frustration, figures of authoritarian States emerged once again, opposing to the creation of a unitary European framework. Rooted in the asserted urgency to regain national identity, the anti-European narrative embraced by these movements promotes the abandonment of austerity policies: the conditions imposed by the austerity policies are regarded as a compression of national sovereignity, by virtue of their mandatory nature. As a result, these positions fear the possibility of national prerogatives on internal economic regulation being gradually taken away from Member States, and they assert that austerity limitations are hindering their decisional autonomy, depriving countries of their self-determination prerogatives. This narrative unveils, though, its inner contradic-

[21]Cfr. CAPRIGLIONE - TROISI, *L'ordinamento finanziario dell'Ue dopo la crisi*, Torino, 2014, p. 121 ss.

[22]See *Schäuble: Austerity is essential to solve crisis,* available at *www.independent.co.uk/ news/ business /news/sch228uble-austerity-is-essential-to-solve-crisis*. See also, in favor of austerity, SCHÄUBLE, *Why austerity is only cure for the Eurozone*, in. *Financial Times*, 5(09), 2011; BUTI e CARNOT,. *The EMU Debt Crisis: Early Lessons and Reforms*, in *Journal of Common Market Studies*, 506, 899-911, 2012; Chen - Galbraith, *Austerity and fraud under different structures of technology and resource abundance*, in Cambridge Journal of Economics, Volume 36, Issue 1, 1 January 2012, pp. 335 – 343; SINN, *Austerity, growth and inflation: remarks on the Eurozone's unresolved competitiveness problem*, in The World Economy, 2014, 371: 1-13.
Contra, STORM e NAASTEPAD, *Europe's Hunger Games: income distribution, cost competitiveness and crisis*, in *Cambridge Journal of Economics*, 2015, 39: 959-986.

tory nature with the idea that the EU will nevertheless provide economic resources, when needed (e.g. when Member States want to sell public debt securities to the ECB).[23]

It is, indeed, true that the mandatory nature of interventions based on authority might appear *prima facie* in contrast with the democratic foundations of the EMU, and therefore support the thesis suggesting the current suspension of the traditional legal criteria applied within national systems. Furthermore, the mechanism created by means of the Maastricht Treaty, and its use of some specific parameters (e.g. the prohibition of a public deficit exceeding 3% of GDP) as a condition for the participation in the process of decision making, raise additional doubts and undermine the foundations of the European Constitution, even when a *recoup* of its essence seems desirable.[24]

A strict economic evaluation on the limits of Maastricht's provisions - their rationale, and the solidity of their basis - is outside the scope of the present work. Nevertheless, I hold true that the consistency and "health" of public account (considering, in particular, the prohibition of using public debt for expenditures other than investments) should, indeed, be considered the expression of a 'moral principle', requiring the preservation of wellness for the generations to come: deficit and public debt should not be passed on future generations in order to exploit contingent electoral goals. Furthermore, over time the EU has introduced various tools with the common aim of mitigating the rigor of Maastricht's parameter (e.g. the s.c. 'investment clause', allowing Member States to temporarily deviate from their MTOs to accommodate investments): as a consequence, it is indisputable that any additional request for flexibility is clearly based on the urgency to gather resources, in order to keep electoral promises.

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[23]See *ex multis Governo, cancellare 250 miliardi di debito pubblico? Una proposta così è irricevibile*, visionabile su *https://www.ilfattoquotidiano.it/2018/05/16/governo-cancellare-250-miliardi-di-debito-pubblico-una-proposta-cosi-e-irricevibile/4360457*

[24]*Ex multis* RINALDI, *Il fallimento dell'euro*, 2011, available at *info@fallimentoeuro.it*, *www.fallimentoeuro.it*; ID. *Europa kaput (S)venduti all'euro*, con presentazione di Savona, Roma, 2013; PERONI, *La crisi dell'Euro: limiti e rimedi dell'Unione economica e monetaria*, Milano, 2012.

In addition, the relevance of the interpretation given to the statement enshrined in the EU legislation of a «closer union» across Europe (EU Treaty, Title I, Article A), in which the missed reference to a concept of integration equivalent to a form of cohesion among members is pointed out, directed to favour the different identity categories should be considered relevant. In this sense are the doubts raised in the scholarly contributions appeared in the aftermath of the signing of Treaty of Maastricht, in relation to the purpose of this Act.[25] In particular, it is relevant the view assumed by Germany that, in a clear way, has excluded the possibility to find in the Monetary Union the foundations of a framework intended to be translated into a political union [26]; therefore the questions around the effective *cohesion* of institutional structure provided by the Treaty, and the difficulty to attribute to new models of cooperation the meaning of constitutive formula of a new institutional architecture.

This context shows the uncertainties that characterize the functioning of relationships among Member States; uncertainties exacerbated, with regard to banking sector, by the difficulties in the correct interpretation of the normative innovations imposed by the EU legislator in order to address the issues experienced by several banks. In this way, we explain the reasons of delays that affect few countries to restore their economic growth, to find an exit strategy from their crisis.

Few criticisms rise in relation to the same developing process of European architecture, as there are several questions on the validity of steps achieved. The

[25]See JOCHIMSEN, *Economic and Monetary Union: a German Central Banker's Perspective*, in *Economic and Monetary Union: Implications for National Policy- Makers*, Gretschmann (ed), Dordrecht, 1993, 196.

[26]See the judgement 12 October 1993 of German Federal Constitutional Tribunal which fixes the limits of compatibility of Monetary Union with the Constitution and principles of national legislative framework; see the document in Giur. cost., 1994, 677 ss and, for a critical view, RESCIGNO G.U., *Il tribunale costituzionale federale tedesco e i nodi costituzionali del processo di unificazione europea*, ivi, 3115 ss; EVERLING, *Zur stellung der Mitgliedstaaten der Europaischen Union als "Herren der Vertrage*", in BEYRLING, BOTHE, HOFMANNE, PETERSMANN, *Rechts zwischen Umbruch und Bewahrung-Volkr-recht-Europarecht-Staatrecht. Festschrift fur R. Bernhardt*, Berlin, 1995, 1161 ss; HERDEGEN, *Germany's Costitutional Court and Parliament: Factors of Uncertainty for the Monetary Union?*, in European Monetary Union Wtch, XIX, 1996, 8 ss.

considerations formulated among the doctrine in the aftermath of European Banking Union, such as the one on the significance of this institutional event that I assumed might constitute the «challenge for a united Europe»[27], lose relevance Therefore, the complex regulatory system issued after the recent financial collapses could, in few cases, fail the outcomes for which is aimed or be inapplicable because in contrast with the policies of some Member States to share the risks that the Banking Union implies.

In some Member States, such as Italy, these circumstances have increased the sense of disaffection towards the EU institutions, already spreading across Europe. This is linked to the situation of *impasse* determined by the financial crisis, in which - as underlined with reference to the banking sector - there is a «frenetic search of profits» which has brought several unscrupolous banks to undertake risks, - against *policy-makers*, regulators and supervisory authorities - in order to undermine the troubles of an «excessive accumulation» of profits.[28]

More generally, it is clear that the EU institutions have not been able to perform their role, as they did not oppose to the «power of market». This, because there was a lack of a «global strategy», which should be considered necessary in order to oppose to the «pressures practiced on single Member States by external factors that, on the one hand, are difficult to manage and, on the other side, overcome the European boundaries by entering in the complex process of globalization».[29] As observed by many parties, Europe, as far as today, is facing a critical time divided between the need of reaffirmation of a logic of cohesion and unity (made less attractive by a widespread sense of discontent linked to several and various causes) and the need of reshaping the original purposes of the economic integration, by the constitution of a «free trade area», of a «customs un-

[27]See CAPRIGLIONE, *European Banking Union. A challenge for a more united Europe*, in *Law and Economics Yearly Review*, 2013, 5 ss.
[28]See MICOSSI, *Dalla crisi del debito sovrano all'Unione bancaria*, Chiti and Santoro (eds), *L'Unione Bancaria Europea*, Pisa, 2016, 29 ss.
[29]In this way BISIO, *Mercati globali and* Public Governance *in Europa*, in *Emerging Issues in Management*, n. 1, 2004, 95, available at *www.unimib.it/upload/gestionefiles/ symphonya/ lastita/ f20041/bisioita12004.pdf.*, which underlines the limits of the Eurocentrism view.

ion» and of a «common market».[30]

In this context it is observed, with respect to the past, a significative change of paradigm of social science; this is oriented to a phenomenology that often affects the forms of international cooperation and, in relation to the EU countries, is an obstacle to the realization of relevant forms of convergence. This reality brings specific problems related to the gap of development models, to insufficient incentives deriving from low interest rates and to uncertainty of the connection between economic growth and credibility of politics. These problems consist in a *knowledge* disconnected from the traditional legal culture and aimed at accepting the sense and context of change. The recall to this framework seems functional to understand the present, which represents a crucial time of change. The ways the new technologies and new culture govern the economic and financial process on markets are still obscure but, for sure, they will affect the nature of capitalism in the future. The reason why those who believed in the 'European project', looking at the future, are now skeptical, - since we live in an 'empty freedom' -, is arguable.

Finding satisfactory responses in order to clarify the indicated questions and defeating the uncertainties characterizing the process of aggregation among EU Member States is the primary prerogative of politics of these countries. In giving a legal response to the answers of civil society (which seeks to stop the austerity measures and to promote equality, social inclusion and common wealth) a significative support could derive from a debate able not only to identify in advance the negative consequences of some European economic policies and but also to prevent (or oppose) the outcomes of official studies of Commission, ECB and IMF.

6. Before moving to the identification of the events currently faced by the EU, it is necessary to recall events that, in the last decade of the past century, characterized the history of Europe: from the end of Berlin wall and dissolution of

[30]See CAPRIGLIONE – SACCO GINEVRI, *Politica e Finanza nell'Unione Europea*, cit., *passim*, in particular page 63.

communism party of Soviet Union and the same URSS. These events encouraged public institutions of the European Community to begin a new phase, aimed at strengthening the competences, functions and powers ascribed to Community bodies. The outcome of this process was the 'single currency' whose creation, as implied in the well-known *Delors Report*, marks a fundamental step in the process of European economic integration, generating expectations of closer forms of unification among participating States.[31] The single currency addresses the scope (convertibility of currencies, liberalization of free movement of capitals, full integration of financial markets, fixed exchange-rate system) considered suitable to ensure increasing levels of cooperation across Europe. In this way, the perspective of the previous model of economic unification is superseded by a project aimed at conferring concreteness to the practice of convergence among Member States of Community.

The Maastricht Treaty of 7 February 1992 legitimized this program, by introducing a remarkable change represented by the replacement of 'domestic currency' with a *unified* one. The significance of this change regards primarily the establishment of *Monetary Union,* the design of common currency and the entrance in the institutional system of the European Central Bank (Art 13 TUE) which joins other institutions - the Commission and the Court of Justice - as legitimation of the European legal framework. Minor emphasis has been put to the change of political dimension of Community/Union. In fact, in the same time, the European citizenship is introduced. the European citizenship adds to the national one of Member States[32]- and establishes new rights, such as the "free movement of voters and

[31]See inter alia PADOA SCHIOPPA, *The European Monetary System: a long-term view, in AA.VV., The European Monetary System*, Cambridge Universitary Press, Cambridge, 1988; MASERA, *L'evoluzione del sistema monetario europeo (aspetti tecno-economici)*, in AA.VV., *Dal sistema monetario europeo al sistema europeo delle banche centrali*, Rome, 1990, 38 ss; TAMBORINI, *Dal Rapporto Delors al Trattato di Maastricht e oltre. Cos'hanno da dire gli economisti?*, in *Economia politica*, 1997, n. 3, 361 ss; PELLEGRINI, *Banca Centrale Nazionale e Unione Monetaria Europea*, Bari, 2003, 156.

[32]See BARTOLE, *La cittadinanza e l'identità europea*, in *La Costituzione europea* (Notes of XIV Annual Conference of AIC), Padova, 2000, 445 ss; LIPPOLIS, *La cittadinanza europea*, Bologna, 1994; CARTABIA, *Cittadinanza europea*, in *Enciclopedia Giuridica Treccani*, VI, Rome, 1995, 3 ss.

candidates"-, and "the political parties at European level, (…) important factor for the integration in the EU, because they contribute to promote a European spirit and to express a political volunteer of European citizens" (Art 191 TCE).[33]

In the search of suitable solutions to solve the obstacles of the identified objectives realization , the tendency to limit to technical sphere the proposition of *formula* in which this new structure is built[34] seems to prevail. The definition of a particular «institutional framework» is on the basis of this architecture, aimed to the realization of a situation of *equality* among Member States, through common monetary strategies, the responsibility of which should have been given to a body of new formation able to assume integrated and agreed decisions.

In this context, the *Eurosystem* performs its functions essentially on behalf of the ECB, which relates «*in primis*, the distinctiveness of emission and govern of currency so the transferring of a sovereign function of federal States to the federation**»**.[35] In this way, the recognition of a prominent role of this institution, whose competences consist in maintaining the 'price stability' to which relates «powers, to exercise in autonomy, coherent with the achievement of that scope».[36] From this point of view the limits that characterize the 'govern' of monetary policy allocated to the ECB are evident. The prerogatives of the latter are identified, in the initial step of activity, in the prevention of practices of deflation and inflation, in addition to significant consultative functions with regard to «the prudential supervision of credit institutions and other financial institutions» (Arts 105, para 6, CE Treaty and 25 of relating Statute).

It is evident that the establishment of single currency has changed the monetary policies (emission of money and administration of liquidity), as the latter, moved out from central banks of Member States of Community, is translated in a supranational dimension and ascribed to a complex system, the European Sys-

[33]See DE CARO, *I partiti politici europei*, in *EUROPA. Sfida per l'Italia,* Luiss University Press, 2017, 190.
[34]See CAPRIGLIONE, *Mercato regole e democrazia*, Turin, 2013, 40 ss.
[35]See MERUSI, *Governo della moneta e indipendenza della Banca Centrale nella Federazione monetaria dell'Europa*, in *Studi e note di economia*, 1997, 7.
[36]See PAPADIA - SANTINI, *La Banca centrale europea*, Bologna, 1998, 28.

tem of Central Banks (ESCB), based on the ECB. The juridical literature has provided several and significant interpretations of this framework, assessing the effect on the economic and financial reality of participating States[37] and focusing the research on the investigation of «transferring of sovereign function**»** from the national and social context to a mechanism of qualified technical control. There are different views, some of them, with the aim of undermining the nature of this event, which have reduced the essence to mere «rational redistribution of powers».[38]

In the past years, searching the *ratio* behind the mentioned framework, the European project in which the consolidation of economic relations was directed to a reduction of sovereignty (aimed to remove the obstacles to institutionalization of a different way to govern the monetary policy)[39] seemed coherent with the maximisation of possibilities of growth. The consolidated interpretation of the principles of international law according to the States - with the aim to favour the trades and economic activities with other countries - can reduce their powers taking coherent strategies aimed to overcome obstacles[40] was of support. Having in mind this, in presence of «progressive crisis of traditional sovereign functions of States in the management and control of economic processes», it is necessary to realize a «verticalization and internationalization of functions» as indicated.[41]

After decades, it is possible to evaluate the effects of this technical 'solution'. It is clarified that the interaction with the foundations of traditional architecture of a State, can determine movements directed to innovate the principles of democratic system. This point of view is confirmed by the M.S. Giannini theory of

[37]See GUARINO, *Verso l'Europa ovvero la fine della politica*, Milan, 1997, *passim*, where, with the clarity that characterizes his view the Author underlines the relevance of role attributable referable to technique in the definition of suitable conditions to support factors and structures of integration in the European context.
[38]See MARZONA e CALDIROLA, *Politica economica e monetaria*, in *Trattato di diritto amministrativo europeo*, edited by Chiti and Greco, t. 1, Milan, 1997, 901.
[39]See CAPRIGLIONE, *Moneta*, in *Enc. dir*., III updated., Milan, 1999, 758 ss.
[40]In this regard see the classic seminal work of ROEPKE, *Economic Order and International Law*, in *Recueil des Cours de l'Academie de droit international de la Haye*, 1954, II, 204 ss.
[41]See PICONE, *Diritto internazionale dell'economia e costituzione economica dell'ordinamento internazionale*, in AA.VV., *Diritto internazionale dell'economia*, Milan, 1982, 38.

the concept of «sovereignty», on which the criticism of modern concept of statualism and its attributes [42] is founded .Therefore, the international sense of Eurocentrism, characterized by the single currency, becomes a relevant factor for the change of the concept of sovereignty[43].The latter diversifies with respect to the concept related to «notional orders of Pandectist to the legal systems following the *ancient regime*»[44] and becomes the requirement of a new pluralistic context in which there is a sort of «polyarchic decentralization of classic sovereignty».[45]

The question at stake is whether or not the process of European integration implies a reduction of sovereignty. In front of these challenges posed by global concerns which cannot solely be solved by the States (for example: the global pollution, the competition with giant such as China etc.), the 'sharing of sovereignty' at the European level represents a step back or forward with respect to the previous regime? I am convinced that this sharing of sovereignty can represent, actually, the only way for the European countries to preserve themselves in the *post-Westfalian* era.[46]

In this logic it is explained the reason why this translation of sovereignty is not confined to the sole exercise of monetary power. This is reflected also in the content of national legislative power to which are imposed procedural limits related to the obligation of preventive consultation of the ECB. This is in line with the normative view according to which the ECB «can issue opinions to submit to the institutions or competent European bodies or national authorities on topics that are within its sphere of competence» (Art 105, para 4, of the Treaty establishing the European Economic Community). Therefore, with the adoption of euro, it is determined in the Member States a sort of reduction of sovereignty with the resulting obligation to adjust the modalities of regulatory harmonization to the ob-

[42]See GIANNINI, *Sovranità*, in *Enc. dir.*, Milan, vol. XLIII, 224 ss.
[43]See CAPRIGLIONE, *The Bank of Italy*, in AA.VV., *Italian Banking and Financial Law*, London: Palgrave Macmillan, 2015, 159.
[44]See DELLA CANANEA, *Sovranità e globalizzazione*, in *Parolechiave*, 2006, n. 35, 97 ss, para 2.
[45]See CARRINO, *Oltre l'Occidente. Critica della Costituzione europea*, Bari, 2005, 174.
[46]It is referred to a process of «communion to forms of sovereignty» in CAPRIGLIONE -IBRIDO, *La Brexit tra finanza e politica*, Milan, 2017, 121.

jective of an effective functioning of *Eurosystem*.

7. The recent crisis has affected the process of integration that links the «convergence» between different countries to the translation of *monetary power* from single Member States to a specific body, the ECB, sole responsible of policies characterizing the function. This is confirmed by the results of search of solutions to problem regarding the stability of sovereign debt market of *Eurosystem,* research that is resolved in forms of transfer of national sovereignty.

I refer, in particular, to the establishment from the Ecofin Council, in May 2010, of the *European Financial Stabilisation Mechanism* (EFSM), followed by the creation, in the June of the same year, of the *European Financial Stability Facility* (the so-called financial stability fund) (EFSF).[47] As pointed out by literature, this is «an instrument of… solidarism», since its *rationale* can be let to the «understandable prerequisite of existence of an interest of EU to support Members in financial difficulties»[48]. Furthermore, it must be borne in mind that the acceptance of 'Financial Stability Fund' interventions - from which few countries (Greece, Ireland and Portugal) have benefitted - work through a restoration of financial conditions pre-participation *programme* to, making by the formulation of a plan of *macroeconomic adjustment*, able to restore the confidence of market in the credit *standing* and in the long-term competition of countries recipient of support.[49]

This programme has entailed the imposition of the so-called *troika* (committee of informal control constituted by representatives of the ECB, European Commission and International Monetary Fund), whose activity is consists in the 'reshaping' of the sovereignty of some Member States which are obliged to accept

[47]See Regulation UE No 407/2010.
[48]See RUOTOLO, *La costituzione economica dell'Unione europea al tempo della crisi globale*, in *Studi sulla integrazione europea*, 2012, 448 ss.
[49]In this regard orient the considerations provided by the *European Stability Mechanism*: «to fulfill its mission, Efsf issues bonds or other debt instruments on the capital markets. The proceeds of these issues are then lent to countries under a programme. The Efsf may also intervene in the primary and secondary bond markets, act on the basis of a precautionary programme and finance recapitalisations of financial institutions through loans to governments», available at *http://www.bankpedia.org/index.php/en/98-english/e/23668-european-financial-stabilityfacility*

the intervention in the national government.

It is true that the European institutions have no formal powers to impose *austerity* rules to States which requested the intervention of 'programmes of financial assistance'. Also in Greece the national balance sheet and the reforms containing these measures have always been formally approved by the Greek Parliament in the context of its sovereign powers. However, it cannot be denied that, with reference to the current situation, there are substantive influencing powers; which means that the failure of Member States to adjust financial commitment may determine the end of the financial support. This kind of intervention reflects the objective of avoiding *moral hazard*. Therefore, the unavoidable consequence of the adoption of such measures is represented by the reduction of powers in the determination of economic policies and government; powers that characterize the independence of Member States and the full exercise of their sovereignty.[50]

A step forward towards the institutional change aimed at the reduction of the national sovereignty scope - and, in the banking sector, of the role of domestic authorities - has been made with the establishment of European Banking Union (EBU), as previously mentioned. This architecture significantly affects the regulatory framework of the Union; based on 'Single Supervisory Mechanism' (SSM), a new formula of intervention, aimed at ensuring the EU financial stability through structural reforms suitable to definitively overcome the risks deriving from the crisis.[51] The ways of participation of national bodies of control to SSM identifies the relating powers within the Banking Union and reshapes the scope of competences of these authorities, marking a significant step with respect to the previous regulatory framework**.**

[50]The assessment of effects of this committee has been at centre of vast institutional debate; for further details, see the Report of European Parliament «on role and activity of *troika* (ECB, Commission and IMF) regarding to countries of Euro area object of programs (2013/2277(Ini)», available at *www.europarl.europa.eu*.

[51]See inter alia WYMEERSCH, *The European Banking Union. A first Analysis*, *Universiteit Gent*, Financial Law Institute, WP, 2012-07, October 2012, 1 ss.; AA.VV., *Dal testo unico bancario all'Unione bancaria: tecniche normative e allocazione di poteri* [Notes of Conference organized by the Bank of Italy, Rome, 16 September 2013], in *Quaderni di ricerca giuridica della Banca d'Italia No 75*; AA.VV., *L'unione bancaria europea*, Pisa, 2016; IBRIDO, *L'unione bancaria europea. Profili costituzionali*, Rome, 2017.

Of course, as pointed out by the ECB Chair[52], the proposal of a major transfer of sovereignty (from the single Countries to the European institutions) should progressively be extended to include all «the structural reforms necessary…(to)… be in line with the Optimum currency area … because something that happens in a Country regards everybody». This is an indication that leaves no doubt about the pathway road that countries of Eurozone should follow in light of development of the process of integration affected by the recent crisis events. However, this pathway cannot let alone the differences among Member States, if it wishes to create, in the near future, an encounter between *technique* and *politics*, in order to allow the realization of *design* of the founding fathers of united Europe.

It follows the perspective of progressive reductions of sovereignty of Member States from which there are justified expectations of 'good government' that should turn into growth and wealth to solve some endemic deficiencies that impair few countries of EU such as Italy.

These expectations, unfortunately, have not yet found adequate response for several reasons, deriving from - as I will mention afterwards - the organisational arrangements and lack of adequate cohesion and solidarity in the process of economic integration. All this has resulted in movements inspired by a lack of confidence in the European institutions. These movements, on a formal declarations level, confirm a strong will to join the Union and Euro. However, they subordinate this intention to the realization of reforms which- instead of being realised through a re-examination of Treaties (made on statements and without presentation of regulatory proposals) - are assumed to be introduced almost coactively (with an unilateral imposition). This implies, in particular, an uncompromising behaviour aimed at the defense of less reliable *financial strategies*, as to be criticized in several contexts. This behavior is, however, intended to be dismissed with threat of the application of a 'procedure of violation', as observed with regard to

[52]See Parliamentary *Audition* of 26 March 2015 by Draghi to the Commissions Economics, Finance and EU Policies on 'Monetary policies of the ECB, the structural reforms and the growth of euro area', available at *www.ecb.europa.eu.*

recent events in Italy.[53]

It is clear that, beyond the statements, behind this position there is the intention (typical of sovereign movements, as it will be seen in the next sections) to undermine from the inside the process of European unification, by hindering the creation of a 'free market without customs', operating on the basis of agreement of 'free trade' and by abandoning more advanced forms of federal and constitutional integration.

The way in which the National Competent Authorities (NCAs) are involved in the Single Supervisory Mechanism (SSM) identifies the inherent powers inside the European Banking Union (EBU) and reshapes the tasks of such authorities, significantly amending the previous legal framework.

Obviously, the proposal of transferring more sovereignty (from each single country to the European Institutions) should progressively be extended to include every structural reform which needs to reach the same level of integration as in the Monetary Union, on the assumption that what happens in a country concerns everyone, as pointed out by the ECB's Governor.[54] Such a statement clarifies which is the path that Euro Zone countries should follow in order to develop a proper European integration process, which, on the contrary, has been recently undermined by the crisis. Nevertheless, the path towards integration cannot disregard the differences among Member States if it really intends to create in the near future a successful combination of *technocracy* and *politics* in order to realise the 'founding fathers' *project* of a united Europe.

The effect of such integration would be a progressive reduction of Member States' sovereignty, in place of which forms of 'good government' - that should generate growth and wellbeing - should reasonably be expected. Hence, the overcoming endemic shortcomings affecting some EU countries, such as Italy.

These expectations, unfortunately, have not been satisfied so far for sever-

[53]See the editorial *L'Italia verso la procedura d'infrazione: ecco le tappe del braccio di ferro con la Ue*, available at *https://www.repubblica.it/economia/2018/11/20/news/procedura_infrazione_ue*
[54]See *Politica monetaria della Bce, le riforme strutturali e la crescita nell'area dell'euro*, available at *www.ecb.europa.eu.*

al reasons, which - mostly - are related to the lack of adequate cohesion and solidarity in the European process of integration. The result of this has, been the distrust towards the European Institutions, which, in turn, has contributed to the increasing popularity of movements which formally confirm their will to remain within the Union and within the Euro Area. Nevertheless, these movements subordinate such intent to the realisation of reforms to be adopted not through the amendment of the Treaties (on a dialectical basis and after a debate on the alternative measures), but almost coercively on the grounds of a unilateral imposition. Such an approach is shaped as an intransigent attitude aimed at supporting fiscal policies which are not credible and, therefore, are criticised in several venues. This attitude, moreover, is intended to be dismissed in front of the threatened application of an 'infringement procedure', as recently happened to Italy.[55]

It is clear that, despite the declarations, the real objective (that is typical of sovereignist movements) underlying such positions is to hinder from the inside the European unification process by reducing its meaning to a mere 'free market without customs duties' based on a 'free trade' agreement. Hence, its effect would be the waiver of more advanced forms of federal and constitutional integration.

8. With regard to the obstacles to the creation of an adequately cohesive relationship among Member States, it is necessary to first analyse the decision-making process within the Union.

It is well known that the deliberative power within the EU is exercised through the so-called *co-decision* mechanism, which involves the Institutions of the so-called 'institutional triangle' (*i.e.* the Commission, the Council and the Parliament). This model clearly shows the Treaties' intent to base the rule-making process on an agreement among the different stakeholders, aimed at overcoming the previous ambiguities. In particular, in this way, the European system can move

[55]See *L'Italia verso la procedura d'infrazione: ecco le tappe del braccio di ferro con la Ue*, available at https://www.repubblica.it/economia/2018/11/20/news/procedura_infrazione_ue.

towards new forms of allocation of functions between the Union, on one side, and the Member States, on the other side.[56] In such a context, the goals of reaching a 'mechanism of comitology'- defined as a heritage of an anachronistic institutional unbalance[57] - looks peculiar.

The recent financial crisis has shown the pre-existing limits of the Union's deliberative power. This applies, in particular, with regard to the ineffectiveness of the structure of the European Parliament, which is divided into 'transnational political groups' (as well as into committees). Therefore, the multiparty compatibility resulting from asymmetries due to the different origin and evolution of such groups has become much more complicated to manage. As a consequence, the structural and functional shortcomings of the European Parliament have clearly emerged. On the opposite, the rationalisation, which has been carried out through a more democratic decision-making process,[58] has not been sufficient and, indeed, still in 2014, the shortcomings of both an euro-national parliamentary system and of a complicated and articulated governance structure were rather clear.[59] Accordingly, an influential scholar has argued that this structure represents the triumph of an intergovernmental arrangement, primarily aimed at preserving itself.[60]

All of the above explains the limited reaction of the European Institutions in the adoption of the necessary measures to cope with the financial meltdown starting back in 2007. In such a context, the benefits arising from advanced forms of legislative harmonisation - and for the Euro Area countries also from the 'single currency' - have not been able to counteract the imbalances (amplified by the crisis itself) that have their roots in some drawbacks on which the convergence process - which is, in turn, the prerequisite for the integration process - has been

[56]See MICOSSI, *Un nuovo equilibrio destinato a durare*, in AA.VV., *Le nuove istituzioni europee. Commento al trattato di Lisbona*, Bassanini - Tiberi, 2° ed., Bologna, 2010, p. 493.
[57]See SAVINO, *La comitologia dopo Lisbona: alla ricerca dell'equilibrio perduto*, *Giornale di diritto amministrativo*, 2011, p. 1041.
[58]See DECARO, *Corso di diritto pubblico dell'economia*, Padova, 2016, p. 43.
[59]See MANZELLA, *Verso un governo parlamentare euro-nazionale?*, in AA.VV, *Il sistema parlamentare euro-nazionale*, Manzella – Lupo, Torino, 2014, p. 16-17.
[60]See AMATO, *Il Trattato di Lisbona e le prospettive per l'Europa del XXI secolo*, in AA.VV., *Le nuove istituzioni europee. Commento al trattato di Lisbona*, Bassanini – Tiberi, *Quaderni di Astrid*, Bologna, 2010, p. 441.

based. Such events have further highlighted the shortcomings of a system characterised by insufficient cohesion, which, in turn, can generate some hegemonic tendencies, as well as a substantial lack of solidarity and nationalistic positions.

This is also why, in some Member States - which are characterised by an economic model based on domestic consumption, as well as the direct involvement of the State in the economy and its pervasive bureaucracy[61]- the crisis has generated a deep recession that, in turn, has caused many businesses default. Pauperisation and worrying unemployment rates have hit mainly the countries of the Mediterranean area, showing the 'dark side' of a post-industrial era involution process that the abovementioned austerity has contributed to exacerbate. These are also the preconditions for a 'democratic drift' which might create a shift towards new forms of deterioration , whose final outcomes it is not possible to foresee, yet.

The pressing need to find economic resources -on one side, to reduce the public debt and, on the other side, to restore economies hit by long periods of recession - impacts the already critical conditions of the banking system, which is, in turn, affected by an increasing amount of non-performing loans and has to face the ECB's requests for capital increase.

Elsewhere, I have already dealt with the contradictory approach and the procedural techniques adopted by the European legislator in order to introduce new measures apt to tackle the negative effects of the global financial crisis.[62] It is necessary to recall the increasing distrust, mainly in Italy, concerning the adoption of new legislative initiatives (particularly Directive 2013/36/EU, so-called CRD IV, and Directive 2014/59/EU, so-called BRRD, along with Regulation 2014/806/EU, so-called SRMR), through which the EU has attempted to provide potential remedies for the difficult situation of business and of the financial systems in order to

[61]See SOTIROPOULOS, *Southern European Public Bureaucracies in Comparative Perspective Line*, Taylor & Francis Online, 25 January 2007.
[62]See CAPRIGLIONE - MASERA, *La corporate governance delle banche: per un paradigma diverso*, *Riv. trim. dir. ec*., 2016, I, p. 296; CAPRIGLIONE, *L'Europa e le banche. Le 'incertezze' del sistema italiano, ibidem*, 2017, I, p. 1; ID., *La nuova gestione delle crisi bancarie tra complessità normativa e logiche di mercato*, *ibidem*, 2017, I, p. 102.

ease the economic recovery.

Even the legal scholarship has severely criticised such a new legal framework which, in some of its parts, overwhelms the means depositors, savers and investors of several Member States have been traditionally protected in a bank crisis scenario.[63] The complexity of the new legal framework as well as the difficulty in applying the bail-in tool, which replaces the pre-existing bail-out, have been pointed out. More generally, a dissenting opinion (often transformed into intolerance) towards the required restrictions of uncontrolled operational forms in order to overcome the *impasse* in which important EU Member States, such as Italy, are stuck has been expressed. The consequence of this is deemed to be a further penalisation of populations already affected by the negative implications of social immobility which has lasted for many years.

Especially in Italy it is possible to find out a conflict between high-level intrinsic capabilities (in several sectors ranging from top quality industrial production, to science and art) and endemic shortcomings, irresponsible leadership, pervasive corruption (which, due to the '*malum agere*' of few people, ends up hiding the commitment and goodwill of many others). Italy has had a socio-political context which, until recently, has neither been able to cope with modernity nor to create the legislative '*humus*', which is necessary to promptly adopt measures for a sustainable growth.

Such a situation is due to the inefficiencies of a bureaucratic system that hinders, delays and makes every kind of enterprise difficult to be carried out. This, in turn, is associated with a weak inclination to respect the rule of law,[64] that is what characterises a system where information is considered by the leadership as

[63]See STANGHELLINI, *La disciplina delle crisi bancarie: la prospettiva europea*, in AA.VV., *Dal Testo unico bancario all'Unione bancaria: tecniche normative e allocazione di poteri*, *Quaderni di Ricerca Giuridica della Banca d'Italia*, n. 75, 2013, p. 156; DI BRINA, *La crisi della banca e degli intermediari finanziari*, in AA.VV., *Manuale di diritto bancario e finanziario*, Padova, 2015, p. 455; GALEAZZO - DE CESARI, *La Commissione UE e le crisi degli enti creditizi e delle imprese di investimento*, *Fall. Proc. Concor.*, 2016, p. 620; ROSSANO, *La nuova regolazione delle crisi bancarie*, Milano, 2017, *passim*; RULLI, *Contributo allo studio della disciplina della risoluzione bancaria*, Torino, 2017, *passim*.

[64]See the World Bank Doing Business Report (www.doingbusiness.org) where Italy is the 51° country in the global ranking.

a 'needed bad'.[65] On these grounds the need for renewal has clearly come up. Citizens aspire to get back to orderly system, transparency, correct exercise of public functions and non-disappointing political parties which, until recently, have exposed the country to uncertainties or, more precisely, to the uncertainties of a future without positive future prospects, especially for the young generations.

Populist movements were born in a context of widespread disappointment for the missed realisation of the European 'federalist' project, which should have been based on sharing and solidarity among different people and countries. Even though they have different political origins, such movements clearly show in their statements the intent of reaffirming the *dogma* of national sovereignty associated with the prospect of bringing around significant *changes*.

The deterioration - that in recent years has affected some EU countries - highlights the uselessness (*rectius* the inadequacy) of the efforts made to counteract it. This has, in turn, made many people think that the European politics is inconsistent. Europe has been blamed for the negative effects of a situation whose causes are enrooted in some States' endemic deficiencies and in the cultural limitations that do not allow to properly analyze and completely understand the reasons for the abovementioned facts. This has fuelled the populists' intolerance towards the burdens provided by the Union's austerity measures and has supported their tendency to channel the 'social protest' into the European integration process rejection.[66] By taking benefit of the widespread perception of economic uncertainty and the 'fear' caused by the migratory flows, such movements 'flourish' by obtaining increasing electoral consensus. They, indeed, manage to attract the population's interest by feeding a rhetoric of the crisis that identifies the responsible for the society's moral and material degradation in three main categories:

[65]See *Il saluto di Ferruccio de Bortoli ai lettori del Corriere della Sera*, *Corriere della sera* 30 April 2015, available at http://www.corriere.it/cronache/15_aprile_30/saluto-lettori-direttore-de-bortoli.
[66]See CAPRIGLIONE - TROISI, *L'ordinamento finanziario dell'UE dopo la Crisi*, Milano, 2014, p. 121.

politicians, bankers and immigrants.[67] These movements, which often have a deceitful attitude, are inevitably intended to take the typical structure of political parties, thereby ending up taking positions that are actually equivalent to the ones they used to criticize.

Even though they are moved by a common reactive nature, populists often have different features being inspired by different socio-economic models, which aim at reaching political purposes that are not always reconcilable. Nevertheless, they find a point of conjunction (*rectius* convergence) not in a common ideology, but in the need to find an 'agreement' allowing them to form a government notwithstanding tensions and reciprocal distrust. Still, the foundation is a 'sovereignist' logic, since they want the full independence of the political power, which, according to Rousseau,[68] must belong to the people. Consequently, they ask for national autonomies, which are, by definition, in contrast with the limitations that are typical of the European supranational organizations of which the States where they are active are members. This might be aligned with the execution of a project aiming at getting strong positions within the Institutions they want to change and, more in general, with the plan to scale back the federative model which was the origin of the EU countries' integration.

In such a context, the negative effects of a type of alliance that benefits from the widespread dissatisfaction flourish on the grounds of an endless propaganda, which is only interested in collecting consensus by exploiting racist feelings and the cultural shortage of huge parts of the electorate. More in detail, such an alliance has been the result of the economic stagnation that, due to the terrible financial crisis of 2007-2008, has affected some EU Member States. It is understandable how the painful remedy measures adopted by the European Institutions

[67]See CAPRIGLIONE - IBRIDO, *La Brexit tra finanza e politica*, *supra*, p. 94, underlining that in Italy a new political movement called 'Movimento Cinque Stelle', «*attraverso la sperimentazione di "pratiche di partecipazione" fondate sulle nuove tecnologie…si è proposto di contribuire alla definizione di un nuovo modello di democrazia*».

[68]See ROUSSEAU, *Social Contract*, published in 1762 where the philosopher elaborated his political proposal aimed at re-founding the society on the basis of a fair social contract, pointing out that it must be the people will to determine the actions to take, since people are the sovereign.

in order to face the internal difficulties have contributed to further slow-down the European integration process, highlighting - and sometimes also creating - new imbalances in the Euro Zone, which have soon become the target of the criticisms feeding the populists' *agere*.

The essays of some economists who, over time, have criticized the Treaties' rules (as well as the ways in which they have been interpreted by the European authorities) often support, from a theoretical perspective, the populists' views. They, therefore, use these criticisms to remark the need of moving back the sovereign functions to the State.[69] But in so doing, they neglect to consider that these economic studies on the Union's asymmetries have a foundational ambiguity concerning the lack of clarity about the value to give to the *interdependence* of our Country, that, instead, has to be considered as necessary and irreversible, as recently underlined by a famous political science expert.[70]

Thus, concerning Italy, when challenging the EU, the criticisms relating to the unbalanced benefits' distribution, which benefits some Countries (the German hegemony) rather than others, prevail. But this, in turn, leads to underestimate the benefits arising from the EU membership! And indeed, populists undervalue the positive effects resulting from the harmonization of financial rules and disregard that, only due to the European *input*, it has been possible to modernize the countries' legal frameworks (that in turn has generated increased levels of competitiveness otherwise impossible to reach).

9. It is evident that the hypothesis based on populism has material effects on the principles of constitutionalism, understood as a doctrine of the limitation and legitimacy of power. Therefore, it affects the main features of the democratic

[69]See DI TARANTO, *Le basi problematiche della moneta europea*, *Aspenia*, *I futuri del capitalismo*, 2012, 56, 176-183; ID., *Il salvataggio temporaneo di Atene? Vantaggioso solo per Berlino*, *Milano Finanza* 16 March 2012; ID., *L'Europa tradita*, Roma, 2014, *passim*; ID., *Così l'Italia può cambiare l'euro (e guadagnarci*), 19 January 2014, available at www.ilsussidiario.net; SAVONA, *Serve un piano B per uscire dall'Euro. Da Renzi mi aspetto molto*, 9 March 2014, available at www.forexinfo.it.

[70]See FABRINI, *Ambiguità o riforme: il dilemma per l'Europa*, *IlSole24Ore*, 11 November 2018.

structure of the countries in which these movements arose. Those movements rely on certain principles - such as freedom, autonomy and representation - which are notoriously the pillars of every system willing to create an organization in which sovereign power belongs to the people. [71]

Indeed, sovereignism can easily lead to an autarchic model which, with the aim of bringing work and well-being to all the citizens, eventually results in limiting their freedom. In this case, populist influences inevitably end up toeing on isolationism and protectionism lines, which could be easily translated into infringements of some fundamental rights (such as the acceptance of those fleeing war and hunger), exploiting people's feeling of being unsafe.

The political power is committed to engage in a struggle to overcome the obstacles that come from outside (i.e. migration) and from EU (which is considered the main cause of unemployment - especially among young people - and rising poverty). This attitude can be seen in the behaviour of these movements' leaders who, in a spasmodic search for consensus, do not miss any opportunity to pursue purposes of electoral propaganda, reaffirming their role in meeting the citizens' needs for security as well as with reference to Europe (which asks Italy to respect the Treaties), regardless of the fact of compromising the "history" of our country, which has always been supportive, open and welcoming towards refugees.

This approach seems to ultimately lead to a new Leviathan, symbol of a power unmoored by the previous logic of state legitimacy, incardinated on legal positivism (meaning that what is right is identified in the decision of the sover-

[71]The traditional paradigm of 'democracy', intended as a form of government in which power resides in the people, is articulated through different political institutions that assure the freedom and equality of all citizens. The concept of democracy also indicates a government system in which sovereignty is exercised by the people, through democratically elected representatives, when it assumes the 'indirect' form, or without any intermediation if it is configured as 'direct'. See, among the others, KELSEN, *La democrazia*, Bologna, 1981; CANFORA, *La democrazia. Storia di un'ideologia*, Roma - Bari, 2004; SARTORI, *Democrazia: cosa è*, Milano, 2007; ZAGREBELSKY, *Imparare democrazia*, Torino, 2007.

eign). [72] Such an attitude is somehow not different from the one of the EU itself, when it impassively states that 'there are rules to be respected' when those reforms that feed the populist phenomenon are presented.

At the European level, this thesis can result in abandoning the vision of a methodological rationalism (of neoliberal matrix), on the basis of which the joint participation of all the Member States is necessary for the definition of EU policies and the unity in participation is indispensable to broaden the pluralistic dialectic on which democratic coexistence is based.

Some populist movements end up opposing the 'progressive' development of globalization, paving the way for economic regimes which, drawing inspiration from Serge Latouche's theories on *degrowth*, [73] have as their objective a sort of egalitarianism based on a basic lifestyle (for which they tend to exclude the search for a consumer-driven society and the creation of new needs). In the past, also Martin Heidegger expressed doubts on the adequacy and coherence of representative democracy to the civil society. [74] On the other hand, there are some maximalist positions, which certainly imply a 'simplification' of the interventionist forms contrary to the governance of the 'complexity' which characterizes the current historical phase. By doing so, these movements are forced to make continu-

[72]See BOBBIO, *Quale socialismo*, Torino, 1976, p. 42, where it is clear the influence of Hobbes' ideas. Hobbes' notion of democracy - in the reference to the theses of modern constitutionalism - it has been defined as a «procedural idea, on which everyone can agree», with the words of MONTEDORO, *Il ruolo della giurisprudenza nei sistemi costituzionali multilivello*, in *Il giudice e l'economia*, Roma, 2015, p. 173.

[73]In his works, opposing the westernization of the planet, the economist proposes a substantial concept of the '*economic'*, an activity able to provide the material means for satisfying people's needs (cfr. *L'occidentalizzazione del mondo. Saggio sul significato, la portata e i limiti dell'uniformazione planetaria*, Torino, 1992). In particular, he aims at a radical change in our consumer society, inviting the West and Europe to get rid of its taboos: unbridled competition, the single currency and the protection of the financial markets.
He follows his thesis on degrowth, intended as a counterpoint to economic liberalism that allows 'to explode the hypocrisy of the addicts of productivism'; hence the need to abandon the system of unlimited growth, which aims only at profit, with disastrous consequences for the environment and for the humanity. It is evident the fideistic character of this position that tends to search for new frontiers of common well-being, different from progress and economic development.

[74]See *MARTIN HEIDEGGER interviewed by Spiegel* from *Scritti Politici (1933-1966)*, edited in Italian by Gino Zaccaria, Casale Monferrato 1998, pp. 263-96, where the famous German philopher is quoted saying: «for me today it is a decisive question as to how any political system -- and which one -- can be adapted to an epoch of technicity. I know of no answer to this question. I am not convinced that it is democracy».

ous compromises with their original ideological positions.

The definition of the relationship between sovereignty and autonomy is even more striking. Indeed, the former is limited to determine a national-popular strategy, reluctant to the constraints imposed by the international community Hence, the reference to theses (apart from their possible degeneration in an extreme right-wing key) considering the possibility (following a Gramscian programmatic line) of putting a brake on 'triumphant capitalism'.[75]

It follows a vision of 'autonomy' understood as the capacity to: (i) escape from the bonds of intergenerational justice (deriving from the need for a sustainable public debt); (ii) proceed to forms of deficit redistribution; (iii) modify the rules at will. In this context, there is a shift from the class struggle (which characterized the years following the second world war) to a new type of conflict, destined to hit especially young people who - it is worth to remember it- represent the weak category to be protected according to the populistic manifesto.

In defining the economic policies, Member States' discretion around the constraints deriving from the European parameters are actually directly proportional to their ability to control public finances. A sustainable public debt is functional to the objective of a socially (and generational) cohesion, which should guide political action.

With reference to the obligations to comply with the European treaties, true autonomy is identified in respecting the recommendations of the EU, in keeping good public accounts, in continuing the process of integration based on solidarity - unfortunately often neglected in the application of the intergovernmental method. These behaviors result in an effective action that does not suffer any constraint and, therefore, achieves the ideal of (decisional, evaluative, etc.) 'independence' to which the sovereign essence can be traced back. Such a behavioral

[75]For a philosophical and political analysis of capitalism, challenging the post-modern drift of the Italian left-wing coalition, transcends the normal spectrum of political right and left, see PREVE, *Destra e sinistra. La natura inservibile di due categorie tradizionali*, Pistoia, 1998; *Il popolo al potere. Il problema della democrazia nei suoi aspetti storici e filosofici*, Casalecchio, 2006; *Nuovi signori e nuovi sudditi. Ipotesi sulla struttura di classe del capitalismo contemporaneo*, Pistoia 2010.

line, while reflecting a logic underlying in the application of Kant's 'moral law', must avoid inflexibility, being this inflexibility a fertile humus for populist movements.

It should also be noted that this view of autonomy can lead to unwanted consequences. Just think of the issues caused by the failure to comply with the Maastricht parameters, reflected in the increasing distrust of financial markets toward the country responsible for such conduct. This resulted in falls in the stock market and raising spread, with an increasing burden for the State's public debt. [76] It is evident how, if limited to a competitive exercise, the acceptance of sovereignism is resolved in a dangerous adventure destined to challenge those who believed to exit, in this way, from the shallows of the EU political immobility, while overcoming the obstacles delaying the growth process.

10. In this context, specific emphasis has been put on the populist approach proposed by Italian politicians in order to shape a 'new model of democracy', giving way to a reality in which the affirmation of Eurosceptic nationalism reflects a "critique of European technostructures... aimed at... overcoming the current Democratic-representative frameworks and creating an unprecedented form of direct deliberative democracy, operating from the bottom"[77]. This ideological approach is the main feature of the thesis supported by a new type of Italian political

[76]With the term *spread* we indicate the yield differential between ten-year government bonds of a Eurozone country and those of Germany. In the last years, the spread has become the benchmark figure to look at when evaluating the level of market confidence toward a certain Member State. Measuring the financial risk, the spread is considered a key parameter to assess an issuing Member State's capability of repaying its public debt. (being correlated to its probability of default); see CAPRIGLIONE, *Mercato regole democrazia*, Milano, 2013, p. 115 ff.
On this argument, it is worth mentioning the words of the Bank of Italy's Governor VISCO (see. speech at the World Savings Day, Rome 2012, October 31, p. 13): «*the reforms will be unable to work their effects in full if doubts and uncertainties about the future of the single currency were to keep sovereign spreads far above the levels consistent with each country's economic fundamentals*». At the last 2018 World Savings Day Visco stated that «*the increase in the spread reflected, in almost equal parts, the increase in the risks of default and redenomination, risks that feed off one another. "Contrary to what happened at the peak of the crisis, when fears had spread about the possibility of a euro break-up, the increase in the risk premium almost exclusively concerned Italy; in the rest of the euro area, investors perceived the risk of redenomination as being very low*» (p. 5).
[77]So CAPRIGLIONE -IBRIDO, *La Brexit tra finanza e politica*, cit., p. 95.

entity, the Five-Star Movement, which has been the bearer of "participatory practices" based on new information technologies.

This approach is actually causing the denial of some dynamics of negotiation, such as mediation and compromise - which notoriously represent the inner essential elements of democratic parliamentarianism[78] -, due to the request of 'honesty', which seems to be defaced by past politicians. That is enough to advocate (in the phase that preceded their current role in the Government) the introduction of punctual statutory prohibitions to the formation of alliances with the traditional parties[79]. These bans obviously failed in the definition of the so-called "Contract of Government", *i.e.* the coalition recently signed with the League[80].

In this respect, the Italian populism has his own peculiar differences from abroad experiences, and surely the affirmation of populist-nationalist ideologies reserves a future full of uncertainties. A new concept of State has been created and it reflects the Schmitt 'intensive form of political unity' which could pose risks of totalitarian deviations (used in the past to achieve a substantial equality of all citizens which still today is believed to guarantee real social uniformity)[81].

Even if the nationalist ideology represents the common factor for the current most popular political parties, in our country populism has turn into several political approaches, characterized by substantial differences. Indeed, the political

[78]See the classic proposition of KELSEN, The democracy, cit.

[79]The prohibition of alliance with other political parties is included in the «Code of Conduct of the elect of the 5 Star Movement in Parliament», in *www.beppegrillo.it/movimento/ Code _-Comportamento_parlamentare. php*. Significant is also the imposition of contracts containing penalties aimed at sanctioning dissonant behavior against the indications of the movement leaders. See CAPRIGLIONE - IBRIDO, op. cit., where we can find the editorial written by TIROCINO, *Il test per la penale sugli eletti, scatta subito la guerra legale. I giuristi: è incostituzionale*, in *Il Corriere della Sera*, 11 gennaio 2017, *www.corriere.it /politica/17_ gennaio_ 12/test-la-penale-eletti-8bc20c74-d83e-11e6-9dfa-46bea8378d9f.shtml.*

[80]We refer to the well-known ' contract '-stipulated at the end of May 2018 between the parties of the Government majority, for the entire duration of the XVIII legislature. Militants of the Five Star Movement and politicians from the League voted the text. You can see the text on https*://www.corriere.it/politica/18_maggio_18/m5s-lega-ecco-contratto-definitivo*, with editorial written by PICCOLILLO, *M5S-Lega, ecco il contratto definitive.*

[81]See the classic writings of SCHMITT, The categories of 'politician': Essays on Political theory, Bologna, 1972; ID., On the Leviathan, Bologna, 2011, in which the Research on the "political" induces the A. to discuss with Hobbes and the famous image of the Leviathan; ID., State Movement people, Bologna, 2018.

populistic parties show Eurosceptic tendencies all together, but some of them feature a right-winged identity (so are the *League* and the *Brothers of Italy*), and others declare a proactive form (characterized by uncertain borders) of an Egalitarian idea (the *Five Star Movement*). Therefore, the degenerative paths of nationalism are represented by: (*i*) a 'fascist drift' in the first case, if an extremist ideology prevails, believing that the centripetal tendencies of rampant Europeanism can be counteracted only by political nationalism, (*ii*) a hypothetic Rousseau idea, also confirmed into the above-mentioned "Social Contract", which considers the proper moral solidity of politicians as an inner expression of good public governance.

Therefore, right and left-wing nationalists both formally act in order to create associative forms able to defend and give security. Moreover, they take political decisions feeling as exclusive depositories of the will of citizens. In this respect, we can affirm that in the country, a type of subversion aimed at erasing the *elite* is actually increasing. This subversive approach, denies the selective function of the *elite* in a democratic state, and causes (in the absence of *elite* political contribute) the rise of human and social irrationality. Otherwise, we should agree with Charles Lindblom's thesis according to which "even in democracies, the masses are persuaded to ask the *elite* only what the *elite* wants to give them".[82] In this way, we have to admit that any choice and/or competition is limited.

Lastly, we cannot exclude that a new concept of democracy is growing up, different from the traditional idea acknowledged in the "constitutional systems of pluralistic democracy" (think of the importance given in the Italian Constitution to the concepts of 'people' and 'sovereignty'). Indeed, in the sovranist-populist logic, which is only addressed to empower new and more restricted *elite*, the new democracy seems to be destined to delate its original reference to civil society and, at the same time, to put any political choice exclusively in the hand of the holders power. From this point of view, in fact, the latter are the sole interpreters of the

[82]See *Politics and markets: the world's political-economic systems*, 1977, New York: Basic; the same thoughts are expressed into *Inquiry and change: the troubled attempt to understand and shape society*, 1990, Yale University Press.

desiderata and the needs of citizens, the realization of which is achieved by them by independently setting the political agenda.

In other words, the current change seems to be destined to turn into a "delegation of power" , for which people represent the formal animator of the reform process, while, as a matter of fact, citizens are considered just a source of political legitimation in order to justify the adoption of policies that are overcoming traditional forms of neoliberal-inspired democracies.

In this respect, the critical mention ("from within") to the European integration process, moved by populist and nationalist parties, even though it might be be considered constructive for the highlighting of the problematic condition of the Union, for other it threatens to grow in an antidemocratic drift, in opposition to the values (and successes) in which people from Member States believed for decades. For sure, populist and nationalist parties will face the redefinition of the European project during the next elections of May 2019, and only in this political battle we will see whether these ideas will result in a dissolutive movement or, as we hope, in a "new and improved nature" of Europe and of its citizens, able to compete with the other giants of the global era.[83]

Certainly, over next years, scholars will have to further deepen the relationship between 'sovereignty and federalism', in order to identify - where it is possible - the cornerstones of an ideological construction aimed at bringing together conceptual hypotheses and technical forms of public intervention, which are actually not easy to conciliate. At this point, some academic research should be considered significant if aimed at clarifying this relevant issue. Among these, I like to point out the analysis made by some eminent jurists - including G. Alpa, P. Ridola and M. Luciani - who, by evaluating the current populist emergence - are giving a new input to the analysis of the delicate topic nationalism and federalism in the future of the EU.[84]

[83]See FABRINI, *Rischio sovranista per i conti dell'Italia*, in I*lSole24Ore* of 6 January 2019.
[84]See in this regard the analyses carried out in this seminar held on July 14, 2016 at the Faculty of Law of the Sapienza University of Rome.

At the present moment and in the light of the above-mentioned considerations, we can affirm - in line with the Bank of Italy Governor Visco's speech - that the challenges of this millennium have reached global dimensions and it is illusory to think that the Italy's future could be independent from the Europe's one. [85]

11. The EU faced a hard test during the last decade; as it was recently written "an unprecedented frequency of shock... have made the foundations wobble".[86] However, despite the raging storms, today there are still valid reasons for EU existence: maintaining conditions of peace and democracy, eliminating frontiers within the Schengen area, promoting economic and cultural development among the Member States. The benefits and opportunities from UE exceed the criticisms considering the EU an abstract and distant entity with negative aspects and functional *defiance*. On the other hand, only a common Member States' awareness of the need to give 'politics' a fresh impulse can achieve the form of a cultural mixture, as well as a socio-economic one, necessary for drawing the EU out of the stand-by phase in which the way to the Union of People actually is. This aim is not included in the current intergovernmental logic, but it certainly was taken into account by the EU 'founding fathers'.

Therefore, once again I am ready to defend EU and future generations, as the living standards of the latter are inevitably threatened by the current - and dangerous - spending policies carried out by populist parties, which only care about potential voters. Sooner or later we will look forward to constructive criticism within the EU; but in the meanwhile, I just have to recall Stephen Decatur's popular speech towards his country, the United States. Even for me, Europe is still "my country, right or wrong".

[85]See *Speech* during "Giornata Mondiale del Risparmio", Rome, October 31, 2018, p. 10 of drafts.
[86]See the editorial written by FERRERA, *L'Europa non è solo burocrazia*, published in *Corriere della sera*, 7 November 2018.

EUROZONE CREATION AND POSSIBLE EXITS: POLITICAL, INSTITUTIONAL, MONETARY AND ECONOMIC ISSUES

An analysis of the key stress points of the single currency and their interactions

Rainer Masera [*]

ABSTRACT: *This paper argues that EMU has been and continues to be a politically driven process. In this perspective, it examines the issues and the implications of potential Euroexit and Euro break up: it underlines that these processes would have a prominent political dimension, as was the case for the creation of the euro. A complex-system network approach is adopted to examine the principal vulnerabilities of the single currency without a state. The euro is at the center of an economic and monetary union with unique political, institutional and policy features. The Eurosystem – which comprises the European Central Bank and National Central Banks - is a construction with no parallel in time and space. The heart of the interactive dynamic web in the Eurosystem is a complicated payments and settlements system: Target Balances. Beyond their accounting functions, the Balances have macroeconomic, macroprudential, balance of payments, banking and monetary – geographical and area-wide – implications. These characteristics were not explored and understood until a few years ago. The risk features continue to be downplayed. This paper tries to bring the analytical and policy understanding one step forward. It shows that - beyond the relevant and complicated assessment of changing underlying factors, also on a country basis - a long-term relationship exists between monetary base creation in the Euro area and the Target System. It ar-*

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gues that the workings of the System in its present form blunt the inherent adjustment mechanism of a currency union. Five key areas of stress of the euro are identified and potential systemic fault lines are examined, with novel insights on transmission mechanisms of contagions and risk spillovers. The findings help outline remedial comprehensive actions of political economy to improve the resilience of the Eurozone.

1. The Eurosystem is at the center of a very complex monetary area, with unique political, institutional and policy features. The Economic and Monetary Union (EMU) is characterized by a single currency without a state. Beyond the well-known points on the alleged lack of optimal currency prerequisites (Mundell, 1973 and Mody, 2018) – which are not entered into here – the incomplete institutional framework and the architecture of the Eurosystem are themselves at the root of possible stress points. From different - official and academic - angles this is widely recognized, but similar diagnoses are the result of very different models and are accompanied by correspondingly different policy prescriptions[1].

The policy management of the EMU has fallen de facto on the primary re-

[1]See for instance the European Commission's Five Presidents' Report (2015), Minenna (2016), Schmidt (2017, 2018), the Meseberg Declaration (2018) and Balassone and Visco (2018).

sponsibility of the ECB, which in July 2012 ("whatever it takes") saved the system from collapse, admittedly with full political support of the EuroCouncil. The excessive reliance on monetary policy – with an over five-fold increase of the consolidated balance sheet of the Eurosystem between 1999 and 2017 – was to a large extent the inevitable response to an unsatisfactory policy mix. This was recognized and underlined also by the President of the ECB in a well-known hearing at the European Parliament: "*In order to make the Euroarea more resilient contributions from all policy areas are needed. The ECB is ready to do its part. … In parallel, other policies should help to put the euro area economy on a firmer ground. It is becoming clearer and clearer that fiscal policies should support the economic recovery through public investment and lower taxation. In addition, the ongoing cyclical recovery should be supported by effective structural policies.*" (Draghi, 2016).

This paper shares the concerns on the existing architecture of the euro. The focus is on the identification of key potential stress points, interactions and contagions: the euro conundrum. The inherent complex network links imply that, to move towards a stable system capable of realizing the goals of the EMU, a comprehensive analytical and policy approach should be adopted, with a view to preventing stress points from turning into fault lines, possibly leading to euroexits and even to the collapse of the euro. As will be shown, in the absence of such coordinated program of political economy (Cardinale et al., 2017), the system will continue to remain vulnerable to shocks and without effective and efficient adjustment mechanisms.

The commonly adopted analytical and policy frameworks focus on pair interactions between stress areas (bank-sovereign; sovereign debt/euroexit; ….). The attempt made in this paper is to offer a holistic framework, by identifying the five key areas of risks, and their complex network relations. Admittedly, this may imply some repetition. The advantage is that the different perspectives allow a better vision and understanding of the overall picture.

The stress/crisis points taken in isolation represent low-probability events. However, as is shown by endogenous risk analysis, the traditional well-behaved

normal type probability/density functions can degenerate under stress into power distributions, possibly leading to systemic risk. This approach should not be identified with “black swan” (extreme event) models (Cont and Wagalath, 2012), although interconnections between the two frameworks can be established.

The paper is organized as follows.

Section 2 underlines that the EMU is first and foremost a politically driven and institutionally constrained exercise. This is the source of economic weaknesses, but also the main explanation of the extraordinary resilience of the common monetary area. The euro was built as an irrevocable construction enshrined in the Treaties of the EU (Schütze and Tridimas eds., 2018).

Section 3 examines the institutional/legal difficulties of euro exit. Explicit reference is made to the ECB views. The traditional arguments are recalled, but the emphasis is on the Pandora box opened by the President of the ECB in response to a written question from Members of the European Parliament. The argument was made that, if a country were to leave the Eurosystem, the Target2 Balances (T2Bs) of its National Central Bank (NCB) would have to be settled in full.

In Section 4, target balances between 1999 and the Great Financial Crisis, and financing gaps in 2007-08, 2011-12, 2017-18 are reviewed. It is recalled that the ECB itself had not realized the full implications of the complex arrangement in the Eurosystem before the critical analysis of Hans-Werner Sinn (2011). He demonstrated that T2B’s were not merely a booking system (“irrelevant balances with no direct relevance to ECB monetary policy”, as had been maintained). He explained that they had to be interpreted within the context of money creation, international capital flows and current account deficits/surpluses in the EA.

Section 5 carries the argument one step forward. The intra Eurosystem-ECB lines of credit - which are automatically generated, unlimited in size, not collateralized and with no redemption date - have critical economic consequences. The Eurosystem/T2B construction can be viewed as a system which lacks the principal adjustment feature of a unified currency, where transfers of money take place automatically, without national central banks interfering (Friedman, 1968).

Section 6 offers insights of the nexus between money creation of the ECB, target balances and adjustment processes. This is done through a close look at the available evidence for the whole period after the global financial crisis. Contrary to common interpretations - which stress the fragmentation of the economic processes and of the underlying factors of T2Bs over time and across countries – it is argued that common key driving elements are represented by money creation in deficit countries and continuing current account surpluses, notably in Germany. The evidence presented suggests that monetary creation of the ECB is associated with the sum of positive or negative balances. The question is posed whether it is "the Target Balance", as officially defined, the driving element of the system, or it is the sum of negative balances which effectively rules the roost. This is not a moot point, in terms of both causal links and adjustment burdens.

These strands of analysis are brought together in Section 7, which provides an integrated approach to the key potential stress areas. Five possible break points of the single currency and their interactions/interconnections are identified. Euro crisis/collapse (these worst-case events would have a preeminent political dimension); sustainability of sovereign debt and implications for euro exit; bank/sovereign loop; risk elements arising from the sustainability of T2Bs; potential liquidity crises in the EA, in the absence of a safe asset.

Section 8 offers the concluding remarks.

2. Immediately after the end of World War 2 the political vision of the "Fathers of Europe" (Konrad Adenauer, Winston Churchill, Alcide de Gasperi, Jean Monnet and Robert Schumann) became the driving force of the process of European integration. There was ample Peoples support to the conviction of political leaders that the wars and the divisions of the past had to be avoided at all costs. Different models were propounded, and a long-term trend was initiated which is at the basis of the EU and the EMU. The key institutional building steps were: the Treaty of London, to create the Council of Europe in 1949; the Treaty of Paris which marked the creation of the European Coal and Steel Community, in 1951;

and the Treaties of Rome which enacted Euratom and the European Economic Community in 1957.

The goal of EMU was officially declared in 1969 at the Hague Summit: a stability and growth path of the European economy would be accompanied by monetary unification. The question of a monetary organization of the Community acquired paramount importance after the problems of the dollar as the anchor of the international monetary system erupted, with the unilateral declaration of inconvertibility in 1971 and the free floating in 1973.

The process of monetary integration in Europe required close collaboration between governments and central banks; the driving force was political. After the difficulties encountered by the snake exchange agreement, a major step in monetary cooperation was the creation of the European Monetary System (EMS). This was introduced by the European Council in December 1978 (Reg. 3181/78) and lasted until 1998. Fixed but adjustable exchange rates with allowed margins of fluctuation were paralleled by a cooperative system of financial assistance and of settlement of credit/debit balances between the national central banks and the European Monetary Cooperation Fund. A collective discipline framework underpinned the EMS (Masera, 1987).

The objective of a single currency was restated in many European Councils, notably in 1988 when a mandate was given to a Committee chaired by Jacques Delors to propose a detailed road map. The report was ready in 1989, it underlined that the introduction of a common currency would have to be preceded by strong and effective economic and fiscal convergence of the countries willing to commit themselves to the single currency.

0n 9-10 December 1991 the European Council held in Maastricht set down the Treaty on European Union and on Fiscal Convergence, with a formal decision to create the EMU[2]. The Maastricht approach was driven by the German "corona-

[2]The Treaty was signed on 7 February 1992, it entered into force on 1 November 1993. The need for an interdisciplinary approach to the analysis of the EMU process was underlined by Capriglione and Sacco Ginevri (2016) and Federico and Arcelli (2017).

tion theory". This "economist approach" held that rigorous and sound initial conditions of fundamental convergence were required to enter the common currency.

The Delors model and the technical work of Treasury and central banks in those years (1988-1991) was geared to ensuring that: i) the necessary convergence measures, notably in terms of fiscal policies, would be taken before joining the common currency which did not have the features of an optimal currency area, and ii) destabilizing fiscal impulses would be prevented after the monetary union, to avoid undermining the operation and the convergence of the Euroarea.

Contrary to current commonly held beliefs the Maastricht criteria were not conceived as an austerity driven framework, neither in terms of deficit nor with reference to debt. The 60% ratio was predicated by reference to the weighted ratio of countries recorded in those years (France and Germany were below the limit, the only deviant country was Italy with a ratio over 110%). The 60% limit was also checked trough the Domar steady state model[3]. Admittedly, with the benefit of hindsight, the real growth assumptions were too optimistic. But this was not clear at the time[4].

At the same time, the political leaders of Germany and France had agreed that the EMU – as defined by the coronation approach - would have to be sustained by political union, to avoid a currency without a state. The following two quotations bear witness of this determination.

[3]As shown by E. Domar (1944) and recognized in the technical preparatory work on EMU, the following steady state relationship holds for the public debt to income ratio. Whatever the initial condition, if the overall deficit is held at 3% of income and the growth rate of nominal income is given by the sum of a constant real component of 3% and a stable rate of inflation of 2%, the ratio converges to a limit of 0.6=3/2+3.

[4]After the exceptional economic growth recorded between 1950 and 1971, with an average annual rate of GDP growth of over 4.5%, the combined effects of the oil crises, wage and price inflation, and the dollar problems concurred in lowering yearly growth to some 2% per year between 1972 and 1990. During the preparatory technical work for Maastricht, the view was broadly shared that with the decline of energy costs, monetary stability and the growth-enhancing features of EMU itself, a sustainable rate of growth of 3% could be projected into the future.

François Mitterrand and Helmut Kohl, 1990:

Our aim is that these fundamental reforms - economic and monetary union as well as political union - should enter into force on 1 January 1993.

(Letter by the German Federal Chancellor Helmut Kohl and French President François Mitterrand to the Irish Presidency of the EC. 19 April 1990. Source: Agence Europe, 20 April 1990)

Helmut Kohl, 1991:

It cannot be repeated often enough: Political union is the indispensable counterpart to economic and monetary union. Recent history, and not just that of Germany, teaches us that the idea of sustaining an economic and monetary union over time without political union is a fallacy.

(H. Kohl: Protocol of the Deutsche Bundestag, 6 November1991)

However, this well-defined and consistent time path was not respected when the euro was created in 1999[5]. The contention made in this study is that the situation had changed significantly ten years after Maastricht. Growth assumption had to be revised downwards and the convergence of debt to the 60% threshold had become exceedingly complicated for countries with debt to income ratios twice as high[6]. The participation of Italy and shortly later of Greece upset the balance.

Strong political pressures of "weak countries" to adopt the single currency found support by the Commission and by France herself. The stated reasons were

[5]The irrevocable conversion rates of national currencies for the euro were adopted by the EU Council upon a proposal from the EC in accordance with Art. 109(4) of the Treaty on 31th December 1998.

[6]The relevance of political drivers, as against respect of technical requirements, is highlighted by the controversy on entry into the single currency between the then Prime Ministers of Spain José Marias Aznar and of Italy Romano Prodi. The former claims that he rejected Italian requests of a common approach of the two countries to postpone their entry. The latter maintains that this is not true, and that Italy was determined to join immediately the euro, with political support from France and Germany. (To recall, the debt/income ratio in 1998 was 64% in Spain, compared with 115% in Italy).

that entering immediately, albeit with an incomplete respect of the Maastricht criteria, would have ensured a better external discipline and therefore effective convergence. The inherent competitive advantage for strong countries also played a role[7].

The Italian case is emblematic: the former Governor of the Bank of Italy and Prime Minister (later President of the Republic) Carlo Azeglio Ciampi, as Treasury Minister in the Prodi Government (1996-98), indicated to Helmut Kohl and to François Mitterrand that in a very few years with the euro and the enhanced discipline the Italian debt to GDP ratio would come down to 60%. A large fiscal space was offered by euro interest rates: Italy's debt servicing costs declined by 40% in the decade 1997-2007. But this was utilized to increase current expenditure of a bloating public sector and concurred to the lack of mutual trust among Member Countries of the EA.

In 1999 Greece was not allowed into the Eurozone for failing to meet the Maastricht economic criteria. But on 1 January 2001 Greece was permitted to join the single currency. To qualify a tough austerity program had been adopted, but as was later ascertained, key macroeconomic indicators had been faked. Official comments on the date of entering the Eurosystem were: "*this is a historic date that places Greece firmly at the heart of Europe*"… "*our inclusion in EMU ensures greater stability and opens up new horizons*". The decisions were greeted with general euphoria and with two-thirds of the Greek voters in favor, according to opinion pools. Similar rhetoric comments came from the Commission in Brussels.

With the admission of Greece twelve EU countries shared the euro. Denmark, Sweden and the United Kingdom were the only EU members outside the eurozone: in all these countries voters and governments were (and are) against joining the monetary union. Later the UK, after a popular referendum in

[7]Jacques Delors underlined that the euro creation was marked by a "fault in execution" of his plan by the political leaders, who decided to turn a blind eye to the fundamental weaknesses and imbalances of some countries which entered the single currency (Delors, 2011). Similar concepts had been expressed by Issing (2008). This political decision can be regarded as the "original sin" of the single currency.

2016, decided to leave the EU.

The key importance of political decision processes on the common currency continues. But relevant changes should be recorded. To start with – although from time to time in certain peripheral countries, in the EC and in the European Parliament lip service is made to political union - this perspective has receded, notably in Germany, the Netherlands and Austria, but also in France. In most new EU member states voters and governments are openly against this model.

The position, previously recalled, taken by the architect of German unification in the Bundestag has been abandoned. His former Mädchen Angela Merkel thinks otherwise and, so far, she has been proved right.

Common political themes in the EU have acquired importance, but also the divide on key issues – immigration, Nato, common defence, relations with the US and with Russia. Popular dissatisfaction with the EU has increased: in weak countries because of the excessive rigor of austerity measures, in strong countries because the rules have been bent trough excessive flexibility[8]. On economic and non-economic grounds the feasibility of political union is at best a very low probability event in the foreseeable feature[9].

Focusing on the euro, the recently accumulated evidence shows that voters and "theoretical" parliamentary majorities in countries in favor of leaving the euro were not sufficient for a state exiting the common currency. Governments decided otherwise. The fears of financial and real domestic crises played, and continue to play, a major role, together with strong European and international pressures.

Reference can be made to three instances:

i. Cyprexit in 2013. According to opinion polls two-thirds of Cypriots were in favor of abandoning the euro, but this did not happen.

[8]A more radical view was propounded by the former Governor of the Bank of England Mervyn King: the Eurozone has created a conflict between a centralized European elite on the one hand and the forces of democracy at the national level (King, 2016).

[9]It is hard not to agree with an important observer as Otmar Issing: "Since EMU was created no progress towards political union has been made – or even really attempted" (Issing, 2015):

ii. Grexit in 2017-18. Also in this case voters were favorable to exiting the common currency. Paradoxically also the German Chancellor Schauble was initially in favor: "we can't undertake a debt haircut for a member of the euro. It is ruled out by the Lisbon Treaty. For that Greece has to exit the currency area"[10]. The current Tsipras government – left wing Syriza plus right wing Independent Greece – went to power with a program to leave the euro, but did not/does not request Grexit.

iii. The Italian case in 2018. During the election campaign Five Stars, League and Forza Italia – which had been critical of the euro – indicated in their political programs that it would not be appropriate after the election to press for Italexit. Vague references were made to a possible parallel currency. In any event opinion polls suggested that, even within Five Stars and League voters, only half would be in favor of exiting the euro. The two parties formed a coalition government. The Prime Minister Giuseppe Conte, and key Cabinet Members were all "technical ministers". They reassured on the Italian allegiance to the eurozone. But the markets showed fears on the effective determination to respect in full Maastricht criteria. The Italian case is indicative of the subtle and complex intertwining of political and economic factors. The spread on sovereign bonds and ratings of Agencies became a common point of reference of media, of political parties and of citizens. The widening of the spread during the Summer of 2018 (250-300 basis points) acquired political and institutional dimensions[11].

[10]The German Finance Minister had already hinted at the possibility of Euroexit in March 2010, when he indicated that the Eurozone required a European monetary fund to be backed by tough sanctions to enforce budgetary discipline, with countries failing to comply facing expulsion from the eurozone "as a last resort".

[11]The very sharp increase in the spread had a major impact on the fall of the Berlusconi Government in November 2011 and the choice of Mario Monti as Prime Minister by the President of the Republic within the same legislature. The risk of repeat of this scenario contributed to the technical agreement between the EC and Italy over the country's budget for 2019 to forestall the opening of a formal infringement procedure for excessive debt. This would have led to renewed sharp increases in the spread and possible downgrades of public debt by credit agencies, which

3. The procedure to exit the euro was outlined in the EU Lisbon Treaty (2007-2009). Art. 50 defines the process through which an EA Member State (MS) can unilaterally leave the Union and hence the euro. The obligations of the euro are therefore linked to the membership of a MS to the EU. Before the enactment of Art. 50 legal doubts were expressed on a MS unilateral decision to exit.

After a MS has left the EU and the euro, it can in principle apply to become a new member of the EU, with the derogation (ART. 139 TFEU) to re-enter to EU immediately and with an indication to join again the common currency at the appropriate time. The difficulties of these political and institutional steps are evidenced by the Brexit process.

The legal issues of euroexit are also highly relevant for the redenomination risks of EA sovereigns. In principle redenomination of debt is governed by national law: EA governments could therefore enact legislation redenominating bonds from euros into the new domestic currency (Lex monetae). This is however complicated by the so-called CACs (Collective Action Clauses). These clauses were put in place during the Greek crisis in all EA countries to ensure that restructuring and redenomination of debt would be governed by agreed rules. More specifically, after the ESM Treaty (2012), CACs have been introduced which prevent redenomination of Government securities with maturity above one year issued on or after 1th January 2013 (Art. 12, par. 3) (cfr. Bardozzetti and Dottori, 2013). It is safe to assume that CACs would prevail on local law[12]. In Italy it is estimated that now some 2/3 of total medium-long term debt is covered by such clauses.

This new framework reduces the possibility of redenomination of public debt in national currencies (Lex monetae): the so-called B-Plans. The issue has been taken up in the Meseberg Declaration of France and Germany (19 June

would have fed negatively to banks with a contraction in credit. In this adverse scenario debt dynamics enters a knife edge, the sovereign/bank loop resurfaces and is made more stringent because of the gradual demise of QE. The stakes are very high for deficit and also for surplus countries, when account is taken of the sustainability of Target balances (Section3 below).

[12]A different legal issue is encountered with reference to T2Bs among EA central banks and the ECB. On these points see Section 8.

2018), with a view to facilitating the orderly restructuring of a sovereign EA debt ("The single-limb aggregation of euro CaCs"). The ESM – and perhaps later the European Monetary Fund (EMF) – would be the examiners and back stop in case of debt unsustainability.

These arguments reinforce the logical/political/policy need to consider the possibility of Eurozone exit clauses, beyond the Art. 50 TEU procedure (Fuest, 2018)[13].

The ECB was created to manage the common currency: a currency and a central bank without a State. It was and is committed to the euro as "irreversible". Three famous public statements (apparently not fully consistent) by Mr. Draghi can be recalled:

- 26 July 2012, speech in London, "*The ECB is ready to do whatever it takes to preserve the euro*".
- 6 November 2012, Letter in response to Mr. C. Morganti, member of the European Parliament, "*The irrevocability of the euro has been part of the EU framework since the Treaty of Maastricht… Under the current Treaties, this irrevocability can be directly derived from the fact that the establishment of an economic and monetary union whose currency is the euro is among the list of objectives of the EU. The Treaties provide that, at the time of the abrogation of the derogation of a Member State, the Council shall irrevocably fix the rate at which the euro shall be substituted for the currency of the Member State concerned. Regarding your question on withdrawing from the euro without leaving the EU, this possibility is not foreseen in the Treaties. The Treaty of Lisbon does not include this possibility, precisely because of the irreversibility of the move to the third stage of EMU for Member States.*".

[13]This was the position expressed by Professor Savona in his writings and more recently – as Minister of the Conte Government - with reference to the possibility of a "black swan" event, which was vehemently denounced as anti-European, notably by many Italian economists.

- 18 January 2017, Letter in response to Mr. M. Valli and Mr. M. Zanni, members of the European Parliament, "*If a country were to leave the Eurosystem, its national central bank's claims on or liabilities to the ECB would need to be settled in full*.".

The response to Messrs. Valli and Zanni stirred waters by indicating the possibility of a Eurozone exit, by outlining an economic framework for Target Balances and a direct link with the ECB monetary policy, by making reference to the need to settle in full outstanding balances in case of exit, and therefore to a risk dimension. A Pandora box was opened, which ultimately raised the question of solvency of NCBs in the Eurosystem.

In principle a national central bank cannot default because, as a result of the monopoly on the creation of the domestic monetary base (granted by the national government), it can print itself out of payments difficulties. It need not even satisfy the condition of a net positive capital.

This general scenario is not applicable to NCBs in the Euroarea. In case of Euroexit the Target liability has to be settled. The common assumption was that the NCB of the exiting country would issue new national fiat currency, which could be used to service its liabilities redenominated in the domestic currency. Should the exiting state so decide, NCB default could be avoided. However, if the liabilities have to be serviced in euro, the argument on the capital adequacy of the NCB becomes relevant. The national Treasury might be able and willing to recapitalize the NCB. A further complication arises if the capital of the central bank in question is held be private investors – and notably by national financial institutions. This would open the bail in/bail-out controversy: ultimately, NCBs are accountable to national Parliaments and tax payers.

The novelty of the response to Valli and Zanni consisted also in an explicit reference to monetary factors under the control of the ECB – notably the changes in T2Bs among EA Central banks in the course of implementation of the ECB Asset Purchase Programs (after 22 January 2015 the Extended APP, see Section 4). More

broadly, the issue of sustainability of Target2 balances – and hence of the euro itself – was brought to the forefront.

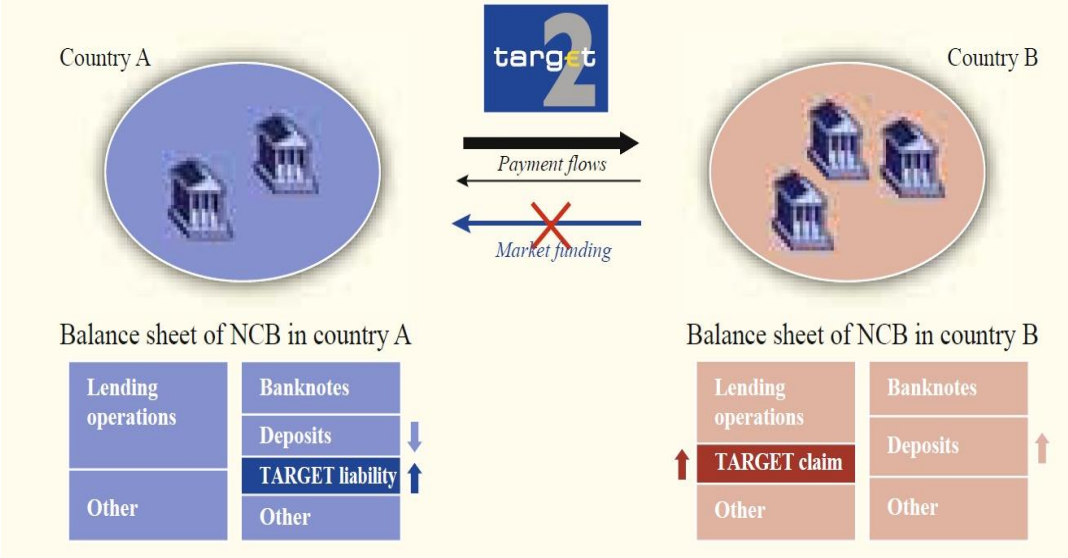
Draghi indicated that the growing imbalances were primarily due to the ECB's own extraordinary bond-buying programme, where many sellers were foreign investors with bank account in Germany. This was widely interpreted as an implicit warning to Target2 debtor countries, notably Italy, that, before leaving the euro, the debt position had to be settled. To recall, when the letter was written Italy had a net negative position of euro 357 billion, while Germany had a positive balance of euro 752 billion Target2 assets.

There was perhaps "constructive ambiguity" in the above statements. The fact remains that the intertwining of Target balances, ECB government bond acquisitions and the possibility of euro exit were for the first time ever admitted by the President of the ECB.

4. Target Balances – in two successive versions[14] – represent the operational mechanism of the Eurosystem. They allow automated real time settlements for cross border payments between commercial banks in different MSs of the Eurozone. Inflows and outflows do not match: remaining claims/liabilities give rise to Target Balances. Intra-system positive items are recorded in the balance sheets of creditor NCBs. The corresponding liabilities appear in the accounts of debtor central banks. No mechanism for settlement of accumulated claims or liabilities of NCBs in the Eurosystem is foreseen. The process of creation of Target Balances is explained in Chart 1.

[14] The Trans-European Automated Real-Time Gross Settlement Express Transfer System is jointly managed by the Bundesbank, the Bank of France and the Banca d'Italia, in cooperation with the ECB. T2B was launched after a relatively long period of planning and testing at the end of 2007 to replace Target1.

Chart 1 - How Target Balances emerge



Source: ECB Economic Bulletin (May 2013).

In spite of their apparent simplicity the target mechanisms constitute a key novel institutional and operating feature of the single currency. They have geographical, balance of payments, banking and monetary interactive implications. They reflect the imbalances in payments flows between national banking systems (approximately one-third of total Target traffic is made of cross-border payments).

From a monetary point of view, Target Balances are the claims and liabilities of Euroarea NCBs vis-à-vis the ECB that result from cross-border payments settled in central bank money. From an accounting perspective, net payment inflows into a country increase the Target claim, net outflows have the opposite effect. The sum of all positive balances is technically defined by the ECBs the Total Target Balance (TTB). The TTB increases if, on a net basis, central bank money flows from a country with a deficit to a country with a claim. The TTB is closely associated with the net positions of Germany, the Netherlands, Finland and Luxembourg (ECB, 2017).

From a balance of payments point of view, cross-border flows of central bank money reflected in changes in target balances are recorded in the financial account of the balance of payments of MSs and are therefore mirrored in other components of the balance of payments, notably the current account and/or port-

folio investment flows.

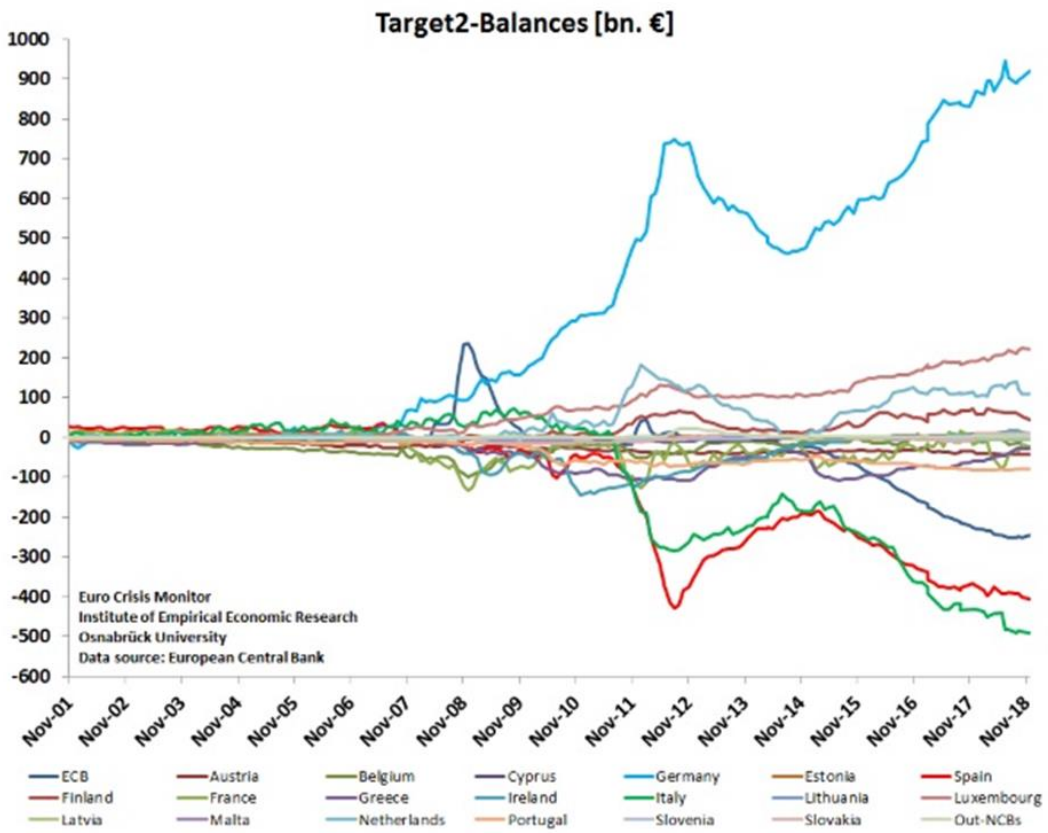
By construction the algebraic sum of all target positions is equal to zero. At first sight, the target system can be considered as a very special instance of a zero-sum game. At any point in time positive and negative balances cancel out, but they can grow indefinitely over time because there is no (mandatory) settlement mechanism. These arrangements create risks for surplus and deficit NCBs alike. Pursuing this game-theoretic comparison a question arises. Is it the surplus countries, which "force" the other members of the EA into negative positions[15], or are the "weak" countries in structural liquidity deficit which press NCBs of countries in strong payments positions into growing positive balances? More generally, the game is integrative, not merely distributive: global profit or loss occurs if we start with a non-zero-sum game for n players and we allow for a $(n+1)^{th}$ player.

From 1999 to 2007 the Target gross settlements system was operated with a decentralized technical structure. It was replaced between November 2007 and May 2008 by the current Target2 version with a single technical platform.

In the Target period (Chart 2) the balances were relatively limited and alternating over time Interbank markets functioned smoothly and balances were quickly settled. During those years sovereign bond differentials were also low.

[15]This case could be interpreted as a manifestation of the "débiteur malgré lui" which characterized the reserve arrangements in the EMS.

Chart 2 - Target Balances



Markets (and central banks) operated in the conviction that sovereign risks had lost relevance in the monetary union, perhaps because risk mutualization schemes were (wrongly) anticipated. The Great Financial Crisis renewed the awareness of country risk in the Eurozone. Under successive impulses large growing and lasting target imbalances emerged and continue to characterize the System (Section 5).

The broad and complex implications of the Target2 mechanism were uncovered by H.W. Sinn (2011). Until then the problem had been ignored and even the statistics were not published by the ECB. The general tenet was that the target framework was merely a bookkeeping system: "Irrelevant balances with no direct relevance to ECB monetary policy". This was the official position of both the ECB and of the Bundesbank.

"*The size and distribution of TARGET2 balances across the Eurosystem central banks are ... irrelevant to their risk exposure from the provision of funds by the Eurosystem: TARGET2 balances do not pose specific risks to individual central*

banks." (Bundesbank, press release 22/02/2011).

Sinn proved – amidst strong criticism of the ECB and of central bank "friendly" academics – that target balances have macroeconomic and balance of payments features and represent official credit lines. He also argued that target claims constitute an exposure risk should the euro breakup. This was again heavily criticized and strongly denied.

At the beginning of 2012, when Jens Weidmann became the new President of the Bundesbank, an internal debate opened in the German Central Bank. A few months later Weidmann wrote to Draghi asking for the collateralization of the Bundesbank exploding target claims. His request did not have an operational sequel. All this helps explain why the letter by Mr. Draghi of 18.01.2017 to Mr. M. Valli and Mr. M. Zanni opened what was called here the Pandora Box.

A final general consideration makes reference to the features and the implications of the ECB EAPP (2015) programme. The novel situation is characterized by the recognized relevance of the Sinn criticism and the advent of Weidmann. With a view to reducing the mutual risk of the expanding purchases, within agreed rules, 20% of the programme itself is retained by the ECB and is therefore subject to risk sharing according to the capital keys of the ECB. 80% is the volume held by national central banks, which retain in their balance sheets the domestic sovereign bonds purchased by the ECB. These holdings are not subject to risk sharing. Naturally, these keys also apply to interest rate margins resulting from the Eurosystem's operations (Gros et al., 2015). These arrangements represent an official recognition of sovereign and NCBs potential risks.

5.

5.1. **2007-08 and 2011-12**: In the words of Mr. Draghi (Letter to Langen, 18.01.2017): "*The increase in TARGET2 balances, observed from mid2007 to late 2008, and again from mid-2011 to mid-2012, was rooted in the market stress and fragmentation that resulted from the financial and sovereign debt crises. As banks in certain countries lost access to market-based funding, they replaced private sources of funding with central bank liquidity obtained from their national central banks through repurchase operations. The subsequent redistribution of this liquidity, which was heavily influenced by market stress, led to higher TARGET2 balances*".

2017 - … : "*…the recent increase in TARGET2 balances largely reflects liquidity flows stemming from the ECB's asset purchase programme (APP). TARGET2 balances have been increasing since the start of the APP owing, in part, to technical factors related to the structure of financial markets. In particular, settlement services are concentrated in some financial centres. Cross-border payments by national central banks for securities purchased under the APP give rise to changes in TARGET2 balances in the course of the implementation of monetary policy. Almost 80% of bonds purchased by national central banks under the APP were sold by counterparties that are not resident in the same country as the purchasing national central bank, and roughly half of the purchases were from counterparties located outside the euro area, most of which mainly access the TARGET2 payments system via the Deutsche Bundesbank…*".

"*However, the current increase in TARGET2 balances is not a symptom of increased stress and is therefore inherently different from the previous episodes of rising balances. It follows that TARGET2 balances per se are neither indicative of market fragmentation, nor necessarily an indicator of imbalances that could affect a country's macroeconomic fundamentals*[16]*. The ECB continues to monitor*

[16]The increase and persistence of Target balances during the APP period, in contrast with the emphasis on stress and frictions in monetary markets during the period 2011-2012, are examined in Eisenschmidt (2017).

TARGET2 balances closely."(Draghi, Letter to Valli and Zanni, 18.01.2017).

2018 - …: The evolving position of the ECB is portrayed in a further response by Mr. Draghi to two members of the European Parliament, Mr Joachim Starbatty and Ms Ulrike Trebesius: "*TARGET2 is integral to Monetary Union as it ensures that banks' reserves held at national central banks (NCBs) can flow freely across euro area Member States. By facilitating the cross-border flow of liquidity between banks, TARGET2 substantially reduces systemic risk and plays a key role in ensuring the smooth conduct of monetary policy, the correct functioning of financial markets, and ultimately banking and financial stability in the euro area. (…) Intra-system balances are an inherent feature of any decentralised monetary union. Limiting their size could restrict the free flow of money across borders and as a result undermine the smooth functioning of Monetary Union. For this reason, neither NCBs nor the ECB have put in place provisions to limit the size of TARGET2 balances, which are, however, constrained by the size and structure of the Eurosystem balance sheet.*" (Draghi, 2018).

This letter is important at least on two grounds. To start with, there is no longer any reference to the potential vulnerabilities of T2Bs to Euroexits. The argument is then made that in a decentralized monetary union[17] T2Bs reduce systemic risk and facilitate the smooth conduct of the single monetary policy.

According to the new "official wisdom", it is acknowledged that T2Bs are related to balance of payments flows in EA countries, net international asset positions, market stress and, above all, the ECB own policies. Following Sinn's seminal analysis, there is now broad agreement that in the EA T2 claims or liabilities of the participating central banks perform a balancing role for the payments accounts of re-

[17]From an economist's perspective, the EU Treaty does not make reference to a decentralized monetary union in the conduct of monetary policy. The Consolidated version of the Treaty of the European Union - TFEU (Official Journal of the European Union, 2016, Art. 12 of the Protocol n. 4 on The Statute of The European System of Central Banks and of The European Central Bank), reads at follows: "*The Governing Council shall formulate the monetary policy of the Community (…). The Executive Board shall implement monetary policy in accordance with the guidelines and decisions laid down by the Governing Council. In doing so the Executive Board shall give the necessary instructions to national central banks.*". In this institutional framework, account being taken of the creation and operation of the SSM and the SRM, ELA should move from a decentralized implementation to a "single" mechanism managed by ECB.

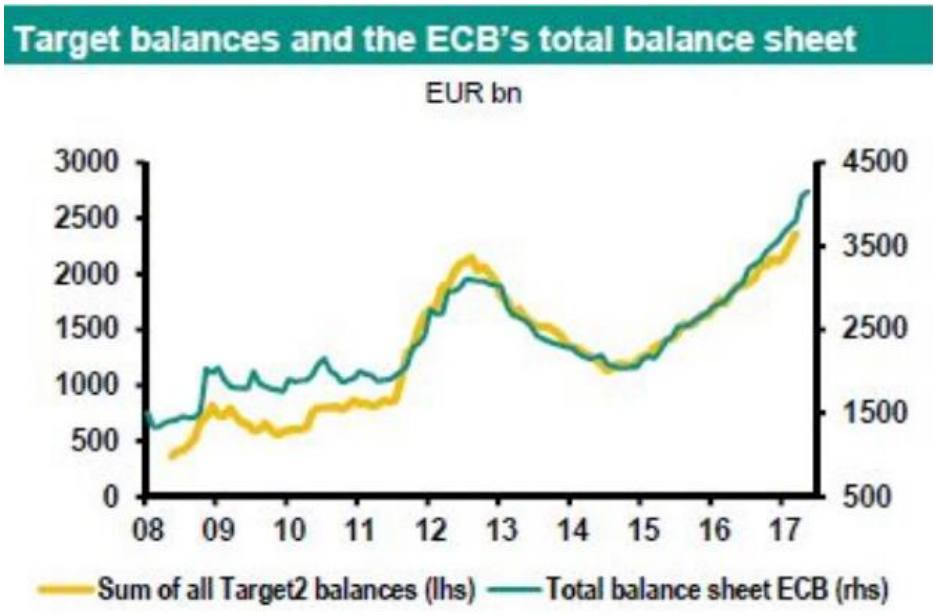
spective countries. In particular, domestic Government bond transactions (and net holdings) are the primary responsibility of each central bank in the Eurosystem. There can be doubt that QE has represented a very significant additional dimension to T2. The ECB itself has built up a large Target liability (Chart 2), as a result of its direct purchases of bonds.

However, the issues of sustainability and risk of large and persisting imbalances are not underlined, contrary to the views of many academic/analyst observers. More specifically, the explanations are fundamentally fragmented, no common threads are recognized, with the risk of losing sight of the forest for the trees. It is admitted that a close monitoring exercise is required and that the ECB itself is responsible for this task. But it is held that intrasystem balances are an integral part of any decentralized monetary union. This approach is widely shared and finds support among NCBs, the ESRB, the EC and certain academic circles.

5.2. A somewhat different line of analysis can be developed. Many "dissenting" voices have been put forward. The existing mechanisms admittedly represent a highly efficient system to permit automatic and limitless cross-countries credit flows. But repayment of balances is not foreseen; large and increasing credits/debits can therefore be postponed for indefinite periods.

A relatively close correlation has been observed for the whole period of operation of T2B between the TTB and the total assets of the ECB. This has suggested a close interaction between the Target balances by surplus countries, the creation of total monetary base and therefore the Eurosystem's monetary policy, as indicated in Chart 3 (Schuiling, 2017).

Chart 3 – Target balances and the ECB's total balance sheet



Sources: Thomson Reuters Datastream, ABN Amro Group economics, A. Schuiling (2017).

In this respect, however, a question can be raised: who "rules the roost?" more specifically, is it the "Target balance" of surplus countries - as officially defined - or is it the sum of negative balances? By construction the two aggregates are broadly mirror images[18], and therefore this may appear as a moot point. But this need not be the case. Is the policy of the ECB spurred by the deficit/debtor or by the surplus/creditor countries?

Let us briefly outline two opposite authoritative views on the causal links, which share however a common "unorthodox" conclusion: the T2B mechanism should be reformed to make it sustainable.

Fiedler et al. (2017) in a document requested by the European Parliament's Committee on Economic and Monetary Affairs, after an in depth analysis of the T2B system, draw the conclusion that it is only according to a cursory examination that the ECB's (E)APP policies lead to widening T2 positions. The root cause of imbalances – which morph into current account financing and capital and deposit

[18]The differences result from the positions of the ECB itself and of EU national banks not belonging to the Eurosystem.

flights – is the large creation of money in deficit countries. This can happen because deficit NCBs can create new liquidity, if and when existing liquidity flows out of the country.

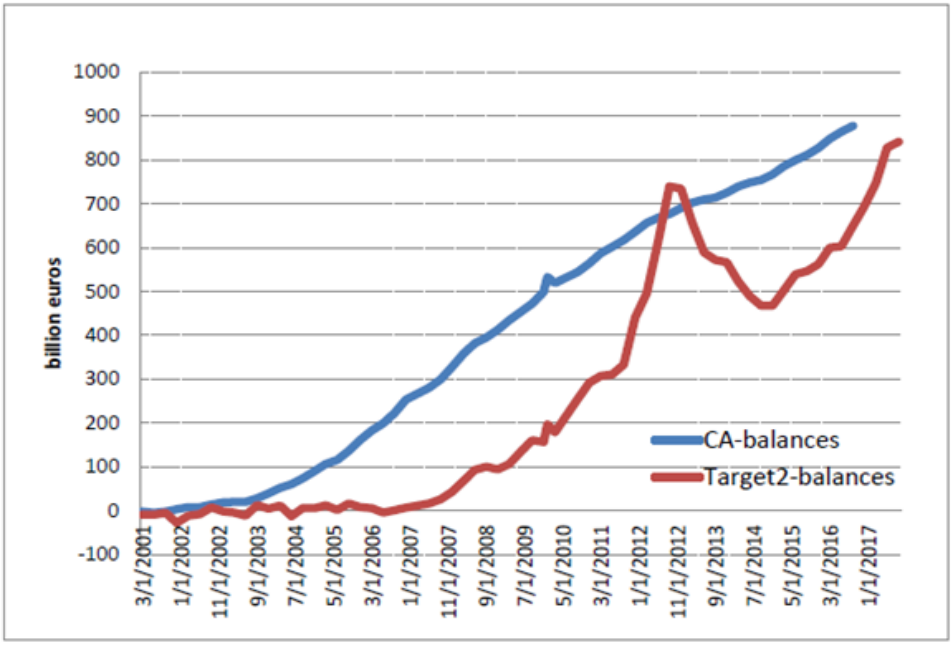
The policy inference is that: "*Any attempt to limit the Target2-positions must restrict the disproportionate creation of central bank liquidity in the deficit countries that are the sine qua non of the observed Target2 dynamics. Once this is stopped, Target2 balances will stop swelling due to current account or capital flight financing. Concretely, the monetary base in the euro area would have to be limited to a normal level, and each NCB would be allowed to issue only a proportion of the overall monetary base. This proportion reflects the countries' economic size and may also reflect country-specific factors that determine the "normal" level of liquidity needs (like payment habits). Once a NCB reaches its proportion of issued base money (plus some supplement), the NCB is not entitled to engage in any additional refinancing operations*." (Fiedler et al. 2017).

At the other end of the spectrum of causal links between T2Bs and financing gaps reference can be made to Turner (2017), a former member of the senior management of the BIS and to Professor De Grauwe (2017), a former member of the Belgian Parliament. They share one of the previous conclusions: T2Bs are a Eurosystem mechanism hard to sustain, which must therefore be reformed to prevent systemic risk. But the root causes of the problems – and therefore the suggested policy action to correct the current system – are very different. According to this second line of thought, the problem rests primarily with payments imbalances in countries with structural surpluses – notably, Germany, the Netherlands, Finland, and Luxembourg. The critical attention is focused on the country and the central bank with record credit balances (Germany and the Deutsche Bundesbank). "*The fundamental issue is Germany's huge international financing gap – a massive current account surplus and strong private capital inflows into the country that exceed the foreign investments that Germans would find attractive and safe*." (Turner, 2017).

"We can now conclude the following. The large accumulation of German current account balances is the fundamental reason of the instability of the TARGET2 balances. As these current account balances increase exponentially, they increase the German claims on the euro area countries. In order to shield the TARGET2 balances from this accumulation of German CA-balances, the willingness of Germany to hold private claims against the euro area must continue to increase. This makes the system fragile. Changes in confidence in the solvency of some countries, or large additions of liquid assets (through QE) can trigger sudden changes in the willingness of private agents in Germany to hold private claims against the other euro area countries. When that happens we observe surges in the TARGET2 balances. This problem will not go away."(De Grauwe, 2017).

The relation between T2Bs and the German current account surpluses is examined in Chart 4.

Chart 4 - Cumulative CA-balance vis-à-vis the euro area and TARGET2-balances (Germany)



Source: CA-balances: Deutsche Bundesbank; Target2-balances: ECB.

Sources: CA-balances: Deutsche Bundesbank; Target2-balances: ECB, De Grauwe (2017).

It must be underlined that the analytical framework, according to this second line of thought, points clearly to adjustment mechanisms with the burden falling mainly but not exclusively on surplus countries.

"*What is ostensibly a payment system has become a mechanism for the official financing of structural balance-of-payments gaps of ever greater size. The net balances emerging from huge two-way flows, not settled by debtors transferring assets to creditors (as under a normal payment system), simply led to the automatic creation of a claim of the creditor central bank on the debtor central bank. Yet no explicit government decision has approved lending on such a scale. Moreover, under the full allotment policy, the Eurosystem imposes no direct limits on how much a national central bank can borrow. Nor does the ECB take collateral on the Target2 debts of national central banks*." (Turner, 2017).

In sum, according to the "surplus" view point, adjustment should be based on collateralization and or direct limits to monetary base creation in deficit countries, whose NCB's would not therefore be allowed to engage in limitless refinancing operations.

The "deficit" point of view holds instead that the problem lies mainly in the huge current account surpluses in Germany, which cannot be offset by counterpart private capital outflows.

6. Before apportioning the relative burdens of adjustments - and more fundamentally - the question should be asked whether the Eurosystem/Target2 arrangements truly reflect the analytical and operational features of a single currency in a monetary union.

The arguments developed by Milton Friedman fifty years ago continue to carry weight: "*the decisive economic characteristic of a unified currency is precisely that transfers of currency take place automatically; requiring no administrative action to affect them, and not being interfered with by such administrative action. If a resident of Illinois makes a payment to a resident of New York, this transaction, taken by itself, necessarily reduces the money balances of Illinois residents and in-*

creases those of New York residents - as is most obvious when the payment takes the form of the literal transfer of currency. If residents of Illinois as a whole are paying more to residents of New York than they are receiving in return, then the amount of money held by residents of Illinois necessarily goes down on this account (i.e., neglecting payments to or receipts from other areas) and that held by residents of New York necessarily goes up. (…) One area may have economic difficulties or may experience declining prices; its residents may become poorer and some may go bankrupt; but as an area, it cannot have a balance of payments problem." (M. Friedman, 1968).

The heart of the liquidity/adjustment mechanisms under one currency is that residents of "deficit areas" lose money and become progressively poorer. The converse is true for "surplus areas", which experience higher incomes and prices. In a fully fledged monetary union – as the US – this mechanism of adjustment is immediate and gradual; large imbalances are unlikely to develop (Friedman, 1968). More important, other stabilizers are at work: fiscal, structural, public (and PPP) investment, capital markets (de Larosière, 2018). The pervasive role of monetary policy and the mechanism of Target balances in the so-called "decentralized" EA framework shift attention from the appropriate mix and the interactions of key economic policies.

Changes in T2Bs in the EA countries mirror net cross-border transfers of reserves. They are correspondingly recorded at the end of each month in the national balances of payments (ECB, Economic Bulletin, 3, 2017). If outflows from a given county are higher than inflows, there will be a net liability position, which will be recorded vis-à-vis the ECB. The converse is true for surplus countries. The ECB acts fundamentally as a pass-trough mechanism between deficit and surplus countries/central banks. The ECB has also a direct net balance, which is however small in comparison to the large imbalances between NCBs.

In the prototype model analysed by Friedman, the automatic solution to the liquidity problem is also the basis of the adjustment mechanism. This scheme is not at work in the EA, where T2Bs are intra area lines of credit between NCBs

which are automatically generated, unlimited and with no redemption date.

"(…) The basic fact is that a unified currency and a system of freely floating exchange rates are members of the same species even though superficially, they appear very different. Both are free market mechanisms for interregional or international payments. Both permit exchange rates to move freely. Both exclude any administrative or political intermediary in payments between residents of different areas." (M. Friedman, 1968).

It may be true that T2Bs perform a payments equilibration function and cushion shocks in the EA, as the ECB maintains, but this comes at the cost of interfering with the adjustment processes, possibly leading to unsustainable positions. In addition, there is also a problem of responsibility and accountability. "*Even if the current setup of Target2 is assessed positive by some observers in its role of buffering shocks and trend reversals in the short run, the Target2 system was not implemented for this purpose and the ECB has no mandate to do so. Member states have never formally decided to install a mechanism that allows for automatic, uncollateralized, unlimited cross-border credit whose repayment is postponed to the indefinite future. Governments should either reform the current system or formally legitimize the current setup.*" (Fiedler et al., 2017).

These problems transcend the debate on the perennial divide and the possible compromise between principle and pragmatism. They raise a fundamental issue, which cannot be downplayed in the EA/EU. It has been argued that the T2B arrangements have a close resemblance to the US Federal Reserve Inter-district Settlement Account (ISA), which keeps track of asset and liability changes across Federal Reserve Banks within Federal Reserve System. However, as has been clearly demonstrated, the formal similarity of a system of central banks which administer together a single currency has no bearing on the underlying adjustment mechanisms at work. To start with, ISA is characterized by the so-called rebalancing mechanism, which implies annual settlement of balances, contrary to what happens in the EA, where persistent large positions are accumulated and which can grow arbitrarily over time and in absolute values (see for instance

Wolman, 2013, and New York Federal Reserve Bank System Open Market Account Holdings of Domestic Securities, July 4, 2018).

More generally, in the US, a fully-fledged integrated banking union exists with a prominent role of interstate bank branching. A safe asset is available (US T-Bills) and the Federal Deposit Insurance System and the FDIC represent key pillars of the banks' integrated network, without the risks of the banks/sovereign loop.

7. By construction positive and negative T2Bs sum to zero. Hence, the alleged correlation between the surplus countries positions and the total creation of ECB monetary base previously referred to (Chart 3) could be mechanically inverted, by pointing to the correlation between the sum of negative positions and the total ECB assets. The two regressions yield in fact similar results, clearly with an inverted sign of the slope coefficient, as is shown in Tables 1 to 4.

Table 1 – Positive Target 2 balances and EuroSystem (ES) total assets

	EuroSystem (ES) (€ millions)	
	ES Total assets	sum of positive T2 balances
2008	2,075,107	185,532
2009	1,903,024	309,939
2010	2,002,210	457,076
2011	2,733,270	791,986
2012	2,962,613	955,833
2013	2,273,287	686,747
2014	2,208,240	612,893
2015	2,780,112	812,735
2016	3,661,423	1,058,483
2017	4,467,611	1,263,961

Source of Data: ECB

Chart 5 – Positive Target 2 balances and EuroSystem (ES) total assets

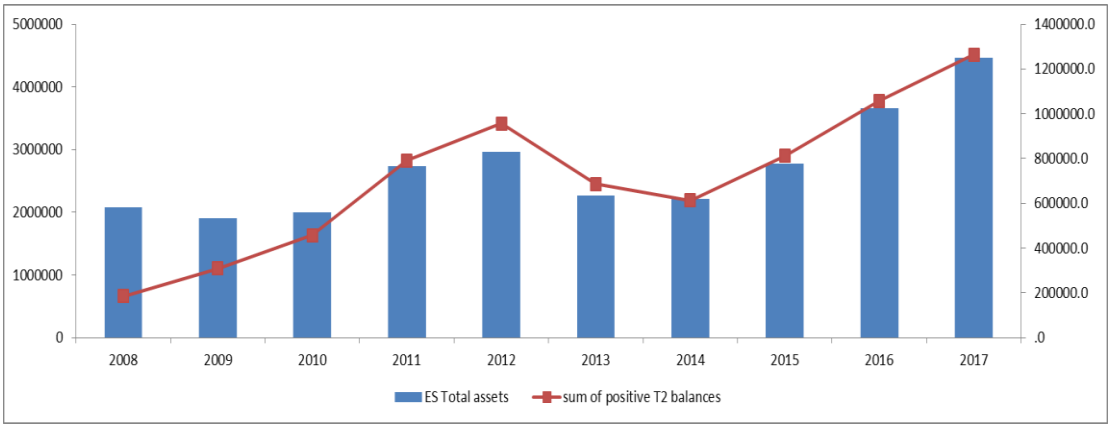


Table 2 – Positive Target 2 balances and EuroSystem (ES) total assets

dependent variable (Y): ES Total assets; independent variable (X): sum of positive T2 balances

R squared	**0,874506372**
mod R squared	**0,873502423**
standard error	314641,5705
number of observations	**127**

	coefficients	*standard error*	*t stat*
constant	**968014,2794**	62197,75482	15,56349232
sum of positive T2 balances	**2,33147881**	0,07899613	29,51383593

Source of monthly T2 balances: Eurocrisis Monitor

The ECB suggested explanations downplay the role of the Target balance (or its negative counterpart). The focus is on the following points:

- sizeable TARGET balances can be a consequence of the injection of large amounts of excess liquidity by the euro area's decentralised central banking system;
- the financial structure of the euro area contributes to the current increase in TARGET balances because cross-border payments are an inherent feature of decentralised APP implementation in an integrated market.

- the rise in the total TARGET balance has followed the upward path implied by cross-border payments for APP transactions, suggesting that other financial flows did not further increase the balance after the implementation of the APP;
- payments related to subsequent portfolio rebalancing are also affected by the financial structure and keep TARGET balances elevated.

All these motivations are plausible but appear fragmented and incomplete. The approach that identifies the Positive Target Balance as the driver behind monetary base creation is perhaps too simplistic and should be revisited to deal with all the complexities embedded in the processes of creation/destruction of Target 2 balances and in the lack of the traditional adjustment mechanism of a unified currency domain. The counter approach based on (the sum of) negative balances equally holds (Tables 3 and 4).

Table 3 – Negative T2 balances (end of year data) (€ millions)

	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017
Austria	-35.699	-19.630	-27.467	-34.591	-39.926	-39.150	-30.087	-29.155	-31.182	-45.906
Belgium	-104.233	-42.520	-13.856	-52.867	-38.161	-15.495	-12.373	-7.748	-18.583	-36.085
Cyprus	-6.542	-7.122	-6.444	-7.908	-7.468	-6.843	-2.501	0	0	0
Estonia	0	0	0	0	0	0	0	0	0	0
Finland	0	0	0	0	0	0	0	0	0	0
France	-117.684	-62.008	-28.349	-77.424	-54.799	-16.188	-17.009	-29.242	-13.803	0
Germany	0	0	0	0	0	0	0	0	0	0
Greece	-35.348	-49.036	-87.088	-104.750	-98.355	-51.116	-49.319	-94.387	-72.257	-59.402
Ireland	-44.364	-53.519	-145.185	-120.434	-79.259	-55.117	-22.736	-3.037	-952	0
Italy	0	0	0	-191.379	-255.102	-229.128	-208.945	-248.859	-356.559	-439.023
Latvia	0	0	0	0	0	0	-797	-1.312	-5.292	-6.340
Lithuania	0	0	0	0	0	0	0	0	-3.590	-4.026
Luxembourg	0	0	0	0	0	0	0	0	0	0
Malta	-665	-814	-1.223	-422	-201	-672	-1.930	-922	0	0
Netherlands	-18.786	0	0	0	0	0	0	0	0	0
Portugal	-18.953	-23.436	-59.912	-60.923	-66.026	-59.565	-54.591	-61.687	-71.588	-81.246
Slovakia	0	-14.521	-13.311	-13.622	0	0	0	0	-5.119	0
Slovenia	-3.570	-3.345	-2.093	-2.733	-4.439	-1.039	0	0	-1.248	-1.434
Spain	-34.989	-41.135	-50.923	-174.979	-337.344	-213.685	-189.865	-254.115	-328.075	-373.736
Negative T2 balances ex ECB and non €-zone NCBs	**-420.834**	**-317.085**	**-458.220**	**-842.032**	**-983.278**	**-694.719**	**-613.793**	**-814.220**	**-1.067.991**	**-1.270.023**

Source of Data: ECB

Table 4 – Negative T2 balances and the EuroSystem's total assets*

dependent variable (Y): ES Total assets; independent variable (X): sum of negative T2 balances

R squared	**0,775602473**
mod R squared	**0,773807293**
standard error	420740,4796
number of observations	**127**

	coefficients	*standard error*	*t stat*
constant	**766872,6138**	96139,46426	7,976668267
sum of negative T2 balances	**-2,747889933**	0,132200704	-20,7857436

Source of monthly T2 balances: Eurocrisis Monitor

The evidence offered in this and the preceding sections is indicative of three facts:

(1) The TB framework has morphed from a payments system into a mechanism of official monetary base financing of structural balance of payments (positive and negative) gaps of Euroarea countries[19]. There is a two-way relationship between external positions of MSs and the Eurosystem's monetary base operations.

(2) The total balance sheet of the ECB is closely correlated with the Target Balance, as officially defined, and equally with the sum of negative balances. The policy of the ECB appears to be affected by NCBs. Deficit countries are able to create new liquidity if existing liquidity flows out. Conversely, NCBs of countries with structural currency account surpluses increase claims on deficit MSs. The Quantitative Easing Policy (QEP) and the mechanisms of T2Bs (with decentralized

[19]This development can be explained – in a somewhat different analytical framework - in terms of "institutional sterilization" operated by commercial banks and NCBs for both surplus and deficit positions (Alessandrini and Fratianni, 2015).

commercial bank reserve accounts) has facilitated both capital outflows from peripheral countries and current account surpluses of core MSs.

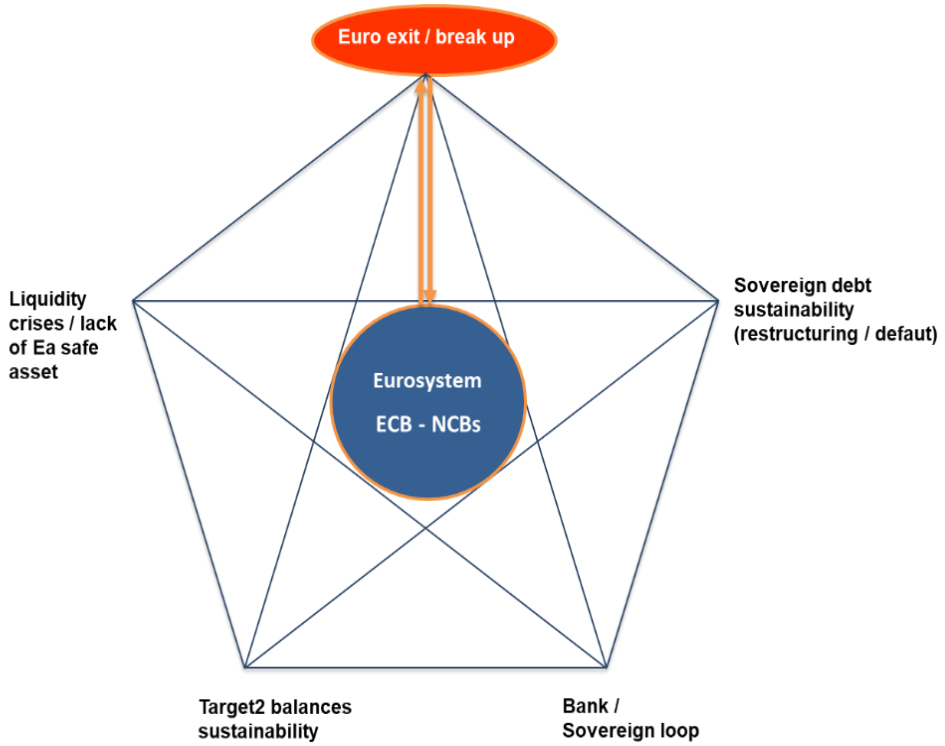
(3) This mesmerizing merry-go-round is hardly sustainable. It occurs because the traditional solution to the liquidity problem in a unified currency area – automatic money transfers – is thwarted, as is the corresponding adjustment mechanism.

These findings are not meant to put in doubt that many fragmented specific explanatory factors must be taken into account to explain in detail the evolution of T2Bs[20]. The aim is to show that common driving forces have also been at work and are related to the mechanism of construction of the system. The evidence presented offers a different and less complacent insight compared to official explanations of the workings and the sustainability of existing Target arrangements in the Eurosystem.

8. Building on the framework developed in the preceding sections, an attempt is made here to identify and analyze the possible key break points and their interactions. The various elements are synthetically reviewed. For simplicity's sake and to better understand their specific features they are examined in succession. Care is taken to explore transmission mechanisms of risk and manifestations of their complex interconnectedness (Danielsson et al., 2012 and Systemic Risk Center, 2013). The analytical approach is that of political economy in terms of medium-term processes (Cardinale et al., 2017; Cardinale and Scazzieri, 2018). This critical assessment is a precondition to offer suggestions and indications for a holistic policy response. Chart 6 offers a graphical network presentation of the five most important critical areas. The elements of the system are nodes and interactions between elements are edges.

[20]See for instance Dor (2016), Banca d'Italia (2017), ECB (2017).

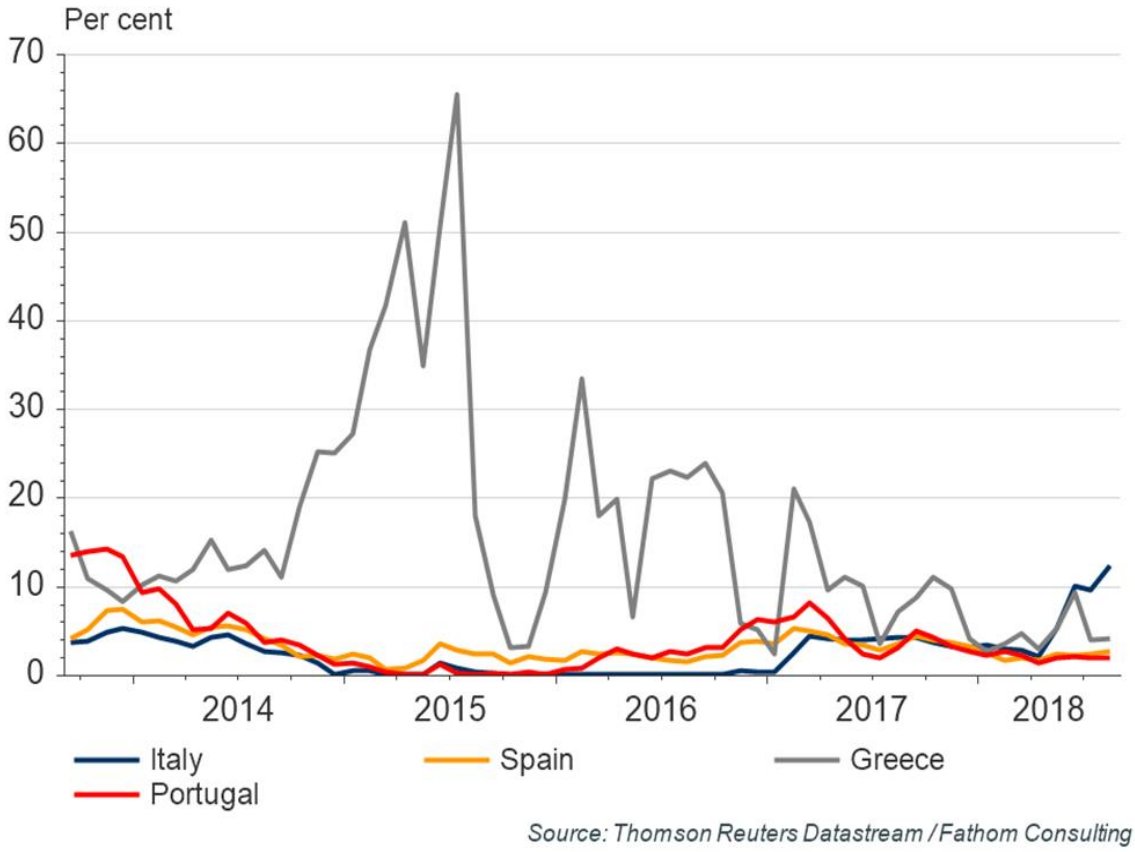
Chart 6 - A network pentagon of key potential stress points of the single currency



Source: Author elaboration

8.1. To start with, attention is devoted to the key stress scenario, which highlights the probability of exit of single countries/currencies for political and/or economic reasons. Measures of this risk for "weak countries" in the Euroarea (EA) are offered and constantly updated by market sources. An example is given by Chart 7, which provides estimates of market-implied probabilities of (single-country) euro exit.

Chart 7 - Euro area market-implied probability of euro exit



Source: Thomson Reuters Datastream / Fathom Consulting

These probabilities must be interpreted with great care because the exit decision is a political choice and available experience shows that governments stood by continuity, also because of the fears of financial/economic meltdowns.

More complex scenarios, with lower and usually unmeasured probabilities refer to critical fault lines leading to euro breakups[21]. In 2012 the ECB minimized the probability of this type of event and of sovereign/bank defaults, which would have created a situation of major financial instability and renewed systemic risk also for the real economy. Arguably, this was possible because the primary goal of inflation close to 2 % was not in conflict with that of avoiding debt crises.

With the prospect of gradual abandonment of monetary easing the two objectives might become in conflict. The primary responsibility of avoiding inflation

[21]An attempt to measure the risk of a Eurozone breakup within five years was offered by Minenna (2015), with specific reference to mid-2012.

pressures notably in hard core countries would become preeminent. And yet higher inflation in countries characterized by structural current account surpluses would represent a key adjustment mechanism in a "traditional" monetary union. But, as was argued, the T2B mechanism blunts this adjustment process. Ultimately, the Target imbalances might become unsustainable and put pressure on the viability of the euro itself.

These stress scenarios are behind the views recently presented by many prominent German policy makers and economists to explore the pros and cons of alternative exit strategies for the euro (Stark, 2017; ESMT, March 2018). The official strong country suggestion to examine the policy option of a two-speed EU has been widely interpreted as the presentation of a framework that might also comprise a managed two-speed euro, which would update the model of the EMS, with two currency blocks.

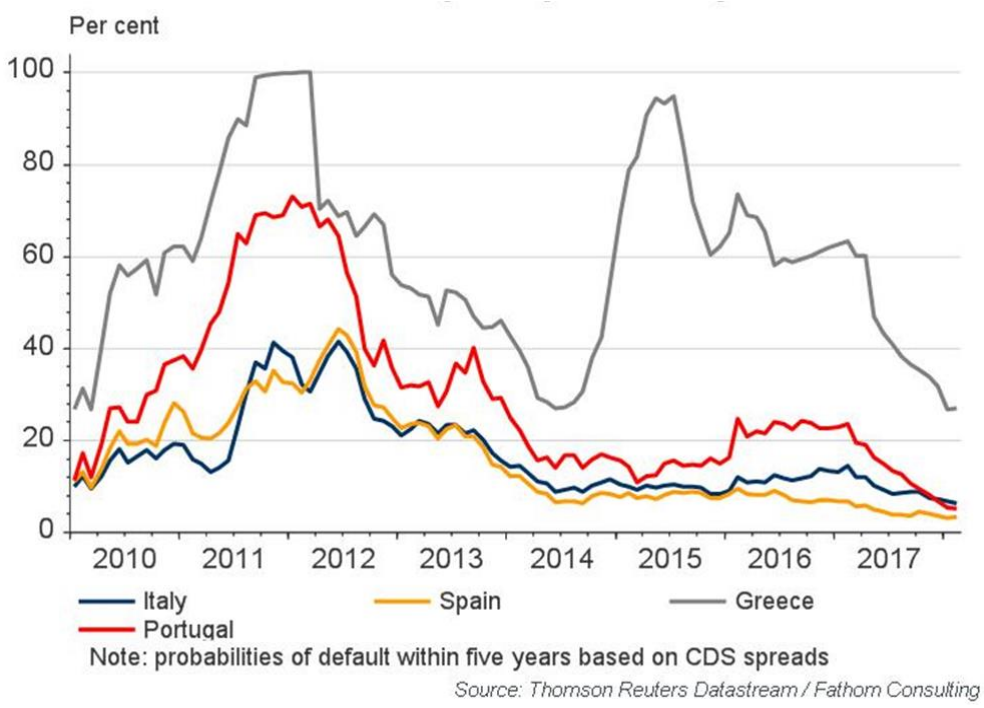
8.2. The gross government debt in the EMU as a percentage of GDP is at very high levels compared to Maastricht (1991) and to the beginning of the euro (1999). Sustainability is vulnerable to interest rate increases, to declines in GDP growth and to a deterioration of primary fiscal balances. In this negative scenario, debt dynamics might enter a diverging path. The threat to sustainability is exacerbated in the EA by the loop between banks and sovereigns, broken but not resolved (Section 8.3). Most highly- indebted countries face potential pressures in terms of their future ability to repay debt with possible liquidity/solvency problems.

In the event of a severe sovereign debt crisis two main scenarios can present themselves: debt restructuring and default events[22]. The two hypotheses are

[22]In the case of Greece in April/May 2012 the Hellenic Republic decided to retrofit CaCs in bonds governed by domestic law and implemented a very large sovereign debt restructuring. In June 2015 the Republic defaulted on a relatively small payment to the IMF (Martinelli, 2016).
On 21 August 2018 Greece emerged from ESM programs with an improved economy. A fiscal surplus is expected in 2018, after a deficit of 15.1% in 2009. GDP growth of 2% is forecast for 2018 and 2019, after a contraction of nearly 30% between 2007 and 2015. But the vulnerability of public debt (180% of GDP) remains very high. The Commission estimates that, to bring the ratio

connected but must be kept separate from legal, analytical and policy perspectives. These contingences are recognized by the markets and - more or less correctly – priced, mainly by means of CDS but also of sovereign bond spreads[23]. For countries most indebted and with higher political uncertainties in terms of firm commitment to EU rules[24] (Greece, Italy, Portugal and Spain) market implied probabilities of default are estimated and regularly updated (Chart 8, see also ESRB, 2018, Chart 1.2 and Visco 2018, Fig.2).

Chart 8 - Euro area market-implied probability of default



below 100% by 2060, primary surpluses of 2.2% will be required alongside nominal growth of 3% for the next 40 years. After exiting the programs Greek sovereign debt is no longer eligible as collateral in the refinancing operations of the Eurosystem, obliging banks to tap costlier Emergency Liquidity Assistance. The doom debt/ bank loop is hardly broken.

[23]The market estimates of default risk can be measured through the Expected Loss (EL) implicit in the credit spread. The main components/drivers affecting default risk are identified through the explicit estimate of PDs and LGDs. All market inferred measures of default risk are highly affected by the market price of risk, which is implicit in the market prices derived under no-arbitrage conditions. Because of this, market prices of risk-neutral PDs are higher than actual (physical) PDs and the difference widens when the market price for risk increases. A further complication is that intra Euroarea spreads necessarily incorporate compensation for both credit and liquidity risks: available econometric evidence suggests that euro sovereign spreads reflect a broadly similar quantitative impact of the two risks, contrary to conventional analysis, which underlines the importance of default risk (Monfort and Renne, 2011 and Schwartz, 2018). A more comprehensive and correct analytical and quantitative approach would require making reference to expected losses and therefore estimating LGDs and EADs, beyond the different measures of PDs.

[24] To recall, when the public debt is above 60% of GDP, the Stability and Growth Pact and the Fiscal Compact prescribe that the evolution of the debt must show a declining trend with an annual rate of 1/20 of the difference between the actual and the 60% limit.

Debt restructurings, in turn, must be divided into two separate cases: preemptive debt restructurings and post-default restructurings. The former are defined as debt exchanges that occur prior to default. The latter refer to situations where debt exchanges take place after a payment default (Asonuma and Trebesch, 2015).

In general, debt restructurings processes have been driven by a default event, but the case of preemptive restructurings can be of great importance in the EMU, notably in the perspective of revision of the European Stability Mechanism (ESM), possibly leading to the creation of a European Monetary Fund (EMF). A model of preemptive automatic/mechanic debt restructurings when certain thresholds are reached would however enhance risks.

As Charts 7 and 8 show, the common approaches to euro exit are focused on "weak countries". This is fundamentally correct, but the issue of euro break up in principle applies also to strong countries, especially in the perspective of unsustainable T2Bs. The case of Greece indicates that restructuring and default need not automatically lead to euro exit.

A key link – not always fully appreciated in the economic literature – between sovereign default and euro exit is represented by the application to official debt instruments of domestic law provisions (lex monetae) or foreign/international law (as in the case of CAC provisions). In principle, the public debt of a country is governed by domestic law, but CACs can be introduced on ex-ante basis, which makes the debt subject in principle to international law. The effective applicability of CACs is however questioned by some law firms.

After the Greek and the sovereign debt/bank crises, the ESM Treaty mandated the gradual introduction of euro CAC harmonized rules in all sovereign bonds issued by EA states after January 2013. The relevance of these apparently technical issues is underlined by the fact that in the Meseberg Declaration (Federal Government of Germany, 2018), France and Germany affirm "*to improve the existing framework promoting debt sustainability and to improve its effectiveness we*

should start working on the possible introduction of Euro CACs with single-limb aggregation".

A synthetic framework of escalating events in case of sovereign debt stress/crisis in the EA is presented in Box 1.

Box 1 - Sovereign debt sustainability/crisis in the EA: a framework of four escalating events*

Stability support and likely to default	
1.	ESM stability support requires prior debt sustainability analysis (DSA), which aims at preventing crises. Two different levels of conditionality are foreseen. The ESM programme can either be precautionary (Enhanced Condition Credit Line) or a full macroeconomic adjustment. In both instances, a special focus would be on fiscal perspectives (and on CAC arrangements). ESM interventions can be complemented by the ECB Outright Monetary Transaction (OMT) scheme[25], also to cope with the risk of liquidity shortages. The likelihood of (country-targeted) OMT activation is arguably greater now, in the perspective of QE tapering/ending. The fully-fledged stability support phase outlined here requires a tripartite agreement of the country requesting and accepting a program, the ESM and the ECB. The IMF could be asked to take part in the deal.
2.	If debt enters into a potential crisis situation (likely to default), ESM interventions – based on the DSA – are broadened, to include preemptive debt restructuring, subject to strict conditionality. This is accompanied by enlarged euro CACs with single limb aggregation. The ECB and (possibly) the IMF can play an accompanying role, as in Case 1.
Default	
3.	If phases 1 and 2 are not sufficient to prevent the manifestation of full crisis, a default event takes place: a government fails to make a principal or interest rate payment on due time. Defaulting countries may be forced to leave the euro. Under current Treaty provisions this would imply a (temporary?) exit from the EU.
4.	After the default, the country concerned could agree to a post-default restructuring, where debt exchanges are negotiated and occur.

*The framework outlined takes account of the note on sovereign debt restructuring prepared by the European Parliament (EPRS, 2017). The document ar-

[25]The OMT program was announced in 2012 (ECB, 2012), but never activated to date. This controversial scheme ("*too close to state financing via the money press*") would have represented a major instance of intertwining between monetary policy and national government financing, arguably against the spirit of Art. 123 of the Treaty on European Union. The Eurosystem was enabled to acquire potentially very large amounts of bonds issued by governments using an ESM program and complying with the conditionality prescriptions, in the assumption of irrevocable commitments to the euro. The OMT framework was defined before the opening of the Pandora Box and is based on the assumption of severe distortions in a country government bond market, as a consequence of "unfounded fears of the reversibility of the euro".

gues that, as part of the EU financial stability instruments, sovereign debt restructuring could usefully form a part of the enlarged EU toolbox. The first two steps are consistent with the analysis on EMU and the ESM contained in the Meseberg Declaration. The issue of settlement of Target liabilities of a defaulted country is likely to require specific rulings with reference to both the preferred creditor status of NCBs and the applicability of a CAC framework.

The four-step framework comprises two phases in the impending crisis/likely-to-fail situations. ESM intervention is broadened to include preemptive debt restructuring, accompanied by Euro CACs with single limb voting procedures. The subsequent two phases outline a post-default event. In case 3, a litigation procedure is initiated, presumably leading to forcing the defaulting countries to leave the euro. Case 4 is characterized by post-default restructuring arrangements: debt exchanges are negotiated, agreed and take place after the formal default.

The official policy approach to mandatory, standardized and identical CACs on all government bonds and all EA countries is a recognition that restructuring/default is a possible, low probability, event. This is an ambiguous message for markets and political parties alike. The potential contradiction is not a novelty. As indicated, the risk of sovereign debt crises, possibly leading to defaults, was/is explicitly admitted by the ECB itself with the EAPP program.

An even more subtle point concerns the formal symmetry, but the substantive asymmetry of CACs standardized arrangements. An economic precondition for the usefulness of the clauses is that they are applicable to countries likely to default/ restructure sovereign debt: this probability must be non-negligible. On the basis of strong econometric evidence – which appears often overlooked - Bardozzetti and Dottori (2013) showed that, for best-rated countries, CACs do not have any effect on public bond issues. But, also for the worst-rated countries the yield discount can narrow to the point of becoming insignificant. The offered explanation is that anticipated opportunistic behavior may imply that ex-ante moral

hazard offsets ex-post benefits[26].

A final relevant issue is that the Eurosystem, in case of a country default, does not enjoy the status of "preferred creditor", although in the 2012 Greek restructuring a seniority status was de facto granted to securities bought by the System under the SMP program (Martinelli, 2016). It would therefore appear that CAC clauses cannot be invoked by the NCBs, and that national law would be applicable. A legal clarification of these points would be desirable.

8.3 This issue has been amply treated. Reference here will be kept to a minimum. In 2011-12 there was a clear possibility of a euro breakup. It was only through the full determination of the ECB that the implosion of the system was avoided. The doom loop would have created a major systemic financial and real instability.

Without the euro the ECB itself would no longer have its "*raison d'être*". The monetary base in euro would disappear, national currencies and central banks would be reenacted. All sovereign domestic debts, including the T2Bs would return to national currency redenomination.

The loop was broken, but not fixed (Angelini et al., 2014). The fundamental shock absorber was and continues to be the EAPP. But the tapering of QE policies is on its way. The creation of the SSM and the introduction of the bank resolution framework, with the adoption of a bail in model, were major institutional and policy advances in the EA. The latter suffers from intrinsic defects (Balassone and Visco 2018), compounded by the difficulties in some countries to accept the principle of no bail-out; the former is weakened because of the home bias of public bonds in the national banking systems and of the inability to recognize the different risk features of national government bonds in the CRR/CRD frameworks

[26]Since their study was published, two relevant developments have taken place with specific reference to Italian Government bond markets. Few BTPs are denominated in US $ and do not appear to be eligible for redenomination. BTPs in € can be CAC or non-CAC compliant. These different clauses can be exploited to try and disentangle redenomination risk (exit from the euro) from fiscal risk (default event) (Gros, 2018 and Guglielmi, 2018), according to these studies, the redenomination component has significantly increased.

(Goodhart, 2013). The stalemate on EDIS represents another source of potential threat (Masera, 2017).

8.4. This section too can be kept very short, because the key elements of analysis have already been developed. Major misconceptions surrounded and continue to characterize the assessment of T2Bs. The high and complex technical features of the system limit its transparency. As indicated, until 2011 the official position of the Eurosystem was that the balances had an accounting nature and were insignificant in terms of their risk position; no relevant macroeconomic, balance of payments, and monetary policy aspects were involved.

T2Bs are the source of many important risks, some of which still under investigation[27]. If a country exits the euro it can default on its liabilities to the Eurosystem. The NCB capital would be the first cushion, but the size of the imbalances has outgrown capital resources for many NCBs. Two types of risks are involved. First, there is the issue of preferred creditor status and then the question of the possibility of redenomination. More fundamentally, the target mechanism has become a major instrument to finance current accounts and capital movements, with no well defined adjustment mechanism. The system has therefore come to play a role both in the monetary creation process and in the financing of payment imbalances in surplus and deficit countries alike.

The Agreement on Net Financial Assets (ANFA) between the ECB and the NCBs is meant to insure that the ECB monetary policy is unaffected by NCB operations related to their national tasks. If these tasks were to interfere in any way with the monetary policy, they can be prohibited, limited or have conditions placed on them by the Governing Council. The limits are meant to insure that operations undertaken by NCBs do not interfere with the single monetary policy[28].

The seminal work by Sinn (2011) and the new evidence offered here are

[27]T2Bs can be used also to hedge redenomination risks in the EA (Cecchetti et al., 2012).
[28]The ANFA was published by the ECB in 2016, with a view to improving the accountability and the transparency of the Eurosystem (ECB 2016).

suggestive of an important role of NCBs Target policies on the quantitative creation of total monetary base. This may be consistent with the desired monetary policy objectives, but if the mechanisms of interaction between NCB balances and the overall monetary creation process have been, and perhaps continue to be, only partially understood, these issues may require clarification.

8.5. Excess liquidity and excess bank reserves have been a key feature of the Eurosystem since 2008-2009. The links between monetary base, money, income and prices have broken down. Base liquidity creation by the Eurosystem was progressively higher and higher than required reserves and desired cash holdings. The provision of liquidity engineered mainly through purchases of public bonds led to negative interest rates also on long term securities in “safe” countries. The progressive significant drawbacks were increasingly recognized. The improved economic situation should lead to a gradual reversal of the extraordinary program of monetary expansion, and the reabsorption of excess liquidity. In this scenario T2 imbalances should gradually disappear. But this requires putting under control liquidity creation in deficit countries and current account surpluses in structural creditor countries. The perspective of normalization of monetary policy and of interest rates can give rise to stress points in certain countries. Fiscal sustainability is key. Focus on this complex scenario can be found in the Meseberg Declaration. It is indicated that precautionary ESM credit lines could be activated to offer stability support “in case of risk of liquidity shortages, where ESM members are facing a risk of gradual loss of market access, without the need for a full programme”.

In the experience of the euro, sovereign and liquidity risks are intertwined and have often a similar order of magnitude. Liquidity risk is defined here in the classic tradition as the risk of being unable to convert into (base) money a financial asset with a regular market price at short notice without significant loss. Marketability is a necessary but not sufficient condition for liquidity. To disentangle credit and liquidity risks it is necessary to estimate actual and risk neutral PD’s. This requires utilizing a risk-free interest rate.

Asset liquidity can also be analyzed through asset portfolio selection models: a key role is played by the Treasury bill market and the corresponding risk-free interest rate. Short term public debt instruments in monetary areas where the central bank is prepared to intervene and to act as lender of last resort in case of sovereign liquidity crisis represent liquid, risk-free assets, which are information insensitive and provide the same yield independently of the state of the world.

These arguments bring to the fore an additional intrinsic weakness of the single currency institutional framework: the lack of a euro perfectly liquid and safe short-term (sovereign) asset (Masera, 2018). The safe-haven is de facto represented by the German Bund market. Many proposals have been made to remedy the situation. Perhaps the most important and well-known is the model developed by a High Level Task Force of the European Systemic Risk Board (ESRB), chaired by the Governor of the Bank of Ireland (ESRB-HLFF, 2018). The scheme draws on a proposal of a group of academics aimed at creating a euro safe asset, with no mutualization of risk. The present writer shares the critical analyses which have been produced on this approach. The synthetic securitization schemes might even have negative implications in case of severe stress[29].

Monetary analysis indicates that there is a second safe and liquid asset: central banks reserves held by banks and currency in circulation, the balance sheet counterparts to central bank assets. Commercial banks produce perfectly liquid and safe assets only if the nominal value of their corresponding deposit liabilities is fully guaranteed. This takes back to the soundness of banks and more specifically to the credibility of government guarantees on deposits up to certain amount. From this perspective too the euro area shows weaknesses. Beyond the extreme case of a euro break up, there is the unresolved issue of EDIS.

The availability of safe assets plays a crucial role also in banking and financial regulation, notably in the risk-weighted capital framework. More specifically the zero-risk-weighting of government bonds in the euro area, irrespective of

[29]Excellent papers have been produced to substantiate these concerns. See for instance Minenna (2017), Claeys (2018) and Mencía and Rodríguez-Moreno (2018).

credit-default risk, represents a structural weakness which negatively affects the sovereign-bank nexus. Real-politik has not allowed to deal with this issue[30].

9. This paper reminds at the outset that the unified currency of the Euro-zone was created in response to a strong political drive and motivation, which goes back to the "Fathers of Europe", after World War 2: "*L'Europe se fera par la monnaie ou ne se fera pas*". This political determination is behind the creation of a system which was meant to be irreversible. Even though significant criticism emerged, this political support continues to be de facto very strong.

The analytical framework presented in this paper is developed according to an economic perspective. But it is recognized that, if the creation of the euro was a political resolution accompanied by institutional and legal processes enacted at EU and country levels, in a similar way euroexit and even more euro breakup events would be political and institutional decisions. Economic and monetary issues would carry great weight, but need not represent the decisive factors. In case of interconnected hazards a holistic examination of fault lines is necessary, but cannot provide an indication of the speed with which a systemic crisis would unfold. Economic, institutional and political domains overlap/interact and span medium-term dynamic processes. An effort was made to combine rigorous economic analysis with legibility for a wider audience.

The creation of the Eurosystem was a highly innovative and complex exercise, notably with reference to the division of responsibilities between the ECB and NCBs. The heart of the interactive web behind the workings of the single currency without a state was and is a complicated, somewhat arcane, payments mechanism – T2Bs. The Eurosystem itself believed that this was fundamentally an accounting system, insignificant in terms of macroeconomic perspectives and risk creation. It was only the painstaking work of Hans-Werner Sinn (2011, 2014, 2016) which allowed to gain better insights and explore the functioning and implications

[30]This is not consistent with the stress testing exercises conducted by the EBA, which required a gradual build up of capital buffers against sovereign debt default.

of the system. Since then a growing literature on the subject, with significant contributions of the Eurosystem itself, has emerged.

This paper tries to bring the analytical and policy understanding one step further. It shows that, beyond the complicated assessment of changing underlying factors, a long-term relationship exists between monetary base creation of the Eurosystem and the Target arrangements. This link is explored by referring to the accumulation of (im)balances in both surplus and deficit NCBs. The existing system allows the creation of automatic and unlimited credit lines, with no repayment date. International payments are facilitated; the traditional adjustment mechanism of a unified currency area – centralized or decentralized - is however de facto neutralized.

The various strands of analysis are brought together to identify and explore key vulnerabilities of the euro, possible fault lines and policy adjustments. The five points of potential stress are: euro exit/euro break up; sovereign debt sustainability (restructuring/default) and euro exit; bank/sovereign loop; sustainability of T2 (im)balances; liquidity crises in the absence of a euro safe asset. They are examined in terms of a holistic framework, with novel insights on transmission channels of contagions and spillovers in a network/endogenous risk framework. The findings help outline remedial comprehensive policy actions: reform of T2Bs is a priority.

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TESTING THE EU FRAMEWORK FOR THE RECOVERY AND RESOLUTION OF BANKS: THE ITALIAN EXPERIENCE

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ABSTRACT: *The financial crisis of 2008-09 and the ensuing sovereign debt and banking crises within the Eurozone exposed the presence of massive moral hazard within banking systems. They led to a regulatory response culminated in the creation of the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM). In order to reduce public support to banks, the Banking Communications and the Bank Recovery and Resolution Directive introduced the burden-sharing and bail-in tools, putting the burden of bank rescue on shareholders and subordinated creditors while minimising the burden on taxpayers. In the light of this general framework, this paper surveys five Italian cases of recovery or resolution of distressed banks during the last five years, to test the flexibility and effectiveness of the EU rules. In Italy, the application of the bail-in was avoided while the application of burden sharing raised specific challenges because of the large amount of subordinated debt held by households. This challenge has been addressed, since the very beginning, by means of compensation tools aiming at remedying specific cases of mis-selling to retail investors. However, while initially this was done under narrow conditions, the broader provisions in the Budget Law for 2019, if resulting in blanket compensation for losses to bondholders (95%) and even to shareholders (30%), would be in clear violation of EU rules.*

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1. The financial crisis of 2008-09 and the ensuing sovereign debt and banking crises within the Eurozone exposed the presence of massive moral hazard within banking systems. They led to a regulatory response mainly centred on improving the governance and risk management of the banks, reducing regulatory forbearance and taming legal and institutional incentives that had fostered excessive risk-taking. Common rules for the banks in all Member States have been included in a Single Rulebook and specific rules have been adopted for the banks in the euro area. In 2012 the European Council decided to launch the Banking Union project, in order to break the vicious circle between sovereign and bank debts – leading to the creation of the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM). The latter is supported by the directive on the recovery and resolution of banks (BRRD)[1], to ensure that all the Member States have a legal framework adequate to manage banks' resolution with an administrative procedure, and the establishment of the Single Resolution Fund (SRF). The new system was legislated at record speed by the end of 2013 and entered fully in force at the beginning of 2016.

During the transition to the new regulatory regime, State aid control was used by the European Commission as a coordination instrument at the EU level to maintain a level playing field in the internal market and encourage distressed banks to restructure and return to viability, thus excluding the need for further public support in the future. In particular, the 2013 Banking Communication by the Commission requires, as a condition for the approval of State aid for the recapitalization of banks, burden sharing for shareholders and holders of subordinated

[1]Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council (BRRD).

debt.[2] The BRRD framework includes, among its tools, rules and procedures for the bail-in of private investors (with bank deposits up to 100.000 euros enjoying full protection under national deposit insurance schemes).

The Banking Union is still incomplete as the agreement on its third pillar of supranational deposit insurance has not been reached by the Member States; moreover, the SRF is perhaps too small, and agreement on an adequate last-resort fiscal backstop in case of a systemic banking crisis still looks out of reach. However, one cannot underestimate what has been achieved in setting up a complex and ambitious regulatory framework that has led to a much stronger banking system. The Court of Justice plays a crucial role since, through its interpretation of the new provisions in the light of the EU legal system, it can strengthen and refine the measures and tools designed by legislators.

By now, the legal framework set up in 2013 has been tested in many concrete cases, thus offering the opportunity to evaluate its effectiveness relative to its intended results. This note reviews its application for the management of bank crises in Italy in the last five years. The Italian experience is interesting because of certain conditions existing when the BRRD entered into force – notably the very large amounts of subordinated bonds convertible into shares that had been placed by the banks in retail investors' portfolios after the explosion of the financial crisis in 2008-09 to recapitalize the banks in very trying capital market conditions. At the end of 2011, households held about euro 35 billion of those junior bonds; in 2013 the new post-crisis rules introduced by the Banking Communication and the BRRD made those bonds "bailinable" to meet bank losses, thus novating their risk characteristics. At the same time, the old system of bank rescues that had always shielded bank creditors from all losses thanks to the intervention of the deposit insurance scheme was challenged by the new interpretation of state aid rules.

[2]Communication from the Commission on the application from 1 August 2013 of State aid rules to support measures in favour of banks in the context of the financial crisis (2013 Banking Communication) (2013/C 216/01).

Table 1 –Italian bank bonds held by households (2000-2018)

	Total bonds (bln euro)	in % of house-holds' financial wealth	Subordinated bonds (bln euro)	in % of bonds held by households	in % of households' financial wealth
2000	194	6,3%			
2008	357	9,4%	27	7,6%	0,7%
2009	377	10,0%	30	8,0%	0,8%
2011	372	10,3%	35	9,4%	1,0%
2015	186	4,4%	29	15,6%	0,7%
2018	81	1,9%	14	16,8%	0,3%

Source: Assonime elaborations on Bank of Italy data

Those subordinated bonds by banks in quite a few cases were placed by means of mis-selling practices. In 2017-2018 more than 1200 complaints were raised before the Securities and Financial Ombudsman (ACF) at Consob by holders of subordinated bonds issued by the four Italian banks resolved at the end of 2015 (Banca Marche, Banca Popolare dell'Etruria e del Lazio, Cassa di Risparmio di Ferrara and Carichieti) and by Veneto Banca and Banca Popolare di Vicenza; 976 of such complaints were deemed admissible and 854 of them were upheld.

Thus, in Italy, repeated bank failures raised with special strength the issue of how to comply with EU rules while at the same time managing their economic and social consequences.

More generally, the BRRD approach whereby the resolution principles applied retroactively to debt instruments already in circulation, rather than only to new issues, is controversial. On the one hand, this retroactive approach is unable to affect the incentives of investors with respect to the financial instruments they already hold; on the other hand, it led to an unexpected increase in the riskiness of household portfolios. By now, the challenge posed to resolution by the large amount of bank debt held by retail investors is acknowledged also by European financial authorities.[3]

[3]Speech by Andrea Enria, Chairperson of the EBA "Restoring asset quality and building loss absorbing capacity", Milan, 30 November 2017, and Statement of the EBA and ESMA on the

As to burden sharing, the Commission Communication on State aid to banks contains some flexibility clauses, notably in points 19 (burden sharing will be applied provided that "financial stability is not put at risk") and 45 (there may be exemptions to the application of burden sharing when its consequences would be disproportionate or would endanger financial stability). However, the Commission does not seem very keen to apply those clauses.

On the other hand, the Court of Justice clarified in its decision C-516/14 - *Kotnik*, that the EU Communication is not legally binding on Member States, and that in principle a State aid measure can be declared compatible even if a State does not strictly follow the path outlined in the Communication, provided that the aid is necessary and proportionate to remedy a serious disturbance in the economy of a Member State pursuant to Article 107(3)(b) TFEU. Nonetheless, the probability that a State does not follow the path established by the Commission, risking a negative decision to be challenged before the Court of Justice, remains rather low.

In the light of this general framework, this paper surveys five Italian cases of recovery or resolution of distressed banks during the last five years, to test the flexibility and effectiveness of the EU rules with respect to their general objectives and the availability of instruments to limit the impact of crises on subordinated debt holders. These cases include the Cassa di Risparmio della provincia di Teramo (Tercas), the 'four banks' mentioned above, Veneto Banca and Banca Popolare di Vicenza (the 'Veneto banks'), Monte dei Paschi di Siena (MPS) and Banca Carige.

2. The crisis of Banca Tercas preceded the adoption of the BRRD. Following an approach often used in the past in support of distressed banks, in 2014 the Interbank Deposit Protection Fund (FITD), which is financed by Italian banks, intervened to cover losses and support the acquisition of Banca Tercas by Banca Popolare di Bari.

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treatment of retail holdings of debt financial instruments subject to the Bank Recovery and Resolution Directive, 30 May 2018, (EBA/Op/2018/03).

However, the European Commission considered that the intervention of the FITD amounted to the grant of State aid, arguing that although employing private resources, its interventions were elicited by public institutions; therefore, the Commission ordered the recovery of the aid. Then, the FITD collected additional funds from banks on a voluntary basis ('voluntary intervention scheme of the FITD'), so as to support the distressed bank while avoiding the application of State aid rules and burden sharing.

The approach of the Commission to the assessment of the original FITD intervention was challenged before the European General Court, and the judgment is still pending.[4] Indeed, there may be purely private reasons which justify a cooperative measure by banks aimed at avoiding a failure which might have systemic consequences. On the other hand, from the point of view of banks participating in the FITD, the need of duplicating allocations (payments to the Fund and payments to the voluntary intervention scheme) appears burdensome and inefficient.

3. Banca Marche, Banca Popolare dell'Etruria e del Lazio, Cassa di Risparmio di Ferrara e Carichieti ('the four banks', with a combined market share of 1% in Italy) had been teetering on the brink of bankruptcy for years. In November 2015 the decision was taken to resolve them in great hurry in order to finalize the resolution before the entry into force of the BRRD, with its new bail-in provisions.[5]

All the conditions for resolution set out in Article 32 of the BRRD were respected. The banks were resolved by transferring their "healthy parts" to bridge banks and by putting their troubled assets in a bad bank. The resolution plans provided for the support of the newly created resolution fund, whose interventions qualify as State aid under EU State aid rules. These plans, which were approved by the European Commission, included the burden sharing for shareholders and subordinated bond holders. Since the application of the bail-in was not yet in force,

[4]Case T-98/16 Italy/Commission and T-196/16 Banca Tercas/Commission.
[5]Exploiting the opportunity provided by the BRRD, legislative decree 180/2015 postponed the entry into force of the bail-in provisions till 1 January 2016.

the resolution did not involve senior bondholders and depositors.[6]

Compensatory measures for investors holding subordinated instruments of resolved banks were provided, subject to some conditions, by specific legislative measures (see Paragraph 7 below).

4. Veneto Banca and Banca Popolare di Vicenza had repeatedly breached supervisory capital requirements and had been unable to provide the ECB with a credible business plan to ensure recovery and recapitalization. After negotiations lasting several months, the ECB stated that the two banks were "failing or likely to fail";[7] a precautionary recapitalization procedure was therefore not applicable.

However, the declaration that a bank is failing or likely to fail is a necessary but not sufficient condition for starting a resolution procedure under EU rules. Pursuant to Article 32 of the BRRD, the resolution procedure may be initiated only when the following three conditions are simultaneously met:

a. the institution is failing or likely to fail;

b. there is no reasonable prospect that any alternative private sector measure (including early intervention measures) would prevent its failure within a reasonable timeframe; and

c. a resolution action is necessary and proportionate, in the public interest, to attain one or more of the resolution objectives, and winding up of the institution under normal insolvency proceedings would not meet those resolution objectives to the same extent.

In this case, the Single Resolution Board (SRB), which is entrusted with the task of assessing whether the third condition (the 'public interest' condition) is met, deemed that the application of Italian procedures for an orderly resolution of banks ('liquidazione coatta amministrativa') would have been sufficient to attain the objectives of the Directive.[8] Thus, since the conditions for a resolution action

[6]http://europa.eu/rapid/press-release_IP-15-6139_en.htm
[7]ECB, press release 23 June 2017, https://www.bankingsupervision.europa.eu/ press/pr/date/2017/ html/ssm.pr170623.en.html
[8]https://srb.europa.eu/en/node/341

under EU rules were not fulfilled, the bail-in procedure was avoided.

State aid was granted to the two banks in order to facilitate their orderly liquidation and the sale of their worthy assets to Banca Intesa.[9] Thus, shareholders and subordinated debt holders were involved through burden sharing. As in the case of the four banks, legislative measures were adopted opening the possibility for investors, under specific conditions, to obtain restoration of their losses (Paragraph 7).

Some commentators criticised the use of the Italian procedure for administrative liquidation as a circumvention of the European bail-in discipline. However, the BRRD is quite clear in attributing to the European resolution procedure a residual role; furthermore, the assessment of the lack of the conditions for resolution was made at the European level, by the Single Resolution Board.

These developments seem to point to an asymmetry whereby the supervisory powers are fully centralised at the ECB while resolution may follow national legal rules.

As to supervision, in its *Landeskreditbank Baden Wurttemberg* judgment (T-122/17) the General Court stated that the ECB's supervisory competence on a significant bank cannot be challenged by a Member State; significant banks are subject to the ECB exclusive competence and this competence can be decentralised to national authorities only if, in specific circumstances, the supervision by the national authorities is 'more' effective than supervision by the ECB. On the other hand, the wording of Article 32 of the BRRD indicates that, if the objectives of the European resolution system are 'equally' met by national rules, then the conditions for the application of the European resolution procedure are not met.

5. In the case of Monte dei Paschi di Siena (MPS) the ECB declared that the bank was not failing or likely to fail and thus was not eligible for resolution. However, although the bank fulfilled the capital requirements under the base scenario

[9]http://europa.eu/rapid/press-release_IP-17-1791_en.htm

of the stress test, the results under the adverse scenario showed that a precautionary recapitalization was needed.

The recapitalization plan, with burden sharing for shareholders and subordinated debt holders, was approved by the Commission under State aid rules, leading to the application of burden sharing.[10] As in previous cases, legislative provisions set out the conditions for compensation of holders of subordinated bonds.

6. For Banca Carige, the vast amount of non-performing and bad loans in the balance sheet made the bank vulnerable to a weakening of financial conditions. Despite the application of the FITD voluntary intervention scheme, the bank remained slightly below the supervisory capital requirements, leading the ECB to require a capital increase. When Carige shareholders' meeting did not approve the capital increase, as the majority shareholder abstained from voting, most Board members resigned; the bank was then placed in special administration ('amministrazione straordinaria') by the ECB, under its early intervention powers provided for by the BRRD and enacted into national legislation (*Testo Unico Bancario,* or TUB, Title IV on early intervention measures and compulsory administrative liquidation, Art. 70).[11]

Public funding for the reorganization of the bank was then provided by Decree Law 1/2019 and will have to be assessed by the European Commission under State aid rules. The question under consideration is whether the bank qualifies for precautionary recapitalization. Should the need for burden sharing emerge, there are no subordinated securities issued by Carige in the porfolios of retail holders.

7. Since 2015 several legislative measures aimed at establishing the conditions under which investors adversely affected by burden sharing can obtain total or partial compensation of their losses.

[10]http://europa.eu/rapid/press-release_IP-17-1905_en.htm
[11]ECB, press release 2 January 2019, https://www.bankingsupervision.europa.eu/press/pr/date/2019/html/ssm.pr190102.en.html

For holders of subordinated debt issued by the four banks and the two Veneto banks, initially the relevant provisions established that compensation might be obtained from a fund (*Fondo di solidarietà*) fed and managed by the FITD.[12] Investors were granted the possibility to obtain either flat compensation (only for households with assets or income not exceeding some thresholds)[13] or compensation through an arbitration procedure at the National Anti-Corruption Authority (ANAC). In the latter case, investors had to prove the mis-selling, i.e. the infringement of the information, diligence and transparency obligations established by the law (the *Testo Unico della Finanza*, or TUF).

In 2018, a new fund (*Fondo di ristoro finanziario)* was set up at the Ministry of Economy and Finance (MEF) with a budget of 25 million euros each year up to 2021, to cover the losses of the "four banks" and the Veneto banks.[14] This fund aims at compensating the banks' customers who have suffered unfair damages, acknowledged either by a court, the ACF at CONSOB or the Arbitration Chamber at ANAC, in case of mis-selling of financial products, including not only subordinated debt but also shares.

Lastly, the 2019 Budget Law replaced this Fund with the *Fondo indennizzo risparmiatori*[15], again at the MEF, with a budget of 525 million euros a year until 2021. The system applies to investors who "suffered an unfair prejudice by banks and their subsidiaries having legal headquarters in Italy ... because of the massive violations of the information, diligence, correctness, objective good faith and transparency obligations" pursuant to the TUF. For both shareholders and bondholders, the maximum compensation is capped at 100,000 euros, and should not exceed 30% of the purchase cost for shareholders and 95% for bondholders. Compensation is net of other redress and is entrusted to a MEF technical commission.

[12]Law 28 December 2015, n. 208, Article 1, co. 855-861; Decree Law 3 May 2016, No 59, converted into Law 30 June 2016, No 119; Decree Law 25 June 2017, No 99, converted into Law 31 July 2017, No 121 (Article 6).
[13]The flat compensation initially reached a percentage of 80% of the purchase price, increased to 95 % by the 2019 Budget law.
[14]Law 27 December 2017, No 205, Article 1, co. 1106-1107.
[15]Law 20 December 2018, n. 145, Article 1, co. 493-507.

Under this system, thus, the restoration of losses is granted regardless of the conditions of selling, for bonds as well as for shares.

As to Monte dei Paschi, the legislator adopted a different approach, establishing that retail investors (excluding professional clients) whose subordinated bonds had been converted into shares could ask the bank to convert their shares into senior bonds at par.[16]

8. The challenge for the application of resolution tools resulting from the large amounts of bank debt held by retail investors makes it clear that the retroactive approach of the BRRD was a hazardous choice. However, looking at the Italian experience with distressed banks in the last five years, the EU framework turns out to be rather flexible and able to deal with different situations.

The application of the bail-in tool in the cases where the banks were failing or likely to fail was avoided either because the relevant provisions were not yet operational in Italy (case of the four banks) or because the SRB decided that the public interest condition for the application of the EU resolution procedure was not met (Veneto banks).

In these cases, as well as for the precautionary recapitalization of MPS, the application of State aid rules has entailed burden sharing for shareholders and holders of subordinated debt. In Italy, the application of burden sharing raised specific challenges because of the large amount of subordinated debt held by households.

This challenge has been addressed, since the very beginning, by means of compensation tools. Compensation of investors, if not properly bounded, could turn out to be a circumvention of the principle of burden sharing, in contrast with European law. However, if it is possible to prove that the investors were victims of mis-selling, compensation is no longer incompatible with EU rules.

This possibility is expressly acknowledged by the DG Comp: “Retail inves-

[16]Decree Law 23 December 2016, No 237, converted into Law 17 February 2017, No 15 (Article 19, co. 2).

tors should be adequately informed about potential risks when they decide to invest in a financial instrument (as required under the EU Markets in Financial Instruments Directive (MiFID 1) and implemented into national law). If a bank fails to do so, in principle, the responsibility of addressing the consequences of mis-selling lies with the bank itself. Such compensation is an entirely separate consideration to burden-sharing under EU State aid rules. There are different ways to allow retail investors who have been mis-sold to be compensated. This is a decision for the responsible national authorities and/or the bank to take. In situations where banks that have mis-sold financial instruments have left the market, it is up to Member States to decide whether to take exceptional measures to address social consequences of mis-selling as a matter of social policy. This falls outside the remit of State Aid rules". [17]

The open issues are to what extent mis-selling can be presumed in relation to the behaviour of individual banks and to what extent there should be a different treatment of holders of subordinated debt compared to shareholders. In any case, the ex-post compensation approach can only be justified as a solution aimed at remedying specific cases of misconduct. Any blanket restoration of losses is likely to elicit objection from Brussels as it would be in clear violation of the principles set out in the BRRD – which, as it may be recalled, were meant to protect the taxpayers from bank losses.

Annex – Bank bonds held by households in Italy

The amount of bank bonds held by households increased significantly in the first decade of the 2000s, and their weight on the total financial wealth of households went from 6,3% in 2000 to 10% in 2009. Since 2013, the trend has been reversed with a drastic reduction that has brought the weight of bank bonds around 2% of the financial wealth of households at the end of 2018.

Subordinated bank bonds held by households amounted to €27 billion at

[17]European Commission, Fact sheet "State aid: How the EU rules apply to banks with a capital shortfall", 25 June 2017.

the end of 2008 (first available figure) and represented 0,7% of their total financial wealth.

Consob official data show that over 20 billion euro of derivative bonds were placed by banks with retail customers in the period July 2007-June 2009, so a large part of the stock was built up in that period and then progressively increased until 2011, remaining around 30 billion euro until the end of 2015. At the end of 2018, the amount of subordinated bonds held by households was reduced to €14 billion (0,3% of financial wealth), but having fallen less than other bank bonds, their weight on the total of financial bonds held by households rose to 16,8%.

Official data from the Bank of Italy show that in September 2018 Italian households held approximately 38% of subordinated bank bonds.[18] This is a very high percentage if compared to that of economies such as France (10%), Spain (less than 30%) and Germany (20%) (ECB data updated to September 2017).

Looking at the maturities of the bonds currently in the household portfolio, it emerges that by 2022 more than 7 billion will mature and by 2027 another 5 billion will mature. By 2027, therefore, the stock of subordinated bank bonds currently held by households will be almost exhausted.

[18]Banca d'Italia, Financial Stability Report, No 2/2018.

"WE KNOW WHAT WE ARE, BUT KNOW NOT WHAT WE MAY BE": CONSIDERATIONS ON THE (NEED FOR) HARMONIZATION OF REGULATIONS FOR FINANCIAL LEASING IN THE EU *

Antonio Blandini ** - Gianfranco Alfano***

ABSTRACT: *The contract of financial leasing represents an important tool through which companies find the capital goods necessary to meet their needs for production, technological modernization and, in general, growth. Despite the widespread use, the national regulations on financial leasing contract still appear often inadequate. What is even more surprising is that the European Union has not issued a comprehensive regulation on this subject. This study shows that it is actually necessary a regulatory intervention aimed to harmonize the national regulations and to fill the gaps that these still present. In particular, it is advisable for the EU to take a clear position on the crucial aspects of the transaction and, mostly, on which issues can be left to the free negotiation of the parties and which ones must be regulated by the law.*

*This paper is the result of a unitary approach and a common reflection by the two authors. However, paragraphs 1, 2, 2.1, 2.2, 7 and 8 can be attributed, in particular, to Antonio Blandini, while paragraphs 3, 4, 4.1, 4.2, 5, 5.1, 5.2, 5.3, 6, 6.1 and 6.2 can be attributed to Gianfranco Alfano.

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default by the lessee. – 6.2. Financial leasing transactions and bankruptcy regulations. – 7. The impact of national regulations on the financial leasing sector and their compatibility with the illegal State aid discipline. – 8. Conclusions.

1. More than sixty years have passed since its first appearance on European markets[1], and the contract of financial leasing still represents an important tool through which companies find the capital goods necessary to meet their needs for production, technological modernization and, in general, growth. Due to its peculiar characteristics, financial leasing is particularly suitable for SMEs, especially for the young ones, without a strong credit history or significant assets, for which access to traditional credit channels would be more complex. Nevertheless, financial leasing has exceeded the initial confinement to an instrument for the financing of businesses, finding a good success also towards consumers.

Despite the widespread use, the national regulations on financial leasing contract still appear often inadequate. As known, at the time of its earliest appearances, both the doctrine and the legislators found it difficult to determine a punctual legal definition for this contractual scheme. These difficulties, partly due to its the great flexibility, partly due to its proximity to other typical contracts (such as the true lease contract and the sale with retention of title contract), led many national policy makers, at first, to let this new operation be subject to the general rules on contracts and, by analogy, to those relating to these typical contracts. Soon, however, the peculiarities of the operation made it clear – especially in *civil law* systems – the need for a specific regulation[2]. As a result, most of the European countries have enacted their own *ad hoc* regulations concerning the fi-

[1]The first appearances of the contractual scheme are traced back to the 1950s in the USA. Financial leasing turned out «a successful equipment financing technique in times of economic recovery», so it was soon exported in Europe, in 1960s. See BACKOVIC, *Adopting and adapting the UNIDROIT Model Law on Leasing*, in *Unif. L. Rev*., 2010, p. 861.

[2]See CUMING, *Model Rules for Lease Financing: A Possible Complement to the Unidroit Convention on International Financial Leasing*, in *Unif. L. Rev*., 1998, 3, p. 383: «The conceptual structure of traditional lease law is not adequate to accommodate this form of financing in that it does not provide a proper basis for recognition of the lessee's economic interests in the leased property».

nancial leasing contract[3], but there are some cases in which financial leasing continues to represent an atypical contract[4].

Precisely because of this lack of uniformity, it can be justified the interest shown by Unidroit on the subject of financial leasing[5]. As well known, Unidroit's activity led, among other things, to the *Convention on International Financial Leasing* (hereafter, the Unidroit Convention) stipulated in Ottawa in 1988, as well as to the formulation of the *Model Law on Leasing*[6] (hereafter, the Unidroit Model Law). These two, although having a different connotation[7], share the same ideological assumptions[8]. The principles derived from them – dating back many years both – are still today in same way significant in the study of the financial leasing

[3]The first European country which issued a law on financial leasing is considered to be France, with the *Loi* n° 66-455 of 2 July 1966 relating to leasing companies. The French legislation has been the reference for those policy makers that subsequently regulated the financial lease, including – *inter alia* – Belgium (with the *arreté royal* n. 55 of 10 november 1967 and the *arreté ministeriel* of 23 february 1968), Spain (Decree n° 15/1977 of 25 February 1977), Greece (Law n. 1665 del 1986). Recently, also Italian law provides for a general discipline on financial lease, introduced by the law n° 124 of 17th August 2017, art. 1, par. 136.

[4]For example, under the German law the *Finanzierungsleasing* is regarded as an atypical lease contract (*atypischer Mietvertrag*).

[5]For a detailed analysis of Unidroit's work on financial leasing, see, amongst other, KRONKE, *Financial leasing and its Unification by Unidroit*, in *Unif. L. Rev.*, 2011, p. 23. Particularly on the Unidroit Convention, see FERRARI, *Principi generali inseriti nelle convenzioni internazionali di diritto uniforme: l'esempio della vendita, del "factoring" e del "leasing" internazionali*, in *Riv. trim. dir. proc. civ.*, 1997, 3 p. 652 (where they can be found further bibliographical references).

[6]Several exponents of the European region participated in drafting the Unidroit Model Law on Leasing, which was adopted on 13 November 2008 by the Joint Session of the Unidroit General Assembly. The Model Law is aimed to be an «important reference» for national legislators in drafting their first leasing law; in particular, according to STANFORD, *Unidroit's Preparation of a Model Law on Leasing: the Crossing of New Frontiers in the Making of Uniform Law*, in *Unif. L. Rev.*, 2009, p. 579, it is «specifically designed for use in developing countries and transition economies» (but, of course, it may be useful for countries with more advanced economies too). For further information on the preparatory work that led to the drafting of the Model Law, also see CASTILLO-TRIANA, *Emerging Markets Embrace Unidroit Advance Work towards a Model Law on Leasing*, in *Unif.. L. Rev.*, 2006, p. 838.

[7]However, CUMING, *Legal regulation of international financial leasing: the 1988 Ottawa Convention*, in *Arizona Journal of International and Comparative Law*, 1989, vol. 7:1, p. 67 points out that «one of the declared objectives of the proponents … [was] also to provide a model that could be used by states as a basis for developing systems of national law for the regulation of domestic financial leasing».

[8]See DEKOVEN, *The Conceptual Approach followed by the Unidroit Model Law on Leasing*, in *Unif. L. Rev.*, 2009, p. 628: «in drafting the model law, we were guided by the drafting principles reflected in the Unidroit Convention but not restricted by them». The main differences between the two has been outlined by CLARIZIA, *Model law on leasing*, in *Europa e dir. priv.*, 2008, 4, p. 969.

contract[9] and will therefore be relevant for the purpose of this contribution[10].

It seems really peculiar, indeed, that there is no EU regulations about leasing; the mainly regard has been given for tax and State Aid reasons, or for some specific purposes (i.e.: IFRS)[11], as it will be shown above. But a comprehensive regulation at the EU level is totally absent: it becomes an amazing riddle, considering the high level of attention that has been paid to other business operations by the European legislator.

This paper focuses on the regulation of the financial leasing contract in the Member countries of the European Union, in order to understand the level of harmonization of these disciplines and to assess the advisability of a future regulatory intervention by the EU. It concerns some of the core topics related to the discipline of financial leasing contract, such as the identification of the essential terms of the contract; the rights and obligations of the parties; the protection of the consumer-lessee; the possibility – and the consequences – of the early termination of the contract. This analysis is carried out on the basis of the principles that can be derived, *inter alia*, from domestic regulations, international conventions, case law, international accounting standards and, of course, best practices.

2. The contractual scheme that characterizes the financial lease adapts flexibly to sundry kinds of assets and meets the needs of different types of entities. In business practice, it appears so variable that some authors have deemed untraceable a unitary definition of financial leasing transactions, which would adapt to

[9]Before the introduction of a specific discipline on financial leasing, the Italian jurisprudence often referred to the Unidroit Convention to fill the regulatory gap. See, *ex multis*, Cass., 16th November 2007, n° 23794, in *Giust. civ*., 2008, p. 914. This process has been defined «an *extrema ratio* gap-filling mechanism» by FRIGNANI, TORSELLO, *Financial Leasing in Italy*, in *Unif. L. Rev*., 2011, p. 357.

[10]In addition to those mentioned above, two other Unidroit's initiatives deserve to be cited: the Unidroit Principles of International Commercial Contracts (1994) and the Cape Town Convention on International Interests in Mobile Equipment (2001).

[11]It is possible to mention the "Detailed guidelines on the treatment of leasing in the framework of the Community's structural financial instruments" (93/C 250/03) too, with their very little impact and relevancy.

any concrete manifestation of the operation[12]. The European countries' national regulations define the transaction in partially different ways. Indeed, it seems possible and needful to identify the essential characteristics of this contractual model, among the extremely nuanced terms of financial leasing in the EU. This direction could justify the normative differentiation with similar types of contracts such as, primarily, true lease and sale with redemption of title.

According to its most agreed definition, the financial leasing contract is an agreement between two parties, which allows a party (the lessee) to use an asset owned by the other party (the lessor) for a certain period of time, in exchange for specified periodic payments. The lessee uses the asset without acquiring immediately its property and pays rentals to the lessor, who legally owns it for the duration of the contract. As the legal owner, the lessor relies on the ability of the lessee to generate sufficient cash flows to make lease payments (more than on the leased asset value)[13]. At the end of the lease contract, the lessee typically has – among the end-of-term options – the right to purchase the leased good at for a nominal fee.

The relationship between the lessor and the lessee, individually considered, shows the typical features of true lease transactions. However, the differences between them are relevant, due, on one hand, to the fact that the financial leasing contract is part of a more complex tripartite operation, in which is usually involved another party (the supplier of the asset); and, on the other hand, to the presence in the financial leasing contract of a purchase option to the lessee[14]. These features, which reflect the overall financial function of the contract, determine significant legal consequences in terms of rights and obligations of the parties involved.

[12]Cfr. CASELLI, *Leasing*, in *Contratto e impresa*, 1985, p. 215, according to whom any rigid defining statements would not adequately adapt to financial leasing transactions.

[13]The crisis of Financial Leasing companies after the 2007/8 economic crash is mainly due to the fact that many leasing companies watched only the leased asset value and not the cash flows ability and capability of the lessee.

[14]The financial leasing contract does not include an agreed transfer of the ownership of the assets, but just a mere option for the lessee to buy the goods. According to R. CLARIZIA, I *contratti di finanziamento. Leasing e factoring*, Torino, 1989, p. 124, the fact that the transfer of ownership is not automatic points out the prevalence of the lessee's aim to get the mere availability of the asset and not its property.

2.1. Many domestic regulations require the leasing company to *purchase* (or *let build*) the asset from a third party, the supplier, based on the requests received by the lessee[15]. Similarly, the Unidroit Convention specifies that «the equipment is *acquired* by the lessor in connection with a leasing agreement»[16]. In this way, the so-called *direct leasing* is excluded from the scope of national regulations and of the Convention, so to apply the regulation of the finance lease contract just in the cases in which the lessor plays an exclusively financing role[17].

The financial leasing contract falls within a *sui generis* tri-partite transaction, carried out through two separate but related contracts: the supply contract stipulated between the manufacturer/seller of the asset and the leasing company, and the contract stipulated between the lessee and the lessor. The lessor is the common part of the two agreements, while the lessee – although not taking part in the supply contract – selects the equipment and the supplier[18] and often defines directly with the latter the essential elements of the subsequent contract to be concluded with the leasing company[19]. The economic purpose of the financial leasing transaction cannot be understood without taking into account the connec-

[15]See *ex multis* the definition of *crédit-bail* transactions provided by art. L. 313-7 of the French *Code monètaire et financier*. In the opposite sense, see the Portuguese law on *locaçao financeira*: art. 1, Decree n° 149 of the 24 June 1995 (as subsequently amended).

[16]Art. 1(2)(b) Unidroit Convention. See also art. 1(1)(a) of the Unidroit Convention, which states that the lessor, «on the specifications of another party (the lessee), enters into an agreement (the supply agreement) with a third party (the supplier) under which the lessor acquires plant, capital goods or other equipment». However, during the preliminary discussions, some of the participants expressed the opinion that «the scope of the rules could be expanded to cover bilateral as well as trilateral leasing transactions». See, *ex multis*, the *Report of the United States advisory committee: review of the revised text of the uniform rules*, *Study LIX – Doc. 11*, 1980, p. 1, available on: https://www.unidroit.org/english/documents/1980/study59/s-59-11-e.pdf.

[17]See LEVY, *Financial Leasing Under the UNIDROIT Convention and the Uniform Commercial Code: A Comparative Analysis*, in *Ind. Int'l & Comp. L. Rev.*, 1995, vol. 5:2, p. 272 (n. 28), who says that «the rationale for providing special protection for the lessor in a finance lease whose function is that of a financier does not exist where the lessor plays the more active role of the supplier».

[18]Pursuant to art. 1(2)(a) of the Unidroit Convention, one of the main characteristics of the financial lease is that the lessee selects the asset and the supplier «without relying primarily on the skill and judgment of the lessor».

[19]See art. 1(2)(b) of the Unidroit Convention, which opportunely points out that the supplier must be aware of the fact that the asset is purchased in order to lease to the lessee.

tion between the two contracts[20]. As a whole, it is crystal clear that the operation has a financing aim [21]. The lessor acts as a mere credit-provider[22]; instead of a sum of money, it purchases the requested asset and makes it available to the customer. Through the periodic payments and the purchase price paid by the lessee, the leasing company obtains the return of the amount paid to the supplier, plus its remuneration[23]. Not by chance, the Unidroit Convention emphasize the circumstance that the periodic payments under the lease are calculated «so as to take into account in particular the amortisation of the whole or a substantial part of the cost of the equipment»[24].

The consequences of this connection are quite considerable. In this regard, some authors defines the relationship between the two contracts as *symbiotic*[25]. It determines, among other things, that the ineffectiveness or invalidity of the supply contract may also entail the financial leasing contract[26], unless the parties dis-

[20]According to CLARIZIA, I *contratti di finanziamento. Leasing e factoring*, Torino, 1989, p. 80, «the connection between the supply and the leasing contracts achieves an overall economic result different from that of the individual contracts». Also see B. FRANÇOIS, *Le crédit-bail financier en France*, in *Unif. L. Rev*., 2011, p. 303, according to whom the finance lease transaction can't be reduced «*a la juxtaposition des contrats qui la composent*».

[21]Commenting on the French law of 1966, which first regulated the *crédit-bail* transaction, CHAMPAUD, *La loi du 2 julliet 1966 sur le crédit bail*, in *JCP G*, 1966, I, 2021, defined it as a «*procédé de financement des investissements productifs moulé dans un opération juridique complexe*».

[22]For the purposes of the Unidroit Convention, «the "lessor" is in the business of financing the acquisition of equipment, and not the business of bailing goods for durations that are less than the useful life of goods». See CUMING, *Legal regulation of international financial leasing: the 1988 Ottawa Convention*, in *Arizona Journal of International and Comparative Law*, 1989, vol. 7:1, p. 47.

[23]According to KRONKE, *Financial leasing and its Unification by Unidroit*, in *Unif. L. Rev.*, 2011, p. 28, «the aggregate value of the rentals includes more than the value of the right of use, namely part of the amortization and the lessor's profit margin». As a result, «French law and its civilian/continental sibling do recognise that the essential function of the *crédit-bail* is that of a financing transaction rather than a mere grant of possession and a right of use for a period of time».

[24]Art. 1(2)(c) of the Unidroit Convention.

[25]See BEY, *De la symbiotique dans les contrats de leasing et crédit-bail mobiliers*, 1970, *passim*; FRANÇOIS, *Le crédit-bail financier en France*, in *Unif. L. Rev*., 2011, p. 303.

[26]See CLARIZIA, I *contratti di finanziamento. Leasing e factoring*, Torino, 1989, p. 97, qualifies this connection as *unilateral*, since only the termination of the supply contract determines the termination of the leasing contract, and not vice versa. According to the constant orientation of the French Court de Cassation, the termination of the financial leasing agreement would be automatic, unless the parties dispose otherwise by means of a specific contractual clause. See *ex multis* the French C. Cass., *Chambre Mixte*, 23rd November 1990. According to DEL SOL, *Les conséquences de la résolution de la vente sur le contrat de crédit-bail*, in *Revue de juridique de l'Ouest*, 1993, 1,

pose otherwise by means of a specific contractual clause[27]. Moreover, thanks to that connection, the lessee may act directly against the supplier, even if neither the law or the financial leasing agreement provides for the transfer of the lessor's substantial position in the supply contract to the lessee[28].

2.2. In many countries, the law treats the contractual clause that provides for the lessee's right to purchase the asset as an essential element of the financial lease[29]. In France, for instance, the various types of *crédit-bail* transactions included in art. L. 313-7 of the *Code monètaire et financier* are all characterized precisely by the fact that the lessee *is given* the possibility of buying some or all of the leased goods at an agreed price[30]. The French approach was followed by almost every European legislator that subsequently regulated the operation. In Spain, the law on the *operaciones de arrendamiento financiero* states that the financial leasing contract must include an *opción de compra*, that the lessee may claim at the end of the contract term[31]; the same rule is also provided, among others, in the

pp. 1-28, the termination of the contract of sale would not determine the «*résolution*», but the «*résiliation*» of the finance lease contract, which implies its termination without any retroactive effects. In other words, the lessee is freed from the obligation to pay the subsequent fees, having no longer the availability of the asset, while the lessor can withhold the sums already collected. However, the doctrine deems invalid any clauses that transfer to the lessee the risk of absolute inefficacy of the supply contract connected to the lease. In this regard, see RESCIO, *La traslazione del rischio contrattuale nel leasing*, Milano, 1989, p. 260.

[27]However, the *Cour de Cassation* does not specify the extent of the parties' freedom of contract in establishing clauses concerning the consequences of the termination of the supply contract. In this way, apparently the leasing company is legitimated to insert clauses – disadvantageous to the user – which exclude that the termination of the supply contract affects the leasing contract, thus not freeing the lessee from the obligation to make further payments. See, about that, DEL SOL, *Les conséquences de la résolution de la vente sur le contrat de crédit-bail*, in *Revue de juridique de l'Ouest*, 1993, 1, pp. 1-28, who considers that such clauses can't entirely «*bafouer*» the principle of the annihilation of the leasing contract following the termination of the supply contract.

[28]See *infra*, par. 5.1.

[29]On the other hand, the Unidroit Convention does not emphasize the lessee's right to purchase the asset at the end of the lease. Pursuant to art. 1(3), the Convention applies «whether or not the lessee has or subsequently acquires the option to buy the equipment».

[30]See art. L. 313-7 of the French *Code monètaire et financier*.

[31]See the Spanish law n° 10 of 26th June 2014, *Disposición adicional tercera*, art. 1, which states that «*el contrato de arrendamiento financiero incluirá necesariamente una opción de compra, a su término, en favor del usuario*».

Belgian Law[32], in the Portugese law[33] and in the Greek law[34]. Even the recent Italian regulation on the *locazione finanziaria* defines this operation on the basis of the presence of a contractual clause giving the lessee the right to purchase the asset[35]. The provision of the purchase option shows the lessee's interest – typical in the finance lease, not in the operative lease – to acquire ownership of the asset and to use it for a longer period than the duration of the contract.

The amount of the consideration established for exercising the purchase option may also be relevant in qualifying the contract. Usually, the internal regulations simply specify that the contract must indicate the consideration; but in some cases the domestic law regulates this aspect in detail. For instance, the Belgian law establishes that, in the financial leasing transactions concerning movable goods, the price of the asset must be determined so as to correspond to the «expected residual value of the asset» at the end of the contract[36]. In France, instead, the law states that the purchase price must take into account «at least partially, of the instalments paid under the lease», without referring to the market value of the asset[37]. In practice, the fee is almost always fixed so as to be presumably lower than the market value of the good. Sometimes it is so insignificant that the exercise of the purchase option may be the only economically rational choice for the lessee (particularly if the leased assets are non-consumable goods, which do not depreciate quickly). When, at the inception of the lease, the contract does not present a real economic alternative for the lessee, it could be questioned whether the contract should actually be qualified as a lease or, instead, as a sale with retention of title[38]. In the lack of a specific regulation, the Italian Courts distinguished, among

[32]Art. 1(1)(e) and art. 1(2)(e) of *Arreté Royal* n° 55 of 10th November 1967, as amended by art. 22 of law n° 16 of 4th March 2012.
[33]Art. 10(2)(f), Decree n. 149 of 24th June 1995, as subsequently amended, on *locação financeira*.
[34]See the Greek law n° 1665/1986.
[35]Art. 1, par. from 136 to 140 of the Italian Law of 17th August 2017, n° 124.
[36]Art. 1, par. 1(e) of the *Arreté Rroyal* n° 55 of 10th November 1967.
[37]Art. L. 313-7 of the French *Code monètaire et financier*.
[38] For VAT purposes, the transaction may be qualified as a *supply of goods*, even if the contract establishes that the transfer of ownership of the asset takes place through the exercise of the purchase option (and not automatically, after the lessee has paid the last installment). It happens, in particular, when it is considered that «exercising the option appears to be the only economically

financial leasing transactions, those contracts with main purpose to grant to the lessee the right to use the asset and those ones with mainly translation purpose, based precisely on the amount agreed for the exercise of the purchase option[39]. On the basis of this distinction – which, however, has not been included in the Italian regulation on financial leasing[40] – the Courts decided whether to apply the rules governing lease transactions or those governing the contract of sale with retention of title.

3. For accounting purposes, IASB provides a clear definition of financial lease transactions in IFRS 16 (*Leases*). This accounting standard was issued in January 2016 and applies to annual reporting periods beginning on after January 1st 2019, as stated by the Regulation (EU) n° 2017/1986[41]. It governs the accounting treatment of both operative and financial leases, and replaces the previous IAS 17, with which only partially shares the so-called *risk and rewards approach*. IFRS 16 is primarily based on the assessment of the *right to control the use* of the leased asset as the criterion for recognizing a lease. In particular, IFRS 16 establishes that a contract «is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration»[42]. The principle distinguishes the accounting treatment of a lease according to whether it is classified as financial or operating lease. In this regard, the most relevant issue that has to be considered it is the identification of the party that faces

rational choice that the lessee will be able to make at the appropriate time if the contract is performed for its full term». See CJEU, First Chamber, 4th October 2017, Case C-164/16.

[39]See Cass., Joint Session, 07th January 1993, n° 65.

[40]There is no trace of this categorization of financial leasing transactions both in the Italian bankruptcy law and in the recent law n° 124 of 17th August 2017.

[41]See art. 2, Regulation (EU) No° 2017/1986 of 31st October 2017 *amending Regulation (EC) No 1126/2008 adopting certain international accounting standards in accordance with Regulation (EC) No° 1606/2002 of the European Parliament and of the Council as regards International Financial Reporting Standard 16*. As stated in its first paragraph, IFRS 16 «sets out the principles for the recognition, measurement, presentation and disclosure of leases»; it replaces IAS 17, IFRIC 4, SIC-15 and SIC-27.

[42]See IFRS 16, par. 9. See also IFRS 16, Appendix B, par. B9: «to assess whether a contract conveys the right to control the use of an identified asset for a period of time, an entity shall assess whether, throughout the period of use, the customer has both of the following: a) the right to obtain substantially all of the economic benefits from use of the identified asset; b) the right to direct the use of the identified asset».

the risks and obtains the rewards related to the transaction[43]. Therefore, the contract «is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership» to the lessee. However, only the lessor differentiates the accounting treatment of the lease depending on whether it is qualified as financial or operating, while the lessee will in any case detect the leased asset in its financial statement[44].

In accordance with the basic principles relating to financial statements, any assessment on the qualification of the contract as a finance lease must be based «on the substance of the transaction rather than the form of the contract»[45]. However, the accounting principle provides some examples of leases operations that have to be classified as finance leases. Nevertheless, these circumstances are «not always conclusive»[46]. For the most part, they reveal the purpose of the operation: to finance the purchase of the asset (and not just the use for a certain period). The most significant indicators – which, according to the IFRS 16, «would *normally* lead» to a finance lease – are the provision of the automatic transfer of ownership of the leased goods to the lessee at the end of the contract; the provision of a price for the (exercise of) the purchase option so low that it is «reasonably certain, at the inception of the lease, that the option will be exercised»; the fact that the duration of the contract covers is less than the useful life of the asset; the fact that «at the inception of the lease, the present value of the minimum

[43]IFRS 16, para. 62, states that a lease «is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership», while it is «classified ad an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership». IAS 17, par. 8, included the same rule. As stated by IFRS 16, Appendix B, par. B53, risks include «the possibilities of loss from idle capacity or technological obsolescence and of variations in return because of changing economic conditions», and rewards include «the expectation of profitable operation over the asset's economic life and of gain from appreciation in value or realization of a residual value».

[44]In this regard, it has been said that the new accounting standard marks a sort of «return to the past». In fact, the recognition of the asset and the related obligation to pay fees in the lessee's financial statement is no longer motivated, as under IAS 17, because of the assimilation of the financial lease to a sale, but just because the leasing contract allows the lessee to get a flow of potential services arising from the asset. See F. CAPALBO, M. SORRENTINO, R. TIZZANO, *L'evoluzione interpretative dell'operazione di leasing nella cultura contabile anglosassone. Una review organica della prevalente dottrina*, in *Riv. dottori commercialisti*, 2017, p. 1.

[45]IFRS 16, par. 63.

[46]IFRS 16, par. 65.

lease payments amounts to at least substantially all of the fair value of the leased asset» and the circumstance that the leased assets are of «such a specialised nature that only the lessee can use them without major modifications». Weaker indicators may consist in the fact that any renewal of the contract for a secondary period leads to the lessee the obligation to pay «a rent that is substantially lower than market rent», or in the fact that in case of termination of the contract by the lessee, «the lessor's losses associated with the cancellation are borne by the lessee» and that «gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (for example, in the form of a rent rebate equaling most of the sales proceeds at the end of the lease)».

4. Only the lessor and the lessee stipulate the financial leasing contract, even if a third party (the supplier of the asset) is usually involved in the transaction. Domestic regulations often impose that only licensed financial institutions – possessing specific capital and formal requisites identified by the authorities responsible for the supervision of financial markets – may operate in the financial leasing sector[47]. In this respect, financial leasing transactions are easily distinguished from operating leases which, as well known, are not included within the list of transactions qualified as financial by the EU Directive on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms [48]. Even if this difference begins to be more difficult to see when a supplier' affiliate get the license as financial institutions (as it happens, for in-

[47]See, *inter alia*, art. L. 515-2 of the French *Code monétaire et financiere* («*Les opérations de crédit-bail mentionnées à l'article L. 313-7 ne peuvent être faites à titre habituel que par des entreprises commerciales agréées en qualité d'établissement de crédit*»); art. 1(136) of the Italian law n° 124 of 4thAugust 2017 (which establishes that, in financial leasing transactions, the lessor must be a company listed in the register of authorized financial intermediaries, held by the Bank of Italy) and the Spanish law n. 10 of 25 June 2014 on the organization, supervision and solvency of credit institutions. According to CLARIZIA, *Model law on leasing*, in *Europa e dir. priv.*, 2008, 4, p. 969, it should be expressly stated by the law that only a bank or a financial institution may be the lessor in financial leasing transactions. *Contra*, see IFC, *Leasing in Development*, 2009, p. 28, where it's said that «there should be no restrictions specifying that only leasing companies or other financial institutions can operate as lessors».

[48]Directive 2013/36/EU of 26 June 2013, Annex 1, to which art. 4, par. 1(26), of Regulation (EU) n° 575/2013 (CRR) refers for identifying the financial institutions.

stance, in the car market).

On the other hand, there are no restrictions on the entities that can stipulate a financial leasing agreement as the lessee. Of course, the intrinsic characteristics of this transaction – in particular the transfer of all the risks to the lessee – make the latter more suitable for professional lessees, possessing business knowledge and experience[49]; nevertheless, it is a fact that this contractual model is increasingly used by consumers[50]. In this regard, it should be pointed out that many national special regulations on financial leasing only consider those transactions aimed at financing professional entities[51]. Similarly, the Unidroit Convention and the Model Law[52] only apply to those contracts covering assets that are not intended «to be used primarily for the lessee's personal, family or household purposes»[53]. In these cases, an operation involving a consumer must be considered in some way (not prohibited, but) "atypical"; therefore, it is not subject to the *ad hoc* regulation on financial leasing, but only to the general law on contracts and consumer protection[54]. However, the most recent regulations on financial leasing do not specify the instrumental destination of the asset or the professional nature of the lessee and, therefore, is peacefully applicable also to consumer-lessees.

In principle, a financial leasing contract can cover any type of asset. Usually,

[49] Cfr. the *Comments by Mr R. Catillo-Triana (Colombia) on memorandum prepared by Unidroit Secretariat*, in *Comments regarding the key issues to be dealt with in a model law on leasing*, 2005, available at https://www.unidroit.org/english/documents/2005/study59a/ab-leasing-1-wp2-e.pdf, where it's clearly said that «leasing is a tool for capital investment, not for consumption».

[50] For the purpose of this paper, the notion of *consumer* is that resulting from European directives. See, in particular, the Directive 2002/65/EC and the Directive 2008/48/EC, according to which "consumer" means any «natural person who … is acting for purposes which are outside his trade, business or profession».

[51] For instance, the French discipline on *crédit-bail* transactions only applies to those agreements covering *biens d'équipement*, *matériel d'outillage* or *biens immobiliers à usage professionnel*. See art. L. 313-7 of the *Code monètaire et financier.*

[52] The intention to not consider consumer leases under the Model law on leasing is already mentioned in the *Memorandum prepared by the Unidroit Secretariat* on the *Key issues raised by the preparation of a model law on leasing*, Study LIXA–Doc.1, 2005, available at https://www.unidroit.org/english/documents/2005/study59a/s-59a-01-e.pdf, where it's said that «consumer leases may have unique concerns that ought to be dealt with independently of this model law».

[53] See art. 1(4) of the Unidroit Convention. According to D.A. LEVY, *Financial leasing under the UNIDROIT Convention and the Uniform Commercial Code: a comparative analysis*, in *Ind. Int'l & Comp. L. Rev*., 1995, Vol. 5:2, p. 275, this exclusion's *ratio* was «the limited instances of consumer leasing at the international level».

[54]See FRANÇOIS, *Le crédit-bail financier en France*, in *Unif. L. Rev*., 2011, p. 297.

the lease relates to non-consumable goods, i.e. assets whose useful life is longer than the lease term (like vehicles or machinery); these goods – and here's a difference with operative leases – could be not standardized, but custom-made on the basis of the lessee's requests. The contract may concern both immovable assets, including those to be built[55], and movable assets, including vehicles, ships and aircrafts[56]. The discipline applicable to the financial leasing transaction may depend on the nature of goods covered by the contract. Sometimes, these kinds of transactions differ either with regard to the form of the contract, the registration requirement or the minimum term of the contract. In some cases, the law may provide a specific regulation on particular real estate leasing transactions. For example, the Italian law lay down a preferential discipline relating to financial leasing operations concerning properties intended to constitute the main residence of the lessee (the so-called *residential real estate leasing*), applying when contract is stipulated by individuals under 35 years old with a total income of less than 55,000 euros per year and who don't own any other households[57]. The leasing contract may also cover intangible assets, such as trademarks, shares or companies[58], and could be used to procure workers to the lessee (the so-called *staff leasing*)[59]. In France, the aforementioned art. L. 313-7 includes among the *crédit-bail* transactions the lease of a company or some of its *éléments incorporels* (par. 3),

[55]For instance, art. L. 313-7 of the French *Code monètaire et financier* includes among the *crédit-bail* transactions both those involving movable capital goods (par. 1) and those whereby a firm leases real estate for business use which it has bought or had built, provided that such transactions enable the lessees to become the owners of some or all of the leased properties, upon expiry of the lease at the latest, via assignment upon execution of a promise to sell or via direct or indirect acquisition of title to the land on which the leased property is built, or via transfer, as of right, of title to the buildings standing on the land belonging to said lessee (par. 2).

[56]Leases of ships and aircraft are usually regulated separately, as it happens under the Unidroit Convention (art. 7).

[57]Specifically, the law allows the lessee, in particular cases of loss of work, to obtain a suspension of the obligation to make periodic payments to the lessor for a period of up to twelve months. See art. 79 of the decree n° 208 of 28th December 2015.

[58]See MARTORANO, *Il leasing d'azienda*, in AMOROSINO et al., *Scritti in onore di Francesco Capriglione*, Padova, 2010, p. 587; ID., *L'azienda*, in BUONOCORE, *Trattato di diritto commerciale*, Torino, 2010, p. 339.

[59]See CORAZZA, *Il modello statunitense dello "staff leasing" e la somministrazione di manodopoera: qualche appunto in prospettiva di una riforma*, in *Dir. relaz. ind*., 2002, 4, p. 553.

and the lease of shares in joint-stock companies[60] (par. 4). Under the French law, a company's shareholdings (shares or quotas) can be purchased by a leasing company and – if the company bylaw allows it – then be leased to the lessee (who must be a physical person; therefore, it could not be the company itself, which otherwise could use the transaction for an indirect false increase of the share capital), who pays the periodic fees and may exercise, at the end of the contract, the right to purchase the asset. The peculiarity of this operation is that it carries out a "splitting" of equity rights: as a result, the lessor is entitled to vote in relation to those decisions concerning statutory changes (which, as such, affect its interest as legal owner of the asset), while the lessee has all the rights normally due to the usufructuary, including the right to receive profits. Of course, these kinds of operations are allowed in other jurisdictions too; but, where the law is silent, it may be more complex to the parties to carry out the transaction coordinating with the general rules of corporate law[61].

4.1. The contract of financial leasing may be stipulated between one lessee and multiple lessors, as in the *joint leasing*. This kind of transaction is usually carried out in cases where the cost of the asset is too high for a single lessor, and it shares the same characteristics of a syndicated loan. Similarly, within the so-called "leasing archipelago"[62] it can also be included the *sale and lease back* transaction, in which are involved only two parties. It is a lease arrangement under which, as well known, the lessee transfers the full ownership of the asset to the lessor and

[60]Art. L. 313-7 of the *Code monètaire et financier* refers to the provisions concerning the rental agreement contained in the articles from L. 239-1 to L. 239-5 of the *Code de commerce*. About the French discipline on financial leasing of shares, see, *ex multis*, FERRY, *La mise en place d'un crédit-bail de titres de société*, in *Semaine Juridique Entreprise et affaires*, 15th May 2007, 23, p. 25-32.

[61]For instance, with regard to the financial leasing of shares, in the absence of any legal provisions, only the legal owner of the shares (the leasing company) is entitled to exercise the equity rights. The parties, by virtue of a specific contractual agreement, may regulate the exercise of these rights (e.g. by conferring the lessee a proxy for decisions that do not affect the interests of the lessor), but these agreements are only effective *inter partes.* See the opinion provided by the Italian National Council of Notaries, Study n° 159-2006/I, *Il leasing di partecipazioni sociali*, in https://www.notariato.it/sites/default/files/159-06.pdf

[62]See LUMINOSO, *I contratti tipici e atipici*, in IUDICA, ZATTI, *Trattato di Diritto Privato*, Milano, 1995, p. 420.

at the same time the lessor leases it back to the lessee. The contract between the lessor and the lessee presents the typical characteristics of any financial leasing agreement: the leasing company purchases the asset for the sole purpose of granting its use to the lessee, in consideration of periodic payments; at the end of the contract, the lessee has the right to repurchase the asset by paying a predetermined price. However, a very peculiar feature characterizes the transaction: the lessee was already the owner of the asset; he sells it to the leasing company in order to obtain immediate liquidity, consisting in the purchase price paid by the lessor, deduced the amount of the first installment paid by the lessee at the inception of the lease. In comparison with other financial leasing transactions, the financing aim of this operation appears even clearer, to the point that one may wonder whether it does not constitute a separate type of contract, deserving autonomous regulation.

In sale and lease back transaction, it is particularly clear that the asset serves as a collateral for the lessor. In some *civil law* systems, the validity of this operation has been long discussed[63], but generally accepted. For instance, the prevailing guideline in the Italian jurisprudence is to consider this operation in abstract valid; even if it happens at times that the court establishes that in the concrete case there are elements that integrate a violation of the prohibition of a forfeiture agreement, such as the existence of a debt and credit situation between the financial institution and the lessee, the economic difficulties of the latter or the disproportion between the value of the transferred asset and the considera-

[63]In particular, it has been questioned the compatibility of this operation with the prohibition of the forfeiture agreement. This prohibition involves the nullity of any agreement that provides that, in case of non-payment by the debtor, the ownership of the mortgaged or pledged asset passes to the creditor. See, *ex multis*, art. 2744 of the Italian *Codice Civile*; art. 1149 and art. 1129 of the German *BGB*; art. 1859 and art. 1884 of the Spanish *Codigo civil*; art. 1371 of the Austrian *AGB*. On the other hand, in France that provision – previously expressed in art. 2078 and art. 2088 of the *Code Napoléon* – has been abrogated through the *sûretés* (security rights) reformation, made by the law n° 346 of 23rd March 2006. For further information, see CANADIAN, *Appunti dubbiosi sulla ratio del divieto del patto commissorio*, in *Foro it.*, 1999, I, p. 184.

tion paid by the leasing company[64]. On the other hand, in those legal systems that do not provide for a prohibition of forfeiture agreement, there is no need for the leaseback operation to comply with the conditions set out above; consequently, the parties may carry out the transaction even if there was a prior credit relationship between them, or the lessee-seller of the asset is in difficult economic conditions. In fact, a peculiar provision included in the Cypriot leasing law offers the possibility to transform mortgage loans into real estate leases, through sale and lease-back transactions, in order to facilitate performing loans[65].

5. Through the financial leasing contract, a division between the economic and the legal ownership of the leased asset is set up. The lessee is considered as the economic owner of the asset, since it has its temporary possession and the right to use like he owns it, while the lessor remains the legal owner of the asset. This breach will recompose only at the contract's expiration, whether the purchase option is exercised or the asset is returned to the lessor. The contractual arrangement of the parties' rights and obligations depends, to a large extent, on this division. First of all, the lessee has the right to use the asset requested for a certain period of time, without immediately purchasing the property. Correspondingly, he irrevocably undertakes to pay to the lessor some agreed periodical fees. As discussed above, one of the most important features of the financial lease – not only for accounting purposes – is the transfer of risks to the lessee. The contractual forms provide for the transfer of any kind of risk, both those concerning the asset being financed (for example, the presence of faults or defects in the functioning of the asset; its loss, theft or damage; technical or normative obsolescence), and those of an economic-financial nature (relating, for example, to tax changes; non-admission, disbursement or revocation of public benefits; changes in the

[64]See, *inter alia*, Cass. Civ., sec. III, 6th July 2017, n° 16646, in *Guida al diritto*, 2017, 32, 85; Cass. Civ., sez. I, 10 maggio 2017, n° 11449, *ivi*, 2017, 23, 39. These judgements point out those indicators that signal the security aim of the transaction.

[65]In this respect, in relation to any leasehold described in the contract, the financial leasing must include, *inter alia*, the nominal and effective interest rate included in the rent, their calculation method and their amendment.

market interest rate)[66]. As a result, starting from the moment the goods are delivered[67], the lessee's commitment to pay the rentals becomes absolute and unconditional for the entire duration of the contract (the so-called *hell or high-water clause*)[68], irrespective of the actual and continued enjoyment of the asset during the whole period. In other words, the lessee's obligation to pay installments to the lessor is not suspended in the event of a temporary inability to use the asset[69].

Beside this obligation, the financial leasing contract usually imposes on the lessee (instead of the lessor) the obligation to provide for the maintenance of the asset, as well as to insure it[70]. These clauses aim at ensuring to the lessor that the leased asset – its main security – is maintained in good condition by the lessee, so to preserve an appreciable market value. In this regard, some authors suggest to include in the contract a clause that gives the lessor the right to carry out periodic inspections of the leased asset, so as to evaluate the conduct of the lessee over time and the conditions (i.e.: the value) of the good[71]. Domestic regulations rarely impose any restrictions on the use of the asset by the lessor[72]. The Unidroit Con-

[66]According to RESCIO, *La traslazione del rischio contrattuale nel leasing*, Milano, 1989, p. 221, «the real extent of these clauses» is represented by the fact that «the lessee bears the risk of events, not attributable to the counterparty, occurred after the purchase of the asset from the supplier, which prevent the enjoyment of the asset same». Even in these circumstances, therefore, the lessee «must perform its performance in the agreed terms».

[67]At the time of delivery, the lessee has to assess the conformity of the goods to what's specified in the leasing contract, checking that they have no obvious defects and – in this case – rejecting them if they are damaged or unsuitable for the agreed use. The acceptance of the assets confirms the fulfillment by the lessor of the obligation to make the required good available to the lessee; by the way, the supplier will continue to respond to the lessee of any asset's defects that will occur after its delivery. On the other hand, clauses that transfer on the lessee also the risk of non-delivery of the goods are generally considered invalid. See, *ex multis*, the Italian Cass. civ., 23rd May 2012, n° 8101.

[68]«The lessee can't invoke the temporary unavailability of the leased asset to suspend, during this period, the payment of the rents». See FRANÇOIS, *Le crédit-bail financier en France*, in *Unif. L. Rev.*, 2011, p. 299.

[69]If the lessee is a consumer, the domestic law may provide for a right to suspend the obligation to pay the rentals in case of supplier non-fulfillment. See *infra*, par. 5.2.

[70]Of course, the contract may also establish that the lessor provides these additional services, re-invoicing the related cost to the lessee. See *infra*, par. 5.1.

[71]See GALLARDO, *Leasing to support Micro and Small Enterprises*, Policy Research Working Paper, The World Bank, 1997, p. 7.

[72]For instance, the Portuguese law on *locação financeira* (art. 10, decree n° 149 of 24th June 1995, as amended) imposes to the lessee the obligations to preserve the leased good and do not make imprudent use of it, make the necessary repairs and insure it against the risk of loss or deterioration.

vention and the Model Law on Leasing generically impose the lessee to «take proper care of the equipment, use it in a reasonable manner and keep it in the condition in which it was delivered» – of course, net of normal wear and tear –, but don't establish any obligation to ensure the good[73]. When no punctual discipline is provided by law, the arrangement of these important obligations is up to a contractual clause; in the lack of such a clause, the transaction would be normally partially governed by the rules laid down for true lease (which may be inadequate, as they make all these obligations fall under the lessor).

From the lessor's point of view, the main obligation deriving from the contract consists in making the required asset *available* to the lessee[74]. The extent of this commitment means that the lessor don't have to ensure to the lessee the full enjoyment of the goods for the entire duration of the contract, but it must let the lessee receive them and guarantee the quiet possession, i.e. that the enjoyment of the assets would not be disturbed or impeded by third parties who have a superior title or right[75].

5.1 Furthermore, the contract may establish that the lessor also provides other services, concerning *inter alia* the maintenance or insurance of the leased asset (but the contract may include some more complex services, concerning intermediation or advice activities). These services are typically offered under operating leases; however, it is not uncommon for them to be included in finance

[73]See art. 9(1) of the Unidroit Convention and, similarly, art. 18(1) of the Unidroit Model Law on Leasing.

[74]According to the Italian legal definition of financial leasing transactions, the lessor acquires the good and *makes it available* to the lessee. As a result, the lessor's obligation is not fulfilled simply buying the good (and paying its price) from the supplier, but making sure that the asset is delivered to the lessee. See TRANQUILLO, *La nuova disciplina del leasing nella l. 124 del 2017*, in *Europa e diritto privato*, 2018, 1, p. 123.

[75]Art. 8(2) of the Unidroit Convention: «The lessor warrants that the lessee's quiet possession will not be disturbed by a person who has a superior title or right, or who claims a superior title or right and acts under the authority of a court, where such title, right or claim is not derived from an act or omission of the lessee». This approach is qualified by R.C.C. CUMING, *Legal Regulation of International Financial Leasing: the 1988 Ottawa Convention*, in *Ariz. Journal of International and Comparative Law*, 1989, 7:1, p. 58 as a «compromise position», since it allow the parties to exclude the lessor's liability. The same rule is also provided by art. 23(1)(c) of the Unidroit Model Law on Leasing.

leases. For the lessee, they contribute to improve the enjoyment of the asset and, therefore, make significantly more attractive the conclusion of the financial leasing contract[76]. However, they usually have non-financial nature and they can be considered as separate and independent from the *stricto sensu* leasing services[77]. For tax purposes[78], the CJEU has repeatedly said that «a supply must be regarded as *ancillary* to a principal supply if it does not constitute for customers an end in itself but a means of better enjoying the principal service supplied»[79]. In a particular case, the CJEU held that, when the leasing company underwrites insurance on the asset and then invoices the full premium paid on the lessee, the supply of insurance services and the supply of the leasing services must in principal be regarded as distinct and independents supplies of services, no matter that they are both provided by the same entity[80]. In other words, according to the Court, the two services are not so closely linked that they must be regarded as constituting a single supply but, to the contrary, they constitute independent services, since the lessee could use the asset even without the additional insurance coverage provided by the lessor.

It's easy to understand that the circumstance that the contract includes these non-financial services could undermine its qualification as a financial lease –

[76]When the financial leasing contract requires that the lessor (and not the lessee) take care of the maintenance of the asset, the contract can be defined as «*maintenance leasing*». See MANTYSAARI, *The Law of Corporate Finance: General Principles and EU Law*, Heidelberg, 2010, Vol. III, p. 33.

[77]For accounting purposes, IFRS 16, par. 15, states that «as a practical expedient, a lessee may elect, by class of underlying asset, not to separate non-lease components from lease components and instead account for all components as a lease».

[78]CJEU, Sixth Chamber, 17th January 2013, Case C224-11. In that regard, the CJEU has previously held that «where … a transaction comprises several elements», they should be regarded as a single supply if they «are so closely linked that they form, objectively, a single indivisible economic supply, which would be artificial split». See CJEU, Sixth Chamber, 27th September 2012, Case C-392/11, para. 15-16; CJEU, First Chamber, 27th October 2005, Case C-41/04.

[79]CJEU, 27th September 2012, Case C-392/11, para. 15. Also see CJEU, Sixth Chamber, 25th February 1999, Case C-349/96, para. 30; CJEU, Third Chamber, 10th March 2011, Joined Cases C-497/09, C-499/09 and C-502/09.

[80]CJEU, Sixth Chamber, January 17th, 2013, Case C224-11. The CJEU stated that «where the lessor insures the leased item itself and re-invoices the exact cost of the insurance to the lessee, such a transaction constitutes … an insurance transaction within the meaning of Article 135, para. 1(a) of Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax, so it falls under the VAT exemption for insurance services».

i.e. it could rather be qualified as an operative lease – and could even undermine the financial nature of the leasing company, which provides them. In fact, as recently clarified by the European Bank Authority (EBA), «an entity which carries out exclusively operational leasing cannot be considered as a financial institution»[81]. The main problem is to determine the extent of the freedom of the parties in including this kind of services in the contract of financial leasing. In some countries, the domestic law expressly identifies which ancillary services may be included. For instance, the Spanish law[82] states that the entities that carry out financial leasing operations may also carry out activities like «maintenance activities of the assigned assets; grant financing connected to a current or future leasing operation; intermediation and management of leasing operations; non-financial leasing activities, which may or may not complement a purchase option; advise and prepare commercial reports». On the other hand, the Cyprus Finance Leasing Law, establishes that the financial leasing company may provide, *inter alia*, the negotiation and purchase of movable or immovable property for the purpose of sale and lease-back transactions, services for the maintenance and safekeeping of property for leasing purposes, assignment of the manufacture or construction of buildings or premises for buying purposes in order to lease them, assignment of the improvement or maintenance of buildings or premises for leasing purposes[83]. As we can see, the list of ancillary services that can be included in the contract is quite variable and depends on the discretionary choices made by the national legislator. In the absence of a single European regulation, in 2015 the European Central Bank (ECB) expressed some interesting considerations in its opinion on Cyprus leasing draft law[84]. In particular, the ECB has specified that the ancillary services allowed

[81]European Bank Authority, Q&A published on May 28th, 2015, question ID: 2014_1644, in *http://www.eba.europa.eu/single-rule-book-qa/-/qna/view/publicId/2014_1644*.
[82]See the Spanish law n° 10 of 26th June 2014, *Disposición adicional tercera*, on the *arrendamiento financiero* transactions.
[83]See the Cypriot Law n° 72(I)/2016 *regulating financial leasing and the activities of financial leasing companies*, which entered into force in Cyprus on 28th April 2016.
[84]Opinion of the European Central Bank of 19th October 2015 on the regulation of financial leasing and financial leasing companies' activities (CON/2015/37). See https://www.ecb.europa.eu/ecb/legal/pdf/en_con_2015_37_f_sign.pdf.

by the law should be «carefully considered, in order to guarantee the financial nature of the entities authorized to perform leasing activities». In the specific case of the Cypriot draft law, the ECB has in fact considered that the services included in the draft law appeared «quite broad» and, primarily, that «typical real estate services should be outsourced».

5.2. Under the financial lease, the lessor should not incur any kind of responsibility related to the leased asset, either towards the lessee or third parties[85]. First of all, the contracts always state that the lessor will not respond to the lessee for the defects of the leased asset[86]. It means that there is a significant difference between the lessor's responsibility in a true (or operative) lease and in a financial lease: this difference should be clarified by the law. It is not by chance that in the Unidroit Convention it is expressly established that «the lessor shall not incur any liability to the lessee in respect of the equipment, save to the extent that the lessee has suffered loss as the result of its reliance on the lessor's skill and judgment and of the lessor's intervention in the selection of the supplier or the specifications of the equipment»[87]. In the absence of a specific rule provided by the law, the parties – or the courts – have to clarify the remedies to the lessee in the event that the goods are flawed or (partially or totally) unfit to the specified use. Under the German law, for instance, the lessor's liability exclusion clause is regarded valid and enforceable, where the potential claims of the buyer (the lessor) under the supply contract have been assigned to the lessee. In Italy, where the recent regulation on financial leasing transactions does not deal with that issue, the *Corte di Cassazione* has always affirmed that the lessee is entitled to act directly against

[85]See CLARIZIA, *I Contratti per il finanziamento dell'impresa. Mutuo di scopo, leasing, factoring*, in V. BUONOCORE, *Trattato di Diritto Commerciale*, Sec. II, 4, Torino, 2002, p. 209: «All the risks related to the asset … are the sole responsibility of the lessee and not the lessor».
[86]According to RESCIO, *La traslazione del rischio contrattuale nel leasing*, Milano, 1989, p. 221, the «real extent» of the clauses is that «the lessee bears the risk of events, not attributable to the counterparty, which, occurring after the purchase of the asset from the supplier, prevent the enjoyment of the asset itself». Even in these conditions, therefore, the lessee «must fulfill its obligations in the agreed terms».
[87]Art. 8(1)(a), of the Unidroit Convention.

the supplier (instead of the lessor, since the liability exclusion clause represent «a natural element of the contract»), by virtue of the atypical connection between the financial leasing and the supply contracts[88]. According to the Italian Supreme Court, the lessee can obtain «the fulfillment of the supply contract, as well as the compensation for the consequently suffered damages», even if this right is not established in the financial leasing contract[89], as long as the supplier was informed, at the time of the conclusion of the supply contract with the lessor, of the circumstance that the asset was intended to be leased to the lessee through the financial leasing contract[90]. Therefore, the Italian Court has adopted the same principles established by the Unidroit Convention, which states that «the duties of the supplier under the supply agreement shall also be owed to the lessee as if it were a party to that agreement and as if the equipment were to be supplied directly to the lessee»[91].

Another fundamental topic that should be taken into consideration by the law is the responsibility of the lessor towards third parties, for events related to the leased asset. In principle, the leasing company should be insulated from tort liability to third parties in which it may incur solely for being the lessor of the equipment. That means that this responsibility should fall on the lessee, as the economic owner of the asset. Art. 8(1)(b) of the Unidroit Convention establishes that the leasing company can't be deemed liable to third parties «in its capacity of lessor» for any damages (patrimonial or personal, including death) caused by the leased asset[92]. On the other hand, the leasing company is not automatically ex-

[88]See Cass. civ., 5th October 2015, n° 19785, in *BBTC*, 2017, 1, p. 35.
[89]On the other hand, the Italian Supreme Court has denied the lessee the right to act to obtain the termination of the supply contract, in the absence of a specific clause (quite usual in practice) included in the finance lease contract.
[90]This assumption is traceable in the art. 1(2)(b) of the Unidroit Convention. Cfr. CUMING, *Legal Regulation of International Financial Leasing: the 1988 Ottawa Convention*, in *Ariz. Journal of International and Comparative Law*, 1989, 7:1, p. 54, according to whom «the *Convention* does not apply unless the supplier is aware that the lessor to whom it is supplying the equipment has contracted or will be contracting to lease the equipment to the lessee».
[91]Art. 10(1) of the Unidroit Convention. Similarly, art. 14 of the Unidroit Model Law on Leasing states that, when the asset «fails to conform to the lease, the lessee may demand a conforming asset from the supplier».
[92]Art. 8(1)(b) of the Unidroit Convention.

empted by the Convention – and should not be by the law – from all the liabilities and burdens in which it incurs in its capacity of legal ownership of the asset. For the latter, the burden sharing should be ruled by the contract or by the law. In some cases, the domestic law transfers to the lessee the obligation to pay certain taxes and penalties related to the legal ownership of the asset. For example, in the automotive leasing sector it is usually established all those costs related to insurance for civil liability or property taxes are borne by the lessee. In Italy, pursuant to art. 7(2) of the law n. 99/2009, only the lessees (not the lessors) are subject to the duty to pay the regional motor vehicle tax. In 2014, the Italian *Corte di Cassazione* ruled that the lessor could not be liable for the damages caused by the leased vehicle in the case that the lessee did not insure it, since only the latter – as the economic owner – has the right to decide whether to use or not the leased asset[93]. Furthermore, again in the automotive sector, national regulations may provide for the obligation to re-register the leased car, if the lessee uses it (of course: for a long period) in a country other than the one in which it was originally registered. In fact, art. 17(14) of the Directive on services in the internal market[94] provides for an additional derogation from the freedom to provide services for the registration of vehicles leased in another Member State. That derogation follows from the case law of the Court of Justice (CJEU), which has recognized that a Member State may impose such an obligation, in accordance with proportionate conditions, in case of vehicles used on its territory[95].

5.3. When the contract is stipulated by a consumer (as the lessee, of course), the general regulation on financial leasing transactions may be not adequate to grant him protection. Consequently, the national law often provide for

[93]Cass., sec. III, 27th June 2014, n° 14635, in *Dir. giust.*, 2014, 1, p. 7.
[94]Directive 2006/123/EC of the European Parliament and of the Council of 12 December 2006 on services in the internal market.
[95]See Directive 2006/123/EC, par. n° 89.

some specific rules in favor of consumer-lessees. For example, the Belgian law[96] imposes that the lessor shall notify the consumer, by using a registered mail, that he is entitled to withdraw the call option one month before the last agreed date[97]. Furthermore, it states that, if the lessor needs a security right from the consumer, it may only be lodged by way of a security deposit in the form of a term account opened for that purpose on behalf of the consumer[98].

A main issue concerns the consumer protection in cases where the leased asset is damaged or unfit for the use. As discussed above, in the event of non-performance or defective performance by the supplier, the lessee is always entitled to act against the latter to obtain the fulfillment of the supply contract. A recent Italian case-law has ruled that «the choice to use an asset through the stipulation of a financial lease agreement reasonably precludes to the lessee the possibility to carry out the legal protections provided for consumers»[99]. Therefore, according to the Court, the consumer-lessee cannot cumulate to the specific protection laid down for the sale and purchase contract stipulated by the leasing company, also that he could benefit where he himself stipulates the contract[100].

Another issue concerns the possibility that the supplier still doesn't perform its obligations, after the lessee has acted against him. May the lessor's liability exclusion clauses be considered valid and enforceable also in these hypotheses? The answer could be not so easy. According to the Directive on credit agreements for consumers, «where the goods or services covered by a linked credit agreement

[96]See art. VII-80 and art. VII-82 of Belgian *Code de droit economique*. For an overview on the Belgian legal framework about financial leasing, see, amongst other, KOHL, *Le leasing financier en Belgique*, in *Unif. L. Rev.*, 2011, p. 58, about «leasing *et crédit-bail au consommateur*».

[97]When the call option is not exercised or the transfer of ownership is not carried out, the financial leasing can be converted into a lease only by entering into a lease agreement. See art. VII-80, al. 2, *Code de droit economique*.

[98]Art. VII-82(1), *Code de droit economique.*

[99]Trib. Napoli, 11th January 2017. However, the decision was also influenced by the fact that the leased asset was a very expensive item (a luxury boat) «that, due to the importance of both purchase and management costs, fits to a kind of "consumption" that is extremely limited to a group of buyers who are particularly expert in the sector».

[100]Cfr. art. 10(1) of the Unidroit Convention states that «the duties of the supplier under the supply agreement shall also be owed to the lessee as if it were a party to that agreement and as if the equipment were to be supplied directly to the lessee». However, the Convention does not apply when the lessee is a consumer.

are not supplied, or are supplied only in part, or are not in conformity with the contract for the supply thereof, the consumer shall have the right to pursue remedies against the creditor if the consumer has pursued his remedies against the supplier but has failed to obtain the satisfaction to which he is entitled according to the law or the contract for the supply of goods or services»[101]. As a result, if the financial leasing contract was considered a *linked credit agreement*[102] under the scope of the Directive, the lessor's would be liable together with the supplier, in the event of the supplier's unfulfillment. But – as well known – the Directive only applies to leasing transactions where the lessee has an «obligation to purchase the object of the agreement»[103]. As a consequence, the peculiar discipline provided by the directive doesn't apply where the financial leasing contract include a mere purchase option. In this regard, even when the agreed price for the exercise of the purchase option is so irrelevant to assume that the purchase of the asset is the only rational choice for the lessee, it doesn't seem that the contract includes an "obligation" for the lessee in the meaning of the Directive. As a consequence, financial leasing is generally excluded from the scope of the Directive. This circumstance means that it should not apply to the transaction the whole discipline provided by the Directive, including those rules relating to the pre-contractual phase, to the information to be included in the contract and to some consumer's rights (such as the right of withdrawal and the possibility of early repayment[104]). Fur-

[101]Art. 15(2) of the Directive 2008/48/CE of the European Parliament and of the Council of 23 April 2008 on credit agreements for consumers and repealing Council Directive 87/102/EEC.

[102]According to art. 3(1)(n) of the Directive, «"linked credit agreement" means a credit agreement where: (i) the credit in question serves exclusively to finance an agreement for the supply of specific goods or the provision of a specific service, and (ii) those two agreements form, from an objective point of view, a commercial unit; a commercial unit shall be deemed to exist where the supplier or service provider himself finances the credit for the consumer or, if it is financed by a third party, where the creditor uses the services of the supplier or service provider in connection with the conclusion or preparation of the credit agreement, or where the specific goods or the provision of a specific service are explicitly specified in the credit agreement».

[103]Art. 2(2)(d) of the Directive 2008/48/CE.

[104]In particular, it would allow the consumer «at any time to discharge fully or partially his obligations under a credit agreement», also being entitled to obtain a «reduction in the total cost of the credit, such reduction consisting of the interest and the costs for the remaining duration of the contract». He would have to pay the lessor only a sum representing the «fair and objectively justified compensation for possible costs directly linked to early repayment of credit provided», not exceeding 1% of the amount of credit repaid early, if the period of time between the early

thermore, it presumably means that the transaction is also excluded from the scope of the Directive on the distance marketing of consumer financial services[105], as well as the Directive on credit agreements for consumers relating to residential immovable property[106] and the Directive on consumer ADR[107].

However, national law may extend the scope of the discipline provided by the Directive. For instance, under the Italian law most of the discipline on consumer credit also applies to the financial leasing contract[108]. In particular, it is established that – in case of non-fulfillment of the supplier – the consumer may ask the lessor to obtain the resolution of the supply contract; starting from this moment, the lessee's obligation to pay rentals is suspended. Once the supply contract terminates, it automatically entails also the termination of the financial leasing contract, so the consumer is entitled to regain all the rentals (and any other fee) he has already paid to the lessor[109].

6. At the end of the term of the financial lease, the lessee typically has to choose between multiple options provided by the contract. The latter can choose, as well known, whether to purchase the ownership of the asset, paying the correspondent expectation in the contract, or return it to the legal owner, the lessor. Alternatively, the lessee may decide to extend the lease term for a further period,

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repayment and the agreed termination of the credit agreement exceeds one year, or 0.5% if the period does not exceed one year.

[105]Directive 2002/65/CE of the European Parliament and of the Council of 23 September 2002 concerning the distance marketing of consumer financial services and amending Council Directive 90/619/EEC and Directives 97/7/EC and 98/27/EC. For an overview, A. Blandini, *Servizi finanziari per via telematica e le prospettive del diritto societario* on line, Banca borsa e titoli di credito, 2016, I, p. 46.

[106]Directive 2014/17/EU of the European Parliament and of the Council of 4 February 2014 on credit agreements for consumers relating to residential immovable property and amending Directives 2008/48/EC and 2013/36/EU and Regulation (EU) N° 1093/2010.

[107]Directive 2013/11/EU of the European Parliament and of the Council of 21 May 2013 on alternative dispute resolution for consumer disputes and amending Regulation (EC) N° 2006/2004 and Directive 2009/22/EC.

[108]Art. 122 of decree n° 385 of 1st September 1993 (*Testo Unico delle leggi in materia bancaria e creditizia*), as amended by art. 1(1) of decree n° 141 of 13rd August 2010. For a general overview on consumer credit regulation in Italy, see M. DE POLI, *Il credito ai consumatori nel testo unico bancario e creditizio*, in F. CAPRIGLIONE, *I contratti dei consumatori*, Milano, 2013, p. 417.

[109]See art. 125*quinquies*(3), of decree n° 385 of 1st September 1993.

through a specific contractual clause or, in its lack, by reaching an agreement with the lessor[110]. These "standard" options are the most frequently included in the contractual forms – not by chance, these ones are implicitly indicated in the Unidroit Convention[111] – but the parties are free to determine different clauses. For example, the contract can include a profit sharing clause, under which the leased asset is sold on the market and the proceeds are divided between the parties[112].

The parties may also decide to terminate the financial leasing contract before the expiration of the originally agreed term. In some cases, a contractual clause provides for such eventuality, imposing on the party requesting the early termination – usually, the lessee – the payment of certain penalties, as well as the right to exercise the right to purchase the asset[113]. When (as it usually happens) the contract does not include this clause, the lessee that intends to extinguish the contract may reach an agreement with the lessor regarding the *quantum* due to the latter; in the lack of such an agreement, he remains obliged to fully perform the obligations provided for in the contract [114]. In several decisions, the Italian *ABF* (Banking and Financial Ombudsman)[115] clarified that, as happens in the case of a

[110]Actually, this is not a mere extension of the first leasing contract, because some of the conditions of the agreement could change. In particular, the amount of the fees is generally lower than the first contract's, consistent with the lower residual value of the leased asset and with the circumstance that the lessor has already recovered all the transaction costs.

[111]Art. 9(2) of the Unidroit Convention states that «when the leasing agreement comes to an end the lessee, unless exercising a right to buy the equipment or to hold the equipment on lease for a further period, shall return the equipment to the lessor (…)».

[112]About the profit sharing clause, see MANTYSAARI, *The Law of Corporate Finance: Generale Principles and EU Law*, Heidelberg, 2010, Vol. III, p. 27.

[113]The termination of the contract may occur with or without the transfer of ownership of the asset. The lessee could opt for the latter solution if the asset is no longer useful and the termination penalties are lower than the leasing and maintenance costs. On the other hand, the decision to purchase the asset may depend on changes in the tax situation related to the ownership of the asset or changes in market conditions (for example: changes in market interest rates), or on other reasons like, for example, the opportunity to sell the asset at a higher price than the amount that has to be paid to the lessor to terminate the contract.

[114]According to FRANÇOIS, *Le crédit-bail financier en France*, in *Unif. L. Rev.*, 2011, p. 299, the duration of the contract is «*irrévocable*» since the financial balance of each party depends on it.

[115]The Italian Banking and Financial Ombudsman (*ABF- Arbitro Bancario Finanziario*) is a system of alternative dispute resolution (ADR), competent in case of disputes that may arise between customers and banks and other intermediaries in the field of banking and financial transactions and services. See, *ex multis*, MAIMERI, *L'*Ombudsman *bancario in Italia*, in F. RIOLO, *La banca e l'arbitrato*, Roma, 1994, p. 514; CAPRIGLIONE, *La giustizia nei rapporti bancari e finanziari*, in *BBTC*, 2010, 3, p. 261; RUPERTO, *L'«Arbitro bancario finanziario»*, ivi,

loan, «the end-of-term is presumed in favor of both parties»; therefore, «the lessor – financial institution having a legitimate interest in the remuneration … – [is entitled] to ask the debtor to pay a sum of money corresponding to the entire amount of the debt, including both the principal and the interest on maturity»[116]. However, in practice it is not uncommon for leasing companies to allow the lessee to terminate the contract. Often the leasing company prepares precompiled forms through which the lessee can request the early termination of the contract. Once the request has been received, the lessor communicates to the lessee the amount to be paid, calculated in relation to the sum of the final price and of the expiring installments, inclusive of interest, discounted according to the market discount rate. Through the payment of this amount, the lessee obtains ownership of the asset in advance.

6.1. Most of the disputes relating to financial leasing transactions concern the non-payment of the rentals by the lessee. Consequently, even the national regulations mainly (or exclusively) focus on this kind of non-fulfillment; nevertheless, it shall not be excluded that the lessor can obtain the termination of the agreement – on the basis of general contract law – even if the lessee doesn't fulfill the other obligations assumed, such as the obligation to maintenance or insure the leased asset[117].

The internal law usually sets a threshold of overdue and unpaid fees beyond which the lessee's default justifies the termination of the contract[118]. The law must consider two opposite interests: the lessee's interests in the leased property, preventing the lessor from terminating the contract after the slightest

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2010, 3, p. 325; DELLA MONACHE, *Arbitro bancario finanziario*, ivi, 2013, 2, p. 144; CARRIERO, *Giustizia senza giurisdizione: l'arbitro bancario finanziario*, in *Riv. trim. dir. proc. civ*., 2014, p. 161.

[116]See *ABF* Milano, decision n° 917 of 28th March 2012; *ABF* Napoli, decision n° 721 of 12th July 2010. The *ABF* emphasize, in those decisions, the lessor's physiological remuneration expectation for the credit provided through the financial leasing transaction.

[117]See BONFATTI, *Il leasing è legge*, in *Rivista di diritto bancario*, 2017, 22, p. 6, who distinguishes between «economical» and «operative» non-fulfillment hypoteses.

[118]The *ratio* of referring even to «non-consecutive» payments is obviously to avoid lessee's opportunistic behavior.

default; and lessor's position, which wants to obtain the repossession of the good in a simple and fast way[119]: considering that – regardless of its formal qualification[120] – the asset provides in many situations the security for the financing[121]. The national regulations are quite variable. In Italy, for instance, a breach is qualified as *serious* when it consist in «at least six monthly or two quarterly even non-consecutive fees ... for real estate leases, or four monthly fees even non-consecutive ... for other financial leases »[122]. The Cypriot law, on the other hand, identifies a different threshold, which varies from two to four overdue and unpaid monthly rents, depending on whether the financial leasing contract relates to movable or immovable property[123]. This regulatory approach, which also has the merit of creating a legal framework that is certain for both parties, is clearly aimed to the protection of the lessee[124]. But it should be noted that, if the law sets a too "generous" threshold, the repossession of the asset by the lessor may be too late, with the consequent lowering of the market value of the asset itself. Therefore,

[119]According to CUMING, *Model Rules for Lease Financing: A Possible Complement to the Unidroit Convention on International Financial Leasing*, in *Unif. L. Rev*., 1998, 3, p. 382, in this phase every delay «seriously diminishes the efficiency of financial leasing». He suggests that «the [Court] order … the lessor … require [to retake possession of the leased asset] should be made available through expedited proceedings so that the period between default and the date of seizure is very short».

[120]According to KRONKE, *Financial leasing and its Unification by Unidroit*, in *Unif. L. Rev*., 2011, p. 29, under certain conditions «for all purposes [financial leasing] creates a security right in favor of the lessor on the lease, as a result of which it is re-characterized as secured transactions in countries that adopted the functional approach to security interest». Cfr. FRANÇOIS, *Le crédit-bail financier en France*, in *Unif. L. Rev*., 2011, p. 313: «*même si elle ne constitue pas une vaie sûreté, la propriété du crédit-bailleur en offre les advantages*».

[121]In particular, the asset provides the security for the financing if the lessor has no reasonable expectation of a meaningful residual value in the goods. See the *UNCITRAL Legislative Guide on Secured Transactions*, adopted on 14 December 2007, pp. 43-44, which defines «security right» any «right created by agreement to secure payment or other performance of an obligation, regardless of the apparent form of the transaction or the language used by the parties. It thus includes financial-lease rights if they function as an "acquisition security right"».

[122]Art. 1(137) of the law n° 124/2017. It applies to every kind of financial leasing transactions, except those falling within the hypoteses covered by the decree n° 72/2016 (*residential real estate leasing*).

[123]Section 33, par. 2(b), Cyprus Financial Leasing Law.

[124]The national legislators usually grant greater protection to the lessee towards the lessor, presumably because they are influenced by the fact that the financial leasing contract is well suited to SMEs.

some authors suggest that the law should just state generic formulas[125], as it's done, for instance, in the Unidroit Convention, which impose without further details that the lessee's default – for the purpose of repossessing the asset – must be «*substantial*»[126].

Even the post-resolution phase – namely the repossession of the asset, its liquidation and the distribution of the proceeds between the lessor and the lessee – should be regulated by the law, in order to allow the lessor to be satisfied through the asset, without reaching an excessive and unjustified profit. In Italy, for example, it is established that the lessor must liquidate the asset at market values, as resulting from public surveys or from an assessment made by an independent technician. The amount thus obtained is then paid to the lessee, deducting a sum corresponding to the unfulfilled fees, the price established for the exercise of the purchase option and the expenses supported by the lessor to repossess and retain the asset[127].

6.2. The law should establish the consequences – particularly regarding the leased asset and the termination of the contract – in case one of the parties is subject to a bankruptcy proceeding[128]. In the event of lessee's insolvency, the lessor should not be dispossessed of its right in the leased goods. Art. 7(1)(a) of the Unidroit Convention states that «the lessor's real rights in the equipment shall be valid against the lessee's trustee in bankruptcy[129] and creditors, including creditors

[125]See CUMING, *Model Rules for Lease Financing: A Possible Complement to the Unidroit Convention on International Financial Leasing*, in *Unif. L. Rev.*, 1998, 3, p. 382.
[126]Art. 13(2) of the Unidroit Convention. According to FERRARI, *Principi generali inseriti nelle convenzioni internazionali di diritto uniforme: l'esempio della vendita, del "factoring" e del "leasing" internazionali*, in *Riv. trim. dir. proc. civ.*, 1997, 3 p. 652, the *favor contractus* – that prevent the contract to be terminated without a *substantial* default by the lessee – should be regarded as a general principle of the Convention, as well as the *favor* for the lessee.
[127]Art. 1(139), of the law n° 124 of 17th August 2017.
[128]For a list of the insolvency procedures provided for in the European countries, see Annex A, Regulation (EU) n° 2018/946 of 4 July 2018 *replacing Annexes A and B to Regulation (EU) 2015/848 on insolvency proceedings.*
[129]Art. 7(1)(b) of the Unidroit Convention specifies that the term "trustee in bankruptcy" «includes a liquidator, administrator or other person appointed to administer the lessee's estate for the benefit of the general body of creditors». Cfr. H. KRONKE, *Financial leasing and its Unification by*

who have obtained an attachment or execution»[130]. Furthermore, the law must impose the conditions and modalities for the contract to continue within the proceeding. Art. 72*quater* of the Italian bankruptcy law[131] (as amended in 2006[132]) establishes, in principle, the suspension of the contract for a certain period, after which the trustee – authorized by the creditors' committee – will choose whether to take over or terminate the contract [133]. If the bankruptcy decision provides for the provisional exercise of the business activity, the contract continues to be executed unless the trustee declares he wishes to terminate it. These provisions are aimed to ensure, in the event of the continuation of the business activity, the availability of the leased asset; on the other hand, if the contract does not continue, the lessor is entitled to the refund of the asset and is obliged to pay the difference between the amount of the sale of the asset at market values and the remaining credit in capital line. In this way, the lessor is adequately protected either if the contract continues or terminates: in the first case, the subsequent payment obligations are met in pre-emption (with priority over other bankruptcy creditors). In the second case, the leasing company is satisfied through the proceeds obtained from the sale of the asset; and the payments already received are exempt from avoidance actions.

On the other hand, the execution of the financial leasing contract should not be affected by the possible insolvency of the lessor. Still referring to the Italian bankruptcy law, the last paragraph of the art. 72*quater* expressly states that the

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Unidroit, in *Unif. L. Rev.*, 2011, p. 32, according to whom it would have been preferable to use the more natural term "insolvency administrator".

[130]See KRONKE, *Financial leasing and its Unification by Unidroit*, in *Unif. L. Rev.*, 2011, p. 33: «Article 7 is designed to prevent the leased asset from being treated as part of the insolvent lessee's estate so as to be available to its general creditor».

[131]Royal Decree n° 267 of 16th March 1942 (*Legge fallimentare*), as amended by decree n° 5 of 9th January 2006. The Italian doctrine stresses the importance of this regulatory intervention, which eliminates «a serious reason of uncertainty regarding the discipline to be applied in relation to one of the most frequent events extinguishing this contractual agreement». See LUMINOSO, *Il* leasing *finanziario: struttura dell'operazione e caratteri del contratto*, in BUONOCORE, *Manuale di diritto commerciale*, XIII ed., Torino, 2016, p. 730.

[132]At the time of writing, the Italian law on business crises is in the process of being radically changed. Nevertheless, even after these changes, the rules relating to the financial leasing contract that are mentioned in this paper will remain almost untouched.

[133]This provision is contained in the art. 72 of the Italian bankruptcy law, to which the first paragraph of the art. 72*quater* refers.

contract continues in these circumstances. The lessee is required to pay the periodic fees and has the right to use the asset, as well as to purchase it at the end of the contract, paying the agreed price.

7. The reasons that usually induce the parties to enter into a financial leasing contract – preferring it to feasible contractual alternatives – are well known. Briefly: for the lessee, the fact it has to bear a lower up-front cash down-payment than a loan[134], the availability and simplicity of the contract and the possibility to include within the agreement some ancillary services that may improve the enjoyment of the good; for the lessor, its strong credit position, guaranteed by the maintenance of legal ownership of the leased asset, and the fact that the equipment is purchased directly from the supplier, so the lessor does not bear the risk that the loaned capital is used by the borrower for other purposes than the agreed ones (a risk that exists in the case of a loan) and may get a significant discount from the supplier (especially if the leasing company is owned or otherwise linked to the supplier). Beyond these intrinsic characteristics of the transaction, the diffusion of the financial leasing contract in a country is strongly influenced by its legal framework. In particular, it is essential that the latter is clear and comprehensible, and that the rules of different nature are well coordinated with each other, so to prevent parties from being exposed to the risks and costs related to legal uncertainty[135]. A key factor to the lessor may be the circumstance that the regulations to which the leasing companies (typically not deposit-taking institutions) are subjected are usually less stringent than banks'[136]. In addition, the lessor may prefer to stipulate a finance lease arrangement rather than a collateralized loan in those countries where the security rights legal framework is inadequate and it

[134]In particular, «the up-front cash down-payment or security deposit required in a lease contract is lower than the equity component or stake in conventional bank financing». See GALLARDO, *Leasing to support Micro and Small Enterprises*, in The World Bank's Policy Research Working Paper, 1997, p. 7.
[135]According to IFC, *Leasing in Development*, 2009, p. 25, a contradictory legislation «is often the worst possible outcome».
[136]Clearly, if the financial leasing activity is not carried out by a bank.

may not be easy their enforcement[137].

Many authors have emphasized the relevance of tax advantages as a key element in the success of the financial leasing sector[138]. In fact, the internal rules on accounting and tax may make the financial leasing contract economically convenient for the parties (especially for the lessee)[139]. In this regard, despite the analysis of the single domestic fiscal regulations is not within the scope of this paper, it should be noted that any tax facilitation provided for by the law must respect the EU's fundamental principles based on the unity of the internal market, particularly concerning illegal state aid. As an example, it could be mentioned the well-known "Spanish Tax Lease System case", where the EU Commission affirmed that some of the fiscal measures composing the alleged system – involving *inter alia* a leasing transaction –constituted illegal State aid, partially incompatible with the internal market[140]. According to the Commission, this Spanish tax-planning system allowed maritime shipping companies (buyers) to benefit from a 20-30% price reduction when purchasing ships constructed by Spanish shipyards (sellers) combining several advantageous tax measures through an elaborate transaction arranged by a bank. In particular, the latter interposed between the seller and the buyer a leasing company and an economic interest company (EIG) set up by the

[137]See CUMING, *Legal regulation of international financial leasing: the 1988 Ottawa Convention*, in *Arizona Journal of International and Comparative Law*, 1989, vol. 7:1, p. 45: «from the lessor's point of view, a financial lease can be a much more flexible legal device than traditional security transactions».

[138]See CUMING, *Legal regulation of international financial leasing: the 1988 Ottawa Convention*, in *Arizona Journal of International and Comparative Law*, 1989, vol. 7:1, p. 67: «the basic reality is that financial leasing is dependent upon taxation laws». In many countries, the law provides for tax advantages relating to this transaction. See *ex multis* the opinions about the tax advantages provided by the Greek law on leasing in VOULGARIS, *La location-financière (*leasing*) en Grece*, in *RHDI*, 2010, vol. 63, p. 236.; GIANNOPOULOS, GIANNOPOULOS, *4 New Financial Institutions and their Tax Treatment*, in *Logistis*, 1996, p. 228.

[139]If a financial leasing transaction is carried out by the lessee for the sole purpose of obtaining tax savings, it could be considered abusive. For example, in Italy the validity of the sale and lease back transaction has been doubted when this operation is carried out by a non-Ias adopter lessee. Far from dedicating here an in-depth analysis on this issue, it can be sufficient to point out that the Courts have nevertheless considered the operation to be valid. See *ex multis* Cass., sec. V, 26th August 2015, n° 17175.

[140]See the Commission Decision of 17th July 2013. The Commission took the view that three of the five fiscal measures under examination constituted illegal State aid – incompatible with the internal market – to the EIGs and their investors and had been unlawfully implemented by Spain since 1st January 2002.

bank, than it sold to investors shares in the EIG and set up a network of contracts between the various parties, including a financial leasing contract between the EIG and the buyer of the ships. The aim of the arrangement was to generate tax advantages for the EIGs and their investors, and to transfer about 85-90% of those advantages to the maritime shipping company in the form of a rebate on the price of the vessel[141]. However, the Commission's decision – still significant in terms of using the financial leasing contract as a tool for granting tax advantages – has been annulled by the General Court of the European Union in 2015, since vitiated by a number of errors and lacking of sufficient statement of reasons concerning the classification as State aid[142].

8. In an October 1997 report drafted for the World Bank, Joselito Gallardo claimed that «a clearly established legal, regulatory and tax framework for leasing transactions is indispensable for this form of financing to grow and take its appropriate place in the financial system»[143]. More than twenty years later, this statement appears still convincing. In the introduction, it has already been stressed that national laws often are not homogeneous and do not adequately regulate the financial leasing transaction. At present, it's quite surprising that the European Union has not issued a comprehensive regulation on this subject. On many occasions,

[141]According to the EU Commission, the EIGs were the primary recipients of the tax advantages, resulting from an early and accelerated depreciation of the leased vessel. Subsequently, the members/investors in the EIGs would benefit from those tax advantages, thanks to the EIG's fiscal transparency. See the Commission Decision of 17th July 2013, par. 45.

[142]See the General Court of the European Union, 17th December 2015, n° 150/2015, Judgment in Joined Cases T-515/13 and T-719/13. According to the Court, the Commission was wrong to declare that the Spanish Tax Lease System constituted a selective economic advantage and, therefore, State aid to the EIGs and investors. In particular, the Court noted that, by reason of the fiscal transparency of the EIGs, only their members (the investors) – not the EIGs themselves – could benefit from the fiscal measures applied to them under the Spanish Tax Lease System. As a result, in the absence of an economic advantage for the EIGs, the Commission was wrong to find that they had benefited from State aid. With regard to the investors, the Court found that the economic advantage obtained by them was not selective: despite the existence of an authorization system, the advantages in question were available, under the same conditions, to any investor who decided to participate in the transactions within the STLS by purchasing shares in the EIGs set up by the banks.

[143]See GALLARDO, *Leasing to support Micro and Small Enterprises*, Policy Research Working Paper, The World Bank, 1997, p. 31.

the normative production issued by the EU has been so copious as to be considered even excessive or disproportionate: but this is not the case of the financial leasing sector. The study carried out here shows that it is actually necessary a regulatory intervention aimed to harmonize the national regulations and to fill the gaps that these still present. In particular, it is advisable for the EU to take a clear position on the crucial aspects of the transaction and, mostly, on which issues can be left to the free negotiation of the parties and which ones must be regulated by the law.

According to that, *de jure condendo*, the European legislation should establish, among other things: a definition of the transaction, which clearly represents the contractual elements necessary for the transaction to be qualified as a financial lease; the essential rights and obligations of the parties, particularly concerning the pathological events related to the breach of one of the parties (or even the supplier); a specific protection for consumer-lessees, which should be not disadvantageous comparing to the protection they may achieve by concluding a different credit agreement. Essentially, it is hoped the introduction of a detailed regulation that takes into consideration the different local legislations and jurisprudence, but at the same time demarcates the extent of the transaction as a "nominate contract", so to avoid the application of the financial leasing specific discipline in cases where the transaction is used as a practical expedient to achieve advantages that are not worthy of protection.

Only through a comprehensive harmonization, the barriers to the creation of a single European market for financial leasing services could be finally eliminated, and the risks related to legal uncertainty avoided.

SMART CONTRACTS AND (NON-)LAW. THE CASE OF THE FINANCIAL MARKETS [*]

Francesco Di Ciommo [**]

ABSTRACT: *Over the last few years, the term 'smart contract', largely coined by technology experts, has also entered the vocabulary of jurists. But what does this expression mean, and why should a jurist reflect on this new conceptual category?*

In attempting to answer these two fundamental questions, this essay reaches the following conclusions:1) smart contracts are not contracts; 2) the terms 'smart contract' and 'blockchain' are not interchangeable; 3) the legal problems raised by the smart contract phenomenon require an analytical approach strongly conditioned by the technological ecosystem of reference and must be assessed on a case-by-case basis; 4) for this reason too, the category in question has substantially no legal significance; 5) in any case, precisely because of this technological conditioning, any attempt by jurists to understand and regulate the phenomenon risks becoming obsolete at the very moment in which it is carried out; 6) furthermore, reasons, issues relating to the validity and effectiveness of so-called smart contracts, and those relating to any liability arising from them are normally handled independently by the computer systems concerned with no reference to the institutions and rules of the legal system, which concentrate solely on trying to avoid market distortions.

The hypotheses outlined above, which certainly arouse general concern, are confirmed by observing what happens on the financial markets, where algorithmic trading (AT) and high-frequency trading (HFT) have become an established reality over the last few years and are continuing to grow.

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SUMMARY: 1. Algorithmic trading and the Internet of Things: a phenomenology of the changing world. – 2. Smart Contracts: a fashionable (non-legal) category. – 3. The Blockchain at the service of Smart Contracts. – 4. The financial markets from Algorithmic Trading (AT) to High-Frequency Trading (HFT). – 4.1. Speed and intensity of trading as competitive factors. – 4.2. HFT and market abuse risks. – 4.3. First attempts at regulating HFT. – 4.4. AT and HFT in the light of MIFID Directives I and II. – 5. Conclusion: law and non-law.

1. It often happens, especially in the so-called social sciences, that the emergence in the practice of unprecedented issues sparks new debate among scholars. The first reaction is to identify a conceptual category to define, and therefore somehow contextualize, the new phenomenon with the more or less explicit aim of fitting it into the system and facilitating its study, and thus, in the case of law, also perhaps identifying its characteristics from the perspective of regulation[1].

Historically, this has greatly favoured the evolution of knowledge in legal scholarship and in the world of law in general, where there is no shortage of examples. Suffice it to mention, in the sphere of civil law, the significant event constituted by the formulation of personality rights, conceptualized for the first time by Otto von Gierke in the late 19th Century, or the all-important development of the theory of the legal transaction, reinforced by the introduction of the BGB in 1896[2]. In both cases, after the emergence of social demand for the protection of new individual interests or the regulation of hitherto neglected matters,

[1]A completely different approach to the subject was adopted by Kant, whose *Critique of Pure Reason* demonstrated that categories are not determinations of reality but only of knowledge, as they represent how the human intellect works applied to the material (of empirical origin) given in sensible intuition. More recently, Gilbert Ryle's approach in the neo-empirical field is worthy of note – in *The concept of mind* (1949), he defined "categories of a concept" as the group of rules that govern its use.

[2]The literature on the two topics mentioned is boundless. See, in particular, MESSINETTI, *Personalità (diritti della)*, *in Enc. dir*., XXXIII, Milan, 1983, 354; by various authors, *Categorie giuridiche e rapporti sociali. Il problema del negozio giuridico*, Milan, 1978; GALGANO, *Il negozio giuridico*, in Tratt. Cicu-Messineo, Milan, 1988; STOLFI, *Teoria del negozio giuridico*, Padua, 1961; and SACCO, *Negozio giuridico. Circolazione del modello*, in *Dig. Disc. Priv*., *Sez. civ*. section, XII, Turin, 1995 respectively.

jurists reacted by creating categories causing heated debate that would have a marked influence on the attitudes of future legislators and judges.

Something similar has been happening over the last few years regarding the complex, and increasingly significant, topic of economic operations independently and directly concluded and/or performed, in whole or in part, by IT software (using algorithms), i.e. a network of computers (or even robots or automata) with no human involvement and mostly operating in cyberspace.

These operations are now known in various sectors (technological, legal, and sociological) across the globe as "algorithmic trading" and identified by the (non-technical) expression "smart contract" (i.e., intelligent contracts), classed under a relatively new category, which, on closer inspection, not only includes contracts but mostly concerns only one or more execution phases of a contract, often a framework contract or adherence agreement.

More specifically, the term smart contract generally refers to situations that envisage the translation and transposition into computer code – making them intelligible to the software (operating through one or more algorithms[3]) – not only of the rules that form what may roughly be called (para)contractual regulation, but also the real-world circumstances on the basis of which a service is to be performed automatically (or partly so), a service to be performed according to those rules; failing that, some effect related to the operation on the basis of the initial formulation must in any case be produced[4].

In other words, as the term is used today, a smart contract may be any economic operation, or part of one, involving two or more parties that can operate, and therefore produce effects independently of human intervention following established rules and the external information acquired in the course of the automated device's activities, forming the basis for the transaction. At the same ti-

[3]For a brief and clear reflection on what algorithms are and how important they are in the 'digital society', see ITALIANO, *Dixit algorithmi. Breve Storia del nostro futuro*, available online at "http://open.luiss.it/2019/01/23/dixit-algorithmi/".
[4]See ASHARAF - ADARSH (ed), *Decentralized Computing Using Blockchain Technologies and Smart Contracts, Emerging research and opportunities*, IGI Global, Hershey, PA (USA), 2017.

me, the software assesses whether certain specific conditions have been fulfilled before proceeding to carry out the operation.

This means that, in a healthy ('neutral') technological environment, shielded from deceptive external influences, the risk of deviation from the predetermined path within which the operation must take place – such as possible non-fulfilment – is extremely limited because automata comply (or should comply[5]) with the orders received. Thus, if the pre-established conditions are fulfilled, the automata will perform the action, or will at least produce the effects their algorithms were set in place to generate.

Moreover, the algorithm is generally programmed to handle all contingencies (hence the term "smart" contracts), reducing to a minimum, or, at least (hopefully) stopping disagreements between the parties in the event of some new occurrence, and preventing changes to the balance of the relationship arising from some unforeseen circumstance.

Lastly, it goes without saying that using an algorithm to carry out a transaction significantly reduces the times and costs of each operation.

For all these reasons, smart contracts are becoming extremely successful on the market as companies are always more willing to use them in both business-to-consumer trade and in business-to-business relations.

Of course, such a broad description of the phenomenon means that the 'smart contract category' can include real contracts, stipulated and executed (more or less) entirely by automated systems, and the individual phases of a contractual transaction, or even just an economic transaction by itself. The latter situation arises, for example, when the automated system only has to ascertain the existence of the conditions necessary to execute all or some of the services dependent on them, which may happen when only the conclusion of the contract is to be left to

[5]In reality, it quite likely that an algorithm will not faithfully reflect the will of the parties. Either the computer "translation" of the contract to be executed may be inaccurate, or the algorithm may take initiatives that were not foreseen by its designer, as (and this will be discussed more fully in the text) many algorithms feed on gained experience. On this, and many other points, see Ed Finn, *What Algorithms Want. Imagination in the Age of Computing*, Mit Ed., Boston (Mass., USA), 2017.

the automatic verification of the conditions under which the parties want the contract to be finalized.

In this regard, it should be observed that when the contract is concluded exclusively by means of one or more software(s), the automated verification of the factual prerequisites for finalization must be carried out in accordance with rules previously set by the parties in a framework contract or at least in contractual terms (normally for a certain period of time). These terms express the will of both parties to enter into a contract by means of automated systems if some specific conditions are met, and perhaps under certain circumstances rather than others, depending on the presence or absence of pre-established variables.

It may happen – and in practice it happens very often – that the terms of the contract (a 'framework') have, in reality, been established by only one party, and can be accepted by any number of counterparties. In today's market dynamics, this generally happens by performing some concrete action – as quick to carry out as it is immediate in its effects – which, rather than fully expressing the intentions of the parties, concretizes the factors upon which the effectiveness of the contractual agreement depends.

These brief notes, which will be developed more fully later, are not so much an attempt to define what is commonly understood today as a smart contract but the product of a necessary effort to contextualize the topic right from the start, albeit in very general and approximate terms. From this first outline, it may in fact be observed how the development of telematics and, more broadly, the continuous innovation that daily marks the latest technologies also (and perhaps especially) brings to the market(s) possibilities that were unimaginable until very recently.

For some time then there has been intense global discussion on the *Internet of Things*, describing how the Internet will increasingly become a vehicle (or

environment) for things rather than people to communicate with each other[6]. The concrete applications of this technology range from handling consumer goods (during production, storage, distribution, sales, and after-sales service) to the tracking of lost or stolen objects and the automated management of technological devices at a distance, and much more.

According to the most reputable studies, the number of objects connected to the Internet exceeded the number of people on the planet in 2008, while in 2020, there will be approximately fifty billion objects connected to the Internet, compared with a world population of approximately 9 billion people. With the growth of the Internet, and with it countless other interconnection networks, new algorithms are being consolidated, computing capacity is constantly on the increase, and the world we live in is changing radically at a hitherto unthinkable pace.

2. It is now widely believed that, working together with robotics, augmented reality, and virtual reality, the Internet of Things will continue to foster the interconnection of people, things, and environments so that in the next few years our lives will be fully digitized and networked[7]. For the more optimistic, this means

[6]The term "Internet of Things" is thought to have been coined by Kevin Ashton in 1999. (See Id., *That "Internet of Things" thing*, in *RFID Journal*, 2012). Among the many publication on the subject, see GERSHENFELD –KRIKORIAN – COHEN, *The Internet of Things*, in *Scientific American*, Vol. 291, No. 4 (October 2004), pp. 76-81; KORTUEM – KAWSAR – SUNDRAMOORTHY – FITTON, *Smart objects as building blocks for the Internet of things*, in *IEEE Internet Computing*, Vol. 14, Issue: 1, Jan.-Feb. 2010; and ZANELLA – BUI – CASTELLANI – VANGELISTA – ZORZI, *Internet of Things for Smart Cities*, id., Vol. 1, Issue: 1, Feb. 2014.

[7]The subject has, in fact, been the object of study for several decades. For one of the first reflections on the question, see. CAIRNCROSS, *The Death of Distance: How the Communications Revolutions Will Change Our Lives*, Boston, 1997. For a diachronic view of the impact that telematics has had so far on our lives from the legal perspective, see, especially for essential bibliographic and jurisprudential references DI CIOMMO, *Diritti della personalità tra media tradizionali e avvento di Internet*, in Comandé (ed), Persona e tutele giuridiche, Torino, 2003, 3; ID., *Evoluzione tecnologica e regole di responsabilità civile*, Naples, 2003; ID., *Internet e crisi del diritto privato: globalizzazione, dematerializzazione e anonimato virtuale*, in *Riv. crit. dir. priv.*, 2003, 11; ID., *Civiltà tecnologica, mercato ed insicurezza*, in *Riv. crit. dir. priv.*, 2010, 565; and ID., *L'accesso ad Internet tra diritto e responsabilità*, in *Comunicazione digitale*, 2014, 29, ID., *Il diritto di accesso alle informazioni in Internet*, in Perlingieri - Ruggeri, *Internet e Diritto civile*, 2015, 77.

objects will continue to do what they have been doing for humans up to now but in a more efficient and ultimately more useful way.

However, the development of these technologies is so rapid, comprehensive, complex, and pervasive that legal observers – and even more so legislators of all latitudes – are inevitably expressing serious doubts about how to address the problems arising from this state of affairs.

One of the results of this uncertainty seems to be the fashion of using the smart contract category – to use a term coined by technology experts[8] – as though it could have some at least descriptive value in the legal sphere too. On the other hand, as is already evident from the few considerations set out here so far, beyond what has been observed here in general terms, the elements included in the category in question are too diverse, like the situations, contractual or otherwise, that can currently be referred to as (or come under the umbrella term) 'smart contract', for it to be of any use in law.

So, despite arising from the best intentions, current attempts to carry out some sort of systematic reasoning or ordering in relation to the category in question – discussing the formulation, nature, interpretation, invalidity, and execution of smart contracts – would appear to be doomed to failure, because each different case in the pseudo-category requires specific considerations, that fit in badly, if at all, with other possible intelligent contracts[9]. Not to mention the fact that

[8]It is commonly believed that the expression was coined by N. Szabo in his *Smart Contracts: Building Blocks for digital market*, 1996, available online at "http://www.fon.hum.uva.nl/rob/Courses/InformationInSpeech/CDROM/Literature/LOTwinterschool2006/szabo.best.vwh.net/smart contracts 2.html.". For a critical reflection on the possibility of reaching a full definition of the phenomenon, see MIK, *Smart Contracts: Terminology, Technical Limitations and Real World Complexity*, 9 *Law, Innovation & Technology*, 269 (2017).

[9]*For the legal scholarship on the subject, in addition to the studies mentioned in the other notes, see especially.* FOX – GLOSTEN – RAUTERBERG, *The New Stock Market: Sense and Nonsense*, in 65 *Duke Law Journal* 191 (2015); REIJERS – O'BROLCHÁIN – HAYNES, *Governance in Blockchain Technologies & Social Contract Theories, in 1 Ledeger 134 (2016);* KÔLVART – POOLA – RULL, *Smart Contracts*, in Kerikmäe – Rull (eds), *The Future of Law and eTechnologies*, Springer, 2016, 133; *K.E.C. Levy, Bopok Smart, Not Street-Smart: Blockchain-Based Smart Contracts and The Social Workings of Law, in 2 Engaging Science, Technology, and Society, 1 (2017);* SCHOLZ, *Algorithmic Contracts, in 20 Stan. Tech. L. Rev. 128 (2017);* WERBACH – CORNELL, *Contracts Ex Machina, in 67 Duke Law Journal, 313 (2017);* RASKIN, *The Law and Legality of Smart Contracts, in 1 Geo. L. Tech. Rev. 305 (2017);* TUR FAÙNDEZ, *Smart contracts. Análisis jurídico, Editorial Reus, Madrid, 2018; and*

these attempts inevitably foster the misunderstanding (aided and abetted by the use of the inaccurate but popular English expression) that when we speak of 'smart contracts' we necessarily refer to contracts, whereas, as we have seen, this is not always the case.

One confirmation of all this uncertainty is, among other things, the fact that when giving an example of a smart contract, reference is often made to what happens in the motor insurance market, where, on the basis of data collected by instruments placed in the vehicles, the software used by the insurance company receives information about the driver's behaviour (such as constantly exceeding speed limits), which can influence the makeup of the relative negotiating relationship, insofar as they may create certain conditions that bring into play or otherwise clauses of advantage or disadvantage (or increase the insurance premium). However, as is evident in the present case, the contribution of technology is limited to sending information to a technological platform that, on the basis of the contractual terms originally reached by the parties, perhaps in a wholly traditional way, gives concrete form to the effects of the contract, depending on the nature of the information[10].

Essentially, this looks like a situation that does not appear to create particular legal problems, as it can be managed by applying common and traditional contractual rules. At the same time, it raises technical issues because it is, of course, necessary to ensure that the data are collected and transmitted correctly and that

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KOLBER, *Not-so-Smart Blockchain Contracts and Artificial Responsability, in 21 Stan. Tech. L. Rev. 198 (2018).*

Among the most interesting Italian studies, see. PARDOLESI – DAVOLA, *"Smart contract" e innovazione a tutti i costi, submitted for publication in Foro it., V,; read by kind permission of the authors;* FINOCCHIARO, *Il contratto nell'era dell'intelligenza artificiale,* in *Riv. trim. dir. e proc. civ.*, 2018, 441; PAROLA – MERATI – GAVOTTI, *Bockchain e smart contract: questioni giuridiche aperte, in Contratti, 2018, 681;* CAGGIANO, *Il contratto del mondo digitale, in Nuova giur. civ., 2018, II, 1152;* CUCCURU, *Blackchain e automazione contrattuale. Riflessioni sugli smart contracts, id., 2017, II, 107;* PASQUINO, *Smart Contracts: caratteristiche, vantaggi e problematiche*, in *Diritto e processo*, 2017, 11; *and* SABATO, *Gli smart contracts: robot che gestiscono il rischio contrattuale, in Contr. e impr., 2017, 378, but also in* Perlingieri - Fachechi *(ed.), Ragionevolezza e proporzionalità nel diritto contemporaneo*, Naples, 2017, 387.

[10]See BELLINI, *Smart Contracts: che cosa sono, come funzionano quali sono gli ambiti applicativi*, available online at "https://www.blockchain4innovation.it/mercati/legal/smart-contract/blockchain-smart-contracts-cosa-funzionano-quali-gli-ambiti-applicativi/".

the resulting automatic variation of the effects of the contract between the parties actually corresponds to what was originally agreed upon.

However, what happens when two or more software companies decide whether to enter into a contract is completely different. They make their own decisions on the basis of the algorithms they are programmed with so they perform, or do not perform, certain actions on the basis of whether certain pre-established conditions are fulfilled. Software products of this kind can 'talk to each other' and, depending on the analysis of the data at their disposal, fully automate a given economic transaction, acquiring, operation after operation, techniques and decisional (behavioral) modalities that can be very different from those originally written into the original algorithm. This comes about because the software is often programmed to memorize the experiences acquired in the field and to adapt its future behaviour to the information acquired. Through these learning and fine-tuning processes, the software products grow by themselves as they acquire information, so it can be very difficult to trace the way they work back to specific human intention or the responsibility of the programmer. This type of so-called algorithmic economic transactions has recently taken off in the financial sector in particular, as we shall see in the coming sections.

In the light of the above, we can safely reiterate what has already been said about the fact that on a strictly legal level, the concept of smart contract seems to refer to such a wide range of situations that it does not lend itself fully to any univocal treatment, except in very general terms of pure recognition.

It comes as no surprise, then, that even in the very earliest European scholarship in addressing the topic, the concept of 'smart contract' was described and defined in very heterogeneous terms[11].

The same uncertainty, also in terms of definition, is reflected in US legal scholarship on smart contract(s), which, however, focuses on a number of macro-themes that can be found in most kinds of transaction within the (pseu-

[11]Among others, see CUCCURU, *op. cit.;* DI SABATO, *op. cit.*; PAROLA – MERATI – GAVOTTI, *op. cit*

do)category at issue and are therefore worth examining. Thus, we examine the question of the presumed autonomy of smart contracts with respect to legal institutions and courts of law, and especially the fact that the algorithms often seek to manage problems of execution and even disputes between the parties automatically too[12]. We shall examine the question of liability in relation to smart contracts, with special reference to operations involving the so-called "black box algorithmic agents", where the decision-making process of the automaton cannot be fully predicted by the parties or the person who set up the algorithm[13]. In conclusion, among other things, we examine in greater detail the crux of the relationship between human will and how the algorithm operates, and from this angle we can observe that the rigidity of the automatism necessarily relegates this will to nothing more than a statement, leading to problems in applying the traditional legal discipline on contracts[14].

3. There is a further topic to be discussed, albeit briefly, in order to complete our discussion of the smart contract and also to attempt to show how an examination of the mode of operation and regulations of the above-mentioned instruments from the legal standpoint today appears not only particularly difficult, given their diversity, but also risks becoming substantially useless in just a few months or years due to the speed with which, thanks to the obsolescence of the technology used, computer protocols and algorithms are continuously modified or replaced by those who control them.

We must also add a reflection on the relationship between the smart contract and the blockchain, as some predict increasing use of so-called smart con-

[12]See RASKIN, *op. cit.*; but also, among others, KOULU, *Blockchains and Online Dispute Resolution: Smart Contracts as an Alternative to Enforcement*, *ScriptEd*, Vol. 13, iss. 1, 2016; and ORTOLANI, *Self-Enforcing Online Dispute Resolution: Lessons from Bitcoin*, 36 *Oxford J. Legal Studies* 529 (2016).

[13]See KOLBER, *op. cit.*; and Sholz, *op. cit.*; but also, among others, T. Gillespie, *Can an Algorithm Be Wrong?, LIMN*, 2, available on-line at "http://limn.it/can-an-algorithm-be-wrong, 2012".

[14]See WERBACH – CORNELL, *op. cit.*; but also, among others, DAVIS, *Contracts As Technology*, 88 *N.Y.U. L. Rev.* 83 (2013); and HOFFMAN, *Relational Contracts of Adhesion*, 85 *U. Chi. L. Rev.* 1396 (2018).

tracts in the near future, given the recent development and popularity of the blockchain, which is expected to continue[15].

Blockchain is a technology based on network users sharing a common database so that their transactions can be managed through a chain of operations that take place between the different nodes in the network[16]. In other words, through the use of an open ledger (the data base) accessible to its users and updated automatically as the clients (nodes) in the chain use it, certainty, verifiability, and knowledge are assigned to specific circumstances.

The shared open ledger is "made up of blocks, each of which represents a number of transactions whose origin and time of execution are assigned indelibly and immutably, through an asymmetric key cryptography mechanism and a time stamp ('timestamping'), respectively. Each block is irreversibly connected to the previous one through a specific algorithmic operation (the 'hash function') and forms, in this way, a chain of blocks ('blockchain') accessible and searchable by all the nodes of the network. Before being added to the chain, each block is checked, validated, and encrypted by the so-called miner nodes through a mathematical operation, and is therefore tamper-proof[17].

It is thus considered that the blockchain confers certainty and immobility to data and documents without the need to resort to authorities, institutions, or some third party and is therefore decentralized with no intermediation.

The first and most important application of blockchain technology came about in 2009, with the so-called bitcoin virtual currency, which had become very

[15]See, among many, GIANCASPRO, *Is a 'smart contract' really a smart idea? Insights from a legal perspective*, 33 *Computer Law & Security Rev.* 825 (2017); LUU – CHU – OLICKEL et Al., *Making Smart Contracts Smarter*, in *Proceedings of the 2016 ACM SIGSAC Conference on Computer and Communications Security - CCS'16*, New York, USA, ACM Press, 2016, 254; HOLDEN – MALANI, *Can Blockchain Solve the Holdup Problem in Contracts?*, *University of Chicago Coase-Sandor Institute for Law & Economics Research Paper No. 846*, 2017, available online at "https://ssrn.com/abstract=3093879"; as well as FILIPPI and WRIGHT, *Blockchain and the Law: The Rule of Code*, Harvard Univ. Press, 2018.

[16]The blockchain is the best-known application of distributed ledger technology (DLT), a technology based on the distribution and sharing of commonly used and useful information among the users of a network. The philosophy behind DLT is in contrast with the traditional logic of integrated and centralized management of information and protocols.

[17]Also PAROLA – MERATI – GAVOTTI, *op. cit.*

successful in previous years, before its exchange value fell sharply in 2018[18]. On the technical level (in both IT and legal terms), however, blockchain clearly provides ideal conditions to foster the use of smart contracts, because, as long as the system works and there are no gaps, it provides certainty about the contents and the date of a given activity and therefore also a given document, and ensures that it cannot be altered[19].

To date, however, there no legal norms nor is there even a regulatory framework governing blockchain in Europe or in the rest of the world[20]. There is currently no certainty, nor can there be, on the concrete applications of this technology either now or in the future, nor, of course, on the arrival of some innovation that will soon make blockchain obsolete. This, however, does not appear to be a problem for smart contracts, as they can operate entirely independently of the blockchain, given that each computer system can be equipped with technologies

[18]In mid-December 2018, the total capitalization of the cryptocurrencies known on the world markets reached 104 billion dollars, down sharply from the peaks recorded during the year but still in line with the figures from the start of August 2017. Compared with other crypto currencies, the bitcoin dominance index stands at over 55%, while its price, on January 27, 2019, stands at €3,107.00, after peaking at €9,183.00 in January 2018, with a historical maximum of €16,721.00 on December 15, 2017. Among the other cryptocurrencies, of particular note is Ethereum, whose value on January 27, 2019 stood at €99.86, after reaching a historical high of €1,136.27 on January 12, 2018. For an updated study on the legal issues relating to the phenomenon of crypto currency, see CAPACCIOLI, *Bitcoin e criptovalute*, in Cassano – Tilli – Vaciao, *Tutele e risarcimento nel diritto dei mercati e degli intermediari*, Milan, 2018, 445.

[19]For a first attempt at identifying and contextualizing the main legal issues relating to the blockchain in Italian scholarship, see SARZANA DI IPPOLITO - NICOTRA, *Diritto della blockchain, intelligenza artificiale e IoT*, Milan, 2018. The topic is also addressed from the specific perspective of cryptocurrency by PELLEGRINI - DI PERNA, *Cryptocurrency (and Bitcoin): a new challenge for the regulator, in Open Review of Management, Banking and Finance*, 2018, 318.

[20]In reality, things are changing in the United States and in Europe alike. On 1 February 2018, the European Commission, with the support of the European Parliament, set up the EU Blockchain Observatory and Forum. On April 10, 2018, on the initiative of twenty-two European countries not including Italy (which joined immediately afterwards), the European Blockchain Partnership was set up to harmonize the approach taken by the various countries. Moreover, on October 3, 2018, the European Parliament approved a resolution entitled "Distributed ledger technologies and blockchains: building trust with disintermediation", where, among other things, Parliament stressed the need for an in-depth assessment of the potential and legal implications of smart contracts. In addition, French government ordinance no. 1674 of 8 December 2017 introduced the possibility of using blockchain to register the ownership and transfer of unlisted securities. (available on the government website "Legifrance" at "https://www.legifrance.gouv.fr/ affichTexte.do?cidTexte=JORFTEXT0000 36171908»; see, among others, GARDENAL – MARCHESE, *Il* blackchain *ammesso nelle operazioni di M&A*, in *Il Sole 24Ore*, available online at "http://www.diritto24.ilsole24ore.com/art/avvocatoAffari/mercatiImpresa/ 2018-03-15/francia-blockhain-ammesso-operazioni-ma-123710.php".

that can attribute a certain degree of certainty and verifiability to the contents of a specific contract, including the identity of the parties, the date, *et cetera*.

In actual practice, only a somewhat modest fraction of the automated economic operations carried out on the Internet, or at any rate using telematic tools, use the blockchain, while all other smart contracts are entered into through other means, whose form and mode of operation depends on the choices of the operators concerned and the capabilities of the technical systems involved, problems related to the certainty of the date, the reliability and verifiability of the information processed automatically, the impossibility of modifying the contents, and the overall security of the operation in question.

Thus, it would be wrong to consider the smart contract to be the spawn of the blockchain, or in some way necessarily tied to this technology, just as it would seem erroneous to state that "blockchain technology allows the self-e-enforceability of the contract"[21]. In fact, the automatism of execution of contracts "when the events pre-established by the parties and recorded in the code" does not depend on the use of the blockchain, but – as we have seen above – is a consequence of the parties sharing an automated computer system to which they both leave the execution in accordance with the framework agreement that they negotiated and concluded beforehand, or that one party proposed and the other accepted, – also beforehand[22].

This allows us to safely predict that smart contracts will also survive the decline and obsolescence that will inevitable befall the blockchain (like all technology) a few months or many years hence. In this regard, it should be noted that the issues relating to the blockchain that have so far prevented its more widespread use are both numerous and significant. The first of these is that executing transac-

[21]The quoted text is from PAROLA, MERATI, GAROTTI, op. cit., esp. 684.

[22]It can thus be argued that blockchain facilitates (but does not actually allow) the self-enforceability of a contract only if we wish to emphasize that the more the parties trust in the reliability of the automatic system, the more likely they will be to entrust one or more phases of the transaction they are interested in to the system.

tions using this technology is by no means expeditious[23], and the verification and validation of data blocks is very costly in terms of organization and energy consumption[24]. Furthermore, there is currently no certainty as to how long the system based on the chains of blocks, and therefore on the thousands and thousands of servers scattered all over the world that constantly process, validate, and store the data, will last, continuing to operate perfectly all day every day.

Evidence for what has just been said about the non-dependence of smart contracts on the blockchain can be found in the experience gained over recent decades in the field of financial transactions. In fact, automata (and, therefore, algorithms) and telematic networks have been used to collect information and plan strategies since the second half of the nineteen-nineties, making trading decisions and executing operations on the markets. And this took place totally independently of any blockchain, as it does even today.

4. Although the subject has so far been substantially neglected, as mentioned above, the financial transactions sector has long been the locus for natural development and application of smart contracts[25]. In fact, the use of algorithms

[23]At present, a transaction on the bitcoin system is estimated to take ten minutes, as this is how the protocol that manages block validation is organized. See "https://www.tokens24.com/it/cryptopedia/basics/come-funzionano-le-transazioni-bitcoin" and "https://support.conio.com/hc/it/articles/115001186449-quanto-tempo-impiega-una-transazione-ad-essere-confermata-".

[24]According to reliable estimates, total annual electricity consumption for the production of bitcoin exceeds 32 terawatts, well above the annual consumption for a country the size of Ireland, which consumes 25 terawatts. See MARRO, *Come lavorano e quanto guadagnano i «minatori» del Bitcoin*, in *Il Sole 24Ore*, 20 December 2017, available online at "https://www.ilsole24ore.com/art/notizie/2017-12-19/come-lavorano-e-quanto-guadagnano-minatori-bitcoin-163810. shtml ?uuid=AEVOppUD".

[25]One of the most recent and constructive examinations of the phenomenon from the purely financial point of view is a work by a group of researchers, *Computerized and High-Frequency Trading*, in *The Financial Review*, vol. 49 (2014), Issue 2, 173-433; and LINTON – MAHMOODZADEH, *Implications of High-Frequency Trading for Security Markets*, USC-INET Research Paper no. 18-02, of 30 January 2018, Univ. Of Southern California, CA (USA), available online at "https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3112978", but also in *Annual Review of Economics*, vol. 10 (2018), 237. See also, among others, CESPA – VIVES, *High Frequency Trading and fragility*, ECB Working Paper no. 2020, February 2017, available online at "https://www.ecb.europa.eu/pub/pdf/scpwps/ ecbwp2020.en.pdf?f0853c8630ef920d9 429e31ff85b2682"; CALCAGNIBILE – BORMETTI – TRECCANI – MARMI – LILLO, *Collective synchronization and high frequency systemic instabilities in financial markets*, 2015, available online at the Cornell University website, "https://arxiv.org/pdf/1505.00704.pdf"; also P.

allowing transactions to be carried out automatically, i.e. without human intervention, has become increasingly commonplace in securities markets all over the world since the 1990s.

To illustrate the importance of the phenomenon, it should be observed from the outset that, according to accredited estimates, even in 2009, algorithmic transactions accounted for around 75% of the volume of stock trade carried out in the United States[26]. Confirmation comes from the incident of May 6th, 2010, when, in the space of just 10 minutes, Dow Jones suffered a flash crash that sent it from 10,650 points to less than 10 thousand, with a return, 10 minutes later, to 10,520 points[27]. This occurred because of a huge number of mutually conditioning swaps that happening at that time with a frequency that immediately revealed the involvement of automata rather than traditional human trading[28]. This triggered the SEC (Security and Exchange Commission) to focus on the question of smart contracts for the first time [29].

Hoffmann, *A dynamic limit order market with fast and slow traders*, Working Paper Series no. 1526, March 2013, European Central Bank, available online at "https://ssrn.com/abstract=1969392"; CAIVANO *et al.*, *High frequency trading. Caratteristiche, effetti, questioni di* policy, Consob Discussion papers, 5 December 2012, available online at "http://www.Consob.it/documents/11973/219968/dp5.pdf/04c93f02-d620-456c-b0a1-868233013f6e";
and, lastly, FRICKE – GERIG, *Too Fast or Too Slow? Determining the Optimal Speed of Financial Markets*, available online at "https://papers.ssrn.com/sol3/ papers.cfm?abstract_id =2363114".

[26]See HENDERSHOTT – JONES – MENKVELD, *Does algorithmic trading improve liquidity*, in *Journal of Finance*, vol. 66 (2011), 1.

[27]See Consob, *Il trading ad alta frequenza. Caratteristiche, effetti, questioni di policy*, December 2012.

[28]The investigations carried out by the SEC (the supervisory body for the U.S. markets) and the CFTC (Commodity Futures Trading Commission) later ascertained that the flash crash of May 6, 2010 had been caused by a single 4.5 billion-dollar order of sale of futures on the S&P 500 index: the order was probably a mistake, also considering that there were no indications regarding price or time frame. The liquidity on the market was not able to absorb it, thus triggering a downward spiral, in turn exacerbated by the triggering of automatic orders.

[29] As has been rightly pointed out, although the SEC (see note no. 25) ascertained that high-frequency trading systems were involved in the peculiar (and somewhat exceptional) intraday trend of the principal Dow Jones index on 6 May 2010, "it is a complex matter to prove whether they have had a positive or negative impact on the operation of the market in this scenario, because the presence of systems able to carry out operations at very high speed certainly exacerbated the fall in prices, but when the negative trend came to an end, the same systems allowed vigorous recovery over the next 10 minutes. It should be noted that following the famous 1987 stock crash, the Dow Jones index took over a year to recover a loss percentage comparable to what was recovered in just 10 minutes in 2010. Observing the contrasting effects that high-frequency systems may have caused in an episode lasting less than an hour is indicative of the

In Europe, and therefore also in Italy, the use of automatic agents to carry out financial transactions is growing but still appears somewhat limited[30].

In fact, at *Borsa Italiana*, the number of transactions carried out by automatic agents adopting so-called strategies of 'high-frequency negotiation' in 2016 and 2017 only reached just under 30% of the entire volume traded, up on 2014, when the percentage had reached 25.4%, and 2015, reaching 28.7%[31]. Nevertheless, the figure is actually quite modest, both in absolute values and in terms of growth trends in comparison to with the results recorded in the more advanced and dynamic markets. We should also consider that almost all the high-frequency foreign traders operating in Italy are foreign[32].

The terms Algorithmic Trading (AT) and High Frequency Trading (HFT) were coined in the United States, where the phenomenon had already taken root in the late nineties. They refer to transactions managed by an automaton using an algorithm (and here we have the smart contract idea again) and high-frequency transactions, characterized by their speed, respectively.

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complexity of the subject". Thus PUORRO, *High Frequency Trading: una panoramica*, in *Questioni di Economia e Finanza (Occasional paper)*, Bank of Italy, no. 198 - September 2013, esp. 5. It should be added that, as will be highlighted later on in this essay, massive use of HFT in recent years has made the financial markets much more volatile, and phenomena of rapid loss and equally rapid recovery of stock market indices less exceptional. See also PAULIN – CALINESCU –WOOLDRIDGE, *Understanding Flash Crash Contagion and Systemic Risk: A Micro-Macro Agent-Based Approach*, in *Journal of Economic Dynamics and Control*, 10.1016/j. jedc.2018.12.008 (2019),

[30]Some estimates state that robot traders handle 66% of the volumes traded on the global financial markets. See CARLINI, *Borse, come il robot trader "cavalca" il populismo e sfrutta lo spread*, in *Il Sole24 Ore*, 5 October 2018, available online at "https://www.ilsole24ore.com/art/finanza-e-mercati/2018-10-02/-borse-come-robot-trader-cavalca-il-populismo--212907.shtml?uuid=AEIR0 KFG".

[31]See the *Relazione Consob per l'anno 2016* (the 2016 Consob Report), of 31 March 2017, 48; *Relazione Consob per l'anno 2017* (the 2017 Consob Report), of 31 March 2018, 52; and the *Relazione Borsa Italiana* (The Italian Stock Exhange Report), of March 2018, 23. See also CHIAMENTI, *Esma mette la museruola all'high frequency trading*, available online at www.bluerating.com/mercati/540483/esma-porta-lhigh-frequency-trading-vero-la-regolamentazi one, showing, among other things, that the highest incidence of HFT (64.2% of the 2014 total and 68% in 2015, source *Relazione Consob per l'anno 2015*, of 31 March 2016) in Italy is in the IDEM (Italian Derivatives) market, where mini futures are traded.

[32]Out of a total of about 29% of the amounts traded through HFT on the MTA (the Italian screen-based stock exchange), 92% of these are attributable to foreign traders. (see *Relazione Consob per l'anno 2017*, cit., 52).

More precisely, the concept of HFT is normally associated with a wide spectrum of automated operational strategies used in financial markets, which represent a sort of evolutionary step forward compared with simple AT. They mainly exploit the speed of execution of transactions and try to maximize the competitive surplus value that this speed can generate. The can also place many similar or identical orders (sale, purchase, booking, cancellation, withdrawal and so on) at the same time and thus cause immediate reactions in other operators, most of them also consisting in automated systems, that perceive the relevant moment on the market and operate accordingly.

As we mentioned, the more the market choices are made by automata, the greater the possibility of performing a large number of transactions in a short time. This is because the increased data-collection and calculation ability of modern computers, together with the strengthening of the communication channels along which the data pass, and the development of scientific methods for studying them, now allows – if equipped with the right algorithms and in possession of the largest and most complete set of information[33] – automated systems to make the choices best suited to their algorithm in a fraction of a second and infinitely multiply them in a very short time, varying the conditions relating to the operation with the changing situation[34]. So much so that HFT constitutes a further evolutionary stage of basic AT, often being set up with the deliberate aim, among other things,

[33]Automata that operate as financial traders use statistical analysis and historical series covering at least 10 years, but they are constantly fed moment by moment with new information that they receive or seek – also using 'semantic analysis' (See LEWIS, *Flash Boys. At Wall Street Revolt*, W.W. Norton & Co., USA, 2014) – on the most disparate platforms. They scan the Internet, and especially social networks, to detect events that can have some impact on the markets and even the mood of investors ahead of the competition.

[34]According to the most recent scientific findings, it takes about five minutes to read a newspaper article and three seconds to write a tweet of 140 characters. Naturally, algorithmic machines have different operating times, as their speed of transaction depends on the power of the processors used and is subject to the speed of light, so the physical distance between two nodes in the communication network affects the time needed to transfer data from one node to another. Systems using HFT not only require the most powerful software and hardware but they also have to be able to reduce their physical distance from trading centres, which in turn allows further reduction of the latency times and leads to a profitable transaction. (see, among many, ANGEL, *When Finance Meets Physics: The Impact of the Speed of Light on Financial Markets and Their Regulation*, in *The Financial Review*, 2014, p. 273).

of gaining economic/financial advantage from the presence of less evolved and more easily predictable algorithmic systems on the trading books[35].

A precursor of HFT, and therefore a first exemplar of AT, is commonly identified in the phenomenon of the so-called SOES bandits, a category of trader that emerged in the mid-1990s. They would carry out several operations a day in order to take advantage of the slightest variations in prices or market makers delays in order to update the prices offered in money or letter[36]. This was facilitated by the decision of the U.S. Securities and Exchange Commission to allow the use of alternative trading systems running parallel to the regulated markets. These systems, operating through computer platforms that bypassed the services offered by the broker-dealers, came to be known as Electronic Communications Networks (ECN). They basically correspond to the MTFs (Multilateral Trading Facilities) now regulated by MIFID in Europe.

The ECNs ran parallel to the regulated markets because, by express regulatory provision, orders given on the former could not be executed on the latter. Consequently, the best price for a transaction on an ECN could actually be lower than the best regulated market price for the same product at the same time, thus damaging investors who had chosen to operate on a platform running as an alternative to the regulated market.

The need to reduce the risk of inefficiency in automated systems operating on ECNs gave impetus to the development of AT equipped with algorithms and technological infrastructures that could allow them to operate very quickly. The fact that different prices for the same financial instruments might appear on the market actually increased the possibilities of taking advantage of arbitrage to the benefit of the operators who, by operating more quickly than the others and being able to process the information present in the various markets more effectively, were able to turn the differences in price that sometimes occurred to their advan-

[35]On this see, again, Puorro, *op. cit.*, part. 9.
[36]See HARRIS and SHULTZ, *The trading profits of SOES bandits*, in *Journal of Financial Economics*, vol. 50 (1997), 39.

tage. Thus, the fastest and most informed trader could buy at the lowest price on the market, often offered by the less informed trader and, at the same time, sell at the highest price. This would bring a gain at zero risk, exploiting both the price differences and the information asymmetry that, as we have seen, depended on the structure of the markets themselves. To counter this phenomenon, in 1997, the SEC imposed the *Limit Order Display* on market makers, obliging them to inform all traders what was the best buy and sell price at any time on the entire market, including ECNs.

A further important factor in the development of the technology behind the HFT is the 2007 US regulatory measure called the Regulation National Market System (Regulation NMS). It included two rules that had a considerable impact on the phenomenon in question[37].

Under the first, the Sub Penny Rule (Rule 612), the U.S. SEC requires all markets to use the decimal system to calculate the prices of shares above or equal to the unit. This limited the 'bid-ask' spread, reducing the cost to the investor of buying and selling a single stock, and at the same time prompting traders to develop increasingly sophisticated algorithmic trading systems to take advantage of minimal price fluctuations.

Under the second rule, the Order Protection Rule (Rule 611), the SEC overcame the problems related to the structural inefficiency of ECNs, related to the lack of information exchange, and, at the same time, replaced the concept of 'best execution' with that of 'best price', according to which the broker who receives an order to buy or sell is obliged to transfer it to the market with the best market price, if there is no possibility of offering the best price in the market in which he operates.

4.1. On closer inspection, the promulgation of the rules mentioned above, although quite recent, are already pieces of history, considering the pace of evolu-

[37]See PANCS, *Designing Order-book transparency*, in *Electronic Communication Network*, J. Eur. Econ. Association, 2014, 24.

tion of the financial markets in recent decades. In this respect, suffice it to say that in the United States alone – where until recently, as we may recall, operation only took place in regulated markets – there are currently more than sixty trading venues for shares, all in competition with each other. This, in addition to being groundbreaking, paves the way for more skilled and faster high frequency traders to obtain excellent results while minimizing the risks, for the reasons mentioned above[38].

Thus, the best organized and most aggressive market operators today focus on the possibility of obtaining constantly improved performance from their technological trading tools, which are superior in terms of speed of making and handling a trading decision on the market, as well as in terms of volumes of trading operations carried out in the shortest time possible. It is clear, in fact, that the more operations the single trader can carry out in the shortest possible time to affect the work of his competitors, or even just to anticipate it, the more useful the operations will be to him. And this will be even evident when, in the next section, we examine the most common strategies adopted by those who do HFT.

From this standpoint, notwithstanding the decisive importance of the power of the software and hardware used by individual operators, reduction of latency times due to the physical distance between the traders' servers and the market platforms is also of fundamental importance[39].

In other words, since orders are electrical impulses that, despite travelling at very high speeds, encounter the limitation of the physical space to be covered, as already mentioned[40]. Thus, a trader wishing to be at the forefront, even using a

[38]On this point see FOX – GLOSTEN – RAUTERBERG, *High-Frequency Trading and the New Stock Market: Sense and Nonsense*, cit.

[39]Latency is the time it takes to carry out the series of operations necessary to move from decision to execution. In today's structured financial markets, in addition to data-processing speed and the time taken to 'decide' to make an investment (or divestment), latency is a key factor in terms of the time that elapses between the operator taking the decision and the moment when the broker receives the order. Latency also impacts on the time needed for the broker to process the order (and thus understand all the elements it contains) and send it to the market where the financial instrument in question is traded, not to mention the time between the moment the order reaches the market and the disclosure of the data to all participants.

[40]See note 34.

system based on an efficient algorithm and a powerful computer processor, may find that it may not be enough to win the competition with other market players. This is because physical distance from the platforms where the stocks are actually traded prevents a decision that has been made quickly and efficiently from reaching the market with equal celerity. Moreover, the same distance can also slow down the acquisition of market information that the software has to carry out moment by moment. This further impairs the decision-making and enforcement process that the automaton has to perform to achieve the desired profit.

To overcome these problems, several private companies have built, or are building, increasingly modern and secure network infrastructures to speed up and make less risky the transfer of data from one point of the network to another so as to promote even more competitive performance with respect to HFT operators. The key is to have a server located not physically far from the preferred trading platform.

Consequently, the phenomenon of 'co-location' has emerged. This is a commercial service offered by the trading platforms themselves, which allows participants in the market, or any interested party, to rent spaces ('racks') near the market platforms in order to locate their servers nearby. An alternative to co-location is 'proximity central hosting', i.e. an IT hospitality service offered by a third party to the interested parties allowing them to carry out their market orders from a physical position close to their chosen platform. On the issues of co-location and proximity central hosting, recent regulatory measures have been put in place in Europe to try to ensure operators have equal conditions of access to different services, as will be briefly illustrated below.

4.2. Increasingly widespread high-frequency financial trading has led to the emergence, or at any rate, the worsening, of certain market situations considered unhealthy, i.e., unsuited to promoting adequate conditions of market development, as well as the opportunities for abuse by the most unscrupulous operators to the detriment of less aware and organized investors.

The first problem, “ghost liquidity”, although not exclusively attributable to HFT, is (also) closely correlated to the use of the more dynamic and aggressive trading technologies. In short, volumes of exchange can increase at any given moment thanks to the use of the most up-to-date high-frequency trading technologies for any number of reasons, especially when there is turbulence on the markets: 1) automata can decide to activate very short-term risk-reduction strategies (buying and selling in the span of a few minutes), and 2) automata inevitably influence each other, so if an automaton decides to buy up a huge amount of a given stock, the others, that collect information on the market and price variations, can also decide to buy that or some other stock, which can bring about a positive moment for the stock exchange and can turn a positive one into one of euphoria.

This gives the impression that new liquid assets have entered the market, but in fact there is nothing, so from then on, thanks to the above-mentioned short-term strategy, the automata will probably begin to sell in order to monetize the gain (and therefore increase the price of the security), quickly setting bearish strategy in motion.

Furthermore, economic theory has identified some strategies, typically adopted by those who operate on high-frequency financial markets, which, if implemented by operators with considerable portfolios or strong liquidity and cutting-edge technologies, can create distorted representations of the trading book and consequent market abuse.

The best known of these are ‘stuffing’, ‘smoking’, ‘spoofing’, ‘layering’, and ‘front running’.

The term ‘stuffing’ refers to the practice of placing a large number of orders on the market using high-frequency trading systems at the same time so as to create a ‘fog’ effect, thus preventing slow traders – operators who do not use advanced technologies – from having an immediate and exact view of what is happening, so they can take advantage of the paralysis of their competitors to carry out profitable operations.

'Smoking', on the other hand is the practice of placing attractive bluff orders for one or more products in order to capture the attention of other operators, especially slow traders, and then immediately changing the trading conditions of the products in question and taking advantage of the slowness of other operators in noticing the change.

The term 'spoofing' refers to operations carried out by traders in order to alter the price trend of a target product (or at any rate its trading conditions). In a nutshell, if a trader intends to sell a product from his portfolio in order to raise the price and sell higher than the best price on the market at that time, he can flood the system with massive orders to buy that product and induce competitors to believe that there really is increased interest in the product and that there is therefore a good chance that the value of stock will increase, thus making it worth buying. Market reactivity to phenomena like this, and the fact that automata observe and talk to each other (as we have already observed), soon hike up the price of the product in question. In the meantime, the trader who started the process takes advantage of the speed of his systems to cancel the orders before they are executed and places the sales orders he was actually interested in from the start, making profitable transactions for him, as sales will probably be finalized at a higher price than the starting price.

The term layering denotes a variation of spoofing, where a trader wishing to spark off a market reaction in the opposite direction to the operation he intends to execute with a given product or products does not place two different orders on the market, namely the one he means to cancel and the true one at slightly different times, as above. He places them simultaneously. However, the first is visible to other operators, while the second is a "hidden order" (and therefore not visible in the trading book). In this way, the market is led to believe there is a certain movement of the market, while the trader operates using hidden orders on the opposite side of the order book, taking advantage of the market's reaction to the visible order, which, in the meantime, is cancelled.

The last, and perhaps most strongly opposed, practice that deserves our attention here is that of 'front running'. It can only be performed by intermediaries operating on the market both on their own account and on behalf of third parties. In this case, the trader, knowing the order that he is about to place on the market for his client, exploits the speed allowed by his computerized trading systems to place an order on his own account (similar or opposite to that of the client) a few moments before placing the client's order on the same market.

These few simple remarks clearly show that the use of high-frequency trading systems paves the way for market manipulation, which can bring the more aggressive and better organized traders huge profits in the short term, but at the same time, not only do they penalize the other operators, but they risk triggering copycat behaviour and further distortion of the markets. This has the overall effect of creating inefficient trading conditions on all markets in the medium term[41]. It goes without saying that the competent authorities are unable to prevent the practices in question from being carried out. In any case, as we have already mentioned, some scholars believe that the use of high-frequency trading systems can actually improve the quality of markets in terms of volatility, liquidity, information, and prices.

In order to prevent fraudulent use of the algorithms leading to market abuse, the market regulatory authorities and legislators in the more advanced countries have adopted regulation to address the issue of high-frequency financial trading, as we shall see in the next two sections.

One more important factor needs to be underlined: despite the millions of daily financial operations that can be categorized as algorithmic trading, there is

[41]IEX was set up in the United States in 2013 to counter the risks associated with the use of high-frequency trading, and to enhance the stability and security of the markets. It is an information-technology platform currently owned by a number of investment funds, where securities can be bought and sold on the stock exchange in different ways from those allowed on other platforms, especialy ways that combat high-frequency trading. For example, to avoid predatory arbitrage, a minimum order latency (350 milliseconds per transaction) is required, co-location is prohibited, and privileged access to market information by some operators but not others is forbidden. See PICARDO, *How IEX Is Combating Predatory Types of High-Frequency Traders*, in *Forbes - Investopedia*, available online at "https://www.forbes. com/sites/investopedia/ 2014/04/23/how-iex-is-combating-predatory-types-of-high-frequency-traders/".

no current record of any significant dispute between private parties to an automated financial transaction: at any rate nothing has hit the front pages, nor has anything come to the attention of scholars.

In practice then, there have been no significant problems regarding the malfunctioning of automata and consequent liabilities concerning, for example, failure to finalize a contract, misunderstanding contractual intent, errors regarding inserting data into the system, or using an electronic impulse, or anything else[42]. This is because, on the one hand, those who use algorithms inevitably accept the risks connected with them (naturally seeking to reduce them to the minimum and taking precautions against the possibility of problems occurring); on the other hand, the speed of the swaps and the importance that trust and reputation have in the financial markets advise against, if not completely prevent, any disputes about the correctness of an automated operation being made known to third parties, as they are handled by the parties themselves and resolved via private systems of dispute resolution alone[43].

A major problem, is, of course, the difficulty supervisory bodies encounter in tracing which software, and so which automatic system, has caused a given market reaction, and to evaluate its actions in terms of lawfulness or illegality in order to apportion any civil, administrative, and/or criminal liability. From this point of view, the traditional juridical rules governing the phenomenon are evidently inadequate[44].

4.3. The first regulatory action relating to HFT date back to the period when, after the 2010 crash mentioned above, two key actors in the U.S. regulatory

[42]Over the last few years, news stories have reported numerous cases of errors (or alleged errors) committed by automata operating in the financial markets that have led to significant stock market movements and/or heavy damage to the traders involved. On the subject in general, see ALDRIDGE – KRAWCIW, *Real-time Risk. What Investors Should Know about Fin-Tech, High Frequency Trading and Flash Crashes*, Hoboken (New Jersey, USA), 2017.
[43]See, among various, ANDREOTTI, *Dispute resolution in transnational security transaction*, Oxford and Portland (Oregon, USA), Hart Publishing Plc, 2017.
[44]For some interesting considerations on the causes and extent of this failure, see YADAV, *The Failure of Liability in Modern Markets*, in *Virginia Law Review*, vol. 102 (2016), 1031.

framework, the SEC and the Commodity Futures Trading Commission (CFTC), jointly presented a report in quick response to an episode that had given rise to concerns about how high-frequency trading is carried out.

The first American regulatory response was to set up a mechanism to identify the activity of 'large traders' whose particularly high volume of trading, due in part to their technical, IT and organizational capabilities, is able to condition market prices[45]. This would make it easier for the authorities themselves to control the activity of the large traders by requiring them to provide the said authorities with information.

This obligation was part of the broad-ranging regulatory reform known as the "Dodd-Frank Wall Street Reform and Consumer Protection Act", strongly supported by the Obama administration, in order to promote fuller regulation of the American markets and provide better protection of the consumers[46].

Among the most significant changes brought by the reform to the world of HFT, the following particular stand out: a) the possibility for the SEC to require hedge funds to draw up reports containing information relating, for example, to the types or amount of assets held, and to make it – and any other information useful for assessing the fund – public; b) setting up a new institution, the Financial Stability Oversight Council (FSOC), to supervize the stability of the market and the financial system as a whole; and c) stricter regulation of the Commodity Market, where it is forbidden to revoke or cancel orders.

In addition, immediately after the reform came into force, the SEC issued two rules, Rule 13h and Rule 13h-1190, requiring, i) large traders to identify themselves as such through written application to obtain a Large Trader Identification Number (LTID), a *conditio sine qua non* for operating as such on the markets, and

[45]See PRASCH, *The Dodd-Frank Act: Financial Reform or Business as Usual*, in *J. Economic Issues*, 2012, 186; M. Richardson, *Regulating Wall Street: the Dodd-Frank Act*, in *Economic Perspectives*, 2012, 45.

[46]The official document containing the reform that American legislator itself called the "*Dodd-Frank Wall Street Reform and Consumer Protection Act*" (12 USC 5301), and approved on 21st July 2010, may be consulted on line at "https://www.congress.gov/111/plaws/publ203/PLAW-111publ203.pdf". See, among many, RICHARDSON, *Regulating Wall Street: the Dodd-Frank Act*, in *Economic Perspectives*, 2012 199.

ii) that such actors present their Large Trader Identification Number to all brokers and/or dealers through whom they have traded on the NMS; iii) that brokers and/or dealers, upon specific request provide the SEC with data relating to transactions carried out by large traders in the NMS by the morning of the day following a transaction; iv) that brokers and/or dealers maintain and constantly update their accounting books and records for any such transactions[47].

The new regulations in question, however, reveal some serious weaknesses, especially as their speed and precision makes algorithmic systems so increasingly efficient that they can evade supervisory authority controls. For this reason, the present US Administration aims to modify the current HFT regulations, but there is still no certainty about the direction to take, as some observers call for the introduction of obligatory periods of latency or presence on the market for an order (to prevent spoofing, layering, and front running), and also to require traders who use technologies designed for high frequency operations to keep the markets updated with information, thus preventing them from taking advantage of the information asymmetry to the detriment of 'low traders'. Other observers, conversely, favour substantial deregulation of the phenomenon in order to promote competition based on technological competition.

4.4. In Europe, the MIFID I and MIFID II directives have introduced important rules on financial transactions carried out using intelligent information systems[48].

[47]See KINI, HARREL, LYONS, *Federal Reserve adopts key Dodd-Frank Act definition*, in *Banking Law Journal*, 2013, 47.

[48]This is, of course, European Parliament Directive 2004/39/EC of 21 April 2004 (the *Markets in Financial Instruments Directive*, hence the acronym MIFID), which, as of 3 January 2018 was replaced by MIFID II, with Directive (2014/65/EU) which, together with MiFIR, namely EU regulation 600/2014, *Markets in Financial Instruments Regulation*, now constitutes the European reference legislation on the matter. The literature on this subject is vast. For an overview of MIFID II, see, among others, PEZZUTO – RAZZANTE, *MIFID II: Le novità per il mercato finanziario*, Turin, 2018; TROIANO – MOTRONI, *La MiFID II, Rapporti con la clientela-regole di governance-mercati*, Padua, 2016; and CAPRIGLIONE, *Prime riflessioni sulla MiFID II (tra aspettative degli investitori e realtà normativa)*, in *Riv. trim. dir. ec.*, 2015, 72. On MIFID, see F. Capriglione, *Intermediari finanziari, investitori, mercati: il recepimento della MIFID. Profili sistematici*, Padua, 2008.

In particular, the latter – expressly acknowledging the positive effects that the introduction of new information and communication technologies has had on the markets – has introduced, or in some cases more fully defined, certain obligations for traders using AT systems and additional obligations for traders using HFT systems.

The most significant innovations include: a) the provision that operators using high-frequency trading techniques must be identified as such by the supervisory authorities and other market operators; b) the obligation for investment firms using automatic trading techniques to set up appropriate organization and control systems to ensure the resilience of their trading systems; c) the obligation for all companies using TA techniques to engage in market making on a continuous basis, except in specific cases, in order to bring liquidity to the market in a regular and transparent manner; d) the obligation for those wishing to offer physical space allowing operators' servers to work close to the trading platforms to guarantee all operators equal conditions so that proximity is not the prerogative of only a few and does not become a competitive factor conditioning the market; e) the recommendation that the regulators of the various markets constantly monitor the work of AT and HFT systems and to encourage a more efficient structure for operators' commissions.

Along with the important innovations just mentioned, it should also be noted that among the main innovations already introduced by MIFID – and reiterated by MIFID II – is the recognition of alternatives to the regulated markets, with the consequent corollary effect of the liberalization of negotiation, and the further provision requiring *best execution* in the execution of trading orders. This recognition, for the reasons already mentioned above, has done much to foster AT, and especially HFT.

One can therefore safely say that in Europe it was the MIFID directive, combined with the development of the alternative markets mentioned above and

the gradual fragmentation of the market, that gave the decisive boost to the spread of the HTF[49].

Returning to the issue of the difference between AT and HFT, it should be noted that algorithmic trading is defined in Article 1 of MIFID II as a set of trading techniques where the choice of trading parameters, such as price, quantity, and the time taken to complete their trading, are left to the "choice" of a highly computerized algorithm. The automatic decision characteristic of AT, among other things, is not limited to the parameters of the individual trade but also extends to "whether to send the order" and how to manage the position once the trade is finalized.

MIFID II therefore identifies zero, or at any rate minimal, human intervention in financial instrument transactions as a fundamental characteristic of AT. Therefore, from a regulatory point of view, this category must include all transactions where an IT algorithm replaces human decision-making activity in trading choices. The article excludes from the category any computer system used only for transmitting orders to one or more trading venues, dealing with orders that do not involve establishing trading parameters, confirming orders, or post-trading handling of the operations carried out[50].

With regard to high-frequency algorithmic trading, MIFID II reaffirms the notion that HFT is a species within the broader genus of AT and distinguishes a specific and more binding regulation for the case in question. HT is described and classified as a set of very high-speed trading mechanisms generally used by operators who "operate on their own account" and use this form of trading to implement strategies of market making (with the risk of market abuse) and/or arbitrage strategies. Article 1 of MIFID II itself specifies how this case is characterized by: a)

[49]On this, see ESMA, *High-frequency trading activity in EU equity markets*, *Economic Report*, no. 1, 2014, part. 5.

[50]All the trading systems, even if highly sophisticated and computerized, that are used exclusively to execute and to manage a set of orders that have already been benchmarked are thus excluded, including those where the price, the quantity of the order, and the time when the swap is to take place have already been established by a human being. See BUSCH - FERRARINI, *Regulation of the EU financial markets: MIFID 2 and MiFIR*, Oxford University Press, Oxford, 2017, part. 137.

the use of "infrastructure designed to minimize network and other latencies, including at least one of the structures for algorithmic order placing: co-location, proximity hosting, or direct electronic access at high speed", b) "establishment by the system of initialization, generation, transmission, or execution of the order for the individual order or transaction without human intervention", and c) "high daily traffic of messages consisting of orders, quotations, or cancellations".

As mentioned above, the ontological difference between the two trading techniques leads to different forms of regulation, especially regarding exemption. Indeed, it should be reiterated that due to its characteristics and potential, HFT is considered to be more threatening to the market (see Recital 62 of MIFID II), and thus, "high-frequency algorithmic trading" requires the application of the relevant MIFID II rule also "to persons who deal in financial instruments other than commodity derivatives or emission allowances or related derivatives on their own account and who do not provide other investment services or perform other investment activities in financial instruments other than commodity derivatives, emission allowances or related derivatives". On the other hand, if these "persons" only use non-high-frequency information technology, the rules on AT will not be applied.

The rules introduced with the approval of MIFID II are also inspired by (and in any case rest on) the intensive work on AT and HFT that ESMA has been doing since 2010 (when it was still operating as CESR). In 2010, in fact, the authority issued a Call for Evidence to probe the structural problems of the financial markets in the light of the impact of new technologies, and in 2011 the same authority published a consultation document called "Guidelines on systems and controls in a highly automated trading environment for trading platforms, investment firms and competent authorities", followed on 24 February 2012 by the publication of the ESMA Guidelines on the same subject with the same title[51].

[51]The Guidelines are available online on the official ESMA website, at the following address: "https://www.esma. europa.eu/sites/default/files/library/2015/11/esma_2012_122_en.pdf".

It should be pointed out that these guidelines are expressly applicable also to entities other than investment firms that are not subject to MIFID if, and in so far as, they are operators with any sort of access to the trading platforms, directly via 'Direct Market Access' (i.e., through a form of electronic access that provides a variety of actors with entry into the market, be they intermediaries and otherwise, without having to become members, using infrastructures and systems made available by one or more participants), or through Sponsored Access (an agreement whereby a member of the market allows its customers to access the market using his/her own ID, in order to place orders directly on the market, but without using the member's infrastructure).

In extreme summary, we might say that ESMA was seeking to pursue two main objectives: firstly, to ensure fair and orderly trading, with particular emphasis on a substantially level playing field and information circulating among all those operating on the market, and secondly, to prevent users of high-frequency trading systems from engaging in market abuse[52].

The importance of the Guidelines and the role of the ESMA in the configuration of the European financial markets is confirmed by the range of powers conferred to the authority by MIFID II, establishing that the ESMA (albeit maintaining the possibility of issuing acts of soft law such as "Recommendations" and "Guidelines"), can and must issue real technical regulatory standards governing specific areas of the vast subject of algorithmic trading and, more specifically, high frequency algorithmic trading.

5. Our reflection so far, starting from the observation that the term 'smart contract' – principally coined by technologists – has entered the lexicon of jurists, has sought to answer two fundamental questions: what is meant by this term and what does it mean for a jurist to think about the new conceptual category?

[52]Pursuant to Legislative Decree No. 58/1998 (TUF) and its implementing provisions contained in Consob Regulation No. 16191/2007, these guidelines were partially implemented in Italy by Consob in its Communication of April 4, 2012.

The outcome of our inquiry is essentially that:

1) smart contracts are not contracts,

2) the terms 'smart contract' and 'blockchain' should not be confused, as they are two totally different and mutually independent phenomena,

3) the legal problems raised by the countless and widely different scenarios that can be classified as smart contracts require an analytical approach strongly conditioned by the technological ecosystem of reference and must, therefore, be addressed on a case-by-case basis,

4) for this reason too, the category in question has substantially no legal significance,

5) in any case, precisely because the nature of smart contracts and how they work depends so much on the technology used, they are significantly affected by technological developments so that any attempt made by jurists to understand and regulate the phenomenon risks becoming obsolete at the very moment it is carried out,

6) It comes as no surprise that, in the field of smart contracts, issues relating to the validity and effectiveness of contracts, or those relating to any liability, are normally handled independently by the computer systems concerned, and therefore with no recourse to the institutions and rules of the legal system.

To corroborate the assumptions summarized above, we have analyzed what happens in the financial markets, within which, for at least twenty years now, the use of computer systems, and therefore algorithms, to analyze data, take decisions and perform trading operations has spread, also (and especially) in order to carry out a very high number of operations in a very short time and enjoy a competitive advantage over less equipped operators.

As we have seen, mainly in sections 4 onwards, systems defined as algorithmic trading and, especially, high frequency trading are used every day to trade millions of securities in the securities markets around the world to a value of billions of euros, but national and supranational legislators have not intervened to regulate the phenomenon through *ad hoc* civil law rules to regulate contracts, the

fulfillment of obligations, and related responsibilities. Rather they have produced public (including potential criminal) law regulations, meant, for the most part, to combat market abuse[53].

These norms do not then aim to alter the existing relationship between the two or more parties to the transaction in question, still less to protect the interests of weaker actors. Rather, they have been conceived solely to protect the market from the negative effects that certain attitudes and/or behaviour of private operators may have on the flow and development of the market.

This observation underlines how technology is modifying the relationship between the law and the different arenas of human experience[54], as legal norms are increasingly being forced to (substantially) abandon the regulation of highly technological phenomena and are, therefore, prone to extremely rapid obsolescence and transnational dynamics[55]. This, however, appears to be well tolerated (if not favoured) by the market operators – or, at least, by the better organized and more influential ones on account of their technological and financial capabilities – as on the one hand they internalize the risk associated with the use of the new technologies through insurance or self-insurance mechanisms, and on the other hand they ensure that the risk of inefficient and damaging disputes is reduced to a minimum. Furthermore, they oblige each other to use private and highly technological systems to resolve any such disputes, also making it possible to limit the risk of repercussions on their reputations, possibly leading, at a given time, to distrust and wariness towards the individual operators concerned or even the market itself.

[53]For an updated and concise overview of the main criminal law issues relating to market manipulation, see MACRILLÒ – CAMINO, *Il diritto penale degli intermediari finanziari*, in Cassano – Tilli – Vaciago, *op. cit*., 517.

[54]On this subject, especially the private law crisis regarding current technological developments, kindly refer to DI CIOMMO, *Internet e crisi del diritto privato: globalizzazione, dematerializzazione e anonimato virtuale*, op. cit.; and ID., *Civiltà tecnologica, mercato ed insicurezza*, op. cit.

[55]On this subject, and for the literature referenced, kindly see DI CIOMMO, *Evoluzione tecnologica e regole di responsabilità civile*, Naples, 2003, esp. chapter 1.

Where technology and business organization cannot reach (namely with regard to the few contentious issues relating to new technology on the market that end up in the traditional courtrooms despite all best efforts), modern legal systems load judges with further responsibilities in addition to their traditional ones, at least in civil law legal systems, as they are asked to make up for the lack of pre-established rules by interpreting and applying (even creative) legal principles to deal with the new questions posed by a world that is changing too quickly and in too complex a way for legislators to keep pace with.

Whether or not this dynamic ensures conditions of formal and substantive justice is another problem that cannot be dealt with here[56].

Our discussion cannot close, however, without underlining that in such a scenario Jean Carbonnier's reflections on the so-called "Kingdom of Non-Law", expressed in terms of "Law and Non-Law", "Law of the Non-Law" and "The Right to Non-Law" are highly apposite [57]. Without, however, agreeing with the great French sociologist where he observes that the law is, by its very nature "flexible", since the juridical phenomenon (also independently of the concept of legal system), understood as a historical reality, not only continuously changes its very characteristics and operational registers due to the social changes it has to follow but expands or contracts in the exercise of its mission and therefore in the occupation of the normative spaces found in society as a function of the conditioning capacity that other factors and other normative agents express in the same society at the same time[58].

[56]On this subject, strongly debated in Italy and abroad for several years now, see the contributions in DI CIOMMO – TROIANO (eds), *Giurisprudenza e autorità indipendenti nell'epoca del diritto liquido. Studi in onore di Roberto Pardolesi*, Rome, 2018. Kindly see also DI CIOMMO, *Sulla giustizia ingiusta (dalla giurisprudenza normativa alla giustizia del caso concreto): la vicenda emblematica delle nullità negoziali*, in *Foro. it*., 2018, V, 249.

[57]See, in particular, CARBONNIER, *Flexible droit* (first edition., Paris, 1969), in Italian translation, *Flessibile diritto*, Milan, 1997; but also ID., *Sociologie juridique* (first edition., Paris, 1978), Paris Puf, 2004. *Among moany*, see also, CUCULO, *Ordinamento giuridico e non-diritto: rileggendo Jean Carbonnier*, in *Sociologia*, 2016, 312.

[58]For many authoritative scholars, the evolution of the relationship between the law and technology will inevitably lead to the decline of law, or at least the affirmation of the predominance of technology, but Carbonnier's approach seems more convincing and ultimately correct. On this, see, among many, the rich dialectic condensed in IRTI - SEVERINO, *Dialogo su*

This analysis allows (and forces) the contemporary jurist to observe how, at this moment in history, the marriage of technology and economics (or better, finance) has (perhaps momentarily) relegated law – at least in the sense in which it is still commonly understood – to a totally different operational, and possibly (and admittedly) even more modest dimension than the constituents of law have occupied for millennia, or at least until a only a few years ago.

diritto e tecnica, Rome-Bari, 2001, wherein the philosopher who advocates the end of law as we know it is counterbalanced by a jurist determined to defend law as the only means able to allow man to choose the "goals" to which technology can be applied.

MICROCREDIT IN THE ITALIAN AND BRAZILIAN LEGAL SYSTEMS: A BIRD'S EYE VIEW *

Roberto Miccù ** - Jose Luis Bolzan de Morais *** - Diego Rossano****

ABSTRACT: *The aim of this paper was to analyze the regulation of microcredit in Brazil and in Italy, contextualizing the activity of microcredit within the Italian legal systemconstitutional order, and identifying the reasons for its poor diffusion.*

We believe that Italy, similarly to what has taken place in Brazil where governments, over the years, have strongly promoted policies to favor the development of microcredit in the country, should invest more in this field. It appears, moreover, appropriate to identify, in law, less strict criteria for access to this sector, as well as more flexible conditions in the areas of auxiliary services, interest rates and capitalization of the microcredit entities.

1. In Italy between 2016 and 2018, the Italian "Ente Nazionale per il Microcredito" registered a three-figure increase in the request for microcredit from financial institutes under contract to it. The figures indicate an increasing trend in re-

*This paper is the result of a unitary approach and a common reflection by the three authors. However, paragraphs 1 and 5 can be attributed, in particular, to Roberto Miccù, while paragraphs 2, 2.1., 2.2., 2.3. can be attributed to Jose Luis Bolzan de Morais. Paragraphs 3, 4 and 6 can be attribued to Diego Rossano. Paragraph 7 can be attributed to the three authors.

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quests of more than three thousand only in 2018, with a net increase with respect to the 463 requests in 2016. This positive tendency also concerns financing actually provided: the credit check was positive in 88% of the cases, and the total sum was € 31.4 million, with a growth rate that from 2016 to date, has increased by 100% annually.

Even if these figures are only a fraction of the total annual Italian finance and banking market, microcredit is an important hub for national economic development, orientated at closing the gap between unexpressed potential, often due to the absence of an adequate guarantees and material economic situations. In synthesis, it appears to be an instrument for direct financial facilitation favoring the integration and increase of production, increasing company competitivity and accelerating the processes of inclusion and financial literacy of small economic initiatives.

Albeit originating – at least in its modern sense - in contexts of low and problematic levels of economic development, microcredit is, in this way, a very interesting instrument also in contexts that are highly advanced and equipped with an advanced financial industry. It is an effective alternative to traditional channels of credit that are often in the grip of regulations and high competitive pressure, both internal and external.

What are, briefly, the identifying characteristics of microcredit? In doctrine, microcredit is defined as the loan of a small sum, generally not supported by a traditional guarantee, with auxiliary services, offered to individuals or groups who are extremely poor or who are victims of financial exclusion[1].

On the practical level and in the context of the various juridical regulations, the institute is then variously applied, assuming different characters[2] according to how the variables of the size of the loan, the absence of a traditional guarantee, the presence of auxiliary services, the nature of the beneficiary and thus the aim of the financing are stated. There therefore exist a variety of microcredit models that de-

[1]See LA TORRE, VENTO, *Microfinance*, Palgrave Macmillan, 2006.
[2]See BOTTI, CORSI, ZACCHIA, *La microfinanza in Europa: modelli a confronto*, *Moneta e Credito*, vol. 70, 2017, 101-129.

pand on geographic context and procedures of reference, especially in industrialized countries[3].

The characteristics of the legal system in which the phenomenon of microcredit (think of India)[4] was originally created and diffused encouraged us to associate to the experience of laws such as those in Brazil, a country between those that are strictly "under development" and those of the most developed countries, to the Italian legal-financial system, with the aim of obtaining a "lesson" on the possibility of improvement and growth of an instrument such as microcredit[5].

With this aim, in this paper we will focus on the analyses of the regulation of microcredit in Brazil and in Italy, contextualizing the activity of microcredit within the Italian legal system[6], and identifying the reasons for its poor diffusion.

2. The interest in microcredit in some way dialogues with the transformations in the forms and formulas of state intervention, under the model of the Social State, in a context of change of perspective, especially due to economic changes when the relationship between the gross domestic product, and financial assets drifts towards the latter in the proportion of dollars from four to one, which is not necessarily confused with a preponderance of the private sector in the supply of credit to these sectors.

On the other hand, it is necessary to consider the transformations in the productive models and in the labor market, which contributes to the expansion of the number of small entrepreneurs circulating in the credit markets, many if not the majority, with difficulties of access to traditional financial services mechanisms.

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[3]See GARRIDO-PRIOR, *Bancarización y microfinanzas. Sistemas financieros para las Mypymes como un dilemma central para el Desarrollo economico en Mexico*, in *Financiamento del crescimiento economico*, ed. Calva, Mexico, 2007, 57 ff.; MARTINEZ, Microcrédito y pobreza en Venezuela: un caso de estudio, Revista mexicana de ciencias politicas y sociales, 2006,p. 95-112

[4]See YUNUS, *Il banchiere dei poveri*, Milano, 2007

[5]See CONDE BONFIL, *Contribucion de las microfinanzas al desarrollo economico y social. Desafiós actuales*., in *Financiamento del crecimiento economico*, ed. Calva, Mexico, 2007.

[6]See LA TORRE, *Il microcredito in Italia tra regolamentazione e mercato*, in Bancaria, 5, 2015, 2 pp. 2 ff.

All this, as it happens in Brazil, must be well understood so that one can understand such novelties and give adequate and qualified answers to them.

Thus, we will here make a small historical development of the microcredit situation in Brazil, especially in the legislative perspective, in order to try to recognize the conditions of possibility for its success or not, responding adequately or not to the economic circumstances peculiar to small activities small-scale trades and manufactures, usually located in the peripheries of the metropolitan regions and in the small cities of the interior of the country, in particular.

2.1. In Brazil, the first experience in microcredit was developed by the Northeastern Union for Assistance to Small Organizations in the cities of Recife (PE) and Salvador (BA). Known as Program One, it ran from 1973 to 1991.

In the 1980s, in the forefront, the first experiences of what could be classified as microcredit emerged, exemplarily the Ceape Network and the Women's Bank, affiliated with international networks - Acción Internacional, Banco Interamericano de Desenvolvimento (BID), Inter-American Foundation e Women's World Banking.

On the other hand, in the 1990s, the first public programs focused on microcredit emerged. In 1996, the National Bank for Economic and Social Development (BNDES) created the Popular Productive Credit Program (PCPP), which provided financial resources to civil society organizations specializing in microcredit. In 1997, the Banco do Nordeste (BNB) launched the CrediAmigo Program and in 1999, Law nº. 9790/99 - called the Third Sector Law - entered into force, which established the so-called Civil Society Organizations of Public Interest (OSCIPs) as non-profit private legal entities, including microcredit as one of the purposes of these entities, through access to public resources for the provision of these funds.

In 2001, under Law nº. 10194/01, the creation and operation of micro-entrepreneurial credit societies (SCMs), legal entities under private law, with a profit-making purpose, were created to encourage the participation of private sector actors in this market.

Then, in 2003, the Federal Government stipulated that banks could use up to 2% (two percent) of the compulsory deposit to which they are liable as capital to shore up their productive and targeted microcredit operations, allowing those who did not have structured operations to negotiate this capital with other organizations that were interested in using microcredit resources.

And, on April 25, 2005, the National Program of Productive Oriented Microcredit (PNMPO) was established, through Law nº. 11110/05, and, on August 24, 2011, under the Brazil Without Misery Plan and PNMPO, the Federal Government launched the Growing Program.

In the same way, over the last twenty years, several state and municipal governments have implemented their own microcredit programs, such as: "Microcredit Program" of Santa Catarina's State Development Agency SA (BADESC), "CredPop" of Minas Gerais's Bank of Development SA (BDMG), "Our Credit" from Espírito Santo's Development Bank (BANDES), among others.

Now, on March 20th, 2018, the Federal Government enacted Law nº 13636/18, amending Laws nº 11110/05 and nº 10735/03, with the conversion of Provisional Measure nº. 802/17.

In this legislation, despite the vetoes imposed by the Federal Chief Executive, reviewing the National Program of Productive Oriented Microcredit (PNMPO), the objective of supporting and financing productive activities of entrepreneurs is reiterated, mainly through the provision of resources for productive microcredit (art. 1°), benefiting natural and legal entrepreneurs of urban and rural productive activities, presented individually or collectively (§ 1°), provided that they have income or gross annual revenue of up to R $ 200,000.00 (two hundred thousand reais), defining (article 1°) what it considers productive oriented microcredit:

§ 3º . For the purposes of the provisions of this Law, it is considered productive microcredit oriented the credit granted to finance the productive activities, whose methodology will be established in regulation, observing the preference for the direct relationship with the entrepreneurs, admitting the use of digital and elec-

tronic technologies that can replace the face-to-face contact. (translated by the author)

Also, it established (art. 3º) which institutions are authorized to participate or operate the PNMPO, bringing together public, private, cooperative, OSCIPS and FINTECHS entities[7].

On the other hand, because of the very characteristics of this type of credit and of its borrowers, credit operations were allowed to be guaranteed using several guarantee instruments (jointly or individually) (art. 5º)

In order to manage the Program (PNMPO), it provided in its operational structure an Advisory Council and a National Microcredit Forum (art. 7º). The first is consultative and propositive, composed of representatives of the Union's organs and entities, with the purpose of proposing policies and actions to strengthen and expand the Program; and the second, with the participation of competent federal agencies and representative entities of the sector, with the objective of promoting the continuous debate among the entities related to the segment[8].

Thus, the legislative formulation is set, and it can be seen that the PNMPO, instituted by Law nº. 11110/05, amended by Law nº 13636/18, maintains, as general

[7]As stated in art. 3º: I - Caixa Econômica Federal; II - National Bank for Economic and Social Development; III - commercial banks; IV - multiple banks with commercial portfolio; V - development banks; VI - central credit cooperatives; VII - individual credit cooperatives; VIII - development agencies; IX - microentrepreneur and small business credit societies; X - civil society organizations of public interest; XI - credit agents established as legal entities, under the terms of the National Classification of Economic Activities (CNAE); XII - fintechs, thus understood the companies that provide financial services, including credit operations, through electronic platforms. (translated by the author)

[8]In art. 7º: I - Ministry of Labor, who will preside; II - Ministry of Finance; III - Ministry of Social Development; IV - Ministry of Industry, Foreign Trade and Services; V - Ministry of Planning, Development and Management; VI - Ministry of National Integration; VII - Secretary of Government of the Presidency of the Republic; VIII - Central Bank of Brazil; IX - National Bank for Economic and Social Development; X - Caixa Econômica Federal; XI - Banco do Brasil S.A .; XII - Banco do Nordeste do Brasil S.A .; XIII - Banco da Amazônia S.A .; XIV - Civil House of the Presidency of the Republic; XV - National Institute of Colonization and Agrarian Reform. In addition to these, the following may be invited: I - National Forum of State Secretaries of Labor (Fonset); II - Brazilian Service of Support to Micro and Small Companies (Sebrae); III - Brazilian Association of Microcredit and Microfinance Operators (ABCRED); IV - Organization of Cooperatives of Brazil (OCB); V - Brazilian Association of Microcredit Societies (ABSCM); VI - Brazilian Development Association (ABDE); VII - Brazilian Federation of Banks (Febraban); VIII - National Union of Cooperative Solidarity Organizations (Unicopas); IX - Brazilian Forum of Solidarity Economy (FBES).

objectives:

• Encourage the generation of work and income among the popular microentrepreneurs.

• Provide resources for targeted productive microcredit.

• Provide technical support to targeted productive microcredit institutions, aimed at strengthening them to provide services to popular entrepreneurs.

Under the PNMPO, targeted microcredit is the credit granted to meet the financial needs of this public, using a methodology based on direct relationship with the entrepreneurs in the place where the economic activity is performed.

According to MTb data, in the Balance Sheet for 2016, that can be find on the website http://trabalho.gov.br/noticias/4444-programa-atende-3-6-milhoes-de-microempreendedores-com-mais-de-r-11-bilhoes, sustains that:

More than R $ 11 billion were released to 3.6 million microentrepreneurs in the country, through the National Program for Productive Microcredit (PNMPO), coordinated by the Ministry of Labor and operationalized through public and private banks, development agencies, credit unions, Civil Society Organizations of Public Interest (OSCIPs), Microentrepreneur Credit Societies and Small Business Enterprises (SCMEPP). (translated by the author)[9]

In the same way, on August 24, 2011, under the Brazil Without Misery Plan and PNMPO, the Federal Government launched the "Grow Program", through the edition of Provisional Measure (MP) 543, as amended by MP 554, of December 23, 2011, and finally converted into Law 12666 of June 14, 2012. This, Grow Program authorized the Union to grant economic subsidy, limited to R$ 500 million per year, to

[9]It is interesting to note, according to the same electronic address: "According to the IBGE National Household Sample Survey (Pnad), the number of entrepreneurs in Brazil corresponds to a quarter of the employed workforce (24.4%) and exceeds 23 , 1 million people. Of these, 84.6% are self-employed and 15.4% are employers.
In this context, estimates indicate that 21.8 million people can reach the number of entrepreneurs who can become PNMPO clients - 85.7% self-employed and 14.5% employers. Of this total, 80.9% are in urban areas and 19.1% in rural areas." (translated by the author)

financial institutions that carry out operations of productive microcredit oriented to first floor, as long as that they carry out productive microcredit operations with the final borrower, microentrepreneur with annual gross revenues of up to R$ 120 thousand, under the following conditions:

- maximum amount of financing per operation: R$ 15,000.00;
- interest rate: 5% p.a. .;
- credit opening rate: 1% on the amount financed.

Also in the normative plan, there is a set of infra-legal regulations, which make up the regulatory framework of microcredit, which may be mentioned: resolutions of the Central Bank of Brazil and, in particular, after the entry into force of Law 13636/18, nº 804 of April 24, 2018, of the, then, Ministry of Labor, through the Deliberative Council of the Workers' Assistance Fund (FAT), providing for the use of its resources for the PNMPO.

As can be seen, the history of microcredit demonstrates how this financing model has contributed and impacted the Brazilian economy. This history can be thought of, as suggested by Lauro Gonzalez, Lya Porto and Eduardo Henrique Diniz, in *cinco momentos*.

For them, it began in the decade of 1970, *by the articulation of the national microfinance institutions to the international networks*. Then, in a second moment, *civil society organizations were introduced as important actors*, followed in a third moment, by the end of the 1990s and beginning of the 2000s, government institutions began to act more strongly, especially at the state and municipal levels. The fourth moment starts with the edition of Law n. 10194/01, *which authorizes the institution of Microentrepreneur Credit Societies (SCM)*. Finally, the National Program of Productive Oriented Microcredit (PNMPO) gives rise to the fifth moment.

All this, for the authors, would make it possible to perceive the participation of different actors and strategies of action in this economic space, and the State acted in two ways: through the performance of public banks and / or the formulation of public microcredit policies.

Há, todavia, quem entenda que a experiência de microcrédito no Brasil deva retroagir apenas aos anos 1990, tendo o terceiro setor papel fundamental, seguido, a partir de 1998, pela criação do *CrediAmigo* do Banco do Nordeste, pela participação dos bancos públicos

There is, however, some who thinks that the experience of microcredit in Brazil should only be retroactive to the 1990s, with the third sector having a fundamental role, followed, since 1998, by the *CrediAmigo* Program of Banco do Nordeste, by the participation of public banks[10].

2.2. In general terms, microcredit assumed a normative meaning in Brazil, being present in Law nº 10735/03, initially, when this legislation determines that a portion of demand deposits of multiple banks, with commercial portfolio, commercial banks and Caixa Econômica Federal bank, should be applied for the supply of this type of credit. This conception was amplified by Law nº 11110/05 - National Program of Productive Oriented Microcredit (PNMPO) - having as sources of funds the Fund for Workers' Assistance (FAT) and funds from demand deposits in banks that have a mandatory destination.

With Law 13636/18, microcredit was linked to that one granted to finance productive activities, preferably through direct relationship with entrepreneurs, but accepting the participation in this field of technological means, as stated in its art. 3º.

Taking this into account, it can be said that, in Brazil, there are two types of microcredit. On the one hand, one, which the objective is the fight against poverty, destined to the generation of employment and income for the needy populations, as, was originally thought. On the other hand, there is the *business* model, which is widely distributed, aimed at financial support and also, often, technical, for small enterprises and entrepreneurs.

On the one hand, we have a model that is more focused on social inclusion

[10]See: COSTA, Fernando Nogueira da. Microcrédito no Brasil. Text for debate. IE/UNICAMP. N. 75. April, 2010

and, on the other hand, one aimed at those who already "venture" in entrepreneurship, in small businesses.

There is also what could be named as public microcredit, offered by entities linked to the State - and corresponding to the largest share of supply - and private microcredit, from economic market agents.

2.3. Revisiting the history of microcredit in Brazil, one notices that although it began in the 1970s, it gained momentum with the governments linked to the Workers' Party, as a rule through policies of social inclusion[11].

However, it has always been verified that one of the greatest needs of the segment is the creation of new funding modalities, concentrated in banking institutions and credit cooperatives - in these only for their associates, despite the role played by the resources public funds managed by the banking and credit institutions managed by the government, especially through funds derived from funds raised from the labor market and from economic agents, such as the Fund for Workers' Assistance (FAT).

In any case, one must always bear in mind that Brazil still lives with a definition constructed decades ago, that of being a "Belindia" - a Country that has a small part of the population living with Belgian economic standards and, on the other hand, of a broad stratum of citizens living in India.

In other words, Brazil presents itself as a country composed of a significant number of poor people and excluded from the financial system, alongside a small number of people with broad access. In fact, this means that the country's socio-economic division is replicated in terms of access to credit, prioritizing economic ac-

[11]As Fernando Nogueira da Costa points out: The biggest financial innovation of the Lula government was popular credit. This program did not follow the pure microcredit model of the Grameen Bank in Bangladesh. But it was a Brazilian model, with modern banking technology, used to deal with specific problems of urbanized society (84% of the population live in cities), mass (the fifth largest population in the world), spread over gigantic territory (almost half the continent) and with great disparity of income. Promoted popular consumer market in the country. View, by the author: Text for Discussion. IE/UNICAMP, Campinas, n. 175, apr. 2010.

tors with greater capacity both in terms of individuals and companies. In addition, since Brazilian inequality is also expressed in geographic terms, there is a concentration of access in the most privileged regions, thus promoting a double advantage for those who already have greater and better economic and financial capacity.

This leads us to consider the importance of microcredit when it comes to financing those who most need it and who are in the most impoverished regions of Brazil.

Thus, with the expansion of the actors involved - see the list present in Law nº 16636/18, art. 3º - there is, at least in terms of legislative recognition, the possibility of participation of several economic actors in the microcredit supply process, in addition to public entities, still predominant, especially in terms of the contribution of resources for this purpose .

This seems to be an important way, even as a mechanism to combat the high unemployment rates observed in the Brazilian economy in the last years - as shown by the surveys of the Brazilian Institute of Geography and Statistics (IBGE)[12] - and indebtedness and default rates - as indicated by the National Consumer Indebtedness and Indebtedness Surveys (PEIC) [13] carried out by the National Confederation of Goods, Services and Tourism (CNC) -, which has led many families to entrepreneurship as the only alternative - as can be seen from the data growth of Individual Microentrepreneurs (MEIs) [14] in the period.

[12]The unemployment rate in Brazil fell to 11.6% in the quarter ended in November, according to data released by the Brazilian Institute of Geography and Statistics (IBGE) in November 2018, influenced once again by the growth of informal work and Brazilians who work on its own. In the October survey, unemployment in the country was 11.7%. A year ago, unemployment was 12%.

[13]"The percentage of families who reported having debts between pre-dated check, credit card, overdraft, store card, personal loan, car and insurance provision reached 59.8% in December 2018, which represents a decrease in compared to 60.3% in November 2018. It was the second consecutive monthly decrease. There was also a reduction compared to December 2017, when the indicator reached 62.2% of the total families." (PEIC, dez/2018. See in: http://cnc.org.br/sites/default/files/arquivos/release_peic_dezembro_2018.pdf, translated by the author)

[14]The MEI - Individual Microentrepreneur - is one that works on its own, has a small business register and exercises one of the more than 400 types of services, commerce or industry. The MEI figure emerged in 2008, with Complementary Law No. 128, seeking to formalize Brazilian workers who, until then, performed various activities without any legal protection or legal security. With legislation

On the other hand, data indicate that the balance of the microcredit portfolio declines in the last years, in the order of 13.2% in April 2018, compared to the same month of 2015, from R $ 5.3 billion to R $ 4, 6 billion and, on the other hand, interest rates rose from 22.5% to 29.2, even as the default rate dropped from 5.7% to 3.1%, in the same comparison.

Such circumstances, according to financial analysts, stem from the concentration of operators, in particular, which can be reversed or minimized, with the extension allowed by the new legislation, especially with the entry in this field of *fintechs*.

3. In Italian law it is known that the activity of public financing is reserved for banks and financial intermediaries authorized by the Banca d'Italia and registered in a specific list for those having specific requisites[15].

Exemptions are particularly limited, given the need to prevent the risk deriving from uncontrolled expansion of credit and of entrusting financing only to those who possess an adequate technical-economic ability. However, those professionals who work in the field of microcredit can access these exceptional regimes of exemptions in a framework of operators and regulatory forms of activity. These latter forms enjoy the advantages of a special regulation that allow them access to the market with less strict conditions with respect to other financial competitors, albeit with the stringent limits of a sector that looks at the financial support towards a chosen group of beneficiaries[16]. The Italian legislator, in fact, felt the need to delimit the field of application of the exceptions to the discipline of financial intermediaries with the objective of avoiding possible opportunistic behavior of operators to profit from legal facilities; of which the imposition of specific subjective requirements for providing

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in place since 2009, more than 7 million people have already been formalized as individual microentrepreneurs. (Ver: http://blog.sebrae-sc.com.br/voce-sabe-o-que-e-um-microempreendedor-individual-mei/)

[15]See, CAPRIGLIONE – LEMMA, *Comment on art. 106*, in *Commentario al Testo Unico delle leggi in materia bancaria e creditizia*, by Capriglione, Milan, 2018, p. 1566 ff.

[16]See, ANTONUCCI, *L'intermediazione finanziaria non bancaria nel d.lgs. 141/2010. Profili di sistema*, in *Riv. trim. dir. econ.*, 1, 2011, p. 29 ff.

microcredit and, as will be seen, the definition of a maximum ceiling for financing[17].

It appears evident how the legislator set out to create, in this field, a difficult reconciliation between the interests of some subjects not being able to access traditional sources of financing alternative to banking and financial channels and the need to prevent unscrupulous operators using less rigid rules to access the market. On the other hand, the necessity of introducing a specific law for microcredit appeared to be urgent for some time in as much as it had already been seen how the organizational and financial constraints of the ordinary regulations were a deterrent for those interested in working in this sector[18].

The regulation of microcredit was thus designed to safeguard the interests of the subjects belonging to the weaker levels of society and, in particular, in favor of those who want to undertake small-sized business activities and people excluded from normal credit circuits, and often labelled as "not bankable". In this regard, in Europe microcredit has been included among the instruments of social inclusion, even with the limits connected with the high management costs of financing carried by those who provide modest, short-term loans[19]. Nevertheless, attention towards this phenomenon has been, in a certain way, untimely: it was seen, in fact, that faced with a global financial crisis and the long double recession from 2007, microcredit

[17]See, BANI, *Comment on art. 111*, in *Commentario al Testo Unico delle leggi in materia bancaria e creditizia*, by Capriglione, Milan, 2018, p. 1635 ff.

[18]See, HARDY, HOLDEN, PROKOPENKO, *Microfinance Institutions and Public Policy*, *IMF Working Paper No. 02/159*, 2002; KARNAMI, *Regulate Microcredit to Protect Borrowers*, *Ross School of Business Paper No. 1133*, 2009, avaiable at SSRN: https://ssrn.com/abstract=1476957, according to which the regulation is needed to protect the microcredit clients in three areas: transparency, interest rate ceiling, and loan recovery practices.

[19]See, European Parliament, *Report with Recommendations to the Commission on a European Initiative for the Development of Micro-credit in Support of Growth and Employment*, 29 January 2009; European Parliament, *A European Initiative for the Development of Micro-credit in Support of Growth and Employment – European Parliament Resolution of 24 March 2009 with Recommendations to the Commission on a European Initiative for the Development of Micro-credits in Support of Growth and Employment*, 29 March 2009. See, also, 283/2010/EU of the European Parliament and of the Council of 25 March 2010 establishing a *European Progress Microfinance Facility for employment and social inclusion* and 1296/2013/EU of the European Parliament and of the Council of 11 December 2013 on a European Union programme for employment and social innovation (EaSI) and amending Decision No 283/2010/EU establishing a *European Progress Microfinance Facility for employment and social inclusion*.

could have efficaciously countered the restrictions that have affected the normal areas of support to productive activity[20]. On the other hand, the strong credit contraction and the imposition of severe measures of vigilance adopted at the global level and thus also at the European level, have certainly not favored the diffusion of microcredit [21].

In this context, in Italy, legislative decree no 141 (the transposition of directive 2008/48/EU) was adopted in 2010, that, modifying the Italian Banking Act, introduced art. 111 and 113. The regulatory framework of reference was completed with a certain delay by the legislative decree of 19th September 2012, n. 169, and the implementing of the ministerial decree of 17th October 2014, no 176, on which the general regulation was faced with addressing some significant shortcomings, especially as concerns the integration of aspects not of secondary importance with respect to the function of the area of microcredit.

It should be stated that in the Italian legal system, already before the introduction of the laws of 2010, microcredit was provided by non-profit ethical banks, consortiums of associations and legal entities (often religious)[22]. These organizations, however, operating without a defined disciplinary framework, have not benefited from an adequate support by public authorities in carrying out their respective activities, although the constitution of the Italian National Committee for microcredit (this non profit public entity was established in 2011) with the decree-law of 10th January 2006, no 2, converted into law 11th March 2006 no 81, has been adopted to encourage the promotion and the development of microcredit.

4. Article 111 of the Italian Banking Act distinguishes two types of microcredit.

The first is the concession of financing: *i)* individuals, *ii)* societies, *iii)* societies with limited responsibility, *iv)* associations, or *v)* cooperative societies, to start or car-

[20]See, RUSSELL, *An introduction to mutual funds worldwide*, West Sussex, 2007, *passim*; VALDEZ, MOLYNEUX, *An introduction to global financial markets*, Palgrave Macmillan, 2015, *passim*.
[21]See, BANI, *Commento all'art. 111,* cit., p. 1639.
[22]See https://www.bancheitalia.it/finanziamenti/the-microcredit.htm

ry out autonomous work or micro-enterprises. This financing has to have, however, three characteristics: a first element, of a quantitative assessment, consisting of the limit of the concession of financing for a sum not greater than € 25,000 and not helped by collateral guarantees; a second element is the finalization of this credit at the start or development of business initiatives or insertion in the work market; finally, financing has to be accompanied by auxiliary services, whose peculiarities are defined by the secondary regulation.

A different type of microcredit is, instead, more markedly social. This type of operation of microcredit is aimed at individuals in conditions of particular economic or social vulnerability. Also in this case there are a series of limits and elements that make up the *proprium* of the regulation being discussed: on the one hand, the financing can have a limit of €10,000, a particularly reduced sum considering the type of potential beneficiary and out of line with maximum limits of credit for consumers regulated in a harmonized form at the supra-national level; on the other hand, financing has to be accompanied by auxiliary services of family budget, have to be finalized to prevent the social and financial exclusion of the beneficiary and have to be made at the most favorable prevailing conditions of the market. This last type of financing can be made both by operators of microcredit, in a strict sense, and by non-profit entities who have the characteristics identified by the ministerial secondary regulation of 2014. In this regard, the legislator has thus conceded to operators possibly engaged in other sectors of activity the possibility to provide microcredit in the presence of specific conditions. In this case, the interested legal entity does not have to be a joint stock company or exclusively carry out microcredit activities.

Therefore, it can be stated that Italian regulations concerning microcredit introduce a model characterized by two parts: on the one hand, microcredit for companies, functioning to increase productive capacity; and on the other hand, microcredit, conforming to what has been established at the European level, favoring the process of social inclusion of needy subjects who, as has been said, are often at the edge of the economic-financial circuit, having a reduced capacity to access traditional

forms of credit.

Two additional notations regard the type of operator who can access this type of activity.

First, the law allows the activity in microcredit only after the inclusion in a specific list, subordinate to a series of conditions, much less strict that those – as has been stated – necessary to access to the market in the ordinary way. The legislator requires, in particular: *i)* the constitution of a cooperative, limited company; *ii)* the deposit of capital, not less than five times the minimum capital required by the constitution of a public limited company; *iii)* the possession of the requirements of honorability and professionalism of certain shareholders and the members of management; *iv)* a legal entity's objective limited to the activity of microcredit as well as any accessory and instrumental activity, and *v)* the presentation of an activity program, in line with what is traditionally provided by other banking and finance operators.

Second, a significant role in the area of microcredit is also given to cooperative credit banks (BCC), which have supported, above all during the recent period of crisis, the economy of the area where they operate by financing the activity of small and medium companies. Therefore, it is not surprising that the BCC has been particularly active in the area of microcredit in as much as it, more than other operators, has established the relationship with the borrower based on trust and respect of the rules of correctness between debtor and creditor[23]. Moreover, the mutual nature of their activity linked to the in-depth knowledge of the territory, means that the BCC is inspired by the values of solidarity rather than profit[24].

[23]See CIRAVEGNA – LIMONE, *Otto modi di dire microcredit*, Bologna, 2007.

[24]See PROVENZANO – ARNONE, *Microcredit and probability of default for small business in Italy*,avaiable on www.euricse.eu/ according to which the default rates of microcredit programs highlighted the fact that distinctive features of the CCBs and the local banks, such as relationship lending, local interaction, the increased availability of soft information, the mutual approach, an efficient organizational structure with few hierarchical levels, may represent the strategic leverage in order to ensure a greater presence of these banks in the field of microcredit and microfinance. The relational approach, as opposed to "transaction lending" of large banks, can facilitate the management of microcredit initiatives that are so different as to be difficult to standardize. The methodologies of credit scoring used by commercial banks that privilege hard information should be updated frequently to represent the real situation of the client's solvency in a changing business environment.

It should be stated, however, that the Italian cooperative sector has been recently the object of reform[25] that could reflect negatively on the specificity of the cooperation of credit and, thus, on the value-driven nature itself that has always characterized the activity of the BCC[26]. In particular, the constitution of three banking groups (two national and one regional) to which the BCCs are obliged to adhere, can produce the effect of keeping governance far from the centers of destination of its strategic input[27]. It is evident that if the actuation of the reforms should implicate, in fact, a radical change of the traditional appearance of such banking institutions; this could negatively affect their action in the area of microcredit[28]. In fact, the eventual abandonment of an operation aimed at favoring economic development in Italy could have a restriction for the granting of microcredit.

5. The innovative character of the phenomenon analyzed here in the framework of sectorial regulation of credit does not allow us to arrive at an easy classification of all the reference provisions within the Italian constitutional order[29]. To some extent, microcredit combines forms of tradition and innovation; analogous architypes were present in all Europe, as well as the Italian credit system, already in the late medieval period. In this regard, an example is the establishment of the pawn brokers; beyond the Alps numerous references are found also in the activation of many forms of financial support for the poorer classes facing the first wave of mass industrialization[30].

From a theoretical point of view, the reflection around "microcredit" is linked to the origins of the so-called "financial exclusion" of groups of “weak” subjects. The

[25]We refer to the Legislative Decree of 14th February 2016, n. 18, converted into law n. 49 of 2016, in turn, modified with the Legislative Decree “milleproroghe” of 25th July 2018, n. 91, converted into law n. 108 of 21st September 2018.
[26]In these terms CAPRIGLIONE, *La riforma del BCC al vaglio del nuovo Governo*, in *www.diritto bancario.it*, giugno 2018.
[27]See CAPRIGLIONE, *La riforma del BCC al vaglio del nuovo Governo*, cit.
[28]According to the data published in May2014, in a study by the Federcasse, 69% of the BCC was active in microcredit both to companies and individuals.
[29]See FALCONE, *Microcredito*, in *Leggi d’Italia PA*, 2012, p. 1 ff.
[30]See BECCHETTI, *Il microcredito*, Bologna, 2009, pp. 18 ff.

theme of microfinance and microcredit, as possible references to the phenomenon of financial exclusion, the cultural substratum, on the one hand, in progress, derives from instances, in a certain sense, of "ethical finance", in a mature and updated attention to the concept of "human rights"[31].

An important aspect is the fact that regulation of microcredit was slowly introduced into Italian regulations during a complex re-ordering of the credit area for consumers given the need for the implementation of the first European directives on this subject. The delayed actuation of the regulation in this area, which had to wait six years until it was possible to fully implement it, betrayed the tepid institutional behavior towards urgent problems of social inclusion in an era in which there was a stimulating push towards uncontrolled phenomena of consumption and borrowing, in a spiral sometimes potentially deleterious for the economic-financial system.

The decree law 141/2010 is downstream of the in-depth consideration of the Finance Commission of the Senate of the Italian Republic that made an investigation into consumer credit. The analysis examined the principal issues that this form of finance generally presents, also in relation to the impact of community legislation on internal regulation and to the statistical data concerning the diffusion of the phenomenon, with the aim of elaborating guidelines for revision. This showed the positive role of consumer credit, but also shone light on a series of issues relative to the substantial profiles of safeguards for the consumer as well as the vigilance of the active operators. For this reason, the Commission showed the necessity of corrective interventions, in occasion of which the Government is committed to take into due account also the need to define a specific regulation aimed at correctly establishing the characteristics of microcredit, combining the necessity to favor the creation of a further channel of credit access with that of assuring the transparency of the sector and an adequate system for its supervision.

Going back to the distinction previously recalled between company micro-

[31]See CAPRIGLIONE, *Etica della finanza e finanza etica*, Roma-Bari, 1997.

credit and social microcredit, it is possible to proceed to a constitutional framework of the phenomenon.

Micro-credit for small enterprises finds its first reference in article 41, comma 3, and article 47, comma 1, of the Italian Fundamental Charter[32]. Further connections are found in the promotion of the conditions that make the right to work effective, a pragmatic element indicated in article 4 of the Constitution, as well as in the principle of subsidiarity found at the last comma of article 118 Cost.[33].

As for the first disposition, it seems correct to detect how microcredit is being configured as a particular form of private economic activity of free initiative in which its social aims and the definition of a specific regime of controls emerge in two forms: on the one hand, through the prevision of objective and specific limits of credit from within the sphere of business microcredit, all aimed to increase national productive capacity by means of the diffusion of vocational business activity "micro"; on the other hand, in the light of the assimilation of the public enforcement regime of controls that inform other dimensions of the banking-finance business. From this point of view, the importance of microcredit appears indirectly reflected in the equal dignity of the system of controls that apply to this sector, given the attribution of sector authority - and, in particular, to the "Banca d'Italia" - of relevant powers directed at the repression of irregularities and expulsion of operators who do not have the correct legal attributes.

Exercising credit - and here with reach the second constitutional reference – thus becomes a means by which regulation serves to reassure the continuation of

[32]GIAMPIERETTI, *Art, 47 Cost*., in BARTOLE, BIN (Eds.), *Commentario breve alla Costituzione*, Padova, 2008; GIAMPIERETTI, *Art. 41 Cost*., in BARTOLE, BIN (Eds.), cit., ; MANFRELLOTTI, Articolo 47, in CLEMENTI, CUOCOLO, ROSA, VIGEVANI, *La Costituzione italiana. Commento articolo per articolo*, Bologna, 2018, p.299 ff.; CASSETTI, *Articolo 41*, in CLEMENTI, CUOCOLO, ROSA, VIGEVANI, *La Costituzione italiana. Commento articolo per articolo*, Bologna, 2018, p. 267 ff.

[33]See RIVOSECCHI, *Art. 118 Cost., Ad vocem*, in CLEMENTI, CUOCOLO, ROSA, VIGEVANI, *La Costituzione italiana. Commento articolo per articolo*, Bologna, 2018, p. 370-371; LONGOBUCCO, *La "questione ermeneutica" della sussidiarietà orizzontale: assiologia costituzionale e attività amministrativa*, in *Temi e problemi di diritto regionale*, Ed. P. Perlingieri, Napoli, 2008, 229 and PELLEGRINI, *"Impresa e finanza" alla luce della dottrina sociale della Chiesa*, in *MB* 2006 (4) , 17-22.

public interest believed to be worthy of particular safeguards. The statute of micro-credit reaffirms the social function of that particular business activity that is substantially the financing of the economy, that is its critical relevance to assure the harmonious development of the society and of the economic and productive fabric.

To this last profile we can connect, inescapably, the theme of work and the work principle anchored in the first article of the Italian Constitution: in an era of constant efforts towards the definition of policies able to assure a reduction in the tendency of unemployment and social marginalization due to globalization and of the transformation of production processes, microcredit is designed to guarantee minimum conditions for basic access to those sources of supply that allow the effective creation of employment.

Incapacitated by cost constraints and by competitiveness that often prevent the realization of long-term policies aimed at supporting employment and a wage, the State "leans", on the other hand, on private business initiatives, defining their conditions and orientating the choices to carry out an activity of clear general interest because of its correlations with economic development in general and thus the reference to a correctly intended principle of horizontal subsidiary appears inescapable.

If from this side we give our attention to social microcredit, other than the references mentioned earlier, a further point can be seen art. 47 and, above all, in articles 2 and 3 of the Italian Charter[34]. The definition of a regime of facilitated access to the credit market is, in fact, instrumental in supporting the part of the population that are negatively effected by the form of economic-financing exclusion. In this, was the prevision of ancillary initiatives aimed at favoring a subjective inclusion to overcome deteriorated material conditions that stop part of the population from accessing consumption and even essential services. Credit thus becomes an instrument to

[34]See CHECCHINI, *Eguaglianza, non discriminazione e limiti dell'autonomia privata: spunti per una riflessione*, in *NGCC*, 2012,II, pp. 186-198; SICLARI, *Tutela del risparmio, educazione finanziaria e principio costituzionale di sussidiarietà orizzontale*, in *Scritti in onore di Francesco Capriglione*, Padova, 2012.

assure dignity to subjects who are not only excluded from the banking system, but are marginalized in the social structure[35].

The constitutional statute of microcredit can soon then join that almost forgotten tradition of economic credit activity as a social function. A tradition that even if it has its own statute recognizing the social function of cooperation that has for so long assured a regime of special discipline in cooperation in the field of credit, that, however, is colored in part by the particular typology of activity discussed here (see art. 45 of the Italian Constitution)[36].

6. Notwithstanding the legislative framework so far set out, microcredit in Italy has had a poor diffusion as can be seen from the studies that have shown its fragmentation and diversification in the market, as well as the insecurity of the programs of intervention adopted[37]. On the other hand, as emerges from the data of the Italian "Ente Nazionale per il Microcredito", highlighted at the beginning of this paper, over the last two years, there has been a trend of clear recovery[38] in as much as the statistics show that Italy is behind most of the other European countries. Therefore, while in the south of Italy it has been used to counter the diffusion of episodes of usury, in the regions of north Italy, its use has been principally to support needy families.

In the past, the reasons for the failure of microcredit were the delay with which Italy, with respect to other European and international countries, had regulated this area with the consequence that the operators in the sector had to comply with the stringent constraints imposed by general regulations[39].

It would be well to consider, however, the regulation introduced in 2010 and

[35]See TORCHIA, *Il consumo del microcredito e la tutela della persona*, Napoli, 2006.
[36]See PIZZOLATO, MATTASSOGLIO, *Articolo 45*, in CLEMENTI, CUOCOLO, ROSA, VIGEVANI, *La Costituzione italiana. Commento articolo per articolo*, Bologna, 2018, p.291 ff.
[37]See, for all, ARNONE, *Divari macroregionali nella diffusione dell microcredit*, in EyesReg, Vol.6, N.2, Marzo 2016.
[38]See the document entitled *Il microcredito imprenditoriale in Italia assistito dalla garanzia MCC. Dati e statistiche al giugno 2018*, available on www.microcredit.gov.it/
[39]See CONZETT, GONZALEZ, JAYO, *Overview of the microcredit sector in the European Union 2008-2009*, EMN, working paper n.6, 2010.

modified in the following years, does not seem to have increased the demand and offer of microcredit; circumstances that justified the adoption of measures aimed at facilitating access to the "Central Guarantee Fund" for who wanted it (we refer, in particular, to the Ministerial Decrees of 24th December 2014 and 18th March 2015).

Under another profile, the doctrine shows how the low request for microcredit in Italy could depend on the poor financial education of its citizens[40]. It is clear that the question is of a general character and concerns the difficulty of the individual to fully understand the complexity of the market, as well as how to use financial services. On this point, it is certainly appreciable the intervention of the Italian legislator that, during the conversion of the well-known decree "*save savings*" (decree law no 237 of 2016 converted into law no 15 of 17th February 2017), introduced specific dispositions concerning financial education, giving this its correct relevance in the framework of instruments for consumer safety.

In particular, the Ministry of Economy and Finance, in conjunction with the Ministry of Education, Universities and Research, adopted a program of "national strategy for Financial, Insurance and Social Security education"; for its actuation a special Committee was set up. On the other hand, the modest resources assigned to this initiative have to be mentioned (€ 1 million) with the aim of supporting the activity of the above-mentioned Committee.

Moreover, it has been observed that the organizations operating in this area of microcredit would not have had the necessary experience to adequately carry out such an important function. Therefore, part of the doctrine hoped for the creation of a strategic network that would allow the above-mentioned legal entities to collaborate with the banking institutes who, thanks to their greater skill and professionalism acquired in the field of granting of credit, could support their activity[41].

[40]See, for all, MCKILLOP, WILSON, *Financial exclusion, public money and management*, 27, 9-12, 2007.
[41]See MALLICK SUSHANTA, HO SHIRLEY, *Making Commercial Microfinance Work for the Poor. The Case of MFIs-Bank Linkage*, in *SSRN Electronic Journal*, 2007, available on https://www.researchgate.net/.

Indeed, a further aspect of criticality that negatively affects the diffusion of the phenomenon of microcredit in Italy is the existence of numerous operational constraints imposed by financial entities (and on their beneficiaries) by regulations on this subject. As an example, we can look at the dispositions concerning the minimum capital required for active organization in the sector that, when an operator is placed on the special list, has to be up-paid and cannot be less than five times that indicated for the constitution of a public limited company. We refer to the regulation that necessitates the possession of specific subjective qualities to be an administrator or a member of the board of directors, as well as those concerning interest rates and auxiliary services. Moreover, it is significant what was established in art. 14 of the ministerial decree no 176/2014 according to which the operators active in the area of microcredit can acquire financial resources of not more than sixteen times the net assets reported in the last approved financial statement.

Therefore, as the doctrine has shown, the Italian legal framework does not provide, in this sector, appropriate mechanisms for access to funding in the markets of capital and credit[42]. From this, there are the limits of a regulation that has stringent requisites of access to the sector to counter the activity of operators unworthy of being safeguarded, thus hindering the diffusion of microcredit.

7. In the light of what has been said, it should be noted that in Brazil, over the years, numerous initiatives have been adopted to favor the development of microcredit. With this aim in mind, the intervention of the state has to be mentioned, that, in this sector, financed programs of specific interventions, above all to safeguard the poorest part of the population. On this point, it has to be stated that for some time the Brazilian legislature has set up regulations in this sector with the aim, on the one hand, of supporting the fight against poverty, and on the other hand, of assuring an adequate financial support for small businesses and entrepreneurs.

[42]See, THE TORRE, *Il microcredito in Italia tra regolamentazione e mercato*, in *Bancaria*, 2015, p. 16.

In this context, however, we should remember the circumstances for which Brazil, faced with a significant number of poor people who are excluded from the financial system, has a restricted circle of individuals who, instead, have easy access to the financial system and credit. The Brazilian legislator has thus strongly felt the need to identify the sources of alternative finance to the traditional bank channels. From this they enlarged the number of subjects who can legitimately provide microcredit and the establishment of regulation that provide significant advantages for those who intend to operate in this sector.

It is thus evident that the success of microcredit in Brazil also depends on the high number of subjects needing financial support; it is relevant that microcredit in Brazil is aimed at 8 million people who, maybe due to the difficult context in which they live, or due to economic transformations in a modern society caused by the effects of the recent crises, find it difficult to find work and start eventual entrepreneurial projects.

Therefore, it is certainly appreciable the efforts made by the Brazilian legislator who favored, by adopting specific measures, the growth of microcredit in Brazil making sure to assure a good participation, in this area, of public institutions and to allow a significant increase in operators able to provide microcredit.

On the other hand, as has been shown above, Italy has regulated this area with some delay with respect to the other European and international countries, with the consequence that subjects active in this sector had to comply with the stringent constraints of a regulation with a general character. To this we must add that the legislature of 2010 wanted to realize a hard reconciliation between the interests of certain subjects in difficult conditions to use sources of financing and the need to stop unscrupulous operators using less rigid rules with respect to those provided by the ordinary rules for market access.

In particular, the existence of numerous operational constraints imposed on financial entities (and their beneficiaries) by the regulations, are an element of criticity able to negatively affect the diffusion of microcredit in Italy. In fact, as was previ-

ously stated, the Italian regulatory framework does not allow, in this sector, easy access to funding from capital and credit markets. In particular, this area necessitates stringent requisites for access for those legal entities interested in operating in this sector; circumstances that limit the diffusion of the phenomenon of microcredit. However, as can be seen from the data reported by the Italian "Ente Nazionale per il microcredito", over the last two years there has been a positive trend with respect to the past.

In the above context, similarly to what has happened in Brazil where governments, over the years, have promised policies to favor the development of microcredit in the country, it is auspicable that, in the future, Italy will invest further in this sector. We refer to the opportunity to increase the resources of the Central Guarantee Fund dedicated to microcredit favoring the stipulation of conventions with private and public entities and the possibility of providing tax benefits for providers. Finally, there is the need to identify, in legislation, less stringent criteria for access to the sector, as well as more flexible conditions in the areas of auxiliary services, interest rates and the capitalization of the microcredit entities.

REVISITING THE ISSUE OF UNITARY ENTERPRISES` "INEFFICIENCY" (ON THE EXAMPLE OF THE STAVROPOL TERRITORY) *

Aleksey P. Anisimov ** – Vyacheslav S. Eliseev *** – Ekaterina V. Stepanova ****

ABSTRACT: *The paper deals with measuring effectiveness criteria of one of the types of Russian legal entities which are unitary enterprises founded either by the Russian Federation or its subjects and municipalities. Having analyzed main features of this legal type of enterprises in the context of the theory of legal entities and doctrinal approaches to determining the criteria for the economic efficiency of their activities, and also having examined the experience of functioning of unitary enterprises in one of the constituent entities of the Russian Federation (the Stavropol Territory), the authors argue that the efficiency does not depend on organizational and legal form, and the current problems of the functioning of unitary enterprises are due to a complex of reasons of complex character.*

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1. In compliance with the provisions 2 of Article 8 of the Constitution of the Russian Federation private, public, municipal and other forms of ownership are equally recognized and protected in the Russian Federation. Similar norms are enshrined in the laws of the constituent entities of the Russian Federation for instance in part 1 of Article 6 of the Statute (framework law) of the Stavropol Territory.[1] In the last regulatory act, moreover, it is noted that "the effective use of state property is of great importance for ensuring the sustainability of regional development and reaching higher standard of living of the population in the region when executive bodies exercise management functions that implement social and economic development goals".

However, the effectiveness of the state property use in Russia and in a number of other former Soviet Union countries often causes doubts which are often justified. Meanwhile, the authors consider the conclusion on comprehensive inefficiency of state property which is sometimes made by the participants of the debate, to groundless. This paper makes an attempt to demonstrate the ambiguity of established ideas, and provide arguments and evidence that state property (and state-owned enterprises using it) is effectively used in certain sectors of national economy.

2. There is no unequivocal opinion on the role of the state in the modern economy. All existing points of view can be classified into three main groups: firstly, absolutization of public administration implemented largely in the USSR in the model of the so-called "mobilization economy" (the theory of planned market economy); secondly, the libertarian theory of economy based on the absolutization of the processes of market self-realization (self-regulation). The latter model was taken as rolemodel in Russian post-Soviet economy (Gaidar 1995); thirdly, the theory of integral economy supported by S. Glazyev (Glazyev 2010) combining long-term planning with market self-realization mechanisms.

[1]The Law of the Stavropol Territory dated October 12, 94 No. 6-kz "Charter (Fundamental Law) of the Stavropol Territory". *Reference Legal System "Consultant Plus",* appeal date 12/14/2018.

In economic science, it is stated that state ownership should be concentrated in those industries and areas where market mechanisms are not effective enough and their functioning on a private basis is difficult or even impossible. These include, first of all, the sectors where large-scale national strategic tasks are solved (basic science, defense and education), also the sectors requiring most expensive projects in which it is not feasible or difficult to achieve long-term goals with only private investment associated with high risks (aerospace industry, nuclear energy, other capital-intensive and knowledge-intensive industries). In addition, state ownership extends to service-producing industries, production of public goods and services, collaborative consumption items (health care, cultural institutions, etc.) and, finally, to production with positive externalities in which the social benefit far exceeds the benefits of individual enterprises (for example in the field of environmental protection) (Abalkin, Miller 1993; Akhmeduev, Medvedev et al 1997).

It is very unfortunate that legal theories see their mission in accompanying the economy are oriented towards economic theories, despite the fact that law has its own subject matter. Practically, this is expressed in the fact that civil law has uniformly gained dominance in the economy, being the law that supports the theory of economic libertarianism, whereas the law that historically accompanied the planned market economy (and was known as “economic law”) has been forgotten. There is an opinion that Russian entrepreneurial law has replaced private commercial code (Laptev 1999). But in fact, entrepreneurial law has become an integral part of civil law developing and providing backing in particular areas and legal support in economic activity (Russian civil law 2011). And even some fields of "classical" commercial law, namely categories of "state-owned enterprises" were consolidated in the Civil Code of the Russian Federation. In particular, the issue of public regulation is directly provisioned by paragraph 4 of chapter 4 “Participation of the Russian Federation, subjects of the Russian Federation, municipal formations in relations regulated by civil law” of the Civil Code of Russia, as well as by paragraph 4 of chapter 4 “State and Municipal Unitary Enterprises”. In this regard, it is also important to name the Federal Law of

November 14, 2002 No. 161-FZ “On State and Municipal Unitary Enterprises”.[2]

The term “public sector of economy” was legally consolidated in the preamble of the Concept of State Property Management and Privatization of the Russian Federation[3] where it refers to “aggregates economic relations associated with the use of public property, enshrined for "federal state unitary enterprises based on the right of economic management or operational management".[4]

In compliance with Article 1 of the Law of the Stavropol Territory[5] of April 14, 2014 No. 25-kz “On the management and disposition of state-owned property of the Stavropol Territory”, “state-owned property of the Stavropol Region is referred to as public-owned movable and real estate property secured by the right of economic management or operational management of state unitary enterprises of the Stavropol Territory ... ","asset complexes of state unitary enterprises ... ".[6] It is not difficult to conclude from the regulatory definitions that state-owned unitary enterprises have a leading place.

3. It should also be stated that some civil law scholars speak out against the existence of unitary enterprises claiming that such legal entities as state enterprises "do not correspond to the market structure of the economy."(Russian civil law 2011*).* On the other hand, partisants of entrepreneurial (business) law including A.V.

[2]Federal Law of November 14, 2002 No. 161-ФЗ “On State and Municipal Unitary Enterprises”. *Collected legislation of the Russian Federation*. 2002. № 48. Art. 4746; 2018. No. 1 (Part I). Art. 54.

[3]This Concept was approved by the Decree of the Government of the Russian Federation dated 09.09.1999 No. 1024 “On the Concept of State Property Management and Privatization in the Russian Federation”. *Collection of Legislation of the Russian Federation*. 1999. No. 39. Art. 4626; 2000. № 49. Art. 4825.

[4]The right of economic management and the right of operational management are the types of limited property rights to property that emerged in the USSR, which have no analogues in European law. The property in this title may belong only to state and municipal unitary enterprises, but not to private individuals.

[5]The Stavropol Territory is a constituent entity of the Russian Federation, located in the central part of Ciscaucasia and on the northern slope of the Greater Caucasus is known for its mineral waters and chernozem soils. It borders on the Krasnodar Territory, the Republic of Kalmykia, the Rostov Region, Dagestan, and the Chechen Republic.

[6]The Law of the Stavropol Territory of April 14, 2014 No. 25-kz “On the management and disposal of property objects of state ownership of the Stavropol Territory”. *Reference legal system “Consultant Plus”*, the date of circulation is 13.09.2018.

Venediktov, V.V. Laptev, V.K. Mamutov, I.V. Ershova, E.P. Gubin, I.V. Doynikov and others hold the opposite opinion (Alekseeva et al 2006).

As noted in the theory of economic law, economic efficiency (productiveness of economic development) is directly dependent on the legal effectiveness (performance of legal support of economic programs), in turn, legal efficiency can be easily identified as an independent criterion.

In legal science, the criterion of legal effectiveness (performance of legal support for economy) is considered to be a complex phenomenon which includes five components: firstly, the "substantive rights criterion" which assesses the rules of conduct proper governing specific areas of economic relations; secondly, the "implementation criterion" which defines the availability of procedural and curial regulations that allow the parties concerned to collect the necessary evidence and protect (exercise) their rights in court or in other authorized state bodies; thirdly, the functional criterion introducing protection of relevant rights and exercise of correspondent functions into duties of public officers and other government employees; fourthly, the "organizational quantitative criterion" assesses the compliance of the number of employees (workers) with the needs that occur in society; finally, in the fifth place, the "criterion of procurement of economic relations" reflecting the compliance of material resources with the needs that are required for implementation of economic relations (Velento, Eliseev 2004).

As for the mechanism for implementing the norms of law in large institutions including in most cases unitary enterprises (with their legal services and departments), the implementation and other criteria are quite high, unlike small businesses, the latter usually do not have financial resources for lawyers and legal services. Accordingly, the reason for low efficiency level of the economy as well as of economic relations involving unitary enterprises can be either "economic idea" itself or the corresponding "substantive economic legislation", as well as both criteria at the same time.

Functioning of unitary enterprises[7] cannot be comprehensively evaluated without analyzing theories of legal entities. There exist and widely known “fictional concepts” that deny the existence of a real subject with properties of a legal personality, and “realistic concepts” (theories on the essence of the legal entity) that recognize the existence of a carrier of such properties, and finally, there isa mixed "fictional realistic concept."

Realistic concepts were comprehensively developed in the Soviet period of economic development; they evaluate human resource and are confined to comparing legal entity with one of the persons involved in activity of the legal entity being either its owner, manager or labour collective (Venediktov 1948; Bratus 1947; Asknazy 1947). The latter person involved was described in the majority of Soviet legal scholars` works who wrote about legal entities.

Currently, Russian legislation is based on fictional concepts. The main feature of this approach is the denial of existence of real subject with the properties of a legal personality (Chigir 1999), since characteristic proclaimed by the fictional theory were enshrined in the official definition of the legal entity (clause 1 of article 48 of the Civil Code of the Russian Federation). In compliance with article 49 of the Civil Code of the Russian Federation, fiction (and not a real participant) is endowed with legal capacity, i.e. the legal entity is a participant of economic relations (processing rights and obligations). So, neither “funds necessary for the training of professional workers who support the production process”, nor the “labor collectives” were included into the composition of enterprises in this theory (see part 2 of clause 2 of article 132 of the Civil Code of the Russian Federation).

The above mentioned identified deficiencies are rectified by fictional realistic theory (concept of the dual nature of the legal entity) which is maximally close to the

[7]In accordance with Article 113 of the Civil Code of the Russian Federation, unitary enterprises are a type of commercial legal entities, the founder of which can be the Russian Federation, its subjects and municipal entities. This type of organization is not endowed with the right of ownership of the property assigned to it, which is indivisible and is not distributed on deposits (shares, shares) among employees.

essence of a business entity and restores the labor component in a fictional theory. The second drawback in defining “legal entity” enshrined in paragraph 1 of Article 48 of the Civil Code is the lack of communication between a legal entity as a subject of law and the persons behind it, which, in fact, shape economic behavior. It focuses on its three main figures in realistic theories of legal entities: firstly, as it appears in the “theory of government”, *the founder* (member, owner) of a legal entity is often the state; secondly, the “director's theory” describes the *head (body)* of the legal entity; finally, the “collective theory” adds and justifies *labor collectives*; the drawback is also eradicated by the fictional-realistic concept of the legal entity.

Subsequently, effective legal support of economic relations arises from the activities of a legal entity; it is not ensured by its legal status (legal capacity) itself, but by the way the rights and obligations are transformed into the rights and obligations of its three main actors: the founder (member, owner) of the business entity, its head (executive body) and labor collective.

The concept of dual nature of the legal entity makes it possible to single out the most important component of the legal effectiveness assessment: firstly, the effectiveness of motivation of the persons` involved in the legal entity which belongs to rather psychological and economic category; secondly, the effectiveness of legal support of relations (connections) between persons involved in the legal entity which form the right of ownership; and finally, effectiveness of legal support of the organization’s relations with other institutions and government bodies. The effectiveness of the production sector of the economy (arguably the main sector of the state) should be estimated by technical efficiency criteria on the basis of availability of modern manufacturing equipment.

In the scientific literature, it is noted that the most important role in evaluating the effectiveness of state unitary enterprises (SUE) and municipal unitary enterprises (MUE) is played by the position of the owner who can use various indicators. The first one includes budgetary efficiency indicator directly dependent on the profit of the SUE (MUE), since the amount of tax deductions to the respective budgets, and, ac-

cordingly, budget expenditures are interconnected. The second indicator is "social efficiency" relevant to social impact of the activities of SUE (MUE) on the population as a whole is expressed in the level and quality of life changes. Social utility is also a social efficiency criterion determined by the degree of the population's will to get profit from the sale of products (goods, works and services) of SUE (MUE) as well as new jobs creation, real salary growth index, an increase in the number of potential consumers of the enterprise, creation of new types of goods, works and services, etc. The third indicator is "economic efficiency" which depends on the result of economic activity and is determined by comparing this result to the costs incurred, aimed at its achievement, The fourth indicator is "target efficiency" which is determined by analysis of the compliance of the founding objectives of SUE (MUE) with actual results and activities (Yurchenko 2014).

These indicators are usually included in the unitary enterprise overall economic efficiency, but in order to make the right decisions, it is necessary to take into account relevant components, since the economic program itself (economic idea) must be advanced and correspond to the "spirit of the times" aimed at sustainable economic result. The set of indicators is aimed at measuring overall economic efficiency of the enterprise which is the final factor in its assessment.

4. It is should be stated that additional performance parameters can be established at the regional level as to how they determine the tasks that are set for the unitary enterprises. In particular, the Decree of the Government of the Stavropol Territory No. 584-p dated December 28, 2015 "On Approval of the State Program of the Stavropol Territory "Property Management " stipulates establishment of key performance indicators for leaders and departments of state unitary enterprises of the Stavropol Territory.[8] First of all it should be stated that there are no more federal

[8]Government Decision of the Stavropol Territory dated December 28, 2015 No. 584-p (as amended on March 29, 2018) "On Approval of the State Program of the Stavropol Territory" Property Management ". *Reference Legal System "Consultant Plus"*, the date of reference 13.12.2018.

state unitary enterprises located on the territory of the Stavropol Territory accounted by the Ministry of Property Relations of the Russian Federation, the last Federal State Unitary Enterprise “Reconstruction” was liquidated on July 21, 2017 through reorganization in the form of transformation into a business entity successor is JSC "Reconstruction".[9]

At the same time, on the List of Organizations of the Russian Federation “List-Org”[10] in the Stavropol Territory there are 13 operating federal state unitary enterprises overwhelmingly in the form of branches (not counting their territorial branches, and subsidiaries), which are directly subordinated to the federal authorities and, in fact, are government bodies, since they are vested with state authority. At the same time, there are 41 inactive unitary enterprises of the federal level listed there, which indicates the general dynamics of the liquidation of enterprises of the given legal form.

Of all “classical” unitary enterprises there is only FSUE “Rassvet-Stavropolie” which is subordinate to the Ministry of Agriculture of the Russian Federation. In the Stavropol Territory, a significant number of unitary enterprises of regional subordination are still preserved, currently there are 43 of them.[11] At the same time, there is a trend to reduce the number of state-owned unitary enterprises: according to the Ministry of Property of the Stavropol Territory, as of September 1, 2016, there were 53 more in the Stavropol Territory, and as of August 1, 2017, there were 46 of them. In addition to the unitary enterprises of regional subordination, according to the information of the “List-Org” Catalog of Russian Organizations, in the Stavropol Territory there are 271 municipal unitary enterprises, including 152 unitary enterprises that are under the jurisdiction of municipal districts and their subordinate local municipal

[9]The official website of the Ministry of Property Relations of the Russian Federation (Ministry of Property of Russia), https://www.rosim.ru/about/structure/sub (the date of reference 13.12.2018).
[10]The catalog of organizations of Russia “List-Org” (the date of reference 13.09.2018), www.list-org.com (the date of reference 13.12.2018).
[11]Official website of the Ministry of Property Relations of the Stavropol Territory, http://mio26.ru/gosudarstvennye-predpriyatiya/gosudarstvennye-unitarnye-predpriyatiya/ (the date of reference 13.12.2018).

authorities (urban and rural settlements), and 119 unitary enterprises in urban districts.

In addition, the Catalog contains 232 inoperative unitary enterprises (79 in municipal areas and 153 in urban districts and cities of regional subordination), including enterprises that are in the process of liquidation. For municipal districts, the total percentage of inactive municipal unitary enterprises out of their total number (existing and inactive municipal unitary enterprises) is 34%, and for urban districts and cities of regional subordination the proportion of inactive enterprises achieves 56%. At the same time, the highest dynamics of "liquidation" of unitary enterprises is observed in the city of Stavropol: in Leninsky district of the city where the proportion of inoperative unitary enterprises shows 54%, in the Oktyabrsky district it is 47% of, and Promyshlenny district is 62% out of total number of (active and inactive) municipal unitary enterprises.

Similar tendency is observed in the city of regional subordination such as the city of Kislovodsk and the city of Georgievsk where the proportion of inactive municipal unitary enterprises equals 47%, 58%in Pyatigorsk, 60% in Mineralovodsky urban district, 65% in Zheleznovods, 68% in Nevinomyysk and 81% in Yessentuki being national leader of inactive unitary enterprises. For comparison, the number of inactive federal unitary enterprises is 76%.

5. In contrast to the cessation of activity of enterprises of private form of ownership, actually inactive unitary enterprises do not disappear due to their inefficiency, but are transformed (reorganized) into organizations of other organizational and legal forms (joint-stock companies, limited liability companies) of private form of ownership. In fact, it is a question of withdrawing from public entities of economic entities under the guise of market transformations. This feature indicates that unitary enterprises are not liquidated due to their economically inefficient activity. Technical efficiency of organizations in the production sector of the Russian economy is determined by availability of high-tech tools and equipment which are expressed by tech-

nological order (the level of development of industrial production of the state economy).

At present, Russia is “stuck” mainly in the fourth technological order (TO-4), its restructuring ended in the early 1990s. The fifth technological order (TO-5) turned out to be a failure for the Russian economy which came during the period of "restructuring"[12] followed by the collapse of the USSR and its economy and the process of "privatization".

Currently, transition to the sixth technological order (a complex of informational and communicational, bioengineering nanotechnologies) is underway. This way is basically humanitarian: healthcare (20% of GDP), education (12-15%), science (5%), culture (3-4%). The problem of the TO-6 is that its base is the “technical-technological and social component” of the TO-5 which is not sufficiently developed in Russia.[13]

Technological orders are indicators of national economy development regardless of its organizational and legal forms, and in this regard, they do not determine the shortcomings of unitary enterprises and the effectiveness of their functioning. On the contrary, only the state as the owner of enterprises is able to allocate additional material resources for purchasing appropriate modern technological equipment.

Low economic efficiency of unitary enterprises is arguably caused by Russia's dependence on external ratings of such American agencies as Moody’s, Standard & Poor’s Fitch et al. In essence, they relate only to competitive market economies and are based on self-regulation processes, where state influence is limited by market (impacting profit) methods. This applies to all states with ratings ranging from “investment” and “stable” to “speculative”, “junk” and “default” (Simon 2013). It should be noted that the Chinese rating agency “Dagong” established in 2015 for Russia a

[12]Perestroika is the policy pursued by the General Secretary of the Communist Party of the USSR, Gorbachev in 1985-1991 aimed at overcoming stagnation in the political and economic life of the Soviet state and society.

[13]Discussion club "Trend". Guest Sergey Glazyev 10/23/2015, http://www.youtube.com/ watch?v =_ v8XBIPBvd0 (the date of reference 13.12.2018)

rating of “A” with a stable outlook while the US rating was lowered to “A-”.[14]

Negative ratings critically affect Russian economic reproduction. Such indicators are not acceptable for unitary enterprises, because their property is not subject to sale, that is it is not an object of the stock market. In this environment, unitary enterprises are automatically given the lowest marks due to their unsuitability for stock valuation. As for the efficiency of state-owned enterprises, we should recall that according to analytical materials of the Accounts Chamber of the Russian Federation on the problem of privatization of state property for the period 1993-2003, not a single large privatized enterprises became more efficient after privatization (Analysis of the privatization 2004).

6. Thus, comparative analysis of enterprises of various organizational and legal forms of the Stavropol Territory has revealed that, in the course of formal transformation of some forms of business into others in a difficult general economic situation, it is not possible to identify in practice the advantages of any particular forms of business. This allows us to conclude unjustified attacks on such a legal form as “unitary enterprise”. The existing drawbacks in efficiency of their functioning are due to more complicated economic reasons which will be reduced in stable and sustainable economy.

[14]The Chinese agency Dagong assigned Russia a credit rating of "A" / World and Politics: an international political journal. Sunday, July 5, 2015, http://mir-politika.ru/17867-kitayskoe-agentstvo-dagong-prisvoilo-rossii-kreditnyy-reyting-a.html (the date of reference 12.12.2018).

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STRATEGIC AND ORGANIZATIONAL EFFECTS OF ENVIRONMENTAL REGULATION ON OPERATIONAL PROCESSES OF SUSTAINABLE MSEs

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ABSTRACT: *Today an effective sustainable development requires stimulating revolutionary operational and technological innovation through an updated environmental regulation and efficient labor market rules. It is becoming always more complex, especially for small companies (MSEs - Micro and Small Enterprises) to understand the relationship between environmental regulation, innovation, and sustainable development, inside the actual context of an increasingly globalizing economy. The European economic development, within the environmental and employment aspects of sustainable development, should be more emphasized and analyzed by EU academics, researchers and decision makers. Often the most crucial problem in achieving sustainability for MSEs is the lock-in or the path dependency due to the failure to envision, design, and implement policies that achieve co-optimization, or the mutually reinforcing, of social goals. Activating a scheme of basic values and principles, that it is possible to identify inside the Corporate Social Responsibility (CSR), is fundamental to efficiently and effectively manage an innovative sustainable MSE. CSR is delivered through a management system aimed at achieving shared objectives with all relevant stakeholders, which takes into consideration the impact of enterprise's actions within*

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the social-environmental context of which it is part.

SUMMARY: 1. Introduction. – 2. Regulatory strategies and sustainability of MSEs. – 3. Company identity, governance and involvement of stakeholders. – 4. Innovative labour strategies in the sustainable tourism business. – 5. Impact of competitiveness on the tourism system and innovative strategies. – 6. Conclusions.

1. MSEs are highly important for the national economies and for the European productive ecosystem in all. The 99.8% of Europe's companies are MSEs, accounting for more than two thirds of employment in the EU-27. Moreover, the economic and political interests that gain from the current system and advancement of its current trends can explain that industrial policy, environmental law and policy, and trade initiatives must be opened by expanding the practice of multi-purpose policy design, and that these policies must be integrated as well[1]. Whilst the individual environmental impacts of each SME are generally small in comparison to those of large companies, the cumulative environmental impact of the sector is considerable.

On one hand, environmental policy is a compliance issue for MSEs. These companies often consider the environmental legislation as a complex and puzzling issue[2]. The European Commission, therefore, helps them better understand this matter and become compliant with all European environmental laws, regulations, standards and other requirements. See, for example, webpages on chemicals and waste policy[3].

On the other hand, environmental policy also means attractive business opportunities for MSEs. Increased resource efficiency, circular economy solutions and participation in green markets represent important opportunities for European MSEs to improve their productivity, boost their competitiveness, register growth and create employment. The "Green Action Plan for SMEs" that was adopted in July 2014

[1]See CASALINO, (2014), Behavioral Additionality and Organizational Impact of European Policies to Promote Internationalization of High-growth Innovative SMEs, Journal of International Business and Economics, American Research Institute for Policy Development, USA, vol. 2, no. 4, pp. 17-44.
[2]See PFEFFER, (1997), New directions for organization theory, Oxford University Press, 1997
[3]See SEABRIGHT, (2004), The Company of Strangers: A Natural History of Economic Life, Princeton University Press.

and the next “Green Action Plan for SMEs Implementation Report” (2018) outline in detail how the Commission, in partnership with Member States and the regions, intends to help MSEs take advantage of resource efficiency improvements, the circular economy and of green markets. Greater support for these changes must also be reinforced by opening the participatory and political space to enable new voices to contribute to integrated thinking and solutions[4].

The Green Action Plan (GAP) sets out a series of objectives and lists actions that will be implemented at European level within the framework of the Multiannual Financial Framework 2014-2020. On September 25, 2015, the 192 countries of the United Nations issued an action program towards the achievement of 17 Specific Objectives (Sustainable Development Goals) declined in 169 targets to reach by 2030. Through the 2030 Agenda is the unsustainability of the current model of economic, social and environmental development was declared and the commitment by all countries to direct their governance towards sustainability paths was signed. The 2030 Agenda is becoming the common language, throughout Europe and the world, to observe the context in which we live. The current economic system is characterized by an excessive exploitation of material and immaterial resources, by an overproduction and an increasingly marked imbalance. in the distribution and use of assets. These factors cause an increase in social and income inequalities, and a dramatic increase in the pollution of aquatic and terrestrial ecosystems. These listed are just some of the aspects examined by the Agenda 2030, whose Goal deals with closely interrelated themes ranging from the defeat of poverty and hunger in the world, to good employment and economic growth, from the fight against climate change, to the consolidation of institutions to guarantee peace. The repercussions of this model reflect negatively on the well-being of the entire population and, implicitly, on the quality of life of everyone[5].

[4]See BUHALIS, LAW, (2008). Progress in information technology and tourism management: 20 years on and 10 years after the Internet - The state of eTourism research, Tourism Management.
[5]See AHMAND, SCHROEDER, (2013), The impact of human resource management practices on operational performance: recognizing country and industry differences, Elsevier.

Activating a scheme of basic values and principles, that it is possible to identify as Corporate Social Responsibility (CSR), is fundamental to efficiently and effectively manage an innovative sustainable MSE. Corporate Social Responsibility is delivered through a management system aimed at achieving shared objectives with all relevant stakeholders, which takes into consideration the impact of company's actions within the social-environmental context of which it is part. The distinctive foundations that characterize the concept of CSR are:

- go beyond the EU law and the national regulations: the companies adopt a socially responsible behavior beyond the legal requirements and voluntarily assume this commitment in line with the development strategy defined in the medium / long term;
- close relationship with sustainability: CSR is intrinsically linked to the concept of sustainable development as companies must consider the economic, social and environmental effects deriving from their work;
- volunteering: the voluntary nature of CSR implies the freedom of choice of organizations.

The relationships and interactions between MSEs and the local context are essential to understand the choices made by companies in the social field, considering the complexity of the relationships that link the company to its territory in a logic of trust and reciprocity. Small-sized companies are actively and voluntarily involved in CSR areas because, by nature, they are interdependent to the local community and its stakeholders (e.g. resident population, public administration, local suppliers, etc.): on one hand, they provide jobs, salaries, high quality services; on the other, they depend on the stability and prosperity of the communities in which they operate. The variables to be managed, also driven by the pressures of the stakeholder base, include the issues of quality products and processes, safety at work and, more generally, the protection of human rights, respect for the environment, efficient use of natu-

ral resources[6]. This perspective commits the "responsible" company along the entire value chain. It implies a set of activities carried out by the company and the other components of the production chain to design, produce, sell, distribute and promote the products / services, a concept that exemplifies the relationship between customer and supplier, internal and external to the company, in the processes of value creation. Although MSEs cannot use the same tools adopted by large companies, they can still enjoy the benefits of socio-environmental responsibility policies and practices, specifically:

- progress the acquisition of new financial resources;
- promptly answer to the profound change in the economic system by anticipating market trends;
- improve the efficiency of business management;
- create a better, safer and more motivating work environment;
- develop strong cohesion with stakeholders;
- create and maintain high reputational capital;
- improve dialogue with banks;
- take advantage of financial-fiscal and administrative-insurance simplifications.

The principles of ethical behavior, relevant to CSR, to human and social capital, to the network-supply chain logic, to follow are:

- vision, values and governance of CSR: the first step towards the construction of an organizational model that allows to combine the objectives of competitiveness with the themes of CSR and sustainable development, is to achieve a full awareness of the role that the company plays in the socio-environmental context in which it operates. The development of a strategic vision of business management and a plan that identifies future actions, through appropriate policies and specific activities, are essential elements in making CSR a tool to manage every area of the company. Within the management model, it is fundamental to define, in an ethical code of conduct,

[6]See HJALAGER, (2010), A review of innovation research in tourism, Tourism Management, 31, 1-12.

the values and principles of behavior of the company. The code of ethics can become a tool for governance of relationships that, if communicated and shared, is the reference on which to assess the behavior and choices of the company towards its stakeholders[7]. The code of ethics formalizes the unwritten rules of "healthy and correct economic management" and therefore lays the general premises for the implementation of strategies consistent with ethical principles;

- territory: the concept of territory and of the link between it and the company is fundamental. Adopting correct and healthy behaviors, socially responsible, and able to create value help to build the trust of the territory. The territory benefits from this in terms of economic-social growth and the improvement of the competitiveness of the companies that operate there, encouraging at the same time the diffusion of such behaviors;
- training: the territory can provide the competent resources with specialized and diversified knowledge thanks to the tradition and the diffusion of quality education and training centers. The training experience is therefore important in the pursuit of socially responsible development objectives and is at the center of the choices of the companies that intend to undertake this direction;
- local welfare, human and social capital: it is important to link up with local welfare and with the development of "human capital" for the enhancement of services and tools for the promotion of CSR, especially in MSEs and in network and district economic systems. Equally rewarding is the qualification of services, the creation of network connection systems for innovation and, more generally, the introduction of models for participation and sharing of choices;
- supply chain management: important aspect for the economic management of MSEs is represented by the control of the supply chain. To mitigate and / or eliminate the risks associated with supply chain management and spread the culture of social responsibility, it is necessary to develop awareness tools for the management and

[7]See BEAUMONT, DREDGE, (2010), Local tourism governance: a comparison of three network approaches, Journal of Sustainable Tourism.

constant monitoring of the supply chain;

- district and supply chain logic, in local production systems: for MSEs, the dissemination and support for the promotion of CSR develops consistently with the qualification of local district systems;
- management and control of business risks: corporate social responsibility is closely linked to the strategic management of internal and external risks. CSR, in fact, implies the adoption of tools and behaviors aimed at improving the management of business risks, including, for example, environmental, health and safety risks. It is a mean to manage quality as it provides companies with indicators to measure their social and environmental impact, helping them to manage it properly;
- future generations: supporting socially responsible behavior also means paying attention to the value of the company, understood as a means by which to transfer knowledge to the territory and to future generations.

The Sustainability Report is consequently an instrument of awareness and propagation of the theme, but also of self-discipline by enterprises and territorial governance, aimed at improving the way of doing business and at an increasingly sustainable development of the territories.

2. Several entrepreneurs assess how emerging regulations might affect their business and take appropriate action, considering also some competitive aspects as scenario planning, stakeholder analysis, strategy development, external and internal communications. Several indicators can be used in a company to evaluate its carbon footprint and understand the likely impact of climate change regulation. To determine the exposure, it is possible to run multiple scenarios to test the effect of regulation on costs, prices, and margins. So, taking in account the current regulation, it is possible to develop a portfolio of organizational actions for carbon reduction measures and a fact base to inform the regulatory requests. The principles underlying the economic management of sustainable MSEs are:

- *responsibility towards the territory*: there must be a strong link between the company and the territory, the value created, relations with local bodies and institutions;
- *attention to all categories of stakeholders and inclusion of their expectations*: internal and external stakeholders, the recognition of their expectations and their satisfaction are fundamental elements for the success of the company. It is necessary to monitor and measure their satisfaction;
- *importance and completeness of the issues faced*: companies operate and are confronted with an economic context both territorial and macroeconomic, from which a variety of issues can arise, among which the company must identify the most relevant ones;
- *transparency in communication*: representation of both positive and negative performances, comparability, clarity and reliability;
- *continuous improvement*: the business continuity, intended as a continuation of company life, is linked to its constant evolution and definition of clear and measurable objectives.

The concept of sustainability implies that the company's primary objective is the correct representation of values, strategies and qualitative-quantitative exchange with the main stakeholders and of the effects that company's activity has on the environment and the community[8]. MSEs have various tools to monitor the sustainability performance and to set improvement objectives, also defined by listening to the needs of the stakeholders. The company should therefore be able to listen to its interlocutors and direct decision-making processes according to their legitimate expectations, in a progressive process of participatory and responsible involvement. Sustainability Reports are the most widespread tools for reporting on activities of organizations in the management of aspects of CSR. The Sustainability Report is a process to assess the choices, activities, results and use of resources in a given period, in order

[8]See WU, (2013), Towards a stakeholder perspective on competitive advantage. International Journal of Business Management, vol. 8, n.4.

to report outside how the company interprets and realizes its institutional mission and mandate. Compared to the traditional budget, the Sustainability Report has a broader information scope and must therefore make the priorities and objectives of the company transparent, comprehensible and achieve the results. It must be carried out on a regular basis, preferably yearly, in order to cyclically compare the planned objectives with the results achieved, favoring the definition of new objectives and commitment of the company. The Sustainability Report derives many of its content from the existing business plans and control processes. Therefore, together with the launch of a social-environmental reporting process, it could be useful, for the most structured companies, to develop an infra-annual reporting system, integrated with the planning, control and accounting information systems.

3. The Sustainability Report for MSEs must represent:

- the performance, choices and objectives defined by the company during the reference year;
- the governance structure adopted;
- the implementation of plans, programs and projects;
- the involvement of the relevant stakeholders;
- the representation of the performances achieved in the different areas of competence related to the economic, social and environmental sphere.

The sustainable balance must not only account for what has been done directly by the company, but also for the effects that it has produced on its sphere of influence, namely the set of the public and private entities that contribute to the achievement of company's objectives.

The Sustainability Report addresses to all those entities, public and private, who, directly or indirectly, are interlocutors of the company, that are interested in its action or that fall within its sphere of action and interest. An enterprise transmits identities and values primarily through its employees and the perception that the

market matures towards itself. The part of the Sustainability Report reserved to the identity of the company refers to that set of conditions that reflect on its way of being, from the objectives' choice, to the way of achieving them, to the relationship with the stakeholders to describe the company[9], clarifying the principles underlying the strategic choices and daily behavior. The recipient must be able to understand how the vision and mission of the company is declined in daily activities, which are the strategic-programmatic lines and priority areas of action and must be able to understand what the corporate governance structure is. The dedicated section to the identity of the company can therefore be divided into the following sections:

- historical path and current context, with reference to sectoral reality;
- valuation guidance (values and mission);
- strategic design;
- description of projects of relevance, future development plans and the relevant interventions identified, represented in the light of their social impact on the territory and assessed according to their environmental and economic impact.

The corporate governance is one of the main interests of the stakeholders / shareholders, directly involved in the problems and control, but also affects other stakeholders when it is a way in which their demands are considered in business decisions. In fact, more and more often the concept of socio-environmental responsibility is assimilated to the idea of an open governance system and the expansion of the corporate economic subject[10]. Within the business strategies the decision-making process must be evaluated with reference to the CSR issues, on the assignment of tasks and responsibilities within this process and the contribution made by each company function. In order to establish a constructive dialogue with all stakeholders, they must be firstly identified. To give a definition, the stakeholders are those entities

[9]See CASALINO, DE MARCO, ROSSIGNOLI, (2015), Extensiveness of Manufacturing and Organizational Processes: An Empirical Study on Workers Employed in the European SMEs, Smart Innovation, Systems and Technologies, 2nd International KES Conference on Smart Education and Smart e-Learning, SEEL 2015, vol. 41, pp. 469-479, Italy.
[10]See DAFT, (2016), Organization theory and design, Cengage Learning – Boston, pp. 69-74.

or people that are expected to be or will be affected or significantly involved in the activities, products and/or services of the company and/or whose actions could influence the ability of the company to implement its strategies and achieve its objectives. This definition includes the entities or persons whose rights under the law or international conventions give them legitimate expectations towards the company. Stakeholders can include both those who "invest" in the company (for example, employees, shareholders, suppliers) and those who are outside the organization (for example, the local communities)[11].

The enterprise must define the sustainability objectives it intends to achieve and the relative path that it intends to follow. Sustainable MSEs therefore have an obligation to communicate also the planned improvement projects and the future development plans. All this must be identified in the Sustainability Report, as well as all progresses, achievements or not and all possible causes of the non-realization. In the case in which new situations have occurred during the year, both endogenous and exogenous, which require the re-planning of one or more objectives, it is necessary to report the changes and the causes that have generated them. The implementation of an integrated management system of social and environmental performance ("Sustainability Governance") is the mean to harmonize the set of strategies and processes used to manage the multiple themes. A MSE oriented towards sustainability governance, can be based on internal reporting systems. However, the financial statements are not suitable for representing the company's social responsibility as they are not suitable for reading all the dimensions and meanings of the company's operations. The first phase of the reporting process consists of an analysis and reflection activity aimed at defining the reporting system, which is the basic structure of the sustainability report. This phase requires the analysis of the following documentation:

[11]See USKOV, CASALINO, (2012), New Means of Organizational Governance to Reduce the Effects of European Economic Crisis and Improve the Competitiveness of SMEs, Law and Economics Yearly Review Journal, Queen Mary University, London, UK, vol. 1, part 1, pp. 149-179.

- institutional documents to draw information on the structure, general guidelines and company programs;
- accounting documents, to link economic and financial resources to planned, ongoing and implemented interventions;
- social / sustainability reports or other social reporting documents prepared by the company in previous years;
- reports, management reports and internal documents representing the results of the rays unified by the company;
- other documents that help to understand the context in which the company operates and the effects of its action (ex. studies and research on the economic, social and environmental system; analysis and evaluation of policies; surveys on perceived quality, etc.);
- the information acquired through the analysis of such documentation must be the object of elaboration, comparison and reflection on the part of the company in order to express its value orientation and complete the areas of reporting.

In case that the company represents a group of entities (e.g. subsidiaries, joint-ventures, subcontractors, etc.), it is appropriate to define the "perimeter" of reporting, to identify the entities that are to be included or not. In order to implement an efficient and effective socio-environmental reporting process, it is necessary to define which tools are used to collect the data and information required by the indicators that the company intend to report. The ability of the company to report on its work depends strictly on the construction of a suitable informative support system and from the level of definition. Data sheets are a tool for the management of data and information related to the issues of responsibility and allow their monitoring and reporting. The editorial approach, the choice of the language, the description and representation of the information content in the Sustainability Report must be designed according to the informational purpose pursued by the document. In general terms, it is necessary to:

- use a simple, fluent and non-redundant language;
- avoid using concepts, terms and references of administrative, technical, sectoral language and, in the case of foreign words and acronyms, it is appropriate to specify the meaning;
- use, when possible, quantitative data, tables and graphs accompanied by explanations that make clear the interpretation.

Before the dissemination, the sustainability report must be approved or drafted by the company's governing body[12]. The Sustainability Report must be realized after the definition of the index and contents, having collected all needed information. In order to facilitate the drafting of the document it is appropriate to identify a person responsible for collecting data and information and drafting the document itself, possibly involving internal operational staff. The individual contributions must follow the drafting method initially defined in order to obtain homogeneous and coherent content.

A correct economic management of sustainable MSEs is fundamental for the company to be able to dialogue with all its interlocutors. For this reason, it is useful to define an articulated plan of organizational communication, both inside and outside. The communication activity is aimed at spreading the sustainability objectives inside and outside the company and, more in general, to the construction of a permanent dialogue with its stakeholders. The communication plan must define:

- the pre-established objectives;
- the different interlocutors to which it is addressed;
- the actions and the communication tools to be adopted;
- the evaluation methods of the results of the communication.

Based on the resources available, the company must permit an effective dissemination of information, making the Sustainability Report available (or an abstract)

[12]See CASALINO, CAVALLARI, DE MARCO, GATTI, TARANTO, (2014), Defining a Model for Effective e-Government Services and an Inter-organizational Cooperation in Public Sector, Proceedings of 16th International Conference on Enterprise Information Systems - ICEIS 2014, INSTICC, Lisbon, Portugal, vol. 2, pp. 400-408.

to all the various interlocutors inside and outside the company[13]. To promote a dialogue with all interlocutors, the company must provide forms of participation to the Sustainability Report and collection of judgments, evaluations and public meetings with the various stakeholders, online forums, satisfaction surveys, opinion polls, etc. This listening activity must aim at evaluating the approval and the communicative effectiveness of the Sustainability Report, as well as the judgment of the recipients on results achieved. Establishing moments of involvement and stakeholder participation, leads to the consolidation of a permanent dialogue between the company and its interlocutors, improving and facilitating the programming and reporting process.

4. Tourism is an instrument of economic development for the involved areas, it is an opportunity for knowledge and cultural and social enrichment of the people, promotes relations between peoples, but also causes pollution and environmental degradation that can contribute to cultural flattening and to the loss of the local traditions of the communities involved. Activating sustainable tourism means maturing and spreading awareness that there are limits to tourism; this is why sustainable tourism should be: durable, dimensioned, integrated and diversified, planned and economically viable. Marketing provides MSEs the necessary tools to offer concrete economic, environmental and social advantages to the area in question: "sustainable tourism" is still in a development phase, so it requires a new marketing-oriented relationship by studying the real needs[14] of "new tourists". The analysis of the macroenvironment and the situation, together with an effective SWOT analysis, are decisive for defining the context. Furthermore, a destination that wants to enhance its natural and cultural heritage, for sustainable development, must have three points of refer-

[13]See FRUSCIANTE, ELSHENDY, CASALINO, (2014), How Motivation Brings to Healthy Organizations: Methods and Incentives to Increase Satisfaction, Efficiency and Productivity, Open Review of Management, Banking and Finance, Regent's University, London, UK, pp. 134-141.
[14]See METALLO, AGRIFOGLIO, FERRARA, CASALINO, DE MARCO, (2012), Why should people use wiki in academic environments? An empirical analysis of undergraduate students, Proceedings of the IASTED International Conference on Computers and Advanced Technology in Education, CATE 2012, pp. 431-437.

ence:

- valorization and protection of environmental and cultural heritage according to sustainability criteria;
- quality of tourist reception of the destination with the consent of the local population: cultural sustainability;
- a coherent orientation of the enterprises towards the client, with a constant study of the tourism market trends.

A marketing strategy and a product strategy aim at achieving the set objectives and defining quality, also given by environmental certifications. The promotion supports the image of the place and provides information that makes the product usable. An important factor contributing to the success of environmental tourism is the price, taking into account that sustainable tourism refers to a high-profile target (respect, environmental protection and conservation of cultural heritage), but not necessarily with high income. Regarding the "distribution" of sustainable tourism, given that the target of natural and cultural tourist destinations is specialized and prefer to travel independently, the Internet is one of the most effective tools. It is therefore essential to monitor both in economic terms and in terms of environmental impact. Sustainability indicators, if they have unexpected negative effects (stress indicators), are essential to review the MSEs strategies adopted during the design phase. It is essential to promote unique and authentic visits, building tourism products, qualifying those already mature according to the specifics of each territory and landscape. The recognition and dialogue with the identity of the places and the characteristics of each landscape must favor the production of exclusive and distinctive material goods, with high added value and difficult to imitate, such as agri-food, handicraft, manufacturing and tourist services. The differentiation of the tourist offer allows to decongest the traditional tourist destinations, to re-balance the destinations and to de-seasonalize the tourist flows. The uniqueness and territoriality of the heritage are the founding elements of local development models capable of being competitive on the global

market, also through the choice of more efficient organizational and governance solutions[15].

Focusing on sustainable management and sustainable use of heritage means recognizing the value of natural and cultural capital, as well as the positive externalities they generate, in terms of ecosystem services. Tourism needs national and territorial heritage but, at the same time, returns a lot to it, enhancing the opportunity to achieve better levels of financial and economic sustainability, reinforcing its long-term management. An adequate sustainable tourism system can improve its competitiveness, generate more value, and increase the quantity and quality of tourist employment. The technological and organizational innovation, the reactivity to the transformations of the market, the skills and the conditions for the activity of the enterprises, are necessary elements that determine the growth of the competitiveness of a Country and its territories as a tourist attraction (besides of human resources, finance and technology). In this sense, it is fair to look for the reduction of tax bureaucratic and regulatory burdens for companies, also through a better use of digital services and the rationalization of the regulatory framework. To this must be added the emergence and regularization of undeclared labor relations, the regulation of new business models favored by digitization and the sharing economy, greater financial support for companies in the sector and the simplification of administrative procedures for big investment projects[16]. The recovery of competitiveness is associated with an expansion of the product and the expansion of the quantity and quality of employment in tourism and in related sectors. Tourism is a labor-intensive sector, where the quality of the offer is strongly linked to the quality of the service and the professionalism of the operators. This is also true in the supply chain as well as in the service and manufacturing sectors that are connected to the tourist activity. A strate-

[15]See GIUSTINIANO, CLEGG, CUNHA, REGO, (2018), Elgar Introduction to Theories of Organizational Resilience. Edward Elgar Publishing.
[16]See SHARDA, GEORGIEVSKI, AHMED, ARMSTRONG, BROGAN, WOODWARD, KOHLI, CLARK, (2006), Leading-edge developments in tourism ICT and related underlying technologies: key findings and future research directions, Gold Coast, Australia, The Sustainable Tourism Cooperative Research Centre (STCRC).

gic plan aimed at sustainable tourism involves reducing the areas of the sector not yet regulated, to grow and diversify professionalism and skills. It also aims to train new generations of workers and entrepreneurs experienced in digital technologies and able to convey creativity and talent in the action of tourism enhancement, to operate within the new forms of integrated enhancement of the territories. The tourist demand - rapidly changing under the pressure of technological innovation, accessibility of information, the opening of new large markets, the transformation of cultures, styles and travel motivations - has full centrality. The tourist is at the center of the valorization system: all the services and, more generally, all the conditions that make possible to transform the visit into a memorable experience must be oriented towards the complete satisfaction of the tourist, in order to push him back and influence, through his narration, new people to visit the country considered. A strategic plan tailored to sustainable tourism recognizes that in the current market travelers tend to seek a tourism experience rather than a mere destination and that promotion tools must be calibrated accordingly, consistent with the needs of multiple travel segments and markets. The system of tourism institutions and operators is fully integrated. Interoperability is promoted, and shared choices and responsibilities are also encouraged. Integration and interoperability are two key concepts of the overall strategy of sustainable tourism which, applied during the elaboration phase, will be repeated in the subsequent implementation phase. Both reflect the need to promote coordinated action between different and heterogeneous organizations that share mutually beneficial public or business objectives. The tourist attraction is the result of multiple factors, such as the availability of infrastructure and services, the accessibility of places, the territorial quality in a broad sense, the regulation of companies and competition, working conditions. Integrating policies is a requirement that naturally involves the permanent and organized cooperation of the institutions and agencies that, at different levels (national, regional and territorial) are entitled to it. A condition for the construction of policies is also to integrate the actors of the tourism system, which has at its center the vast and varied system of companies. Integrating the

actors means building the governance of tourism policies, activating tools for coordination and interrelation functional to the development of the tourism system. In this sense, the State, the Regions, the Local Authorities - which represent an important component in determining the success of the sector - will facilitate the creation of fertile ground for the entrepreneurial system to have the organizational, regulatory, regulatory, financial and economic support instruments, of public infrastructures - to better face the global competitive arena. The construction of the ability of these diverse and heterogeneous organizations to interact having shared and mutually beneficial objectives raises an issue of interoperability, i.e. exchange of information and knowledge among organizations, through the transfer of data between their information systems. A Strategic Plan for the activation of a sustainable tourism identifies three transversal principles, needed for the identification of the intervention path: sustainability, innovation and accessibility/permeability (physical and cultural). Sustainability in tourism is a strategy of economic development that aims to protect and enhance human, artistic, environmental and cultural heritage, and is the driving force behind advanced economies. Sustainability is not only in environmental terms but also with reference to economic development, intermodal and soft mobility, economic and territorial sustainability, the use of heritage, the creation and innovation of tourism products, the use of resources financial, authenticity and identity. The “World Tourism and Travel Council”, attributes to sustainability in tourism a value strongly linked to the concept of durability over time. In fact, it meets the current needs of tourists and those who host them by protecting and enhancing the places and at the same time improving the prospects for the future. Sustainability in tourism integrates the management of all resources in such a way that the economic and social needs can be satisfied by combining the protection of the landscape, the memory of the places, the local culture and the environment. Sustainability in tourism is an essential element of competitiveness, thus becomes a factor of modern and creative development, capable of favoring the evolution of traditional tourism models while respecting the new demands of demand. Sustainability in tourism must therefore actively

contribute to the conservation of natural resources and the landscape, including providing incentives and signals for the diversified use of rural resources, giving value to landscapes and biodiversity, stimulating investment in protection and enhancement[17].

Innovation refers to the introduction of new factors that bring benefits in order to strengthen its competitiveness[18]. These include tangible and intangible benefits, for all the stakeholders of the tourism sector and which contribute to increasing the value of the tourist experience and the "core competences" of the sector. In this sense, innovation involves a wide area of areas ranging from tourist destinations, to products, to technologies, to processes, to business and organizational models, to professional profiles and to managerial tools and practices, extending to marketing, communication, operational processes, pricing, quality of services and products. The challenge of digitization is linked to the innovation of the organizational process and of the product, which represents the true frontier of an irreversible change within which one must operate[19]. The viral distribution of information, the profound changes in the decision-making process of the traveler and the knowledge available to all connected users, are today more than ever the main levers of change. The abundance of data and tools push to have the utmost attention to big data and their use in tourism, aimed at better understanding how the market is oriented and how to improve predictive marketing techniques. The term accessibility is a set of conditions:

- allow accessibility for tourism and use through mobility systems, even sustainable, helping to reduce isolation of peripheral territories or poorly served, where there are resources that can be valorized;

[17]See CHANG, (2003), Six fundamentals of strategic implementation of information systems for destination management organizations, e-Review of Tourism Research (eRTR).
[18]See CASALINO, CIARLO, DE MARCO, GATTI, (2012), ICT Adoption and Organizational Change. An Innovative Training System on Industrial Automation Systems for enhancing competitiveness of SMEs, Proceedings of 14th International Conference on Enterprise Information Systems - ICEIS 2012, MACIASZEK, L., CUZZOCREA, A., CORDEIRO, J. (Eds.), INSTICC, Setubal, Portugal, pp. 236-241.
[19]See CASALINO, RUBICHI, GASPARRI, PIZZOLO, (2017), Organization of Processes Digitization and e-Invoicing Services for an Effective Digital Transformation of Public Sector, DigitCult - Scientific Journal on Digital Cultures, vol. 2, n. 1, Aracne.

- promote tourist enjoyment for all without distinction of age, health or other;
- make it possible for visitors to understand and interpret the history, complexity and variety of heritage visited (cultural permeability), appreciating the uniqueness and helping to strengthen the identity of places.

First, it is necessary to base the country's tourism development strategy starting from the needs expressed by tourists (demand), in order to answer with a differentiated offer of tourism systems that allow sector operators to conquer new and significant market shares. Through this strategic approach, accessibility is considered an option of choice on part of the market, overcoming the concept of the mere fulfillment of legislative norms on architectural barriers in the tourist offer. Implementing a strategy in this sense involves a context analysis based on objective information and the fundamental requirements concerning accessibility, as well as a targeted choice-based set the goals.

5. An appropriate marketing strategy to develop sustainable tourism aims to expand the tourism offer of MSEs to make them more sustainable and more competitive. In particular, the strategy is oriented to the full use of the competitive advantage linked to the plurality and variety of cultural, natural, anthropological and other cultural heritage, also expressed towards local skills, knowledge, talents and traditions. The strategic lines intend to qualify tourism in the major attractions of the country, making its use more sustainable and innovative, and aim to promote greater dissemination of visitor flows, through:

1. the creation of alternative forms of travel (for example, roads and paths) as instruments of capillary and ramified knowledge of the history and heritage of the country;
2. the growth of attractiveness of the tourist system understood not only as historical centers but also as cultural landscapes and serial sites of less well-known monumental complexes;

3. the responsible use of widespread landscape contexts, such as protected terrestrial and marine areas, mountain and rural areas and related agricultural production.

In this vision, the landscape plays a fundamental role in the sustainable tourism development strategy as a unifying part of the material and immaterial attraction bodies' elements. The innovative marketing strategies for the development of a sustainable tourism aim to activate a complementary offer, integrated and expanded with respect to large destinations (such as major cities) and to the main tourism products (such as the seaside, the open air, the congress, thermal, food and wine). From these it's possible to know the enormous historical, artistic and landscape heritage widespread in the area of reference. It also promotes the development of minor tourist destinations, such as mountain areas, where tourism is often the main economic activity, which contributes to the enhancement and conservation of the environment[20]. Cultural and tourist development is one of the factors to relaunch local development processes that, to be successful, must be strongly integrated with other resources – both of an economic nature (for example, agriculture) and social resources (the material culture of places) - that characterize the territories. Above all, intervention strategies must be territorially integrated to fully exploit the competitive advantage deriving from the "proximity diversity", i.e. the fact that neighboring territories can be very different for types of tangible and intangible assets and characteristics. Sustainable tourism development strategies aim to create more favorable conditions for the consolidation and relaunch of the extended tourism MSEs chain as a key sector for sustainable development. These concerns:

- the adaptation of the infrastructural network to improve accessibility and intermodality;
- promotion of innovation, digitalization and creativity;

[20]See CASALINO, (2014), Simulations and Collective Environments: New Boundaries of Inclusiveness for Organizations?, International Journal of Advances in Psychology (IJAP), Science and Engineering Publishing, USA, vol. 3, issue 4, pp. 103-110.

- dissemination of entrepreneurship, improvement of quantity and quality of employment, with attention to the youth, as well as the formation of new abilities of the human resources in the tourism sector;
- the simplification of the regulatory system and the reduction of bureaucratic and fiscal burdens;
- rationalization and simplification of aid schemes;
- the creation and strengthening of business combinations.

The transversal principles of this strategy will be the security and sustainability, both environmental (compatibility with the commitments made by the international community in terms of pollution reduction and greater use of renewables), and economic (through efficient, durable and functional interventions for the development, including tourism, of the territories). Other cross themes are:

- quality life improvement;
- competitiveness of urban and metropolitan areas - through the development of mass rapid transport systems, of new intelligent transport services for local public transport, shared mobility services, mobility cycle-pedestrian and “on-demand” services for low-demand areas;
- enhancement of infrastructures as elements of the landscape and factors to promote tourist demand - cycling routes, historical itineraries, mountain railways, etc. - integrating transport and tourism offers.

From these, the objectives of a strategic plan for the development of sustainable tourism are:

- the digitization of the tourism system and development of innovative services;
- adjustment of the infrastructure network to promote accessibility, permeability and internal mobility;
- increase of hospitality culture and development of skills adapted to market changes;
- re-qualification of tourism businesses and tourism industry repositioning with-

in international (and regional) supply chain / network dynamics;

- adjustment and simplification of the regulatory framework, also in relation to previous objectives.

6. An effective and innovative business strategy will aim to maximize the use of communication tools to raise the demand, favoring a dynamic selection of markets in which to intervene, of products and strategies to promote and commercialize. The brand, through a promotion aligned to the value proposition, able to distinguish one country from another, is a great resource to exploit: culture[21] and lifestyle. The facilitation of market access for green MSEs could be guided by the following objectives:

- promote a greener European internal market;
- facilitate access to international markets for green entrepreneurs;
- enable concretely the uptake of resource efficiency technology through mobilities actions and cooperation exchanges between European MSEs.

The actions towards these objectives address the problem associated with the weak internationalization of European MSEs. This problem is not unique to the green technology industries, but the faster growing environmental technology markets urges for quick action from the European green technology and service providers, including MSEs. The European cluster organizations are envisaged to play a significant role in these activities. It is up to the destination's marketing to seduce the demand, lead it to purchase and get it back, to stimulate country' story and to amplify its influence. All this even in presence of integrated promotion strategies[22].

The impact of the contents generated by the travelers on consumers' behavior requires, as a goal to pursue the complete innovation of techniques and promotion channels, an effective capacity of continuous adaptation of business goals, powered by the monitoring of the reputation and listening to demand.

[21]See WILLIAMSON, (1985), The Economic Institutions of Capitalism. Firms, Markets, Relational Contracting, The Free Press, New York.
[22]See EJARQUE, (2010), Destination Marketing: la nuova frontiera della promo commercializzazione turistica, Milano, Hoepli.

The adopted advertising strategy must be differentiated and specialized, articulated on the sustainable product portfolio and focused on the most dynamic segments to relaunch the green sector, declined especially on the domestic market[23]. In order to identify an innovative strategy for the development of sustainable tourism it is necessary to structure a territorial marketing plan[24]. This is a programmatic and implementation document able to identify, analyze and link the resources that characterize the territory with the aim of elaborating one or more strategies for the transformation of these resources into identity - creating a winning and attractive image in the tourism market. It will define and strengthen also the embedded features of a country. They are described as all the identity characters of a territory, recognized and attractive both for those who discover the territory and for those who live in a territory in a real sustainable way.

[23]See SALAMAN, STOREY, BILLSBERRY, (2005), Strategic Human Resource Management: defining the field, in Strategic human resource management: theory and practice, Sage Publications, London.
[24]See PFEFFER, (1998), Seven practices of successful organizations, California Management Review, 40(2), pp. 96–124.